TAX FOR THE Owner-Manager

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SR & ED: Are the CRA and Parliament Pulling in Opposite Directions?

Anecdotal evidence suggests that the CRA has been adopting an increasingly restrictive view of SR & ED eligibility. When it comes to determining what types of activities qualify for SR & ED benefits, the wording of the legislation itself is rather vague. However, useful guidance can be gleaned from the history of the legislation and from the court decisions that have considered the definition of SR & ED.

In October 2010, the federal government established a panel of experts to examine the economic efficacy of various R & D incentives, including the SR & ED program. A review of the approximately 200 submissions received by the panel leaves little doubt that some Canadian businesses are experiencing diminished access to SR & ED benefits. This excerpt from the submission made by the Canadian Federation of Independent Business is indicative of many:

> There is concern with inconsistency in the decisions being made on SRED applications. Some members have had their applications denied after having had it accepted for the exact same type of work a year earlier while others have told us about firms doing similar types of R&D but having one application accepted in one part of the country but denied in another.

The Act deals with SR & ED eligibility in two places. Subsection 37(1) contains several pages of rules pertaining to fiscal issues, and subsection 248(1) contains a dozen or so paragraphs that attempt to define what kinds of R & D work qualify. In our experience, most SR & ED disputes between taxpayers and the CRA involve the interpretation of the definition of "scientific research and experimental development" in subsection 248(1). Most of these disputes arise from misinterpretation (either by the CRA or by the taxpayer) of the meaning of the term "experimental development" in paragraph (c) of the definition, which in our experience is the basis for the large majority of SR & ED claims.

Given the disagreement that seems to have developed between the CRA and taxpayers about what qualifies as "experimental development" and what does not, it is helpful to look at what Parliament's intention was when it chose to use that phrase in the Act. While most of the subsection 248(1) definition has remained essentially the same since 1966 (when it was contained in regulation 2900), the one part that has changed significantly over time is the wording of paragraph (c). A review of the six revisions to date shows that Parliament was intent on broadening, not narrowing, the range of activities that qualify as "experimental development."

The last material change in the definition of "experimental development" was made in 1994, when the wording changed from "use of the results of basic or applied research" for the purpose of creating something new to "achieving technological advancement" for the purpose of creating something new. To solidify Parliament's intention, legislators added a few more key phrases to the end of paragraph (c) that allow even "incremental improvements" to something new to qualify as SR & ED. In short, the 1994 revisions changed the definition of "experimental development" from the utilization of "scientific research" to the seeking of "technological advancement" in aid of creating something new. This is a significant change in the eligibility requirement: "scientific" implies a result of knowledge, but "technological" implies a result of practical functionality.

Another signal of Parliament's intention was seen in 1995 when the definition of "scientific research and experimental development" was moved from regulation 2900 to subsection 248(1). Regulations can be amended by the governor in council (that is, Cabinet), but amendment of the Act requires the assent of Parliament. It can be argued that the definition was moved into the Act to protect it from administrative predation, such as might occur during periods of fiscal belt tightening. It is exactly this legislative permanence of the definition that makes the Canadian SR & ED program superior to its US counterpart, which, owing to budgetary constraints, has been allowed to lapse 13 times since 1981.

While the legislation is the baseline starting point to determine eligibility for SR & ED, it is not the whole story. Court decisions provide guidance on the meaning of "experimental development" in paragraph (c) of the definition. Although space does not permit a summary of those decisions in this note, in our view the courts have consistently upheld the requirement that experimental development must entail systematic investigation to address a technological uncertainty whose resolution is outside the bounds of the standard body of knowledge possessed by a qualified specialist. The decisions make it clear that "experimental development" does not require the production of scientific knowledge that is new to the world, and it does not require the presence of a technological obstacle characterized by shortcomings or limitations of the current state of technology, as is suggested in some of the CRA's latest administrative publications.

The legislative history of the definition of "scientific research and experimental development" and the courts' interpretation of this definition point to a Canadian government intent on ensuring that Canadian business can count on tax credits as a reliable incentive for incremental product development and technical problem solving, not just for scientific research.

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