

1 Overhead allocation options and methods

You can choose the traditional method and claim all actual SR&ED expenditures you incurred during the year, or you can elect¹ to use the proxy method for the year.

Before starting, it should be noted that neither the capital costs, nor rent, related to a building are eligible for tax credits however, most other overheads are.

The following paper provides a list of issues to consider in choosing the appropriate alternative:

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¹ under ITA clause 37(8)(a)(ii)(B)

1.1 Traditional method

The tax legislation provides that certain other expenditures are also directly attributable to the prosecution of SR&ED. These other expenditures are considered to include,

“any expenditure, **or portion thereof**, ... that is directly related to the prosecution of SR&ED ...”²

If you use the traditional method of overhead allocation, you are allowed to develop your own method to allocate overhead expenditures to SR&ED.

The only legislative & CRA requirements in this respect is that the method used must be reasonable.

1.1.1 Examples of potential traditional overhead base

Include³ “reasonable portions” of:

- general and administrative expenses, such as personnel or accounting staff,
- the cost of light, heat and long distance telephone charges,
- the cost of maintenance and upkeep of premises, facilities or equipment provided for SR&ED, including a reasonable portion of the municipal taxes and cost of insurance for the building.

Do **not** include:

- “prescribed” expenditures⁴, &
- expenses already directly allocated to SR&ED (i.e no double counting).

1.1.2 CRA Requirement for “reasonable basis” of determination

“The method used to determine the portion of the municipal taxes that is directly related to this use must also be reasonable and **may, for example, be based on the square meters of the building used for SR&ED over the total square meters of the building. Other methods can be used to determine the portion of an expenditure** that is directly related to the provision of premises, facilities or equipment for the prosecution of SR&ED provided they are reasonable in the circumstances. In all cases, whichever method is used, the **taxpayer must be able to support that it is reasonable.**”⁵

² Paragraph 2900(2)(c) of the Regulations

³ CRA Interpretation Bulletin 151-R4, paragraphs 18 & 19

⁴ listed in ITA Regulation 2902

⁵ Quote from CRA Interpretation Bulletin 151-R4, paragraph 19

1.1.3 Prescribed expenditures: out of SR&ED overhead base

The Income tax legislation⁶ does not allow certain types of expenditures for ITC purposes. The most common prescribed expenditures are:

- interest and other financing costs;
- a legal or accounting fee; and
- expenditures for “used” equipment.

1.2 Alternative election available for Proxy method of overhead allocation

The proxy method⁷ provides an alternative way to determine your SR&ED expenditures and investment tax credit (ITC) for overhead expenditures. It calculates a substitute amount for “overhead expenditures” using a formula, rather than specifically identifying and allocating these expenditures, as you would with the traditional method.

This amount is used to determine your qualified SR&ED expenditures for ITC purposes but is not otherwise deductible for tax purposes. As a result actual overheads continue to be deducted as “non-SR&ED” related overheads⁸ rather than being included in the SR&ED expenditure pool.

1.2.1 Exclusions from the “salary base”

The prescribed proxy amount is calculated as a fixed percentage (65%) of the “salary base” of the employees directly engaged in SR&ED. The salary base does not include

- taxable benefits⁹,
- bonuses,
- remuneration based on profits, or
- an amount included in the year because of non payment from a prior year¹⁰.

1.2.2 Limits on specified employees

For specified employees there is a further limitation on the salary base for purposes of calculating the prescribed proxy amount. The salary base for a specified employee is the least of the following amounts:

⁶ ITA Regulation 2902

⁷ elect under clause 37(8)(a)(ii)(B) to use the proxy method

⁸ expenses to earn business income deducted under ITA section 9

⁹ including all amounts included in employee’s income under sections 6 and 7 of the ITA

¹⁰ deemed incurred in the year under subsection 78(4) of the ITA – see section L for

- (1) actual R&D salaries or wages
- (2) 75% of total salaries or wages
- (3) 2.5 x Y.M.P.E for the calendar year.

There is an overall cap on the prescribed proxy amount which may limit the proxy amount you have otherwise determined. The prescribed proxy amount cannot be greater than actual overhead expenses (less prescribed expenses under Regulation 2902) deducted in the financial statements.

1.3 Differences between proxy election & traditional overhead treatments

Traditional overheads:

- Amounts form part of SR&ED expenditure pool & qualified expenditures for ITC purposes.
- This election will also allow companies to claim furniture and other office equipment that would not be allowed under the proxy method.

A comparison between the effects of these two methods has been provided in the following table.

1.3.1 Excerpt from CRA form T4088.Rev01– Guide to form T661

1.3.2 Treatment of expenses under the proxy and traditional methods

Expenditure	Traditional method	Proxy method
Direct SR&ED salaries or wages	<ul style="list-style-type: none"> ■ eligible for ITC ■ deductible 37(1)(a) (see line 300) 	<ul style="list-style-type: none"> ■ eligible for ITC and base for proxy amount (see line 502) ■ deductible 37(1)(a) (see line 300)
<ul style="list-style-type: none"> ■ Overhead expenditures directly related to SR&ED ■ Materials transformed in performing SR & ED 	<ul style="list-style-type: none"> ■ eligible for ITC ■ deductible 37(1)(a) 	<ul style="list-style-type: none"> ■ not specifically identified ■ covered in prescribed proxy amount (see examples below)—PPA is eligible for ITC. ■ deductible as regular business expenses only—not deductible under 37(1)(a)
Other expenditures claimed separately: <ul style="list-style-type: none"> ■ materials consumed in performing SR&ED ■ lease costs of SR&ED equipment ■ expenditures for SR&ED directly undertaken on your behalf ■ third-party payments 	<ul style="list-style-type: none"> ■ eligible for ITC ■ deductible 37(1)(a) 	<ul style="list-style-type: none"> ■ eligible for ITC ■ deductible 37(1)(a)
The proxy amount covers overhead expenditures such as: <ul style="list-style-type: none"> ■ office supplies ■ general purpose office equipment ■ heat, water, electricity, and telephones ■ support staff salaries or wages ■ travel and training ■ property taxes ■ maintenance and upkeep of SR&ED premises, facilities or equipment ■ any other eligible expenditures directly related to the prosecution of SR&ED that you would not have incurred if the SR&ED had not occurred 		

Summary of proxy inclusions & exclusions:

Amounts included in the proxy amount:

Generally speaking the proxy amount represents an allocation for administrative activities above (i.e. clerical support, accounting, SR&ED contract administration, purchasing, training or maintenance) as outlined above.

Amounts not included in the proxy amount:

Technical activities such as “computer programming” and “testing” are generally eligible to the extent that they are in support of eligible SR&ED projects. These support activities should therefore be tied to the resolution of one or more technical uncertainties and then claimed as direct SR&ED wages rather than as proxy overheads.

SR&ED Traditional Overhead Allocations

The balances below represent all expense balances on the income statement and have been organized to determine a base for allocation of SR&ED overhead expenses using the the "traditional" method of overhead allocation.

Expense class

I Direct SR&ED: (already claimed so NOT part of overhead base)

Wages & salaries
Supplies
Consulting fees
Third-party payments

II Eligible for SR&ED overhead base:

Cost of goods sold:

Wages & salaries (if included in COGS)

Eligible for SR&ED overhead base:

Wages & salaries
Fringe benefits
Supplies
Consulting fees
Telephone & fax
Travel
Utilities
Taxes (business & realty)
Insurance
Training
Postage

Total SR&ED overhead base (II)

*

III Balance of General Ledger expenses INELIGIBLE for SR&ED overhead base:

Costs prescribed by Reg. 2902

Legal & audit
Interest & bank charges
Meals & entertainment
Management bonus
Amortization
Administrative Salary
Interest & share transfer fees
Advertising or selling expense
Conference or convention fees
Dues or fees for membership in a scientific or technical society or organization
Fines or penalties

Other costs ineligible per section 37(1):

Materials in cost of goods sold
Rent for a building
Sales wages & expenses (non-SR&ED)
Total prescribed expenses

Traditional SR&ED overhead allocation

Total SR&ED labour x eligible administrative overhead base (II)*

Total labour (tabulated above **)