

## Minutes of September 14, 2000

### Hamilton Region SR&ED Practitioner's meeting

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Minutes prepared and distributed September 2000 by David Sabina, group moderator

### Issue 1: Status of SR&ED eligibility on "salary & wages" incurred outside of Canada

As previously stated, based on the results of the Tigney Technologies and LGL appeals, the CCRA has taken the position that it will deny SR&ED credits eligibility<sup>1</sup> on "salary and wages" of Canadian employees while abroad<sup>2</sup>.

One of the most compelling arguments to support the eligibility of SR&ED credits on "salary and wages" of Canadian employees while abroad is the fact that the **Canadian employee remains taxable on his or her salary and wages** regardless of where these duties are performed. As a result, in most if not all cases, the CCRA earns substantially greater tax revenues from the personal taxes of the individual employee than it pays out to the SR&ED performers (i.e. the employers) on these wages.

In a previous meeting our group unanimously agreed that the current tax policy appears to inhibit achievement of our Science Policy goal to, "ensure that new knowledge can be acquired and disseminated widely, from Canadian sources and from around the world." These issues were submitted to Norine Heselton, Director General of the SR&ED program.

David Sabina received a response to this letter supporting a "deny all foreign expenses" position. Its **current rational** for this position is that it believes that there could be **loss of infrastructure** from encouraging Canadians to travel abroad.<sup>3</sup> This is in fact **in complete contradiction of a 1997 study performed by the Department of Finance** confirmed that the result of these activities is a net influx of infrastructure to the Canadian economy.<sup>4</sup>

We propose to explore these results as well as potential avenues for follow-up including letters to the Ministers of Finance and Industry. The group proposed to delay the issue of this letter until the result of the upcoming Federal elections and then renew its focus on this issue with the appropriate ministries in the new year.

### Issue 2: Negative tax effects from proper treatment of

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<sup>1</sup> By way of inclusion in Canadian expenses defined under ITA subsection 37(1)

<sup>2</sup> SR&ED Application Policy Paper 95-01R – Issue 2: SR&ED outside Canada

<sup>3</sup> CCRA rulings letter – January 14, 2000, N. Heselton, Director General

<sup>4</sup> "Why and How Governments support Research and Development," December 1997, Department of Finance (copies available at meeting or on request)

## **“development costs” still unchanged**

For taxation years that begin after 1995 the tax legislation provides for a phase-out<sup>5</sup> of the enhanced<sup>6</sup> ITC's for CCPC<sup>7</sup>'s based on their “taxable capital.” Basically, the \$2,000,000 expenditure limit for enhanced ITC's is reduced, on a straight-line basis, as the taxable capital of the company, and any other companies under common control, exceeds \$10,000,000. By the time taxable capital reaches \$15,000,000 the enhanced credit is fully phased out.

In the case of capitalized development costs, the costs have not been expensed in the periods in which the work was performed and therefore become part of the “retained earnings” portion of the “equity” balance of the corporation.

In many provinces (including Ontario) the definition of “taxable capital” provides for a deduction of amounts (such as SR&ED expenses) that are otherwise deductible for tax purposes independent of whether they are capitalized in the financial statements. Unfortunately, the Federal capital tax calculation<sup>8</sup> provides no similar reduction of “development costs” from the calculation of taxable capital.

This issue was submitted to the CCRA but no positive actions have been witnessed to date. The group reiterated its concern that the government provide relief to small and medium sized corporations similar to that provided in Ontario to encourage GAAP compliance.

## **Issue 3: Financial Statement & tax implications of “super-allowance” being treated as government assistance**

Reproduced below is Department of Finance News Release No. 2000-039, dated May 9, 2000, concerning certain proposals contained in the February 28, 2000 Federal Budget.

“Minister Martin announced today that the measure regarding the treatment of provincial deductions for scientific research and experimental development (SR&ED) expenditures will **apply to taxation years commencing after February 2000**. As originally announced in the budget, this measure would have applied for taxation years ending after February 2000. Under this measure, provincial deductions for SR&ED expenditures that exceed the actual amount of the expenditure will be taken into account in determining government assistance for the purposes of the federal investment tax credit base. Postponing the implementation date addresses concerns about the impact of the timing of this change on corporate budgeting strategies for the year 2000.”

The group discussed the financial statement & tax implications of this change but did not provide any specific examples of complications which would prove problematic in its application.

## **Issue 4: Use of databases to track SR&ED project technical and financial information**

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<sup>5</sup> Mechanics of phase-out formula provided in subsection 127(10.2) of the Income Tax Act.

<sup>6</sup> Qualified CCPC's receive a fully refundable, 35% Federal Investment Tax Credit (ITC) on their first \$2 million of qualified SR&ED expenditures. These credits are generally 20%, non-refundable credits otherwise.

<sup>7</sup> Canadian Controlled Private Corporation

<sup>8</sup> Taxable capital and capital tax ITA part I.3, section 181 and calculated per Federal Tax Schedule 33

Many practitioners will be aware of recent releases of SR&ED tax credit preparation software. These include products from KPMG, Price Waterhouse Cooper's and RPR Consultants, to name a few.

In order to facilitate this discussion, David Sabina provided a demonstration of such a program and opened the floor to feedback on the desired functions of such a system.

Some of the favourable and unfavourable aspects of the general designs of such systems included:

Pros:

Ability to correlate research steps with specific uncertainties

Ability to correlate costs to specific research steps

Simplicity of use

Cons:

Integration of confidential information (e.g. employee salaries) which would restrict widespread use in the company.

Most parties agree that database technologies of this nature were likely to significantly streamline the client compliance costs as well as CCRA administrative functions and could pave the way to an ability to have electronic filing of SR&ED claims. This will likely be a topic of future meetings.

October 19, 2001

**Attention: Hamilton SR&ED Practitioners' Group Members**

**Re. Minutes of October 11 meeting**

Dear member,

Please find attached the minutes summarizing the major issues, analysis and recommendations contemplated during the above noted meeting of the Hamilton R&D practitioners' group.

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Please feel free to send any comments or questions on these issues or to provide details of other issues you would like to see addressed. (Please respond by fax 905- 631-0698 or email [dsabina@meuk.net](mailto:dsabina@meuk.net))

Regards,

Dave Sabina,  
Hamilton Group Leader

## Attendees:

<u>Name</u>	<u>Firm</u>
Allen, Peter	Software Management Solutions
Dreiger, Susan	KPMG
Gribowski, Jerry	Gribowski & Assoc.
Hall, Denis	Tech Team Management
Moore, Michael	Taylor Leibow
Murphy, Patrick	Consultant
Sabina, David	MEUK Corporation
Vertucci, Rocco	MEUK Corporation

## Issue 1: Status of SR&ED eligibility on “salary & wages” incurred outside of Canada

As previously stated, based on the results of the Tigney Technologies and LGL appeals, the CCRA has taken the position that it will deny SR&ED credits eligibility<sup>1</sup> on “salary and wages” of Canadian employees while abroad<sup>2</sup>.

One of the most compelling arguments to support the eligibility of SR&ED credits on “salary and wages” of Canadian employees while abroad is the fact that the **Canadian employee remains taxable on his or her salary and wages** regardless of where these duties are performed. As a result, in most if not all cases, the CCRA earns substantially greater tax revenues from the personal taxes of the individual employee than it pays out to the SR&ED performers (i.e. the employers) on these wages.

In a previous meeting our group unanimously agreed that the current tax policy appears to inhibit achievement of our Science Policy goal to, “ensure that new knowledge can be acquired and disseminated widely, from Canadian sources and from around the world.” These issues were submitted to Norine Heselton, Director General of the SR&ED program.

David Sabina received a response to this letter supporting a “deny all foreign expenses” position. Its **current rational** for this position is that it believes that there could be **loss of infrastructure** from encouraging Canadians to travel abroad.<sup>3</sup> This is in fact **in complete contradiction of a 1997 study performed by the Department of Finance** confirmed that the result of these activities is a net influx of infrastructure to the Canadian economy.<sup>4</sup> This “inconsistency” in published policy was brought to the

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<sup>1</sup> By way of inclusion in Canadian expenses defined under ITA subsection 37(1)

<sup>2</sup> SR&ED Application Policy Paper 95-01R – Issue 2: SR&ED outside Canada

<sup>3</sup> CCRA rulings letter – January 14, 2000, N. Heselton, Director General

<sup>4</sup> “Why and How Governments support Research and Development,” December 1997, Department of Finance (copies available at meeting or on request)

attention of the CCRA during our last meeting.

Results of group discussion:

The group discussed the issues and agreed that the main issue would be to ensure that the recipient of the “salary or wages” is not otherwise eligible for foreign tax credit on these amounts. Though there were no foreign tax experts in the group, it was proposed that group members try to contemplate examples of potential abuse for the next meeting and that these results, as well as potential avenues for follow-up, be documented and sent to the CCRA as well as Ministers of Finance and Industry.

**Issue 2: Provincial harmonization issues - “development costs” / qualified corporations**

For taxation years that begin after 1995 the tax legislation provides for a phase-out<sup>5</sup> of the enhanced<sup>6</sup> ITC’s for CCPC<sup>7</sup>’s based on their “taxable capital.” Basically, the \$2,000,000 expenditure limit for enhanced ITC’s is reduced, on a straight-line basis, as the taxable capital of the company, and any other companies under common control, exceeds \$10,000,000. By the time taxable capital reaches \$15,000,000 the enhanced credit is fully phased out.

In the case of capitalized development costs, the costs have not been expensed in the periods in which the work was performed and therefore become part of the “retained earnings” portion of the “equity” balance of the corporation.

In many provinces (including Ontario) the definition of “taxable capital” provides for a deduction of amounts (such as SR&ED expenses) that are otherwise deductible for tax purposes independent of whether they are capitalized in the financial statements. Unfortunately, the Federal capital tax calculation<sup>8</sup> provides no similar reduction of “development costs” from the calculation of taxable capital.

Results of group discussion:

This issue was submitted to the CCRA but no positive actions have been witnessed to date. The group re-iterated its concern that the government provide relief to small and medium sized corporations similar to that provided in Ontario to encourage GAAP compliance.

Other issues on provincial harmonization

This also raises a discussion issue as to why there are two growing definitions of “qualified” corporations (for the purposes of enhanced credits). The federal government requires them to have less than \$15,000,000 in taxable capital whereas, Ontario and Quebec have extended their definitions to \$50,000,000.

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<sup>5</sup> Mechanics of phase-out formula provided in subsection 127(10.2) of the Income Tax Act.

<sup>6</sup> Qualified CCPC’s receive a fully refundable, 35% Federal Investment Tax Credit (ITC) on their first \$2 million of qualified SR&ED expenditures. These credits are generally 20%, non-refundable credits otherwise.

<sup>7</sup> Canadian Controlled Private Corporation

<sup>8</sup> Taxable capital and capital tax ITA part I.3, section 181 and calculated per Federal Tax Schedule 33

These issues were briefly discussed but it was recognized that the scope of these Federal “taxable capital” changes would need to be addressed by the Department of Finance and a hope that they will be addressed in the near future.

### **Issue 3: Tax cases now on line (better access to information among CCRA & claimants)**

During prior meetings, the group noted that CCRA published policies did not always keep pace with precedents and decisions be issued by the Tax Court of Canada on SR&ED issues. Because CCRA personnel formerly had no access the decisions, it was often a burdensome matter to present filing positions which were not directly outlined in existing interpretation bulletins or information circulars. An example was the two year delay in integration of the results of the 1993 case of “Cultures LaFlamme v. the Queen” in which the taxpayer established that there was “no requirement to offset proceeds from the sale of experimental production against SR&ED labour expenses incurred.” Unfortunately, this information was not integrated into information Circular 86-4R3 until 1995. In several of the practitioner’s experience, during this two year interim, this issue caused considerable confusion amongst claimants and auditors.

During fiscal 2000, the Tax Court of Canada has implemented procedures to provide these cases on line.

#### **Results of group discussion:**

As a result, the group concluded that this information would likely have a positive influence on CCRA-claimant interaction.

### **Issue 4: Foreign contractors in Canada (how & when to claim for SR&ED)**

Many SR&ED practitioners will be aware that contractors must be, “taxable suppliers,”<sup>9</sup> in order to be claimed for SR&ED tax credit purposes. Basically, this means that they must file a Canadian income tax return.

#### **Results of group discussion:**

The group briefly discussed the merits and implications of taking this filing position through an example comparing the effects of having the foreign SR&ED contractor file vs. not file a Canadian tax return. All parties agree that this position may create substantial opportunities for SR&ED claimants who “import” foreign contractors. A summary of this example is available from page 10 of the 2001-2 edition of the MEUK SR&ED newsletter (<http://www.meuk.net/news/news.html>).

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<sup>9</sup> “taxable supplier” - defined per ITA subsection 127(9)

### **Issue 5: Software examples released – CCRA / claimant feedback to date**

Towards the end of the 2000 year, the CCRA in cooperation with CATA, released a paper which commented on a variety of software issues. This paper included 14 specific project examples for the software industry. To date, it has been the authors experience that these examples have been met with mixed acceptance from both the CCRA & industry.

#### **Results of group discussion:**

The group briefly discussed the development of the paper and were provided with 2 specific project examples based on the papers' contents (these examples are available at request from dsabina@meuk.net).

Most group members were familiar with the paper and agreed that, to date, the feedback from SR&ED claimants within the software community had been positive. It was also noted that Elizabeth Koopman (Science Manager – Mississauga District) was proposing to organize a “software workgroup” in the Mississauga area and that interested parties could contact her at (905) 566-6148 or elizabeth.koopman@ccra-adrc.gc.ca)

### **Issue 6: Loss on ITC refundability on repayments of government assistance**

Under current legislation, ITC's generated by repayment of government assistance are not refundable under any circumstance. This is as result of problems with the specific wording of ITA subsection 127.1 regarding tax credit refundability. The group was provided with a copy of a letter regarding this issue, as sent to the Department of Finance (by another taxpayer). One of the major issues of concern was the fact that the loss of ITC refundability, for taxpayers with income under the small-business limit, would often result in an inability to use the tax credits before their expiration.

#### **Results of group discussion:**

Overall, the group expressed considerable concern with respect to this issue since an increasing proportion of IRAP and NRC assistance for SR&ED is coming in the form of repayable loans. At this point we propose to wait for the feedback from the CCRA and the department of finance.

### **Issue 7: Ontario problems**



#### **a) why pre-approval required for OBRI (Ontario Business Research Institute) credit**

It is the authors experience that several small research companies have hired universities to perform eligible “third party” research however, they been denied the OBRI tax credit on the basis that they did not apply within the pre-approval timeframe (90 days of contract signing).

Given that the legitimacy of the third party payments are audited by the CCRA, it is unclear why we need this approval process. This issue has been raised to MPP Cam Jackson who has forwarded it to appropriate officials at the Ontario Ministry of Finance. To date the issue has been reviewed by Mr. Roger Filion<sup>10</sup>, and is currently under review by senior Ministry staff.

#### **Results of group discussion:**

The seriousness of this issue was underlined by the fact that several group members were unaware of these advanced ruling requirements and in fact had clients who may be nearing, or past, these deadlines.

#### **Minister may dispense with requirement for ruling<sup>11</sup>**

“At any time **after May 6, 2000**, the Minister may give a direction that rulings no longer need to be obtained under this section in respect of contracts entered into after the date of the Minister's direction, **if the Minister is satisfied that corporations**, their officers, directors and shareholders, partnerships and their members and eligible research institutes are **conducting their business and affairs in a manner that meets the spirit and intent of this section.**”

Despite these great “budget speech announcements” as of October 2001 the Ontario Ministry is still vigorously enforcing this requirement. In the author’s opinion, the government should grant this credit to all corporations performing work which has qualified as a third party payment for federal SR&ED purposes. Hopefully, the proposed changes will take effect in the near future.

#### **b) “super-allowance” replaced by “exclusion of Federal ITC’s” from Ontario income**

### **Taxability of Super-allowances**

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<sup>10</sup> the senior manager, tax advisory, corporations tax branch, at the ministry (phone 905-433-5422)

<sup>11</sup> Ontario budget speech May 6, 2000

As a result of its 2000 budget, the federal government has proposed that, for taxations year beginning after February 22, 2000, provincial deductions for R&D in excess of actual expenditures would be treated as taxable government assistance.

### **Quebec drops superdeductions**

As a result of this, the Québec superdeductions assistance program was cancelled for corporations with taxation years commencing after February 29, 2000.<sup>12</sup>

### **Ontario replaces Super Allowance**

Ontario is proposing to suspend the R&D Super Allowance for two years and, in its place, allow corporations to exclude from Ontario taxable income the portion of the federal investment tax credit that relates to qualifying Ontario Scientific Research and Experimental Development (SR&ED) expenditures<sup>13</sup>.

This measure would be effective for a 24-month period, beginning with the first taxation year for which the federal super-deduction provision would apply to the corporation. To qualify for the Ontario benefit under this proposal, the investment tax credit must:

- be included in federal taxable income during the 24-month period; and
- be in respect of qualifying Ontario SR&ED expenditures incurred by the corporation during the 24-month period or in the taxation year immediately preceding the 24-month period.

Ontario then called upon the federal government to revisit its 2000 Budget proposal and to ensure that federal legislation does not target Ontario's R&D Super Allowance.

### Group's analysis and comment - "Loophole" in the wording?

In the authors' opinion, the effectiveness of Ontario's proposal requires a literal reading of the definition of "government assistance,"

"Government assistance means assistance from a government, municipality or other public authority whether as a grant, subsidy, forgivable loan, deduction from tax, investment allowance or as any other form of assistance **other than as a deduction under subsection (5) or (6);**"<sup>14</sup> (emphasis added)

Given that subsection 127(5) referred to above represents the, "federal SR&ED investment tax credit," it appears that this amount is specifically excluded and will not be subject to tax.

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<sup>12</sup> As per CCRA Application Policy Paper SR&ED 2000-03

<sup>13</sup> As posted per the Ontario Ministry of Finance website, "Ontario Budget 2001" Paper C pgs 97-98 - 2001

<sup>14</sup> Government assistance defined per ITA subsection 127(9)

Ironically, this “legislative” exclusion of the 127(5) credit was to avoid double counting since the amount was already included in taxable income through another section<sup>15</sup>.

Despite this fact, if the issue is brought to court, everyone in the group agreed that the judge will likely rely on a literal reading of the act and the Ontario position will be successful. Informal discussions with the Ontario Ministry of Finance have indicated that this is likely their legal interpretation.

#### Effect(s) on Ontario SR&ED claimants

It is also not surprising that Ontario proposed this as a two-year measure since this is likely the amount of time it would typically take the federal government to change the existing legislation. In the meantime, SR&ED claimants must try to determine which position they are going to file under given the uncertainty of the, “most current legislation.”

#### Results of group discussion:

Discussion with the Ontario Ministry of Finance indicated that the legislation was still proposed and should receive first reading by November 2001 and expected to be passed by December 2001. In the meantime it is unclear whether taxpayers should:

- file the forms based on this new legislation (before being passed), or
- continue to file & tax the super-allowance, or
- continue to file & not tax the super-allowance.

In fact, it appears that both the filing positions of the participants were equally spread among the three options above. Though technically taxpayers should file the Super-allowance and tax it, then amend all SR&ED claims once the legislation is passed this level of “red tape” is clearly in no party’s interest.

As a result the group saw this as an immediate concern to all Ontario SR&ED claimants since these inconsistencies will likely contribute to audit baglogs. In the meantime, the group looks to the CCRA to provide direction on any recommended filing positions.

#### **c) SR&ED stock options – effects on employee if SR&ED denied**

The 2000 Ontario budget announced an [ORES0] credit which exempted SR&ED employees from up to \$100,000 per year of stock option benefits & capital gains.

Eligibility for this credit requires:

- SR&ED performers to have SR&ED expenses > 10% of revenues, &
- SR&ED employees to spend >=30% of his or her time on SR&ED activities.

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<sup>15</sup> taxation of federal SR&ED ITC per ITA paragraph 37(1)(e)

Prior to the meeting, the minister clarified that employees would have to repay the amounts if either the SR&ED percentages are subsequently adjusted upon audit.

Results of group discussion:

Given that the majority of the group was unaware of the existence of these benefits these issues were not seen as a major concern to SR&ED practitioners.

July 10, 2002

## **Hamilton region SR&ED Practitioners' Group**

### **Re. Minutes of Meeting – June 12 (5-7 p.m.)**

Dear member,

Please find attached the minutes summarizing the major issues, analysis and recommendations contemplated during the above noted meeting of the Hamilton SR&ED practitioners' group.

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Regards,

Dave Sabina, C.A.  
Hamilton Group Leader

## **Attendees**

<b>Attendee</b>	<b>Company</b>
Ayling, John	Halton Region (host)
Baron, Frank	Baron & Associates
Bateman, Gary	Bateman MacKay C.A.'s
Baxter, Don	Burlington Economic Develop Corp
Cantor, Harvey	Harvey Cantor, C.A.
Dalton, Steven	MEDT
Driedger, Sue	KPMG
Foley-Bennet, Al	Bell & Co, C.A.'s
Gribowski, Jerry	Gribowski and Assoc.
Hale-Malhinha, Sandy	BDO Dunwoody LLP
Hayes, Wayne	MEUK Corporation
Hill, Keith	CCRA - Hamilton
Murphy, Patrick	Patrick Murphy, CMA
Rotenberg, Lawrence	L. Rotenberg, LLB
Sabina, David	MEUK Corporation
Sava, Michael	IRAP (presenter)
Wauben, Ina	CCRA - Hamilton
Zilkey, Paul	New Solutions Capital Group

## **New issues:**

### **NRC / IRAP overview**

A brief overview of the types of assistance available to SR&ED performers through the industrial research assistance program (IRAP) was provided by Dr. Michael Sava. This was followed by a question and answer session, which highlighted some of the following important issues:

- Funding is available for both the SR&ED process as well as the marketing process.
- Only one project at a time may be funded.
- The maximum funding on any single SR&ED project is \$25,000.
- The funding must be approved before the project is started.
- Any rights developed under a IRAP funded project may not be sold outside of Canada for a period of five years from the funding date.
- Unlike the CCRA, the IRAP program has NO published examples of eligible projects rather, the advisors themselves, after interviewing the client, use their judgment as to whether eligible projects exist.
- Perhaps the most surprising “revelation” to practitioners was Dr. Sava’s opinion that the **assistance of SR&ED practitioners as liaison** between IRAP and their client was **NOT recommended or encouraged** and that the client should apply to the IRAP office directly. ([www.nrc.ca/irap/](http://www.nrc.ca/irap/) or 1-877-994-0727).

## New CCRA releases

### SR&ED Investment Tax Credits for Farm Producers via “Agricultural organizations”

The Canada Customs and Revenue Agency (CCRA), in co-operation with Agriculture and Agri-Food Canada (AAFC), has developed a process so that farm organizations can participate in the program. The new process provides for the distribution of investment tax credits to farm producers who contribute to SR&ED through their agricultural organizations.

In the agriculture industry, **investments of this kind are often referred to as check-offs, assessments, or levies**. They are used by agricultural organizations, in part, to finance research and development work that benefits the individual contributors, as well as the agricultural industry as a whole.

### Implications and group commentary

The group agreed that agricultural SR&ED performers should be on the look-out for such payments which may not otherwise be “clearly flagged” as SR&ED expenses.

The group also suggested that these payments would likely also qualify for an additional 20% fully refundable Ontario Business Research Institute (OBRI) credit, if the appropriate pre-approval forms are filed on a timely basis (i.e. within 90 days of signing the contract). The requirement to file for the “pre-approval” was also discussed later in the meeting.

## New - APP 2002 - 01 - administrative salaries or wages

Application Policy SR&ED 2002 – 01, March 12, 2002

SUBJECT: Expenditures incurred for administrative salaries or wages - "directly related" test - for traditional overhead claimants

There have been cases where dedicated SR&ED performers have claimed, under the traditional method, all or a large portion of, the expenditures incurred for administrative salaries or wages. The expenditures were claimed either as all or substantially all (ASA) attributable to, or directly attributable to, the prosecution of SR&ED in Canada.

### TASKS/DEPARTMENTS THAT ARE **DIRECTLY RELATED** TO SR&ED WORK

- Financing of SR&ED (is "directly related" if the funds are used to perform SR&ED)
- Evaluating, recruiting and hiring of SR&ED personnel



- Technical implementation and control of scientific projects; defining future SR&ED direction; supervision of SR&ED group and SR&ED project selection/evaluation. Such tasks are usually performed by a VP Technology.
- Evaluating the technological feasibility of a product and the potential SR&ED efforts and costs involved
- Technological planning for on-going SR&ED projects (assignment of technological personnel, job priority, development of technological strategies, assessment of quality of materials used)
- Work performed by clerical staff for tasks directly related to payroll, purchasing and accounting.

#### TASKS/DEPARTMENTS THAT ARE GENERALLY NOT DIRECTLY RELATED TO SR&ED WORK

- Bidding costs
- Purchasing (other than direct purchasing of material/SR&ED equipment)
- Taxation and Legal services
- Sales, marketing and advertising
- Employee relations
- Development of benefits program for SR&ED personnel
- Corporate secretary and reporting to shareholders
- Initiating and closing of licensing agreements
- Feasibility studies (non-technological) leading to potential SR&ED collaborations and assessing the commercial feasibility of a given technology
- Commercialisation of existing intellectual property
- Review and approval of SR&ED budgets
- Patent application

In the group's opinion, this represents a potential tightening of activities, which may have been formerly allowed under the traditional method.

They also felt that the paper still leaves significant ambiguity since there remains a fair amount of judgement in evaluating the cut-off between "commercial and technical" feasibility given that commercial constraints often drive the technical objectives.

Examples:

- "Financing of SR&ED" is eligible but "review and approval of SR&ED budgets" is not. Most SR&ED practitioners agreed that it is hard to "finance" SR&ED without a "budget"?
- Work performed, "by clerical staff for tasks directly related to payroll, purchasing and accounting" is eligible but, "development of benefits program for SR&ED personnel" is not?

Based on these and other issues the group agreed that:

- The paper likely creates as much confusion as it removes and

- That the paper underlines the importance for claimants to pay due attention to clearly documenting the linkage of any SR&ED work claimed to the resolution of “specific technical uncertainties.”

### **Food and Consumer Packaged Goods Sector SR&ED Guidance Document<sup>1</sup>**

This paper describes the elements of a SR&ED project as conducted by the Food and Consumer Packaged Goods Industry in a stated attempt to, “clarify SR&ED in this industry from a practical viewpoint and describes the methods by which these activities are accomplished.”

In the groups’ opinion, the paper outlined a variety of “technical issues” which they believe to be of relevance to most if not all researchers in the agricultural sector. Additional input and commentary was provided by CCRA representative, Ina Waubin, who had involvement on the development of the paper.

The technical issues were addressed with under 3 separate headings. The major implications to SR&ED performers has been reproduced below:

#### **1) Formula Ingredient, Manufacturing Specifications (F.I.M.S.)**

The science and technology involved in the development of product formulations and manufacturing process specifications usually requires SR&ED to meet consumer needs throughout worldwide geographical locations and temperature zones. As a result, are some of the key attributes which create a basis for SR&ED eligibility are:

- Product stability,
- consistency in quality,
- flavor,
- texture,
- form,
- extended shelf life &
- safety

This is generally accomplished by developing specifications for formulations and manufacturing parameters. (F.I.M.S. is the terminology used to describe this activity).

In the case of materials derived from agricultural sources of variability and thus potentially eligible technological uncertainty can be caused by factors such as,

- time of harvest,
- change in species variety,
- growing location and conditions,

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<sup>1</sup> Prepared by Food and Consumer Products Manufacturers of Canada (FCPMC) & Canada Customs and Revenue Agency (CCRA)

- seasonal climatic variation,
- water availability,
- stress factors etc.

## 2) Consumer Research

The CCRA admits that, “it is impractical to predict consumer reaction to a given prototype, based solely on meeting certain chemical or physical criteria that have been achieved scientifically.” Industrial scientists cannot rely on data from laboratory analysis to predict consumer acceptance, hence consumer testing has emerged as a valid analytical tool used in support of R&D projects. **Therefore consumer testing is eligible when used in support of a SR&ED project.** The testing instrument may be trained sensory panels, employees, consumers and users.

The paper also provided a list of they types of eligible and ineligible testing which are often utilized to evaluate experimental products during the experimental development process. These were reviewed with the group and felt to be of significant long-term benefit to claimants in the industry.

## 3) Scale-up and Commercialization

Finally the paper clarified that, “as a project moves through various phases of development, frequent trials on a larger scale will be required. These experimental trials are often part of a SR&ED project using equipment of any appropriate scale.” The group believed that this was merely a “consistent re-iteration” of the “scale-up” issues as outlined in Information Circular 86-4.

In the group’s opinion this paper likely provides significant clarification to claimants as to the cut-off of between eligible activities vs. those that are ineligible “style changes.” Generally speaking a “style change” includes any work aimed at aesthetic improvements rather than objective and verifiable advancements of technical knowledge. As a result, the group agreed that this portion of the paper will likely be of considerable long-term significant to claimants in the agricultural, food and packing industries.

## Water and Energy Sources as Materials

The CCRA states that, “generally water and energy sources used to carry out SR&ED are not considered to be materials. Their costs are treated as overhead expenses and could be allowable SR&ED expenditures only in the traditional method of calculating the investment tax credit (ITC).”

However, there are circumstances where water and energy sources used in performing SR&ED could be considered materials consumed, based on the definitions of "materials" and "consumed" in Application Policy 2000-01. In this respect an Interim Instructional Sheet was released to clarify how water and energy sources should be treated for SR&ED purposes.<sup>2</sup>

#### CCRA's "New" Policies - Water and Energy Sources as Consumed Materials

In most industries, specifically in the chemical, petrochemical, minerals, pulp and paper and textile industries, water consumed is usually separated into **several streams**. One is the **utility water** used throughout the plant, another stream is the **boiler feed water**, which is used to generate steam on site, and the third is the **process water stream** which, like any other feed material, enters the process and becomes part of intermediate and/or final product(s), as governed by the chemical equation(s) on which the process is based.

This **process water stream** is often pre-treated or conforms to specifications unique to the process. Once water enters the process, for all practical purposes, it is **rendered useless** - as process water feed - even if it is recovered. As a result, such process water streams meet the definition of "materials" and "consumed".

With respect to energy use, a similar argument could be made that some of the energy sources used in the plant can be part of the chemical/physical process - i.e. it is part of the conversion/production process and is integral to the chemical reaction on which the process is based.

The cost of such energy sources used in a process, that is part of SR&ED, could be included in the cost of materials consumed.

#### Financial and Technical Review Issues Related to Water and Energy Use

Where expenditures on portion of water and energy sources that might qualify as "materials consumed" are expected to be significant, the claimant has the choice of the **traditional method** of calculating ITCs, where cost of **all water and energy sources directly attributable to the SR&ED are allowable overhead expenditures**.

A claimant can also choose the **proxy method** of calculating ITCs and claim water and energy sources as consumed materials. In the case of proxy, claimants will **have to identify and document clearly the portion of the water and energy sources "consumed"** in the process.

#### Implications and group commentary

In the group's opinion, this represents a potential **"loosening" of the rules regarding the types of expenses covered by the proxy method** and is also likely of considerable interest to most "processing" industries.

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<sup>2</sup> Excerpts and commentary from the CCRA's recent Addendum to Application Policy SR&ED 2000-01

### **The Account Executive Service for the (SR&ED) Program**

This program was briefly discussed with the CCRA representatives. Basically it involves personalized service from a designated representative of the Federal Government's SR&ED Program to provide:

- ways to simplify the SR&ED claim process for the company;
- guidance in understanding the SR&ED Program requirements;
- clarification about what you should keep to support the claim; and
- information about the status of claims after filing.

Most practitioner's agreed that this service is generally provided to both new and repeat claimants without the need for specific requests.

## **Recent SR&ED tax cases results & implications**

The group briefly reviewed the results and implications of two recent tax cases.

### **DATA CALC RESEARCH CORPORATION v. THE QUEEN**<sup>3</sup>

#### Facts:

This appeal is from an assessment for the appellant's 1986 taxation year whereby the Minister of National Revenue denied SR&ED ITC's in the amount of \$665,607 claimed in its return of income for the 1986 taxation year since the claim was not filed until 1999: well past the 18 month deadline.

#### Issue(s): extension of 18 month filing deadline

Whether the late-filing could be warranted and, if so, under what conditions.

#### Relevant legislation, Ruling & rationale:

Basically the credit was denied as based on current legislation, qualified expenditures must be identified on or before the due date for filing the tax return for the subsequent taxation year.

#### Implications and group commentary

The group agreed that this case underlined the fact that neither the CCRA, nor the Tax Courts, are willing to extend the prescribed filing deadlines. In the author's opinion this underlines the importance for taxpayers to file on a timely basis.

### **MIMETIX PHARMACEUTICALS INC. v. THE QUEEN**<sup>4</sup>

#### Facts:

During the year in question, Mimetix (a foreign corporation) owned 50 common shares in the capital stock of the appellant, and two Canadian residents, who were also directors owned 25 common shares each.

There were three directors elected to the board, one a U.S. resident and the other two Canadians.

#### Issue(s): "defacto" control

Both parties agreed that no one had de jure control over the appellant. The issue is rather whether the appellant was controlled in fact, directly or indirectly in any manner whatever, by a non-

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<sup>3</sup> (TCC) Docket: 2000-1413-IT-G Date: 2002/02/22

<sup>4</sup> (TCC) Docket: 1999-4847-IT-G Date: 2001/11/08

resident. In other words, it has to be determined whether the non-resident corporation Mimetix Inc. ("Mimetix"), which owned 50 per cent of the voting shares of the appellant in 1996, exercised "de facto" control over the Canadian company.

The CCRA's council pointed out that;

ØThe two Canadian directors, who, according to the appellant's argument, were supposed to control the appellant, in fact knew almost nothing about the appellant (for example one did not know at the time of his examination for discovery how many employees were working for the appellant, who had signing authority for the appellant, etc.).

ØMimetix had financial control over the appellant and had a controlling influence over the appellant's affairs. This is best illustrated, in his view, by the fact that a Canadian director of the appellant, had to leave following a conflict with another U.S. director, who was not a shareholder, director or officer of the appellant, but was hired by the U.S. director on his own decision, without any resolution of the board of directors.

#### Relevant legislation and analysis:

De facto control within the meaning of subsection 256(5.1) of the Act which reads as follows:

"Control in fact. ..., a corporation shall be considered to be so controlled by another corporation, person or group of persons (in this subsection referred to as the "controller") at any time where, at that time, the controller has any direct or indirect influence that, if exercised, would result in control in fact of the corporation, except that, where the corporation and the controller are dealing with each other at arm's length and the influence is derived from a franchise, license, lease, distribution, supply or management agreement or other similar agreement or arrangement, the main purpose of which is to govern the relationship between the corporation and the controller regarding the manner in which a business carried on by the corporation is to be conducted.."

#### Ruling & rationale:

Based on the facts provided, the judge e concluded that,

"Indeed the evidence discloses that the only director that exercised such control and supervision was the non-resident director. ... without the approval of the board of directors"

#### Implications and group commentary

In the group's opinion this case underlines the importance of clearly considering "defacto" control issues whenever there are foreign shareholders or directors of a Qualified Canadian Controlled Private Corporation.

## **Status of issues raised during previous meetings**

### **SR&ED eligibility on “salary & wages” incurred outside of Canada**

As previously stated, based on the results of the Tigney Technologies and LGL appeals, the CCRA has taken the position that it will deny SR&ED credits eligibility<sup>5</sup> on “salary and wages” of Canadian employees while abroad<sup>6</sup>.

One of the most compelling arguments to support the eligibility of SR&ED credits on “salary and wages” of Canadian employees while abroad is the fact that the **Canadian employee remains taxable on his or her salary and wages** regardless of where these duties are performed. As a result, in most if not all cases, the CCRA earns substantially greater tax revenues from the personal taxes of the individual employee than it pays out to the SR&ED performers (i.e. the employers) on these wages.

In a previous meeting our group unanimously agreed that the current tax policy appears to inhibit achievement of our Science Policy goal to, “ensure that new knowledge can be acquired and disseminated widely, from Canadian sources and from around the world.” These issues were submitted to Norine Heselton, Director General of the SR&ED program.

David Sabina received a response to this letter supporting a “deny all foreign expenses” position. Its **current rational** for this position is that it believes that there could be **loss of infrastructure** from encouraging Canadians to travel abroad.<sup>7</sup> This is in fact **in complete contradiction of a 1997 study performed by the Department of Finance** confirmed that the result of these activities is a net influx of infrastructure to the Canadian economy.<sup>8</sup> This “inconsistency” in published policy was brought to the attention of the CCRA during our last meeting.

The group re-addressed these issues and agreed that the current situation and lack of results to date warranted follow-up with the Ministers of Finance and Industry. A copy of this letter will be available by the end of July at [www.meuk.net](http://www.meuk.net) (under the heading “SR&ED issues”).

### **Provincial harmonization issues - “development costs” / qualified corporations**

For taxation years that begin after 1995 the tax legislation provides for a phase-out<sup>9</sup> of the enhanced<sup>10</sup> ITC’s for CCPC<sup>11</sup>’s based on their “taxable capital.” Basically, the \$2,000,000 expenditure limit for enhanced ITC’s is reduced, on a straight-line basis, as the taxable capital of the

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<sup>5</sup> By way of inclusion in Canadian expenses defined under ITA subsection 37(1)

<sup>6</sup> SR&ED Application Policy Paper 95-01R – Issue 2: SR&ED outside Canada

<sup>7</sup> CCRA rulings letter – January 14, 2000, N. Heselton, Director General

<sup>8</sup> “Why and How Governments support Research and Development,” December 1997, Department of Finance (copies available at meeting or on request)

<sup>9</sup> Mechanics of phase-out formula provided in subsection 127(10.2) of the Income Tax Act.

<sup>10</sup> Qualified CCPC’s receive a fully refundable, 35% Federal Investment Tax Credit (ITC) on their first \$2 million of qualified SR&ED expenditures. These credits are generally 20%, non-refundable credits otherwise.

<sup>11</sup> Canadian Controlled Private Corporation



company, and any other companies under common control, exceeds \$10,000,000. By the time taxable capital reaches \$15,000,000 the enhanced credit is fully phased out.

In the case of capitalized development costs, the costs have not been expensed in the periods in which the work was performed and therefore become part of the “retained earnings” portion of the “equity” balance of the corporation.

In many provinces (including Ontario) the definition of “taxable capital” provides for a deduction of amounts (such as SR&ED expenses) that are otherwise deductible for tax purposes independent of whether they are capitalized in the financial statements. Unfortunately, the Federal capital tax calculation<sup>12</sup> provides no similar reduction of “development costs” from the calculation of taxable capital.

This issue was submitted to the CCRA but no positive actions have been witnessed to date. The group re-iterated its concern that the government provide relief to small and medium sized corporations similar to that provided in Ontario to encourage GAAP compliance.

Again, the group re-addressed these issues and agreed that they warranted follow-up with the Ministers of Finance and Industry. A copy of this letter will be available by the end of July at [www.meuk.net](http://www.meuk.net) (under the heading “SR&ED issues”).

### **Loss on ITC refundability on repayments of government assistance**

Under current legislation, ITC’s generated by repayment of government assistance are not refundable under any circumstance. Since the author is aware that this issue has already been raised with the Department of Finance (by another taxpayer), we propose to defer writing to the minister on this issue.

## **Ontario problems**

### **a) OBRI pre-approval**

Why pre-approval required for OBRI (Ontario Business Research Institute) credit?

It is the authors experience that several small research companies have hired universities to perform eligible “third party” research however, they been denied the OBRI tax credit on the basis that they did not apply within the pre-approval timeframe (90 days of contract signing).

Given that the legitimacy of the third party payments are **audited by the CCRA, it is unclear why we need this approval process**. This issue has been raised to MPP Cam Jackson who has forwarded it to The Honourable James Flaherty (Minister of Finance).

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<sup>12</sup> Taxable capital and capital tax ITA part I.3, section 181 and calculated per Federal Tax Schedule 33

The group reviewed the status of the representations and responses received back from Mr. Flaherty and agreed that the apparent mis-understanding of the issues and the Ministerial level warranted a follow-up letter. A copy of this letter is currently available at [www.meuk.net](http://www.meuk.net) (under the heading “SR&ED issues”).

b) “Super-allowance” replaced by “super deduction” from Ontario income

This latest “Super-allowance” proposal as outlined in the 2001 Ontario budget was briefly discussed. Many group members felt that the new method, while providing roughly similar tax relief to claimants, was much easier to administer than the previous Super-allowance incentive.

**Hamilton Region SR&ED Practitioner's Workshops**  
**Minutes of meetings: May 16<sup>th</sup>, 2003 & September 4<sup>th</sup>, 2003**  
**Holiday Inn – Burlington**

Topics discussed during May & September 2003 meetings:

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Minutes prepared and distributed October 10, 2003 by David Sabina, group moderator

### **1.1. List of attendees & participants**

#### **May 16, 2003 meeting**

<u>Participant</u>	<u>Company</u>
Patrick Murphy	Patrick Murphy Consulting
Brian Allendorf	Brian Allendorf, C.A., C.B.V.
Debbie Davy	Ernst & Young
Gul Nawaz	Nawaz Taub Noor & Wasserman, C.A.'s
Liz McFadden	C-Bass Ltd.
Mike McFadden	C-Bass Ltd.
Christie Henderson	Henderson Partners LLP
Heather Tremblay	Henderson Partners LLP
John Neumayer	KPMG
Manoucher Ghazi-Z.	Bench and Donath C.A.'s
Dominic Iaonnoni	CCRA
Seemant Thakkar	Nawaz Taub Noor & Wasserman
Harvey Cantor	Harvey Cantor Professional Corporation
Kris Unni	Scott Batenchuk , C.A.'s
Paul Bradley	Paul Bradley, C.A.
Wayne Hayes	MEUK Corporation
Michelle Jamieson	MEUK Corporation

#### **September 4, 2003 meeting**

<u>Participant</u>	<u>Company</u>
Doug Soules	DingFeld Nakamura, C.A.s
Keith Rosen	Stern Cohen LLP
Frank Baron	Frank Baron Consulting
Rocco Vertucci	Ernst & Young LLP
Jerry Gribowski	Gribowski & Assoc
John F. Neumayer	KPMG
Kris Unni	Scott Batenchuk & Co. LLP
Ken Edwards	HMS Software
Lori Simpson	Evans Martin
Barry Doerbecker	Barry Doerbecker, C.A.
Wayne Hayes	MEUK Corporation
Michelle Jamieson	MEUK Corporation

## **2. New T661 form**

### **2.1. Elimination of "technological uncertainty heading" in Part 2**

The SR&ED project description requirements have changed in several areas:

#### **Previous requirements: form T661 E (99 & 01)**

##### **Step 2 – Detailed Project Description**

For each project listed in Step 1 above, identify the project and answer questions A to E below.

**A.** What are the **scientific or technological objectives in quantitative or variable terms**, of the work you are claiming?

**B.** What **scientific or technological advancement** did you expect to achieve as a result of performing this work? In what field of science or technology did you expect to achieve this advancement? Explain why this is a scientific or technological advancement.

**C.** Explain what **scientific or technological uncertainty** you have to resolve to achieve the advancement stated in B above.

**D. Describe in chronological order, the work**, including all support work performed in this taxation year to resolve the scientific or technological uncertainty stated in C above. Your description must demonstrate the systematic nature of the investigation such as analyses and experiments performed, interpretation of the results obtained, and conclusions made. What progress was made towards the scientific or technological objectives (from A above) as a result of this work? If all or part of the work that you are claiming was performed by contractors, describe what work was performed by the contractors and include a copy of the statement of work from the contract.

**E.** Specify the **technical documents available** to substantiate the work described in D above.

#### **New requirements: form T661 E (03) – required after June 30, 2003**

##### **Part 2 – Scientific or Technological Project Information**

**A. Scientific or Technological Objectives** – What is the technological **or** scientific objective of your project? Does this project involve scientific research or experimental development? What field of science or technology does the project involve?

**B. Technology or Knowledge Base Level** – Before you started your project, what were the technological limitations of your products or processes to be overcome, **or** if your project work was predominantly scientific research, give a perspective in terms of the scientific knowledge that you were seeking before you started your work? You can use the information you provided last year if your project is continuing from last year and the objectives have not been achieved or changed.

**C. Scientific or Technological Advancement** – What advancement in technology is being sought, what were the problems or challenges that you could not solve using commonly available experience and required you to seek an advance in the underlying technology to achieve the objective in A above, **or** what was the new scientific knowledge sought in your work?

**D. Description of Work in this Taxation Year** – Describe the work, including experiments and analyses, that you did in this taxation year to achieve the above technological **or** scientific objectives.

E. **Supporting Information** – What technical records or documents such as records of trials, test results, progress and final reports, meeting minutes, employee activity records, prototypes, new products, generated over the course of the work are available to support your work?

#### Discussion & commentary

The group was initially alarmed with the apparent removal of the “technological uncertainty” heading. The issue was discussed during both meetings with the general consensus of the group being:

- **The addition of the section to clarify “Technology or Knowledge Base Level” was seen as a positive step** in helping claimants to outline benchmarks of “available information / standard practices” from which to further define and illustrate uncertainties. The group recognized that this information was always required however they felt that the previous “advancement” heading did not provide as clear a prompt for claimants to outline this information.
- The information required in the **new “Scientific or Technological Advancement” section** still requires examination of **“the problems or challenges** that you could not solve using commonly available experience...” and as such, the group felt that this section **still requires the definition and analysis of “scientific or technological uncertainty.”**

#### Conclusions

Based on the above issues and discussions the group concluded that the **new form was a positive change** with it main focus to clarify that the “technological uncertainties” addressed should be continually benchmarked against the company’s “knowledge base.”

As a result the new form was seen to represent minor, positive clarifications as to the optimal SR&ED project structure but NOT as a significant change in required project documentation. As a result most practitioners believed that the current SR&ED related Information Circulars did NOT need to be revised to reflect these changes.

### **2.2. BN number required for all subcontractors**

The key issue dealt with the fact that the new T661 form requires BN numbers for all SR&ED subcontractors claimed. The previous form provided an exception for small suppliers under \$30,000. As a result practitioners may get diagnostic errors when finalizing claims that include payments to “non-registered” subcontractors.

#### Discussion & commentary:

Some of the potential methods to “clear” the filing diagnostics with unregistered “small suppliers” were:

- input a “dummy” business number such as 88888 8889, OR
- some programs will allow users to input NR (non-registrant) in the business number field

In the meantime, the CCRA has not provided any specific guidance on this issue.

### **2.3. Reporting for Unpaid amounts**

Often taxpayers will claim SR&ED expenses “accrued” during the taxation year but unpaid 180 days after year-end. Currently the form requires disclosure of this amount on line 315 (for wages) & 500 (other SR&ED expenses) however, it is unclear what degree of supporting details should be submitted and the full extent of the related tax effects.

#### **Example - Sample Facts**

A “business owner” performs eligible SR&ED work on his company’s behalf but does not have the funds available to pay himself a “reasonable salary” for the work performed. The business owner estimates that his normal “salary” for this work would have been \$100,000.

#### **SR&ED claim = Accrual of reasonable subcontractor fees in year performed**

The taxpayer must assert that costs have been “**incurred**” in the year due to the nature of the work. It is important that the taxpayer claims this work during the year in question to avoid missing the 18 month filing deadline<sup>1</sup> for SR&ED costs. In this case we would try to accrue reasonable, non-arm’s-length salary costs (i.e. \$100,000) related to the current year’s work.

#### **Effect of this position**

There is a provision in the SR&ED legislation, which (temporarily) denies an investment tax credit for any costs, which remained unpaid within 180 days of year-end<sup>2</sup>. These costs will be audited in the current year and a conclusion will be made on their “reasonableness,” however, investment tax credits will be paid on these amounts only in the years in which they are actually paid. Furthermore, if this transaction is properly structured, employees will not have to pay tax on wages until they are “received.”<sup>3</sup>

#### **Tax issues, discussion & commentary:**

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<sup>1</sup> ITA subsection 37(11) requires any SR&ED claims to be filed in prescribed form within 18 months of year-end

<sup>2</sup> ITA subsection 78(4) denies ITC’s on amounts until taxation year in which paid

<sup>3</sup> ITA subsection 5(1) only taxes employees on income “received” during the year

### 2.3.1. Degree of disclosure required

Practitioners were unsure the degree of additional detail required to support these allocations but assume that it would be similar to the timesheet requirements used by a typical SR&ED employee.

### 2.3.2. Reporting for unpaid wages vs. other types of expenses

Unpaid wages (in once) - It would appear the unpaid wages would not be included in the balance of SR&ED wages (line 300 or 305) but would be disclosed separately (line 315) and only added to the total expenses in the year when paid (line 310).

Non-wages (in-out-in) - Unpaid SR&ED expenses other than wages would be accrued to the respective cost category (subcontractors, materials, etc.) and would then be “removed” for the “qualified expenses” calculation (line 520) and added back in the year paid (line 500).

Once the mechanics of these formulas were understood practitioners did not appear to have any remaining concerns.

### 2.3.3. Risks of being deemed a Salary Deferral Arrangement (SDA)

#### Conditions that create a Salary Deferral Arrangement (SDA)<sup>4</sup>

- Plan or arrangement, funded or not; and
- Any person has a right (including such a right that is subject to one or more conditions) in a taxation year to receive an amount after the year where it is reasonable to consider that **one of the main purposes** for the creation or existence of the right is **to postpone tax payable** under this Act by the taxpayer in respect of an amount that is salary or wages of the taxpayer for services rendered by the taxpayer in the year or a preceding taxation year;

#### Negative implications

The net tax effects of being deemed an SDA is the immediate taxation to the employee. Since the amount is not subject to withholding by the employer (under ITA 153) until the amount is paid. The tax effects of this timing difference could be significant.

#### Planning to avoid SDA provisions

However, to avoid the SDA rules, the plan should meet one of the specific exemptions. In general, the available exceptions to employ could be:

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<sup>4</sup> Definition [ITA 248(1)]



- 1) Payment of amounts within 3 years of earning the amount;
- 2) The conditions for payment carry significant risk – such as tied to the revenues earned from the results of the SR&ED being performed; or
- 3) Have the payment tied to the retirement or death of the shareholder/employee with a reference to the stock price of the company.

### 3. Commercial vs. experimental production

The CCRA felt that an article written in a recent SR&ED newsletter<sup>5</sup> may be misleading. This article indicated that, based on the facts outlined in a recent CCRA example, an SR&ED tax credit planning opportunity had been missed.

CCRA fact scenario:

- 1) Corporation A gives a **contract** to Corporation B (arm's length) for the construction of equipment to meet unique performance criteria.
- 2) The contract **requires that Corporation B perform SR&ED** on behalf of corporation A in the development of the equipment.
- 3) Corporation A identified the SR&ED and non-SR&ED and allocated the costs accordingly (SR&ED portion \$800,000, \$200,000 commercial portion). The CCRA's Research and Technology Advisor found the allocation to be **reasonable**.
- 4) There is a conversion to commercial use and the ITC recapture rules will apply using the FMV of the equipment at the time of conversion estimated at \$500,000.

Recommended planning / raising issues of concern:

- 5) Since the contract above clearly contemplated SR&ED being performed, I proposed that the purchaser could have the contractor separately identify and invoice the “labour” vs. the “material or capital” portions of the work. Examples of potentially eligible “labour” components within the contractor’s fee could be the costs to design, assemble, test and replace components. These could then be removed from the \$800,000 base used for the “carve-out” in the previous example.

Specific issues in contention / addressed during the meetings:

- i) differences in treatment of “in-house” labour vs. “subcontractor” labour,
- ii) the definition of “property” and the extent to which it includes “costs to transform” materials into SR&ED products,
- iii) legal support for the CCRA’s position that experimental production “must be used solely for evaluation purposes,” vs. the legal precedence established in the Tax Court of Canada case of Cultures LaFlamme vs. MNR. and
- iv) a discussion of how these factors are (could be) structured to prevent “double dips” of the same expenses by multiple claimants.

A summary of these issues, The CCRA’s stated position and the results of the group feedback has been provided in the following table:

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<sup>5</sup> Complete newsletter 2003-1 available for download in PDF format at [www.meuk.net](http://www.meuk.net) / news

	<b><u>Issue</u></b>	<b><u>CCRA position</u></b>	<b><u>page*</u></b>	<b><u>DSCA position</u></b>	<b><u>page**</u></b>
1	In house vs. subcontract labour	ITC repayment on subs if sold	4	ITC repayment if commercial vs. experimental	3
2	"Property" definition	Includes subcontracted but not internal labour	4 & 5	Does not include costs to transform	4
3	Experimental vs. commercial production definition	If sold then commercial	5	If necessary to resolve uncertainty then experimental	2 & 3
4	Double dips	Not addressed		No double dip since only 1 party claims	3 & 6

\* Per letter sent by Mel Machado (CCRA) to David Sabina - response (May 1, 2003)

\*\* Per letter sent by David Sabina (April 2, 2003) to Mel Machado (CCRA)

\* Note: A more complete discussion of these issues is provided in the noted letters which are available for download at [www.meuk.net](http://www.meuk.net) / SR&ED issues.

### **3.1. Issues in agreement – no carve out of SR&ED wages**

The CCRA agrees that the “salary and wages” (i.e. internal labour) will NOT face any commercial production allocation or “carve-out.”

### **3.2. Issues in contention**

#### **3.2.1. Carve out of SR&ED subcontractors**

Though the CCRA agrees that the “salary and wages” (i.e. internal labour) will NOT face any commercial production allocation or “carve-out” any costs claimed for “subcontractors” must be reduced by any proceeds of sale of experimental production.

Ironically, both sides of the argument center on the interpretation of the definition of “property” under subsection 127(32) “meaning of cost” which states that, for the purposes of subsection (27), (28) & (29), [the ITC recapture rules]

“cost of a particular property to a taxpayer shall not exceed the amount paid by the taxpayer to acquire the particular property from a transferor of the particular property and, for greater certainty, does not include amounts paid by the taxpayer to maintain, modify or transform the particular property.”

In the group's opinion, the fact that the definition of property specifically excludes, "amounts paid by the taxpayer to maintain, modify or transform the particular property" indicate that the costs for a contractor to "transform it" from a raw material into a prototype would not be "property" as the CCRA proposes. As a result this issue remains unresolved for the current time.

### 3.2.2. Definition of "Commercial" production

Definition of "commercial" production based upon whether the experimental production was sold (CCRA position) rather than if necessary to resolve technological uncertainties (group position).

### **Summary & recommendations: use internal vs subcontract labour**

Based on the discussions to date the group felt that:

- 1) the CCRA's current position placed a heavier burden on smaller companies (i.e. those that have to subcontract work rather than hire full-time staff).
- 2) The CCRA was providing mixed signals as to the determination of whether production was experimental or commercial as it did in the Cultures LaFlamme case.
- 3) Unless this issue is further resolved through negotiation or the courts, it will definitely be in the claimants interest **to always use internal rather than subcontracted labour for any work on production experimental production that may eventually be sold.**

## **4. Ontario SR&ED issues**

### **4.1. Ontario OITC taxability - timing of tax on proxy amount**

#### Summary of issue: timing of tax on proxy amount

Several tax programs defer taxation of the "proxy portion" of the OITC until the subsequent taxation year. During our September 2003 meeting we reviewed the legislative support for this treatment under the income tax legislation and related tax planning implications as submitted and explained by Barry Doerbecker, C.A.

#### 4.1.1. Tax mechanics of issue: received vs. receivable

Have you ever wondered why your accounting software automatically uses:

- a different number on line 430 (government assistance related to the research expenditure pool) than
- it uses on lines 534 and 536 (government assistance related to qualified expenditures) when transferring the Ontario Innovation Tax Credit (OITC) earned for the year?
- You may also notice in the following year that the difference shows up on line 604b on the T2 Sch. 001.

What the program and CCRA are doing is reducing the government assistance on line 430 for the amount of assistance earned on the Prescribed Proxy Amount (PPA) and treating it as income the following year by making the adjustment on schedule 1.

Note that this discussion focuses only on the OITC, as this treatment is automatically performed by the tax software. However, I believe this treatment should be applied to all government assistance.

#### CCRA Administrative support:

The quick answer to the above question is due to the Canada Customs and Revenue Agency's (CCRA) instructions to line 430 as contained in the Guide to Form T661 – Claiming Scientific Research and Experimental Development (both the 2001 and 2003 versions). Both guides state the following:

“If you are using the proxy method, do not deduct the assistance for expenditures that the prescribed proxy amount replaces.”

The CCRA has gone further in SR&ED Application Policy Paper SR&ED 2000-03 to state the following:

“In determining the amount of assistance in the pool of deductible SR&ED expenditures the amount of provincial or territorial tax credits which relates to the

PPA is not considered to be assistance that reduces the SR&ED allowable expenditures under paragraph 37(1)(d).

As the PPA is not an expenditure under paragraphs 37(1)(a) or subparagraph (b)(i), but is a notional amount which is used in lieu of the actual overhead expenditures in the calculation of the ITC, the PPA is not added to the SR&ED expenditure pool.

Consequently, the portion of the provincial or territorial tax credits which relates to the PPA should be included in income under section 9 or paragraph 12(1)(x) of the Act

The Ontario Innovation Tax Credit (OITC), can only be earned on a maximum amount of \$2,000,000 in R&D expenditures applied on a pecking order by type of expenditure, i.e. current, proxy, and capital. ...

Using the pecking order calculations rather than using the prorated method to determine the ITC will result in different amounts of qualified expenditures, ITCs and SR&ED deductible expenditure pool balance.”

Now we know the CCRA position with respect to this issue. However, the guide and application policy paper are not law. So what does the law state?

#### Legislative support (ITA):

In this situation, we are dealing with three main areas. The main area is contained within section 37 of the *Income Tax Act*. Paragraph 37(1)(d) states that the research expenditure pool must be reduced by the total of all amounts of government assistance, as that term is defined in subsection 127(9), in respect of an expenditure described in paragraph 37(1)(a) or 37(1)(b). The first of those paragraphs deal with current expenditures and the second deals with capital expenditures. In neither section are you allowed to deduct the PPA.

To further emphasize the point, paragraph 37(1)(e) requires the expenditure pool to be reduced for the federal Investment Tax Credit used in the prior year (under subsection 127(5) or 127(6)) where that amount can be attributed to a paragraph 37(1)(a) expenditure or the PPA.

Therefore, it is easy to conclude that if parliament had intended for government assistance on the PPA to reduce the expenditure pool, then it would have explicitly stated that in 37(1)(d) as it did in 37(1)(e).

So does that leave government assistance on the PPA free from tax? Unfortunately, the answer is no. The amount is taxable under paragraph 12(1)(x) of the *Income Tax Act*. When reading this section and comparing it to the definition of government assistance under 127(9) there is a strikingly similar set of words:

“... grant, subsidy, forgivable loan, **deduction from tax**, investment allowance, or any other form ...” that is “... from a government, municipality, or other public authority...”

Therefore, government assistance is always taxable. But what about the timing of when it is taxable?

The amount taxable under 37(1)(d) as a reduction to expenditures is to be reported on the basis of

“... at the taxpayer’s filing-due date for the year, the taxpayer has received, is entitled to receive, or can reasonably be expected to receive,”

the government assistance on the expenditures. Therefore, the amount is included in income as it is earned, as it is based on the amount receivable.

However, the wording of 12(1)(x) states that

“... any particular amount received by the taxpayer in the year, in the course of earning income from a business or property, ...”

#### **4.1.2. Summary of overall tax effects / implications**

Therefore, the **government assistance on the PPA is only taxable when actually received.**

Simple solution

Note that the CCRA and the tax software will assume this amount is actually received the following year. While this may not be the case (especially those that file their SR&ED claim close to the 18 month deadline), for simplicity this assumption is normally followed.

#### **Advanced planning techniques**

The opportunity exists for further deferral of the taxation of this amount.

Example:

- For a 2001 claimed filed in 2002
- the amount may not be received until fiscal 2003 or even 2004 and
- the company would be entitled to defer recognition of the proxy related ITC until this time!).

This could be a major advantage to a firm who had exceeded income limits to the extent it faced a partial phase out its enhanced ITC’s.

## **4.2. Ontario Business-Research Institute Tax Credit – Pre-approval**

### Overview:

The Ontario Business-Research Institute Tax Credit is a 20 per cent refundable tax credit on qualified Ontario research and development (R&D) expenditures incurred by an Eligible Research Institute (ERI) under a research contract funded by the corporation claiming the credit.

The credit requires “pre-approval” via submission of an application within 90 days of signing the contract with the University.

### 4.2.1. Issue: Why Ontario pre-approval required since audited by CCRA?

A major result of this “pre-approval” requirement is that the small performers are being consistently “excluded” from claiming the OBRI credit since, though they are aware of the SR&ED program itself, they lack the awareness of the advance ruling requirements.

Furthermore, they are accustomed to preparing all of the required information for year-end submissions with their corporate tax returns.

This was addressed in a letter to the Honourable Janet Lynne Ecker, Minister of Finance, which outlined the fact that all of **the requested information was already available from the T661 form itself.**

### Analysis and discussion:

This was addressed in a letter to the Honourable Janet Lynne Ecker, Minister of Finance, Government of Ontario which she responded to. (Letters available for download at [www.meuk.net](http://www.meuk.net) / SR&ED issues).

### 4.2.2. Response to date: no plans to waive requirement

Based on the Minister’s response, to date there is no plan for the Ontario government to waive the pre-approval requirement despite the fact that Quebec has waived this requirement for its University based SR&ED credit.

The practitioners’ group felt that this placed an increased degree of risk on practitioners to keep their clients informed of this requirement throughout the year rather than at year-end tax time!



## ***“SR&ED Practitioner's Workshop” – Meeting minutes***

**Thursday, July 15<sup>th</sup>, 2004 2:00-4:00 pm**

**Lo Presti's Restaurant - Hamilton**

### **1) Allocation of Labour Expenditures For SR&ED Guidance Document SR&ED Directorate July 2004**

Discussed the fact that where formal systems have not been implemented, claimants can determine SR&ED salaries and wages using appropriate labour allocation methodologies. This document is intended to provide guidance on the elements of such methodologies and to provide an illustration of a sample application.

Levels of information: generally three levels at which information can be summarized:

- high (corporate or strategic concept level)
- medium (project level)
- low (activity level)

**Example of an allocation methods discussed further.**

### **2) ON 2004 BUDGET CHANGES RE. ASSOCIATED CORPORATIONS**

The group discussed the policy intent of these provisions for associated corporations is to prevent the multiplication of the expenditure limit by corporations controlled by the same person or group of persons.

### **3) 2002 SR&ED Client Survey results**

Issues covered: Simplification, Timeliness & Consistency

### **4) SR&ED partnership committee issues**

Group briefly Issues include Strategic Business Plan, Large Business claims and Electronic Filing (2005).

### **5) Application Policy 2004-1: Retiring allowances**

Group discussion focused on clarification that these payment may be eligible as an “overhead expense” for traditional overhead claimants.

### **6) PLASTICS MATERIALS, PROCESSING, EQUIPMENT & TOOL MAKING GUIDANCE DOCUMENT DATE: April, 2004**

The policy paper provides guidance and example relevant to mold and tool makers.

## **The group then briefly discussed issues from prior years:**

1. New T661 form - 2003
  1. Elimination of "technological uncertainty heading" in Part 2
  2. BN number require for all subcontractors
  3. Reporting for Unpaid Amounts
    1. Degree of disclosure required
    2. Report for unpaid wages vs. other types of expenses
    3. Risks of being deemed a Salary Deferral Arrangement (SDA)
2. Commercial vs. experimental production - 2003
  1. Issues in agreement - no carve out of SR&ED wages
  2. Issues in contention
    1. Carve out of SR&ED subcontractors
    2. Definition of "Commercial" production
3. Ontario SR&ED issues - 2003
  1. Ontario OITC taxability - timing of tax on proxy amount
    1. Tax mechanics of issue: received vs. receivable
  2. Ontario Business-Research Institute Tax Credit - Pre-approval
    1. Issue: Why Ontario pre-approval required since audited by CCRA?
    2. Response to date: no plans to waive requirement
4. Administrative wages - cut-off of "financing activities" (2003)
5. SR&ED "salary & wages" incurred outside of Canada - 2000 & 2001
6. Capital tax implications from "development costs" - 2000 & 2003
7. Loss on ITC refundability on repayments of government assistance - 2001
8. Foreign contractors in Canada (how & when to claim for SR&ED) - 2001
9. Issues of other groups - for potential discussion
  1. SR&ED self-assessment and recourse methods (Toronto 2002)
    1. Second review
    2. Alternative dispute resolution (ADR)
  2. Materials consumed (Toronto 2002)
  3. Accessibility of credits to all claimants (Toronto 2002)
    1. Companies other than qualified CCPC's
    2. Individuals

For further details on each of these issues I welcome you to explore our website at ([www.meuk.net](http://www.meuk.net) / SR&ED Issues / Practitioner meetings)

**Participants:**

<b><u>Moderator:</u></b>	<b><u>Company</u></b>
David Sabina	MEUK Corporation
 <b><u>Participant</u></b>	
Geoff Green	MEDT
Darlene Sigel	Schilling and Laird
Rocco Vertucci	Ernst & Young LLP
Anthony Falco	Glenn Graydon Wright LLP
Atif Akhatar	Glenn Graydon Wright LLP
Jeff Wade	Wade & Partners
Ian Marchall	Wade & Partners
Bruce Johnstone	Robbinex Inc.
Brian Allendrof	BGA Tax Strategies
Sondra Meis	MEDT
Ernest	EDM (Machinery developer)
James	EDM (Machinery developer)
Scott Wilson	E Motion Picture studios
Cameron Wilson	E Motion Picture studios
Richard Masters	Sita
Peter Khan	JPK Associates
Gorsev Pristine	Medisolve
 Total attendning	 18

## **HAMILTON REGION SR&ED PRACTITIONERS WORKSHOP:**

**Date:**

Thursday, January 20, 2005

**Time:**

2-4 PM

**Location:**

Holiday Inn, Burlington,  
3063 South Service Rd.

### **Topics discussed:**

**A) Recent CRA Directives:**

**Recent CRA Directives - financial**

- Prototypes, Pilot Plants, Custom Products and Commercial Assets
- Filing Requirements for SR&ED
- Reporting deadlines: corporations, partnerships & proprietorships
- Recourse for missed deadlines / filing early enough to catch deficiencies
- Allocation of Labour Expenditures for SR&ED
- Retiring Allowances.

**Recent CRA Directives - technical**

- Plastics, materials processing, equipment & tool making guidance document including 16 project examples
- Pulp and paper sector guidance document

**B) Other recent financial developments:**

- New definition of "prescribed" Stock Exchanges in Canada

**C) Follow-up on significant issues from prior meetings:**

**Recently resolved issues:**

- Commercial vs. experimental production - 2003 vs. 2005: no carve out of SR&ED wages OR SR&ED subcontractors to the extent required to resolve technological uncertainties.

**Unresolved issues:**

- SR&ED "salary & wages" incurred outside of Canada – 2000+
- Capital tax implications from "development costs" – 2000+
- Ontario Business-Research Institute Tax Credit - Pre-approval  
Issue: Why Ontario pre-approval required since audited by CRA?  
Response to date: no plans to waive requirement – next steps

Sincerely, Dave Sabina

Hamilton Region SR&ED practitioners group, team leader

## **ATTENDEES:**

Practitioners Workshop

January 20, 2005

### **Moderator**

David Sabina

MEUK Corporation

### **Participant**

### **WP ref**

### **Company**

Chris Smillie	6	RBC
Darlene Sigel	7	Schilling and Laird, CA's
Frank Fiasche	8	BDO
Ed Collis	10	Collis Weitzman, CA's
Sandy Hale	11	BDO Dunwoody
Bryan G. Allendorf	12	CA
Frank Baron	2	CMA
Benny Esposto	13	DJB, CA's
Len Lucier	14	Deloitte and Touche
Elie Benatar	16	CA
John Neumayer	18	KPMG
Gale Robinson Gow	21	Procter & Gamble
Jennifer Smith	20	Vincero Capital
Christine Gribowski	24	
Harvey Cantor	25	Harvey Cantor Progeessional Corporation, C.a., C.P.A. (Oregon)

Michelle Jamieson

MEUK Corporation

Jon Leong

MEUK Corporation

**Total Attending**

**18**

# **SR&ED Practitioner's Workshop meeting minutes**

## **SR&ED (Scientific Research & Experimental Development) Practitioner's workshop<sup>1</sup>:**

**Thursday, October 27, 2005 - (3 pm – 5 pm)**  
**Holiday Inn – Burlington (QEW & Guelph Line)**

### **Topics discussed:**

<b>I</b>	<b>Recent SR&amp;ED tax cases &amp; related issue(s)</b> .....	<b>2</b>
I.1	Alcatel – SR&ED eligibility of stock options .....	2
I.1.1	Ruling & rationale: qualified SR&ED expense.....	2
I.1.2	Moderator note – subsequent events – proposal to disallow > Nov. 14, 2005 .....	2
<b>II</b>	<b>New CRA pronouncements</b> .....	<b>2</b>
II.1	New T661 form – required >September 30, 2005 .....	2
II.1.1	Now need “statements of work” for subcontractors .....	2
II.1.2	If missing > 18 months ENTIRE CLAIM could be denied! .....	2
II.2	APP 2002-02R2: Experimental vs. Commercial Production .....	3
II.2.1	Clarification - “sale” does NOT disqualify SR&ED work BUT warrants further examination .....	3
II.2.2	Case examples of eligible vs. ineligible work .....	3
II.2.3	Effects on recommended documentation: .....	4
II.3	Reasonableness of Shareholder/Manager Remuneration - SR&ED planning – keeping income <\$300,000 .....	4
II.3.1	Tax Economics of this issue – concept of “integration” .....	5
II.3.2	Group concerns & recommendation – provide clarity & legislative relief.....	6
II.4	SR&ED filing deadlines – 15 vs. 18 months?.....	6
II.4.1	CRA – position – file within 15 months for safety.....	6
II.4.2	Canada Post filing procedures .....	7
II.4.3	Issue – proving “prescribed information” filed within 18 months! .....	7
<b>III</b>	<b>Attendees:</b> .....	<b>8</b>

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<sup>1</sup> \* Note - SR&ED Practitioners are generally accountants or consultants who prepare SR&ED claims on behalf of their clients.

## **I Recent SR&ED tax cases & related issue(s)**

### **I.1 Alcatel – SR&ED eligibility of stock options**

#### **I.1.1 Ruling & rationale: qualified SR&ED expense**

The main issue is whether the benefits conferred on the employees by way of stock option constituted

“... expenditures made in respect of an expense incurred in the year for salary or wages ...”<sup>2</sup>.

The group discussed the effects of the new measures particularly the concept that expenses which were not recognized in the income statement could be qualified SR&ED expenditures!

We briefly discussed the subsequent CRA Note on stock option benefits claimed for SR&ED and pronouncements on the timing and quantification of amount claimed.

#### **I.1.2 Moderator note – subsequent events – proposal to disallow > Nov. 14, 2005**

On November 14, 2005 government notes proposed legislation that would prevent salary and wages incurred as a result of stock options to no longer be qualified SR&ED expenditures. You will I’ll ever be unlikely that this legislation we passed into law and receive royal assent before the upcoming federal election in January 2006.

## **II New CRA pronouncements**

### **II.1 New T661 form – required >September 30, 2005**

#### **II.1.1 Now need “statements of work” for subcontractors**

CRA Representative Bill McKerrall provided initial clarification that a statement of work could be,

- a separate statement,
- description within the project, or
- any other reasonable outline of what the subcontractor did with respect to SR&ED activities.

#### **II.1.2 If missing > 18 months ENTIRE CLAIM could be denied!**

Furthermore Mr. McKerrall clarified that failure to provide such information could result in the claim being deemed incomplete. If such an event occurs beyond 18 month filing deadline the event could be the denial of the entire SR&ED claim!

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<sup>2</sup> within the meaning of subclause 37(8)(a)(ii)(B)(IV) of the Act

## **II.2 APP 2002-02R2: Experimental vs. Commercial Production**

### **II.2.1 Clarification - “sale” does NOT disqualify SR&ED work BUT warrants further examination**

This revision is a clarification of the expenditure rules that apply in the situations described above. The key principles stated in the application policy have not changed.

The CRA now notes,

**“that the sale of any production, whether it results in a profit or a loss, should not be used to determine whether the context of the ED is EP or CP+ED. Rather, a product sale should trigger further investigation identifying other technical considerations and evidence (supporting facts) that can be used to determine the context of the work.”**

For the purposes of this paper, experimental production (EP) is defined as follows:

**“EP means the output of experimental development that is required to verify whether the technological objectives have been met and/or if a technological advance is achievable and**

**The purpose of the trial is to evaluate the technical aspect of the project. This is determined on the basis of the technical considerations and evidence relating to the particular trial. Accordingly, the resulting sale of the EP is normally only incidental or secondary to the carrying out of ED work.”**

### **II.2.2 Case examples of eligible vs. ineligible work**

Specifically participants discussed the issue of custom product production and experimental production undertaking within a commercial application.

Mr. McKerrall clarified the CRA’s opinion that,

**“where a subcontractor undertook any activity that did not involve technological uncertainty in its performance, it would not be eligible within the SR&ED claim.”**

Group discussion of this concept then focused on a series of “real life” examples:

#### **II.2.2.1 Example of excluded portion(s)**

##### **Subcontractors:**

If the contractor was hired to machine apart which was necessary in evaluating a technological uncertainty, however, the design and manufacture of the component itself did NOT involve technological uncertainty, the cost of the component would NOT be eligible for SR&ED claim.

#### **II.2.2.2 Example of eligible portion(s)**

##### **Subcontractors:**



If however, a Canadian subcontractor's invoice specifically identified the cost related to their "experimentation or development," this portion of the overall subcontractor costs, may be eligible as a SR&ED subcontractor claim.

### Internal labour (salary & wages):

With respect to the company's internal labor, during mixed experimental/commercial development situations, Mr. McKerrall clarified that qualified activity costs need to be clearly correlated with the resolution of the stated technological uncertainties.

Using a commercial machinery example, where a reasonable sample of parts needed to be fabricated for testing purposes, the internal labour costs to fabricate these parts may be qualified SR&ED expenditures, despite the fact that these parts may eventually be sold. In this situation, the materials themselves would NOT be eligible since they had not been "consumed:" in the SR&ED.

### **II.2.3 Effects on recommended documentation:**

The group recognized that the determination of a reasonable sample size would be specific to each fact situation and would likely remain an area of considerable professional judgment.

In the group's view, these pronouncements emphasize the **importance of ensuring that adequate documentation from suppliers is obtained at the time of the development.** Additional representations after-the-fact with respect to the development activities performed may not provide sufficient evidence in all CRA audit situations!

It also underlines the importance of continually documenting significant uncertainties and be able to correlate related SR&ED activities.

### **II.3 Reasonableness of Shareholder/Manager Remuneration - SR&ED planning – keeping income <\$300,000**

At the 2001 Canadian Tax Foundation conference, the CRA discussed its long-standing policy on when shareholder /manager remuneration will be considered reasonable<sup>3</sup> (deductible) for tax purposes.

The CRA stated it,

**"would not challenge the reasonableness of remuneration that was paid by a Canadian-controlled private corporation (CCPC) to an individual who is a shareholder of the corporation, provided the individual is active in the business operations and resident in Canada."**

The CRA clarified, that **this policy would NOT apply where,**

**"the income used to pay the remuneration is not derived from the normal business operations of the CCPC."**

**This creates two levels of potential problems:**

#### **1) Eligible payments "from" the CCPC**

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<sup>3</sup> for purposes of section 67 of the Income Tax Act (the Act)

- Includes “salary and wages”<sup>4</sup> only (no management fees, or payments to retirement plans)

## **2) Sources of income “for” the CCPC**

- Includes active business income and certain “incidental” capital transactions (no investment or passive income)

### **Question 4**

Can you give us some examples of situations that the CRA would consider to be beyond the intent of the policy?

### **Response 4**

**Yes. We would consider a situation in which a CCPC pays the remuneration out of the proceeds generated from a major sale of business assets, including the sale of the entire business assets or those of a large division, to be beyond the intent of the policy.** This would encompass all sources of income triggered by the proceeds, including capital gains, recapture of capital cost allowance, and income arising from the disposition of eligible capital properties. **We would not generally be concerned with situations where there is a sale of some of the assets, which is incidental to the normal business operations.**<sup>5</sup>

While the first of these issues can be avoided by ensuring that the year end bonuses have appropriate with-holding of employment taxes (i.e. T-4 slip reporting) the second issue (sources of income) continues to create what many tax practitioners feel are “intolerable degrees of uncertainty” in the tax planning process with respect to determining the optimal salary vs. dividend mix.

## **Rulings and directives to date:**

Since the conference, the CRA has provided a number of **advance income tax rulings** on the issue.

In one of the first rulings<sup>6</sup> the assets of a CCPC including fixed assets, working capital, and goodwill were sold generating taxable amounts - some related to goodwill<sup>7</sup>. The CCPC had **six shareholders, three of whom were active** in the day-to-day management of the operations of the business prior to its sale. Subsequent to the sale, the corporation **declared a bonus payable to the three active shareholders.**

In the ruling, it was stated that the purpose of the payment of the bonus was to remunerate the owner-managers for their contribution towards the successful management of the corporation. Based upon the facts at hand, **the CRA ruled the Act<sup>8</sup> would not apply to prohibit the corporation from deducting the amount of the bonus** in computing its business income for the applicable taxation year.

## **II.3.1 Tax Economics of this issue – concept of “integration”**

Generally speaking the federal government allows the payment of the “management bonus” to be deductible to the extent as long as it is made to a “taxable individual.” Part of the reason for this concession is the fact that the tax rate paid by the individual at the top marginal rate (i.e. on income above \$115,000) is approximately 45% (30% federal and 15% provincial). Failure to allow the full deductibility of the bonus payments would in fact be punitive since the amount

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<sup>4</sup> “salary & wages” defined in ITA subsection 127(9) to include all amount in ITA sections 5-8. Generally this means that the recipient has tax with-held at source and receives a T-4 slip.

<sup>5</sup> CRA response at the 2001 Canadian Tax Foundation conference

<sup>6</sup> Ruling 2004-0060191R3.

<sup>7</sup> Subsection 14(1) of the Act will tax amounts that are dispositions of eligible capital property (franchise rights and goodwill )

<sup>8</sup> section 67 and paragraphs 18(1)(a) and 18(1)(e)

would still be taxable to the recipient yet non-deductible to the payor. In cases where such double taxation occurs, the ultimate tax rate could wind up being more than 100% of the income earned!

### Group analysis and discussion

The group discussed the fact that the ability to “bonus down” taxable income to the \$300,000 small-business limit was based on a CRA administrative pronouncement, rather than any actual tax legislation or directives in the income tax act and respective technical notes.

In the author’s opinion, this problem compounded by the fact that these **decisions are all based on CRA administrative procedures** (i.e. rather than any specific legislation). **Since the CRA has no authority to create legislation (only to follow it)** this means that, **in the event of a disagreement, the taxpayer has NO recourse through the tax courts.**<sup>9</sup>

Having provided precedents of taxpayers going to court on other issues where the CRA failed to adhere to its own administrative procedures in the past, the group (along with tax practitioners in general) are concerned with the high degree of ambiguity inherent in making year-end salary and bonus recommendations.

### **II.3.2 Group concerns & recommendation – provide clarity & legislative relief**

Even though the first of these advance tax rulings on “reasonableness of remuneration” provides some positive indication that the CRA **“may” provide “favourable” treatment of “passive” income,**” in the group’s opinion, it still leaves tax planners in **doubt with respect to defining what might be deemed a “major” sale** of business assets and outlines **dangers of earning “non-active” income.**

As a result, **until our “elected officials”** (or at least the tax courts) **provide legislation** (or precedence) on this issue, tax advisors will live with **considerable uncertainty.**

### **II.4 SR&ED filing deadlines – 15 vs. 18 months?**

Most claimants and SR&ED practitioners seem aware that corporate claims for SR&ED tax credits include a requirement to file a, “SR&ED return with all prescribed information,” within 18 months of its corporate year-end<sup>10</sup> although the full extent of what this includes, is often at issue.

#### **II.4.1 CRA – position – file within 15 months for safety**

“Question:

**When does an SR&ED claim need to be filed** in order for the CRA to review and **advise the claimant of any deficiencies** in the SR&ED claim?

CRA Response:

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<sup>9</sup> Other than as a general appeal under section 67 which refers to “fair market values” and therefore may not provide “clear” relief.

<sup>10</sup> Filing deadline per ITA subsection 37(11)

If an SR&ED claim is filed **within 90 days before the reporting deadline**, the CRA should have sufficient time to conduct a review to determine whether or not the claim meets the filing requirements and to advise the claimant of any deficiencies in the claim.”<sup>11</sup>

What many taxpayers seem unaware of is the fact that these returns can be filed through Canada Post up to the very last day of this filing deadline. As a result the group discussion focused on some filing procedures which the tax preparers could use to simplify the filing procedures.

## **II.4.2 Canada Post filing procedures**

### **Relevant legislation**

The Income Tax Act states, “when anything other than a remittance is sent by **first class mail (or equivalent)**, the item is **deemed received when the item was mailed.**”<sup>12</sup>

### **Effects of weekends and holidays**

Interpretation Act section 26 states “Where the time limited for the doing of a thing expires or falls on a holiday, the thing may be done on the day next following that is not a holiday.”

Interpretation Act section 35 defines “Holiday”<sup>13</sup> to mean Sunday among other specified days during the year.

### **Related “Xpresspost” planning**

Unfortunately if you just mail the envelope you will not have proof of filing. As a result the group discussion lead to a proposal that taxpayers could take the following steps:

- use the Canada Post, Xpresspost service
- document the company name, year end & “tax returns enclosed” on the Xpresspost slip
- perhaps include an “enclosure letter” which could further list the enclosed documents
- have the Canada Post agent stamp both their Xpresspost tracking slip as well as any additional “enclosure” letters you may include with respect to your “enclosed” documents.

## **II.4.3 Issue – proving “prescribed information” filed within 18 months!**

**While the recommended filing methods (above) can be used to prove that the claim was filed “on time” it may not be enough to prevent the claim being denied due to “failure to submit prescribed information in prescribed form.”** In fact if any significant portion of the claim is missing the entire claim could be jeopardized!

In several cases taxpayers have maintained that all prescribed information was submitted and sadly there seems to be **little if any recourse to challenge the CRA’s assertion that one or more pieces of information were missing.**

Perhaps the eventual development of electronic filing of the SR&ED forms will provide some further assurance for those filing claims near the 18 month prescribed filing deadline. In the meantime, the **group concluded that the safest method of preventing the denial of a claim is to file within 15 months of a corporation’s the taxation year end!**

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<sup>11</sup> CRA Application Policy SR&ED 2004-02, Filing Requirements for Claiming SR&ED Carried Out in Canada, Question 4, October 5, 2004

<sup>12</sup> paragraph 248(7)(a)

<sup>13</sup> “holiday” means any of the following days, namely, Sunday; New Year’s Day; Good Friday; Easter Monday; Christmas Day; the birthday or the day fixed by proclamation for the celebration of the birthday of the reigning Sovereign; Victoria Day; Canada Day; the first Monday in September, designated Labour Day; Remembrance Day; ...any day appointed by proclamation...

### **III Attendees:**

#### **Practitioners Meeting 3:00-5:00 10/27/2005**

<b><u>Participant</u></b>	<b><u>Firm</u></b>
David Sabina - Moderator	MEUK Corporation
Bill McKerrall - CRA representative	Canada Revenue Agency (CRA)
Susan Morrison	Susan Morrison, CA
Julie Bond	Bond Consulting
Jacob Senderski	Bond Consulting
Peter Khan	JPk Associates
SR&ED Client of Peter Khan	JPk Associates
Margo Ross	Sims and Company. C.A.'s
Armando Valeri	SLF Group, C.A.'s
John Carusi	Tino-Gaetani, CA's
Bianca Tino-Gaetani	Tino-Gaetani, CA's
Rocco Vertucci	Ernst & Young LLP
Frank Fiasche	BDO Dunwoody LLP
Sandy Hale	BDO Dunwoody LLP
Debbie Davy	Mastertechwriter Inc.
Alex Schiappa	Mintz & Partners LLP
John Bartlett	John Bartlett, C.A, CPA
Janie Lim	OME Group
Stephanie Roesler	OME Group
Ed Collis	Collis Weitzman, CA's
Oscar Weitzman	Collis Weitzman, CA's
Chris Chan	KPMG
Jay Mclean	KPMG
Jerry Gribowski	Gribowski & Associates
Timothy Wright	Timothy Wright, C.A.
Ann Lam	MacKay, Brehm & Smyth
Frank Baron	Frank Baron Consulting
Harvey Cantor	Harvey Cantor, C.A.
Patrick Murphy	Murphy & Co.
Derek Tarko	MEUK Corporation
Michelle Jamieson	MEUK Corporation
<b>Total Attending</b>	<b>29</b>

# **Hamilton Region SR&ED Practitioner meeting**

## **Minutes - March 9, 2006**

Minutes of the March 9, 2006 SR&ED practitioner's meeting regarding recent developments to Scientific Research and Experimental Development (SR&ED) project management and tax credit claims.

<b>Recent CRA pronouncements .....</b>	<b>2</b>
New T661 form – required >September 30, 2005 .....	2
Now need “statements of work” for subcontractors .....	2
If missing > 18 months ENTIRE CLAIM could be denied! .....	2
New APP SR&ED 2005-01 on Shared-Use-Equipment .....	2
Intended use vs. Actual use .....	2
Prescribed Depreciable Property (PDP) .....	2
New APP SR&ED 2005-02 on Assistance.....	2
Assistance versus contract payment .....	2
<b>The OITC – How is it Taxed? .....</b>	<b>2</b>
Issue: timing of tax on proxy amount .....	2
Tax mechanics of issue: received vs. receivable .....	2
Legislative support for deferral .....	2
<b>Recent SR&amp;ED tax cases &amp; related issue(s).....</b>	<b>3</b>
Alcatel – SR&ED eligibility of stock options .....	3
Ruling & rationale: qualified SR&ED expense .....	3
Legislative proposal to disallow > Nov. 17, 2005 .....	3
<b>Overview of recent SR&amp;ED tax cases.....</b>	<b>3</b>

## **Recent CRA pronouncements**

### **New T661 form – required >September 30, 2005**

#### **Now need “statements of work” for subcontractors**

CRA Representative Bill McKerrall provided initial clarification that a statement of work could be,

- a separate statement,
- description within the project, or
- any other reasonable outline of what the subcontractor did with respect to SR&ED activities.

#### **If missing > 18 months ENTIRE CLAIM could be denied!**

Furthermore Mr. McKerrall clarified that failure to provide such information could result in the claim being deemed incomplete. If such an event occurs beyond 18 month filing deadline the event could be the denial of the entire SR&ED claim!

Due to the interest this issue has created among practitioners, we propose to briefly address this issue during the meeting.

### **New APP SR&ED 2005-01 on Shared-Use-Equipment<sup>1</sup>**

#### **Intended use vs. Actual use**

The CRA clarifies,

“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 ...**”

#### **Prescribed Depreciable Property (PDP)**

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

“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).”

*Need clarification of what this means.*

In general the group discussed

### **New APP SR&ED 2005-02 on Assistance<sup>2</sup>**

#### **Assistance versus contract payment**

Discussion of the factors that differentiate and the amount of judgment involved. Factors cited included: degree of

- Pricing vs. Risks (ceilings)
- Control of resulting Intellectual Property
- Contract for Goods vs. services

## **The OITC – How is it Taxed?**

### **Issue: timing of tax on proxy amount**

#### **Tax mechanics of issue: received vs. receivable**

Several tax programs defer taxation of the "proxy portion" of the Ontario Innovation Tax Credit (OITC) until the subsequent taxation year.

What the program and CCRA are doing is reducing the current years government assistance for the amount of assistance earned on the **Prescribed Proxy Amount (PPA)** and treating it as income the following year by making the adjustment on schedule 1.

In other word the **government assistance on the PPA is being treated as taxable only when actually received.**

### **Legislative support for deferral**

#### **Income Tax Act (Warning – this is complex!)**

<sup>1</sup> CRA APP SR&ED 2005-01, September 8, 2005, Shared-Use-Equipment

<sup>2</sup> CRA APP SR&ED 2005-02, October 28, 2005, General Rules Concerning the Treatment of Government and Non Government Assistance

Basically In this situation, we are dealing with three main areas. The main area is contained within section 37 of the *Income Tax Act*. Paragraph 37(1)(d) states that the research expenditure pool must be reduced by the total of all amounts of government assistance, as that term is defined in subsection 127(9), in respect of an expenditure described in paragraph 37(1)(a) or 37(1)(b). The first of those paragraphs deal with current expenditures and the second deals with capital expenditures. In neither section are you allowed to deduct the PPA.

To further emphasize the point, paragraph 37(1)(e) requires the expenditure pool to be reduced for the federal Investment Tax Credit used in the prior year (under subsection 127(5) or 127(6)) where that amount can be attributed to a paragraph 37(1)(a) expenditure or the PPA.

Therefore, it is easy to conclude that if parliament had intended for government assistance on the PPA to reduce the expenditure pool, then it would have explicitly stated that in 37(1)(d) as it did in 37(1)(e).

So does that leaves government assistance on the PPA currently not taxable? The answer is no. The amount is taxable under paragraph 12(1)(x) of the *Income Tax Act*. When reading this section and comparing it to the definition of government assistance under 127(9) there is a strikingly similar set of words:

“... grant, subsidy, forgivable loan, **deduction from tax**, investment allowance, or any other form ...” that is “... from a government, municipality, or other public authority...”

Therefore, government assistance is always taxable. But what about the timing of when it is taxable?

The amount taxable under 37(1)(d) as a reduction to expenditures is to be reported on the basis of

“... at the taxpayer’s filing-due date for the year, the taxpayer has received, is entitled to receive, or can reasonably be expected to receive,”

the government assistance on the expenditures. Therefore, the amount is included in income as it is earned, as it is based on the amount receivable.

However, the wording of 12(1)(x) states that

“... any particular **amount received** by the taxpayer in the year, in the course of earning income from a business or property, ...”

The net result being that **government assistance on the PPA is only taxable when actually received.**

## **Recent SR&ED tax cases & related issue(s)**

### **Alcatel – SR&ED eligibility of stock options**

#### **Ruling & rationale: qualified SR&ED expense**

#### **Legislative proposal to disallow > Nov. 17, 2005**

On November 17, 2005 government notes proposed legislation that would prevent salary and wages incurred as a result of stock options to no longer be qualified SR&ED expenditures.

A Notice of Ways and Means Motion was tabled proposing amendments to the Income Tax Act to clarify that the amount of an expenditure allowable to a taxpayer, and upon which a tax credit or deduction may be claimed, is limited to **the amount actually disbursed by the taxpayer.**

In general, the proposal related to employee stock options applies to options granted and shares issued on or after November 17, 2005.

## **Overview of recent SR&ED tax cases**

The past two decades have witnessed a release of a variety of SR&ED related tax cases. The main issues and potential implications are outlined on the following page. Copies of the judgments are available from the Tax Court of Canada’s website.<sup>3</sup>

These were discussed in varying detail based on the issues cited in the attached “SR&ED tax case overview”.

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<sup>3</sup> Tax Court of Canada website [www.tcc-cci.gc.ca]



## SR&ED tax case overview

TOPICAL AREA	APPELLANT	PRIMARY ISSUE	WIN/LOSE/DRAW?	RULING & RATIONALE	UNRESOLVED ISSUES AND OPPORTUNITIES	SIGNIFICANCE
<b>SR&amp;ED cases regarding "Technological Advancement"</b>						
1A) TECHNOLOGICAL ADVANCEMENT	Northwest Hydraulic	"system uncertainties" basis for eligibility?	Win	4 of 5 projects eligible due to "system uncertainties"	Landmark case on technological eligibility	High
1B)	Rainbow Pipeline	definition of "technological advancement"	Win	rejection of an hypothesis is an advance	Significant precedent on definition of "technological advancement"	Moderate
2) BUSINESS VS.	Nathan	software development - business vs. technology?	Draw	2 of 4 projects eligible - technology vs. business	business vs. technology software issues - eg. Patents U.S. vs. Japan	Low
3) SYSTEMATIC	Hun-Medipharma	eligibility of analysis without "clinical trials"	Win	SR&ED work can be "experimentation OR analysis"	"systematic investigation" envisions contemplation of technological	Moderate
4A) TECHNICAL RECORDS	RIS Christie	"lack of documentation"	Lose - round 1 Win - round 2 appeal	ineligible - lack of any experimentation or analysis engineer died prior to trial - court sympathetic	Successful result &/or patent NOT proof of experimentation courts may be sympathetic for CCPC's in extreme circumstances	Moderate Moderate
4B)	R.J. Miller	lack of technical documentation	Lose	claimant must provide evidence	need evidence of experimentation	Low
4C)	Blue wave Seafoods	challenging science officer's analysis	Lose	insufficient evidence to refute CRA recommendations	challenge auditor qualifications before opinion rendered	Low
4D)	Maritime-Ontario	adequacy of technical documentation	Lose	must illustrate methods utilized & results	need evidence of experimentation	Low
<b>SR&amp;ED cases regarding "Financial Issues"</b>						
5A) WAGES	Alcatel	stock options - whether SR&ED "cost" incurred	Win - round 1 Draw - round 2	SR&ED "cost" is dilution of shareholder interest legislation to disallow > Nov. 14, 2005	Courts contemplate "costs" not in taxable income 2 year window to amend 2004 - 2005 taxation years	High High
5B)	CDD-REM	payments to "specified employees"	Win - round 1 Draw - round 2	eligible based on "evidence" Subsequent events: "non-arm's length" payments	courts allow reasonable estimate of costs incurred post 1996 - only "salary & wages" allowed "NAL parties"	Low Low
5C)	Synchrosat	allocating salary to only SR&ED activities	Lose	only SR&ED percentage claimable	need system to document employee experimentation time	Low
5D)	Eigorecherche	time allocation - SR&ED vs. non-SR&ED projects	Lose	"reasonable" basis for allocation required	could structure "non-SR&ED" done during unpaid time	Moderate
6) MATERIALS	Consolux	materials used in SR&ED then sold	Win - round 1 Draw - round 2	eligible if required for SR&ED Subsequent legislation repayment of ITC's on sale	short-lived precedent to include "commercial materials"	Low High
7A) CAPITAL	Dew Engineering	building vs. "other structure"	Win	temporary lab not a "building" - no fixed foundation	Clarification: labour eligible - materials "sold" excluded	Moderate
7B)	Waxman	whether cattle eligible SR&ED capital	Win	eligible if ASA (>90%) SR&ED intent	courts take literal interpretation of "building"	Moderate
8A) ASSISTANCE/GRANTS	Com Dev Ltd.	government fees - "assistance" or "revenue"	Win	fixed price contract not purchase of SR&ED	short-lived precedent to include "commercial materials"	Low
8B)	Les Cultures Laflamme	sale of experimental production	Win	subsequent sale irrelevant if SR&ED performed	eligible if SR&ED intent - repayment if sold	High
9) UNPAID AMOUNTS	Chartwell	eligibility of unpaid amounts	Win	need to claim costs during the year incurred	Structure SR&ED contracts-"taxpayer" to bear "risks"	High
10A) FOREIGN EXPENSES	Data Kinetics Ltd.	foreign "mainframe" costs Canadian SR&ED?	Win	attributable to SR&ED if researcher "in Canada"	clarifies SR&ED labour eligible despite subsequent sale	High
10B)	LGL	data collection outside Canada SR&ED?	Draw - round 2 Lose	Subsequent events: only payments to "taxable suppliers" ineligible if physically outside Canada	opportunity to claim unpaid wages definition of "in Canada" issue of contention	Moderate High
11) OVERHEAD	Aurora Marine	eligibility of Yacht expenses for SR&ED	Win	Subsequent events: eligible if within "EEZ"	subcontractor BNP now required to claim payment courts took literal interpretation of "in Canada"	Moderate
12) "ASA"	Quantities	"costs" or "revenues" basis for ASA SR&ED	Draw - round 2 Lose	SR&ED eligible even if not otherwise tax deductible SR&ED costs basis for eligibility	marine work eligible to 200 nauts - still "unclear" travel abroad courts took liberal interpretation of "SR&ED costs incurred"	Low Low
13A) FILING EXTENSIONS	Daucalec Research	extension of 18 month filing deadline	Lose	qualified expenditures - identified by filing due date	Preferential ITC's "sole purpose performers" gone 1992	Low
13B)	Alex Parallel Computers	basis for extension of filing deadline	Win	CRA cannot restrict Minister's power to extend deadlines	object under proper sections of ITA - see Alex Parallel	High
14A) QUALIFIED CCPC STATUS	Minetex	if US director with 50% of shares has control?	Draw - round 2 Lose	Legislation - Nov. 17, 2005 restriction of SR&ED extension actions of US director w/o consent of Canadian director(s)	extension for reasons other than CRA IC (illness/disasters) must file within 18 months of year end - preferably 15	High High
14B)	HSC Research	Factors in evaluating defacto control	Win	separate directors - no control evidenced	consent from 1 of 2 Canadian directors to solve problem Landmark case on definition of "defacto control"	High
15) ITC USE	Ainsworth Lumber -	ordering of ITC use	Win	Act clarifies that taxpayer "may" deduct [credits] indicates that	right to order affairs to minimize taxes	Moderate

## **Questions or feedback**

The Hamilton Region SR&ED Practitioners' Group welcomes your questions or feedback on any issues raised in this letter.

We also encourage interested parties to examine:

- past SR&ED newsletters &
- practitioner minutes,

all of which are available at,

**[www.meuk.net](http://www.meuk.net)**

## **Terms of use**

Although we endeavor to ensure accurate and timely information throughout this letter, it is not intended to be a definitive analysis of the legislation, nor a substitute for professional advice. Before implementing decisions based on this information, readers are encouraged to seek professional advice, in order to clarify how any issues discussed herein, may relate to their specific situations.

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## **HAMILTON REGION SR&ED PRACTITIONERS WORKSHOP:**

Minutes of the SR&ED Practitioner's Workshop

**Date:**

Thursday, September 20, 2007

**Time:**

4:30-6:00 PM

**Location:**

Holiday Inn, Burlington,  
3063 South Service Rd.

**Topics of discussion:**

**A) Recent SR&ED tax cases & related interpretative issue(s)**

- Armada - **eligibility of SR&ED preparation fees**

Discussion issues: group agreed with judge that technical portion of this work is likely eligible under "traditional" method of overhead allocation

- Nuytten - personal (T1) SR&ED claim disallowed since work in Co.

Discussion issues: group agreed that problem was likely due to failure of owner manager to separate personal from business issues

- Hopmeyer - Whether SR&ED eligible while insolvent

Discussion issues: group agreed with judge that company was "carrying on business" despite filing of alternate evidence by family members (re. claim for ABIL)

- Systemhac - Director fined \$75,000 for **SR&ED tax fraud** in B.C. court

Discussion issues: group agreed that facts clearly indicated fraud however penalty seemed rather light compared to crime. There were additional questions raised as to 3<sup>rd</sup> party liability of the accountants however, there was not enough "public" information to develop related conclusions.

**B) Recent CRA & Ontario Directives - financial**

- 2007 SR&ED limits for specified employees

Discussion issues: group discussed new rates and strategies to set "owner manager" wages to avoid ineligible "bonus" amounts at year end.

- CRA & Ontario harmonization 2008

Timeline for implementation - What's next?

Transitional Mechanism for SR&ED

Unresolved issues – still under discussion

Discussion issues: group agreed that harmonization will likely be of benefit but was confused with mechanics of proposed "transitional mechanism."

**C) Practitioner issues with CRA & Ontario MOF processing**

- Ontario OITC assessments & related problems created

- issued pre-CRA assessment for small claims (<\$15K) &

- 4-6 month post-CRA assessment for larger claims (>\$50K)

- proposed effects under harmonization in 2008/2009

Discussion issues: group agreed as a whole that smaller returns were being assessed quickly with larger claims often taking more than 4 months.

We believe that rationale is more of a cash flow issue with the ministry (i.e inability to pay larger claims) while trying to maintain a reasonable “average” turn around time. Group further agreed that harmonization should result in **faster refunds?**

- CRA SR&ED assessment practices

- RC59 (authorizations being lost – steps to get back quickly)

Discussion issues: group agreed these authorizations are often missed or negated from the CRA (and Ontario MOF) systems. The group member also provided various strategies for getting re-authorized including:

- faxing RC59 directly to an individual at the CRA (if they will let you) &
- faxing form to Winnipeg taxation centre (which can take only a week instead of 2-4 weeks elsewhere)

- proposals for **potential e-filing of SR&ED** claims

Discussion issues: Current queries are in process with CRA Ottawa (Peter Armstrong, Pierre Coutu & Roxane Brazeau-LeBlond) for further details re. whether “general requirements” for e-filing software can be developed/agreed?

- CRA proposes to audit claims post assessment (has anyone experienced this?)

Discussion issues: group agreed that this problem had occurred in isolated scenarios however there was often extenuating circumstances to explain this variance. As a result the group did not identify this as an ongoing problem.

- dispute resolution: success to date + future of 2<sup>nd</sup> Admin review process

Discussion issues: group members had mixed reviews of this process. Several had experienced success with the process but dissatisfaction at the time required to “begin the process” (usually > 6 months). Once the process was started however, it appeared that a resolution could usually be obtained within 2 months.

**D) New services for claimants – SR&ED factoring agents**

- Details on recent parties who wish to lend or factor \$ for SR&ED tax credits

Discussion issues: One of the participants (Dan Gregory, C.A.) provided a presentation to the group on behalf of his firm (Goldeye Capital) regarding a newly proposed SR&ED factoring service. The goal would be to provide 90% of the funds and purchase the SR&ED credit balances at or near time of filing the returns. Further information is available at [www.goldeyecapital.com](http://www.goldeyecapital.com).

As a follow-up on this issue, we also received information on a similar service from Mr. Glenn Dalzell of TCE Capital Corporation. Further information is available at [www.tcecapital.com](http://www.tcecapital.com)

Event Moderated by Dave Sabina, C.A.  
Hamilton Region SR&ED practitioners group, team leader

<b>SR&amp;ED Practitioner's Workshop Attendees</b>		<b>September 20, 2007</b>	
<b>Participant</b>	<b>Company</b>	<b>E-mail</b>	<b>Business Phone</b>
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3 Paul Baron	Baron and Associates		
4 Frank Fiasche	BDO Dunwoody	<a href="mailto:ffiasche@bdo.ca">ffiasche@bdo.ca</a>	519) 824-5410 x202
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17 Gerry Kowalski	Craftec Graphics		(905) 264-9955
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32 Bill Murphy	Murphy + C o	<a href="mailto:bmurphy@worldchat.com">bmurphy@worldchat.com</a>	905-335-5783
33 Isobel Murphy	Murphy + C o		
34 Pat Murphy	Murphy + C o		
35 Bernard Taub	Nawaz Taub Noor & Wasserman		
36 Gul Nawaz	Nawaz Taub Noor & Wasserman	<a href="mailto:gnawaz@ntnw.ca">gnawaz@ntnw.ca</a>	(905) 273-5888
37 S.A Sami	Nawaz Taub Noor & Wasserman		
38 Chris Chipman	OME Group	<a href="mailto:cchipman@omegroup.com">cchipman@omegroup.com</a>	905-602-4549 ex 239
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40 Kris Unni	SB Partners	<a href="mailto:kunni@sbpartners.ca">kunni@sbpartners.ca</a>	905-633-6331
41 Peter Simpson	Simpson & Associates	<a href="mailto:peter@simpsonandassociates.ca">peter@simpsonandassociates.ca</a>	(905) 464-0029
42 Earl Viner	SRnED Limited	<a href="mailto:evsmed@rogers.com">evsmed@rogers.com</a>	416) 878-7215
43 Adam Furbacher	Taylor Leibow	<a href="mailto:afurbacher@taylorleibow.com">afurbacher@taylorleibow.com</a>	(905) 523-0000 ext 271
44 Roy Bilic	TRT Consulting	<a href="mailto:royb@mountaincable.net">royb@mountaincable.net</a>	905-531-3736
45 Ana Culina- Jajcinovic	Vine and Partners	<a href="mailto:anaj@vine.on.ca">anaj@vine.on.ca</a>	
46 Brock Whitwell	Vine and Partners		905-631-5600
47 Dieter Birk	Vineland Partners	<a href="mailto:dbirk@sred.info">dbirk@sred.info</a>	905-562-1664

## **HAMILTON REGION SR&ED PRACTITIONERS WORKSHOP:**

Minutes of the SR&ED Practitioner's Workshop

**Date:**

Thursday, September 18, 2008

**Time:**

4:30-6:00 PM

**Location:**

Holiday Inn, Burlington,  
3063 South Service Rd.

### **Overview - Topics of discussion:**

The discussion followed a discussion of issues which have been outlined in further detail as follows:

I) MEUK SR&ED newsletters (download at [www.meuk.net/resources\\_newsletters.html](http://www.meuk.net/resources_newsletters.html) )

A) 2008-1 (20 Minutes)

- i) Recent SR&ED tax cases & related issue(s)
- ii) Recent CRA pronouncements
  - 2008 budget
  - Enhanced incentives
  - SR&ED wages outside Canada eligible up to 10% if no foreign taxes paid
  - Carry-back of non-refundable ITC – restriction on refunds
- iii) Ontario SRED credits - recent changes
  - (OBRI) – pre-approval requirement waived
  - Ontario harmonization - The Transitional Debit/Credit

B) 2008-2 (20 Minutes)

- i) Recent CRA pronouncements
  - New T661 form in Fall 2008
- ii) SR&ED program usage & spending statistics
  - Credits earned by rate of ITC's, size of corp. & industry sector
- iii) International comparisons of R&D incentives
  - Marginal effective tax rates on investments in R&D assets
- iv) SR&ED – dispute resolution - appeals and objections

II) Overview 4 issues from CATA (30 Minutes) (download at [www.cata.ca](http://www.cata.ca) )

- i) Definition of SR&ED -248(1)
  - (technological eligibility 11 examples-App. A)
- ii) Contracts – Goods vs. services & who claims
  - (CRA confusion 6 examples-App. B)
- iii) Filing deadline for SR&ED claims
  - (18-month deadline)
- iv) Use of normally kept books and records as basis for allocating costs to SR&ED work

Event Moderated by;

- Dave Sabina, C.A. Hamilton Region SR&ED practitioners group, team leader &
- Dominic Ioannoni, Canada Revenue Agency

**SRED Practitioner's workshop****September 18th, 2008****Name****Moderators**David Sabina  
Dominic Ioannoni**Participants**Ajay Sinha  
Alan Fyfe  
Alex Murphy  
Alex Ross  
Alex Schiappa  
Allan Gordon  
Andrea McPhail  
Andrew Kolodziej  
Armando Valeri  
Barry Doerbecker  
Bennie Esposto  
Bob McDougal  
Brian Theissen  
Charles Walas  
Cheng-Chung Yu  
Chris Chipman  
Colin Goodall  
David Learmonth  
Dharmesh Gandhi  
Earl Viner  
Ed Collis  
Feisal Hurzdok  
Frank Baron  
Frank Dodaro  
Frank Fiashe  
Gautam Shah  
Gul Nawaz  
Harjeet Rana  
Harvey Cantor  
Isabel Poustie  
Jack Holmes  
Jason Schwandt  
Jay Mclean  
Jay Wiged  
Jerry Gribowski  
Jigna Shah  
Joe Lehocki  
Jonathan Spencer  
Koon Szeto  
Kris Shah  
Kyle Williams  
Leo Ditschun  
Liz Boydell  
Marie Rea  
Mark Stewart  
Mark Vainberg  
Mary Girbic  
Matthew Brake  
Mike Panayi  
Mukesh Tanna  
Oscar Weitzman  
Peter Allen  
Peter Kahn  
Peter Martens  
Philip Milman  
Rakesh Gupta  
Robert Bender  
Robin Peaker  
Ron Stokker  
Roy Bilic  
Rudy Morrone  
Rueben Moitra  
Stephen Beech  
Steve Nagy  
Susan Underwood  
Tammy Alp  
Ted Korn  
Thomas Nagel  
Tim Winter  
Tony Bamrah  
Vishal Bhandari  
Zile Tharghirala  
**Total Attending****Company**MEUK Corporation  
CRA  
  
Sinran  
Scitax Advisory Partners LLP  
Murphy Co  
Gowlings  
Deloitte  
Duacur Worthington & Assoc.  
  
Gordon & Miltein Chartered Accountants  
SLF - Schwartz Levitsky Feldman llp  
Henderson Partners  
Durwood Jones Barkwell & CO  
  
Bridgman & Durksen  
  
Cheng-Chung Yu Professional Corporation  
OME Group  
Kudlow & McCann Professional Corporation  
MEUK Corporation  
OME Group  
SRnED Limited  
Collis & Weitzman  
Archonix corp  
Franks Baron, C.M.A.  
Fazzari & Partners LLP  
BDO Dunwoody LLP  
Private SR&ED Co. (Fomrrely with OME)  
Nawaz Taub & Wasserman CA's LLP  
sinran  
Harvey Cantor Professional Corporation  
Murphy Co  
JC Holmes Int.  
  
KPMG  
Deloitte  
Gribowski & Associates Limitted  
OME Group  
Stevenson Lehocki C.A.s  
JD Spencer Consulting  
Software Management Solutions  
OME Group  
Maxim Strategy Consultants Inc.  
Braith Waite  
Halton Organizing & Bookkeeping  
Stephen D. Jones, C.A.  
Mcmaster Innovation Centre  
Deacur Worthington & Assoc.  
RDC Inc.  
Whey group  
Pinnacle Consulting  
Mukesh Tanna, C.A.  
Collis & Weitzman  
Software Management Solutions  
JPK Associates  
  
Milman & Company  
Hi-Tech Research Consultants  
R.V. Bender, CA  
Stern Cohen LLP,CA's  
  
SR&ED Consulting  
Gowlings  
Hi-Tech Research Consultants  
Deloitte  
Michael Bossy Group Professional Corporation  
R.V. Bender, CA  
Tino-Gaetani & Carusi  
Maxim Strategy Consultants Inc.  
Novatron Systems  
Canadian Tax Foundation  
OME Group  
Maxim Strategy Consultants Inc.

## **Details on issues discussed:**

### **I A) Discuss issues from newsletter 2008-1**

#### **Recent SR&ED tax cases & related interpretative issue(s)**

**But they discuss and review these cases with a focus more on the related SR 90 interpretation problems in actual fact the cases of self.**

White star - representation by officer vs. legal counsel  
Ruling & rationale: denied - self-representation not warranted

Discussion issues: The group agreed the time and effort required to get a legal review was perhaps onerous. This is discussed further in the “dispute resolution” section below.

Chichkov – NAL payments & carrying on business  
Ruling & rationale: no SR&ED & NAL payment (ineligible)

Discussion issues: The group agreed that non-arm's-length transactions should be documented with the same degree of detail used for non-arm's-length transactions.

Foster - LPs eligibility & frivolous appeal  
Ruling & rationale: clearly limited partner –fined \$3,000 in costs

Discussion issues: The court believed that case was frivolous at the outset. Given that the amount in question was only \$2,000 with the resultant fines at \$3,000, the courts appear to be sending a strong statement that the use of the judicial system to “defer” payments (i.e. as opposed to addressing legitimate issues) will be severely punished.

#### **Recent CRA & Ontario Directives - financial**

##### **2008 Federal budget**

###### **a) enhanced incentives**

Discussion issues: The group briefly wrote it reviewed the 2008 budget recommendations for the enhanced credit.

There was some question as to how the amounts would be prorated for tax years ending after every February 25th 2008 (i.e. straight line or prompt the user for actual costs).

###### **b) SR&ED wages outside Canada eligible up to 10% if no foreign taxes paid**



Discussion issues: The issue on the eligibility of a Canadian employee's salary or wages while travelling abroad was originally raised by the group in its first meeting (1999) and had been subsequently re-iterated each year since.

The group rejoiced to see that after 9 years this issue (which affects most claimants) has finally been addressed.

### **Carry-back of non-refundable ITC – restriction on refunds**

Discussion issues: The group briefly discussed the mechanics of the formulas with respect to;

- use of nonrefundable and refundable ITC's
- being limited to the maximum ITC earned in a taxation year.

It was agreed that this fact was generally not well known and it was likely to be stumbled upon by accident in the cases of many claimants.

### **Ontario SRED credits - recent changes**

(OBRI) – pre-approval requirement waived

Discussion issues: The group agreed that the removal of this requirement is long over due. Furthermore, the forms required to complete the 20% refundable OBRI (Ontario Business Research Institute) credit have not kept pace with this legislation since it indicates that such pre-approval is still required.

The group appeared guardedly optimistic that this issue may eventually be resolved with the harmonization of Ontario and CRA SR&ED divisions.

Ontario harmonization:

a) effects on service

Discussion issues: The group agreed as a whole that smaller returns were being assessed quickly with larger claims often taking more than 4 months.

Many group members concurred that it has been difficult to obtain information on the status of Ontario accounts since the merger in April 2008.

b) The Transitional Debit/Credit

Discussion issues: An example of the 12 year deferral for the transitional credit was reviewed.

### **I B) Discuss issues from newsletter 2008-2**

## **Recent CRA pronouncements - New T661 form in Fall 2008**

A new, simplified SR&ED claim form will be released including;

- an enhanced “Complete Claim Checklist” &
- a clear format for submitting project details.

Discussion issues: The group agreed that any clarifications as to what constitutes a “complete claim” will be useful given issues with respect to the 18 month filing deadline.

Many practitioners were also wondering, if and when, it would be possible to **electronically file** SR&ED returns.

## **SR&ED program usage & spending statistics**

Federal & provincial SR&ED funding

Expenditures by Province

Number of companies claiming SR&ED credits

Credits earned by “rate of ITC’s”

Credits earned by “size of corporation”

Credits earned by “industry sector”

Discussion issues: The group performed a quick review of these balances making note of the fact that

- all growth is related to small and medium-size corporations &
- the manufacturing sector represented almost 50% of all claims.

The other major item of interest was the fact that the province of Quebec provided more SR&ED funding than all of the provinces and territories combined.

International comparisons of R&D incentives

Marginal Effective Tax Rates (METR) on investments in R&D assets

Discussion issues: A brief review of Canada's competitiveness based on the new measurement METR versus the old measurement standard of the B-Index was performed.

As with prior studies, **Canada still remains one of the top three countries** with respect to the “true” (marginal) cost of SR&ED after taxes and all incentives.

SR&ED – dispute resolution - appeals and objections

- dispute resolution: success to date + future of 2<sup>nd</sup> Admin review process

Discussion issues: Group members had mixed reviews of 2<sup>nd</sup> Admin review process.

Several had experienced success with the process but dissatisfaction at the time required to “begin the process” (usually > 6 months).

Once the process was started however, it appeared that a resolution could usually be obtained within 2 months.

## **II) Discussion of Issues from CATA:**

### **i) Definition of SR&ED -248(1)**

Discussion issues: The group discussed 11 examples of SR&ED problems encountered by companies with respect to interpretation of the definition of “SR&ED” from the income tax act.

The group agreed that some of the most common problems illustrated these examples were also experienced across the GTA, including;

#### **a) work done in a commercial environment**

This type of work is often being completely discounted on the basis of the eventual sale of a product rather than an examination of the technology issues in question.

In other words the CRA concludes, “if the product was sold there could NOT have been any technological uncertainty involved in the development.”

There was additional discussion on the issue as to when and where

- only incremental costs (i.e. rework components) vs.
- the full costs to an address in uncertainty should be claimed.

The group agreed that it was safest to only claim “incremental costs” in any commercial situation however, it was recognized that this could be an issue for further discussion.

#### **b) process improvement**

Examples illustrated CRA disallowed improvements to proprietary processes since they were in a commercial environment. This issue was tied to the commercial environment issue above.

The group agreed that the best protection for claimants to guard against such issues was to;

- tie the activities in question to
- the resolution of specific pre-stated technological uncertainties.

### **ii) Contracts – Goods vs. services & who claims**

Discussion issue 1 – goods vs. services: The group briefly discussed the appropriateness of the following three indicators proposed by CATA:

- **Whether a contract is for services**
- **Transfer of intellectual property (IP) / Rights to exploit**
- **Pricing method vs. risks assumed by the contractor**

The nature of the conversation consisted of a review of the five examples provided (see appendix B).

The group agreed that the **area that was most problematic** was the position of several CRA officials that the performer need to, “own the rights absolutely” rather than merely illustrating “**entitlement to exploit**” is defined as follows:

“...this requirement is considered to be met in cases where the taxpayer has the **right to use** a patent that results from the SR&ED project even if the taxpayer is charged a royalty or similar fee for the use of the patent. This requirement is also considered to be met in cases where the taxpayer is **entitled to distribute and market** any product that results from the SR&ED project.”<sup>1</sup>

The group believes the examples in question illustrate that this confusion is prevalent across Canada and suggested that;

- CRA employees would likely benefit from further training and clarification on
- what constitutes “entitlement to exploit” and therefore eligibility.

#### Discussion issue 2: who claims the credit

When is a contract SR&ED performer required to;

- reduce qualifying expenditures by
- the payment received for its work
- pursuant to contract with an arm’s length party?

The group reviewed the legislation, specifically;

Paragraph 127(9)(a)(i) defines “**contract payment**” as “an amount paid or payable to a taxpayer, by a taxable supplier in respect of the amount, for SR&ED **to the extent that it is performed for or on behalf of a person or partnership entitled to a deduction in respect of the amount because of subparagraph 37(1)(a)(i) or (i.1), and....**”

In simpler terms:

- **if the payor does NOT claim the amount** (by filing a Canadian SR&ED claim)
- the amount is **NOT a “contract payment”** meaning there would be
- NO reduction to qualified SR&ED expenditures

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<sup>1</sup> CRA Interpretation Bulletin-151-R5, paragraph 37

The group also commented that the current reporting requirements for contractors (a description of the nature of the work, their business number and the projects which they worked on) provides an adequate audit trail to prevent any double dipping by claiming the same costs from both the performer and the payer perspectives.

### iii) Filing deadline for SR&ED claims (18-month deadline – vs. 15 months per CRA)

Discussion issues: group discussed the fact that CRA was being particularly stringent on 18 month filing deadline. Several practitioners indicated that they had experienced denials on a similar basis.

We reviewed some of CATA proposals including a recommendation that the 18 month filing deadline should be removed or perhaps extended.

Examples cited included;

- Simply submitting the wrong project description has resulted in the CRA refusing to allow the clerical oversight to be fixed when discovered just a few days after the filing deadline.
- Failure to include “business numbers” for subcontractors or
- “technical documentation” in a separate section have resulted in denials of SR&ED claims.

The discussion then focused on the background of the S&ED objectives and concluded that the reason for this stringency was likely due to the fact that CRA did not wish to make payouts on work that was done without any knowledge of the SRED tax credit system. In other words they didn't want to reimburse clients for SR&ED payments that were made without any intention of claiming the credits.

It was also noted that a CRA application policy paper provided that **claims filed within 90 days of the 18 month filing deadline would be given a “second chance”** in the event that any prescribed information was missing.<sup>2</sup>

As a result the group agreed that it would be **prudent for all claimants and practitioners** to consider a **15 month filing deadline**.

### iv) Use of normally kept books and records as basis for allocating costs to SR&ED work

Discussion issues: group members discussed the 3 CATA provided examples of problems (see handout slide #46) encountered on the issue of keeping appropriate employee timesheets:

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<sup>2</sup> CRA APP SR&ED 2004-2 – Appendix Question 4

- i) Companies are being told that they must establish dedicated SR&ED record systems, including the requirement that they maintain activity based records if they are to continue claiming.
- ii) One consulting firm was told that they should set up an additional dedicated system for any SR&ED they wished to claim to avoid having to reduce for contract payments. Note, this claimant clearly does not receive “contract payments” from their clients, and the CRA had accepted their claims for years.
- iii) Software company received a written warning to keep time sheets in an audit of their 2004 claim in April 2005. The 2005 claim is audited, and all labour after April 2005 is disallowed because there were no daily activity time sheets (claim was filed using the argument programmers were ASA for a specified period). To make matters worse, the CRA threatened to impose penalties if they tried to file the same way again under subsection 163(2).

The group agreed that the optimal system would likely;

- a) clearly document all related technological uncertainties and
- b) ensure that all work being claim correlated to relevant supporting activities.

If this was done in a reasonable manner the group felt that actual day-to-day timesheet documentation was less meaningful since it often would not provide the degree of detail (i.e. how work correlated with resolution related uncertainties) with respect to “commercial” vs. “pure SR&ED” projects.

## **Appendix A: CATA-Finance Workshop July 10, 2008 248(1) “SR&ED” Examples**

### **Example 1**

Some offices take the position that any work that is not using experimental techniques but using standard methods or protocols is not eligible even when used in applied research, let alone in ED studies.

### **Example 2**

Some offices take the position that (d) activities such as data collection that would have to be done in a similar project without SR&ED is not eligible work even when the data collected is analyzed for the SR&ED.

### **Example 3**

Reviewers continually take the position that trials associated with highly experimental risky SR&ED process developments cannot be experimental production, because of the presence of a sale.

- In one case where an attempt to develop a new process failed, because high scrap rates could not be controlled, all experimental production associated with trials was denied in spite of the use of dedicated trials, formal DOEs, reports of results, etc. The reviewer maintained that it was eligible, but commercial. The process was abandoned and the company returned to the traditional processes. What product that could be salvaged from the experimental productions was transferred to inventory.
- In another case, a major multi-national Canadian manufacturer was told that any of the work the claimant undertook in their facilities to improve their proprietary process technologies was not eligible, because “it was commercial and excluded under (i).”

### **Example 4**

A consulting engineering firm was developing new process technologies and completed the development and validation of new design concepts and practices but did not proceed to the build phase. The CRA’s position was that since there was no experiment, only analysis using standard analytical and computing methodologies, the work to develop the new design practices was ineligible.

### **Example 5**

One office has advised local practitioners that (e) – (k) trump (a), (b), (c) and (d).

### **Example 6**

A large Canadian manufacturer decided to invest in a new line of products for which all existing process knowledge is highly protected proprietary and protected with confidentiality agreements, patents, etc. As a starting point, they acquired new leading edge manufacturing technology and proceeded to develop the process manufacturing knowledge and the interrelated design practice knowledge needed for the product line. The CRA denied the claim saying that the work was simply routine process optimization.

### **Example 7**

The control of felt hairs which impact paper quality is a major industry problem. A study of the use of a chemical control strategy commonly used for waste water management was considered a success and the results were published. The CRA turned this claim down as simply work on extending a known process, i.e., process optimization.

**Example 8**

A consulting engineering firm studied the use of indigenous reconstructed wetland/flora to attenuate a chemical spill in a boreal region. Such an approach had never been attempted. The CRA allowed some initial lab work, but not the field data collection which was an integral part of evaluating the remedial concept. This work led to several publications.

**Example 9**

The CRA insisted that only engineering work incremental to the SR&ED was eligible in a claim for the development of a new design approach to a co-gen plant, ignoring that the engineering work met the commensurate test.

**Example 10**

CRA officials in one region have formally taken the position that the study of how and if existing environmental and geological methodologies, etc. can be made effective in new situations and/or for new purposes is not eligible. The existence of publishable results and/or the demonstration that the results are important new engineering practice knowledge are ignored.

**Example 11**

A manufacturer had to develop new processes so that they could use as inputs materials of a much lower quality than currently used and still maintain their product standards. The CRA said that this was simply a material change and refused to even meet the company's representatives.



## **Appendix B: CATA - Contract Interpretation Examples**

### **Contract Interpretation Examples**

#### **Example 1**

An environmental consulting firm has successfully claimed for SR&ED for years. For the first time, the CRA has told them that they must reduce their claims for what the CRA agrees are eligible SR&ED projects by the payments they have received. The performer clearly retains all intellectual property (IP) rights and provides products to their clients other than the underlying SR&ED. There is no evidence of direction from the payer and the payer is not interested in the scientific advancements per se.

#### **Example 2**

A large engineering consulting firm reviewed all of their work for possible SR&ED and examined their contract relationships in light of the CRA's policies. They claimed very little of their SR&ED work, because of the uncertainties related to the wording of the contracts. The CRA attempted to argue in protracted discussions that they disagreed with the claimant's application of the policy in all cases, saying that the claimant was performing SR&ED on behalf of their client. Over a period of a year or more of discussion, the financial reviewer consistently did not wish to address the contextual facts around the contracts. Eventually, a **negotiated** settlement was achieved. The contract issue is still outstanding in the subsequent claims of the claimant.

#### **Example 3**

A contract for delivery of a software product to specifications was initially treated by the performer as an SR&ED "contract payment" and the amount was netted against their qualified expenditures. The contract appeared to the CRA to be for SR&ED performed on behalf of the payer as the price was based on time and materials.

The performer engaged professional advisors who noted that the payer did not have the ability to direct the work and did not receive the IP (source code). The payer would not have been able to claim the ITC as they were not performing SR&ED.

The contractor (performer) was allowed to amend their claim to exclude the contract payment.

#### **Example 4**

A software company undertook development of custom applications for its customer, a government agency, and performed SR&ED in the course of developing these products.

The CRA proposed a significant reduction to the claim. The company was advised that if they did not accept the proposal, the CRA would treat the revenue as government assistance or a "contract payment" and the entire amount would be disallowed.

After a protracted and contentious review, a **negotiated** settlement was achieved which did not treat the revenue as contract payment. However, the underlying issues of the nature of the contract were not resolved.

#### **Example 5**

A contract for environmental remediation was treated as a contract for SR&ED although the engineering firm performing the work retained all of the intellectual property (IP), supervised and directed the work and delivered a guaranteed solution. The payer did not claim the payment as SR&ED. Although the performer should have been able to claim the ITC, the performer was denied its claim because of CRA's interpretation of the nature of the payment, which was that the engineering firm had been "paid for their work"; therefore, they had received a "contract payment".

#### **Example 6**

A software company undertook development of custom applications for its customers and performed SR&ED in the course of developing these products. The CRA proposed disallowing all claims on the basis that the company had received "contract payments" which reduce qualified expenditures.

After a protracted review, a **negotiated** settlement was achieved which did not treat the revenue as contract payments. This solution was necessary as the parties were unable to resolve the issues relating to the nature of the contract which did not contemplate SR&ED claims.

## **Minutes of Hamilton Region SR&ED Practitioners' meeting (Sept 17/09)**

### **Date:**

Thursday, September 18, 2009;

### **Time:**

4:30-6:00 PM

### **Location:**

Travelodge, Burlington,  
2020 Lakeshore Rd.

Event Moderated by;

- Dave Sabina, C.A. Hamilton Region SR&ED practitioners group, team leader &
- Dominic Ioannoni, Canada Revenue Agency

## **Overview - Topics of discussion:**

I) Specific issues addressed in the 2009 MEUK SR&ED newsletters as follows:

A) 2009-1 (20 Minutes) – New project reporting format

- i) CRA software example - project COMMENTARY
- ii) Template(s) to identify and quantify the required elements:
- iii) Providing technical documents via website
- iv) Best practices for isolating SR&ED “key criteria”

B) 2009-2 (10 Minutes)

- i) Recent SR&ED tax cases & related issue(s)
  - Advanced Agricultural – Eligibility of clinical trials
    - revoking “proxy” election once filed
  - Spasic – “hobby” vs. “carrying on business”
    - “documentation”
- ii) 2009 Federal & Ontario budgets
  - expenditure limit phase out range increased to \$500 – 800K for 2010+
  - new ORDTC (discussed further per 2009-4 below)

C) 2009-3 (10 Minutes)

Factoring SR&ED credits

- Selected SR&ED funding / factoring agents in the Golden Horseshoe area
- 6 W's of factoring SR&ED credits &
- Considerations for SR&ED claim preparers

D) 2009-4 (20 Minutes)

- i) Recent CRA Directives on filing new T661 SR&ED forms (Q&A's)
- ii) Calculation of Ontario's new ORDTC
  - ORDTC IS reduced by the OITC
  - OITC is NOT reduced by the ORDTC

## **II) SR&ED Ombudsmen request for feedback**

5 main questions for claimant & preparer feedback

## **List of attendees & participants:**

### **ATTENDEES:**

#### **September 17, 2009 Hamilton Region SR&ED Practitioners Workshop**

	<b><u>Name</u></b>	<b><u>Firm</u></b>
1	Alan Fyfe	FCS
2	Alex Murphy	Murphy & Co.
3	Alex Schiappa	Deloitte
4	Andrew Kolodziej	Benetax/Gordon & Milstein C.A.
5	Armando Valerie	SLF Group
6	Barry Doerbecker	Henderson Partners LLP
7	Beth Yeh	Roth Mosey & Partners
8	Bill Murphy	Murphy & Co.
9	Bob Turner	INAC Services Limited
10	Bryan Allendorf	BGA Tax Strategies
11	Chris Chipman	OME
12	Chris Dehann	Unknown
13	Chris Fattaei	Shirlon Plastics
14	Christine Gribowski	Gribowski and Associates Limited
15	Danny Ladouceur	R&D ONE
16	David Sabina	MEUK Corporation
17	Debra Porter	MEOI (Ministry of Enterprise)
18	Dieter Birk	Geofuel
19	Dominic Ioannoni	CRA
20	Doris Turner	Shirlon Plastics
21	Duncan Peake	Williams and Partners
22	Earl Viner	SRnEd Limited
23	Erik Roller	Tino-Gaetani & Carusi
24	Frank Baron	Frank Baron, C.M.A.
25	Frank Dodaro	Fazzari & Partners LLP
26	Frank Fiasche	BDO Dunwoody LLP
27	Glenn Dalzell	TCE Capital
28	Gul Nawaz	Nawaz Taub Noor & Wasserm/Morrison & Hollingsworth
29	Harvey Cantor	Harvey Cantor, C.A.
30	Jack Klieb	DM Primers Inc.
31	Jay Wignai	Deloitte
32	Jeff Robertson	BDO Dunwoody LLP
33	Jerry Gribowski	Gribowski and Associates Limited
34	John Carusi	Tino-Gaetani & Carusi
35	Kris Shah	OME Group
36	Kyle Hannah	Shirlon Plastics
37	Mark Sims	Graham Mathew Professional Corp.
38	Mary Grbic	Research Development Consulting inc.
39	Niru Desai	Saija Enterprises Inc.
40	Pat Murphy	Murphy & Co.
41	Paul Zilkey	FCB Financial
42	Peter Davies	Expert Solutions
43	Peter Kahn	JPK Associates Inc.
44	Peter Lambert	Graham Mathew Professional Corp.
45	Roy Bilic	Roy Bilic, C.A.
46	Sandy Hale	BDO Dunwoody LLP
47	Shannon Depalo	Deloitte
48	Stephanie Cormack	Murphy & Co.
49	Steve Dalton	MEOI (Ministry of Enterprise)
50	Tanya Radenovic	BOND Consulting
51	Thomas Nagel	Novatran Systems
52	Tony Bamran	OME Group
53	Vinay Khosla	Kurz Ghuman Khosla LLP

## **Details on issues discussed:**

Note all of these issues have additional “**backup documentation**” available at:

[http://www.meuk.net/resources\\_practitioners.html](http://www.meuk.net/resources_practitioners.html)

### **I) Specific issues addressed in the 2009 MEUK SR&ED newsletters as follows:**

#### **A) 2009-1 (20 Minutes) – new project format**

- i) CRA software project COMMENTARY
- ii) Template(s) to identify and quantify the required elements:
- iii) Providing technical documents via website
- iv) Best practices for isolating SR&ED “key criteria”

Discussion issues: The discussion centered on the review of the sample project description (Data warehouse improvement) that was provided with the release of the November 2008 T661 form and examined what practitioners perceived to be both the strong and weaker aspects of the current project description.

Notable areas for improvement included:

- the ability to quantify objectives &
- thereby illustrate measurement and analysis. .

Stronger aspects of the sample claim included:

- the illustration of technological versus business objectives &
- evidence of related technological uncertainties.

#### **B) 2009-2 (10 Minutes)**

##### **i) Recent SR&ED tax cases & related issue(s)**

- Advanced Agricultural – Eligibility of clinical trials
  - Ruling & rationale: LOSS - NOT SR&ED since lacked “hypotheses”
- Advanced Agricultural – revoking “proxy” election once filed
  - Ruling & rationale: LOSS - NO ability to revoke election
- Spasic – “hobby” vs. “carrying on business”
  - Ruling & rationale: LOSS - carrying on business requires “documentation”

Discussion issues: These recent cases were summarized very quickly however most of the conclusions and issues were deemed obvious to the majority of group participants. .

**ii) 2009 Federal & Ontario budgets**

- expenditure limit phase out range increased to \$500 – 800K for 2010+
- 2009 Ontario budget phase out range as per federal
- new ORDTC (discussed further per 2009-4 below)

Discussion issues: The mechanics of these new phase-out formulas were quickly reviewed and felt to be straightforward and their interpretation. The only significant issue of contention was on the mechanics of the calculation of the ORDTC (which is discussed later per 2009-4 below).

**C) 2009-3 (10 Minutes)**

**Factoring SR&ED credits**

- Selected SR&ED funding / factoring agents in the Golden Horseshoe area
- 6 W's of factoring SR&ED credits
- Considerations for SR&ED claim preparers

Discussion issues: The group discussion focused on the recent increase in need for SR&ED financing based on current economic conditions. Discussion examined and compared four alternative suppliers in the Southern Ontario region.

In particular one of the participants (Paul Zilkey) of TCE capital provided additional details on the financing methodology(ies) in question.

**D) 2009-4 (20 Minutes)**

**i) Recent CRA Directives on filing new T661 SR&ED forms (Q&A's)**

Discussion issues:

D) Issues on “completeness” of new T-661 form.

We discussed the following excerpts from APP 2004-02r2-eng Filing Requirements for Claiming SR&ED released June 11, 2009:

- **Q.2 If neglect to tick a certain box or I tick the wrong box on Form T661, will claim be denied?**
  - **A.2 No, with one exception (box 160 or 162 proxy election).**

- Q.4 When does an SR&ED claim need to be filed in order for the CRA to review and advise the claimant of any deficiencies in the SR&ED claim?
  - A.4 If an SR&ED claim is filed at least 90 days before the reporting deadline, the CRA should have sufficient time to conduct a review.
- Q.5 Can I submit (IRAP) project summaries instead of completing Part 2 of Form T661?
  - A.5 No.
- Q.6 Will the CRA disallow a project based on the technical content or quality of the narratives provided on lines 240 to 252?
  - A.6 No (unless NO details provided).

2) Options for using commercial tax software file a previous version of Form T661?

- For 2008 & prior tax years:
  - Use prior version
  - File paper copy OR
  - Use version (08) and attach descriptions

	If my tax year ends in:		
	2008 or earlier	2009	2010 or later
Which version of Form T661 can I use?	Form T661 (07) or Form T661(08)	Form T661(08)	Form T661(08)
Which format can I use to file my project information?	Form T661 (07) or (08) formats	Form T661(08) Part 2	Form T661(08) Part 2
If I have more than 20 projects, how many project narratives must I submit to the CRA?	The 20 largest projects in dollar value	The 20 largest projects in dollar value	All projects claimed

## ii) Calculation of Ontario's new ORDTC

Discussion issues: to discuss the mechanics of the new ORDTC calculation including the following potential problem:

- The ORDTC IS reduced by the OITC
- The OITC is NOT reduced by the ORDTC
- Result = Manual entry required for Taxprep and Profile which most practitioners are NOT performing.

**Unresolved issue:**

- **What about claims filed without this adjustment? Practitioner are unsure if the CRA will:**
  - **make this adjustment via “notice of Re-assessment”**
  - **make the adjustment in a future year or**
  - **ignore it.**

**II) SR&ED Ombudsmen request for feedback**

Discussion issues: in an effort for a serious performance the SR&ED Ombudsmen has requested feedback on **5 main questions for claimant & preparer feedback:**

**Re. Post Feb. 21/07 SR&ED claims:**

- Did **CRA adequately inform** taxpayers about the recent changes to the T661 form?
- Has the **cost of filing** and defending an SR&ED claim changed?
- Did CRA accept your **request for a "second opinion"**?
- Did CRA review and audit your claim act in a **professional and courteous manner?**
- Has any CRA person ever attempted to **dissuade you from retaining professional advice?**

**The Forms for submission available at:**

<http://www.taxpayersrights.gc.ca/frm-fil-eng.pdf>



**Minutes of discussions**  
**for Hamilton Region SR&ED Practitioners' meeting (Sept 16/10)**

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**I) Specific issues addressed in the 2010 MEUK SR&ED newsletters<sup>1</sup> as follows:**

**A) 2010-1 (10 Minutes)**

- i) update on status of CRA's SR&ED Tax Ombudsman
- ii) Discussion of how IP affects market value – using SR&ED info. to identify value

**B) 2010—2 (15 Minutes)**

- i) Meeting CRA criteria of “Technological Advancement”
  - analysis & discussion of required components +
  - practices to capture this information

**C) 2010-3 (20 Minutes)**

- i) Release of the CRA guide to conducting a technical review
  - discussion of select items and implications to claimants
- ii) Federal Legislative Proposals Status as of June 30, 2010
- iii) Aggressive tax planning - Federal proposals to require new reporting of “contingent fees”

**II) SR&ED Changes not details in newsletters above (40 minutes):**

- A) Electronic filing – practitioner experiences to date & related strategies
- B) Update on SR&ED financing sources& factoring agents
- C) Other issues as requested by participants &/or SR&ED blogs.
  - a. Latest version of Cantax will only allow seven projects
  - b. Case selection reasons – CRA internal criteria list
  - c. OMDC – inability to claim on failed SR&ED expenses
  - d. CATA – claims that new review manuals = tighter policy
  - e. Sample size – what's appropriate?

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<sup>1</sup> These newsletters are available for download at: [http://www.meuk.net/Newsletters\\_and\\_Publications.aspx](http://www.meuk.net/Newsletters_and_Publications.aspx)

# LIST OF ATTENDEES

## Hamilton Region SR&ED Practitioners' Workshop Attendees Sept. 16, 2010

<u>Name</u>	<u>Company</u>
Ajay Sinha	SM Financial SR&ED consultants
Alex Murphy	Murphy & Co.
Alex Schiappa	Deloitte
Allan Gordon	Allan Gordon C.A.
Angus Shuttleworth	Collis & Weitzman
Armondo Valeri	
Arne Luik	RDP Associates
Beth Ye	Roth Mosey, CA's
Brian Hartman	R&D Funding Management In.
Brian Kipp	Impact 360
Chris Chang	The De Factor Group Inc.
Danny Ladouceur	R&D ONE INC.
Christine Gribowski	Gribowski and Associates
Chris Chipman	OME Group Consultants Inc.
Darren Drury	Pinnacle Consultants Inc.
David Bodi	The Empyrean Group Inc.
David Learmonth	MEUK Corporation
David Milne	SR&ED Limited
Don Nagle	Novatron Systems
David Williams	Maxim Strategy Consultants
Dorothy Tapley	Arconas Corporation
Edward A. Collis	Collis & Weitzman
Frank Abrams	ZenPeak
Frank Fiasche	BDO
Frank Naccarato	The Empyrean Group Inc.
Gerry Gribowski	Gribowski and Associates
George Howie	CTC Group
Gautam Shah	Gautam Shah CA
Gordon Kerr	CPG CA's
Glen Dalzell	TCE Capital Corporation
Greg Farrell	BeneFACT
Greg Garland	Pricewaterhouse Coopers LLP
Harjett Rana	SM Financial SR&ED consultants
Isabel Murphy	Murphy & Co.
Jacques Goyette	R&D ONE INC.
James Perly	Perly Consulting
Janna Kantor	HSP
Jay McLean	Pricewaterhouse Coopers LLP
Jay Wigna	Deloitte
Jim Lycett	Odyssey Scientific group
John Sutherland	Deloitte
Karol Shaw	Karol P. Shaw CA
Kris Unni	SB Partners LLP
Kim Ackerman	Impact 360
Kyle Williams	Maxim Strategy Consultants

**Hamilton Region SR&ED Practitioners' Workshop**  
**Attendees Sept. 16, 2010**

<u><b>Name</b></u>	<u><b>Company</b></u>
Laura Martin	Business Improvement Group, Inc.
Lokesh	SM Financial SR&ED consultants
Lowell Hendricks	Arconas Corporation
Mahmood Qasmi	Northbridge Consultants
Mark Klingbaum	Klingbaum Barkin LLP
Masood Mahmood	Accsoft Business Solutions, Inc.
Michael Johnlester	Consultant
Mike Panayi	Pinnacle Consultants Inc.
Narayan Ghimire	FlavorChem International Inc.
Neha Tikn	TSI
Nick Rousopoulos	Debra L. Smith C.A.
Pat Murphy	Murphy & Co.
Paul Goode	Arconas
Paul Zilkey	Century Services Inc.
Peter Allen	Xplornet
Peter Wright	Impact 360
Rick Burdeniuk	BeneFACT
Robert Aceti	Robert Aceti CGA, Business Advisory Services
Ron Dorombozi	Consultant
Roy Bilic	Mountain Cable
Ryan	SM Financial SR&ED consultants
Sapna Santdasani	SGI Lighting
Sarmen Khagerian	Maxim Strategy Consultants
Shabir Gova	SGI Lighting
Shari Stolpmann	Beckett Lowden Read, LLP
Simon Francis	Fuller Landau LLP Chartered Accountants & Business Advisors
Stephan Schweighofer	Business Improvement Group, Inc.
Stephanie Cormack	Murphy & Co.
Sudha Correia	Canadian Research Incentives
Thomas Nagel	Novatron Systems
Tim Robertson	SRED Simple
Vinay Khosla	Bateman MacKay, CA's
Vishal Bhandari	Maxim Strategy Consultants
William Murphy	Murphy & Co.
Zak Siddiqui	ZHS.ca
<u><b>Moderators</b></u>	
David Sabina	MEUK Corporation
Domenic Iaconomi	Canada Revenue Agency
<b>TOTAL number of attendees</b>	<u><b>32</b></u>

**I) Specific issues addressed in the 2010 MEUK SR&ED newsletters as follows:**

A more complete discussion of these issues is presented in MEUK SR&ED newsletter 2010-1. This and other issues available at [http://www.meuk.net/Newsletters and Publications.aspx](http://www.meuk.net/Newsletters_and_Publications.aspx)

**Status of CRA's SR&ED Tax Ombudsman**

**I i) CRA's SR&ED Tax Ombudsman queries**

- **5 main questions for claimant & preparer feedback: Re. Post Feb. 21/07 SR&ED claims:**
  - Did CRA adequately inform taxpayers about the recent changes to the T661 form?
  - Has the cost of filing and defending an SR&ED claim changed?
  - Did CRA accept your request for a "second opinion"?
  - Did CRA review and audit your claim in a professional and courteous manner?
  - Has any CRA person ever attempted to dissuade you from retaining professional advice?

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**Moderator's note:**

The group discussed the issues briefly but it was felt that any issues with respect to the items cited were likely pre the 2007 cut-off date.

As a result it was generally concluded that the current system has likely improved with respect to any of the issues stated.

**Subsequent event: update issued in Globe and Mail**  
**Report expected January 2011**

BARRIE McKENNA — OTTAWA  
From Wednesday's Globe and Mail  
Published Tuesday, Nov. 09, 2010

The first of several reports was released in November 2010. Next up for the ombudsman is an examination of problems with the Canada Child Tax Benefit, expected to be released in December.

Mr. Dubé said he is also poised to complete a long-awaited report **“in January [2011] at the latest” on widespread problems involving the \$3-billion-a-year federal Scientific Research and Experimental Tax credit program.**

Businesses have long complained about a litany of administrative problems, including a lack of consistent or scientifically-based decisions, increasingly complex requirements and lengthy delays in processing claims.

“We’ve heard a lot of industry complaints,” Mr. Dubé said. “Now we have to put the allegations to the CRA and see what they say.”

## How IP affects market value

**Market Value Comparative: Technology vs. heavy mfg. : May 2000 (pre- "Dot com" crash) & 2009 (present)**

Industry / Company	Stock market listing symbol (NASDAQ)	Market Value \$ Billions		Revenues \$ Billions		Value/ Revenues		Net Income \$ billions		Value/ Income	
		2000	2009	2000	2009	2000	2009	2000	2009	2000	2009
<b>Technology</b>											
Oracle Corporation	ORCL	224.0	107.3	9.3	22.4	24.0	4.78	1.4	5.5	155.3	19.4
Sun Microsystems Inc.	JAVA	139.0	7.2	13.1	13.9	10.6	0.52	1.3	0.4	108.5	17.7
Microsoft Corp.	MSFT	366.0	209.9	22.4	58.4	16.4	3.59	8.7	14.6	41.8	14.4
<i>Average</i>		<b>252.5</b>	<b>108.1</b>	<b>14.9</b>	<b>31.6</b>	<b>13.5</b>	<b>3.0</b>	<b>3.8</b>	<b>6.8</b>	<b>101.9</b>	<b>17.2</b>
<b>Heavy Mfg. - U.S. Auto</b>											
Ford Motor Co.	F	60.0	25.8	162.6	146.0	0.4	0.18	7.2	-14.7	8.3	-1.8
DaimlerChrysler AG	DAI	56.0	34.2	150.4	135.1	0.4	0.25	5.8	2.0	9.7	17.1
General Motors Corp.	GRM(@NYSE)	56.0	0.5	176.6	149.0	0.3	0.003	6.0	-30.9	9.3	-0.01
<i>Average</i>		<b>57.3</b>	<b>30.2</b>	<b>163.2</b>	<b>215.1</b>	<b>0.4</b>	<b>0.1</b>	<b>6.3</b>	<b>-14.5</b>	<b>9.1</b>	<b>5.1</b>

### Moderator's note:

The group discussed the examples above with respect to the **value** the market places on **intellectual capital and technology**.

It was further noted that;

- many companies do not
- capital and amortize "development costs" and
- therefore may be missing the opportunity to
- provide users of the financial statements with
- this potentially valuable information.

Overall the group agreed that the **SR&ED related documentation was an excellent starting point for capturing "development costs."**

A brief overview of how this strategy might be enabled was provided on the next page.

## ***Example: Using SR&ED info. to identify value***

### **Step1: Identify costs which meet the 5 criteria for capitalization as “development costs”**

Universal Research Corporation

Identification of development vs. research costs for financial statement disclosure

for the fiscal year ended December 31, 2009

#### **Capitalization criteria per CICA handbook section 3450.21 \***

Project #:	Name:	start	end	Net costs to date @ Dec. 31, 2009:	1) product defined & costs identified	2) technical feasibility established at year end	3) mgmt. intent to market the product	4) future market clearly defined	5) adequate resources exist to bring to market	Devel. Cost (Y / N)?
901	Widget development	Jan-08	Jun-10	\$315,582	Y	Y	Y	Y	Y	Y
902	Widget improvement	Jan-09	Aug-10	\$24,131	Y	Y	Y	Y	Y	Y

#### **Notes:**

\* - MUST capitalize & amortize costs if ALL 5 "development cost" capitalization criteria have been met at year end.

This is performed EACH taxation year. In this example, project 901 had met the criteria for both the 2008 and 2009 taxation years

### **Step2: Amortize “development costs” over the expected economic life of the product/process**

Project / product	Amount	Total Cost	Year	ITC on expenses*	Total capitalized cost*	Amortization			NBV 2009
						start	rate**	Accumulated Amort'n 2009	
901 Widget development	\$66,000	\$66,000	2008	\$27,390	\$38,610	2008	20.00%	\$7,722	\$315,582
	<u>\$512,000</u>	\$578,000	2009	\$212,480	\$404,130	2009	20.00%	<u>\$80,826</u>	
902 Widget improvement	\$55,000	\$55,000	2009	\$22,825	\$32,175	2009	25.00%	\$8,044	\$24,131
Totals	<u>\$633,000</u>	\$699,000		\$262,695	\$474,915			\$96,592	\$339,713

#### **Notes:**

\* The capitalized costs should be net of related grants &/or SR&ED investment tax credits on this research

\*\* Amortization rate - straight line over estimated economic life of the technology (5 years) with NO half year provision



## Meeting CRA criteria of “Technological Advancement”

### Taking your car to the mechanical and claiming, “it doesn’t work!”

- A (Properly trained) mechanic would likely start a conversation like;
  - Mechanic: “What happens when you turn the key in the ignition? Does it start?”
  - Client: “Sure it starts fine.”
  - Mechanic: “Does the engine run?”
  - Client: “Sure it runs fine.”
  - Mechanic: “What happens when you put the transmission in gear? Does it move?”
  - Client: “Sure it moves but it jerks and sometimes backfires.”
  - Mechanic: “Okay. That will be \$500 for not just  
» telling me the problem in the first place!”

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#### **Moderator’s note:**

Recently the CRA has appeared to increase it’s scrutiny on SR&ED claimants based on one basic challenge claiming that they:

“Do not see the technological advancement.”

To many this situation with the mechanic (above) seems almost foolish since most people would just tell the mechanic the specific problem in the first place.

Ironically when it comes to explaining “technological advancement” some CRA officials appear to provide similar lack of detail in their feedback to SR&ED claimants.

In the group’s opinion a more acceptable and useful answer would be to clarify which of the 5 major components (illustrated next page were lacking in the clients project description.

# Recent challenges to “TA”

## CRA Definition of “TA”

- Step 1 a): Benchmark “standard practice”
- Step 1 b): Quantified Objectives outside of “standard practice”
- Step 2): Identify “technological uncertainty”
- Step 3 a): Ensure “experimentation” done “systematically”
- Step 3b): Clarifying the “technological conclusions / advancements”

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### **Moderator’s note:**

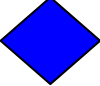


As noted on the prior page, in the group’s opinion a more acceptable and useful answer would be to clarify which of the 5 major components (illustrated above) were lacking in the clients project description.

The group the reviewed some “best practices” to ensure;

- relevant information
- is captured efficiently

a **1 page summary** of the what the group agreed would likely be in the nature of **relevant information** is suggested in the next page.

## MEUK - suggested SR&ED project description structure

I	i)	 <b><u>State of Existing technology: Benchmarking methods &amp; sources for citings</u></b>	<b><u>Number of</u></b>	<b><u>Explanatory notes / results:</u></b>
		Internet / Google Searches	_____	internet sites
		Articles	_____	articles
		Patent searches	_____	patents
		Competitive methods	_____	products / processes
		Similar prior in-house technologies	_____	products / processes
		Potential components	_____	products
		Queries to experts	_____	responses
		Other	_____	____ (specify)
	ii)	<b><u>Objective(s)</u></b>		
		<b><u>Performance measures</u></b>	<b><u>Existing benchmark</u></b>	<b><u>Units of measure</u></b>
				<b><u>Performance objective</u></b>
II)		 <b><u>Technological Uncertainties</u></b>	<b><i>Outline top 5 key variables</i></b>	
III	i)	<b><i>for EACH ACTIVITY</i></b>	<b><i>define fiscal year</i></b>	
		 <b><u>Experimentation method</u></b>	<b><u>Number of</u></b>	<b><u>Explanatory notes: justification of sample size</u></b>
	i a)	Analysis / simulation	_____	alternatives
	i b)	Process trials	_____	runs / samples
	i c i)	Prototypes	_____	samples
	I c ii)	prototype revisions	_____	revisions
	ii a)	<b><u>Results - tie to performance objectives in I ii) above</u></b>		
	ii b)	<b><u>Conclusions - tie to variable(s) in Uncertainties II)</u></b>		
	iii)	<b><u>Documentation - tie to Activities in III i)</u></b>		
	iv) a)	<b><u>Costs: labour hours by direct employees - tie to Activities in III i)</u></b>		
	iv) b)	<b><u>Costs: labour \$ via contractor - tie to Activities in III i)</u></b>		
	v)	<b><u>Costs: materials - consumed or transformed - tie to Activities in III i)</u></b>		

## Release of the CRA guides to conducting a technical review

- discussion of select items and implications to claimants

### Technical review guides – versions for CRA staff & for claimants

- i) **Claim Review Manual for CRA R&T Advisors**
  - Effective June 1, 2010
  - Replaces Technical Review manual (2000)
    - Highlights: no recordings, timing & T2020/T98 files, treatment of objections
- ii) **SR&ED Technical Review: A Guide for Claimants**
  - summarizes procedural steps
  - Identifies how RTA's will work &
  - Provided BEST practices

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Technical review guides – versions for CRA staff & for claimants

#### **Moderator's note:**

The group discussed specific aspects of these manuals including the documentation that should and should not be maintained.

It was largely agreed that any increase in communication (whether positive or negative results) early in the process, would be in the interest of all parties.

## Federal Legislative Proposals Status as of June 30, 2010

### Federal Legislative Proposals Status as of June 30 ,2010

Provision	Description
37(8)(a)(ii)(B)(V) "Materials transformed" can now be claimed under the proxy method.	<b>Materials under the proxy method</b> Under the proxy method, the phrase "materials consumed" is changed to "materials consumed or transformed." Also, there reference in the French version of subclause 37(8) (a)(ii)(B)(V) to "matériel" is changed to "matériaux" in the ITA. Effective Date: For costs incurred after February 23, 1998.
127(27)(b),(c),(e),(f) Originally part of the December 20, 2002 Notice of Ways and Means Motion.	<b>ITC can be recaptured on unpaid shared use equipment (SUE)</b> Technical amendments include having an ITC recapture on a property even though the expenditure for the property was unpaid; this include SUE. Also for the purposes of ITC recapture, "cost" was amended to "cost or a portion of costs" and there was clarification for the calculation of ITC recapture on first-term SUE and second-term SUE. <b>Effective Date: For dispositions and conversions that occur after December 20, 2002</b>
<b>New section 143.3</b> Stock option benefits can no longer be an expenditure.	<b>Stock option benefit denial of expenditure</b> The value of an option granted by a taxpayer is not considered to be an expenditure for income tax purposes. Also, the increase between the option price and the exercised share price is not an expenditure per paragraph 143.3(3)(b). Original release Technical Notes: 2005-08 <b>Effective Date: November 17, 2005</b>
<b>New subsection 220 (2.2)</b> Requests for ministerial discretion to file the prescribed Form T661 or prescribed information past the 18 months can no longer be considered.	<b>Removal of subsection 220(2.1) discretion</b> Under proposed subsection 220(2.2), subsection 220(2.1) does not extend to a prescribed form...or prescribed information filed on or after the day specified in subsection 37(11) or paragraph (m) of the definition of "investment tax credit" in subsection 127(9). The effect of new subsection 220(2.2) is that a person cannot deduct an SR&ED expenditure under section 37, or claim an investment tax credit in respect of an expenditure, if the person takes more than the additional 12 months allowed to make a claim with the Minister. Original release Technical Notes: 2005-080 <b>Effective Date: November 17, 2005</b>
<b>248(1)</b> Definition of Scientific Research and Experimental Development (SR&ED), French version of the ITA	<b>"Engineering"</b> work is among the work listed in paragraph 248(1)(d).The French version of paragraph (d) of the definition is <b>changed to refer to "travaux de génie" instead of "travaux techniques."</b> It was never intended for there to be a difference between the English and French versions of the ITA. <b>Effective Date: Upon Royal Assent</b>
<b>2902(e)</b>	The provisions of paragraph 2902(e), defines a <b>prescribed expenditures</b> to include, among other things, an expenditure for SR&ED where a claimant received or was entitled to receive a reimbursement. The proposed amendments to paragraph 2902(e) are consequential to the amendments to the <b>definition of "contract payment", in subsection 127(9), which renders the provisions of paragraph 2902(e), as redundant</b> for ITC purposes. <b>Effective Date: applicable for amounts that became receivable after December 20, 1991</b>

#### Moderator's note:

This table tracks the progress of outstanding federal draft legislation amending the Income Tax Act (ITA) that impacts on the Scientific Research and Experimental Development (SR&ED) Program.

Former Bill C-10 ceased to exist with the dissolution of the 39th Parliament on September 7, 2008, and has not presently been reintroduced to the 40th Parliament.

Despite this fact the CRA will administer the proposed amendments as if they are law.

Implications to claimants: The group acknowledged that w most issues seem to be in the clients interest, to follow there are select items in which a claimant may choose not to follow the CRA's direction.

An example might be claims for "stock option benefits" which technically have been ineligible since November 2005 however, as illustrated on the following chart, this legislation is not in force.

## Aggressive tax planning - Federal proposals to require new reporting of “contingent fees”

### New proposals: Aggressive tax planning - reporting of “contingent fees”

- Reportable transaction bears at least two of the following three hallmarks (page 5):
    - Avoidance Transaction
    - Confidential Protection &/or
    - Contractual protection
- Issue: what do these terms mean and would they apply to “typical SR&ED work done on contingency?”

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#### Moderator’s note:

With respect to consultants who perform SR&&ED work with fees based on “contingency” it’s was generally felt that SR&ED related services were NOT reportable since;

- 1) Not an Avoidance Transaction since they were specifically provided for by the act

However, **certain “aggressive” positions** within the interpretation of what is SR&ED might be argued as involving,

- 2) Confidential Protection (where the taxpayer is prevented from disclosing method [especially to the CRA] by the consultant) &/or
- 3) Contractual protection (where taxpayer is indemnified by the consultant against any losses).

If these situations exist within the contract consultants may wish to examine these rules further.

## **II) SR&ED Changes not details in newsletters above:**

### **Electronic filing – practitioner experiences to date & related strategies**

## **II) SR&ED Changes not details in newsletters above**

### **A) Electronic filing –**

**Practitioner experiences to date &  
Related strategies:**

- keeping online documentation**
- summarizing # iterations & methods used**
- methods to transfer data from Science to tax forms?**

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### **Moderator's note:**

Overall the group had mixed feedback regarding the move to e-file but many agrees that the assessment time had been greatly reduced in the case of many claimants.



## Update on SR&ED financing sources& factoring agents

### Moderator's note:

The group briefly discussed and compared some of the main SR&ED funding agents operating in Ontario using a shortened version of the attached table.

### Selected SR&ED funding agents in the Golden Horseshoe area

<u>Comparative Factor</u>	<u>Goldeye</u>	<u>TCE</u>	<u>New Solutions</u>	<u>Century Services</u>	<u>Espresso Capital</u>
Initial Fees:	\$3,000	0.7% of funding + legal (\$2,000)	1-2% of required \$ upon acceptance of Commitment Letter	0.5% @ acceptance of Terms Letter	0% to 7%
Monthly fees:	N/A (Factor fee)	2-2.25%	3%	2%	2%
Minimum fee:	10%	6%	3% / month	1.50%	5%
Minimum funding:	\$100,000	\$250,000	\$100,000	\$200,000	100000
% advanced up to:	70%	70%		80%	
Accrued (from start of yr.)					70%
Submitted Claims			65%		75%
Approved Claims			90%		90%
Repayment if claim fails:	No	Yes	Yes	Yes	Yes
Typical approval time:	7-14 days	5-7 days	3-10 days	3 - 7 days	3-10 days
Established:	2007	1992	1999	1990	2009
Industries served:	All	All	All	All	All
# claims financed to date:	DND	>100	>25	<100	>50
Personal guarantees req'd:	No	Yes	Yes	Yes	No
Restrictions:	No start-ups	None	Trustee required if Initial SR&ED	None	None
Website:	goldeyecapital.com	tcecapital.com	newsolcapital.com	centuryservices.com	espressocapital.com
Contact person:	Dan Gregory dangregory@ goldeyecapital.com 416.709.9266	Glen Dalzell gdalzell@ tcecapital.com 416-496-7065	Patrick Wieland pwieland@ newsolcapital.com 905-279-1355	Paul Zilkey pzilkey@ centuryservices.com 416-931-8518	Garron Helman garron@ espressocapital.com 647-404-5005

**Other issues as requested by participants &/or SR&ED blogs.**

## **II C) Other issues**

- a) Latest version of Cantax will only allow seven projects**
  - recommendations on Cantax in general?**

20

*As per the Sept. 14, 2010 posting reproduced on the following page:*

*The latest version of Cantax will only allow seven projects*

### **Moderator's note:**

**The group discussed the fact that there were still significant differences in preparing the T661 claims dependent on the brand of software used.**

**In the group's experience it appears that the market appears to be dominated by two main programs as follows:**

**Taxprep (45%)**

**Profile (45%)**

**Cantax, DR Tax and other programs. (10%)**

**As a result the group agreed that extra care should be taken to review completeness particularly when using the "non-main stream" programs.**

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1 of 1 [See all new discussions >](#)



We recently learned that the latest version of Cantex will only allow seven projects. If you try to enter an eighth project the entire... [+ 4 hours ago](#)

## ***Case selection reasons – CRA internal criteria list***

### **b) Case selection reasons – CRA internal criteria list:**

- What is this list and how is it used by CRA?
- To be addressed by Dominic Iaonnoni of CRA

21

*As per the July 2010 posting reproduced on the following page:*

*The CRA has certain codes used to identify review issues – are these available to the public?*

#### **Moderator's note:**

**CRA moderator Dominic Iaonnoni explained that these are just internal codes used to identify review issues.**

**They are not available to the public.**

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#### CRA Technical Review: "Case Selection Reason"

As of July 2010, I have noticed that a SR&ED Review Report cover sheet, provided by the RTA, has indicated a "Case Selection Reason"

For example, the reason in this case was : 2337 (35% RD)

I can only assume these are the codes for the 'flags' that indicate the SR&ED claim should be reviewed further by the RTA, or financial reviewer, in this case: because the claimant has submitted a percentage of their expenditures to (revenue, or total labor) that exceeds 35%.

Has anyone else seen these reason codes, and could you provide some insight into them?  
15 days ago

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**Benoit Remillard** [benoit\[at\]amergex.com](#) • In French, it's titled "Genre de demande" (Type of claim) and from what I can see, it just says whether it's a 20% or 35% credit and whether it's an original claim or an amended one.

14 days ago • [Reply privately](#) • [Flag as inappropriate](#)



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## **OMDC – inability to claim on failed SR&ED expenses**

### **c) OMDC – inability to claim on failed SR&ED expenses**

#### **Per discussion with Mark Sonnenberg (OMDC)**

- Amounts claimed for SR&ED are ineligible for OMDC credits**
- This is being applied even if/when SR&ED expenses are denied by CRA**

22

*As per the Sept. 15, 2010 email reproduced on the following page:*

Per discussion with Mark Sonnenberg (OMDC)

- Amounts claimed for SR&ED are ineligible for OMDC credits
- This is being applied even if/when SR&ED expenses are denied by CRA

#### **Moderator's note:**

The group noted that this was due to the use of the word “claimed” in the legislation.

This underlines the importance of correctly choosing whether to claim SR&ED vs. Ontario Interactive Media credits for any projects which may qualify for both.

**David Sabina**

---

**From:** Mark Sonnenberg (OMDC) [Msonnenberg@omdc.on.ca]  
**Sent:** Wednesday, September 15, 2010 10:56 AM  
**To:** David Sabina  
**Subject:** RE: SR&ED practitioner meeting - quick question on "double dipping" costs  
**Follow Up Flag:** Follow up  
**Flag Status:** Red

On page 22 of our June 2010 guidelines:

Expenditures for which the qualifying corporation or qualifying predecessor corporation makes a claim under section 90, 91 or 92 of the Act or section 43.5, 43.8 or 43.10 of the *Corporations Tax Act*, or incurred by the corporation in carrying out activities that constitute scientific research and experimental development for the purposes of paragraph 37(1)(a) of the Income Tax Act (Canada) or subparagraph 37(1)(b)(i) of that Act do not constitute Ontario Labour Expenditures under the OIEMTC.

So, the client needs to decide where they are going to claim certain expenditures. IF the client decides to make the claim under SR&ED, then these are specifically excluded as per the above. Although it may not be "fair" as you say, it's the law. I have no discretionary powers on this point.

---

**From:** David Sabina [mailto:dsabina@meuk.net]  
**Sent:** Wednesday, September 15, 2010 10:45 AM  
**To:** Mark Sonnenberg (OMDC)  
**Subject:** RE: SR&ED practitioner meeting - quick question on "double dipping" costs

Really? So even if the costs are not accepted by the CRA they are still being rejected by the Ontario Ministry for the OMD?

I agree that this seems unfair and will mention it during tomorrow's meeting.

In your opinion is the change required on the OMD side or with the CRA?

Regards, Dave Sabina

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SR&ED products - www.rdbase.net  
SR&ED services - www.meuk.net

---

**From:** Mark Sonnenberg (OMDC) [mailto:Msonnenberg@omdc.on.ca]  
**Sent:** Wednesday, September 15, 2010 10:44 AM  
**To:** David Sabina  
**Subject:** RE: SR&ED practitioner meeting - quick question on "double dipping" costs

Nope. Rejected.

---

**From:** David Sabina [mailto:dsabina@meuk.net]

9/15/2010

***CATA – claims that new review manuals = tighter policy***

d) CATA – claims  
New review manuals =  
tighter policy

August 2010 Article by Russ Roberts claims:

- More challenges to “Technological Advancement” criteria
- Less “latitude” experienced by previously successful claimants
- Higher focus on documentation especially in “commercial” settings (i.e. cut-off of SR&ED)

23

***As per the Aug. 2010 CATA posting reproduced on the following page:***

- The CRA is becoming more stringent in certain areas.

**Moderator’s note:**

This fact has been noted by several practitioners.

The group again discussed and reiterated the importance of being able to document the “technological advancement” criteria discussed earlier in this meeting.





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## Scientific Research and Experimental Development (SR&ED) Tax Incentive Program Alert and Call to Action August 2010

**Russ Roberts, CATAAlliance, Sr. VP, Tax & Finance**

**Note:** Please circulate the CATA SR&ED Alert broadly. Items are linked to more detailed exp We welcome your views and participation in advancing Canada's high tech business growth.

**Alert: CRA has issued new, stringent review protocols for SR&ED claims.**

**If you have claims currently under review or coming up for review, or if you are fil claims, you should understand the implications of these changes. You cannot assu you can rely on past experience as a predictor of how to support your claims or of outcome of your claims, going forward.**

Specifically, the CRA has released two new documents, both effective June 1, 2010:

- an internal procedural manual for its Research and Technology Advisors (RTAs), the *Review Manual for Research and Technology Advisors*. The CRA has posted a public ( version of this manual on its website <http://www.cra-arc.gc.ca/txcrdt/sred-rsde/oblctns/ntr-tchrvw-eng.html>
- a guide that provides an overview of the claim review process for claimants to help t prepare for technical reviews of their claims, The SR&ED Technical Review: A Guide i Claimants (draft). To see the guide, go to the CRA website at <http://www.cra-arc.gc.ca/txcrdt/sred-rsde/oblctns/tchrvw-cmmnt-eng.html>. The CRA indicates that t a concise version of the new, internal Claim Review Manual for RTAs.

The CRA's website states that the Claim Review Manual for RTAs and the Technical Review ( claimants "cancel and replace the *Guide to Conducting a Scientific Research and Experieme Development Review Part 1: The Technical Review* dated January 14, 2000."

Both the Claim Review Manual for RTAs and the Technical Review Guide for claimants are of effective June 1, 2010. However, from what we understand, the CRA has been applying Clai Manual procedures even to some reviews that were started before June 1, 2010. Also, the T Review Guide for claimants has been posted as a "draft" for limited comment by August 1, ;

**Impact**

Those experiencing reviews under this new regime are finding:

- the reviews much more rigid; and
- the positions being taken and the information requirements more oriented to dedicat projects as opposed to projects where the R&D is highly integrated within the contex need to develop advanced technologies required for improved commercial products, and services.

We are hearing of companies that thought they knew what was expected and that had good experiences now not being able to support their current claims to the satisfaction of reviewe their claims are reviewed under these new protocols.

Senior SR&ED practitioners are emphasizing similar concerns to us. Specifically, they are sa

## ***Sample size – what's appropriate?***

### **e) Sample size – what's appropriate?**

- **This is an ongoing issue**
- Example provided by Harvey Cantor, C.A.:**
- **200 test sample devices required per initial estimate**
  - **DOE worked down to 83 samples**
  - **70 tested in field, 10 in house, 3 extra**
  - **CRA disallowed all materials but allowed 97% of labour**

24

*As per the Sept. 2010 email reproduced on the following page:*

One of the group members had an issue (outlined above) regarding appropriate sample sizes.

#### **Moderator's note:**

The group discussed the concept of determining and appropriate sample size for an experiment and agreed that ;

- while there were base principles to estimate these sizes
- these in turn required assumptions which were ultimately subjective &
- as a result “professional judgment” (or opinion) will always play a portion.

To provide an overview of some “best practices” for supporting a minimum sample sizes have also been provided.

- **Appropriate sample size?** *Issue submitted by Harvey Cantor, C.A.*

Claimant is in extremely highly regulated industry. Claimant works with both the creation of prototype devices and management of data initiated from a number of devices both from itself and 5 other manufacturers, each of which have their own proprietary ways of managing and handling data.

Claimant's goal is to create, capture and process data in a way that ensured confidentiality for the manufacturer's, operator's or regulator's knowledge. Claimant was simultaneously involved in an experimental network as the operators' used a number of different varieties of communication approaches including 19,200 baud serial, to 10 base T 10-1000, fibre, and frame relay radio. Estimated population of data initiated devices approximate 10,000.

The claimant could only test its prototype devices on its own proprietary machines in house as due to highly restricted environment it was not even allowed access to samples of machines. In order to complete its tests of prototypes it had to come to agreements with both the local operator and the regulator in respect to where it could test its devices and the number of units to be tested. As part of its agreement the claimant was also required to provide a limited amount of data to the regulator and operator and accept their requirements and specifications as to trial size.

Key issues in the data collection were effecting efficient and accurate near real time collection of data over distributed networks. The claimant's engineers felt that in order to test its devices and because of the combination of data from machines of 6 manufacturers and the different communications they would require about 200 test devices. The operator initially offered to make available 160 devices from other manufacturers but later restricted it to 70.

The test did not fully resolve all the uncertainties. At the end of the year there were still problems with data collisions and control of duplicated data

Claimant's labour was 97% allowed

Claimant purchased materials for 200 test prototype devices because purchased components had to be custom built and long lead times were required

Claimant only built 83 devices, deployed 70 in the field, 10 were used in the in house tests and 3 were for quick replacement if a unit failed.

CRA has disallowed materials for 190 test prototype devices

What is the appropriate sample size?

## **SR&ED planning - Determining an Appropriate Sample Size**

The SR&ED legislation clarifies that [any] “testing” which is “commensurate with the needs and directly in support of the project” is eligible for ITC’s.

Many SR&ED eligible projects involve testing or sampling of a product or a production process. Inevitably, when the repetitive measurement of any parameter is involved, the question will always arise;

“What is an appropriate number of test runs or samples required for my project?”

CRA often challenges this aspect of SR&ED claims, leaving it to the claimant to justify the original number of test runs/samples put forward. This is particularly likely in situations where the “experimental production” is being sold in what might be considered a “commercial” operation.

### **When does the SR&ED testing end?**

If the technical rationale for determining the number of test runs/samples required is weak (or non-existent), the claimant may have a large portion of their claim rejected.

At this point, most people (even the engineers in the crowd) start to grow a little nervous, because setting that significant “number” involves dealing with statistics from a varying degree of sources including

- Statistical and engineering texts
- Industrial standards: eg. ISO, Six Sigma
- Industry specific: Pharmaceuticals, etc.

Although the process of determining sample size can be a bit confusing for most people, determining an acceptable answer can be done knowing what it is you want to prove!

The following is provided as a generic guide to help find your way through the basic principles.

#### **Define Project Objectives First**

Clearly defining your ultimate goal will frame the prescribed scope of work for the research project and ultimately the number of samples required.

In short, the number of specific objectives is directly proportional to the statistically significant sampling/testing requirements. This “scoping” exercise involves consideration of several components that are inextricably linked:

- 1) the types of tests required – consideration must be given to the:
  - complexity of the test itself,
  - time and cost required to conduct the test
  - analysis of results to support the objectives.

#### **Effects of environment**

Sampling or testing the performance of a machine or production line will typically require much different baseline considerations than say testing a new consumer product or computer program;

- 2) number of variables to include in the test matrix – consideration must be given to
  - a ceiling on what can be achieved within
  - practical performance and budget limitations;

Typically the number of inter-dependent variables will affect the overall number of tests required on an exponential basis.

- 3) evaluation criteria used to support decision making  
As the precision becomes finer and confidence levels increase, so does the requirement for sampling/testing.
  - While acceptable confidence limits for many scientific projects are between 90 – 95%, the precision may be acceptable at  $\pm 20\%$ , whereas confidence levels may be as high as 99 – 99.9% with high precision ( $\pm 5\%$  or smaller) for some industrial or pharmaceutical applications.

Although Items 1, 2, and 3 are mutually dependent, there is flexibility in setting the level of precision and confidence you wish to attain with respect to significant data, i.e., do you want to be within  $\pm 10\%$  precision of a 90% confidence interval, or do you want to be within  $\pm 5\%$  of a 99% confidence interval?

In short, the number of test runs or samples required for any given project is driven by the precision and level of confidence demanded by your defined objectives.

### **Rules of thumb / industry standards**

Although there are some general rules of thumb, there is no way to avoid the fact that some calculations need to be performed to develop a justifiable sample size number.

## Sample Size calculation example

Determining a sample size can quickly become very complicated conceptually.

Say you have a factory that produces widgets, and your competitor claims that 'half your widgets' come off the assembly line defective.

How many widgets should you randomly select (as a sample) to find out the percentage of widgets that tend to be defective during normal production?

If your normal production is 5,000 widgets per month, and you want to be 95% confident in your results, within a range of 10 percentage points of the mean, your sample size should be as calculated below<sup>12</sup>:

**Determine Sample Size**

Confidence Level: ☒ 95% ☐ 99%

Confidence Interval:

Population:

sample size needed:

Let's say within your sample of 94 widgets the mean defective rate was 30%.

This means that;

- 95% of the time your normal production
- will have defect rates between 20% and 40%,
- meaning between 1,000 - 2,000 defective widgets
- for every 5,000 produced.

### Glossary of Terms

When choosing a correct sample size for a survey or study, you can use a "sample calculator", as shown above in the widgets example. You need to specify the following items:

- Confidence level – the percent of the time the mean of your results will lie within the confidence interval.

- Confidence interval – the precision applied to the specific mean quantity (i.e. the range that the mean lies within, mean  $\pm$  value)
- Population – the total number of individuals (the group size) about which you wish to determine some average result / property; the lot size or expected production; the number of people who are purchasing a product as a way to estimate the population size.

Also, from a population, a sample size is chosen to magnify the characteristics of that population. The sample calculator takes into account the population and confidence requirements. It computes an appropriate sample size to ensure the results are accurately representing the population.

### Limitations:

The sample calculator does not take into account many specifics when attempting to apply it to certain industries or cases. Certain industry standards and practices will alter the recommended sample size due to unaccountable demands at the time. It is meant to be used as a guideline when choosing a sample size.

On the next page we illustrate a generic chart<sup>13</sup> giving standard sample sizes based on the level of confidence chosen, population size, and confidence intervals.

### Notable quotes:

*"If everything seems to be going well,  
you have obviously overlooked  
something."*

*"When everything is coming your way,  
you're in the wrong lane."*

- Steven Wright, scientist and comic

<sup>12</sup> The calculator is from the website of Creative Research Systems – The Survey System found at: <http://www.surveysystem.com/sscalc.htm>

<sup>13</sup> taken from the IEEE website at <http://www.ieee.org/portal/pages/corporate/research/sample sizes.html>

## Sample Sizes

Population Size (N)	95% Level of Confidence				99% Level of Confidence		
	±3%	±5%	±10%		±3%	±5%	±10%
500	250 <sup>a</sup>	218	81		250 <sup>a</sup>	250 <sup>a</sup>	125
1,000	500 <sup>a</sup>	278	88		500 <sup>a</sup>	399	143
1,500	624	306	91		750 <sup>a</sup>	460	150
2,000	696	323	92		959	498	154
4,000	788	341	94		1,142	544	158
5,000	880	357	95		1,347	586	161
10,000	965	370	96		1,556	622	164
20,000	1,014	377	96		1,687	642	165
50,000	1,045	382	96		1,777	655	166
100,000	1,058	383	96		1,809	659	168

Note: The choice of +/- 3 percent, +/- 5 percent, and +/- 10% for confidence intervals is based on the tendency of researchers to use these intervals or a similar range of intervals in the design of their surveys.

<sup>a</sup>:

Population sizes for which the assumption of normality does not apply; in such cases, the appropriate sample size is 50 percent of the population size.

Source: Rea, Louis., and Richard A. Parker. *Designing and Conducting Survey Research: A Comprehensive Guide*. 2nd ed. San Francisco, CA: Jossey-Bass, 1997, page 121.

## **LINKS TO OTHER SUPPORTING DOCUMENTS:**

A more complete discussion of these issues is presented in;

- MEUK SR&ED newsletters
- 2010-1 through 2010-3.

These and other issues available at [http://www.meuk.net/Newsletters\\_and\\_Publications.aspx](http://www.meuk.net/Newsletters_and_Publications.aspx)

# **MINUTES OF THE ANNUAL HAMILTON REGION SR&ED PRACTITIONERS WORKSHOP**

**Date:**

Thurs, Sept. 22, 2011

**Time:**

4:30-6:30 PM

**Location:**

McMaster U, Ron Joyce Centre,  
Burlington, ON, 4350 S. Service Rd.

**Recording of webcast at:** <http://youtu.be/OzMWFdD1H1o> select “show more” to view “specific issues” below

The group discussed the following issues in the order they developed since our last meeting:

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## **Sep 22 2011 meeting attendees:**

<b><u>SR&amp;ED Practitioner</u></b>	<b><u>Firm</u></b>
Alex Murphy	Murphy & Co.
Andrew Fyfe	Scitax Advisory Partners LLP
Andrew Kolodziej	Benetax
Barry Doerbecker	Henderson & Partners LLP
Bernie Taub	Nawaz Taub & Wasserman CA's LLP
Bob Ritchie	Braithwaite Technology Consultants
Bob Turner	INAC Services Limited
Brian Marvel	MEDTT
Bryan Glutek	PWC
Chris Fattaei	TEI
Christine Gribowski	Gribowski & Associates Limited
Cory Haynes	Almacg
Darren Drury	Pinnacle Consultants
Dave Marshall	Performance Improvement Online
Diwakar Kamath	Diwakar Kamath, C.A., C.P.A (USA)
Dominic Iaonnoni	CRA / Moderator
Earl Viner	SRNED LIMITED
Ed Collis	Collis & Weitzman
Eric Roller	SR&ED Practitioner
Geoff Falk	Goulet Associates
Grant Ward	INAC Services Limited
Greg Farrell	Benefact Consulting Group
Greg Garland	PWC
Gul Nawaz	Nawaz Taub & Wasserman CA's LLP
Harvey Cantor	Harvey Cantor C.A.
Jack Smagala	Braithwaite Innes Chartered Accountants
Jay McLean	PWC
Jay Wigna	Deloitte
Jeffrey Dodgson	AKR Consulting
Jerry Gribowski	Gribowski & Associates Limited
John Carusi	Tino Gaitani & Carusi
John Oster	Deloitte
Lauar Martin	Business Improvement Group Inc.
Lucy Rojao	Techcentive Services
Marcus Guenther	Focus ROI consulting
Margaret Karpinska	Business Improvement Group Inc.
Mark Vainberg	SRED Professionals
Myriam Zitouni	MEDTT
Neha Tiku	TSI
Niru Desai	Sarja Enterprises Inc
Pat Murphy	Murphy Co.
Peter Davies	Expert Solutions
Peter Khan	JPK Associates
Prakash Pabari	Prakash Pabari, C.A.
Ray Kechun Wu	AKR Consulting INC
Richard Krummenacher	Deeth & Co. Chartered Accountants
Rob Jenkins	SR&ED Practitioner
Rob Zawydiwski	SR&ED Practitioner
Stephanie Cormack	Murphy Co.
Steven Dalton	MEDTT
Thomas Nagel	Novatron Systems
Tony Canale	Valcan Consulting Inc.
Trevor Butle	Buttle and Tavano Professional Corp.
Vinay Khosla	Bateman MacKay

## **ATTENDED VIA WEBCAST:**

Alain Mitchell	Mgestion Inc.
Armando Valeri	SLF
Brian Kipp	Impact 360 Degrees Inc.
Chris Chipman	Ernst & Young
David Bodi	TEGI

Garri Terzian  
 Glenn Skene  
 Jim Lycett  
 Lee Anne Acernese  
 Lila Abid  
 Mei Mei Fok  
 Paul Zilkey  
 Sarmen Khagerian  
 Stephan Schweighofer  
 Tom Liang

Braithwaite Technology Consultants Inc.  
 Braithwaite Technology Consultants Inc.  
 Odyssey Scientific  
 Jack Bolzan, C.A.  
 Odyssey Scientific  
 Globility  
 Century Services Inc.  
 Maxim Strategy  
 Business Improvement Group Inc.  
 Saka Solutions

**TOTAL PRACTITIONER**                      **69**  
**ATTENDEES**

**ATTENDEES FROM INDUSTRY (NON SR&ED PRACTITIONERS):**

Alex Romano	Xiris Automation Inc.
Ali Zohouri	Fairview Inc.
Bardia Khosravi	RIM
Wenli Zhang	Learning Library

**REGISTERED BUT COULD NOT ATTEND:\***

Beth Cosby	MSCM
Charles Wallace	INAC Services Limited
Chris Chipman	Ernst & Young
Darren Jack	Impact 360
Dave Hill, C.A.	Dave Hill, CA
David Chodikoff	Miller Thomson, LLP
Derek Clarke	Braithwaite Technology Consultants Inc.
Gautam Shah	SR&ED Practitioner
Irene Faria	MSCM
Isabel	Murphy Co.
Joe Truscott	Joseph Truscott CA
Joseph Hsueh	Joseph Hsueh, C.A.
Leo Ditschun	Braithwaite Technology Consultants Inc.
Lisa Hyde	Impact 360
Lloyd Whiting	Dairy Farmers of Ontario
Martin Lee	Bateman MacKay
Mike Lester	Mike Lester, P.Eng.
Mike Wolfer	BMO Capital Markets
Mohsen Khodaeian	Aerospace Consultant
Patricia Marchand	Patricia Marchand, CGA
Philton Moore	Philton Moore, LLB
Rachel	MSCM
Rocco Vertucci	Ernst & Young
Ron Dorombozi	SR&ED Practitioner
Rowda Mohamud	BDC
Roy Bilic	Turn - r- tech Ltd.
Sarmen	Maxim Strategies
Stephan Schweighofer	Business Improvement Group Inc.
Theo Meimar	R&D Tax Solutoins
Tim Miron	Beckett Lowden Read, LLP

**TOTAL DIRECT**                      **103**  
**PARTICIPANTS:**

\* We would like to thank all participants and recognize that many of those registered and unable to attend have provided ongoing input and feedback!

## D) SR&ED 2011-1 (15 Minutes)

Recent SR&ED tax cases & related issue(s)

- SPECTROL INC. – time extension for objection or appeal - win
- SUNATORI – accruing wages payable – win + lose?

The group began with discussion of issues raised during the

- last 3 months of 2010 &
- first 3 months of 2011

referred to as SR&ED 2011-1.

The past year has witnessed a release of a variety of smaller cases. The main issues and potential implications are outlined in the following pages. Copies of the judgments are available from the Tax Court of Canada's website.<sup>1</sup>

## **SPECTROL INC. – time extension for objection or appeal<sup>2</sup> - win**

### **Facts:**

The Appellant had filed its 2003 and 2004 tax returns within the time specified

The assessment for 2003 was not issued until March 26, 2008 and the assessment for 2004 was not issued until May 7, 2008.

The President of the Appellant stated that the appellant did not receive the notice of assessments for 2003 and 2004 until after an inquiry was made in 2009.

Shortly after the Appellant received a copy of the notice of assessment for 2003 in April 2009, the Appellant filed the document which is stated to be a notice of appeal (to the Tax Court of Canada) rather than a Notice of Objection (to the Canada Revenue Agency).

### **Issue(s):**

The CRA claimed it did not receive a notice of objection or an application for an extension of time to serve a notice of objection in relation to either assessment until May 5, 2010 – more than two years after the initial assessment.

### **Relevant legislation and analysis:**

The procedure to follow if a taxpayer wants to object to an assessment (or a reassessment) is set out in the Act. Subsection 165(1) of the Act provides that:

“A taxpayer who objects to an assessment under this Part may serve on the Minister a notice of objection, in writing, setting out the reasons for the objection .... on or before the day that is 90 days after the day of mailing of the notice of assessment.”

The proper procedure to follow to request an extension of time to file a notice of objection is to make such request to the Minister, not the tax Court.

If the Minister refuses the application or 90 days have elapsed without a decision from the Minister, then (and only then) the taxpayer may apply to this Court to have the application granted to extend the time within which a notice of objection may be served.

In order to grant the Appellant's application for an order to extend the time to serve a notice of objection the requirements of subsection 166.2(5) of the Act must be satisfied.

The first requirement is that the application be made within one year after the end of the time period within which a notice of objection could have been served.

This condition was satisfied as the application was sent to the CRA in April 2009 and the one year time period referred to above would not have expired until June 2009 (which would be 90 days plus one year after March 26, 2008 - the date of the assessment for 2003).

### **Ruling & rationale:**

The judge stated,

“It seems... more likely than not that the Appellant sent to the CRA in April 2009 the same document that was filed with this Court at that time.

Since this document was formatted and set up as a Notice of Appeal to this Court it could easily not have been recognized by the CRA as an application to extend the time to serve a notice of objection and hence not entered into their records as such.

It seems to me that it is just and equitable in the circumstances that the application be granted.”

### **Implications and author's commentary**

In the author's opinion this case illustrates;

- a) the importance of understanding **the proper procedures for “objections” (to the CRA) vs. “appeals” (to the Tax Court) &**
- b) leniency of the courts if relevant information has been filed (even if improper in format).

<sup>1</sup> Tax Court of Canada website [www.tcc-cci.gc.ca]

<sup>2</sup> SPECTROL INC., v. THE QUEEN, 2010TCC390

## **SUNATORI – accruing wages payable<sup>3</sup>** **– win + lose?**

### **Facts:**

The Appellant was a professional engineer and the sole shareholder and employee of the company at all relevant times.

In its SR&ED claims the company paid the Appellant a salary on December 31 of each of the subject years as follows:

- i) \$44,000 for 2004;
- ii) \$46,000 for 2005;
- iii) \$48,000 for 2006; and
- iv) \$50,000 for 2007.

The method of payment of the salaries was by delivery of a cheque to the Appellant on December 31 of each of the subject years.

On the same day, the Appellant gave the company a cheque for the same amount as a loan.

Neither cheque was ever presented for payment but the Appellant believes the end result is that the salary was paid and the loan back was effected.

On the same day as these cheques were delivered, a determination was also made by the Appellant, in his personal capacity as a creditor, that the loan to the company was a bad debt.

The related EI and CPP withholdings and remittances were made by the company however, based on the fact that an ABIL<sup>4</sup> was claimed there were likely income taxes deducted.

### **Issue(s):**

Among several other issue the CRA questioned whether the loan was, “bona fide.” The result of this issue would have other tax implications including whether they were, “bad debts” (or ABIL) for income tax purposes.

### **Relevant legislation and analysis:**

The income tax act prevents a deduction or credit on any amounts which are “incurred” but never “paid.” This requires an “add-back” to income for any such amounts

which remain unpaid 180 days from the taxation year end.<sup>5</sup>

### **Ruling & rationale:**

Based on the scenario presented the judge commented that;

“I can only add in closing that it seems to me that the Appellant may have misunderstood any CRA suggestion **that salaries need not be funded in order to give rise to the targeted refundable investment tax credits.**

It is **the incurrence of the expense, not the payment of the expense that generates an SR&ED expenditure** that generates the refundable credits.

That is, the company need only have incurred the salary expenses on the accrual basis to obtain refundable credits.”

On this basis the judge did NOT allow the loans in question to be treated as ABIL’s.

### **Implications and author’s commentary**

In the author’s opinion, it does not appear reasonable that the company could claim the debt as “bad” the moment it was issued and continue this practice for 4 years in a row.

This case illustrates an “unfortunate” scenario where the taxpayer was unaware of the proper mechanism to accrue unpaid salary and wages via line 315 of the T661 form.

This strategy is discussed in further detail in our SR&ED newsletter 2004-1.<sup>6</sup>

### **Notable quote:**

**“Sometimes when you win you lose.  
Sometimes when you lose you win.”**

**- Anonymous**

<sup>3</sup> GO SIMON SUNATORI v. THE QUEEN, 2010 TCC 346

<sup>4</sup> ABIL - an allowable business investment loss

<sup>5</sup> ITA subsection 78(4)

<sup>6</sup> Newsletter 2004-1 available at:  
[http://www.meuk.net/Newsletters\\_and\\_Publications.aspx](http://www.meuk.net/Newsletters_and_Publications.aspx)



## D) SR&ED 2011-1

### Recent CRA Pronouncements

- SR&ED Filing Req's Policy – DRAFT
- Third-Party Payments Policy - DRAFT
- SR&ED avg. CRA Processing Times
- Potential penalties “frivolous” claims
- T661 – Part B: More space for project descriptions (50/100 lines)

## **Recent CRA Pronouncements**

On December 1, 2010 the following draft documents have been posted for feedback on the CRA Web site. The deadline for such feedback was January 15, 2011.

We have provided excerpts and commentary on what we feel to be the most relevant sections.

## **SR&ED Filing Requirements Policy – DRAFT<sup>7</sup>**

In order to earn an ITC, a claimant **must**;

- **file a prescribed form**
- **containing prescribed information**
- in respect of an ITC amount, earned on an outlay, expense, or expenditure for SR&ED,
- on or before the day that is 12 months after the claimant's income tax return filing due date
- for the year in which the expenditure was incurred.

A claimant must also have met the filing requirements for SR&ED expenditures before an ITC can be earned.

**Form T661** is the **prescribed form** for the purposes of determining **SR&ED expenditures**.

**Schedule T2SCH31** is the **prescribed form** for corporations to claim **SR&ED ITC's**.

For **Form T661**, **Schedule T2SCH31**, or **Form T2038(IND)**, the CRA proposes that;

- **prescribed information means**
- **the information requested**
- **on the prescribed form.**

### **Other “potentially” prescribed forms**

**Prescribed information will also include any attachments** or schedules necessary to provide the information requested on **Form T661**, including, **if applicable, forms T1145, T1146, T1174, and T1263**. Briefly, these are for;

- Form T1145, Agreement to Allocate Assistance Between Persons Not Dealing at Arm's Length for (SR&ED)
- Form T1146, Agreement to Transfer Non-Arm's Length (SR&ED) Expenditures

•Form T1174, Agreement Between Associated Corporations to Allocate Salary or Wages of Specified Employees for (SR&ED)

•Form T1263, Third-party payments for Scientific Research and Experimental Development (SR&ED)

•Schedule T2SCH49, Agreement Among Associated Canadian-Controlled Private Corporations to Allocate the Expenditure Limit

### **Date received**

- **Hand-delivered** claims will be considered filed on that day.
- **First-class mail** considered filed on the date of the postmark. If reporting deadline **Saturday, Sunday or a statutory holiday**, extended to **next business day**.
- **E-file<sup>8</sup>**: filing date established **when electronic signature validated**. It will remain in effect as long as
  - **any errors** in transmission are **corrected** &
  - the filer retransmits the return
  - **within five business days**.
  - **If > five business days** to successful validation, the filing date is **date confirmation number** issued.

### **Implications and author's commentary**

The proposed requirements include **ALL fields of ALL relevant forms to be completed in ALL cases!**

In the author's opinion, **if these rules are enforced narrowly** they could result in the denial of many “valid” claims in which the company has not submitted information within the 18 month corporate filing deadline.

Examples of **problem areas** might include:

- Project descriptions – what if information on;
  - o only 2 of the to 3 employees was listed on one of the projects
  - o the business number of one of the subcontractors or collaborators was omitted?
  - o Would you lose on the costs for the project, the subcontractor or perhaps the entire claim?

<sup>7</sup> Available for download at:  
<http://www.cra-arc.gc.ca/txcrdt/sred-rsde/pblctns/ntr-sr0912b-eng.html>

<sup>8</sup> CRA's Corporation Internet Filing service



#### Examples of **problem areas (ctnd.):**

- Paper copies of attachments: examples include;
  - o the signed directors resolutions which
  - o accompany forms T1145, T1146 & T1174.
  - o What if the returns are e-filed on time but the resolutions are not acknowledged as “received” on time?
- Lack of awareness (claimant): examples
  - o If “proxy” method for overhead allocation must calculate the “proxy cap” based on total, non-prescribed expenses.
  - o The limit for wages of a specified employee's is 5 x YMPE<sup>9</sup>. must be allocated among the associated group. Form T1174 provides this information and **thus must be filed** with Form T661.
  - o What if these were missed?

In the author's experience **the CRA tends to frown** on claims which are not filed with the original tax returns (i.e. as **amendments**) particularly as they approach the **18 month** corporate filing deadline.

As a result it would not be surprising to see a large number of the claims filed beyond the 15 month “safe filing deadline” to be rejected for “completeness” issues.

#### **Additional clarifications via Q&A [summarized]:**

##### Question 2 – file claim without tax return

What happens when an SR&ED claim is filed without an income tax return?

Response: Claimant will meet the filing requirements for SR&ED expenditures & ITC, but processing of claim delayed until income tax return filed.

##### Question 6 – “safe filing deadline”<sup>10</sup> (90 days early)

When does an SR&ED claim need to be filed in order for the CRA to review and advise the claimant of any deficiencies in the SR&ED claim?

Response: If an SR&ED claim is filed at least 90 days before the reporting deadline, the CRA should have sufficient time to advise the claimant of any deficiencies in the claim.

##### Question 7 – will all or part of claim be denied?

Will the CRA disallow the entire claim for not meeting the filing requirements?

Response: [Example] A claimant has filed expenditures for 25 projects, but supplied the project information for only 20. The other relevant prescribed information was provided.

The CRA will not disallow the entire claim.

- The CRA will **not accept any information** with respect to **the five missing projects** after the reporting deadline, and all the associated costs will not be allowed as SR&ED expenditures.
- The relevant prescribed information for the **other 20** projects was provided by the reporting deadline and the **CRA will accept this portion** of the claim.

#### **Implications and author's commentary**

Based on the responses above it seems that;

- issues which can be **isolated to the “project” level** (i.e. Part 2 of form T661) may only jeopardize the eligibility of those projects whereas,
- issues at the **claim level** (e.g. list of contact persons, fax numbers, number of projects claimed, etc.) could jeopardize the entire claim.
- It would be in every claimant's interest to **file the SR&ED claims within the “safe filing deadline”** to earn a “second chance” to provide missing information.

<sup>9</sup> the year's maximum pensionable earnings

<sup>10</sup> Term developed by MEUK Corporation defined as 90 days of the SR&ED filing deadline

## **Third-Party Payments Policy - DRAFT<sup>11</sup>**

Some of the most significant clarifications are:

### **Eligible types of entities (to perform work)**

- A entity – Corporations resident in Canada;
- B-F entity – Approved associations, universities & non-profit research corporations.

### **Payments must be for SR&ED**

- To be considered as a third-party payment, a payment made by the claimant must be for the purposes of SR&ED.
- The **claimant's obligation is to show** that the payments are **made for SR&ED**.
- Third-party payments must be made only for SR&ED work. When a payment is made for a **combination of SR&ED work and non-SR&ED work**, the payment **would not qualify** as a third-party payment.
- An exception to this rule in “research chairs,” where a portion of a payment for SR&ED is allowed.

### **Types of third-party payments that qualify**

Payments could be direct financial contributions, funding of students or employees doing the SR&ED, or payments in kind.

#### **Payments in kind**

If property or a service is supplied for the prosecution of SR&ED, a claimant may be able to claim the **fair market value** as a payment. There are two issues to consider for payments of this nature:

#### 1) Valuation of the property or service provided

The **claimant is responsible** to provide evidence indicating the fair market value of the property or service.

#### 2) Conditions under which property or service provided

The property or service [should] be provided to the university or college, without any conditions involving direct or indirect payments back to the claimant.

Where payments in kind involve property or services that are provided conditionally, the amount that may be claimed will be determined on a case-by-case basis.

#### 3) Cost of a building

In general, a claimant cannot claim the cost of a building for SR&ED unless it is a, “prescribed special-purpose building.”<sup>12</sup>

However, there are **exceptions where** third-party payments;

- to certain recipient entities
- may be used to **acquire a building, a leasehold interest in a building or,**
- to pay an amount in respect of the **rental expense**
- as long as the building is to be committed **solely for SR&ED in Canada.**

### **Author's commentary: Provincial vs. CRA definitions**

In the author's opinion there is a significant problem with the determination of eligible type B through F entities.

For example, the **Ontario OBRI approved list vs. CRA approved entities are inconsistent.**

- eg. Mount Sinai Hospital and 20+ other institutions are listed as eligible Ontario Business Research Centres
- but NOT listed as federal (CRA) approved entities

In the author's experience the administrators of these institutions are themselves confused on how these situations came about and how best to resolve them.

In the author's view one of the main benefits of harmonization would be the elimination of such “double standards” and “ambiguities.” As a result this should be standardized.

<sup>11</sup> sr0912b-eng THIRD PARTY PAYMENTS DRAFT DEC. 1, 2010

<sup>12</sup> ITA Regulation 2900(3)

Characteristic	Third-party payment	Contract expenditures for SR&ED performed on the claimant's behalf
Control of SR&ED	Performer	Payer
Rights	Non-exclusive (generally published) but preferential right to exploit results is required	Exclusive
Number of funders	Usually more than one payer	Usually limited to one payer
Type of SR&ED	Often basic or applied research	Commercially focused
Tax treatment	Generally cash basis	Accrual

### Third-party vs. Contract expenditures for SR&ED

The paper proposes the following distinctions:

#### 1) Control

- Payments are generally made to **contractors for tasks** or pieces of work. In such cases, the **claimant** rather than the contractor **would control** the work.
- For **third-party payments**, the **claimant generally does not control** the work performed.

#### 2) Rights (vs. results)

- **In a contract situation**, SR&ED services are performed for a **payer** who **receives the rights** to the SR&ED. The entitlement to the SR&ED tax incentive occurs at the time the SR&ED is performed.
- In comparison, a third-party payment situation gives the **payer entitlement only to the results** of the SR&ED.

#### 3) Tax treatment

- with the exception of payments to an A entity
- third-party payments become eligible for the SR&ED at the time the payment is made (cash basis), rather than at the time the SR&ED is performed (accrual basis)

### Implications and author's commentary

In the author's opinion there are still **several situations** where the determination of **"subcontractor" vs. "third party"** payment is **unclear**.

An example might be;

- a software developer being
- paid by a machinery developer
- to provide code to control a machine more accurately.

In this case,

- Arguably the software developer controls the work &
- The machinery developer may only receive results (eg. Perhaps ideas why it did not work).

1. Would such a scenario be a "third party payment?"
2. How much weight does the criteria related to "multiple funding" parties weigh against the other criteria?
3. What if you file as a third party payment and the CRA challenges this position beyond the 18 month corporate filing deadline?

## **SR&ED claim average CRA Processing Times**

April 1, 2010 to December 31, 2010

<b>Type of Claim</b>	<b>CRA Success Rate</b>	<b>Average Days within CRA's control</b>	<b>Average Days outside CRA's control</b>	<b>Total Average Time (days)*</b>
Refundable claims 120 Days	96%	39	29	68
Refundable claimant-adjusted claims 240 Days	97%	100	43	143
Non-Refundable claims 365 Days	97%	96	91	187
Non-Refundable claimant-adjusted claims 365 Days	96%	145	126	271
All claims	97%	69	48	118

In January 2011, the CRA released the results, to the end of 2010, of its ability to deliver the SR&ED credit against its service level standards. The CRA's service level standards for the SR&ED program are as follows<sup>13</sup> from receipt of a complete claim:

- (1) Refundable claims -- 120 calendar days
- (2) Non-refundable claims -- 365 calendar days
- (3) Claimant-requested adjustments to refundable claims -- 240 calendar days
- (4) Claimant-requested adjustments to non-refundable claims -- 365 calendar days

### **Implications and author's commentary**

While it appears that the CRA is fairly consistent in meeting its stated standards (95+% of the time) it is also important to understand what these numbers do NOT tell us:

- how many claimants are assessed in less than 10 days?  
We have witnessed several clients (who e-filed returns) being assessed within 48 hours!

- how many claimants correspondingly waiting the full 120 or 240 days? Does this vary in relation to the size of the claims?

### **Notable quote:**

**“The most important thing in communication is to hear what isn't being said.”**

**- Peter Drucker**

<sup>13</sup> Source CRA 2010 Annual Report to Parliament

## **Potential for penalties to be levied on “frivolous” claims**

During the CRA’s Ontario Region - 14th Annual Tax Practitioner Information Session, Jan. 12, 2011 - Royal Botanical Gardens the CRA proposed that;

- a) there has been a increasing number of claims filed without any supporting documentation available
- b) when the claimant is prompted for more information the claim is being withdrawn &
- c) the CRA feels that it’s resources are being unduly wasted.

As a result they are proposing to begin charging both claimants and claim preparers with “penalties” for misfiling.

Though the CRA did not get into details as to the level of penalties they are contemplating, we felt that it would be worthwhile to outline the typical levels of penalties contemplated within the income tax act.

### **Penalties to taxpayers & preparers:**

Section 163 of the income tax act outlines a series of penalties which can be levied by the CRA for “False statements or omissions.”

It provides **for penalties to both the person signing the tax return and to any “third party advisors”** which may have assisted in the “misrepresentation.”

These **penalties** are fairly broad and **start at**

- **25% of the credits obtained or claimed** <sup>14</sup>

Plus **additional penalties upon conviction:**

- **up to 200% of the credits claimed &/or**
- **imprisonment for a term not exceeding 2 years!**<sup>15</sup>

### **Implications and author’s commentary**

In the author’s opinion the;

- **2010 (e.g. e-filing) and**
- **2011 changes** (completeness requirements, penalties, etc.)

represent the **most significant** changes in the **history of the SR&ED program!**

It is becoming clear that there is a “tightening” of the program to the point that;

- **claimants with strong SR&ED tracking systems will benefit** while
- **those lacking** these systems will soon be **“extinct!”**

### **Notable quote:**

**“Do or do not. There is no try!”**

**- Yoda**

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<sup>14</sup> ITA 163 (various subsections)

<sup>15</sup> ITA 239(1.1) Offences and Punishment

## **T661 – Part B: More space for project descriptions (50/100 lines)**

Beginning Nov. 25, 2010 there is more space provided on the electronic versions of the income tax returns for T661 Part 2 “Project information.”<sup>16</sup>

In accordance with the new CRA requirements, changes have been made to increase the maximum number of lines ... from 35 to 50 or from 70 to 100, in the Section B fields as follows:

- 240 (standard practice/objectives) - 50 lines
- 242 (technological uncertainty) - 50 lines
- 244 (investigation & conclusions) - 100 lines

Similarly, for those claimant who opt to use the Section C “Basic or Applied Research” format

- 250 (advancement) - 50 lines
- 252 (investigation/ conclusions) - 100 lines

On the paper copy, the lines have been numbered so you can more easily ensure that your text does not exceed the maximum limit.

## **Implications and author’s commentary**

Remember that each one of these lines can contain a maximum of 78 characters.

Furthermore the **word limits (350 & 500) are still in place!**

In this author’s opinion this is a **positive step** which will;

- **allow claimants to provide data in table format (where appropriate)**
- **without unduly restricting them to less than the allotted word limits (350 / 500).**

This was often the case in prior claims where claimants explained data in a tabular format with the result that they;

- used up so much space that the actual word count was <50% of the prescribed 350/500 word limits &/or

they were forced to condense the data to a point where it became difficult to read.

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<sup>16</sup> Nov 25th, CCH Taxprep 2010 v2.0 releaseotes :  
<http://tc.cch.ca/cchservices/download/files/documents/TXP/RNTXPT2201020EN.pdf>

## D) SR&ED 2011-2

### Recent SR&ED tax cases & issue(s)

- Jentel – Illustrating “Technological Advancement” - lose
- Table 1 - Jentel – “What if?” = eligibility

The group discussed why the case failed and how it could have qualified.

In general there was agreement that the evidence was insufficient to clearly establish the existence of SR&ED.

## 2011-2: Recent SR&ED tax cases & related issue(s)

The past year has witnessed a release of a variety of smaller cases. The main issues and potential implications are outlined in the following pages. Copies of the judgments are available from the Tax Court of Canada's website.<sup>17</sup>

### Jentel – Illustrating “Technological Advancement” - lose<sup>18</sup>

#### Facts:

The appellant (Jentel) develops and manufactures engineered thermoformed plastic products.

In previous fiscal years, Jentel had developed Multi-Bins, a small-parts storage system.

The SR&ED work in question aimed to improve the existing product with respect to: size, weight, load, modularity & fastening methods.

Jentel grouped the work into four SR&ED “activities”:

- a. Bin Front and Back Panels
  - a. Tested “various” molding conditions
  - b. using 8 different plastic materials then
  - c. tested 2 plastics re. thickness vs. strength
- b. Stands
  - a. Built prototypes using combinations of wood, plastic & aluminum
  - b. Load tests showed aluminum best
- c. Sliders
  - a. tested “various” shapes and forms of sliders.
  - b. none worked satisfactorily
- d. Dividers
  - a. performed tests to mold a groove in the front panel
  - b. Including 3 molds,
  - c. each of different casting material &
  - d. “many” different groove designs
  - e. all failed to meet consistency

In respect to this work both sides agreed that,

- “contemporaneous records of this work were kept &
- the work was performed in a systematic manner.”

#### Issue(s):

Whether the work constituted SR&ED, as that term is defined in subsection 248(1) of the *Income Tax Act* (the “Act”).

The CRA argued that the,

“Appellant failed to demonstrate a systematic investigation through experiment or analysis performed to resolve any scientific or technical uncertainties.”

#### Relevant legislation

##### Income tax act

**SR&ED** is defined for income tax purposes<sup>19</sup>, as follows:

“**scientific research and experimental development** means **systematic investigation** or search that is carried out **in a field of science or technology by means of experiment or analysis** and that is

(a) **basic research...**,

(b) **applied research... or**

(c) **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 thereto,...

#### Case law:

1) **CW Agencies:** In this case the judged noted,

“Five criteria have been used by the Courts to assist in determining whether a particular activity constitutes SR&ED ... (in **C.W Agencies**) summarized as follows<sup>20</sup>:

1. Was there a **technological risk or uncertainty** which could not be removed by routine engineering or standard procedures?
2. Did the person claiming to be doing SRED formulate **hypotheses** specifically aimed at reducing or eliminating that technological uncertainty?

<sup>17</sup> Tax Court of Canada website [www.tcc-cci.gc.ca]

<sup>18</sup> JENTEL MANUFACTURING LTD.,  
V. THE QUEEN, 2011 TCC 261

<sup>19</sup> in subsection 248(1) of the Act

<sup>20</sup> Federal Court of Appeal in *C.W. Agencies Inc. v. The Queen*, 2001 FCA 393, 2002, DTC 6740, paragraph 17



3. Did the procedure adopted accord with the total discipline of the scientific method including the formulation **testing and modification of hypotheses**?

4. Did the process result in a **technological advancement**?

5. Was a detailed **record of the hypotheses tested**, and results kept as the work progressed?

2) **Northwest Hydraulic**: “In discussing whether a **technological risk or uncertainty** existed, Justice Bowman (as he then was) noted the following in the **Northwest Hydraulic** decision at paragraph 16:

a. Implicit in the term “technological risk or uncertainty” in this context is the requirement that it be a type of uncertainty that **cannot be removed by routine engineering or standard procedures** ... If the resolution of the problem is **reasonably predictable** using standard procedure or routine engineering there is no technological uncertainty as used in this context.

b. What is “routine engineering”? It is this question, (as well as that relating to technological advancement) that appears to have divided the experts more than any other. Briefly it **describes techniques, procedures and data** that are **generally accessible to competent** professionals in the field.

### Analysis:

Having reviewed the;

- evidence provided by the appellant vs.
- the clear **requirement to illustrate “hypotheses”**
- the judge cited the obvious weaknesses
- the **claimant provided RESULTS (i.e. what worked)**
- rather than **CONCLUSIONS (i.e. why this worked better than the other options)**

### Ruling & rationale:

In this case the judge concluded,

“The argument fails for the simple reason that the **Appellant did not establish a *prima facie* case that it was attempting technological advancement.**”

### Implications and author’s commentary

We hate to say we told you so but our [SR&ED newsletter 2010-2 \(Technological Advancement Edition\)](#) outlined

- exactly how this scenario would unfold
- if/when the claimant omits ANY of the **5 criteria**,
- forming the basis of **“technological advancement.”**

We propose that;

- typically several specific performance objectives
- will “stack up” to create technology objectives
- that require we put forward hypotheses as to
- the “key variables” effecting the outcome.

Perhaps this case lacked sufficient technical specificity?

### **Resources NOT cited:**

CRA’s “Plastics Guidance Document” provides 18 examples of “eligible projects” within the, Plastics Materials, Processing, Equipment & Tool Making industries.

In the author’s opinion this paper provided multiple examples of “hypotheses” which represent “valid” technological uncertainties with this or similar fields of technology.

### Re-Write- how this project MIGHT have qualified

Using these examples & concepts we have taken the facts provided in the case and outlined this project under 2 scenarios ( **next page**):

- 1) A **failing application** (i.e. as viewed by the judge) &
- 2) **Recast to eligibility** by illustrating,
  - **“technological advancement” including,**
  - **“hypotheses and conclusions.”**




### Notable quote:

**“If it can't be expressed in figures, it is not science; it is opinion.”**

**- Lazarus Long / Robert Heinlein**

**Table 1 - Jentel – “What if?” = eligibility**

**Jentel - revisited using the RDBASE.NET suggested SR&ED project description structure**

		<b><u>ELIGIBILITY: WHAT IF?:</u></b>	<b><u>Negative indicators</u></b>	<b><u>Positive indicators of eligibility</u></b>
<b>I</b>		<b><u>PROJECT OBJECTIVE BEYOND STANDARD PRACTICE: (THINKING OUTSIDE THE BOX)</u></b>		
	i)	<b><u>Benchmarking Existing technology: sources</u></b>	Relied on verbal representations of the company's owner regarding the state of existing technology.	Provided specific <b>evidence of known technology limits</b> via: articles, competitive products, expert opinions, patent searches, prior in house failures, blogs, etc.
	ii)	<b><u>Objective(s)</u></b>	Testing of known plastic characteristics vs. known production techniques	Ideally we would provide <b>quantified objectives</b> such as cost, strength, weight, tolerances, failure rates,... which <b>"stack up" to require "experimentation"</b> in areas beyond "standard practice" (such as); 1) different configurations on measured structural integrity, 2) effects of plastic melting process conditions, 3) additive reagents &/or 4) modifying extrusion/forming techniques on produced plastic physico-chemical characteristics.
<b>II</b>		<b><u>TECHNOLOGICAL UNCERTAINTIES</u></b>	No alteration of process or formulations = comparative assessment of knowns	a <b>"matrix" of variables (parameters)</b> were identified for testing under different described conditions. <b>HYPOTHESES</b> = can we improve the existing predictive model for effects re: altered <b>temperature of melt, mix time, order of reagent addition, type of reagents, rate of cooling, etc.</b> influence on measured final plastic characteristics/parameters.
<b>III</b>		<b><u>EXPERIMENTATION (SYSTEMATIC INVESTIGATION)</u></b>	Focus on <b>RESULTS</b> (What happened?) <b>INSTEAD of CONCLUSIONS</b> (Why it happened?)	Provide evidence of <b>"testing or analysis" to resolve ANY</b> of the stated <b>VARIABLES of "technological uncertainty."</b>
Jentel grouped the work into four SR&ED “activities”: we have reproduced the first 2				
		<b><u>1) Bin Front and Back Panels</u></b>	No alternate designs contemplated	<b>Analyzed or tested</b> effects of differing part geometries and structures on overall performance
		a. Tested “various” molding conditions	Tried the 3 methods used on other similar parts without understanding WHY they performed differently	<b>178 samples tested</b> to examine how the plastic melting process could be modified to optimize the combination of backpressure, altered max temperature, temperature profile in relation to mix time, mix speed, uniformity of the resin, melt & fibre distributions, order of reagent addition, etc. then <b>CONCLUDED why one better</b> (e.g. hi temp melt fibres proved optimal but only if we held max temp to 300 Deg C and increased mix time by 40% to ensure adequate fibre distribution)
		b. using 8 different plastic materials then	Used 8 different sheets without understanding WHY each performed differently	<b>Identified, analyzed or tested</b> expected causes of performance differences: e.g.. Viscosity, rheology, ...etc. A <b>CONCLUSION</b> would also help but it is NOT necessary to have on EVERY activity.
		c. tested 2 plastics re. thickness vs. strength	Testing to provide a “result” (e.g.. Plastic 1 is better) vs. a conclusion (i.e. why it's better)	<b>Analyzed or tested</b> thickness vs. strength vs. variables in the part design above for example: extrusion temperature, cooling time, humidity effects on embrittlement, flex or other characteristics (system uncertainty). <b>CONCLUDED</b> why one better (e.g. HDPE sample proved effective but required 17% more cooling time in order to maintain flex. We attribute this to a combination of the molding pressure and chemical effects of a new resin.)
		<b><u>2) Stands</u></b>		
		a. Built prototypes using combinations of wood, plastic & aluminum	Did mock-ups without a test matrix of alternatives & “extremely accurate measurements”	<b>Analyzed or tested</b> effects of differing part geometries (shape of parts, angles, thicknesses) vs. materials (specify gauges of metal, etc.) & fastening methods (clamping, adhesives, snap fit, ...)
		b. Load tests showed aluminum best	“load bearing strength” the only measured parameter	<b>Concluded</b> that a combination of 10 gauge polished aluminum had the optimum rigidity to support our newly designed plastic insert while maintaining price and load requirements.

# Globe & Mail SR&ED related articles by Barrie McKenna

11-Mar-11	<u><a href="#">Flawed R&amp;D scheme costs taxpayers billions</a></u>								
5 pages	Issue #1 - % of cost paid to consultants								
	Issue #2 - net "benefit" for every \$ of taxes								
	Issue #3 - certain industries don't advance technology & others automatically do								
	Issue #4 - that CRA risk controls aren't working								
	Issue #5 - alternatives to refundable credit								
28-Jun-11	<u><a href="#">Canada slides further in innovation rankings</a></u>								
2 pages	New Issue #1 - Canada higher in credits vs. direct grants								
	Issue #2 - should focus on clusters								
3-Jul-11	<u><a href="#">Time for action on innovation, not more study</a></u>								
3 pages	New Issue #1 - Canada declined in some performance 2008 to 2010								
	Issue #2 - provide more funds for venture capital & commercialization								
	Issue #3 - let politicians pick the clusters								

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The group discussed the impact of several recent articles regarding the SR&ED industry.

# Issue #1 - % of cost paid to consultants /

## Table 2: Compliance Cost

Compliance Cost % of SR&ED Claim		
\$ Claimed	Cost as a % of Claim	
	Mean	Median
<\$200K	29.5%	14.8%
\$200K-\$1M	4.3%	2.9%
\$1-10M	2.8%	2.1%
>\$10M	0.9%	0.7%
All times	9.1%	2.8%

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The group discussed the unlikelihood that 1/3 of the government's SR&ED funding was being allocated to consultants & claim preparers.

## Responsible “SR&ED”- preparers & journalists

Recently the CRA identified the **an increase in ineligible claims** which it attributed largely to a recent appearance of a **new type of “rogue” SR&ED consultants** who urge ineligible clients to attempt SR&ED claims.

This was detailed in our prior [SR&ED Newsletter 2011-1](#) (page 9).

To further “sensationalize” this issue **the Globe and Mail** ran an article entitled, [Flawed R&D scheme costs taxpayers billions](#)”<sup>21</sup> which, **in the author’s opinion**,

- a) Provided examples of specific (inappropriate) practices used by one of these Rogue consultants
- b) presented “opinions” which may mislead readers.

### Globe & Mail issue #1 - % of cost paid to consultants

The article stated,

“This year, **Ottawa and the provinces will dispense \$4.7-billion** to more than 20,000 Canadian companies.

**But a third or more of that cash is being wasted and paid to consultants** as a result of hazy rules on what's legitimate R&D and limited government auditing resources,

**according to dozens of interviews** with consultants, claimants and government officials.”

### Notable quote:

**“Some people change their ways when they see the light; others when they feel the heat.”**

**- Caroline Schoeder**

### Additional sources of information:

Statistics on Compliance costs<sup>22</sup>;

A 1996 survey conducted by Industry Canada<sup>23</sup> (reproduced in table 2 below) quoted “total compliance” costs ranging from 30% for small firms to <1% for large firms.

An additional report from the OECD quoted “total compliance” costs ranging from 15% for small companies to less than 7% for larger companies.

**Table 2: Compliance Cost % of SR&ED Claim**

\$ Claimed	Cost as a % of Claim	
	Mean	Median
<\$200K	29.50%	14.60%
\$200K-\$1M	4.30%	2.90%
\$1-10M	2.80%	2.10%
>\$10M	0.90%	0.70%
All firms	9.10%	2.80%

### Author’s commentary:

The majority of SR&ED funds is paid to about 4,000 of the 20,000 total claimants. These represent “large” claimants who qualify for a 20% federal credit.

In the author’s experience these large and relatively sophisticated companies are unlikely to spend more than 5% of the credits received in consulting or compliance fees.

Consulting Fees of 30+% may exist in the “Qualified CCPC” market but, as illustrated by the chart below, this represents less than 1/3 of the total government tax \$ invested each year.

As a result the **author proposes the claim that 1/3 of the \$4.7 billion “wasted on consultants” somewhat dubious.**

It would be interesting to evaluate the sources of this information including how many “large claimants” were included in their sample.

<sup>21</sup> Globe & Mail, March 11, 2011 Link to article:  
<http://www.theglobeandmail.com/report-on-business/flawed-rd-scheme-costs-taxpayers-billions/article1939418/>

<sup>22</sup> [www.ic.gc.ca/eic/site/eas-aes.nsf/vwapj/wp06e.pdf/\\$FILE/wp06e.pdf](http://www.ic.gc.ca/eic/site/eas-aes.nsf/vwapj/wp06e.pdf/$FILE/wp06e.pdf)  
*Canadian Tax Journal* 1996 Vol. 43, No. 6

<sup>23</sup> MEASURING THE COMPLIANCE COST OF TAX EXPENDITURES: THE CASE OF RESEARCH AND DEVELOPMENT INCENTIVES, Industry Canada, 2006

## Table 3: Companies claiming SR&ED credits

	Credits Earned by Rate By Value of Credits - \$ millions			By Number of Corporations			
	Earned at 35% rate	Earned at 20% rate	Total credits earned	Earning at 35% rate	Earning at 20% rate	Earning Both 35% & 20% rates	Total corporations earning credits
2002	865	2,397	3,262	11,603	4,133	325	16,061
2003	954	2,238	3,193	13,418	4,309	339	18,066
2004	1,083	2,271	3,354	15,295	4,051	339	19,685

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Computing the Value of Deduction 2002 (thousands of dollars computed by country)		
Country	Large company	Small company
Australia	6,861	6,861
Austria	6,875	6,875
Belgium	1,669	1,666
Canada	6,827	6,878
Denmark	6,891	6,891
Finland	1,61	1,61
France	6,919	6,919
Germany	1,625	1,625
Greece	1,615	1,615
Ireland	1,612	1,612
Italy	1	1
Italy	1,626	6,967
Japan	6,991	6,879
Korea	6,874	6,821
Netherlands	6,969	6,969
Netherlands	6,961	6,947
New Zealand	1,621	1,621
Norway	1,618	6,794
Portugal	6,865	6,865
Spain	6,999	6,999
Sweden	1,615	1,615
Switzerland	1,61	1,61
United Kingdom	6,964	6,894
United States	6,914	6,914

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**Table 3: Companies claiming SR&ED credits<sup>24</sup>**

	Credits Earned by Rate			By Number of Corporations			
	By Value of Credits - \$ millions						
	Earned at 35% rate	Earned at 20% rate	Total credits earned	Earning at 35% rate	Earning at 20% rate	Earning Both 35% & 20% rates	Total corporations earning credits
2002	865	2,397	3,262	11,603	4,133	325	16,061
2003	954	2,238	3,193	13,418	4,309	339	18,066
2004	1,083	2,271	3,354	15,295	4,051	339	19,685

**Table 4: Comparing R&D funding by country<sup>25</sup>**

If we want to make a rough comparison of Canada's funding vs. other industrialized countries we can use a ration named the "Beta Index" ( B-Index).

It is calculated as:

the After Tax Cost of \$1 of R&D / (1- the tax rate)

Simply stated the:

B-Index = before-tax income needed to break even on one dollar of R&D outlay.

The lower the B-Index the more favorable it is for a company to perform R&D in a particular country.

As we can see from this comparative Canada does in fact have one of the lowest B-Indices however, **many countries provide other "direct" funding** instead of "tax incentives."

The OECD report provides a further comparison of the total % of "business expenditures on research & development" (BERD) which are financed by the government.

This table (Table 5 – figure 1) indicates that the Canadian government finances approximately 4% of total business research whereas most other countries are significantly higher (e.g France, US & UK are all >10%).

As a result it appears that the Canadian government is not nearly as generous as other countries in funding SR&ED. Despite this fact the SR&ED credit appears to have created a scenario where a smaller amount of funding is in fact creating a significant amount of SR&ED.

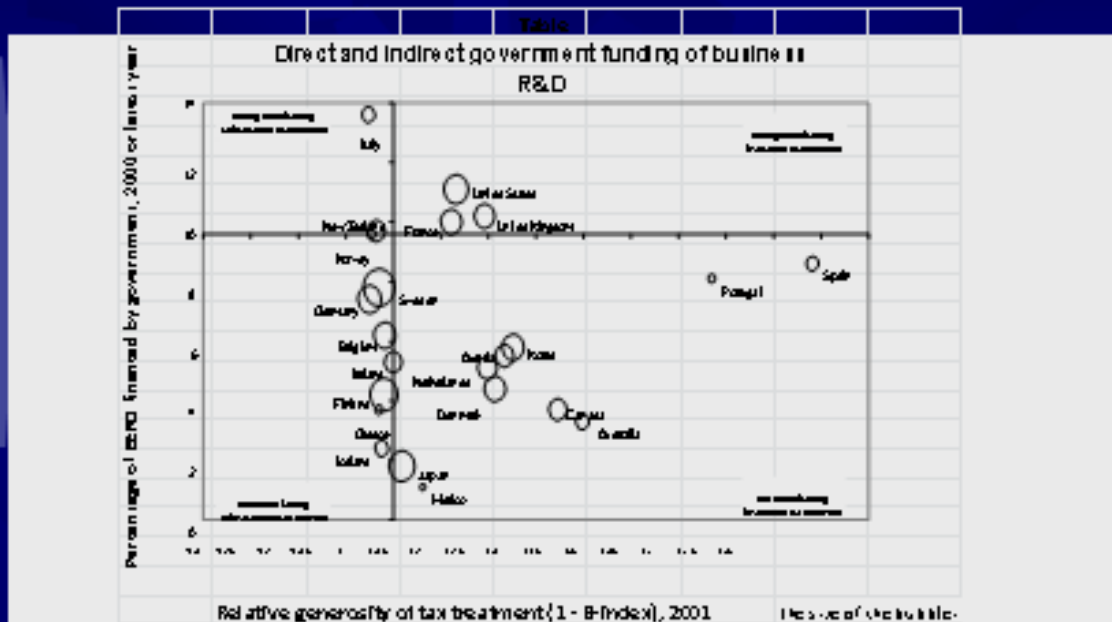
Comparing the value of B-indexes 2002		
(manufacturing companies, by country)		
Country	Large company	Small company
Australia	0.801	0.801
Austria	0.875	0.875
Belgium	1.009	1.006
<b>Canada</b>	<b>0.827</b>	<b>0.678</b>
Denmark	0.893	0.893
Finland	1.01	1.01
France	0.939	0.939
Germany	1.025	1.025
Greece	1.015	1.015
Iceland	1.012	1.012
Ireland	1	1
Italy	1.026	0.557
Japan	0.991	0.879
Korea	0.874	0.821
Mexico	0.969	0.969
Netherlands	0.901	0.647
New Zealand	1.023	1.023
Norway	1.018	0.768
Portugal	0.665	0.665
Spain	0.559	0.559
Sweden	1.015	1.015
Switzerland	1.01	1.01
United Kingdom	0.904	0.894
United States	0.934	0.934

<sup>24</sup> Tax Incentives for Scientific Research and Experimental Development, October 2007 consultation Paper, Department of Finance Canada

<sup>25</sup> TAX INCENTIVES FOR RESEARCH AND DEVELOPMENT: TRENDS AND ISSUES, OECD, 2002



## Table 5 - Gov't funding of business (OECD)



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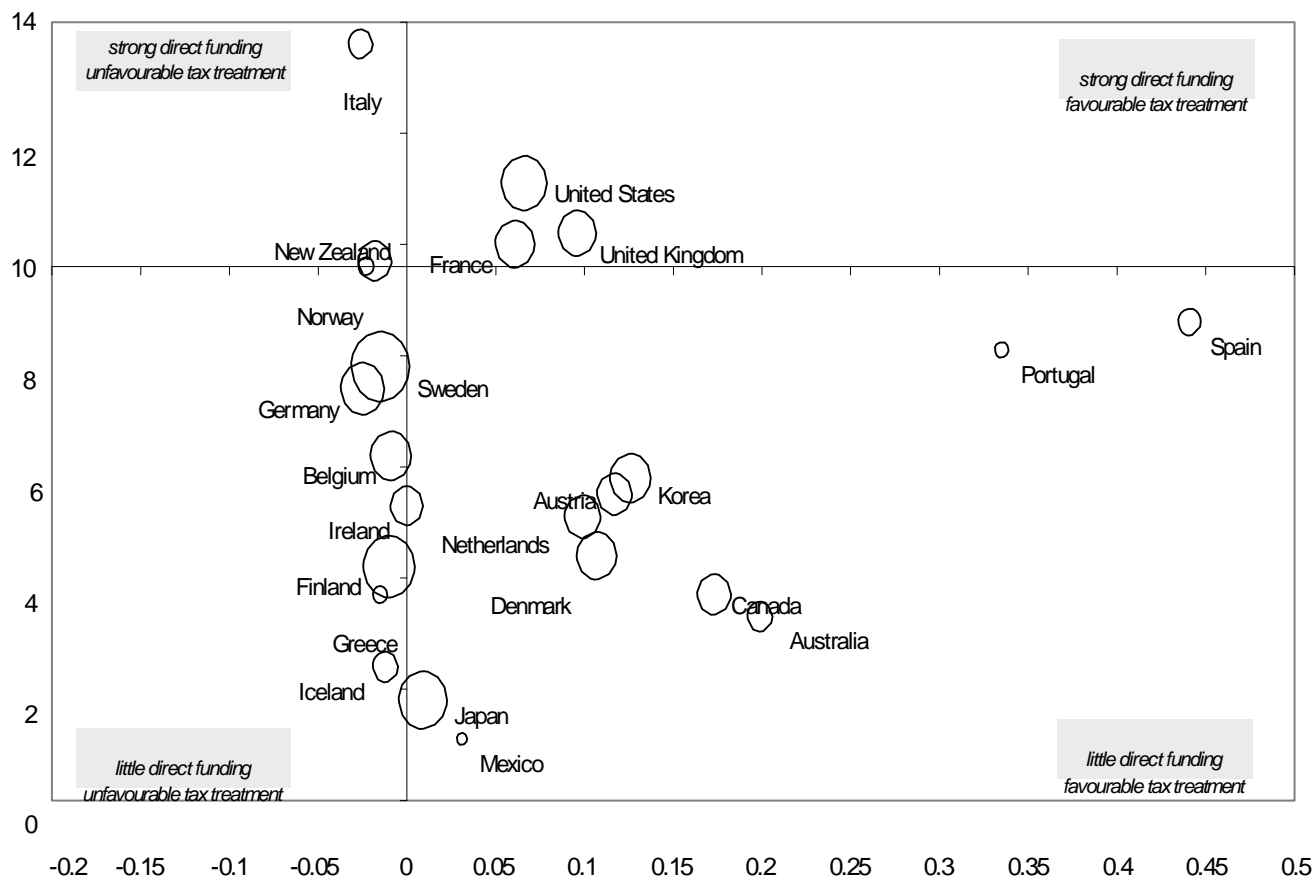
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It was noted that despite Canada's government invests less than 1/3 of the funding per capita seen by the US and other government we seem to remain competitive in overall performance.

This might be seen as an indicator that the indirect funding (via SR&ED tax credits) are more effective than direct funding (such as defence contracts or grants) for stimulating business focused SR&ED.



**Table 5 - Direct and indirect government funding of business (OECD)**



**Relative generosity of tax treatment (1 - B-index)**

**Notes:**

The size of the bubble indicates the ratio BERD/DPI

B-Index = before-tax income needed to break even on one dollar of R&D outlay;

BERD = business expenditures on research and development ;

DPI = business value-added. Source: OECD.

**Notable quote:**

**“If it can't be expressed in figures, it is not science; it is opinion.”**

**- Lazarus Long / Robert Heinlein**

## Table 6: payback /tax \$ - ignores social rate of return (est. @ 600-800%)

Study	Estimated Elasticity of R&D to Tax Credit	Period of Analysis	Country
Australian Bureau of Industry Economics (1983)	-1	1984-94	Australia
McFledge and Wards (1983)	-0.6	1962-82	Canada
Mansfield and Switzer (1985)	-0.04 to -0.18	1960-83	Canada
Bernstein (1986)	-0.13	1961-88	Canada
Bernstein (1986)	-0.14 (short run) -0.3 (long run)	1964-82	Canada
Mansfield (1989)	-0.35	1961-83	United States
Berger (1983)	-1.0 to -1.5	1961-88	United States
Billy and Lawrence (1987, 1992)	-0.75	1961-89	United States
Hall (1983)	-1.0 to -1.5	1961-91	United States
McCulchen (1993)	-0.28 to -1.07	1962-85	United States
Hines (1993)	-0.28 to -1.07	1964-89	United States
Madri and Mamuneas (1996)	-0.95 to -1.0	1966-88	United States
Bloom, Griffith and Van Reenen (1996)	-0.16 (short run) -1.1 (long run)	1979-94	UK and Australia

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### Author's commentary / group discussion:

Though the Canadian government funding seems to represent a larger proportion of "tax credits" vs. other incentives, **MOST other countries provide other forms of "incentive" specifically for R&D (tables 4 & 5).**

Even though the studies show that there is approximately

- "equal" economic payback of tax \$ invested (table 6)
- in direct tax revenues **BUT**
- **another 500% social return** on this investment by way of "spillovers!"

**Mathematically speaking the "full  
picture" indicates up to 600%  
(economic + social) return of every tax  
\$ invested.**

## Issue #2 – net “benefits” for every \$ of taxes

The Globe Article stated,

“The result, experts said, is that Canadian taxpayers are spending billions on a **program that too often delivers little or no new R&D...**

In fact, the government's own studies have found the program **generates almost no economic benefits.**”

### Additional sources of information:

#### **‘1) Canadian Department of Finance**

Finance Canada estimates for every dollar of assistance provided via the SR&ED ITC, there is a net economic gain of 11 cents.<sup>26</sup>

Thus, with about \$3.4 billion in assistance provided each year, the annual net economic gain is about \$370 million.

#### **‘2) In its report, the European Commission concluded,**

- “One can say with some caution that fiscal incentives stimulate business R&D.
- It is difficult to evaluate the amount of additional R&D per unit of forgone public revenue.
- Evaluations show a positive, but moderate, level of additionality
- Additional potential R&D spillovers would strengthen the positive impact of any tax credit”

#### **‘3) In the 2002 report by the OECD<sup>27</sup> stated,**

- “Depending on national circumstances, R&D tax incentives can be an effective instrument for inducing a certain degree of private sector research.
- Studies show that, depending on their design, tax incentives can **increase private research spending by an amount equal to the loss in tax revenue** on average.

<sup>26</sup> Parsons, Mark and Nicholas Phillips. “An Evaluation of the Federal Tax Credit for Scientific Research and Experimental Development.” Department of Finance Working Paper 2007-08. September 2007.

<sup>27</sup> OECD, *Tax Incentives for Research and Development: Trends and Issues* (2002) 25 (“OECD 2002 Report”); available at: <http://www.oecd.org/dataoecd/12/27/2498389.pdf>.

- Most studies also find that **social returns to such R&D far outweigh private returns.**

According to the 2006 OECD report, “Econometric studies find that;

- **social rates of return to R&D**
- **can be up to five times higher**
- **than private rates of return..**

The report sites these **social “spillovers”** of value since;

- ideas once produced,
- can diffuse widely and be used by
- other firms, industries & countries.

**Table 6: Comparing R&D payback per tax \$<sup>28</sup>**

OECD summary: Effectiveness of R&D Tax Credits			
Study	Estimated Elasticity of R&D to Tax Credit	Period of Analysis	Country
Australian Bureau of Industry Economics (1993)	-1	1984-94	Australia
McFetridge and Warda (1983)	-0.6	1962-82	Canada
Mansfield and Switzer (1985)	-0.04 to -0.18	1980-83	Canada
Bernstein (1986)	-0.13	1981-88	Canada
Bernstein (1996)	-0.14 (short run) -0.3 (long run)	1964-92	Canada
Mansfield (1986)	-0.35	1981-83	United States
Berger (1983)	-1.0 to -1.5	1981-88	United States
Bally and Lawrence (1987, 1992)	-0.75	1981-89	United States
Hall (1993)	-1.0 to -1.5	1981-91	United States
McCutchen (1993)	-0.28 to -1.07	1982-85	United States
Hines (1993)	-0.28 to -1.07	1984-89	United States
Nadri and Mamuneaus (1996)	-0.95 to -1.0	1966-88	United States
Bloom, Griffith and Van Reemen (1999)	-0.16 (short run) -1.1 (long run)	1979-94	G7 and Australia

#### Author’s commentary:

Though the Canadian government funding seems to represent a larger proportion of “tax credits” vs. other incentives, **MOST other countries provide other forms of “incentive” specifically for R&D (tables 4 & 5).**

Even though the studies show that there is approximately

- **“equal” economic payback** of tax \$ invested (**table 6**)
- in direct tax revenues **BUT**
- **another 500% social return** on this investment by way of **“spillovers!”**

Mathematically speaking the “full picture” **indicates up to 600% (economic + social) return of every tax \$ invested.**

<sup>28</sup> Ibid OECD 2002



## Issue #3 – certain industries don't advance technology & others automatically do

- Experiences?
- Sector specific guides?
- Focus on “clusters?”

### **Issue #3 – that certain industries don’t advance technology & others automatically do**

- a) Could food & material sciences involve “technological advancement?”

The Globe Article stated,

“Money is often paid out to decidedly low-tech and routine manufacturing, such as

- baking gluten-free cake,
- making injection-moulded auto parts or
- growing potted roses.”

#### Author’s commentary:

The Canada Revenue Agency has in fact

- [published sector-specific guides](#)
- containing examples of eligible work
- for EACH of these industries
- **because they may conduct eligible work.**

### **Notable quote:**

**“The essence of science: ask an impertinent question, and you are on the way to a pertinent answer.”**

**- Jacob Bronowski**

- b) Do other industries automatically qualify for “technological advancement?”

The Globe Article stated,

“Toronto-based iSkin Inc., which developed antimicrobial covers and wireless accessories for iPads and iPhones, recently ran into the CRA’s get-tough policy.

The company applied for \$1.8-million in tax credits, but was **rejected** after an audit on the grounds that its work amounted to **routine engineering**.

“The act is vague to begin with, and interpretive,” complained Ron Juliani, iSkin’s **director of business** affairs. “One company can get approved for something minor, while another like us, is summarily dismissed ... We should be the poster child for R&D, yet we’re punished for it.”

There seems to be a **“mandate from the top” to reduce the number of claims**, whether they’re legitimate or not, Mr. Juliani said.”

#### Author’s commentary:

A number of companies assume that they “automatically qualify” due to the industry they are in.

In the article above we have an opinion from the **“director of business development”** that the system is “unfair.”

The author would be much more convinced if, **instead** the company provided representations from **the “director of research”** providing examples of specific technological **hypotheses** or advancements.

The author proposes that this company’s SR&ED submission likely contained weaknesses similar to those illustrated in the Jentel case (earlier in this newsletter).

In the author’s experience the **CRA;**

- **reviews** are based on **objective criteria &**
- **do not** attempt to reduce legitimate claims.



## Issue #4 – that CRA risk controls aren't working

- Experiences?
- NOTE: many practitioners disagree and feel these controls are working.

## **Issue #4 – that CRA risk controls aren't working**

The Globe Article stated,

“The result is that CRA is rubber stamping large volumes of smaller claims that look legitimate because more thorough reviews are too costly and time consuming.

Meanwhile, many larger claims are being arbitrarily scaled back or rejected.”

### **Author's commentary:**

In the author's experience the CRA risk criteria are effective at isolating the companies who do NOT meet the eligibility criteria.

While some of the smaller claims may require less detail the review criteria appears to be consistent.

This was discussed with the group and consensus was generally that the issues in contention were usually justified by the claimants lack of **relevant documentation**.



## Issue #5 – alternatives to refundable credits / Table 5: Comparatives

Direct Financial Support (Grants)	Fiscal Incentives (tax credits)
More targeted	More neutral
- Social return >>> Private return	- Business knows better - Avoid picking winners - Market friendly
Better budget control	More predictable for Wider reach Administrative cost can be very low More accessible

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## **Issue #5 – alternatives to refundable credits**

The Globe Article stated,

“Mr. Hearn of Scitax suggested that a **better alternative to refundable credits for all companies would be a flow-through share scheme**, similar to those currently offered in the mining and resource sector.”

### **Author’s commentary:**

While the author does NOT claim to be an economist we propose that the following table provides a basic summary of the political and economic question to be addressed.

It summarized the pros & cons of;

- fiscal incentives (tax credits) vs.
- direct financial support (R&D grants),

reproduced as Table 5.

**Table 5: Comparative R&D funding measures<sup>29</sup>**

<b>Direct Financial Support (Grants)</b>	<b>Fiscal Incentives (tax credits)</b>
More targeted	More neutral
- Social return >>> Private return	- Business knows better
	- Avoid picking winners
	- Market friendly
Better budget control	More predictable for
	Wider reach
	Administrative cost can be very low
	More accessible

### **Notable quote:**

**“Celebrate what you want to see more of.”**

**- Tom Peters**

<sup>29</sup> B Van Pottelsberghe, S Nysten and E Megally, *Evaluation of Current Fiscal Incentives for Business R & D in Belgium* (Working Paper; Solvay Business School; Université Libre de Bruxelles; 2003); available at: <http://www.belspo.be/belspo/stat/rap/fiscRDJune03.pdf>

## D) SR&ED 2011-2

Recent CRA pronouncements

- SR&ED Lease Expenditures Policy – draft

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## Recent CRA pronouncements

During 2011 the CRA release a series of 4 DRAFT policy papers.

- Salary & wages
- Capital equipment
- Leases &
- Shared use equipment

In the author's opinion these papers do not contain any significant changes. They do however, illustrate or clarify a few concepts which are worth highlighting.

### SR&ED Lease Expenditures Policy – draft<sup>30</sup>

#### 3.5 Meaning of “building”

**Building** is a broad term covering any structure with walls and a roof affording protection and shelter that is affixed to the land. For example, a mobile home would be considered a building if the wheels, the trailer hitch, brakes and emergency lights are removed and the unit is **affixed to cement pads on the ground and services**, such as hydro and water, are installed.

**Portable shelters** such as housing, office and other service units are regarded as buildings if they are **installed and intended to remain** in a particular location.

Property that is **attached to a building**, however firmly, is included in capital cost allowance (CCA) Class 8 if it is acquired exclusively for those purposes stated in CCA Class 8.

For example,

Concrete footings, foundations and structural steel exclusively for the support of machinery are regarded as CCA Class 8 property.

Stairs and platforms, the sole purpose of which is to provide access to machinery, also fall within CCA Class 8, whether they are attached to the building or the machinery.

#### **Bandwidth allowed as lease of equipment under proxy method<sup>31</sup>**

It may be difficult to determine whether the lease of **bandwidth is an overhead** expenditure covered by the proxy amount **or the lease of equipment**.

The Tax Court of Canada dealt with a similar issue in the case of *Data Kinetics*. In this case the claimant used the proxy method to calculate its SR&ED expenditures and included the cost to lease a dedicated telephone line and a mainframe located outside of Canada.

The Judge concluded that the amount represented the lease of equipment.

Applying the principles asserted in *Data Kinetics*, the cost associated with bandwidth would be allowed as a lease of equipment under the proxy method because it was dedicated for SR&ED.

#### Author's commentary:

Based on a quick read of this information it appears there may be **opportunities** to claim;

- **Structural costs related to SR&ED machinery &**
- **“leases” for bandwidth**

which may not have been claimed previously.

#### Notable quote:

**“I have made this letter longer than usual, only because I have not had the time to make it shorter.”**

**- Blaise Pascal**

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<sup>30</sup> SR&ED Lease Expenditures Policy – draft released Mar 19, 2011

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<sup>31</sup> Paragraph 4.3.1

## D) SR&ED 2011-3

Recent SR&ED tax cases & related issue(s)

- Soneil – evidence of hypotheses and experiments – lose
- Global Enviro Inc. – criminal charges for false claim - lose

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## 2011-3: Recent SR&ED tax cases & related issue(s)

The main issues and potential implications are outlined in the following pages. Copies of the tax court judgments are available from the Tax Court of Canada's website.<sup>32</sup>

### Soneil – evidence of hypotheses and experiments – lose<sup>33</sup>

#### Facts:

This case represented an appeal to a prior (2007 judgment).

The claimant and primary developer Mr. Jain holds Master of Science in controlled system engineering

Mr. Jain stated, in cross-examination, that he did not produce any new components when conducting his work on the four projects.

He also acknowledged that each of the projects involved areas where;

- products performing similar functions &
- a wide body of knowledge already existed

He stated that, while the Appellants used existing parts and components, the research was with respect to the application of the parts and components.

Types of evidence provided:

- The only evidence provided with respect to the Power Optimization Project was a single page plan contains 11 items in point form.  
  
Inhibitor Project
- Four pages handwritten notes- two are simple diagrams.
- The pages do not contain any details with respect to the nature or results of the tests.
- Mr. Jain was uncertain/ unclear who prepared the notes or when they were prepared (via the company or a subcontractor)

#### Issue(s):

Whether the work constituted SR&ED, as that term is defined in subsection 248(1) of the *Income Tax Act* (the "Act").

The CRA argued that the,

"Appellant failed to demonstrate a systematic investigation through experiment or analysis performed to resolve any scientific or technical uncertainties."

#### Relevant legislation

##### Income tax act

**SR&ED** is defined for income tax purposes<sup>34</sup>, as follows:

**"scientific research and experimental development** means **systematic investigation** or search that is carried out **in a field of science or technology by means of experiment or analysis** and that is

(a) basic research..,

(b) applied research,.. or

(c) **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 thereto,..."

#### Case law:

In addition to the quotations from the cases of CW Agencies & Northwest Hydraulics (see prior newsletter 2011-2) the judge also cited several other precedents;

"As noted by my colleague Justice Little in *Zeuter Developments*, at paragraph 28:

... While not absolutely necessary, it is beyond doubt that a taxpayer who creates a well-supported claim will facilitate the process in determining whether something qualifies as SR&ED.

As stated in *RIS-Christie*, the only reliable method of demonstrating that scientific research was undertaken in

<sup>32</sup> Tax Court of Canada website [www.tcc-cci.gc.ca]

<sup>33</sup> SONEIL INTERNATIONAL LIMITED, V. THE QUEEN, 2011 TCC 261

<sup>34</sup> in subsection 248(1) of the Act

a systematic fashion is to produce documentary evidence.”

### Analysis:

Based upon the testimony of Mr. Jain, it appears that the Appellants **did not maintain a detailed record of the testing of any hypothesis formed** for the projects or of the results of the testing, as the work progressed

### Ruling & rationale:

In this case the judge commented,

Mr. Jain did not provide evidence of the Appellants encountering change or of what any change meant with respect to a specific hypothesis, nor did he indicate whether a change in the hypothesis was required.

As a result he concluded

the Appellants did not provide the Court with sufficient evidence to support a finding that their work was characterized by;

- trained and systematic observation,
- measurement and experiment and
- the testing and modification of hypotheses.

### Implications and author's commentary

In the author's view the results of this case are clear and the lesson obvious, you must record;

- the results or the “experiments” then
- illustrate related “analysis of hypotheses
- also referred to as technological uncertainties.”

### Notable quote:

**“You can't just ask customers what they want and then try to give that to them. By the time you get it built, they'll want something new.”**

- Steve Jobs

## **Global Enviro Inc. – criminal charges for false claim - lose<sup>35</sup>**

### Facts:

This was an appeal from a prior 2009 conviction.

It took place in Alberta Criminal court rather than the tax court of Canada.

In this case the company filed a claim for the May 31, 2002 taxation year. Some of the costs in the claim were related to prior taxation years.

The CRA then notified the client that (due to the filing deadlines) only costs related to the 2002 and subsequent years would be claimable.

The company then, “provided documentation to the CRA after this meeting that was intentionally misleading and designed to continue to pursue the claim.”

The company and its President were each fined \$250,000 representing approximately 77% of the total tax benefit “falsely claimed.”

### Issue(s):

The original 2009 case dealt with the criminal issue. The appeal dealt with an attempt to lower or reduce the fines.

### Relevant legislation and analysis:

Section 239(1.1)(g)(ii) of the *Income Tax Act* provides for a fine on summary conviction of, “not less than 50% and not more than 200% of the amount ... entitled”.

### Ruling & rationale:

The \$250,000 fine imposed on each Appellant is approximately 77% of this amount. This is on the low end of the range set out in the *Income Tax Act* and, in my view, there is no reason to reduce it”

### Implications and author's commentary

In the author's discussions to date, these fines and related enforcement measures are actually being perceived as seen as a positive step by most “honest” claimants and claim preparers.

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<sup>35</sup> R. v. Global Enviro Inc., and Ian George McIntyre, 2011 ABQB 32

## D) SR&ED 2011-3

2 new “SR&ED” articles in the Globe & Mail

- Canada slips further in innovation rankings (June 28, 2011)
- Time for action on Innovation, not more study (July 3, 2011)

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## **Globe & Mail: June issues**

- 1) Should Canada shift from credits to grants?
- 2) Should we focus on clusters vs. all technologies?



## **Globe & Mail: July issues**

- 1) Causes of performance decreases from 2008 to 2010 (recession)?
- 2) Providing more funds for VC and commercialization – good idea?
- 3) Let politicians pick the clusters – good idea? Any risks?



## **2 new “SR&ED” articles in the Globe & Mail**

Recently the **Globe and Mail** has run a series of articles regarding SR&ED tax credit industry and related policies.

**“The most successful people are those who are  
good at Plan B.”  
- James Yorke**

### **Globe & Mail SR&ED related articles by Barrie McKenna**

- |           |   |
|-----------|---|
| 11-Mar-11 | <b><u>Flawed R&amp;D scheme costs taxpayers billions</u></b>  |
| 5 pages   | Issue #1 - % of cost paid to consultants<br>Issue #2 – net “benefits” for every \$ of taxes<br>Issue #3 – certain industries don’t advance technology &<br>others automatically do<br>Issue #4 – that CRA risk controls aren’t working<br>Issue #5 – alternatives to refundable credits |
| 28-Jun-11 | <b><u>Canada slips further in innovation rankings</u></b>   |
| 2 pages   | New issue #1 - Canada higher in credits vs. direct grants<br>Issue #2 – should focus on clusters  |
| 3-Jul-11  | <b><u>Time for action on Innovation, not more study</u></b>   |
| 3 pages   | New issue #1 - Canada declined some performance 2008 to 2010<br>Issue #2 – more funds for venture capital & commercialization<br>Issue #3 – let politicians pick the clusters   |

The first of these article, “Flawed R&D scheme costs taxpayers billions,” was detailed in our prior [SR&ED Newsletter 2011-2](#).

The following 2 articles make additional proposals on how policies should be set.

### **Canada slips further in innovation rankings (June 28, 2011)**<sup>36</sup>

- 1) Should Canada shift from credits to grants?
  - Discussed in prior newsletter
- 2) Should we focus on clusters vs. all technologies?
  - If so who should pick?

### **Notable quote:**

<sup>36</sup> View at: [http://license.icopyright.net/3.8425?icx\\_id=/icopyright/?artid=2077788](http://license.icopyright.net/3.8425?icx_id=/icopyright/?artid=2077788)

### **Time for action on Innovation, not more study (July 3, 2011)**<sup>37</sup>

- 1) Causes of performance decreases from 2008 to 2010?
  - Certain indicators have decreased slightly vs. other OECD countries but much can be attributed to recession.
- 2) Providing more funds for VC and commercialization – good idea?
  - In the author’s opinion this is a good idea to augment the commercialization SR&ED related projects.
- 3) Let politicians pick the clusters – good idea? Any risks?

In the author’s opinion the “free market” is better suited to determine this via SR&ED to ALL technology industries.

<sup>37</sup> View at: [http://license.icopyright.net/3.8425?icx\\_id=/icopyright/?artid=2084968](http://license.icopyright.net/3.8425?icx_id=/icopyright/?artid=2084968)

## D) SR&ED 2011-3

### Recent CRA pronouncements

- DRAFT Policy on the Eligibility of Work for SR&ED (June 20, 2011)

### Reviews and reports to watch for

- Review of Federal Support to R&D [Jenkins panel] – Oct 2011
- Taxpayers' Ombudsman – fall 2011

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## CRA's SR&ED Tax Ombudsman queries

- **5 main questions for claimant & preparer feedback: Re. Post Feb. 21/07 SR&ED claims:**
  - Did CRA adequately inform taxpayers about the recent changes to the T661 form?
  - Has the cost of filing and defending an SR&ED claim changed?
  - Did CRA accept your request for a "second opinion"?
  - Did CRA review and audit your claim in a professional and courteous manner?
  - Has any CRA person ever attempted to dissuade you from retaining professional advice?

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## **Recent CRA pronouncements**

One June 20, 2011 the CRA released a series of 6 papers for public feedback. Three of these deal with overhead allocation issues, 2 with contract payments and the final with the “eligibility of work for SR&ED.”

After a review of the 6 draft documents I believe that 5 of them re-iterate current CRA practices and thus warrant little comment.

### **DRAFT Policy on the Eligibility of Work for SR&ED (June 20, 2011) + SEE APPENDIX B**

Our firm does however see a variety of problems and issues within the, "DRAFT Policy on the Eligibility of Work for SR&ED (June 20, 2011)."

Basically the core issue stems for the use of the term "technological advancement" in the project description, box 240.

We propose they should INSTEAD be asking for: a) benchmarks of standard practice & b) quantified objectives going beyond these limits.

The "technological advancements" are then illustrated by;  
\* the "conclusions" on "variables of technological uncertainty"

\* at the final stage of the "scientific method / process."

A copy of this submission is available for download at:

[http://www.meuk.net/Resources\\_Hot\\_Issues.aspx](http://www.meuk.net/Resources_Hot_Issues.aspx)  
(reproduced in Appendix B of these minutes)

#### **Author's commentary:**

What is a “hypothesis?”

What does this mean for SR&ED?

We discuss these issues in depth in the above noted submission.

To summarize: the best evidence may be a “test matrix” of the variables under examination & experimentation.

## **Reviews and reports to watch for**

## **Review of Federal Support to R&D [Jenkins panel] – Oct 2011**

The report of the independent Expert Panel led by Tom Jenkins that is reviewing federal support to R&D. It is expected to be released in October, 2011.

There are over 200 submissions which are available for review at:

[http://rd-review.ca/eic/site/033.nsf/eng/h\\_00006.html](http://rd-review.ca/eic/site/033.nsf/eng/h_00006.html)

Some of the more consistent &/or notable recommendations are:

Improve the level of consistency from auditor to auditor.

- Provide full or partial refundability to all claimants
- Simplify & streamline the program
- Consistency / permanence - Avoid too many small programs
- Provide consistency on reviews
- Provide for commercialization of successful products – similar to IRAP

In the author's opinion the best summary” recommendation comes from the Canadian Council of Chief Executives:<sup>38</sup>

According to the OECD, it is important

“to avoid inefficiencies arising from operating too many schemes at too small a scale. In our view, Canada's system of direct support programs for business R&D suffers from precisely that problem:

Too many small programs targeted at individual sectors, regions and constituencies, with insufficient coordination and, in some cases, poorly defined program objectives.

We therefore recommend that the federal government adopt a clear policy framework in support of business innovation.”

The author proposes the panels current, “innovation frameworks,”<sup>39</sup> appear to address these issues.

## **Taxpayers' Ombudsman – fall 2011**

The report of the Taxpayers' Ombudsman on the systemic review of the SR&ED Program is also expected to be released this summer or fall.

<sup>38</sup> download at: <http://rd-review.ca/eic/site/033.nsf/eng/00096.html>

<sup>39</sup> Innovation frameworks: <http://rd-review.ca/eic/site/033.nsf/eng/00027.html>

## **Closing comments by CRA** **Moderator (Dominic Iaonnoni)**

We have provided the following summary of the major issues discussed by Mr. Iaonnoni at the end of the meeting.

Due to the fact that CRA staff are not allowed to be recorded this material is not included in the webcast.

### **1) Fraud: preventing misinterpretations**

In response to the discussion on fraud and related penalties many practitioner asked for recommendations on how to prevent any misunderstandings.

Mr. Dominic Iaonnoni proposed that the practitioner should;

- ask the right questions
- provide the correct guidance +
- document the clients responses in writing

Example: If the practitioner sees a project where the client initially claims 100 hours and recommends:

i. “hey this sounds good can we say we spend 300 hours on this by allocating hours for staff who were not directly involved in the SR&ED activities claimed,” this would be seen as practitioner **fraud** in the CRA eyes.

ii.. “can you please explain if there were any supporting activities” and then subsequently helped the client identify the actual 300 hours of SR&ED support work, this would **NOT be fraud**.

**Author’s note:** Of course the extent of supporting activities may always be a question of judgment but the CRA seems to be focusing on situations in which it discovers evidence that misrepresentation was clearly intended (i.e. situation i).

### **2) Downscreening vs. site reviews**

a. The CRA intends to continue downscreening 85%+ of claims.

b. The specific criteria used to identify claims for review are confidential however,

“-maintaining adequate documentation & having it available during the review”

- will smooth the review process.

## CRA directives on “entitlement to exploit”

Practitioners were concerned that;

- These clarifications appear to be missing from the current CRA policy documents &
- Many CRA reviewers seem confused on this concept.

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## Appendix A: CRA directives on “entitlement to exploit”



Canada Customs  
and Revenue Agency

Agence des douanes  
et du revenu du Canada

NO.: **IT-151R5**      DATE:      October 17,  
2000

SUBJECT INCOME TAX ACT  
: **Scientific Research and Experimental  
Development Expenditures**

### Group discussion:

Practitioners were concerned that;

- These clarification appear to be missing from the current CRA policy documents &
- Many CRA reviewers seem confused on this concept.

Ideally the practitioners are hoping to see this concept clarified / restated in any new SR&ED manuals.

### *Entitlement to Exploit the Results*

¶ 37. The determination of whether a taxpayer is "entitled to exploit the results" of SR&ED is a question of fact that can only be determined on a case-by-case basis.

For example, this requirement is **considered to be met in cases where the taxpayer has the right to use a patent that results from the SR&ED project even if the taxpayer is charged a royalty or similar fee** for the use of the patent. **This requirement is also considered to be met in cases where the taxpayer is entitled to distribute and market any product that results from the SR&ED project.**

In addition, when a taxpayer makes a payment for SR&ED to a corporation described in subparagraph 37(1)(a)(i.1) or to an approved university or other entity described in subparagraph 37(1)(a)(ii) and it is likely that the SR&ED **project will not result in a product or patent**, the taxpayer will be considered to have **met this requirement** if it can be established that the taxpayer has, as a consequence of the payment, been granted **a preferential right to use the results** of the SR&ED in its business.





## **Appendix B: CRA Policy on the Eligibility of Work for SR&ED ITC's** **(Draft)**

### **EXCERPTS WITH COMMENTARY BY MEUK CORPORATION**

#### **2.0 What does SR&ED mean?**

Five types of work are identified in the definition of SR&ED:

1. basic research work [paragraph (a)];
2. applied research work [paragraph (b)];
3. experimental development work [paragraph (c)];
4. support work [paragraph (d)]; and
5. excluded work [paragraphs (e) to (k)].

Basic research, applied research, and experimental development are conducted through a systematic investigation or search carried out in a field of science or technology by means of experiment or analysis for specific purposes. The purpose of basic and applied research is for the advancement of scientific knowledge, whereas the purpose of experimental development is achieving technological advancement. **IN THE AUTHOR'S OPINION, THIS ENTIRE SECTION IS CONFUSING. FROM A PRACTICAL STANDPOINT ILLUSTRATION OF ALL THE 3 CRITERIA ARE REQUIRED WHETHER "EXPERIMENTAL DEVELOPMENT" OR BASIC RESEARCH OR APPLIED RESEARCH.**

**HAVING DIFFERENT DESCRIPTION STRUCTURES FOR "RESEARCH" VS. "EXPERIMENTAL DEVELOPMENT" PROJECTS;**

- **SHOWS DISCONTINUITY BETWEEN**
- **THE SR&ED REQUIREMENTS ENVISIONED BY THE CRA VS.**
- **WHAT IS ACTUALLY REQUIRED BY THE LEGISLATION AND THE TAX COURTS**

It must **first** be established that there is a **systematic investigation** or search carried out in a field of science or technology by means of experiment or analysis;

and **[second?]** that the **purpose** of the work is to advance scientific knowledge (basic research or applied research) or to **achieve technological advancement** (experimental development).

**IN THE AUTHOR'S OPINION, THIS CLARIFICATION IS USEFUL AND IS PERHAPS ALL THAT IS NEEDED IN THIS ENTIRE SECTION.**

**IT COULD BE FURTHER ARGUED THAT THE ILLUSTRATION OF "TECHNOLOGICAL ADVANCEMENT" INCLUDES ADRESSING 5 VS. 3 SPECIFIC STEPS AS FOLLOWS:**

**Goal 1a): Ensure proper definition of existing knowledge at the outset**

**Goal 1 b): Quantification of objectives vs. standard practice**

**Goal 2: Correlation of the research steps to specific, technical uncertainties (IDEALLY SPECIFIC "VARIABLES"):**

**Goal 3a): Ensuring work was done “systematically” & costs correctly identified**

**Goal 3b): Clarifying the “technological conclusions / advancements”**

- **ADDITIONAL RELATED LEGISLATIVE REFERENCES +ANALYSIS**
  - o **ARE PROVIDED IN SR&ED NEWSLETTER 2010-2**
  - o **AVAILABLE FOR DOWNLOAD AT**  
[http://www.meuk.net/Newsletters\\_and\\_Publications.aspx](http://www.meuk.net/Newsletters_and_Publications.aspx)

In other words, it must first be determined that there is basic research, applied research, or experimental development. If so, there is SR&ED. This is discussed in [section 2.1](#). **IN THE AUTHOR'S OPINION, THIS CLARIFICATION IS NOT RELEVANT SINCE;**

**- THERE IS REALLY NO DISTINCTION IN**

**- THE REQUIREMENT TO APPLY THE “SCIENTIFIC METHOD”**

**- TO ANY OF THESE FIELDS.**

The next step is to determine the scope of work within the definition. This is discussed in [section 2.2](#).

### **2.1 Step 1: Determining if basic research, applied research, or experimental development work was carried out**

The definition of SR&ED in the *Income Tax Act* describes how SR&ED is performed as well as its purpose.

How is SR&ED performed?

By a systematic investigation or search that is carried out in a field of science or technology by means of experiment or analysis.

Why is SR&ED performed?

For the advancement of scientific knowledge, or for the purpose of achieving technological advancement aimed at creating new, or improving existing, materials, devices, products, or processes.

An approach, to establish if the work done meets the manner and purpose described above, is the application and demonstration of the following three criteria:

- scientific and technical content,
- scientific or **technological advancement\***, and
- scientific or technological uncertainty.

### **IN THE AUTHOR'S VIEW;**

**IT IS AMBIGUOUS AND CONFUSING TO ASK THE CLAIMANT TO;**

- **ILLUSTRATE “\*TECHNOLOGICAL ADVANCEMENT” BY**
- **SHOWING “TECHNOLOGICAL ADVANCEMENT.”**

**THIS IS USING THE TERM “TECHNOLOGICAL ADVANCEMENT” TO DEFINE ITSELF.**

### **RECOMMENDATION: THE TERM**

- **“TECHNOLOGICAL ADVANCEMENT,” IN THIS INSTANCE, SHOULD BE CHANGED TO**



- **“OBJECTIVES BEYOND INDUSTRY STANDARD PRACTICE.”**

**THE NEXT ISSUES WOULD BE TO PROVIDE DIRECTION ON HOW THESE STANDARD PRACTICE LIMITS SHOULD BE ILLUSTRATED.**

These three criteria also help to organize, evaluate, and present work that meets the definition of SR&ED.

## **2.1.1 How basic research, applied research, and experimental development work is carried out**

### **Scientific and technical content**

To satisfy the criterion of scientific and technical content, **the scientific method** must be demonstrated. This entails the following steps:

- defining and documenting the scientific or **technological uncertainty**;
- **formulating one or more hypotheses** designed to reduce or eliminate the uncertainties;
- planning, executing, and documenting the testing of the hypotheses by experiment or analysis; and
- developing and documenting logical conclusions based on the results or findings of the experiments or analysis.

The formulation of a hypothesis designed to resolve the scientific or technological uncertainty is an essential step in the process described above. The hypothesis must be clearly articulated and tested by experiment or analysis.

### **IN THE AUTHOR'S VIEW:**

**IT SEEMS EVIDENT THAT THE CRA IS REFERING TO THE “SCIENTIFIC METHOD” WHICH HAS THE FOLLOWING, INTERNATIONALLY ACCEPTED, DEFINITION:**

#### **From Wikipedia, the free encyclopedia**

**Scientific method refers to a body of [techniques](#) for investigating [phenomena](#), acquiring new [knowledge](#), or correcting and integrating previous knowledge.<sup>[1]</sup>**

To be termed scientific, a method of inquiry must be based on gathering [empirical](#) and [measurable](#) evidence subject to specific principles of reasoning.<sup>[2]</sup>

The [Oxford English Dictionary](#) says that scientific method is: "a method of procedure that has characterized natural science since the 17th century, consisting in systematic observation, measurement, and experiment, and the formulation, testing, and modification of hypotheses."<sup>1</sup>

**A linearized, pragmatic scheme is sometimes offered as a guideline for proceeding [CORRELATED TO THE SR&ED PROJECT CRITERIA AS FOLLOWS]:**

1. Define a question [OBJECTIVE]
2. Gather information and resources (observe) [BENCHMARK STANDARD PRACTICES]

3. Form an explanatory hypothesis [IDENTIFY VARIABLES OF TECHNOLOGICAL UNCERTAINTY]
4. Perform an experiment and collect data, testing the hypothesis [SYSTEMATIC INVESTIGATION]
5. Analyze the data
6. Interpret the data and draw conclusions [TECHNOLOGICAL ADVANCEMENT] that serve as a starting point for new hypothesis
7. Publish results
8. Retest (frequently done by other scientists).

The iterative cycle inherent in this step-by-step methodology goes from point 3 to 6 back to 3 again.

#### **Documentation is inherent to the scientific method**

Documentation is naturally produced during SR&ED. In **adopting the scientific method**, the progression of work is built on analyzing results from step to step. It is expected that the indicators or measures to be used to determine if the scientific or technological objectives of the work are met will be identified and documented at an early stage of the work. The scientific method requires a detailed record of the scientific or technological uncertainty, the hypotheses for its resolution, tests, and results.

#### **2.1.2 The purpose of basic research, applied research, and experimental development**

Work for the purpose of scientific or technological advancement implies an attempt to resolve scientific or technological uncertainty. The scientific or technological advancement is the targeted outcome of the work while the scientific or technological uncertainty is the driver for the work. Therefore, attempts to achieve scientific and technological advancements and to resolve scientific and technological uncertainties occur simultaneously. **IN THE AUTHOR'S VIEW THIS IS CONFUSING. ACHIEVING TECHNOLOGICAL ADVANCEMENT REQUIRES REMOVING TECHNOLOGICAL UNCERTAINTY AS A COMPONENT.**

Companies conducting basic or applied research typically set out to advance scientific knowledge, whereas companies undertaking experimental development typically set out to resolve technological uncertainty. Regardless, companies making claims for SR&ED must be able to identify both the scientific or technological uncertainty addressed and the scientific or technological advancement sought or resulting from the work. **IN THE AUTHOR'S VIEW THIS ENTIRE SECTION AND THE DISTINCTION BETWEEN "RESEARCH" OR "DEVELOPMENT" IS IRRELEVANT FOR THE PURPOSES OF DETERMINING IF SR&ED OCCURRED.**

**IT CONFUSES READERS RATHER THAN PROVIDING ANY GUIDANCE. AS A RESULT THIS DISCUSSION IS LIKELY MORE RELEVANT TO AN "ACADEMIC" PAPER THAN A GUIDANCE DOCUMENT FOR SR&ED CLAIMANTS.**

**INSTEAD THE ONLY RELEVANT CRITERIA SHOULD BE THE EXISTENCE OF A "SEARCH FOR SCIENTIFIC OR TECHNOLOGICAL ADVANCEMENT."**

#### **Scientific or technological advancement**

**IN THE AUTHOR'S VIEW THIS SHOULD BE THE MAIN CRITERIA (SECTION 3) WITH THE FOLLOWING SUBSECTIONS:**

**3.1a): Ensure proper definition of existing knowledge at the outset**

**3.1 b): Quantification of objectives vs. standard practice**

**3.2: Correlation of the research steps to specific, technical uncertainties (IDEALLY SPECIFIC "VARIABLES"):**

**3.3a): Ensuring work was done "systematically" & costs correctly identified**

**3.3B): Clarifying the "technological conclusions / advancements"**

Scientific or technological advancement is the generation of information or the discovery of knowledge that advances the understanding of scientific relations or technologies. Therefore, to satisfy the criterion of scientific or technological advancement, the work must seek to generate information or lead to the discovery of knowledge that advances this understanding.

An advancement in the **understanding of scientific relations or technologies** means that the new knowledge must be applicable in a broader sense. That is, the new knowledge is applicable to other situations or circumstances beyond the current project.

#### **Scientific or technological uncertainty**

**IN THE AUTHOR'S VIEW THE IDENTIFICATION OF THE SPECIFIC "VARIABLES" UNDER EXPERIMENTATION WOULD BE A STRONG INDICATOR OF ELIGIBILITY. FROM A REPORTING STANDPOINT, THE ABILITY TO;**

- ILLUSTRATE THE EXISTENCE OF A "TEST MATRIX" OF**
- THE "KEY VARIABLES" DETERMINING PERFORMANCE**
- WOULD INDICATE UNDERSTANDING OF THE "RELATIONS OF TECHNOLOGIES."**

### **2.2.1 Support work**

Support work must be:

1. Commensurate with the needs of the basic research, applied research, or experimental development work. In other words, it must be corresponding or proportionate in the amount, size, extent, or duration of work that is necessary to carry out basic research, applied research, or experimental development.
2. Directly in support of the basic research, applied research, or experimental development work. That is to say, the activity was carried out specifically to perform the related basic research, applied research, or experimental development.
3. With respect to one of the eight categories of work listed below:
  - oengineering;
  - odesign;
  - ooperations research;
  - omathematical analysis;
  - ocomputer programming;
  - odata collection;

- o testing; or
- o **psychological research\***.

It is important to note that support work can be in a field of science or technology that is different from that of the basic research, applied research, or experimental development work.

### 2.2.2 Excluded work

According to the definition of scientific research and experimental development in subsection 248(1) of the *Income Tax Act*, SR&ED “does not include work with respect to:

- (e) market research or sales promotion,
- (f) quality control or routine testing of materials, devices, products or processes,
- (g) **research in the social sciences or the humanities\***,
- (h) prospecting, exploring or drilling for, or producing, minerals, petroleum or natural gas,
- (i) the commercial production of a new or improved material, device or product or the commercial use of a new or improved process,
- (j) style changes, or
- (k) routine data collection.”

**IN THE AUTHOR’S OPINION THERE IS INHERENT AMBIGUITY IN THE FACT THAT;**

- **PSYCHOLOGICAL RESEARCH IS LISTED AS A POTENTIALLY ELIGIBLE SUPPORTING ACTIVITY &**
- **YET IS ALSO SPECIFICALLY THE “EXCLUDED” AS A “SOCIAL SCIENCE.”**

**IN THE AUTHOR’S EXPERIENCE THIS HAS BEEN A SOURCE OF CONFUSION FOR**

**- MANY SOFTWARE DEVELOPERS WHO DO NOT UNDERSTAND WHY**

**- “PSYCHOLOGICAL RESEARCH TO MAKE THEIR PRODUCT MEASURABLY MORE INTUITIVE” IS**

**- NOT AN ELIGIBLE SR&ED ACTIVITY WHEREAS,**

**- PSYCHOLOGICAL RESEARCH PERFORMED BY A PHARMACEUTICAL COMPANY**

**- IN COMBINATION WITH CHEMICAL & BIOCHEMICAL & PHYSIOLOGICAL TESTS**

**- FOR A FINAL STAGE OF DRUG APPROVALS**

**- WOULD LIKELY BE AN ELIGIBLE SUPPORTING ACTIVITY.**

**AS A RESULT IT WOULD BE PRUDENT TO;**

**- PROVIDE FURTHER DIRECTION AND EXAMPLES OF**

**- WHEN, WHERE, HOW & WHY “PSYCHOLOGICAL RESEARCH”**

**- APPLIES (OR NOT) IN THIS &/OR OTHER INDUSTRY SPECIFIC, APPLICATION POLICY PAPERS.**

### 3.0 Considerations related to SR&ED in a business context


This section provides guidelines in applying the definition of SR&ED in a business context.

### 3.3 Standard practice

IN THE AUTHOR'S OPINION THE CURRENT WORDING OF THIS SECTION;

- PROVIDES TOO MUCH GUIDANCE & EXAMPLES OF
- SITUATIONS THAT WILL NOT QUALIFY FOR SR&ED BUT
- LITTLE GUIDANCE ON WHAT INFORMATION WILL HELP TO QUALIFY.

AS A RESULT IT WOULD BE PRUDENT TO ASK THE CLAIMANT TO PROVIDE DETAILS ON HOW THEY ESTABLISHED / DEFINED "STANDRD PRACTICE" WITHINT THEIR "BUSINESS ENVIRONMENT":

I		<u>PROJECT OBJECTIVE BEYOND STANDARD PRACTICE:</u>			
	i)	<u>State of Existing technology: Benchmarking methods &amp; sources for citings</u>			
			<u>Number (#) of</u>		<u>Explanation (re. technology limits)</u>
		Internet / Google Searches		internet sites	
		Articles		articles	
		Patent searches		patents	
		Competitive methods		products / processes	
		Similar prior in-house technologies		products / processes	
		Potential components		products	
		Queries to experts		responses	
		Other		____ (specify)	
	ii)	<u>Objective(s)</u>	<u>Performance measures</u>		
		<u>Existing benchmark</u>	<u>Units of measure</u>	<u>Performance objective</u>	

### Glossary

IN THE AUTHOR'S OPINION, SINCE BOTH THE CRA AND THE TAX COURTS REFER TO:

- THE "SCIENTIFIC METHOD" AS A REQUIRED COMPONENT OF SR&ED
- IT WOULD BE PRUDENT TO DEFINE IT.

ONE POSSIBILITY MAY BE AS FOLLOWS;

From Wikipedia, the free encyclopedia

"Scientific method" refers to a body of techniques for investigating phenomena, acquiring new knowledge, or correcting and integrating previous knowledge.<sup>[1]</sup>

To be termed scientific, a method of inquiry must be based on gathering empirical and measurable evidence subject to specific principles of reasoning.<sup>[2]</sup>

The Oxford English Dictionary says that scientific method is: "a method of procedure that has characterized natural science since the 17th century, consisting in systematic

**observation, measurement, and experiment, and the formulation, testing, and modification of hypotheses."**<sup>[1]</sup>

A linearized, pragmatic scheme of the four points above is sometimes offered as a guideline for proceeding:

1. Define a question [OBJECTIVE]
2. Gather information and resources (observe) [BENCHMARK STANDARD PRACTICES]
3. Form an explanatory hypothesis [IDENTIFY VARIABLES OF TECHNOLOGICAL UNCERTAINTY]
4. Perform an experiment and collect data, testing the hypothesis [SYSTEMATIC INVESTIGATION]
5. Analyze the data
6. Interpret the data and draw conclusions [TECHNOLOGICAL ADVANCEMENT] that serve as a starting point for new hypothesis
7. Publish results

Retest (frequently done by other scientists). The iterative cycle inherent in this step-by-step methodology goes from point 3 to 6 back to 3 again.

**In the author's opinion this definition can become even more complicated under current expansions of the historical definition(s) as illustrated below:**

Four essential elements<sup>[34][35][36]</sup> of a scientific method<sup>[37]</sup> are iterations,<sup>[38][39]</sup> recursions,<sup>[40]</sup> interleavings, or orderings of the following:

- Characterizations (observations,<sup>[41]</sup> definitions, and measurements of the subject of inquiry)
- Hypotheses<sup>[42][43]</sup> (theoretical, hypothetical explanations of observations and measurements of the subject)<sup>[44]</sup>
- Predictions (reasoning including logical deduction<sup>[45]</sup> from the hypothesis or theory)
- Experiments<sup>[46]</sup> (tests of all of the above)

## Psychological research

Research into the functions of the mind and the behaviour of humans or animals in relation to their environment.

Subsection 248(1), paragraph (g) of the definition of scientific research and experimental development in the *Income Tax Act* specifically excludes work with respect to research in the social sciences or the humanities. Psychology is a social science; however, paragraph (d) of the definition of SR&ED in the Act lists psychological research work as eligible work when it is undertaken directly in support of an eligible SR&ED project in a field of science other than the social sciences or humanities. Only the amount of psychological research that is commensurate with the needs and directly in support of an eligible SR&ED project can be claimed. **AS NOTED – THIS WOULD BENEFIT FROM ACTUAL ILLUSTRATIONS VIA ONE OR MORE SR&ED PROJECT EXAMPLES.**

### Scientific and technical content – (criterion) **SUGGEST THIS BE CRITERIA 3**

One of the three criteria that means that the scientific research and experimental development activity must incorporate a systematic investigation or search carried out by qualified personnel. For additional details refer to [section 2.1.1. VS 2.1.3](#)

### Scientific or technological advancement – (criterion)

One of the three criteria **[SUGGEST THIS BE REWORDED. IT IS THE ONLY CRITERIA WHICH MUST BE MET & ENCOMPASSES 3 TO 5 MAIN COMPONENTS.**

**THE DEFINITION OF AN OBJECTIVE BEYOND THE “STANDARD PRACTICE” OF THE TECHNOLOGY IS THE FIRST COMPONENT.]**

that means that the work must generate information or lead to the discovery of knowledge that advances the understanding of scientific relations or technologies. For additional details refer to [section 2.1.2.](#)

### Social sciences

In general, the specialized teaching and research conducted in disciplines characterized by their concern with human beings, their culture, and their economic, political, and social relationships with the environment.

Academicians generally categorize knowledge into four main areas: physical sciences, biological sciences (or natural sciences), humanities, and social sciences, although others recognize only two categories: natural sciences and social sciences. Generally, the social sciences include anthropology, economics, political science, [psychology](#), sociology, criminology, education, geography, law, psychiatry, philosophy, religion, and history. Management is also considered a social science.

**Psychology is a social science**; however, subsection 248(1), paragraph (d) of the definition of scientific research and experimental development in the *Income Tax Act* lists psychological research work as eligible work when it is undertaken directly in support of an eligible SR&ED project in a field of science other than the social sciences or the humanities. Only the amount of psychological research that is commensurate with the needs and directly in support of an SR&ED project can be claimed.

**AS NOTED – THIS WOULD BENEFIT FROM ACTUAL ILLUSTRATIONS VIA ONE OR MORE SR&ED PROJECT EXAMPLES.**

### Systematic investigation or search

The use of a method that usually includes scientific or technological problem definition, hypothesis formulation, experimentation and analysis of the hypothesis, and deduction and conclusion to arrive at new or improved products or processes, or expanded knowledge. **THIS SOUNDS LIKE THE DEFINITION OF THE “SCIENTIFIC METHOD” WHICH IS INTERANTIOALLY ACCEPTED.**

**PERHAPS THESE DEFINITIONS COULD THEREFORE BE CONVERGED TO PROVIDE CLAIMANTS A MORE INTUITIVE UNDERSTANDING OF THE REQUIREMENTS.**

### Technology base or level

The technology base refers to the existing level of technology and consists of the knowledge of the technological resources within the company and sources available publicly.

The technological resources within the company include:

- technical knowledge, education, training, and experience of its personnel; and
- its technical capabilities typified by its current products, techniques, practices, and methodologies (for example, trade secrets and intellectual property).

Publicly available sources generally include scientific papers, publications, journals, textbooks, and internet-based information sources as well as expertise accessible to the company (for example, through recruiting employees or hiring contractors). The company is expected to have information that is common knowledge at the time the work is performed. Common knowledge is knowledge available to professionals familiar with the specific areas of science or technology in question. **THIS COULD BE INTEGRATED INTO THE DEFINITION OF STANDARD PRACTICES.**



## **Questions or feedback**

We welcome your questions or feedback on any issues raised in this letter. Please email [dsabina@meuk.net](mailto:dsabina@meuk.net).

We also encourage interested parties to examine past SR&ED minutes& newsletters &

## **Terms of use**

Although we endeavor to ensure accurate and timely information throughout this letter, it is not intended to be a definitive analysis of the legislation, nor a substitute for professional advice.

Before implementing decisions based on this information, readers are encouraged to seek professional advice, in order to clarify how any issues discussed herein, may relate to their specific situations.

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# **MINUTES OF THE ANNUAL HAMILTON REGION**

## **SR&ED PRACTITIONERS WORKSHOP**

**Date:**

Thurs, Sept. 27, 2012

**Time:**

4:00-6:30 PM

**Location:**

McMaster U, Ron Joyce Centre,  
4350 S. Service Rd. Burlington, ON,

Recording of webcast at: <http://www.youtube.com/watch?v=6-1elljfg3Y>

select “show more” to view “specific issues” below

The group discussed the following issues in the order they developed since our last meeting:

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## **Welcome / List of attendees:**

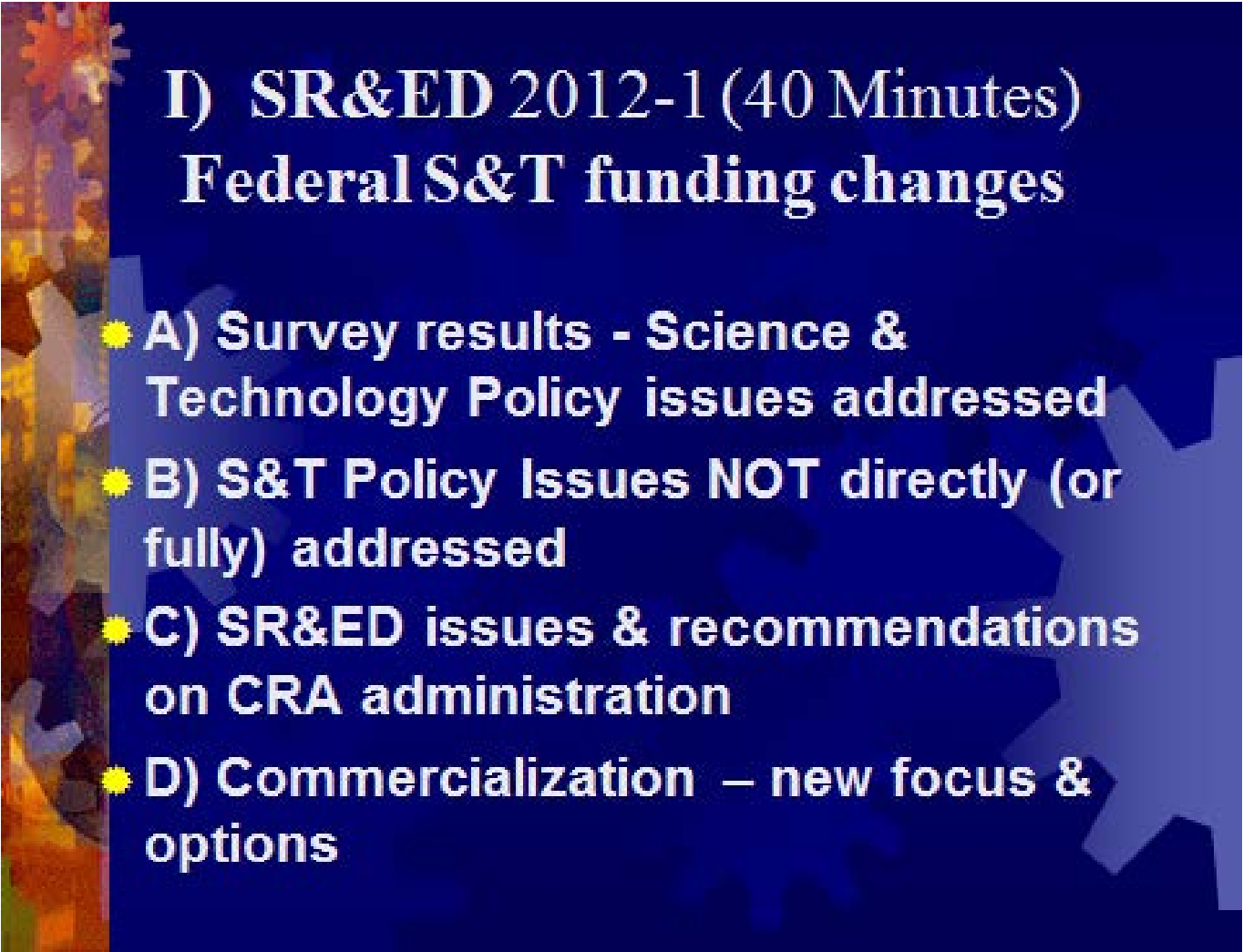
<b>Name</b>	<b>Firm</b>
<b>Moderators</b>	
David Sabina	MEUK / RDBASE Consortium
Dominic Ioannoni	CRA Research Technology
Russ Roberts	CATA
<b>Attended In person</b>	
Alex Murphy	Murphy & Co
Allan Gordon	SRED Professionals LTD.
Andrew Bauder	IRAP
Andrew Kolodziej	Benetax
Arnie Luik	RDP Associates Inc.
Barry Doerbecker	Henderson Partners LLP
Bob Turner	INAC Services Limited
Chris Fattaei	Chris Fatteai
Chris Stoute	Professor at Ryerson University
Christine Ermarkaryan	Global R&D Consulting Group Inc.
Christine Gribowski	Gribowski Associates
Cory Poechman	Pinnacle Consultants
Darren Drury	Pinnacle Consultants
Earl Viner	Viner R & D Tax Specialists
Eric Richardson	Skura
Gul Nawaz	Nawaz Taub Noor & Wasserman
Harvey Cantor	Harvey Cantor C.A.
Jay McLean	PricewaterhouseCoopers
Jay Wigna	Deloitte
Jerry Gribowski	Gribowski Associates
Julia Stubbs	Benefact
Julie Bond	Bond Consulting Group Inc.
Kierek Jaszccuk	Consultant
Laura Martin	Business Improvement Group
Leo Ditschun	Braithwaite Technology Consultants Inc.
Margaret Karpinska	Business Improvement Group Inc
Mark Vainberg	SRED Professionals LTD.
Matt	Pinnacle Consultants
Patrick Murphy	Murphy & Co
Peter Martens	Pippard Incorporated
Qasmi Mahmood	NorthBridge Consultants
Robert Galipaeu	Benefact
Robert Zawadzki	Consultant
Theo Meimar	R&D Tax Solutions
Tom Nagel	Novatron Systems

<b>Attendees via Webcast</b>	
Ammar Khalid	Maxim Strategy Consultants Inc.
Bryan Ferguson	Bell Canada
Crystal Garvey	Windsor Machine & Stamping (2009) Ltd
Duncan Peake	Duncan Peake Professional Corporation
Eric Martin	Emergex
Greg Doucette	SOMOS Consulting Group Ltd.
Greg Farrell	CI Solutions
Heather Posgate	Ideacia ONE Inc. Group of Companies
Katrina Carpenter	Georgian Bay Management Solutions Inc.
Kim Ackerman	Impact 360 Degrees Inc.
Mark Daugela	Time Consulting
Martin Taves	Business Improvement Group
Martine Javelas	Ericsson
Mike Lester	Certitude Engineering
Mokhtar Amalou	Bell Canada
Neha Tiku	Techcentive Services Inc.
Paul Zubkov	ATP Canada
Peter Wright	Impact 360 Degrees Inc.
Pierre Morin	Canada Revenue Agency
Sarmen Khagerian	Maxim Strategy Consultants Inc.
Stephen Viszlai	Tolko Industries
Todd Louie	Sheldon & Milstein
Vishal Bhandari	Maxim Strategy Consultants Inc.

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Christine Gribowski	Gribowski Associates
Cory Poechman	Pinnacle Consultants
Darren Drury	Pinnacle Consultants
Earl Viner	Viner R & D Tax Specialists
Eric Richardson	Skura
Gul Nawaz	Nawaz Taub Noor & Wasserman
Harvey Cantor	Harvey Cantor C.A.
Jay McLean	PricewaterhouseCoopers
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Mark Daugela	Time Consulting
Martin Taves	Business Improvement Group
Martine Javelas	Ericsson
Mike Lester	Certitude Engineering
Mokhtar Amalou	Bell Canada
Neha Tiku	Techcentive Services Inc.
Paul Zubkov	ATP Canada
Peter Wright	Impact 360 Degrees Inc.
Pierre Morin	Canada Revenue Agency
Sarmen Khagerian	Maxim Strategy Consultants Inc.
Stephen Viszlai	Tolko Industries
Todd Louie	Sheldon & Milstein
Vishal Bhandari	Maxim Strategy Consultants Inc.



## **I) SR&ED 2012-1 (40 Minutes)**

### **Federal S&T funding changes**

- A) Survey results - Science & Technology Policy issues addressed**
- B) S&T Policy Issues NOT directly (or fully) addressed**
- C) SR&ED issues & recommendations on CRA administration**
- D) Commercialization – new focus & options**



## 2012-1

### March 29, 2012 Federal budget - Science & Technology (S&T) funding changes

Finance Minister Jim Flaherty, announced the 2012 budget will be released Thursday, March 29.

In a Dec.16, 2011 speech to reporters, Prime Minister Stephen Harper indicated the 2012 federal budget will have significant changes to the SR&ED tax credit program stating,

“It is the government's most explicit commitment to act on the recommendations of, Innovation Canada: A Call to Action:”

- an expert panel report headed by
- Open Text Corp. chairman, Tom Jenkins
- that was released in October, 2011

We propose the relevant reports on S&T include

- Jenkins - Federal Commission / POV
- Mowat (U of T) - Academic POV
- Matthews/ CATA - VC + industry POV
- CD Howe / PWC - Private Commission POV
- Canada's S&T Policy- Conservative Party POV

The related SR&ED issues have been **discussed in prior meetings and newsletters** and have been summarized in the following documents ([click to view](#)):

- [SR&ED newsletter 2011-2](#) (12pages)
- [SR&ED newsletter 2011-4](#) (25 pages)
- SR&ED Practitioner meeting Sept 22, 2011
  - o [Minutes](#) (58 pages)
  - o [Webcast of meeting](#) (90 minutes)
- [Letter to Mike Wallace, MP](#) (Feb. 3, 2012, 11 pages)
- [Slides on key issues](#) (Feb. 8, 2012, 45pages)

### **Survey administered**

We submitted the issues cited to SR&ED stakeholders (practitioners and claimants) in the form of an [online survey](#).

### **Summary of findings (next page)**

To date we have compiled approximately 120 responses.

In general term most SR&ED practitioners and claimants appear to;

1) **Agree with most recommendations** but

2) **Strongly Disagree** with proposals to;

- o **shift of SR&ED funds to grants**
- o **& have a new NRC agency (vs. CRA) administer the program**

# SR&ED Survey: Claimant & Practitioner responses

## RECOMMENDATIONS FOR SR&ED (JERKIN'S & OTHER RECENT REPORTS)

	Agree	Disagree	No Opinion
1) Refund of MC's to large & foreign companies (full or partial)	70%	10%	20%
2) Concentrate new funds on 4 key industries "strategic clusters"	20%	30%	50%
3) Restrict eligible costs to labour only vs. materials & capital	40% initial - 90%+ discussion*	10-60% *	0%
4) Shift funding from SR&ED tax credits to direct (grants, contracts & VC)	5%	90%	5%
5) Reduce filing deadline to 6 (vs. 18 months)	60-90%*	10-30%*	0%
6) CRA continue to administer technological eligibility vs. new "NRC" based agency	80%	10%	10%

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## S&T / SR&ED Survey responses



### SURVEY - OPINIONS ON POTENTIAL SR&ED CHANGES - 2012

#### BUDGET

Prime Minister Harper has indicated the 2012 federal budget will have significant changes to the SR&ED tax credit program stating, "It is the government's most explicit commitment to act on the recommendations of, Innovation Canada: A Call to Action." (aka the "Jenkins's Report")

The purpose of this survey is to gather input from SR&ED Practitioners.

#### RECOMMENDATIONS FOR SR&ED (JENKIN'S & RECENT REPORTS)

#### Agree

#### Disagree

#### No Opinion

- 1) Refund of ITC's to large & foreign companies (full or partial)
- 2) Concentrate new funds on 4 key industries "strategic clusters"
- 3) Restrict eligible costs to labour only vs. materials & capital
- 4) Shift funding from SR&ED tax credits to direct (grants, contracts & VC)
- 5) Reduce filing deadline to 6 (vs. 18 months)
- 6) CRA administer technological eligibility vs. new "NRC" based agency

70%

10%

20%

20%

30%

50%

40% initial - 90%  
> discussion\*

10-60% \*

0%

5%

90%

5%

60-90%\*

10-30%\*

0%

80%

10%

10%

#### POTENTIAL METHODS TO ACHIEVE "OBJECTIVES" IN JENKIN'S REPORT

#### Agree

#### Disagree

#### No Opinion

- 1) COMMERCIALIZATION: Refund ITC's to large co's if "collaborate" with CCPC's
- 2) Understand industry preference SR&ED (25,000+ claimants/yr.) to IRAP (2,500?)

90%

0%

10%

100%

0%

0%

#### COMMENTS:

THE RESULTS ABOVE REPRESENT THE OPINIONS OF APPROXIMATELY 120 RESPONDENTS AT FEB 2, 2012.

\* NOTE: MANY RESPONDENTS WERE UNCERTAIN ON VARIOUS POSITIONS. ONCE THESE WERE DISCUSSED DIRECTLY THEY TENDED TO SHIFT THEIR ORIGINAL OPINIONS. THE %'S OUTLINED IN THE RESPONSE TABLE DISPLAY THE ORIGINAL THEN FINAL %'S (AFTER DISCUSSION).

## **A) Survey results - Science & Technology Policy issues addressed**

Recent reports have made a series of specific recommendations relate to S&T policy:

### **1) Refund of ITC's to large & foreign companies (full or partial)**

It has long been observed that a substantial amount of R&D is moving outside of Canada due to large corporations inability to use [non-refundable credits](#).

This also provides potential mechanisms to encourage work with small & medium sized enterprises (SME's) to address further issues on commercialization.

#### **Comments by Survey Respondents**

- 1) "Set up separate program for Foreign companies but leave SRED as is. It works and gives much direction to Canadian companies."
- 2) "large/foreign entities should be entitled to partial refundable ITCs"

#### **Group Recommendations**

Consider **refundable SR&ED credits for large firms who "collaborate" with small Canadian firms.**

This meets all objectives including "commercialization" and "knowledge" transfer (discussed in section D).

It is also already supported in the current layout of the SR&ED claim form.

### **2) Concentrate new funds on 4 key industries "strategic clusters"**

Since this is more of an economic than a tax issue most respondents often showed a mixed response or no opinions.

Of those with an opinion we appear to have an equal mix of supporters (software developers) or strong resistance (manufacturing sector) however, the opinions appear based more on the specific interests of the respondents than any factual analysis.


#### **Comments by Survey Respondents**

- 1) I found the conclusions and recommendations of the Jenkins report to be extremely disappointing and ill-informed. Government selection of key industries has never been successful in the past.

#### **Group Recommendations**

This could be a source of opportunity if done with proper, "balance."

Some of the issues on determining the optimal allocations have been provide in the Industry specific commentary in the "sectors to receive new funding" section of [newsletter 2011-4](#).



## **A-3) Restrict eligible costs to labour vs. materials & capital**

### **PROS:**

- Used effectively by Quebec for decades
- CRA can review (payroll withholdings)
- Hedged transaction, i.e. Canadian wages & “employee income taxes”

### **CONS;**

- “Timesheet” tracking issues

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### **3) Restrict eligible costs to labour only vs. materials & capital**

#### **This is one of the major areas of disagreement!**

Proponents for this method argue that unlike credits for materials & equipment which can be sourced from other countries, credits based on Canadian wages represents a “hedged” transaction from a Department of Financial perspective.

In other words the only way to earn credits is to pay wages which in turn require income taxes withholdings to fund these credits.

It is also very easy to review from a CRA perspective since they can confirm all T-4 reported earnings & related payroll remittances.

Those against this focus cite the needs of industry for such funding & related problems in determining “adequate” time reporting.

#### **Comments by Survey Respondents**

- 1) “Len Lucier's comment at the recent annual Hamilton SR&ED Conference was right on the mark: one of the most challenging aspects for claimants relates to CRA's acceptance of the labour allocation.

It is illogical for the Jenkins Panel to have concluded that a labour-only basis to determine ITC's will simplify the determination of the SR&ED calculation.

In fact, determination of eligible contract and material expenditures is trivial compared to labour expenditures for SMEs that do not require a time card system to run their business.”

- 2) "In my MBA classes we were taught to shift resources from less profitable areas to more profitable areas regardless that both areas are profitable. By focusing the SRED resources / credits on labour only this is achieved.”

- 3) “This idea is brilliant & long overdue!

- used effectively by Quebec for decades
- it greatly simplifies the calculations
- CRA can quickly review (payroll withholdings)
- creates a hedged transaction, i.e. the only way to
  - o earn more credits is to
  - o pay more Canadian wages which in turn
  - o creates the “employee income taxes”
  - o to pay the credits.

As a result, this process is much easier to budget for all stakeholders (government & business).”

#### **Group Recommendations**

There is **little group consensus** on this issue **unless** it is **reworded** as follows:

“If we need to reduce SR&ED funding somewhere would you prefer labour or materials & capital?”

Once this issue was considered the consensus would be to;

Focus the claims on wages (labour)

- i. Using the Quebec model with
- ii. Wages (direct or via Canadian Contractors)
- iii. Simplified calculations

This can also provide a basis to:

- increase claimants incentive to keep time records,
- documentation of experimental development &
- hopefully reduce compliance costs

further addressing CRA & Parliament's concerns on these issues.

## **A-4) Shift funding from SR&ED to grants, contracts & VC)**

**Understand “industry” preference of  
SR&ED over direct funding:**

- **> 25,000 companies claim SR&ED every year (73% of Jenkins survey) vs.**
- **< 1,000 VC funded deals / year &**
- **< 5,000 ? IRAP/NRC funded grants / year (17% of Jenkins survey)**

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## **Group discussion – summary of significant comments**

### **Direct (Grants) vs. Indirect funding (tax credits)**

The pros and cons were discussed including the potential for abuse or misappropriations due to;

- The lack of published information on the number of companies funded each year
- the small degree of people making decisions without secondary review
- The length of time IRAP advisors stay with clients (often 10+ years)
- Secrecy of the process
- The apparent hostility which many IRAP advisors exhibit towards any external advisors
- Many felt this ranged from mere unprofessionalism to borderline anti-social behavior

### **Direct comments from the group:**

#### **Pro Direct funding / IRAP:**

[Regarding Fairness & Objectivity] “I have worked for IRAP and can guarantee that no advisor has funded their cousins.”

“Both IRAP and SR&ED are competent. Why can’t they agree and share resources?”

“why no science review by IRAP instead of CRA?”

#### **Pro SR&ED tax credits:**

“the client must call on their own & the IRAP advisors will not talk to professionals. Clients don’t have the resources and professionals can’t help.”

“In my experience, IRAP, as review is really non-existent, is very prone to fraud - much more so than SR&ED.”

“We need to discover why the vast majority of claimants appear to favor SR&ED tax credits to IRAP grants or any other type of direct funding.”

“the right to file objections and go to tax court present a completely different system than a discretionary system based on grants.”

### **Other methods - Patent box concept: for commercialization**

Dr. Russ Roberts:

“With the patent box, concept you get additional tax credits associated with commercialization, patent expenses, etc. of the SR&ED eligible product / process developed.”

“It has been used successfully in other countries and shown to maximize benefits from technologies by preventing business going offshore. This has been an issue with SR&ED, VC and other funding options.”

“This is also similar to IRAP funding of the commercialization portion of a project which had previously received funding of the research and development.”



## **4) Shift funding from SR&ED tax credits to direct (grants, contracts & VC)**

### **Grants**

Statistics on the total number of IRAP claimants or any of the other “direct” programs are not publicly posted. Perhaps the best current statistics are cited in the Jenkins report.

“Among the **488 survey respondents**<sup>1</sup> that had accessed a federal R&D program in the past three years,

- **73 % reported using the SR&ED tax credit program,**
- **17 % IRAP,**
- **No other program** was identified by **more than 1 %** of the companies.”

This strongly suggests that federal programs are;

- not well known or
- accepted by business.’

### **Contracts (procurement)**

Few respondents addressed this issue.

A great example of past failures might be the 1990’s when federal government decided to license Microsoft Office (US firm) instead of Corel Office (Canadian firm) which;

- had combined Lotus & WordPerfect technologies
- representing a realistic challenge to what is effectively
- now a worldwide product monopoly.

### **Venture Capital**

Venture Capital represents a source of opportunity if done properly. The real issues will come down to a matter of “balance.”

These investors typically do **<1,000 deals / year** in Canada and generally **demand a minimum 40% annual return** on investment. This is discussed further in [newsletter 2011-4](#) page 23-24.

### **Comments by Survey Respondents**

- 1) “I am against any further support being forwarded to IRAP. For 25 years my company and 35 of my clients have witnessed the continued arrogance and incompetence of IRAP’s consultants. How the government has justified supporting such a group of ineffective freeloaders is beyond our understanding to give these people even more power will certainly destroy R&D in Canada.”
- 2) “IRAP is a process which needs fixing - never any allocations and far too long lead time to hope of funding - companies can’t invest the time for the hope of getting 50% that will only grind their SRED claim. Jenkins report was so self-serving and too restricted in what could be recommended it is useless.”
- 3) In the early 2000’s, there was much criticism of direct funding programs such as TPC. Media criticism was that government (and academia) did not have a good track record at “picking winning companies” and the investment decision was best left to industry (through the SR&ED program). It is interesting how the pendulum has started to swing back the other way.”
- 4) “The VC market has disappeared in Canada as angel investors have had their wings clipped. This is a key driver to the economy to the point that the government gave \$50 m to the BDC as a VC fund and these bureaucrats didn’t know what to do with it.”
- 5) “Grants for SR&ED as a replacement for tax credits is a very bad idea. Decisions on grants take too long and usually have to be made by technically uninspired people. Is the government trying to reduce the costs of ITCs? I don’t know, but if so, then specifically address that issue.”
- 6) “Need more certainty in the program to encourage investing funds in new research, but don’t want to slow down process with extensive grant applications before starting research.”
- 7) “In my experience, grants such as IRAP and regional grants are far more susceptible to fraud than the SR&ED program. Recent SR&ED cases in Montreal are the exception. IRAP field officers have been (and may still be?) contractors, not employees of NRC. There have been many cases of nepotism, kick-backs, etc. There are few checks on them except the fact that their pot of money is more limited.”

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<sup>1</sup> “Jenkins” report (Figure 5.3)

- 8) The reports largely ignore the history of the debate of grants versus tax credits and why Canada went to tax credits.

I was a heavy participant in the period 1977 to 1989 when SR&ED was young and grants were still the main government support. I ran contract R&D labs in Calgary and in Sydney, Nova Scotia. I witnessed the growth of regional grant agencies, under both Liberal and Conservative governments.

The selective grants dried up in 1989 because the NAFTA and other trade agreements made direct grants to industry not possible if it interfered with fair trade of goods or services. SR&ED did not interfere – all companies are treated equal.

A return to grants would be to institutes not companies – otherwise, any benefits would go to lawyers to fight the WTO and NAFTA litigations.

- 9) Why not simplify (and expand) the direct funding approach instead of SR&ED? A rhetorical question, it would seem, as the intent of government in introducing change to the latter program, I believe, is to ultimately reduce its financial commitment and burden under the cloak of improved program efficiency. "

#### Other recent comments – Globe & Mail

A March 11, 2011 Globe & Mail [article](#) provides quotes from Andrew Dunn, a managing partner at Deloitte, expressing worries Ottawa will slash the credit scheme on a potentially "faulty" premise.

"Moving from credits to grants puts the decision in the hands of government," he said.

"Canada has a bad history of grant-type programs. The global trend is from grants to credits."

#### Group Recommendations

Industry recommends that the government first understand "industry" preference of SR&ED (tax credits) over direct funding (grants):

- > 25,000 companies claim SR&ED every year vs.
- < 1,000 VC funded deals / year &
- < 5,000 ? IRAP/NRC funded grants / year

Venture capital represents an opportunity but if overly funded, it may not only

- play havoc with "free market" forces but also
- "play into" a strategy of putting,
- "all of the eggs into very few baskets."

#### **Notable quote:**

"Clarification on these issues would be helpful to taxpayers so they are not blind-sided at the time of the next Federal Gov't budget."

- SR&ED survey respondent

## **A-5)Reduce filing deadline to 6 (vs. 18 months)**

According to a recent CATA pronouncement

- approximately 30% of the CRA
- costs of compliance relate to
- amended claims
- (typically filed between 6-18 months from year end).

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## **5) Reduce filing deadline to 6 (vs. 18 months)**

**This is one of the major areas of disagreement!**

According to a recent CATA white paper approximately 30% of the Canada Revenue Agency's costs of compliance relate to amended claims (typically filed between 6-18 months from year end).

They propose that,

“Almost **one-third of claims** received by the CRA in any given year are **retrospective** claims being filed for **previous years**.”

A significant portion of these claims appear to be of a speculative nature, providing windfall revenues to businesses & consultants [resulting in] questionable value as incentives for the SR&ED.”

They then go on to suggest,

“if the SR&ED program eliminated retrospective claims filed for previous years ... it could free up as much as 30 per cent in funding to be redeployed into direct investment.”

### Comments by Survey Respondents

While most survey respondents were against this measure, when it was reworded as

“If some costs had to be cut and this could save 30% of CRA review time would you consider this?”

the consensus tended to shift to support the reduction of this filing timeline.

### Group Recommendations


In a properly structured SR&ED system companies should be able to report these costs with their tax return (filing due date of 6 months from year end)

As a related issue the CRA may in turn relax its filing requirements on a “complete claim” so as not to “punish” claimants for simple omissions or “honest” mistakes.

### **Notable quote:**

“Each person's work is always a portrait of himself.”

- Samuel Johnson



## A-6) CRA vs. new agency for “technology” eligibility

- Maintains strong history and basis for objection, appeal & tax court review.
- No similar rights or objectivity under any grant programs.
- Right vs. a privilege -accountability

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## **6) CRA continue to administer technological eligibility vs. new "NRC" based agency**

Many of these issues have also been addressed in the our discussion of Grants vs. SR&ED tax credits (issue 4).

The following additional comments are specific to this issue.

### **Comments by Survey Respondents**

- 1) "Is the government trying to get more consistent adjudication of claims? If so, we need a few more technical people at HQ and a hiring policy for technical reviewers which attracts more recently retired technical professionals rather than MSc.s with little practical experience."
- 2) "Nothing to do with R&D funding should be in the Tax Act. Period."
- 3) "SR&ED – administer by CRA or other party?"

Key factors favoring the CRA include,

- Respect – It is a felony to file a false income tax return. Most people could cite stories of the laws and precedence that both protect the “rights” of the taxpayer (e.g. Duke of Westminster decision) & punish those who violate the system (e.g. Al Capone).
- Corruption - Can you name anyone convicted of “grant” or “government procurement” frauds? The only ones I can recollect involved unsuccessful attempts to charge former Prime Ministers Brian Mulroney & Jean Cretien with complicity in improper funding allocations to their “friends.”
- Rights – as a taxpayer if you have performed SR&ED you can appeal decisions to the tax court since you have a “right” to the funds. You can’t do this with IRAP or any grants. As a result there is NO certainty which is the most important criteria for industry acceptance of any program.
- History / Infrastructure – Tax law has a system of lawyers, CA’s, and judges trained in tax law. Moving this to a grant system represents the

elimination of the full recourse process & shifts the funding to a fully discretionary process at the discretion of politicians and their friends.”

### **Group Recommendations**

Continue to use the CRA as the primary reviewer of SRED claim since this;

- Maintains strong history and basis for objection, appeal and tax court review &
- No similar rights or objectivity under grant programs.



## **B-2) US vs. Canada— collaboration vs. confrontation**

- US continues to expand
- Governor of Michigan questions the fairness of “business tax breaks”
- Potential for collaboration since
  - The IRS code provides for credits using similar definitions &
  - The Canadian SR&ED form already contemplates “collaborative” claims for SR&ED projects.

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## **B) S&T Policy Issues NOT directly (or fully) addressed**

### **1) Macro vs. Micro Economics – benefit of every \$ invested**

Several newspaper articles have provided factual information in a potentially “misleading manner” when they discuss the [“marginal tax utility” of every dollar](#) the government invests in SR&ED incentives.

The articles report that the tax investment only provides

- equal 1:1 payback of every tax \$ invested
- by way of direct tax revenues (marginal utility)
- however, this creates an estimated 500% social return on this investment
- by way of “spillovers!”

Mathematically speaking the “full picture” indicates up to 600% (economic + social) return of every tax \$ invested.

#### **Authors Recommendations**

While the facts stated in the article are correct: the marginal utility for every tax dollar invested is “break even,” this is only one piece of a “larger picture.”

When considering the Jenkin’s report recommendations we should endeavor to consider the;

- full “economic” vs.
- just the marginal value of incentives.

### **2) US vs. Canada – collaboration vs. confrontation**

- The US continues to [announce expansion of this credit](#)
- The governor of Michigan<sup>2</sup> has questioned the [fairness of Canadian policies](#)
- There appears to be a huge potential for collaboration since
  - The IRS code provides for credits using similar definitions &
  - The Canadian SR&ED form already contemplates “collaborative” claims for SR&ED projects.

#### **Authors Recommendations**


Recommendation for US vs. Canada collaboration

- Consider co-operative
- Claim & Review functions
  - Between US & Canadian Companies (claims)
  - Using both IRS & CRA staff (reviews)
- For claims in both jurisdictions

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<sup>2</sup> “Canada Should End Business Tax Breaks, Michigan’s Snyder Says,” Business Week, Nov., 8, 2011





## **B-3) Regulation of fees for consultant support**

### **Cons:**

- other methods – free market
- effects (eg. US, IRAP) – non use

### **Ideas:**

- simplify the system
- use free market forces

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## **Group discussion – summary of significant comments**

### **Contingency fee regulation - Opening queries to group**

Dr. Russ Roberts:

“Do contingency fees cause high costs for companies & are there abuses we can cite?”

### **Direct comments from the group:**

#### **Pro contingency fees**

“the forms are complicated...requiring consultants who know what they are doing...”

“fees have come down recently...market could be adjusting fees down...”

“could be argued that contingency fees discourage bad claims due to risk to consultant business and reputation

“They also protect claimants from bad/unsuccessful claims in that they keep their money. Without contingency fees, dirty consultants get paid even without success for claimant

“why not do a bad claim for hourly work?”

“Consulting Fees must cover overhead and marketing costs - registration costs can increase contingency fees.

They are putting contingency and aggressive behaviour in same basket. They should deal with aggression separately

“Contingency affects small business and helps clients do what they cant do

“Contingency fees are the market places response to the uncertainty, risk and unpredictability of the SR&ED program

"The current proposal appear to treat consultants as if they are thieves. We are not thieves"

“I agree, the issue is not how firms are paid, but how the program is administered.”

### 3) **Regulation of fees for consultant support**

Changes are expected to limit consultants' share of the SR&ED credit as Ottawa expresses concern that too much federal science cash is flowing outside the “intended” sector.

#### **Globe & Mail articles on % SR&ED paid to consultants**

To “sensationalize” this issue in March 11, 2011 the Globe and Mail ran an article entitled,

[Flawed R&D scheme costs taxpayers billions<sup>3</sup>](#)

which, in the author’s opinion,

- a) Provided examples of specific (inappropriate) practices used by one of these Rogue consultants
- b) presented “opinions” which may mislead readers.

The article stated,

“This year, Ottawa and the provinces will dispense \$4.7-billion to more than 20,000 Canadian companies.

But a third or more of that cash is being wasted and paid to consultants as a result of hazy rules on what's legitimate R&D and limited government auditing resources,

according to dozens of interviews with consultants, claimants and government officials.”

[Ottawa eyes keeping science cash out of accountants' hands<sup>4</sup>](#)

According to this March 7, 2012 article,

**Gary Goodyear, the federal minister of science and technology**, is hinting that upcoming changes will aim to limit these added costs to the SR&ED program.

"I'm not concerned about what accountants charge for their everyday business. My concern is simply that that money then moves out of the science, research & development sectors & into another area of our economy."

The article also quoted **Andrew Dunn, a managing partner at Deloitte** who disputed that consultants are pocketing too much of the R&D credits.

“While some consultants charge contingency fees of 30 or 40 percent, the overall numbers are much lower.”

He pointed to a survey by the Canadian Institute of Chartered Accountants which found that the

“top six accounting firms in Canada earned \$117-million in 2010 from SR&ED”.

Mr. Dunn then recommended the,

“government could root out overly aggressive practices by banning contingency fees and requiring registration of all consultants.”

#### **Authors Commentary**

Using the example quoted, if the top 6 CA firms can be assumed to complete 100% of the claims for large corporations (i.e. not “Qualified CCPC’s”) the

Average compliance costs of SR&ED would be

- = Total SR&ED fees / total SR&ED credits claimed
- = \$0.117 billion / \$ 4 billion
- = 2.9% (cost of compliance as % credit received)

<sup>3</sup> Globe & Mail, March 11, 2011 Link to article;  
<http://www.theglobeandmail.com/report-on-business/flawed-rd-scheme-costs-taxpayers-billions/article1939418/>

<sup>4</sup> Globe and Mail March 7, 2012, By Bill Curry & Barry McKenna

## Authors personal experience, examples & opinions

### Facts & Issues

1) **Client choice** - I have practiced in the SR&ED field since 1993. From 1993 to 2000 I worked on some of the largest SR&ED files in Canada on an hourly or flat fee basis.

On almost all hourly agreements “sophisticated” clients required a budget and authorization before incurring any fee overruns. In reality these resulted in “flat fees.”

When I left partnership and started MEUK Corporation I decided to offer clients all 3 billing options:

- hourly,
- flat fee or
- % of recovery

I have **clients who prefer each of these options** for various reasons.

2) **Needless complexity** - As the co-author of the SR&ED course for the Canadian Institute of CA's and seminar leader for the past 15 years I can say that I spend over 30 minutes explaining the just the rules on “specified employees.”

He course itself runs a full 8 hours and only provide an overview of many “complex” issues.

Most CA's walk out of the course claiming it is:

- needlessly complicated &
- one of the most confusing areas of income tax they have ever explored.

The result is that they tend to charge a minimum \$5,000 for compilation of the SR&ED related tax forms, assuming the client prepares the technical (project) descriptions.

3) **Related liability** - Worse yet I have seen lawsuits for millions of dollars against CA's for failure to adequately:

- plan or complete the SR&ED forms
- within required deadlines.

### Analysis

My experiences on billing methods is at each has its own pros & cons however, it is ultimately the claimant who should be empowered with choice..

The majority (approximately 80%) of first time claimants, under \$100,000 of ITC's prefer to use the % recovery in the first year.

The % fees for this work range from 2-20% of recovery dependent on the nature of the work and range of services provided.

I have some flat fee clients who's fees (including costs to plan & complete the project descriptions & income tax forms) are <2% of total credits.

Fees at the higher end of this fee range tend to be paid by clients with weaknesses in the SR&ED documentation systems.

Most clients will not pay aggressive fees for services which they believe they can perform on their own.

If the free market willing to pay high fees for product or service it is because they perceive high value.

### Related Recommendations

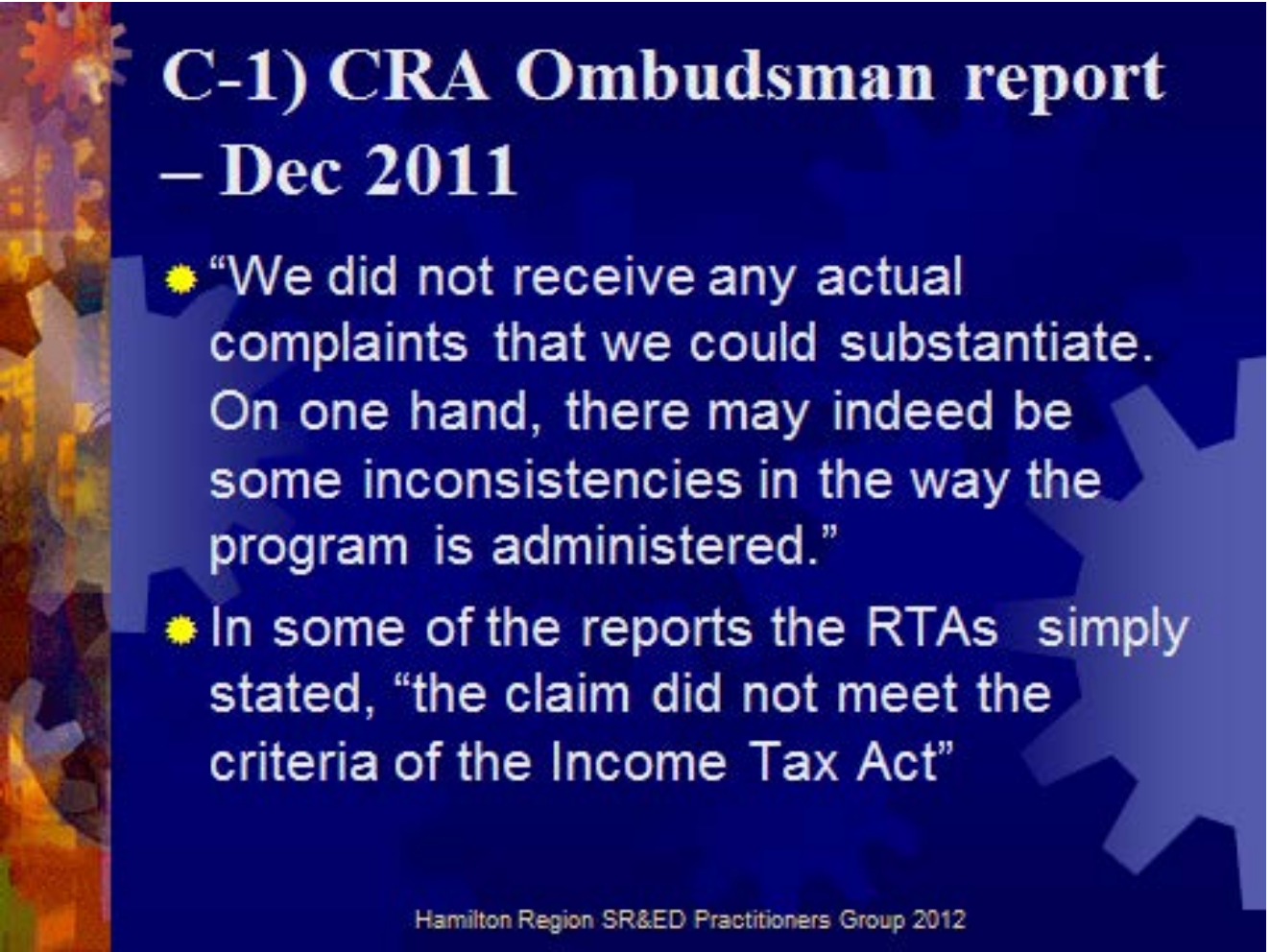
The free market is likely the best mechanism to determine the fair price of any service commodity.

It should be the client's choice which method of billing & payment best meets their business needs.

As a result the government should not attempt to regulate the fee or service providers other than as to quality of work.

The Jenkins and other current SR&ED reports recommend, “streamlining the SR&ED claim system.”

If the government policy makers & CRA wish to reduce the fees consultants charge all they need do is simplify the current complexity of the program.



## C-1) CRA Ombudsman report – Dec 2011

- ☀ “We did not receive any actual complaints that we could substantiate. On one hand, there may indeed be some inconsistencies in the way the program is administered.”
- ☀ In some of the reports the RTAs simply stated, “the claim did not meet the criteria of the Income Tax Act”

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## **C) SR&ED issues & recommendations on CRA administration**

### **1) Ombudsman report<sup>5</sup>**

In December 2011 the CRA Ombudsman released its report on

[Issues of service & fairness within the SR&ED Program](#)

#### **Select excerpts:**

Although our Office heard criticisms and comments through consultations with claimants about the perception of regional discrepancies,

“we did not receive any actual complaints that we could substantiate. On one hand, there may indeed be some inconsistencies in the way the program is administered.”

In some of the reports the RTAs<sup>6</sup> simply stated that,

“the claim did not meet the criteria of the Income Tax Act”

without explaining in a clear and complete manner how the decision was arrived at.

This is an excerpt from one such Technical Review Report:

“Designing a XYZ is not considered an attempted technological advancement.

The work is not considered to be performed for the purpose of achieving technological advancement and therefore it does not meet subsection 248(1)(c) of the Income Tax Act.”

#### **Author’s commentary**

It should be noted that the report was premised on 5 main questions for claimant & preparer feedback, regarding post Feb. 21/07 SR&ED claims:

- Did CRA adequately inform taxpayers about the recent changes to the T661 form?
- Has the cost of filing and defending an SR&ED claim changed?
- Did CRA accept your request for a "second opinion"?
- Did CRA review and audit your claim in a professional and courteous manner?
- Has any CRA person ever attempted to dissuade you from retaining professional advice?

The report was silent as to the responses to these specific questions.

The report otherwise speaks for itself: no one provided evidence to back up their complaints.

#### **Related Recommendations**

We suggest the best solution to this issue would be for;

- One or more claimants to
- post relevant complaints publicly
- for SR&ED stakeholder review & input since

This should to remove the “secretive” nature of the

- current process & provide
- required accountability based on specific facts.

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<sup>5</sup> This publication is available in electronic format at [www.oto-boc.gc.ca](http://www.oto-boc.gc.ca).

<sup>6</sup> CRA “Research & Technology Advisors”



## **C-2) SR&ED issues on CRA administration**

- 1) Technology eligibility
- 2) Financial structure
- related administration

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## **Group discussion – summary of significant comments**

### **Issue – RTA does not have background in correct field of science**

#### **Direct comments from the group:**

#### **Disagree with CRA's use of RTA without proper technical qualification**

“My client claimed actuary science, but computer science RTA was sent. We argued we needed mathematician. This was solved months later after several disputes.”

“A claim for a large pulp and paper company was refused. The RTA said no advancements in chemical engineering.”

“We have a reviewer sent to food, manufacturing company and we still don't know what their background is and are told we are not allowed to ask.”

#### **Defending CRA's use of RTA's without matching technical qualification**

“I think this could backfire if we keep pressing it. We all do claims that are arguable out of our own fields of science, so CRA could argue the same point.”

“We can't expect every RTA to be expert but should be open minded.”

#### **Neutral position – potential solutions IRS rebuttal presumption**

“It should be noted that the IRS requires its R&D Tax credit auditors to support challenges to a claim by providing a **rebuttal presumption that the discovery test is not met.**”

In short this means the claimant is required to keep reasonable evidence that they attempted to define standard practice.

If completed the **IRS would have to demonstrate** that the information would have been known to skilled professionals had they performed (before the research was undertaken) a reasonable investigation of the existing level of information in the particular field of science or engineering.” (Reg § 1.41-4(a)(3)(v))



## 2) **Related - Administration of the SR&ED program by the CRA**

### **CRA SR&ED Directorate - top 5 program problems (Jan 11, 2012)**

The CRA's SR&ED Directorate held its annual practitioners meeting in Burlington, Ontario on January 11, 2012.

The CRA's new Director General for SR&ED, Susan Betts, listed the **top five concerns of industry and CRA about SR&ED**.

For industry:

- 1) RTA's not qualified to correctly assess claims
- 2) Narrowing eligibility criteria
- 3) Complexity of process and forms
- 4) Requirement for supporting documents too onerous
- 5) Outcomes uncertain year to year and lack of consistency

For CRA:

- 1) Personal attacks against CRA staff
- 2) Incomplete claims / information not sufficient to allow desk review processing
- 3) Success fee billings "unfairly" divert benefits from taxpayers to consultants
- 4) Increasingly aggressive claims
- 5) Claims withdrawn if challenged by CRA
  - including penalties for unjustified claims &
  - prosecution of claimants & tax advisors

## **Authors Recommendations**

### **Technological eligibility recommendations – 2 steps**

We propose that the CRA management could consider 2 steps to improve the current system:

#### **1) 1 complete project example / industry**

- based on existing [CRA SR&ED examples](#) &
- compliant with all
  - a. technology & tax reporting expected of claimants & related
  - b. [precedence set by the Tax Court of Canada](#)


#### **2) Dispute resolution mechanism**

- objective,
- third party, 2nd review system to
- Arbitrate /settle disputes
- In a timely manner (30 day objective)

### **Financial eligibility recommendations – 1 step**

We propose that SR&ED policy makers can assist CRA management by

- moving to a labour based system
- with simplified calculations.



## **D) Commercialization via T661 claim – Canada & Int'l**

Collaboration via T661 claim;

- a single project description for multiple claimants (reduced compliance costs),
- additional incentives to large firms who work with SME's &
- perhaps even joint incentives for work with
  - Canadian & US companies, jointly administered
  - By the CRA and the IRS.

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## **D) Commercialization – new focus & options**

### **SME and large firm – collaboration for commercialization**

#### Facts:

Several of the reports acknowledge that

- "large, multi-national" co's have
- strong commercialization infrastructures &
- prefer to have SR&ED funding vs.
- SME's who need commercialization assistance.

A [Feb.28, 2012 report from CATA](#) acknowledges,

“53 per cent of surveyed companies compete in the market without collaborating with industry peers.”

The report then recommends that,

“To compete and survive, small companies need to collaborate among themselves, as well as with large anchor companies that have built-in channels to the market. Canada does not have a culture of collaboration,”

“The government must encourage collaboration among Canadian industry companies on a much larger scale than at present, where most of the incentives were focused on collaboration between government labs and industry and on ways to get more academic institutions to license their inventions to industry,”

#### **Group Recommendations**

Consider incentive for;

- "large co's" to act as "ANCHORS" for
- development, mentoring & commercialization with
- SME's on SR&ED projects.

This could be implemented;

- based on previously approved SR&ED projects &
- as a basis to implement the proposed &/or
- refundable SR&ED ITC treatments.

As noted in the section on US collaboration the

- Canadian SR&ED form already contemplates
- Collaborative claims for SR&ED projects

As a result we recommend the:

- existing SR&ED claim information can be used to
- identify “collaborative” SR&ED work, allowing;
  - a single project description for multiple claimants (reduced compliance costs),
  - additional incentives to large Canadian firms who work with Canadian SME's &
  - perhaps even joint incentives for work with
    - Canadian & US companies,
    - jointly administered by the CRA & IRS.

***See example on next page***

# D) Collaborative work using SR&ED form

## Part 2 – Project information

Complete a separate Part 2 for each project claimed this year.

CRA internal form identifier 060  
Code 1101

<b>Section A – Project Identification</b>		
<b>200</b> Project title (and identification code if applicable)		
<b>202</b> Project start date	<b>204</b> Completion or expected completion date	<b>206</b> Field of science or technology code (See guide for list of codes)
<div> <div>Year</div> <div>Month</div> </div>	<div> <div>Year</div> <div>Month</div> </div>	
Project claim history		
<b>208</b> 1 <input type="checkbox"/> Continuation of a previously claimed project <b>210</b> 1 <input type="checkbox"/> First claim for the project		
<b>218</b> Was any of the work done jointly or in collaboration with other businesses? ..... 1 <input type="checkbox"/> Yes 2 <input type="checkbox"/> No		
If you answered yes to line 218, complete lines 220 and 221.		
<b>220</b>	Names of the businesses	<b>221</b> SN
1		
2		
3		

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## SR&ED claim form – method to claim “collaborative work”

### Part 2 – Project information

Complete a separate Part 2 for each project claimed this year.

CRA Internal form Identifier 060  
Code 1101

<b>Section A – Project Identification</b>		
<b>200</b> Project title (and identification code if applicable)		
<b>202</b> Project start date	<b>204</b> Completion or expected completion date	<b>206</b> Field of science or technology code (See guide for list of codes)
<div style="display: flex; justify-content: space-around;"> <div> <div style="border-bottom: 1px solid black; width: 20px; height: 10px;"></div> <div style="border-bottom: 1px solid black; width: 20px; height: 10px;"></div> <div style="border-bottom: 1px solid black; width: 20px; height: 10px;"></div> <div style="border-bottom: 1px solid black; width: 20px; height: 10px;"></div> </div> <div> <div style="border-bottom: 1px solid black; width: 20px; height: 10px;"></div> <div style="border-bottom: 1px solid black; width: 20px; height: 10px;"></div> </div> </div> <div style="display: flex; justify-content: space-around; font-size: small;"> <span>Year</span> <span>Month</span> </div>	<div style="display: flex; justify-content: space-around;"> <div> <div style="border-bottom: 1px solid black; width: 20px; height: 10px;"></div> <div style="border-bottom: 1px solid black; width: 20px; height: 10px;"></div> <div style="border-bottom: 1px solid black; width: 20px; height: 10px;"></div> <div style="border-bottom: 1px solid black; width: 20px; height: 10px;"></div> </div> <div> <div style="border-bottom: 1px solid black; width: 20px; height: 10px;"></div> <div style="border-bottom: 1px solid black; width: 20px; height: 10px;"></div> </div> </div> <div style="display: flex; justify-content: space-around; font-size: small;"> <span>Year</span> <span>Month</span> </div>	
Project claim history		
<b>208</b> 1 <input type="checkbox"/> Continuation of a previously claimed project <b>210</b> 1 <input type="checkbox"/> First claim for the project		
<b>218</b> Was any of the work done jointly or in collaboration with other businesses? ..... 1 <input type="checkbox"/> Yes 2 <input type="checkbox"/> No		
If you answered yes to line 218, complete lines 220 and 221.		
<b>220</b>	<b>Names of the businesses</b>	<b>221</b> <b>BN</b>
1		
2		
3		

### Collaboration – stage 1 (Large & Small companies)

Consider “refundable credit” incentive for;

- "large co's" to act as "ANCHORS" for
- development, mentoring & commercialization with
- SME's on SR&ED projects
- Including a single project description for multiple claimants (reduced compliance costs),

### Collaboration – stage 2 (Canada–US SR&ED)

Consider extending SR&ED 1 “collaboration”;

- To include joint incentives for work between
- Canadian & US companies,
- Jointly administered by the CRA & IRS

## **Crowd funding for SME's – follow US model?**

The Entrepreneurs Access to Capital Act, recently passed in the U.S House of Representatives with overwhelming support. It is now being reviewed by the U.S. Senate.

In Canada, CATA and other technology policy groups have launched advocacy campaigns to encourage provincial securities legislators to adopt similar approaches.

Peter Andrews, CATA Director stated,

“the crowd funding model is like a bake sale, where people pitch in a small amount of money to get a project off the ground.”

Key features of the new U.S. crowd funding legislation include:

- \$1,000,000/year limit on the amount an issuer can raise (\$2,000,000 if audited financial statements);
- limits on the amount sold to any investor in any year

lesser of ;

(a) \$10,000

(b) 10% of the investor's annual income).

A recent issue of Small Business Report provides additional insights Crowd Funding and Start up Capital.

## **Group Recommendations**

Most parties agree that this appears to be a promising incentive for;

- "small companies" to "raise private capital"
- Development & Commercialization of SR&ED
- Without the use of taxpayer funds.

As a result most parties support recommendations to speed the passing of this legislation in Canada.



## **What was not said – items for 2013+ budgets**

- Many of the issues raised by various SR&ED reports
- were NOT addressed in this budget but may appear in 2013 onwards
- These are summarized in the remaining slides

Hamilton Region SR&ED Practitioners Group 2012



**2012-2:**  
**Summary of SR&ED changes**

**SR&ED changes in March 29 ,2012 Federal budget**

<b>Year change proposed to start (prorate)</b>	<b><u>2012</u> <u>current</u></b>	<b><u>2013</u></b>	<b><u>2014</u> <u>full effect</u></b>
1) Federal ITC rate (non-CCPC)	20	20	15
2) Subcontractor costs (% eligible)	100	80	80
3) Rate to calculate proxy (overhead)	65	60	55
4) Capital equipment (% eligible)	100	100	0

**Summary of the changes**

The federal government released its budget on March 29, 2012 including 4 minor changes to the SR&ED tax credit program.

These changes are summarized above.

The actual legislation (Notice of Ways & Means Motion) has also been reproduced on the next page.

**Author's commentary:**

Overall these changes appear relatively modest based on the media buildup and proposals of various S&T reports.

**What was not said – items for 2013+ budgets**

Of interest were many of the issues raised by various SR&ED reports which were not addressed in this specific budget but may appear in 2013 onwards.

A survey (link to complete the survey) was conducted by the RDBASE.NET Consortium of SR&ED practitioners to

- inform stakeholders of these changes
- gather input & opinions

These results are summarized in

- **SR&ED newsletter 2012-1 &**
- **related presentation.**



## **NWMM – Federal Budget,** **March 29, 2012**

### **Scientific Research and Experimental Development Program<sup>7</sup>**

(20) That,

(a) for taxation years that end after 2013, the reference to “20%” in paragraph (a.1) of the definition “investment tax credit” in subsection 127(9) of the Act be replaced with “15%”, except that for taxation years that include January 1, 2014, it shall be read as a reference to the percentage that is the total of

(i) 20% multiplied by the proportion that the number of days that are in the taxation year and before 2014 is of the number of days in the taxation year, and

(ii) 15% multiplied by the proportion that the number of days that are in the taxation year and after 2013 is of the number of days in the taxation year;

(b) for taxation years that end after 2013, the reference to “15%” in subsection 127(10.1) of the Act be replaced with “20%”, except that for taxation years that include January 1, 2014, it shall be read as a reference to the percentage that is the total of

(i) 15% multiplied by the proportion that the number of days that are in the taxation year and before 2014 is of the number of days in the taxation year, and

(ii) 20% multiplied by the proportion that the number of days that are in the taxation year and after 2013 is of the number of days in the taxation year;

(c) for expenditures incurred after 2012, subparagraph (a)(ii) of the definition “qualified expenditure” in subsection 127(9) of the Act be amended to include only 80% of an expenditure that

(i) would otherwise be included under that subparagraph,

(ii) is for scientific research and experimental development performed for or on behalf of the taxpayer by another person or partnership with whom the taxpayer deals at arm’s length, and

(iii) has been reduced to exclude any amount of a capital nature incurred by the other person or partnership in the performance of the scientific research and experimental development;

(d) the percentage at which the prescribed proxy amount, for a taxation year, referred to in paragraph (b) of the definition “qualified expenditure” in subsection 127(9) of the Act is calculated be, for taxation years that end after 2012, the percentage that is the total of

(i) 65% multiplied by the proportion that the number of days that are in the taxation year and before 2013 is of the number of days in the taxation year,

(ii) 60% multiplied by the proportion that the number of days that are in the taxation year and in 2013 is of the number of days in the taxation year, and

(iii) 55% multiplied by the proportion that the number of days that are in the taxation year and after 2013 is of the number of days in the taxation year;

and

(e) for expenditures made by a taxpayer after 2013,

(i) section 37 of the Act be amended to exclude an expenditure in respect of the use or the right to use property that would, if it were acquired by the taxpayer, be capital property of the taxpayer,

(ii) paragraph 37(1)(b) of the Act be repealed,

(iii) subparagraphs (a)(i) and (iii) of the definition “qualified expenditure” in subsection 127(9) of the Act be repealed, and

(iv) section 127 of the Act be amended to exclude from the SR&ED qualified expenditure pool an expenditure in respect of the use or the right to use property that would, if it were acquired by the taxpayer, be capital property of the taxpayer.

<sup>7</sup> Federal Budget 2012 Notice of Ways & Means Motion  
<http://www.budget.gc.ca/2012/plan/anx4-2-eng.html>

# Murray Arlin Dentistry PC

- Tritan program to log dental implants
  - 200 variables
  - 50 used
  - 12,000 patient records
- Sole evidence for 2007 & 2008 was 2007 article
- Whether hypotheses required vs.
- Evidence of experimentation or analysis “performed.”

Hamilton Region SR&ED Practitioners Group 2012

## **Group discussion – summary of significant comments**

### **Direct comments from the group:**

“I’m surprised they weren’t able to find any history in the Triton DIMS program itself.

<http://triton-sys.com/Page2.html>”

“The dentist was not able to remember exactly when he did the analysis - the verbal and documentation with both doubtful if done in the right timeframe.”

“This case still leaves several questions. If the correct evidence had been identified it could have gone differently.”

## **2012-3: Recent SR&ED tax cases** **& related issue(s)**

Copies of the judgments are available from the Tax Court of Canada's website.<sup>8</sup>

### **Murray Arlin Dentistry PC – adequate documentation<sup>9</sup>**

#### **Facts:**

The appellant is a professional corporation that operates the dental practice which specializes in implants.

Fifteen years ago, Dr. Arlin purchased a computer software program called the Tritan Dental Implant Management System, which is designed to track the success rate of various types of dental implants.

Dr. Arlin uses the software to compare the success rate of implants in different circumstances. Some of **the variables relate to the patients' circumstances** (e.g. smokers versus non-smokers) and other variables to the **characteristics of the implant device**.

The program contains approximately 200 potential inputs for every implant. According to the testimony, Dr. Arlin uses about 50 of these. Currently he has records for approximately 12,000 implants.

Dr. Arlin believes that by studying this data he can provide a useful addition to scientific knowledge.

Dr. Arlin estimated that he spent 350 hours per year on SR&ED since Fridays were spent on research when he does not see patients.

#### **Evidence of experimentation or analysis**

Dr. Arlin testified that he updated his research for all of his lectures.

The judge also noted that;

- a) this testimony was very brief
- b) should have provided greater detail and documentary support &
- c) many of the **lectures** were
  - not given to implant specialists &
  - had a **marketing component**.

#### **Issue(s):**

- 1) whether there was systematic investigation &
- 2) whether the allocation of Dr. Arlin's time was reasonable.

#### **Relevant legislation and analysis:**

A significant focus at the hearing was on the requirement of "systematic investigation" in the definition of SR&ED<sup>10</sup> in Income Tax Act.

The CRA argued the research is not sufficiently documented to qualify as "systematic investigation" since;

- a) Dr. Arlin "failed to develop specific **hypotheses prior to the data collection &**
- b) there is **insufficient evidence of time spent** by Dr. Arlin on research in the relevant years.

#### **Ruling & rationale: loss due to lack of documentation**

The judge;

- a) was "reluctant to agree with" the requirement for "hypotheses [to be] determined prior to the data collection" however,
- b) "the main problem ... very little detailed evidence regarding the analysis done in the years at issue and the time spent."

She stated that,

"the Tritan program is designed to present comparative tables at the press of a button. The actual time spent on applied research potentially might be very small....

In order to support the appellant's claims, the evidence as to actual research done, and the amount of time spent, would have to be much more detailed."

<sup>8</sup> Tax Court of Canada website [www.tcc-cci.gc.ca]

<sup>9</sup> Murray Arlin Dentistry Professional Corporation v. The Queen - Tax Court of Canada, 2012 TCC 133, Informal procedure

<sup>10</sup> Income Tax Act subsection 248(1)

### Implications and author's commentary

Though the judge did not require pre-stated hypotheses these might have helped the situation as far as relevant evidence.

The biggest disappointment in this case was the claimant's inability to provide any real evidence of experimentation or analysis.

We are told they provided a single research article which was published in 2007 in order to support claims for the 2007 and 2008 taxation years. Clearly the 2007 article could NOT have dealt with the 2008 work and perhaps not even 2007 work.

### Results vs. Conclusions:

Basically Dr. Arlin's system was able to illustrate "what" happened however he did not appear to have any written evidence attempting to document;

Why these results occurred &

How any conclusions were formulated.

### Evidence examples

The following list illustrates the types of evidence which are typically used to substantiate these types of claims. If Dr. Arlin had provided any of these they would have been excellent supporting documentation.

**Notebooks** – dated daily with brief, **point form notes of hypotheses, related analysis & time spent**

**Emails** – correspondence with the suppliers & colleagues regarding any hypotheses & analysis.

**Test Reports** – any queries from the Tritan system which were used to analyze hypotheses.

### Defining the SR&ED hypotheses

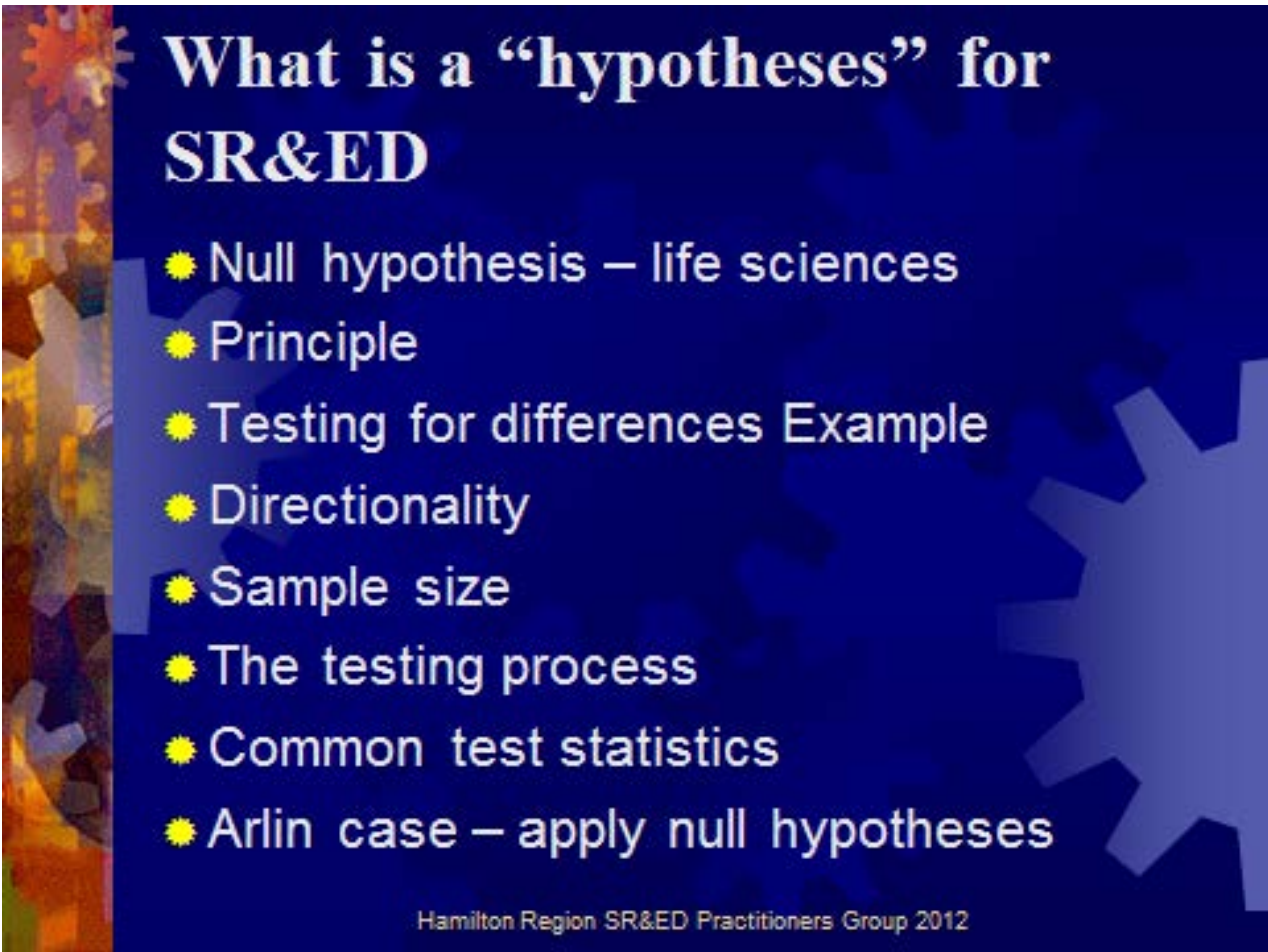
This is probably one of the most important and misunderstood sections of the SR&ED process.

To address this issue further in the next section we have outlined some of the key issues and opportunities in defining the "hypotheses for SR&ED purposes."

### Notable quote:

**"The general advice concerning statistics is, figures never lie, but liars figure"**

**-Anonymous**



# What is a “hypotheses” for SR&ED

- Null hypothesis – life sciences
- Principle
- Testing for differences Example
- Directionality
- Sample size
- The testing process
- Common test statistics
- Arlin case – apply null hypotheses

Hamilton Region SR&ED Practitioners Group 2012

# What is a “hypotheses” for SR&ED

## Null hypothesis<sup>11</sup>

The practice of science involves formulating and testing hypotheses, assertions that are capable of being proven false using a test of observed data.

The null hypothesis typically corresponds to a general or default position. For example, the null hypothesis might be that there is no relationship between two measured phenomena or that a potential treatment has no effect.

The term was originally coined by English geneticist and statistician Ronald Fisher in 1935. It is typically paired with a second hypothesis, the alternative hypothesis, which asserts a particular relationship between the phenomena.

## Principle

Hypothesis testing works by collecting data and measuring how likely the particular set of data is, assuming the null hypothesis is true.

For instance, a certain drug may reduce the chance of having a heart attack. Possible null hypotheses are

"this drug does not reduce the chances of having a heart attack" or

"this drug has no effect on the chances of having a heart attack".

The test of the hypothesis consists of administering the drug to half of the people in a study group as a controlled experiment.

If the data show a statistically significant change in the people receiving the drug, the null hypothesis is rejected.

## Testing for differences

In scientific and medical research, null hypotheses play a major role in testing the significance of differences in treatment and [control](#) groups.

The typical null hypothesis at the outset of the experiment is that no difference exists between the control and experimental groups (for the variable being compared). Other possibilities include:

- that values in samples from a given population can be modeled using a certain family of [statistical distributions](#).
- that the [variability](#) of data in different groups is the same, although they may be centered around different values.

## Example

Given the test scores of two random [samples](#) of men and women, does one group differ from the other? A possible null hypothesis is that the mean male score is the same as the mean female score:

$$H_0: \mu_1 = \mu_2$$

where:

$H_0$  = the null hypothesis

$\mu_1$  = the mean of population 1, and

$\mu_2$  = the mean of population 2.

A stronger null hypothesis is that the two samples are drawn from the same population, such that the variance and shape of the distributions are also equal.

A **one-tailed hypothesis** is a hypothesis in which the value of a parameter is specified as being either:

- above a certain value, or
- below a certain value.

An example of a one-tailed null hypothesis would be that, in a medical context, an existing treatment, A, is no worse than a new treatment, B.

The corresponding alternative hypothesis would be that B is better than A. Here if the null hypothesis were accepted (i.e. there is no reason to reject the hypothesis that A is at least as good as B), the conclusion would be that treatment A should continue to be used.

If the null hypothesis were rejected, the result would be that treatment B would be used in future, given that there is evidence that it is better than A.

A hypothesis test would look for evidence that B is better than A, not for evidence that the outcomes of treatments A and B are different.

Formulating the hypothesis as a "better than" comparison is said to give the hypothesis **directionality**.

## Directionality

Quite often statements of point null hypotheses appear not to have a "directionality", namely, that values larger or smaller than a hypothesized value are conceptually identical.

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<sup>11</sup> From Wikipedia, the free encyclopedia

However, null hypotheses can and do have "direction"—in many instances statistical theory allows the formulation of the test procedure to be simplified, thus the test is equivalent to testing for an exact identity.

For instance, when formulating a one-tailed alternative hypothesis, *application of Drug A will lead to increased growth in patients*, then the true null hypothesis is the opposite of the alternative hypothesis, i.e. *application of Drug A will not lead to increased growth in patients* (a composite null hypothesis).

The effective null hypothesis will be *application of Drug A will have no effect on growth in patients* (a point null hypothesis).

## **The testing process**<sup>12</sup>

In the statistical literature, statistical hypothesis testing plays a fundamental role.[8][*citation needed*]

The **usual line of reasoning** is as follows:

1. There is an initial research hypothesis of which the truth is unknown.
2. The first step is to state the relevant **null and alternative hypotheses**. Specifically, the null hypothesis allows to attach an attribute: it should be chosen in such a way that it allows us to conclude whether the alternative hypothesis can either be accepted or stays undecided as it was before the test.
3. The second step is to consider the statistical assumptions being made about the sample in doing the test; for example, assumptions about the statistical independence or about the form of the distributions of the observations.
4. Decide which test is appropriate, and state the relevant **test statistic  $T$** . – SEE DETAILS ON NEXT PAGE
5. Derive the distribution of the test statistic under the null hypothesis from the assumptions. In standard cases this will be a well-known result.

For example the test statistic may follow a Student's  $t$  distribution or a normal distribution.

6. The distribution of the test statistic partitions the possible values of  $T$  into those for which the null hypothesis is rejected, the so called critical region, and those for which it is not.

7. Compute from the observations the observed value  $t_{obs}$  of the test statistic  $T$ .

8. Decide to either **fail to reject** the null hypothesis or **reject** it in favor of the alternative.

The decision rule is to reject the null hypothesis  $H_0$  if the observed value  $t_{obs}$  is in the critical region, and to accept or "fail to reject" the hypothesis otherwise.

An **alternative process** is commonly used:

6. Select a significance level ( $\alpha$ ), a probability threshold below which the null hypothesis will be rejected. Common values are 5% and 1%.
7. Compute from the observations the observed value  $t_{obs}$  of the test statistic  $T$ .
8. From the statistic calculate a probability of the observation under the null hypothesis (the p-value).
9. Reject the null hypothesis or not. The decision rule is to reject the null hypothesis if and only if the p-value is less than the significance level (the selected probability) threshold.

### **Choice of testing process**

The two processes are equivalent. The former process was advantageous in the past when only tables of test statistics at common probability thresholds were available. It allowed a decision to be made without the calculation of a probability. It was adequate for classwork and for operational use, but it was deficient for reporting results.

The latter process relied on extensive tables or on computational support not always available. The explicit calculation of a probability is useful for reporting. The calculations are now trivially performed with appropriate software.

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<sup>12</sup> Statistical hypothesis testing - Wikipedia, the free encyclopedia Page 5 of 22  
[http://en.wikipedia.org/wiki/Statistical\\_hypothesis\\_testing](http://en.wikipedia.org/wiki/Statistical_hypothesis_testing) 5/28/2012



## Common test statistics

In order to address the null hypotheses a series of analytical methods are applicable:

**One-sample tests** are appropriate when a sample is being compared to the population from a hypothesis. The population characteristics are known from theory or are calculated from the population.

**Two-sample tests** are appropriate for comparing two samples, typically experimental and control samples from a scientifically controlled experiment.

**Paired tests** are appropriate for comparing two samples where it is impossible to control important variables. Rather than comparing two sets, members are paired between samples so the difference between the members becomes the sample. Typically the mean of the differences is then compared to zero.

**Z-tests** are appropriate for comparing means under stringent conditions regarding normality and a known standard deviation.

**T-tests** are appropriate for comparing means under relaxed conditions (less is assumed).

**Tests of proportions** are analogous to tests of means (the 50% proportion).

**Chi-squared tests** use the same calculations and the same probability distribution for different applications:

- [Chi-squared tests](#) for **variance** are used to determine whether a normal population has a specified variance. The null hypothesis is that it does.
- Chi-squared tests of **independence** are used for deciding whether two variables are associated or are independent.
- Chi-squared **goodness of fit** tests are used to determine the adequacy of curves fit to data. The null hypothesis is that the curve fit is adequate.

[F-tests](#) (analysis of variance, ANOVA) are commonly used when deciding whether groupings of data by category are meaningful. If the variance of test scores of the left-handed in a class is much smaller than the variance of the whole class, then it may be useful to study lefties as a group. The null hypothesis is that two variances are the same - so the proposed grouping is not meaningful.

## Sample size

Statistical hypothesis testing involves performing the same experiment on multiple subjects. The number of subjects is known as the [sample size](#). The properties of the procedure depends on the sample size.

Even if a null hypothesis does not hold for the population, an insufficient sample size may prevent its rejection. If sample size is under a researcher's control, a good choice depends on

- the [statistical power](#) of the test,
- the [effect size](#) that the test must reveal and
- the desired [significance level](#).

The statistical power is the probability of rejecting the null hypothesis when it does not hold in the population (i.e., for a particular effect size).

The significance level is the probability of rejecting the null hypothesis when the null hypothesis holds in the population.

According to published theory, “**Generally fewer than 30 trials puts any conclusion at risk.**”

## Further issues in health science studies

Biostats uses basic statistics only as a foundation.

Biological variability results in developing stats applications well beyond those that have been listed & generally requires advice from a biostats practitioner.

Each study has to tailor its stats tools to the overall objectives & intended approach of the study (e.g.,

- different applications/premises used to identify
- causal agents affecting health in epidemiology vs.
- determining potential health outcomes in treatment studies, etc.).

then study specific objectives including,

- calculation of adequate population size,
- methodology (inclusion/exclusion criteria, type & number of biomarkers, cohort assignment, etc.) &
- statistical analyses methods which are inextricably linked.

A study protocol that incorporates all these facets prior to embarking on data collection is a key component of an eligible study.



## **Arlin case revisited– application of null hypotheses**

Based on the facts as provided it appears Dr. Arlin may have required a null hypothesis to use as the basis for:

Each set of circumstances/conditions that would potentially influence success/no-success (smoker / non-smoker / diabetic / immuno-compromised /plaque profile /etc.);

Each condition would represent a different cohort and inclusion/exclusion criteria need to be specified;

Outline statistical analyses for data with associated calculation of target population size (would need to identify a control for comparative purposes for each cohort);

Ongoing data development is SR&ED eligible, so annual reviews of data/trends necessary to maintain continuity and demonstrate analysis.

The above represents demonstration of systematic approach flowing from the null hypotheses, then

- time can be allocated by patient enrollment/visitations
- within any given year specific to intervention requirements including;
  - dentist /assistant for data collection &
  - annual analysis review).

Much of this would be present in the patient records, it's the ongoing analyses that are key.

### **Author's note:**

Records relating to of any of these tests would be strong evidence of SR&ED.

As previously noted, had Dr. Arlin produced such records he would likely have been successful in his claim.

# 2012 Provincial SR&ED updates

- Manitoba – 20% ITC
  - Currently 5% refundable all corps
  - Increase to 10% refundable
- Saskatchewan – 15% ITC
  - Currently refundable all corps
  - > Mar 31, 2012 refundability restricted to CCPC's up to \$3 million exp. Limit

Hamilton Region SR&ED Practitioners Group 2012

## **2012 Provincial SR&ED updates**

So far the provincial budgets have been released for BC, Saskatchewan, Manitoba, Ontario & Quebec.

The only significant provincial changes to the SR&ED Tax Credit

### **Manitoba**

The Manitoba SR&ED tax credit (ITC) rate remains 20%; however the budget provides a reminder that starting 2012 the refundable portion of the ITC will be 10% (up from 5% in 2011).


### **Saskatchewan**

Saskatchewan introduced measures to make the province's Research and Development Tax Credit non-refundable, except for certain Canadian-controlled private corporations (CCPCs);

Currently, Saskatchewan provides a 15% refundable Research and Development (R&D) Tax Credit for all corporations.

For R&D expenditures incurred after March 31, 2012:

- a 15% refundable R&D tax credit can be claimed by CCPCs on up to \$3 million of qualifying expenditures annually; and
- a 15% non-refundable credit can be claimed on qualifying expenditures incurred by: CCPCs exceeding the above limit and other corporations.



## **International Def'n of Qualified Projects (Scientific Method)**

- Phase 0: Eligible fields of S&T (OECD)
- Phase 1: Objectives > “Standard Practice”
- Phase 2: Variables of Technological Uncertainty
- Phase 3: “Systematic” Experimentation
- Putting it all together – the Project template

## 2012-4

# International R&D Tax Credits

Often companies perform eligible research in several countries.

A detailed review of the government funding methods in most countries illustrates that almost all countries use a similar definition of the R&D project and thus the eligible activities.

### History of the international definition

The **Frascati Manual** is a document setting forth the methodology for collecting statistics about research and development. The Manual was prepared and published by the Organisation for Economic Co-operation and Development (OECD).

In June 1963, OECD experts met with the NESTI group (National Experts on Science and Technology Indicators) at the Villa Falconieri in Frascati, Italy. Since then it has been revised several times. In 2002 the 6th edition was published.

The manual sets forth fundamental definitions for: basic research, applied research, and research & development. It also organizes Fields of science into main and sub-categories.

Over the past 40 years, the NESTI group has developed a series of documents, known as "Frascati Family", which includes manuals on:

- R&D (Frascati Manual),
- innovation (Oslo Manual),
- human resources (Canberra Manual),
- technology balance of payments and patents as science and technology indicators.

Originally an OECD standard, it has become an acknowledged standard in R&D studies all over the world and is widely used by various organisations associated with the United Nations and European Union.

### Three forms of research

The Frascati Manual outlines three forms of research. These are basic research, applied research and experimental development:[1]

1. **Basic research** is experimental or theoretical work undertaken primarily to acquire new knowledge of the underlying foundation of phenomena and observable facts, **without any particular application or use in view.**
2. **Applied research** is also original investigation undertaken in order to acquire new knowledge but **directed towards a specific practical aim or objective.**
3. **Experimental development** is systematic work, drawing on existing knowledge gained from research and/or practical experience, which is directed to producing **new materials, products or devices**, to installing new processes, systems and services, or to improving substantially those already produced or installed.

### Definition of Qualified Activities via Eligible Projects (Scientific Method)

“For a ... project to be classified as R&D, its completion must be dependent on a scientific &/or **technological advance**, the aim of the project must be the **systematic resolution** of a scientific and/or **technological uncertainty**.”<sup>13</sup>

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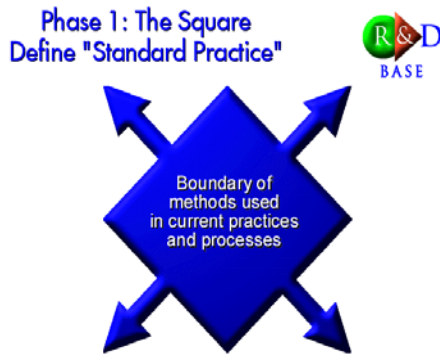
<sup>13</sup> Frascati Manual 2002 paragraph 135

## **Phase 0: Defining Eligible Fields of Science or Technology**

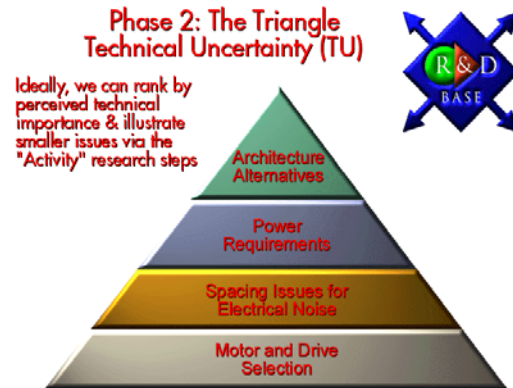
### Fields of science - OECD classifications 2007

<b>1. Natural Sciences</b>	1.1 Mathematics 1.2 Computer and information sciences 1.3 Physical sciences 1.4 Chemical sciences 1.5 Earth and related environmental sciences 1.6 Biological sciences 1.7 Other natural sciences	<b>ELIGIBLE for R&amp;D tax credits</b>
<b>2. Engineering &amp; Technology</b>	2.1 Civil engineering 2.2 Electrical engineering, electronic engineering, information engineering 2.3 Mechanical engineering 2.4 Chemical engineering 2.5 Materials engineering 2.6 Medical engineering 2.7 Environmental engineering 2.8 Environmental biotechnology 2.9 Industrial Biotechnology 2.10 Nano-technology 2.11 Other engineering and technologies	
<b>3. Medical &amp; Health Sciences</b>	3.1 Basic medicine 3.2 Clinical medicine 3.3 Health sciences 3.4 Health biotechnology 3.5 Other medical sciences	
<b>4. Agricultural Sciences</b>	4.1 Agriculture, forestry, and fisheries 4.2 Animal and dairy science 4.3 Veterinary science 4.4 Agricultural biotechnology 4.5 Other agricultural sciences	
<b>5. Social Sciences</b>	5.1 Psychology 5.2 Economics and business 5.3 Educational sciences 5.3 Sociology 5.5 Law 5.6 Political Science 5.7 Social and economic geography 5.8 Media and communications 5.7 Other social sciences	<b>NOT ELIGIBLE for R&amp;D tax credits</b>
<b>6. Humanities</b>	6.1 History and archaeology 6.2 Languages and literature 6.3 Philosophy, ethics and religion 6.4 Art (arts, history of arts, performing arts, music) 6.5 Other humanities	

## Phase 1: Objectives Beyond “Standard Practice”



## Phase 2: Variables of Technological Uncertainty



### A) Define industry “standard practice”

“The basic criterion for distinguishing R&D from related activities is the presence in R&D of an appreciable element of novelty and the resolution of scientific and/or technological uncertainty,

i.e. when the solution to a problem is **not readily apparent to someone familiar with the basic stock of common knowledge** and techniques for the area concerned.”<sup>14</sup>

### B) Technological objective beyond standard practice

“... If the primary objective is to make **further technical improvement** on the product or process then the work comes within the definition of R&D ..... if the primary objective is to develop markets, to do preproduction’s planning or control system working smoothly, then the work is no longer R&D.”<sup>15</sup>

“The basic criterion for distinguishing R&D from related activities is the presence in R&D of an appreciable element of novelty and the resolution of **scientific and/or technological uncertainty**,

i.e. when the solution to a problem is not readily apparent to someone familiar with the basic stock of common knowledge and techniques for the area concerned.”<sup>16</sup>

The paper includes some supplementary criteria for distinguishing R&D:

- What is new or innovative about this project?
- Is it seeking previously undiscovered phenomena, structures or relationships?
- Does it apply knowledge or techniques in a new way?
- Is there a significant chance that it will result in new (extended or deeper) understanding of phenomena,
- relationships or manipulative principles of interest to more than one organization
- Are the results expected to be patentable?

<sup>14</sup> Frascati Manual 2002 paragraph 84

<sup>15</sup> Frascati Manual (2002) proposed standard practice for survey on research and experimental development Paragraph 111

<sup>16</sup> Frascati Manual 2002 paragraph 84



### Phase 3: Process of “Systematic” Experimentation



“Research and experimental development is **creative work undertaken systematically** to increase the stock of knowledge, including knowledge of humanity, culture and society, and the use of this stock of knowledge to devise new applications.”<sup>17</sup>

Research has been defined in a number of different ways. "In the broadest sense of the word, the definition of research includes **any gathering of data, information and facts for the advancement of knowledge.**"<sup>18</sup>

Generally, research is understood to follow a certain structural process including<sup>19</sup>:

- Observations and Formation of the Objective
- Hypothesis: A testable prediction which designates the relationship between two or more variables.
- Gathering, Analysis & Interpretation of data
- Test, revising of hypothesis
- Conclusion, reiteration if necessary

### Implications to R&D Tax Credit Claimants: The Project Template (next page)

The Frascati directives and requirements indicate the following project documentation methodology:

- If researcher teams can compile this information,
- they should be able to claim related tax credits,
- in ANY related country.
- Examples of completed R&D projects by country are available at [www.rdbase.net](http://www.rdbase.net)

### Notable quote:

**“They always say time changes things, but you actually have to change them yourself.”**

**- Andy Warhol**

<sup>17</sup> (OECD (2002) Frascati Manual: proposed standard practice for surveys on research and experimental development, 6th edition

<sup>18</sup> Wikipedia definition of “Research”

<sup>19</sup> Wikipedia definition of “Scientific Method”



## Putting it all together – The Project Template

### RDBASE.NET template for claiming tax credits internationally



#### **I** PROJECT OBJECTIVE BEYOND STANDARD PRACTICE:

**GOAL is to prove to Government (CRA, IRS, etc.) :**

##### **i) State of Existing technology: Benchmarking methods & sources**

*Technology limits of "readily available" information to someone "skilled in the art."*

	<u>Number (#) of</u>	
i Internet / Google Searches	_____	internet sites
ii Articles	_____	articles
iii Patent searches	_____	patents
iv Competitive methods	_____	products / processes
v In-house technologies	_____	products / processes
vi Potential components	_____	products
vii Queries to experts	_____	responses
viii Other	_____	

##### **ii) Objective(s)**

##### **Performance benchmarks (top 5)\***

*Quantifiable Objectives beyond known limits*

	<u>Benchmark 1</u>	<u>Benchmark 2</u>
i Existing benchmark	_____	_____
ii Units of measure	_____	_____
iii Performance objective	_____	_____
iv <i>Result (III below)*</i>	_____	_____

#### **II** TECHNOLOGICAL UNCERTAINTIES

*Using "science" to formulate hypotheses & experiments*

##### **Variables for experimentation (top 5)\*\***

	<u>Variable 1</u>	<u>Variable 2</u>
Name of variable	_____	_____

#### **III** EXPERIMENTAL ACTIVITY

*Defined by tax year\**

##### **i) Experimentation method**

##### **Number of**

*Justify sample sizes via "variables"*

i Analysis / simulation	_____	alternatives
ii Process trials	_____	runs / samples
iii Prototypes	_____	samples
prototype revisions	_____	revisions

*Quickest*

*Longer*

*Longest*

##### **ii) Analysis**

i Results	_____	* vs. Objectives I
ii Conclusions	_____	** on Variables II
iii Documentation	_____	Experiments/Analysis

*Identify the unexpected  
Attempt understand "why?"  
Proof experiments & costs*

##### **iii) Direct Costs**

i Wages	_____	Hours / Employee
ii Contractors	_____	Labour \$ / Contractor
iii Materials	_____	Consumed/transformed

*\* PROJECTS span multiple years but  
ACTIVITIES match tax years.*

# R&D funding by country

- Comparison of
  - Beta indices
  - Overall funding
  - Proportions
    - Direct (grants / procurement) vs.
    - Indirect (tax credits)

## Comparing R&D Funding by Country<sup>20</sup>

If we want to make a rough comparison of Canada's funding vs. other industrialized countries we can use a ration named the "Beta Index" ( B-Index).

It is calculated as:

After tax cost of \$1 of R&D / (1- tax rate)

Simply stated:

B-Index is the before-tax income needed to break even on one dollar of R&D spent.

The **lower** the B-Index the more **favorable** it is for a company to perform R&D in a particular country.

As we can see from this comparative that Canada does in fact have one of the lowest B-Indices however, **many countries provide other "direct" funding** instead of "tax incentives."

The OECD report provides a further comparison of the total % of "Business Expenditures on Research & Development" (BERD) which are financed by the government (next page).

### Notable quote:

**"He who asks a question is a fool for 5 minutes.**

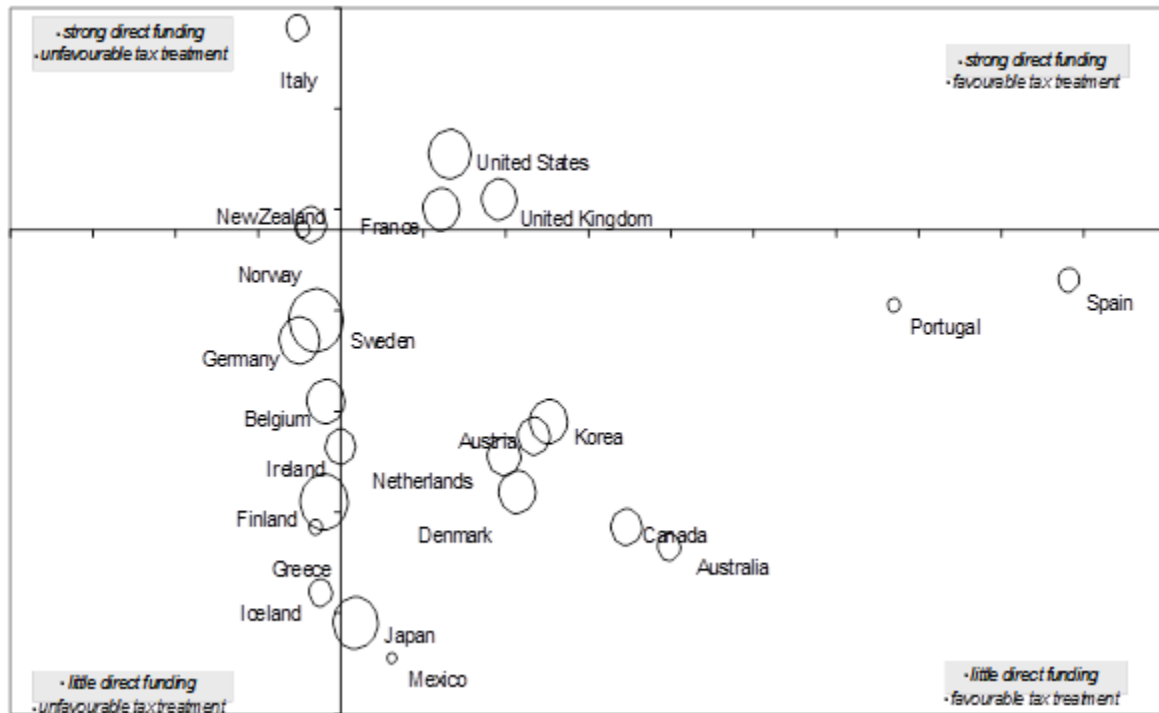
**He who does not ask a question remains a fool forever."**

**- Chinese proverb**

<b>Comparing the value of B-indexes 2002</b>		
(manufacturing companies, by country)		
<b>Country</b>	<b>Large company</b>	<b>Small company</b>
Australia	0.801	0.801
Austria	0.875	0.875
Belgium	1.009	1.006
<b>Canada</b>	<b>0.827</b>	<b>0.678</b>
Denmark	0.893	0.893
Finland	1.01	1.01
France	0.939	0.939
Germany	1.025	1.025
Greece	1.015	1.015
Iceland	1.012	1.012
Ireland	1	1
Italy	1.026	0.557
Japan	0.991	0.879
Korea	0.874	0.821
Mexico	0.969	0.969
Netherlands	0.901	0.647
New Zealand	1.023	1.023
Norway	1.018	0.768
Portugal	0.665	0.665
Spain	0.559	0.559
Sweden	1.015	1.015
Switzerland	1.01	1.01
United Kingdom	0.904	0.894
United States	0.934	0.934

<sup>20</sup> Tax Incentives for Research and Development: Trends and Issues, OECD, 2002

**Government funding of business (OECD)**  
**Direct (Grants) vs. Indirect (Tax Credits)**



**Authors Analysis & commentary:**

This table indicates that the Canadian government finances approximately 4% of total business research whereas most other countries are significantly higher (e.g. France, US & UK are all >10%).

As a result it appears that the Canadian government is not nearly as generous as other countries in funding SR&ED.

Despite this fact the SR&ED credit appears to have created a scenario where a smaller amount of funding is in fact creating a significant amount of SR&ED.

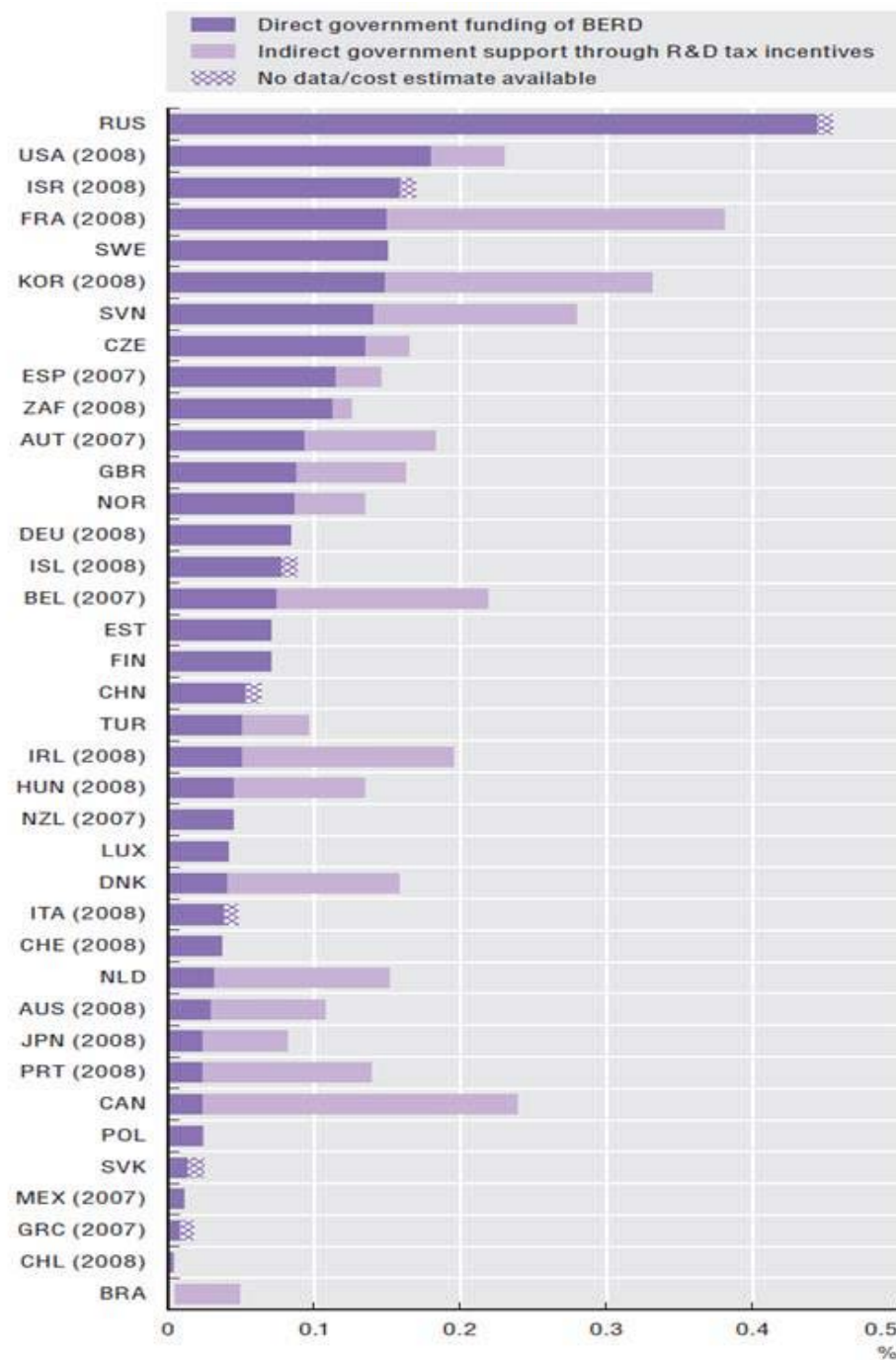
The next page provides a comparison of the funding provided directly (grants & contracts) vs. indirectly (tax credits). NOTE: These balances **do NOT** include “military & defence” related R&D spending.

**Notable quote:**

**“The best way to have a good idea is to have a lot of ideas.”**

**- Dr. Linus Pauling**

## Government Funding of Business R&D - Direct vs. Tax Credits<sup>21</sup>



Source: OECD, based on OECD R&D tax incentives questionnaires, January 2010 and June 2011; and OECD, Main Science and Technology Indicators Database, June 2011. See chapter notes.

<sup>21</sup> OECD SCIENCE, TECHNOLOGY AND INDUSTRY SCOREBOARD 2011 © OECD 2011

## Charging of Contingent fees by R&D tax consultants

- Canada contemplating regulation of fees for consultant support
  - How to define services (technical, tax, IP, funding,...)
  - What is a contingent fee vs. warranty
  - Question on rates
- US perspective - Ryan LLC challenge to IRS legality of contingent fees



## Contingent Fees Charged by R&D Tax Consultants

### Canada contemplating regulation of fees for consultant support

Changes are expected to limit consultants' share of the SR&ED credit as Ottawa expresses concern that too much federal science cash is flowing outside the "intended" sector.

On August 3, 2012 Finance Minister Flaherty announced,

"We continue to strive to make improvements to the administration of the SR&ED program and look forward to hearing from taxpayers and tax preparers on any initiatives that could allow us to make further progress.

The consultations seek input from stakeholders to better understand:

- Why firms hire third-party tax preparers on a contingency-fee basis;
- why these tax preparers charge contingency fees;
- the prevalence of this practice;
- the amounts charged; and
- the impacts of this practice on the effectiveness of the SR&ED tax incentive program.

The [attached document](#) provides guidance for the consultation.

Related Document<sup>22</sup>: Consultation Regarding the Impact of Contingency Fees on the Effectiveness of the Scientific Research and Experimental Development Tax Incentive Program."

Stakeholders are invited to provide comments by October 1, 2012 to SRED-Consultations to [RSDE@fin.gc.ca](mailto:RSDE@fin.gc.ca) or:

SR&ED Consultations  
Department of Finance  
140 O'Connor Street  
Ottawa, Ontario  
K1A 0G5

### Author's personal experience, examples & opinions

#### Facts & Issues:

3) **Client choice** - I have practiced in the SR&ED field since 1993. From 1993 to 2000 I worked on some of the largest SR&ED files in Canada on an hourly or flat fee basis.

On almost all hourly agreements "sophisticated" clients required a budget and authorization before incurring any fee overruns. In reality these resulted in "flat fees."

When I left partnership and started MEUK Corporation I decided to offer clients all 3 billing options:

- Hourly
- Flat Fee
- % of Recovery

I have **clients who prefer each of these options** for various reasons.

4) **Needless complexity** - As the co-author of the SR&ED course for the Canadian Institute of CA's and seminar leader for the past 15 years I can say that I spend over 30 minutes explaining just the rules on "specified employees."

The course itself runs a full 8 hours and only provides an overview of many "complex" issues.

Most CA's walk out of the course claiming it is;

- needlessly complicated &
- one of the most confusing areas of income tax they have ever explored.

The result is that they tend to charge a minimum \$5,000 for compilation of the SR&ED related tax forms, assuming the client prepares the technical (project) descriptions.

3) **Related liability** - Worse yet I have seen lawsuits for millions of dollars against CA's for failure to adequately;

- plan or complete the SR&ED forms
- within required deadlines.

<sup>22</sup> <http://www.fin.gc.ca/activity/consult/sred-rsde-eng.asp>

### Analysis:

My experiences on billing methods is that each has its own pros & cons however, it is ultimately the claimant who should be empowered with choice.

The majority (approximately 80%) of first time claimants, under \$100,000 of ITC's prefer to use the % recovery in the first year.

The % fees for this work range from 2-20% of recovery dependent on the nature of the work and range of services provided.

I have some flat fee clients who's fees (including costs to plan & complete the project descriptions & income tax forms) are <2% of total credits.

Fees at the higher end of this fee range tend to be paid by clients with weaknesses in the SR&ED documentation systems.

Most clients will not pay aggressive fees for services which they believe they can perform on their own.

If the free market willing to pay high fees for product or service it is because they perceive high value.

### Related recommendations:

The **free market** is likely the best mechanism to determine the fair price of any service commodity.

It should be the client's choice which method of billing & payment best meets their business needs.

As a result the government should not attempt to regulate the fee or service providers other than as to quality of work.

The Jenkins and other current SR&ED reports recommend, "streamlining the SR&ED claim system."

***If the government policy makers & CRA wish to reduce the fees consultants charge all they need do is simplify the "perceived" current complexity of the program.***

## US Perspective - Ryan LLC Challenge to IRS Legality of Contingent Fees<sup>23</sup>

Since 2007 the IRS has prohibited the use of contingent fees for R&D tax credit consultants. These restrictions are outlined in IRS Circular 230.

This has resulted in a backlash by many US practitioners.

The related issues appear to be universal and have been outlined clearly in a recent complaint filed by one such practitioner.

On April 11, 2012 Ryan LLC filed suit in the U.S. District Court seeking judgment that the IRS has;

- exceeded the scope of authority to regulate the practice of CPAs before the IRS &
- requesting a permanent injunction against the IRS enforcing such provisions of Circular 230 to regulate the practice of CPA's.

Ryan, a US CPA firm which provides global tax services, alleges that the contingent fee restrictions imposed on practitioners in 2007 amendments to Circular 230 are unconstitutional because they;

- unconstitutionally restrict the ability of taxpayers to pursue Ordinary Refund Claims with the IRS in violation of the petition Clause of the First Amendment of the United States Constitution.
- exceed the scope of regulation authorized in the statute.

### Author's commentary:

Given that the USA is regarded as a leader in the concept of "free market" forces vs. government control and regulation it appears ironic that they would favor the "regulation" method to decide such policies.

As this issue gains momentum in Canada we expect to see harmonization of the results in the US and internationally.

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<sup>23</sup> Full complaint as filed by Ryan LLC (69 pages) - <http://www.ryan.com/Assets/Downloads/Complaint.pdf>



## Recent SR&ED tax cases & related issue(s)

- Bagtech (PWC Trustee) – CCPC status with > 50% foreign shareholders
- Ruling & rationale: win Unanimous Shareholders Agreement breaks control
- Implications:
  - See other similar cases (Perfect Fry)
  - ITA 256

## **Recent SR&ED Tax Cases & Related Issue(s)**

Copies of the judgments are available from the Tax Court of Canada's website.<sup>24</sup>

### **Bagtech (PWC Trustee) - CCPC Status with > 50% Foreign Shareholders<sup>25</sup>**

#### **Facts:**

Despite the fact that the "person" holds more than 50% of Class A shares of Bagtech, under the USA (Unanimous Shareholders Agreement), it could elect a majority of directors. According to the USA, these are residents of Canada who elect a majority of directors,

- 4 of 7 directors during 2004 and
- 4 of 8 directors during 2005.

#### **Issue(s):**

Can the terms of a USA for the election of directors of a corporation be taken into account in determining de jure & or defacto "control" of a company?

#### **Relevant legislation and analysis:**

It appears from paragraph 146 (1) of the CBCA four conditions in order that an agreement could be described as unanimous shareholder agreement.

- First, the agreement must, of course, be lawful and consistent with the general requirements of the contracts.
- Then, the agreement must be written, and it is important to clarify that this requirement is indeed a condition of validity, not only a question of evidence.
- It must also be signed by all shareholders of a corporation, either among themselves or with third parties.

- Finally, it must restrict in whole or in part the powers of directors to manage the business and affairs of society, or supervise the management.

### **Ruling & Rationale: win USA breaks control**

Based on the facts and legislation in question the judge concluded that the foreign "person" could not,

"control Bagtech within the meaning of the ITA<sup>26</sup> ... [with the result] the company is entitled to a "refundable investment tax credit."

#### **Implications and author's commentary:**

In Canada this issue tends to recur every 5-10 years (see Perfect Fry 2004).

The issue is also prevalent internationally due to the enhanced research tax incentives for domestic SME's (Small & Medium Sized Enterprises).

The rulings tend to vary so this will likely be an issue of contention for many years to come.

### **Notable quote:**

**"In every work of genius, we recognize our once rejected thoughts"**

**- Ralph Waldo Emerson**

<sup>24</sup> Tax Court of Canada website [www.tcc-cci.gc.ca]

<sup>25</sup> PWC Trustee for BIOARTIFICIAL GEL TECHNOLOGIES (BAGTECH) INC v. The Queen - Tax Court of Canada, 2012 CCI 120, Date : 20120412, Dossier : 2009-3734(IT)G

<sup>26</sup> paragraph b) of the definition of a CCPC in subsection 125 (7)

## **Group discussion – other issues - summary of significant comments**

### **Entitlement to Exploit criteria**

Background – It is sometimes unclear to claimant that they do not need to own all rights to a product in order to claim SR&ED. They do however need “entitlement to exploit” the results.

**Ensuring “entitlement to exploit”** - Canada Revenue Agency (CRA) directives on this issue have been provide in IT-151R5, para 37,

“...this requirement is considered to be met in cases where the taxpayer has the right to use a patent that results from the SR&ED project even if the taxpayer is charged a royalty or similar fee for the use of the patent. **This requirement is also considered to be met in cases where the taxpayer is entitled to distribute and market any product that results from the SR&ED project.**”

Per Russ Roberts: “This should be a non-issue. It has been clear for many years that claimants need not own the full rights to a product or process in order to meet the entitlement to exploit criteria.”

CRA response: “This should be addressed by the Financial Reviewer. Some of the RTA’s may still be confused on the issue.”

## **Questions or feedback**

We welcome your questions or feedback on any issues raised in this letter. Please email [dsabina@meuk.net](mailto:dsabina@meuk.net).

We also encourage interested parties to examine past SR&ED minutes& newsletters &

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