Appealing an SR&ED claim

The Canadian tax system's provisions for research and development aren't quite as old as *CAmagazine*, but they do date back more than 60 years, to 1948. While the provisions always targeted scientific research, they were broadened in 1985 to include "experimental development" — giving us the acronym SR&ED. In 1994, the government further strengthened the definition of experimental development, thereby reaffirming its support for industrial R&D undertaken in pursuit of new products or processes.

Given the government's apparent commitment to fostering R&D in Canada, it is discouraging to see how much CRA has varied its views on SR&ED eligibility over the years, with no material changes in the legislation to back them up. Peter Weissman, one of the co-authors of this article, wrote about this problem in the 1990s (see "Credit where it's due," September 1997, p. 30) and it's happening again today.

What is driving this trend? Has CRA changed its policies on SR&ED eligibility? If so, are these changes supported under the legislation? If not, what is the best way to get redress?

The political environment

The federal government has to balance competing (even conflicting) goals when it comes to economic development policy for science and technology. One is to offer an internationally competitive R&D tax credit incentive. Another is to control actual tax credit disbursements to contain costs. Yet another is to guard against what appears to be an explosion of abusive claims.

Over the past four years, cost containment and abuse control seem to have won out. Now there are growing indications that both taxpayers and the government believe the SR&ED program is malfunctioning. In September 2009, the taxpayer's ombudsman, Paul Dubé, was asked to investigate whether CRA was correctly administering the program. His report has yet to be released, but he has been quoted as saying there have been "a lot of industry complaints." Then in October 2010, the federal government set up a six-member SR&ED expert review panel headed by Open Text chair Tom Jenkins to review the economic benefits of all forms of government funding for R&D, including SR&ED. And in the past few months, several associations have voiced their dissatisfaction with the program. For example, the Canadian Manufacturers and Exporters reported in a submission to the expert review panel that "problems in the administration of the [SR&ED] system include uncertainty with respect to eligibility, tighter definitions that exclude many previously eligible development activities, lack of technical expertise, long processing times, and lack of client [taxpayer] support."

SR&ED rules and current trends

CRA has published a variety of guidelines, administrative policies and interpretation bulletins to help taxpayers better understand the SR&ED rules. However, these are not law themselves, but merely statements of administrative policy. The actual legislation is to be found in the Income Tax Act (Canada). There, the definition of SR&ED has not changed in any material way since the mid-1990s.

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The challenge right now is to keep up with CRA's moving administrative definition of what is eligible.

Ultimately, Canada's tax courts decide on the correct interpretation of the act. But although there have been some important decisions, none can justify the extent to which CRA has narrowed its definition of SR&ED eligibility. While the act and jurisprudence can probably support some of CRA's recent policy tightening, we are seeing an increasing number of aggressive SR&ED assessments that are not supportable by either. Unfortunately, most taxpayers (and many accountants) are not sufficiently familiar with the nuanced differences between law and administrative policy to appreciate which audit positions are correct. Here are some audit strategies that, in our view, are not supported.

Project deconstruction: The taxpayer makes a claim for a project involving a set of interrelated activities that are collectively necessary for the technological advancement. The CRA auditor arbitrarily breaks the project into smaller subprojects, then assesses some of these as "standard engineering" and, therefore, not eligible. The claim is either reduced or disallowed altogether.

Misinterpretation of experimental development: Most SR&ED claims are made for work that is experimental development as defined in paragraph 248(1)(c) of the act. The term "experimental development" was first enacted in 1985 spe-

cifically to broaden the legislation to cover industrial R&D aimed at product development. However, CRA auditors are now too frequently importing the more restrictive wording from paragraphs 248(1)(a) or (b) and saying the taxpayer has failed to demonstrate "an advancement in a field of science or technology," thus imposing pre-1985 rules.

Technological obstacle versus technological uncertainty: An SR&ED claim is disallowed on grounds that there was no "technological uncertainty" or "technological obstacle" that would justify making a systematic investigation.

The act doesn't actually contain the words "technological uncertainty" or "technological obstacle." Rather, the term "technological uncertainty" evolved from a 1997 court case, *Northwest Hydraulic Consultants Ltd.* There, Justice Bowman described uncertainty as something not known to a qualified specialist in a given field. The term "technological obstacle" appeared in 2008 with CRA form T661-08, but has yet to be sanctioned by any jurisprudence. In various publications since then, CRA has taken to defining "obstacle" as shortcomings in the existing state of the art. It now seems to be using the entire world as a benchmark and as such is setting the eligibility bar much higher than it was set in 1997.

Traditional versus proxy overhead methods: A taxpayer makes a claim using the traditional method for overhead costs, which involves a more detailed accounting of actual overheads, but also allows for a broader scope of eligible activity than the proxy method, where the overhead is deemed to be 65% of the claimed T4 wages. The CRA auditor denies the expenditures for these broader-scope activities, allows an overhead of about 65% of the T4 wages, and effectively negates the taxpayer's use of the traditional method.

Redress options

Given the administrative policies CRA has recently adopted, we think the Tax Court of Canada (TCC) is currently the best venue for SR&ED matters where the main issue is scientific eligibility. Of course, a notice of objection remains useful for expenditure-related issues in an eligible claim. However, we find it is now taking 24 to 36 months for an appeals officer even to be assigned to an SR&ED objection.

Before the TCC process can begin, a notice of objection must have been served on CRA within 90 days of the date shown on the notice of assessment. In rare circumstances it might be possible to extend this deadline by up to a year. An appeal can be launched in the TCC on the 91st day after the notice of objection has been served, so long as CRA has not notified the taxpayer that it has made a decision on the objection within 90 days following the date it was served. In our view, the present objection backlog is so large, the objection will probably not even be acknowledged within 90 days.

Once the notice of appeal is filed, a trial can be secured within 24 months. However, most actions are resolved at a settlement meeting or conference.

While the TCC route looks promising, it still requires expert knowledge of the rules of procedure and the legislation. Also, the taxpayer must be prepared to present evidence as to why the claimed activity meets the legislated definition. This is critical in the TCC process because the onus of proof is on the taxpayer. The facts the CRA used to make the assessment are presumed correct.

Despite these caveats, we still think the TCC is the best option for resolving SR&ED disputes. Of course, it would be preferable not to have any disputes at all. We look forward to seeing the CRA realign its operating doctrines with the original objective of the SR&ED program — encouraging research and innovation in the private sector.

For an expanded version of this article, please visit www.camagazine.com/SR&ED2011.

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