Written Submission for the Second Phase of the Government of Canada's Consultations on the Review of SR&ED

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Introduction

We are pleased to submit Quantum Industry Canada's (QIC) input for the second phase of the Scientific Research and Experimental Development (SR&ED) program consultations. As the collective voice of Canada's quantum sector, QIC represents nearly 60 organizations ranging from dynamic startups to global leaders, all dedicated to transforming our country's quantum strengths and capabilities into business success and economic prosperity.

In our initial submission, we outlined the critical role that SR&ED plays in supporting our emerging sector. You can find our original submission here. We appreciate the Government of Canada's commitment to engaging with stakeholders and providing us the opportunity to offer further input through this second phase of consultations. Given the significance of the SR&ED program to our industry, these consultations are crucial for ensuring the program effectively supports the innovation and growth necessary for Canada's global leadership in quantum technologies..

The Canadian quantum industry, while nascent, holds immense potential for economic growth and national security. Strategic enhancements to the SR&ED program will be instrumental in fostering this potential, enabling the commercialization of research, and supporting the creation of high-value jobs across the country.

Thank you for considering our recommendations. We look forward to continuing our collaboration with the Government of Canada to strengthen our nation's position as a leader in this transformative field.

Sincerely,

Lisa Lambert

Lisa Lambert
Chief Executive Officer

QUANTUM INDUSTRY CANADA

1. What are some of the challenges faced by research-and-development-performing small- and medium-sized Canadian public corporations when it comes to financing?

Financing is a significant barrier to growth for both private and public corporations involved in research and development (R&D). The challenges vary slightly between public and private entities, but both face substantial hurdles that impede their progress.

Public Corporations:
Public corporations must invest heavily in maintaining an image of growth and potential success to attract investment. This effort often targets non-technical investment analysts, requiring extensive background material and training to convey the company's value proposition. This necessity subjects these companies to the whims of market trends, where certain technologies or application areas become temporarily 'hot,' creating a bubble mentality. The pressure to constantly demonstrate growth and potential can divert focus and resources from actual R&D efforts. There are significant legal and accounting costs to maintain registration which eat up the funds required for R-D and the focus of management.

Private Corporations:
Private corporations, particularly those in the pre-revenue stage and those involved in deeptech or academic research commercialization, face acute cashflow challenges. Securing funding is particularly difficult due to the stringent requirements of most government support programs, such as NRC IRAP, which often demand revenue minimums or significant upfront cash resources. These prerequisites exclude many early-stage, IP-rich but cash-poor companies from accessing much-needed financial support.

Challenges across both sectors:
Financial continuity:

1. Securing funding that spans several years is crucial for allowing a complete innovation ecosystem to grow and reach its full potential. However, funding availability is often influenced by trends, leading to a lack of financial continuity and stability necessary for long-term R&D projects.

SR&ED program:

2. While the SR&ED program is notable for not requiring revenue minimums, it still necessitates significant upfront time and cash investment often necessitating the engagement of consultants to navigate which can reduce the credit's impact by up to 30%. The subjective nature of the application review process by non-expert personnel means that companies must spend money without any guarantee of receiving SR&ED credits. This uncertainty makes the program less effective and discourages calculated risk-taking on valuable IP portfolios.

Revising SR&ED to address these financing challenges (like in ways outlined in Recommendations 1 and 2 of our Phase 1 submission) would foster a more robust and sustainable R&D ecosystem in Canada. Implementing measures that provide critical cashflow and flexibility to innovative Canadian companies during their most vulnerable stages would help lay the foundation for the next generation of companies to support long-term Canadian prosperity.

2. To avoid any potential disincentives to growth, would entrepreneurs favour a program with one single rate accessible to all, even if it means somewhat lower support for small Canadian-controlled private corporations?

While a single rate accessible to all might simplify the process, it does not necessarily improve it in ways that align with the goals of fostering R&D growth and retaining intellectual property within Canada. Here are some considerations:

Support for CCPCs:

- Government funding should be strategically used to promote the growth of Canadian-Controlled Private Corporations (CCPCs). This is essential for retaining intellectual property (IP) and ensuring that the benefits of R&D activities contribute to the Canadian economy. A single rate could potentially dilute the impact on small CCPCs, which are often the most in need of support.

Proportional rates based on need:

- A more effective approach would be to adjust the rate or eligibility criteria based on the specific situation of the company. This could take into account factors such as company size, voting control, and growth stage. By tailoring support proportionally to the need, the program can more effectively target and nurture early-stage, IP-rich companies that require more substantial support to scale and thrive.

Retention of IP and continued growth:

- To bolster the retention of IP and support the continued growth of R&D within Canada, there should be mechanisms in place to encourage Canadian control. For instance, if there is a change of control to a foreign entity, a penalty or repayment mechanism could be implemented. This would ensure that the benefits of government support are maximized within the Canadian context (see Recommendation 5 of our Phase 1 submission).

In summary, while a single rate might seem simpler, it does not address the nuanced needs of different types of companies. A differentiated approach that considers company size, voting control, and growth stage would better support the objectives of developing and retaining IP, promoting Canadian innovation and competitiveness, and fostering long-term economic prosperity.

3. How should the concept of "Canadian" public corporations be defined, should the government proceed with measures to improve access to the SR&ED program's enhanced credit for Canadian public corporations?

To define "Canadian" public corporations for the purpose of enhancing access to the SR&ED program's credits, the following criteria should be considered:

Canadian majority controlling interest:

1. The simplest and most straightforward criterion is to define a Canadian public corporation as one where a majority of controlling interest is held by Canadian citizens or entities. This ensures that decision-making power remains within Canada, aligning the company's interests with national economic goals.

Prioritizing R&D activities in Canada:

2. Beyond ownership, the definition should emphasize the importance of conducting and advancing a significant portion of the company's R&D activities within Canada. By focusing on where the R&D activities are carried out, we ensure that the economic and innovative benefits of the SR&ED program are maximized within Canada.

This dual approach ensures that the benefits of the SR&ED program are directed towards enhancing Canadian innovation and economic growth.

4. The SR&ED program currently has rules to prevent the multiplication of the expenditure limit by Canadian-controlled private corporations with common control. If enhanced support were extended to public corporations, how should relationships among legal entities be delineated?

Companies that are large enough to create multiple entities to exploit additional tax credits typically do not require extra support. To prevent the multiplication of the expenditure limit by public corporations, the following guidelines should be applied:

Apply limits to the controlling parent company:

- Eligibility and expenditure limits should be applied to the controlling parent company rather than to its subsidiaries separately. This approach ensures that the SR&ED support is not multiplied across multiple entities under common control, maintaining the integrity of the program.

Independent entity qualification:

- For an entity to qualify independently for its own SR&ED limit, it should be truly independent, without common control by a larger parent company. This ensures that only entities genuinely in need of support benefit from the enhanced credits.

This approach aligns with the rationale provided in the response to question 3, ensuring that SR&ED support is targeted effectively and prevents misuse by larger corporations with the capacity to create multiple entities.

5. Current global initiatives rely on accounting concepts of relationship and control to determine whether entities are included in a large business corporate group. Should existing international practices of this sort be adapted for determining relations for public corporations in the context of the SR&ED program?

Adapting existing international practices to determine relationships and control within the SR&ED program is essential. This approach ensures that parent corporations and large business groups are subject to a single shared limit on SR&ED credits, thereby distributing the credit more broadly to smaller, independent Canadian-controlled firms and fostering a Canadian economy driven by domestic innovations and technology.

6. What is the optimal size-based metric (e.g., taxable capital employed in Canada, revenue) to phase out enhanced support for public corporations, including those in a corporate group?

The optimal size-based metric for phasing out enhanced support for public corporations should consider multiple factors to accurately reflect the company's capacity and needs:

- Gross revenue: Using gross revenue as a metric ensures that larger companies with substantial income gradually lose enhanced support, redirecting resources to smaller firms that need it more.
- R&D expenditure to revenue ratio: This metric highlights companies that are heavily investing in R&D relative to their size. Companies with a high R&D to revenue ratio demonstrate a commitment to innovation and should retain support longer, promoting continuous development.
- Cash flow: Assessing cash flow provides insight into a company's liquidity and operational efficiency. Companies with strong cash flow are better positioned to self-fund R&D activities and can have their enhanced support phased out sooner, making room for those with more constrained finances.

By integrating these metrics, the SR&ED program can more effectively target support, fostering a balanced and thriving innovation ecosystem.

7. How does refundability under the SR&ED program influence investment decisions and planning? To what degree would Canada become a more competitive location to undertake research and development (R&D), compared to other jurisdictions, if credits earned at the general rate were partially or fully refundable?

Refundability under the SR&ED program significantly influences investment decisions by providing immediate financial relief and enhancing cash flow, which is especially critical for early-stage intellectual property development. If credits earned at the general rate were partially or fully refundable, it would make Canada a more attractive location for R&D activities. This refundability would encourage both Canadian and foreign companies to maintain and expand their R&D efforts within the country, bolstering the retention and development of IP.

Additionally, providing refunds incrementally throughout the year, rather than as a single lump sum after the fact, would further improve cash flow and support continuous innovation (see Recommendation 2 from our Phase 1 submission). Implementing this alongside a "poison pill" repayment mechanism would ensure that SR&ED support drives Canadian innovation and economic growth while maintaining competitiveness on the global stage (see Recommendation 5 from our Phase 1 submission).

8. Would it be preferable that the government make the general rate refundable, but at a reduced rate? What would be an acceptable trade-off in this regard?

Refunds are crucial for small, R&D intensive companies that are not yet profitable, as tax credits would not address their immediate liquidity issues. Reducing the rate could hinder small company R&D unless current inefficiencies in the SR&ED program are addressed, ensuring that any rate reduction has a net-neutral or positive impact.

Given that up to 30% of credits are diverted to SR&ED consultants, there may be room to reduce the refund rate slightly while still increasing overall value if current SR&ED program inefficiencies are addressed. However, if current inefficiencies are not reformed, a rate reduction would be harmful and counterproductive to small companies' R&D efforts.

9. In your view, should SR&ED-eligible activity be broadened from the existing OECD definition of SR&ED, generally used by Canada and other countries offering R&D tax credits? If so, how would you propose to amend the current definition? Why would any additional activities warrant government support?

The current definition of SR&ED is overly complex and often incomprehensible, as highlighted in public training sessions. Broadening the definition to include R&D equipment, patent and IP protection costs, and commercialization and continuous Improvement activities will modernize SR&ED and bolster Canadian innovation and prosperity by supporting the entire lifecycle of R&D activities. This holistic approach ensures that Canadian companies can develop, protect, and

commercialize their innovations domestically, leading to sustainable growth and a stronger national economy.

Additionally, the 'experimental' portion of the definition should be revised to include activities that apply known principles in new areas. This change would promote innovation and productivity enhancement rather than just focusing on high-risk R&D with uncertain payoffs.

While these additions will increase the scope of eligible activities, cost neutrality can be maintained by eliminating support for the largest claimants, as detailed in the responses to questions 4, 5, and 6 (in addition to our Phase 1 submission). SR&ED can and should support a larger number of primarily small Canadian firms conducting innovative R&D activities.

10. Can you provide specific examples of activity that you think should be eligible for the SR&ED program that are not currently eligible? Would such a change bring additional predictability to claimants?

The following (which we included in Recommendation 3 of our Phase 1 submission) should be SR&ED eligible expenses:

- R&D equipment: The purchase and depreciation of specialized laboratory equipment essential for quantum research and development should be eligible for SR&ED credits. This adjustment addresses the high costs and rapid depreciation of specialized equipment in fast-moving sectors like quantum, lowering financial barriers (particularly for SMEs), encouraging further investment, and spurring innovation.
- Patent and IP protection costs: Given the immense value of intellectual property (IP) in tech and deep-tech sectors like quantum, and in light of increasing emphasis on research security, expenses related to patent filings and IP protection, including data security and secure research environments, should be recognized as SR&ED eligible. More specifically, eligible patent and IP protection costs should include prior art searches, patentability assessments, drafting and filing patent applications, and patent protection fees — whether those fees are incurred by internal or external IP professionals. This change is vital to promote IP retention in Canada and to maintain and advance Canada's position among world leaders in the development of critical technologies like quantum that impact the country's national interest.
- Commercialization and continuous improvement activities: Extending eligibility to cover commercialization and continuous improvement activities will support the entire development lifecycle of critical technologies like quantum. This includes market analysis, product validation, product-market fit, and scalability activities that are essential for market adoption, as well as activities aimed at refining technologies post-commercialization to maintain global competitiveness.

Including these activities would enhance predictability for claimants by providing clearer guidelines and a broader scope of eligible activities, thus supporting continuous innovation and commercialization efforts.

11. How could the SR&ED program be enhanced to support businesses conducting R&D in the digital age, particularly in respect of software development and the emergence of artificial intelligence?

The SR&ED program could be enhanced by ensuring that software development and AI and quantum related R&D activities are clearly recognized as eligible. This includes more training and orientation for SR&ED representatives on the nature of R&D in these fields.

The concept of 'experimental' development should be broadened to include high-risk software and AI and quantum projects that do not necessarily require proof of failure to demonstrate their innovative nature. Additionally, providing clearer guidance on eligible software activities and establishing data sets for software R&D would further support businesses in the digital age.

12. To what extent do businesses face financial challenges and trade-offs in protecting their intellectual property (IP) in Canada and abroad? Would it be appropriate for the government to provide additional support to these activities under the SR&ED program? If so, what would be a cost-effective approach?

Many small businesses cannot afford the high cost of patenting and instead rely on trade secrets, which is risky. Providing additional support for IP protection under the SR&ED program is crucial.

There are many potential solutions. One cost-effective approach could be the establishment of a not-for-profit entity that negotiates bulk rates for patent services with major legal firms. In return, this entity could ask for the right to license the technology to other Canadian SMEs or pursue infringers in other countries, sharing proceeds with the original owner. This would reduce the financial burden on small businesses and promote IP retention and commercialization within Canada.