

# Developments\*

Information and updates on scientific research and experimental development

October 29, 2008

## Scientific Research and Experimental Development (SR&ED) Work Outside Canada

In the 2008 federal budget, the Department of Finance made an important tax policy change to the scientific research and experimental development (SR&ED) investment tax credit (ITC) program. Under the new policy, certain salary and wages of Canadian-resident employees carrying on SR&ED work outside Canada will qualify for ITCs. Previously, SR&ED work carried on outside Canada did not qualify, although administratively the Canada Revenue Agency (CRA) did allow certain expenditures for work outside Canada as overhead costs if the traditional method (rather than the proxy method) was used for claiming overhead type expenditures.

The policy change allows salary and wages incurred for SR&ED work carried on outside Canada to qualify for ITCs if:

- the salary and wages incurred by the taxpayer are in respect of Canadian-resident employees carrying on SR&ED work outside Canada;
- the work outside Canada is directly undertaken by the taxpayer;
- the SR&ED is related to the taxpayer's business; and
- the work is solely in support of SR&ED carried on by the taxpayer in Canada.

Claims for salary and wages for work outside Canada cannot exceed 10% of the total salary and wages the taxpayer incurred for SR&ED carried on in Canada. In addition, salary and wages:

- in the case of specified employees will not include remuneration based on profits or a bonus; and
- must not be subject to an income or profits tax imposed by a foreign country (Canada's income tax treaty with the country where the support work was carried out should be considered.)

The change was enacted by Bill C-50,<sup>1</sup> which received royal assent on June 18, 2008, and is effective for taxation years ending after February 25, 2008.

### What salary and wages qualify?

The work done outside Canada can be any SR&ED work that falls within the definition of SR&ED in subsection 248(1), paragraphs (a), (b), (c) and (d) of the *Income Tax Act* (ITA). This does not restrict the work to the eight listed activities (work) in paragraph 248(1)(d). However, the salary and wages will be allowed only if the work was solely in support of SR&ED carried on in Canada.

1. *An Act to implement certain provisions of the budget tabled in Parliament on February 26, 2008, and to enact provisions to preserve the fiscal plan set out in that budget.*

Payments to sub-contractors or persons who are not employees of the taxpayer will not qualify, because the work is not “directly undertaken” by the taxpayer.

## Interaction with the CRA’s administrative policy

Before the tax policy change, notwithstanding the general limitation that foreign work in support of SR&ED did not qualify for ITCs, the CRA administratively allowed certain expenditures in respect of work that *did not* constitute SR&ED, including foreign travel expenditures (could include salary and wages), to be included for ITC purposes. This policy is outlined in paragraph 46 of IT-151R5, “Scientific Research and Experimental Development Expenditures (Consolidated).”

Expenditures in respect of work that did not constitute SR&ED carried on outside Canada were allowed as overhead expenditures only if the taxpayer used the traditional method and the expenditures were for:

- 1) the acquisition of equipment or materials used in SR&ED in Canada;
- 2) visits to foreign customers in respect of SR&ED carried on in Canada to update the customer on the status of the SR&ED project; or
- 3) training for SR&ED carried on in Canada.

The three types of expenditure were allowed because of paragraph 39 of IT-151R4, the previous version of the interpretation bulletin, which stated:

“However, expenditures including foreign travel expenditures that are incurred for other activities carried

on outside Canada, that are in support of SR&ED carried on in Canada, but do not constitute SR&ED in and by themselves, may be deductible under subsection 37(1) provided the requirements of this subsection are otherwise met and the expenditures meet the requirements of subparagraph 37(7)(c)(ii).”

This paragraph had made it clear that the CRA intended to allow some expenditures incurred for work outside Canada. However, claimants, practitioners and industry were unsure of the types of work and related expenditures that could be claimed. The CRA made the necessary clarification in IT-151R5, paragraph 46. The exceptions were limited to the three activities listed above and the CRA resisted expanding the list of activities.

With the new change in tax policy to allow salary and wages incurred by the taxpayer in respect of SR&ED work performed outside Canada, the three restrictions (enumerated above) on the circumstances under which expenditures for work outside Canada would be allowed on an administrative basis may no longer be relevant in the case of salary and wages. However, under the new rules, travel and other overhead costs can still be claimed, but only if the traditional method is used.

The table below shows how the new rules apply.

Under the new rules, any salary and wages incurred for work that is solely in support of the SR&ED carried on by the taxpayer in Canada can be claimed, whether the proxy method or the traditional method is used.

### Treatment of salary and wages for SR&ED work carried on outside Canada

			Old rules		New rules	
			Traditional method	Proxy method	Traditional method	Proxy method
<b>SR&amp;ED work of Canadian-resident employees<sup>1</sup></b>					✓ <sup>1</sup>	✓ <sup>1</sup>
<b>Work for the three enumerated purposes formerly covered by the administrative rule</b>	1 Acquisition of equipment or materials used in SR&ED in Canada	For a specific SR&ED project in Canada	✓ <sup>2</sup>	Did not apply under old rules	✓ <sup>1</sup>	✓ <sup>1</sup>
		Not for a specific SR&ED project in Canada	May qualify as overhead expenditure		May qualify as overhead expenditure	Covered by proxy amount
	2 Visits in respect of SR&ED carried on in Canada to update foreign customers on the status of the SR&ED project	✓ <sup>2</sup>	✓ <sup>1</sup>		✓ <sup>1</sup>	
	3 Training for SR&ED carried on in Canada	Time spent outside Canada to study or research a new technology specific to an SR&ED project carried out in Canada	✓ <sup>2</sup>		✓ <sup>1</sup>	✓ <sup>1</sup>
Training not specific to an SR&ED project in Canada		May qualify as overhead expenditure	May qualify as overhead expenditure	Covered by proxy amount		

1. New rules apply to salary and wages of Canadian-resident employees carrying on SR&ED work outside Canada.

2. Qualifies as overhead expenditure.

Whether the work is solely in support of that SR&ED is a question of fact, to be answered case by case. However, given CRA policy and interpretations, including the comments made during the 2007 APFF conference in Montreal, it can be concluded that any SR&ED work carried on outside Canada in support of an SR&ED project in Canada should meet the “solely” test.

## Conclusion

The change in tax policy will create numerous other opportunities to claim support or other SR&ED work carried on outside Canada, and should benefit many

industries, including manufacturing, pharmaceutical, renewable energy, automotive, aerospace and agriculture (farm equipment).

## For more information

For help determining what this policy change means to you or your company, please contact your PricewaterhouseCoopers adviser or any of the following individuals:

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