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SR&ED Newsletter **Edition 2011-3**

Welcome to the third 2011 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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Recent SR&ED tax cases & related issue(s)

The main issues and potential implications are outlined in the following pages. Copies of the tax court judgments are available from the Tax Court of Canada's website.¹

Soneil – evidence of hypotheses and experiments – lose²

Facts:

This case represented an appeal to a prior (2007 judgment).

The claimant and primary developer Mr. Jain holds Master of Science in controlled system engineering

Mr. Jain stated, in cross-examination, that he did not produce any new components when conducting his work on the four projects.

He also acknowledged that each of the projects involved areas where;

- products performing similar functions &
- a wide body of knowledge already existed

He stated that, while the Appellants used existing parts and components, the research was with respect to the application of the parts and components.

Types of evidence provided:

- The only evidence provided with respect to the Power Optimization Project was a single page plan contains 11 items in point form.

Inhibitor Project
- Four pages handwritten notes- two are simple diagrams.
- The pages do not contain any details with respect to the nature or results of the tests.
- Mr. Jain was uncertain/ unclear who prepared the notes or when they were prepared (via the company or a subcontractor)

Issue(s):

Whether the work constituted SR&ED, as that term is defined in subsection 248(1) of the *Income Tax Act* (the "Act").

The CRA argued that the,
"Appellant failed to demonstrate a systematic investigation through experiment or analysis performed **to resolve any scientific or technical uncertainties.**"

Relevant legislation

Income tax act

SR&ED is defined for income tax purposes³, as follows:

"scientific research and experimental development means **systematic investigation** or search that is carried out **in a field of science or technology by means of experiment or analysis and** that is

(a) basic research.,

(b) applied research,.. or

(c) **experimental development**, namely, work undertaken **for the purpose of achieving technological advancement** for the purpose of **creating new, or improving existing**, materials, devices, **products or processes**, including incremental improvements thereto,..."

Case law:

In addition to the quotations from the cases of CW Agencies & Northwest Hydraulics (see prior newsletter 2011-2) the judge also cited several other precedents;

"As noted by my colleague Justice Little in *Zeuter Developments*, at paragraph 28:

... While not absolutely necessary, it is beyond doubt that a taxpayer who creates a well-supported claim will facilitate the process in determining whether something qualifies as SR&ED.

As stated in *RIS-Christie*, the only reliable method of demonstrating that scientific research was undertaken in a systematic fashion is to produce documentary evidence."

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

² SONEIL INTERNATIONAL LIMITED, V. THE QUEEN, 2011 TCC 261

³ in subsection 248(1) of the Act

Analysis:

Based upon the testimony of Mr. Jain, it appears that the Appellants **did not maintain a detailed record of the testing of any hypothesis formed** for the projects or of the results of the testing, as the work progressed

Ruling & rationale:

In this case the judge commented,

Mr. Jain did not provide evidence of the Appellants encountering change or of what any change meant with respect to a specific hypothesis, nor did he indicate whether a change in the hypothesis was required.

As a result he concluded

the Appellants did not provide the Court with sufficient evidence to support a finding that their work was characterized by;

- trained and systematic observation,
- measurement and experiment and
- the testing and modification of hypotheses.

Implications and author's commentary

In the author's view the results of this case are clear and the lesson obvious, you must record;

- the results or the "experiments" then
- illustrate related "analysis of hypotheses
- also referred to as technological uncertainties."

Notable quote:

"You can't just ask customers what they want and then try to give that to them. By the time you get it built, they'll want something new."

- Steve Jobs

Global Enviro Inc. – criminal charges for false claim - lose⁴

Facts:

This was an appeal from a prior 2009 conviction.

It took place in Alberta Criminal court rather than the tax court of Canada.

In this case the company filed a claim for the May 31, 2002 taxation year. Some of the costs in the claim were related to prior taxation years.

The CRA then notified the client that (due to the filing deadlines) only costs related to the 2002 and subsequent years would be claimable.

The company then, "provided documentation to the CRA after this meeting that was intentionally misleading and designed to continue to pursue the claim."

The company and its President were each fined \$250,000 representing approximately 77% of the total tax benefit "falsely claimed."

Issue(s):

The original 2009 case dealt with the criminal issue. The appeal dealt with an attempt to lower or reduce the fines.

Relevant legislation and analysis:

Section 239(1.1)(g)(ii) of the *Income Tax Act* provides for a fine on summary conviction of, "not less than 50% and not more than 200% of the amount ... entitled".

Ruling & rationale:

The \$250,000 fine imposed on each Appellant is approximately 77% of this amount. This is on the low end of the range set out in the *Income Tax Act* and, in my view, there is no reason to reduce it"

Implications and author's commentary

In the author's discussions to date, these fines and related enforcement measures are actually being perceived and seen as a positive step by most "honest" claimants and claim preparers.

⁴ R. v. Global Enviro Inc., and Ian George McIntyre, 2011 ABQB 32

2 new “SR&ED” articles in the Globe & Mail

Recently the **Globe and Mail** has run a series of articles regarding SR&ED tax credit industry and related policies.

Notable quote:

“The most successful people are those who are
good at Plan B.”
- **James Yorke**

Globe & Mail SR&ED related articles by Barrie McKenna

- 11-Mar-11 **Flawed R&D scheme costs taxpayers billions**
5 pages Issue #1 - % of cost paid to consultants
Issue #2 – net “benefits” for every \$ of taxes
Issue #3 – certain industries don’t advance technology &
others automatically do
Issue #4 – that CRA risk controls aren’t working
Issue #5 – alternatives to refundable credits
- 28-Jun-11 **Canada slips further in innovation rankings**
2 pages New issue #1 - Canada higher in credits vs. direct grants
Issue #2 – should focus on clusters
- 3-Jul-11 **Time for action on Innovation, not more study**
3 pages New issue #1 - Canada declined some performance 2008 to 2010
Issue #2 – more funds for venture capital & commercialization
Issue #3 – let politicians pick the clusters

The first of these article, “Flawed R&D scheme costs taxpayers billions,” was detailed in our prior [SR&ED Newsletter 2011-2](#).

The following 2 articles make additional proposals on how polices should be set.

Canada slips further in innovation rankings (June 28, 2011)⁵

- 1) Should Canada shift from credits to grants?
 - Discussed in prior newsletter
- 2) Should we focus on clusters vs. all technologies?
 - If so who should pick?

Time for action on Innovation, not more study (July 3, 2011)⁶

- 1) Causes of performance decreases from 2008 to 2010?
 - Certain indicators have decreased slightly vs. other OECD countries but much can be attributed to recession.
- 2) Providing more funds for VC and commercialization – good idea?
 - In the author’s opinion this is a good idea to augment the commercialization SR&ED related projects.
- 3) Let politicians pick the clusters – good idea? Any risks?
 - In the author’s opinion the “free market” is better suited to determine this via SR&ED to ALL technology industries.

⁵ View at: http://license.icopyright.net/3.8425?icx_id=/icopyright/?artid=2077788

⁶ View at: http://license.icopyright.net/3.8425?icx_id=/icopyright/?artid=2084968

Recent CRA pronouncements

One June 20, 2011 the CRA released a series of 6 papers for public feedback. Three of these deal with overhead allocation issues, 2 with contract payments and the final with the “eligibility of work for SR&ED.”

After a review of the 6 draft documents I believe that 5 of them re-iterate current CRA practices and thus warrant little comment.

DRAFT Policy on the Eligibility of Work for SR&ED (June 20, 2011)

Our firm does however see a variety of problems and issues within the, "DRAFT Policy on the Eligibility of Work for SR&ED (June 20, 2011)."

Basically the core issue stems from the use of the term "technological advancement" in the project description, box 240.

We propose they should INSTEAD be asking for: a) benchmarks of standard practice & b) quantified objectives going beyond these limits.

The "technological advancements" are then illustrated by; * the "conclusions" on "variables of technological uncertainty"

* at the final stage of the "scientific method / process."

A copy of this submission is available for download at:

http://www.meuk.net/Resources_Hot_Issues.aspx

Author's commentary:

What is a “hypothesis?”

What does this mean for SR&ED?

We discuss these issues in depth in the above noted submission.

To summarize: the best evidence may be a “test matrix” of the variables under examination & experimentation.

Reviews and reports to watch for

Review of Federal Support to R&D [Jenkins panel] – Oct 2011

The report of the independent Expert Panel led by Tom Jenkins that is reviewing federal support to R&D. It is expected to be released in October, 2011.

There are over 200 submissions which are available for review at:

http://rd-review.ca/eic/site/033.nsf/eng/h_00006.html

Some of the more consistent &/or notable recommendations are:

Improve the level of consistency from auditor to auditor.

- Provide full or partial refundability to all claimants
- Simplify & streamline the program
- Consistency / permanence - Avoid too many small programs
- Provide consistency on reviews
- Provide for commercialization of successful products – similar to IRAP

In the author's opinion the best summary” recommendation comes from the Canadian Council of Chief Executives:⁷

According to the OECD, it is important

“to avoid inefficiencies arising from operating too many schemes at too small a scale. In our view, Canada's system of direct support programs for business R&D suffers from precisely that problem:

Too many small programs targeted at individual sectors, regions and constituencies, with insufficient coordination and, in some cases, poorly defined program objectives.

We therefore recommend that the federal government adopt a clear policy framework in support of business innovation.

The author proposes the panels current, “innovation frameworks,”⁸ appear to address these issues.

Taxpayers' Ombudsman – fall 2011

The report of the Taxpayers' Ombudsman on the systemic review of the SR&ED Program is also expected to be released this summer or fall.

⁷ download at: <http://rd-review.ca/eic/site/033.nsf/eng/00096.html>

⁸ Innovation frameworks: <http://rd-review.ca/eic/site/033.nsf/eng/00027.html>

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],

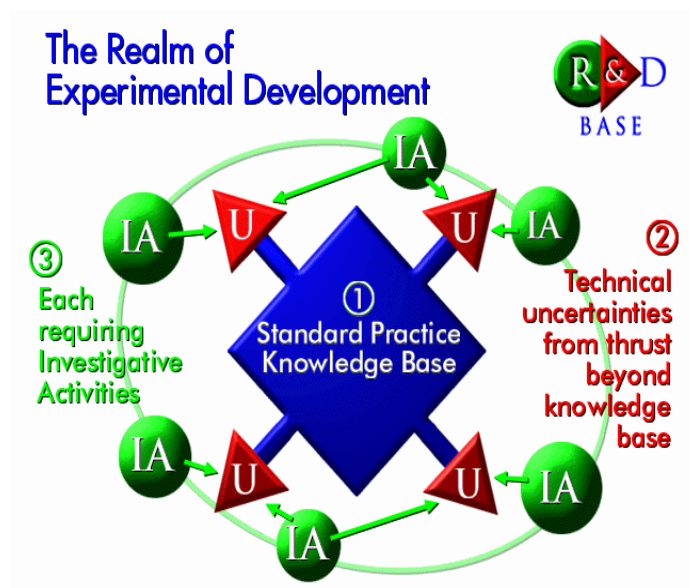
all of which are designed to simplify the SR&ED tax credit claims. These are available from our website at,

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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