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LES ABEILLES – A TAXPAYER FRIENDLY SR&ED DECISION

Overview

The Scientific Research and Experimental Development ("SR&ED") Tax Incentive Program was established in 1985 and remains the largest source of federal support for research and development. Most industrialized nations have similar programs and subsidies in order to compete globally. In the context of patentable intellectual property, novelty and utility are considered by reviewing the state of the art in the industry. In the SR&ED context, novelty and utility are considered on the basis of knowledge reasonably available in the public domain. As a result, unlike in the case of patentable intellectual property, it is possible to have similar SR&ED claims by multiple claimants, since claimants might not know what other claimants are claiming for.

The SR&ED program is administered by the Canada Revenue Agency ("CRA") according to the provisions of the *Income Tax Act* (Canada) ("ITA"). Virtually every province and territory also has a SR&ED program and most rely on the federal definitions contained in the ITA. The Compliance Programs Branch of CRA is responsible for administering the program through its specialized SR&ED Directorate.

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Scientific research and experimental development is defined for income tax purposes in subsection 248(1) of the ITA as systematic investigation or search that is carried out in a field of science or technology by means of experiment or analysis and that is

(a) basic research, namely, work undertaken for the advancement of scientific knowledge without a specific practical application in view,

(b) applied research, namely, work undertaken for the advancement of scientific knowledge with a specific practical application in view, or

(c) experimental development, namely, work undertaken for the purpose of achieving technological advancement for the purpose of creating new, or improving existing, materials, devices, products or processes, including incremental improvements thereto.

In applying this definition in respect of a taxpayer, it also includes work undertaken by or on behalf of the taxpayer with respect to engineering, design, operations research, mathematical analysis, computer programming, data collection, testing or psychological research, where the work is commensurate with the needs, and directly in support, of work described in paragraph (a), (b), or (c) that is undertaken in Canada by or on behalf of the taxpayer,

"Scientific research and experimental development" does not include work with respect to:

(a) market research or sales promotion,

(b) quality control or routine testing of materials, devices, products or processes,

(c) research in the social sciences or the humanities,

(d) prospecting, exploring or drilling for, or producing, minerals, petroleum or natural gas,

(e) the commercial production of a new or improved material, device or product or the commercial use of a new or improved process,

(f) style changes, or

(g) routine data collection.

While definitions in the ITA related to the SR&ED program appear clear, as always, the devil is in the details. The two major points of contention between CRA and claimants revolve around what constitutes SR&ED and the level of supporting documentation required. One of CRA's major policy directives was the preparation and issue of their Claim Review Manual for Research and Technology Advisors (the "Manual") in the summer of 2010, with subsequent updates through to 2014. CRA has cited various tax cases to support their policies as set out in the Manual.

That said, there is jurisprudence supportive of claimants' positions that put in doubt some of CRA's current policies and administration of the SR&ED program. The recent Tax Court of Canada decision in *Les Abeilles Service de Conditionnement Inc. v. The Queen* ("*Les Abeilles*"), raises further doubts with respect to several of CRA's policy and administrative positions.

The *Les Abeilles* Decision

In its 2009 taxation year, Les Abeilles Service de Conditionnement Inc. ("Les Abeilles") made four claims for SR&ED in respect of four distinct projects. Three of the projects related to improving productivity and efficiency in the assembling of dryers, while the fourth project related to synchronizing and accelerating certain printing services. The majority of the expenditures giving rise to the claims related to salary expenses incurred in tests undertaken on Les Abeilles production lines.

In denying Les Abeilles' claims, CRA took the position that the activities did not have scientific or technological uncertainty, systematic investigations were not carried out and the activities did not amount to experimental development. Les Abeilles appealed CRA's position to the Tax Court of Canada. In finding for the taxpayer, the Court made several helpful comments.

a. Expert Witnesses

In support of their positions, the taxpayer and the Crown each put forward an expert witness. Justice Jorré gave little weight to the testimony of the Crown's expert, Mr. Kooi, who was also the scientific advisor to CRA in the audit, on the basis that his testimony was not sufficiently impartial and he made factual errors. Justice Jorré noted that the expert report indicated confusion between the role of scientific advisor and the role of expert witness. In support of this finding, the Court noted that Mr. Kooi appeared to be guided by CRA guidelines, including certain standards for proving facts; while natural to do so in his role as scientific advisor, it was not appropriate in his role as expert witness. As noted by the Court, the role of the expert witness is to express an opinion on the basis of fact, not to determine the facts – that is the role of the Court.

This finding highlights the importance of challenging expert witnesses and potentially calls into question CRA's practice of using its internal staff as expert witnesses. Where a taxpayer objects to a reassessment, CRA will likely rely on its internal staff for advice. Such advice will likely be viewed differently at the objection stage by CRA, where, for example, commentary on the claimant's adherence to stated CRA policies and procedures may be viewed as more relevant, than it will, in light of Les Abeilles, on an appeal to the Tax Court of Canada.

b. What constitutes "scientific research and experimental development"

The Court cited the previously accepted five criteria for determining what constitutes SR&ED set out in *Northwest Hydraulic Consultants Limited v. Her Majesty the Queen* ([1998] DTC 1839) ("*Northwest Hydraulic Consultants*"), but held that these criteria are helpful considerations, not absolutes. Generally, the five criteria (also referred to in the industry as the "five questions") are:

(i) Was there scientific or technological uncertainty that cannot be removed by normal procedures or routine engineering?

(ii) Did the claimant make assumptions specifically designed to reduce or eliminate this scientific or technological uncertainty?

(iii) Were scientific methods employed in this process?

(iv) Did the process result in technological progress?

(v) Is there a detailed account of the steps taken and the results of the tests carried out?

In loosening the bounds of these five criteria, Justice Jorré noted, for example, that the research does not have to lead to technological progress for it nevertheless to be SR&ED. Work undertaken in the interest of technological progress, even if it fails, can still qualify. This makes eminent sense as work in an area of scientific or technological uncertainty will not always be successful. Such work is nevertheless scientific research.

WORK UNDERTAKEN IN THE INTEREST OF TECHNOLOGICAL PROGRESS, EVEN IF IT FAILS, CAN STILL QUALIFY.

The Court further recognized that increasing the productivity and flexibility of a process can constitute "technological advancement". In determining whether there has been experimental development, Justice Jorré stated that one must consider the project as a whole rather than looking at each individual test or step separately. This finding contrasted with the approach taken by CRA.

In considering the issue of scientific or technological uncertainty, the Court noted that the taxpayer had sought ready-made solutions in talking with suppliers and by performing internet searches. Finding none, Justice Jorré held that there was sufficient scientific and technological uncertainty. Based on the substantial documentary evidence, the Court had no difficulty in finding that the taxpayer had applied a scientific approach to arrive at a solution. As such, Justice Jorré held that the SR&ED claims were valid. Interestingly, in arriving at his conclusion, Justice Jorré noted that the costs involved in performing the research were relatively modest.

Comments and Conclusion

The *Les Abeilles* decision appears to ease the criteria enunciated in *Northwest Hydraulic Consultants* and provides helpful guidance on their application.

As mentioned above, Justice Jorré held that research that fails to result in progress may nevertheless be scientific research. The Court also accepted internet searches as evidence that scientific or technological uncertainty existed. As a result, not

knowing how to achieve project goals may give rise to scientific or technological uncertainty. It should be noted that in this case, the taxpayer had maintained substantial documentary evidence of the steps that had been taken and the methods employed in the course of their research and development. The decision highlights the importance of maintaining such documentation.

CRA is now on notice that in reviewing an application, the whole project must be considered instead of analyzing each individual step. This is constrained somewhat in that research and development must have occurred in the particular year for which the claim is being made, even in the case of a particular project that may take multiple years from start to finish.

Given these findings and guidance on the application on the *Northwest Hydraulic Consultants* criteria, CRA's policies and administrative positions regarding SR&ED claims will hopefully be revised.

The decision in *Les Abeilles* presents an opportunity for taxpayers whose claims were previously denied, or partially denied, based on prior case law and current CRA policy, possibly to have their claims revisited. Generally, a corporate taxpayer has 90 days from the date of the Notice of Reassessment to file an objection to CRA to have the reassessment reconsidered. In certain circumstances, CRA may grant a taxpayer's request to be allowed to object after this 90-day period provided that the request is made within one year following the expiry of the 90-day period. Comparable rules generally apply for appeals to the Tax Court of Canada by claimants who were unsuccessful in their objection.

CRA MAY GRANT A TAXPAYER'S REQUEST TO BE ALLOWED TO OBJECT AFTER THIS 90-DAY PERIOD.

Our tax team and strategic partner SR&ED experts have the expertise to assist claimants making SR&ED claims and those who have recently been denied their SR&ED claim. We encourage you to contact Gerald Courage (416-595-8163, gcourage@millerthomson.com) or David Woolford (416-595-8180, dwoolford@millerthomson.com) at Miller Thomson LLP, or Brian Hartman (519-212-4694, bhartman@busimpgroup.ca) at Business Improvement Group Inc. to discuss your situation and take action where appropriate.

Postscript

At a recent CRA–Industry SR&ED discussion in Edmonton, Alberta, Hélène Marquis, National Director SR&ED Technical, stated that CRA will be revising the first two of the "five questions" as follows:

- Question 1 will be revised to remove the comparison to "standard practice" by deleting the last half of the sentence so that it will read, "Was there a scientific or a technological uncertainty?"
- Question 2 will be revised to refer to the "total discipline of the scientific method" to more closely reflect a process that occurs in Industry, such that the questions will read, "Was the adopted procedure consistent with the total discipline of the scientific method, including formulating, testing, and modifying the hypotheses?"

Ms. Marquis also stated that CRA recognizes that most efforts that lead to a SR&ED claim may be "routine engineering" in nature and CRA has to continue to review claims from a high level. She mentioned that determining "standard practice" has been very difficult for CRA to nail down especially where CRA's technical reviewer is not entirely familiar with the particular industry.

It will likely take time for the above changes to be reflected in CRA's written policies and procedures. In the meantime, claimants now have more leeway in their recent past, current and future SR&ED claims.

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