Canadian Industry Report

Software Publishers

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In addition to content provided by Welch LLP, the information contained in this report has been sourced from IBISWorld Inc - IBISWorld Industry Report 51121CA.

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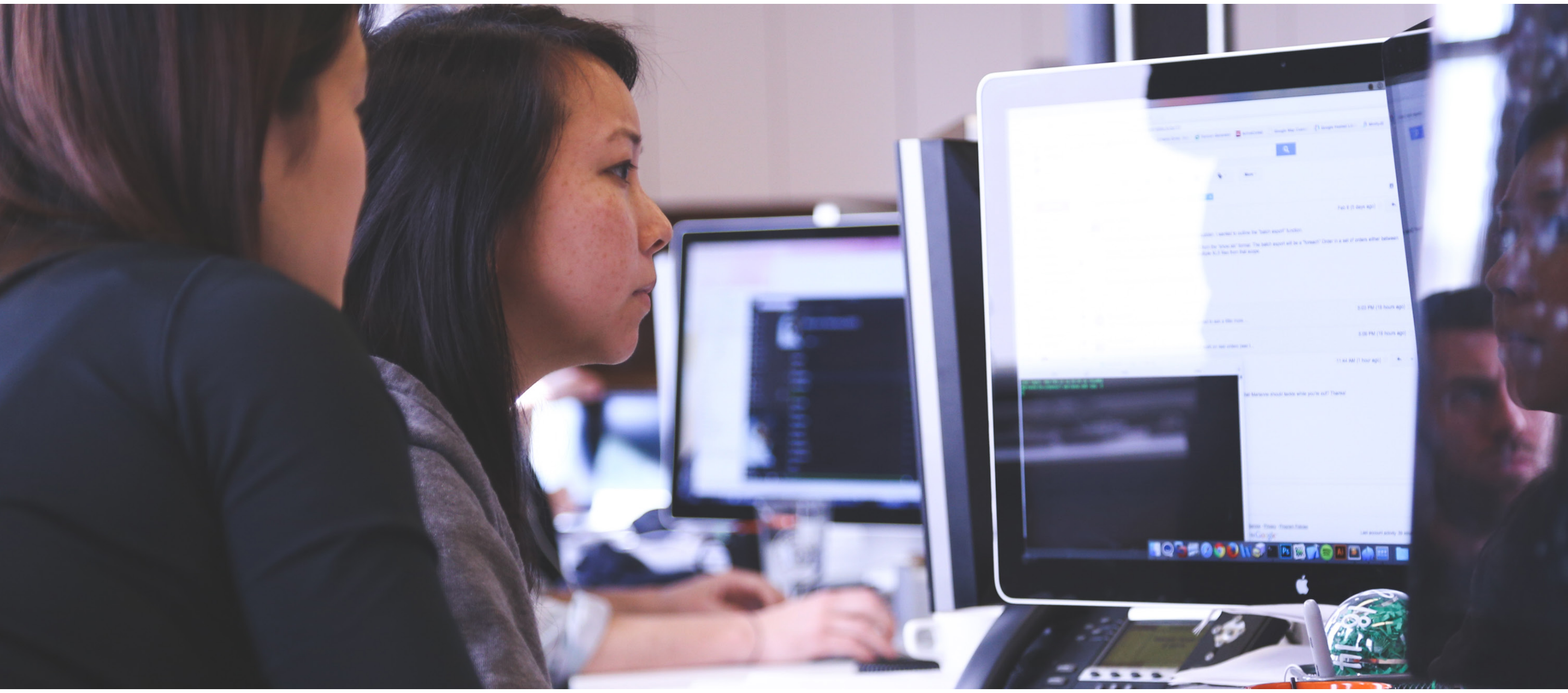
Forward

In this report you will find information on the current state, trends and future growth of your industry to help gain a better understanding of the Software Publisher industry in Canada. The information within this document has been sourced by IBISWorld 2017.

You will also find information provided by Welch LLP on tax considerations for operating in the US and potential tax credits available to Software companies in Canada.



Key Statistics

The Software Publishing industry is a growth industry, always searching for new products, services and markets. Rapid advancement in complementary industries, primarily semiconductors and telecommunications, continues to open up new opportunities for software publishers.

2,526 # of Businesses	**$8.9B** Total Revenue
1.9% Annual Growth 2012-17	**$4.0B** Salary Expenses
2.4% Annual Growth 2017-22	**$862M** Total Profits

Industry **Overview**

Current Performance

The Software Publishing industry is a growth industry, always searching for new products, services and markets. Rapid advancement in complementary industries, primarily semiconductors and telecommunications, continues to open up new opportunities for software publishers.

As a result, the industry experienced strong growth during the start of the period; however, declines in corporate profit growth in 2015 and 2016 hampered industry revenue. Consequently, revenue grew at an annualized rate of 1.9% over the five years to 2017. Revenue will rise 2.9% in 2017, reaching $8.9 billion, due to strong growth in per capita disposable income and corporate profit.

Rising Demand

The increasing use of technology in business and consumers' everyday lives has been a key driving factor behind rising demand. On the business side, rising corporate profit, which grew at an annualized rate of 2.3% over the five years to 2017, has provided businesses with the means to invest in new types of software. For consumers, per capita disposable income greatly influences demand, as software is often viewed as a discretionary item.

Shift to the cloud and subscription based business models

Businesses and consumers alike have already embraced cloud-computing services. Although operators are expected to focus on new types of software, such as security software like password management and artificial intelligence, distribution of this software is expected to predominately take place via the cloud.

As businesses and consumers continue to embrace cloud-computing, operators will continue to shift to subscription-based business models, including SaaS and cloud computing, which produce more stable cash flows than the traditional develop-and-release format and allow for easier distribution of software. Furthermore, SaaS business models improve security by allowing the software publisher to release incremental updates that install automatically; with traditional antivirus programs, security is compromised because users have to install updates themselves, which they often fail to do. As companies continue to focus on subscription models, revenue generated by releasing periodic updates and selling them to customers will continue to decline.

Improving technology and falling hardware prices will continue making computers, cell phones, video games, and, ultimately, software more accessible to more people.

Industry Structure

Life Cycle Stage	***Growth***
Revenue Volatility	***Medium***
Capital Intensity	***Low***
Industry Assistance	***Low***
Concentration Level	***Medium***
Regulation Level	***Light***
Technology Change	***High***
Barriers to Entry	***Medium***
Industry Globalization	***High***
Competition Level	***High***

Products & Markets

Software Publishing - Major Markets Segmentation 2017

35% Operating systems & productivity software

25% Business analytics & enterprise software

15% Security software

13% Database, storage & backup software

8% Design, editing & rendering software

4% Video game software

Software Publishing - Sales Segmentation 2017

45.7% Sales outside of Canada (exports)

45.6% Sales to businesses

7.1% Sales to NFPs & government

1.6% Sales to individuals & households

Top Canadian Software Business Locations (%)

48% Ontario

21% British Columbia

14% Quebec

12% Alberta

3% Atlantic Canada

2% Manitoba

Tax Considerations: **Operating in the U.S.**

W | ***Canadian businesses operating in or selling to customers in the United States may be subject to income taxes in the U.S. and/or may need to collect and remit U.S. state sales tax.***

It is very common for software companies to target the U.S. as a primary market for sales. Welch LLP has highlighted some of the tax considerations when selling or operating in the U.S.

Whether a Canadian company is subject to U.S. federal and/or state taxation depends on several factors. For U.S. federal income tax purposes, the controlling document is the Canada-U.S. Income Tax Convention (Treaty) and a determination of whether the company has a permanent establishment in the U.S. For state income and sales tax purposes, the primary factor is whether the company has nexus within one or more states.

Permanent Establishment (PE)

If a Canadian company has a PE in the U.S. it is subject to U.S. federal income taxation. A PE includes a place of management, branch, office, or factory. It also includes a building site or construction/installation project if the construction or installation period exceeds twelve months. In addition, there are also services PE rules, which may deem a PE to exist based on services performed in the U.S. by Canadian employees.

Companies that have a PE should be filing U.S. federal income tax returns. If a Canadian company is operating as a branch in the U.S., the U.S. federal and state income tax liability will be treated as a foreign tax paid. The startup may then be eligible for a foreign tax credit on its Canadian tax return, which should decrease the company's Canadian tax liability.

A company that does not have a PE must file an annual US federal tax return to disclose its Treaty-based position in order to avoid an annual U.S. $10,000 penalty.

Nexus

The concept of nexus essentially looks at whether a business has a non-trivial presence in one or more states. It is determined on a state-by-state basis and there are slightly different criteria between nexus for sales tax and nexus for income taxes. In determining whether the Canadian business has nexus, consider if the business has employees (including those attending trade shows), provides installation or implementation, has inventory stored, or has a physical location or property (including intangible property) in the state.

Rules vary from state to state and even a temporary presence may be enough to establish nexus. In Pennsylvania, for example, if a consultant is present in the state for more than seven days the business is considered to have nexus. In addition, a growing trend in certain states is the adoption of economic nexus rules, whereby nexus is deemed to exist in a state where the business has a threshold amount of revenue- notwithstanding that the business does not have a physical presence in the state.

It is also worth noting that if two businesses are affiliated with one another, in determining if one of them has nexus, the operations of the other can be taken into account. For example, in New York, if a business without nexus has as little as 5% cross-ownership with another

Tax Considerations: **Operating in the U.S.**

(cont.)

business that does have nexus, it can result in the first company having nexus as a result of the affiliate nexus rules. Other connections including sharing of intellectual property such as trademarks can also result in the affiliate rules applying.

It is crucial to carefully consider the operations of a business in relation to each state in which it operates or has customers.

State Sales Tax

A Canadian business with nexus for sales tax purposes in a state will be required to register for a sales tax permit to collect and remit sales taxes like any other business operating in that state.

As with GST/HST in Canada, sales tax rates can vary significantly from one jurisdiction to another. However, in the U.S., there is no federal sales tax. The total sales tax that a business must collect and remit is comprised of state and local sales taxes.

The tax amounts collected must be remitted to the state periodically; typically, as a company's sales increase so does the frequency of its remittances. Some local jurisdiction's sales taxes are reported and remitted to the state which passes them onto the local authorities, but others require that separate reporting be done.

Most services and some goods are exempt from sales taxes; however these rules vary on a state-by-state basis. Additionally, a customer can avoid paying the sales taxes if they present a valid exemption certificate. This can occur when the use of a product or service is deemed exempt (e.g. if the product is for resale or further manufacturing) or when the customer has been deemed exempt (e.g., a not-for-profit or government organization).

For more information contact our Director of U.S. Tax, Alan Tippett, CPA (Indiana) - atippett@welchllp.com - 613.236.9191

Industry **Consolidation**

Intellectual property remains a driving force behind industry acquisitions

The Software Publisher industry has been a hotbed of mergers and acquisitions over the past five years.

Despite the growing number of operators, large software companies have aggressively targeted innovative companies, particularly those with strategic patent portfolios. With such a rapid rate of technological advancement, patents play a key role in this industry's frequent legal disputes. Small, innovative software publishers often find that competitors have copied elements of their products.

Portfolio expansion is a driving force behind industry acquisitions. Although the industry contains many small operators, the largest companies in the industry all have substantial product portfolios and use acquisitions to acquire smaller players with innovative technology. Acquisitions can help operators stay ahead of emerging trends in the software industry and match their products to clients' needs. Additionally, by having a wide portfolio, operators can be viewed as an all-inclusive provider for customers' needs; consequently, many operators also offer hardware in addition to software, which allows them to cross-sell industry products with non-relevant products and vice versa.

Software company valuations can be very complex and standard valuation rules such as multiple of EBITDA or revenue may not be appropriate.

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Competitive **Landscape**

Scarcity of highly skilled, creative programmers is the most limiting factor for software publishers, leading to very high wages or stock based compensation plans.

Market Concentration

The Software Publishing industry has a low level of market share concentration, with the top four companies (Microsoft, SAP, Oracle and IBM) generating an estimated 33% of industry revenue. Due to the varied nature of the software market, no single company dominates software publishing as a whole.

Retail Software

Competition in the market for retail software can be fierce. Many small operators exist in this industry and the ability for small companies to advertise and distribute their product inexpensively via the internet has the potential to threaten larger companies. Another threat is the open source software movement, wherein programmers contribute to publicly available code that is then distributed freely. Although such software can lack the polish (e.g. usability, attractiveness and stability) of professionally published programs, it can be updated more easily. The one software segment largely immune to the open source movement is video games, which require not only programming but significant efforts in asset creation and organization. Smaller and individual video game developers, often referred to as indie games, market their products on the basis of their uniqueness.

Enterprise Software

While the enterprise software market is enormous, the massive profitability of the major companies in the industry suggests a systemic inefficiency. That inefficiency arises due to customers' difficulty in comparing competitors' prices directly. In addition, the wave of acquisitions made by the major companies in this market has led to each offering a sprawling list of overlapping products with unintuitive names, and feature lists that are so weighed down with jargon and business speak that they are largely unintelligible. However, these companies have a competitive advantage in that clients requiring enterprise software often have significant constraints that all but rule out smaller and open source competitors. Many require their software supplier to offer significant support contracts, and for those contracts to be backed by an extensive support staff. In addition, many customers have either internal or external security requirements. The banking industry and military contractors, for instance, both have very particular and demanding certification processes for any software they use. Such requirements reduce the ease with which new companies can penetrate the enterprise market.

Barriers to Entry

The Software Publishing industry has moderate barriers to entry, although certain product segments have much stronger barriers than others. Although companies are willing to license their patented technology in many cases, patents on intellectual property are commonly used to limit competition. On an investment basis, there are few barriers to entry for software publishing startups. Many software companies begin with little more than a handful of computers and programmers. Scarcity of highly skilled, creative programmers is the most limiting factor for software publishers, leading to very high wages or stock based compensation plans.

Globalization

Globalization is on the rise, as major players in the Software Publishing industry increasingly become multinational companies and control a large percentage of the worldwide software publishing market. In addition, many of the industry's companies are headquartered outside of Canada. Many industry players have made acquisitions and formed collaborative alliances across national borders to achieve economies of scale and reach local markets.

Competitive **Landscape** (cont.)

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Competition in this industry is high and the trend is increasing.

Top 5 Key Success Factors (Source IBISWorld)

1. Access to the latest available and most efficient technology and techniques
The most successful software publishers take great care to ensure developers use industry best practices, including systematic bug tracking, efficient coding, and thorough stability testing.

2. Undertaking technical research and development
Software publishers spend large sums of revenue on research and development, leading to more innovative products and a broader customer base.

3. Protection of patents
Software publishers frequently amass patents. These patents help maintain competitive advantages on key products and are often used in legal disputes with other software publishers.

4. Access to highly skilled workforce
Software publishers employ highly skilled software developers who possess a very specific skill set and a capacity for creativity.

5. Having a high profile in the market
Products in this industry can require significant investments and often must be purchased before the customer has proof of their quality or effectiveness. Maintaining a high profile is a key to attracting customers in such an environment.

Profit/ Cost Structure

Acquisitions by top-level companies have enabled them to consolidate operations while raising prices. Technological advances have further reduced what were already low production costs. However, rising wage costs have somewhat mitigated profit growth over the period.

10% Profit

Industry Costs

45%	11%	5%	4%	25%
Wages	Purchases	Rent & Utilities	Marketing	Other

Tax Credits **(SR&ED)**

You may be a candidate for the Scientific Research & Experimental Development Tax Credit

SR&ED

As a software company, your fundamental business activities are the epitome of eligibility for significant refundable tax incentives. Two noteworthy incentives available to companies in Canada are the Industrial Research Assistance Program (IRAP) and the Scientific Research and Experimental Development Program (SR&ED).

IRAP is a discretionary grant program available through the National Research Council (NRC). In order to be considered for funding, your company must be a small to medium-sized enterprise, operating in Canada, which is both incorporated and profit-oriented, and has fewer than 500 full-time employees. The company must be working towards continued growth and profit generation through the development and commercialization of innovative, technology-driven products, services, or processes in Canada.

SR&ED is a federal tax incentive program administered by the Canada Revenue Agency (CRA) designed to encourage Canadian businesses of all sizes to conduct research and development in Canada.

Generally, Canadian-controlled private corporations (CCPCs) can earn a refundable investment tax credit (ITC) at the enhanced rate of 35% on qualified SR&ED expenditures, up to a maximum threshold of $3 million. This 35% ITC is 100% refundable on qualified SR&ED expenditures . A non-refundable ITC at the basic rate of 15% on an amount over the $3 million threshold can also be earned.
Other corporations can earn a non-refundable ITC at the basic rate of 15% on qualified SR&ED expenditures. The ITC can be applied to reduce tax payable.

In order to qualify for SR&ED credits, the work conducted by your company must meet the definition of scientific research and experimental development (SR&ED) in subsection 248(1) of the Income Tax Act. Eligible activities include basic or applied research, namely work undertaken for the advancement of scientific knowledge and/or experimental development, namely, work undertaken for the purpose of achieving technological advancement for the purpose of creating new, or improving existing, materials, devices, products or processes, including incremental improvements.

If you feel that your company meets the above criteria, you can submit a claim as part of your corporate tax compliance activities. It is recommended to consult with an experienced advisor in order to compile the appropriate forms to claim the ITCs.

The perception exists that any company that receives IRAP funding should not bother claiming SR&ED because the IRAP funding received offsets any SR&ED claim on that project. While it is true that IRAP funding received typically reduces your SR&ED claim (with some exceptions), there is still a strong financial benefit to filing an SR&ED claim. What is often forgotten is that the impact of the proxy overhead amount gets added to salaries for a SR&ED claim. In most cases, the total return between IRAP and SR&ED dollars can be astounding.

Where you have the opportunity for an IRAP grant, do not forego your SR&ED claim. If you need some advice or you are not sure where to start in the IRAP or SR&ED process, please feel free to contact our tax credit specialist Joshua Smith.

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Industry Report: **Software Publishers in Canada**

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