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SR&ED Newsletter **Edition 2009-2**

Welcome to the second 2009 edition of our newsletter regarding recent developments to Scientific Research and Experimental Development (SR&ED) project management and tax credit claims.

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Notable quote:

"The difference between genius and stupidity is that genius has its limits."

-- Albert Einstein

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

The past year has witnessed a release of a variety of smaller cases. The main issues and potential implications are outlined in the following pages. Copies of the judgments are available from the Tax Court of Canada's website.¹

Advanced Agricultural – Eligibility of clinical trials²

Facts:

The first series of issues dealt with the admissibility of the work performed on three sets of separate clinical trials as SR&ED.

Trial #48:

- The claimant Advanced Agricultural Testing [appellant] undertook a **research contract for another company (Schering-Plough)** under which it bought 250 heifers and 250 steers.
- The cattle were divided into random groups, weighed and implanted with one of the implants to be tested.
- The **protocol** for this trial was **prepared by Schering-Plough.**
- Having **collected the data** throughout the trial, which consisted of the weights of the animals and the observations as to the existence of abscesses in their ears, they turned it over to Schering-Plough.
- There is **no evidence** that the appellant made any statistical **analysis** of the data.

Trial #49:

The CRA's expert witness was critical of trial #49 on a number of grounds related to its design and execution.

- The three pastures used for the study were of poor and uneven quality;
- the animals at the start were of very different weights, varying between 509 and 587 lbs.;
- the **animals were weighed only twice** in the pasture phase, at the beginning and at the end.

Trial #50:

A postgraduate student at the University of Guelph, required a topic for her doctoral thesis and her faculty

advisor, who had funding available for a study of corona virus, was able to connect the student with the appellant as a client for the project.

The technical support provided by the staff of Advanced Agricultural Testing included;

- provision of cattle for the study, handling cattle for purposes of data
- collection, identification, and recording of diagnoses according to profiles &
- handling and treatment of sick cattle.

Issue(s):

- 1) To what extent does work on performing clinical trials qualify as SR&ED?

Relevant legislation and analysis:

With respect to the evidence provided by both **expert witnesses** (CRA & Claimant) the **judge found;**

"...evidence **less useful** than it should have been:"

"**If they had been asked to give their opinion as scientists as to what constitutes "systematic investigation or search"** then their evidence **could have been helpful**, particularly in relation to trial #49.

Instead they were all asked the most general of questions, and thereupon launched into lengthy and rambling speeches in which they **purported to answer the ultimate question [i.e. is the work SR&ED]** that is before me in respect of each trial, rather than confining themselves to scientific opinion..... [which] **leave(s) me reluctant** to give significant weight to any of the opinion evidence."

Routine testing: The definition of SR&ED specifically excludes work with respect to,

"quality control or **routine testing** of materials, devices, products or processes..."³

"One **purpose of this exclusionary provision** clearly is to **prevent** claims in respect of products that have already been developed, where the work done is simply **to put existing products to use rather than to develop a new product** or to improve an existing one."

Ruling & rationale: LOSS - NOT SR&ED since lacked "hypotheses"

¹ Tax Court of Canada website [www.tcc-cci.gc.ca]

² ADVANCED AGRICULTURAL TESTING INC., Citation: 2009TCC190, April 7, 2009

³ Definition of SR&ED per ITA 248(1)

In the judge's view, there were two fundamental reasons that the various trials **cannot qualify as SR&ED**:

1) Analysis (lack of):

The **first** is that its **purpose and effect** was simply to **compile the results**.

To this extent the judge commented,

“Trial 48: His [the appellants] ideas on the subject may have contributed in some measure to the development of the protocol, but the **research was that of Schering-Plough**, from the protocol through to the statistical analysis.

“Trial 50: The evidence overwhelmingly demonstrates that it was Dr. Martin and colleagues at the **University of Guelph who did the research,....**

[In both cases] The **appellant's role .. was limited to data collection**, which is specifically excluded...”

2) Hypothesis (lack of):

The **second** fundamental problem is the, “**inability** of the appellant to point to anything in the evidence that can properly be called **a hypothesis to be tested, or a protocol by which to conduct the trial.**”

To provide support the judge commented,

“The stated objectives..., rather than formulating a hypothesis to be tested, amount **simply to a proposed comparison of the effectiveness** of the four implants tested during the pasture phase of the trial, and of the bolus.

There was **no variation in the way that the implants were used** in the pasture phase; the single difference was the particular product that was applied to each group.

Neither do I find that the appellant has **formulated a hypothesis** to be tested.

Nor am I satisfied that before the trial took place the appellant **had any plan** that could be described as a protocol for systematic investigation to test a hypothesis.

It **simply used four different commercial products** at the pasture stage, and one at the feedlot stage, **to compare their effectiveness.**”

Implications and author's commentary

In the author's view this case outlines the critical importance of;

- documenting all hypotheses, test results

- related analysis &
- conclusions.

If the claimant had been able to show;

- more **input into design of the protocol** &
 - **analysis / interpretation of the results**
- the claim would likely have succeeded.

Advanced Agricultural – revoking “proxy” election once filed⁴

Facts:

The Minister takes the position that bedding for the cattle and diesel fuel are overhead items, and so not accountable separately under the proxy reporting method.

The appellant's position is that they are both direct costs. If unsuccessful in this respect the appellant wished to revoke the “proxy” election for overhead allocation and to use the “traditional” method which would in turn allow such expenses.

Issue:

Ability to revoke proxy election once made.

Relevant legislation and analysis:

The claimant argued that ITA subsection 220(3.2) and Regulation 600 specifically provide authority for the Minister to permit revocation of certain elections made under the Act.

Since the Regulation 600 provisions do not include an election made under subsection 37(10), the Minister has no such power.

Ruling & rationale: LOSS - NO ability to revoke election

The Minister's power to permit revocation of an election made under the Act is limited to those election provisions that have been named in Regulation 600, and they do not include subsection 37(10).

Implications and author's commentary

This case outlines the importance of **comparing** the effects of the **proxy election to the traditional overhead** method **before filing** of each year.

⁴ ADVANCED AGRICULTURAL TESTING INC., Citation: 2009TCC190, April 7, 2009

It should also be cautioned that the **traditional overhead** method merely **requires a “reasonable” basis of allocation** however, agreeing with the CRA as to what is “reasonable” is not always a simple process and can hold up assessments for additional weeks or months.

Spasic – “hobby” vs. “carrying on business”⁵

Facts:

Mr. Spasic is employed full-time at Ford Motors as a millwright.

In his time off work Mr. Spasic hopes to be able to develop a transducer that is sensitive enough that it can form part of a sonic imaging device capable of producing three-dimensional images.

He had begun his venture in 1999. In each of the years since then through 2007, Mr. Spasic claimed a business loss equal to the full amount of his expenses.

In the years in question, 2003 through 2005, Mr. Spasic was in the early stages of pursuing his desire. At some stage he built a simple transducer but not one with the capabilities needed to pursue his projects.

In the three years in question, these were in the range of \$20,000, \$10,000 and \$6,000 respectively.

The taxpayer’s pursuits were in the early stages. In his own words, he had performed research and development in his basement workshop and he was working towards a research and development business.

He **did not track** or record his **experimental efforts** or results.

Mr. Spasic never received any revenues from his pursuits.

Issue:

Whether or not Mr. Spasic “carried on a business” in the years 2003 through 2005 and as a result, whether he was entitled to deduct business losses?

Relevant legislation and analysis:

The Court’s former Chief Justice Bowman in his 1998 decision in *Kaye v. The Queen*⁶, described the test to be applied simply as,

“In answering this question the hypothetical reasonable person would look at such things as capitalization, knowledge of the participant and time spent.

He or she would also consider whether the person claiming to be in business has gone about it in an **orderly, businesslike way** and in the way that a business person would normally be expected to do.”

Ruling & rationale: LOSS - carrying on business requires “documentation”

Upon analyzing the evidence and related legislation the judge concluded;

“Based upon the totality of the evidence, I am simply unable to conclude that Mr. Spasic had started to carry on a business in any of the years in question.

The **underlying commerciality** of an endeavour can often best be **recognized by the organized or methodical approach** with which the endeavour is pursued.

I do **not think a business person, a scientist or an engineer** could describe Mr. Spasic’s pursuits as business-like.”

Implications and author’s commentary

In the author’s view this case reiterates the extreme importance of **documenting:**

- all **SR&ED activities** &
- all **shareholder transactions**.

Often business owners take “short-cuts” in documentation which would not be present in normal “business transactions.”

These short-falls leave them open to “re-interpretations” on a variety of issues (e.g. whether a payment is salary (eligible) or bonus (ineligible)).

Notable quote:

“The world is changing very fast. Big will not beat small anymore. It will be the fast beating the slow.”

-- Rupert Murdoch

⁵ *Joavan Spasic v. The Queen* - Citation: 2009TCC193, April 7, 2009

⁶ *Kaye v. The Queen*, 98 DTC 1659

New T661 form – problems & opportunities (update)

In our prior SR&ED Newsletter (2009-1) we provided an in-depth analysis of the problems and opportunities within the new T-661 claim form (released Nov. 10, 2008). Since this release we have the following issue updates:

Unresolved issues:

Each box printing on a separate page – each description now 7 pages

A review of the project printout illustrates that each box currently prints out on a single page. As a result each project description (when we include the other portions of the form) is now approximately 7 pages.

In the author's opinion, this is very confusing for the taxpayer to review before submission and hardly results in a concise (2 page) description as provided in the CRA example.

Potentially resolved issues:

Providing documentation via website

Another key issue for claimants is the loss of the ability to attach technical documents.

In many cases these documents allowed the project author to concisely explain his or her problems (i.e. a picture tells a thousand words).

The author posed a question to the CRA's Director General of SR&ED (Helene Dompierre):

Question(s): Can the claimant:

- a) upload project descriptions to a secure website,
- b) refer to them in the current project description and
- c) expect to have the CRA reviewer examine them?

Response: Yes.

Resolved issues:

Profile (corporate tax software) word limits too low

- Previously we could only upload 3,948 characters to box 244
- With the newest release (version 2008-4.1 released March 20, 2009) we can now upload 5,660 characters

to box 244 which makes it similar to other tax software on the market (e.g. Taxprep)

- Given the 700 word limit for this section the average word length (with spaces) is now 7.8 characters (vs. 4.5 prior)

Author's recommendations:

7 page project description

Recommendation: Just learn to live with it ☺. Paper is cheap and electronic filing is just around the corner (estimated for March 2010).

Providing pictures and documents via website

Recommendation: Despite the recommendation to provide links to pictures/ supporting documents, the author would caution any claimants filing beyond 15 months from year end to ensure that the projects can "stand alone" (i.e. make sense even without the pictures in question) and use the additional information for "clarification purposes."

Interested parties may also wish to review our R&D Base, SR&ED project tracking system (www.rdbase.net) which provides this functionality.

Use of different tax software packages

Recommendation: The differences in the software packages appear to have been mitigated with the latest release however, tax preparers should be vigilant as to when and how information is being "truncated."

It may also still be advisable to attach an extra copy of the description (in traditional format) where specific printing problems are encountered.

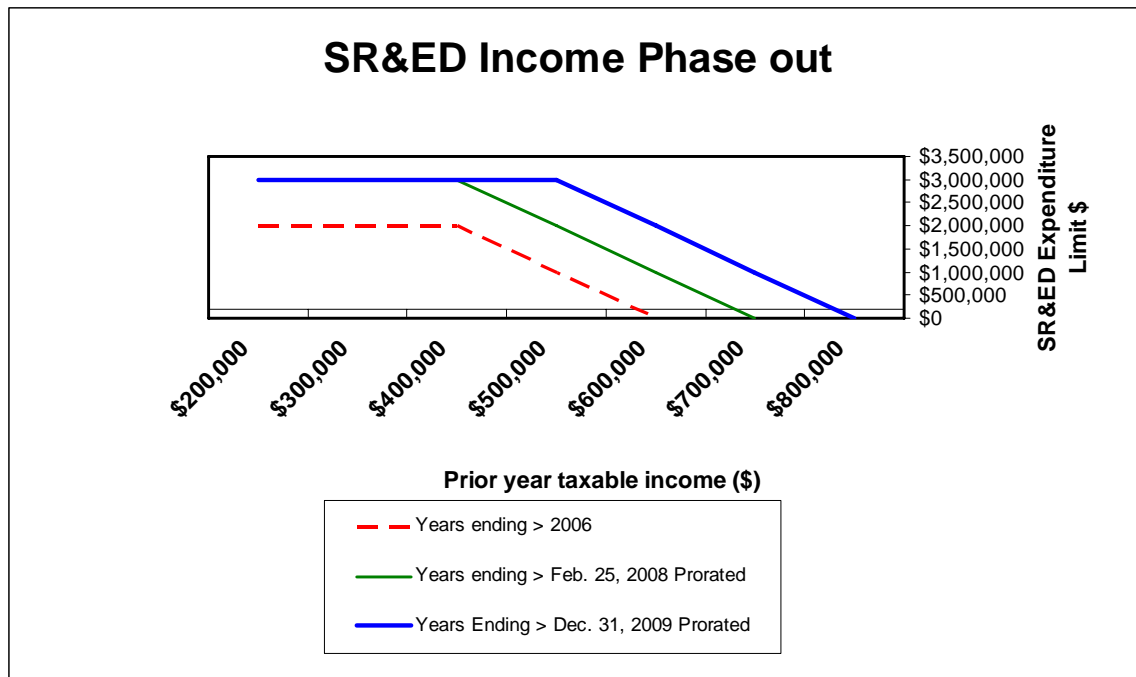
Notable quote:

"There is nothing wrong with change, if it is in the right direction"

-- Sir Winston Churchill

Recent CRA pronouncements

2009 budget – enhanced incentives⁷



There are two rates of federal investment tax credits (ITC's) for SR&ED;

- a general rate of 20 per cent and
- an enhanced rate of 35 per cent for small Canadian-controlled private corporations (CCPC's).

CCPC's are eligible to claim the enhanced ITC rate of 35 per cent on up to \$2 million of qualified SR&ED expenditures annually. Unused ITC's are fully refundable in respect of the first \$2 million of current expenses per year.

Previously (up to 2008) the \$2 million expenditure limit is phased out for CCPC's whose;

- taxable income for the previous taxation year is between \$400,000 and \$600,000 or
- taxable capital [assets] employed in Canada for the previous taxation year is between \$10-15 million.

The 2008 and 2009 budgets;

- increase the expenditure limit for the enhanced ITC rate of 35 per cent, and
- increasing the phase-out ranges on taxable income and taxable capital as follows:

i) Expenditure Limit – now \$3 million (Feb. 25/08 – prorated)

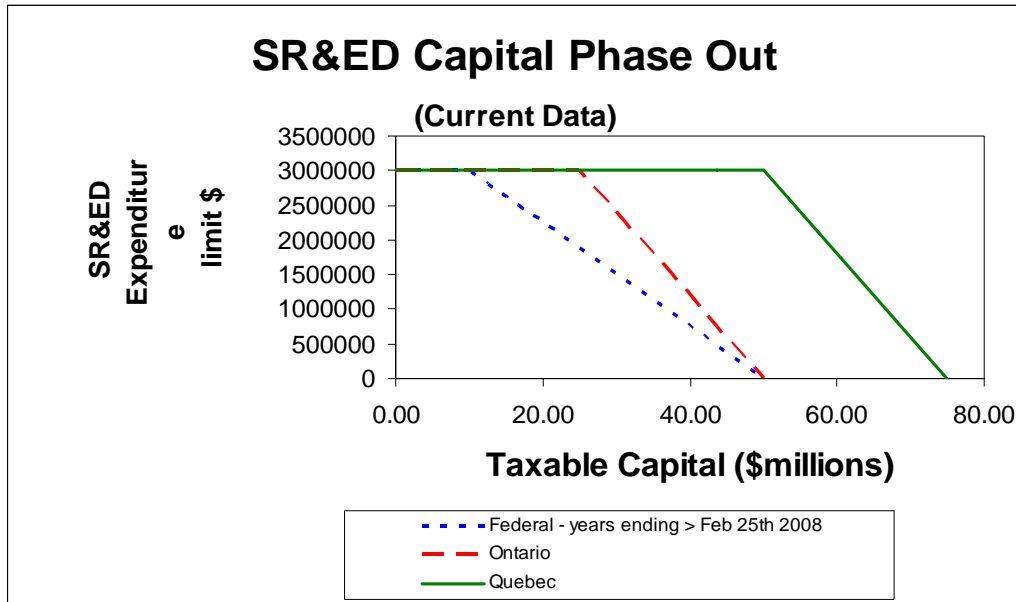
For taxation years ending after **Feb. 25, 2008** the maximum qualified expenditures on which the enhanced 35 per cent rate can be earned has increased to \$3 million from \$2 million. For **years which straddle** this date the increase will be **prorated**.

Notable quote:

"The pessimist complains about the wind; the optimist expects it to change; the realist adjusts the sails."

-- William Arthur Ward

⁷ Complete Budget document available at www.budget.gc.ca/2008/pdf/plan-eng.pdf



As a result of the increase in the expenditure limit to \$3 million, the maximum amount of **fully refundable SR&ED ITC's** available for qualifying CCPC's will increase **from \$700,000 to \$1.05 million.**

ii) Taxable Income Phase-Out Limit – to \$500- 800K (2010 prorated)

To increase the **upper limit** of the phase-out range for prior-year taxable income to \$800,000 from \$700,000 (for 2008) and \$600,000 (pre-2008).

The expenditure limit will continue to be reduced by \$10 for each \$1 by which taxable income for the previous taxation year exceeded \$500,000.

iii) Taxable Capital Phase-Out Limit to \$50 million (Feb. 25/08 prorated)

To increase the upper limit of the phase-out range for prior-year taxable capital to \$50 million from \$15 million.

Notable quote:

"Be the change you want to see in the world."

-- Mahatma Gandhi

Graphs & Mechanics of the new phase-out formulas

The proposed legislation⁸ provides the following formula; "...a particular corporation's **expenditure limit for the 2010 and subsequent taxations year** is the amount determined by the formula

$$(\$8 \text{ million} - 10A) \times (\$40 \text{ million} - B) / \$40 \text{ million where}$$

A is the greater of

- (a) \$500,000, and
- (b) the amount that is
 - (i)the particular corporation's **taxable income** for its immediately **preceding taxation year ...**

B is

- (a) nil, if the following amount is less than or equal to \$10 million:
 - (i) ...the amount that is its taxable capital employed in Canada ... for its immediately preceding taxation year" or
 - (b) in any other case, the lesser of \$40 million and the **amount by which** the amount determined under subparagraph (a)(i) [**i.e taxable capital**]... **exceeds \$10 million.**

Author's commentary:

Though the wording of this legislation seems complex these new provisions **represent a significant enhancement to the SR&ED program** and will have a **significantly positive effect on medium sized clients.**

⁸ ITA proposed subsection 127(10.2)

Summary of credits by Province:

Qualified corporations (enhanced ITC's)

Qualified CCPC*				
Provinces & Territories	Prov./Terr. Credit	Prov./Terr. Refundable? <i>(Federal is refundable)</i>	Federal Credit Refundable (reduced by Prov./Terr. credit)	Combined
AB	10%	Yes	31.50%	41.50%
BC	10%	Yes	31.50%	41.50%
MB	20%	No	28.00%	48.00%
NB	15%	Yes	29.75%	44.75%
NL	15%	Yes	29.75%	44.75%
NS	15%	Yes	29.75%	44.75%
ON	10%	Yes		
ON	4.5%	No	29.93%	44.43%
PEI	0%	N/A	35.00%	35.00%
QC	20%	Yes	28.00%	48.00%
SK	15%	No	29.75%	44.75%
YK	15%	Yes	29.75%	44.75%
NWT	0%	N/A	35.00%	35.00%
NV	0%	N/A	35.00%	35.00%

Other claimants

Other companies (non Qualified CCPC)				
Provinces & Territories	Prov./Terr. Credit	Prov./Terr. Refundable? <i>(Federal is non-refundable)</i>	Federal Credit Non-refundable (reduced by Prov./Terr. credit)	Combined
AB	10%	Yes	18%	28%
BC	10%	No	18%	28%
MB	20%	No	16%	36%
NB	15%	Yes	17%	32%
NL	15%	Yes	17%	32%
NS	15%	Yes	17%	32%
ON	10%*	Yes		
ON	4.5% **	No	17.10%	31.60%
PEI	0%	N/A	20%	20%
QC	10%	Yes	18%	28%
SK	15%	No	17%	32%
YK	15%	Yes	17%	32%
NWT	0%	N/A	20%	20%
NV	0%	N/A	20%	20%

Notes:

* - Ontario allows foreign and public companies to claim the 10% (OITC) as long as they meet the income & size tests.

** - The new Ontario 4.5% (ORDTC) credits is effective for costs incurred after Dec 31, 2008.

Recent Provincial pronouncements

Ontario 2009 budget – enhanced incentives⁹

New phase out limit (\$500-800K) – effective Dec.31/09

The OITC is currently subject to a **graduated phase-out where taxable income exceeds \$400,000** and is fully **eliminated at \$700,000** of taxable income. The Budget proposes to **increase these thresholds to \$500,000 and \$800,000 respectively.**

It is intended that the effective date of these changes parallel that of the federal amendments announced in the 2009 federal Budget.

Accordingly, they will be **effective for taxation years ending after 2009** with a pro-ration for taxation years that straddle December 31, 2009.

Non-refundable 4.5% credit - effective Dec.31/08

The Ontario research and development tax credit (ORDTC) is a 4.5% non-refundable tax credit on eligible expenditures incurred in a taxation year that ends after 2008.

This credit is meant to replace the existing Ontario SR&ED incentive relating to the treatment (i.e. non-taxability in Ontario) of the federal SR&ED ITC's.

Notable quote:

“Our enemies are innovative and resourceful, and so are we. They never stop thinking about new ways to harm our country and our people, and neither do we.”

-- George Bush

Alberta – 2009 new 10% refundable SR&ED ITC¹⁰

Effective after Dec 31, 2008

The Alberta Scientific Research and Experimental Development (SR&ED) tax credit program provides;

- a **10% fully refundable** tax credit to **[ANY] corporations,**
- with a permanent establishment in Alberta,
- that carry on **SR&ED activities in Alberta &**
- incur **eligible expenditures after December 31, 2008.**

Other details:

- Expenditures by a partnership, trust, or individual are not eligible for this program (i.e. **only corporations**).
- There is a **\$4 million expenditure limit** (among associated corporations) prorated for days in a year which straddle January 1, 2009 (i.e. maximum ITC is \$400K / year)
- There is a **filing deadline** similar to the Federal SR&ED credits (18 months from year end).
- There are **NO ownership, income or taxable capital limits** in order to qualify for this credits (i.e. all corporations including foreign, public and large companies can qualify)

⁹ Complete Budget document available at www.budget.gc.ca/2008/pdf/plan-eng.pdf

¹⁰ Alberta Bill 48 has taken effect December 1, 2008

Notable quote:

*"Any man who can drive safely while kissing a pretty girl
is simply not giving the kiss the attention it deserves"*

-- Albert Einstein

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 &
- our SR&ED tax guide [the Guide to R&D Base],

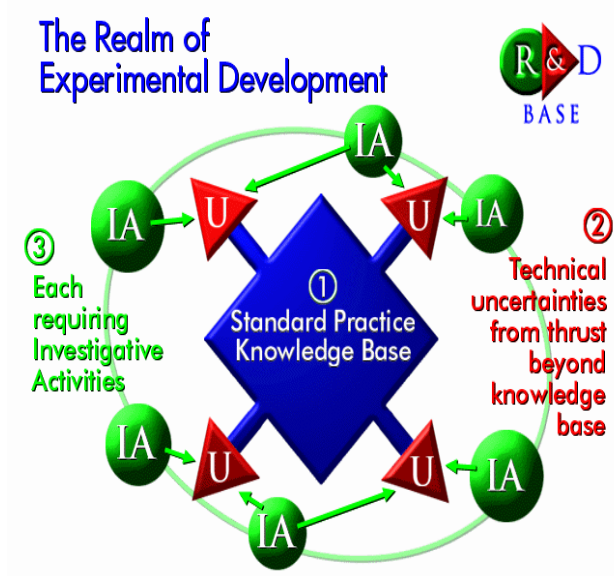
all of which are designed to simplify the SR&ED tax credit claims. These are available from our website at,

www.meuk.net

- For an overview of our “R&D Base” software &
- additional tutorials defining eligible SR&ED activities,

please go to:

www.rdbase.net



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Although we endeavor to ensure accurate and 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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