SR&ED
Scientific Research & Experimental Development Tax Credits

Practitioner workshop
September 22, 2014

Part 1

SR&ED Newsletter 2014 –1

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I) New Canada Revenue Agency Procedures

New form T661(13) to reflect 2013 changes

- Suggested project reporting format
- Report formats to address new CRA questions

New form T661(13) to reflect 2013 changes

CRA OLD FORMAT (up to 2013)		CRA NEW FORMAT (after 2013)	
T661 Box #	3 Criteria	T661 Box #	3 Criteria
240	Advancement (50 lines): "What technological advancements were you trying to achieve?"	n/a	replaced by box 245 below
242	Technological Uncertainty (50 lines): What technological obstacles/uncertainties did you have to overcome to achieve the technological advancements described in Line 240?	242	Technological Uncertainty > Standard Practice (50 lines): "What scientific or technological uncertainties did you attempt to overcome – uncertainties that could not be resolved using standard practice?"
244	Activities (100 lines): What work did you perform in the tax year to overcome the scientific or technological uncertainties described in Line 242? (Summarize the systematic investigation or search)	244	Activities (100 lines): What work did you perform in the tax year to overcome the scientific or technological uncertainties described in Line 242? (Summarize the systematic investigation or search)
n/a	formerly box 240 above	246	Advancement (50 lines): What scientific or technological advancements did you achieve as a result of the work described in Line 244?

3 step documentation process:

"Technological Advancement" requires 3 key steps

STEPS

1) DEFINE PRIOR ART

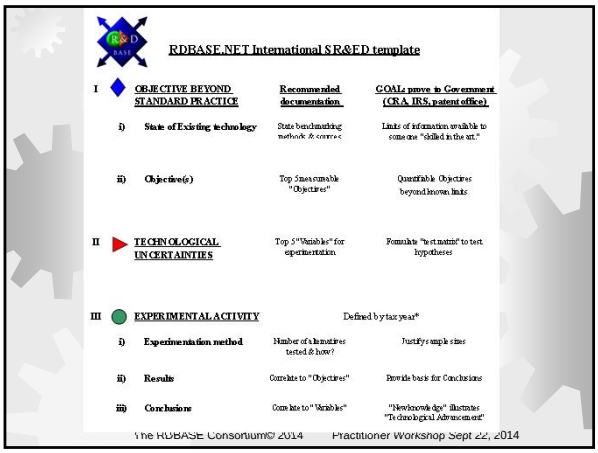
2) CORRELATE prior art to VARIABLES for experiments

3) ANALYSIS of & CONCLUSIONS on VARIABLES

Notable quote:

"It's tough when markets change and your people within the company don't."

- Harvard Business Review



Notable quote:

"It is not how many ideas you have. It's how many you make happen."

- Accenture

CRA NEW FORMAT (after 2013)		HOW TO PROVIDE INFO.
T661 Box #	3 Criteria	RDBASE SR&ED project - 5 Steps
n/a	replaced by box 246 below	
242	Technological Uncertainty > Standard Practice (50 lines): "What scientific or technological uncertainties did you attempt to overcome – **uncertainties that could not be removed using standard practice**?"	I i): Define Standard Practice (SP) **I ii): Objectives > Standard Practice & II: Technological uncertainties** to research
244	Activities (100 lines): What work did you perform in the tax year to overcome the scientific or technological uncertainties described in Line 242? (Summarize the systematic investigation or search)	**III i):** List **selected research logs** to show work done "systematically"
246	Advancement (50 lines): What scientific or technological advancements **did you achieve** as a result of the work described in Line 244?	**III ii & iii): Display results & conclusions.** The "technological conclusions" = advancements if all other criteria met.

Notable quote:

"Innovation is the ability to convert ideas into invoices."

- L. Duncan

New CRA RFI procedures & recommendations to address

- The most notable of the "standard" questions across the country fall into 2 main categories:
- 1) Technical documentation
  - a. Evidence of experiments
  - b. Due diligence to define standard practice
- 2) Financial info (detailed timesheet correlation)

1) Technical documentation

a) Evidence of "relevant" experimentation

The CRA requests, "Please send …

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

1) Technical documentation

b) Evidence "due diligence" to define standard practices

The CRA requests, "…copies of the **contemporaneous evidence** that:

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

Notable quote:

"The best ideas lose their owners and take on lives of their own."

- N. Bushnell

Recommendations to address RFI procedures on Standard practice

I ◆ **PROJECT OBJECTIVE BEYOND STANDARD PRACTICE:** *GOAL is to prove to Government (CRA, IRS, etc.) :*

i) **State of Existing technology: Benchmarking methods & sources**

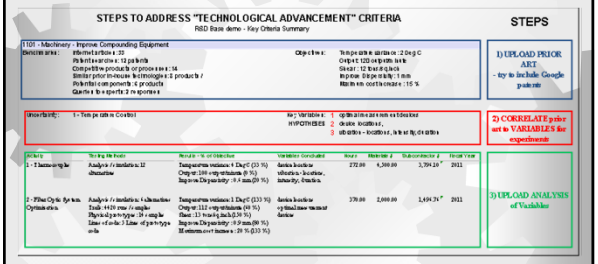
Technology limits of "readily available" information to someone "skilled in the art."

		Number (#) of
i	Internet / Google Searches	internet sites
ii	Articles	articles
iii	Patent searches	patents
iv	Competitive methods	products / processes
v	In-house technologies	products / processes
vi	Potential components	products
vii	Queries to experts	responses
viii	Other	

ii) **Objective(s)** — **Performance benchmarks (top 5)*** — *Quantifiable Objectives beyond known limits*

		Benchmark 1	Benchmark 2
i	Existing benchmark		
ii	Units of measure		
iii	Performance objective		
iv	*Result (III below)**		

Prior Art – search example (7 slides)



Notable quote:

"Small opportunities are often the beginning of great enterprises."

- Demosthenes

Steps 1&2 – Objectives & Variables for search

1101 - Machinery - Improve Compounding Equipment

Benchmarks: Internet searches: 33; Patent searches: 2 patents; Competitive products or processes: 14; Similar prior in-house technologies: 8 products / Potential components: 6 products; Queries to experts: 2 responses

Objectives: Temperature variance: 2 Deg C; Output: 120 output/minute; Shear : 12 tons/sq.inch; Improve Dispersivity : 1 mm; Maximum cost increase : 15 %

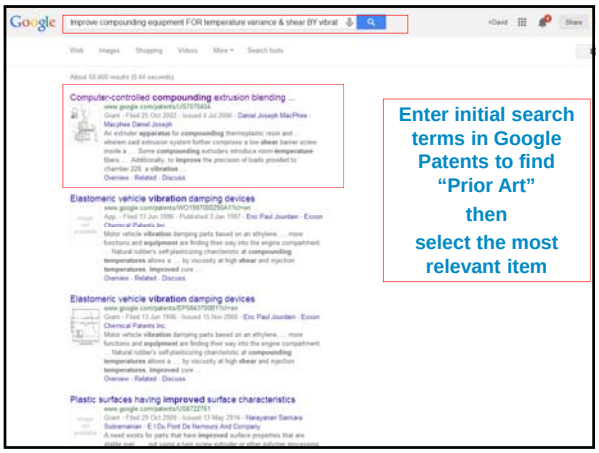
Uncertainty: 1 - Temperature Control

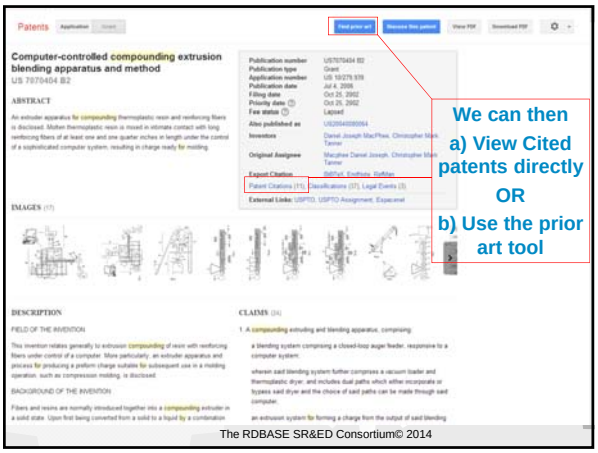
Key Variables: device locations, optimal measurement devices, vibration - locations, intensity, duration

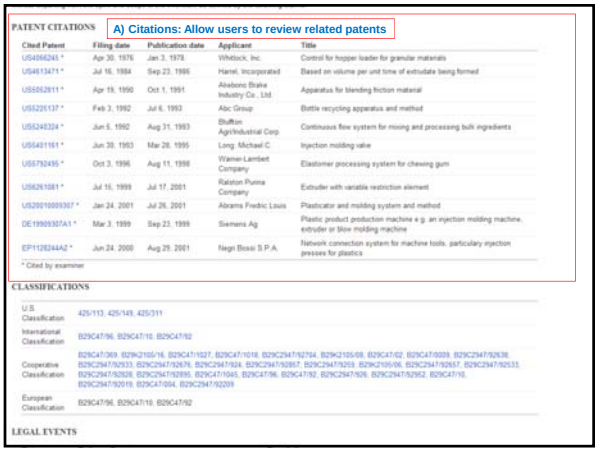
RDBASE - Prior Art Search Example

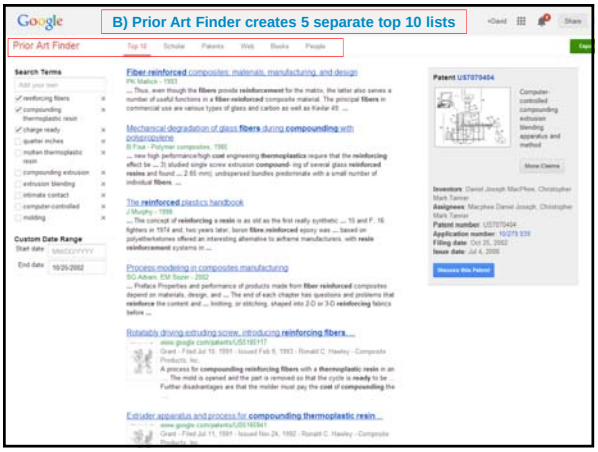
X - designate as term to search on patent databases

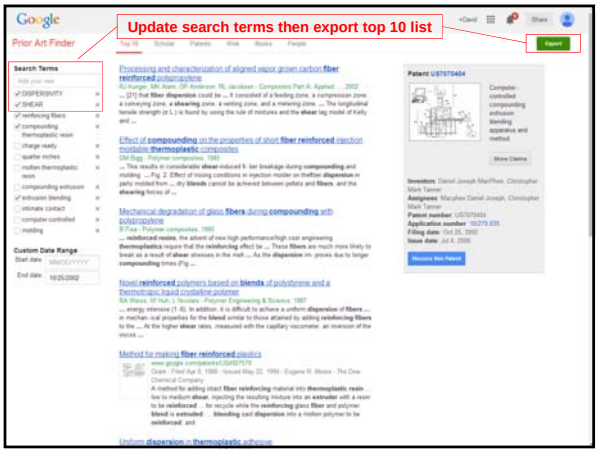
Project name	TO/FOR	Objectives	BY	Key variables (to achieve objectives)
X Improve compounding	X	Temperature variance		optimal measurement devices
		Output		device locations
		Shear	X	vibration - locations, intensity, duration
		Dispersivity		
		Cost		











2) Financial info (detailed timesheet correlation)

CRA requests, "For salaries, wages and contract labour, please provide:

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

Recommended timesheet details to address RFI procedures

Recommended Employee time detail for SR&ED *(record for each project / each year)*

Employee details			Linking work to SR&ED				SR&ED wages	
First Name	Last Name	Hours Worked	Type of work	Variables researched	Comments	Location	hourly $ rate	SR&ED $
			1) Design 2) Testing 3) Programming 4) Supervision	*OPTIONAL - Link to the variables in the project*	*OPTIONAL - should be completed by the more senior people if possible.*	*Country + Province or State*		
ALREADY EXISTS most systems			This information is MISSING in most time reporting systems				Complete @ y/e	
NRED TOTALS BY STATE/PROVINCE							$_____	

Recommendations

- Ultimately each employee should be able to identify how his or her
  - - "design or testing" work was
  - - "necessary to resolve"
  - - one or more of the stated "uncertainties."

New energy sector R&D project examples from Australia

July 2013 Australian government released 6 R&D project examples for Energy Industry

- - Dye sensitive solar cells
- - Battery life
- - Wind wake (wind farm software)
- - Solar capture
- - Energee (microalgae use)
- - Supplygrid (smart meter)

<u>Notable quote:</u>

"The key to success is for you to make a habit throughout your life of doing the things you fear."

- Vincent Van Gogh

They also have examples for other industries including:

- - Agrifood
- - Biotech
- - ICT (Information & communications)
- - Manufacturing &
- - Built Environments (construction)

Relevance of foreign examples

In the author's opinion these examples are a useful source of ideas since:

- The Canadian & Australian definitions of eligible SR&ED work are the same
- These examples appear more complete than CRA's 10 new examples which illustrate only specific concepts instead of entire project descriptions.

Notable quote:

"The reasonable man adapts himself to the world;

the unreasonable one persists in trying to adapt the world to himself.

Therefore all progress depends on the unreasonable man."

- George Bernard Shaw

Notable quote:

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

- B. F. Skinner

SR&ED Newsletter 2014 –2

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- Laboratoire du-var Inc. – documenting owners time for SR&ED - LOSS 3
- Coveley– wage accruals & ABILs – PARTIAL LOSS – many lessons 4

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

- Fio – CRA use of evidence during TCC Appeal - WIN
- Laboratoire du-var Inc. – documenting owners time for SR&ED - LOSS
- Coveley– wage accruals & ABILs – PARTIAL LOSS – many lessons
- Airmax (from 2013 – revisited)
  - Issue 2) informal appeal $12K limit / result in year

Fio – CRA use of evidence during TCC Appeal - WIN

- FACTS/ISSUE: CRA used information obtained from the court to further reassess the appellant (Fio)
- WIN/LOSE: WIN - costs of $25,000
- RULING /RATIONALE: "I cannot accept argument that provides more favourable treatment to one of the parties. The Respondent (CRA) cannot use the Discovery Documents in any other proceeding before this Court or any other court . "
- IMPLICATIONS: shows confusion Objection (ITA section 165) / Appeals (section 169)
- SIGNIFICANCE: Moderate

Laboratoire du-var Inc. – documenting owners time - LOSS

- ISSUE: History of successful claims claimant & spouse – reduced to 25% & 0% for 2005 & 2006.
- WIN/LOSE: LOSE - The appellant insisted they should have considered the prior rulings
- RULING /RATIONALE: "A direct relationship between the various components and the claim submitted is required and must be established on a balance of probabilities."
- IMPLICATIONS: Need real time documentation
- SIGNIFICANCE: Moderate

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

- FACTS:
- Mr. Coveley holds mechanical & electrical engineering degrees. He was the chief technology officer & 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
- In 2006 each claimed ("ABIL") in their income tax returns
- ISSUE: Are the appellants entitled to deduct an ABIL?
- WIN/LOSE: Mrs. - WIN / Mr. LOSS

Coveley– wage accruals & ABILs

- ISSUE 2: WHEN are the appellants entitled to deduct an ABIL?
- WIN/LOSE: LOSS
- RULING /RATIONALE: "Based on this the judge concluded that the debt was not a bad debt at the end or 2006 & ether neither party would qualify for ABIL deduction."

Coveley– wage accruals & ABILs

IMPLICATIONS:

- This illustrates a tax planning opportunity (accruing wages for unpaid work) which can be used by SR&ED intensive companies in early stages.
- It also underlines the complications with claiming losses on a company which;
  - is in poor financial position but
  - still active in any manner.

SIGNIFICANCE: Moderate

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

Economic overview of the SR&ED program in Canada

- Shift from tax credits to grants
- New BDC loan program for SR&ED

Shift from tax credits to grants

Research and Development in Canadian Industry

Total business enterprise research and development expenditures

	2010	2011	2012	2013	2014	% total
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%**

Total research and development personnel (full-time equivalent)

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			26%
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%**

Shift from tax credits to grants

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

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

Increase in SR&ED Objections

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.

Notable quote:

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

- *Anonymous*

New BDC loan program for SR&ED

September 2014 loan to $250,000

Key terms:

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

- Info: 1 888 463-6232 or info@bdc.ca

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
- CRA reduces concern with SR&ED consulting fees
- SALT (Self-Assessment Learning Tool)

T661 – Revised optional filing measure for Part 9

Administrative measure Part 9 separately

- **Step 1.** Submit complete Form T661(13) by deadline. For Part 9 provide name of each claim preparer – line 940 & business number – line 945
- **Step 2.** You must submit a paper copy of the T661(13) -provide the billing arrangements – lines 950, 955, 960 & 965

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***

CRA reduces concern with SR&ED consulting fees

In the 2013 budget 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."

SALT (Self-Assessment Learning Tool)

Tool divided in **two standalone** interactive PDF files - download on your computer

- **Step 1** will help you understand the eligibility requirements for SR&ED work
- **Step 2** estimate expenditures & ITC.
- http://www.cra-arc.gc.ca/txcrdt/sred-rsde/slt-eng.html

SALT - 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.

New tax changes

- TCC informal appeal limit increase to $25K
- Stock option benefit denial of expenditure
- New rules on defining "control" & association

TCC informal appeal limit increase to $25k

After June 25, 2013 Informal Procedure Application

"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**; ..."

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

Notable quote:

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

- ***Elbert Hubbard***

Stock option benefit denial of expenditure

- 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"

New rules on defining "control" & association

new 256.1(6)deems acquisition of control if:

- Shares of the corporation held by a person(s), have …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.

Hot SR&ED issues in the media

- Social Media sites
  - Sample Comments on common themes
- Public media Globe & Mail
  - double dips on loans vs. credits

Notable quote:

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

- ***Elbert Hubbard***

The RDBASE Consortium© 2014 Practitioner Workshop Sept 22, 2014

Social Media sites - Sample Comments common themes

Linked In Groups which discuss SR&ED tax credit issues:		
Group	**Scope**	**# Members**
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

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

Recent Globe & mail article made the following statements &/or claims:

"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 t**hreatening to turn the rules** of the game upside down."

Author's opinion

Statements taken together could mislead readers since;

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

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

Notable quote:

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

- ***Demetri Martin***

Part III – other issues

Other issues of interest or cited by participants

Globe & Mail

September 19, 2014, By BILL CURRY

CRA staffing shakeup throws promised tax crackdown into question;

- "notices went out to more than **100 staff who handle taxpayer appeals of CRA decisions**, according to the Union of Taxation Employees…appears those auditors will be **shifted to a new focus** on small and medium-sized Canadian businesses.."
- "To be clear, the CRA is not reducing the number of tax evasion and tax avoidance experts or the number of auditors," he wrote in an e-mail."
- "This work force adjustment process will not result in any auditor positions being cut."

Video series: CRA's SR&ED

Tax Incentive Program (Sep 9, 2014)

- Video 1: Who can claim SR&ED tax incentives? (2:05 min)
- Video 2: What work qualifies for SR&ED tax incentives?(3:47)
- Video 3: How do you calculate your SR&ED expenditures & investment tax credit? (3:08 min)
- Video 4: How to apply for SR&ED tax incentives? (3:59 min)
- Both videos & Transcripts available for download.

Video 2: What work qualifies for SR&ED tax incentives?

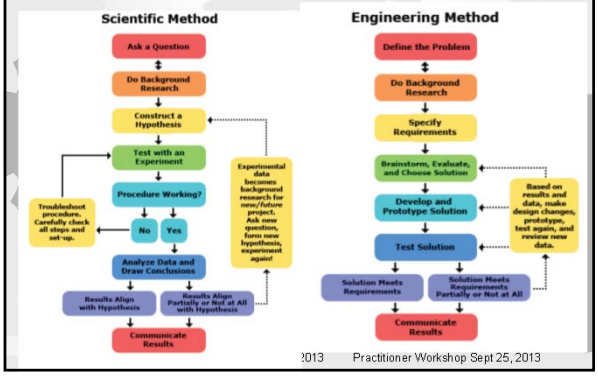
- "So how do you know that you've achieved technological advancement? An easy way is to ask yourself: what technological uncertainties did you encounter when you tried to develop the product or process?
- Technological uncertainties are barriers that prevent you from achieving your goals. The knowledge that you gain in overcoming those barriers is the technological advancement."

Video 2: What work qualifies for SR&ED tax incentives?

- "In a nutshell, if you're doing a systematic investigation or search, by experiment or analysis, to advance science or technology, your work qualifies!
- It's that simple!"

Comparing the Engineering Design Process and the Scientific Method

http://www.sciencebuddies.org/engineering-design-process/engineering-design-compare-scientific-method.shtml



Dispute resolution - formal vs. informal appeal strategies

Typical dispute resolution steps & timelines

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

Dispute resolution - formal vs. informal appeal strategies

General Procedure (tax court)

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

Informal Procedure (tax court)

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

SR&ED changes in March 29, 2012 Federal budget

	Year change proposed to start (prorate)	2012 current	2013	2014 full effect
1)	Federal ITC rate (non-CCPC)	20	20	15
2)	Subcontractor costs (% eligible)	100	80	80
3)	Rate to calculate proxy (overhead)	65	60	55
4)	Capital equipment (% eligible)	100	100	0

International definition of an R&D project

- "For a … project to be classified as R&D, its completion must be dependent on a scientific &/or **technological advance**, the aim of the project must be the **systematic resolution** of a scientific and/or **technological uncertainty**."
  - Source: Frascati Manual 2002, paragraph 135

2014 YMPE set at $52,500

SR&ED wages - annual limits				
1 SR&ED labour:		YMPE	Specified employees*	Non-specified
	2012	$ 50,100	$ 250,500	No limit
	2013	$ 51,100	$ 255,500	No limit
	2014	$ 52,500	$ 262,500	No limit
2 Salary base for proxy amount				
	2012	$ 50,100	$ 125,250	No limit
	2013	$ 51,100	$ 127,750	No limit
	2014	$ 52,500	$ 131,250	No limit

*Specified employees own >=10% any class of stock (or related to such shareholders).

SR&ED Salary & Wage inclusions

		Specified employees*	Non-specified employee	ITA section
1	**R&D labour for the:**			
a)	R&D expenditure pool (for deduction), &			37(1)
b)	Qualified expenses (for ITC calculation)			127(9)
	Type of expense:			
	· salary & wages	**In**	**In**	(5-8)
	· bonuses or profit based remuneration	**Out**	**In**	37(9) & 5(1)
	· Expenses paid > 180 days	**Out**	**Out**	78(4)
	Maximum	**5 x [YMPE]**	**N/A**	37(9.1)
2	**Salary base for proxy amount (for ITC calculation)**			
	Type of expense:			
	· Income from employment	**In**	**In**	5
	· bonuses/profit based remuneration	**Out**	**Out**	5(1) & 37(9)
		Out	**Out**	6 & 7
	· Expenses paid > 180 days	**Out**	**Out**	78(4)
	Maximum	**2.5x [YMPE]**	**N/A**	Reg. 2900(7)