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Bulletin

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New TCC Ruling Favours Taxpayer on "Shop Floor" SR&ED

Taxpayer win highlights value of expert testimony on technological advancement and uncertainty ...

A new ruling by the Tax Court of Canada shows that with the aid of properly presented evidence on facts, taxpayers can win back SR&ED claims that CRA has rejected on scientific grounds.

On October 23, 2014, Justice Gaston Jorré allowed an appeal to the Tax Court of Canada (TCC) made by Abeilles Service de Conditionnement Inc. for tax year 2009. In addition to allowing all of the disputed SR&ED claims, Justice Jorré also allowed costs to the taxpayer which presumably would include a substantial portion of the legal fees plus the cost of the expert witness.

1. Background

Abeilles is located in the east end of Montreal and is 49% owned by General Electric. The company manufactures electric motors and other component subassemblies such as heating elements, control panels etc. used in household appliances. It has been making SR&ED claims since 2003. General Electric is not Abeilles only customer.

In its tax year 2009 Abeilles claimed total expenditures of approximately $400K in salaries and $5K in materials in respect of four R&D projects. All four of these projects concern improving the efficiency of automated manufacturing assembly processes versus development of the appliance product itself. Two of these projects were continued from prior tax years (in which they were allowed by CRA) and two were new projects started in 2009.

The case came to trial in July 2013 after CRA rejected the claim on grounds that none of the claimed work met the definition of SR&ED-eligible activity as set out in subsection 248(1) of the Income Tax Act. CRA's reasons for this rejection were that the R&D work undertaken in the claimed projects was standard practice and/or routine engineering with no technological uncertainty, no technological advancement nor any systematic investigation. CRA also cited a lack of contemporaneous documentation to corroborate the claimed work.

2. Findings on Expert Testimony

Expert witness testimony was highly significant to this case. Both the taxpayer and the Crown deployed experts with solid technological credentials: The expert witness called by the taxpayer is qualified with a Bachelor of Science degree in Pure Mathematics, a Masters in Aerospace Engineering and a PhD in Mechanical Engineering. The Crown's expert – the same CRA science advisor who originally assessed the claims – holds a Bachelor's degree in Chemical Engineering and a master's and a doctorate in Mechanical Engineering.

The court found that the Crown's expert (a CRA employee) was not sufficiently impartial after the taxpayer objected that the he was not "independent": As described in items [83, 91-97, 114] of the judgment, Justice Jorré notes that he had not adequately separated his role as a CRA auditor from that of an expert witness. At items [91, 95] the court observes the expert's "confusion" between his duty to uphold the very CRA administrative policies that formed the basis of the original assessment and his role at court which is to "clarify" technical evidence so that the court can make its decision.

The court also noted that when assessing the original filing, the CRA's expert had made an arithmetic error with respect to the duration of the production trials by confusing man-hrs of work effort with days of duration of the production trials which likely led to his viewing the claimed expenditures as excessive. See items [99, 109, 111-113].

3. Other Findings of Note

In addition to the independence of expert witnesses, this judgment provides the following with respect to SR&ED scientific eligibility. To access specific "items", access the judgment text via this URL: http://www.scitax.com/pdf/Dckt_2011-2054-IT-G_23-Oct-2014_Google_Translated.pdf

3.A Increases in productivity rate and flexibility of the process are acknowledged to constitute a "technological advancement". See items [131, 132, 133, 146, 162-164].

3.B Projects should be assessed as a whole and across multiple years, not "de-constructed" until no eligibility remains. See items [129, 135, 150-152].

3.C A diligent search by the taxpayer that shows a lack of information public domain with respect to how to achieve the outcome sought in the project, is adequate evidence of "technical uncertainty". See items [155, 177].

3.D The need to develop a commercially viable (i.e. cost effective solution) can be a factor of technological uncertainty with respect to SR&ED eligibility. See items [11, 137].

3.E Adjusting a manufacturing process can constitute "systematic investigation". See item [158].

3.F Technological progress in the manufacturing process equates to "advancement". See item [162].

3.G At item [154] the court accepted that the criteria of technological uncertainty can be met by the taxpayer not knowing how to achieve some goal that is very specific to its situation. This is a clear distinction from the statement *"Technological uncertainties may arise from shortcomings or limitations of the current state of technology that prevent a new or improved capability from being developed. In other words, the current state of technology may be insufficient to resolve a problem."* which appears in the definition of technological uncertainty given in CRA's current guidance document "Eligibility of Work for SR&ED Investment Tax Credits Policy". Although the CRA policy goes on to offer a broader definition of technological uncertainty framed in the context of knowledge available in the taxpayer's community, it is the "no shortcomings or limitations of the current state of technology" reasoning that CRA auditors all too frequently cite in their assessments.

3.H The court acknowledged that the requirement to develop a cost effective solution was a practical factor with respect to the criteria of technological advancement and technological uncertainty. See items [11, 156].

3.I While contemporaneous documents are needed to corroborate the occurrence of SR&ED, those documents need not have special content relating to SR&ED; it is sufficient to be able to cross link the work claimed to the timeframe of the claims. See item [11].

4. Lessons Learned

Initial reaction to this ruling in the SR&ED community is that it sets a new precedent that will cause CRA to suddenly "relax" its scientific eligibility criteria. While for reasons set out in "Conclusions" below we think this is unlikely, there are several lessons to be taken from it:

4.A Expert witness testimony is vital to any tax court litigation concerning the scientific eligibility of R&D work for SR&ED tax credits.

4.B In the courtroom, taxpayers must vigorously challenge the independence (and impartiality) of expert witnesses brought forth by the Crown on behalf of CRA. In Abeilles, the taxpayer's legal counsel objection to the CRA expert was a critical turning point for the trial – see item [114]. One example of a taxpayer's failing to raise and press such objection to the court can be seen in item [11] of Zeuter Development Corporation v. The Queen TCC 31-Oct-2006 wherein the court ruled against the taxpayer and denied the appeal.

4.C SR&ED cases turn on a mix of "fact" (what happened) and "law" (the rules of the legislation and court precedents). It is important to understand that the "law" is separate and distinct from whatever policies or guidelines CRA publishes to guide it's auditors. While CRA's published policies are generally well aligned with the law, there are sometimes significant differences between the two. As noted by Justice Jorré in items [89-91], the court does not want the facts or the law viewed through the lens of CRA policy. Abeilles is a good illustration of how taxpayer's can win tax court litigation of SR&ED matters by properly addressing both the facts and the law.

4.D One of the key areas where CRA administrative policy seems to diverge from legislation and jurisprudence is with respect to the difference between SR (scientific research), AR (applied research) and ED (experimental development) each of which has its own definition in subsection 248(1) of the Income Tax Act; the primary difference between these three is that only SR and AP make a requirement for the creation of scientific knowledge whereas the requirement for ED is technological advancement. The CRA has recently modified the SR&ED claim form T661 such that the same responses are required for SR, AP and ED; furthermore CRA auditors are writing assessments citing lack of scientific knowledge creation as grounds for denying claims. In items [163, 164] of Abeilles, Justice Jorré distinguishes that the requirement for ED (experimental development) is "technological progress" versus the "advancement of knowledge" which was the bar understood (and presumably applied) by the CRA auditor. See item [124].

4.E The taxpayer was able to satisfy the court on the "technological uncertainty" criteria by showing that it had undertaken due diligence by means of searching the internet and consulting knowledgeable persons within the orbit of its own organization. See items [155, 177].

4.F Taxpayers can recover costs (legal fees, payments to expert witnesses etc.) associated with the litigation through the tax court process. However the extent of such recovery is determined by various factors (including whether or not a settlement offer was made) which are beyond the scope of this bulletin.

5. Conclusions

Many speculate that the Abeilles judgment will trigger a wholesale change in the scientific eligibility criteria that the CRA and the courts use to assess SR&ED claims: It won't. CRA seems thoroughly committed to the new policy doctrine it released in December 2012 and there is not enough "new" content in Justice Jorré's ruling to overturn the existing benchmark rulings (i.e. Jentel, CW Agencies) that have been affirmed by the Federal Court of Appeal.

While Justice Jorré wrote (item [143]) that the five criteria for science eligibility that the FCA has affirmed are "not absolute", he still referenced all of them in his judgement. He also (items [130, 157]) reconfirmed the link between systematic investigation and scientific method. What he did do was provide additional (and practical) clarity with respect to how those criteria of "law" map onto the facts of an SR&ED case. His writings on what constitutes "technological uncertainty" (items [142, 177]) and "technological advancement" (items [163, 164]) give a significantly broader and more clear interpretation of these criteria than presently exists in either CRA administrative policies or previous jurisprudence.

Finally this case reinforces the value of expert witnesses in SR&ED cases and reminds taxpayers to press for independence of any such witnesses brought forward by the CRA. It remains to be seen if in light of this ruling, the CRA continues to deploy its own employees as experts in the tax court.

LEARN MORE

Tax Court Canada judgment for Abeilles service de conditionnement inc. for tax year 2009: the French language original and verbatim translation to English by Google Translate:
http://www.scitax.com/pdf/Dckt_2011-2054-IT-G_23-Oct-2014_Google_Translated.pdf

Tax Court Canada and Federal Court of Appeal judgments for Jentel Manufacturing Ltd. for tax year 2005:
TCC: http://www.scitax.com/pdf/Dckt_2008-3875-IT-G_11-Jun-2010.pdf
FCA: http://www.scitax.com/pdf/Dckt_A-222-10_14-Dec-2011.pdf

Tax Court Canada judgment for Zeuter Development Corporation (see item [11] re taxpayer's failure to object to CRA's expert):
http://www.scitax.com/pdf/Dckt_2005-3306-IT-I_31-Oct-2006_WARNING_Informal_Procedure_No_Precedent.pdf

Article *Tax Court Canada Jentel Short and Sweet Guidance on SR&ED Eligibility* – Canadian Tax Journal December 2011:
http://www.scitax.com/pdf/Jentel.Short.and.Sweet.Guidance.on.SR&ED.Eligibility.Canadian.Tax.Journal.Dec2011.pdf

CRA's guidance document *Eligibility of Work for SR&ED Investment Tax Credits Policy* (current at date of this publication):
http://www.cra-arc.gc.ca/txcrdt/sred-rsde/clmng/lgbltywrkfrsrdnvstmnttxcrdts-eng.html

Definition of SR&ED per Subsection 248(1) of the Income Tax Act (current at date of this publication):
http://www.scitax.com/pdf/Definition.of.SR&ED.Sec_248_1.pdf

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 and Associates LLP – 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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