



## Ontario R&D companies face difficult decisions Seeing beyond the numbers...

As you have probably learned by now, the Ontario and Federal corporate tax regimes will be harmonized for taxation years ending after December 31, 2008. While one of the main reasons for this change is to simplify the tax regime for Ontario corporations, it can complicate tax planning for all Ontario corporations, but no more so than for owner managed R&D companies.

### Harmonization transitional rules

Ontario and Federal tax attributes can vary from one and other, and as a result, the harmonization of the two tax regimes needed to include rules to cover such scenarios. Transitional provisions were passed into law by which Ontario tax attributes are written up or down to their federal counterparts. A transitional credit (Ontario attributes exceed Federal attributes) or debit (Federal attributes exceed Ontario attributes) is created to even out the taxpayer's situation. This balance is either deducted or added to the Ontario income taxes payable over the next 5 years. The intention is that the taxpayer is not penalized nor rewarded due to the harmonization.

While the average Ontario Corporation will have a small transitional debit or credit balance, R&D companies may find themselves with large balances due to significant differences between their Federal and Ontario R&D pools.

### Transitional credits vs. R&D tax credits

The law introduced has taken into consideration the potential scenario of taxpayers being burdened by large

transitional debit balances and provided the possibility for corporations to elect to defer a portion (or all) of the additional taxes that would be payable. This election must be made in writing for the corporation's first taxation year ending after December 31, 2008. However, no provision exists to consider the reverse scenario where companies have a large transitional credit balance.

Take for example an R&D company with a two million dollars balance in their Ontario R&D pool, and a nil balance in their Federal pool. All other tax attributes being equal, a transitional credit of \$280,000 would be generated. This credit is non-refundable and must be used by the taxpayer within 5 years, or it will be lost.

A common approach used by a number of owner managed companies, especially R&D companies, is to bonus down to the small business deduction level (currently \$400,000). This avoids the payment of higher rates of tax, and also avoids a "grind" of the eligible expenditure limit. This grind effectively reduces the investment tax credits received on R&D expenditures from 35% to 20% and transforms the investment tax credits into a non-refundable tax credit. In addition, the Ontario Innovation Tax Credit can be lost (10% refundable credit).

The challenge facing R&D companies is that at the \$400,000 income level, they can only apply \$22,000 of the transitional credit, as this is the extent of Ontario taxes payable (corporate minimum tax not considered for purposes of example). Over a five year span, the total use of the transitional credit would be \$110,000 based on current legislation. Based on previous

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example, this would leave \$170,000 in the transitional credit which would go unused and would be lost.

## To bonus or not to bonus

Let's face it, no one likes missing out on tax credits. So what can be done to avoid this loss of credits? The only solution is to increase income in order to increase the taxes payable. This may or may not be achievable for some companies. For those who can increase their income, either by reducing bonus amounts, decreasing discretionary deductions or other creative tax approaches, the increase in income will provide the opportunity to access these credits.

That being said, the impact on the R&D claim must be taken into consideration before making a final decision on an approach in order to maximize the value to the corporation. As outlined above, leaving income in excess of the small business deduction can impact the total investment tax credits received and their refund ability. The use of the transitional credits must be weighed against the potential loss of R&D credits and loss of cash inflows from the R&D refund, both of which might be vital to a company's operations.

## R&D non-refundable credits

You might think that the above scenario will only apply to a select few and that you need not worry about it as your company is not sitting on a large transitional credit. However, the extent of the above issue is compounded by the Ontario non-refundable credits which have been introduced as part of the harmonization process.

Previously, the federal investment tax credits earned on eligible R&D expenditures were taxable for federal tax purposes but not for Ontario purposes. Due to harmonization, the taxability of federal investment tax credits for Federal and Ontario purposes must be identical. As a result, the government of Ontario, wanting to compensate R&D taxpayers for the new taxability of the federal ITCs, introduced a non-refundable tax credit equal to 4.5% of eligible R&D expenditures. This credit can be carried forward 20 years.

Consider a company which incurs \$1,000,000 in eligible R&D expenditures every year. They would receive a non-refundable credit of \$45,000 on an annual basis. Once again, based on taxable income of \$400,000, they can only utilize \$22,000 of the non-refundable credits. The result is that after a 20 year period, the unused balance of R&D credits will total \$460,000: significant credits that no corporate taxpayer will want to lose.

## What to do?

Unfortunately, there are no magical and universal solutions for R&D companies. Given all the variables involved, each company will be required to evaluate their circumstances and evaluate what is best for them given their specific situation. Letting the credits lapse or leaving large sums of income every few years are but a few of the options that will need to be evaluated. This brief article only scratches the surface of the issues facing R&D companies, but one thing is certain: careful planning must be undertaken in anticipation of this change in law to ensure optimal use of all the credits available. With such a short window of opportunity to use up the transitional credits, the time to act is now as implementation of a plan of attack may take a few years. Your Collins Barrow advisor would be pleased to help you plan out this approach.

## Our Team Members are:

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