SR&ED Newsletter
Edition 2016 –1

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

Contents

Recent SR&ED tax cases – TECHNOLOGY issue(s)

Copies of the judgments are available from the Tax Court of Canada's website.[1] We also welcome you to view this commentary in project format.[2]

ACSIS EHR[3] - Software (stability)

Facts:

The Appellant is a company based in Fredericton, New Brunswick. Its business activities focus on the development of health information systems including the creation of software applications for the centralized management of national healthcare.

In 2004, Belize sought the assistance of the Appellant in implementing a national healthcare system in that country. After commencing the project, the Appellant encountered a number of challenges including poor telecommunication infrastructure which made it was unable to utilize its Electronic Health Record ("EHR") solution.

According to the Appellant, it engaged in organized experimental and developmental activities to establish a new technology, the Accesstec Capacity Strengthening Information System, in order to adapt its existing EHR technology in an attempt to overcome the infrastructure challenges.

The evidence suggested that the available open source replication solutions were inappropriate as they were meant for very different purposes within the field, designed to work with strong connectivity infrastructure.

Issue(s):

1. Evidence of advancement & systematic investigation.

Relevant legislation and analysis:

2. *Income Tax Act*[4]: 37(1)(*a*)(i) & 248(1)

The claimant provided a SR&ED activity sample that elaborated on the systematic investigative process that occurred with respect to a particular task, of observing and analyzing replication functionality over dial-up,

The primary objectives & uncertainties included:

1. Database replication in an unreliable network environment had to be explored as available tools were inadequate and research was scarce;

2. Approaches had to be formulated to transport data, merge changes to database records from multiple databases, preserve and merge changes to records at multiple locations without loss of critical data while overcoming frequent network interruptions;

3. The unknown implications that multi-site, asynchronous data manipulation would have for the real world applications that it would need to support;

4. Even if uncertainties could be overcome, it was unknown if their developed hypothesis would be sufficient to enable the nation-wide, mission-critical data applications;

5. Recovery from data integrity problems when nodes were offline for any extended period of time; and

6. After extended periods of dis-connectivity and large amounts of changes queued up, how to exchange those changes to other nodes in an environment of infrequent connectivity.

Ruling & rationale:
WIN – No open source solutions

According to the judge;

"Since an appropriate replication solution was not available, the Appellant undertook experimental development work to create technology that could mimic a stable communications infrastructure in the hostile environment that existed in Belize."

Implications and author's commentary

Though the case provides little in the way of specific activities it does provide a generic framework of eligibility. As a result it is likely of moderate long term significance.

Notable quote:

"We're still in the first minutes of the first day of the Internet revolution."

- Scott Cook

[1] Tax Court of Canada website [www.tcc-cci.gc.ca]
[2] View projects at: https://app.rdbase.net/Default.aspx
[3] ACSIS EHR (Electronic Health Record) INC. v THE QUEEN- 2015 TCC 263, December 1, 2015
[4] *Income Tax Act*, RSC 1985, c.1 (5th Supp.) (the "*Act*")

Emotion – Search Engine Optimization[5]

Facts:

The company has a division named Rank Higher which developed methods & strategies to optimize webpage designs for various objectives including retrieval & ranking in internet search engines (primarily Google).

They had made successful claims for SR&ED credits in prior years. The claim for the 2012 taxation year was rejected so they filed an informal appeal which limited federal Investment Tax Credits claim of $51,196 to $25,000.

The 2012 project aimed at creating a data structure to index & optimize data to rank high in key word search through various search engines.

Issue(s):

1. Evidence of advancement & systematic investigation.

Relevant legislation and analysis:

2. *Income Tax Act*[6]: 37(1)(*a*)(i) & 248(1)

The CRA argued:

The fact that the intellectual property in search engines algorithms is not shared is not a technological uncertainty or obstacle.

The attempt to identify the undisclosed intellectual property of search algorithms used for ranking websites and the tests claimant ran for this purpose is not a technological advancement.

The trial and error process in this project is the standard approach to reverse engineering the search algorithms and the results often **cannot be consistently repeated and verified as major search engine operators are constantly changing their ranking algorithms**.

The company:

Objected to the portrayal of these activities as reverse engineering of the Google search engine, as they believed it was much broader research and certainly not limited to Google.

In the Appeal Emotion summarized the technological uncertainties as: …to identify and evaluate the contributing variables (greater than 200) used in Google algorithms to structure the data better for indexing the pages in accordance with the key word that has been searched.

Emotion acquired a Google Search Appliance so it could test how Google classifies data and breaks it down into data collections. The Appellant did not limit its work just to Google but covered other search engines as well. It created tests using similar language in different formats (in one experiment 25 websites were created) to figure out how data could be more efficiently organized for optimal retrieval.

Ruling & rationale:
LOSS – Reliance on 3rd party (Google) methods

The judge ruled that;

> "The experiments of submitting several different versions of websites to determine the significance of variables relies on existing technology in a routine manner.
>
> As explained in Northwest Hydraulics, "routine" describes techniques, procedures and data generally available to competent professionals in the field and that is how I interpret what Emotion did."

Implications and author's commentary

It appears that any work related to Search Engine Optimization (SEO) activities would **no longer** qualify for SR&ED tax credits.

The rationale for this would be the fact that Google or other **search engine creators can arbitrarily change their methods** so knowledge of the procedures is not viewed as "science."

While the judges rational for denying the claims seems confusing (routine research) the net result is that claims with closed source components including virtually all SEO activities are now ineligible.

Notable quote:

"You affect the world by what you browse."

- Tom Berners Lee

[5] EMOTION Pictures Studies Inc.v. The Queen, (2015 TCC 323), Dec. 11, 2015, Informal appeal

[6] *Income Tax Act*, RSC 1985, c.1 (5th Supp.) (the "*Act*")

ITC INVOICE TO CASH INC – Software (interoperability) [7]

Facts:

The Appellant company made a claim for federal investment tax credits ("ITCs") in the amount of $32,425 & elected to proceed pursuant to the Informal Procedure and to limit the appeal amount to $25,000.

With the exception of the Appellant's own Factorsuite, according to the CRA's key witness (Mr. Pellissero), although the structures of the products were unknown, the main challenge was to obtain information from one product and then move it to another & that this challenge could be resolved by the use of well-known techniques.

The Appellant's agent, Mr. Louie, submitted the uncertainties related to a lack of information respecting those third-party products.

They claimed objectives or areas of uncertainty notably to understand the structure of data belonging to a third party software vendor.

Issue(s):

1. Evidence of advancement & systematic investigation.

Relevant legislation and analysis:

2. *Income Tax Act*[8]: 37(1)(*a*)(i) & 248(1)

The claimed uncertainty involved the attempt to understand the structure of data belonging to a third party software vendor in order to have it work in conjunction with its own Factorsuite application.

The company testified that the processes of data mining and data mapping were used to determine the data in the database and its structure. This included the examination of event logs in order to determine how a program was functioning.

The appellant indicated that the technique of process mining may have been available as early as 2008. According to the CRA expert witness, the technique existed in 2007 and information on it was available.

Ruling & rationale: LOSS – Failure to benchmark Standard Practice (SP)

The judge stated;

"Based on the evidence adduced, the Appellant has not demonstrated that its activities were anything more than routine engineering or standard procedures.

While I agree that an amalgam of different techniques may constitute a technological advancement, this will only be so where a new technique is created that has never been previously used in that particular industry.

Otherwise, the individual utilization of techniques, such as use of mining, mapping, process mining or caching, could never give rise to an advancement.

However, this is not the case in the present appeal and I remain unconvinced by the evidence, or I should say lack of it, that process mining was a new technique at the time that the Appellant employed it and that any of the other techniques employed were anything more than the **standard procedures** available at the time.

For these reasons, the appeal is dismissed."

Implications and author's commentary

The case confirms that combinations of different techniques could lead to technological advancement however this **requires greater comparison to existing techniques & knowledge** than that provide by the claimant.

Notable quote:

"If you're too open-minded, your brains will fall out."

- Lawrence Ferlinghetti

[7] 2015 TCC 269, Date: 2015 10 30, Docket: 2014-1702(IT)I
[8] *Income Tax Act*, RSC 1985, c.1 (5th Supp.) (the "*Act*")

Recent SR&ED tax cases – FINANCIAL issue(s)

Often, there are amounts which remain unpaid and which will only become eligible for tax credit in the year in which they are actually paid.

ACSIS – increase in legal fee reimbursement to 95% - WIN[9]

Facts:

In November 2015 ACIS filed a Notice of Motion to the Tax Court of Canada seeking an increase in the original cost award.

The Crown responded that costs should not exceed 50 percent of the taxpayer's legal fees plus disbursements.

Issue(s):

Under what circumstances will the courts award full legal costs?

Relevant legislation and analysis:

Tax Court of Canada Rules (General Procedure) Rule 147(7).

Section 18.26 of the Tax Court of Canada Act provides that this Court may vary awards of costs from that prescribed by the tariff.

Subsection 147(3) of the Rules sets out the factors that this Court may consider in reviewing an award of costs:

147 (3) In exercising its discretionary power pursuant to subsection (1) the Court may consider,

(a) the result of the proceeding,
(b) the amounts in issue,
(c) the importance of the issues,
(d) any offer of settlement made in writing,
(e) the volume of work,
(f) the complexity of the issues,
(g) the conduct of any party that tended to shorten or to lengthen unnecessarily the duration of the proceeding,
(h) the denial or the neglect or refusal of any party to admit anything that should have been admitted,

(i) whether any stage in the proceedings was,
(i) improper, vexatious, or unnecessary, or
(ii) taken through negligence, mistake or excessive caution,

(i.1) whether the expense required to have an expert witness give evidence was justified … and

(j) **any other matter relevant** to the question of costs.

Ruling & rationale:
WIN – judge has discretion

The judged concluded,

"[14] I am of the view that an award of enhanced costs in the amount of 95 percent of the invoiced fees …is reasonable … based primarily on

- the Appellant's demonstrated willingness to negotiate a settlement, the reasonableness of those proposals,
- the Respondent's refusal to participate in any meaningful manner in the settlement negotiation process &
- the eventual success of the Appellant's appeal."

Implications and author's commentary

The case illustrates the various benefits of preparing a tax court level "appeal" to issues that cannot be resolved at the "objection" level.

Notable quote:

"What is research but a blind date with knowledge?"

- Will Harvey

[9] ACSIS EHR (ELECTRONIC HEALTH RECORD) INC., Appellant, v THE QUEEN, 2015 TCC 50

Jaft – Wages owing only if SR&ED eligible - LOSS[10]

Facts:

For the taxation years 2003, 2004, 2005 and 2006, JAFT filed claims with CRA for SR&ED tax credits related to research and development expenses in connection with its work with respect to sick building syndrome.

The claims included salaries paid to the three employees. CRA allowed JAFT's claim for the taxation years 2003 and 2004.

When JAFT received the related tax credit refunds for those years, it used that money to fund the employee source deductions for federal and provincial income tax, employment insurance and Canada Pension Plan that arose from the payment of the salaries.

The CRA denied JAFT's claims for SR&ED tax credits for the taxation years 2005 and 2006.

This has resulted in numerous proceedings in the Tax Court which will require the Tax Court to consider, among other circumstances, the wording and effect of an agreement dated August 20, 2004, between JAFT and the three employees called "the development agreement" which read as follows:

> The amount of compensation shall be claimed as part of JAFT's annual SR&ED claim.
>
> Should any part of JAFT's SR&ED claim, related to the compensation of the members of the development group, be reduced or denied, the member(s) acknowledges that they are not entitled to that compensation related to the reduction and agree to repay the over compensation to JAFT.

The salaries were initially unpaid but were claimed in the application for the SR&ED tax credits as a future contingent liability of JAFT to avoid immediate liability for the payment of employee source deductions.

In November 2004, **CRA advised** JAFT that, for the payment of **salaries to be considered for the SR&ED tax credit program, they could not be contingent payments.** As a result, JAFT paid the salaries in 2005 and 2006 and the employees immediately lent the money back to JAFT, which was in difficult financial circumstances.

CRA assessed JAFT, and Jones and Laufer as directors of JAFT, for unpaid employee source deductions.

Issue(s):

Could the claimant have achieved their **objectives (not paying income taxes until SR&ED wages approved)** using the existing rules of the income tax act?

Relevant legislation and analysis:

The appellants applied under provincial legislation to have the employment contracts and the related salaries for 2005 and 2006 rescinded.

This in turn could have the effect of over-riding the federal income tax legislation.

Ruling & rationale: LOSS – insufficient basis for Provincial court to effect tax precedent

The judge ruled,

> "This is a matter for the Tax Court, which is a specialized court created by Parliament with expertise in tax matters.
>
> The application here was contrary to the principle of judicial economy as, whatever the outcome in the Court of Queen's Bench, the appeal of the tax assessments must still be heard by the Tax Court..."

Implications and author's commentary

The CRA's position (that the wage payments could not be contingent) was correct however, the taxpayer could have achieved its objectives using the existing legislation.

In fact the SR&ED legislation contemplates unpaid amounts for SR&ED.

Legislation & planning opportunities have been discussed in newsletter 2004-1- view PDF or (watch video).

Notable quote:

"Research is what I'm doing when I don't know what I'm doing."

- Wernher von Braun

[10] JAFT Corp v Jones et al, 2015 MBCA 77

Easy Way Cattle – Failure to file schedule 31 - LOSS[11]

Facts:

The appellant company filed the SR&ED form (schedule 32) which contained all required cost information by the 18 month corporate filing deadline.

It did not file the accompanying schedule 31 within the filing deadline.

Issue(s):

Should the company be eligible for tax credits if all SR&ED tax forms not filed by deadline?

Relevant legislation and analysis:

Income Tax Act: 37(11), 127(9) & 248(1)

Filing requirement – SR&ED expenses 37(11)

> "no amount …may be deducted under subsection 37(1) unless the taxpayer files with the Minister a prescribed form containing prescribed information in respect of the expenditure on or before the day that is 12 months after the taxpayer's filing-due date for the year."

Filing requirement – SR&ED credits 127(9)(m) - denies the investment tax credit for the claims if

> "the taxpayer does not file with the Minister a prescribed form containing prescribed information in respect of the amount on or before the day that is one year after the taxpayer's filing-due date for the particular year;"

The Appellant argued that Schedule 31 is not a prescribed form. & also argued that, even if Schedule 31 was a prescribed form, it was still entitled to the investment tax credit since sch 32 already provided all prescribed information.

Counsel for the Respondent argued Schedule 31 is the prescribed form which must be filed pursuant to the requirements of paragraph (m) of the definition of investment tax credit in subsection 127(9). If no schedule 31 is filed, no investment tax credits are available.

Ruling & rationale:
LOSS – Act requires ALL prescribed forms

The judge stated,

> "I agree … for the purpose of paragraph (m) of the definition of an ITC in subsection 127(9) of the Act, Schedule T2SCH31, Investment Tax Credit– Corporations, is the prescribed form for corporations."

Implications and author's commentary

Since the Act specifies a prescribed form for each of the sections related to costs (37) & credits (127) it seems reasonable to assume that each would be required.

It is also arguable that other forms could be required or "prescribed" in certain circumstance including (but not limited to) forms for

- non-arm's length expenses (T-1145, T-1146)
- third party payments T-1263 & specified employee wages (T-1174).

This case outlines the risks of filing more than 15 months from year end.

Notable quote:

"The public have an insatiable curiosity to know everything, except what is worth knowing."

- Oscar Wilde

[11] ACSIS EHR (ELECTRONIC HEALTH RECORD) INC., Appellant, v THE QUEEN, 2015 TCC 263

Questions or feedback

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

We also encourage interested parties to examine:

- past newsletters
- RDBASE.NE online R&D software &
- additional tutorials on managing R&D at

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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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