Written Submission: Pre-Budget Consultations in Advance of the 2021 Federal Budget

August 7, 2020

Submitted on behalf of AbCellera Biologics Inc.
by Andrew Booth (Chief Financial Officer)

Recommendations:

1. AbCellera recommends that the Government of Canada amend the *Income Tax Act*'s annual expenditure limit formula (Subsection 127(10.2)) to enable improved access to the enhanced Scientific Research & Experimental Development tax credit. Specifically, we propose replacing the taxable capital cap with a sliding scale calculation that includes the portion of revenue that a corporation reinvests into research and development (R&D).

COVID-19 has government officials, public policy experts, economists, and industry leaders around the world scrambling for answers on how to recover jobs, secure domestic supply chains, and rebuild economies.

A critical component of Canada's economic recovery will be strategically investing in high-growth sectors where we have a globally competitive advantage. Incentivizing the growth and expansion of successful, homegrown companies working on world-leading technologies will pay dividends to the Canadian economy as it works its way out of the damage caused by COVID-19. Incentivizing investments into business-led research and development (R&D) is a means through which the Government of Canada can drive productivity, employment, and competitiveness in the economic recovery period and beyond.

The Scientific Research and Experimental Development (SR&ED) Tax Credit has long been a mechanism that incentivizes Canadian businesses of all sizes, and in all sectors, to conduct research and development (R&D). Despite SR&ED's success in supporting start-ups, its eligibility criteria creates a disincentive for growth for larger companies, which is incongruent with the Government's stated objectives of growing Canadian anchor firms.

AbCellera recommends that the Government of Canada consider two changes to the formula by which eligibility for the enhanced SR&ED tax credit is determined. These changes were originally presented to the Standing Committee on Finance in May 2019, pursuant to *Budget 2019*'s Implementation Bill[1].

At present, a particular corporation's annual expenditure limit – which determines the level of enhanced SR&ED tax credit they receive – is determined by a formula outlined in the *Income Tax Act* (Subsection 127(10.2)). This formula includes taxable capital. AbCellera recommends:

1. Removing taxable capital as a factor in the determination of a corporation's expenditure limit; and,

2. Amending the formula to add the proportion of revenue that a corporation reinvests into research and development (R&D) as a factor in the determination of a corporation's expenditure limit.

The purpose of these two recommendations is to provide improved access to the enhanced Scientific Research and Experimental Development (SR&ED) tax credit for Canadian-headquartered companies who are creating and retaining Intellectual Property (IP) in Canada, while maintaining incentives for these corporations to raise capital, conduct R&D, and create jobs – all of which must be foundational components of Canada's post-COVID-19 economic recovery strategy.

Specific proposed amendments to the *Income Tax Act* have been outlined in Appendix A.

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[1] Evidence from Witness Andrew Booth: Standing Committee on Finance Meeting May 15, 2019. https://www.ourcommons.ca/DocumentViewer/en/42-1/FINA/meeting-213/evidence

The Challenge with the Taxable Capital Test

Companies like AbCellera – Canadian-headquartered firms seeking to remain in Canada – face a technical challenge as they pursue continued growth through the use of enhanced SR&ED tax credits. Under SR&ED's current eligibility framework, Canadian corporations are disincentivized from growing beyond a certain level – the capital threshold under which they remain eligible for the enhanced SR&ED tax credit[2].

There are a number of inequities that emerge when companies are evaluated with this taxable capital test:

Inequities relative to growth

The taxable capital test creates a perverse disincentive to growth. New debt or equity financing increases taxable capital without consideration of whether that capital has been reinvested into R&D activities. The "grind-down" of SR&ED benefits disincentivizes companies from taking risks and expanding their R&D portfolios. Companies are incentivized to "stay small" to avoid tripping the taxable capital wire.

Under the current framework, Canadian corporations are also disincentivized from raising foreign capital, as doing so beyond a certain level would disqualify them from the enhanced SR&ED credit – once again encouraging purposeful underperformance.

Inequities relative to capital intensity

A taxable capital test is particularly damaging in research-based and capital-intensive industries like biotechnology. Companies in this industry are typically required to make significant capital investments to facilitate innovation (e.g. manufacturing facilities, large-scale infrastructure, highly specialized equipment, etc.). The current SR&ED framework favors non-capital-intensive research companies with smaller balance sheets. Companies with larger capital investments – and, accordingly, more taxable capital on their balance sheets – are inherently stickier, and more likely to endure in Canada over time.

Inequities relative to success

A taxable capital measurement also biases evaluation towards companies who generate losses rather than earnings. The retained earnings of profitable enterprises increase taxable capital, while the deficits of non-profitable enterprises decrease taxable capital. As such, companies who are successful in converting R&D activities into profits are penalized.

The Solution – Encouraging SR&ED Reinvestment

Canadian corporations with the ability to invest in innovation, raise foreign capital, and pursue growth should be permitted – if not encouraged – to do just that, without losing out on tax credits. Revising the capital threshold will allow SR&ED to be used more effectively across more Canadian-headquartered companies.

AbCellera proposes a replacement of the capital threshold with a sliding scale based on the proportion of revenue a firm reinvests into eligible SR&ED activities (R&D). By instituting this change, a corporation's expenditure limit will

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[2] With the taxable capital test, otherwise qualifying enhanced SR&ED tax credits are reduced once taxable capital reaches $10 million and fully eliminated when it reaches $50 million. (Department of Finance, Explanatory Notes Relating to the Income Tax Act and Other Legislation).

be reduced based only on the extent to which they choose to reinvest in research and development – which is, as we know, an incredibly important activity for government to be encouraging, particularly in the COVID-19 economic recovery period.

As was proposed before the Standing Committee on Finance in May 2019, we would propose replacing the taxable capital cap with a sliding scale where a 1% enhanced SR&ED credit is granted to companies who reinvest half a per cent of their gross revenues into SR&ED-eligible research and development. This enhanced credit would be capped at a maximum of 20% above the base rate for those companies that invest 10% or more of revenues into R&D.

With the ability to roll over refundable tax credits into R&D programs, companies like AbCellera would be offered the opportunity to make the necessary and previously-unseen-in-Canada investments in product development and infrastructure, meaning new jobs for scientists, engineers, and other highly educated Canadians. By the very nature of SR&ED activities, this will also lead to more IP created by Canadian-headquartered companies who can then commercialize it globally.

The Opportunity: Investing in R&D

The post-COVID-19 period is an opportunity for the Government of Canada to make fundamental changes and emerge from the pandemic with new and lasting economic strength. Despite Canada's long-standing scientific pedigree and strong record in fundamental and applied research, we have historically punched below our weight in business-led research and development.

Data from Bloomberg Business shows that there is not a single Canadian company among the global top 200 spenders on R&D[3]. In 2018, the Council of Canadian Academics found that R&D as a share of GDP has steadily declined in Canada since 2001, and now stands well below the OECD average[4]. Finally, in Bloomberg's 2020 Innovation Index, Canada ranked 22nd, just behind Slovenia and just ahead of Iceland[5].

This is an opportune time for the Government of Canada to harness homegrown innovation and make strategic investments in incubating the scientific and technical knowledge, discoveries and ideas that will lead to Canadian economic growth and competitiveness – a critical foundation of our country's economic recovery agenda. There is an opportunity for Canada to come out from COVID-19 stronger, more competitive, and more innovative than before.

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[3] *Canada falling behind in the 'intangible' economy as we give up our tech to foreigners, report warns*. Bloomberg News. https://financialpost.com/technology/canada-falling-behind-in-the-intangible-economy-report-warns

[4] *Competing in a Global Innovation Economy: The Current State of R&D in Canada*. Council of Canadian Academics. http://new-report.scienceadvice.ca/assets/report/Competing_in_a_Global_Innovation_Economy_FullReport_EN.pdf

[5] *Bloomberg Innovation Index 2020*. https://www.bloomberg.com/news/articles/2020-01-18/germany-breaks-korea-s-six-year-streak-as-most-innovative-nation

About AbCellera
Founded and headquartered in Vancouver, B.C., AbCellera is a privately-held biotech company with a drug discovery platform that searches and analyzes natural immune systems to find antibodies that can be used to prevent and treat disease. Through a collaboration with U.S-based Eli Lilly, AbCellera had the world's first COVID-19 clinical trial for a monoclonal antibody treatment (LY-CoV555), which went from initial screen to in patients in only 90 days – setting a world record by a fair margin. On August 3, 2020, AbCellera and Eli Lilly announced that LY-CoV555 had progressed to Phase 3 clinical trials.

In May 2020, AbCellera received $175.6 million in funding support from the Government of Canada's Strategic Innovation Fund to expand efforts related to the discovery of antibodies for use in drugs to treat COVID-19, and to build technology and manufacturing infrastructure for antibody therapies against future pandemic threats.

Appendix A: Proposed Amendments to the *Income Tax Act*

Removal of Taxable Capital from Expenditure Formula, Replacement with SR&ED Reinvestment Level

Additions are noted in bold, underline and highlight. Deletions are noted with strikethrough.

Subsection 127(10.2) of the *Income Tax Act*:

Expenditure limit

(10.2) For the purpose of subsection (10.1), a particular corporation's expenditure limit for a particular taxation year is the amount determined by the formula

$3 million × ($40 million – A)/$40 million

where

A

is

- (a) nil, if the following amount is less than or equal to $10 million:
    - (i) if the particular corporation is not associated with any other corporation in the particular taxation year, the amount that is its taxable capital employed in Canada (within the meaning assigned by section 181.2 or 181.3) for its immediately preceding taxation year, and
    - (ii) if the particular corporation is associated with one or more other corporations in the particular taxation year, the amount that is the total of all amounts, each of which is the taxable capital employed in Canada (within the meaning assigned by section 181.2 or 181.3) of the particular corporation for its, or of one of the other corporations for its, last taxation year that ended in the last calendar year that ended before the end of the particular taxation year, and
- (b) in any other case, the lesser of $40 million and the amount by which the amount determined under subparagraph (a)(i) or (ii), as the case may be, exceeds $10 million.

<u>$3 million × SR&ED reinvestment level</u>

Notes:

- This amendment to Subsection 127(10.2) removes taxable capital as a factor in the determination of a corporation's expenditure limit.
- The formula in subsection 127(10.2) is amended to add the proportion of revenue that a corporation reinvests into research and development (R&D) as a factor in the determination of a corporation's expenditure limit ("SR&ED reinvestment level").

Definition of SR&ED Reinvestment Level

Subsection 127(9) of the *Income Tax Act* is amended by adding the following definition in alphabetical order:

“SR&ED reinvestment level”
SR&ED reinvestment level for purposes of subsection 127(10.2) is that proportion of ten times the taxpayer’s “SR&ED qualified expenditure pool”, as defined by subsection 127(9), is of the taxpayer’s “gross revenue”, as defined by subsection 248(1), for the previous taxation year.

Notes:

- The new definition “SR&ED reinvestment level” is introduced so that a Canadian-headquartered firm’s (including CCPCs’) eligibility for an enhanced investment tax credit for qualified scientific research and experimental development (SR&ED) expenditures under subsection 127(10.1) is based on the proportion of prior year revenues reinvested into current year SR&ED activities.
- As proposed in May 2019, a 1% enhanced SR&ED tax credit will be granted to companies which invest 0.5% of global gross revenues in SR&ED eligible activities in Canada, up to a maximum of 20% enhanced SR&ED tax credit granted to companies which invest 10% or more of gross revenue in SR&ED-eligible activities.