



## Recent Items of Interest Respecting the Deductibility of SR&ED Credits

### IN THIS ISSUE

SR&ED—5 Questions, 3 Criteria  
Two Recent Cases Involving  
SR&ED Expenses

Scientific Research and Experimental Development (SR&ED) expenses and credits are a fairly significant component of our economy and this is recognized by our government. In 2010, the government undertook a review of its policies and procedures with respect to the SR&ED program and issued a directive recently. Highlights of their announcement are below along with some digests of recent tax cases involving SR&ED credits.

### CRA's SR&ED Policy Review Project

On December 19, 2012, the Canada Revenue Agency (the "CRA") announced that it had completed its SR&ED Policy Review Project which was undertaken in November of 2010. The project involved a review of its policies and procedures in order to consolidate and clarify the policy documents and guidance documents with respect to the SR&ED program. The completion of the project was marked

with the release of several SR&ED policy documents on the CRA's website. In addition, the CRA released a list of SR&ED documents that it has archived as of December 31, 2012. It notes that these archived documents will be removed from the CRA's website on June 28, 2013. The list of archived documents includes the application policies, the sector guidelines, the guidance documents, and Information Circulars IC 97-1, IC 94-2, IC 94-1, IC 86-4R3, IC 86-4R2SUP2, and IC 86-4R2SUP1.

Reproduced below is a set of questions and answers released by the CRA on December 19, 2012 regarding the consolidated SR&ED policy documents.

1. *When do the consolidated policy documents come into effect?*

The consolidated policy documents come into effect immediately upon their release.

2. *Have the policies and procedures changed?*

No. The principles explained in the previous SR&ED publications have not changed. Changes have been made to the text to improve clarity and readability, and the policies have been updated to reflect legislative changes and jurisprudence. In addition, the policy information has been reformatted and restructured to present it in a user-friendly way on the CRA Web site.

3. *What is the difference between the "Eligibility of Work for SR&ED Investment Tax Credits Policy" document and the "IC 86-4R3"?*

In the IC 86-4R3, the CRA had described three criteria — scientific or technological advancement, scientific and technical

content, and scientific or technological uncertainty — that had to be satisfied for work to be deemed SR&ED.

In the Eligibility of Work for SR&ED Investment Tax Credits Policy document, using the definition of SR&ED as the starting point, the CRA has based its approach on answering five questions. This approach, established by the courts, essentially supplements how the three criteria are applied by providing a logical order for assessing them. It is important to note that both approaches (the three criteria and the five questions) are equivalent and assess the eligibility of the work in the same way. The following table shows the relationship between the three criteria and the five questions.

Five Questions	Three Criteria
1. Was there a scientific or a technological uncertainty — an uncertainty that could not be removed by standard practice?	Scientific or technological uncertainty
2. Did the effort involve formulating hypotheses specifically aimed at reducing or eliminating that uncertainty?	Scientific and technical content
3. Was the adopted procedure consistent with the total discipline of the scientific method, including formulating, testing, and modifying the hypotheses?	Scientific and technical content
4. Did the process result in a scientific or a technological advancement?	Scientific or technological advancement
5. Was a record of the hypotheses tested and the results kept as the work progressed?	Scientific and technical content

*4. What is the difference between the consolidated SR&ED policy documents and the previous financial policy documents?*

The topics covered by the consolidated SR&ED policy documents closely match the lines of Form T661, *Scientific Research and Experimental Development (SR&ED) Expenditures Claim*, and should help in preparing a claim. The

information related to each policy is also cross-linked to other policies and the glossary of SR&ED terms, where applicable. Also, based on the comments we received during the public consultations, the policy documents have been changed to make them easier to read and to ensure that the information is clear.

*5. Where are the scientific and technical examples?*

The SR&ED scientific and technical examples are being reviewed. Similar to the procedure followed during the consolidation of the SR&ED policy documents, we will post the draft versions of the scientific and technical examples on our Web site in 2013 for public consultations.

*6. Will the consolidated policy documents create a greater burden for supporting evidence?*

No. The requirement for supporting evidence stays the same. It is important to maintain supporting evidence (e.g. information, records, and documentation) to substantiate that the SR&ED work was performed and allowable expenditures have been incurred. Please refer to Appendix 2 of the latest version of the T4088 Guide for information on documentation and other evidence to support an SR&ED claim.

*7. Will the CRA change Form T661 and Guide T4088 because of the release of these documents?*

Yes. In October 2013, the CRA will release a revised Form T661, *Scientific Research and Experimental Development (SR&ED) Expenditures Claim*, and Guide T4088, *Scientific Research and Experimental Development (SR&ED) Expenditures Claim — Guide to Form T661*, to reflect the changes related to the release of these documents and to accommodate the legislative changes coming into effect on January 1, 2014.

*8. Do these documents reflect all the changes made to the SR&ED program that were announced in the 2012 Federal Budget?*

No. Since the budget changes will come into effect on different dates, these documents will continue to be updated at different times in 2013.

*9. What will happen to the previous SR&ED policy documents?*

The previous publications, whose content has been captured in the consolidated SR&ED policy documents, will be archived on the CRA Web site as of December 31, 2012. To

make a smooth transition to the new format, the CRA will keep both the previous publications and the consolidated policy documents on the CRA Web site for six months. After that, the previous publications will be removed. All other necessary documents (e.g. claim forms, guides, and brochures) will be retained.

## Two Recent Tax Cases of Interest Respecting SR&ED Expenses

*Only portion of salaries corporate taxpayer paid to sole shareholder and his wife deductible as SR&ED expense*

T was the sole shareholder of the corporate taxpayer. Initially, the Minister disallowed deductions claimed for 2003 to 2006 for all salaries the taxpayer paid to T and his wife in connection with the taxpayer's scientific research and experimental development ("SR&ED") projects in which they were involved. On the taxpayer's appeal to the Tax Court of Canada, the Minister agreed to permit the deduction for 2003 and 2004, and the deduction for 2005 of 25% of the salary paid to T. A consent judgment to this effect was therefore inserted into the Court's judgment allowing the taxpayer's appeal in part.

The appeal was allowed in part. The remaining salaries paid to T and his wife during 2005 and 2006 were much larger than those usually claimed for SR&ED projects. The evidence produced by the taxpayer on this issue was vague and general and did not assist in establishing any direct connection between the remaining salaries in dispute and the SR&ED projects involved. T's wife also failed to testify, the taxpayer's records were inadequate, and the taxpayer failed generally to support its contentions in support of the deductions claimed. The Minister was ordered to reassess, but only to give effect to the consent judgment.

*Laboratoire Du-Var Inc. v. The Queen* (2012 DTC 1301)

*Corporate taxpayer's research work on home heating and air conditioning systems held to constitute SR&ED*

The corporate taxpayer installed heating, ventilation, and air conditioning systems in residential homes. During 2007 and 2008, the taxpayer worked on a project developing a High Static High Velocity Fan Coil System (the "Project"). The Minister disallowed most of the scientific research and experimental development ("SR&ED") expenses and investment tax credit deductions claimed for 2007 and 2008 on the ground that most of the Project involved nothing but routine engineering. The Minister also moved the deduction of the expenses and credits claimed from 2007 to 2008, because they had not been paid within 180 days of the end of 2007. The taxpayer appealed to the Tax Court of Canada, electing to use the Informal Procedure and conceding that its SR&ED expense claim should be reduced by \$33,650, leaving in dispute \$387,553.

The taxpayer's appeal was allowed in part. According to the Tax Court of Canada in *Northwest Hydraulic Consultants Limited v. The Queen*, to qualify for SR&ED treatment, the activity in question must involve: (a) technological risk or uncertainty which cannot be remedied by routine engineering; (b) formulated hypotheses aimed at eliminating the technological uncertainty; (c) the use of scientific method, including the formulation, testing, and modification of hypotheses; (d) technological advancement; and (e) detailed record keeping of the whole process. In this case, the Project met all of these criteria, particularly since there clearly was technological uncertainty with respect to the noise, space, and efficiency of the systems being work on. However, the Minister was justified in moving the expenses claimed from 2007 to 2008 because of the 180-day rule. Because the taxpayer had elected to have its appeal heard under the Informal Procedure, its additional refundable investment tax credits were limited to \$12,000 for 2008 under section 18.1 of the *Tax Court of Canada Act*.

*1726437 Ontario Inc. o/a Airmax Technologies v. The Queen* (2013 DTC 1008)