

Minutes of September 14, 2000
Hamilton Region SR&ED Practitioner's meeting

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Minutes prepared and distributed September 2000 by David Sabina, group moderator

Issue 1: Status of SR&ED eligibility on “salary & wages” incurred outside of Canada

As previously stated, based on the results of the Tigney Technologies and LGL appeals, the CCRA has taken the position that it will deny SR&ED credits eligibility¹ on “salary and wages” of Canadian employees while abroad².

One of the most compelling arguments to support the eligibility of SR&ED credits on “salary and wages” of Canadian employees while abroad is the fact that the **Canadian employee remains taxable on his or her salary and wages** regardless of where these duties are performed. As a result, in most if not all cases, the CCRA earns substantially greater tax revenues from the personal taxes of the individual employee than it pays out to the SR&ED performers (i.e. the employers) on these wages.

In a previous meeting our group unanimously agreed that the current tax policy appears to inhibit achievement of our Science Policy goal to, “ensure that new knowledge can be acquired and disseminated widely, from Canadian sources and from around the world.” These issues were submitted to Norine Heselton, Director General of the SR&ED program.

David Sabina received a response to this letter supporting a “deny all foreign expenses” position. Its **current rational** for this position is that it believes that there could be **loss of infrastructure** from encouraging Canadians to travel abroad.³ This is in fact **in complete contradiction of 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.⁴

We propose to explore these results as well as potential avenues for follow-up including letters to the Ministers of Finance and Industry. The group proposed to delay the issue of this letter until the result of the upcoming Federal elections and then renew its focus on this issue with the appropriate ministries in the new year.

Issue 2: Negative tax effects from proper treatment of

¹ By way of inclusion in Canadian expenses defined under ITA subsection 37(1)

² SR&ED Application Policy Paper 95-01R – Issue 2: SR&ED outside Canada

³ CCRA rulings letter – January 14, 2000, N. Heselton, Director General

⁴ “Why and How Governments support Research and Development,” December 1997, Department of Finance (copies available at meeting or on request)

“development costs” still unchanged

For taxation years that begin after 1995 the tax legislation provides for a phase-out⁵ of the enhanced⁶ ITC's for CCPC⁷'s based on their “taxable capital.” Basically, the \$2,000,000 expenditure limit for enhanced ITC's is reduced, on a straight-line basis, as the taxable capital of the company, and any other companies under common control, exceeds \$10,000,000. By the time taxable capital reaches \$15,000,000 the enhanced credit is fully phased out.

In the case of capitalized development costs, the costs have not been expensed in the periods in which the work was performed and therefore become part of the “retained earnings” portion of the “equity” balance of the corporation.

In many provinces (including Ontario) the definition of “taxable capital” provides for a deduction of amounts (such as SR&ED expenses) that are otherwise deductible for tax purposes independent of whether they are capitalized in the financial statements. Unfortunately, the Federal capital tax calculation⁸ provides no similar reduction of “development costs” from the calculation of taxable capital.

This issue was submitted to the CCRA but no positive actions have been witnessed to date. The group reiterated its concern that the government provide relief to small and medium sized corporations similar to that provided in Ontario to encourage GAAP compliance.

Issue 3: Financial Statement & tax implications of “super-allowance” being treated as government assistance

Reproduced below is Department of Finance News Release No. 2000-039, dated May 9, 2000, concerning certain proposals contained in the February 28, 2000 Federal Budget.

“Minister Martin announced today that the measure regarding the treatment of provincial deductions for scientific research and experimental development (SR&ED) expenditures will **apply to taxation years commencing after February 2000**. As originally announced in the budget, this measure would have applied for taxation years ending after February 2000. Under this measure, provincial deductions for SR&ED expenditures that exceed the actual amount of the expenditure will be taken into account in determining government assistance for the purposes of the federal investment tax credit base. Postponing the implementation date addresses concerns about the impact of the timing of this change on corporate budgeting strategies for the year 2000.”

The group discussed the financial statement & tax implications of this change but did not provide any specific examples of complications which would prove problematic in its application.

Issue 4: Use of databases to track SR&ED project technical and financial information

⁵ Mechanics of phase-out formula provided in subsection 127(10.2) of the Income Tax Act.

⁶ Qualified CCPC's receive a fully refundable, 35% Federal Investment Tax Credit (ITC) on their first \$2 million of qualified SR&ED expenditures. These credits are generally 20%, non-refundable credits otherwise.

⁷ Canadian Controlled Private Corporation

⁸ Taxable capital and capital tax ITA part I.3, section 181 and calculated per Federal Tax Schedule 33

Many practitioners will be aware of recent releases of SR&ED tax credit preparation software. These include products from KPMG, Price Waterhouse Cooper's and RPR Consultants, to name a few.

In order to facilitate this discussion, David Sabina provided a demonstration of such a program and opened the floor to feedback on the desired functions of such a system.

Some of the favourable and unfavourable aspects of the general designs of such systems included:

Pros:

Ability to correlate research steps with specific uncertainties

Ability to correlate costs to specific research steps

Simplicity of use

Cons:

Integration of confidential information (e.g. employee salaries) which would restrict widespread use in the company.

Most parties agree that database technologies of this nature were likely to significantly streamline the client compliance costs as well as CCRA administrative functions and could pave the way to an ability to have electronic filing of SR&ED claims. This will likely be a topic of future meetings.

October 19, 2001

Attention: Hamilton SR&ED Practitioners' Group Members

Re. Minutes of October 11 meeting

Dear member,

Please find attached the minutes summarizing the major issues, analysis and recommendations contemplated during the above noted meeting of the Hamilton R&D practitioners' group.

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Please feel free to send any comments or questions on these issues or to provide details of other issues you would like to see addressed. (Please respond by fax 905- 631-0698 or email dsabina@meuk.net)

Regards,

Dave Sabina,
Hamilton Group Leader

Attendees:

<u>Name</u>	<u>Firm</u>
Allen, Peter	Software Management Solutions
Dreiger, Susan	KPMG
Gribowski, Jerry	Gribowski & Assoc.
Hall, Denis	Tech Team Management
Moore, Michael	Taylor Leibow
Murphy, Patrick	Consultant
Sabina, David	MEUK Corporation
Vertucci, Rocco	MEUK Corporation

Issue 1: Status of SR&ED eligibility on “salary & wages” incurred outside of Canada

As previously stated, based on the results of the Tigney Technologies and LGL appeals, the CCRA has taken the position that it will deny SR&ED credits eligibility¹ on “salary and wages” of Canadian employees while abroad².

One of the most compelling arguments to support the eligibility of SR&ED credits on “salary and wages” of Canadian employees while abroad is the fact that the **Canadian employee remains taxable on his or her salary and wages** regardless of where these duties are performed. As a result, in most if not all cases, the CCRA earns substantially greater tax revenues from the personal taxes of the individual employee than it pays out to the SR&ED performers (i.e. the employers) on these wages.

In a previous meeting our group unanimously agreed that the current tax policy appears to inhibit achievement of our Science Policy goal to, “ensure that new knowledge can be acquired and disseminated widely, from Canadian sources and from around the world.” These issues were submitted to Norine Heselton, Director General of the SR&ED program.

David Sabina received a response to this letter supporting a “deny all foreign expenses” position. Its **current rational** for this position is that it believes that there could be **loss of infrastructure** from encouraging Canadians to travel abroad.³ This is in fact **in complete contradiction of 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.⁴ This “inconsistency” in published policy was brought to the

¹ By way of inclusion in Canadian expenses defined under ITA subsection 37(1)

² SR&ED Application Policy Paper 95-01R – Issue 2: SR&ED outside Canada

³ CCRA rulings letter – January 14, 2000, N. Heselton, Director General

⁴ “Why and How Governments support Research and Development,” December 1997, Department of Finance (copies available at meeting or on request)

attention of the CCRA during our last meeting.

Results of group discussion:

The group discussed the issues and agreed that the main issue would be to ensure that the recipient of the “salary or wages” is not otherwise eligible for foreign tax credit on these amounts. Though there were no foreign tax experts in the group, it was proposed that group members try to contemplate examples of potential abuse for the next meeting and that these results, as well as potential avenues for follow-up, be documented and sent to the CCRA as well as Ministers of Finance and Industry.

Issue 2: Provincial harmonization issues - “development costs” / qualified corporations

For taxation years that begin after 1995 the tax legislation provides for a phase-out⁵ of the enhanced⁶ ITC’s for CCPC⁷’s based on their “taxable capital.” Basically, the \$2,000,000 expenditure limit for enhanced ITC’s is reduced, on a straight-line basis, as the taxable capital of the company, and any other companies under common control, exceeds \$10,000,000. By the time taxable capital reaches \$15,000,000 the enhanced credit is fully phased out.

In the case of capitalized development costs, the costs have not been expensed in the periods in which the work was performed and therefore become part of the “retained earnings” portion of the “equity” balance of the corporation.

In many provinces (including Ontario) the definition of “taxable capital” provides for a deduction of amounts (such as SR&ED expenses) that are otherwise deductible for tax purposes independent of whether they are capitalized in the financial statements. Unfortunately, the Federal capital tax calculation⁸ provides no similar reduction of “development costs” from the calculation of taxable capital.

Results of group discussion:

This issue was submitted to the CCRA but no positive actions have been witnessed to date. The group re-iterated its concern that the government provide relief to small and medium sized corporations similar to that provided in Ontario to encourage GAAP compliance.

Other issues on provincial harmonization

This also raises a discussion issue as to why there are two growing definitions of “qualified” corporations (for the purposes of enhanced credits). The federal government requires them to have less than \$15,000,000 in taxable capital whereas, Ontario and Quebec have extended their definitions to \$50,000,000.

⁵ Mechanics of phase-out formula provided in subsection 127(10.2) of the Income Tax Act.

⁶ Qualified CCPC’s receive a fully refundable, 35% Federal Investment Tax Credit (ITC) on their first \$2 million of qualified SR&ED expenditures. These credits are generally 20%, non-refundable credits otherwise.

⁷ Canadian Controlled Private Corporation

⁸ Taxable capital and capital tax ITA part I.3, section 181 and calculated per Federal Tax Schedule 33

These issues were briefly discussed but it was recognized that the scope of these Federal “taxable capital” changes would need to be addressed by the Department of Finance and a hope that they will be addressed in the near future.

Issue 3: Tax cases now on line (better access to information among CCRA & claimants)

During prior meetings, the group noted that CCRA published policies did not always keep pace with precedents and decisions be issued by the Tax Court of Canada on SR&ED issues. Because CCRA personnel formerly had no access the decisions, it was often a burdensome matter to present filing positions which were not directly outlined in existing interpretation bulletins or information circulars. An example was the two year delay in integration of the results of the 1993 case of “Cultures LaFlamme v. the Queen” in which the taxpayer established that there was “no requirement to offset proceeds from the sale of experimental production against SR&ED labour expenses incurred.” Unfortunately, this information was not integrated into information Circular 86-4R3 until 1995. In several of the practitioner’s experience, during this two year interim, this issue caused considerable confusion amongst claimants and auditors.

During fiscal 2000, the Tax Court of Canada has implemented procedures to provide these cases on line.

Results of group discussion:

As a result, the group concluded that this information would likely have a positive influence on CCRA-claimant interaction.

Issue 4: Foreign contractors in Canada (how & when to claim for SR&ED)

Many SR&ED practitioners will be aware that contractors must be, “taxable suppliers,”⁹ in order to be claimed for SR&ED tax credit purposes. Basically, this means that they must file a Canadian income tax return.

Results of group discussion:

The group briefly discussed the merits and implications of taking this filing position through an example comparing the effects of having the foreign SR&ED contractor file vs. not file a Canadian tax return. All parties agree that this position may create substantial opportunities for SR&ED claimants who “import” foreign contractors. A summary of this example is available from page 10 of the 2001-2 edition of the MEUK SR&ED newsletter (<http://www.meuk.net/news/news.html>).

⁹ “taxable supplier” - defined per ITA subsection 127(9)

Issue 5: Software examples released – CCRA / claimant feedback to date

Towards the end of the 2000 year, the CCRA in cooperation with CATA, released a paper which commented on a variety of software issues. This paper included 14 specific project examples for the software industry. To date, it has been the authors experience that these examples have been met with mixed acceptance from both the CCRA & industry.

Results of group discussion:

The group briefly discussed the development of the paper and were provided with 2 specific project examples based on the papers' contents (these examples are available at request from dsabina@meuk.net).

Most group members were familiar with the paper and agreed that, to date, the feedback from SR&ED claimants within the software community had been positive. It was also noted that Elizabeth Koopman (Science Manager – Mississauga District) was proposing to organize a “software workgroup” in the Mississauga area and that interested parties could contact her at (905) 566-6148 or elizabeth.koopman@ccra-adrc.gc.ca)

Issue 6: Loss on ITC refundability on repayments of government assistance

Under current legislation, ITC's generated by repayment of government assistance are not refundable under any circumstance. This is as result of problems with the specific wording of ITA subsection 127.1 regarding tax credit refundability. The group was provided with a copy of a letter regarding this issue, as sent to the Department of Finance (by another taxpayer). One of the major issues of concern was the fact that the loss of ITC refundability, for taxpayers with income under the small-business limit, would often result in an inability to use the tax credits before their expiration.

Results of group discussion:

Overall, the group expressed considerable concern with respect to his issue since an increasing proportion of IRAP and NRC assistance for SR&ED is coming in the form of repayable loans. At this point we propose to wait for the feedback from the CCRA and the department of finance.

Issue 7: Ontario problems

a) why pre-approval required for OBRI (Ontario Business Research Institute) credit

It is the authors experience that several small research companies have hired universities to perform eligible “third party” research however, they been denied the OBRI tax credit on the basis that they did not apply within the pre-approval timeframe (90 days of contract signing).

Given that the legitimacy of the third party payments are audited by the CCRA, it is unclear why we need this approval process. This issue has been raised to MPP Cam Jackson who has forwarded it to appropriate officials at the Ontario Ministry of Finance. To date the issue has been reviewed by Mr. Roger Filion¹⁰, and is currently under review by senior Ministry staff.

Results of group discussion:

The seriousness of this issue was underlined by the fact that several group members were unaware of these advanced ruling requirements and in fact had clients who may be nearing, or past, these deadlines.

Minister may dispense with requirement for ruling¹¹

“At any time **after May 6, 2000**, the Minister may give a direction that rulings no longer need to be obtained under this section in respect of contracts entered into after the date of the Minister's direction, **if the Minister is satisfied that corporations**, their officers, directors and shareholders, partnerships and their members and eligible research institutes are **conducting their business and affairs in a manner that meets the spirit and intent of this section.**”

Despite these great “budget speech announcements” as of October 2001 the Ontario Ministry is still vigorously enforcing this requirement. In the author’s opinion, the government should grant this credit to all corporations performing work which has qualified as a third party payment for federal SR&ED purposes. Hopefully, the proposed changes will take effect in the near future.

b) “super-allowance” replaced by “exclusion of Federal ITC’s” from Ontario income

Taxability of Super-allowances

¹⁰ the senior manager, tax advisory, corporations tax branch, at the ministry (phone 905-433-5422)

¹¹ Ontario budget speech May 6, 2000

As a result of its 2000 budget, the federal government has proposed that, for taxations year beginning after February 22, 2000, provincial deductions for R&D in excess of actual expenditures would be treated as taxable government assistance.

Quebec drops superdeductions

As a result of this, the Québec superdeductions assistance program was cancelled for corporations with taxation years commencing after February 29, 2000.¹²

Ontario replaces Super Allowance

Ontario is proposing to suspend the R&D Super Allowance for two years and, in its place, allow corporations to exclude from Ontario taxable income the portion of the federal investment tax credit that relates to qualifying Ontario Scientific Research and Experimental Development (SR&ED) expenditures¹³.

This measure would be effective for a 24-month period, beginning with the first taxation year for which the federal super-deduction provision would apply to the corporation. To qualify for the Ontario benefit under this proposal, the investment tax credit must:

- be included in federal taxable income during the 24-month period; and
- be in respect of qualifying Ontario SR&ED expenditures incurred by the corporation during the 24-month period or in the taxation year immediately preceding the 24-month period.

Ontario then called upon the federal government to revisit its 2000 Budget proposal and to ensure that federal legislation does not target Ontario's R&D Super Allowance.

Group's analysis and comment - "Loophole" in the wording?

In the authors' opinion, the effectiveness of Ontario's proposal requires a literal reading of the definition of "government assistance,"

"Government assistance means assistance from a government, municipality or other public authority whether as a grant, subsidy, forgivable loan, deduction from tax, investment allowance or as any other form of assistance **other than as a deduction under subsection (5) or (6);**"¹⁴ (emphasis added)

Given that subsection 127(5) referred to above represents the, "federal SR&ED investment tax credit," it appears that this amount is specifically excluded and will not be subject to tax.

¹² As per CCRA Application Policy Paper SR&ED 2000-03

¹³ As posted per the Ontario Ministry of Finance website, "Ontario Budget 2001" Paper C pgs 97-98 - 2001

¹⁴ Government assistance defined per ITA subsection 127(9)

Ironically, this “legislative” exclusion of the 127(5) credit was to avoid double counting since the amount was already included in taxable income through another section¹⁵.

Despite this fact, if the issue is brought to court, everyone in the group agreed that the judge will likely rely on a literal reading of the act and the Ontario position will be successful. Informal discussions with the Ontario Ministry of Finance have indicated that this is likely their legal interpretation.

Effect(s) on Ontario SR&ED claimants

It is also not surprising that Ontario proposed this as a two-year measure since this is likely the amount of time it would typically take the federal government to change the existing legislation. In the meantime, SR&ED claimants must try to determine which position they are going to file under given the uncertainty of the, “most current legislation.”

Results of group discussion:

Discussion with the Ontario Ministry of Finance indicated that the legislation was still proposed and should receive first reading by November 2001 and expected to be passed by December 2001. In the meantime it is unclear whether taxpayers should:

- file the forms based on this new legislation (before being passed), or
- continue to file & tax the super-allowance, or
- continue to file & not tax the super-allowance.

In fact, it appears that both the filing positions of the participants were equally spread among the three options above. Though technically taxpayers should file the Super-allowance and tax it, then amend all SR&ED claims once the legislation is passed this level of “red tape” is clearly in no party’s interest.

As a result the group saw this as an immediate concern to all Ontario SR&ED claimants since these inconsistencies will likely contribute to audit baglogs. In the meantime, the group looks to the CCRA to provide direction on any recommended filing positions.

c) SR&ED stock options – effects on employee if SR&ED denied

The 2000 Ontario budget announced an [ORES0] credit which exempted SR&ED employees from up to \$100,000 per year of stock option benefits & capital gains.

Eligibility for this credit requires:

- SR&ED performers to have SR&ED expenses > 10% of revenues, &
- SR&ED employees to spend >=30% of his or her time on SR&ED activities.

¹⁵ taxation of federal SR&ED ITC per ITA paragraph 37(1)(e)

Prior to the meeting, the minister clarified that employees would have to repay the amounts if either the SR&ED percentages are subsequently adjusted upon audit.

Results of group discussion:

Given that the majority of the group was unaware of the existence of these benefits these issues were not seen as a major concern to SR&ED practitioners.

July 10, 2002

Hamilton region SR&ED Practitioners' Group

Re. Minutes of Meeting – June 12 (5-7 p.m.)

Dear member,

Please find attached the minutes summarizing the major issues, analysis and recommendations contemplated during the above noted meeting of the Hamilton SR&ED practitioners' group.

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Regards,

Dave Sabina, C.A.
Hamilton Group Leader

Attendees

Attendee	Company
Ayling, John	Halton Region (host)
Baron, Frank	Baron & Associates
Bateman, Gary	Bateman MacKay C.A.'s
Baxter, Don	Burlington Economic Develop Corp
Cantor, Harvey	Harvey Cantor, C.A.
Dalton, Steven	MEDT
Driedger, Sue	KPMG
Foley-Bennet, Al	Bell & Co, C.A.'s
Gribowski, Jerry	Gribowski and Assoc.
Hale-Malhinha, Sandy	BDO Dunwoody LLP
Hayes, Wayne	MEUK Corporation
Hill, Keith	CCRA - Hamilton
Murphy, Patrick	Patrick Murphy, CMA
Rotenberg, Lawrence	L. Rotenberg, LLB
Sabina, David	MEUK Corporation
Sava, Michael	IRAP (presenter)
Wauben, Ina	CCRA - Hamilton
Zilkey, Paul	New Solutions Capital Group

New issues:

NRC / IRAP overview

A brief overview of the types of assistance available to SR&ED performers through the industrial research assistance program (IRAP) was provided by Dr. Michael Sava. This was followed by a question and answer session, which highlighted some of the following important issues:

- Funding is available for both the SR&ED process as well as the marketing process.
- Only one project at a time may be funded.
- The maximum funding on any single SR&ED project is \$25,000.
- The funding must be approved before the project is started.
- Any rights developed under a IRAP funded project may not be sold outside of Canada for a period of five years from the funding date.
- Unlike the CCRA, the IRAP program has NO published examples of eligible projects rather, the advisors themselves, after interviewing the client, use their judgment as to whether eligible projects exist.
- Perhaps the most surprising “revelation” to practitioners was Dr. Sava’s opinion that the **assistance of SR&ED practitioners as liaison** between IRAP and their client was **NOT recommended or encouraged** and that the client should apply to the IRAP office directly. (www.nrc.ca/irap/ or 1-877-994-0727).

New CCRA releases

SR&ED Investment Tax Credits for Farm Producers via “Agricultural organizations”

The Canada Customs and Revenue Agency (CCRA), in co-operation with Agriculture and Agri-Food Canada (AAFC), has developed a process so that farm organizations can participate in the program. The new process provides for the distribution of investment tax credits to farm producers who contribute to SR&ED through their agricultural organizations.

In the agriculture industry, **investments of this kind are often referred to as check-offs, assessments, or levies**. They are used by agricultural organizations, in part, to finance research and development work that benefits the individual contributors, as well as the agricultural industry as a whole.

Implications and group commentary

The group agreed that agricultural SR&ED performers should be on the look-out for such payments which may not otherwise be “clearly flagged” as SR&ED expenses.

The group also suggested that these payments would likely also qualify for an additional 20% fully refundable Ontario Business Research Institute (OBRI) credit, if the appropriate pre-approval forms are filed on a timely basis (i.e. within 90 days of signing the contract). The requirement to file for the “pre-approval” was also discussed later in the meeting.

New - APP 2002 - 01 - administrative salaries or wages

Application Policy SR&ED 2002 – 01, March 12, 2002

SUBJECT: Expenditures incurred for administrative salaries or wages - "directly related" test - for traditional overhead claimants

There have been cases where dedicated SR&ED performers have claimed, under the traditional method, all or a large portion of, the expenditures incurred for administrative salaries or wages. The expenditures were claimed either as all or substantially all (ASA) attributable to, or directly attributable to, the prosecution of SR&ED in Canada.

TASKS/DEPARTMENTS THAT ARE **DIRECTLY RELATED** TO SR&ED WORK

- Financing of SR&ED (is "directly related" if the funds are used to perform SR&ED)
- Evaluating, recruiting and hiring of SR&ED personnel

- Technical implementation and control of scientific projects; defining future SR&ED direction; supervision of SR&ED group and SR&ED project selection/evaluation. Such tasks are usually performed by a VP Technology.
- Evaluating the technological feasibility of a product and the potential SR&ED efforts and costs involved
- Technological planning for on-going SR&ED projects (assignment of technological personnel, job priority, development of technological strategies, assessment of quality of materials used)
- Work performed by clerical staff for tasks directly related to payroll, purchasing and accounting.

TASKS/DEPARTMENTS THAT ARE GENERALLY NOT DIRECTLY RELATED TO SR&ED WORK

- Bidding costs
- Purchasing (other than direct purchasing of material/SR&ED equipment)
- Taxation and Legal services
- Sales, marketing and advertising
- Employee relations
- Development of benefits program for SR&ED personnel
- Corporate secretary and reporting to shareholders
- Initiating and closing of licensing agreements
- Feasibility studies (non-technological) leading to potential SR&ED collaborations and assessing the commercial feasibility of a given technology
- Commercialisation of existing intellectual property
- Review and approval of SR&ED budgets
- Patent application

In the group's opinion, this represents a potential tightening of activities, which may have been formerly allowed under the traditional method.

They also felt that the paper still leaves significant ambiguity since there remains a fair amount of judgement in evaluating the cut-off between "commercial and technical" feasibility given that commercial constraints often drive the technical objectives.

Examples:

- "Financing of SR&ED" is eligible but "review and approval of SR&ED budgets" is not. Most SR&ED practitioners agreed that it is hard to "finance" SR&ED without a "budget"?
- Work performed, "by clerical staff for tasks directly related to payroll, purchasing and accounting" is eligible but, "development of benefits program for SR&ED personnel" is not?

Based on these and other issues the group agreed that:

- The paper likely creates as much confusion as it removes and

- That the paper underlines the importance for claimants to pay due attention to clearly documenting the linkage of any SR&ED work claimed to the resolution of “specific technical uncertainties.”

Food and Consumer Packaged Goods Sector SR&ED Guidance Document¹

This paper describes the elements of a SR&ED project as conducted by the Food and Consumer Packaged Goods Industry in a stated attempt to, “clarify SR&ED in this industry from a practical viewpoint and describes the methods by which these activities are accomplished.”

In the groups’ opinion, the paper outlined a variety of “technical issues” which they believe to be of relevance to most if not all researchers in the agricultural sector. Additional input and commentary was provided by CCRA representative, Ina Waubin, who had involvement on the development of the paper.

The technical issues were addressed with under 3 separate headings. The major implications to SR&ED performers has been reproduced below:

1) Formula Ingredient, Manufacturing Specifications (F.I.M.S.)

The science and technology involved in the development of product formulations and manufacturing process specifications usually requires SR&ED to meet consumer needs throughout worldwide geographical locations and temperature zones. As a result, are some of the key attributes which create a basis for SR&ED eligibility are:

- Product stability,
- consistency in quality,
- flavor,
- texture,
- form,
- extended shelf life &
- safety

This is generally accomplished by developing specifications for formulations and manufacturing parameters. (F.I.M.S. is the terminology used to describe this activity).

In the case of materials derived from agricultural sources of variability and thus potentially eligible technological uncertainty can be caused by factors such as,

- time of harvest,
- change in species variety,
- growing location and conditions,

¹ Prepared by Food and Consumer Products Manufacturers of Canada (FCPMC) & Canada Customs and Revenue Agency (CCRA)

- seasonal climatic variation,
- water availability,
- stress factors etc.

2) Consumer Research

The CCRA admits that, “it is impractical to predict consumer reaction to a given prototype, based solely on meeting certain chemical or physical criteria that have been achieved scientifically.” Industrial scientists cannot rely on data from laboratory analysis to predict consumer acceptance, hence consumer testing has emerged as a valid analytical tool used in support of R&D projects. **Therefore consumer testing is eligible when used in support of a SR&ED project.** The testing instrument may be trained sensory panels, employees, consumers and users.

The paper also provided a list of they types of eligible and ineligible testing which are often utilized to evaluate experimental products during the experimental development process. These were reviewed with the group and felt to be of significant long-term benefit to claimants in the industry.

3) Scale-up and Commercialization

Finally the paper clarified that, “as a project moves through various phases of development, frequent trials on a larger scale will be required. These experimental trials are often part of a SR&ED project using equipment of any appropriate scale.” The group believed that this was merely a “consistent re-iteration” of the “scale-up” issues as outlined in Information Circular 86-4.

In the group’s opinion this paper likely provides significant clarification to claimants as to the cut-off of between eligible activities vs. those that are ineligible “style changes.” Generally speaking a “style change” includes any work aimed at aesthetic improvements rather than objective and verifiable advancements of technical knowledge. As a result, the group agreed that this portion of the paper will likely be of considerable long-term significant to claimants in the agricultural, food and packing industries.

Water and Energy Sources as Materials

The CCRA states that, “generally water and energy sources used to carry out SR&ED are not considered to be materials. Their costs are treated as overhead expenses and could be allowable SR&ED expenditures only in the traditional method of calculating the investment tax credit (ITC).”

However, there are circumstances where water and energy sources used in performing SR&ED could be considered materials consumed, based on the definitions of "materials" and "consumed" in Application Policy 2000-01. In this respect an Interim Instructional Sheet was released to clarify how water and energy sources should be treated for SR&ED purposes.²

CCRA's "New" Policies - Water and Energy Sources as Consumed Materials

In most industries, specifically in the chemical, petrochemical, minerals, pulp and paper and textile industries, water consumed is usually separated into **several streams**. One is the **utility water** used throughout the plant, another stream is the **boiler feed water**, which is used to generate steam on site, and the third is the **process water stream** which, like any other feed material, enters the process and becomes part of intermediate and/or final product(s), as governed by the chemical equation(s) on which the process is based.

This **process water stream** is often pre-treated or conforms to specifications unique to the process. Once water enters the process, for all practical purposes, it is **rendered useless** - as process water feed - even if it is recovered. As a result, such process water streams meet the definition of "materials" and "consumed".

With respect to energy use, a similar argument could be made that some of the energy sources used in the plant can be part of the chemical/physical process - i.e. it is part of the conversion/production process and is integral to the chemical reaction on which the process is based.

The cost of such energy sources used in a process, that is part of SR&ED, could be included in the cost of materials consumed.

Financial and Technical Review Issues Related to Water and Energy Use

Where expenditures on portion of water and energy sources that might qualify as "materials consumed" are expected to be significant, the claimant has the choice of the **traditional method** of calculating ITCs, where cost of **all water and energy sources directly attributable to the SR&ED are allowable overhead expenditures**.

A claimant can also choose the **proxy method** of calculating ITCs and claim water and energy sources as consumed materials. In the case of proxy, claimants will **have to identify and document clearly the portion of the water and energy sources "consumed"** in the process.

Implications and group commentary

In the group's opinion, this represents a potential **"loosening" of the rules regarding the types of expenses covered by the proxy method** and is also likely of considerable interest to most "processing" industries.

² Excerpts and commentary from the CCRA's recent Addendum to Application Policy SR&ED 2000-01

The Account Executive Service for the (SR&ED) Program

This program was briefly discussed with the CCRA representatives. Basically it involves personalized service from a designated representative of the Federal Government's SR&ED Program to provide:

- ways to simplify the SR&ED claim process for the company;
- guidance in understanding the SR&ED Program requirements;
- clarification about what you should keep to support the claim; and
- information about the status of claims after filing.

Most practitioner's agreed that this service is generally provided to both new and repeat claimants without the need for specific requests.

Recent SR&ED tax cases results & implications

The group briefly reviewed the results and implications of two recent tax cases.

DATA CALC RESEARCH CORPORATION v. THE QUEEN³

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.

Relevant legislation, Ruling & rationale:

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.

Implications and group commentary

The group agreed that this case underlined the fact that neither the CCRA, 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.

MIMETIX PHARMACEUTICALS INC. v. THE QUEEN⁴

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.

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 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-

³ (TCC) Docket: 2000-1413-IT-G Date: 2002/02/22

⁴ (TCC) Docket: 1999-4847-IT-G Date: 2001/11/08

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 CCRA's council pointed out that;

ØThe 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.).

ØMimetix 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. director, 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 within the meaning of subsection 256(5.1) 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, except that, where the corporation and the controller are dealing with each other at arm's length and the influence is derived from a franchise, license, lease, distribution, supply or management agreement or other similar agreement or arrangement, the main purpose of which is to govern the relationship between the corporation and the controller regarding the manner in which a business carried on by the corporation is to be conducted.."

Ruling & rationale:

Based on the facts provided, the judge e 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"

Implications and group commentary

In the group's opinion this case underlines the importance of clearly considering "defacto" control issues whenever there are foreign shareholders or directors of a Qualified Canadian Controlled Private Corporation.

Status of issues raised during previous meetings

SR&ED eligibility on “salary & wages” incurred outside of Canada

As previously stated, based on the results of the Tigney Technologies and LGL appeals, the CCRA has taken the position that it will deny SR&ED credits eligibility⁵ on “salary and wages” of Canadian employees while abroad⁶.

One of the most compelling arguments to support the eligibility of SR&ED credits on “salary and wages” of Canadian employees while abroad is the fact that the **Canadian employee remains taxable on his or her salary and wages** regardless of where these duties are performed. As a result, in most if not all cases, the CCRA earns substantially greater tax revenues from the personal taxes of the individual employee than it pays out to the SR&ED performers (i.e. the employers) on these wages.

In a previous meeting our group unanimously agreed that the current tax policy appears to inhibit achievement of our Science Policy goal to, “ensure that new knowledge can be acquired and disseminated widely, from Canadian sources and from around the world.” These issues were submitted to Norine Heselton, Director General of the SR&ED program.

David Sabina received a response to this letter supporting a “deny all foreign expenses” position. Its **current rational** for this position is that it believes that there could be **loss of infrastructure** from encouraging Canadians to travel abroad.⁷ This is in fact **in complete contradiction of 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.⁸ This “inconsistency” in published policy was brought to the attention of the CCRA during our last meeting.

The group re-addressed these issues and agreed that the current situation and lack of results to date warranted follow-up with the Ministers of Finance and Industry. A copy of this letter will be available by the end of July at www.meuk.net (under the heading “SR&ED issues”).

Provincial harmonization issues - “development costs” / qualified corporations

For taxation years that begin after 1995 the tax legislation provides for a phase-out⁹ of the enhanced¹⁰ ITC’s for CCPC¹¹’s based on their “taxable capital.” Basically, the \$2,000,000 expenditure limit for enhanced ITC’s is reduced, on a straight-line basis, as the taxable capital of the

⁵ By way of inclusion in Canadian expenses defined under ITA subsection 37(1)

⁶ SR&ED Application Policy Paper 95-01R – Issue 2: SR&ED outside Canada

⁷ CCRA rulings letter – January 14, 2000, N. Heselton, Director General

⁸ “Why and How Governments support Research and Development,” December 1997, Department of Finance (copies available at meeting or on request)

⁹ Mechanics of phase-out formula provided in subsection 127(10.2) of the Income Tax Act.

¹⁰ Qualified CCPC’s receive a fully refundable, 35% Federal Investment Tax Credit (ITC) on their first \$2 million of qualified SR&ED expenditures. These credits are generally 20%, non-refundable credits otherwise.

¹¹ Canadian Controlled Private Corporation

company, and any other companies under common control, exceeds \$10,000,000. By the time taxable capital reaches \$15,000,000 the enhanced credit is fully phased out.

In the case of capitalized development costs, the costs have not been expensed in the periods in which the work was performed and therefore become part of the “retained earnings” portion of the “equity” balance of the corporation.

In many provinces (including Ontario) the definition of “taxable capital” provides for a deduction of amounts (such as SR&ED expenses) that are otherwise deductible for tax purposes independent of whether they are capitalized in the financial statements. Unfortunately, the Federal capital tax calculation¹² provides no similar reduction of “development costs” from the calculation of taxable capital.

This issue was submitted to the CCRA but no positive actions have been witnessed to date. The group re-iterated its concern that the government provide relief to small and medium sized corporations similar to that provided in Ontario to encourage GAAP compliance.

Again, the group re-addressed these issues and agreed that they warranted follow-up with the Ministers of Finance and Industry. A copy of this letter will be available by the end of July at www.meuk.net (under the heading “SR&ED issues”).

Loss on ITC refundability on repayments of government assistance

Under current legislation, ITC’s generated by repayment of government assistance are not refundable under any circumstance. Since the author is aware that this issue has already been raised with the Department of Finance (by another taxpayer), we propose to defer writing to the minister on this issue.

Ontario problems

a) OBRI pre-approval

Why pre-approval required for OBRI (Ontario Business Research Institute) credit?

It is the authors experience that several small research companies have hired universities to perform eligible “third party” research however, they been denied the OBRI tax credit on the basis that they did not apply within the pre-approval timeframe (90 days of contract signing).

Given that the legitimacy of the third party payments are **audited by the CCRA, it is unclear why we need this approval process**. This issue has been raised to MPP Cam Jackson who has forwarded it to The Honourable James Flaherty (Minister of Finance).

¹² Taxable capital and capital tax ITA part I.3, section 181 and calculated per Federal Tax Schedule 33

The group reviewed the status of the representations and responses received back from Mr. Flaherty and agreed that the apparent mis-understanding of the issues and the Ministerial level warranted a follow-up letter. A copy of this letter is currently available at www.meuk.net (under the heading “SR&ED issues”.)

b) “Super-allowance” replaced by “super deduction” from Ontario income

This latest “Super-allowance” proposal as outlined in the 2001 Ontario budget was briefly discussed. Many group members felt that the new method, while providing roughly similar tax relief to claimants, was much easier to administer than the previous Super-allowance incentive.

**Hamilton Region SR&ED Practitioner's Workshops
Minutes of meetings: May 16th, 2003 & September 4th, 2003
Holiday Inn – Burlington**

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Minutes prepared and distributed October 10, 2003 by David Sabina, group moderator

1.1. List of attendees & participants

May 16, 2003 meeting

<u>Participant</u>	<u>Company</u>
Patrick Murphy	Patrick Murphy Consulting
Brian Allendorf	Brian Allendorf, C.A., C.B.V.
Debbie Davy	Ernst & Young
Gul Nawaz	Nawaz Taub Noor & Wasserman, C.A.'s
Liz McFadden	C-Bass Ltd.
Mike McFadden	C-Bass Ltd.
Christie Henderson	Henderson Partners LLP
Heather Tremblay	Henderson Partners LLP
John Neumayer	KPMG
Manoucher Ghazi-Z.	Bench and Donath C.A.'s
Dominic Iaonnoni	CCRA
Seemant Thakkar	Nawaz Taub Noor & Wasserman
Harvey Cantor	Harvey Cantor Professional Corporation
Kris Unni	Scott Batenchuk , C.A.'s
Paul Bradley	Paul Bradley, C.A.
Wayne Hayes	MEUK Corporation
Michelle Jamieson	MEUK Corporation

September 4, 2003 meeting

<u>Participant</u>	<u>Company</u>
Doug Soules	DingFeld Nakamura, C.A.s
Keith Rosen	Stern Cohen LLP
Frank Baron	Frank Baron Consulting
Rocco Vertucci	Ernst & Young LLP
Jerry Gribowski	Gribowski & Assoc
John F. Neumayer	KPMG
Kris Unni	Scott Batenchuk & Co. LLP
Ken Edwards	HMS Software
Lori Simpson	Evans Martin
Barry Doerbecker	Barry Doerbecker, C.A.
Wayne Hayes	MEUK Corporation
Michelle Jamieson	MEUK Corporation

2. New T661 form

2.1. Elimination of "technological uncertainty heading" in Part 2

The SR&ED project description requirements have changed in several areas:

Previous requirements: form T661 E (99 & 01)

Step 2 – Detailed Project Description

For each project listed in Step 1 above, identify the project and answer questions A to E below.

A. What are the **scientific or technological objectives in quantitative or variable terms**, of the work you are claiming?

B. What **scientific or technological advancement** did you expect to achieve as a result of performing this work? In what field of science or technology did you expect to achieve this advancement? Explain why this is a scientific or technological advancement.

C. Explain what **scientific or technological uncertainty** you have to resolve to achieve the advancement stated in B above.

D. Describe in chronological order, the work, including all support work performed in this taxation year to resolve the scientific or technological uncertainty stated in C above. Your description must demonstrate the systematic nature of the investigation such as analyses and experiments performed, interpretation of the results obtained, and conclusions made. What progress was made towards the scientific or technological objectives (from A above) as a result of this work? If all or part of the work that you are claiming was performed by contractors, describe what work was performed by the contractors and include a copy of the statement of work from the contract.

E. Specify the **technical documents available** to substantiate the work described in D above.

New requirements: form T661 E (03) – required after June 30, 2003

Part 2 – Scientific or Technological Project Information

A. Scientific or Technological Objectives – What is the technological **or** scientific objective of your project? Does this project involve scientific research or experimental development? What field of science or technology does the project involve?

B. Technology or Knowledge Base Level – Before you started your project, what were the technological limitations of your products or processes to be overcome, **or** if your project work was predominantly scientific research, give a perspective in terms of the scientific knowledge that you were seeking before you started your work? You can use the information you provided last year if your project is continuing from last year and the objectives have not been achieved or changed.

C. Scientific or Technological Advancement – What advancement in technology is being sought, what were the problems or challenges that you could not solve using commonly available experience and required you to seek an advance in the underlying technology to achieve the objective in A above, **or** what was the new scientific knowledge sought in your work?

D. Description of Work in this Taxation Year – Describe the work, including experiments and analyses, that you did in this taxation year to achieve the above technological **or** scientific objectives.

E. **Supporting Information** – What technical records or documents such as records of trials, test results, progress and final reports, meeting minutes, employee activity records, prototypes, new products, generated over the course of the work are available to support your work?

Discussion & commentary

The group was initially alarmed with the apparent removal of the “technological uncertainty” heading. The issue was discussed during both meetings with the general consensus of the group being:

- **The addition of the section to clarify “Technology or Knowledge Base Level” was seen as a positive step** in helping claimants to outline benchmarks of “available information / standard practices” from which to further define and illustrate uncertainties. The group recognized that this information was always required however they felt that the previous “advancement” heading did not provide as clear a prompt for claimants to outline this information.
- The information required in the **new “Scientific or Technological Advancement” section** still requires examination of **“the problems or challenges** that you could not solve using commonly available experience...” and as such, the group felt that this section **still requires the definition and analysis of “scientific or technological uncertainty.”**

Conclusions

Based on the above issues and discussions the group concluded that the **new form was a positive change** with its main focus to clarify that the “technological uncertainties” addressed should be continually benchmarked against the company’s “knowledge base.”

As a result the new form was seen to represent minor, positive clarifications as to the optimal SR&ED project structure but NOT as a significant change in required project documentation. As a result most practitioners believed that the current SR&ED related Information Circulars did NOT need to be revised to reflect these changes.

2.2. BN number required for all subcontractors

The key issue dealt with the fact that the new T661 form requires BN numbers for all SR&ED subcontractors claimed. The previous form provided an exception for small suppliers under \$30,000. As a result practitioners may get diagnostic errors when finalizing claims that include payments to “non-registered” subcontractors.

Discussion & commentary:

Some of the potential methods to “clear” the filing diagnostics with unregistered “small suppliers” were:

- input a “dummy” business number such as 88888 8889, OR
- some programs will allow users to input NR (non-registrant) in the business number field

In the meantime, the CCRA has not provided any specific guidance on this issue.

2.3. Reporting for Unpaid amounts

Often taxpayers will claim SR&ED expenses “accrued” during the taxation year but unpaid 180 days after year-end. Currently the form requires disclosure of this amount on line 315 (for wages) & 500 (other SR&ED expenses) however, it is unclear what degree of supporting details should be submitted and the full extent of the related tax effects.

Example - Sample Facts

A “business owner” performs eligible SR&ED work on his company’s behalf but does not have the funds available to pay himself a “reasonable salary” for the work performed. The business owner estimates that his normal “salary” for this work would have been \$100,000.

SR&ED claim = Accrual of reasonable subcontractor fees in year performed

The taxpayer must assert that costs have been “**incurred**” in the year due to the nature of the work. It is important that the taxpayer claims this work during the year in question to avoid missing the 18 month filing deadline¹ for SR&ED costs. In this case we would try to accrue reasonable, non-arm’s-length salary costs (i.e. \$100,000) related to the current year’s work.

Effect of this position

There is a provision in the SR&ED legislation, which (temporarily) denies an investment tax credit for any costs, which remained unpaid within 180 days of year-end². These costs will be audited in the current year and a conclusion will be made on their “reasonableness,” however, investment tax credits will be paid on these amounts only in the years in which they are actually paid. Furthermore, if this transaction is properly structured, employees will not have to pay tax on wages until they are “received.”³

Tax issues, discussion & commentary:

¹ ITA subsection 37(11) requires any SR&ED claims to be filed in prescribed form within 18 months of year-end

² ITA subsection 78(4) denies ITC’s on amounts until taxation year in which paid

³ ITA subsection 5(1) only taxes employees on income “received” during the year

2.3.1. Degree of disclosure required

Practitioners were unsure the degree of additional detail required to support these allocations but assume that it would be similar to the timesheet requirements used by a typical SR&ED employee.

2.3.2. Reporting for unpaid wages vs. other types of expenses

Unpaid wages (in once) - It would appear the unpaid wages would not be included in the balance of SR&ED wages (line 300 or 305) but would be disclosed separately (line 315) and only added to the total expenses in the year when paid (line 310).

Non-wages (in-out-in) - Unpaid SR&ED expenses other than wages would be accrued to the respective cost category (subcontractors, materials, etc.) and would then be “removed” for the “qualified expenses” calculation (line 520) and added back in the year paid (line 500).

Once the mechanics of these formulas were understood practitioners did not appear to have any remaining concerns.

2.3.3. Risks of being deemed a Salary Deferral Arrangement (SDA)

Conditions that create a Salary Deferral Arrangement (SDA)⁴

- Plan or arrangement, funded or not; and
- Any person has a right (including such a right that is subject to one or more conditions) in a taxation year to receive an amount after the year where it is reasonable to consider that **one of the main purposes** for the creation or existence of the right is **to postpone tax payable** under this Act by the taxpayer in respect of an amount that is salary or wages of the taxpayer for services rendered by the taxpayer in the year or a preceding taxation year;

Negative implications

The net tax effects of being deemed an SDA is the immediate taxation to the employee. Since the amount is not subject to withholding by the employer (under ITA 153) until the amount is paid. The tax effects of this timing difference could be significant.

Planning to avoid SDA provisions

However, to avoid the SDA rules, the plan should meet one of the specific exemptions. In general, the available exceptions to employ could be:

⁴ Definition [ITA 248(1)]

- 1) Payment of amounts within 3 years of earning the amount;
- 2) The conditions for payment carry significant risk – such as tied to the revenues earned from the results of the SR&ED being performed; or
- 3) Have the payment tied to the retirement or death of the shareholder/employee with a reference to the stock price of the company.

3. Commercial vs. experimental production

The CCRA felt that an article written in a recent SR&ED newsletter⁵ may be misleading. This article indicated that, based on the facts outlined in a recent CCRA example, an SR&ED tax credit planning opportunity had been missed.

CCRA fact scenario:

- 1) Corporation A gives a **contract** to Corporation B (arm's length) for the construction of equipment to meet unique performance criteria.
- 2) The contract **requires that Corporation B perform SR&ED** on behalf of corporation A in the development of the equipment.
- 3) Corporation A identified the SR&ED and non-SR&ED and allocated the costs accordingly (SR&ED portion \$800,000, \$200,000 commercial portion). The CCRA's Research and Technology Advisor found the allocation to be **reasonable**.
- 4) There is a conversion to commercial use and the ITC recapture rules will apply using the FMV of the equipment at the time of conversion estimated at \$500,000.

Recommended planning / raising issues of concern:

- 5) Since the contract above clearly contemplated SR&ED being performed, I proposed that the purchaser could have the contractor separately identify and invoice the “labour” vs. the “material or capital” portions of the work. Examples of potentially eligible “labour” components within the contractor’s fee could be the costs to design, assemble, test and replace components. These could then be removed from the \$800,000 base used for the “carve-out” in the previous example.

Specific issues in contention / addressed during the meetings:

- i) differences in treatment of “in-house” labour vs. “subcontractor” labour,
- ii) the definition of “property” and the extent to which it includes “costs to transform” materials into SR&ED products,
- iii) legal support for the CCRA’s position that experimental production “must be used solely for evaluation purposes,” vs. the legal precedence established in the Tax Court of Canada case of Cultures LaFlamme vs. MNR. and
- iv) a discussion of how these factors are (could be) structured to prevent “double dips” of the same expenses by multiple claimants.

A summary of these issues, The CCRA’s stated position and the results of the group feedback has been provided in the following table:

⁵ Complete newsletter 2003-1 available for download in PDF format at [www.meuk.net / news](http://www.meuk.net/news)

	<u>Issue</u>	<u>CCRA position</u>	<u>page*</u>	<u>DSCA position</u>	<u>page**</u>
1	In house vs. subcontract labour	ITC repayment on subs if sold	4	ITC repayment if commercial vs. experimental	3
2	"Property" definition	Includes subcontracted but not internal labour	4 & 5	Does not include costs to transform	4
3	Experimental vs. commercial production definition	If sold then commercial	5	If necessary to resolve uncertainty then experimental	2 & 3
4	Double dips	Not addressed		No double dip since only 1 party claims	3 & 6

* Per letter sent by Mel Machado (CCRA) to David Sabina - response (May 1, 2003)

** Per letter sent by David Sabina (April 2, 2003) to Mel Machado (CCRA)

* Note: A more complete discussion of these issues is provided in the noted letters which are available for download at www.meuk.net / SR&ED issues.

3.1. Issues in agreement – no carve out of SR&ED wages

The CCRA agrees that the “salary and wages” (i.e. internal labour) will NOT face any commercial production allocation or “carve-out.”

3.2. Issues in contention

3.2.1. Carve out of SR&ED subcontractors

Though the CCRA agrees that the “salary and wages” (i.e. internal labour) will NOT face any commercial production allocation or “carve-out” any costs claimed for “subcontractors” must be reduced by any proceeds of sale of experimental production.

Ironically, both sides of the argument center on the interpretation of the definition of “property” under subsection 127(32) “meaning of cost” which states that, for the purposes of subsection (27), (28) & (29), [the ITC recapture rules]

“cost of a particular property to a taxpayer shall not exceed the amount paid by the taxpayer to acquire the particular property from a transferor of the particular property and, for greater certainty, does not include amounts paid by the taxpayer to maintain, modify or transform the particular property.”

In the group's opinion, the fact that the definition of property specifically excludes, "amounts paid by the taxpayer to maintain, modify or transform the particular property" indicate that the costs for a contractor to "transform it" from a raw material into a prototype would not be "property" as the CCRA proposes. As a result this issue remains unresolved for the current time.

3.2.2. Definition of "Commercial" production

Definition of "commercial" production based upon whether the experimental production was sold (CCRA position) rather than if necessary to resolve technological uncertainties (group position).

Summary & recommendations: use internal vs subcontract labour

Based on the discussions to date the group felt that:

- 1) the CCRA's current position placed a heavier burden on smaller companies (i.e. those that have to subcontract work rather than hire full-time staff).
- 2) The CCRA was providing mixed signals as to the determination of whether production was experimental or commercial as it did in the Cultures LaFlamme case.
- 3) Unless this issue is further resolved through negotiation or the courts, it will definitely be in the claimants interest **to always use internal rather than subcontracted labour for any work on production experimental production that may eventually be sold.**

4. Ontario SR&ED issues

4.1. Ontario OITC taxability - timing of tax on proxy amount

Summary of issue: timing of tax on proxy amount

Several tax programs defer taxation of the "proxy portion" of the OITC until the subsequent taxation year. During our September 2003 meeting we reviewed the legislative support for this treatment under the income tax legislation and related tax planning implications as submitted and explained by Barry Doerbecker, C.A.

4.1.1. Tax mechanics of issue: received vs. receivable

Have you ever wondered why your accounting software automatically uses:

- a different number on line 430 (government assistance related to the research expenditure pool) than
- it uses on lines 534 and 536 (government assistance related to qualified expenditures) when transferring the Ontario Innovation Tax Credit (OITC) earned for the year?
- You may also notice in the following year that the difference shows up on line 604b on the T2 Sch. 001.

What the program and CCRA are doing is reducing the government assistance on line 430 for the amount of assistance earned on the Prescribed Proxy Amount (PPA) and treating it as income the following year by making the adjustment on schedule 1.

Note that this discussion focuses only on the OITC, as this treatment is automatically performed by the tax software. However, I believe this treatment should be applied to all government assistance.

CCRA Administrative support:

The quick answer to the above question is due to the Canada Customs and Revenue Agency's (CCRA) instructions to line 430 as contained in the Guide to Form T661 – Claiming Scientific Research and Experimental Development (both the 2001 and 2003 versions). Both guides state the following:

“If you are using the proxy method, do not deduct the assistance for expenditures that the prescribed proxy amount replaces.”

The CCRA has gone further in SR&ED Application Policy Paper SR&ED 2000-03 to state the following:

“In determining the amount of assistance in the pool of deductible SR&ED expenditures the amount of provincial or territorial tax credits which relates to the

PPA is not considered to be assistance that reduces the SR&ED allowable expenditures under paragraph 37(1)(d).

As the PPA is not an expenditure under paragraphs 37(1)(a) or subparagraph (b)(i), but is a notional amount which is used in lieu of the actual overhead expenditures in the calculation of the ITC, the PPA is not added to the SR&ED expenditure pool.

Consequently, the portion of the provincial or territorial tax credits which relates to the PPA should be included in income under section 9 or paragraph 12(1)(x) of the Act

The Ontario Innovation Tax Credit (OITC), can only be earned on a maximum amount of \$2,000,000 in R&D expenditures applied on a pecking order by type of expenditure, i.e. current, proxy, and capital. ...

Using the pecking order calculations rather than using the prorated method to determine the ITC will result in different amounts of qualified expenditures, ITCs and SR&ED deductible expenditure pool balance.”

Now we know the CCRA position with respect to this issue. However, the guide and application policy paper are not law. So what does the law state?

Legislative support (ITA):

In this situation, we are dealing with three main areas. The main area is contained within section 37 of the *Income Tax Act*. Paragraph 37(1)(d) states that the research expenditure pool must be reduced by the total of all amounts of government assistance, as that term is defined in subsection 127(9), in respect of an expenditure described in paragraph 37(1)(a) or 37(1)(b). The first of those paragraphs deal with current expenditures and the second deals with capital expenditures. In neither section are you allowed to deduct the PPA.

To further emphasize the point, paragraph 37(1)(e) requires the expenditure pool to be reduced for the federal Investment Tax Credit used in the prior year (under subsection 127(5) or 127(6)) where that amount can be attributed to a paragraph 37(1)(a) expenditure or the PPA.

Therefore, it is easy to conclude that if parliament had intended for government assistance on the PPA to reduce the expenditure pool, then it would have explicitly stated that in 37(1)(d) as it did in 37(1)(e).

So does that leave government assistance on the PPA free from tax? Unfortunately, the answer is no. The amount is taxable under paragraph 12(1)(x) of the *Income Tax Act*. When reading this section and comparing it to the definition of government assistance under 127(9) there is a strikingly similar set of words:

“... grant, subsidy, forgivable loan, **deduction from tax**, investment allowance, or any other form ...” that is “... from a government, municipality, or other public authority...”

Therefore, government assistance is always taxable. But what about the timing of when it is taxable?

The amount taxable under 37(1)(d) as a reduction to expenditures is to be reported on the basis of

“... at the taxpayer’s filing-due date for the year, the taxpayer has received, is entitled to receive, or can reasonably be expected to receive,”

the government assistance on the expenditures. Therefore, the amount is included in income as it is earned, as it is based on the amount receivable.

However, the wording of 12(1)(x) states that

“... any particular amount received by the taxpayer in the year, in the course of earning income from a business or property, ...”

4.1.2. Summary of overall tax effects / implications

Therefore, the **government assistance on the PPA is only taxable when actually received.**

Simple solution

Note that the CCRA and the tax software will assume this amount is actually received the following year. While this may not be the case (especially those that file their SR&ED claim close to the 18 month deadline), for simplicity this assumption is normally followed.

Advanced planning techniques

The opportunity exists for further deferral of the taxation of this amount.

Example:

- For a 2001 claimed filed in 2002
- the amount may not be received until fiscal 2003 or even 2004 and
- the company would be entitled to defer recognition of the proxy related ITC until this time!).

This could be a major advantage to a firm who had exceeded income limits to the extent it faced a partial phase out its enhanced ITC’s.

4.2. Ontario Business-Research Institute Tax Credit – Pre-approval

Overview:

The Ontario Business-Research Institute Tax Credit is a 20 per cent refundable tax credit on qualified Ontario research and development (R&D) expenditures incurred by an Eligible Research Institute (ERI) under a research contract funded by the corporation claiming the credit.

The credit requires “pre-approval” via submission of an application within 90 days of signing the contract with the University.

4.2.1. Issue: Why Ontario pre-approval required since audited by CCRA?

A major result of this “pre-approval” requirement is that the small performers are being consistently “excluded” from claiming the OBRI credit since, though they are aware of the SR&ED program itself, they lack the awareness of the advance ruling requirements.

Furthermore, they are accustomed to preparing all of the required information for year-end submissions with their corporate tax returns.

This was addressed in a letter to the Honourable Janet Lynne Ecker, Minister of Finance, which outlined the fact that all of **the requested information was already available from the T661 form itself.**

Analysis and discussion:

This was addressed in a letter to the Honourable Janet Lynne Ecker, Minister of Finance, Government of Ontario which she responded to. (Letters available for download at www.meuk.net / SR&ED issues).

4.2.2. Response to date: no plans to waive requirement

Based on the Minister’s response, to date there is no plan for the Ontario government to waive the pre-approval requirement despite the fact that Quebec has waived this requirement for its University based SR&ED credit.

The practitioners’ group felt that this placed an increased degree of risk on practitioners to keep their clients informed of this requirement throughout the year rather than at year-end tax time!

“SR&ED Practitioner's Workshop” – Meeting minutes

Thursday, July 15th, 2004 2:00-4:00 pm

Lo Presti's Restaurant - Hamilton

1) Allocation of Labour Expenditures For SR&ED Guidance Document SR&ED Directorate July 2004

Discussed the fact that where formal systems have not been implemented, claimants can determine SR&ED salaries and wages using appropriate labour allocation methodologies. This document is intended to provide guidance on the elements of such methodologies and to provide an illustration of a sample application.

Levels of information: generally three levels at which information can be summarized:

- high (corporate or strategic concept level)
- medium (project level)
- low (activity level)

Example of an allocation methods discussed further.

2) ON 2004 BUDGET CHANGES RE. ASSOCIATED CORPORATIONS

The group discussed the policy intent of these provisions for associated corporations is to prevent the multiplication of the expenditure limit by corporations controlled by the same person or group of persons.

3) 2002 SR&ED Client Survey results

Issues covered: Simplification, Timeliness & Consistency

4) SR&ED partnership committee issues

Group briefly Issues include Strategic Business Plan, Large Business claims and Electronic Filing (2005).

5) Application Policy 2004-1: Retiring allowances

Group discussion focused on clarification that these payment may be eligible as an “overhead expense” for traditional overhead claimants.

6) PLASTICS MATERIALS, PROCESSING, EQUIPMENT & TOOL MAKING GUIDANCE DOCUMENT DATE: April, 2004

The policy paper provides guidance and example relevant to mold and tool makers.

The group then briefly discussed issues from prior years:

1. New T661 form - 2003
 1. Elimination of "technological uncertainty heading" in Part 2
 2. BN number require for all subcontractors
 3. Reporting for Unpaid Amounts
 1. Degree of disclosure required
 2. Report for unpaid wages vs. other types of expenses
 3. Risks of being deemed a Salary Deferral Arrangement (SDA)
2. Commercial vs. experimental production - 2003
 1. Issues in agreement - no carve out of SR&ED wages
 2. Issues in contention
 1. Carve out of SR&ED subcontractors
 2. Definition of "Commercial" production
3. Ontario SR&ED issues - 2003
 1. Ontario OITC taxability - timing of tax on proxy amount
 1. Tax mechanics of issue: received vs. receivable
 2. Ontario Business-Research Institute Tax Credit - Pre-approval
 1. Issue: Why Ontario pre-approval required since audited by CCRA?
 2. Response to date: no plans to waive requirement
4. Administrative wages - cut-off of "financing activities" (2003)
5. SR&ED "salary & wages" incurred outside of Canada - 2000 & 2001
6. Capital tax implications from "development costs" - 2000 & 2003
7. Loss on ITC refundability on repayments of government assistance - 2001
8. Foreign contractors in Canada (how & when to claim for SR&ED) - 2001
9. Issues of other groups - for potential discussion
 1. SR&ED self-assessment and recourse methods (Toronto 2002)
 1. Second review
 2. Alternative dispute resolution (ADR)
 2. Materials consumed (Toronto 2002)
 3. Accessibility of credits to all claimants (Toronto 2002)
 1. Companies other than qualified CCPC's
 2. Individuals

For further details on each of these issues I welcome you to explore our website at (www.meuk.net / SR&ED Issues / Practitioner meetings)

Participants:

<u>Moderator:</u>	<u>Company</u>
David Sabina	MEUK Corporation
<u>Participant</u>	
Geoff Green	MEDT
Darlene Sigel	Schilling and Laird
Rocco Vertucci	Ernst & Young LLP
Anthony Falco	Glenn Graydon Wright LLP
Atif Akhatar	Glenn Graydon Wright LLP
Jeff Wade	Wade & Partners
Ian Marchall	Wade & Partners
Bruce Johnstone	Robbinex Inc.
Brian Allendrof	BGA Tax Strategies
Sondra Meis	MEDT
Ernest	EDM (Machinery developer)
James	EDM (Machinery developer)
Scott Wilson	E Motion Picture studios
Cameron Wilson	E Motion Picture studios
Richard Masters	Sita
Peter Khan	JPK Associates
Gorsev Pristine	Medisolve
Total attending	18

HAMILTON REGION SR&ED PRACTITIONERS WORKSHOP:

Date:

Thursday, January 20, 2005

Time:

2-4 PM

Location:

Holiday Inn, Burlington,
3063 South Service Rd.

Topics discussed:

A) Recent CRA Directives:

Recent CRA Directives - financial

- Prototypes, Pilot Plants, Custom Products and Commercial Assets
- Filing Requirements for SR&ED
- Reporting deadlines: corporations, partnerships & proprietorships
- Recourse for missed deadlines / filing early enough to catch deficiencies
- Allocation of Labour Expenditures for SR&ED
- Retiring Allowances.

Recent CRA Directives - technical

- Plastics, materials processing, equipment & tool making guidance document including 16 project examples
- Pulp and paper sector guidance document

B) Other recent financial developments:

- New definition of "prescribed" Stock Exchanges in Canada

C) Follow-up on significant issues from prior meetings:

Recently resolved issues:

- Commercial vs. experimental production - 2003 vs. 2005: no carve out of SR&ED wages OR SR&ED subcontractors to the extent required to resolve technological uncertainties.

Unresolved issues:

- SR&ED "salary & wages" incurred outside of Canada – 2000+
- Capital tax implications from "development costs" – 2000+
- Ontario Business-Research Institute Tax Credit - Pre-approval
Issue: Why Ontario pre-approval required since audited by CRA?
Response to date: no plans to waive requirement – next steps

Sincerely, Dave Sabina

Hamilton Region SR&ED practitioners group, team leader

ATTENDEES:

Practitioners Workshop

January 20, 2005

Moderator

David Sabina

MEUK Corporation

Participant

WP ref

Company

Chris Smillie	6	RBC	
Darlene Sigel	7	Schilling and Laird, CA's	
Frank Fiasche	8	BDO	
Ed Collis	10	Collis Weitzman, CA's	
Sandy Hale	11	BDO Dunwoody	
Bryan G. Allendorf	12	CA	
Frank Baron	2	CMA	
Benny Esposito	13	DJB, CA's	
Len Lucier	14	Deloitte and Touche	
Elie Benatar	16	CA	
John Neumayer	18	KPMG	
Gale Robinson Gow	21	Procter & Gamble	
Jennifer Smith	20	Vincero Capital	
Christine Gribowski	24		
Harvey Cantor	25	Harvey Cantor Professional Corporation, C.a., C.P.A. (Oregon)	

Michelle Jamieson

MEUK Corporation

Jon Leong

MEUK Corporation

Total Attending

18

SR&ED Practitioner’s Workshop meeting minutes

SR&ED (Scientific Research & Experimental Development) Practitioner’s workshop¹:

Thursday, October 27, 2005 - (3 pm – 5 pm)
Holiday Inn – Burlington (QEW & Guelph Line)

Topics discussed:

I	Recent SR&ED tax cases & related issue(s)	2
I.1	Alcatel – SR&ED eligibility of stock options	2
I.1.1	Ruling & rationale: qualified SR&ED expense.....	2
I.1.2	Moderator note – subsequent events – proposal to disallow > Nov. 14, 2005	2
II	New CRA pronouncements	2
II.1	New T661 form – required >September 30, 2005	2
II.1.1	Now need “statements of work” for subcontractors	2
II.1.2	If missing > 18 months ENTIRE CLAIM could be denied!	2
II.2	APP 2002-02R2: Experimental vs. Commercial Production	3
II.2.1	Clarification - “sale” does NOT disqualify SR&ED work BUT warrants further examination	3
II.2.2	Case examples of eligible vs. ineligible work	3
II.2.3	Effects on recommended documentation:	4
II.3	Reasonableness of Shareholder/Manager Remuneration - SR&ED planning – keeping income <\$300,000	4
II.3.1	Tax Economics of this issue – concept of “integration”.....	5
II.3.2	Group concerns & recommendation – provide clarity & legislative relief.....	6
II.4	SR&ED filing deadlines – 15 vs. 18 months?.....	6
II.4.1	CRA – position – file within 15 months for safety.....	6
II.4.2	Canada Post filing procedures	7
II.4.3	Issue – proving “prescribed information” filed within 18 months!	7
III	Attendees:	8

¹ * Note - SR&ED Practitioners are generally accountants or consultants who prepare SR&ED claims on behalf of their clients.

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

I.1 Alcatel – SR&ED eligibility of stock options

I.1.1 Ruling & rationale: qualified 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 ...”².

The group discussed the effects of the new measures particularly the concept that expenses which were not recognized in the income statement could be qualified SR&ED expenditures!

We briefly discussed the subsequent CRA Note on stock option benefits claimed for SR&ED and pronouncements on the timing and quantification of amount claimed.

I.1.2 Moderator note – subsequent events – proposal to disallow > Nov. 14, 2005

On November 14, 2005 government notes proposed legislation that would prevent salary and wages incurred as a result of stock options to no longer be qualified SR&ED expenditures. You will I’ll ever be unlikely that this legislation we passed into law and receive royal assent before the upcoming federal election in January 2006.

II New CRA pronouncements

II.1 New T661 form – required >September 30, 2005

II.1.1 Now need “statements of work” for subcontractors

CRA Representative Bill McKerrall provided initial clarification that a statement of work could be,

- a separate statement,
- description within the project, or
- any other reasonable outline of what the subcontractor did with respect to SR&ED activities.

II.1.2 If missing > 18 months ENTIRE CLAIM could be denied!

Furthermore Mr. McKerrall clarified that failure to provide such information could result in the claim being deemed incomplete. If such an event occurs beyond 18 month filing deadline the event could be the denial of the entire SR&ED claim!

² within the meaning of subclause 37(8)(a)(ii)(B)(IV) of the Act

II.2 APP 2002-02R2: Experimental vs. Commercial Production

II.2.1 Clarification - “sale” does NOT disqualify SR&ED work BUT warrants further examination

This revision is a clarification of the expenditure rules that apply in the situations described above. The key principles stated in the application policy have not changed.

The CRA now notes,

“that the sale of any production, whether it results in a profit or a loss, should not be used to determine whether the context of the ED is EP or CP+ED. Rather, a product sale should trigger further investigation identifying other technical considerations and evidence (supporting facts) that can be used to determine the context of the work.”

For the purposes of this paper, experimental production (EP) is defined as follows:

“EP means the output of experimental development that is required to verify whether the technological objectives have been met and/or if a technological advance is achievable and

The purpose of the trial is to evaluate the technical aspect of the project. This is determined on the basis of the technical considerations and evidence relating to the particular trial. Accordingly, the resulting sale of the EP is normally only incidental or secondary to the carrying out of ED work.”

II.2.2 Case examples of eligible vs. ineligible work

Specifically participants discussed the issue of custom product production and experimental production undertaking within a commercial application.

Mr. McKerrall clarified the CRA’s opinion that,

“where a subcontractor an undertook any activity that did not involve technological uncertainty in its performance, it would not be eligible within the SR&ED claim.”

Group discussion of this concept then focused on a series of “real life” examples:

II.2.2.1 Example of excluded portion(s)

Subcontractors:

If the contractor was hired to machine apart which was necessary in evaluating a technological uncertainty, however, the design and manufacture of the component itself did NOT involve technological uncertainty, the cost of the component would NOT be eligible for SR&ED claim.

II.2.2.2 Example of eligible portion(s)

Subcontractors:

If however, a Canadian subcontractor's invoice specifically identified the cost related to their "experimentation or development," this portion of the overall subcontractor costs, may be eligible as a SR&ED subcontractor claim.

Internal labour (salary & wages):

With respect to the company's internal labor, during mixed experimental/commercial development situations, Mr. McKerrall clarified that qualified activity costs need to be clearly correlated with the resolution of the stated technological uncertainties.

Using a commercial machinery example, where a reasonable sample of parts needed to be fabricated for testing purposes, the internal labour costs to fabricate these parts may be qualified SR&ED expenditures, despite the fact that these parts may eventually be sold. In this situation, the materials themselves would NOT be eligible since they had not been "consumed:" in the SR&ED.

II.2.3 Effects on recommended documentation:

The group recognized that the determination of a reasonable sample size would be specific to each fact situation and would likely remain an area of considerable professional judgment.

In the group's view, these pronouncements emphasize the **importance of ensuring that adequate documentation from suppliers is obtained at the time of the development.** Additional representations after-the-fact with respect to the development activities performed may not provide sufficient evidence in all CRA audit situations!

It also underlines the importance of continually documenting significant uncertainties and be able to correlate related SR&ED activities.

II.3 Reasonableness of Shareholder/Manager Remuneration - SR&ED planning – keeping income <\$300,000

At the 2001 Canadian Tax Foundation conference, the CRA discussed its long-standing policy on when shareholder /manager remuneration will be considered reasonable³ (deductible) for tax purposes.

The CRA stated it,

"would not challenge the reasonableness of remuneration that was paid by a Canadian-controlled private corporation (CCPC) to an individual who is a shareholder of the corporation, provided the individual is active in the business operations and resident in Canada."

The CRA clarified, that **this policy would NOT apply where,**

"the income used to pay the remuneration is not derived from the normal business operations of the CCPC."

This creates two levels of potential problems:

1) Eligible payments "from" the CCPC

³ for purposes of section 67 of the Income Tax Act (the Act)

- Includes “salary and wages”⁴ only (no management fees, or payments to retirement plans)

2) Sources of income “for” the CCPC

- Includes active business income and certain “incidental” capital transactions (no investment or passive income)

Question 4

Can you give us some examples of situations that the CRA would consider to be beyond the intent of the policy?

Response 4

Yes. We would consider a situation in which a CCPC pays the remuneration out of the proceeds generated from a major sale of business assets, including the sale of the entire business assets or those of a large division, to be beyond the intent of the policy. This would encompass all sources of income triggered by the proceeds, including capital gains, recapture of capital cost allowance, and income arising from the disposition of eligible capital properties. **We would not generally be concerned with situations where there is a sale of some of the assets, which is incidental to the normal business operations.**⁵

While the first of these issues can be avoided by ensuring that the year end bonuses have appropriate with-holding of employment taxes (i.e. T-4 slip reporting) the second issue (sources of income) continues to create what many tax practitioners feel are “intolerable degrees of uncertainty” in the tax planning process with respect to determining the optimal salary vs. dividend mix.

Rulings and directives to date:

Since the conference, the CRA has provided a number of **advance income tax rulings** on the issue.

In one of the first rulings⁶ the assets of a CCPC including fixed assets, working capital, and goodwill were sold generating taxable amounts - some related to goodwill⁷. The CCPC had **six shareholders, three of whom were active** in the day-to-day management of the operations of the business prior to its sale. Subsequent to the sale, the corporation **declared a bonus payable to the three active shareholders.**

In the ruling, it was stated that the purpose of the payment of the bonus was to remunerate the owner-managers for their contribution towards the successful management of the corporation. Based upon the facts at hand, **the CRA ruled the Act⁸ would not apply to prohibit the corporation from deducting the amount of the bonus** in computing its business income for the applicable taxation year.

II.3.1 Tax Economics of this issue – concept of “integration”

Generally speaking the federal government allows the payment of the “management bonus” to be deductible to the as long as it is made to a “taxable individual.” Part of the reason for this concession is the fact that the tax rate paid by the individual at the top marginal rate (i.e. on income above \$115,000) is approximately 45% (30% federal and 15% provincial). Failure to allow the full deductibility the bonus payments would in fact be punitive since the amount

⁴ “salary & wages” defined in ITA subsection 127(9) to include all amount in ITA sections 5-8. Generally this means that the recipient has tax with-held at source and receives a T-4 slip.

⁵ CRA response at the 2001 Canadian Tax Foundation conference

⁶ Ruling 2004-0060191R3.

⁷ Subsection 14(1) of the Act will tax amounts that are dispositions of eligible capital property (franchise rights and goodwill)

⁸ section 67 and paragraphs 18(1)(a) and 18(1)(e)

would still be taxable to the recipient yet non-deductible to the payor. In cases where such double taxation occurs, the ultimate tax rate could wind up being more than 100% of the income earned!

Group analysis and discussion

The group discussed the fact that the ability to “bonus down” taxable income to the \$300,000 small-business limit was based on a CRA administrative pronouncement, rather than any actual tax legislation or directives in the income tax act and respective technical notes.

In the author’s opinion, this problem compounded by the fact that these **decisions are all based on CRA administrative procedures** (i.e. rather than any specific legislation). **Since the CRA has no authority to create legislation (only to follow it)** this means that, **in the event of a disagreement, the taxpayer has NO recourse through the tax courts.**⁹

Having provided precedents of taxpayers going to court on other issues where the CRA failed to adhere to its own administrative procedures in the past, the group (along with tax practitioners in general) are concerned with the high degree of ambiguity inherent in making year-end salary and bonus recommendations.

II.3.2 Group concerns & recommendation – provide clarity & legislative relief

Even though the first of these advance tax rulings on “reasonableness of remuneration” provides some positive indication that the CRA **“may” provide “favourable” treatment of “passive” income,** in the group’s opinion, it still leaves tax planners in **doubt with respect to defining what might be deemed a “major” sale** of business assets and outlines **dangers of earning “non-active” income.**

As a result, **until our “elected officials”** (or at least the tax courts) **provide legislation** (or precedence) on this issue, tax advisors will live with **considerable uncertainty.**

II.4 SR&ED filing deadlines – 15 vs. 18 months?

Most claimants and SR&ED practitioners seem aware that corporate claims for SR&ED tax credits include a requirement to file a, “SR&ED return with all prescribed information,” within 18 months of its corporate year-end¹⁰ although the full extent of what this includes, is often at issue.

II.4.1 CRA – position – file within 15 months for safety

“Question:

When does an SR&ED claim need to be filed in order for the CRA to review and **advise the claimant of any deficiencies** in the SR&ED claim?

CRA Response:

⁹ Other than as a general appeal under section 67 which refers to “fair market values” and therefore may not provide “clear” relief.

¹⁰ Filing deadline per ITA subsection 37(11)

If an SR&ED claim is filed **within 90 days before the reporting deadline**, the CRA should have sufficient time to conduct a review to determine whether or not the claim meets the filing requirements and to advise the claimant of any deficiencies in the claim.”¹¹

What many taxpayers seem unaware of is the fact that these returns can be filed through Canada Post up to the very last day of this filing deadline. As a result the group discussion focused on some filing procedures which the tax preparers could use to simplify the filing procedures.

II.4.2 Canada Post filing procedures

Relevant legislation

The Income Tax Act states, “when anything other than a remittance is sent by **first class mail (or equivalent)**, the item is **deemed received when the item was mailed.**”¹²

Effects of weekends and holidays

Interpretation Act section 26 states “Where the time limited for the doing of a thing expires or falls on a holiday, the thing may be done on the day next following that is not a holiday.”

Interpretation Act section 35 defines “Holiday”¹³ to mean Sunday among other specified days during the year.

Related “Xpresspost” planning

Unfortunately if you just mail the envelope you will not have proof of filing. As a result the group discussion lead to a proposal that taxpayers could take the following steps:

- use the Canada Post, Xpresspost service
- document the company name, year end & “tax returns enclosed” on the Xpresspost slip
- perhaps include an “enclosure letter” which could further list the enclosed documents
- have the Canada Post agent stamp both their Xpresspost tracking slip as well as any additional “enclosure” letters you may include with respect to your “enclosed” documents.

II.4.3 Issue – proving “prescribed information” filed within 18 months!

While the recommended filing methods (above) can be used to prove that the claim was filed “on time” it may not be enough to prevent the claim being denied due to “failure to submit prescribed information in prescribed form.” In fact if any significant portion of the claim is missing the entire claim could be jeopardized!

In several cases taxpayers have maintained that all prescribed information was submitted and sadly there seems to be **little if any recourse to challenge the CRA’s assertion that one or more pieces of information were missing.**

Perhaps the eventual development of electronic filing of the SR&ED forms will provide some further assurance for those filing claims near the 18 month prescribed filing deadline. In the meantime, the **group concluded that the safest method of preventing the denial of a claim is to file within 15 months of a corporation’s the taxation year end!**

¹¹ CRA Application Policy SR&ED 2004-02, Filing Requirements for Claiming SR&ED Carried Out in Canada, Question 4, October 5, 2004

¹² paragraph 248(7)(a)

¹³ “holiday” means any of the following days, namely, Sunday; New Year’s Day; Good Friday; Easter Monday; Christmas Day; the birthday or the day fixed by proclamation for the celebration of the birthday of the reigning Sovereign; Victoria Day; Canada Day; the first Monday in September, designated Labour Day; Remembrance Day; ...any day appointed by proclamation...

III Attendees:

Practitioners Meeting 3:00-5:00

10/27/2005

<u>Participant</u>	<u>Firm</u>
David Sabina - Moderator	MEUK Corporation
Bill McKerrall - CRA representative	Canada Revenue Agency (CRA)
Susan Morrison	Susan Morrison, CA
Julie Bond	Bond Consulting
Jacob Senderski	Bond Consulting
Peter Khan	JPK Associates
SR&ED Client of Peter Khan	JPK Associates
Margo Ross	Sims and Company. C.A.'s
Armando Valeri	SLF Group, C.A.'s
John Carusi	Tino-Gaetani, CA's
Bianca Tino-Gaetani	Tino-Gaetani, CA's
Rocco Vertucci	Ernst & Young LLP
Frank Fiasche	BDO Dunwoody LLP
Sandy Hale	BDO Dunwoody LLP
Debbie Davy	Mastertechwriter Inc.
Alex Schiappa	Mintz & Partners LLP
John Bartlett	John Bartlett, C.A, CPA
Janie Lim	OME Group
Stephanie Roesler	OME Group
Ed Collis	Collis Weitzman, CA's
Oscar Weitzman	Collis Weitzman, CA's
Chris Chan	KPMG
Jay Mclean	KPMG
Jerry Gribowski	Gribowski & Associates
Timothy Wright	Timothy Wright, C.A.
Ann Lam	MacKay, Brehm & Smyth
Frank Baron	Frank Baron Consulting
Harvey Cantor	Harvey Cantor, C.A.
Patrick Murphy	Murphy & Co.
Derek Tarko	MEUK Corporation
Michelle Jamieson	MEUK Corporation
Total Attending	29

Hamilton Region SR&ED Practitioner meeting

Minutes - March 9, 2006

Minutes of the March 9, 2006 SR&ED practitioner’s meeting regarding recent developments to Scientific Research and Experimental Development (SR&ED) project management and tax credit claims.

Recent CRA pronouncements	2
New T661 form – required >September 30, 2005	2
Now need “statements of work” for subcontractors	2
If missing > 18 months ENTIRE CLAIM could be denied!.....	2
New APP SR&ED 2005-01 on Shared-Use-Equipment	2
Intended use vs. Actual use	2
Prescribed Depreciable Property (PDP)	2
New APP SR&ED 2005-02 on Assistance.....	2
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Recent SR&ED tax cases & related issue(s).....	3
Alcatel – SR&ED eligibility of stock options	3
Ruling & rationale: qualified SR&ED expense	3
Legislative proposal to disallow > Nov. 17, 2005	3
Overview of recent SR&ED tax cases.....	3

Recent CRA pronouncements

New T661 form – required >September 30, 2005

Now need “statements of work” for subcontractors

CRA Representative Bill McKerrall provided initial clarification that a statement of work could be,

- a separate statement,
- description within the project, or
- any other reasonable outline of what the subcontractor did with respect to SR&ED activities.

If missing > 18 months ENTIRE CLAIM could be denied!

Furthermore Mr. McKerrall clarified that failure to provide such information could result in the claim being deemed incomplete. If such an event occurs beyond 18 month filing deadline the event could be the denial of the entire SR&ED claim!

Due to the interest this issue has created among practitioners, we propose to briefly address this issue during the meeting.

New APP SR&ED 2005-01 on Shared-Use-Equipment¹

Intended use vs. Actual use

The CRA clarifies,

“The **test for SUE is based on the actual use** of the equipment, during its operating time in the first and second period. **However, the test for PDP is based on the intended use of the equipment ...**”

Prescribed Depreciable Property (PDP)

The definition of PDP under subsection 2900(11) of the Regulations is found in Appendix A of this document.

¹ CRA APP SR&ED 2005-01, September 8, 2005, Shared-Use-Equipment

“It should be noted that a property is not PDP if at the time of its acquisition, it was not intended to be used for SR&ED in the context of the assembly, construction or commissioning of a facility, plant or line for commercial manufacturing, commercial processing or other commercial purposes (other than SR&ED).”

Need clarification of what this means.

In general the group discussed

New APP SR&ED 2005-02 on Assistance²

Assistance versus contract payment

Discussion of the factors that differentiate and the amount of judgment involved. Factors cited included: degree of

- Pricing vs. Risks (ceilings)
- Control of resulting Intellectual Property
- Contract for Goods vs. services

The OITC – How is it Taxed?

Issue: timing of tax on proxy amount

Tax mechanics of issue: received vs. receivable

Several tax programs defer taxation of the "proxy portion" of the Ontario Innovation Tax Credit (OITC) until the subsequent taxation year.

What the program and CCRA are doing is reducing the current years government assistance for the amount of assistance earned on the **Prescribed Proxy Amount (PPA)** and treating it as income the following year by making the adjustment on schedule 1.

In other word the **government assistance on the PPA is being treated as taxable only when actually received.**

Legislative support for deferral

Income Tax Act (Warning – this is complex!)

² CRA APP SR&ED 2005-02, October 28, 2005, General Rules Concerning the Treatment of Government and Non Government Assistance

Basically In this situation, we are dealing with three main areas. The main area is contained within section 37 of the *Income Tax Act*. Paragraph 37(1)(d) states that the research expenditure pool must be reduced by the total of all amounts of government assistance, as that term is defined in subsection 127(9), in respect of an expenditure described in paragraph 37(1)(a) or 37(1)(b). The first of those paragraphs deal with current expenditures and the second deals with capital expenditures. In neither section are you allowed to deduct the PPA.

To further emphasize the point, paragraph 37(1)(e) requires the expenditure pool to be reduced for the federal Investment Tax Credit used in the prior year (under subsection 127(5) or 127(6)) where that amount can be attributed to a paragraph 37(1)(a) expenditure or the PPA.

Therefore, it is easy to conclude that if parliament had intended for government assistance on the PPA to reduce the expenditure pool, then it would have explicitly stated that in 37(1)(d) as it did in 37(1)(e).

So does that leaves government assistance on the PPA currently not taxable? The answer is no. The amount is taxable under paragraph 12(1)(x) of the *Income Tax Act*. When reading this section and comparing it to the definition of government assistance under 127(9) there is a strikingly similar set of words:

“... grant, subsidy, forgivable loan, **deduction from tax**, investment allowance, or any other form ...” that is “... from a government, municipality, or other public authority...”

Therefore, government assistance is always taxable. But what about the timing of when it is taxable?

The amount taxable under 37(1)(d) as a reduction to expenditures is to be reported on the basis of

“... at the taxpayer’s filing-due date for the year, the taxpayer has received, is entitled to receive, or can reasonably be expected to receive,”

the government assistance on the expenditures. Therefore, the amount is included in income as it is earned, as it is based on the amount receivable.

However, the wording of 12(1)(x) states that

“... any particular **amount received** by the taxpayer in the year, in the course of earning income from a business or property, ...”

The net result being that **government assistance on the PPA is only taxable when actually received.**

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

Alcatel – SR&ED eligibility of stock options

Ruling & rationale: qualified SR&ED expense

Legislative proposal to disallow > Nov. 17, 2005

On November 17, 2005 government notes proposed legislation that would prevent salary and wages incurred as a result of stock options to no longer be qualified SR&ED expenditures.

A Notice of Ways and Means Motion was tabled proposing amendments to the Income Tax Act to clarify that the amount of an expenditure allowable to a taxpayer, and upon which a tax credit or deduction may be claimed, is limited to **the amount actually disbursed by the taxpayer.**

In general, the proposal related to employee stock options applies to options granted and shares issued on or after November 17, 2005.

Overview of recent SR&ED tax cases

The past two decades have witnessed a release of a variety of SR&ED related tax cases. The main issues and potential implications are outlined on the following page. Copies of the judgments are available from the Tax Court of Canada’s website.³

These were discussed in varying detail based on the issues cited in the attached “SR&ED tax case overview”.

³ Tax Court of Canada website [www.tcc-cci.gc.ca]

SR&ED tax case overview

TOPICAL AREA	APPELLANT	PRIMARY ISSUE	WIN/LOSE/DRAW?	RULING & RATIONALE	UNRESOLVED ISSUES AND OPPORTUNITIES	SIGNIFICANCE
SR&ED cases regarding "TECHNOLOGICAL ADVANCEMENT"	1A) Northwest Hydraulic	"system uncertainties" basis for eligibility?	Win	4 of 5 projects eligible due to "system uncertainties"	Landmark case on technological eligibility	High
	1B) Rainbow Pipeline	definition of "technological advancement"	Win	rejection of an hypothesis is an advance	Significant precedent on definition of "technological advancement"	Moderate
	2) Nstehen	software development - business vs. technology?	Draw	2 of 4 projects eligible - technology vs. business	business vs. technology software issues - eg. Patents U.S. vs. Japan	Low
	3) Hum-Medipharma	eligibility of analysis without "clinical trials"	Win	SR&ED work can be "experimentation OR analysis"	"systematic investigation" envisions contemplation of technological	Moderate
4A) TECHNICAL RECORDS	RIS Christie	"lack of documentation"	Lose - round 1 Win - round 2 appeal	ineligible - lack of any experimentation or analysis engineer died prior to trial - court sympathetic	Successful result &/or patent NOT proof of experimentation courts may be sympathetic for CGPC's in extreme circumstances	Moderate Moderate
	4B) R.J. Miller	lack of technical documentation	Lose	claimant must provide evidence	need evidence of experimentation	Low
	4C) Blue wave Seafoods	challenging science officer's analysis	Lose	insufficient evidence to refute CRA recommendations	challenge auditor qualifications before opinion rendered	Low
	4D) Maritime-Ontario	adequacy of technical documentation	Lose	must illustrate methods utilized & results	need evidence of experimentation	Low
SR&ED cases regarding Financial Issues						
5A) WAGES	Alcatel	stock options - whether SR&ED "cost" incurred	Win - round 1 Draw - round 2	SR&ED "cost" is dilution of shareholder interest legislation to disallow > Nov. 14, 2005	Courts contemplate "costs" not in taxable income 2 year window to amend 2004 - 2005 taxation years	High High
	CDD-REM	payments to "specified employees"	Win - round 1 Draw - round 2	eligible based on "evidence" Subsequent events: "non-arm's length" payments	courts allow reasonable estimate of costs incurred post 1996 - only "salary & wages" allowed "NAL parties"	Low Low
5C) Synchronost	allocating salary to only SR&ED activities	Lose	only SR&ED percentage claimable		need system to document employee experimentation time	Low
5D) Eignorecherche	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
6) MATERIALS	Consolux	materials used in SR&ED then sold	Win - round 1 Draw - round 2	eligible if required for SR&ED Subsequent legislation repayment of ITC's on sale	short-lived precedent to include "commercial materials" Clarification: labour eligible - materials "sold" excluded	Low High
7A) CAPITAL	Dew Engineering	building vs. "other structure"	Win	temporary lab not a "building" - no fixed foundation	courts take literal interpretation of "building"	Moderate
7B) Waxman	whether cattle eligible SR&ED capital	Win	eligible if ASA (>90%) SR&ED intent		short-lived precedent to include "commercial materials"	Low
8A) 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
	Les Cultures Laflamme	sale of experimental production	Win	subsequent sale irrelevant if SR&ED performed	clarifies SR&ED labour eligible despite subsequent sale	High
9) UNPAID AMOUNTS	Chartwell	eligibility of unpaid amounts	Win	need to claim costs during the year incurred	opportunity to claim unpaid wages	High
	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
10B) FOREIGN EXPENSES	LGL	data collection outside Canada SR&ED?	Lose	ineligible if physically outside Canada	subcontractor BNF now required to claim payment	High
	Aurora Marine	eligibility of Yacht expenses for SR&ED	Win	Subsequent events: eligible if within "EEZ"	courts took literal interpretation of "in Canada"	Moderate
11) OVERHEAD	Quanteries	"costs" or "revenues" basis for ASA SR&ED	Win	SR&ED eligible even if not otherwise tax deductible	marine work eligible to 200 maits - still "unclear" travel abroad	Low
13A) FILING EXTENSIONS	Datacale Research	extension of 18 month filing deadline	Lose	SR&ED costs basis for eligibility	courts took liberal interpretation of "SR&ED costs incurred"	Low
	Alex Parallel Computers	basis for extension of filing deadline	Win	qualified expenditures - identified by filing due date	object under proper sections of ITA - see Alex Parallel	Low
14A) QUALIFIED CCPC STATUS	Mimtex	if US director with 50% of shares has control?	Lose	CRA cannot restrict Minister's power to extend deadlines	extension for reasons other than CRA IC (illness/disasters)	High
	HSC Research	Factors in evaluating defacto control	Win	Legislation - Nov. 17, 2005 restriction of SR&ED extension	must file within 18 months of year end - preferably 15	High
14B) ITC USE	Ainsworth Lumber	ordering of ITC use	Win	actions of US director w/o consent of Canadian director(s) separate directors - no control evidenced	consent from 1 of 2 Canadian directors to solve problem Landmark case on definition of "defacto control"	High
			Win	Act clarifies that taxpayer "may" deduct [credits] indicates that	right to order affairs to minimize taxes	Moderate

Questions or feedback

The Hamilton Region SR&ED Practitioners' Group welcomes your questions or feedback on any issues raised in this letter.

We also encourage interested parties to examine:

- past SR&ED newsletters &
- practitioner minutes,

all of which are available at,

www.meuk.net

Terms of use

Although we endeavor to ensure accurate and timely information throughout this letter, it is not intended to be a definitive analysis of the legislation, nor a substitute for professional advice. Before implementing decisions based on this information, readers are encouraged to seek professional advice, in order to clarify how any issues discussed herein, may relate to their specific situations.

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HAMILTON REGION SR&ED PRACTITIONERS WORKSHOP:

Minutes of the SR&ED Practitioner's Workshop

Date:

Thursday, September 20, 2007

Time:

4:30-6:00 PM

Location:

Holiday Inn, Burlington,
3063 South Service Rd.

Topics of discussion:

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

- Armada - **eligibility of SR&ED preparation fees**

Discussion issues: group agreed with judge that technical portion of this work is likely eligible under "traditional" method of overhead allocation

- Nuytten - personal (T1) SR&ED claim disallowed since work in Co.

Discussion issues: group agreed that problem was likely due to failure of owner manager to separate personal from business issues

- Hopmeyer - Whether SR&ED eligible while insolvent

Discussion issues: group agreed with judge that company was "carrying on business" despite filing of alternate evidence by family members (re. claim for ABIL)

- Systemhac - Director fined \$75,000 for **SR&ED tax fraud** in B.C. court

Discussion issues: group agreed that facts clearly indicated fraud however penalty seemed rather light compared to crime. There were additional questions raised as to 3rd party liability of the accountants however, there was not enough "public" information to develop related conclusions.

B) Recent CRA & Ontario Directives - financial

- 2007 SR&ED limits for specified employees

Discussion issues: group discussed new rates and strategies to set "owner manager" wages to avoid ineligible "bonus" amounts at year end.

- CRA & Ontario harmonization 2008

Timeline for implementation - What's next?

Transitional Mechanism for SR&ED

Unresolved issues – still under discussion

Discussion issues: group agreed that harmonization will likely be of benefit but was confused with mechanics of proposed "transitional mechanism."

C) Practitioner issues with CRA & Ontario MOF processing

- Ontario OITC assessments & related problems created

- issued pre-CRA assessment for small claims (<\$15K) &

- 4-6 month post-CRA assessment for larger claims (>\$50K)

- proposed effects under harmonization in 2008/2009

Discussion issues: group agreed as a whole that smaller returns were being assessed quickly with larger claims often taking more than 4 months.

We believe that rationale is more of a cash flow issue with the ministry (i.e inability to pay larger claims) while trying to maintain a reasonable “average” turn around time. Group further agreed that harmonization should result in **faster refunds?**

- CRA SR&ED assessment practices

- RC59 (authorizations being lost – steps to get back quickly)

Discussion issues: group agreed these authorizations are often missed or negated from the CRA (and Ontario MOF) systems. The group member also provided various strategies for getting re-authorized including:

- faxing RC59 directly to an individual at the CRA (if they will let you) &
- faxing form to Winnipeg taxation centre (which can take only a week instead of 2-4 weeks elsewhere)

- proposals for **potential e-filing of SR&ED** claims

Discussion issues: Current queries are in process with CRA Ottawa (Peter Armstrong, Pierre Coutu & Roxane Brazeau-LeBlond) for further details re. whether “general requirements” for e-filing software can be developed/agreed?

- CRA proposes to audit claims post assessment (has anyone experienced this?)

Discussion issues: group agreed that this problem had occurred in isolated scenarios however there was often extenuating circumstances to explain this variance. As a result the group did not identify this as an ongoing problem.

- dispute resolution: success to date + future of 2nd Admin review process

Discussion issues: group members had mixed reviews of this process. Several had experienced success with the process but dissatisfaction at the time required to “begin the process” (usually > 6 months). Once the process was started however, it appeared that a resolution could usually be obtained within 2 months.

D) New services for claimants – SR&ED factoring agents

- Details on recent parties who wish to lend or factor \$ for SR&ED tax credits

Discussion issues: One of the participants (Dan Gregory, C.A.) provided a presentation to the group on behalf of his firm (Goldeye Capital) regarding a newly proposed SR&ED factoring service. The goal would be to provide 90% of the funds and purchase the SR&ED credit balances at or near time of filing the returns. Further information is available at www.goldeyecapital.com.

As a follow-up on this issue, we also received information on a similar service from Mr. Glenn Dalzell of TCE Capital Corporation. Further information is available at www.tcecapital.com

Event Moderated by Dave Sabina, C.A.
Hamilton Region SR&ED practitioners group, team leader

SR&ED Practitioner's Workshop Attendees		September 20, 2007	
Participant	Company	E-mail	Business Phone
1	Harvey Cantor	Harvey Cantor, C.A.	hc@harcn.com (416) 502-0540
2	Frank Baron	Baron and Associates	fbaron@sympatico.ca (905) 845-2466
3	Paul Baron	Baron and Associates	
4	Frank Fiasche	BDO Dunwoody	ffiasche@bdo.ca 519) 824-5410 x202
5	Andrew Kolodziej	Benetax	andrewkolodziej@hotmail.com 905) 279-9525
6	Ajoa Mintah	Bond Consulting Group	ajoa@bondconsulting.ca
7	Danial Godos	Bond Consulting Group	daniel@bondconsulting.ca
8	Edward Haliska	Bond Consulting Group	edward@bondconsulting.ca
9	Erwin Beltran	Bond Consulting Group	erwin@bondconsulting.ca
10	Joanie Cameron	Bond Consulting Group	joanie@bondconsulting.ca
11	Julie Bond	Bond Consulting Group	julie@bondconsulting.ca 416.503.4607
12	Meredith Robinson	Bond Consulting Group	meredith@bondconsulting.ca
13	Mike Bond	Bond Consulting Group	mike@bondconsulting.ca
14	Moe Haliska	Bond Consulting Group	moe@bondconsulting.ca
15	Rob Jenkin	Braithwaite Technology Consultants Inc	jenkin@braithwaite.ca 416-499-2861 ext. 338
16	Oscar Weitzman	Collis and Weitzman	(905)333-4000
17	Gerry Kowalski	Craftec Graphics	(905) 264-9955
18	Dan Gregory	Goldeye Capital	dangregory@goldeyecapital.com (416) 709-9266
19	Gerry Gribowski no file but...	Gribowski & Co.	
20	Joseph A. Truscott	Joseph Truscott Prof. Corp.	joetruscott@josephtruscott.com 905 528 0234 Ext 224
21	Peter Khan	JPK Associates	prakhan@rogers.com 519 488-1744
22	Greg Farrell	KPMG	gkfarrell@kpmg.ca 519-747-8856
23	Greg Visentin	KPMG	gvisentin@kpmg.ca 519-747-8257
24	Jay McLean	KPMG	jimclean@kpmg.ca (519) 747-8290
25	Yanjun Liu	KPMG	yvliu@kpmg.ca (519) 747-8238
26	David Learmonth	MEUK Corporation	dlearmonth@meuk.net 905-631-5600
27	Angela Palaisy	MEUK Corporation	apalaisv@meuk.net 905-631-5600
28	David Sabina	MEUK Corporation	dsabina@meuk.net 905-631-5600
29	Irene Faria	MSCM, CA's	ifaria@mscm.ca 416-626-6000
30	Rosario Suppa	MSCM, CA's	rsuppa@mscm.ca 416-626-6000
31	Alex Murphy	Murphy + C o	alex2@sympatico.ca 905-335-5783
32	Bill Murphy	Murphy + C o	bmurphy@worldchat.com 905-335-5783
33	Isobel Murphy	Murphy + C o	
34	Pat Murphy	Murphy + C o	
35	Bernard Taub	Nawaz Taub Noor & Wasserman	
36	Gul Nawaz	Nawaz Taub Noor & Wasserman	gnawaz@ntnw.ca (905) 273-5888
37	S.A Sami	Nawaz Taub Noor & Wasserman	
38	Chris Chipman	OME Group	cchipman@omegroup.com 905-602-4549 ex 239
39	Gautam Shah	OME Group	gshah7@yahoo.com 905-709-2648
40	Kris Unni	SB Partners	kunni@sbpartners.ca 905-633-6331
41	Peter Simpson	Simpson & Associates	peter@simpsonandassociates.ca (905) 464-0029
42	Earl Viner	SRnED Limited	evsmed@rogers.com 416) 878-7215
43	Adam Furbacher	Taylor Leibow	afurbacher@taylorleibow.com (905) 523-0000 ext 271
44	Roy Bilic	TRT Consulting	royb@mountaincable.net 905-531-3736
45	Ana Culina- Jajcinovic	Vine and Partners	anaj@vine.on.ca
46	Brock Whitwell	Vine and Partners	905-631-5600
47	Dieter Birk	Vineland Partners	dbirk@sred.info 905-562-1664

HAMILTON REGION SR&ED PRACTITIONERS WORKSHOP:

Minutes of the SR&ED Practitioner's Workshop

Date:

Thursday, September 18, 2008

Time:

4:30-6:00 PM

Location:

Holiday Inn, Burlington,
3063 South Service Rd.

Overview - Topics of discussion:

The discussion followed a discussion of issues which have been outlined in further detail as follows:

- I) MEUK SR&ED newsletters (download at www.meuk.net/resources_newsletters.html)
- A) 2008-1 (20 Minutes)
 - i) Recent SR&ED tax cases & related issue(s)
 - ii) Recent CRA pronouncements
 - 2008 budget
 - Enhanced incentives
 - SR&ED wages outside Canada eligible up to 10% if no foreign taxes paid
 - Carry-back of non-refundable ITC – restriction on refunds
 - iii) Ontario SRED credits - recent changes
 - (OBRI) – pre-approval requirement waived
 - Ontario harmonization - The Transitional Debit/Credit
 - B) 2008-2 (20 Minutes)
 - i) Recent CRA pronouncements
 - New T661 form in Fall 2008
 - ii) SR&ED program usage & spending statistics
 - Credits earned by rate of ITC's, size of corp. & industry sector
 - iii) International comparisons of R&D incentives
 - Marginal effective tax rates on investments in R&D assets
 - iv) SR&ED – dispute resolution - appeals and objections
- II) Overview 4 issues from CATA (30 Minutes) (download at www.cata.ca)
- i) Definition of SR&ED -248(1)
 - (technological eligibility 11 examples-App. A)
 - ii) Contracts – Goods vs. services & who claims
 - (CRA confusion 6 examples-App. B)
 - iii) Filing deadline for SR&ED claims
 - (18-month deadline)
 - iv) Use of normally kept books and records as basis for allocating costs to SR&ED work

Event Moderated by;

- Dave Sabina, C.A. Hamilton Region SR&ED practitioners group, team leader &
- Dominic Ioannoni, Canada Revenue Agency

SRED Practitioner's workshop**September 18th, 2008****Name****Moderators**David Sabina
Dominic Ioannoni**Participants**Ajay Sinha
Alan Fyfe
Alex Murphy
Alex Ross
Alex Schiappa
Allan Gordon
Andrea McPhail
Andrew Kolodziej
Armando Valeri
Barry Doerbecker
Bennie Esposto
Bob McDougal
Brian Theissen
Charles Walas
Cheng-Chung Yu
Chris Chipman
Colin Goodall
David Learnmonth
Dharmesh Gandhi
Earl Viner
Ed Collis
Feisal Hurzdok
Frank Baron
Frank Dodaro
Frank Fiashce
Gautam Shah
Gul Nawaz
Harjeet Rana
Harvey Cantor
Isabel Poustie
Jack Holmes
Jason Schwandt
Jay Mclean
Jay Wiged
Jerry Gribowski
Jigna Shah
Joe Lehocki
Jonathan Spencer
Koon Szeto
Kris Shah
Kyle Williams
Leo Ditschun
Liz Boydell
Marie Rea
Mark Stewart
Mark Vainberg
Mary Girbic
Matthew Brake
Mike Panayi
Mukesh Tanna
Oscar Weitzman
Peter Allen
Peter Kahn
Peter Martens
Philip Milman
Rakesh Gupta
Robert Bender
Robin Peaker
Ron Stokker
Roy Bilic
Rudy Morrone
Rueben Moitra
Stephen Beech
Steve Nagy
Susan Underwood
Tammy Alp
Ted Korn
Thomas Nagel
Tim Winter
Tony Bamrah
Vishal Bhandari
Zile Tharghirala
Total Attending**Company**MEUK Corporation
CRA

Sinran
Scitax Advisory Partners LLP
Murphy Co
Gowlings
Deloitte
Duacur Worthington & Assoc.

Gordon & Miltein Chartered Accountants
SLF - Schwartz Levitsky Feldman llp
Henderson Partners
Durwood Jones Barkwell & CO

Bridgman & Durksen

Cheng-Chung Yu Professional Corporation
OME Group
Kudlow & McCann Professional Corporation
MEUK Corporation
OME Group
SRnED Limited
Collis & Weitzman
Archronix corp
Franks Baron, C.M.A.
Fazzari & Partners LLP
BDO Dunwoody LLP
Private SR&ED Co. (Fomrrely with OME)
Nawaz Taub & Wasserman CA's LLP
sinran
Harvey Cantor Professional Corporation
Murphy Co
JC Holmes Int.

KPMG
Deloitte
Gribowski & Associates Limited
OME Group
Stevenson Lehocki C.A.s
JD Spencer Consulting
Software Management Solutions
OME Group
Maxim Strategy Consultants Inc.
Braith Waite
Halton Organizing & Bookkeeping
Stephen D. Jones, C.A.
Mcmaster Innovation Centre
Deacur Worthington & Assoc.
RDC Inc.
Whey group
Pinnacle Consulting
Mukesh Tanna, C.A.
Collis & Weitzman
Software Management Solutions
JPK Associates

Milman & Company
Hi-Tech Research Consultants
R.V. Bender, CA
Stern Cohen LLP,CA's

SR&ED Consulting
Gowlings
Hi-Tech Research Consultants
Deloitte
Michael Bossy Group Professional Corporation
R.V. Bender, CA
Tino-Gaetani & Carusi
Maxim Strategy Consultants Inc.
Novatron Systems
Canadian Tax Foundation
OME Group
Maxim Strategy Consultants Inc.

Details on issues discussed:

I A) Discuss issues from newsletter 2008-1

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

But they discuss and review these cases with a focus more on the related SR 90 interpretation problems in actual fact the cases of self.

White star - representation by officer vs. legal counsel
Ruling & rationale: denied - self-representation not warranted

Discussion issues: The group agreed the time and effort required to get a legal review was perhaps onerous. This is discussed further in the “dispute resolution” section below.

Chichkov – NAL payments & carrying on business
Ruling & rationale: no SR&ED & NAL payment (ineligible)

Discussion issues: The group agreed that non-arm's-length transactions should be documented with the same degree of detail used for non-arm's-length transactions.

Foster - LPs eligibility & frivolous appeal
Ruling & rationale: clearly limited partner –fined \$3,000 in costs

Discussion issues: The court believed that case was frivolous at the outset. Given that the amount in question was only \$2,000 with the resultant fines at \$3,000, the courts appear to be sending a strong statement that the use of the judicial system to “defer” payments (i.e. as opposed to addressing legitimate issues) will be severely punished.

Recent CRA & Ontario Directives - financial

2008 Federal budget

a) enhanced incentives

Discussion issues: The group briefly wrote it reviewed the 2008 budget recommendations for the enhanced credit.

There was some question as to how the amounts would be prorated for tax years ending after every February 25th 2008 (i.e. straight line or prompt the user for actual costs).

b) SR&ED wages outside Canada eligible up to 10% if no foreign taxes paid

Discussion issues: The issue on the eligibility of a Canadian employee's salary or wages while travelling abroad was originally raised by the group in its first meeting (1999) and had been subsequently re-iterated each year since.

The group rejoiced to see that after 9 years this issue (which affects most claimants) has finally been addressed.

Carry-back of non-refundable ITC – restriction on refunds

Discussion issues: The group briefly discussed the mechanics of the formulas with respect to;

- use of nonrefundable and refundable ITC's
- being limited to the maximum ITC earned in a taxation year.

It was agreed that this fact was generally not well known and it was likely to be stumbled upon by accident in the cases of many claimants.

Ontario SRED credits - recent changes

(OBRI) – pre-approval requirement waived

Discussion issues: The group agreed that the removal of this requirement is long over due. Furthermore, the forms required to complete the 20% refundable OBRI (Ontario Business Research Institute) credit have not kept pace with this legislation since it indicates that such pre-approval is still required.

The group appeared guardedly optimistic that this issue may eventually be resolved with the harmonization of Ontario and CRA SR&ED divisions.

Ontario harmonization:

a) effects on service

Discussion issues: The group agreed as a whole that smaller returns were being assessed quickly with larger claims often taking more than 4 months.

Many group members concurred that it has been difficult to obtain information on the status of Ontario accounts since the merger in April 2008.

b) The Transitional Debit/Credit

Discussion issues: An example of the 12 year deferral for the transitional credit was reviewed.

I B) Discuss issues from newsletter 2008-2

Recent CRA pronouncements - New T661 form in Fall 2008

A new, simplified SR&ED claim form will be released including;

- an enhanced “Complete Claim Checklist” &
- a clear format for submitting project details.

Discussion issues: The group agreed that any clarifications as to what constitutes a “complete claim” will be useful given issues with respect to the 18 month filing deadline.

Many practitioners were also wondering, if and when, it would be possible to electronically file SR&ED returns.

SR&ED program usage & spending statistics

Federal & provincial SR&ED funding

Expenditures by Province

Number of companies claiming SR&ED credits

Credits earned by “rate of ITC’s”

Credits earned by “size of corporation”

Credits earned by “industry sector”

Discussion issues: The group performed a quick review of these balances making note of the fact that

- all growth is related to small and medium-size corporations &
- the manufacturing sector represented almost 50% of all claims.

The other major item of interest was the fact that the province of Quebec provided more SR&ED funding than all of the provinces and territories combined.

International comparisons of R&D incentives

Marginal Effective Tax Rates (METR) on investments in R&D assets

Discussion issues: A brief review of Canada's competitiveness based on the new measurement METR versus the old measurement standard of the B-Index was performed.

As with prior studies, **Canada still remains one of the top three countries** with respect to the “true” (marginal) cost of SR&ED after taxes and all incentives.

SR&ED – dispute resolution - appeals and objections

- dispute resolution: success to date + future of 2nd Admin review process

Discussion issues: Group members had mixed reviews of 2nd Admin review process.

Several had experienced success with the process but dissatisfaction at the time required to “begin the process” (usually > 6 months).

Once the process was started however, it appeared that a resolution could usually be obtained within 2 months.

II) Discussion of Issues from CATA:

i) Definition of SR&ED -248(1)

Discussion issues: The group discussed 11 examples of SR&ED problems encountered by companies with respect to interpretation of the definition of “SR&ED” from the income tax act.

The group agreed that some of the most common problems illustrated these examples were also experienced across the GTA, including;

a) work done in a commercial environment

This type of work is often being completely discounted on the basis of the eventual sale of a product rather than an examination of the technology issues in question.

In other words the CRA concludes, “if the product was sold there could NOT have been any technological uncertainty involved in the development.”

There was additional discussion on the issue as to when and where

- only incremental costs (i.e. rework components) vs.
- the full costs to an address in uncertainty should be claimed.

The group agreed that it was safest to only claim “incremental costs” in any commercial situation however, it was recognized that this could be an issue for further discussion.

b) process improvement

Examples illustrated CRA disallowed improvements to proprietary processes since they were in a commercial environment. This issue was tied to the commercial environment issue above.

The group agreed that the best protection for claimants to guard against such issues was to;

- tie the activities in question to
- the resolution of specific pre-stated technological uncertainties.

ii) Contracts – Goods vs. services & who claims

Discussion issue 1 – goods vs. services: The group briefly discussed the appropriateness of the following three indicators proposed by CATA:

- **Whether a contract is for services**
- **Transfer of intellectual property (IP) / Rights to exploit**
- **Pricing method vs. risks assumed by the contractor**

The nature of the conversation consisted of a review of the five examples provided (see appendix B).

The group agreed that the **area that was most problematic** was the position of several CRA officials that the performer need to, “own the rights absolutely” rather than merely illustrating “**entitlement to exploit**” is defined as follows:

“...this requirement is considered to be met in cases where the taxpayer has the **right to use** a patent that results from the SR&ED project even if the taxpayer is charged a royalty or similar fee for the use of the patent. This requirement is also considered to be met in cases where the taxpayer is **entitled to distribute and market** any product that results from the SR&ED project.”¹

The group believes the examples in question illustrate that this confusion is prevalent across Canada and suggested that;

- CRA employees would likely benefit from further training and clarification on
- what constitutes “entitlement to exploit” and therefore eligibility.

Discussion issue 2: who claims the credit

When is a contract SR&ED performer required to;

- reduce qualifying expenditures by
- the payment received for its work
- pursuant to contract with an arm’s length party?

The group reviewed the legislation, specifically;

Paragraph 127(9)(a)(i) defines “**contract payment**” as “an amount paid or payable to a taxpayer, by a taxable supplier in respect of the amount, for SR&ED **to the extent that it is performed for or on behalf of a person or partnership entitled to a deduction in respect of the amount because of subparagraph 37(1)(a)(i) or (i.1), and...**”

In simpler terms:

- **if the payor does NOT claim the amount** (by filing a Canadian SR&ED claim)
- the amount is **NOT a “contract payment”** meaning there would be
- **NO** reduction to qualified SR&ED expenditures

¹ CRA Interpretation Bulletin-151-R5, paragraph 37

The group also commented that the current reporting requirements for contractors (a description of the nature of the work, their business number and the projects which they worked on) provides an adequate audit trail to prevent any double dipping by claiming the same costs from both the performer and the payer perspectives.

iii) Filing deadline for SR&ED claims (18-month deadline – vs. 15 months per CRA)

Discussion issues: group discussed the fact that CRA was being particularly stringent on 18 month filing deadline. Several practitioners indicated that they had experienced denials on a similar basis.

We reviewed some of CATA proposals including a recommendation that the 18 month filing deadline should be removed or perhaps extended.

Examples cited included;

- Simply submitting the wrong project description has resulted in the CRA refusing to allow the clerical oversight to be fixed when discovered just a few days after the filing deadline.
- Failure to include “business numbers” for subcontractors or
- “technical documentation” in a separate section have resulted in denials of SR&ED claims.

The discussion then focused on the background of the S&ED objectives and concluded that the reason for this stringency was likely due to the fact that CRA did not wish to make payouts on work that was done without any knowledge of the SRED tax credit system. In other words they didn't want to reimburse clients for SR&ED payments that were made without any intention of claiming the credits.

It was also noted that a CRA application policy paper provided that **claims filed within 90 days of the 18 month filing deadline would be given a “second chance”** in the event that any prescribed information was missing.²

As a result the group agreed that it would be **prudent for all claimants and practitioners** to consider a **15 month filing deadline**.

iv) Use of normally kept books and records as basis for allocating costs to SR&ED work

Discussion issues: group members discussed the 3 CATA provided examples of problems (see handout slide #46) encountered on the issue of keeping appropriate employee timesheets:

² CRA APP SR&ED 2004-2 – Appendix Question 4

- i) Companies are being told that they must establish dedicated SR&ED record systems, including the requirement that they maintain activity based records if they are to continue claiming.
- ii) One consulting firm was told that they should set up an additional dedicated system for any SR&ED they wished to claim to avoid having to reduce for contract payments. Note, this claimant clearly does not receive “contract payments” from their clients, and the CRA had accepted their claims for years.
- iii) Software company received a written warning to keep time sheets in an audit of their 2004 claim in April 2005. The 2005 claim is audited, and all labour after April 2005 is disallowed because there were no daily activity time sheets (claim was filed using the argument programmers were ASA for a specified period). To make matters worse, the CRA threatened to impose penalties if they tried to file the same way again under subsection 163(2).

The group agreed that the optimal system would likely;

- a) clearly document all related technological uncertainties and
- b) ensure that all work being claim correlated to relevant supporting activities.

If this was done in a reasonable manner the group felt that actual day-to-day timesheet documentation was less meaningful since it often would not provide the degree of detail (i.e. how work correlated with resolution related uncertainties) with respect to “commercial” vs. “pure SR&ED” projects.

Appendix A: CATA-Finance Workshop July 10, 2008 248(1) “SR&ED” Examples

Example 1

Some offices take the position that any work that is not using experimental techniques but using standard methods or protocols is not eligible even when used in applied research, let alone in ED studies.

Example 2

Some offices take the position that (d) activities such as data collection that would have to be done in a similar project without SR&ED is not eligible work even when the data collected is analyzed for the SR&ED.

Example 3

Reviewers continually take the position that trials associated with highly experimental risky SR&ED process developments cannot be experimental production, because of the presence of a sale.

- In one case where an attempt to develop a new process failed, because high scrap rates could not be controlled, all experimental production associated with trials was denied in spite of the use of dedicated trials, formal DOEs, reports of results, etc. The reviewer maintained that it was eligible, but commercial. The process was abandoned and the company returned to the traditional processes. What product that could be salvaged from the experimental productions was transferred to inventory.
- In another case, a major multi-national Canadian manufacturer was told that any of the work the claimant undertook in their facilities to improve their proprietary process technologies was not eligible, because “it was commercial and excluded under (i).”

Example 4

A consulting engineering firm was developing new process technologies and completed the development and validation of new design concepts and practices but did not proceed to the build phase. The CRA’s position was that since there was no experiment, only analysis using standard analytical and computing methodologies, the work to develop the new design practices was ineligible.

Example 5

One office has advised local practitioners that (e) – (k) trump (a), (b), (c) and (d).

Example 6

A large Canadian manufacturer decided to invest in a new line of products for which all existing process knowledge is highly protected proprietary and protected with confidentiality agreements, patents, etc. As a starting point, they acquired new leading edge manufacturing technology and proceeded to develop the process manufacturing knowledge and the interrelated design practice knowledge needed for the product line. The CRA denied the claim saying that the work was simply routine process optimization.

Example 7

The control of felt hairs which impact paper quality is a major industry problem. A study of the use of a chemical control strategy commonly used for waste water management was considered a success and the results were published. The CRA turned this claim down as simply work on extending a known process, i.e., process optimization.

Example 8

A consulting engineering firm studied the use of indigenous reconstructed wetland/flora to attenuate a chemical spill in a boreal region. Such an approach had never been attempted. The CRA allowed some initial lab work, but not the field data collection which was an integral part of evaluating the remedial concept. This work led to several publications.

Example 9

The CRA insisted that only engineering work incremental to the SR&ED was eligible in a claim for the development of a new design approach to a co-gen plant, ignoring that the engineering work met the commensurate test.

Example 10

CRA officials in one region have formally taken the position that the study of how and if existing environmental and geological methodologies, etc. can be made effective in new situations and/or for new purposes is not eligible. The existence of publishable results and/or the demonstration that the results are important new engineering practice knowledge are ignored.

Example 11

A manufacturer had to develop new processes so that they could use as inputs materials of a much lower quality than currently used and still maintain their product standards. The CRA said that this was simply a material change and refused to even meet the company's representatives.

Appendix B: CATA - Contract Interpretation Examples

Contract Interpretation Examples

Example 1

An environmental consulting firm has successfully claimed for SR&ED for years. For the first time, the CRA has told them that they must reduce their claims for what the CRA agrees are eligible SR&ED projects by the payments they have received. The performer clearly retains all intellectual property (IP) rights and provides products to their clients other than the underlying SR&ED. There is no evidence of direction from the payer and the payer is not interested in the scientific advancements per se.

Example 2

A large engineering consulting firm reviewed all of their work for possible SR&ED and examined their contract relationships in light of the CRA's policies. They claimed very little of their SR&ED work, because of the uncertainties related to the wording of the contracts. The CRA attempted to argue in protracted discussions that they disagreed with the claimant's application of the policy in all cases, saying that the claimant was performing SR&ED on behalf of their client. Over a period of a year or more of discussion, the financial reviewer consistently did not wish to address the contextual facts around the contracts. Eventually, a **negotiated** settlement was achieved. The contract issue is still outstanding in the subsequent claims of the claimant.

Example 3

A contract for delivery of a software product to specifications was initially treated by the performer as an SR&ED "contract payment" and the amount was netted against their qualified expenditures. The contract appeared to the CRA to be for SR&ED performed on behalf of the payer as the price was based on time and materials.

The performer engaged professional advisors who noted that the payer did not have the ability to direct the work and did not receive the IP (source code). The payer would not have been able to claim the ITC as they were not performing SR&ED.

The contractor (performer) was allowed to amend their claim to exclude the contract payment.

Example 4

A software company undertook development of custom applications for its customer, a government agency, and performed SR&ED in the course of developing these products.

The CRA proposed a significant reduction to the claim. The company was advised that if they did not accept the proposal, the CRA would treat the revenue as government assistance or a "contract payment" and the entire amount would be disallowed.

After a protracted and contentious review, a **negotiated** settlement was achieved which did not treat the revenue as contract payment. However, the underlying issues of the nature of the contract were not resolved.

Example 5

A contract for environmental remediation was treated as a contract for SR&ED although the engineering firm performing the work retained all of the intellectual property (IP), supervised and directed the work and delivered a guaranteed solution. The payer did not claim the payment as SR&ED. Although the performer should have been able to claim the ITC, the performer was denied its claim because of CRA's interpretation of the nature of the payment, which was that the engineering firm had been "paid for their work"; therefore, they had received a "contract payment".

Example 6

A software company undertook development of custom applications for its customers and performed SR&ED in the course of developing these products. The CRA proposed disallowing all claims on the basis that the company had received "contract payments" which reduce qualified expenditures.

After a protracted review, a **negotiated** settlement was achieved which did not treat the revenue as contract payments. This solution was necessary as the parties were unable to resolve the issues relating to the nature of the contract which did not contemplate SR&ED claims.