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Bulletin

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Appealing an SR&ED Claim

New policies and court rulings mean tougher audits and more rejections Here's what you can do if you disagree with CRA …

In this bulletin we discuss what options exist when you disagree with CRA's assessment of your SR&ED claim. We review recent trends in SR&ED audits and discuss the pros and cons of notice of objection and tax court when seeking redress on SR&ED.

Over the last five years many taxpayers have found that the CRA is taking an increasingly narrow view of what qualifies as "eligible" SR&ED. In some cases taxpayers who have had a long history of successful claims and trouble-free audits are suffering severe cuts or outright denials of their entire claims. Also, CRA victories in two recent court tax court cases (Jentel and Murray Arlin Dentistry) could well set the stage for another round of clampdowns in the near future.

Changes in the SR&ED Administrative and Policy Environment

Looking ahead, in December 2012 CRA will release new versions of 20 key SR&ED policy guidance documents (including IC86-4), many of which codify substantially more restrictive positions with respect to the types of R&D activities and expenditures that qualify for the tax credit as compared to those currently in force. While these policy guidance documents do not have the force of law, they are an accurate roadmap of the criteria that CRA auditors will apply when assessing your claim.

The impact of these policy changes will be amplified by two additional factors:

First, CRA recently implemented a new set of internal work standard known as the SR&ED Claim Review Manual that sets out how SR&ED audits are to be conducted and defines relatively high standards on key matters such as what constitutes a "systematic investigation".

Second, the 2012 federal budget introduced changes to financial eligibility rules that will affect subcontractors, capital equipment and proxy overhead starting in 2013.

At Scitax, a significant and growing portion of our business is helping clients who come to us with SR&ED claims originally prepared either in-house or by other consultants that have been either wholly or partially denied by CRA. In an alarming number of these cases we find that CRA auditors have issued eligibility assessments which, while being aligned with these new policy directives, are not supportable by either the legislation or the court precedents. Unfortunately, when it comes to SR&ED, very few taxpayers or accountants are sufficiently familiar with the nuanced differences between law and administrative policy on SR&ED to recognize flaws in a CRA audit ruling.

Trends in SR&ED Audits

Here are a few of the more common strategies that CRA auditors use to justify cuts or reductions to SR&ED claims. Although many of these are aligned with positions set out in drafts of the 20 new policy documents to be released in December 2012, they are not at this point well supported in either the legislation or existing jurisprudence:

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 SR&ED claim is either reduced or disallowed altogether. With this strategy, almost any SR&ED claim can be broken down into pieces of "standard engineering," none of which has "sufficient scientific" content on its own to be eligible.

Misinterpretation of "experimental development": The vast majority of 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 specifically to broaden the scope of the legislation to encompass industrial R&D activity aimed at product development. However, CRA auditors are now too frequently importing the more restrictive "basic research and applied science" wording from paragraphs 248(1)(a) or (b) and disallowing the claim on the basis that the taxpayer has failed to demonstrate "an advancement in a field of science or technology," thus effectively subjecting taxpayers to pre-1985 rules.

Overly rigorous definition of "systematic investigation": CRA's new SR&ED Claim Review Manual instructs auditors that in order to qualify as SR&ED, the taxpayer should provide contemporaneous documentary evidence of having undertaken a five-step process of systematic investigation involving observation, formulation of an objective, description of the uncertainty, and formulation and testing of hypotheses. Such a formal process is unlikely except in academia or a dedicated research facility. Paragraph 248(1)(c) of the act makes provision for experimental development work as distinct from "basic" or "applied" scientific research.

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

The Income Tax 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. During the case, Justice Bowman described uncertainty as something not known to a qualified specialist in a given field. The term "technological obstacle" appeared in 2008 with the 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 would seem that CRA is now using the entire world as a benchmark and as such is setting the eligibility bar much higher than Justice Bowman did in 1997.

Failure to appreciate the difference between the traditional and proxy overhead methods:

There are two methods of claiming overhead costs as an SR&ED expenditure. The simplest and most commonly used is the "proxy method," whereby the overhead is deemed to be 65% of the claimed T4 wages. Alternatively, the taxpayer can elect to use the "traditional method," which involves a more complex and detailed accounting of actual overheads, but also allows for a broader scope of eligible activity than the proxy method. Under the traditional method for example, expenditures incurred for long-term planning of future SR&ED projects, human resource activities, preparation of the T661, certain clerical tasks, repairs, maintenance and supplies, all attract SR&ED. In most cases the proxy method provides the best result, but in certain situations, the traditional method is required to fully capture all the overheads.

We are seeing an increasing number of cases where the CRA auditor denies the expenditures for the "broader scope" activities, allows an overhead amount equivalent to about 65% of the T4 wages, and effectively negates the taxpayer's election of the traditional method.

Know Your Options – Notice of Objection or Tax Court?

Any taxpayer who has had SR&ED claims reviewed by the CRA over the past four years has probably suffered a substantial cutback in benefit eligibility. In some assessments, CRA might well have deliberately or inadvertently relied on administrative positions that are not supported by the legislation. Given the extent of SR&ED policy change presently underway, the likelihood of flawed assessments is increasing dramatically.

There are a number of redress measures available for taxpayers that have experienced a flawed assessment. Each involves a different estimated time frame for relief and a different cost. Given the administrative policies that CRA has recently adopted, we believe the Tax Court of Canada (TCC) is currently the best venue for the resolution of SR&ED matters where the main issue is "scientific eligibility."

Why not resolve your SR&ED dispute through notice of objection? The notice of objection process remains a useful route when it comes to specific expenditure issues in an otherwise eligible claim. However, based on our experience it is now taking 24 to 36 months for an appeals officer even to be

assigned to an SR&ED objection, and that is only the first step in the review process. Perhaps more significantly, appeals officers – who consider and decide the objection – are CRA employees, and when faced with a choice between the agency's administrative policy and the legislation, they will not typically overturn an assessment decision that is consistent with administrative policy.

The Tax Court Process

Before the tax court process can begin, a notice of objection must have been served on CRA within 90 days of the date shown on the most recent notice of assessment or re-assessment. If the notice of objection pertains to a tax year in which no tax was payable, it may be necessary to apply to CRA for a "loss determination" before filing the objection.

There are two time boundaries governing an appeal to the Tax Court of Canada:

- The earliest the appeal can be lodged to the tax court for a given tax year is 91 days after the notice of objection was served to the CRA for that tax year.
- The latest the appeal can be lodged to the tax court for a given tax year is 90 days after the CRA notifies the taxpayer of its decision with respect to the notice of objection filed for that tax year.

Once the notice of appeal is filed in the TCC, if necessary, a trial can be secured within 24 months if not sooner. However, the TCC route does not always mean a trial. There are a variety of TCC pre-trial procedures that taxpayers can use to get the government to consider an earlier resolution. For example, a settlement meeting can be arranged informally by simply asking the Department of Justice counsel assigned to the file to agree to hold one. Alternatively, the taxpayer can make a formal request that TCC schedule a settlement conference. The CRA is obliged to attend at such a conference with its counsel, and the conference is presided over by a judge of the court. The TCC has affirmed that it is committed to facilitating the settlement of appeals without resorting to a trial wherever possible and, indeed, most SR&ED-related actions are settled in exactly this way.

While the TCC route looks promising for redress of flawed SR&ED assessments, there are two caveats. First, even a settlement conference is a highly structured process that requires expert knowledge of the rules of procedure and the legislation. Second, like any court action, the taxpayer must be prepared to present evidence to support its position. In SR&ED cases this means documenting exactly why the claimed activity meets the legislated definition.

This is critical in the TCC process because the onus of proof – the obligation to establish the facts – is on the taxpayer. The facts that CRA relied on in making the assessment are presumed correct. That said, the burden of proof in TCC is the civil standard of a "balance of probabilities" and not the criminal standard requiring proof "beyond a reasonable doubt."

Despite these caveats, we still think the TCC is the best option for resolving SR&ED disputes, especially when it concerns scientific eligibility.

Conclusion

The first priority for any SR&ED claiming taxpayer is to avoid the need to appeal at all by submitting a correctly documented claim and ensuring that adequate records are kept to document the work. If CRA does decide to undertake an audit of the claim, it is important to ensure that the auditors' questions are answered and that any supplementary information that is requested be provided in a timely fashion – the audit process might seem onerous, but resolving issues will be vastly quicker and less costly than appealing afterwards. Even if an appeal seems inevitable, every attempt should be made to settle as much as possible during the audit stage and thereby limit the number of issues to be dealt with in the appeal.

If you do see a dispute with CRA auditors looming, we strongly recommend that you seek professional advice from Scitax as early as possible in the process in order to ensure that any information that you provide to CRA during the audit process will not undermine your chances of success in a subsequent Notice of Objection or Tax Court action.

Learn More

Jentel: Short and Sweet Guidance on SR&ED Eligibility – Canadian Tax Journal, Dec 2011
http://www.scitax.com/pdf/Jentel.Short.and.Sweet.Guidance.on.SR&ED.Eligibility.Canadian.Tax.Journal.Dec2011.pdf

CRA Publication: SR&ED Program Claim Review Manual
http://www.cra-arc.gc.ca/txcrdt/sred-rsde/pblctns/clm-rvw-mnl-eng.html

Scitax Bulletin #50: Canada's 2012 Federal Budget
http://www.scitax.com/pdf/bulletin.50.30-mar-2012.pdf

Murray Arlin Dentistry PC in Tax Court Canada Dckt #2010-3646(IT)I 12-Apr-2012
http://decision.tcc-cci.gc.ca/en/2012/2012tcc133/2012tcc133.html

Northwest Hydraulic Consultants Ltd. in Tax Court Canada Dckt# 97-531-IT-G 1-May-1998
http://decision.tcc-cci.gc.ca/en/1998/1998tcc97531/1998tcc97531.html

Jentel Manufacturing in Tax Court Canada 11-Jun-2010 Dckt #2008-3875(IT)G
http://decision.tcc-cci.gc.ca/en/2011/2011tcc261/2011tcc261.html

Jentel Manufacturing in Federal Court of Appeal Dckt #A-222-10 14-Dec-2011
http://decisions.fca-caf.gc.ca/fc-eliisa/highlight?language=EN&courtScope=fca&all=&title=Jentel&citation=&path=http://decisions.fca-caf.gc.ca/en/2011/2011fca355/2011fca355.html&query=eliisa.title%3AJentel

About Scitax

Scitax Advisory Partners LP is a Canadian professional services firm with specialist expertise in all aspects of planning, preparing and defending Scientific Research and Experimental Development (SR&ED) tax credit claims.

We offer a multi-discipline team of engineers, chartered accountants and tax lawyers to ensure that your SR&ED issues are covered from every angle.

While we normally work in concert with our client's existing accountants, our affiliated tax-dedicated chartered accounting firm – Cadesky Tax – is an expert resource for advice on any taxation matter such as may arise either during the planning and preparation of your claim or while dealing with CRA afterwards.

In addition to planning and preparing new claims, we also engage on claims that have been challenged by CRA auditors or that have received negative assessments for either scientific or expenditure eligibility. If a satisfactory settlement cannot be achieved with CRA at the local office level, we will appeal your assessment through either Notice of Objection or Tax Court of Canada procedures with the assistance of our affiliated firm of tax lawyers.

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