

# Developments\*

Information and updates on scientific research and experimental development

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## SR&ED Planning for Ontario Corporate Tax Harmonization

If you have not considered the effect of the upcoming harmonization of the Ontario and federal corporate tax systems, your corporation may receive a surprise tax bill. However, if it performs Scientific Research and Experimental Development (SR&ED) in Ontario, planning can reduce or defer transitional tax that may arise.

As first announced in 2006, Ontario's corporate income tax system will be harmonized with the federal corporate income tax system, starting with taxation years ending after December 31, 2008. Harmonization is expected to decrease the compliance burden of corporations with Ontario filing requirements. However, for SR&ED claimants harmonization creates many complexities, as well as opportunities. This issue of *Developments* highlights the key issues for SR&ED claimants. The broader implications are discussed in our January 11, 2008 *Tax Memo*, "Ontario Tax Harmonization: What it Means for Corporations."

### Corporate Income Tax Harmonization

Corporations that have a taxable presence in Ontario calculate and pay Ontario corporate income taxes in a manner substantially similar to federal income tax. The move to a single tax administration means that, for taxation years ending after 2008, the federal definition of taxable income will apply for Ontario income tax purposes and the differences between the federal and Ontario definitions will be eliminated.

### Transition

Harmonization will affect items included in, or deductible from, income for Ontario tax purposes that differ from those used in computing income for federal tax purposes. Commencing taxation years ending after December 31, 2008, federal tax attributes, such as balances in loss pools and SR&ED pools, will also apply for Ontario corporate tax purposes. Under transitional provisions, the adoption of federal tax attributes may create an additional tax liability or tax credit, as follows:

		Result	Excess reflects amounts deducted
Greater amount of tax attributes	Federal	Tax liability (transitional debit)	For Ontario tax purposes, but not federal
	Ontario	Tax credit (transitional credit)	For federal tax purposes, but not Ontario

## New concepts

The transitional rules rely on the following new concepts:

- **Transition time** is the date for determining a corporation's transitional debit or credit. It is the beginning of the taxation year that includes the beginning of 2009. For corporations with a December 31 taxation year end, the transition time will be January 1, 2009.
- **Reference period** is the period over which the transitional debit (or credit) is added to (or reduces) Ontario tax payable. It starts at the beginning of a corporation's first taxation year ending after December 31, 2008 (January 1, 2009, for corporations with a December 31 taxation year end) and ends five calendar years later (December 31, 2013, for corporations with a December 31 taxation year end).
- **Total federal balance** is the sum of a corporation's federal tax attributes immediately before the transition time (referred to as "federal balance").
- **Total Ontario balance** is the sum of a corporation's Ontario tax attributes immediately before the transition time (referred to as "Ontario balance").

## Federal balance and Ontario balance

For corporations with a December 31 taxation year end, the calculation date for the federal balance and Ontario balance will be December 31, 2008. Tax attributes to be used in calculating the federal and Ontario balance include:

- undepreciated capital cost;
- cumulative eligible capital;
- income reserves, including reserves in respect of services to be rendered or goods to be delivered;
- capital gains reserves;
- Scientific Research and Experimental Development (SR&ED) pools;
- cumulative Canadian:
  - exploration expense;
  - development expense; and
- oil and gas property expense;
- the adjusted cost base of partnership interests;
- undeducted gifts carried forward; and
- loss pools, including non-capital and net capital loss carryforwards.

## Transitional debits or credits

The new rules will result in either a transitional debit or a transitional credit for each taxation year that falls within the reference period:

A **transitional debit** is an amount that is added to the corporation's Ontario tax payable, if, immediately before the transition time, the corporation's federal balance exceeds its Ontario balance. The transitional debit is:

$$(\text{Federal balance} - \text{Ontario balance}) \times 14\% \times \text{Ontario allocation}$$

A **transitional credit** is an amount that is deducted from the corporation's Ontario tax payable, if, immediately before the transition time, the corporation's Ontario balance exceeds its equivalent federal balance. The transitional credit is:

$$(\text{Ontario balance} - \text{Federal balance}) \times 14\% \times \text{Ontario allocation}$$

Transitional credits will not be refundable, but can be carried forward to one or more subsequent years in the five-year period. Therefore, transitional credits that cannot be used in the five-year period will be lost.

## Scientific Research and Experimental Development Pools

Differences between federal and Ontario SR&ED pools will give rise to transitional debits and credits. However, corporations can elect to defer the transitional tax related to a transitional debit balance that results from SR&ED pool differences. In simplified terms, an election can be made to defer transitional tax that would result if, at the transition time, the federal SR&ED pool exceeds the sum of the Ontario SR&ED pool and unclaimed investment tax credits (related to SR&ED performed in Ontario) carried forward.

This election, which must be made in writing in the corporation's tax return for its first taxation year ending after December 31, 2008, allows corporations to defer payment of the transitional tax on SR&ED pool differences for up to seven years (the "deferral period"), starting with the 2009 taxation year. The amount of the transitional tax that can be deferred is limited to the lesser of the transitional tax resulting from the SR&ED pool difference and the aggregate transitional tax otherwise determined.

However, despite this election, a corporation must pay transitional tax if, during any taxation year in the deferral period, cumulative SR&ED expenditures deducted exceed cumulative SR&ED expenditures incurred. In this case, the transitional tax liability for a particular taxation year in the deferral period would be calculated as:

(cumulative SR&ED expenditures deducted in the deferral period – cumulative SR&ED expenditures incurred in the deferral period) x 14% x Ontario allocation

For taxation years ending after the deferral period (i.e., after December 31, 2015, for calendar year ends), if the corporation deducts any SR&ED expenditures in computing its income for the year, some or all of the transitional tax that had been deferred becomes payable.

## Planning for SR&ED Performers

### Election to defer transitional tax

The SR&ED transitional rules effectively allow a corporation to elect to defer its transitional tax related to its SR&ED differences for seven years, beginning with the 2009 taxation year. This is a significant benefit to companies that faced a near-term cash tax liability as a result of SR&ED pool differences, but could not realize the benefit of the increased SR&ED pool for Ontario income tax purposes until many years later. As mentioned, the election must be made in writing in the corporation's tax return for its first taxation year ending after December 31, 2008.

### Refiling previous returns

In addition, because investment tax credits are not included in determining the total federal balance or total Ontario balance, corporations can refile previous year returns to optimize the use of federal investment tax credits and SR&ED pool deductions. Companies should review their particular facts to determine whether this SR&ED planning opportunity could reduce or defer transitional tax.

### Tax rate arbitrage

The 14% tax rate used to compute the transitional debits and credits may also create planning opportunities involving tax rate arbitrage.

## Ontario Research and Development Incentives

### New Ontario Research and Development Tax Credit

Since February 29, 2000, Ontario has permitted corporations to exclude from income, federal investment tax credits claimed in the preceding taxation year that relate to Ontario research and development expenditures. For taxation years ending after December 31, 2008, this benefit is eliminated and will be replaced by a 4.5% non-refundable tax credit on qualifying SR&ED expenditures attributable to a permanent establishment in Ontario in respect of SR&ED carried on in Ontario.

This tax credit will reduce Ontario income taxes payable. Unused credits can be carried forward 20 years and carried back three, but not to taxation years ending before 2009.

If desired, corporations will be able to waive all or part of their entitlement to this credit. Because the 4.5% tax credit is considered government assistance for federal purposes, companies may choose to waive entitlement in order to maximize their qualified expenditures for computing federal credits.

### Ontario Innovation Tax Credit

The Ontario Innovation Tax Credit (OITC), a 10% tax credit for SR&ED carried on in Ontario by a qualifying corporation having a permanent establishment in Ontario, will continue to be available. Newly-enacted legislation implements 2008 Ontario budget proposals that enhance this credit. The changes parallel enhancements to the federal SR&ED tax credit that were proposed in the 2008 federal budget and are also enacted. The Ontario enhancements increase the thresholds used to determine the OITC for taxation years ending after February 25, 2008, as follows:

	Previous	New
<b>OITC expenditure limit</b>	\$2 million	\$3 million
<b>Phase-out range</b>	Taxable income	\$400,000 to \$700,000
	Taxable capital	\$25 million to \$50 million

To determine the expenditure limit for a taxation year that includes February 26, 2008, separate calculations with the old and new phase-out ranges are required.

## Summary

Ontario SR&ED performers should identify and consider pursuing planning opportunities to reduce a transitional tax liability. To help you review your corporation's options, contact your local PricewaterhouseCoopers SR&ED professionals listed below.

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