



SR&ED Newsletter

Edition 2014 –2

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

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Recent SR&ED tax cases

Fio – CRA use of evidence during TCC Appeal - WIN¹

Facts

During a tax court appeal for its 2007, 2008 and 2009 taxation years the CRA used information obtained from the court to further reassess the appellant (Fio) for those years.

The Appellant (Fio) brought a motion for an order vacating the reassessments & directing the Minister of National Revenue and/or the Attorney General of Canada **to pay \$100,000** as “punishment for her/their contempt of this Court” and awarding the costs of this motion on a full indemnity basis.

Issue

This issue before the Court is whether the Minister breached the “implied undertaking rule” by using information obtained by the Respondent in the course of pre-trial discovery proceedings to reassess the Appellant.

Legislation & analysis

Income Tax & other legal precedence

The CRA’s defence argued that section 241 of the ITA provides a complete code governing how the Minister can use a taxpayer’s information. In effect, it overrides the **implied undertaking rule**.

Basically the “implied undertaking rule” focuses on the protection of privacy rights and promoting full discovery and full and frank disclosure. It has been adopted by most levels of court in Canada.

Analysis:

Fio argued that, if the Court allows the Minister’s conduct to stand, the Minister can effectively delay a dispute ad infinitum by reassessing, and that such a situation would undermine the role of this Court and the administration of justice.

The CRA’s defence was that the relationship between the Minister and the taxpayer is a different relationship than that of normal litigants. Because of this relationship, the implied undertaking rule does not apply to the Minister in the fact situation before the Court.

Ruling & rationale (Judge’s comment) - loss

The judge concluded,

“I cannot accept an argument that provides more favourable treatment to one of the parties before the Court. The **Respondent (CRA) cannot use the Discovery Documents** in any other proceeding before this Court or any other court .

The Appellant requests costs on a full indemnity basis. I do not believe that the Respondent’s conduct warrants an awarding of costs on a solicitor and client basis. Such costs are reserved for cases of reprehensible, outrageous or scandalous behaviour.

However, it is my view that the conduct of the Respondent requires an award of substantial costs. In light of the Respondent’s conduct, I have decided to award the **Appellant costs of \$25,000.**”

Author’s comment: moderate significance

This case illustrates the high level of misunderstanding of the differences between the

- Objection process &
- Tax Court of Canada appeals processes.

even by Canada Revenue Agency staff.

Likely of high importance give current level of objections and the likelihood of these proceeding to the appeal process.

<u>Typical dispute resolution steps & timelines</u>		
<u>Step - Administerd by</u>	<u>Parties</u>	<u>Expected timeframe</u>
I) Canada Revenue Agency		
a) Negotiate with CRA reviewer	CRA & client	30 days
b) 2nd admin. review	CRA & client	180 days
c) Objection [ITA s. 165]	CRA & client	365+ days
II) Tax Court of Canada [ITA s. 169]		
a) Appeal - Informal	CRA, Dept. of Justice & Client	6-9 months
b) Appeal - General	CRA, Dept. of Justice & Client	2-3 years

¹ Fio Corporation v. The Queen - 2014 TCC 58, Date: 2014-04-29

Laboratoire du-var Inc. – documenting owners time for SR&ED - LOSS²

Facts

Over the years, the appellant submitted many research and development projects. The vast majority were received favorably by the Canada Revenue Agency that usually accepted them as submitted.

For the **2003 and 2004** taxation years, all the salary paid to **Mr. Trudeau and his spouse as salary expenditures** for various research and development projects was **allowed; for the 2005 and 2006** years, the Canada Revenue Agency (the Agency) **allowed Mr. Trudeau's expenditures at 25% and disallowed all of Ms. Nadon's.**

Issue

Therefore, the only issue is the following: were the salaries of Pierre Trudeau and his spouse Louise Nadon considered eligible expenditures?

Legislation & analysis

Income Tax Act

The act only requires that the wages be,

“expenditure made in respect of an expense incurred in the year for salary or wages of an employee who is **directly engaged** in scientific research and experimental development in Canada **that can reasonably be considered to relate** to such work having regard to the time spent by the employee thereon.”³

CRA Guidance

He noted that the Agency had modified and restricted the qualification criteria by tightening the control mechanisms on one hand, and adding an array of new elements on the other.

The appellant repeatedly insisted during the examination by the respondent's representatives that they should have considered the prior records where the president and his spouse's salaries were fully allowed, in particular for 2003 and 2004.

Ruling & rationale (Judge's comment) - loss

The judge denied the appellants claims stating

“Despite the many questions the president, Mr. Trudeau, was asked, he was **never able to provide specific explanations to establish a direct and unequivocal relationship** in terms of the work attributed to the research project for which he billed hours of work that were disallowed, thereby giving rise to the sole issue under appeal

A direct relationship between the various components and the claim submitted is required and must be established on a balance of probabilities, so it would seem that each research and development project is a specific case with specific data.”

Author's comment: moderate significance

Recent CRA requests for information include,

“We require documentation to support the time spent in SR&ED by the specified employees.

We require **time sheets and/or time logs to** support the time spent working during the year and the time spent doing work **directly engaged in SR&ED** for work performed in Canada.

The time sheets or time logs **must be detailed enough** for us to determine what duties you were performing in order to determine if they meet the "directly engaged in SR&ED" definition.”

As a result it is **increasingly important** for all researchers (especially owners of the company) **to keep logs of their work on a daily or at least weekly basis.**

Notable quote:

“Give a person a fish and you feed them for a day. Teach a person to use the Internet and they won't bother you for weeks, months, maybe years”

-Anonymous

² Laboratoire Du-Var Inc. v. The Queen. v. The Queen - 2012 TCC 366, Date: 2012-10-17

³ ITA 37(8)(a)(ii)(B)

Coveley– wage accruals & ABILs – PARTIAL LOSS – many lessons⁴

Facts

The appellants are the co-founders of cStar Technologies Inc (“cStar”). They are husband and wife.

Mr. Coveley holds mechanical and electrical engineering degrees. He was the chief technology officer and senior vice- president of cStar. He is also an employee of cStar. Mr. Coveley is **not a shareholder** of cStar.

Mrs. Coveley is the sole shareholder, president and chief executive officer of cStar. She is also an employee of cStar.

Starting in 1998, the appellants **made loans** to cStar comprising of their **unpaid remuneration**, cash advances and corporate expenses that they paid on behalf of cStar with their personal credit cards.

In 2006 each appellant claimed an allowable business investment loss (“ABIL”) in their income tax returns

The Minister of National Revenue (the “Minister”) disallowed the ABILs on the basis that the appellants did not meet the requirements of the Income Tax Act (the “Act”) for claiming an ABIL.

Issue

Are the appellants entitled to deduct an ABIL in computing their incomes?

Legislation & analysis

Income Tax Act

“Business investment loss” is defined in part as follows at paragraph 39(1)

(c): “a **taxpayer's business investment loss** for a taxation year from the disposition of any property is the amount, if any, by which the **taxpayer's capital loss** for the year from a disposition after 1977 . . . to which subsection 50(1) applies”, exceeds any of the amounts subsequently referred to.

50. (1) Debts established to be **bad debts and shares** of bankrupt corporation.. [where]

(i) the corporation has during the year become a bankrupt (within the meaning of subsection 128(3))

....

(ii) is insolvent ...& a winding-up order made in the year, **or**

(iii) at the end of the year,

(A) the corporation is **insolvent**,

(B) neither the corporation nor a corporation controlled by it **carries on business**,

(C) the fair market value of the share is nil, and

(D) it is **reasonable to expect that the corporation will be dissolved or wound up** and will not commence to carry on business

Ruling & rationale (Judge's comment) - loss

The judge used a 3 step process to determine if either Mr or Mrs. Coveley would be eligible to claim the ABIL.

a) Was there a debt owed to the appellants by cStar?

The accrued salaries were credited to the appellants' loan accounts. In my view, this is sufficient to establish the existence of debts owed to the appellants by cStar.

b) The debt was incurred for the purpose of gaining or producing income from a business or property

Since there was no interest on the loans it became relevant whether the loan was by a common shareholder.

Accordingly, the judge's view was the condition the debt be incurred for the purpose of gaining or producing income from a business or property **is fulfilled for Mrs. Coveley (shareholder), but not for Mr. Coveley.**

His ABIL claim must therefore be disallowed on this basis.

(c) Did the debt become bad when claimed?

There was no evidence that the appellants made reasonable efforts to recover their debts ...tried to sell any of cStar's assets, such as patents or to sell any of cStar' shares.

The evidence showed that the appellants were not ready to share control of cStar with potential investors.

⁴ Michael Coveley v. The Queen - 2013 TCC 417, Date: 2013-12-20

Based on this the judge **concluded that the debt was not a bad debt at the end of 2006** & either neither party would qualify for ABIL deduction.

Author's comment: moderate significance

The judge also commented that,

“The appellants’ salaries should have not been included in their income, as the salaries were not received by them. Subsection 5(1) of the Act.”

This illustrates a **tax planning opportunity (accruing wages for unpaid work)** which can be used by SR&ED intensive companies in or early stages of their business cycle.

It also underlines the complications with claiming losses on a company which;

- is in poor financial position but
- still active in any manner.

Notable quote:

“All of us could take a lesson from the weather. It pays no attention to criticism”

- Anonymous

Notable quote:

**“To steal ideas from one person is plagiarism;
> to steal from many is
> research .”**

- Steven Wright

Notable quote:

“The real problem is not whether machines think but whether men do.”

- B. F. Skinner

Economic overview of the SR&ED program in Canada

Research and Development in Canadian Industry						
<u>Total business enterprise research and development expenditures</u>						
	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>	<u>% total</u>
Manufacturing	7,334	7,577	7,434	7,159	7,131	36%
Services	7,056	7,470	7,049	6,951	6,914	35%
Information and communications technologies	4,664	5,128	4,770	4,673	4,625	23%
Mining and oil and gas extraction	981	1,044	1,244	994	941	5%
Utilities	188	193	230	237	214	1%
Construction	113	137	100	103	105	1%
Agriculture, forestry, fishing and hunting	131	124	95	92	94	0%
Total all industries (x 1,000,000)	20,467	21,673	20,922	20,209	20,024	100%
<u>Total research and development personnel (full-time equivalent)</u>						
Services	73,293	78,729	70,044	n/a	n/a	40%
Manufacturing	63,861	59,933	56,445			32%
Information and communications technologies	48,147	49,379	45,106			25%
Mining and oil and gas extraction	2,044	2,011	1,763			1%
Agriculture, forestry, fishing and hunting	1,945	1,750	1,439			1%
Construction	1,916	1,835	1,318			1%
Utilities		1,343	1,148			1%
Total all industries	191,206	194,980	177,263			100%

According to the CRA

- The SR&ED program is the single largest federal tax incentive program that supports business research and development.
- The SR&ED program provided over \$3.6 billion in tax assistance to over 23,000 claimants in 2012 alone⁵.

The table above illustrates that businesses in Canada anticipated spending just over \$20 billion on industrial research and development (R&D) in 2014.⁶

Over 90% of total expenditure can be allocated to 3 main groups (manufacturing, service & Information technology).

Shift from tax credits to grants

While the latest figures on spending have not been published by the government it appears that there has been a reduction in

- 2007 levels of \$4.1 Billion & 25,000 claimants
- 2012 levels of \$3.6 Billion & 23,000 claimants

There has also been an increase in objection & appeals (roughly 600 objections in Ontario alone).

Many of the claimants being denied had claimed successfully in prior years.

Industries hardest hit appear to be manufacturing & software.

⁵ Canada Revenue Agency news release Feb. 6, 2014

⁶ Statistics Canada Table 358-0024 Business enterprise research and development (BERD) characteristics, by industry group based on the North American Industry Classification System (NAICS)

New BDC loan program for SR&ED

In September 2014 the Business Development Bank of Canada (BDC) is providing a new loan to **borrow up to \$250,000** to cover R&D and other tax credit-related expenses for a given fiscal year.

The key “tax credit financing” terms are:

- Up to 125% of claim (if previous successful claims) or
- 100% (if first time)
- Interest Rates: 6 to 9%
- No prepayment penalty;

Make no capital payments while you wait for your refund

Further reduce financial stress on your business by deferring your capital payments until your tax credit arrives.

Once you get your tax credit, you decide what’s good for your business

When you receive your tax credit, you can pay back the loan to reduce your debt, or you can transfer the amount to a term loan and use your tax credit money for other business needs, such as funding growth projects, buying equipment or stepping up your marketing efforts.

You can take up to three more years to pay back the term loan.

Pay back at any time with no penalty

There are no fees if you decide to pay back the loan earlier, leaving you choices if opportunities arise.

Limit your personal risk

Your personal assets are not taken as collateral for the loan.

For more information

For further information contact the BDC at

- 1 888 463-6232
- info@bdc.ca

Notable quote:

“I am so clever that sometimes I don't understand a single word of what I am saying.”

- Oscar Wilde

Notable quote:

“A clever, imaginative, humorous request can open closed doors and closed minds.”

- Percy Ross

New CRA SR&ED pronouncements

SR&ED T661 Claim Form – Revised optional filing measure for Part 9

As of **January 1, 2014**, Part 9 of the Form T661 (13) must be fully completed. If any of the prescribed claim preparer information is missing, incomplete or inaccurate, a penalty of \$1,000 may be assessed.

For claim preparers who have concerns about the confidentiality of their information, the CRA has introduced an administrative measure to permit Part 9 of the Form T661 (13) to be **filed separately**.

Step 1. Submit with your return, a complete Form T661(13) by the SR&ED reporting deadline. For Part 9 you will need to:

- check the appropriate box at line 935 attesting to whether a claim preparer was engaged in any aspect of the preparation of the claim;
- **provide the name of each claim preparer – line 940;**
- **provide each claim preparer’s business number – line 945;**
- certify that the information provided in this part is complete and accurate – line 970; and
- sign and date Part 9 - line 975.

However, in Part 9 you must not enter the billing arrangement data – lines 950, 955, 960 and 965 respectively.

Step 2. You must submit a paper copy of the T661(13), completing only Part 1 – General Information, and Part 9 – Claim preparer information. Both Parts 1 and 9 must be completed in their entirety for each claim preparer. You will need to:

- check the appropriate box at line 935 attesting to whether a claim preparer was involved in any aspect of the preparation of the claim;
- provide the name of the claim preparer – line 940;
- provide the claim preparer’s business number – line 945;
- **provide the billing arrangement code, billing rate, other billing arrangement(s) and the total fee paid, payable or expected to pay – lines 950, 955, 960 or 965 respectively;**
- certify at line 970, sign and date Part 9 at line 975; and
- send Parts 1 and 9 directly to your [tax centre](#) at the same time you file your return.

Do not resubmit Parts 2 through 8 or Part 10 of the T661(13).

If the CRA does not receive a complete Part 9 with the details for each claim preparer involved in preparing the SR&ED claim, the CRA may apply a \$1,000 penalty.

CRA reduces concern with SR&ED consulting fees

In the [2013 budget](#)⁷ the Government confirmed:

“The submissions received by the Government during the consultations indicated that intervention to regulate contingency fees directly is not required:

- the market for SR&ED tax preparers is competitive, contingency fee rates have declined over time and
- there is no evidence that this type of billing arrangement results in higher compliance costs for businesses.”

Notable quote:

“You can tell whether a man is clever by his answers.

You can tell whether a man is wise by his questions.”

- Naguib Mahfouz

⁷ Chapter 3.4: Investing in World-Class Research and Innovation

SALT (Self-Assessment Learning Tool)

SALT includes clear explanations of key concepts and tips on how to effectively structure an SR&ED claim submission.

The tool is divided into two standalone interactive PDF files that you can [download on your computer](#). No information will be transferred to the CRA through this tool.

[SALT Step 1](#) will help you understand the **eligibility requirements for SR&ED** work and help you determine if your company project might include SR&ED work.

The report generated at the end of this step will help you understand why your work is potentially eligible (or not) for the SR&ED Program. The information in your report can then be used to prepare your SR&ED claim.

[SALT Step 2](#) (PDF, 183 KB) will help you identify the **extent of eligible work** performed during the course of your project. This step will also help you estimate allowable expenditures associated with your work and the potentially claimable ITC.

Author's opinion:

These steps closely resemble the actual submission for the T661 form.

They may provide a basis for potential claimants to receive pre-approvals or other guidance being offered in CRA outreach efforts.

Ideally they could provide additional direction by way of sample projects.

Notable quote:

“The desire to seem clever often keeps us from being so.”

- Francois de La Rochefoucauld

Notable quote:

“I never make stupid mistakes. Only very, very clever ones.”

- John Peel

New tax changes

TCC informal appeal limit increase to \$25K

New legislation has been passed applicable after June 25, 2013 Informal Procedure Application⁸

“Where a taxpayer has so elected in the taxpayer’s notice of appeal or at such later time as may be provided in the rules of Court, and

the aggregate of all amounts in issue is equal to or less than \$25,000; ...”

Since this \$25,000 limit relates only to the federal tax credit it effectively allows a claimant in Ontario to;

- Claim up to \$40,000 (when you factor in the Ontario credits of up to 14.5%) &
- Get a ruling within 1 year of the initial disagreement with the CRA

Given the current level of objections this it is likely of immediate significance to claimants.

Stock option benefit denial of expenditure

In 2005 legislation proposed that the value of an option granted by a taxpayer is not considered to be an expenditure for SR&ED income tax purposes.

This legislation was recently passed with an effective Date: November 17, 2005 **except that for securities issued or sold before the announcement date (October 24, 2012)**, the definition "option" in subsection 143.3(1) of the Act, as enacted by subsection (1), is to be read without reference to its paragraph (a).

In the author’s view it is interesting to note that this opportunity potentially lasted until 2012 despite the legislation being proposed effective 2005.

New rules on defining “control” & association

In general terms, new 256.1(6) counters tax avoidance structures under which corporate tax attributes were traded by arm’s length persons in circumstances where a corporation (in a loss position) that has undeducted attributes (i.e., SR&ED ITCs) acquires control of a corporation that is profitable.

Because the loss corporation acquires control of the profitable corporation, the owners of the corporation avoid, subject to the general anti-avoidance rule (GAAR), an acquisition of control of the loss corporation and the application of the tax attribute trading rules.

This new provision deems there to have been an **acquisition of control of a corporation**, applies at a particular time if:

Shares of the corporation held by a person(s), have at the particular time, a fair market value (FMV) that exceeds **75% of the FMV of all the shares of the capital stock** of the corporation.

Author’s opinion:

This change appears to address concerns that loss companies are being used inappropriately.

Notable quote:

“One machine can do the work of fifty ordinary men. No machine can do the work of one extraordinary man.”

- Elbert Hubbard

⁸ 18. (1) The provisions of sections 18.1 to 18.28 apply in respect of appeals under the [Income Tax Act](#)

Hot SR&ED issues in the media

Linked In Groups which discuss SR&ED tax credit issues:

<u>Group</u>	<u>Scope</u>	<u># Members</u>
SR&ED Canada	Canadian SR&ED issues	1,560
CATA SR&ED	Canadian SR&ED issues	1,216
R&D tax credit forum	International R&D Tax credits	1,076

Social Media sites

The R&D Tax credit is administered in over 60 countries around the world. Most of these countries use the same international definition for eligible work.

Various social media groups have formed to address specific issues. This section examines issues & specific comments posted to these groups.

Sample Comments on common themes

Inconsistency:

“It looks like the strength of the Claim does not matter to CRA. Sometimes I have a feeling that CRA is putting all claims on a big table and at random selects 5% that will be rejected. I have seen some very strong claims being rejected and some very weak ones being approved.”

“We are hearing that files under audit are being steamed rolled to an assessment and that requests for supporting documentation go beyond reason and reflect new expectations beyond what had been previously experienced.”

“One thing that's clear, at least to me, is that several years ago Harper's Government was very concerned by the increasing size of the program, which now seems to be getting smaller for whatever reason.”

Recognizing Technological Advancement:

“There's a trend in CRA with the mistaken belief that standard practice means "experimenting with practices and methods known to you. In that case, there is no SR&ED ever. Our position is always: if it's standard practice, then no experimentation is required.”

“There seems to be a discrepancy between CRA's definition and those in common research papers in the field in what in fact constitutes an IT Technology when using that as a basis for whether the technology base was advanced in the project.”

Public media Globe & Mail – double dips on loans vs. credits

A recent Globe & mail article⁹ made the following statements &/or claims including:

“Governments everywhere continue to finance factory upgrades, new aircraft models, drug research, and an infinite array of industrial projects.”

“It’s all tolerated despite strict World Trade Organization rules that prohibit most subsidies. There are some notable exemptions for assistance targeted at research, disadvantaged regions or mandated environmental upgrades.”

“The R&D loophole in particular is so large that governments routinely drive planes and autos through it. Slap “innovation” on a program and you’re good to go.”

“For years, many companies have been billing taxpayers twice when they do R&D – once via R&D tax credits, and then again through direct assistance for the same work, typically in the form of government loans, investments and other repayable contributions.”

“But a Tax Court decision last year in a case involving Halifax-based Immunovaccine Technologies Inc. and the Canada Revenue Agency **is threatening to turn the rules of the game upside down.**”

“The problem was that Immunovaccine Technologies was also claiming R&D tax credits on its research work. The Canada Revenue Agency rejected a large chunk of the credits, and the company appealed.”

“The Tax Court upheld the CRA’s ruling, effectively ending this form of double-dipping by arguing that companies should not get government assistance and also tax credits.”

“If another party has borne the economic cost of a taxpayer’s participation in scientific research and experimental development, there is no need to allow deductions or credits as an incentive for that taxpayer to engage in [R&D] activities,” Justice Lucie Lamarre wrote in her decision.

“Experts say the ruling will have an effect far beyond Immunovaccine Technologies, by making government loans potentially unattractive to thousands of Canadian companies.”

The article also noted that,

“The case also stokes the ongoing debate about how government can best spur companies to innovate and do more R&D.”

“A 2011 report by a federally appointed R&D panel, headed by Open Text Corp. executive chairman Tom Jenkins, recommended that Ottawa shift its emphasis away from tax credits to direct funding.”

Author’s opinion:

In the author’s view these statements when taken together can be misleading to readers since

- the **legislation always reduced the SR&ED** tax credits
- for they type of assistance in the Immunovaccine case.

As a result this is likely an isolated incident of a claimant who did not understand the SR&ED rules.

In the author’s experience most claimants seem to understand the general principle that

- SR&ED credits are earned on
- the portion of SR&ED cost which they pay for directly

Acknowledging the ongoing debate between direct funding (grants) and direct funding (tax credits), as cited earlier in this newsletter,

- grants appear to be seeing a shift in funding
- which is being taken from the SR&ED program.

Notable quote:

“The digital camera is a great invention because it allows us to reminisce. Instantly.”

- Demetri Martin

⁹ The Globe and Mail, “Tax Court ruling to change the government subsidy game,” Published Sunday, Mar. 16 2014

Questions or feedback

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

We also encourage interested parties to examine:

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

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Although we endeavor to ensure accurate & timely information throughout this letter, it is not intended to be a definitive analysis of the legislation, nor a substitute for professional advice.

Before implementing decisions based on this information, readers are encouraged to seek professional advice, in order to clarify how any issues discussed herein, may relate to their specific situations.

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