

Issues of service and fairness within the
**Scientific Research and Experimental
Development
Tax Incentive Program**

An Observation Paper
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GLOSSARY OF TERMS AND ACRONYMS

ASR	Administrative Second Review
Claimant	The individual taxpayer or business filing for Scientific Research and Experimental Development tax incentives
Complaint	A written expression of dissatisfaction by a taxpayer to the Ombudsman about service or treatment received from the Canada Revenue Agency accompanied by a signed consent authorizing the Canada Revenue Agency to release confidential information about that taxpayer to the Ombudsman
CPB	Compliance Programs Branch
CRA	Canada Revenue Agency
CRM	<i>Claim Review Manual</i> – a guide to scientific reviews for Research and Technology Advisors
FR	Financial Reviewer
FRM	Financial Review Manager
ITC	Investment Tax Credit
NOOS	Notice of Objection Section
NOR	Notice of Reassessment
NTSS	National Technology Sector Specialist
OTO	Office of the Taxpayers' Ombudsman
RTA	Research and Technology Advisor
RTM	Research and Technology Manager
RTPA	Research and Technology Policy Advisor
SR&ED	Scientific Research and Experimental Development
SR&ED Stakeholders	All participants and those who take an interest in the SR&ED program
TRR	Technical Review Report

Table of Contents

EXECUTIVE SUMMARY	1
INTRODUCTION.....	2
What is the SR&ED Tax Incentive Program?	2
The Significance of SR&ED to Stakeholders.....	2
The Need for an Investigation	3
Complaints.....	4
Objective	5
General Findings	5
THE MANDATE OF THE TAXPAYERS’ OMBUDSMAN.....	7
PROGRAM BACKGROUND	8
THE ASSESSMENT PROCESS	10
ISSUES	11
General Concerns	11
1. Regional Comparisons	13
2. Preliminary Eligibility Discussion	15
3. Explaining Determinations of Ineligibility.....	17
4. Administrative Second Review	19
5. The Appeals Process	20
CONCLUSION	23
APPENDIX	24

EXECUTIVE SUMMARY

The Scientific Research and Experimental Development (SR&ED) Tax Incentive Program was established in 1985 and remains the largest source of federal support for business research and development. It is administered by the Compliance Programs Branch of the Canada Revenue Agency (CRA).

Upon hearing of dissatisfaction with the SR&ED program expressed by some claimants and their representatives, the Office of the Taxpayers' Ombudsman (OTO) began an investigation to determine whether the CRA's administration of the program is consistent with the service rights within the Taxpayer Bill of Rights. Our investigation focussed on service issues such as the sufficiency and timeliness of the CRA's communication to claimants as well as questions of administrative fairness.

We held consultations with tax intermediaries (e.g. accounting firms, tax preparers, industry associations) and claimants and urged them to file formal complaints with our Office, but very few did so. Our investigation also involved an examination of the CRA's policies and procedures, as well as discussions with CRA personnel who administer the SR&ED program.

There is much at stake for those involved in the SR&ED program. On one hand, the CRA must administer a \$3 billion tax incentive program to eligible claimants while ensuring that incentives are only provided to those who qualify. At the same time, claimants, consultants and claim preparers have a considerable interest in how the program is administered as it can have a significant impact on their revenues.

Although we heard numerous accounts of discontent with the SR&ED program among claimants, we were unable to validate many of the criticisms due to a lack of complaints to investigate. This Observation Paper is therefore not a Special Report with formal recommendations. Rather, it contains observations on the issues raised by SR&ED stakeholders that are within the mandate of the Taxpayers' Ombudsman. These include the issues of regional comparisons, Preliminary Eligibility Discussions, the rationale provided for ineligible claims, Administrative Second Review, and the Appeals Process.

We hope that our investigation and reported observations will be informative and foster productive dialogue between the CRA and claimants, for the benefit of the entire SR&ED community.

INTRODUCTION

What is the Scientific Research and Experimental Development (SR&ED) Tax Incentive Program?

The SR&ED Tax Incentive Program is a program of tax incentives intended to encourage businesses to engage in research and development. Federal government support to business for research and development is based on the belief that such innovation provides valuable benefits to the wider Canadian economy. The SR&ED program provides incentives to firms undertaking research and development through an income tax deduction as well as an investment tax credit which is either fully or partially refundable.

The SR&ED program was introduced in 1985 and has remained the largest single source of federal support for research and development by business within Canada. Each year, the program provides over \$3 billion in investment tax credits.

The SR&ED program is administered by the CRA according to the provisions of the *Income Tax Act*. The Compliance Programs Branch (CPB) of the CRA is responsible for administering the program through its specialized SR&ED Directorate.

The Significance of SR&ED to Stakeholders

The environment in which the SR&ED program is administered is highly charged. Given the amounts of money at stake, the issues brought to our attention are significant to the research and development community. The assistance provided by the SR&ED program has been especially important to the development of new companies, since they may be eligible for tax credits before they even earn enough revenue to pay income taxes. Indeed, some start-up companies may be dependent for their very survival on their eligibility for SR&ED assistance. Many established businesses that have been allowed SR&ED deductions or received tax credits for a period of time have come to expect and depend on these incentives, even building them into their budgets. If the tax deductions or refundable credits suddenly disappear, the impact on those businesses can be significant. Furthermore, researchers often devote several years of effort and become emotionally invested in these projects.

Consultants and claim preparers have a significant interest in how the SR&ED program is administered as well.

As the Canadian Chamber of Commerce has pointed out, it is important that federal support help to unleash higher levels of R&D activity, since productivity growth driven by innovation is central to national prosperity.¹ For the SR&ED program to have its intended effect, it must be administered in a manner that inspires the trust and confidence of claimants. If the SR&ED program is to be seen as fair, it must be delivered in a consistent and timely manner so that businesses can depend on it.

Yet with over 18,000 claimants each year and over \$3 billion of taxpayer money involved, the CRA needs to be as vigilant as possible to ensure that only eligible claimants receive the SR&ED program incentives. The stakes are high for the government as well as for industry.

The Need for an Investigation

Shortly after the inception of the OTO, we began to hear a variety of criticisms of the SR&ED program from claimants and their representatives. The Ombudsman heard numerous accounts of discontent with the SR&ED program during his outreach tours and encouraged claimants to file complaints with our Office. Meanwhile, OTO investigators took note of media reports and held discussions with SR&ED claimants and their representatives to get a sense of what was causing discontent and what the issues were.

Eventually our Intake Unit received a small number of complaints from claimants about the CRA's administration of the SR&ED program, although the majority of them were not related to the Ombudsman's mandate, which is to uphold the Taxpayer Bill of Rights and to promote professional service and fair treatment by the CRA. Many of the complaints and representations we received from claimants focused on the CRA's interpretation or application of the legislation and policies governing the SR&ED program. Those issues are not within the mandate of the Ombudsman to investigate. Of the handful of mandate-related complaints we received related to issues dealt with in this paper, only two could be substantiated.

Nevertheless, as a result of complaints filed by claimants, the concerns raised by stakeholders, and the program's national scope and potential impact on a significant part of the SR&ED community, we launched a systemic investigation. The investigation focused on questions of service, such as the sufficiency and timeliness of the CRA's communication to claimants, as well as issues of administrative fairness: essentially, whether the CRA is administering the SR&ED program in a manner consistent with the service rights specified in the Taxpayer Bill of Rights.

¹ Canadian Chamber of Commerce, Policy Brief, April 2011.

During the course of our investigation, representatives from our Office held various consultations with SR&ED stakeholders, including businesses of various sizes, individual claimants, consultants, consulting groups, and accounting firms.

We also invited claimants to submit comments about the SR&ED program through our Web site and received numerous submissions.

As part of our investigation we also obtained significant amounts of information from the CRA about the policies and procedures it follows in administering the SR&ED program, complemented by focus group discussions with CRA personnel administering the front line functions of the program. Our Office held teleconferences with each region, where over 50 participants including Research and Technology Advisors, Research and Technology Managers, Financial Reviewers, and Financial Review Managers participated in open and candid discussions concerning the program. We also met with the Directors and the Director General from the CRA's SR&ED Directorate. In response to our requests, the CRA also provided a great deal of information concerning the issues raised during the investigation.

Complaints

Our Office heard numerous anecdotes and allegations about the SR&ED program from claimants who did not wish to file a formal complaint with our Office or who wished to remain anonymous. Many representatives, claimants, and interest groups involved in SR&ED were quite vocal in their criticisms of the way the SR&ED program was being administered. Yet despite our best efforts to encourage these claimants and their representatives to file complaints so that we could investigate the merits and potential causes, most did not do so.

A complaint is a written expression of dissatisfaction or discontent by a taxpayer about the service or treatment received from the CRA, supported by accounts of what transpired and when. Most importantly, it includes a signed consent form authorizing the CRA to share confidential taxpayer information with the OTO in order that the complaint may be thoroughly investigated.

Our Office is committed to investigating mandate-related complaints thoroughly in a confidential and impartial manner. If we have a complaint we can investigate an issue and determine whether there really is a problem; if we do not, we are unable to test allegations and compare taxpayers' experiences to the relevant CRA policy in order to assess whether there was a lack of fairness or a lapse in service. We cannot act in a meaningful way on speculation and allegations that are not supported by evidence. Without evidence, we cannot draw credible conclusions about a perceived problem, let alone make feasible recommendations to correct the problem.

Despite our ongoing best efforts during this investigation to encourage claimants and their representatives to submit written complaints on the key issues, we were provided with very few, and most of those were found to be without merit. We were disappointed not to have received complaints about actual cases, past or present, that would have allowed us to do a thorough analysis of these issues and to formulate recommendations if necessary.

Objective

We originally saw this investigation as an opportunity to address issues of service and fairness in the CRA's administration of the SR&ED program and make recommendations aimed at helping the CRA improve the service experience for taxpayers.

Through research and analysis, we had hoped to assess whether the CRA is administering the SR&ED program fairly and providing professional service to claimants. We expected that our investigation of complaints and analysis of the issues would result in the publication of a Special Report with recommendations.

However, given the nature of the information received, specifically the absence of complaints, we are limited to making observations about those SR&ED issues that were brought to our attention and that are within the Ombudsman's mandate.

Our examination of the level of service and fairness provided by the CRA to taxpayers within the SR&ED program focused on whether taxpayer service rights were being respected in the following contexts:

- Regional Comparisons
- Preliminary Eligibility Discussion
- Rationale Provided for Ineligible Claims
- Administrative Second Review
- Appeals Process

General Findings

What we have observed is that many claimants feel that the CRA does not always administer the SR&ED program in a predictable and timely manner. When credits or refunds are not delivered promptly, when decisions about ineligibility are not explained adequately or in a timely fashion, or when the appeals process is confusing, claimants may perceive that the program is not being administered fairly.

On the other hand, making predictable and timely decisions while administering such a complex program is a formidable challenge for the CRA. It is a considerable challenge to be consistent, or even appear to be consistent, in a nation-wide program in which over 18,000 claims are received yearly and not every one can be reviewed. The eligibility of those claims that are reviewed rests on whether the claimant can demonstrate that the criteria of the *Income Tax Act* and the Regulations have been met. For the OTO, addressing criticisms of the CRA's service and fairness in the administration of some aspects of the SR&ED program, and assessing the merit of those criticisms, was difficult in the absence of complaints on most of the issues the Ombudsman is mandated to address.

It is hoped that our observations will raise awareness of issues that impact claimants and the CRA. By focusing on these issues of service and fairness, we seek to foster productive dialogue between the CRA and claimants who are making claims within the SR&ED program.

THE MANDATE OF THE TAXPAYERS' OMBUDSMAN

The Taxpayers' Ombudsman is an independent and impartial officer appointed to review service-related complaints about the CRA and uphold the Taxpayer Bill of Rights. The Ombudsman's mandate is also fulfilled by identifying and investigating systemic and emerging service-related issues that could have a negative impact on taxpayers.

The Taxpayers' Ombudsman may not review complaints relating to tax policy and legislation or matters that are before the courts.

The articles of the Taxpayer Bill of Rights relevant to this paper are the following:

- **Article 5:** the right to be treated professionally, courteously, and fairly;
- **Article 6:** the right to complete, accurate, clear, and timely information from the CRA;
- **Article 10:** the right to have the costs of compliance taken into account when tax legislation is administered;
- **Article 11:** the right to expect the CRA to be accountable;
- **Article 15:** the right to be represented by a person of one's choice.

In the context of SR&ED, the term "taxpayers" includes claimants, third party representatives, businesses, associations, and SR&ED interest groups. During this review, our Systemic Investigation Unit heard from all of these.

Based on a well-defined mandate, our investigation was never intended to be an overall evaluation of the SR&ED program. It focused on issues related to the SR&ED program that were within the Ombudsman's mandate. We were not able to tackle all the issues brought to our attention because so many of them were outside this mandate.

It is beyond the Ombudsman's mandate to review issues of policy and legislation and, as a result, questions about how the CRA interprets and applies the portions of the *Income Tax Act* relevant to SR&ED, or whether sections of the Act need amendment, were not addressed. Similarly, the level at which the CRA reviews claims and the technical scrutiny it employs are not within the Ombudsman's mandate. Discussions about the role of government in SR&ED and which branch of government is best suited to administer this program were also not within the scope of this investigation. As a result, our research and analysis did not seek answers to those questions.

PROGRAM BACKGROUND

The SR&ED Tax Incentive Program was introduced in 1985 and is administered by the CRA pursuant to the *Income Tax Act*, while the Department of Finance is responsible for the *Income Tax Act*. This program has remained the largest single source of support for research and development within Canada, and over the years the CRA has made several administrative changes in order to deliver this incentive more efficiently.

The SR&ED program has two components. The first is an income tax deduction which allows businesses to claim certain expenditures, such as salaries and wages of employees directly involved in SR&ED and the costs of some materials and machinery used substantially for SR&ED.

The second component is an SR&ED investment tax credit (ITC). Each year, the SR&ED program provides over \$3 billion in ITCs to over 18,000 claimants.² Any business operating and performing R&D in Canada is eligible to apply for the ITCs but the ITC rate they are eligible for depends on the size of the company (as defined in the legislation). Small Canadian-controlled private corporations (CCPCs), as determined by income and capital thresholds, are eligible for ITCs of 35% of qualifying expenses, while large CCPCs, and public and foreign-controlled corporations, are eligible for a 20% rate.

To make a claim for the SR&ED program, claimants must complete and submit the prescribed forms, along with the appropriate ITC schedule/form. The claim forms must be submitted within 18 months of the due date of the claimant's income tax return for the year in which the SR&ED expenditure was incurred.³

R&D activities must fall into one of three categories specified under subsection 248(1) of the *Income Tax Act* to qualify for SR&ED incentives: experimental development, applied research, or basic research. The term "scientific research and experimental development" is defined in that subsection 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

² *Support for Your R&D in Canada – Overview of the Scientific Research and Experimental Development (SR&ED) Tax Incentive Program*, CRA, RC4472.

³ *About Our Program*, CRA external Web site: <http://www.cra-arc.gc.ca/txcrdt/sred-rsde/bts-eng.html> (accessed July 1, 2011).

- (a) basic research, namely, work undertaken for the advancement of scientific knowledge without a specific practical application in view,
- (b) applied research, namely, work undertaken for the advancement of scientific knowledge with a specific practical application in view, 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,

and, in applying this definition in respect of a taxpayer, includes

- (d) work undertaken by or on behalf of the taxpayer with respect to engineering, design, operations research, mathematical analysis, computer programming, data collection, testing or psychological research, where the work is commensurate with the needs, and directly in support, of work described in paragraph (a), (b), or (c) that is undertaken in Canada by or on behalf of the taxpayer,

but 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 collection⁴

To assist claimants, the CRA makes available interpretation and guidance documents that provide technical guidelines to clarify what constitutes SR&ED according to the Income Tax Regulations. One such document, the Information Circular 86-4R3, sets out the criteria to be applied in determining whether an activity qualifies for SR&ED tax incentives. In order to be eligible for SR&ED, claimants must demonstrate that the work claimed meets the three criteria of scientific or technological advancement,

⁴ *Income Tax Act*, 1985, c. 1 (5th Supp.).

scientific or technological uncertainty, and technical content. What the CRA looks for in determining whether a project qualifies as SR&ED is evidence that the type of technical risk or uncertainty involved can not be overcome by routine engineering or standard procedures, and thus requires technological advancement.

Claimants must also provide, upon request, current documents that are generated through the operation of the business or in implementing the project in question. Contemporaneous documentation (documentation created during the implementation of the project) is not only proof that the project claimed actually occurred, but is generally viewed as a by-product of the scientific method.

THE ASSESSMENT PROCESS

The CRA's *SR&ED Technical Review: A Guide for Claimants*, published July 25, 2011, describes the assessment process.

All SR&ED claims are assessed in the Tax Centre upon filing⁵. Some claims are accepted as filed. Others are selected for a desk review or for a more detailed technical or financial review, and sent to the Coordinating Tax Service Office, where the Control Centre decides whether the claim must be reviewed in more detail by the Research and Technology Advisor (RTA) or the Financial Reviewer (FR), or both.

When a claim is selected for review, the RTA reviews all the information filed with the current SR&ED claim as well as any information from past claims, and if necessary asks the claimant for more information or clarification. For those claims selected for detailed review, the FR will conduct a corresponding financial review of the SR&ED claim.

If a site visit is deemed necessary, the RTA will attend the claimant's premises, discuss the SR&ED work claimed, and resolve any issues that have arisen during the review. A list of activities or documents to be reviewed during the site visit is sent to the claimant in advance. At the end of a site visit, the RTA should give the claimant a preliminary verbal indication of the RTA's eligibility decisions or outstanding concerns so that the claimant can bring forward other representations or information if they wish. The results of the RTA's work are documented in an SR&ED Review Report, which is given to the claimant later.

When both the technical and financial reviews are completed, the FR works with the RTA to prepare the CRA proposal.

⁵ <http://www.cra-arc.gc.ca/txcrdt/sred-rsde/pblctns/gd-tchrw-eng.html> (accessed September 19, 2011).

During the review process, the claimant is encouraged to discuss any disagreement with the RTA or FR first, in order to resolve the dispute, and then if necessary with the Research and Technology Manager (RTM) or Financial Review Manager (FRM). Thirdly, the claimant can ask for an administrative second review by the Assistant Director, SR&ED.

Claimants who still do not agree with the final notice of assessment or reassessment have the right to avail themselves of the first step in the CRA's formal dispute resolution process by filing a Notice of Objection with its Appeals Branch.

ISSUES

General Concerns

Quality and Eligibility of Claims

During the preparation of this paper, it became clear that the difference in perceptions between some SR&ED claimants and the CRA on certain issues is considerable. Some taxpayers decry the fact that it is the Compliance Programs Branch within the CRA that administers the SR&ED program and claim that its enforcement culture makes it ill-suited to administer an incentive program intended to deliver tax refunds and credits. They allege that the CRA is being too tight-fisted in administering the SR&ED program, over-emphasizing its audit role and denying claims in a manner that is contrary to the program's intended purpose. Generally, taxpayers and their representatives are calling for more equilibrium between the CRA's two functions of protecting the tax base and administering an incentive program.

The CRA, on the other hand, claims that it has struck the appropriate balance, while acknowledging that it does have concerns about the appropriateness and quality of a growing number of SR&ED claims. According to an article in *The Globe and Mail*, "CRA spokesman Andy Meredith insisted that a 'majority' of SR&ED claims are legitimate, but he confirmed the Agency is witnessing 'a growing trend' toward a deteriorating 'quality' of claims."⁶ As a result, the CRA says it finds itself having to scrutinize certain claims more closely to eliminate unsubstantiated claims and ensure the fiscal integrity of the program is maintained.

Documentation

Some SR&ED claimants or their representatives have expressed to us that they feel the CRA is demanding too many documents and records from them in support of

⁶ Barrie McKenna, *The Globe and Mail*, February 6, 2011.

their claims for SR&ED. Some claimants have said that the CRA is requiring them to provide documentation to substantiate their claims that would not normally be produced in the course of business.

“We can lick gravity, but sometimes the paperwork is overwhelming.”

Dr. Wernher Von Braun

The CRA, on the other hand, tells us that the documentation it requests should be produced in the course of business if the scientific method is being properly applied.

In a seminal Tax Court of Canada case about SR&ED, *Bowman, J.T.C.C.*, said this about the need for adequate documentation:

“These elements must however operate within the total discipline of the scientific method....Although the *Income Tax Act* and the Regulations do not say so explicitly, it seems self-evident that a detailed record of the hypothesis, tests and results be kept, and that it be kept as the work progresses.”⁷

The Merriam-Webster dictionary defines the scientific method as, “principles and procedures for the systematic pursuit of knowledge involving the recognition and formulation of a problem, the collection of data through observation and experiment, and the formulation and testing of hypotheses.”⁸

In determining the eligibility of a project as SR&ED, the CRA has a two-part test to apply. First, it must determine whether the project as a whole meets the requirements set out in the definition of SR&ED in subsection 248(1) of the *Income Tax Act*. If the project does not meet these requirements, the enquiry stops there.

However, if the project as a whole is eligible, then the CRA must undertake a review to determine whether the work being done is eligible SR&ED. Whether or not an expenditure is related, eligible SR&ED work must be determined on a case-by-case basis. Any claim for SR&ED assistance must provide supporting evidence that sets out the hypothesis developed, the technological uncertainties targeted for elimination, the methodology and procedures by which those hypotheses were tested, as well as the observations made and conclusions drawn. Based upon the relevant legislation and jurisprudence, the CRA takes the position that the only reliable way to demonstrate that scientific research or experimental development has been carried out in a systematic fashion is for claimants to produce this supporting evidence.

⁷ *Northwest Hydraulic Consultants Ltd. v. The Queen* [1998] 3 C.T.C. 2520, pp. 5-6.

⁸ <http://www.merriam-webster.com/dictionary/scientific+method> (accessed January 3, 2011).

Canada's tax system is based on voluntary compliance and self-assessment; consequently, taxpayers are expected to be able to provide documentation to substantiate what they report to, or claim from, the CRA.

Observation

Without any specific complaints on this issue to investigate, we are unable to comment on whether or not the CRA's documentation requirements in support of SR&ED claims are fair, adequately communicated to claimants, and consistent with the Taxpayer Bill of Rights.

1. Regional Comparisons

One of the concerns we heard from claimants is that they perceive a lack of consistency in the way the SR&ED program is administered across the country. They suggest that there are discrepancies from region to region, and even among CRA employees, in the way the legislation is interpreted and decisions rendered. Some companies applying for the SR&ED program report that they have had claims turned down while companies in other regions that appear to be doing similar work have had their claims for SR&ED incentives accepted. These observations can create the impression that the program is not being delivered in a consistent and predictable manner across the country. The comments and concerns about possible regional discrepancies within the SR&ED program made their way to the Office of the Minister of National Revenue whereupon then-Minister Keith Ashfield asked that we address the issue in the course of our investigation.

Analysis

Investigators from our Office met with SR&ED specialists within the CRA to discuss the perception of some claimants that there are regional inconsistencies in the administration of the SR&ED program.

Our analysis revealed that several factors could create the impression of discrepancies between regions. Perception may not coincide with reality. What may appear on the surface to be two companies doing similar work may actually be found to be two very different projects for the purposes of SR&ED once the "nuts and bolts" details are examined.

One factor is context. The industry or sector in which SR&ED claims are submitted could have a bearing on whether they are actually comparable or just appear to be similar. A research or development project may be innovation-eligible for SR&ED in one industry or for a particular claimant, but the same project may not be considered

innovation in another company or sector given the state of technology in that company or sector. The fact that the project was determined to qualify for the SR&ED program due to its innovative characteristics in one context does not mean that the same project should be automatically eligible in another context.

Another factor that makes it difficult to draw comparisons, or conclude that there are discrepancies in interpretation, is that some projects that are indeed similar may receive different determinations depending on whether they are subject to review or not. The CRA cannot review every claim for SR&ED tax incentives and credits, and some claims are simply accepted as filed without being subjected to an in-depth review to determine eligibility. One project that is subject to review and determined not to qualify for SR&ED incentives may be similar to another project that is accepted as filed. In these cases it is not an inconsistency in the CRA's interpretation that leads to different results; it is the fact that one project was reviewed while the other was simply accepted as filed.

Some claimants have suggested that it might be that some RTAs are too stringent while others are too lenient. However, we have not been able to establish that as a factual situation. The CRA should indeed strive for consistency in the treatment of comparable projects; however, in the absence of complaints on this issue we could not identify and address cases of inconsistency.

We have noted in the course of our investigation, however, that the CRA is making efforts to improve consistency across the country. At regular national conferences information is shared among people working in the various regions. The CRA also addresses issues regarding the consistency of program administration through the recently developed SR&ED Quality Assurance (QA) program, which was fully implemented as of April 1, 2010.

The *SR&ED Quality Assurance Operations Manual* lists the objectives of the QA program and states that the overall objective is to assist the SR&ED program in attaining high standards of quality. The following objectives are listed:

- to examine the quality of the claim review activities delivered, in comparison to established quality standards;
- to identify and highlight quality practices;
- to identify and recommend areas of the claim review process that need improvement; and
- to identify possible training requirements.

The CRA defines “quality” in this context as consistency, professionalism, timeliness, and due process.

The CRA states that the QA program was designed to maximize consistency across the country. National QA reviews are undertaken in order to improve consistency. Part of the strategy is to focus on specific issues or industry sectors, which would ensure that the claims reviewed and the decisions made within and across regions, issues, and sectors are consistent and appropriate. Also, QA assessments are to be conducted in a timely fashion, either before or shortly after the RTA has completed the SR&ED review.

During our focus group discussions with CRA employees we had the opportunity to discuss the subject of alleged inconsistencies in administration of the front line functions of the program. There was consensus among the various CRA focus groups that a consistent emphasis was being placed on the use of the *Claim Review Manual* by all RTAs and for that reason they believe that all claims are being given the same due process.

Observation

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. On the other hand, there are, as noted, a number of reasons why such discrepancies might appear to exist without that actually being the case. In the absence of complaints, we were unable to determine whether there actually are discrepancies in the application of the SR&ED program from one region of Canada to another.

2. Preliminary Eligibility Discussion

SR&ED claims are reviewed within the CRA by RTAs. Preliminary eligibility discussions are an opportunity for RTAs to advise claimants of their initial impressions of a claim and eliminate potential surprises for the claimant in the final decision on eligibility. According to the *Claim Review Manual* and the CRA internal technical guides we examined, RTAs should advise claimants of preliminary decisions or concerns they have about the claim as early as possible. This would include feedback on, for example, the sufficiency of supporting documentation in the claim. The *Claim Review Manual* also recommends that RTAs provide claimants with a “preliminary verbal indication” of the eligibility decision before completion of the final report, although this step is not mandatory. A preliminary eligibility discussion gives claimants the

opportunity to respond to the RTA's concerns and, if necessary, provide additional information to support the claim.

According to CRA policy, if the RTA is unable to make a preliminary decision at the end of a site visit, they should at least provide the claimant with an outline of the next steps and an indication of when a decision might be expected.

Some claimants or their representatives did file complaints claiming that some RTAs were either not communicating their eligibility concerns or decisions, or not doing so soon enough in the review process. In some cases, they alleged that RTAs had not communicated any eligibility concerns or preliminary decisions at all before issuing the SR&ED Technical Review Report. Although we received four complaints on this issue, we were not able to substantiate these claims, since three of the complaints were found to be without merit (our investigation discovered that the claimant had actually received preliminary comments on eligibility from the RTA) and in the fourth case the claimant received a preliminary eligibility discussion during the site visit but merely wanted further communication with the RTA after submitting additional documentation.

It is expected that RTAs will have eligibility discussions with claimants to ensure certainty in the claim review process. Timeliness is crucial. If the RTAs communicate their concerns or decisions at an early stage, the claimants will have the opportunity to explain or defend their SR&ED claims. They will be aware of the doubts or concerns they will have to overcome in the RTA's mind in order for their claims to succeed, and will be able to prepare and submit clarifications, corrections, and additional information to address the concerns of the RTA.

Claimants point out that SR&ED is an incentive program and without these eligibility discussions, they are not assured that they are receiving a thorough consideration of their claims. That creates doubts about whether they are receiving all they are entitled to from the SR&ED program.

Communicating the preliminary eligibility concerns and opinions to claimants in a timely manner is fundamental to respecting the Taxpayer Bill of Rights. Fairness calls for the RTA to advise claimants of their impressions, doubts, and concerns about the eligibility of a claim before making a final decision.

Observation

Taxpayers have a right to complete, accurate, clear, and timely information from the CRA (Article 6). They also have the right to expect the CRA to be accountable (Article 11), which means they have the right to expect the CRA to explain its decisions. Furthermore, taxpayers have a right to procedural fairness, which includes the right

to be advised of the case they have to meet. The CRA currently has a policy in place that provides for timely preliminary eligibility discussions within the SR&ED program, and claimants will benefit as long as this policy is applied consistently.

The CRA offers a pre-claim project review process that allows SR&ED claimants to submit proposed claims for pre-approval. The CRA has also begun development of an enhanced online tool to assist SR&ED claimants with the claim process. We understand that the CRA will announce more details on these new initiatives in the coming months. We therefore encourage the CRA to continue to take whatever steps are necessary to keep taxpayers adequately informed about their SR&ED claims, and maximize its accountability to claimants.

3. Explaining Determinations of Ineligibility

As noted above, when an RTA has made a determination on the eligibility of a claim to the SR&ED program, that decision is communicated to the claimant in a Technical Review Report. In the course of consultations we held with SR&ED claimants during our investigation, we heard claims that the Technical Review Reports prepared by RTAs did not always provide sufficient explanations of why a claim had been determined to be ineligible or partially ineligible. As a result, some claimants said they lack confidence in the correctness of CRA decisions about eligibility for SR&ED incentives.

Our Office received two complaints from taxpayers alleging that they had not been provided with an adequate explanation of why their SR&ED claims were determined to be ineligible. In one case, we sent a Request for Action to the CRA, which resulted in the taxpayer being provided with a satisfactory explanation shortly thereafter. In the second case, we were unable to complete an investigation as the claimant decided to incorporate this issue in an appeal to the Tax Court of Canada.

According to the CRA's *Claim Review Manual* section 6.8.6.1 – Documenting Determinations Concerning Issues of Eligibility, “Determinations of eligibility should be documented to avoid misunderstandings or ambiguity, and to demonstrate that they are based on the *Income Tax Act* and CRA policies.” The CRA policy stipulates that the RTA should explain the reasons for the decision on eligibility in the Technical Review Report, citing a combination of facts, legislation, and policy, that enables the claimant to understand the decision.

Section 6.8.11 of the CRA's *Claim Review Manual* provides that an RTA's Technical Review Report will be reviewed by an RTM in certain situations to ensure quality. The manual suggests that reports be reviewed by the RTM in these situations:

- the claim is found completely ineligible or substantially ineligible;
- there is a significant change in eligibility of claimed work from the prior year's review;
- the claimant does not concur with the RTA's findings; or
- the scope of the actual review is significantly different from what was planned based on the issues identified during screening and risk assessment.

The CRA's QA program is intended to ensure the consistency of Technical Review Reports as well as their compliance with the law, policies, and directives. Unfortunately, the final report from the first round of QA evaluations was unavailable to our Office for analysis at the time of publication.

Investigators from our Office did, however, review several excerpts from a sampling of SR&ED Technical Review Reports. We observed that there do indeed appear to be variations in the quantity and quality of explanations provided to claimants in these reports.

In most cases, the RTAs did justify their decisions, to varying degrees, and the majority provided sufficient information to support their decisions.

In some of the reports we reviewed, however, RTAs 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*."

Through its own internal reviews, the CRA has also noted the failure of some RTAs to consistently provide an adequate explanation of the reasons for their determination that a claim is ineligible for the SR&ED program.

The CRA acknowledged to us that simply referring to elements of the work as "standard practice," "knowledge commonly available to the industry," "routine testing," "routine engineering," or making statements such as "the work does not contribute to an advancement in a field of science or technology," without adequately explaining why the work has been found to have those characteristics, would not be defensible should the claimant decide to appeal the decision by filing a Notice of Objection. The Technical Review Report should always cite the evidence or information that led the RTA to determine that the work did not qualify for the SR&ED program.

Observation

The Taxpayer Bill of Rights entitles taxpayers to complete, accurate, clear, and timely information. It also provides that taxpayers can expect the CRA to be accountable, and as the Ombudsman reported in *The Right to Know*,⁹ that means that the CRA has an obligation to explain its decisions.

A Technical Review Report that does not contain a sufficient explanation of the reasons for the decision on ineligibility infringes upon the claimant's taxpayer service rights. The absence of an adequate explanation about why a claim is ineligible is unfair to the claimant, who is then not in a position to contest the finding. It also diminishes CRA accountability. The failure to provide adequate reasons for decisions creates doubt about the RTA's decisions and the integrity of the SR&ED program as a whole.

RTMs are considered the last line of quality control before the eligibility decision is presented to the claimant in the form of the Technical Review Report. Seeing an opportunity to ensure quality by expanding RTM oversight of the work done by RTAs, one Tax Services Office in the Ontario region has implemented a peer review process for Technical Review Reports within the CRA. If feasible, the CRA may do well to consider implementing this practice nationally.

4. Administrative Second Review

The Compliance Programs Branch (CPB) of the CRA is responsible for administering the SR&ED program. CPB has put in place an informal dispute resolution procedure for SR&ED claims called Administrative Second Review (ASR), which is intended to ensure that the technical reviews carried out by RTAs are consistent with the current SR&ED legislation and policies and the claims were given due process. While the CRA claims that it is not feasible, due to resource constraints, to perform a full second technical review on every file in which the claimant disagrees with the outcome, an ASR allows the Assistant Director or a designate to review a file on a discretionary basis to see if the technical and financial review process, as well as the final decision, complies with the relevant SR&ED policies and legislation. However, an ASR must be requested before the file is closed and the notice of assessment issued. After the technical and financial reviews are completed, the RTA will issue a proposal letter with the Technical Review Report to the claimant, and allow a period of time for the claimant to reply, generally thirty (30) days. Subsequently if no new information is received, the RTA will close the file and the Notice of Assessment will be issued to the claimant. The claimant then no longer has the option of requesting an ASR. If

⁹ J. Paul Dubé, *The Right to Know*, Taxpayers' Ombudsman Report, August 2010, p. 4.

they disagree with the findings, they will have to file a Notice of Objection with the Appeals Branch of the CRA.

An ASR is not a second technical review and it is not part of the appeals process. It is simply an administrative review of the relevant information within the coordinating Tax Services Office to ensure that the claimant was given due process and that the SR&ED technical and financial reviews were carried out in a manner consistent with the relevant legislation, policies, and guidance documents.

There appears to be considerable confusion within the SR&ED community about the ASR process. Some claimants believe that the ASR is simply a review by the SR&ED Directorate within the CPB to determine whether the claim received due process. Others believe it is part of the procedure in Appeals Branch that deals with Notices of Objections. Claimants even expressed the belief that their claim could not receive an ASR unless they first exhausted all CRA redress mechanisms and filed an appeal to the Tax Court of Canada. Some claimants who did receive an ASR for their claim have told us they do not know why or how they qualified for an ASR.

Observation

It is apparent that SR&ED claimants would benefit from a better understanding of the ASR; namely, what it is, when it is granted and what it involves. Taxpayers would benefit from enhanced communication and outreach from CRA aimed at raising awareness and understanding of this important step in the claim review process.

5. The Appeals Process

Once the SR&ED technical and financial reviews are completed, and the SR&ED Technical Review Report is finalized, the claimant is sent a Notice of Assessment (NOA). If a claimant requests an adjustment to an already assessed claim, the CRA will then make the adjustment and send a Notice of Reassessment (NOR) to the claimant. These notices summarize the SR&ED ITCs allowed or disallowed based on the findings of the reviews. An SR&ED claimant who does not agree with the NOA/NOR has the right to a formal review by filing a Notice of Objection with the CRA's Appeals Branch. A Notice of Objection must be filed within 90 days of the date of the NOA/NOR. According to the CRA:

The mandate of the Appeals Branch is to provide a fair and impartial process to resolve disputes, service complaints and requests for relief arising from decisions

made under the legislation and programs administered, and services provided, by the Canada Revenue Agency.¹⁰

Claimants are entitled to object to either the scientific findings or the financial determination of the claim, or both. The CRA's appeals process provides taxpayers with a review of whether the assessing position is correct and supportable. In other words, upon receiving a Notice of Objection, the Appeals Branch will review the correctness of the NOA/NOR and whether it is supported by the facts and law.

If only the financial aspects of the NOA/NOR are being appealed, the Appeals Officer assigned to the file will handle the review in the same way as any other taxpayer Objection, by assessing all the relevant facts, legislation, jurisprudence, policies and any new information provided at the objection stage relating to the issue.

If the scientific aspects of the decision are being appealed, the Appeals Officer does not undertake the review. While the Appeals Branch is responsible for the resolution of the objection, it relies on the scientific expertise within the CPB. The Appeals Officer refers that portion of the objection to the Notices of Objection Section (NOOS) within the CPB, and the review is carried out by a distinct group of Research and Technology Policy Advisors (RTPA) who are not involved in making any original scientific determinations on SR&ED claims. This is done because the Appeals Branch does not have in-house personnel qualified to evaluate the scientific aspects of an SR&ED objection. The CRA notes that because NOOS Advisors are located within CPB this helps NOOS Officers to remain current about current issues related to the SR&ED program policies and procedures.

The NOOS provides advice to the Appeals Branch Headquarters (Tax and Charities Appeals Directorate). This Directorate reviews the recommendation provided by the NOOS on the science issues, identifies the financial issues to be reviewed, considers the risks involved and provides its own recommendation to the Appeals Officer regarding the resolution of the objection.

In some situations, due to the complexity of the science issues and significant risk involved, the Tax and Charities Appeals Directorate may request the services of an external consultant to review the science issues in dispute. This may involve a more detailed review, including site visits of the claimant's activities to determine which activities qualify as SR&ED.

The final decision on the objection is communicated to the claimant by the Appeals Officer.

¹⁰ <http://www.cra-arc.gc.ca/E/pub/tg/p148/p148-e.html#P2>

Analysis

The OTO has not received any formal complaints from SR&ED claimants about the fairness of the CRA's process for handling Notices of Objection. However, our discussions with SR&ED stakeholders have revealed a lack of understanding of the CRA's Appeals Process.

Some claimants believe, wrongly, that the appeals process is only a review of whether due process was respected and not whether correct determinations were made. Some believe that there is no point in asking the CRA for a formal review of a CRA decision. Many members of the SR&ED community have said they would like the appeals process to involve a full second scientific review, essentially a second full eligibility determination exercise.

The appeals process within the legal system may be helpful in understanding the CRA appeals process. Legal appeals do not constitute a new trial. They are an examination of whether appropriate procedure was followed and whether the decision is legally correct. An appeals court typically reviews the grounds for appeal, the pleading of the parties, a transcript of the proceedings, and the evidence exhibits produced at trial. It rarely hears witnesses. If the appeals court finds that the trial was unfair or finds errors in the decision, it can quash or vary the original decision or order a new trial.

The objection process within the CRA's Appeals Branch is somewhat similar. The function of the Appeals Branch is to resolve disputes and determine whether the CRA's NOA/NOR are correct in fact and law. The Appeals Branch considers the issues raised in the Notice of Objection, along with the other relevant documentation. It does not re-commence the original decision-making process.

Observation

Confidence in the CRA appeals process would be greatly enhanced if SR&ED claimants and their representatives had a better understanding of the procedure.

CONCLUSION

The SR&ED Tax Incentive Program provides over \$3 billion in investment tax credits and is the largest source of federal support for business research and development. As the agency responsible for administering the SR&ED program, the CRA faces the dual challenge of ensuring that eligible claimants receive the incentives in a consistent and timely manner while ensuring that only those claimants who are eligible benefit from this program.

We have heard much dissatisfaction expressed about the CRA's administration of the SR&ED program, yet many of the issues raised were beyond the Ombudsman's mandate and we received very few complaints about issues within that mandate. As one commentator remarked, "there is a lot of noise in the machine," but this Office had very few opportunities to investigate actual complaints. As a result we were unable to validate many of the criticisms we heard about the way the SR&ED program is being administered. That precluded us from reaching evidence-based conclusions upon which we could formulate recommendations.

Nonetheless we have made observations in this paper which we believe will be of value to stakeholders and the CRA.

The first observation is that many claimants and their representatives do not know or understand some of the CRA's policies for administering the SR&ED program. Our discussions with SR&ED stakeholders revealed a lack of understanding of the CRA's Appeals Process, the Administrative Second Review, and the policy on preliminary eligibility discussions.

Secondly, there is a perception among some claimants that the SR&ED program is not administered consistently across the country, as some apparently similar claims have received different eligibility determinations in different parts of the country.

The observations we have made speak to the need for the CRA to continue, and even enhance, its proactive communication with SR&ED claimants and their representatives. There are reasons why apparently similar claims can result in different eligibility determinations in different parts of the country other than discrepancies or inconsistencies in the application of policy, and these should be explained to claimants. Overall, stakeholders would benefit from greater clarity with regard to the CRA's policies and procedures for this program. The CRA continues to review and refine its policies for administering the program, and its efforts to improve timeliness and consistency are noteworthy. Stakeholders will be well served by improvements to policy and procedure as long as those changes are communicated in a complete and timely manner.

APPENDIX

TAXPAYER BILL OF RIGHTS

1. You have the right to receive entitlements and to pay no more and no less than what is required by law.
2. You have the right to service in both official languages.
3. You have the right to privacy and confidentiality.
4. You have the right to a formal review and a subsequent appeal.
5. You have the right to be treated professionally, courteously, and fairly.*
6. You have the right to complete, accurate, clear, and timely information.*
7. You have the right, as an individual, not to pay income tax amounts in dispute before you have had an impartial review.
8. You have the right to have the law applied consistently.
9. You have the right to lodge a service complaint and to be provided with an explanation of our findings.*
10. You have the right to have the costs of compliance taken into account when administering tax legislation.*
11. You have the right to expect us to be accountable.*
12. You have the right to relief from penalties and interest under tax legislation because of extraordinary circumstances.
13. You have the right to expect us to publish our service standards and report annually.*
14. You have the right to expect us to warn you about questionable tax schemes in a timely manner.*
15. You have the right to be represented by a person of your choice.*

**Service rights upheld by the Taxpayers' Ombudsman*