TAX FOR THE Owner-Manager

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New Form T661 for SR & ED Claims

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The CRA has released form T661-08 ("Scientific Research and Experimental Development (SR & ED) Expenditure Claim"). The new form replaces T661-06. Either version of the form can be used for taxation year-ends up to December 31, 2008. The new form T661-08 is mandatory for taxation year-ends from January 1, 2009. The introduction of the new form accompanies a general tightening of the CRA's approach to SR & ED claims that makes it more difficult for many taxpayers to obtain program benefits.

For the CRA, the new form improves efficiency: (1) it eliminates stand-alone technical submission documents, thereby reducing the paper burden and the associated labour; (2) it converts SR & ED project technical descriptions to a standardized format with tightly defined, albeit limited, text content; and (3) it features a significantly increased number of "tick boxes" that will aid in automated screening—that is, the profiling of claims for potentially contentious audit issues such as contract payments, work outside Canada, and projects done in an environment of commercial production.

For taxpayers who claim SR & ED, the benefits are less certain. There is mounting anecdotal evidence that the CRA has been making significant administrative changes in its interpretation of the scientific eligibility criteria. Those changes seem to be aimed at curtailing, if not eliminating, claims for activity under paragraph (c) of the definition of "experimental development" in subsection 248(1) in favour of claims for "basic research" (paragraph (a)) or "applied research" (paragraph (b)). If such a change in the interpretation of SR & ED eligibility is being implemented, certain industries, such as software, custom machinery, and manufacturing, can expect that the CRA will use the enhanced profiling capability supported by form T661-08 to apply greater scrutiny to claims from those sectors.

New form T661-08 makes a clear distinction between basic and applied research (paragraphs (a) and (b) of the definition) and experimental development (paragraph (c)). The form provides for only 1,050 words of technical description in the categories of basic and applied research, whereas 1,400 words are available for describing experimental development. The additional word count for experimental development is allocated to a mandatory description of "technological obstacles."

The new term "technological obstacles" seems to be related to the familiar SR & ED criterion of "technical uncertainty," but the CRA guide that accompanies the new form places the bar somewhat higher for "obstacle" than for "uncertainty." Guide T4088 defines technological obstacles as "the shortcomings and/or limitations of the current state of technology that prevented you from developing the new or improved capability." Technological uncertainty is defined in *Information Circular* 86-4R3 as "[w]hether or not a given result or objective can be achieved, and/or how to achieve it, is not known or determined on the basis of generally available scientific or technological knowledge or experience."

Senior CRA officials have stated that there is "no new policy," and there has been no change in the legislation. Is there any real evidence that the release of form T661-08 heralds a shift in policy with regard to SR & ED? Two respected national associations representing different sectors of the Canadian business community (Canadian Advanced Technology Alliance and Canadian Manufacturers and Exporters) have recently issued communiqués to the federal government citing widespread complaints from their members. The complaints indicate that the CRA's SR & ED administrative policies are indeed changing despite the government's statements to the contrary. Both CATA and CME have observed that not only are CRA auditors

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assessing SR & ED claims more harshly, but new and significantly different criteria are being applied to judge scientific eligibility.

Beyond the broad policy implications of what constitutes eligible SR & ED and what does not, new form T661-08 will have a significant impact on SR & ED claimants in all industry sectors.

While the creation of the new form was likely rooted in an initiative aimed primarily at small business, the most severe impact will likely be felt by big business. The filing process dictated by the new form requires that detailed descriptions be written for all projects claimed. Previously, descriptions were required only for the 20 largest projects. Clearly, big companies with large and complex claims will have much more work to do for the 2009 year-end SR & ED filings.

Moreover, the number of projects in a claim for a given total dollar amount will increase. For example, a company making an SR & ED claim for $1 million in expenditures may find that six or even nine projects are needed to describe the scope of R & D activity that had historically been covered in three or four projects. There are two reasons for this. First, form T661-08 requires that each project be classified using one five-digit code selected from a list of about 150 different science and technology fields. Since only one code is allowed per project, multidisciplinary projects will now have to be split into multiple individual projects, one for each discipline. Second, with a maximum of 1,400 words per project, only the most skilled wordsmiths will be able to adequately explain complex R & D activity without resorting to the creation of multiple projects.

From a compliance standpoint, there are two areas of concern. First, since the project technical descriptions and other information (such as availability of supporting documents) are now part of the tax return, the company officer who signs the tax return is now accountable for the accuracy of the scientific and technical information. Previously, such information was typically contained in separate documents that were one step removed from the main body of the tax return and did not always contain the same level of certification that was present on form T661. Second, form T661-08 makes no provision for the inclusion of diagrams, charts, tables, photographs, or anything except text characters. Much of the documentation that would have been sent to the CRA must now be retained at the taxpayer's site in case of audit. This, together with the superior suitability of the new form for profiling, automated or otherwise, implies that the CRA expects to rely on rigorous field audits of what it views as "risky claims." Anyone who doubts that the frequency of such audits will increase need only know that by mid-2009 the CRA will have hired at least 100 additional SR & ED science auditors.

The names of the three key employees whose wages are claimed in the project, presumably the leaders, must be given, along with their qualifications (university degree, diploma, etc.). While this requirement does not necessarily mean that persons without such qualifications will be excluded from SR & ED claims, it signals that the CRA may be considering using academic qualifications as one of its project pre-screening criteria.

The matter of contract payments gets its own set of screening flags. Line 266 is a statement of payment received for the claimed SR & ED work. Lines 267 through 269 identify any subcontractors that were paid to perform SR & ED work. There is also a requirement in the guide and on form T661-08 that the taxpayer have contract documents, including a statement of work at hand, available in the event of a "detailed review"—that is, an audit.

Recommendations

1) If your year-end falls in the first half of the year (January through June 2009), mark the implementation date for form T661-08 so that your SR & ED claim is filed correctly and in plenty of time. Allow extra time to gather information and prepare the project's technical descriptions. It is likely that most accounting firms, and even some SR & ED consultants, will be surprised by the magnitude of these changes. The CRA itself might run into some glitches as it rolls out this process, leading to delays in claim processing and prolonged audits.
2) Plan your tax affairs so that more of the expected SR & ED benefit is absorbed to reduce taxes payable at year-end. This reduces dependence on the refund cheque, which could be delayed 12 months because filings must now be current before one can begin to apply for an SR & ED benefit.
3) Because of the new screening flags for incoming and outgoing contract payments in addition to the requirement for a "statement of work," it is now more important than ever to have formal written contracts for all transactions, whether buying or selling, since you cannot tell which ones will have to be included in your SR & ED claim.

4) Implement a time-tracking system. Do not wait until the end of the year to identify the projects and write the story. Define a list of projects and then map out the associated activities in real time throughout the year. Log the time entries using a project management coding system that can be referenced back to the coding system being implemented by the CRA.
5) Assemble a database of qualifications (degree, institution, year of graduation, etc.) for all employees likely to be engaged in SR & ED activity. It is worth noting that qualifications need not be limited to university degrees; technicians and skilled tradespeople also carry designations worth recording. It is desirable to tie the qualifications into the time-tracking system, if possible.
6) Implement a document management system. Use your corporate server as a repository to store and organize documents that evidence SR & ED work. Use the same project management coding as that used in the time tracking suggested in recommendation 4.