

NO.: **IT-151R5 (Consolidated)**

DATE: See *Bulletin Revisions* Section

SUBJECT: INCOME TAX ACT
Scientific Research and Experimental Development Expenditures

REFERENCE: Section 37 (also sections 13, 37.1, 87, 96, 110, 110.1, 118.1, 125, 127, 127.1, 149, and 194; subsections 11(2), 18(9), 88(1), 111(1), 248(1), and 249(4); paragraphs 12(1)(v), 12(1)(x), and 251(5)(b) of the *Income Tax Act* (the “Act”); and sections 2900, 2901, 2902, 2903, and 4606, and paragraph 1102(1)(d) of the *Income Tax Regulations* (the “Regulations”))

Latest revision: the Appendix

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Bulletin Revisions

Application

This bulletin cancels Interpretation Bulletin IT-151R3 dated June 24, 1988. The comments in this bulletin generally apply to expenditures on scientific research and experimental development incurred in taxation years ending after December 2, 1992. IT-151R4 will continue to apply, subject to certain transitional provisions, to those expenditures incurred in taxation years ending before that time and after December 15, 1987.

Summary

The *Income Tax Act* contains various tax incentives for taxpayers performing scientific research and experimental development (SR&ED). These incentives are an integral part of the federal government's efforts to stimulate industrial research and development. This bulletin outlines the incentives that are available and explains which expenditures qualify for the incentives and who is eligible to receive them. Specifically, this bulletin discusses the mechanism by which expenditures of a current and capital nature on SR&ED carried on in Canada may be pooled and deducted in calculating the income from a business carried on by a taxpayer in the year the expenditure is made or in any subsequent year. It deals with the provisions that may restrict a corporation's ability to claim any portion of the pool of expenditures on SR&ED following an acquisition of the corporation's control. The deductibility of expenditures for SR&ED carried on outside Canada is also addressed.

The bulletin describes the investment tax credit provisions of the Act that allow SR&ED claimants to reduce their Part I tax payable and discusses the expenditures on SR&ED carried on in Canada that qualify for an investment tax credit.

The bulletin also explains the general basis of calculating the amount of investment tax credits. It discusses the enhanced investment tax credit available to certain Canadian-controlled private corporations (CCPCs) for some of their qualified expenditures on SR&ED and it discusses the requirements a CCPC must meet to qualify for the enhanced investment tax credit.

The bulletin addresses the mechanism by which certain taxpayers may obtain a partial refund of the unused portion of the investment tax credits earned during the year and the conditions under which certain CCPCs may be refunded the full amount of the unused portion of the current year's investment tax credit for current expenditures on SR&ED.

Finally, the bulletin addresses the consequences an amalgamation or a winding-up may have on the SR&ED performer's pool of deductible SR&ED expenditures and the amount of investment tax credits. It discusses the particular consequences to a partnership incurring SR&ED expenditures and earning investment tax credits for the qualifying SR&ED expenditures.

Discussion and Interpretation

INTRODUCTION

Definition of Scientific Research and Experimental Development

¶ 1. Generally, for work performed after February 27, 1995, for the purposes of the Act, SR&ED is defined in subsection 248(1). Under this definition, SR&ED means systematic investigation or search carried out in a field of science or technology by means of experiment or analysis. It must be

- (a) basic research, namely, work undertaken for the advancement of scientific knowledge without a specific practical application in view;
- (b) applied research, namely, work undertaken for the advancement of scientific knowledge with a specific practical application in view; or
- (c) experimental development, namely, work undertaken for the purposes of achieving technological advancement for the purpose of creating new, or improving existing, materials, devices, products or processes, including incremental improvements thereto.

Under paragraph (d) of the definition of SR&ED in subsection 248(1), SR&ED also includes work of a taxpayer that is commensurate with the needs and directly in support of work described in (a), (b) and (c) that is undertaken in Canada by, or on behalf of, the taxpayer. However, the definition of SR&ED excludes work for the following:

- market research or sales promotion;
- quality control or routine testing of materials, devices, products or processes;
- research in the social sciences or the humanities;
- prospecting, exploring or drilling for, or producing minerals, petroleum or natural gas;
- the commercial production of a new or improved material, device or product, or the commercial use of a new or improved process;
- style changes; or
- routine data collection.

Applicable to taxation years that begin after 1995, subsection 37(13) deems work that a taxpayer performs for a person or partnership to be SR&ED for the purposes of sections 37, 127 and 127.1 if

- the work would have been SR&ED if the person or partnership had performed it, and
- the taxpayer and the person or partnership were not dealing at arm's length at the time the taxpayer performed the work.

¶ 2. Technical guidelines that reflect the Canada Customs and Revenue Agency's interpretation of these provisions of the Act and Regulations are discussed in the current version of Information Circulars 86-4, *Scientific Research and Experimental Development*, and 97-1, *Scientific Research and Experimental Development – Administrative Guidelines for Software Development*. The Brochure T4052, *An Introduction to the Scientific Research and Experimental Development Program*, provides a general overview on how the incentive program works and the filing requirements. Other information on SR&ED, including application policies issued by the CCRA, are available on our Web site at www.cra.gc.ca/sred.

General Discussion of Conditions to Deduct

¶ 3. Generally, section 37 provides that a taxpayer carrying on a business in Canada in a taxation year may deduct, in calculating income from the business for the year, expenditures of a current and of a capital nature for SR&ED carried on in Canada that relate to a business of the taxpayer. A taxpayer who has made SR&ED expenditures in a year in respect of a particular business may, to the extent that those expenditures have not been deducted in the year, deduct those expenditures in any subsequent year in calculating income from that or any other business carried on by the taxpayer in the subsequent year (subject to certain limits, as discussed in ¶ 44, if the taxpayer is a corporation whose control has been acquired by a person or group of persons). In addition, a taxpayer may deduct an expenditure of a current nature incurred in carrying on SR&ED outside Canada in the year the expenditure was made (see ¶s 45-47).

Taxation Year

¶ 4. References in subsection 37(1) to a “year” are generally references to a taxation year. However, in the case of an individual (other than a testamentary trust) who carries on an unincorporated business which has a fiscal year-end other than December 31, subsection 11(2) provides that the reference to a “year” relates to a fiscal period of the business ending in the year.

GENERAL REQUIREMENTS

Carrying On a Business

¶ 5. In order to be eligible to claim a deduction under subsection 37(1) in a taxation year, a taxpayer must carry on a business in Canada in the year. Whether a taxpayer is carrying on a business is a question of fact that must be determined on a case-by-case basis. In the case of a start-up operation, refer to the current version of IT-364, *Commencement of Business Operations*, which sets out factors to consider in determining whether a taxpayer has begun to carry on a business in Canada.

Filing Requirement

¶ 6. In order to be eligible to claim a deduction under subsection 37(1) in a taxation year for an expenditure on, or in respect of, SR&ED, a taxpayer must also file a prescribed form (Form T661, *Claim for Scientific Research and Experimental Development (SR&ED) in Canada*, or Form T665, *Simplified Claim for Scientific Research and Experimental Development (SR&ED) in Canada*) containing prescribed information in respect of the expenditure. The Guide T4088, *Claiming Scientific Research and Experimental Development, Guide to Form T661*, provides detailed line-by-line explanations on how to complete the lines in Form T661. Instructions on completing Form T665 are attached to that form.

For taxation years that begin before 1996, the prescribed form must be filed on, or before, the filing-due date for the following taxation year. However, under subsection 149(7), the prescribed form must be filed by any corporation exempt from Part I tax under paragraph 149(1)(j) on, or before, its filing-due date for all taxation years that end after February 27, 1995. Subsection 149(7.1) provides a penalty for those corporations if they fail to file the prescribed form on time. The filing-due date for a particular taxation year is the date the taxpayer's return of income under Part I for the year is, or would be, required to be filed if any tax were payable under that Part for the year. For taxation years that begin after 1995, a taxpayer must file form T661 on, or before, the day that is 12 months after the taxpayer's filing-due date for the year in which the expenditure is incurred.

Unless a taxpayer identifies an expenditure on a prescribed form filed on time, subsection 37(11) prevents the taxpayer from deducting any amount under subsection 37(1) in respect of the expenditure. In addition, subsection 37(11) effectively requires a taxpayer to identify, on the prescribed form for a particular taxation year, an expense in respect of unpaid wages, salaries or other remuneration that would be incurred in the year if section 78(4) had not applied to the expenditure, in order for the expense to be deductible under subsection 37(1) in the year in which it will actually be paid. Subsection 37(11) applies to expenditures that would be incurred in taxation years that begin after 1995. When, in a taxation year that begins before 1996, an expense in respect of unpaid wages, salaries or other remuneration would have been incurred by a taxpayer, had it not been for the application of subsection 78(4), the taxpayer is only required to identify the expense on the prescribed form of the year in which it is paid. Before the 1997 taxation year, subsection 37(12) eliminates the filing requirement for an expenditure reclassified as an expenditure in respect of SR&ED by the Minister on an assessment of the taxpayer's tax payable under Part I for the year, or on a determination that no tax under Part I is payable for the year. However, applicable to the 1997 and subsequent taxation years, subsection 37(12) deems an expenditure in respect of which the taxpayer has not met the filing requirement in subsection 37(11) not to be an expenditure on, or in respect of, SR&ED.

POOL OF DEDUCTIBLE EXPENDITURES FOR SR&ED CARRIED ON IN CANADA

Calculation of Pool of Deductible SR&ED Expenditures

¶ 7. Subsection 37(1) provides for the calculation of a taxpayer's pool of deductible expenditures for SR&ED carried on in Canada. In general, the pool of deductible SR&ED expenditures is increased by the following:

- the amount of expenditures of a current and of a capital nature on SR&ED carried on in Canada;
- certain payments to corporations and approved entities for SR&ED;
- the amount of repayments of government and non-government assistance that had previously reduced the pool of deductible SR&ED expenditures; and
- the amounts that have been included in the taxpayer's income for a previous year under paragraph 12(1)(v).

Generally, the taxpayer's pool of deductible SR&ED expenditures is decreased by the following:

- the amount of government and non-government assistance that the taxpayer has received, is entitled to receive or can reasonably be expected to receive for SR&ED expenditures included in the pool (see ¶ 39);
- its "super-allowance benefit amount" as defined in subsection 127(9) for the year or for preceding taxation years in respect of a province (see ¶ 41);
- amounts claimed as investment tax credits in a preceding year that may reasonably be attributed to a prescribed proxy amount (see ¶ 56), to qualified SR&ED expenditures of a current nature or to amounts included at the end of a preceding taxation year in the taxpayer's SR&ED qualified expenditure pool because of paragraph 127(13)(e) (see ¶ 54);
- amounts deducted under subsection 37(1) in previous years (except amounts described in subsection 37(6) as discussed in ¶ 36); and
- amounts the taxpayer has deducted under section 61.3 in preceding years to the extent these amounts did not exceed the balance of the pool of deductible SR&ED expenditures in the year in which the amount was claimed.

If the pool of deductible SR&ED expenditures has a positive balance at the end of the year, the amount a taxpayer may deduct for that year under subsection 37(1) cannot be more than the balance in the pool. If the pool of deductible SR&ED expenditures has a negative balance at the end of a year, paragraph 12(1)(v) requires the negative balance to be included in the taxpayer's income for the year. Various other transactions, such as claims for Part VIII tax and acquisitions of control, as described in ¶s 43 and 44, may also increase or decrease the taxpayer's pool of deductible SR&ED expenditures.

For 1998 and subsequent taxation years, paragraph 37(1)(c.2) increases a taxpayer's pool of deductible SR&ED expenditures by the total of all amounts added because of subsection 127(27), (29) or (34) to the taxpayer's tax payable under Part I for any preceding taxation year (see ¶ 52). In the case of a partnership, paragraph 37(1)(c.3) increases the partnership's pool of deductible SR&ED expenditures by the total of all amounts each of which was an amount added to the tax otherwise payable of a member of the partnership under subsection 127(30) for a preceding fiscal period of the partnership (see ¶ 94).

Expenditures of a Current and of a Capital Nature for SR&ED Carried On in Canada

General

Overview

¶ 8. Expenditures of a current nature on SR&ED carried on in Canada directly undertaken by, or on behalf of, a taxpayer, or expenditures of a current nature that are payments made after 1995 to Canadian resident corporations to be used for SR&ED carried on in Canada, may be included in the pool of deductible SR&ED expenditures under subparagraphs 37(1)(a)(i) and (i.1). Expenditures of a current nature that are payments to corporations and approved entities for SR&ED may be included in the pool of deductible SR&ED expenditures under subparagraphs 37(1)(a)(ii) and (iii). The conditions pertaining to the inclusion of these payments in the pool of deductible SR&ED expenditures are discussed in ¶s 32 and 38. Expenditures of a capital nature on SR&ED carried on in Canada may be included in the pool of deductible SR&ED expenditures under paragraph 37(1)(b). Subparagraphs 37(1)(a)(i) and 37(1)(b)(i) specify that expenditures of a current and capital nature made by a taxpayer on SR&ED that is directly undertaken by, or on behalf of, the taxpayer, must be related to a business of the taxpayer (see ¶ 34). Similarly, subparagraph 37(1)(a)(i.1) provides that payments to Canadian resident corporations are to be used for SR&ED that is related to the business of the taxpayer. In addition, for a payment to be included in the pool of deductible SR&ED expenditures under subparagraph 37(1)(a)(i.1), the taxpayer making the payment must be entitled to exploit the results of the SR&ED (see ¶ 37).

Classification of expenditures

¶ 9. While all expenditures on SR&ED may be considered expenditures of a capital nature, for the purposes of section 37, expenditures of a current nature on SR&ED are considered to be those expenditures that do not result in the acquisition of land, a leasehold interest in land, or property that would otherwise be depreciable property to the taxpayer. Under paragraph 37(1)(b), expenditures of a capital nature are only those expenditures that result in the acquisition of property that would be the taxpayer's depreciable property (other than property referred to in ¶ 12) if section 37 did not apply. The comments in the current version of IT-128,

Capital Cost Allowance – Depreciable Property, may be of assistance in determining whether a particular property is depreciable property.

Timing of expenditures

¶ 10. Subsection 37(1.2) deems a SR&ED expenditure of a capital nature not to have been made until the property acquired with the expenditure becomes “available for use” by the taxpayer as determined under subsections 13(26) to 13(32). To determine when current expenditures qualify for inclusion in the pool of deductible SR&ED expenditures, the following guidelines apply. When a taxpayer carries on SR&ED in Canada with the taxpayer’s own staff, or contracts with another person to have such SR&ED directly undertaken on the taxpayer’s behalf, current expenditures fall under subparagraph 37(1)(a)(i) and normal “accrual” accounting principles apply. For example, if a liability is incurred for materials that are later used in SR&ED, the cost of these materials is considered to be an expenditure on SR&ED in the year in which they are consumed in a qualifying activity, even though payment for them is made in a different year. Also, when an expenditure relates to a contract for services to be performed, such an amount will normally be included in the pool of deductible SR&ED expenditures under subparagraph 37(1)(a)(i). When the services are not performed before the end of the taxpayer’s taxation year, paragraph 18(9)(a) will apply to deny the deduction until the taxation year in which the services are actually performed. However, before 1996, paragraph 18(9)(a) does not apply to payments referred to in clause 37(1)(a)(ii)(E) (see ¶ 33) by reason of the application of paragraph 18(9)(d). In addition, for payments made after 1995, as long as the payer and the payee are dealing with each other at arm’s length at the time of the payment, because of the application of paragraph 18(9)(d), paragraph 18(9)(a) does not apply to any payment described in subparagraph 37(1)(a)(ii) or (iii) provided that the payment cannot be considered to be a payment described in subparagraph 37(1)(a)(i). Since third party payments to corporations resident in Canada are not included in subparagraph 37(1)(a)(ii) after 1995 but in subparagraph 37(1)(a)(i.1), as a result of the application of paragraph 18(9)(a), the SR&ED will have to be performed before the amount of such a payment can be included in the payer’s pool of deductible SR&ED expenditures. However, under paragraph 18(9)(e), for the purposes of section 37 and the definition of “qualified expenditure” in subsection 127(9), any portion of an expenditure that is not deductible in a taxation year because of the application of paragraph 18(9)(a) is deemed not to be made or incurred in the year but made or incurred in the subsequent year to which the expenditure can reasonably be considered to relate.

Exceptions

Remuneration for specified employees

¶ 11. Under subsection 37(9), an expenditure on, or in respect of, SR&ED carried on in Canada does not include a

bonus, or remuneration based on profits, in respect of a person who is a “specified employee” of the payer. A “specified employee” is defined under subsection 248(1) and, in a particular year, includes an employee who does not deal at arm’s length with the employer or who owns, directly or indirectly, at any time in the year, 10% or more of the issued shares of any class of the capital stock of the employer or of any other corporation related to the employer. Thus, for example, if a corporation pays or accrues a bonus to an employee who is its sole shareholder and therefore a specified employee, the bonus is not an expenditure on, or in respect of, SR&ED. However, a bonus paid or payable by the same corporation to an employee who is not a specified employee of the corporation will not be prevented by subsection 37(9) from being an expenditure on, or in respect of, SR&ED. In addition, under subsection 37(9.1), the amount that a taxpayer can claim as an expense on SR&ED for a taxation year that begins after March 5, 1996, for salary or wages of a specified employee, is subject to a limit. For the purposes of clauses 37(8)(a)(ii)(A) and (B), such an expense is limited to five times the Year’s Maximum Pensionable Earnings (YMPE) as determined under section 18 of the *Canada Pension Plan* prorated for the number of days on which the taxpayer is a specified employee during the year. Subsection 37(9.2) to (9.4) provide rules for determining the allocation of salary and wages of a specified employee of two or more associated corporations. For these purposes, subsection 37(9.5) deems individuals related to a particular corporation, certain partnerships and certain limited partnerships to be corporations associated with the particular corporation.

Buildings

¶ 12. Generally, after 1987, expenditures of a capital nature that relate to the acquisition of a building (other than a prescribed special-purpose building) including a leasehold interest in a building, do not constitute expenditures on, or in respect of, SR&ED under subparagraph 37(8)(d)(i). Prescribed special-purpose buildings are approved by the Department of Finance on a building-by-building basis. To date, only one type of building has been prescribed as a special-purpose building and it is described in section 2903 of the Regulations. The comments in the current version of IT-79, *Capital Cost Allowance—Buildings or Other Structures*, may be of assistance in distinguishing between expenditures for the acquisition of buildings and expenditures for the acquisition of other structures.

Payments for the use of, or the right to use, a building and payments enabling the recipient to acquire a building or leasehold interest

¶ 13. Outlays and expenses made or incurred after 1987 for the use of, or the right to use, a building (other than a prescribed special-purpose building—see ¶ 12) generally do not constitute expenditures on SR&ED under subparagraph 37(8)(d)(ii). However, rental expenses, incurred in a taxation year that began before March 6, 1996 are excepted from this rule if they were incurred under a written lease agreement

that was renewed, extended or entered into before June 18, 1987 by the taxpayer or a person with whom the taxpayer did not deal at arm's length at the time the lease was renewed, extended or entered into. Subparagraph 37(8)(d)(iii) further provides that payments made by a taxpayer to an approved research institute or approved association which does not deal at arm's length with the taxpayer, or to a corporation (other than a resident Canadian corporation that is exempt from Part I tax under paragraph 149(1)(j) and is dealing at arm's length with the taxpayer), do not constitute SR&ED expenditures to the extent that they may reasonably be considered to have been made to enable the recipient to acquire a building or a leasehold interest in a building or to pay an amount in respect of the rental expense for a building. A payment made by a taxpayer to an approved university, college or organization does not constitute an expenditure on SR&ED to the extent that the amount of the payment may reasonably be considered to have been made to enable the recipient to acquire a building, or a leasehold interest in a building in which the taxpayer has, or may reasonably be expected to acquire, an interest.

Expenditures to acquire rights arising out of SR&ED

¶ 14. Subsection 37(4) provides that no deduction may be made under section 37 in respect of an expenditure to acquire rights in, or arising out of, SR&ED. As a result, expenditures made by a taxpayer to purchase, or to entitle the taxpayer to use, the results of a SR&ED program in which the taxpayer did not participate may not be included in the pool of deductible SR&ED expenditures. Subsection 37(4) will apply to deny a deduction under section 37 for a royalty or other similar payment for products or processes that will have use beyond the SR&ED stage (i.e., which become part of a marketed product). Subsection 37(4) will generally not apply to deny a deduction for an expenditure on something that is merely a tool for performing SR&ED. For example, subsection 37(4) will not apply to deny a deduction for expenditures made to acquire capital property (that may result from the SR&ED efforts of others) required to support the taxpayer's SR&ED efforts but that will not be incorporated into the end product, provided the taxpayer is not acquiring any right to commercially exploit the results of the other party's SR&ED. Expenditures made by a taxpayer to acquire patents or other legal protection related to the results of a SR&ED program are not deductible under section 37 regardless of whether the taxpayer participated in the program.

Donations as SR&ED

¶ 15. When an expenditure that qualifies for a deduction under section 37 is otherwise deductible under section 110.1 or 118.1, subsection 37(5) provides that no deduction for that expenditure may be made under section 110.1 or 118.1 in calculating the taxable income of, or the tax payable by, the taxpayer for any taxation year.

Projects resulting in the acquisition of property

¶ 16. Certain projects result in the acquisition of property that can reasonably be expected to be used in the taxpayer's business or that will be sold. Projects, such as the development of a custom product, that may involve SR&ED work may also involve commercial production work that does not constitute SR&ED under paragraph (i) of the definition of SR&ED in subsection 248(1). To determine the eligible expenditures on SR&ED for such projects, the SR&ED work and the non-SR&ED work should be identified and the project costs allocated between these activities. However, where a property is being constructed during a particular project for its experimental or technical content and is not being constructed for commercial use or sale, paragraph (i) of the definition of SR&ED in subsection 248(1) is not considered to apply and it is not necessary to allocate the project costs between the SR&ED and the commercial production work.

Expenditures of a Current Nature on, or in Respect of, SR&ED

General

¶ 17. Subsection 37(8) defines the expression "expenditures on, or in respect of, SR&ED." Subparagraph 37(8)(a)(i) defines this expression when it occurs in subsection 37(2) and describes the requirements that must be met for expenditures on SR&ED carried on outside Canada to be deductible under that subsection. These requirements are described in ¶ 47. Subparagraph 37(8)(a)(ii) defines the expression "expenditures on, or in respect of, SR&ED" when it occurs elsewhere than in subsection 37(2). It describes the requirements that expenditures must meet to be included in the pool of deductible expenditures under subsection 37(1) for SR&ED carried on in Canada. Subparagraph 37(8)(a)(ii) provides that expenditures of a taxpayer on, or in respect of, SR&ED carried on in Canada include only the expenditures described under clause 37(8)(a)(ii)(A) (see ¶ 18), except if the taxpayer elects to have the rules in clause 37(8)(a)(ii)(B) apply (see ¶ 23).

Expenditures of a current nature on, or in respect of, SR&ED: traditional method

General

¶ 18. In a taxation year for which a taxpayer has not made an election under clause 37(8)(a)(ii)(B), expenditures of a current nature on, or in respect of, SR&ED include only expenditures described:

- under subclause 37(8)(a)(ii)(A)(I), if all or substantially all of the expenditure is attributable to the prosecution, or to the provision of premises, facilities or equipment for the prosecution, of SR&ED in Canada; or
- under subclause 37(8)(a)(ii)(A)(II), if the expenditure is directly attributable as determined by regulation (see ¶ 19) to the prosecution, or to the provision of premises, facilities or equipment for the prosecution, of SR&ED in Canada.

An expenditure of a current nature that is used 90% or more for SR&ED purposes is considered to be “all or substantially all” attributable to the prosecution of SR&ED, or to the provision of premises, facilities or equipment for the prosecution of SR&ED, as the case may be. For example, subject to the “specified employee” rules of subsections 37(9) to (9.5), the wages of an employee hired for SR&ED purposes are considered all or substantially all attributable to the prosecution of SR&ED if 90% or more of this employee’s time is devoted to the prosecution of SR&ED.

Expenditures directly attributable to SR&ED

¶ 19. Subsection 2900(2) of the Regulations describes the expenditures that are directly attributable to the prosecution of SR&ED for the purposes of subclause 37(8)(a)(ii)(A)(II). Paragraph 2900(2)(a) of the Regulations provides that an expenditure of a current nature is directly attributable to the prosecution of SR&ED if it is the cost of materials consumed in such prosecution. Applicable for costs incurred after February 23, 1998, paragraph 2900(2)(a) of the Regulations provides that an expenditure of a current nature is directly attributable to the prosecution of SR&ED if it is the cost of materials consumed or transformed in such prosecution. Costs incurred prior to February 24, 1998, for materials transformed but not consumed in the prosecution of SR&ED may be directly attributable to the prosecution of SR&ED under paragraph 2900(2)(c) of the Regulations where the criteria of that paragraph are met (see ¶ 20), in accordance with the decision in *Consoltex Inc. v. The Queen*, 97 DTC 724, [1997] 2 CTC 2846 (TCC).

Paragraph 2900(2)(b) of the Regulations provides that certain expenditures for employee remuneration are directly attributable to the prosecution of SR&ED. These expenditures are the portion of salaries or wages incurred for an employee who directly undertakes, supervises or supports the prosecution of SR&ED to the extent the amount incurred can reasonably be considered to relate to such prosecution. However, see ¶ 11 for the restriction concerning bonuses, salaries and wages of specified employees.

¶ 20. Paragraph 2900(2)(c) of the Regulations provides that certain other expenditures are also directly attributable to the prosecution of SR&ED. These expenditures include any expenditure, or portion thereof, that is directly related to the prosecution of SR&ED and that would not have been incurred if such prosecution had not occurred. For example, a portion of general and administrative expenses, such as the relevant portion of expenditures for training employees or for personnel or accounting staff, that is directly related to the prosecution of SR&ED and that would not have otherwise been incurred is considered to be directly attributable to the prosecution of SR&ED. Also, a portion of certain overhead expenses, such as the cost of light, heat and long distance telephone charges, is generally considered to be directly attributable to the prosecution of SR&ED if it can be established that such portion otherwise meets the requirements of paragraph 2900(2)(c) of the Regulations. The portion of factory overheads or general and

administrative expenses that does not meet the requirements of paragraph 2900(2)(c) of the Regulations may be included in the pool of deductible SR&ED expenditures to the extent that it relates to the provision of premises, facilities or equipment for the prosecution of SR&ED carried on in Canada and otherwise meets the requirements of subsection 2900(3) of the Regulations as discussed in ¶ 21.

¶ 21. For the purposes of subclause 37(8)(a)(ii)(A)(II), subsection 2900(3) of the Regulations describes the expenditures that are directly attributable to the provision of premises, facilities or equipment for the prosecution of SR&ED. Paragraph 2900(3)(a) of the Regulations provides that the cost of the maintenance and upkeep of premises, facilities or equipment provided for SR&ED is directly attributable to the provision of such premises, facilities or equipment. Paragraph 2900(3)(b) of the Regulations provides that certain other expenditures are also directly attributable to the provision of premises, facilities or equipment for the prosecution of SR&ED carried on in Canada. These other expenditures include any expenditure, or portion thereof, that is directly related to the provision of premises, facilities or equipment for the prosecution of SR&ED in Canada and that would not have been incurred if those premises, facilities or equipment had not existed. For example, under this paragraph, if a building owned by the taxpayer is used for the prosecution of SR&ED, a reasonable portion of the municipal taxes or the cost of insurance for the building is considered to be directly attributable to the SR&ED. In such cases, the method used to determine the portion of the municipal taxes that is directly related to this use must also be reasonable and may, for example, be based on the square meters of the building used for SR&ED over the total square meters of the building. Other methods can be used to determine the portion of an expenditure that is directly related to the provision of premises, facilities or equipment for the prosecution of SR&ED provided they are reasonable in the circumstances. In all cases, whichever method is used, the taxpayer must be able to support that it is reasonable.

Interest expense

¶ 22. Interest expense incurred on money borrowed for the prosecution of SR&ED is deductible as a SR&ED expenditure only to the extent that the borrowed money is used to make SR&ED expenditures which are otherwise deductible under section 37.

Expenditures of a current nature on, or in respect of, SR&ED: proxy method

General

¶ 23. Taxpayers who file Form T661 or T665 with their income tax return for a particular year in accordance with subsection 37(10) may elect under clause 37(8)(a)(ii)(B) to use an alternate method to determine their current expenditures on, or in respect of, SR&ED for the year. For a taxation year for which the taxpayer has made such an election, the taxpayer’s current expenditures on, or in respect

of, SR&ED include only the following expenditures described in subclauses 37(8)(a)(ii)(B)(I), (II), (IV), (V) and (VI):

- an expenditure of a current nature for, and all or substantially all of which is attributable to, the lease of facilities, premises and equipment (other than general purpose office equipment or furniture (GPOEF)—see ¶ 25) for the prosecution of SR&ED in Canada;
- an expenditure in respect of the prosecution of SR&ED in Canada directly undertaken on the taxpayer’s behalf;
- the portion of an expenditure for salary or wages incurred in the year for an employee who is directly engaged in SR&ED in Canada that can reasonably be considered to relate to such work having regard to the time spent by the employee thereon (see ¶s 26 and 27);
- the cost of materials consumed in the prosecution of SR&ED in Canada; and
- one half of any other expenditure of a current nature in respect of the lease of premises, facilities or equipment (other than GPOEF) used primarily for the prosecution of SR&ED in Canada.

“All or substantially all” and “primarily”

¶ 24. Under subclause 37(8)(a)(ii)(B)(I), an expenditure to lease premises, facilities or equipment (other than GPOEF) that is intended to be used 90% or more in the prosecution of SR&ED at the time it is made and is actually used in that manner is considered, subject to paragraph 37(8)(d) (see ¶ 13), to be an expenditure for, and all or substantially all attributable to, the lease of premises, facilities or equipment for the prosecution of SR&ED. However, if the premises, facilities or equipment are used primarily (more than 50%) but less than 90% for the prosecution of SR&ED, one half of the expenditure in respect of the lease of premises, facilities or equipment is included as an expenditure on, or in respect of, SR&ED under subclause 37(8)(a)(ii)(B)(VI).

General purpose office equipment or furniture

¶ 25. Expenditures to acquire or lease general purpose office equipment or furniture (GPOEF) are not expenditures on, or in respect of, SR&ED under subclause 37(8)(a)(ii)(B)(I), (III) or (VI). GPOEF includes all furniture, such as desks, chairs, lamps, filing cabinets and bookshelves. It also includes photocopiers, fax machines, telephones, pagers, typewriters, word processors, teletypes and calculators. Computers, including hardware, software and ancillary equipment, are not considered to be GPOEF.

Salary and wages

¶ 26. Under subclause 37(8)(a)(ii)(B)(IV), an expenditure on, or in respect of, SR&ED includes the portion of an expenditure made in respect of an expense for salary and wages of an employee who is directly engaged in SR&ED (see ¶ 27) in Canada that can reasonably be considered to relate to such work having regard to the time spent by the employee on such SR&ED. When that portion represents all or substantially all (90% or more) of the time spent by the

employee on such work, all of the expenditure is deemed to be on SR&ED. However, see ¶ 11 for restrictions concerning bonuses, salaries and wages of specified employees. The expression “salary or wages” is defined in subsection 248(1) and means income from an office or employment as calculated under subdivision a of division B of Part I (sections 5 to 8 inclusively) of the Act. Salary or wages of an employee generally includes vacation pay as well as any expenditure made in respect of a benefit that would be taxable to the employee under section 6.

Employees directly engaged in the prosecution of SR&ED

¶ 27. Whether an employee is, at a particular time, directly engaged in SR&ED is a question of fact based on the duties performed by the employee and not on the employee’s job title. Generally, employees conducting experimentation and analysis in the performance of basic research, applied research, or experimental development are considered to be directly engaged in SR&ED. In addition, employees are considered to be directly engaged in SR&ED when they are performing technical support work such as engineering, design, operations research, mathematical analysis, computer programming, (non-routine) data collection, testing or psychological research that are commensurate with the needs and directly in support of the basic or applied research or experimental development work. Managers and supervisors are also considered to be directly engaged in SR&ED when they are performing experimentation and analysis in the performance of basic research, applied research or experimental development and when they are carrying out technical activities in support of the research or development work. In addition, managers and supervisors who supervise the ongoing SR&ED work are also considered to be directly engaged in SR&ED if, and to the extent, they are directing the course of the ongoing SR&ED or providing direct technical input into the SR&ED work. However, any time spent by a manager or supervisor performing non-technological management activities or decision-making functions that do not directly influence the course of the SR&ED, even if it relates to the SR&ED, is not considered to be time the manager or supervisor is directly engaged in SR&ED.

Expenditures of a Capital Nature on, or in Respect of, SR&ED

General

¶ 28. Under paragraph 37(1)(b), the amount of expenditures of a capital nature that may be included in the taxpayer’s pool of deductible SR&ED expenditures for a taxation year (see ¶ 30) is limited to the lesser of

- (a) the total of all expenditures of a capital nature made in the year or any previous year ending after 1958 on SR&ED carried on in Canada that is directly undertaken by, or on behalf of, the taxpayer and that is related to a business of the taxpayer; and

- (b) the amount that would be the undepreciated capital cost of the property so acquired as of the end of the taxation year, calculated as if no amount had been deducted in respect of the property under section 37 for the taxation year.

Separate prescribed class

¶ 29. Paragraph 1102(1)(d) of the Regulations excludes from the classes of property on which capital cost allowance may be claimed property that has been acquired by an expenditure for which the taxpayer is allowed a deduction under section 37. Therefore, a taxpayer is prevented from duplicating claims for expenditures of a capital nature by claiming capital cost allowance on such property. In addition, subsection 37(6) provides that, for the purposes of section 13, an amount claimed under subsection 37(1) that may reasonably be considered to be in respect of property described in paragraph 37(1)(b) will be deemed to be an amount that has been allowed to the taxpayer as capital cost allowance. Since subsection 37(6) also deems the property to be of a separate prescribed class, subsection 13(1) may require an amount to be included in the taxpayer's income as recapture of capital cost allowance if the property is disposed of. In calculating the amount that would otherwise be the undepreciated capital cost of the property, the capital cost of the property will be reduced by the amounts that were deducted under subsection 37(1) that may reasonably be considered to be in respect of the property. Paragraph 13(7.1)(e) reduces the capital cost of depreciable property and, consequently, the undepreciated capital cost of the property by the amount of any investment tax credit that was deducted in a preceding year for the property. Paragraph 13(7.1)(f) usually reduces the capital cost of depreciable property and, consequently, the undepreciated capital cost of the property by the amount of any assistance the taxpayer has received or is entitled to receive. However, paragraph 13(7.1)(a) provides that the capital cost and undepreciated capital cost of the property is not reduced by an amount described in paragraph 37(1)(d). Accordingly, in the calculation of the undepreciated capital cost of the property, the amount of government or non-government assistance the taxpayer received, is entitled to receive or can reasonably be expected to receive for the acquisition of the property that would otherwise be depreciable property used in the taxpayer's SR&ED projects (see ¶ 39), will not reduce the capital cost of the property. A taxpayer may thus be required to include an amount in income under subsection 13(1) even though there has not been a disposition of the particular property. For example, this could occur when the taxpayer has claimed a deduction under subsection 37(1) for the entire capital cost of the property and also claims any portion of the investment tax credit for that property.

Expenditures of a capital nature on, or in respect of, SR&ED

¶ 30. Subparagraph 37(8)(a)(ii) provides that references in section 37 (other than in subsection 37(2)—see ¶ 47) to expenditures of a capital nature on, or in respect of, SR&ED in Canada include only the expenditures described under subclause 37(8)(a)(ii)(A)(III) or, for a taxation year that the taxpayer has made an election under clause 37(8)(a)(ii)(B) (see ¶ 17), expenditures described in subclause 37(8)(a)(ii)(B)(III). Under subclause 37(8)(a)(ii)(A)(III), an expenditure of a capital nature on, or in respect of, SR&ED means an expenditure that, at the time it was incurred, was for the provision of premises, facilities or equipment, when at that time it was intended that:

- it would be used during all or substantially all of its operating time in its expected useful life for the prosecution of SR&ED in Canada; or
- that all or substantially all of its value would be consumed in the prosecution of SR&ED in Canada.

Under clause 37(8)(a)(ii)(B), an expenditure of a capital nature on, or in respect of, SR&ED includes only an expenditure described in subclause 37(8)(a)(ii)(A)(III) other than GPOEF (see ¶ 25). Outlays to acquire GPOEF are included in a prescribed class and are eligible for capital cost allowance at the prescribed rate.

¶ 31. The phrase “all or substantially all” is normally viewed as meaning “90% or more.” An expenditure to provide a particular piece of equipment which is to be used partly for SR&ED and partly for other purposes will meet this requirement of subclause 37(8)(a)(ii)(A)(III) if the equipment's anticipated use for other purposes during its operating time in its expected useful life does not exceed 10% or if it is intended that not less than 90% of the value of the property acquired is to be consumed in the prosecution of SR&ED. The determination of whether an expenditure of a capital nature is to be used all or substantially all of its operating time in its expected useful life in the prosecution of SR&ED is made at the time the property is acquired. In making this determination, the intended use of the property in the year in which the expenditure was made as well as over its expected useful life will be considered. Subsequent use of the property may provide evidence of the taxpayer's intention at the time the expenditure was made. However, when the subsequent use is contrary to the taxpayer's stated intention, the taxpayer must be able to support the contention that the property was intended to be used all or substantially all of its operating time in its expected useful life in the prosecution of SR&ED in Canada. Furthermore, see ¶ 52 for a discussion of the recapture rules that may apply. Generally, operating time means the time the equipment usually runs or functions. Whether equipment is used for SR&ED during its operating time is a question of fact that can only be determined on a case-by-case basis. However, time spent to set up equipment for SR&ED work, and time spent to switch the equipment back to another use, will usually be considered to be operating time in which the equipment is used for the

prosecution of SR&ED, as long as it is reasonable in the circumstances. If an existing property is used temporarily for SR&ED, the direct costs (including maintenance and repairs) that would not have been incurred if the SR&ED had not been carried out may be included in the calculation of the pool of deductible SR&ED expenditures under paragraph 37(1)(a). No amount of the cost or undepreciated capital cost of that property may be included under paragraph 37(1)(b).

Payments to Be Used for SR&ED

General

¶ 32. Payments to be used for SR&ED (other than those described in ¶ 13) that are made to corporations resident in Canada which are exempt from Part I tax under paragraph 149(1)(j), to approved entities (see ¶ 33 and the appendix) and, when the payment is made before 1996, to corporations resident in Canada, may be included in the calculation of the pool of deductible SR&ED expenditures under subparagraph 37(1)(a)(ii). Payments to these organizations will qualify only if they are to be used for SR&ED carried on in Canada related to a business of the taxpayer and if the taxpayer making the payment is entitled to exploit the results of the SR&ED (see ¶ 37).

Approval of Minister

¶ 33. The term “approved” as used in section 37 and defined in subsection 37(7) refers only to the approval, by the Minister, of associations or other organizations. It does not refer to the approval of SR&ED programs. To determine whether an institution or association has been approved by the Minister for purposes of section 37, the taxpayer should consult the list of certain approved entities in the appendix, or if the name is not indicated there, contact the organization in question. For the purposes of clause 37(1)(a)(ii)(B), all Canadian universities and affiliated colleges are considered to be approved. An “approved organization,” for the purposes of clause 37(1)(a)(ii)(E), includes the Natural Sciences and Engineering Research Council, the Medical Research Council and the Social Sciences and Humanities Research Council. To apply for “approved” status, an institution or association should write to the Deputy Assistant Commissioner, Income Tax Rulings Directorate, Policy and Legislation Branch, Canada Customs and Revenue Agency, Ottawa ON K1A 0L5.

Related to a Business

¶ 34. Whether a payment is to be used for, or an expenditure is made on or in respect of, SR&ED that is related to a taxpayer’s business is generally a question of fact that must be determined on a case-by-case basis. Paragraph 37(8)(b) provides, for greater certainty, that references to SR&ED related to a business include any SR&ED that may lead to, or facilitate, an extension of that business. For SR&ED to be related to a business carried on by a taxpayer, it is necessary to have some interconnection or link between the SR&ED and the taxpayer’s business. This requirement

will generally be satisfied when the results of the SR&ED, if successful, have a direct and beneficial application in the business that is carried on by the taxpayer. Paragraph 37(8)(c) provides that the prosecution of SR&ED, in and by itself, is only considered a business of the taxpayer to which the SR&ED relates if the taxpayer derives all or substantially all of its revenue from the prosecution of SR&ED. For this purpose, a taxpayer deriving 90% or more of its revenue from the prosecution of SR&ED is considered to derive “all or substantially all” of its revenue from the prosecution of SR&ED.

Revenue From the Prosecution of SR&ED

¶ 35. Revenue from the prosecution of SR&ED includes revenue from the sale of rights in, or arising out of, SR&ED carried on by the taxpayer. Income from the performance of SR&ED carried out on behalf of another taxpayer is generally considered to be revenue from the prosecution of SR&ED. Royalties earned from licensing the results of SR&ED or from the sale of such results (for example, a patent) are also generally considered to be revenue derived from the prosecution of SR&ED. However, if a taxpayer contracts with another person for SR&ED to be performed on the taxpayer’s behalf, for the purposes of paragraph 37(8)(c), the taxpayer cannot be said to derive “all or substantially all of the taxpayer’s revenue from the prosecution of SR&ED carried on by the taxpayer” if the taxpayer pursues no activities, other than retaining the rights pertaining to any results from the SR&ED performed and commercializing these rights or results. Furthermore, revenue derived from the commercial exploitation of products or processes developed by using the know-how does not constitute revenue from the prosecution of SR&ED within the meaning of paragraph 37(8)(c), but rather it constitutes the sale of finished products. Income from a transaction that involves a licence but is in substance a sale of a finished product (for example, application software) is not considered to be revenue derived from the prosecution of SR&ED. Revenue arising from the prosecution of SR&ED generally envisages the provision of scientific research for a fee or a sale of the know-how developed.

Business Carried On by a Related Corporation

¶ 36. Subsection 37(1.1) provides that (notwithstanding paragraph 37(8)(c)) for the purposes of subsection 37(1), where a corporate taxpayer performs SR&ED that is related to a business actively engaged in by another corporation that is related to the taxpayer at the time the taxpayer makes an expenditure or payment for SR&ED, the SR&ED is considered to be related to a business of the taxpayer at that time. Thus, for example, if the taxpayer performing SR&ED is a wholly-owned subsidiary of another corporation, the subsidiary’s SR&ED will be considered to be “related to a business of the taxpayer” if the SR&ED is related to a business carried on by the parent. The parent must be actively engaged in the business at the time the subsidiary makes the expenditure, or payment for, SR&ED. In

determining whether two corporations are related for the purposes of subsection 37(1.1), the determination is to be made without reference to a right referred to in paragraph 251(5)(b).

Entitlement to Exploit the Results

¶ 37. The determination of whether a taxpayer is “entitled to exploit the results” of SR&ED is a question of fact that can only be determined on a case-by-case basis. For example, this requirement is considered to be met in cases where the taxpayer has the right to use a patent that results from the SR&ED project even if the taxpayer is charged a royalty or similar fee for the use of the patent. This requirement is also considered to be met in cases where the taxpayer is entitled to distribute and market any product that results from the SR&ED project. In addition, when a taxpayer makes a payment for SR&ED to a corporation described in subparagraph 37(1)(a)(i.1) or to an approved university or other entity described in subparagraph 37(1)(a)(ii) and it is likely that the SR&ED project will not result in a product or patent, the taxpayer will be considered to have met this requirement if it can be established that the taxpayer has, as a consequence of the payment, been granted a preferential right to use the results of the SR&ED in its business. However, an arrangement involving payments to an entity described in subparagraph 37(1)(a)(i.1) or (ii) by a taxpayer who owns shares of a corporation which will exploit the results of a SR&ED project does not meet this requirement because it is the taxpayer making the payment who must be entitled to exploit the results of the SR&ED.

Payments for Basic or Applied Research

¶ 38. Under certain circumstances, a corporation can include in its pool of deductible SR&ED expenditures under subparagraph 37(1)(a)(iii) a payment made to a corporation that is resident in Canada and exempt from tax under paragraph 149(1)(j). To be included in the pool of deductible SR&ED expenditures under this subparagraph, the payment must be for SR&ED that is basic or applied research carried on in Canada. The primary purpose of the payment for SR&ED must be for the taxpayer to use the results from the basic or applied research in conjunction with other SR&ED activities directly undertaken by, or on behalf of, the taxpayer that relate to a business of the taxpayer. Furthermore, the basic or applied research must have technological potential for application in other types of businesses that are not related to the business carried on by the paying corporation.

Assistance for SR&ED

Receipt and Repayment of Assistance

¶ 39. Paragraph 37(1)(d) deals with the amount of government and non-government assistance (see ¶ 40) that, at the taxpayer’s filing-due date (see ¶ 6) for the year, a taxpayer has received, is entitled to receive or can reasonably be expected to receive for an expenditure described in paragraph 37(1)(a) or 37(1)(b). Under paragraph 37(1)(d),

the amount of such assistance decreases the pool of deductible SR&ED expenditures. For taxation years that begin before 1996, government and non-government assistance in respect of expenditures described in paragraph 37(1)(a) or 37(1)(b) will reduce the pool of deductible SR&ED expenditures if, at the time of filing the return of income for the year, the taxpayer has received, is expected to receive or can reasonably be expected to receive the assistance. Paragraph 37(1)(c) provides that any repayment of such assistance increases a taxpayer’s pool of deductible SR&ED expenditures in the year of repayment to the extent it had previously reduced the pool.

Government and Non-Government Assistance

¶ 40. “Government assistance” is defined in subsection 127(9). It means assistance from a government, municipality or other public authority whether as a grant, subsidy, forgivable loan, deduction from tax (other than an investment tax credit claimed under subsection 127(5) or (6)), investment allowance or as any other form of assistance. For example, certain provincial tax credits that are available for taxpayers performing SR&ED that reduce the amount of provincial taxes payable are considered government assistance.

Subsection 127(9) defines “non-government assistance” as an amount that would be included in the taxpayer’s income under paragraph 12(1)(x) (read without reference to subparagraphs (vi) and (vii) thereof). Essentially, non-government assistance is an amount that can reasonably be considered to have been received as an inducement or as a reimbursement, contribution, allowance or as assistance for the cost of property or for an outlay or expense. Such an amount will constitute non-government assistance to the extent it was not otherwise included in calculating the taxpayer’s income or deducted in calculating any balance of undeducted outlays, expenses or other amounts for the year or a preceding taxation year. Non-government assistance may be in the form of a grant, subsidy, forgivable loan, deduction from tax, allowance or any other form of inducement or assistance.

The determination of whether a particular loan will constitute government or non-government assistance depends on the particular facts and circumstances concerning that loan. The fact that a full recourse loan is interest-free or is made at a lower than commercial rate of interest will generally not classify the loan as government or non-government assistance.

Super-Allowance Benefit Amount

¶ 41. For taxation years beginning after February 2000 and ending after 2000, paragraph 37(1)(d.1) provides for the reduction of a corporation’s pool of deductible SR&ED expenditures for a taxation year by its “super-allowance benefit amount” in respect of a province for the year and preceding taxation years.

Under subsection 127(9), the term “super-allowance benefit amount” of a corporation in respect of a province for a taxation year is calculated using the following formula:

$$(A-B) \times C$$

where

A is the amount in respect of an SR&ED expenditure incurred in a particular year that the corporation is, or becomes, entitled to deduct in computing its income or taxable income for purposes of calculating its provincial income tax payable for any taxation year;

B is the SR&ED expenditures otherwise determined (without reference to provincial income tax credits); and

C represents the provincial rate of tax to be applied to convert the excess of A–B into an income tax credit equivalent. Where a corporation’s expenditure limit for the year (see ¶ 81) is nil, C is the maximum provincial corporate income tax rate applicable to active business income earned in that province for the year. Otherwise, C is the rate of provincial income tax applicable to a corporation that is not associated with any other corporation in the year and that has taxable income for the year of less than \$200,000 earned from carrying on an active business in that province.

Effect of Investment Tax Credit

¶ 42. Under paragraph 37(1)(e), the taxpayer’s pool of deductible SR&ED expenditures will be reduced by the amount of investment tax credit deducted or deemed to be deducted (as discussed in ¶ 85) by the taxpayer under subsection 127(5) in calculating taxes payable in a preceding year, to the extent that it may reasonably be considered to relate to

- a “prescribed proxy amount” (see ¶ 56) of a preceding taxation year of the taxpayer;
- qualified SR&ED expenditures of a current nature made in a preceding taxation year; or
- an amount included in the taxpayer’s “SR&ED qualified expenditure pool” at the end of a preceding taxation year because of paragraph 127(13)(e) (see ¶ 54).

To the extent that an investment tax credit deducted or refunded may reasonably be considered to relate to a property acquired in a preceding year as “shared-use-equipment” (see ¶ 61) or may reasonably be considered to arise as a result of a qualified SR&ED expenditure of a capital nature, it will reduce the capital cost of the property acquired (see ¶ 29) under paragraph 13(7.1)(e). For record-keeping purposes, a taxpayer should, therefore, separate investment tax credits either deducted or available that were earned for qualified SR&ED expenditures from those earned on other qualified property. Furthermore, investment tax credits earned for a prescribed proxy amount or for current expenditures on SR&ED should be separated from those earned on expenditures of a capital nature or shared-use-equipment since investment tax credits earned on current expenditures on SR&ED and a prescribed proxy

amount may be subject to a different refund rate as discussed in ¶s 85 to 87.

Expenditures Renounced for the Purposes of Part VIII Tax

¶ 43. When a corporation issued scientific research and experimental development tax credit securities to investors before 1986, the corporation was permitted to generate a Part VIII refund if it renounced its entitlement to deduct all or a portion of its SR&ED expenditures and renounced its ability to claim an investment tax credit on these expenditures. Such renounced expenditures reduced the taxpayer’s pool of deductible SR&ED expenditures in accordance with the provisions of paragraph 37(1)(g).

Acquisition of Control

¶ 44. Paragraph 37(1)(h) and subsection 37(6.1) restrict the carryforward of a corporation’s SR&ED expenditures if there has been an acquisition of its control by a person or group of persons at any time before the end of a taxation year. Generally, these provisions (combined with the application of subsection 249(4), which deems the corporation’s year to have ended immediately before the acquisition of control) operate to reduce a corporation’s pool of deductible SR&ED expenditures to nil at the time control of the corporation is acquired. Paragraph 37(1)(h) and subsection 37(6.1) provide that, in a subsequent taxation year throughout which the business to which the expenditures relate is carried on by the corporation for profit or with a reasonable expectation of profit, the corporation’s pool of deductible SR&ED expenditures may be reinstated. The pool of deductible SR&ED expenditures will be reinstated only to the extent of the income (before claiming any deduction under subsection 37(1)) earned by the corporation, after the acquisition of control, from the business to which the expenditures related. In addition, if properties are sold, leased, rented or developed, or services are rendered, in the course of carrying on the corporation’s business before the acquisition of control, the pool of deductible SR&ED expenditures will be reinstated only to the extent of the income for the year (before claiming any deduction under subsection 37(1)) from any other business substantially all the income of which is derived from the sale, leasing, rental or development of similar properties or the rendering of similar services.

SR&ED OUTSIDE CANADA

General

¶ 45. Expenditures of a capital nature on SR&ED carried on outside Canada are not deductible under section 37. Current expenditures on SR&ED carried on outside Canada, if it is directly undertaken by, or on behalf of, the taxpayer and is related to the taxpayer’s business may be deducted under subsection 37(2). Current expenditures made by payments to an approved association, university, college, research institute or other similar institution to be used for SR&ED carried on outside Canada that is related to the

taxpayer's business, are also deductible under subsection 37(2) provided that the taxpayer is entitled to exploit the results of such SR&ED. Current expenditures on SR&ED carried on outside Canada cannot be carried forward and must be deducted in the year the expenditure is incurred. The nature and location of the activities will indicate whether SR&ED is carried on inside or outside Canada.

Foreign Work in Support of SR&ED

¶ 46. For the purpose of section 37, a taxpayer's work with respect to engineering, design, operations research, mathematical analysis, computer programming, data collection, testing and psychological research that is commensurate with the needs and directly in support of basic research, applied research, or experimental development of the taxpayer that is carried on in Canada is SR&ED under paragraph (d) of the definition of SR&ED in subsection 248(1). Thus, when a taxpayer performs such work outside Canada, notwithstanding that the work is commensurate with the needs and directly in support of a particular Canadian SR&ED project of the taxpayer, the expenditures relating to such work that is directly undertaken by, or on behalf of, the taxpayer and is related to the taxpayer's business may only be deductible under subsection 37(2) as expenditures on SR&ED carried on outside Canada. Foreign travel expenditures, and any other expenditure (including salaries or wages of a Canadian employee undertaking foreign travel), for SR&ED carried on outside Canada may only qualify for a deduction under subsection 37(2). Even if a particular expenditure for SR&ED carried on outside Canada is incurred in Canada or is made through a Canadian subcontractor, or if it represents a minor portion of the project, it will not qualify for a deduction under subsection 37(1). However, expenditures, including foreign travel expenditures

- for the acquisition of equipment or materials used in SR&ED in Canada,
- for training for SR&ED carried on in Canada, or
- for visits to foreign customers in respect of SR&ED carried on in Canada to update the customer on the SR&ED project's status

that are incurred for an activity that does not constitute SR&ED carried on outside Canada 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(8)(a)(ii).

Expenditures for SR&ED Carried On Outside Canada

¶ 47. Subparagraph 37(8)(a)(i) provides that references in subsection 37(2) to expenditures on, or in respect of, SR&ED carried on outside Canada include only expenditures that are incurred for, and all or substantially all of which are attributable to, the prosecution of SR&ED, or current expenditures that are directly attributable (as determined by subsection 2900(2) of the Regulations) to the prosecution of

SR&ED. See ¶ 18 for comments on the meaning of "all or substantially all." The comments relating to subsection 2900(2) of the Regulations discussed in ¶s 19 and 20 also apply for the purposes of determining whether expenditures are directly attributable to the prosecution of SR&ED carried on outside Canada as required by clause 37(8)(a)(i)(B).

RECAPTURE OF SR&ED ALLOWANCE

General

¶ 48. Although the additional allowance for SR&ED was eliminated in 1983, subsection 37.1(3) applies before the 1995 taxation year, to require a corporation that claimed an additional allowance under section 37.1 for research property to include an amount in income if a research property is disposed of. The recapture to be included in income is equal to the lesser of

- (a) 50% of the lesser of
 - (i) the fair market value of the property at the time of disposition, and
 - (ii) the capital cost of the property to the corporation at the time of disposition;

and

- (b) the amount, if any, by which the total of the amounts deducted under section 37.1 by the corporation for any taxation year beginning before the disposition, and by any associated corporations for taxation years ending in or before the year of disposition, exceeds the total of amounts previously included in the corporation's and any associated corporation's income because of subsection 37.1(3).

However, section 37.1 has been repealed for the 1995 and subsequent taxation years.

¶ 49. For taxation years before 1995, when a corporation transfers a research property to an associated corporation in a transaction to which either subsection 85(1) or 88(1) applies, any recapture is deferred until the property is sold. The transferred property is deemed to be a research property of the associated corporation. If the corporation's proceeds of disposition for the property are less than its capital cost, the recipient's capital cost is deemed to be the same as that of the transferor. The allowance will be immediately recaptured when a rollover under subsection 85(1) is made to a non-associated company. Section 37.1 has been repealed for the 1995 and subsequent taxation years.

Research Property

¶ 50. A "research property" is defined by subsection 37.1(5) to be capital property (described in paragraph (b) of the definition of "qualified expenditure" in subsection 37.1(5)) that was acquired as a result of an expenditure made by a corporation after the end of its 1977 taxation year. The property must not have been used for any other purpose whatever before its acquisition, and the expenditure must not be an expenditure prescribed in section 2901 of the

Regulations. Section 37.1 has been repealed for the 1995 and subsequent taxation years.

INVESTMENT TAX CREDIT

General

¶ 51. The comments in ¶s 52 to 88 discuss the investment tax credit for qualified expenditures on SR&ED. Comments on the investment tax credits of a taxpayer that is a member of a partnership are contained in ¶s 92 to 97. Taxpayers should also refer to forms T661, T665, T2038, *Investment Tax Credit (Individuals)*, and Schedule 31 of the T2 return for corporations, *Investment Tax Credit – Corporations*, for more information on investment tax credits relating to SR&ED.

Investment Tax Credit Calculation

General

¶ 52. Under subsection 127(5), a taxpayer's investment tax credit may be used to reduce the taxpayer's Part I tax otherwise payable. The definition of "investment tax credit" ("ITC") in subsection 127(9) provides for the calculation of the amount of investment tax credit that is available to a taxpayer at the end of a particular taxation year. The investment tax credit of a taxpayer includes:

- for taxation years beginning after February 2000 and ending after 2000, 20% of the excess of a taxpayer's SR&ED qualified expenditure pool at the end of the year over the total of all its super-allowance benefit amounts (see ¶ 41) for the year in respect of each province, as well as the total amount of 20% of such excess determined for the 10 previous years or the 3 subsequent years;
- for taxation years that begin after 1995, 20% of the taxpayer's SR&ED qualified expenditure pool (see ¶ 54) at the end of the year, of the 10 previous years, or of the 3 subsequent years; for taxation years that begin before 1996, the specified percentage (see ¶ 53) of the qualified expenditures the taxpayer made in the year, in the 10 previous years, or in the 3 subsequent years; and
- the specified percentage of government assistance, non-government assistance or contract payments that had reduced the amount of qualified expenditures that the taxpayer repaid in the year, in the 10 previous years, or in the 3 subsequent years.

Therefore, investment tax credits may be applied to reduce tax in the year the expenditure or repayment is made, any of the 3 prior years or any of the 10 subsequent years. However, subparagraph 127(5)(a)(ii) prevents an amount of investment tax credit at the end of a particular year from being carried back to a previous taxation year to the extent that the investment tax credit was deductible in the particular year. For taxation years that begin before 1994, the amount of investment tax credit that can reduce the amount of tax otherwise payable is subject to an annual investment tax credit limit that is defined in subsection 127(9). Section 127.1 provides that unused

investment tax credits of certain taxpayers may be refunded in the year the expenditure is incurred (see ¶s 85 to 88).

Subsections 127(27) and 127(29) require a taxpayer to add an amount to the taxpayer's tax payable under Part I in certain circumstances where a SR&ED property has been converted to commercial use or disposed of (without having previously been converted to commercial use) after February 23, 1998. These investment tax credit recapture provisions also apply if the property is incorporated in another property which is converted to commercial use or is disposed of without having been previously converted to commercial use. Generally, subsections 127(27) and 127(29) apply to property acquired in the taxpayer's taxation year, or in any of the 10 preceding taxation years, where the "cost of the particular property", as defined by subsection 127(32), was a qualified expenditure (see ¶ 55) to the taxpayer. This would include expenditures of a capital nature on, or in respect of, SR&ED expenditures (see ¶ 30) and for-shared-use equipment (see ¶ 62).

Subsection 127(27) (or 127(28) for partnerships—see ¶ 94) applies when a percentage (the "ITC percentage") of the cost of the particular property can reasonably be considered to be included in the taxpayer's ITC at the end of the taxation year. The amount to be added to tax payable under Part I is the lesser of

- the amount that can reasonably be considered to be included in computing the taxpayer's ITC in respect of the property, and
- the ITC percentage of either
 - the proceeds of disposition of the property (if the property is disposed of to a person who deals at arm's length with the taxpayer), or
 - the fair market value of the property (in any other case).

Subsection 127(29) applies when all or part of the qualified SR&ED expenditure can reasonably be considered to have been transferred by the taxpayer under subsection 127(13). The amount to be added to tax payable under Part I is the lesser of

- the amount that can reasonably be considered to have been included in computing the transferee's ITC in respect of the qualified SR&ED expenditure that was the subject of the transfer (the "transferred expenditure"), and
- the percentage applied by the transferee in determining its investment tax credit in respect of the transferred expenditure of either
 - the proceeds of disposition of the property (if the property is disposed of to a person who deals at arm's length with the taxpayer), or
 - the fair market value of the property (in any other case),

less any amount that has been added to the taxpayer's tax payable under subsection 127(27) in respect of the property.

Under subsection 127(33), subsections 127(27) and (29) do not apply to a taxpayer who disposes of SR&ED property to a non-arm's length purchaser if the purchaser continues to use the property all or substantially all for SR&ED. However, under subsection 127(34) (and subsection 127(35) for partnerships), non-arm's length purchasers who subsequently resell property acquired from a vendor and in respect of which subsection 127(33) applied, or who convert it to commercial use, will be required to add to their tax otherwise payable under Part I for the year an amount of "recapture" of the ITC similar to the recapture amount described for subsection 127(27).

Specified Percentage

¶ 53. Subparagraph (e)(v) of the definition of "specified percentage" in subsection 127(9) provides for a rate of 20% to be applied to qualified expenditures in respect of SR&ED. Under paragraph (f) of the definition of "specified percentage", the specified percentage applied to repayments of government or non-government assistance that reduced

- the capital cost to a taxpayer of a property under paragraph 127(11.1)(b),
- the amount of a qualified expenditure under paragraph 127(11.1)(c) or (e), or
- the taxpayer's prescribed proxy amount under paragraph 127(11.1)(f)

is the specified percentage that applied in respect of the property, the qualified expenditure or the prescribed proxy amount. For taxation years that begin after 1995, paragraph (f.1) of the definition of "specified percentage" in subsection 127(9) provides for a specified percentage of 20% for repayments of government assistance, non-government assistance or contract payments that have reduced the cost of an expenditure under any of subsections 127(18) to (20).

SR&ED Qualified Expenditure Pool

¶ 54. Subsection 127(9) defines the expression "SR&ED qualified expenditure pool." At the end of a taxpayer's taxation year, it will be equal to the total of the amount of the taxpayer's qualified expenditures incurred in the year, plus the amount of qualified expenditures transferred from a non-arm's length taxpayer under paragraph 127(13)(e), less the amount of qualified expenditures transferred to a non-arm's length taxpayer under paragraph 127(13)(d) (see ¶ 65).

Qualified Expenditures

General

¶ 55. A "qualified expenditure" is defined in subsection 127(9) and includes expenditures of a current or of a capital nature on SR&ED carried on in Canada that are described in paragraph 37(1)(a) or subparagraph 37(1)(b)(i). However, for the purposes of subsections 127(5) to 127(25) and section 127.1, expenditures described in paragraph 37(1)(a) that are unpaid on the day that is 180 days after the end of the

taxation year in which they are incurred are deemed by subsection 127(26) not to be incurred until the time they are actually paid. However, subsection 127(26) does not apply to expenditures that are paid on or before September 18, 1996. A qualified expenditure also includes an expenditure for first or second term shared-use-equipment (see ¶s 61 and 62) as well as a prescribed proxy amount (see ¶ 56). However, as discussed in ¶s 64 to 76, certain provisions may prevent what would otherwise be qualified expenditures from qualifying as such. For taxation years beginning before 1996, under paragraphs 127(11.1)(c) and (e) or, for taxation years that begin after 1995, under subsection 127(11.5), the amount of a qualified expenditure (other than a prescribed proxy amount) made by a taxpayer must be determined without reference to subsections 13(7.1) and 13(7.4). In addition, for taxation years that begin after 1995, under subsection 127(11.5), the amount of a qualified expenditure (other than a prescribed proxy amount) must be determined after the application of subsection 127(11.6). The purpose of these rules is to reduce the amount of an expenditure in respect of the purchase of goods or services from non-arm's length parties by the amount by which the amount of the expenditure for the service, or the capital cost to the taxpayer of the property, exceeds the supplier's "adjusted service cost," or "adjusted selling cost," as the case may be. Subsection 127(11.7) and 127(11.8) give meaning to the expressions "adjusted service cost" and "adjusted selling cost."

Prescribed proxy amount

General

¶ 56. Taxpayers that elect to use the proxy method to determine their expenditures on, or in respect of, SR&ED (see ¶ 23) cannot treat any portion of general overhead expenses as qualified expenditures under paragraph 37(1)(a) because these expenses are not specifically described in subclauses 37(8)(a)(ii)(B)(I) to (VI) and are therefore not expenditures on, or in respect of, SR&ED. However, in lieu of these general overhead expenses, these taxpayers can include as a qualified expenditure an amount referred to as the prescribed proxy amount. The prescribed proxy amount of a taxpayer is a notional amount that is calculated under subsection 2900(4) of the Regulations. The taxpayer does not include this amount in the pool of deductible SR&ED expenditures and does not deduct it when calculating income. It represents the amount of overhead expenditures related to SR&ED and is used to determine the taxpayer's investment tax credits for these overhead expenditures. The actual overhead expenses the prescribed proxy amount represents are ordinary business expenses that may be deducted in the year. Although the prescribed proxy amount is not included in the pool of deductible SR&ED expenditures, any investment tax credit the taxpayer claimed in a previous year that can reasonably be considered to be in respect of a prescribed proxy amount of a previous year will reduce the pool of deductible SR&ED expenditures under paragraph 37(1)(e) as discussed in ¶ 42.

Salary base

¶ 57. Subsection 2900(4) of the Regulations provides that, subject to the overall cap described in ¶ 60, the prescribed proxy amount for a taxation year is 65% of the **salary base**. The salary base is the total of the eligible salaries and wages of the taxpayer's employees who are directly engaged in SR&ED carried on in Canada and that can reasonably be considered to relate to such work having regard to the time spent by the employees on the SR&ED. However, under subsection 2900(9) of the Regulations, the amount of an employee's salaries and wages that the taxpayer can use in determining the salary base cannot include an amount described in section 6 or 7, an amount deemed under subsection 78(4) to have been incurred, remuneration based on profits, or bonuses. In addition, subsections 2900(7) and 2900(8) of the Regulations may further restrict the amount of salaries and wages that the taxpayer can take into account for a "specified employee" (see ¶ 58).

Specified employees

¶ 58. Under subsection 2900(7) of the Regulations, the amount that the taxpayer can include in the salary base for a specified employee (see ¶ 11) is restricted to the lesser of 75% of the specified employee's salary and wages (excluding taxable benefits, remuneration based on profits, and bonuses) and 2.5 times the YMPE (see ¶ 11) for the calendar year in which the taxpayer's taxation year ends prorated for the number of days of employment in the year. There is no proration for the time during the year that the employee is not a specified employee.

Specified employees employed by an associated corporation

¶ 59. Under subsection 2900(8) of the Regulations, if a specified employee of a corporation is also an employee of an associated corporation, the amount of salary and wages that can be included in the salary base of either or both corporations may be restricted further. Subsection 2900(8) of the Regulations restricts the amount of salaries and wages that the taxpayer that is a corporation can include in its salary base for an individual who is a specified employee of the corporation if, in its taxation year ending in a particular calendar year, the corporation is associated with another corporation that has employed the same individual in its taxation year ending in that particular calendar year. The total amount of salary and wages in respect of the employee that can be included in the salary base may not exceed 2.5 times the YMPE and must be shared between the associated corporations. Under subsection 2900(10) of the Regulations, an individual related to a particular corporation is deemed, for the purposes of subsection 2900(8) of the Regulations, to be a corporation associated with the particular corporation. A partnership, any member of which is an individual related to a particular corporation or is a corporation associated with a particular corporation, is also deemed for these purposes to be a corporation associated with the particular corporation under subsection 2900(10) of the Regulations.

Overall cap

¶ 60. The prescribed proxy amount of a taxpayer for a taxation year in respect of a business for which the taxpayer has elected under clause 37(8)(a)(ii)(B) is subject to an overall cap under subsection 2900(6) of the Regulations. The prescribed proxy amount cannot exceed the total of all amounts deducted when calculating the taxpayer's income for the year from the business, other than amounts incurred for an outlay or expense made or incurred for the use of, or the right to use, a building (other than a prescribed special-purpose building) and amounts deducted under sections 20, 24, 26, 30, 32, 37, 66 to 66.8 and 104. If a taxpayer, having elected under clause 37(8)(a)(ii)(B), carries on more than one business, the taxpayer should add the amounts specified under subsection 2900(6) of the Regulations that were deducted when calculating the taxpayer's income for the year from all businesses. Generally, the overall cap will not operate to restrict the prescribed proxy amount if the taxpayer has deducted more than \$65 of non-SR&ED expenses (other than rent in respect of a building, capital cost allowance, interest and financing costs, allowance for doubtful accounts, and all other amounts deductible under section 20) for each \$100 of eligible salary included in the salary base.

Shared-use-equipment*General*

¶ 61. The definition of a "qualified expenditure" in subsection 127(9) includes an expenditure in respect of first term shared-use-equipment and second term shared-use-equipment. For the purposes of the definition of "investment tax credit" in subsection 127(9), the amount of a qualified expenditure in respect of shared-use-equipment, under paragraph 127(11.1)(e) for taxation years that begin before 1996, is equal to $\frac{1}{4}$ of the capital cost of first or second term shared-use-equipment less the amount of any related assistance or contract payment (see ¶ 77). However, for taxation years that begin after 1995, for the purposes of the definition of "qualified expenditure" in subsection 127(9), paragraph 127(11.5)(b) provides that the amount of an expenditure for first or second term shared-use-equipment is deemed to be $\frac{1}{4}$ of the capital cost of the equipment determined as if no amount were added because of section 21, without reference to subsections 13(7.1) and 13(7.4), and after the application of subsection 127(11.6) (see ¶ 55). The reduction of the qualified expenditures under subsections 127(18) to 127(20) (see ¶ 77) for assistance or contract payments for such shared-use-equipment reduces the amount of qualified expenditures under paragraph (h) of the definition of "qualified expenditure" in subsection 127(9).

First and second term shared-use-equipment

¶ 62. First and second term shared-use-equipment are defined in subsection 127(9). First term shared-use-equipment of a taxpayer means depreciable property of the taxpayer (other than prescribed depreciable property—see ¶ 63) acquired after December 2, 1992, that is used by the

taxpayer, during its operating time (see ¶ 31) in the “first period,” primarily (more than 50%) for the prosecution of SR&ED in Canada. The “first period” is the period that starts at the time the property was acquired, and available for use (see ¶ 76), by the taxpayer, and ends at the end of the taxpayer’s first taxation year that occurs at least 12 months after that time. Pursuant to paragraph (c) of the definition of “qualified expenditure” in subsection 127(9) and subparagraph 2902(b)(iii) of the Regulations, property must not have been used, or acquired for use or lease, for any purpose whatever before it was acquired by the taxpayer. Second term shared-use-equipment of a taxpayer means property of the taxpayer that was first term shared-use-equipment and that is used by the taxpayer, during its operating time in the “second period,” primarily (more than 50%) for the prosecution of SR&ED in Canada. The “second period” is the period that starts at the time the property was acquired, and available for use (see ¶ 76), by the taxpayer, and ends at the end of the taxpayer’s first taxation year that occurs at least 24 months after that time. However, both first and second term shared-use-equipment do not include GPOEF (see ¶ 25).

Prescribed depreciable property

¶ 63. Property that is prescribed depreciable property cannot be “first term shared-use-equipment” and therefore not “second term shared-use-equipment”, and consequently does not qualify for investment tax credits. Under subsection 2900(11) of the Regulations, a building or a leasehold interest in a building is a prescribed depreciable property. Also, when a property, or part of a property, is acquired by a taxpayer who intends to use it in the prosecution of SR&ED during the assembly, construction or commissioning of a facility, plant or line for commercial purposes, the property, or part of a property, is a prescribed depreciable property if, at the time it was acquired, the taxpayer or a person related to the taxpayer intended:

- that it would be used during its operating time in its expected useful life primarily for purposes other than SR&ED; or
- that its value would be consumed primarily in work other than SR&ED.

The determination of whether a particular property is a prescribed depreciable property is made at the time the property is acquired. To make this determination, the intended use of the property in the year in which the expenditure was made as well as over its expected useful life must be considered. Although the subsequent use of a property may differ from the taxpayer’s intention at the time the expenditure was made, if the taxpayer can support that, at the time it was acquired, the property was intended to be used primarily for SR&ED work over its expected useful life, the property does not become a prescribed depreciable property.

Exclusions

Expenditures renounced or not filed on prescribed form

¶ 64. Expenditures that are deductible under subsection 37(1), expenditures for shared-use-equipment and prescribed proxy amounts may be prevented from being qualified expenditures for the purposes of the investment tax credit if they are a “prescribed expenditure” described in section 2902 of the Regulations (see ¶s 67 to 74), or an expenditure that has been renounced for the purposes of Part VIII tax as discussed in ¶ 43. In addition, except where subsection 127(11.4) applies, paragraph (e) of the definition of “qualified expenditure” in subsection 127(9) excludes expenditures in respect of which the taxpayer does not file a prescribed form (Form T2038 for individuals and Schedule 31 of the T2 return for corporations) by a certain date. For expenditures incurred in taxation years that begin before 1996, the form must be filed on or before the filing-due date (see ¶ 6) for the year following the year in which the expenditure was incurred. For expenditures that would be incurred in a taxation year that begins after 1995 if the Act were read without reference to subsections 127(26) and 78(4), the form must be filed on or before the day that is 12 months after the taxpayer’s filing-due date for the particular taxation year. However, for taxation years prior to 1997, subsection 127(11.4) provides that this filing requirement does not apply to an expenditure that has been reclassified by the Minister as an expenditure in respect of SR&ED on an assessment of the taxpayer’s tax payable, or on a determination that no tax is payable, by the taxpayer under Part I for the year. For the 1997 and subsequent taxation years, subsection 127(11.4) is repealed and subsection 37(12) deems an expenditure in respect of which the taxpayer has not met the filing requirement in subsection 37(11) not to be an expenditure on, or in respect of, SR&ED. For taxation years that begin after 1995, the exclusion of expenses not filed on a prescribed form by a certain date is provided by paragraph (m) of the definition of “investment tax credit,” in subsection 127(9), and paragraph (e) of the definition of “qualified expenditure” in subsection 127(9) has been repealed.

Expenditures for SR&ED by non-arm’s length performer

¶ 65. For taxation years that begin after 1995, an expenditure (other than an expenditure for salary or wages of an employee of the taxpayer) incurred for SR&ED performed by a person or partnership to which the expenditure is paid or payable and with which the payer is not dealing at arm’s length, is not a qualified expenditure to the payer under paragraph (f) of the definition of “qualified expenditure” in subsection 127(9). In addition, subsection 127(24) prevents taxpayers from using an arm’s length party to circumvent this rule. When a person or partnership (A) contracts with an arm’s length party for the performance of SR&ED, and the SR&ED is then subcontracted by that party to another person or partnership (B) that does not deal at arm’s length with A, and one of the main purposes of the arrangement can reasonably be considered to be to cause the amount paid or

payable by A to be a qualified expenditure, subsection 127(24) deems this amount not to be a qualified expenditure. When this anti-avoidance rule does not apply, and an amount is received for SR&ED from a person or partnership with which the recipient is not dealing at arm's length, the amount received or receivable by the performer in such circumstances will not be a contract payment (see ¶ 78). However, the qualified expenditures that the recipient incurs may be transferred to the payer under subsection 127(13). A partnership may not be a party to such a transfer since under paragraph 127(8)(a) a partnership is not considered to be a person for the purpose of subsection 127(13). To transfer qualified expenditures between non-arm's length taxpayers under subsection 127(13), the two parties must file a joint agreement in accordance with subsection 127(15). However, for the purposes of determining a taxpayer's refundable investment tax credit (see ¶ 86), subsection 127(14) preserves the nature (whether current or capital) of a transferred expenditure. Under paragraph 127(13)(d), the qualified expenditures transferred in a particular year are excluded from the recipient's SR&ED qualified expenditure pool at the end of the year and are included in the payer's SR&ED qualified expenditure pool under paragraph 127(13)(e) for the payer's first taxation year that ends at, or after, the particular year. For a particular taxation year, the recipient can choose to transfer to the payer under paragraph 127(13)(c) the amount that would, if the payer and the recipient were dealing with each other at arm's length (see the current version of IT-419, *Meaning of Arm's Length*), be a contract payment for the performance of SR&ED on behalf of the payer that is paid on, or before, the day that is 180 days after the end of the particular taxation year in respect of either

- a qualified expenditure that the recipient would have incurred in the year (if the Act were read without reference to subsections 127(26) and 78(4)) and paid by the day that is 180 days after the end of the year that is in respect of that portion of the SR&ED that was performed at a time when the recipient did not deal at arm's length with the payer; or
- an amount in respect of the SR&ED added under subsection 127(13) to the recipient's SR&ED qualified expenditure pool at the end of the year.

However, the recipient cannot choose to transfer to the payer more than the amount that the recipient's SR&ED qualified expenditure pool would have been at the end of the year had it not been for this transfer. Should the recipient attempt to do so, subsection 127(13) provides that the amount that can be transferred is nil. Subsection 127(16) provides an anti-avoidance rule that reduces to nil the addition in the payer's SR&ED qualified expenditure pool for the transferred expenditures when the payer and the recipient do not deal at arm's length as a result of a transaction, event or arrangement, or a series of transactions, events or arrangements, the principal purpose of which was to enable the payer and the recipient to enter into the agreement under subsection 127(13).

Non-taxable supplier

¶ 66. Under paragraph (g) of the definition of "qualified expenditure" in subsection 127(9), for taxation years that begin after 1995, an expenditure described in paragraph 37(1)(a), other than an expenditure on SR&ED directly undertaken by the taxpayer, is not a qualified expenditure if it is paid or payable by the taxpayer to, or for the benefit of, a person or partnership that is not a "taxable supplier" in respect of the expenditure. A "taxable supplier" in respect of an amount is defined in subsection 127(9) to include a person resident in Canada or a Canadian partnership. It also includes a non-resident person, and a partnership that is not a Canadian partnership, by which the amount was payable, or by or for whom the amount was receivable, in the course of carrying on a business through a permanent establishment (as defined by regulation) in Canada.

Prescribed expenditures of a current nature

¶ 67. Prescribed expenditures within the meaning of section 2902 of the Regulations are not qualified expenditures and, therefore, do not earn investment tax credits. Prescribed expenditures include expenditures of a current nature incurred by a taxpayer for the general administration or management of a business, including:

- (a) administrative salaries or wages and related benefits for a person whose duties are not all or substantially all directed to the prosecution of SR&ED, except to the extent that such expenditures are directly attributable to the prosecution of SR&ED as determined by subsection 2900(2) or (3) of the Regulations (see ¶s 19 to 21);
- (b) a legal or accounting fee;
- (c) interest and other financing costs described in any of paragraphs 20(1)(c) to (g) of the Act;
- (d) an entertainment expense;
- (e) an advertising or selling expense;
- (f) a convention expense and, after January 11, 1995, a conference expense;
- (g) a due or fee for membership in a scientific or technical society or organization; and
- (h) a fine or penalty.

Prescribed expenditures also include current expenditures for the maintenance and upkeep of premises, facilities or equipment to the extent that such expenditures are not attributable to the prosecution of SR&ED.

¶ 68. A particular expenditure described in ¶ 67 will not be a prescribed expenditure if it is incurred, in taxation years beginning before February 23, 1994, by a taxpayer that derives all or substantially all of its revenue from the prosecution of SR&ED carried on by it (see ¶ 35). For example, under clause 2902(a)(i)(C) of the Regulations, an expenditure for interest made by a taxpayer will normally not be a qualified expenditure for the purposes of subsection 127(5) even if the expenditure is included in the pool of deductible SR&ED expenditures under subsection 37(1).

However, if a taxpayer derives all or substantially all of its revenue from the prosecution of SR&ED, such an expenditure incurred in taxation years beginning before February 23, 1994 will not be prescribed, and the taxpayer may be entitled to an investment tax credit for that expenditure. A taxpayer whose revenue is derived all or substantially all from the prosecution of SR&ED or from the sale of rights in, or arising out of, SR&ED carried on by the taxpayer is hereinafter referred to as a sole-purpose SR&ED performer.

Sole-purpose SR&ED performer

¶ 69. In determining whether a particular taxpayer is a sole-purpose SR&ED performer, consideration is given not only to the taxpayer's revenue in a particular taxation year but also to the pattern established over a number of taxation years. However, such pattern may not be relevant if the taxpayer's operations have changed significantly. In addition, for a start-up operation, the manner in which the taxpayer is proposing to derive its income will be taken into account. Consequently, if a taxpayer intends to manufacture, process and sell a product, or otherwise plans to actively exploit any technology developed, other than through the sale of rights to the product or technology, the taxpayer would not be considered a sole-purpose SR&ED performer.

¶ 70. A taxpayer that qualifies as a sole-purpose SR&ED performer may compromise its status as such if the taxpayer receives significant other income that is not derived from the prosecution of SR&ED or the sale of rights in, or arising out of, SR&ED. For example, interest income that represents a significant portion of a taxpayer's revenues may result in the loss of the taxpayer's status as a sole-purpose SR&ED performer. However, when the interest income is derived from the temporary investment of funds that are to be used in SR&ED work and the funds are spent on qualifying research within a reasonable time, the interest income will generally not result in a loss of such status.

¶ 71. The expenses of a sole-purpose SR&ED performer are not necessarily all qualified SR&ED expenditures. As indicated in ¶ 55, a qualified expenditure (other than a prescribed proxy amount or for shared-use-equipment) as defined in subsection 127(9), must first be deductible under subsection 37(1). Consequently, expenditures incurred by a sole-purpose SR&ED performer for work that does not constitute SR&ED, such as market research or sales promotion, are not qualified expenditures because they are not expenditures on SR&ED.

Prescribed expenditures of a capital nature

¶ 72. Prescribed expenditures also include certain expenditures of a capital nature. An expenditure to acquire property before December 3, 1992, that is neither incurred for, nor is all or substantially all attributable to, the prosecution, or to the provision of premises, facilities or equipment for the prosecution, of SR&ED (see ¶ 38) is a prescribed expenditure. After December 2, 1992, an

expenditure to acquire property is a prescribed expenditure except if it is an expenditure that, at the time it was incurred, was

- for first or second term shared-use-equipment, or
- for the provision of premises, facilities or equipment for the prosecution of SR&ED, and it was intended at that time either
 - that they would be used during all or substantially all of their operating time in their expected useful life in the prosecution of SR&ED in Canada, or
 - that all or substantially all of their value would be consumed in the prosecution of SR&ED in Canada.

Expenditures for the acquisition of qualified property, within the meaning assigned by subsection 127(9), are also prescribed expenditures under subparagraph 2902(b)(ii) of the Regulations. Furthermore, expenditures for the acquisition of property that has been used or acquired for use or lease, for any purpose whatever before the taxpayer acquired it are prescribed expenditures under subparagraph 2902(b)(iii) of the Regulations. To be considered not to have been used, the property must not only be new when the taxpayer acquired it, but it must not have been acquired for use or lease or for any purpose whatever by any previous owner. As a result of these requirements, if a property that has been used or was acquired for a use (even though unused) is transferred to a new owner, eligibility for the investment tax credit is not transferable. However, when a lessor acquires new property which has yet to be leased and then jointly elects under section 16.1 with the first lessee of the property, the property will not be considered to have been used or acquired for use or lease, for any purpose whatever before the lessee acquired the leasehold interest in the property. The cost of a piece of equipment that is used regularly for demonstration purposes is considered to be a prescribed expenditure. However, new equipment that is demonstrated for or tested by a prospective purchaser of that particular piece of equipment would not normally be considered to have been used for a purpose.

Other prescribed expenditures

¶ 73. Expenditures made to acquire rights in, or arising out of, SR&ED and SR&ED expenditures in respect of which an amount is deductible under section 110.1 or 118.1 of the Act are also prescribed expenditures under paragraphs 2902(c) and 2902(d), respectively, of the Regulations.

¶ 74. Under paragraph 2902(e) of the Regulations, an expenditure of a current or of a capital nature is a prescribed expenditure to the extent the taxpayer making the expenditure has received or is entitled to receive a reimbursement for the expenditure from a person resident in Canada other than

- (a) Her Majesty in right of Canada or a province, or an agent thereof;

- (b) a corporation, commission or association that is controlled, directly or indirectly in any manner whatever, by a person described in (a); or
- (c) a municipality in Canada or a municipal or public body performing a function of government in Canada.

In addition, an expenditure for which a taxpayer has received or is entitled to receive a reimbursement from a person that is not resident in Canada will also constitute a prescribed expenditure to the extent that the reimbursement is deductible by the non-resident in computing the non-resident's taxable income earned in Canada for any taxation year. Accordingly, when the non-resident cannot deduct the reimbursement, the related expenditure of the taxpayer is not a prescribed expenditure. Although the determination of whether a taxpayer has received or is entitled to receive a reimbursement is generally a question of fact dependent on the contractual arrangements that exist between the parties, a payment that a taxpayer has received or is entitled to receive under a "fixed-fee" or similar contractual arrangement would not normally constitute a reimbursement. However, a payment under an arrangement that specifically provides for the repayment of a taxpayer's expenditures will generally be a reimbursement.

Expenditures incurred in the course of earning exempt income

¶ 75. The definition of "investment tax credit" in subsection 127(9) also excludes a qualified expenditure made in the course of earning income from a business if any income from that business is exempt from Part I tax. However, such an expenditure is excepted from this rule if it was made before 1992, under a written agreement entered into on or before July 13, 1990, or if it was made for the purpose of completing the construction of property that was under construction by, or on behalf of, the taxpayer on or before July 13, 1990.

Property available for use

¶ 76. For the purposes of sections 127 and 127.1, subsection 127(11.2) provides that an expenditure to acquire property described in subparagraph 37(1)(b)(i) is deemed not to have been made until the property becomes available for use by the taxpayer, determined without reference to paragraphs 13(27)(c) and 13(28)(d). For property acquired and expenditures incurred after February 21, 1994, subsection 127(11.2) will be relevant in applying section 127.1 and subsections 127(5), (7) and (8), and paragraph (a) of the definition of "investment tax credit" in subsection 127(9), and for taxation years that begin after 1995, in applying paragraph (a.1) of that definition. Under subsection 127(11.2), a taxpayer that has acquired first term shared-use-equipment after February 21, 1994, will also be deemed not to have acquired the equipment before it is considered to have become available for use by the taxpayer, determined without reference to paragraphs 13(27)(c) and 13(28)(d).

Government Assistance, Non-Government Assistance and Contract Payments

General

¶ 77. *For taxation years that begin before 1996*

For purposes of calculating a taxpayer's investment tax credit, paragraphs 127(11.1)(c) and (e) specify that the amount of a qualified expenditure, other than a prescribed proxy amount, made by a taxpayer must be determined without reference to subsections 13(7.1) and 13(7.4). However, under paragraph 127(11.1)(c), qualified expenditures in respect of SR&ED must be reduced by the amount of any government assistance, non-government assistance (see ¶ 40) or contract payment (see ¶ 78) that can reasonably be considered to be in respect of the expenditures that, at the time of filing of the taxpayer's tax return for the year in which the expenditures were made, the taxpayer has received, is entitled to receive or can reasonably be expected to receive. Under paragraph 127(11.1)(e), for the purposes of calculating a taxpayer's investment tax credit, the amount of a qualified expenditure for first term shared-use-equipment or for second term shared-use-equipment of the taxpayer shall be deemed to be $\frac{1}{4}$ of the capital cost of the equipment less the amount of any government assistance, non-government assistance or contract payment that can reasonably be considered to be in respect of, or for the acquisition of, the property and that, at the time of filing of the return of income for the taxation year ending coincidentally with the first period, the taxpayer has received, is entitled to receive or can reasonably be expected to receive. Under paragraph 127(11.1)(f), the prescribed proxy amount is deemed to be the prescribed proxy amount otherwise determined minus the amount of any government assistance, non-government assistance or contract payment that is received, is entitled to be received or can reasonably be expected to be received at the time of filing the return of income for the year in which the expenditure was incurred, that can reasonably be considered to be for an expenditure described in subparagraph 37(8)(a)(ii) other than an expenditure described in clause 37(8)(a)(ii)(B). An expenditure described in subparagraph 37(8)(a)(ii) that is not described in clause 37(8)(a)(ii)(B) is an expenditure that would have been included in the pool of deductible SR&ED expenditures instead of being deducted as a normal business expense or included in a prescribed class, if the taxpayer had not elected under clause 37(8)(a)(ii)(B).

For taxation years that begin after 1995

Paragraph (h) of the definition of "qualified expenditure" in subsection 127(9) restricts the amount of an otherwise qualified expenditure by any reduction required under subsections 127(18) to (20). Subsection 127(18) generally reduces the amount of qualified expenditures the taxpayer has otherwise incurred in the year that can reasonably be considered to be in respect of SR&ED, by the amount of government assistance, non-government assistance or contract payments (hereinafter referred to as assistance), whether related to qualified or non-qualified expenditures,

that can reasonably be considered to be in respect of SR&ED that the taxpayer has received, is entitled to receive or can reasonably be expected to receive on or before the taxpayer's filing-due date for the year (see ¶ 6). Furthermore, under subsections 127(19) and (20), the taxpayer's qualified expenditures may also be reduced by an amount of assistance received, receivable, or that can reasonably be expected to be received, in respect of the SR&ED by persons or partnerships with whom the taxpayer is not dealing at arm's length at the time the SR&ED is performed.

Subsection 127(19) applies when the amount of assistance that, on or before their filing-due date for a taxation year, persons or partnerships (the recipient) have received, are entitled to receive or can reasonably expect to receive in respect of SR&ED, and that has not been applied in preceding years under subsections 127(18) to (20), is greater than the total of

- all amounts that would, if subsection 127(18) had not applied, be qualified expenditures in respect of the SR&ED incurred in the year by the recipient; and
- all amounts that would, if subsection 127(19) had not applied, be qualified expenditures in respect of the SR&ED incurred in their taxation year ending in the recipient's taxation year by persons or partnerships who were not dealing at arm's length with the recipient at the time when the SR&ED was performed.

In such cases, subsection 127(19) eliminates the qualified expenditures incurred by the non-arm's length persons in respect of the SR&ED.

When the assistance in respect of SR&ED does not exceed the total qualified expenditures incurred by the taxpayer and persons or partnerships with which the taxpayer is not dealing at arm's length at the time the SR&ED is performed, subsection 127(19) does not usually apply. When this is the case, subsection 127(20) allows members of a related group to agree to allocate between themselves the qualified expenditures reduction resulting from the assistance.

Subsection 127(20) provides that a taxpayer and a person or partnership with whom the taxpayer does not deal at arm's length (the transferee) may, on or before the taxpayer's filing-due date for the year, file an agreement whereby the amount specified in the agreement would reduce the amount of qualified expenditures incurred in respect of the SR&ED by the transferee in the transferee's taxation year that ends in the taxpayer's taxation year to the extent that the SR&ED was performed at a time when the transferee and the taxpayer were not dealing at arm's length. If no allocation under subsection 127(20) is made or if an insufficient amount is allocated, subsection 127(21) may operate to reduce the qualified expenditures of every person or partnership that performed SR&ED at a time when it was not dealing at arm's length with a person or partnership (the recipient) that has received, is entitled to receive or can reasonably expect to receive a particular amount of assistance in respect of the SR&ED. Under subsection 127(21), the lesser of

- the portion of a particular amount of assistance in respect of SR&ED the recipient has received, is entitled to receive or can reasonably expect to receive on or before the recipient's filing-due date for a taxation year and that has not been applied in the year or in previous years under subsections 127(18), (19) or (20), and
- the amount of qualified expenditures a person or partnership has incurred in its taxation year that ends in the recipient's taxation year, in respect of the SR&ED that was performed at a time when the person or partnership is not dealing at arm's length with the recipient

is deemed to be an amount of government assistance received by the person or partnership in respect of the SR&ED.

Subsection 127(18) would then apply to reduce the amount of the person or partnership's qualified expenditures otherwise determined. Subsection 127(21) does not apply if subsection 127(19) applies to the particular amount of assistance in respect of the year. Under subsection 127(22), the agreement under subsection 127(20) would be deemed not to have been filed if it is not filed in prescribed form by the time specified in paragraph 127(22)(b), if it is not accompanied with documents described in paragraph 127(22)(c), or if an agreement amending it has been filed according to subsections 127(20) and 127(22).

Contract payment

¶ 78. A "contract payment," as defined under subsection 127(9), means:

- (a)
 - (i) in a taxation year that begins before 1996, an amount payable after December 20, 1991, for SR&ED to the extent that it can reasonably be considered to have been performed for, or on behalf of, a person entitled to a deduction in respect of the amount because of subparagraph 37(1)(a)(i) or clause 37(1)(a)(ii)(D); or
 - (ii) in a taxation year that begins after 1995, an amount paid or payable to a taxpayer by a "taxable supplier" (see ¶ 66) in respect of the amount for SR&ED performed:
 - for, or on behalf of, a person or partnership entitled to a deduction for the amount under subparagraph 37(1)(a)(i) or (i.1), and
 - at a time when the taxpayer and the person or partnership are dealing at arm's length; or
- (b) an amount (other than a prescribed amount) payable by a Canadian government, municipality or other Canadian public authority or by a person exempt from Part I tax under section 149 for SR&ED to be performed for it or on its behalf.

For the purposes of (b), a prescribed amount is described in section 4606 of the Regulations as an amount received from the Canadian Commercial Corporation in respect of an amount received by that Corporation from a foreign government, foreign municipality or other foreign public authority.

In addition to the above, applicable for taxation years that begin after 1995, subsection 127(25) deems an amount to be a contract payment to a taxpayer who is an SR&ED performer where there is an arrangement between the taxpayer and a person or partnership with whom the taxpayer is dealing at arm's length one of the main purposes of which is to cause an amount not to be a contract payment to the taxpayer by having the amount paid or payable to another person or partnership and received or receivable by the taxpayer from a person or partnership who is not a taxable supplier in respect of the amount.

Repayment of Assistance

¶ 79. Paragraph (e.1) of the definition of “investment tax credit” in subsection 127(9) provides that a taxpayer who repays government assistance, non-government assistance or a contract payment will be entitled to an investment tax credit for the repayment to the extent that the assistance repaid had previously reduced the amount of the taxpayer’s

- capital cost of a property under paragraph 127(11.1)(b),
- qualified expenditures under any of subsections 127(18) to (20) (as discussed in ¶ 77) or,
- for taxation years that began before 1996 (as discussed in ¶ 77), the taxpayer’s
 - qualified expenditures on SR&ED under paragraph 127(11.1)(c), or
 - prescribed proxy amount under paragraph 127(11.1)(f).

Paragraph (e.2) of the definition of “investment tax credit” in subsection 127(9) provides that a taxpayer who repays government assistance, non-government assistance or a contract payment that had reduced the amount of the taxpayer’s qualified expenditure under any of subsections 127(18) to (20) or under paragraph 127(11.1)(e) in respect of first or second term shared-use-equipment will be entitled to an amount of investment tax credit for $\frac{1}{4}$ of the amount repaid. For this purpose, a repayment made by the taxpayer in any taxation year preceding the first taxation year ending coincidentally with the first period or the second period in respect of first term shared-use-equipment or second term shared-use-equipment, respectively, shall be deemed to have been made by the taxpayer in that first taxation year. In addition, subsection 127(10.8) deems the amount of assistance that was applied to reduce the amount of a qualified expenditure that was not received by the taxpayer in a taxation year and that ceased to be an amount that the taxpayer may reasonably expect to receive, to be an amount of assistance repaid by the taxpayer in the year.

Additional Amount for Certain Corporations

General

¶ 80. Under subsection 127(10.1), certain corporations may be entitled to an additional amount of investment tax credit (up to a yearly expenditure limit described in ¶ 81) on its SR&ED qualified expenditure pool, or in taxation years that

begin before 1996, for the qualified expenditures the corporation incurred in the year. For taxation years beginning after February 2000 and ending after 2000, in calculating this additional amount, the SR&ED qualified expenditure pool at the end of the year must be reduced by the taxpayer’s super-allowance benefit amount for the year in respect of a province (see ¶ 41).

The additional amount provided by subsection 127(10.1) increases the effective rate of investment tax credit on the excess of a corporation’s SR&ED qualified expenditure pool over its super-allowance benefit amount for the year to 35%. To qualify for this additional amount for a particular year, a corporation must be a CCPC throughout the taxation year. For taxation years beginning before 1994, the CCPC’s taxable income for its immediately preceding taxation year, together with the taxable income of all corporations with which it is associated in the particular year for their taxation years that ended in the preceding calendar year, cannot exceed the total of the CCPC’s and the associated corporations’ business limits (as determined under section 125) for those preceding years. For taxation years beginning after 1993 and before 1996, the CCPC’s taxable income for its immediately preceding taxation year, together with the taxable income of all corporations with which it is associated in the particular year for their taxation years that ended in the preceding calendar year, cannot exceed twice the total of the CCPC’s and the associated corporations’ business limits (as determined under section 125) for those preceding years. A corporation will not be prevented from qualifying for the additional amount in its first taxation year simply because it did not have an “immediately preceding taxation year.” However, CCPCs carrying on a business in a partnership are not entitled to the additional amount under subsection 127(10.1) for the SR&ED that the partnership performs.

Expenditure limit

¶ 81. Subsection 127(10.2) defines the yearly expenditure limit for the purposes of subsection 127(10.1). The expenditure limit otherwise determined under this subsection may be nil in a taxation year that a corporation is associated with another corporation unless all of the CCPCs that are associated in the year file an agreement in prescribed form allocating the expenditure limit among themselves in accordance with subsection 127(10.3). For a particular taxation year that begins after 1995, the expenditure limit of a corporation that is not associated with another corporation will generally be \$2 million less 10 times the excess, if any, of the corporation’s taxable income in the preceding taxation year over \$200,000. However, this amount will be proportionately reduced to the extent that the corporation’s business limit for the year is less than \$200,000. When the corporation is associated with another corporation in a particular taxation year that begins after 1995, the expenditure limit for the year will generally be \$2 million less 10 times the amount, if any, by which the total of

- the corporation’s taxable income for its last taxation year ending in the preceding calendar year,

and

- the taxable income of corporations with which it is associated in the particular year for their last taxation years ending in the previous calendar year

exceeds \$200,000.

The amount of the expenditure limit will also be proportionately reduced to the extent that the total of the business limits of the corporation and its associated corporations is less than \$200,000. For taxation years that begin after 1996, to determine the expenditure limit of a corporation for a particular taxation year, the taxable income of the corporation for the previous year and of corporations with which it is associated in the particular year for the last taxation year ending in the previous calendar year must be determined before taking into consideration the specified future tax consequences for the year. The expression “specified future tax consequence” is defined in subsection 248(1). For a particular taxation year that begins after 1993 and before 1996, the expenditure limit is \$2 million less 10 times the amount, if any, that the total of the corporation’s taxable income for the previous year and the taxable income of corporations with which it is associated in the particular year for their taxation years ending in the previous calendar year, exceeds \$200,000. In addition, generally, for taxation years ending after June 30, 1994, the amount of a corporation’s business limit for a particular year will be gradually eliminated under subsection 125(5.1) when the corporation had taxable capital employed in Canada for its last taxation year of between \$10 million and \$15 million. However, if the corporation is associated with one or more corporations in the year, the amount of its business limit will be gradually eliminated under subsections 125(5) and (5.1) when the associated corporate group had taxable capital employed in Canada of between \$10 million and \$15 million for their last taxation year ending in the preceding calendar year. However, there are transitional provisions for taxation years that straddle July 1, 1994 which prorate this reduction of the business limit on the basis of the number of days in the taxation year after that date. Consequently, in a particular taxation year that begins after 1995, the expenditure limit of corporations (and of associated corporate groups) whose taxable capital employed in Canada in the previous taxation year (or in the last year ending in the previous calendar year) exceeds \$15 million will be nil. Generally, for taxation years beginning before 1994, the expenditure limit that can be shared among associated corporation is \$2 million.

Short taxation year

¶ 82. Subsection 127(10.6) provides additional rules with respect to the determination of a CCPC’s expenditure limit. In the event a taxpayer’s taxation year is less than 51 weeks, paragraph 127(10.6)(b) provides that the expenditure limit will be prorated on the basis of the number of days in the taxation year. Paragraph 127(10.6)(a) applies if a CCPC has more than one taxation year in the same calendar year and is associated with another CCPC in two or more of these taxation years. Under that paragraph, the expenditure limit of

the CCPC for each taxation year in that calendar year in which it is associated with the other CCPC will be the amount that would have been the CCPC’s share of the expenditure limit for the first such taxation year (had there been only one taxation year in that calendar year) prorated on the basis of the number of days in each short taxation year. For the purpose of determining a CCPC’s expenditure limit under subsection 127(10.2) for a taxation year that begins after 1995, and that is less than 51 weeks, paragraph 127(10.6)(c) provides that its taxable income and business limit for the year will be determined by multiplying those amounts by the ratio that 365 is to the number of days in the year.

Repayments of assistance

¶ 83. Paragraphs (e.1) and (e.2) of the definition of “investment tax credit” in subsection 127(9) provide that a taxpayer making a repayment of government assistance, non-government assistance or a contract payment in a particular year will be entitled to an amount of investment tax credit (calculated at the rate described in paragraph (f) or (f.1) of the definition of “specified percentage” in subsection 127(9)) in the particular year to the extent that the repayment had reduced the amount of the taxpayer’s qualified expenditures in a preceding year, as described in ¶ 77. Under subsection 127(10.7), a taxpayer making such a repayment may be entitled to an additional amount of investment tax credit. The additional amount of investment tax credit added in the year of repayment is equal to the amount to which the taxpayer would have been entitled under subsection 127(10.1) in the preceding year (if the assistance repaid had not reduced the amount of qualified expenditures) less the amount determined under subsection 127(10.1) for the preceding year.

Acquisition of Control

¶ 84. If control of a corporation has been acquired by a person or group of persons, subsections 127(9.1) and (9.2) and paragraphs (j) and (k) of the definition of “investment tax credit” in subsection 127(9) may apply to restrict the availability of the corporation’s investment tax credits. In general, these provisions limit the application of investment tax credits to the tax on the income from a particular business carried on by the corporation before the acquisition of control or any other business substantially all the income of which is from the sale, leasing, rental, or development of properties or the rendering of services similar to those of the particular business carried on by the corporation before the acquisition of control.

Refundable Investment Tax Credits

General

¶ 85. Section 127.1 applies to a taxpayer, other than a person exempt from Part I tax under section 149, who has filed with the taxpayer’s return of income for the year either Form T2038 or Schedule 31 of the T2 return, as appropriate,

containing prescribed information. However, section 127.1 does not apply if the prescribed form is filed with a return of income under subsections 70(2), 104(23), 150(4) or, for taxation years that begin before April 27, 1996, under paragraph 128(2)(e) or, for taxation years that begin after April 26, 1996, under paragraph 128(2)(f). Under section 127.1, the taxpayer is deemed to have paid on account of the taxpayer's tax payable under Part I for the year the lesser of the taxpayer's refundable investment tax credit for the year and the amount designated by the taxpayer on either Form T2038 or Schedule 31 of the T2 return, as appropriate:

- for taxation years that end after February 22, 1994, on the taxpayer's balance-due day for the year as defined in subsection 248(1); or
- on the day on which the return of income or Form T2038 is filed for taxation years that end before February 23, 1994.

¶ 86. "Refundable investment tax credit" of a taxpayer for a taxation year is defined in subsection 127.1(2) as modified by subsection 127.1(2.01). Generally, for a "qualifying corporation" (described in ¶ 87), an individual other than a trust, or a trust each beneficiary of which is either a qualifying corporation or an individual other than a trust, the refundable investment tax credit is 40% of the unclaimed balance of the investment tax credit earned in the current year for qualified expenditures. Furthermore, a qualifying corporation, other than an "excluded corporation" (described in ¶ 87), may generally be refunded any portion of the unclaimed balance of the investment tax credit earned in the year at the effective rate of 35% (see ¶ 80) for its SR&ED expenditures of a current nature and its prescribed proxy amount. In addition, for taxation years beginning after 1993, under subsection 127.1(2.01), a CCPC, other than a qualifying corporation or an excluded corporation, may be refunded

- any portion of the unclaimed balance of the investment tax credit earned in the year at the effective rate of 35% (see ¶ 80) for qualified expenditures of a current nature and its prescribed proxy amount,

and

- 40% of the unclaimed balance of the investment tax credit earned in the year at the effective rate of 35% for qualified expenditures of a capital nature.

Qualifying Corporation and Excluded Corporation

¶ 87. The terms "excluded corporation" and "qualifying corporation" are defined in subsection 127.1(2). A corporation is an excluded corporation if, at any time during the year, it is a corporation that is either controlled (directly or indirectly, in any manner whatever) by, or is related to

- (a) one or more persons exempt from Part I tax under section 149;
- (b) Her Majesty in right of a province, a Canadian municipality or any other public authority; or

(c) any combination of the above.

For taxation years ending after June 1994, to be a qualifying corporation, the corporation must first be a CCPC throughout the year. If the CCPC is associated with another corporation during the particular year, its taxable income for its last taxation year ending in the preceding calendar year and the taxable incomes of corporations with which it is associated in the particular year for their last taxation years ending in the previous calendar year must not exceed the total of the CCPC's and the associated corporations' business limits for those years. However, if the CCPC is not associated with other corporations in the particular year, the CCPC's taxable income in the preceding taxation year must not exceed its business limit for that year for it to be a qualifying corporation. For these purposes, the business limit is generally determined under section 125. However, for taxation years that begin before 1996, the business limit will be determined under section 125 as it read in its application to taxation years that end before July 1994.

In a particular taxation year that begins after 1995, corporations (and associated corporations) whose taxable capital employed in Canada in the previous taxation year (or in the last year ending in the previous calendar year) exceeds \$15 million will not have a business limit (see ¶ 81) and, therefore, will not meet the conditions to be a qualifying corporation. Because they will also have an expenditure limit that is nil (see ¶ 81), they will be prevented from earning refundable ITCs. For taxation years that begin after 1995, to determine whether a CCPC is a qualifying corporation for a particular taxation year, the taxable income of the corporation for the previous year and of corporations with which it is associated in the particular year for the last taxation year ending in the previous calendar year must be determined before taking into consideration the specified future tax consequences for the year. The expression "specified future tax consequence" is defined in subsection 248(1).

For a taxation year ending before July 1994, a "qualifying corporation" is a corporation that is a CCPC throughout the taxation year whose taxable income for the immediately preceding taxation year, together with the taxable incomes of all corporations with which it was associated in the particular year for their taxation years that ended in the preceding calendar year, does not exceed the total of the CCPC's and the associated corporations' business limits (as determined under section 125) for those preceding years.

Reduction of Available Investment Tax Credits

¶ 88. Subsection 127.1(3) deems amounts deemed by subsection 127.1(1) to be paid on account of a taxpayer's Part I tax to be amounts deducted under subsection 127(5). Consequently, such amounts reduce the taxpayer's investment tax credits available for carryback or carryforward.

AMALGAMATION AND WINDING-UP

Continuation of Predecessor Corporations

¶ 89. When there has been an amalgamation of two or more corporations, as defined in section 87 (see the current version of IT-474, *Amalgamations of Canadian Corporations*), paragraph 87(2)(l) provides that the new corporation is deemed, for the purposes of section 37 and Part VIII, to be the same corporation as, and a continuation of, each predecessor corporation. Similarly, when there has been a winding-up of a taxable Canadian corporation to which subsection 88(1) applies (see the current version of IT-488, *Winding-up of 90%-Owned Taxable Canadian Corporations*), paragraph 88(1)(e.2) causes paragraph 87(2)(l) to apply so that the parent corporation is deemed for the purposes of section 37 and Part VIII to be the same corporation as, and a continuation of, its subsidiary.

Capital Cost of Research Property

¶ 90. For the purpose of section 37.1, when there has been an amalgamation of two or more corporations, as defined in section 87, the new corporation's capital cost of a research property acquired from a predecessor corporation is deemed to be equal to the capital cost of the property to the predecessor corporation under subparagraph 87(2)(l.1)(iii). For this purpose, a predecessor corporation includes any corporation that was itself an amalgamated corporation. Subparagraph 87(2)(l.1)(iii), together with subparagraph 87(2)(l.1)(iv), has the effect of deferring any potential recapture of SR&ED allowance as described in ¶ 48. When a subsidiary's research property was acquired by its parent as a result of a winding-up to which subsection 88(1) applies, subsection 37.1(4) deems the property to be research property of the parent and, if the capital cost of the property to the subsidiary exceeds the subsidiary's proceeds of disposition, the capital cost to the parent will be deemed to be the subsidiary's capital cost so that any potential recapture of SR&ED allowance is deferred. For the 1995 and subsequent taxation years, however, section 37.1 has been repealed.

Availability of Investment Tax Credits

¶ 91. Where there has been an amalgamation of two or more corporations, as defined in section 87, paragraph 87(2)(qq) provides that, for the purposes of calculating the investment tax credit of the newly amalgamated corporation at the end of any particular taxation year, the corporation is deemed to be the same corporation as, and a continuation of, any predecessor corporation. For windings-up to which subsection 88(1) applies, paragraph 88(1)(e.3) provides for the flow-through of investment tax credits from a subsidiary corporation to a parent corporation. These provisions allow the amalgamated or parent corporation to claim any unused investment tax credit of predecessor or wound-up subsidiary corporations. Such claims are subject to the time limits

described in the definition of "investment tax credit" in subsection 127(9). Paragraph 88(1)(e.3) also provides that the parent is deemed to be the same corporation as, and a continuation of, the subsidiary for the purposes of the definition of "first term shared-use-equipment" and "second term shared-use-equipment" (see ¶ 61). This provision allows the time periods stipulated in respect of first and second term shared-use-equipment not to be severed as a result of a winding-up to which subsection 88(1) applies.

PARTNERSHIPS

SR&ED Expenditures

¶ 92. In calculating a partner's share of the income or loss of a partnership for a taxation year under subsection 96(1), paragraph 96(1)(e.1) requires that the partnership income for the year be calculated as if the amounts available under subsection 37(1) in its pool of deductible SR&ED expenditures were deducted by the partnership under section 37(1). Consequently, a partnership is unable to carry forward SR&ED expenditures for deduction in a subsequent year. In addition, paragraph 96(1)(g) provides that, in calculating the share of a partnership loss that is deductible by a "specified member" of the partnership for a taxation year, a loss from any source or sources in a particular place must be reduced by any amounts deducted under section 37 in calculating the partnership income from that source or sources in a particular place. For the purposes of paragraph 96(1)(g), the term "specified member" of a partnership in a fiscal period or taxation year is restricted to any member of the partnership who is a "limited partner" as defined in subsection 96(2.4) at any time in the period or year.

¶ 93. If paragraph 96(1)(g) restricts the amount of a partnership loss that a limited partner can deduct, the amount that is not deductible is not allowable to other members of the partnership, does not constitute a "limited partnership loss" (within the meaning of subsection 96(2.1)) for the purposes of subsection 111(1), and does not reduce the amount of the adjusted cost base of the taxpayer's partnership interest.

Allocation of Investment Tax Credits

¶ 94. Subsection 127(8) provides for the allocation of the amount that may reasonably be considered to be a partner's share of the amount of investment tax credit of the partnership to a taxpayer that is a partner at the end of the fiscal period of the partnership. An allocation of investment tax credits is generally considered to be the partner's reasonable share of the investment tax credits if it is made in the same proportion in which the partners have agreed to share any income or loss and if section 103 of the Act is not applicable in respect of the agreement to share such income or loss.

Under subsection 127(28), there will be a reduction in a partnership's SR&ED ITC available for allocation under subsection 127(8) in certain circumstances where an SR&ED property (or a property that incorporates the SR&ED property) has been converted to commercial use, or disposed of without having been previously converted to commercial use, after February 23, 1998. Generally, subsection 127(28) applies to property acquired in the fiscal period of a partnership or in any of the 10 preceding fiscal periods where the "cost of the particular property" (as defined by subsection 127(32)), or the cost of a property that incorporates the particular property, was included in an amount, a percentage of which (the "ITC percentage") can reasonably be considered to have been included in computing the partnership's SR&ED ITC. The amount determined under subsection 127(8) is reduced by the lesser of

- the amount that can reasonably be considered to have been included in respect of the property in computing the amount determined under subsection 127(8) in respect of the partnership; and
- the ITC percentage of either
 - the proceeds of disposition of the property (where the property is disposed of to a person who deals at arm's length with the partnership); or
 - the fair market value of the property (in any other case).

Where, at the end of a taxation year, a taxpayer is a member of a partnership that does not have a large enough balance in the partnership's ITC otherwise available for allocation under subsection 127(8) to offset the ITC recapture required by subsection 127(28) (or subsection 127(35)—see ¶ 52), subsection 127(30) applies to increase the taxpayer's tax payable under Part I for the year by the amount that can reasonably be considered to be that taxpayer's share of the shortfall. Where a taxpayer is a member of a partnership that is itself a member of a partnership, subsection 127(31) provides a rule for allocating any additional tax payable under subsection 127(30) by deeming that additional tax payable to be an amount required by subsection 127(28) to be deducted in computing the amount under section 127(8).

¶ 95. Under paragraph 127(8)(b), an investment tax credit earned by a partnership for a SR&ED expenditure, and for a repayment of government assistance, non-government assistance or a contract payment that reduced the cost of a qualified expenditure on SR&ED under paragraph 127(11.1)(c), paragraph 127(11.1)(f) for taxation years that begin before 1996, or any of subsections 127(18) to 127(20), cannot be allocated to a taxpayer that is a "specified member" of the partnership within the meaning assigned by subsection 248(1). A specified member of a partnership in a fiscal period or taxation year is a member who is a limited partner (as defined in subsection 96(2.4)) of the partnership at any time in the period or year. A specified member can also be any member of the partnership other than a member who on a regular, continuous and substantial basis throughout that part of the period or year during which the

business of the partnership is ordinarily carried on and during which he or she is a member of the partnership is

- (a) actively engaged in those activities of the partnership business other than its financing; or
- (b) carrying on a similar business as that carried on by the partnership in its taxation year, otherwise than as a member of a partnership.

To be considered actively engaged in the activities of a partnership, a partner would normally be expected to contribute time, labour and attention to the business of the partnership to a sufficient extent that such contributions would be a determinant in the successful operation of the business.

¶ 96. Subsection 127(8.3) provides that the amount by which certain of the partnership investment tax credits exceeds the total of the amounts determined under subsections 127(8) and (8.1) to be a limited partner's share of those investment tax credits will be reallocated to partners who were members of the partnership throughout its fiscal period and who were not limited partners during that fiscal period. The investment tax credits that may be reallocated under subsection 127(8.3) include those earned for SR&ED expenditures and, for taxation years that begin after 1995, for the SR&ED qualified expenditure pool, as well as those for repayments of government assistance, non-government assistance or contract payments that reduced the amount of a qualified expenditure other than shared-use-equipment. The amount that may be reallocated to a particular partner that was not a limited partner is the portion that is reasonable in the circumstances considering the partner's investment in the partnership, including debt obligations of the partnership. The provisions of paragraph 127(8)(b) will apply to prevent a specified member that is not a limited partner from adding, in computing that member's investment tax credit for the year under subsection 127(8), any investment tax credits reallocated under subsection 127(8.3) for SR&ED expenditures and, for taxation years that begin after 1995, for the SR&ED qualified expenditure pool, as well as those for repayments of government assistance, non-government assistance or contract payments that reduced the amount of a qualified expenditure other than shared-use-equipment. Furthermore, investment tax credits that, because of paragraph 127(8)(b), cannot be allocated to a partner described in paragraph (b) of the definition "specified member" in subsection 248(1) cannot be reallocated to other partners. As a result, those investment tax credits are not otherwise available for carryforward or carryback. When subsections 127(8) and 127(8.3) require an amount to be included in calculating a partner's investment tax credit for a taxation year, the partner may elect under subsection 127(8.4), in the partner's return of income under Part I for the year, to have any portion of that amount deemed not to have been added in calculating the partner's investment tax credit at the end of the year.

¶ 97. Under subsection 127(12), investment tax credits allocated to a partner under subsection 127(8) that may reasonably be considered to relate to depreciable property are deemed, for the purposes of subsection 13(7.1), to have been received by the partnership, at the end of its fiscal period in which the allocation was made, as assistance from a government for the acquisition of depreciable property. Similarly, under subsection 127(12.1), investment tax credits allocated to a partner under subsection 127(8) that may reasonably be regarded as relating to current expenditures on SR&ED that are qualified expenditures will reduce the total of the current expenditures on SR&ED that may be claimed

by the partnership at the end of the fiscal period in which the allocation was made. In circumstances as described in ¶ 96, when a partner elects under subsection 127(8.4) (that a portion of the investment tax credits that would have otherwise been allocated to that partner be deemed not to have been required under subsection 127(8) to be included in calculating the partner's investment tax credit), the elected portion of the investment tax credit will not reduce the capital cost of depreciable property acquired or the amount of SR&ED expenditures that may be deducted under subsection 37(1) in calculating the partnership income.

APPENDIX – LIST OF CERTAIN “APPROVED” ENTITIES FOR SR&ED PURPOSES

The information in respect of an application for “approved” status for SR&ED purposes and the subsequent granting of approval is considered to be confidential. Generally, the rules under section 241 treat taxpayer information as confidential and do not permit the CCRA to provide information in respect of a taxpayer to another person. Such confidentiality provisions would preclude providing a public list of the entities that have been granted “approved” status. However, subsection 241(5) permits information regarding a taxpayer to be provided to any other person with the consent of the taxpayer.

In response to numerous requests to identify publicly the universities, colleges, associations, research institutes and similar institutions that have been “approved” for the purposes of clauses 37(1)(a)(ii)(A) and (B) and subsection 37(2), the CCRA has published a list of such approved entities that have given their consent pursuant to subsection 241(5). The approval given by the Minister pursuant to the authority granted in subsection 37(7) is based on information provided and representations made by an entity at the time it applies for such approval. Changes in the organization or the activities of an entity may affect its status as an approved entity.

Approved entities **that have consented to be publicly identified** as of June 4, 2003 are as follows:

Alberta Research Council, Edmonton, Alberta

Canadian Arthritis Network, Toronto, Ontario

Centre des technologies du gaz naturel (Québec) Inc., Montréal, Québec

Centre for Cold Ocean Resources Engineering, Memorial University of Newfoundland, St. John’s, Newfoundland

Children’s Hospital of Eastern Ontario (CHEO) Research Institute Trust, Ottawa, Ontario

Field Crop Development Centre, Alberta Ministry of Agriculture, Food and Rural Development, Edmonton, Alberta

Genesis Research Foundation, Toronto, Ontario

*Harvard University, Massachusetts, USA

L’institut de recherche et de développement en agroenvironnement (IRDA; Research and Development Institute for the Agri-Environment), Québec

London Health Sciences Centre Research Inc., London, Ontario

McGill University-Montreal Children’s Hospital Research Institute, Montreal, Quebec

National Research Council of Canada, Ottawa, Ontario

Ottawa Health Research Institute, Ottawa, Ontario

Research Branch, Agriculture and Agri-Food Canada, Ottawa, Ontario

The Arthritis Research Centre Society of Canada, Vancouver, British Columbia

The John P. Robarts Research Institute, London, Ontario

The Lawson Research Institute, London, Ontario

Toronto Hospital Research Institute, Toronto, Ontario

*University of North Dakota, North Dakota, USA

Veterinary Infectious Disease Organization, University of Saskatchewan, Saskatchewan

*for purposes of a deduction under paragraph 37(2)(b)

Bulletin Revisions

Since the issuance of IT-151R5 on October 17, 2000, there have been no revisions to ¶ 1, ¶s 3 to 5, ¶s 8 to 11, ¶s 13 to 18, ¶s 20 to 31, ¶s 34 to 39, ¶s 42 to 50, ¶s 54 to 79, and ¶s 81 to 97.

A reference to Brochure T4052 and the CCRA's Web site providing information on SR&ED was added to ¶ 2. [October 10, 2002]

A reference to Form T4088 was added to ¶ 6. [October 10, 2002]

¶ 7 has been revised to reflect the enactment of paragraph 37(1)(d.1) which reduces the pool of deductible SR&ED expenditures by the super-allowance benefit amount. [October 10, 2002]

¶ 19 has been amended to incorporate the italicized note that was below it since the revision to paragraph 2900(2)(a) of the Regulations has now been enacted. [October 10, 2002]

In ¶ 32 a reference to ¶ 33 and the appendix was added after the words "approved entities". [October 10, 2002]

¶ 40 has been revised to include the discussion of interest-free loans found in former ¶ 41. In addition, the reference to the Ontario Research and Development Super Allowance has been deleted since it is no longer available. [October 10, 2002]

New ¶ 41 has been added to reflect the new definition of "super-allowance benefit amount" in subsection 127(9). [October 10, 2002]

¶ 52 has been changed to include the amendment to paragraph (a.1) of the definition of "investment tax credit" which now requires that the SR&ED qualified expenditure pool be reduced by the "super-allowance benefit amount" for purposes of calculating the ITC. In addition, a sentence has been added to clarify that the ITC recapture rules apply to shared-used-equipment as well as to SR&ED expenditures of a capital nature. [October 10, 2002]

¶ 53 has been revised to delete the reference to Atlantic Canada's higher specified percentage rate of ITC since it has generally not been available since 1993. [October 10, 2002]

¶ 80 has been modified to reflect the amendment to paragraph 127(10.1)(b) which reduces a corporation's SR&ED qualified expenditure pool eligible for the additional ITC rate of 15% by its super-allowance benefit amount. [October 10, 2002]

The new appendix added to the bulletin contains comments on releasing the names of certain approved entities for SR&ED purposes as well as the list of such entities that have consented to be publicly identified. This information was included in the *Income Tax Technical News* No. 23 dated June 18, 2002. [October 10, 2002]

Comments on the granting of approved entity status have been added to the appendix, as well as the name of a recently approved entity. [May 14, 2003]

The name of a recently approved entity was added to the appendix. [July 23, 2003]

Throughout the bulletin, we have made minor changes for clarification and readability purposes and to ensure that certain other information is current.