

Research and development in the BRICS

Global R&D Tax News

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Welcome

Welcome to our April issue of PwC's Global R&D Tax News.

Competition for innovation has been significantly driven by changes to political systems around the globe. This quarterly issue addresses the growing R&D tax incentives in the "BRICS," in addition to some recently proposed changes in other regimes and other updates.

The BRICS (Brazil, Russia, India, China, and South Africa) are the fastest growing and largest emerging market economies and contribute a major part of world GDP growth. In February of this year, the Organisation for Economic Co-operation and Development's (OECD) Working Party of National Experts on Science and Technology Indicators issued a report on "Measuring R&D in Developing Countries." The report is an annex to the Frascati manual, and focused on the BRICS, specifically to address the gaps that other practice guides have not filled in relation to R&D activities in Africa, Central and

South Asia, and Latin America and the Caribbean. As these emerging economies represent a "threat" to the developed economies of North America and Europe in terms of innovation, the annex addresses a variety of issues such as:

- Measurement of R&D expenditure
- Measurement of R&D personnel
- Specific fields of R&D activity
- Foreign and internationally controlled entities
- Other sectoral classification issues
- Strengthening R&D statistical systems.

In this issue of Global R&D Tax News, PwC teams from Brazil, Russia, India, China, and South Africa provide highlights of each of their respective R&D regimes. As you compare these R&D tax incentives with those countries that have more mature systems in place, you will see similarities, and also unique ways incentives have been designed to attract investment and spur innovation.

In addition, PwC China's Indirect Tax Leader, Alan Wu, takes a closer look at Value Added Tax (VAT) reform and the impact on R&D in China. As of 1 January 2012, a selected number of businesses and industries became the first participants in the China VAT pilot program. The reforms are expected to be rolled out in the future.

Finally, some recent developments from Canada reflect the government's efforts to meet budget deficits by reducing the rate and simplifying the administration of the Scientific Research and Experimental Development (SR&ED) Tax Credit.

I hope you find this issue informative and encourage you to visit us on the web by clicking [here](#).

If you have any thoughts or comments on any of the topics covered, please contact me or any of country contacts listed at the end of this issue.



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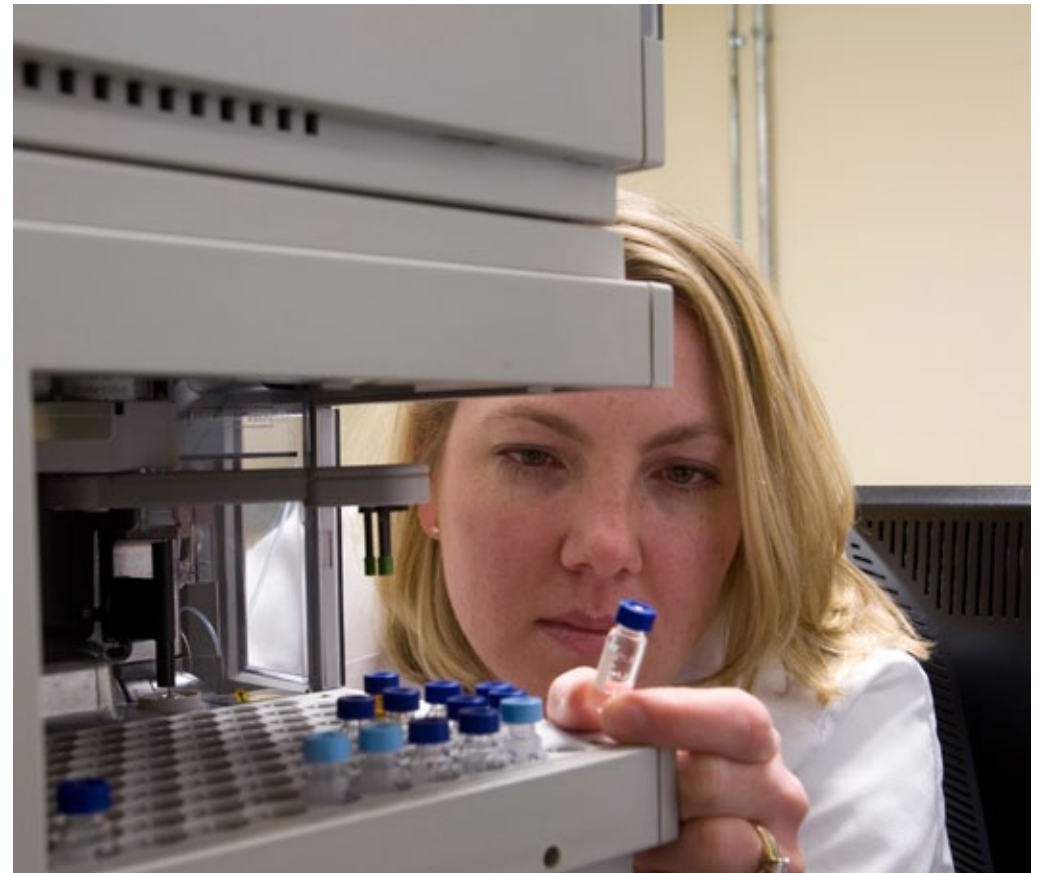
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Brazil

The main tax incentives applicable to companies that invest in R&D in Brazil are provided in Law No. 11.196 of November 21, 2005, known as the “Lei do Bem” or “Tax Benefits Act,” and are implemented by Decree No. 5.798 of June 7, 2006. Articles 17 to 26 of the Law 11.196/2005 consolidate a set of automatic tax incentives for companies that conduct technological innovation activities.

Concept of technological innovation

The Tax Benefits Act defines technological innovation as (1) the conception of a new product or manufacturing process or (2) the addition of new functionalities or characteristics to an existing product or process, as long as this addition constitutes incremental improvement leading to improved quality or productivity and, consequently, greater competitiveness. A project does not need to be innovative to the sector; however, it must represent a new development for the taxpayer.



Brazil

Continued

Income tax incentives

The main incentive provided to taxpayers that conduct technological innovation activities is an additional 60% deduction for purposes of calculating their corporate income tax liabilities (Imposto de Renda de Pessoa Jurídica or IRPJ, at 25%) and the calculation base of the social contribution on net profits (Contribuição Social sobre o Lucro Líquido or CSLL, at 9%). If the taxpayer increases the amount of research by up to 5% in a given year, the additional deduction increases to 70%; if it increases more than 5% in a given year, the additional deduction increases to 80% of the qualified expenses. In addition, an extra 20% deduction is available on the expenses of developing any innovation that is later patented; however, the extra 20% deduction is only valid once the patent is issued.

The 60% to 100% deduction is in addition to a regular 100% deduction in the year of acquisition of new assets used in R&D. Consequently, taxpayers are able to obtain a super deduction equal to 160% to 200% of qualifying expenses.

A significant limitation of this incentive is that it can be used only in the year for which the R&D spending is incurred. If an eligible company has no real profits in that particular year or if its profits are insufficient for deducting all R&D expenses, the nondeductible portion of expenses cannot be used.

Accelerated amortization of intangibles

Expenditures related to the purchase of intangible assets that will be used exclusively in R&D activities may be fully amortized during the assessment period in which they are made.

Excise tax

A direct deduction of 50% of the Excise Tax (Imposto sobre Produtos Industrializados or IPI) may be claimed on equipment, machinery and instruments, accessories, and parts and tools used in R&D activities. This deduction is made directly on the purchase and therefore increases cash flow.

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Russia

R&D expenses that are incurred by a taxpayer independently or with other entities (to the extent of its share in those joint expenses), or that are based on an agreement in which the taxpayer acts as the beneficiary of the R&D activities, are deductible for corporate tax purposes after the R&D activities or their phases are completed and the parties sign an order confirming the completion and approval of the activities.

A taxpayer may deduct productive R&D expenses if the results of those R&D activities are used in the production or sale of goods (or performance of works or provision of services). Those expenses are deductible in equal parts during a period of one year beginning the month after the month that the R&D activities or their phases are completed. A taxpayer also may deduct in equal parts during a period of one year the R&D expenses that did not produce positive results, subject to compliance with the Tax Code.

Taxpayers conducting R&D activities included on the Russian government's list (the list was updated and expanded by Russian Government Resolution No. 96 of 6 February 2012) are entitled to a deduction using a coefficient of 1.5. In addition, certain goods, works, and services are exempt from the 18% Russian VAT, including exclusive rights over inventions, useful models, designs, software, topography of integral circuits, know-how, and the rights to use such intellectual property under a license.

Changes effective January 1, 2012

On June 7, 2011, Russian President Dmitry Medvedev signed Federal Law No. 132-FZ, which introduces several significant changes in tax rules with respect to R&D, including a new procedure for recognition of R&D expenses for tax purposes. Law No. 132-FZ's new rules took effect on January 1, 2012.



Russia

Continued

Law No. 132-FZ establishes an explicit list of R&D expense items that can be recognized as such for tax purposes, including:

- depreciation of fixed and intangible assets used for R&D;
- payments relating to employees engaged in R&D activities;
- the costs of materials, energy, fuel, and water acquired for the performance of R&D activity; and
- the cost of R&D work performed by third parties.

Other expenses directly connected with R&D may be deducted in the amount of 75% of the payroll of employees involved in R&D.

Under Law No.132-FZ, taxpayers that conduct R&D activities included in the Russian government's list and that recognize the relevant R&D expenses using the 1.5 multiplier must submit a special R&D completion report to the tax authorities. This report is submitted together with the final tax return for the relevant tax period when the R&D work (work stage) was completed. If a taxpayer fails to file an R&D completion report, R&D expenses are recognized for tax purposes only in the cost amounts incurred.

Law No.132-FZ also inserts a new article into the Tax Code entitling taxpayers to set up a provision for future R&D expenses. A provision for implementing each approved R&D program may be set up for a period of no more than two years.

The size of the established provision cannot exceed the size of planned expenses (budget estimate) for implementing an R&D program that has been approved by the relevant taxpayer. Law No.132-FZ provides a formula for calculating the maximum size of provision contributions. Expenses incurred are written off using the provision. If the amount of the established provision is less than the amount of actual expenses, the difference is additionally deducted as an expense.

The amount of a provision that was not completely used by the taxpayer within the period of the provision's creation is included in the non-sale income of the reporting (tax) period when the relevant contributions to the provision were made.

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India

Overview

Over the years, India has emerged as a destination of choice for a number of multinational corporations making investments into the country. Specifically, India continues to develop its position in the region as a destination for R&D activity.

India's demographic advantage in the availability of skilled manpower has spurred technological capabilities in the country and in turn has continued to attract investments. Moreover, the Indian Government over the past two decades has offered, and continues to offer, preferential tax treatment for spends on in-country R&D activity in various forms.

Expenditure-based incentives

Indian tax law permits taxpayers to claim a tax deduction of scientific R&D expenditures, subject to the following conditions:

- One hundred percent (100%) deduction for revenue and capital expenditures (other than cost of land) on scientific research activity.
 - Revenue expenditures on scientific research activity related to the business incurred up to three years prior to commencement of business, deductible in the year of commencement.
 - One hundred seventy five percent (175%) deduction for any sum paid to specified research institutions, 125% deduction for any sum paid to scientific research companies recognized by the prescribed authority, and 125% deduction for any sum paid to a specified research association for research in social science or statistical research.
- Two hundred percent (200%) weighted deduction to companies (other than those engaged in manufacturing of certain restricted items such as beer, wine, tobacco, etc.) for capital and revenue expenses (excluding cost of land and building) for approved "in-house R&D" expenditures for units recognized by the Department of Scientific and Industrial Research (DSIR). The R&D expenditures should be incurred for the company's "own" business and supported by manufacturing operations. Although the deduction was scheduled to expire on March 31, 2012, the Indian Government has announced its intention to extend this benefit till March 31, 2017 in the annual budget proposals for 2012. This proposal will be effective once passed by both Houses of Parliament and upon receiving Presidential assent (likely in May 2012).

Export-based incentives

Indian tax law provides for a tax holiday in respect of export of services (including research services), subject to certain conditions. In general, the following key regimes exist in this regard:

- Special Economic Zone (SEZ) regime
 - An entrepreneur can set up its unit in an SEZ and benefit from a 100% tax holiday for the first five years, followed by a 50% tax holiday for the next five years, and further followed by a 50% tax holiday for an additional period of five years, subject to certain conditions. The tax holiday applies to export profits, including profit from export services such as R&D. However, SEZ units are liable to pay minimum alternate tax at the rate of approximately 19.5%, although this is creditable over a subsequent 10-year period when the entity starts paying regular income taxes under the normal regime.

India

Continued

- The draft Direct Tax Code (DTC) proposed by the Indian Government in 2009/2010 has provisions to limit this profit-linked tax holiday incentive to SEZ units that begin to provide services before April 1, 2014. However, an investment-linked incentive will be available to SEZ units that commence operations after this date under the DTC proposals.
- Software Technology Parks (STP)/ Export Oriented Unit (EOU) scheme – Under this regime, Indian companies involved in the export of products or services (including research services) could benefit from a tax holiday for a period of 10 years. However, this exemption is no longer available after the Indian financial year ended March 31, 2011.

The SEZ regime (like the STP and EOU regimes) also provides indirect tax benefits such as an exemption from customs duties on imports, exemption from excise (manufacturing) tax, abatement of value added tax, and abatement (or refund, in certain situations) of service taxes.

Changing landscape

At a policy level, the Indian Government appears to be sensitive to the need to further incentivize R&D activity in the country. The Indian Prime Minister recently has called for industry to double R&D spends (India currently spends only about 1% of its GDP on research activity). In the recently announced Manufacturing Policy (in late 2011), the Indian

Government has indicated that they would encourage time bound programmes for building strong capacities with R&D facilities and also to encourage growth and development of these capacities in the private sector.

With the continued attention to R&D activity and extension of preferential tax treatment on R&D spends (including on capital expenditures), the expectation is that India will start attracting increased R&D activity in the near future.

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China

Corporate income tax super-deduction

To encourage R&D activities in China, companies are allowed an extra 50% expense deduction for eligible R&D costs. Such eligible R&D costs include expenses incurred through the development of new technology and products. They also cover salary expenses for R&D personnel and the depreciation of instruments and equipment used for R&D purposes. Tax losses attributable to R&D deduction claims can be carried forward up to five years.

High/New Technology Enterprise incentive

Enterprises that qualify as High/ New Technology Enterprises (HNTEs) upon assessment by the relevant authorities are entitled to a reduced corporate income tax (CIT) rate of 15% as compared with the standard CIT rate of 25%. In addition to the reduced tax rate, newly established

HNTEs in the Five Special Economic Zones (Hainan, Shantou, Shenzhen, Xiamen, and Zhuhai) and the Pudong New Area within Shanghai may enjoy a “2 + 3 tax holiday” (a two-year tax exemption followed by a three-year 50% tax reduction in CIT).

The key requirements to qualify as HNTE include ownership of core proprietary IP rights, products, or services falling under the scope of “encouraged” domains, and R&D expenditures, and both income from relevant activities and headcount of R&D/ technical personnel meeting certain minimum thresholds.

Technology Advanced Service Enterprise

During the period from July 1, 2010 to December 31, 2013, a certified Technology Advanced Service Enterprise (TASE) located within one of the 21 service outsourcing model cities in China, as

listed below, may enjoy the following tax incentives:

- business tax exemption on offshore service income;
- a reduced CIT rate of 15%, as compared with the standard CIT rate of 25%; and
- any educational expenses up to 8% of total salary may be deducted in calculating CIT and any balance above that amount may be carried forward.

The service outsourcing model cities are:

- | | |
|--------------|--------------|
| 1. Beijing | 13. Nanjing |
| 2. Changsha | 14. Shanghai |
| 3. Chengdu | 15. Shenzhen |
| 4. Chongqing | 16. Suzhou |
| 5. Dalian | 17. Tianjin |
| 6. Daqing | 18. Wuhan |
| 7. Guangzhou | 19. Wuxi |
| 8. Hangzhou | 20. Xiamen |
| 9. Harbin | (added in |
| 10. Hefei | early 2010) |
| 11. Jinan | 21. Xian |
| 12. Nanchang | |

The TASE must engage in information technology outsourcing, business process outsourcing, and knowledge process outsourcing, and the revenue from such activities must equal at least 50% of the total income of the enterprise for that year. In addition, the TASE must have a legal personality and a clean administrative record for the past two years, and 50% or more of total employees must have a junior college degree or above.

Software and integrated circuits

Various incentives exist for the software and integrated circuit (IC) industries. Some of the major tax-related preferential policies include:

- Software enterprises that benefit from a refund of VAT may use the refund for R&D or expansion of production without the refund being treated as taxable income;

China

Continued

- Qualified software and integrated circuit enterprises may enjoy a “2 + 3 tax holiday” (somewhat different than above – a two-year tax exemption followed by a three-year 50% tax reduction in CIT starting from the first profit-making year) or a “5 + 5 tax holiday” (a five-year tax exemption followed by a five-year 50% tax reduction in CIT starting from the first profit-making year) upon meeting certain requirements;
- “Key software enterprises” included in the state plan may pay CIT at a reduced rate of 10%, unless a CIT exemption already applies in that particular year; and
- Business tax exemption for qualified software and IC related services (e.g., development, design, and consultancy).

Income tax exemption for the transfer of technology

The first ¥5 million (\$65,000) of income from qualified technology transfers are exempt from the CIT. Any income in excess of ¥5 million is taxed at a 50% reduced CIT rate.

Venture Capital Enterprise

For a Venture Capital Enterprise (VCE) that makes an equity investment in a non-listed, small, new, or high-tech enterprise for more than two years, 70% of its investment amount may be used to offset the taxable income of the VCE in the year after the holding period has reached two years. Any portion that is not used in that year can be carried forward and deducted in the following years.

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South Africa

Research and development expenditure

The South African government is aware of the need for South Africa to become more actively engaged in scientific and technological innovation and has perhaps cast envious eyes over the ocean to other countries that have so successfully established themselves as world leaders in various specialist areas of technological innovation.

From a tax perspective, some research and development expenditure incurred in South Africa qualifies for deduction under the general deduction provisions of the Income Tax Act. However, some expenditure may be of a capital nature and therefore not deductible under these provisions; the dividing line in this regard may be difficult to draw. Due to this uncertain ambit of the general deduction provisions in regard to R&D expenditure as well as to provide a strong fiscal and financial incentive, section 11D of the Income Tax was introduced to provide a specific tax allowance for qualifying R&D expenditure.

The scope of qualifying R&D projects

The intent of section 11D is to provide a 150% deduction in respect of scientific and technological research and development. But how are the tax rules to differentiate between expenditure on research aimed at developing an improved product and the routine quality control processes in which

virtually every manufacturer engages? It is difficult to draw these and other lines and to express qualifying criteria for R&D expenditure clearly and unambiguously. And of course, the South African Revenue Service (“SARS”) faces problems of monitoring and enforcement to ensure that a taxpayer engaged in genuinely qualifying scientific research does not include the salaries of ordinary administrative staff as R&D expenses.

What R&D projects will qualify for the 150% deduction?

As regards the over-arching question as to what kind of research qualifies for the fiscal incentive, section 11D provides that expenditure incurred in any research and development for the purpose of discovering scientific or technological knowledge or for creating any invention that is patentable under the Patents Act 57 of 1978, any design that is registrable in terms of the Designs Act 195 of 1993, any computer program as defined in the

Copyright Act 98 of 1978, or any knowledge essential to such invention, design, or computer program potentially can qualify for the 150% deduction.

Section 11D in its new format goes further than its previous incarnation and now provides for the deductibility of expenditure incurred not merely in creating anew, but in improving, any such invention, design, or computer program if the expenditure relates to a new or improved function, improved performance, improved reliability, or improvement of quality in that invention, design, computer program, or knowledge.

In order to be deductible, the expenditure in question must be:

- actually incurred;
- by the taxpayer;
- directly and solely in respect of research and development undertaken in South Africa.

South Africa

Research and development expenditure—Continued

The words “directly and solely” are, it seems, intended to exclude administrative expenses such as the salary of staff who are not themselves engaged in research and development.

In addition to satisfying the foregoing requirements, qualifying expenditure must be incurred:

- in the production of income; and
- in the carrying on of any trade.

These are, of course, also key requirements for the deductibility of expenditure under the general deduction provisions, but it is noteworthy that, unlike in the general deduction provisions, expenditure is not disqualified from deduction under section 11D merely because it was “of a capital nature.” Thus, capital expenditure that satisfies the criteria for deductibility in section 11D also will be deductible. Conversely,

non-capital research and development expenditure that fails to satisfy the criteria in s 11D may be deductible under the general deduction provisions—but of course, the incentive for a taxpayer to bring his expenditure under section 11D is the prospect of a 150% deduction.

Approval of qualifying R&D expenditure

Apart from the statutory criteria, outlined above, that must be satisfied for the expenditure on research and development to qualify for the 150% deduction, there is another significant hurdle to be cleared by the taxpayer. Section 11D provides for the establishment of a statutory committee which will be required to “evaluate” taxpayers’ applications. That committee is to determine whether the taxpayer’s application for approval of research that may qualify for the 150% deduction satisfies the criteria set out in s 11D(1)(a) and (b), namely, that it is research directed to discovering new scientific or

technological knowledge or creating a patentable invention, a registrable design, or a computer program.

In conclusion

Expenditure on research and development is, inherently, an expensive risk, with no guarantee of worthwhile results. Without a strong fiscal incentive, the business sector may be disinclined to divert resources to research and development, or may choose to outsource it to countries where it can be done more cheaply. It remains to be seen how strong an incentive the revised s 11D turns out to be in this regard.

It also remains to be seen whether judicial review of a Ministerial decision to decline an application for research that will qualify for the 150% tax deduction turns out to be an effective remedy for aggrieved applicants.

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China VAT Reform and the Impact on R&D

As of 1 January 2012, a number of selected businesses and industries in Shanghai became the first participants in the China Value Added Tax (VAT) Reform Pilot Program ('Pilot Program'). There is already speculation that these Shanghai participants will be joined by counterparts in Beijing later this year and potentially other regions and industries in the future.

This article focuses on the key aspect of the reform, how it will impact R&D, and expected major benefits.

Background

The China indirect tax system consists of two mutually exclusive taxes—the VAT and the Business Tax (BT). Outside of the Pilot Program, VAT is imposed only on the sale or importation of goods and the provision of processing, repair, and replacement services.

The provision of all other services (including R&D) and the transfer of intangible and immovable property fall under the BT. BT has a range of rates from 3%, 5%, and 5% to 20%, with R&D currently subject to a rate of 5%.

BT is a cumulative tax, meaning that any BT incurred is a cost to the business with no credit entitlement for BT paid. For example, a service provider undertaking R&D services for a third party / head office would need to account for BT on such transactions, but also would incur a BT or VAT cost (e.g., on the purchase of services or other goods) in providing those

R&D services. This BT or VAT incurred by the provider is not recoverable.

Generally speaking, BT also applies on the export of services, and so the provision of R&D services from a local Chinese entity to an overseas head office can be subject to BT. There is an exemption to this general treatment; however, businesses need to apply for and receive approval prior to utilising the exemption (discussed below).

Key aspects of the reforms

Under the Pilot Program, Shanghai businesses in selected industries—transportation and “modern services”—will transform from BT payers to VAT payers. R&D services falls within the category of modern services and will be subject to a VAT rate of 6%.

The change from BT to VAT will bring about several changes to businesses undertaking R&D. Key changes will include the following:

Availability of input VAT credits on R&D-related expenditure.

As the provision of R&D services comes within the scope of VAT, the providers of such services now are also entitled to claim input VAT credits on any VAT they incur in undertaking that service. The availability of input VAT credits can effectively reduce the cost of providing those services.

However, in assessing the benefit gained from these reforms, a short and long term, view needs to be taken. In the long-term it is expected that all industries and services would migrate into the VAT system. In the short term, the problem remains that recipients of the R&D services may still be in the BT system. For these businesses, the VAT levied on R&D services will continue to be a cost.

China VAT Reform and the Impact on R&D

Continued

Treatment of exports

The provision of R&D services to entities outside China under the Pilot Program can be treated as zero-rated. The benefit of 'zero-rated' treatment is that no VAT will be levied on the provision of the R&D service, while input VAT credits still will be available to the provider on VAT incurred on related costs.

While the introduction of the zero-rated treatment will represent a positive outcome for R&D exporters, the practical application of these rules is unclear and more guidance is expected. It will be important to discuss with the tax authorities the policies on exports to ensure that the relevant services are eligible for such treatment.

Importation of services

R&D services undertaken by entities outside China and provided to Shanghai entities also will be subject to VAT. The resident entity (or a withholding agent where one is present) will be required to withhold the VAT amount and remit it to the tax authorities. While the withholding obligation mirrors the current treatment under BT, the Pilot Program will also allow service recipients that are general VAT payers to claim an input VAT credit on this VAT paid. As a result, the effective VAT cost to these businesses will be zero.

Considerations for R&D Providers

Structuring

It is important to note that, for the time being, R&D services undertaken by businesses outside of Shanghai continue to be subject to BT at 5%. In addition, businesses that are not in the selected pilot industries and that are not currently under the VAT system also will continue to be subject to BT.

The expectation is that the VAT reforms will be rolled out across China; however, the time frame for this roll out is not yet known. It is unlikely that a complete roll-out will happen within the next two years. As a consequence, it will be

important for businesses to evaluate how best to structure their R&D services to achieve a tax-efficient outcome in this interim period. This evaluation should take into consideration the status of the recipient of the R&D services (general VAT payer or BT payer) and the location of the service provider (in Shanghai or outside of Shanghai). This analysis should identify whether there is a potential benefit to be gained from undertaking such services within or outside of the Pilot Program.

It also will be important to factor in and address other key areas including the impact to IT and accounting systems, pricing, and cash flow in order to effectively manage the transition.

China VAT Reform and the Impact on R&D

Continued

Outsourcing exemption

For R&D service providers who are not participating in the Pilot Program, the relief mechanisms under the existing BT exemptions continue to apply and can be utilised, one of them being the BT exemption for ‘offshore outsourcing.’ Under this exemption, certain types of R&D services are eligible for BT exemption where those services are provided to entities outside China and are performed by entities located in selected cities. The eligible types of R&D consist of R&D in the areas of software, information technology, medicine and biotechnology, and product technology.

In order to enjoy the exemption, the R&D provider, in most cases, must first apply and then receive approvals from the

relevant commerce authority and in-charge tax authority. It is only after the applications are submitted and approved that the provider can enjoy the BT exemption. Local practice varies, and the information that will be required by the various authorities for the application will differ according to the cities in which the application will be made. It is essential that adequate preparation is put into the application to ensure that it meets the specific requirements. Any failure to do so may result in a delay in processing or the application being rejected.

Whilst the BT exemption for ‘offshore outsourcing’ is more limited and the application time-consuming in comparison to the ‘zero rated’ treatment available (pending guideline) under the Pilot Program, it still provides an adequate incentive for R&D providers in those specific fields and cities. R&D providers not currently utilizing this exemption should examine whether they are eligible to apply for the exemption. R&D providers do not have to be high tech or technology advance enterprises.

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Canada 2012 Federal budget: Continued tightening

On March 29 Canada's Federal Minister of Finance, Jim Flaherty, presented the majority government's budget. The budget does not change corporate or personal tax rates. This Tax news article discusses the tax initiatives proposed in the budget.

Business tax measures

General Scientific Research and Experimental Deduction (SR&ED) Investment Tax Credit (ITC) rate reduced

SR&ED ITC rates presently are 35% for qualifying Canadian-controlled private corporations (CCPCs) and 20% for other corporations. The 35% rate applies on the first \$3 million of qualified SR&ED expenditures incurred in a year and is refundable.

The budget proposes that the general 20% ITC rate be reduced to 15% for taxation years ending after 2013. For a taxation year that includes January 1, 2014, the 5% reduction in the ITC rate will be prorated accordingly.

The 35% rate for qualifying CCPCs remains unchanged. After 2013, SR&ED expenditures in excess of the \$3 million expenditure limit will earn ITCs at the reduced rate of 15%.

There is no additional reduction in the amount of SR&ED refundability available to CCPCs, other than as a result of the changes proposed in the budget.

SR&ED capital expenditures eliminated

Capital expenditures used all or substantially all in SR&ED are fully deductible in the year and earn ITCs.

The budget proposes to exclude capital expenditures from being a deductible SR&ED expenditure and also from any ITC entitlement. This change also applies to exclude payments made for the use or the right to use property, which if acquired by the taxpayer would be a capital property of the taxpayer. Consequently, lease costs of equipment no longer will qualify for ITCs.

This change will apply to capital property acquired on or after January 1, 2014, and to amounts paid or payable after 2013 in respect of the use of, or the right to use, capital property.

Overhead proxy rate reduced

SR&ED overhead expenditures can be claimed by using the elective proxy method or the traditional method (i.e., identifying each overhead expenditure directly related and incremental with SR&ED activities on an item-by-item basis). The proxy method allows taxpayers to claim as SR&ED overhead expenditures 65% of the total salary and wages of employees directly engaged in SR&ED.

The budget proposes to reduce the 65% proxy rate to 60% for 2013 and to 55% after 2013. The proxy rate that will apply for taxation years that include days in 2012, 2013, or 2014 will be pro-rated based on the number of days in the taxation year that are in each of those calendar years.

This reduction will require taxpayers that typically elect to use the proxy method to consider whether the traditional method would be more beneficial.

Canada 2012 Federal budget: Continued tightening

Continued

SR&ED contract payments reduced

A taxpayer that contracts SR&ED work to be undertaken on its behalf by an arm's-length party may deduct the contract payment and claim an ITC.

The budget proposes to disallow from the expenditure base for ITC purposes the "profit element" of arm's-length SR&ED contracts. Taxpayers now will be able to claim only 80% of the SR&ED contract amount paid to an arm's-length contractor. This change will apply to expenditures incurred on or after January 1, 2013.

Furthermore, consistent with the proposed change to disallow ITCs on capital expenditures, arm's-length contract payments also must be reduced for any amount paid in respect of a capital expenditure incurred by the performer in fulfilling the contract. The performer will be required to inform the payer of these amounts.

The capital expenditures incurred by a performer in fulfilling a SR&ED contract will first reduce the contract amount before the 80% eligibility ratio is applied.

In addition, the amount that the performer is required to net against its own SR&ED qualifying expenditures as a result of the contract payment will be reduced by the amount the performer received with respect to the capital expenditure.

Contingency fee arrangements

Observers have criticized the SR&ED program for excessive complexity, which results in high compliance costs, forcing companies to retain consultants on a contingency fee arrangement and consequently diminishing the benefits available under the program.

The budget states that "In the coming year, the Government will conduct a study, including consultations with taxpayers, to better understand why firms

choose to hire consultants on a contingency-fee basis and determine what action is required."

Enhancing predictability

The budget announced new funding of \$6M over two years for the Canada Revenue Agency (CRA) to implement changes to the administration of the SR&ED program. The CRA will:

- conduct a pilot project to determine feasibility of a formal pre-approval process;
- enhance the existing online self-assessment eligibility tool;
- work collaboratively with industry representatives to address emerging issues;
- make more frequent and effective use of "tax alerts;" and
- improve the Notice of Objection process to allow for a second review of scientific eligibility determinations.

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