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JENTEL: SHORT AND SWEET GUIDANCE ON SR & ED ELIGIBILITY

David R. Hearn, Jason A. Puterman, and A. Christina Tari

Jentel Manufacturing Ltd. v. The Queen
2011 TCC 261

KEYWORDS: SCIENTIFIC RESEARCH AND EXPERIMENTAL DEVELOPMENT ■ SR & ED ■ TAX COURT OF CANADA

INTRODUCTION

The decision of the Tax Court of Canada to dismiss the appeal in the *Jentel* case generated a buzz in the scientific research and experimental development (SR & ED) community. Did the decision set a precedent marking the end of SR & ED tax credit claims for product development in the industrial arena? A careful analysis of the reasons for judgment confirms that the short answer is “no.” What is notable about *Jentel* is the clear and concise guidance that it provides on the meaning of “experimental development” in paragraph (c) of the SR & ED definition in subsection 248(1) of the Income Tax Act.²⁹

The taxpayer, Jentel Manufacturing Ltd. (“Jentel Manufacturing”), developed and manufactured engineered thermoformed plastic products for consumer and industrial use. It performed custom work for third parties and manufactured a proprietary product called Multi-Bins.³⁰ The subject of the appeal was the minister’s denial of SR & ED benefits on expenditures made by Jentel Manufacturing to improve its Multi-Bins product in its 2005 taxation year.³¹

To understand the cause for the buzz in the SR & ED community, an appreciation of some history is in order. The ability to make a claim for “scientific research” was introduced into the Canadian income tax system in 1948. Thirty-five years later, claims for “experimental development” were permitted when a new paragraph (c) was added to the definition for SR & ED, now contained in subsection 248(1) of the Act.

29 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this feature are to the Act.

30 *Jentel Manufacturing Ltd. v. The Queen*, 2011 TCC 261, at paragraph 4.

31 The relevant expenditures are summarized *ibid.*, at paragraph 5 of the decision, reproducing the description in the statement of agreed facts.

Indeed, to date, the most significant changes to the definition of SR & ED have involved the wording in paragraph (c). The last material change to this paragraph was made in 1994, when the wording changed from “development, namely use of the results of basic or applied research for the purpose of creating new, or improving existing, materials, devices, products or processes” to “experimental development, namely, work undertaken for the purpose of achieving technological advancement for the purpose of creating new, or improving existing, materials, devices, products or processes, including incremental improvements thereto.”

Whereas the former “results of basic or applied research” seemed to require some new scientific knowledge, the change in wording to “technological advancement” appeared to shift the emphasis to an advancement of some practical utility. The SR & ED community interpreted the change to signify a substantial broadening of the types of work that would qualify as eligible for an SR & ED tax credit. Indeed, since 1994 there has been a general increase in the number of SR & ED claims filed each year, and the vast majority are made as “ED” under paragraph (c).³²

Starting in 2008, an increasing number of complaints were heard from the SR & ED community that the Canada Revenue Agency (CRA) had narrowed its eligibility criteria such that claims for work that had historically qualified as ED were now being denied.³³ The government’s response to these complaints was to organize program reviews, first by the Taxpayers’ Ombudsman³⁴ and subsequently by an expert review panel.³⁵

It is within this historical framework that the May 2011 decision in *Jentel* should be read.

32 Canada Revenue Agency, *Annual Report to Parliament* (Ottawa: CRA, various years, 2000–2010) (www.cra-arc.gc.ca/gncy/nnnl/menu-eng.html); Robert Schellings, *Industrial R&D Statistics by Region 1994–2003*, Statistics Canada catalogue no. 88F0006XIE (Ottawa: Statistics Canada, 2005) (www.statcan.gc.ca/pub/88f0006x/88f0006x2005017-eng.pdf); and Statistics Canada, “Nature of Research and Development, 2000–2004” (2006) 30:8 *Service Bulletin Science Statistics* 1–15 (www.statcan.gc.ca/pub/88-001-x/88-001-x2006008-eng.pdf).

33 See, for example, the submission by the Canadian Federation of Independent Business to the Review of Federal Support to Research and Development, February 18, 2011, at 3 ([http://rd-review.ca/eic/site/033.nsf/vwapj/sub115.pdf/\\$file/sub115.pdf](http://rd-review.ca/eic/site/033.nsf/vwapj/sub115.pdf/$file/sub115.pdf)). See *infra* note 35 for further information about the review panel and access to other submissions.

34 Canada, Taxpayers’ Ombudsman, “Public Consultations on Systemic Issues, SR&ED” (www.oto-boc.gc.ca/systemc_nqrs/sred-rsde-eng.html).

35 While the Taxpayers’ Ombudsman has yet to report its findings, the Independent Panel on Federal Support to Research and Development—commonly referred to in the SR & ED community as “the Jenkins panel” after the chair of the panel, P. Thomas Jenkins (who is also the executive chair and chief strategy officer of Open Text Corporation)—released its report on October 17, 2011. The Jenkins panel’s recommendations, if implemented, would lead to substantial reductions in SR & ED benefits for Canadian-controlled private corporations. The panel’s website can be found at rd-review.ca/eic/site/033.nsf/eng/h_00003.html. There is an archive with the submissions made to the panel at rd-review.ca/eic/site/033.nsf/eng/h_00006.html. The report can be found at rd-review.ca/eic/site/033.nsf/eng/home. A full description of the changes proposed to SR & ED by the Jenkins panel can be found in Bulletin 48 of Scitax Advisory Partners LP at www.scitax.com/pdf/bul-048.pdf.

STATUTORY DEFINITION OF SR & ED

Under the existing SR & ED legislation, classic scientific research in a laboratory setting (“SR”), and shop floor industrial product or process development (“ED”) attract the same benefit rate.

The definition of what kinds of activity qualify as eligible to attract SR & ED benefits is extremely broad. Arguably, this may be beneficial since it avoids the need to update the legislation as fields of science and technology evolve. Given the breadth of the definition, much of the existing policy with respect to what is eligible has been derived from court decisions.

For a claim in respect of industrial research and development such as the claim made in *Jentel*, the relevant wording of the SR & ED definition can be reduced to the following:

“[S]cientific research and experimental development” means systematic investigation or search that is carried out in a field of technology by means of experiment or analysis and that is . . .

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

THE ISSUE

In *Jentel*, the only issue was whether the expenditures incurred to improve Multi-Bins were for the performance of work that constituted SR & ED in accordance with the definition in subsection 248(1).³⁶ Two of the minister’s assumptions were in dispute:

- (l) the Appellant failed to demonstrate a systematic investigation through experiment or analysis performed to resolve any scientific or technical uncertainties³⁷ that may have arisen through the development of the [Multi-Bin] or its component parts; and
- (m) the work performed by the Appellant in its development of the Product or its component parts is in line with standard product development and does not represent scientific or technical advancement.³⁸

³⁶ *Jentel*, supra note 30, at paragraph 7.

³⁷ In its pleading, the Crown used the term “technical uncertainty.” In prior cases and CRA publications, the term generally used is “technological uncertainty”: *CW Agencies Inc. v. Canada*, 2001 FCA 393, per Sexton J writing for a unanimous court (Stone, Evans, and Sexton JJ); *Northwest Hydraulic Consultants Ltd. v. The Queen*, 98 DTC 1839 (TCC), per Bowman J; *Information Circular* 86-4R3, “Scientific Research and Experimental Development,” May 24, 1994; and CRA guide T4088, “Guide to Form T661: Scientific Research and Experimental Development (SR&ED) Expenditures Claim.”

³⁸ *Jentel*, supra note 30, at paragraph 26.

In the statement of agreed facts filed during the hearing in the Tax Court, Jentel Manufacturing clearly established that its approach was systematic: the company recognized a problem, conceived various solutions, conducted experiments to test those solutions, kept contemporaneous records of the experimental results, and applied those results iteratively to achieve its product development objective.³⁹

The appeal turned on the question of “technological uncertainty.” The appellant called the owner and president of Jentel Manufacturing as its only witness and introduced as exhibits five physical prototypes arising from the work claimed as SR & ED. However, all of this evidence focused on product novelty. It did not address the technological uncertainty.

The Crown also only called one witness, the research technology adviser for the CRA. In the reasons for judgment, D’Arcy J stated that he placed no weight on the evidence of the CRA witness because he found it to be “opinion evidence.”⁴⁰ Accordingly, the CRA officer was not considered an expert witness. D’Arcy J was therefore required to consider the assumptions pleaded by the Crown and to determine whether the statement of agreed facts, the testimony of Jentel’s owner and president, and the physical exhibits refuted those assumptions.

THE LAW

In considering whether the work performed by the appellant in improving its Multi-Bins was a technological advancement, D’Arcy J turned to the law on point that is found in two of the leading SR & ED decisions, *Northwest Hydraulic* and *CW Agencies*.⁴¹

His decision, applying the law to the facts, was that the work done by Jentel Manufacturing to improve its Multi-Bins was “routine engineering” and, as such, did not require any “new” knowledge that was beyond “standard procedures.”⁴² In other words, the work done by Jentel Manufacturing to improve its Multi-Bins did not entail any advancement beyond “something that is known to, or, at all events, available to persons knowledgeable in the field” or any “technological uncertainty” outside “techniques, procedures and data that are generally accessible to competent professionals in the field.”⁴³ In the case before the courts, the “field” would be plastic moulding while “persons knowledgeable” and “competent professionals” would presumably be either mechanical engineers or technologists, or skilled tool and die makers.

In the words of D’Arcy J, no “technological risk” was involved in the work.⁴⁴ The changes in the type and thickness of the plastic used in the manufacture of the Multi-Bins, the changes in the moulds and the casting materials used for the moulds, the

39 See supra note 31.

40 *Jentel*, supra note 30, at paragraph 3.

41 These cases are cited supra note 37.

42 *Jentel*, supra note 30, at paragraphs 10, 17, and 28.

43 *Northwest Hydraulic*, supra note 37, at paragraphs 16-4(a) and 16-1(b).

44 *Jentel*, supra note 30, at paragraphs 10, 16, 17, and 22.

use of different materials for the stands,⁴⁵ and the use of two manufacturing processes (thermoforming and injection moulding),⁴⁶ all constituted “the use of existing manufacturing processes in an attempt to build a better product, while controlling manufacturing costs.”⁴⁷

During the taxation year in issue, Jentel Manufacturing vastly improved its Multi-Bins. They were smaller, significantly lighter, and easier to install; less labour was required to manufacture them; and they required less energy to transport.⁴⁸ However, although Jentel Manufacturing clearly achieved something new, the reasons for the decision in this case reinforce the position that simply creating “something new” in a systematic fashion does not automatically lead to SR & ED eligibility; there must also be a “technological advancement” attended by “technological uncertainty.”

The term “technological uncertainty” is not found in the Act. It was introduced into the SR & ED regime through the two key decisions relied on by D’Arcy J in *Jentel: Northwest Hydraulic* and *CW Agencies*. Both decisions establish that SR & ED benefits are allowed for the cost of undertaking a systematic investigation that aims to overcome a technological uncertainty that is obstructing the achievement of a technological advancement for the purpose of creating something new. Unfortunately, the definition of “technological uncertainty” has been somewhat fluid over the years. *Northwest Hydraulic* cast it in a sociological context—as knowledge available from within a “community”—whereas recent CRA policy (as yet untested in the courts) has attempted to redefine the term as an “obstacle” arising from the need to overcome shortcomings in the underlying technology.⁴⁹

In *Jentel*, the appellant did not produce an expert witness to provide opinion evidence that the work conducted by the company to improve its Multi-Bins involved “technological uncertainty” and “technological advancement.” Rather, the evidence presented was the testimony of the owner and president of the company, and was confined to the nature of the improvements to the product and the physical exhibits (the five models of the Multi-Bins).

SR & ED benefits are allowed *in addition* to the regular business deductions that a company would otherwise be allowed for the expenses incurred in improving the

45 Ibid., at paragraphs 14 and 24.

46 Ibid., at paragraphs 15 and 18-22.

47 Ibid., at paragraph 22.

48 It should be noted that there is no requirement that the experimentation actually result in success. The “scientific method” (which Bowman J referenced in his “five stage process” to determine “technological uncertainty” in *Northwest Hydraulic*, supra note 37, at paragraph 2) does not require a positive result. Had Jentel Manufacturing actually tested a new process in its experimentation that failed to achieve its objectives, but that was a process new to the company, the industry, or the world at large, the work done ought to have qualified for the SR & ED benefit.

49 See CRA guide T4088, supra note 37, at 9, line 244. There is nothing in *Jentel* to support any alteration in the definition of “technological uncertainty” established in *Northwest Hydraulic* and *CW Agencies*. In particular, there is nothing to support a position that “technological uncertainty” requires an obstacle posed by a shortfall in the existing state of the technology.

product that it offers to the market. The SR & ED program is intended to subsidize the costs of overcoming technological uncertainty to achieve technological advancement; it was never intended to subsidize the costs of routine product development.

In *Jentel*, the Tax Court has reinforced the eligibility requirements for “experimental development” under paragraph (c) of the SR & ED definition, and has done so in a short and sweet judgment. While the reasoning has already been established in other, longer decisions involving more complex factual scenarios, *Jentel* provides more useful guidance for taxpayers in industry because it involves only one project in relation to which both the evidence led in court and the court’s reasons for denying SR & ED eligibility are clearly set out.

Jentel Manufacturing filed an appeal to the Federal Court of Appeal on June 9, 2011.⁵⁰

David R. Hearn, Jason A. Puterman, and A. Christina Tari