

## ARE TAX ADVISER FEES AN ELIGIBLE SR & ED EXPENDITURE?

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Expenditures on scientific research and experimental development (SR & ED) are fully deductible in computing income and earn investment tax credits. In two cases—one recent—the issue was whether fees paid to consultants who assisted in the preparation of the claim for SR & ED benefits were qualified expenditures in addition to the costs incurred in prosecuting the research. In both cases—*Val-Harmon* (97 DTC 551) and *Armada* (2007 DTC 879)—the Tax Court’s ruling can be described as a firm “maybe.” In *Val-Harmon*, the pivotal issue was the nature of the professional service provided, while in *Armada* it was the timing of the expenditure in relation to the fiscal period in which the SR & ED was actually carried on.

Unfortunately, it is not possible to tell from the reports of the cases whether the subject claims were made using the traditional or the proxy overhead method. This information is significant factor in this debate; without it, the value of the decisions for deciding other cases is suspect.

### Val-Harmon

In *Val-Harmon*, an amount of \$20,638 was paid to an SR & ED consulting company, Gessat Inc. It was neither an accounting nor a legal firm. The fees were

for services that included the preparation of the T661 form and supporting technical and financial information. The taxpayer claimed the entire fee as a qualified SR & ED expenditure and did not differentiate between the amounts charged for the technical and the accounting aspects of the services.

Somewhat inexplicably, the minister had relied on regulation 2902(a)(i) to support its side of the case. The regulation provides that “a legal or accounting fee” is not an eligible SR & ED expenditure. The taxpayer based its arguments on regulation 2900(2), which allows “other expenditures that are directly related to such prosecution and that would not have been incurred if such prosecution had not occurred.” The taxpayer said that Gessat’s fees were for engineering services, not legal or accounting advice, and would not have been incurred had no SR & ED been undertaken.

At the opening of the trial, the minister applied for an amendment to its pleadings, adding a reference to regulation 2900(2) in support of an argument that the fees were not in any event “directly related” to the prosecution of the SR & ED. The court refused the amendment on the basis that to amend the pleadings at that late date would unfairly prejudice the taxpayer’s case. The court allowed 75 percent of the \$20,638 fee as an eligible SR & ED expenditure on the basis that it represented costs necessarily incurred to make the SR & ED claim. The court acknowledged that had the minister pleaded regulation 2900(2) on a timely basis, the result might have been different, although it did not categorically state that this would have been the case.

### Armada Equipment

In *Armada*, the taxpayer paid a total of \$28,618 to an accounting firm in connection with its SR & ED claim. Some \$18,618 of the total was to reimburse the accountants for a disbursement they had made to an engineer retained by them to assist in the identification and description of the SR & ED and the preparation of the claim. *Armada* included the \$18,618 in its SR & ED claim, and the CRA denied it as an eligible expenditure.

The court upheld the minister’s position and found that none of the \$18,618 claimed by *Armada* was an eligible SR & ED expenditure. However, the court stopped short of specifically stating that the earlier decision in *Val-Harmon* was incorrect. The court’s finding was based on the rationale that the fees were paid for a service rendered after the SR & ED was already complete: “I conclude that a ‘qualified expenditure’ must be incurred in connection with ongoing research and development, and not incurred after-the-fact because research and development have already taken place” (paragraph 20).

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## Practical Considerations

Unfortunately, the *Armada* case is more indicative than definitive. On the surface, the court's decision seems to indicate that the professional services fees paid for the preparation of an SR & ED claim are not an eligible expenditure and should not be claimed. However, before one reaches this conclusion, several important factors should be considered.

■ **Are the fees for engineering or technical services or for legal or accounting services?** Legal or accounting services are specifically excluded in the regulations; however, the Act is silent on fees paid to engineers.

■ **Traditional or proxy overhead method?** The traditional overhead method for determining what qualifies as technical work may offer a broader scope than the proxy method. CRA *Application Policy* no. 96-06 contains a table comparing the eligibility of various activities under the traditional and proxy overhead methods. The last row of the table shows "preparation of the T661 for SR & ED projects carried out in the current year by employees," with a tick mark for "eligible" under the "traditional" method.

■ **Were services rendered in the claim period?** The decision in *Armada* was, arguably, based largely on the timing of the services. *Armada* claimed fees for services that were rendered after the claimed SR & ED work was complete. It is not clear whether the fees claimed were incurred in the same fiscal period as the claimed projects or whether they were claimed in a subsequent year. However, the *Armada* ruling becomes somewhat less relevant if the professional services performed are rendered in the same fiscal period as the SR & ED work being claimed and the amount of those fees is paid out within 180 days of the fiscal period end-date.

## Conclusions and Recommendations

There is still no definitive position on the character of professional service fees incurred in preparing SR & ED claims. There seems to be wiggle room for both the CRA and taxpayers in either direction. It is likely that the CRA will review claims for SR & ED preparation fees on a case-by-case basis. While one cannot say how the CRA will react to any specific claim, some steps may help to slant things in the taxpayer's favour in a claim for preparation fees:

- Use the traditional overhead method. Cite *Application Policy* no. 96-06 as grounds.
  - Get separate invoices for engineering and technical writing services. Avoid claiming legal and accounting fees.
  - Have the professional services rendered in the same time period as the claimed SR & ED projects.
  - Claim the professional services fees in the fiscal year in which they are actually rendered—that is, do not claim the cost of preparing the fiscal year 2006 SR & ED claim in fiscal year 2007.
  - Ensure that the fees are paid within 180 days of the fiscal year-end.
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