



SR&ED Newsletter Edition 2013 –2

Recent developments to Scientific Research & Experimental Development (SR&ED) project management & tax credit claims.

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Recent SR&ED tax cases

Cal Amp – bonuses linked to SR&ED - loss¹

Facts

During the year the company (CalAmp) paid bonuses to employees of a company it had acquired (Old Dataradio).

According to the court the evidence reveals that the bonuses were paid mainly on the basis of two factors:

- a) the belief by shareholders that salaried employees of an acquired company should share in the financial **success resulting from the sale of the company** &
- b) the corresponding benefit to the purchaser CalAmp Corp. of creating conditions which would favour the **retention of employees** following its acquisition of Old Dataradio.

The CRA reduced ITC's by \$131,260 on the basis that the amount \$1,990,036 (bonuses paid to its employees engaged in SR&ED) didn't constitute an expenditure of SR&ED.

Issue

Whether the company is entitled to an investment tax credit ("ITC") in respect of bonuses paid to these employees engaged in "SR&ED"?

Legislation & analysis

Income Tax Act

Under the proxy method, such as in the present case, salary and wages for SR&ED purposes are allowed under the Income Tax Act, as follows:

"that **portion** of an expenditure made in respect of an expense incurred in the year for salary or wages of an employee who is directly engaged in scientific research and experimental development in Canada

that can reasonably be **considered to relate** to such work having regard to the time spent by the employee thereon, [...]"²

CRA Guidance

"SR&ED Salary or Wages Policy"³, specifies that:

"There would be **no reasonable link** between the expenditure and the prosecution of SR&ED where, for example, an employee [...] receives:

- salary, including a bonus, when the income that was used to pay the amount was not earned from the ongoing, normal activities of the business.

This would include an amount paid to an employee that was earned from a **capital transaction** such as the sale of the business, the sale of shares or the sale of an asset. [...]"

Ruling & rationale (Judge's comment) - loss

"I must distinguish the method of calculating the bonuses from the reasons for paying the bonuses. The **reasons for paying the bonuses** will reveal whether there is a sufficient **nexus with SR&ED**.

In this case, the payment of the bonuses at issue was an isolated event and not the result of the application of Old Data radio's traditional policy in respect of Christmas bonuses.

[as a result], the Appellant has not shown the expenditures "as having a direct relationship with the research projects and also being essential to their completion[...]"

Author's comment: moderate significance

In the author's opinion this case shows the importance of **directly clarifying how any bonuses** to employees relate **to any related SR&ED** work performed.

Additional consideration should be taken to avoid structuring this remuneration as "royalties" or "commissions" which would also be excluded from SR&ED tax credit claims.⁴

¹ CalAmp Wireless Networks Inc. v. The Queen - 2013 TCC 201, Docket: 2010-3708(IT)G, June 25, 2013

² ITA subclause 37(8)(a)(ii)(B)(IV)

³ SR&ED Salary or Wages Policy, Canada Revenue Agency: December 19, 2012

⁴ ITA Regulation 2902 prescribed expenses

Lyrtek – CCPC status & defacto control - loss⁵

Facts

As a public corporation, Lyrtech claimed against its tax payable non-refundable investment tax credits at the rate of 20% of its eligible R&D expenditure account.

In 2005, Lyrtech restructured its business in order to transfer its R&D activities to a new corporation, the appellant (Lyrtek RD Inc.)

The majority of voting shares for Lyrtek RD Inc. were held in a trust. The trustees also controlled Lyrtek.

The terms and conditions of the research contract between Lyrtech and the appellant.

- was of indeterminate duration but Lyrtech could terminate it on 60 days' notice without providing any reason.

- Lyrtech determined what research work the appellant was to conduct

- the intellectual property resulting from this research work belonged to Lyrtech.

- For its research work, the appellant was entitled to receive only
 - 10% of the royalties Lyrtech collected on the sale of products resulting from the research work &
 - 25% of the proceeds from licences granted by Lyrtech.

Issues

The issue is whether the appellant was a "Canadian-controlled private corporation", as defined in subsection 125(7) of the Act.

Legislation & analysis

“Canadian-controlled private corporation” means a private corporation that is a Canadian corporation **other than**

(a) a corporation **controlled**, directly or indirectly **in any manner whatever**, by one or more **non-resident** persons, by one or more **public corporations** ... or by any combination of them,...

Ruling & rationale (Judge’s comment)- loss

“Taking all these facts into consideration, I find that Lyrtech exercised a **dominant economic influence** over the appellant.

The appellant was not an independent profit centre and could not survive or continue its activities without the financial support of Lyrtech.

The appellant could not finance itself without Lyrtech's help.”

Author’s comment: moderate significance

In the author’s opinion the concept of a separate company to perform the SR&ED was clever however the necessary structuring and financing steps were not followed.

One key step would be to provide a cost plus basis which allowed the SR&ED performer to illustrate a “reasonable expectation of profit.”

Much like a similar case ([Mimetex pharmaceuticals](#)), this case outlines the importance of structuring shareholders agreements to require a majority of the Canadian directors approval before making any major decisions.

Interestingly if such steps are taken these agreements may even override voting or “de jure” control held by foreign parties. See case of Bagtech⁶ in [newsletter 2012-4](#) for more details.

LYRTECH RD INC.,vs. THE QUEEN, 2013 TCC 12, Docket: 2009-1057(IT)G, January 24, 2013

⁶ PWC Trustee for BIOARTIFICIAL GEL TECHNOLOGIES (BAGTECH) INC v. The Queen - Tax Court of Canada, 2012 CCI 120, Apr. 4, 2012, Dossier : 2009-3734(IT)G

Immunovaccine – if repayable SR&ED loan “government assistance” - loss⁷

Facts

The appellant was incorporated in March 2000 as a research and development company to develop projects for the creation of vaccine technology.

The Atlantic Canada Opportunities Agency (ACOA) is a federal government funding agency which provided a contribution to the appellant of \$3,786,474, spread over four years (2005 through 2008), in respect of costs incurred to complete such projects.

The Minister determined the appellant’s entitlement to SR&ED tax credits on the basis that contributions received were “government assistance” within the meaning of subsection 127(9) of the ITA and reduced the claims accordingly.

Issues

The issue is whether the loans received by the appellant from ACOA were “government assistance” as defined in subsection 127(9) of the ITA.

Legislation & analysis

Income Tax Act

“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...⁸

Analysis

The appellant’s position is that the contribution from ACOA does not constitute government assistance within the meaning of but rather an ordinary loan advanced on reasonable terms for business purposes.

Ruling & rationale (Judge’s comment) - loss

“...the inclusion of “forgivable loan” in the definition suggests that “government assistance” would reflect Parliament’s intention to restrict access to tax relief for SRED expenditures and to RITCs where relief was provided in some other form.

Under such circumstances, it is reasonable to conclude that a contribution that is made by the government and is repayable may constitute “government assistance”.

I therefore disagree with the appellant that the common factor linking the terms enumerated in the definition of “government assistance” is that each represents a transfer of funds advanced with no expectation of repayment.”

Author’s comment: low significance

In the author’s opinion this case appeared somewhat frivolous and that the act is quite clear. Repayable loans which are issued for the purpose of research and development are to be treated as government assistance.

Having said this, the strategic issue in planning these contracts would be to tip the scale of risk to the performer instead of the government.

In other words **if the contractor assumes the majority of risk** for the SR&ED such payments will be treated as commercial payments rather than government assistance.

The **four criteria** will which the CRA and the tax courts will consider to determine whether such payment is “government assistance” include the following:

CRA “Assistance & Contract Payments Policy” Dec. 19, 2012

Definition of “contract payment” in subsection 127(9)

Positive indicators

- i) SR&ED Performance Required
- ii) Pricing based hourly
- iii) Intellectual Property (IP) to client
- iv) Contract for Services

Negative indicators

- Contract not explicit wrt SR&ED
- Pricing vs. Risks (ceiling)
- IP to performer
- Contract for Goods

In this case the funding contract was not treating the funds as “pre-payment” by an “end user” for the eventual product since it had clear links to the SR&ED work.

⁷ IMMUNOVACCINE TECHNOLOGIES INC. vs. THE QUEEN, 2013 TCC 103, Docket: 2011-245(IT)G, April 10, 2013

⁸ subsection 127(9) of the ITA

New SR&ED measures proposed by parliament

Budget 2013 – new reporting on SR&ED preparer fees

According to the Department of Finance,

“Budget 2013 introduces measures to provide the Canada Revenue Agency with new resources and administrative tools to better respond to **the minority of SR&ED program tax preparers and SR&ED performers** who participate in claims where the **risk of non-compliance** is perceived to be **high** and eligibility for the SR&ED program unlikely.”

Requirements

In particular, in instances where one or more third parties have assisted with the preparation of a claim,

- the Business Number of each third party
- details about the billing arrangements including
- whether contingency fees were used &
- the amount of the fees payable.

In instances where no third party was involved, the claimant will be required to certify that no third party assisted in any aspect of the preparation of the SR&ED program claim.

Penalty for non-compliance

Budget 2013 proposes that a new penalty of

- \$1,000 be imposed in respect of
- each SR&ED program claim for which
- information about SR&ED program
- tax preparers & billing arrangements is
- missing, incomplete or inaccurate.

The SR&ED program claimant and tax preparer will be jointly and severally liable for the penalty.

Timing of implementation

This measure will apply to SR&ED program claims filed on or after the **later of January 1, 2014** and the day of Royal Assent to the enacting legislation.

Author’s comment: low significance

Due to the fact that certain journalist published articles which “falsely” claimed that:

- upwards of \$1 billion / year
- is being paid to SR&ED consultants

the government has begun collecting information on these fees to confirm or deny whether these accusations have any merit.

These results will likely be used to determine:

- whether billings which are “contingent” on the success of the claim are in the interest of all parties &
- if any further regulation is thereby required.

Notable quote:

“Minds are like parachutes; they work best when open.”

- T. Dewar

Tax Court of Canada – informal appeal levels to rise – related SR&ED strategies

Overview

Currently all judgments that allow appeals under the informal procedure are limited to

- Taxes payable of \$12,000, or
- Taxable income of \$24,000.

Those amounts, \$12,000 and \$24,000, are increased to \$25,000 and \$50,000, respectively.⁹

Timing of implementation

The amendments apply with respect to appeals for which

- a notice of appeal is filed with the Tax Court
- after the day on which Royal Assent is received.

Author’s comment: high significance

As discussed in [newsletter 2012-5](#) this “informal procedure” strategy has some of the following advantages:

General Procedure (tax court)

- generally cost \$40,000+
- require use of a lawyer (tax litigator)
- take 3+ years during which
- subsequent SR&ED claims can be held up

Informal Procedure (tax court)

- \$100 application fee
- client or accountant can represent
- no lawyer required
- takes < 1 year
- limited to \$12,000 / year
- **provides legal precedent for future years**

As a result there are few incentives & huge barriers to prevent taxpayers from using the general procedure no matter how much their claim has merit.

Implications to claimants

In the author’s opinion the CRA desperately needs an arbitration method to get disputed claims settled **quickly**.

Sadly the informal procedure seems to be the best current method to achieve any type of “justice.”

<u>Typical dispute resolution steps & timelines</u>			
	<u>Step</u>	<u>Parties</u>	<u>Expected timeframe</u>
1	Negotiate with CRA reviewer	CRA & client	30 days
2	2nd admin. review	CRA & client	180 days
3	Objection	CRA & client	365 days
4	Tax Court of Canada		
	a) Appeal - Informal	CRA, Dept. of Justice client	6-9 months
	b) Appeal - General	CRA, Dept. of Justice client	2-3 years

Notable quote:

“Innovation is the ability to convert ideas into invoices.”

- L. Duncan

⁹ Notice of Ways and Means Motion , Explanatory Notes Relating to the Income Tax Act & the Tax Court of Canada Act, April , 2013, clauses 24 & 25

Status of current SR&ED legislation

Source	SR&ED related issue	Effective date	Status
2013 Federal Budget	penalty of \$1,000 for incomplete info about SR&ED tax preparation	1-Jan-14	Pending
2012 Federal Budget	Expenditure of a capital nature will no longer qualify for SR&ED tax incentives.	1-Jan-14	Now law
	Rate of overhead under the proxy method reduced from 65% to 55% over a two year period.	Expenditures after 2012	Now law
	Contract SR&ED & third-party payments will only be 80% eligible for ITCs.	Expenditures after 2012	Now law
	The basic 20% ITC for SR&ED qualified expenditures will be reduced to 15%.	Expenditures after 2012	Now law
Prior budgets	Stock option benefit denial of expenditure	17-Nov-05	Pending
	Removal of subsection 220(2.1) discretion	17-Nov-05	Pending

Implications to SR&ED claimant's

The table above illustrates the status of various pronouncements as of March 31, 2013.

Technically SR&ED claimants are only required to follow these rules once they have received Royal assent and become law.

In the interim they are merely recommendations which the CRA will apply as if they were law.

This creates an interesting position for any of the "pending" legislation on this table.

Reviewing the length of time that it takes to pass some of this legislation, the 2012 budget changes were:

- announced in March 29, 2012 &
- approved into law December 14, 2012 (Bill C-45)

As a result we can hope that the proposed changes to the informal appeal to the Tax Court of Canada will be passed by the end of 2013.

Notable quote:

“There are no old roads to new directions.”

- The Boston Consulting Group

New CRA pronouncements & procedures

Request for information (RFI) procedures

Since approximately January 2013 the CRA has been sending “requests for information” (RFI’s) to a large % of claimants.

These RFI’s tend to include questions which can be divided into 3 categories:

- Standard questions asked nationally of all claimants
- Questions specific to a district office &
- Questions specific to an individual reviewer

Technical documentation

On your T661 Part 2, you indicated availability of contemporaneous information as captured in the table below.

Line Description	Project Number(s)
270 Project planning documents	1
271 Records of resources . . . , time sheets	1,2 & 3
272 Design of experiments	1,2 & 3
273 Project records, laboratory notebooks	1,2 & 3
274 Design, system architecture ... code	
275 Records of trial runs	2 & 3
276 Progress reports, minutes ... meetings	
277 Test protocols, test data ... conclusions	1 & 3
278 Photographs and videos	
279 Samples, prototypes ... other artefacts	
280 Contracts	1,2 & 3
281 Others:	

Please send this information up to maximum of **five (5) letter-sized (8.5" x 11") pages for each project** claimed which you feel best demonstrates that the work meets the definition of SR&ED in Subsection 248(1) of the Income Tax Act.

In addition, if not included in the above sample, please send us copies of the **contemporaneous evidence** that:

- recorded your initial **due diligence** activities and that shows that available technology could not overcome the technological problem or obstacle that you faced;
- recorded **the plan** you subsequently devised to overcome the technological problem or obstacle;
- Preserved the **new technological knowledge** gained by the company.

SR&ED Wages & Contractor labour

For salaries, wages and contract labour, please provide:

- An organization chart with job descriptions/duties for each person claimed.
- **Details of activities** for each SR&ED Project claimed, including
- number of hours claimed **for each individual per activity, per month.**

Contractors

For each contractor, we require a copy of the contract(s) & statement(s) of work.

Author’s comment (high significance)

New focus on “weekly” timesheet details

Perhaps the most notable item in the RFI questionnaires is consistent request for **timesheet** detail at a monthly, **weekly** or in some cases even a daily level.

These requests seem to be focused on small and large claimants alike.

Since current CRA directions on how to prepare proper timesheet are vague as to what is actually required this is likely to become an issue of contention.

Ultimately each employee should be able to identify how his or her

- “design or testing” work was
- “necessary to resolve”
- one or more of the stated “uncertainties.”

Having the development team agree on the key variables of experimentation allows this correlation to take place.



Re: Scientific Research and Experimental Development (SR & ED) Claim



Request for Information (RFI)

Thank you for submitting your claim for the above fiscal period. We have examined the information you submitted and found that the work you described does not appear to meet the definition of SR&ED in section 248(1) of the Income Tax Act. Consequently, as part of the administration of the Scientific Research and Experimental Development (SR&ED) Program by the Canada Revenue Agency (CRA), we require the following technical and financial information in order to determine whether your SR&ED claim requires a detailed review:

Technical Information:

- 1) People and contractors who did the work
 - A list of all people and contractors claimed with, for each, their
 - job title,
 - duties,
 - expertise/credentials, and
 - activities in the claimed project(s).
 - An organization chart for the people claimed.
- 2) Activities claimed
 - **Details of activities for each SR&ED project claimed, including number of hours claimed for each individual person or contractor per activity, per month.**
- 3) On Form T661 *Scientific Research and Experimental Development (SR&ED) Expenditures Claim*, you indicated that the evidence is available to support your claim(s). Please send us for each claimed project:
 - a sample of your **contemporaneous evidence that you feel best demonstrates that the work meets the definition of SR&ED** in Subsection 248(1) of the Income Tax Act **up to a maximum of five (5)** letter-sized (8.5" x 11") pages for each project claimed.

In addition, if not included in the above sample, please send us copies of the **contemporaneous evidence** that:

- **recorded your initial due diligence activities and that shows that available technology could not overcome the technological problem or obstacle that you faced;**
- **recorded the plan you subsequently devised to overcome the technological problem or obstacle;**

- preserved the new technological knowledge gained by the company that was generated or created during the systematic search or investigation to create technological advancement.

Do not send original documents, bulk printouts of time records or source code, optical media or other mass storage devices (CDs, DVDs, flash memory) or physical samples, as we are unable to store these items. At CRA's option, these items may be returned to you without review of their contents. Send copies of documents and keep all originals handy in the event your SR&ED claim is subsequently selected for a detailed review.

Financial Information:

- 4) Form T661 and allowable SR&ED expenditures
 - Reconciliation of expenditures claimed on Form T661 to the adjustment made on line 118 of Schedule T2SCH1: *Net Income (Loss) for Income Tax Purposes* and the financial statements.
- 5) Revenues
 - Details regarding the source of your revenue(s), including sales invoices and contracts
- 6) Salary or wages directly engaged in SR&ED
 - Working paper(s) showing salaries claimed for each SR&ED project reconciled to the amount claimed on Form T661. Identify any bonuses, taxable benefits, severance payments or related benefits such as the employer's share of Canada Pension Plan, Employment Insurance, and Worker's Compensation Board payments that were included
 - Time records in support of the time spent by the employee in SR&ED and non-SR&ED activities. Time records may include employee time sheets, workbooks, diaries, meeting notes, etc. In the absence of time records, please explain the methodology used for the allocation of SR&ED and non-SR&ED activities
 - Payroll records to support employee wages expensed in the year including T4 information slips.
 - Details of wages payable and proof of payment for any portion of the claimed wages paid within 180 days after the fiscal year end.
- 7) Cost of materials consumed and/or transformed in performing SR&ED.
 - Itemized list with associated costs of the specific material items consumed and/or transformed for each SR&ED project that reconciles to the Form T661 amount claimed. Identify any payables at year-end.
 - Receipts supporting the claimed materials; and
 - Cancelled cheques supporting payment of the claimed materials.

You may send the information in paper-copy format by mail/courier to [REDACTED] in an envelope marked 'Private and Confidential'. Please note that CRA does not consider fax or email to be secure forms of electronic transmission.

Please provide the requested information on or before [REDACTED]. If you do not submit the requested information by this date, CRA will process your claim on the basis of information on hand; this may result in disallowance of your SR&ED claim.

Please note, only a sample of information is currently being requested. If your claim is subsequently selected for a Detailed Technical and/or Financial Review, the CRA may contact you again to request more information and/or to set a time and place for a meeting to discuss your claim and review your contemporaneous information.

What if new CRA forms do not address prior issues?

On December 19, 2012 the CRA released revised policy papers to replace the prior collection of Information Circulars, Interpretation Bulletins & Application Policy papers.

According to the CRA these new papers **do not represent** any change in policy however we have found:

- these papers are silent on several issues &
- those issues are now being challenged by CRA staff.

The main question is,

“In the absence of any new directives,

- is it reasonable for claimants to
- rely on these old directives?

Examples of these issues include the following.

Entitlement to Exploit

Ensuring “entitlement to exploit” - The Canada Revenue Agency’s (CRA) prior directives on this issue stated,

“...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.**”¹⁰

Author’s comment

There is no reference to this issue in the current policy papers and the author has seen situations where claimants are now being told they must own all rights in order to claim SR&ED tax credits.

SR&ED project examples

The CRA had over 120 published examples of potential SR&ED projects.

Currently they have announced that they are working on a new series but unclear when these might be released.

In the meantime we propose that:

- the existing project examples are still relevant &
- are also adequately supplemented by existing Tax Court precedence

Notable quote:

My mechanic told me,

"I couldn't repair your brakes, so I made your horn louder."

- Steven Wright

¹⁰ CRA, IT-151-R5 paragraph 37

Complete claims & filing deadline

CRA – prior position (on claims filed within 15 months of year end)

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:

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.¹¹

The **new Dec. 2012 policy paper** reads,

“If the forms are reviewed by the CRA before the SR&ED reporting deadline, the CRA will advise the claimant of any deficiencies and the claimant will be allowed, up to the SR&ED reporting deadline, to provide any missing information.”¹²

Noticeable this new policy paper also adds to the list of “prescribed forms” to include the following:

Prescribed information & forms

“Prescribed information is the information to be provided on a form or the manner of filing a form as authorized by the Minister of National Revenue.”

Prescribed forms for SR&ED expenditures

Forms T661 & Schedule T2SCH31 are the prescribed forms for SR&ED expenditures & tax credits respectively.

Prescribed information for SR&ED forms

Prescribed information **will also include any attachments or schedules necessary** to provide the information requested on:

Form T661, including, if applicable, forms

- T1145 (non-arm’s length costs),
- T1146 (non-arm’s length credits),
- T1174 (specified employees / assoc. co’s), &
- T1263 (third party payments)

Schedule T2SCH31,

- Schedule T2SCH49 (exp. limit assoc. co’s).

Author’s comment

There is no longer any mention of what might happen if the CRA identifies deficiencies beyond the 90 day limit.

In the authors opinion the **risk of omitting** a related schedule is very high and poses a **major concern** to claimants & preparers alike.

Notable quote:

**“Everyone has a photographic memory;
some just don't have film”**

- Steven Wright

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

¹² CRA SR&ED Filing Requirements Policy, December 19, 2012

Questions or feedback

We welcome your questions or feedback on any issues raised in this letter.

We also encourage interested parties to examine:

- past SR&ED newsletters
- SR&ED tax guide [the Guide to RDBASE.NET],
- “RDBASE.NET” online SR&ED tracking software &
- additional tutorials re. eligible SR&ED activities at

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Although we endeavor to ensure accurate & 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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