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This document – authored by the Canadian Advanced Technology Alliance (“CATA”) provides an excellent snapshot of how Canada Revenue Agency has been administering the SR&ED program in most of Canada since mid-2008. Since CATA’s membership is primarily companies in software / IT, the findings are somewhat slanted towards CRA’s activities in that sector. However, CATA’s findings remain germane and valid – to a greater or lesser extent – in most sectors.

We draw your attention to two areas in particular:

- Section 7.0 on pages 7 to 12 deals specifically with the **new T661** and – perhaps more importantly – the policy changes implicit in it.
- Appendix B on pages 15 to 18 outlines CRA’s most recent position on **scientific eligibility** as articulated to the Canadian Electrical Association by senior members of CRA management. CATA notes that the positions articulated by CRA management on this occasion “*are more restrictive than those applied historically in the program*” .

DOCUMENT TITLE: **Scientific Research and Experimental Development (SR&ED) Tax
Incentive Program
Disconnect - The CRA’s New Perspective and New Requirements
December 14, 2008**

<http://www.cata.ca/files/PDF/CATASREDJan62008.pdf>

Date Posted at Scitax.com : 25-Jan-2009

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Scientific Research and Experimental Development (SR&ED) Tax Incentive Program

Disconnect - The CRA's New Perspective and New Requirements

December 14, 2008

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Appendix A New Documentation for the SR&ED Tax Incentive Program Released by the CRA Since November 10, 2008

Appendix B Scientific Research and Experimental Development (SR&ED) Tax Incentive Program, Current Issues

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1.0 Call for Government Action

1.1 The Canadian Advanced Technology Alliance (*CATA Alliance*) is concerned that the SR&ED tax incentive system is disconnecting from:

- today's economic realities where incentives are required to promote rapid, enduring competitiveness gains. The current directions of the SR&ED program will hinder Canada's ability to improve its lagging productivity and develop critical expertise.
- business needs for an effective and efficient incentive system that integrates with firms' normal development and business practices without creating distortions and with minimal compliance costs to both the private sector and the public sector; and
- the program's objectives to effectively support technological innovation in Canadian products and processes at the commercialization edge.

1.2 ***CATA Alliance* calls on the Government to refocus the management of the SR&ED tax credits so that they are once again effective and efficient at the commercialization end of the technology innovation cycle.**

- The goal should be the consistent, predictable and timely delivery of a company's full entitlement to the credits under the legislation without distorting the way companies conduct their business. The result should be the maximum economic benefit achievable with, of course, appropriate due diligence by both the private sector and the public sector.

1.3 ***CATA Alliance* believes that these goals can only be achieved if policy consensus and jurisprudence are re-established and new simplified approaches to filing are issued.**

- Given the administrative issues that have repeatedly arisen over the more than two decades of the program's existence because of the conflict that exists between the Agency's mandated focus on compliance and the program's needs, *CATA Alliance* believes that a neutral, independent third party oversight process must be established to ensure that any changes retain historic policy, sectoral and size neutrality, and have minimal impact on how businesses choose to operate.
- The filing requirements must be consistent with the way businesses conduct their developments and should not favour one approach over another.
- *CATA Alliance* suggests that a distinction may be needed in the requirements for the claims of the smaller companies and the requirements that are appropriate for the larger firms with their inherently more complex development needs and practices.

1.4 ***CATA Alliance* calls for the credits to be universally refundable and for the appropriate changes to the legislation to be made as a key component of the Government's response to the economic crisis.**

- The CRA's own claimant satisfaction survey in 2005 revealed that only 60% of larger firms (firms with revenue over \$50 million) were satisfied with the effectiveness of the program in encouraging the claimant to conduct more R&D in Canada, and only 48% of larger firms were satisfied with the effectiveness of the program in encouraging the claimant to stay in Canada.¹
- All Canadian businesses need to innovate to survive today and the return on such an investment will be one of the best options that Government could choose.

2.0 Background

2.1 The 2008 Federal Budget responded to the business community's concerns about the CRA's administration of Canada's \$ 4 billion program of tax incentives for scientific research and experimental development, the SR&ED Tax Incentive Program. The SR&ED tax credits are intended to encourage Canadian business to invest in R&D. The overall aim of this program is to promote the creation of improved and hence more competitive Canadian products and processes by businesses of all sizes and in all industry sectors.

2.2 Pre-budget consultations had highlighted a plethora of administrative problems with the program that ranged from the refusal of CRA staff to follow the Agency's historic policies on what is eligible for the tax credits to the lack of objectivity, consistency and timelines of the Agency's reviews, and the inadequacy of the Agency's redress processes for the program.

Concerning was the fact that administrative issues were particularly pervasive in the assessment of the administration by the larger firms that provided input to the consultations. Larger firms often questioned whether the credits could be influential in attracting investment, given uncertainties about how the Agency's reviewers would treat their claims.

More recently, a survey of 43 Canadian multinational R&D performers in Montreal and Toronto that included 17 of the global top 50 R&D performers and 25% of all R&D conducted in Canada also shows that concerns with administrative issues and the lack of refundability of the credits are significantly impacting on the decisions of these companies to not use the program.²

¹ Paper by CATAAlliance, *SR&ED Tax Incentive Program Canada Revenue Agency (CRA) 2005 Claimant Satisfaction Survey – Analysis of the CRA's Report on the Results of their Study*, October 2007, page 5. http://www.cata.ca/files/PDF/Analysis_of_SRED_2005.pdf

² Paper by Hausch, J.; de Luca, A.; and Hill, G.; presented at the 2008 Annual Tax Conference, Canadian Tax Foundation, Calgary, November 30 – December 2, 2008.

In fact, as early as 2005, the CRA's own claimant satisfaction survey revealed that only 51% of larger firms (firms with revenue over \$50 million) were satisfied with the CRA's administration of the program.³

2.3 In the 8 months since the Budget, the community has sought the opportunity to be consulted on how to most effectively bring about improvement and on an action plan for doing so. The point is that for changes to be truly effective they must be compatible with the way that businesses operate efficiently. This is particularly true for software engineering development practices and for how large, multifaceted engineering developments must be managed in both the IT and manufacturing sectors.

Both the Minister of National Revenue and the Agency are being encouraged to engage with the community in consensus based consultation on which the SR&ED program has been built since its inception in the mid-1980s.

2.4 In the meantime, the Agency has been developing new requirements for claiming and what appear to be significant changes to longstanding program policy. In the first week of November, the Agency began releasing new forms (e.g., T661 claim form) that are to be used for all claims for tax years ending after December 31, 2008, associated guidance, and a new self-assessment screening test for eligibility. To date, 13 new documents have been posted. (See Appendix A for list of documents.) Many of the changes seem more consistent with the Agency's recent corporate focus on compliance and hence on revenue recovery than with the administration of an incentive where entitlement and economic return with accountability are critical metrics of success.

3.0 Issue

3.1 A reading of this new material reveals that in defining an SR&ED project the CRA is moving away from a position well established in policy and jurisprudence to a much more naïve, classic concept of how R&D is managed. Specifically, the CRA seems to have taken the view that R&D is managed or should be thought of as relatively isolated endeavours in contrast to the highly integrated approach that businesses must take to improve their products and processes to successfully compete. In particular, this classic concept is not common to the software and engineering development environments commonly used by Canadian businesses. The CRA is now clearly refusing to recognize entitlement for engineering work in environments where R&D is associated with commercial activities.

³ Paper by CATAAlliance, *SR&ED Tax Incentive Program Canada Revenue Agency (CRA) 2005 Claimant Satisfaction Survey – Analysis of the CRA's Report on the Results of their Study*, October 2007, page 4. http://www.cata.ca/files/PDF/Analysis_of_SRED_2005.pdf

These CRA positions render the SR&ED incentives relatively ineffective at promoting incremental advancements in existing products and processes achieved through technological innovation carried out in the context of a commercial environment. It is these kinds of investments in product and process innovation that can give the economy the quickest returns during times of economic stress.

3.2 The Agency says the new material is aimed at simplification and improving clarity through the use of plain language and that the material does not represent changes in policy. At the same time, CRA Head Office officials have been outlining their position on eligibility, a position that impacts significantly on what has been historically supported by the credits. As well, it is now becoming clear to industry, claimants and practitioners that the new form and guide are not simpler and ultimately require more work and change for many claimants. The CRA has set a documentation standard that is realistic only for relatively dedicated projects focused on narrow R&D challenges - not on the highly complex, integrated, cross-functional projects common to engineering and software innovation in the private sector in Canada.

4.0 Analysis

4.1 Over the last month, the Canadian Advanced Technology Alliance (*CATAAlliance*) has conducted small roundtable discussions with tax managers and practitioners from across the country to get their take on the changes. As well, *CATAAlliance* has consulted with senior experts recognized for their years of experience with the program and with its Board of Directors.

5.0 Results of the CRA's recent releases

5.1 The net result of all of this change by the CRA seems to be much narrower support for business innovation with more stringent, costly documentation requirements that are most likely to be met only when SR&ED projects are conducted in relatively dedicated R&D environments.

5.2 The CRA's position severely impacts on the traditional support provided by the SR&ED tax credits for innovation at the edge of commercialization - a key to Canadian competitiveness.

5.3 Overall, there seems to be a shift by the CRA very much towards early stage research and away from the software and engineering work conducted to incrementally improve products and processes, and assist Canadian firms to remain competitive. This is in spite of the fact that

incremental improvements are a stated intent of the legislation⁴ and what is needed to maintain the competitiveness of existing manufacturing infrastructure.

5.4 In the IT sector, the CRA's shift raises questions about how much work associated with application development will be treated as eligible. Equally, for manufacturers the shift raises questions about the eligibility of incremental improvements required to keep Canadian processes competitive through shop floor research.

5.5 The CRA's position seems fundamentally out of step with what is needed in these stressed economic times and even with what is recognized as needed in Canada by the Government in respect to innovation. Kevin Lynch, Clerk of the Privy Council, remarked at a recent OECD roundtable:

"...why such a focus on innovation and globalization today? Neither is remotely a recent phenomenon.

*All true, but what is more recent is a clearer analytic understanding of the **role** of innovation in driving growth in productivity performance and standards of living. Innovation, the ability to envisage and create new products and services, or to produce existing products in different ways, lies at the heart of modern competitiveness. Joseph Schumpeter noted: 'without innovation, no entrepreneurs; without entrepreneurial achievement, no capitalist returns and no capitalist propulsion....'"⁵*

5.6 The Agency's actions and inherent compliance perspective seem to be taking Canadian support for business innovation in the opposite direction of what is needed and, for that matter, in the opposite direction of our competitors. Countries like the UK and France have drawn extensively from the historic Canadian definitional experience of what is eligible, which is consistent with international standards. Experts familiar with the tax incentive programs of other countries report that those programs are not limiting their support for experimental development to the narrower view that now seems to be officially being taken by the CRA. In fact, in recognition of the importance of this type of stimulus for creating the infrastructure needed to climb out of this recessionary period, France has just announced that as part of their economic stimulus package, their credit will be fully refundable for all claimants when the credits cannot be used to offset corporate taxes.

⁴ *Income Tax Act*, Part XVII, 248(1)(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."

⁵ "Science, Technology and Innovation in the Global Environment: Emerging Trends and Policy Challenges", remarks by Kevin Lynch, Clerk of the Privy Council, Secretary to the Cabinet and Head of the Public Service of Canada – OECD Roundtable, March 17th, 2008, Ottawa. http://www.pco-bcp.gc.ca/index.asp?lang=eng&Page=clerk-greffier&Sub=speeches-discours&Doc=20080317_e.htm

5.7 The SR&ED tax credits are known to provide some of the best returns of any form of infrastructure investments that can be made. It is the position of the CATAAlliance, that the CRA's changes are highly counterproductive and are putting Canadian firms at a distinct competitive disadvantage globally at a time of extreme economic stress.

6.0 Conclusion

6.1 The conclusion is that the CRA is implementing what are some of the most significant set of changes in the history of the SR&ED program in the context of an improvement initiative.

- The guidance sets new standards expressed as requirements for how projects are characterized, supported, documented, and costs justified.
- The CRA has outlined much narrower official positions on what constitutes SR&ED than that supported in jurisprudence or that supported by historic CRA policies.
- The CRA has introduced a new term, "Technological Obstacles/Uncertainties", which is defined in a way that seems much more restrictive and inconsistent with the fundamental policy laid out in the CRA's core policy document on what constitutes a "technological uncertainty". (See Information Circular, IC 86-4R3, section 2.10.2, <http://www.cra-arc.gc.ca/E/pub/tp/ic86-4r3/ic86-4r3-e.html>.)⁶

7.0 Commentary and Observations Specific to Recent Releases by the CRA

Note: this detailed analysis of the new T661 Form, the new Guide to the T661, the recently introduced SR&ED Eligibility Self-Assessment Tool, and the new public policy positions of the CRA is not intended to be definitive, but rather illustrative of how the CRA's expectations have changed and what some of the implications are for claimants.

⁶ The policy positions outlined in Information Circular IC 86-4 were developed as a consensus by an independent neutral third party panel of senior Canadian experts in consultation with the community after Revenue Canada had

- established with the Department of Finance the Government's intent;
- obtained internal legislative rulings on the critical technical positions that had to be addressed in the IC; and
- obtained the advice of the Department of Justice on how best to frame the policy to maximize its credibility in the eyes of the courts where the established jurisprudence suggested that in the case of an incentive, the courts looked towards broader interpretations consistent with the legislation.

The courts have continued to provide strong support for the role of public-private sector consensus on interpretations and for liberal and broad interpretations of the SR&ED tax incentives. Refer to *Northwest Hydraulic Consultants Limited v. Her Majesty the Queen*, 98 DTC 1839; and *Consoltex Inc. v. The Queen*, 97 DTC 724.

For some details of the consensus-based consultation process and the panel members, see Appendices A & B of IC 86-4 and IC 86-4R2.

7.1 Eligibility

- According to the CRA’s new “SR&ED Eligibility Self-Assessment Tool”, “**all**” potential methods (solutions) within the claimant’s current level of training and experience must be exhausted before a “**technological obstacle/uncertainty**” exists. The SR&ED Eligibility Self-Assessment Tool (<http://www.cra-arc.gc.ca/txcrdt/sred-rsde/ssssmnt/menu-eng.html>) states that:

*“Technological Obstacles/Uncertainties are shortcomings and/or limitations of the current state of technology that prevented you from developing the new or improved capability. These are the technological problems or unknowns that cannot be overcome by applying **all** of the methods that are within your current level of training and experience.”* (Bold added for emphasis.) (Extract from “SR&ED Eligibility Self-Assessment Tool”, <http://www.cra-arc.gc.ca/txcrdt/sred-rsde/ssssmnt/menu-eng.html>, Glossary: “technological obstacles”.)

- Hence, advancements focused on understanding which methods, techniques, and practices are the best solution for solving given types of technological problems or how best to solve a technological challenge would seem excluded.
- Hence, eligible projects would seem only to start after all methods have been explored and by inference only when there is a risk of not finding a solution, i.e., not when the technological uncertainty, which by definition includes the exploration of methods, is first recognized. ”. (See Information Circular, IC 86-4, section 2.10.2, <http://www.cra-arc.gc.ca/E/pub/tp/ic86-4r3/ic86-4r3-e.html>.)

Hence, from the CRA’s new perspective, the work of engineers to understand how and which existing methods and practices, etc. are effective for what purpose and/or how to extend them to new problems and environments would not be Experimental Development.

The new concept of “Technological Obstacles/Uncertainties” is much more limited than the current policy on what constitutes a “Technological Uncertainty” as set out as one of the critical concepts in IC 86-4. Specifically, the historic policy supports the fact that Experimental Development includes advancing the knowledge of how one can achieve capabilities through the use of existing methodologies and practice or extend the use of engineering practice (methodologies and techniques) to do something that engineers did not know how to do before. IC 86-4, section 2.10.2, states:

Whether or not a given result or objective can be achieved, and/or how to achieve it, is not known or determined on the basis of generally available scientific or technological knowledge or experience. This criterion implies that we cannot know the outcome of a project, or the route by which it will be carried out without removing the technological or scientific uncertainty through a program of scientific research or experimental development. Specifically, scientific or technological uncertainty may occur in either of two ways:

- *it may be uncertain whether the goals can be achieved at all; or*

- *the taxpayer may be fairly confident that the goals can be achieved, but may be uncertain which of several alternatives (i.e., paths, routes, approaches, equipment configurations, system architectures, circuit techniques, etc.) will either work at all, or be feasible to meet the desired specification or cost targets, or both of these.*

(Information Circular, IC 86-4, section 2.10.2, <http://www.cra-arc.gc.ca/E/pub/tp/ic86-4r3/ic86-4r3-e.html>.)

This type of work represents a major portion of the Experimental Development work that has currently been claimed for advancing engineering and software development techniques. Very seldom is the focus of Experimental Development on entirely new methodologies, albeit the potential solutions are always new to or unproven as a solution for the type of challenge being encountered.

Consistent with the CRA's narrowing view of Experimental Development above are the positions outlined this fall by the CRA's senior management on the Agency's current interpretation of the legislation. (For details, see Appendix B for document, "Current Issues", developed by the Canadian Electricity Association (CEA) and the CATAAlliance.) Specifically, the CRA noted that eligible work on the extensions of new technologies beyond the initial core development would be very limited and based on the specific facts of the case. This seems inconsistent with historic policy as set out in IC 86-4 which specifically supports incremental improvements.

- According to the CRA's new guidance, the results of Scientific Research work are "often published in scientific journals and other peer reviewed publications."
 - Hence, as presented, the new guidance seems to be setting up an additional reference point, i.e., publication or publishable, even though publication does not occur in most private sector research.

7.2 Scope of a Project, Work and Environments

- According to the new CRA guidance, project descriptions, and hence projects are to be focused either around a science advancement (basic and/or applied research) or a technological advancement, but not both.
 - Hence, multidisciplinary projects where advancements can occur in multiple fields of science and technologies will likely need to be broken down into multiple projects so that they can be reviewed from the artificial perspective of either engineering or science.

Ironically. It is at the interface of science and technology that some of the most innovative R&D occurs. Advances often occur from both perspectives, not just from one or the other.

- According to the new CRA guidance, projects must be defined in terms of specific, limited numbers of fields of science or technology which the CRA has extracted from international descriptors intended for statistical purposes only. The use of “other” as a category for technological fields is not allowed by the CRA, although international conventions do recognize the need for this.

Only one field can be used for a given project and the technological advancements in the project description are to be characterized by how this field is advanced.

- Hence, large, multidisciplinary, and multidimensional projects will likely need to be artificially broken down into their subprojects according to the number of fields being advanced. Such a project will no longer be able to be submitted as a single overall description of the whole technological project even when the actual advancements are occurring at the interface of several fields, a very common happening.
- According to the new CRA guidance, projects exist only at the point where work begins on the “Technological Obstacle/Uncertainty”. This contrasts with historic policy which focuses on when the “technological uncertainty” is first identified, i.e., when it is determined that normal or known solutions to the problem do not work. That is, the new policy is that a project exists (starts) only after “**all**” known methodologies within the engineers’ experience that could conceivably be used have failed to provide a solution.
- According to the new CRA guidance, projects are complete either when the “technological obstacles/uncertainties” are overcome or the project is “terminated for any reason”.
 - Hence, the CRA seems to be indicating that a new project stops when work is terminated, whether for technological reasons or business reasons.
 - Hence, with the requirement that projects be focused to narrow domains, as potential approaches to solutions in one domain are eliminated and new ones examined in different domains, new projects will need to be initiated one at a time, potentially leading to a plethora of projects related to even just a single technological challenge.
- According to the CRA, the engineering work considered to be SR&ED as defined by the legislation is impacted by whether the project is conducted within a dedicated R&D focus or in conjunction with a commercial endeavour, such as learning how to advance an existing commercial process or to understand the impact of real load conditions on software technologies or new process technologies.
 - Hence, engineering work needed to develop or validate a technological advancement that has normally been considered to be SR&ED even when associated with the commercial use of the technology is no longer to be included as SR&ED.

- This concept will result in a carve-out when engineering work is conducted in a commercial context. Such work is now to be treated as overheads and is not to be included in the proxy calculation as it has been in the past.

7.3 Requirements, Documentation Standards

Note: The T661 Form is what is termed a prescribed form, and hence the specific information to be included in it according to the new Guide becomes formal requirements. Failure to complete any item as the CRA's guidance outlines is grounds for the CRA to deny a claim. Correction or additions can be made only up to 18 months after a given year end. These new requirements are to take effect for tax years ended after Dec. 31, 2008.

In principle, the CRA is allowing claimants to use the previous version of the T661 Form for earlier years, although the appropriate versions for electronically completing forms for these years are no longer being made available. (CATAAlliance brought this matter to the attention of the Commissioner of the CRA in a letter dated December 4, 2008, and to the attention of the Minister of National Revenue in a letter dated December 14, 2008. See copy of letter to Minister of National Revenue at http://www.cata.ca/Media_and_Events/Press_Releases/cata_pr12160801.html. Subsequently, on December 19, 2008, the CRA revised the T661 Questions and Answers that they had posted on November 10, 2008, to include additional transitional measures for filing the new T661 form.)

According to the new CRA guidance:

- projects must be supported by contemporaneously generated documents or other evidence of the chronology of the systematic, experimental or analytical process that was used to resolve the “Technological Obstacles/Uncertainties”;
 - the contemporaneous material is also to serve as the source for the summaries that are to be “extracted for” the project description;
 - the evidence should be able to be linked to work elements claimed, who performed them, why it was necessary to achieve the specific advance for the project, how materials were used, and quantities, etc.; and
 - work for which there is no relevant supporting evidence will “likely be disallowed”, implying that verbal evidence will not be accepted.
- Hence, when SR&ED is conducted in commercial environments, new provisions will normally have to be made to document the SR&ED projects in terms of the classic, systematic iterative process of experimentation and analyses envisioned by the CRA. This is not how large, complex engineering and software development projects are

managed and documented in today's environment where efficiency and speed are critical factors.

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APPENDIX A

New Documentation for the SR&ED Tax Incentive Program Released by the CRA Since November 10, 2008

[2008-12-01]

[Revised - Application Policy SR&ED 2004-02R: Filing Requirements for Claiming SR&ED](#)

[2008-11-17]

[Questions and Answers - SR&ED Eligibility Self-Assessment Tool and Other Products](#)

[2008-11-17]

[News Release – Claiming scientific research and experimental development tax credit made easier for small businesses](#)

[2008-11-17]

[SR&ED Eligibility Self-Assessment Tool](#)

[2008-11-17]

[RC4467, Support for your R&D in Canada](#)

[2008-11-17]

[RC4472, Overview of the Scientific Research and Experimental Development \(SR&ED\) Tax Incentive Program](#)

[2008-11-10]

[Questions and Answers - New SR&ED Form T661 and Guide](#)

[2008-11-10]

[Revised Form T661, Scientific Research and Experimental Development \(SR&ED\) Expenditures Claim](#)

[2008-11-10]

[Revised T4088, Guide to Form T661 - Scientific Research and Experimental Development \(SR&ED\) Expenditures Claim](#)

[2008-11-10]

[Clickable Form T661](#)

[2008-11-10]

[Example of Form T661 - Scientific Research and Experimental Development \(SR&ED\) Expenditures Claim](#)

[2008-11-10]

[Revised T1145, Agreement to Allocate Assistance Between Persons Not Dealing at Arm's Length for Scientific Research and Experimental Development \(SR&ED\)](#)

...continued **APPENDIX A**

[2008-11-10]

[Revised T1146, Agreement to Transfer Between Persons Not Dealing at Arm's Length Qualified Expenditures Incurred in Respect of Scientific Research and Experimental Development \(SR&ED\) Contracts](#)

[2008-11-10]

[Revised T1174, Agreement Between Associated Corporations to Allocate Salary or Wages of Specified Employees for Scientific Research and Experimental Development \(SR&ED\)](#)

[2008-11-10]

[Revised T1263, Third-Party Payments for Scientific Research and Experimental Development \(SR&ED\)](#)

Scientific Research and Experimental Development (SR&ED) Tax Incentive Program

Current Issues

In a recent meeting with the Canadian Electricity Association (CEA)¹, Senior Head Office Canada Revenue Agency (CRA) officials highlighted the following positions as the correct application policy for the SR&ED Tax Credits. These positions are more restrictive than those applied historically in the program. Subsequently, CRA's Head Office confirmed to the Canadian Advanced Technology Alliance (CATAAlliance) that these positions were correct policy.

It should be noted that these restrictive new policy positions described below are already being applied in some regions in the country but not all. The subjective nature of the policy positions described below and the fact that they are being applied on an inconsistent basis decreases predictability and it makes it harder for companies to use the SR&ED incentives to influence their R&D investment decisions.

1) The concept of a Core Technology

CRA's new policy position

Under this concept, the development of a core technology qualifies as scientific research and experimental development (SR&ED) but extensions to that technology for the use that it was intended or the development of that technology for use in situations for which it was not designed to be used would not qualify as eligible SR&ED, or at least only initial extensions on a limited case specific basis would qualify. This concept can be highly subjective which makes the ability of taxpayers to claim SR&ED for incremental improvements very problematic.

Concerns about CRA's new policy position

This restriction is inconsistent with current CRA policy guidance, namely Information Circular IC 86-4R3 and the associated Guide "Recognizing Experimental Development" and it is not sanctioned in law. Section 248 of the *Income Tax Act* defines SR&ED to include "...work undertaken for the purpose of achieving a technological advancement for the purpose of creating new, or improving existing materials, devices, products or processes, including *incremental improvements thereto*²". In addition, as noted by the Courts, "Most scientific research involves gradual, indeed infinitesimal, progress.

¹ September 5, 2008, meeting of the Canadian Electricity Association (CEA) and the CRA, in Calgary.

² Emphasis added.

Spectacular breakthroughs are rare and make up a very small part of the results of SRED in Canada.”³

Impact on Business

If this focus on the core technology is applied consistently, much critically needed R&D based improvements and efficiency gains undertaken today will fail to qualify for the SR&ED incentives.

2) The concept of a Primary Purpose Test.

CRA’s new policy position

Under this concept, if a project is undertaken for SR&ED and something else (such as for making money), the primary purpose must be SR&ED for the work to qualify. CRA says that they will use their discretion to allow work as SR&ED or not, depending on whether they deem the facts to support a claimant’s assertion that the primary purpose of the work is focused on SR&ED.

Concerns about CRA’s new policy position

This is a highly subjective test as, inherently, most R&D projects conducted by business have primarily commercial intent.

An example of this would be a project where experimental production is required to prove out a technology. The norm is for product to be produced as a part of an SR&ED experiment and for it to be sold at the end of the day or reprocessed into usable goods for sale if there is a market. This is simply good business practice albeit some offices are saying that it is proof that the overriding purpose is commercial and not the SR&ED needs that have driven the study.

In respect of experimental production, the government has legislated “recapture rules” so that when, as in the above example, a product is sold or converted to commercial use, the taxpayer must recapture any expenditure claimed as SR&ED. These recapture provisions are intended to protect the tax base for the government while still providing support for the associated SR&ED in these dual purpose situations.

Impact on Business

If a primary purpose test is applied consistently, claims for SR&ED focused on improving products and processes will decrease dramatically. The more predictable

³ Justice Bowman in *Northwest Hydraulic Consultants Limited v. The Queen*, 98 DTC 1839, Tax Court of Canada, May 1, 1998

claims will be limited to situations where SR&ED is conducted in dedicated research environments in contrast to application settings and shop floor environments. Even in these cases, CRA's positions are currently seen as problematic in some regions.

3) **The concept that SR&ED Support work (248(1)(d)) is incremental to the business project.**

CRA's new policy position

Recently, senior CRA officials have indicated that the exclusions in subparagraphs 248(1) (e) to (k) of the *Income Tax Act* override the inclusion of eligible support work as defined in subparagraph 248(1)(d). There is an indication that despite this position, CRA is prepared to allow support work on a discretionary basis, i.e., on a case-by-case basis.

Support activities include engineering, design, operations research, mathematical analysis, computer programming, data collection, testing or physiological research, where the work is commensurate with the needs of and directly in support of eligible, basic research or applied research or experimental development. The *Income Tax Act* goes on to exclude routine testing, commercial production and other activities. The exclusions, other than the one contained in subparagraph (g) related to research in the social sciences or the humanities, were meant to draw a line between work that is eligible support work and work such as testing that in and of itself is ineligible.

Concerns about CRA's new policy position

This interpretation of the *Income Tax Act* is not sanctioned by the legislation, or in case law, or in the CRA's current guidance. The application of the discretion in applying this interpretation by the CRA would be highly subjective and has already led to unpredictability over the application of the rules by certain offices.

Impact on Business

By taking the position that all the exclusions in 248(1) (e) to (k) override the eligibility of support work as defined in 248(1)(d), except at their discretion, the CRA has increased uncertainty for claimants about what is eligible and decreased the effectiveness of the credits as influencers.

Summary

Historically, the SR&ED program has worked well as an incentive for investments in innovation when there is a consensus between the Canada Revenue Agency, industry and SR&ED practitioners; when there is a strong Head Office oversight of the regions; and when the program is administered in a consistent and predictable manner. Only when this

is achieved has the SR&ED program been an effective incentive to business to invest in technology innovations to improve their products and processes. The 2008 Budget stated that the key administrative challenges identified by stakeholders consulted on the program “were in the areas of accessibility, predictability and consistency”⁴. These policy positions outlined above show that these challenges still exist today.

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⁴ Budget 2008, Chapter 3, “Scientific Research and Experimental Development Tax Incentive Program”, “Administrative Improvements”