CANADA'S R&D TAX INCENTIVES

PRESENTED BY

Claude E. Jodoin, M.Fisc.

St-Louis
Minneapolis
Chicago

June 10, 11 and 12, 2009

A CANADIAN PERSPECTIVE ON CANADA-US CROSS BORDER TAX ISSUES

- Overview of Applicable Income Tax Rates
- Snapshot of R&D Incentives:
  - Federal Tax Incentives
  - Québec Tax Incentives
  - Ontario Tax Incentives
- Choice of Entity
- Structuring Ideas and Issues

FASKEN MARTINEAU

2009 CORPORATE TAX RATES

	Québec	Ontario	Federal
General Business (non-CCPC)	11.9%	14%	19%
Small Corporations (CCPC only)	8%	5.5%	11%
Investment Income (non-CCPC)	11.9%	14%	19%
Capital Tax	0.24%	0.225%	0%

2009 CORPORATE TAX RATES: OTHER COMMENTS

- Federal: General business rate will be reduced to 18% in 2010, to 16.50% in 2011 and to 15% in 2012;
- In Ontario, income from manufacturing and processing is taxed at a rate of 12% and both the general and M&P rates will be 10% by July 1, 2013;
- In Ontario, the capital tax rate will be reduced to .15% on January 1, 2010 and will be eliminated on July 1, 2010;
- In Ontario, the CCPC rate will be reduced to 4.5% by July 1, 2010;
- Québec capital tax rate will be reduced to .12% in 2010 and will be eliminated in 2011.

SNAPSHOT OF FEDERAL TAX INCENTIVES

- The three main components of the federal incentives in Canada relating to R&D can be summarized as follows:
  - the ability to claim a deduction in computing income for current and capital expenditures incurred in the year;
  - the ability to claim, in addition to the deduction in computing income, a tax credit in respect of most R&D expenditures;
  - the ability to include, as part of one's R&D expenditures for purposes of the R&D tax credit, 65% of R&D salaries on account of overhead and similar expenditures.

FASKEN MARTINEAU

SNAPSHOT OF PROVINCIAL TAX INCENTIVES

QUÉBEC:

- Deduction from income: same as federal
- Tax credit: always refundable
  - CCPC:
    - 37.5% of first $3 million of qualified expenditures
    - 17.5% on excess
  - Non-Canadian controlled: 17.5%
  - Qualifying expenditures**:**
    - Salaries and wages
    - 50% of arm’s length R&D contract cost
  - University Research: 28% of contract cost (need ruling)
- Tax holiday for foreign researchers
  - 5 year provincial tax holiday on salary (100% year 1 and 2, then 75%, 50% and 25%)

SNAPSHOT OF PROVINCIAL TAX INCENTIVES

ONTARIO:

- Harmonized with federal
- Deduction from income: same as federal
- Tax credit:
  - 10% refundable on first $3 million (same criteria as federal except that only 40% of capital expenditure qualify)
  - Other: 4.5% non-refundable on qualifying expenditures (same as federal i.e. salary, equipment, etc.)
  - OBRITC: 20% refundable on first $20 million per year.

CHOICE OF ENTITY

- Corporations vs. Partnerships:
  - Corporations have a separate legal personality, while partnerships do not.
  - Certain entities are "hybrids" in that they are classified differently for US and Canadian tax purposes.
  - For example:
    - Nova Scotia Unlimited Liability Company (NSULC) (British Columbia and Alberta) is considered a corporation for Canadian tax purposes but is treated as a partnership in the US;
    - A US LLC is treated as a corporation for Canadian tax purposes but is treated as either a corporation or partnership in the US.

CHOICE OF ENTITY (Cont'd)

- Jurisdiction of incorporation (federal or provincial)
- Differences:
  - Canadian resident directors (federal and Ontario) (need 25%);
  - ULC (Alberta, British Columbia and Nova Scotia);
  - Minority rights protection;
  - Unanimous Shareholders Agreement.

CHOICE OF ENTITY (Cont'd)

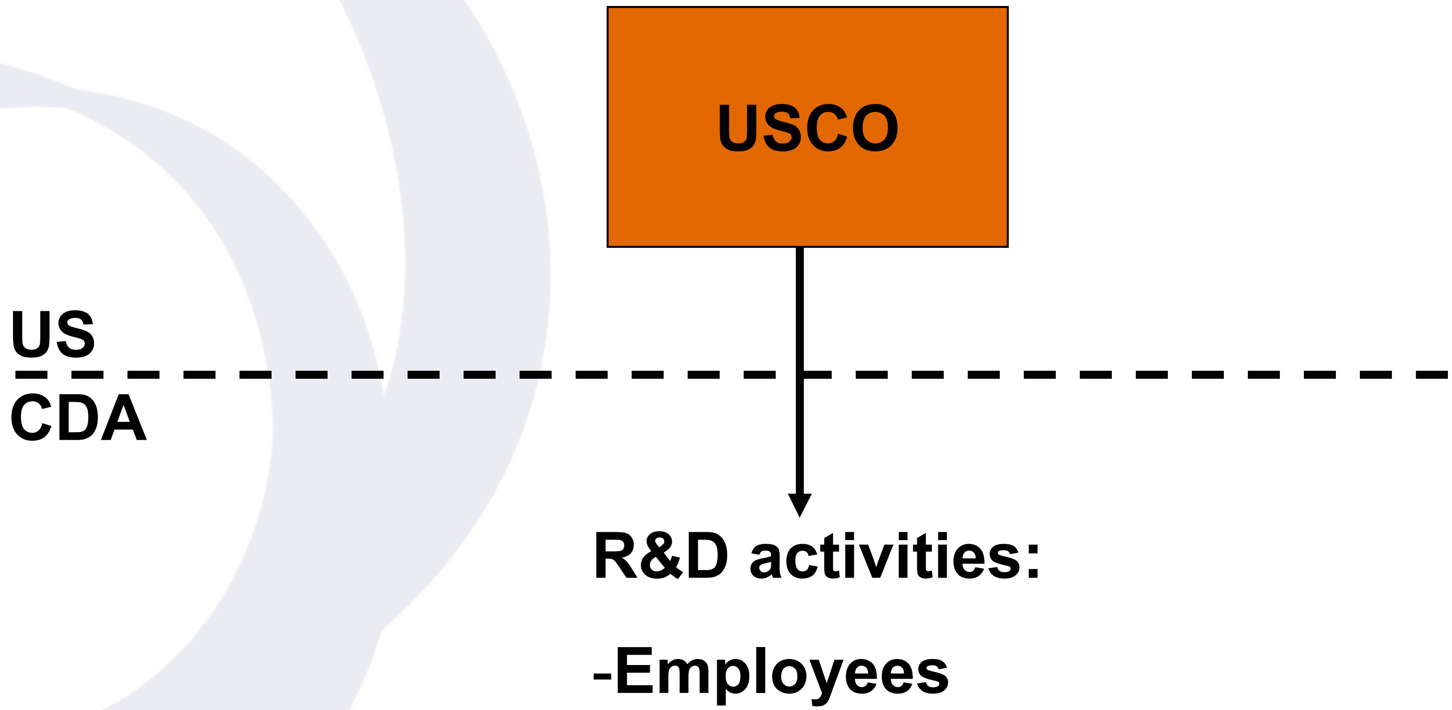
Canadian principles of entity classification

- **Classification of domestic entities**:
  - Depends on the private law characteristics of the entity.
- **Classification of foreign entities**:
  - For Canadian tax law purposes classification of foreign entities is based on the criteria applied to domestic entities.
  - For tax treaty benefit purposes, the trend has been to consider the characterization of the entity in the state of fiscal residence (this was not always so)

CHOICE OF ENTITY (Cont'd)

ENTITY	Canadian classification	Default US classification (elective)	Treaty benefit entitlement (if CTB)
C Corporation	Corporation	Corporation	YES
S Corporation	Corporation	Flow Through	YES (Canada)
LLC (separate person)	Corporation	Partnership (Corporation)	Possible
LLP (separate person)	Partnership	Partnership (Corporation)	NO (Subject to look through) (NO)
Partnership	Partnership	Partnership	NO (Subject to look through)

1. USCO CARRIES OUT R&D DIRECTLY



USCO CARRIES OUT R&D DIRECTLY (Cont'd)

- USCo must carry on business in Canada
- Gets 20% federal credit on all R&D expenses in Canada
- Gets provincial credit of 17.5% on R&D salaries (in Québec) or 4.5% of all R&D expenses in Ontario

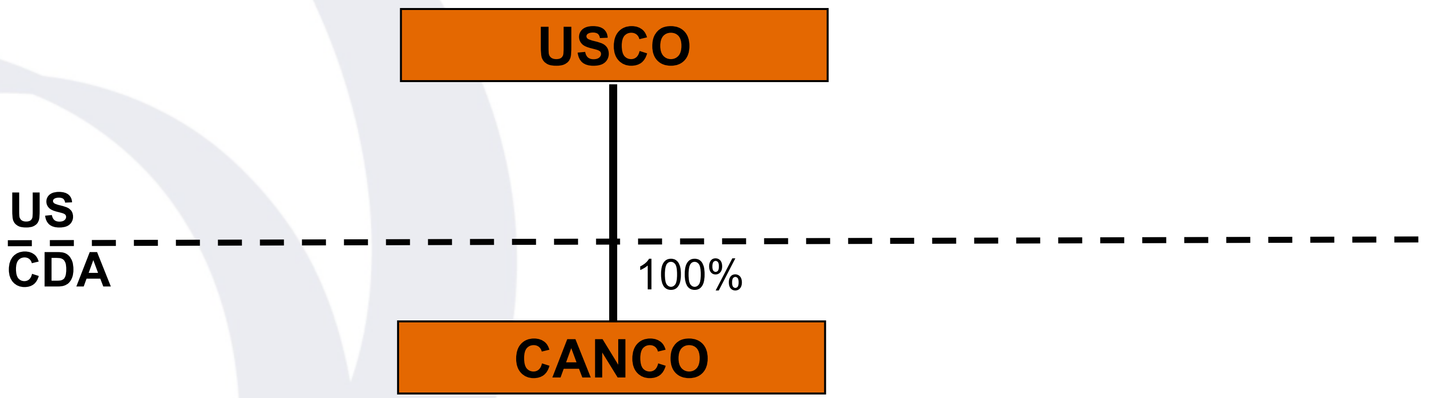
Example of benefit:

R&D expenses: $1,000,000 ($800,000 salaries/$200,000 equipment)

The Canadian Tax Advantage
Net Cost of R&D in 2009

		Federal	Québec	Federal	Ontario
A.	Expenditures for R&D equipment	$200,000	$200,000	$200,000	$200,000
B.	R&D salaries	$800,000	$800,000	$800,000	$800,000
C.	Proxy Amount (65% of B) (overhead):	$520,000	-----	$520,000	$520,000
D.	Tax credit	$276,000	$140,000	$290,320	$68,400
E.	Tax savings	$110,960	$86,156	$121,843	$89,779
F.	**Net cost to the corporation**	**$386,884**		**$429,658**	

2. USCO HAS A CANADIAN SUBSIDIARY TO CARRY OUT R&D

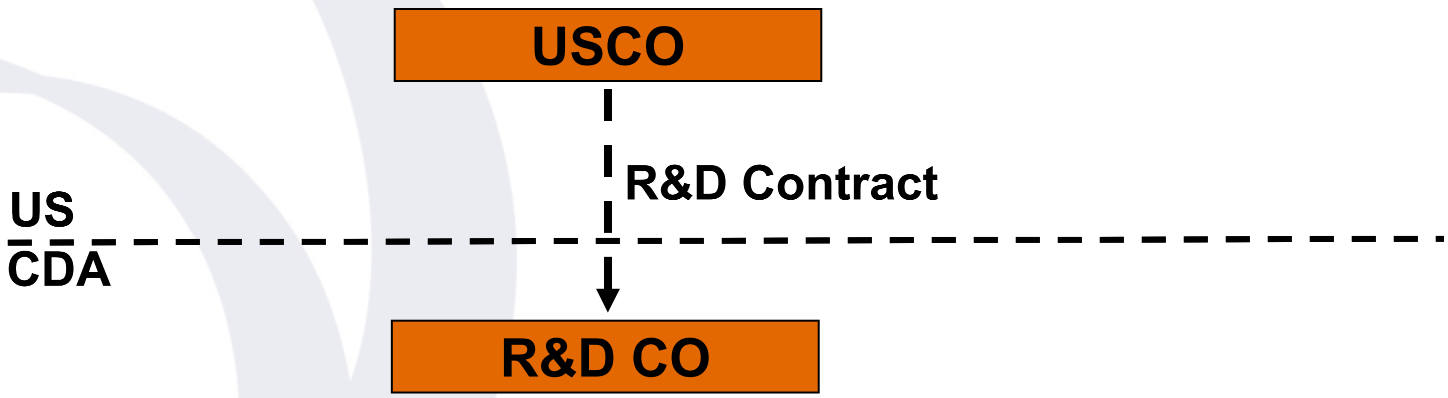


- Canco is a subsidiary of USCo
- Canco carries out R&D in Canada (either itself or under contract for USCo)

COMMENT:

- If Canco carries out R&D for USCo:
  - USCo owns the IP from the R&D
  - Canco gets federal 20% tax credit (and provincial tax credit)
- If Canco carries out R&D for itself: owns the IP (may be licensed from/to USCo)

3. USCO CONTRACTS FOR R&D WITH A CCPC



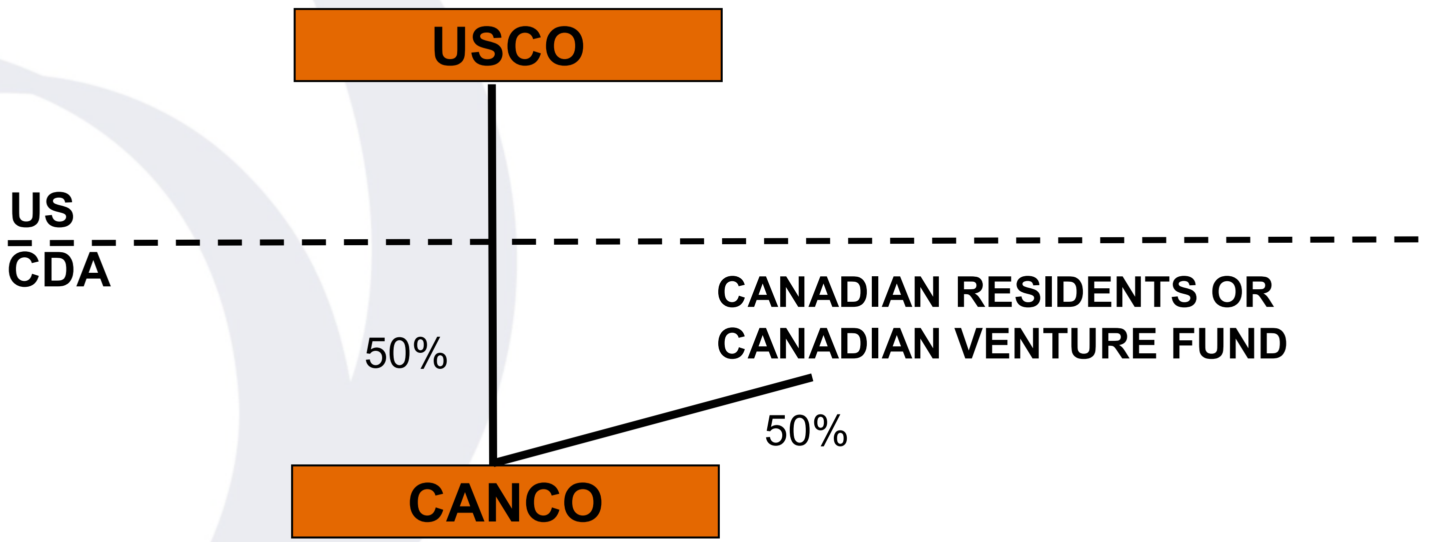
- US Opco does not carry on business in Canada
- R&D Co is a CCPC that carries out R&D for US Opco at a price less tax incentives (and thus passes on the incentives)

NET COST TO SUBCONTRACT TO A CCPC

	QUÉBEC	ONTARIO
Provincial Tax Credit	$300,000	$202,100
Federal Tax Credit	$427,000	$461,265
TOTAL CREDIT	**$727,000**	**$663,365**
Net Cost before income taxes	$273,000	$336,635

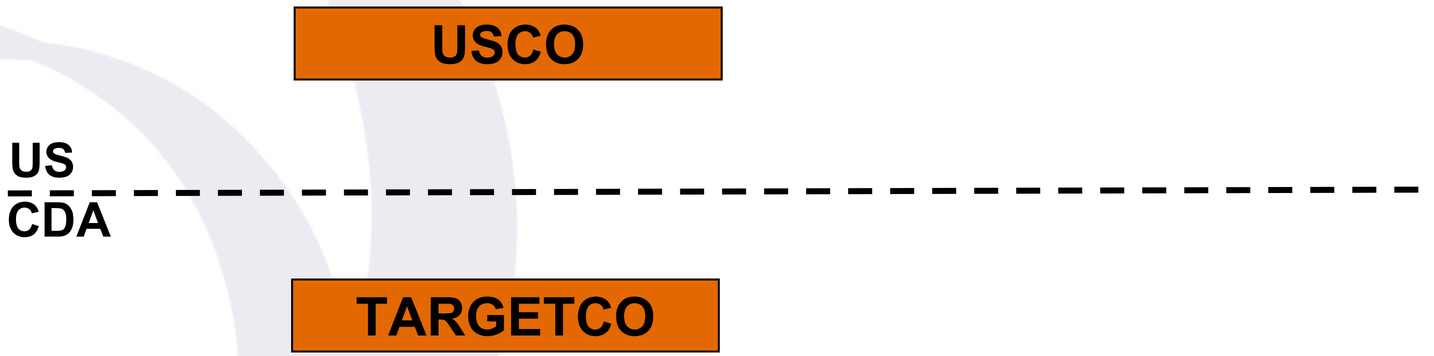
- Contract cost: $1 million
- R&D Expenses: Salaries: $800,000
  Equipment: $200,000

4. USCO HAS A CCPC CARRY OUT R&D



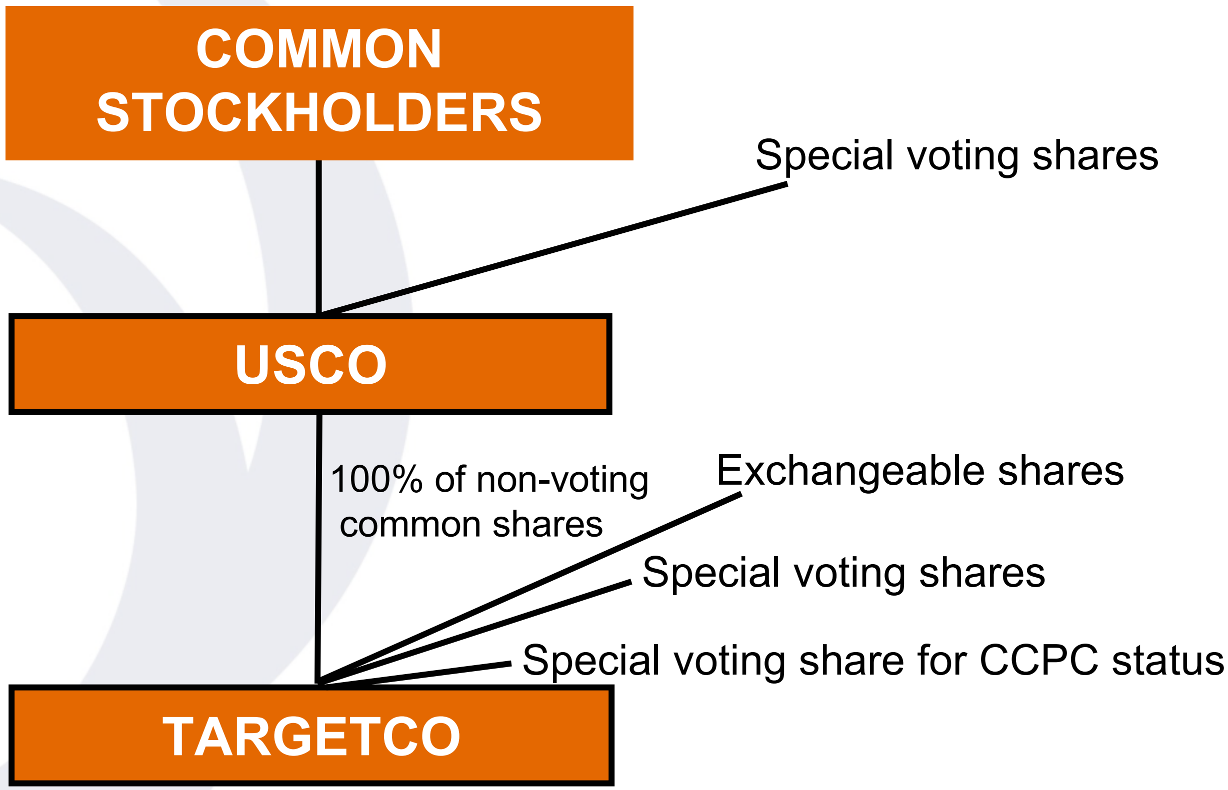
- Canco carries out R&D in Canada
- Caveat: *de facto* control?
- Definition of CCPC: not controlled by non-resident and/or public company

5. ACQUISITION BY USCO OF CANADIAN TARGET



- Classic Dilemma:
  - USCo wants to acquire shares of TargetCo and pay in stock of USCo
  - Canadian tax rules do not allow rollover/deferral treatment where transfers are made to non-resident companies
  - Outright purchase will disqualify Target from retaining CCPC status for R&D incentives

SOLUTION: EXCHANGEABLE SHARE STRUCTURE



- Special voting shares at USCo level provides existing shareholder of TargetCo with votes they would have upon an exchange
- Exchangeable shares: are shares that can be exchanged for shares of USCo at a fixed exchange ratio
- Special voting shares of TargetCo ensure:
  - Maintaining CCPC status for TargetCo
  - That USCo has a say in management of TargetCo

FASKEN MARTINEAU

Biography

Claude E. Jodoin is a firm partner who specializes in tax law, and has developed an expertise in business financing, financial instruments, the purchase and sale of businesses, corporate reorganizations, including cross-border acquisition transactions involving the issuance of exchangeable shares. His vast experience is regularly sought in major files involving large public issues of securities on behalf of financial institutions, the establishment of complex financial structures and the reorganization of important national and international public and private corporations. Mr. Jodoin works closely with corporations involved in the high technology and biotechnology sectors, developing structures to benefit from scientific research and experimental development tax incentives. Within the course of his practice, he has also been called upon to represent clients before Revenue Québec, the Canada Revenue Agency and the Canada Border Services Agency. Some of his interventions have led to legislative or regulatory amendments.

Finally, he has, since 1991, been actively involved in goods and services tax (and provincial retail sales tax) matters, having been both an author and presenter of numerous articles and conferences, and mentioned as an authority in these matters. He is also recognized as one of Canada's best Tax Law lawyers in The Best Lawyers in Canada (2008 edition).

Direct Line: **(514) 397-7489**

Email: **cjodoin@fasken.com**

Full Biography

Thank you!

FASKEN MARTINEAU

www.fasken.com