



APPLICATION POLICY

NUMBER: SR&ED 2005-01

SUBJECT: Shared-Use-Equipment

DATE: September 8, 2005

Purpose

The purpose of this paper is to clarify the application of the rules for shared-use-equipment (SUE) and prescribed depreciable property (PDP) when administering the scientific research and experimental development (SR&ED) legislation under the *Income Tax Act* (the Act) and the *Income Tax Regulations* (the Regulations).

Background

Expenditures on new capital property that is intended to be used during all or substantially all of its operating time in its expected useful life for the prosecution of SR&ED carried on in Canada, or where all or substantially all of its value is intended to be consumed in such prosecution, may qualify for investment tax credits (ITCs) (such expenditures are called “SR&ED capital expenditures”). Please refer to Application Policy SR&ED 2003-01 “*Capital Property Intended to be Used All or Substantially All for SR&ED*” for further information on SR&ED capital expenditures and on the intent test.

Before December 3, 1992, expenditures for new capital property that did not meet the ASA test but that was used primarily (more than 50%) during its operating time in SR&ED did not qualify for ITCs. This was of concern to claimants that performed SR&ED in a shop-floor environment where property can often be used for both SR&ED and commercial work.

As a result, rules were introduced for property acquired after December 2, 1992, to allow partial ITCs for expenditures on first and second term SUE. Both first term SUE and second term SUE are defined in subsection 127(9) of the Act.

A PDP is excluded from being considered first term and second term SUE. Consequently, costs to acquire a PDP do not qualify for ITCs. PDP is defined in subsection 2900(11) of the Regulations (see the discussion on PDP in Appendix A).

First Term Shared-Use-Equipment

A property must meet certain criteria to qualify as first term SUE. The property must be:

- depreciable property;
- equipment that does not qualify as an SR&ED capital expenditure (is not ASA);
- equipment that is not a PDP as per subsection 2900(11) of the Regulations;
- equipment other than general purpose office equipment or furniture;
- new equipment (i.e., it must not have been used or acquired for use or lease, or for any other purposes before the claimant acquired it); and
- equipment that is used by the claimant, during its operating time in the period starting with the time the equipment was acquired and available for use, and ending at the end of the first taxation year ending at least 12 months after that time (the “first period”), primarily for the prosecution of SR&ED in Canada.

Second Term Shared-Use-Equipment

For depreciable property to qualify as second term SUE, it must be property that qualified as first term SUE. The property must be used primarily for SR&ED in Canada during its operating time during the second period. The second period begins at the time the property was acquired and was available for use and ends at the end of the first taxation year, ending at least 24 months after that time (see Example A).

Intended use vs. Actual use

The test for SUE is based on the **actual** use of the equipment, during its operating time in the first and second period. However, the test for PDP is based on the intended use of the equipment (see the section on PDP in Appendix A).

Qualified Expenditures

Paragraph 127(11.5)(b) of the Act provides that, for the purpose of the definition of a “qualified expenditure”, the amount of a claimant’s expenditure for first or second term SUE is deemed to be $\frac{1}{4}$ of the capital cost of the equipment respectively. This amount is determined after the application of the non-arm’s length rules as described in subsection 127(11.6) of the Act. Paragraph 127(11.5)(b) further states that the capital cost to the claimant is computed as if no amount were added for the cost to borrow money described in section 21 and determined without reference to deeming provisions described in subsections 13(7.1) and 13(7.4) of the Act.

The cost of the property is not included in the pool of deductible SR&ED expenditures as it is included on the Capital Cost Allowance (CCA) schedule, and subject to the applicable CCA rate and rules. Paragraph 13(7.1)(e) reduces the capital cost of depreciable property by the amount of any ITC that was deducted or refunded in a preceding year for the property.

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Example A

On March 15, 2000, Company A purchased and put into use a new machine for \$300,000. The machine is to be used both in SR&ED and in manufacturing and processing (M&P) over its expected useful life. As a result, the new machine is not an SR&ED capital expenditure. The machine is not PDP. The machine runs 8 hours a day, 5 days a week. The company has a December 31 year-end. The operating time of the machine for SR&ED and M&P is as follows:

Time period	Operating Time	SR&ED	M&P
March 15, 2000 to December 31, 2000	1,600	1,300	300
January 1, 2001 to December 31, 2001	2,000	1,600	400
January 1, 2002 to December 31, 2002	2,000	800	1,200
Total	5,600	3,700	1,900

For the tax year ending December 31, 2000:

The cost of the equipment will be included in the regular CCA class and subject to the normal rules of CCA.

For the tax year ending December 31, 2001:

The machine was used primarily in SR&ED (2,900/3,600 or 81%) for the period from the time the machine is available for use (March 15, 2000) to the end of the first tax year ending at least 12 months after that time (December 31, 2001). Therefore, it is first term SUE, and the company can include 25% of \$300,000 (\$75,000) as a qualified expenditure for ITC purposes.

For the tax year ending December 31, 2002:

The machine was used primarily in SR&ED (3,700/5,600 or 66%) for the period from the time the machine is available for use (March 15, 2000) to the end of the first tax year ending at least 24 months after that time (December 31, 2002). Therefore, it is second term SUE, and the company can include 25% of \$300,000 (\$75,000) as a qualified expenditure for ITC purposes.

Any ITC earned and applied for SUE reduces the UCC of the class in the year subsequent to its utilization. Applied means that the ITC on SUE was either refunded or used to offset taxes payable.

Operating Time

The term ‘Operating Time’ is not defined in the Act; however, operating time usually means the time that the equipment normally runs or functions. The time that the machine is idle is **not** included in the calculation. Whether the equipment is used for SR&ED during its operating time is a question of fact that can only be determined on a case-by-case basis. However, the onus is on the claimant to maintain documentation, such as a logbook, which would support the SR&ED use of the equipment for the period.

Available for Use Rules

Equipment is deemed to be acquired when it becomes available for use (subsection 127(11.2) of the Act).

Subsections 13(26) to (32) of the Act provide rules that apply to determine when a property will be considered to have become available for use by a claimant.

Generally, an asset is considered to become available for use and eligible for capital cost allowance and investment tax credit at the earliest of:

- the time at which the property is first used by the claimant for the purpose of earning income
- the time the property is delivered or is made available to the claimant and is capable of producing a saleable product or service.

Assistance

According to subsection 127(18) of the Act, the qualified expenditures of a claimant are reduced by any government assistance, non-government assistance, or contract payments that the claimant has received, is entitled to receive, or can reasonably be expected to receive in respect of SR&ED on or before the filing due date of a taxation year.

Example B

Company A incurred an \$80,000 expenditure on equipment on July 19, 2000. The company has a year-end of December 31. The equipment meets the SUE criteria in both the December 31, 2001 year for the first period, and the December 31, 2002 year for the second period. Company A received \$21,000 of assistance for SR&ED to purchase the equipment. For the purpose of this example, assume that there are no other qualified expenditures.

The qualified expenditure otherwise determined before the reduction for the assistance received is \$20,000 (25% of \$80,000) in 2001, and \$20,000 in 2002.

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Subsection 127(18) of the Act requires that the assistance that is in respect of SR&ED shall be applied to reduce the qualified expenditures incurred in the year for SR&ED. In 2001, the assistance of \$21,000 will fully reduce the qualified expenditures for first term SUE. There will be a carry-forward of the remaining \$1,000 of assistance to reduce the qualified expenditures for the second term SUE in 2002 to \$19,000 in that year.

ITC Recapture

In Application Policy SR&ED 2000-04R2 – *Recapture of Investment Tax Credit*, the Canada Revenue Agency's (CRA) position on ITC recapture is outlined.

Under paragraph 127(27)(d), the ITC recapture rules apply where the claimant disposes of the property (that earned ITC) or converts it to commercial use. It is a question of fact whether a property has been converted to commercial use.

When determining if SUE was converted to commercial use, it is the CRA's position that a conversion will only occur for SUE when the usage of the equipment for SR&ED becomes incidental. For this purpose, there will only be recapture of the ITC in respect of SUE when the property has been all or substantially all converted to commercial use.

In the draft technical amendments to the Act released on December 20, 2002, there is a proposal to amend the ITC recapture rules applicable to SUE in subsection 127(27). These amendments apply to dispositions and conversions that occur after December 20, 2002. In this application paper we have reflected this proposal as if it were law.

The new legislation will reflect that since only a portion of the cost of the property that is SUE (25% or 50%) is a qualified expenditure, then only this percentage of the proceeds of disposition or the fair market value will be included in the recapture calculation, and not the full amount.

Example C

A claimant purchases equipment for \$160,000. It is shared-use-equipment and the claimant makes a claim in each period. The ITC rate for the claimant is 20%.

First term SUE: ITC calculation

$$20\% (\$160,000 \times 25\%) = \$8,000 \text{ ITC.}$$

Second term SUE: ITC calculation

$$20\% (\$160,000 \times 25\%) = \$8,000 \text{ ITC.}$$

The claimant subsequently sells the equipment for proceeds of disposition (PD) of \$100,000.

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Under the current legislation, the recapture of ITC under subsection 127(27) would be the lesser of:

- \$16,000 ($20\% \times \$160,000 \times 50\%$) as the property had been claimed as first and second-term SUE, and
- \$20,000 ($20\% \times \$100,000$ PD).

As a result, **under the current legislation**, the ITC recapture is \$16,000.

Under the proposed legislation, however, as only a portion (50%) of the cost of the property was a qualified expenditure, the second amount in the above calculation will be \$10,000 ($20\% \times \$100,000 \times 50\%$).

Consequently, the ITC recapture is \$10,000.

Prescribed Depreciable Property (PDP)

The definition of PDP under subsection 2900(11) of the Regulations is found in Appendix A of this document.

Property that is PDP is not first term SUE and, therefore, not second term SUE, and does not qualify for ITCs even if the use test for SUE is met.

A property, or part of a property, that meets both of the following conditions under paragraphs (c) and (d) of Regulation 2900(11) is PDP

- At the time that the equipment was acquired, the claimant **intended** that it would be used in the prosecution of SR&ED during the assembly, construction or commissioning of a facility, plant or line for commercial manufacturing, commercial processing, or other commercial purposes (other than SR&ED); and
- At the time that the equipment was acquired, the claimant **intended** that it would be used during its operating time in its expected useful life primarily for purposes other than SR&ED, or that its value would be consumed primarily in activities other than SR&ED.

It should be noted that a property is not PDP if at the time of its acquisition, it was not intended to be used for SR&ED in the context of the assembly, construction or commissioning of a facility, plant or line for commercial manufacturing, commercial processing or other commercial purposes (other than SR&ED).

The determination of whether a particular property is a PDP is made at the time the property is acquired. To make this determination, the intended use of the property in the year in which the expenditure was made as well as over its expected useful life, must be considered.

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Subsequent use of the property may provide evidence of the claimant's intention at the time the expenditure was made. Although the subsequent use of a property may differ from the claimant's intention at the time the expenditure was made, if the claimant can support that, at the time it was acquired, the property was intended to be used primarily for SR&ED work over its expected useful life or that its value would be consumed primarily in SR&ED activities, the property does not become a PDP.

Equipment used in pilot plants as defined in the current version of Information Circular 86-4 will not be considered PDP in accordance with paragraphs 2900(11)(c) and (d) of the Regulations. Pilot plants are also discussed in Application Policy 2004-03 *Prototypes, Pilot Plants/Commercial Plants, Custom Products and Commercial Assets*.

Appendix B provides five examples to illustrate these rules for PDP.

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APPENDIX A

Prescribed Depreciable Property

Prescribed depreciable property is defined in subsection 2900(11) of the Regulations.

The depreciable property of a claimant that is prescribed for the purposes of the definition “first term shared-use-equipment” in subsection 127(9) of the Act is:

- (a) a building of the taxpayer;
- (b) a leasehold interest of the taxpayer in a building;
- (c) a property of the taxpayer if, at the time it was acquired by the taxpayer, the taxpayer or a person related to the taxpayer **intended** that it would be used in the prosecution of scientific research and experimental development during the assembly, construction or commissioning of a facility, plant or line for commercial manufacturing, commercial processing or other commercial purposes (other than scientific research and experimental development) and **intended**
 - (i) that it would be used during its operating time in its expected useful life primarily for purposes other than scientific research and experimental development, or
 - (ii) that its value would be consumed primarily in activities other than scientific research and experimental development; and
- (d) part of a property of the taxpayer if, at the time the part was acquired by the taxpayer, the taxpayer or a person related to the taxpayer intended that the part would be used in the prosecution of scientific research and experimental development during the assembly, construction or commissioning of a facility, plant or line for commercial manufacturing, commercial processing or other commercial purposes (other than scientific research and experimental development), and intended
 - (i) that it would be used during its operating time in its expected useful life primarily for purposes other than scientific research and experimental development,
 - (ii) or, that its value would be consumed primarily in activities other than scientific research and experimental development.

APPENDIX B

Examples – PDP

Example 1

Facts:

The SR&ED project consists of the development of a new M&P process. A new production line was installed as part of the SR&ED project and modification work was done on M&P equipment, which is incorporated in the new production line. More than 75% of the claimant's total production is carried out on this new production line. The percentage of use of the M&P equipment for SR&ED during the "first period" is 70%.

Question: Does the M&P equipment qualify as first term SUE?

Pursuant to paragraphs 2900(11)(c) and (d) of the Regulation, a property or part of a property that meets both of the following conditions will be PDP and therefore will not qualify as SUE:

1. the claimant intended at the time that the equipment was acquired, that it would be used in the prosecution of SR&ED during the assembly, construction or commissioning of a facility, plant or line for commercial manufacturing, commercial processing or other commercial purposes (other than SR&ED) ; and
2. the claimant intended at the time that the equipment was acquired that it would be used during its operating time in its expected useful life primarily for purposes other than SR&ED, or that its value would be consumed primarily in activities other than SR&ED.

In this case, the project involves the development of a new process and the M&P equipment claimed as SUE is incorporated in a new production line. The M&P equipment was intended to be used in the prosecution of SR&ED during the assembly, construction or commissioning of a facility, plant or line for commercial manufacturing, commercial processing or other commercial purposes.

The intent of the first point above has, therefore, been met. The other point is to determine the claimant's intention concerning the use of the property during its expected useful life.

The facts indicate that, substantially all of the production is carried out on this new line. Therefore it seems that the claimant's intention at the time it acquired the property was that the property would be used primarily during its expected useful life for activities other than SR&ED. The onus is on the claimant to demonstrate that the intention was to use the property primarily for SR&ED during its operating time in its expected useful life.

Conclusion:

In this example, the property is PDP according to paragraph 2900(11) (c) or (d) of the Regulations. Therefore, the claimant would not be able to claim the property as SUE and, therefore, it is not eligible for ITC.

Example 2

Facts:

The claimant acquires a new machine and intends to use it primarily for SR&ED and the rest of the time in M&P. The machine is not an SR&ED capital expenditure.

It is used primarily for SR&ED purposes in the first period, and it was not used or intended to be used in the assembly, construction or commissioning of a facility, plant or line for commercial manufacturing, commercial processing or other commercial purposes.

Question: Can this property qualify as SUE?

To qualify as first term SUE, the property must meet the following criteria. It must:

1. be depreciable property;
2. be equipment that is not a SR&ED capital expenditure;
3. not be PDP;
4. not be general purpose office equipment or furniture;
5. be new; and
6. be used primarily (more than 50% of its operating time) for SR&ED during the first period.

Since the property was not used (or intended to be used) for SR&ED purposes during the assembly, construction or commissioning of a facility, plant or line for commercial manufacturing, commercial processing or other commercial purposes, the property is not a PDP.

Conclusion:

Since the property was used primarily for SR&ED purposes during the first period, the property qualifies as SUE. It is the claimant's responsibility to provide documentation that the property was primarily used in SR&ED.

Note: There will be ITC recapture for SUE when the property is sold or has been all or substantially all converted to commercial use.

Example 3

Facts:

A piece of equipment is acquired by a claimant to be used in the prosecution of SR&ED during the construction of an assembly line for commercial production purposes, and it is to be used primarily in other SR&ED activities once the assembly line is completed. Due to unforeseen circumstances, the equipment cannot be used primarily for SR&ED purposes during its operating time throughout its expected useful life. The percentage of use of the equipment for SR&ED during the first period is 70% of its operating time.

Question: Does the equipment become PDP?

The determination of whether a particular property is a PDP is made at the time the property is acquired. To make this determination, the intended use of the property over its expected useful life must be considered. Although the subsequent use of a property may differ from the claimant's intention at the time the expenditure was made, if the claimant can support that, at the time it was acquired, the property was intended to be used primarily for SR&ED activities over its expected useful life, the property does not become a PDP. Assuming that the original intent can be justified, the claimant is not prevented from earning the ITC for SUE, provided all other conditions of first-term SUE are met.

Conclusion:

Thus, the property is not prescribed depreciable property. It could qualify as SUE to the extent that it meets all the other criteria listed in example 2. To pass the use test, the property needs to be used during its operating time primarily in the prosecution of SR&ED in the first period. Based on the facts provided, the property meets the use test because its actual operating time for SR&ED during the first period exceeds 50%.

Example 4

Facts:

A claimant acquires a new machine to replace an existing one that is part of a line. The machine is performing one of the five steps of a continuous manufacturing process.

When the initial work is started, unexpected technical difficulties arise, and as a result, the property is used primarily for the prosecution of SR&ED during the first and second periods.

Question: Is the machine a PDP?

At the time the property was acquired, the claimant did not intend that the property be used in the prosecution of SR&ED **in the context** of the assembly, construction or commissioning of a facility, plant or line for commercial manufacturing, commercial processing or other commercial purposes. The machine is acquired to replace an existing machine that is used for commercial production. It should be noted also that the property is not a facility within the meaning of subsection 2900(11) of the Regulations.

Finally, paragraph 2900(11)(d) of the Regulations does not apply as it refers to part of a property, not part of a facility.

Conclusion:

Thus, the property is not prescribed depreciable property. It could qualify as SUE if it meets all the other criteria listed in Example 2.

Example 5

Facts:

A company planned to build a new full-scale commercial fluidized bed recovery boiler for the continuous chemical and energy recovery of a Pulp and Paper kraft black liquor in a fully commercial and pre-existing pulp and paper mill operation. The cost for the company would be \$20 million. The company decided to bypass an expensive and time-consuming pilot scale recovery boiler, in favour of full-scale plant trials.

As a result, the planned scale-up factor between the original bench-scale “proof-of-concept” equipment and the full-scale boiler exceeded 1100, and significant technological uncertainties remained prior to the commissioning of the new boiler.

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Since the design of the new full-scale recovery boiler was based upon the results of much smaller bench-scale data, company staff fully expected that extensive SR&ED via mill trials would be required during the commissioning phase and through the first full year of operation. There were numerous technological uncertainties, prior to the commissioning phase, that were associated with both the end products and the process operation and reliability.

Operations data indicated that SR&ED was carried out for 55% of the operational time of the boiler for the first period, and that the time decreased to 30% in the second period.

Question: Can the fluidized bed recovery boiler be claimed as SUE?

The company intended that SR&ED would be carried out on this boiler during its assembly, construction, and commissioning. In addition, the company's intent was to use this boiler primarily for commercial work after the SR&ED was complete. According to subsection 2900(11) of the Regulations, the equipment is PDP.

Conclusion:

Therefore, even though the equipment's use exceeded 50% for the first period, no ITC can be claimed. The PDP exclusion applies as per subsection. 2900(11) of the Regulations.