Scitax™
Scitax Advisory Partners LP
R&D Tax Credit Specialists

Bulletin

DIRECTORS:
David R. Hearn, Managing Director
Michael C. Cadesky, BSc, MBA, FCA

NUMBER 46 | JUNE 6, 2011

Significant New Tax Court Canada Ruling on SR&ED?

Jentel clarifies the need to prove the "technological risk or advance" – for better or worse

On May 11, 2011, Justice Steven K. D'Arcy dismissed an appeal to the Tax Court of Canada ("Tax Court") made by Jentel Manufacturing Ltd. of Calgary for its SR&ED claim for tax year 2005. Our "Learn More" feature at the end of this bulletin gives a URL at which you can read Jentel and two other important court rulings involving SR&ED.

Jentel is a concise, clearly written judgement that confirms the meaning of "systematic investigation" that has been established in several earlier court rulings. It also restates the need for advancement and uncertainty as a pre-requisite for attracting SR&ED benefits to expenditures made in the investigation.

Is it there anything new here? Not really. Is it significant to SR&ED claimants? Absolutely. Yet, at the end of the day, Jentel might be as important, if not more important to read as an illustration of the impact of Tax Court process, as it is about defining SR&ED.

Background

In his reasons for judgement, Justice D'Arcy cites *Northwest Hydraulics*, which is generally acknowledged to be a seminal decision that has shaped both administrative policy and jurisprudence in relation to SR&ED. He also cites *C.W. Agencies*, which judgement also cites *Northwest Hydraulics*, and with approval. This is important because *C.W. Agencies* is a decision by the Federal Court of Appeal, which is a level above the Tax Court. The Tax Court is the trial court in Canada. An appeal from a Tax Court decision is taken to the Federal Court of Appeal.

Both *Northwest Hydraulics* and *C.W. Agencies* are lengthy cases and not particularly easy to read – especially for persons outside the legal profession. This is largely because these cases involve multiple projects with multiple different scientific issues. *Jentel*, on the other hand, involves a small number of relatively simple projects that were described to the court in a Statement of Agreed Facts ("SAF"). This makes it particularly useful as readily accessible guidance to anyone with an interest in SR&ED – both taxpayers and CRA.

So, what happened in *Jentel*? Simply put, a company that manufactures moulded plastic products made an SR&ED claim for expenditures incurred for experimental development related to improving its modular storage bin system product. As described in the SAF, the work undertaken involved determining geometric shapes to provide snap fit closures and evaluating the strength / weight properties of various materials shaped by means of different manufacturing processes for this application. The CRA reassessed to deny Jentel's claims, and Jentel instituted an appeal to the Tax Court of Canada.

Justice D'Arcy's comment "I found both witnesses to be credible. However, I have placed no weight on Mr. Leong's testimony as most of his evidence was, in my view, opinion evidence." [3] is intriguing and a tad cryptic. Mr. Leong was the CRA's science / technical advisor. Since all expert testimony is by nature "opinion evidence" it is not clear whether the court found something lacking in Leong's credentials or that the Crown failed to undertake the requisite procedures to qualify him as an expert witness. It is notable that over the years, CRA has seldom called its own SR&ED science auditors in court proceedings.

The Result

The court dismissed the taxpayer's appeal, finding that none of the activities for which expenditures were claimed qualified as eligible for SR&ED. The judgement makes two important findings:

> First, the court acknowledged and accepted that, as stated in the SAF, the taxpayer had undertaken a "systematic investigation" and that adequate records had been kept to support the investigation [5].
>
> Second, the court ruled that although a systematic investigation had been undertaken, no evidence was presented to show that it had been undertaken in an attempt to achieve a technological advancement [28] that involved a technological uncertainty [16]. In summary, Justice D'Arcy's finding that the taxpayer must lead evidence to prove both that there was a scientific investigation and that the investigation involved an attempt to achieve a technological advancement, is not really new in the jurisprudence on SR&ED – this was the finding in *C.W. Agencies*. What is new in *Jentel* is the level of clarity achieved in the judgement of this principle – for better or worse.

So why is this ruling significant to taxpayers who seek to claim SR&ED?

What It Does

The judgment highlights the potential danger of using a Statement of Agreed Facts in tax litigation. An SAF records the facts that both the appellant taxpayer and the Crown agree on, so that there is no need to lead evidence to prove these facts. Although this can make the trial less expensive and less risky, the downside is that it can limit the scope of information available in the proceedings and there is no guarantee that the judge will interpret those facts in the way you expect.

While the SAF in *Jentel* was useful to establish the fact of an adequately documented systematic investigation, Justice D'Arcy is clear in stating that he did not have evidence of an attempt to achieve a technological advance before him. He is equally clear in stating that the two sources of evidence that he relied on in making his decision were the SAF and the testimony of the owner and president of *Jentel*, and it appears from the judgement and the parts of the SAF that are quoted in the decision, that the SAF and the evidence of the company's president focused on the need to improve the form of the product, rather than the challenges inherent in changing the form.

We wonder why factors such as failures due to unanticipated changes in the behaviour properties of the materials during thermo-forming were never raised in evidence as the technical uncertainty; One would expect to see at least some mention of things like flexural modulus or tensile strength mentioned in relation to specific failure modes observed in various iterations of experimental prototype products. The absence of this type of evidence suggests that the reliance on the SAF was a double-edged sword. While the SAF allowed certain facts to be established quickly and cheaply, it did not go far enough to establish the technological advance attempted, which is what was needed to win the trial.

Unfortunately, what we fear may happen is that *Jentel* may be used by CRA auditors to clamp down even more aggressively on SR&ED claims for "shop floor" work in general and mould/ die-forming claims in particular.

What It Doesn't Do

There is nothing here that vindicates CRA's new definition of technological uncertainty / obstacle as "shortcomings and/or limitations of the current state of technology that prevented you from developing the new or improved capability". This is the CRA's current administrative replacement for the definition established by Justice Bowman in his *Northwest Hydraulics* ruling, which was that technological uncertainty is "something that exists in the mind of the specialist" … "that cannot be removed by routine engineering or standard procedures".

Neither is there anything that would support a requirement that a claim for "experimental development" as this term is defined in paragraph "c" of the definition of SR&ED in subsection 248(1) of the Act must entail an advancement of scientific knowledge (as is required under paragraphs "a" and "b" of this subsection).

Conclusion

In our view the negative outcome in this case is largely attributable to two factors:

> First, the apparent reliance on a Statement of Agreed Facts, which can limit the scope of information that is presented to the court. It is the Tax Court judge who makes findings of fact from the evidence presented. The Tax Court judge's finding of fact generally cannot be changed on appeal. Reliance on a Statement of Agreed Facts at the Tax Court can be particularly dangerous in SR&ED cases where there is typically a large set of complex facts that must be clearly presented, often in an historical timeline.
>
> Second, the taxpayer chose not to present expert evidence concerning the technological uncertainty it was trying to resolve. While presenting expert testimony can be costly, it is essential in an SR&ED appeal because in Tax Court Canada proceedings the onus of proof – the obligation to establish the facts – is on the taxpayer.

In paragraph [10] of the *Jentel* ruling, Justice D'Arcy's writes: "In my view the work involved the Appellant using *existing* manufacturing processes and *existing* materials in an attempt to improve its *existing* product. This involved routine engineering and standard procedures" [*emphasis added*].

Perhaps more than any other court ruling on SR&ED, *Jentel* highlights the requirement that SR&ED claims have to be made in respect of specific problems or challenges that are outside the bounds of what a competent professional would be expected to know. Unless the work is truly "new to the world", the taxpayer has to lead evidence to clearly show how existing methods and standard practices failed to achieve the objective, and thus gave rise to the need for a systematic investigation.

LEARN MORE

"Appealing an SR&ED Claim", *CAmagazine* June-July 2011-06-02
http://www.camagazine.com/archives/print-edition/2011/june-july/upfront/value-added/camagazine49716.aspx

Jentel Manufacturing Ltd. v Her Majesty The Queen, 2001 TCC 261, TCC docket 2008-3875(IT)G
http://decision.tcc-cci.gc.ca/en/2011/2011tcc261/2011tcc261.html

C.W. Agencies Inc. v H.M.Q., 2002 D.T.C. 6740 (Federal Court of Appeal)
http://decisions.fca-caf.gc.ca/en/2001/2001fca393/2001fca393.html

Northwest Hydraulic Consultants v H.M.Q., 98 D.T.C. 1839 (Tax Court of Canada)
http://decision.tcc-cci.gc.ca/en/1998/1998tcc97531/1998tcc97531.html

About Scitax

Scitax Advisory Partners is a professional services firm with specialist expertise in Scientific Research and Experimental Development (SR&ED) tax credits.

We offer a team of senior technical consultants all of whom have ten or more years experience in the SR&ED field. All Scitax technical consultants have engineering or science backgrounds and at least twenty years industry experience in their particular field prior to consulting.

Our primary function is to produce a technical submission package that most effectively communicates your SR&ED claim to CRA in a way that highlights eligibility and expedites processing. We assist you in identifying and preparing all required documentation including project technical descriptions, cost schedules, and everything else your tax preparer needs to file the claim. Once your claim is filed, Scitax will advocate for you with CRA and help you negotiate fair settlement of your claim.

While we normally work with our client's existing tax advisors, our affiliated firm Cadesky and Associates can provide a full package of tax services if required.

DIRECTORS:
David R. Hearn, Managing Director
Michael C. Cadesky, BSc, MBA, FCA

Scitax Advisory Partners LP
TD Centre, 77 King Street West, Suite 2401, Toronto ON | 416-350-1214 | www.scitax.com