



R&D TAX CREDITS

Are You Getting All You Can?

Misperceptions surrounding R&D activities mean many manufacturers are missing out on valuable tax credits

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It's no secret that the food and beverage industry is fuelled by consumers looking for new product and packaging choices. In addition to consumer pressure, manufacturers must comply with regulatory bodies such as Health Canada, the Food and Drug Administration (FDA) and the Canadian Food Inspection Agency (CFIA) for issues like HACCP implementation, new nutritional labelling requirements, traceability requirements and trans fat elimination. As a result, food and beverage manufacturers continually reassess their product formulations, processes, packaging materials and equipment in order to improve product performance, enhance overall efficiencies and remain competitive.

What the majority of manufacturers don't know, however, is that some of the costs attributable to these development activities may qualify for tax credits and cash rebates under the Scientific Research and Experimental Development (SR&ED) program if they meet the Canada Revenue Agency's (CRA) technical eligibility criteria. The SR&ED (for the purpose of this text and simplicity SR&ED tax credits are referred to as R&D tax credits) program is intended to encourage Canadian companies to conduct research and development that will lead to new or improved, technologically advanced products or processes.

Yet many food and beverage manufacturers let their R&D tax incentives pass. In 2004, according to Statistics Canada, R&D expenditures for food, beverage and tobacco product

manufacturing businesses represented only 0.83 per cent of total R&D expenditures across the manufacturing sector. Having provided services to a number of R&D tax credit claimants in various Canadian food and beverage manufacturing companies, it's clear that most businesses are under claiming because of a lack of understanding about the program.

One key misconception is that eligible R&D activities occur only in a laboratory setting, a mistake that leads most manufacturers to only claim activities that take place in their R&D departments. This is a major oversight, as many other projects may involve R&D-eligible activities such as scale-up to commercial production volume, process improvements, equipment upgrades or optimization projects. Manufacturers that rely on their parent companies to perform R&D in their U.S. division also often believe there are no eligible R&D activities in the Canadian sister plant. This is not always true, as products developed in the U.S. for manufacturing in a Canadian plant frequently require adaptability work due to ingredient or process variability. Therefore, the activities undertaken by the Canadian plant to adapt the process or formulation may be eligible to receive R&D tax credits.

QUALIFYING ACTIVITIES

There are a number of activities that may qualify for R&D tax credits in the food and beverage industry. Here's a partial list:

- New product and package development, product improvement, formulation alterations and product line extension;
- Development or improvement of the manufacturing processes for product fabrication;
- Re-assessment of product formulation, process or packaging materials to improve product performance and enhance efficiencies;
- Experimentation performed to establish formulation and manufacturing parameters;
- Experimentation performed to establish product consistency, product quality, process control procedures and manufacturing parameters;
- Experimentation performed to improve productivity;
- Sensory and consumer research used in support of an R&D project;
- Modification of equipment for product manufacturing.

A summary of the different phases of new or modified product/package development in the food and beverage industry is presented in the diagram on page 40, along with possible activities under each section. The shaded boxes represent where eligible R&D activities may be found. In all cases, the key consideration in determining whether a project qualifies is whether or not the CRA's eligibility criteria have been fulfilled. That is, for work to qualify for the tax credits the company must demonstrate that the work has advanced its technological and scientific knowledge, and was systematically carried out in Canada by competent people.

QUALIFYING R&D EXPENDITURES

- R&D wages;
- Subcontracting and/or third-party payments to research institutions or universities;
- Cost of R&D equipment, if certain conditions are met;
- Materials consumed and transformed;
- R&D related overhead or 65 per cent of R&D wages based on the method chosen.

BENEFITS OF THE PROGRAM

At the federal level, all taxpayers qualify for a 20-per-cent tax credit on all R&D expenditures, including capital expenditures. Qualifying Canadian Controlled Private Corporations (CCPC) can earn a 35-per-cent tax credit on the first \$2 million in expenditures. This credit is fully refundable for current expenditures and 40 per cent refundable for capital expenditures.

In addition to the federal credits, those who carry out R&D may be eligible to obtain tax credits, ranging from 10 per cent to 35 per cent, in Ontario, B.C., Saskatchewan, Manitoba, Quebec, New Brunswick, Nova Scotia and Newfoundland on R&D expenditures established at the federal level. This excludes Quebec, where the eligible costs are restricted to direct and indirect R&D wages and subcontracting incurred in Quebec.

The combined effect of both the federal and provincial program means that the net cost of doing R&D could be as low as \$218 on R&D spending of \$1,000 depending on the size and location of the business.

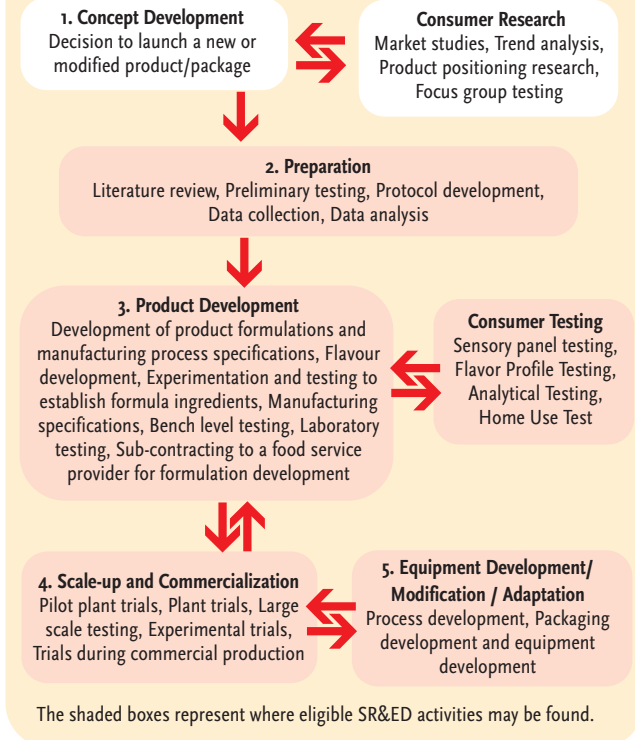
ENHANCING YOUR TAX CREDITS

If your company is already claiming R&D tax credits, you may want to consider whether all eligible activities are being identified and claimed, and whether your operations are structured to enhance R&D tax credits. One area that is often overlooked involves situations in which Canadian affiliates are receiving funding from the non-resident parent corporation to carry out R&D in Canada. Often the Canadian affiliate does not claim the R&D costs on the grounds that they were fully funded. However, under the R&D tax credit program, non-resident funded R&D costs may still be eligible.

In general, most businesses can benefit from structuring their accounting system to capture all the costs. Special attention should be made to your third-party contracts to ensure you are entitled to claim any related tax benefits. Subcontracting work done by suppliers involving experimental work or support thereof is often not claimed by either party. In other situations, the claim is made by the supplier instead of the person paying for the R&D. Therefore, contracts with suppliers should be negotiated to ensure that the tax credits are attributed to the company that is paying for the work.

Once the claim is filed with your tax return, the CRA will review it and carry out a science and financial audit if necessary. The CRA has more information and guidelines for each

Summary of different phases involved in product development/modification



The shaded boxes represent where eligible SR&ED activities may be found.

industry sector on its website (<http://www.cra-arc.gc.ca/tax-credit/sred/menu-e.html>).

Busy operators may want to consider hiring a consulting firm that offers services in preparing R&D claims. While many of these consulting firms offer various services, it's important to ensure that you hire knowledgeable professionals who have experience in identifying eligible activities in the food and beverage industries, since the CRA has specific guidelines for each industry sector. The consulting firm should have an integrated approach, with the ability to prepare both the scientific and tax filing by having engineers, accountants and tax professionals on staff. They must also possess significant proven experience in defending claims before the CRA.

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