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Has Tax Court Set New Bar for SR&ED Documentation?

Latest ruling could curtail oral testimony as alternative to documentation...

On June 8, 2015, Justice Randall S. Boccock of the Tax Court of Canada in Edmonton upheld CRA assessments whereby software as service provider Highweb & Page Group Inc. was denied SR&ED ITCs on R&D expenditures of \$25K in TY2007 and \$38K in TY2008.

This denial amounted to Highweb's entire claim for TY2007 and about 85% of its claim for TY2008. The claims pertained to development of software that provides a suite of web-based services such as CRM, document management and business process workflow.

The claimed work in TY2007 was mainly aimed at making the existing system "portable" across multiple software platforms using a J# code base. In TY2008 this same work continued plus some additional new work on investigating differences in how in how .NET and J# handle certain query processes.

Appendix 1 of the ruling (which occupies 11 of the 22 pages) provides some interesting insights into CRA's thinking with respect to what constitutes "technological advancement" in the context of commercial software applications. In short, CRA ruled that the only aspect of the work (about 10%) that qualified as SR&ED pertained to development of code to provide data mapping of QueryBeans between .NET and Java. CRA ruled that the remaining 90% of the work consisted of applying the techniques that a trained IT professional would perform under the same circumstances, i.e. writing code within the limits of the software. The only work CRA assessed as eligible is highlighted in bold type on page 8 of Appendix 1 (page 18 of the ruling).

At item [19] of the ruling, the court rejected the argument of "system level uncertainty" that is so often cited in support of claims for software development on grounds that: "The Appellant did not tender sufficient concurrent documentation or records to show that the challenge of system and internet incompatibility (beyond STA2 - Phase II) was analyzed sufficiently to establish a need for technological experiments or investigation."

In items [18] and [19], two new terms are introduced into the lexicon of SR&ED terminology: "knowledge gap" and "technological gap" which have not been seen before and may well find their way into future editions of CRA policy documents. Unlike the now banished term "technological obstacles" which had no basis anywhere, CRA could point to this ruling as justifying their use.

However, the ruling is most severe with respect to setting an elevated requirement for technical supporting documentation to corroborate the claimed work. To paraphrase Justice Boccock's writing at item [23]: although it may well be that some incremental technological uncertainty and technological advancement occurred, there was "manifest disregard and non-compliance with the essential and well-known procedural requirements of the scientific method and its fundamental requirement for detailed and current recordkeeping in order to document the technological uncertainty, the hypotheses, the experiments, the results, and achievements."

This statement on record keeping at item [23] is more explicit (and restrictive) than any existing. Extant jurisprudence generally leaves the door open a crack with phrasing such as appears in item [28] of Zeuter Development (TCC 2006) which reads the "only reliable method of demonstrating that scientific research was undertaken in a systematic fashion is to produce documentary evidence." The Highweb ruling omits the escape clause "only reliable" which has allowed the court to accept oral testimony of a "credible witness" in the absence of documents such as supported a taxpayer win on both science and delivery of tax forms at item [72] of TCC ruling on 6379249 Canada Inc. in March 2015 (link below).

Fortunately this is a ruling under the Tax Court's Informal Procedure, so technically it sets no precedent. However, it contains many new phrases that may well turn up in future general procedure rulings which will set precedents – and as of this writing there are some 75 or so pending SR&ED cases in which tax court jurists will have the opportunity to do so.

Learn More

Tax Court Canada judgment for Highweb and Page Inc. June 2015 for tax years 2007 and 2008 (WARNING informal procedure, no precedent value):

http://www.scitax.com/pdf/Dckt_2014-1703-IT-I_8-Jun-2015.pdf

Tax Court Canada judgment for Zeuter Development Corporation Inc. October 2006 for tax years 2000, 2001 and 2002 (WARNING informal procedure, no precedent value):

http://www.scitax.com/pdf/Dckt_2005-3306-IT-I_31-Oct-2006.pdf

Tax Court Canada judgment for 6379249 Canada Inc. March 2015 for tax years 2009 and 2010 (see item [72] re oral testimony of credible witness):

http://www.scitax.com/pdf/Dckt_2012-3634-IT-G_31-Mar-2015.pdf

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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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