

# **Interpretative issues regarding**

## **SR&ED tax credits**

### **An overview of recent SR&ED Tax cases & Related implications for claimants**

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## **I Introduction**

In this article, we will use tax court analysis to illustrate some of the most common “interpretation problems” concerning SR&ED tax incentives. Our goal is to illustrate the degree of influence the Canadian taxpayers and tax courts have had as co-architects of the current SR&ED tax credit system.

Given that we are dealing with a cross-disciplinary team (i.e. scientists and accountants), this article will examine :

- an overview of the program itself
- tax cases dealing with the “technological eligibility” of projects (i.e. scientific issues) &
- tax cases dealing with “financial eligibility” of the costs in question (i.e. accounting issues).

### **I.1 What is the SR&ED program?**

The SR&ED program is an incentive program designed to encourage R&D in Canada. The Canada Revenue Agency (CRA) administers the program.

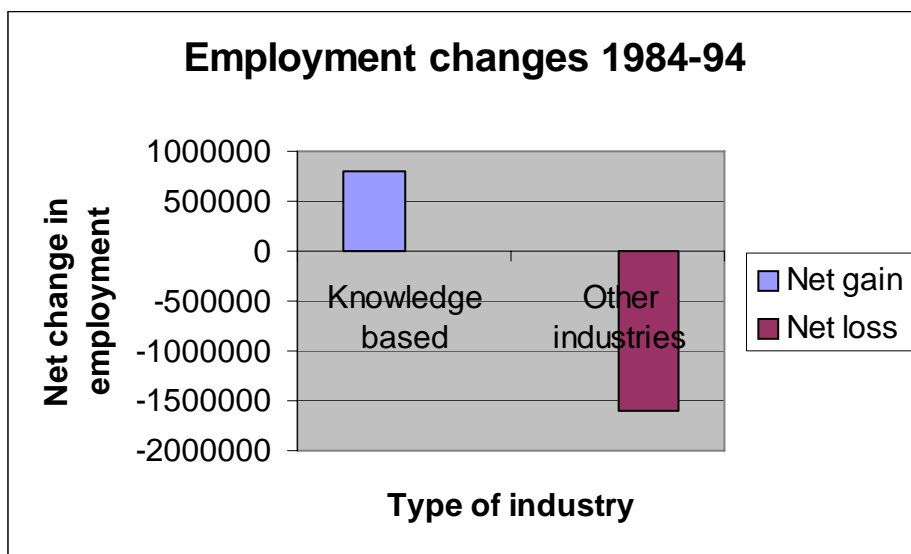
Each year, the CRA receives claims from over 11,000 companies participating in the program and provides over \$1.8 billion in tax credits annually delivered by more than 500 CRA employees across Canada. 70% of claims are from small and medium

businesses. Most provincial and territorial governments provide R&D incentives, either separately or as part of the federal program.<sup>1</sup>

Qualifying companies get money back in the form of a refund, a reduction of taxes payable, or both. If a company is developing or improving any products, processes, or materials, this work may qualify for substantial refunds and/or tax credits under the federal government’s Scientific Research and Experimental Development (SR&ED) program.

## I.2 “Knowledge” companies are the source of all current economic growth

In 1996 the Federal government released a report that examined the sources of growth for the Canadian economy<sup>2</sup>. The results of this report are shocking to many:



- From 1984 to 1994 there was a net loss of 800,000 full-time jobs in Canada

Looking deeper into these numbers we find;

- A loss of 1,600,000 permanent positions for individuals with secondary school or equivalent education
- A gain of 800,000 new jobs for those with post-secondary education, particularly within the technical and science fields.

This “global” phenomenon has been experienced in virtually all industrialized nations!

To address the need to retain and develop this technical base, Canada has one of the most favorable tax credit systems in the world with respect to the promotion of scientific research and experimental development (SR&ED) activities.

**As a result, in the views of most economists and political parties the SR&ED tax incentive is not a luxury: it is a necessity!**

## I.3 Objectives of the program:

<sup>1</sup> Source – CRA website: [www.cra-arc.gc.ca](http://www.cra-arc.gc.ca) – April 2006

<sup>2</sup> Science and Technology for the New Century – A Federal Strategy,” Department of Supply & Service, March 1996

### **I.3.1 Stated Science Policy – Minister of Industry**

Currently the federal government has three **stated objectives** for its science policy<sup>3</sup>:

- 1) sustainable job creation & economic growth,
- 2) improved quality of life, and
- 3) advancement of knowledge.

With respect to the third criteria, advancement of knowledge, the objective clarifies its goal to be,

“To create in Canada world centres of excellence in scientific discovery; to build a broad base of scientific inquiry; to foster Canadian participation in all major fields of science and technology; and to ensure that new knowledge can be acquired and disseminated widely, from Canadian sources and from around the world.”

#### **Financial overview – hedged transaction**

A good way to summarize the current Canadian SR&ED tax credit system is as a “hedged transaction.” By this we mean that the types of expenses which qualify for credit are mainly:

- Canadian employees - taxable on their wages &
- Taxable subcontractors - who must pay Canadian employees and related income taxes.

These types of payments will generally create more tax revenue for the CRA than they will pay out in related ITC’s.

While other types of qualified SR&ED expenses namely, foreign materials and capital equipment consumed in Canadian SR&ED, may create profits attributable outside Canada, they are typically a smaller component of most claims.

The policy objective behind funding these purchases would likely be aimed at the stated science policy objective, “to ensure that new knowledge can be acquired and disseminated widely, from Canadian sources and from around the world.” Furthermore, certain provinces (eg. Quebec) do not provide ITC’s for materials or capital and instead base their credits primarily on SR&ED wages.

An understanding of this “hedged transaction” framework will help claimants to understand why the system cannot pay ITC’s to foreign SR&ED performers for work performed outside Canada: a key issue of contention during the mid and late 1990’s!

### **I.4 Why are there so many interpretation problems with claims?**

**The SR&ED tax credit program is one of the very “tax returns” that require a claimant provide reports of both a scientific and a financial nature.**

To further promote this problem, The Canadian Institute of Chartered Accountants (CICA) has identified this work is beyond the “core curriculum” of the C.A. designation. As a result, it is left to the discretion of each province to decide whether there is any education on the issue whatsoever.

As a result, in the author’s experience, most Chartered Accountants feel inadequately trained to service their clients in this area.

**The net result is that many Chartered Accountants have graduated without any knowledge of this program and not surprisingly, they feel inadequately trained to service their clients in this area!**

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<sup>3</sup> *Science & Technology for the New Century – A Federal Strategy, March 1996, Industry Canada*

## **II Overview of the SR&ED tax credit rules and rates**

### **II.1 Legislative definitions of SR&ED – inclusions & exclusions**

SR&ED is defined for income tax purposes<sup>4</sup>, 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, and, in applying this definition to a taxpayer,

includes

(d) work undertaken by or on behalf of the taxpayer with respect to engineering, design, operations research, mathematical analysis, computer programming, data collection, testing or psychological research, where the work is commensurate with the needs, and directly in support, of work described in paragraph (a), (b) or (c) that is undertaken in Canada by or on behalf of the taxpayer, but

does not include work with respect to

(e) market research or sales promotion,

(f) quality control or routine testing of materials, devices, products or processes,

(g) research in the social sciences or the humanities,

(h) prospecting, exploring or drilling for, or producing, minerals, petroleum or natural gas,

(i) the commercial production of a new or improved material, device or product or the commercial use of a new or improved process,

(j) style changes, or

(k) routine data collection.”<sup>5</sup>

### **II.2 Canadian vs. international SR&ED Incentives**

**An interesting point to mention is that this definition is largely based on the “defacto” worldwide definition of as defined by the Organization for International Co-operation and Development (OECD).**

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<sup>4</sup> in subsection 248(1) of the Act

<sup>5</sup> end of ITA subsection 248(1) definition of SR&ED

Similar SR&ED tax incentives are in place in the U.S. and most European countries. Most of these countries have similar (in fact identical) definitions of technical eligibility. Canada remains a world leader with respect to the incentives provided to both large and small claimants.

The Competitive Alternatives, G7-2004 Edition, is a comprehensive, international survey conducted by KPMG. It demonstrates that Canada's SR&ED costs are the lowest among major western countries namely: the U.S., U.K., France, Germany, Italy and Japan.<sup>6</sup>

<b>CANADA'S R&amp;D COSTS VERSUS OTHER COUNTRIES</b>	
<b>Country</b>	<b>Percentage</b>
<b>Canada</b>	<b>-21%</b>
Italy	-13.2%
United Kingdom	-9.4%
France	-8.4%
Netherlands	-4.5%
United States	0% (baseline)
Germany	8.2%
Japan	27.8%

### **II.3 True costs of SR&ED – Beta indices – Ontario vs. the world**

In Ontario, according to a study by The Conference Board of Canada, the “true after tax” cost for R&D is significantly lower than in any G7 nation, Australia, Korea, Mexico or Sweden.<sup>7</sup>

<b>INTERNATIONAL COMPARISON OF (B-INDEXES) (for a large manufacturing company)</b>	
<b>Country</b>	<b>B-Index *</b>
Canada—ON	0.787
United States—CA	0.879
Australia	0.890
France	0.914
Korea	0.918
Mexico	0.969
United Kingdom	1.000

<sup>6</sup> Source: KPMG, *The Competitive Alternatives: G7-2004 Edition* ([www.competitivealternatives.com](http://www.competitivealternatives.com))

<sup>7</sup> Source: *The Conference Board of Canada*

Japan	1.010
Sweden	1.015
Italy	1.027
Germany	1.051

\* The B-Index measures the break-even cost of R&D by calculating the after-tax cost of doing R&D divided by (1 minus the applicable tax rate). This index is useful for international comparison since it considers both the ITC's (which investors like) as well as high tax rates (which investors dislike). The lower the value, the greater the incentive for the firm to invest in R&D.

## **II.4 CRA criteria for Project technical eligibility**

To administer this legislative definition of SR&ED the CRA has developed additional directives and guidelines.

### **II.4.1 Definition of a “project”**

Excerpts from CRA form T4088<sup>8</sup>:

“To establish whether or not the work you claim is eligible, we have to examine eligibility **at the project level**. You must present your claim showing your work organized as SR&ED projects.”

“**An SR&ED project consists of a set of interrelated activities** that meet the **three criteria** of SR&ED defined in the current version of Information Circular 86-4, *Scientific Research and Experimental Development*. This means that the set of activities must be necessary for:

1. the attempt to achieve specific scientific or **technological advancement** and
2. overcome scientific or **technological uncertainty**, and
3. must be pursued through a **systematic investigation** by means of experiment or analysis performed **by qualified individuals**.”<sup>9</sup>

### **II.4.2 Quantified technological objectives and timeframes required**

The CRA requires that the scientific or **technological objectives** you state:

- “be quantifiable or verifiable,
- contemplate a reasonable timeframe (generally <= 3years)” &<sup>10</sup>
- “be clearly stated at an early stage in the project's evolution”<sup>11</sup>.

## **II.5 CRA guidelines on the three SR&ED “eligibility criteria”**

<sup>8</sup> This is the CRA's guide to the T661 form

<sup>9</sup> Excerpts from CRA form T4088<sup>9</sup> - the Guide to completing an SR&ED claim

<sup>10</sup> CRA form T4088, part 2, paragraph A – Guide to the T661 form.

<sup>11</sup> Information Circular 86-4R3, paragraph 2.10.3

## “Technological advancement” requires three components

The CRA clarifies that:

“In the context of experimental development, scientific or **technological advancement is the knowledge acquired in carrying out the SR&ED project**, which advances the understanding of the underlying scientific relations or technology. ..For an experimental development activity to be eligible ... it must seek to advance the taxpayer's technological knowledge base. The **technological advance achieved has only to be slight.**”<sup>12</sup>

### II.5.1 Phase 1: The square = define “standard practice”

“Commonly available sources of knowledge or experience are those that can reasonably be assumed to be **readily available to those with basic training or experience in the field of concern**. These resources enable them to be sufficiently **qualified to participate** in SR&ED. They also include knowledge that is available in the **business context** of the firm....An enterprise may not have **practical access** to information proprietary to a competitor, or known in specialist or academic circles.”<sup>13</sup>

“The **search for a meaningful advance** in the body of scientific or technological knowledge should be present as a guiding element in every eligible project. This requirement is **satisfied whether or not the activity is successful**. In other words, determining that **a hypothesis is incorrect also represents a scientific or technological advance.**”<sup>14</sup>

### II.5.2 Phase 2: The triangle = technological uncertainty

The CRA recognizes two specific sources of eligible “technical uncertainty” for SR&ED:

“Specifically, **scientific or technological uncertainty** may occur in either of two ways:

[**scientific uncertainty**] it may be uncertain whether the goals can be achieved at all ; or

[**system uncertainty**] the taxpayer may be fairly confident that the goals can be achieved, but may be **uncertain which of several alternatives (i.e., paths, routes, approaches, equipment configurations, system architectures, circuit techniques, etc.)** will either work at all, or be feasible to meet the desired **specifications or cost targets**, or both of these...Work on combining standard technologies, devices, and/or processes is **eligible if non-trivial combinations of established (well-known) technologies and principles for their integration carry a major element of technological uncertainty**; this may be called a "system uncertainty.”<sup>15</sup>

In the author’s opinion, this definition underlines the importance of continually outlining initial expectations and explaining resultant variances for work with any significant integration uncertainties.

### II.5.3 Phase 3: The circle = Activities & conclusions

The CRA requires work **to be supervised by personnel with appropriate technical backgrounds** and clarifies that in describing activities performed.

“It **must demonstrate the presence of analysis or experiment** in the methodology you used to carry out the work. It must also include the results you obtained **and the conclusions you made**. For example, the types of technical records that are appropriate to support your claim are:

- an analysis of the problem,
- internal design documents and drawings,

<sup>12</sup> Excerpt from IC 86-4R3 paragraph 2.13

<sup>13</sup> CRA IC 86-4R3 – glossary

CRA Guidelines<sup>14</sup> Excerpt from IC 86-4R3 paragraph 2.12

<sup>15</sup> CRA IC 86-4R3 paragraph 2.10.2

- test data and results, &
- progress reports.”<sup>16</sup>

The CRA has published a series of industry specific examples<sup>17</sup>.

## II.6 Eligible costs & tax credit rates

Qualified expenditures include Canadian;

- Wages,
- Materials,
- Subcontractors,
- Overheads &
- Capital equipment

to the extent that they are, "consumed through SR&ED performed in Canada."

Generally speaking “Qualified Corporations” are CCPC’s with prior-year:

- a) taxable income of \$300,000 or less AND
- b) taxable capital (roughly equal to assets) of under \$10 million.

Business Type		Tax Credit Rates (%)		
		Federal	Ontario	Total
<b>1</b>	<b>Unincorporated Businesses</b>	20	0	20
<b>2</b>	<b>Qualified Canadian Controlled Private Corporations (CCPCs)</b>	35	10	45
<b>3</b>	<b>Other "Qualified" Corporations</b>	20	10	30
<b>4</b>	<b>All Other Corporations</b>	20	0	20

The **Ontario and the Federal 35% credits are fully refundable**. The other federal credits (i.e those earned at 20%) must be applied against income taxes payable.

\* The provinces of Ontario and Quebec use ranges of \$25 and \$50 million of assets employed in Canada for phasing out their

Form T4088 – Guide to form T661

<sup>17</sup> Available for download at [www.cra-arc.gc.ca/taxcredit/sred](http://www.cra-arc.gc.ca/taxcredit/sred) OR [www.rdbase.net](http://www.rdbase.net)

enhanced credits to “Qualified Corporations.”

## II.6.1 Sample SR&ED tax credit calculation for qualified corporation in Ontario

I <u>Eligible Expenses: for deduction</u>	<u>Expense type</u>		<u>Total</u>
	<u>Current</u>	<u>Capital</u>	
Labour	250,000		
Materials	50,000		
Subcontractors	100,000		
ASA (>90%) SR&ED Capital		100,000	
Eligible (deductible) R&D Expenses	400,000	100,000	<u>500,000</u>
<b>II <u>Qualified Expenses: for calculation of ITC's</u></b>			
<b><u>Add</u></b>			
Proxy (SR&ED overhead allocation) if elected	162,500		
Shared Use (>50% SR&ED) Equipment allocation		25,000	
Qualified Expenditures for SR&ED ITC	562,500	125,000	<u>687,500</u>
<b>III <u>Credits:</u></b>			
			<u>% refundable *</u>
<b>Ontario Innovation Tax Credit (OITC)</b>			
Current Expenditures (10%)	56,250		100%
Capital expenses - ASA SR&ED (4%)		5,000	100%
Total Ontario Innovation Tax Credit (OITC)	56,250	5,000	<b>61,250</b>
Qualified Expenditures for Federal SR&ED ITC	506,250	120,000	<u>626,250</u>
<b>Federal Investment Tax Credit Earned (35% )</b>			
Current Expenditures (35%)	177,188		100%
Capital expenses - ASA SR&ED (35%)		42,000	40%
Total Federal Investment Tax Credit	177,188	42,000	<b>219,188</b>
Portion which must be applied vs. taxes payable		25,200	
Expected Investment Tax Credit refunds	233,438	21,800	
Total Investment Tax Credits earned*	233,438	47,000	<u>280,438</u>

\* The entire amount of this credit would be refunded to the corporation to the extent that there are no income taxes payable.

### III SR&ED cases regarding “technological eligibility”

<u>TOPICAL AREA</u>	<u>APPELLANT</u>	<u>PRIMARY ISSUE</u>	<u>WIN - LOSE - DRAW?</u>	<u>RULING &amp; RATIONALE</u>	<u>IMPLICATIONS: UNRESOLVED ISSUES AND OPPORTUNITIES</u>	<u>LONG-TERM SIGNIF.</u>
1) TECHNOLOGICAL ADVANCEMENT	Rainbow Pipeline	definition of "technological advancement"	Win	rejection of an hypothesis is an advance	Significant precedent on definition of "technological advancement"	Moderate
2) TECHNOLOGICAL UNCERTAINTY	Northwest Hydraulic Consultants	"system uncertainties" basis for eligibility?	Win	4 of 5 projects eligible due to "system uncertainties"	Landmark case on technological eligibility	High
3A) SYSTEMATIC INVESTIGATION	Hun-Medipharma	eligibility of analysis without "clinical trials"	Win	SR&ED work can be "experimentation OR analysis"	"systematic investigation" envisions contemplation of technological alternatives	Moderate
3B) EVIDENCE OF INVESTIGATION I	RIS Christie	"lack of documentation"	Lose - round 1	ineligible - lack of any experimentation or analysis	Successful result &/or patent NOT proof of experimentation	Moderate
			Win - round 2 (FCA)	engineer died prior to trial - court sympathetic	courts may be sympathetic for CCPC's in extreme circumstances	Moderate
3C) EVIDENCE OF INVESTIGATION II	R.J. Miller	lack of "experimentaion or analysis"	Lose	claimant must provide evidence	need evidence of experimentation	Low

#### III.1 Rainbow Pipeline<sup>18</sup> - definition of “technological advancement” (the square)

##### Facts & Summary

For further information regarding cases examining the issue of the definition of “technological advancement,” the reader is referred to the Rainbow Pipeline case, the main points of which are briefly summarized here.

The aforementioned case involves a multi-million dollar study into the failure of a pipeline due to a combination of metal corrosion and Stress Corrosion Cracking (“SCC”) issues. The initial dispute was not as to whether such an inquiry was necessary, but whether the work in question fell under the classification of SR&ED.

In 1995-1996, the NEB [National Energy Board] held an inquiry into SCC on Canadian oil and gas pipelines which confirmed that, “there was very little research on SCC failures in pipelines prior to 1993-1994.” Rainbow participated in the SCC inquiry and made available the results of its research into SCC as a result of the pipeline ruptures in February and July, 1993.

##### III.1.1 Ruling & rationale: Determining causes of problems = technological advancement

It was in part due to the impartial “third party” evidence provided by the NEB study that the judge concluded,

“The **rejection after testing of an hypothesis is nonetheless an advance** in that it eliminates one hitherto untested hypothesis. Much scientific research involves doing just that. **The fact that the initial objective is not achieved**

<sup>18</sup> Date: 1999/09/15, Docket: 96-4369-IT-G I, (TCC)

invalidates neither the hypothesis formed nor the methods used. On the contrary it is possible that the very failure reinforces the measure of the technological uncertainty.”

### **III.2 Northwest Hydraulic Consultants<sup>19</sup> – “system uncertainties” create basis for eligibility (the triangle)**

#### Facts:

The company ("NHC") carried on a specialized branch of hydraulic engineering, incorporated in 1972 as a CCPC by a small group of professors from the University of Alberta.

Five engineering projects were selected by counsel as representative of the technical issues in question.

The Canada Revenue Agency's science officer & expert witness responded,

“...that no real new or improved devices or processes were developed.

The devices and processes developed ... may have been "new" in the sense of a new location (i.e. a hydraulic structure that was not there before, or the implementation of a river improvement scheme), but all of the work described ... refers to standard devices and processes, which are routinely used in similar design situations all over the world.

...that none of the projects led to generic or specific technological advancements, with the possibility of creating new or improving existing devices or processes, ...[for use] in other engineering design situations.”

#### Issue: achievement of technological advancements

Did the projects in question meet all three of the eligibility criteria; most notably the requirement for scientific or technological advancement?

#### Relevant legislation and analysis:

The CRA was willing to accept the existence of technical uncertainty and systematic investigation but held fast that no technical advancements were achieved. Based on the evidence examined the judge concluded:

*"The respondent's position ... was essentially that the appellant, admittedly a world leader in the field of hydraulic model testing, by its own excellence sets the standard for what represents routine engineering or standard practice. ...I think that this sets an unrealistically high standard ... that would discourage scientific research in Canada."*

### **III.2.1 Ruling and rationale: 4 of 5 projects eligible due to “system uncertainties”**

Each of the eligible projects illustrated specific uncertainty in design or placement (see below).

The choices of components could also have unpredictable upstream or downstream effects on other components.

In the author’s opinion, had the taxpayer been able to illustrate similar technical facts and alternatives in its ineligible project, it may at have been 100 percent successful in its appeal.

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<sup>19</sup> *Northwest Hydraulic Consultants Ltd., v The Queen, (Date: 1998/05/01 – TCC, Docket: 97-531(IT))*

<u>Project</u>	<u>Result</u>	<u>Objective/Advance</u>	<u>Reason for judgement</u>
Lock & Dam	<b>Eligible</b>	evaluate & propose redesigns for hydro electric powerhouse	uncertainties inherent in change in flow pattern & velocity not readily predictable Used different features than prior stnd. Practice to create desired flow patterns
Sedimentation Study	<b>Ineligible</b>	devise a solution to < sediment deposit at particular area of river	3 alternatives - flushing, deadpond & extended peninsula Nothing innovative & final answer would be apparent as a result of tests proposed using stnd. Techniques
Diversion dam & intake for irrigation	<b>Eligible</b>	Develop dam for area with braided channels & maintain a low flow channel for intake in hi sediment river	3 models made - river, intake & settling basin Actual research indicated specific uncertainty in each design model as well as inter-related uncertainties between the models. Illustrated specific failures of existing sedimentation model or "design guide" on the proposed design
Dam apron repair	<b>Eligible weak</b>	reproduce conditions to determine reasons for damage & quantify then document effects of a plunge pool	1:40 model created for 3 alternatives 1 -radial divide walls, 2 -change gate sequence, & 3 -reshape apron & sealing of apron joints Advance not spectacular in the judge's view but it did > understanding of effect of falling jet of water & spreading of flow through change in sequence of gates as well as dividing wall system
River diversion dam	<b>Eligible strong</b>	Optimal combination of weirs, radial gates & walls of diff. Types	Identified 5 project design options - 3 for physical observ'n 1 -radial sluices & free ogee crest 2 - flow release control by collapsible rubber dams 3 - 4 sediment sluices sep. by overflow sec'n w gates Identified additional related uncertainties on layouts & supported "need for physical vs. numeric modelling" Innovative combination & alignment of factors seen by judge as strong support for technological advancement

### Judicial review of CRA Information Circular 86-4R3

**The judge further commented on the legal implications of the Income Tax Act's definition of "experimental development." In his view,**

"The addition of these words ["**including incremental improvements thereto**"] in 1995 ... appears to have been in response to a concern that the achievement or **attempted achievement of slight improvements** was not covered. I should not have thought it was necessary to say so. **Most scientific research involves gradual, indeed infinitesimal, progress. Spectacular breakthroughs are rare and make up a very small part of the results of SR&ED in Canada.**"

### Comments and author's opinion:

In this case the tax courts took to ruling on specific technical eligibility of a scientific process. By so doing they have provided a "case study example" to all other SR&ED claimants of potential projects. They also clearly illustrate examples of "system uncertainties" for claimants to benchmark against the legislation.

As a result the freedom of information provided by the tax court disclosure process has provided taxpayers with a valuable series of real life examples of eligible work.

### **III.3 Hun-Medipharma<sup>20</sup> - “eligibility of analysis without clinical trials” (the circle)**

#### Facts

The appeal examined two separate projects: Project 1/b - Anti-stress Tablet (for human use) & Project 2: Medical Skin Care Products (for human use).

#### Main issues and conclusions

The primary issue of this case might be summarized as, whether the legal definition of SR&ED requires the scientific research and experimental development to be carried out by “experiment and analysis” or merely by “analysis.” In the judge’s opinion, “It can be made by *experiment OR analysis*, provided it is in fact a systematic investigation.”

#### Analysis of main issues

The CRA science auditor’s major concern with both projects is that they, “**consisted only of a review of the literature on a certain subject** in the preparation for a DIN [drug submission] application to HPB [Health Protection Branch]. Also, there were **no clinical trials conducted**,” although she admitted that there, “was conceptual work done on the project.”

#### **III.3.1 Ruling & rationale: SR&ED work can be “experimentation OR analysis”**

The judge concluded “the legislation, “does not require that systematic investigation be made by both experiment and analysis. It can be made by *experiment or analysis*, provided it is in fact a systematic investigation.”

#### Comments and author’s opinion:

In the author’s opinion, this case outlines that a broad variety of activities are envisioned in the definition of “systematic investigation” and how the courts are often required to “interpret” the literal meaning of legislative phrases like “experimentation or analysis.”

### **III.4 RIS Christie<sup>21</sup> - “lack of documentation” + listing of evidence expected**

#### Facts

The taxpayer in this case had developed a new concrete forming medium. Though a patent was eventually granted for this process the CRA went as far as challenging the fact that, “any new technologies were developed.” Their main argument focused on the non-existence of, “systematic investigation,” in that no evidence of repeatable experiments and subsequent analysis of those experiments took place.

The taxpayer was able to provide 39 pages of documentation relating to technical issues however, none of this documentation evidenced analysis of tests or hypothesis performed and appeared to be either general concepts without any technical specifics or routine applications to the correct answer.

#### Legislation & analysis:

Author's note: Unfortunately, the taxpayer provided very little evidence in its own support. However, the CRA expert provided the following example of issues which he would have accepted within the realm of eligible SR&ED in this circumstance.

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<sup>20</sup> *Hun-Medipharma*

<sup>21</sup> *RIS Christie v. The Queen* [1996] E.T.C. 537 (TCC), [1999] E.T.C. 2004 (FCC)

Following is the list of 10 potentially eligible activities / issues that the expert witness would have expected to see examined in an eligible claim in this area of research:

- (a) What was the experimental set-up?
- (b) What test specimens were used?
- (c) How many specimens were tested?
- (d) What were the test parameters?
- (e) What temperature ranges were used?
- (f) What loading procedure was used?
- (g) Was foam injected and then temperature measures taken?
- (h) What device was used to measure the temperature?
- (i) At what location were the temperatures measured?
- (j) As it was a composite system, even thermal rise would produce substantial stresses in the various components. Was any attempt made to model the problem analytically and then measure the thermal deformations.

[Author's note: Ideally we would also explain "why" any of the above decisions were made. These types of issues are consistent with the types of problems outlined in the examples of the Plastics Industry Application Paper (IC 94-1) with respect to technical content and documentation requirements.]

#### **III.4.1 Original ruling & rationale: ineligible due to lack of any experimentation or analysis**

A full reading of the case and some comments made by the taxpayer to the judge help to illustrate additional reasons why the taxpayer was unsuccessful however, the major implication to claimants is that the existence of a technical patent does not automatically indicate the existence of eligible SR&ED.

Probably the most important lesson for SR&ED claimants is that we should be able to illustrate analysis as to the rationale for the results discovered so that the principles can be systematically added to the company's existing knowledge base.

#### **III.4.2 Taxpayer appealed and won: primary engineer died prior to trial**

The taxpayer, unhappy with the Tax Court of Canada's decision elected to bring the issue forth to the Federal Court of Appeal.

It should be emphasized that the **taxpayer won on appeal** due to the fact that the **primary engineer had died** prior to the trial, the remaining business partner was in poor health and therefore, in the judge's opinion,

"...If, however, a taxpayer has a plausible explanation for the failure to adduce such evidence, it is still open to the court to hold that, on a balance of probabilities, systematic research was undertaken."

#### **Comments and author's opinion:**

The implications of this case are multifold:

- a) it provides another excellent listing of potentially eligible activities for the concrete development field
- b) it illustrates how the tax courts will often "bend over backwards" to accommodate the small SR&ED performer &
- c) it clarifies that the courts will consider ANY evidence but if NOE is forthcoming, the claim will be denied!

#### **III.5 R.J. Miller<sup>22</sup> – lack of "experimentation or analysis"**

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<sup>22</sup> *R.J. MILLER & ASSOCIATES (1986) LTD. V. THE QUEEN*, Date: 2001 0 102 Docket: 97-1632-IT-G; 97-1633-IT-G

## Facts:

SR&ED work denied without comprehensive explanation

The Corporation's research included two projects for the years in question: (a) the Custom Stock (1993 and 1994) and (b) the Receiver-Trigger (1994).

Mr. Miller, a skilled marksman, formulated in his mind what he wanted in a custom shotgun. He hired Weber, a gunsmith, to carry out his technical innovations. Together they created the Custom Stock. In the same manner the Corporation developed a technologically advanced Receiver-Trigger and Recoil system. All were eventually incorporated in a custom shotgun for which the Corporation has secured a patent in Canada and the U.S.

The CRA science auditor concluded that the work on the Custom Stock met all the above requirements however, the work on the Receiver-Trigger did not qualify since there was no technical advancement or technological uncertainty. This opinion was offered without a comprehensive analysis.

## Issues: Qualifications of science auditor

The core issue concerned the determination of which development activities would be eligible. One of the taxpayer's main arguments was that the auditor was not sufficiently qualified to evaluate the work in question.

## Legislation & analysis:

As a result the judge looked to the evidence provided during the trial specifically,

In June of 1993 the first shotgun was examined for fitting. The prototype was in service by August of 1993. It worked from the first firing and did not require a single modification since the initial installation. In the words of the gunsmith,

"We started with one gun. I look at the parts, I designed the piece; I built it and tested it. **It worked from the first go.** No changes were required." (emphasis added)

### **III.5.1 Ruling & rationale: claimant must provide evidence**

The judge examined the SR&ED eligibility issues established in the case of Northwest Hydraulic Consultants v. the Queen and stated,

"It is clear that an Appellant has the burden of proof to show that the Minister's assumptions are incorrect. Usually in situations dealing with a specialized and technical area, the Court looks to be instructed by experts. In this case the use of experts was badly lacking on both sides."

As a result, the judge concluded that the technical uncertainty criterion was not satisfied and the case dismissed.

## Implications and author's commentary:

In the author's opinion, this case reiterates the importance of correlating any SR&ED activities to one or more specific, technical uncertainties. Given the taxpayer could not illustrate system uncertainty as to, "which of several alternatives: i.e. paths, routes, approaches, equipment configurations, ....etc. would meet the desired specifications," the judge had no choice but to deny the admissibility of this work.

Despite the taxpayer's misfortune this case provides a simple illustration of the "routine engineering" within the bounds of "standard practice."

Before we examine issues with respect to “financial eligibility” the following table summarizes some of the most significant areas where legislative precedence has provided both taxpayers and legislators with examples and “best practices” for documentation.

**III.6 Summary of major lessons on “technological eligibility”**

<b>Indicators of technological eligiblity</b>	
<b>Positive indicators</b>	<b>Negative indicators</b>
Benchmark industry "standard practices" Identify uncertainties in methodologies Evidence analysis of alternatives Maintain evidence (drawings, notes)	Failure to compare to similar products Focus on features Successful on first attempt No evidence of analysis or experimentation

## IV SR&ED cases regarding Financial issues

<u>TOPICAL AREA</u>	<u>APPELLANT</u>	<u>PRIMARY ISSUE</u>	<u>WIN - LOSE - DRAW?</u>	<u>RULING &amp; RATIONALE</u>	<u>IMPLICATIONS: UNRESOLVED ISSUES AND OPPORTUNITIES</u>	<u>LONG-TERM SIGNIF.</u>
1-1) WAGES	Alcatel	stock options - whether SR&ED "cost" incurred	Win - round 1	SR&ED "cost" is dilution of shareholder interest	Courts contemplate "costs" not in taxable income	High
			Draw - round 2	legislation to disallow > Nov. 14, 2005	2 year window to amend 2004 - 2005 taxation years	High
1-2)	CDD-REM	payments to "specified employees"	Win - round 1	eligible based on "evidence"	courts allow reasonable estimate of costs incurred	Low
			Draw - round 2	Subsequent events: "non-arm's length" payments	post 1996 - only "salary & wages" allowed "NAL parties"	High
1-3)	Synchrosat	allocating salary to only SR&ED activities	Lose	only SR&ED percentage claimable	need system to document employee experimentation time	Low
1-4)	Ergorecherche	time allocation - SR&ED vs. non-SR&ED projects	Lose	"reasonable" basis for allocation required	could structure "non-SR&ED" done during unpaid time	Moderate
2) MATERIALS	Consoltex	materials used in SR&ED then sold	Win - round 1	eligible if required for SR&ED	short-lived precedent to include "commercial materials"	Low
			Draw - round 2	Subsequent legislation repayment of ITC's on sale	Clarification: labour eligible - materials "sold" excluded	High
3) CAPITAL	Dew Engineering	building vs. "other structure"	Win	temporary lab not a "building" - no fixed foundation	courts take literal interpretation of "building"	Moderate
4) ASSISTANCE / GRANTS	Com Dev Ltd.	government fees - "assistance" or "revenue"	Win	fixed price contract not purchase of SR&ED	Structure SR&ED contracts- "taxpayer" to bear "risks"	High
5) SALE OF PROTOTYPES	Les Cultures Laflamme	sale of experimental production	Win	subsequent sale irrelevant if SR&ED performed	clarifies SR&ED labour eligible despite subsequent sale	High
6-1) FOREIGN EXPENSES	Data Kinetics Ltd.	foreign "mainframe" costs Canadian SR&ED?	Win	attributable to SR&ED if researcher "in Canada"	definition of "in Canada" issue of contention .	Moderate
			Draw - round 2	Subsequent events: only payments to "taxable suppliers"	subcontractor BN# now required to claim payment	High
6-2)	LGL	data collection outside Canada SR&ED?	Lose	ineligible if physically outside Canada	courts took literal interpretation of "in Canada"	Moderate
			Draw - round 2	Subsequent events: eligible if within "EEZ"	marine work eligible to 200 nauts - still "unclear" travel abroad	Low
7) OVERHEAD	Aurora Marine	eligibility of Yacht expenses for SR&ED	Win	SR&ED eligible even if not otherwise tax deductible	courts took liberal interpretation of "SR&ED costs incurred"	Low
8-1) FILING EXTENSIONS	Datacalc Research	extension of 18 month filing deadline	Lose	qualified expenditures - identified by filing due date	object under proper sections of ITA - see Alex Parallel	Low
			Win	basis for extension of filing deadline	CRA cannot restrict Minister's power to extend deadlines	extension for reasons other than CRA IC (illness/disasters)
Draw - round 2	Legislation - Nov. 17, 2005 restriction of SR&ED extension	must file within 18 months of year end - preferably 15			High	
9) QUALIFIED CCPC STATUS	Mimetex Pharmaceutical	if US director with 50% of shares has control?	Lose	actions of US director w/o consent of Canadian director(s)	consent from 1 of 2 Canadian directors to solve problem	High

In this section we will examine cases dealing with nine different areas of financial contention.

## **IV.1 R&D WAGES**

### **IV.1.1 Alcatel<sup>23</sup> – SR&ED eligibility of stock options**

#### **Facts: stock options exercised**

The corporation formerly known as Newbridge Networks Corporation, engaged in ("SRED") in Canada and maintained an employee stock option program.

In calculating its 1994 SRED expenditures the corporation included the value of stock option benefits derived by those employees who were directly engaged in the prosecution of SRED in the amount of \$23,344,318 and claimed investment tax credits ("ITC's") of \$4,668,864 with respect to the stock option benefits.

**The company did not record the amount in issue as an expense on its income statement for the 1994 (or any preceding) taxation year** and its financial statements reflected only the increase in the number of shares and share capital equal to the aggregate of the exercise price of all the shares acquired under the program (plus the corresponding increase in cash).

The Canada Revenue Agency (CRA) disallowed the ITC claim on the basis that the stock option benefits derived by the employees of the Appellant were not "expenditures incurred".

#### **Issue(s): whether eligible SR&ED expense**

The main issue is whether the benefits conferred on the employees by way of stock option constituted "... expenditures made in respect of an expense incurred in the year for salary or wages ..."<sup>24</sup>.

#### **Relevant legislation and analysis:**

The CRA argued that, the option program conferred a benefit on employees without making any outlay and therefore did so without making any "expenditure."<sup>25</sup>

The court further noted, "stock option benefits fall within the meaning of salary or wages."<sup>26</sup>

Perhaps the easiest way to understand the problem is via the attached overview of the mechanics of the taxations of stock options. At the time of exercising the option the "employee" has an income inclusion on his or her personal tax return however, this transaction has NO effect on the issuer's (i.e. employer's) financial statements.

#### **IV.1.1.1 Ruling & rationale: qualified SR&ED expense**

In the judge's view,

**"... The expenditure consists of the consideration which the Appellant foregoes when it issues its shares for less than market value."**

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<sup>23</sup> *ALCATEL CANADA INC., v. THE QUEEN*, February 24, 2005, Docket: 2003-748(IT)G, (TCC)

<sup>24</sup> *within the meaning of subclause 37(8)(a)(ii)(B)(IV) of the Act*

<sup>25</sup> *as required by subclause 37(8)(a)(ii)(B)(IV)*

<sup>26</sup> *salary or wages as defined in section 248 of the Act*

Treatment of stock options			
Taxpayer / event	Federal effects - Public Co. issuer		
	Tax effects	Example	Income to employee
<b>Issue of option</b> Ensure no bargain purchase (BP)	Only 50% of gain taxable at exercise of option if no BP	Year 1- 100 options exercise @ \$12/share Share price = \$10/sh	Nil
<b>Exercise of option</b>	Calculate income inclusion for employee 50% taxable if no BP	Year 5 - exercise when share price = \$20/sh income = \$4/sh = \$400 taxable benefit to employee NO "expense" to employer	\$400 employment income * <i>claimed by Alcatel as SR&amp;ED wages</i>
<b>Disposition of stock</b> <i>acquired via option</i>	Capital gain or loss on sale	Year 10 - sell @ \$30/sh Capital gain = \$10 share 50% taxable = \$500	\$500 taxable CG

\* employment income calculated as  $(\$20 \text{ proceeds} - \$12 \text{ cost base}) \times 50\% \text{ of capital gain taxable} \times 100 \text{ shares} = \$400$

### Implications and author's commentary

To the author's knowledge this is the first significant case giving direction on potential treatment of stock option compensation and also illustrates that the courts are willing **to consider the "substance" of a transaction regardless of how they are reflected in the financial statements.**

#### **IV.1.1.2 Subsequent events – Department of Finance proposal to disallow > Nov. 14, 2005**

On November 14, 2005 federal government proposed legislation that would prevent salary and wages incurred as a result of stock options to no longer be qualified SR&ED expenditures.

### Implications and author's commentary

In the author's opinion this is a great illustration of an instance where the courts interpretation of the legislation may have been inconsistent with the intentions of the parliament and the Department of Finance and as a result the laws are amended. Despite this fact the case send a clear indication that the courts will take a literal interpretation of the legislation when interpreting SR&ED issues.

#### **IV.1.2 CDD-REM<sup>27</sup> - Payments to "specified employees"**

##### Facts: no invoice for payment(s)

The case dealt with a lack of documentary evidence for SR&ED payments that were originally claimed as SR&ED wages, but upon audit, were found to be undocumented payments to the companies of the controlling shareholders.

<sup>27</sup> *CDD-REM Process, Vacuum Technology Corporation v. The Queen - 2000/11/28, Docket: 1999 – 4891 (IT) I, (TCC – informal procedure)*

During its 1993 and 1994 taxation years, the corporation made payments to other corporations, that were also shareholders, claiming that the SR&ED portions of these payments were 25% and 35%, respectively.

### Issue(s): Documentation required to support SR&ED?

The main issue concerned whether the amounts without direct invoice documentation were in fact, “on account of SR&ED.”

### Relevant legislation & analysis

The CRA argued that, “there was no evidence of the liability of the company to pay the amounts” and that, “the information on the T4s [slip]... was the most accurate method to be used,” since “this was a non-arm's length situation”<sup>28</sup>.

### IV.1.2.1 Ruling & rationale: eligible based on “evidence”

#### SR&ED payment eligibility without invoice documentation

The court concluded that while,

“A paper trail including the use of invoices, which are accurate and issued at proper times showing that the work was done, what the charges were for, how much work was done and how much was paid, is a better way of doing it .....**based on the credibility of the witnesses and other documents submitted the court was satisfied** that the amounts, “were also paid out by the Appellant company **on account of R&D.**”

### Implications and author’s commentary

Though the judge provided the taxpayer with the desired relief, he clarified that;

“*Without the viva voce evidence of the persons who testified, in the absence of the proper paper trail, this result could not have been reached. If the Court did not believe what these witnesses had to say, this result could not be reached.*”

In the author’s opinion this case underlines the importance of continual vigilance regarding the ongoing documentation required to support any SR&ED contract amounts.

The specific facts of this case may be less relevant subsequent to 1996 when new legislation<sup>29</sup> was passed to prohibit these and most other “non-salary” payments to “specified employees.”<sup>30</sup> Despite this fact, the issue of the amount of time sheet detail required (hourly daily, monthly....) remains an issue requiring professional judgment and as a result an area of ongoing contention between the CRA and SR&ED claimants.

### IV.1.3 Synchronat - allocating salary to only SR&ED activities<sup>31</sup>

#### Facts:

The company submitted that, during the entire 2001 taxation year, the scientist [Dr. Sen] worked as a full-time employee of Synchronat Limited working more than 40 hours a week to undertake four separate activities, but he charged for only 540 man-

<sup>28</sup> under paragraph 251.1(b) of the Act

<sup>29</sup> restrictions on specified employees per ITA subsections 37(9) &(9.1)

<sup>30</sup> “specified employee” defined per ITA subsection 248(1)

<sup>31</sup> *Synchronat Limited v. The Queen (2003TCC380)*

hours of his time to the company for all his work performed during the year (i.e. the time for eligible SR&ED Activity A). The CRA proposed that calculation of the total salary of the Appellant's shareholder related to eligible SR&ED activity is \$29,299 x 25% = \$7,324.66.

#### Issue: allocating salary to only SR&ED activities

Whether the entire salary paid during the year (in the amount of \$29,299) was attributable only to that one eligible activity.

#### **IV.1.3.1 Ruling & rationale: only SR&ED percentage claimable**

When the appellant filed its claim for SR&ED it declared that work was a combination of the four activities listed. It was only during the audit that the appellant conceded that Activity "A" alone qualified as an eligible SR & ED activity.

As a result only 25 per cent of the salary earned in 2001 qualified as an SR&ED expenditure.

#### Implications and author's commentary

In the author's opinion this case illustrates the importance of clearly allocating research activities to one or more technological uncertainties. Though the taxpayer lost in this case, the result could have been different had his allocation been more "reasonable."

#### **IV.1.4 Ergorecherche<sup>32</sup> – aggressive allocation of time to SR&ED vs. non-SR&ED projects**

##### Facts

In a case similar Synchrosat, the taxpayer performed 6 eligible SR&ED projects during the year. The taxpayer claimed costs for only the first three projects since it received contract payments related to the work performed on the latter three. These latter three "unclaimed" projects accounted for almost 70 percent of the total time spent by two specified employees. Each of the employees in question had documented over 3,000 total hours of time being spent on the six projects.

The taxpayer, on preparing the claim, attempted to allocate all salaries paid to the specified employees to be fully attributable to only the 3 projects claimed.

##### Legislation & analysis

The Canada Revenue Agency proposed to reassess the taxpayer by allocating labour costs to the projects based on actual time spent.

The taxpayer referred to judgments in such cases as *Stuart Investments Ltd. v. the Queen* [1984] and to Lord Tomlin's dictum, established in the famous case of *Inland Revenue Commissioners v. Duke of Westminster* [1936] that,

“Every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be.”

#### **IV.1.4.1 Ruling and rationale: “reasonable” basis for allocation required**

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<sup>32</sup> *Ergorecherche et Conseils Inc. v. The Queen* (CTC \_\_\_\_\_, [1997])

Unfortunately for the taxpayer, the judge did not concur with this point of view. The judge referred to the definition of a “qualified expenditure” in subsection 127(9) of the income tax act. This legislation requires the qualified expenditure be incurred in the year in respect of SR&ED. Based on this definition the judge concluded that,

"Since the shareholder-employees' salaries were determined on the basis of the appellant’s liquid assets, if the appellant wishes to include them in calculating SR&ED expenditures it must suggest a rational method for connecting their salaries with SR&ED. There is no room for discretion here, nor is it question of applying the principal of freely ordering ones affairs accepted in *Stubart*. It is simply a matter of applying the act.

**Authors commentary and related planning methodology**

In the author’s opinion, the taxpayer's main problem was the arbitrariness of their allocations. The judge did not state that alternate allocations would not be accepted however, these allocations must, “suggest a rational method for connecting their salaries with SR&ED.”

In the author’s opinion, had the taxpayers allocated their eligible R&D time over a standard work (1,800 hours) year rather than the total hours actually spent (>3,000 hours), its appeal might have been far more credible since a “reasonable allocation basis” would then have been proposed.

**IV.1.4.2 Example of potential problem & related planning with unpaid overtime**

An example of the types of problems The Canada Revenue Agency's assessment policy can create is obvious if we contemplate the following scenario:

ABC Company’s top scientist is intended to spend all of her salaried time (1,800 hours) on eligible SR&ED activities.

She then volunteers another 400 hours of unpaid time after work in self development as well as training of promising upcoming technical employees.

The CRA's stated assessment policies (application policy paper 96 – 06), they will likely try to reduce the taxpayer’s claim for the time that the scientist volunteered in excess of his or her expected work hours. This may in turn create a scenario where such employees will be prevented from working overtime or developing further skills on their own behalf despite any long-term benefits that would accrue their employer. This is likely not the intent or spirit of the legislation.

Fortunately, as the author has illustrated, the judgment of this case does not indicate that ABC Co. would be penalized in this manner if “reasonable” allocations of SR&ED costs were made to encompass the concept of a “full work year” as a “finite” number of hours.

The case highlights important issues relating to the need to document the efforts spent and the degree of subjectivity in determining the reasonableness of the related supporting documentation.

<b>Lessons on claiming SR&amp;ED wages</b>		
<b>Issue</b>	<b>Positive indicators</b>	<b>Negative indicators</b>
Ability to reasonably allocate SR&ED hours	Management representations Technical documentation Time sheets	Results vs. conclusions Lack of documentation

## **IV.2 MATERIALS**

### **IV.2.1 Consoltex<sup>33</sup> - Materials Consumed in SR&ED**

#### **Facts**

The cost of yarn (materials as well as labour) for experimental runs (some up to 52 km) were found to be eligible even though there was a "commercial sale" of the end product.

#### **Legislation and analysis of main issue:**

The Canada Revenue Agency's assessment policies (particularly those outlined in SR&ED Application Policy Paper 96-07) would generally not allow the "materials" component of such expenses (to the extent they were recovered from the eventual customer), claiming that they were more in the nature of "commercial" vs. "experimental" production.

Support for The Canada Revenue Agency's position appears in ITA (Income Tax Act) Regulation 2900(2)(a) which states that Materials must be "*consumed*" in the SR&ED prosecution.

#### **IV.2.1.1 Ruling & rationale: eligible if required for SR&ED**

The tax court judge appears to have addressed this issue clearly and directly and felt that if the SR&ED work using the material was eligible on a technical basis, all material costs would be included. He stated that this method of allocation was in the nature of the intent of the Income Tax Act and that,

"To whittle away at those [the SR&ED] provisions defeats that object [to encourage Canadian SR&ED]."

#### **Author's discussion on the "materials consumed" issue during the 1990's**

Much of the problem previously experienced between The Canada Revenue Agency and taxpayers as a result of the "carve-out" of costs due to the eventual sale of experimental product was largely due to the fact that this cost reduction or carve-out was applied to all SR&ED costs (i.e. labour, subcontractors, overheads, and materials) rather than strictly the material component(s).

This "all or nothing" approach was used by The Canada Revenue Agency in both the 1993 Cultures LaFlamme case, which they also lost, and apparently (though the details of the case are somewhat unclear on this issue) in the Consoltex case.

This "all in" or "all out" position left the tax court judges in a precarious position. If they attempted to reduce all costs by any proceeds received, the credit would then only fund businesses that experience continual failures rather than those which developed successful products through the SR&ED process. This did not appear to be the intent of the program. Consequently, this "binary - i.e. all in or all out" decision, in our opinion, resulted in the Cultures LaFlamme and (perhaps the) Consoltex decisions and was justified (under this premise) given the wording of the Income Tax Act.

This problem was subsequently resolved by parliament by introducing new legislation on the subsequent disposition of SR&ED materials and capital.

#### **IV.2.1.2 Subsequent events: repayment of ITC's on sale of SR&ED materials**

The "new" interpretation of "commercial vs. experimental" use for *materials only* appears to follow the wording of the Act in subsection 37(8) regarding "materials consumed [in the prosecution of SR&ED]."

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<sup>33</sup> *Consoltex Inc. v. The Queen (TCC 1997 ETC 148)*

Subsequent legislation also provides for repayment of the ITC's earned on materials to the extent that they are subsequently sold<sup>34</sup> however, the labour costs incurred to produce these items still remains eligible. In the author's option this differentiation between "hard" and "soft" costs appears to have provided considerable clarity to taxpayers.

### Author's discussion on the "materials consumed" issue after 1999

While the comments in the Consoltex case are interesting, in the authors option it is yet another illustration of the department of Finance updating the legislation updating the legislation to be in conformance with the intentions of parliament and how the court system is integral in the ongoing evolution of the current SR&ED system.

## **IV.3 CAPITAL EQUIPMENT (>50% OR > 90% R&D)**

### **IV.3.1 Dew Engineering<sup>35</sup> – Building vs. "other structure"**

#### Facts & analysis:

The taxpayer in this case incurred costs to develop a temporary laboratory. Although connected to the taxpayer's plant by bolts, the lab could be disconnected and prepared to be shipped to a new location in one day. The Canada Revenue Agency attempted to deny the taxpayer any investment tax credits on these expenses on the basis that the laboratory was a "building" within the meaning of the relevant provisions of the income tax act.

The case made reference to the Supreme Court of Canada decision in British Columbia Forest Products vs. MNR and also referred to The Canada Revenue Agency's IT -- 79R3. One underlying theme in both of these directives was the fact that a building envisions a construction which is intended to remain permanently in place on a permanent foundation. The judge went on to list the seven factors which he found relevant in the determination of whether the structure meets the meaning of a building as contemplated in this SR&ED legislation:

- 1) The lab has no foundation and is not affixed to the ground.
- 2) It sits on the ground like some mobile homes.
- 3) It is designed to be and is in fact portable.
- 4) It can be easily disassembled and reconstructed.
- 5) When in place, its energy needs are met by connecting to facilities of the structure to which it is appended.
- 6) Its cost was minimal in the general context of building costs: and
- 7) Its life expectancy was only 20 years.

#### **IV.3.1.1 Ruling and rationale: temporary lab eligible since not a "building"**

The judge found that the structure did not meet the definition of a building within the meaning prescribed in the Income Tax Act (ITA).

#### Authors commentary

While this case is likely not a "main stream" issue to claimants, it is an interesting illustration of the fact that virtually every type of SR&ED expense definition is being tested and perhaps in some cases litigated!

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<sup>34</sup> *Repayment of ITC's per ITA subsections 127(27-35)- effective for dispositions post Feb 23, 1998*

<sup>35</sup> *Dew Engineering and Development Ltd. vs. Queen [1996] 3 CTC 2904 (TCC)*

## **IV.4 FINANCIAL ASSISTANCE / CONTRACT PAYMENTS FOR SR&ED**

### **IV.4.1 Com Dev Ltd. v. The Queen<sup>36</sup> – SR&ED assistance or commercial revenue**

#### **Facts:**

Spar Aerospace Limited ("Spar") was awarded a contract by the Canadian government to design and manufacture a satellite ("Radarsat"). Com Dev was selected as a subcontractor for the design and manufacture of components. In total, it received \$28,350,000 arising from the Spar-Com Dev Contract. Despite these fees, Com Dev suffered a \$4,283,000 loss on the contract. It attempted to seek compensation from the Government of Canada but was unable to do so because there was no contractual relationship between Com Dev and the Government of Canada. The Canada Revenue Agency also claimed that the \$ 28,350,000 received under the Spar agreement was government assistance.

#### **Main Issue:**

The Canada Revenue Agency claimed that all proprietary rights accrued to the Canadian Government and therefore all amounts received were "government assistance."

#### **Relevant legislation:**

The judge clarified that to qualify as a contract payment under paragraph (b) in subsection 127(9), an amount must:

- 1) be payable by a Canadian government, municipality or other Canadian public authority or by a person exempt from tax under Part I by virtue of section 149; **and**
- 2) be payable for SR&ED performed for it or on its behalf.

#### **Judge's Analysis:**

Despite the inclusion of a clause claiming that,

"All Technical Information and Inventions conceived or developed or first actually reduced to practice in performing the Work under this Contract shall be the property of Her Majesty, and the Contractor shall have no rights in and to the same except as may be provided by Her Majesty..."

Another clause stated,

"..the intellectual property for any deliverable computer software, processes, methods, techniques and know-how in existence or residence within COM DEV prior to effective date of the Contract is proprietary to COM DEV and can solely be used for the purposes of the RADARSAT program."

### **IV.4.2 Ruling & rationale: fixed price components contract did NOT include the purchase of SR&ED**

The judge felt that the effect of the second clause at a minimum severely restricted Her Majesty's right to a proprietary interest in technical information and inventions under the contract and therefore, "do not allow the Spar-Com Dev contract to simply speak for itself."

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<sup>36</sup> citing - [1999] 2 C.T.C. 2566 (T.C.C.)

As a result the payment was NOT a contract payment NOR was it government assistance. Instead the judge concluded that the, “contractual relationship based on a fixed firm price for the purchase of the components did **not** include the purchase of SR&ED.”

### Comments and Author’s Opinion

The fact that the assistance was not deemed to be received from the government was also an issue worthy of note since many auditors deem any amounts received “directly or indirectly” from any level of government to be “government assistance.” This would indicate that, though all government contracts tend to limit the upside payment of any contracted amounts, those that do so with the effect of passing substantial technical and business risk to the taxpayer may not be deemed as government assistance.

Based on the continually increasing co-operation between government and private SR&ED performers, in the author’s opinion, this case will likely be of considerable long-term significance. It is also a great illustration of the high degree of judgment involved in evaluating and documenting some of the following key determinants:

#### **Definition of "contract payment" in subsection 127(9)**

<b><u>Positive indicators</u></b>	<b><u>Negative indicators</u></b>
1 SR&ED Performance Required	Contract not explicit wrt SR&ED
2 Pricing based hourly	Pricing vs. Risks (ceiling)
3 Intellectual Property (IP) to client	IP to performer
4 Contract for Services	Contract for Goods

## **IV.5 SALE OF EXPERIMENTAL PRODUCTION**

### **IV.5.1 Les Cultures Laflamme<sup>37</sup> (1984) – sale of experimental production**

#### **Facts:**

The appellant instituted an appeal from the assessment of respondent, the Minister of National Revenue (the "Minister"), for its 1986 taxation year.

The company specialized in the production of oyster mushrooms. The Canada Revenue Agency agreed that 80 per cent of the current expenditures, that is \$85,104, was related to research and development but it must be reduced by income from the sale of experimental production, that is \$96,979.

#### **Issues:**

(a) whether the sums received from the sale of a product developed during the SR&ED phase of that product must be deducted in the calculation of the amount of qualified expenditures of a current nature for the investment tax credit.

#### **Legislation and Analysis:**

The deduction for scientific research and experimental development is calculated under subsection 37(1).

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<sup>37</sup> Les Cultures Laflamme (1984) Inc., v MNR (TCC), June 17, 1992. [Docket: 89-2514(IT)]

There is nothing in this subsection or elsewhere in the Act or Regulations which requires scientific research and experimental development expenditures to be reduced by the income from the sale of experimental production.

#### **IV.5.2 Ruling & rationale: subsequent sale irrelevant if SR&ED performed**

There was no reduction of SR&ED costs.

Despite this ruling this issue remains an ongoing issue of contention with the CRA. It is most commonly encountered in situations where there are commercial installations of new prototype lines or facilities. Generally speaking the CRA looks for reasonable estimates of incremental costs and will accept all related labour and subcontractor costs.

#### **Comments and Author's Opinion**

Also of significant note is the fact that subsequent legislation has also evolved to provide for repayment of the ITC's related to materials and capital if they are subsequently "sold" or "converted to commercial use."

### **IV.6 FOREIGN EXPENSES**

#### **IV.6.1 Data Kinetics Ltd. v. R. [1998](TCC) – foreign “mainframe” costs may be Canadian SR&ED**

##### **Facts:**

The taxpayer rented computer time on a mainframe computer in Alabama and incurred \$191,360 in communication charges. All work was performed by the taxpayer's employees from facilities based in Ottawa.

The Canada Revenue Agency allowed \$165,157 as a foreign SR&ED expenditure under subsection 37(2) (which in turn does not earn any investment tax credit).

##### **Issue: rental of mainframe outside Canada**

If mainframe outside Canada were the costs to rent mainframe time and related communication charges: SR&ED performed in Canada (as per ITA subsection 37(1)) vs. SR&ED performed outside Canada (as per ITA subsection 37(2)).

##### **IV.6.1.1 Ruling and rationale: attributable to SR&ED if researcher “in Canada”**

The taxpayer was successful. After a review of the legal definition of the term lease<sup>38</sup> the judge found that rental payments for such time were,

“...attributable to the lease of equipment..”

and hence, SR&ED carried on in Canada thus deserving 37(1) treatment as long as researcher performing related work in Canada.

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<sup>38</sup> *Black's law Dictionary* – “...word “lease” means a contract by which one owning such property grants to another the right to possess, use and enjoy it for specified period of time in exchange for periodic payment ...”

### Comments and author's opinion:

It should be noted that the legislation has been subsequently updated to require qualified SR&ED payment be made to a "taxable supplier." As a result this case is likely of low long term significance as a great illustration of how the legislation has evolved to address the overall objectives of the program. If we step back to contemplate the principles of a "hedged transaction" it is interesting to note the evolution of the new legislation appears to meet this objective and appears to have been initiated and developed based on this and similar court precedence.

### **IV.6.2 LGL<sup>39</sup> -"data collection outside Canada not SR&ED"**

#### Facts:

During the year the company claimed four separate SR&ED projects. The Canada Revenue Agency agreed that each of the projects in its entirety was SR&ED and that the expenditures were of a current nature.

The issue of contention related to activities involved tracking whales which fact that the data collection conducted off the northern coast of Alaska which they believed was "outside Canada" despite the fact that all employees on the ship were Canadian and fully taxable in Canada on the wages earned.

#### Main issue:

The sole issue addressed by the Tax Court was whether certain SR&ED costs for work, that was admittedly carried on in Alaska as part of the four eligible projects, would qualify under paragraph 37(1)(a) of the *Income Tax Act* as SR&ED "carried on in Canada".

#### Legislation and Analysis

The case is an interesting summary of foreign SR&ED issues in that it cites precedence set in two separate cases.

The first was *Tigney Technology Inc. v. R.*, [1997] 2 C.T.C. 2333 which it recognized had been appealed to the Federal Court of Appeal and accordingly it made no comment on it beyond observing that, "the experiments in Kentucky appear to have been a rather small incident of the SR&ED carried on in Canada. Here the very basis [almost 30% of costs] of the SR&ED that was conducted was the data collected off the shore of Alaska."

In the second case: *Data Kinetics Ltd. v. The Queen*, 98 DTC 1877, the only activity outside of Canada was the use of a dedicated telephone line connected with a mainframe computer in the U.S. The judge noted that in this case no personnel of that taxpayer ever went to the U.S., and on this basis alone felt that the case was distinguishable from those presented by LGL.

#### **IV.6.2.1 Ruling and rationale: ineligible if physically outside Canada**

Despite the fact that the data collection conducted off the northern coast of Alaska was brought to Canada and analyzed as part of the overall research projects, the judge felt that the wording "carried on in Canada" as contained in paragraph 37(1)(a) was clear: the work must physically take place in Canada.

As a result the court ruled that the portion of the work with in Canadian waters was eligible but the portion within International or foreign waters was not.

#### Author's opinion: Canadian employee abroad still raises serious, unresolved issues

While this overall position to deny foreign expenses appears to have merit, in the author's opinion, one portion still creates

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<sup>39</sup> *LGL Limited v. The Queen [1999] (TCC)*

policy inconsistencies: to deny investment tax credit on the portion of the Canadian employees SR&ED work done abroad. Particularly troubling in this case is the fact that the Canadian employee remains fully taxable on his or her Canadian salary during the period traveled abroad yet this amount “mysteriously” becomes ineligible for SR&ED tax credits.

The author has written letters to the Director General of the SR&ED program dating back to 1996 but has not received any responses contemplating a full understanding of this issue at the policy level!

It has been the author’s experience that the typical engineer or scientist may travel an average of two or three weeks per year on SR&ED related functions. Furthermore, a 1997 study performed by the Department of Finance confirmed that the result of these activities is a net influx of infrastructure to the Canadian economy.<sup>40</sup> This will undoubtedly remain an issue of ongoing contention until the tax courts provide direction for the Department of Finance to base some new legislation.

## **IV.7 OVERHEAD INCLUSIONS**

### **IV.7.1 Aurora Marine<sup>41</sup>- Eligible Yacht expenses**

#### **Facts: Yacht used 100% in SR&ED activities**

The CRA, while admitting the validity of some research using a Yacht, disallowed certain expenses including the yacht's slippage and insurance.

Based on the testimony of the taxpayer, the judge was, “satisfied that the boat was used exclusively at all times for the purpose of testing the various [SR&ED] products.”

#### **Issue: Whether certain overheads eligible?**

In the author’s opinion, the key legislative question was, “what expenses would be allowed under the traditional method of overhead allocation?”

#### **Relevant legislation & analysis**

Since this case was an informal appeal it did not provide an in depth legislative analysis and as a result carries less precedence than a traditional tax court of Canada ruling.

#### **IV.7.1.1 Ruling & rationale: all relevant overheads eligible**

Because the yacht was exclusively used for the research and development, the yacht's slippage and yacht insurance was envisioned by the legislation.<sup>42</sup>

#### **Implications and author’s commentary**

The case is also of interest since it further illustrates that the courts are willing allow a reasonable allocation of overhead expenditures to any SR&ED activities. Of particular interest is the fact that SR&ED includes fees for a Yacht which would otherwise NOT be deductible for income tax purposes!

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<sup>40</sup> “Why and How Governments support Research and Development,” December 1997, Department of Finance (.PDF copy on CD Rom)

<sup>41</sup> *Aurora Marine Industries Inc. v. The Queen*: 2000/11/28, Docket: 1999 – 4891 (IT) I, (TCC)

<sup>42</sup> “traditional” overheads defined per ITA Regulation 2900(3)

## **IV.8 FILING EXTENSIONS (>18 months)**

### **IV.8.1 Datacalc Research 43 - extension of 18 month filing deadline**

#### Facts:

This appeal is from an assessment for the appellant's 1986 taxation year whereby the Minister of National Revenue denied SR&ED ITC's in the amount of \$665,607 claimed in its return of income for the 1986 taxation year since the claim was not filed until 1999: well past the 18 month deadline.

#### Issue(s): extension of 18 month filing deadline

Whether the late-filing could be warranted and, if so, under what conditions?

#### **IV.8.1.1 Ruling & rationale: qualified expenditures must be identified by filing due date**

Basically the credit was denied as based on current legislation, qualified expenditures must be identified on or before the due date for filing the tax return for the subsequent taxation year.<sup>44</sup>

#### Implications and author's commentary

It seems quite clear that, neither the CRA, nor the Tax Courts are willing to extend the prescribed filing deadlines. In the author's opinion this underlines the importance for taxpayers to file on a timely basis.

### **IV.8.2 Alex Parallel Computers<sup>45</sup> -basis for extension of filing deadline**

#### Main Issue

Whether The Canada Revenue Agency can waive requirement to file, "SR&ED return with all prescribed information," by 18-month deadline.

#### Facts

On March 1, 1993, the company engaged the University of Ottawa to perform certain SR&ED work.

On March 12, 1996, The Canada Revenue Agency signed an agreement with the taxpayer, agreeing that, 66.5% of the amounts spent with the University qualified as SR&ED for its 1994 and 1995 taxation years.

The taxpayer did not file its 1994 return until June 12, 1996, i.e., three months after the signing of the agreement with The Canada Revenue Agency *and six weeks after the statutory (18-month) deadline (i.e. April 30, 1996).*

The Canada Revenue Agency refused to both:

1. waive the requirement for the filing by taxpayer of prescribed forms for 1994 and,
2. extend the time for filing taxpayer's 1994 return.

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<sup>43</sup> (TCC) Docket: 2000-1413-IT-G Date: 2002/02/22

<sup>44</sup> ITA subsection 37(11)

<sup>45</sup> *Alex Parallel Computers Research Inc. v. The Queen* [1998] (FCTD)

## Relevant Legislation

- The Income Tax Act states,

“Where any provision of this Act or a regulation requires a person to file a prescribed form, receipt or other document, or to provide prescribed information, the Minister may waive the requirement, but the person shall provide the document or information at the Minister’s request”<sup>46</sup>

and clarifies that,

“The Minister may at any time extend the time for making a return under this Act.”<sup>47</sup>

- The Canada Revenue Agency’s Application policy SR&ED 96-01, states,

“The definition of qualified expenditure in subsection 127(9) of the Act requires certain prescribed information to be filed within prescribed time frames. Any requests to waive this requirement, under subsection 220(2.1) should be denied. Subsection 220(2.1) was included in the Act to accommodate E-filing.”

### **IV.8.2.1 Ruling and rationale: CRA cannot restrict Minister’s power to extend**

The judge in this case sided with the taxpayer, finding:

- a. “that [The Canada Revenue Agency’s] only ground for refusing taxpayer's request was that, as a matter of *Departmental policy*, Ministerial waivers (under subsection 220(2.1)) of requirements to file prescribed forms to be limited to situations involving electronic filings;”
- b. that, in reaching this decision, “[The Canada Revenue Agency] having elevated departmental policy to the equivalent of a statutory requirement, [had] unduly narrowly construed subsection 220(2.1);”

### **Comments and author’s opinion:**

In the author’s opinion, the judge’s ruling is of little surprise once one takes a clear look at the legislation. The result

Regardless of this fact, the case is likely of considerable long-term significance in that it;

- once again illustrates that taxpayers should be wary of The Canada Revenue Agency documents which do not appear to have direct, legislative support, &
- establishes a precedent that there may be other instances where “extensions” of the filing deadline may be warranted.

**Also of interest is the fact that November 2005 introduced legislation which proposes to restrict the Minister’s discretion on this extensions!** Once again an example of the court system driving the SR&ED system development.

## **IV.9 “CCPC” & “ASSOCIATED CORPORATION” STATUS**

### **IV.9.1 Mimetex Pharmaceutical<sup>48</sup> - whether US director with 50% of shares has control**

#### Facts:

During the year in question, Mimetix (a foreign corporation) owned 50 common shares in the capital stock of the appellant, and two Canadian residents, who were also directors owned 25 common shares each.

<sup>46</sup> ITA subsection 220(2.1)

<sup>47</sup> ITA subsection 220(3)

<sup>48</sup> (TCC) Docket: 1999-4847-IT-G Date: 2001/11/08

There were three directors elected to the board, one a U.S. resident and the other two Canadians.

### Issue(s): “defacto” control

Both parties agreed that no one had “de jure” (voting) control over the appellant. The issue is rather whether the appellant was controlled in fact, directly or indirectly in any manner whatever, by a non-resident. In other words, it has to be determined whether the non-resident corporation Mimetix Inc. (“Mimetix”), which owned 50 per cent of the voting shares of the appellant in 1996, exercised “de facto” control over the Canadian company.

The CRA’s council pointed out that;

- The two Canadian directors, who, according to the appellant's argument, were supposed to control the appellant, in fact knew almost nothing about the appellant (for example one did not know at the time of his examination for discovery how many employees were working for the appellant, who had signing authority for the appellant, etc.).
- Mimetix had financial control over the appellant and had a controlling influence over the appellant's affairs. This is best illustrated, in his view, by the fact that a Canadian director of the appellant, had to leave following a conflict with another U.S. doctor, who was not a shareholder, director or officer of the appellant, but was hired by the U.S. director on his own decision, without any resolution of the board of directors.

### Relevant legislation and analysis:

De facto control is contemplated within the meaning of the Act which reads as follows:

“Control in fact. .... a corporation shall be considered to be so controlled by another corporation, person or group of persons (in this subsection referred to as the "controller") at any time where, at that time, **the controller has any direct or indirect influence that, if exercised, would result in control in fact of the corporation, ...**”<sup>49</sup>

#### **IV.9.1.1 Ruling & rationale: control evidenced by actions**

Based on the facts provided, the judge concluded that,

**“Indeed the evidence discloses that the only director that exercised such control and supervision was the non-resident director. ... without the approval of the board of directors.”**

### Author’s commentary & implications to corporate structure

This example illustrates that there are considerable pitfalls and potential opportunities to structuring ventures with foreign shareholders, public companies and other companies in a manner that maintains CCPC status and eligibility for enhanced tax credits. In many cases considerable judgement will be involved to determine whether “control” is present. This will therefore, likely remain an issue of potential litigation and on-going development for professionals involved in structuring and maintaining these types of corporate entities.

## **V Concluding remarks**

It is the author’s hope that this paper has illustrated the high degree of influence of both the Canadian

- taxpayers and

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<sup>49</sup> ITA subsection 256(5.1)

- the tax courts

have had as co-architects of the current SR&ED tax credit system!

Hopefully the paper has illustrate that there will always be a requirement for “professional judgment” in determining the eligibility of both the “technology” and the related “cost of development” however, I believe that these issues can be administered fairly and objectively once all of the issues are clarified.

It is my strong assertion that the resultant SR&ED tax credit system illustrates previously unparalleled levels of “co-operation” and “partnership” between industry and government.

In the author’s opinion, this is a positive shift from their traditional roles of “regulation” and “taxation!” The continual development of this system on both the federal and provincial levels is likely to keep Canada in the forefront of countries in which companies choose to perform SR&ED.

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