

Guide to Conducting a Scientific Research and Experimental Development Review

Part 1: The Technical Review

Prepared by the SR&ED Directorate,
Canada Customs and Revenue Agency
in cooperation with industry partners and stakeholders

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Chapter 1

An Overview

The purpose of this document is to provide a single source of reference to consultants under contract to the Canada Customs and Revenue Agency (formerly Revenue Canada) who are responsible for reviewing the eligibility of work submitted for treatment as Scientific Research and Experimental Development (SR&ED) under subsection 248(1) of the Income Tax Act (ITA). It outlines the objectives, the process and the reporting requirements of an evaluation of eligibility. In addition, this document describes the roles of the Canada Customs and Revenue Agency (CCRA) SR&ED staff and consultants involved during the review process. The document introduces issues that may arise during a review, and provides guidance with respect to communications between the reviewer and the claimant.

The SR&ED Program

The SR&ED program is a tax incentive initiative of the federal government designed to support and foster science and technology, particularly research and development (R&D) conducted by companies, in Canada. It represents the largest single source of government R&D funding to Canadian industries and is widely recognized as a very important program.

In the mid to late 1990's, nearly 12,000 Canadian companies claimed approximately \$1.4 billion in investment tax credits (ITCs) each year through the SR&ED program. Small and medium-sized businesses generally represent about three-quarters of the total number of claims and these participants receive approximately 30 per cent of the ITCs under the program in any given year.

The Department of Finance is responsible for the formulation of the tax policy relating to the SR&ED program. CCRA is responsible for the administration of the SR&ED program. As a program of the CCRA, the SR&ED directorate's objective is to promote and deliver with consistency, certainty and timeliness, to all SR&ED performers, the tax-based incentive designed to stimulate SR&ED work in Canada. For more information about the structure of the SR&ED program, please refer to the "Information Guide to the SR&ED program" or Appendix A.

SR&ED Claimants

CCRA's claimants under the SR&ED program can generally be categorized into two primary groups.

Refundable Claimants

The SR&ED program delivers refundable investment tax credits to Canadian controlled private corporations (CCPCs). Corporations that are CCPCs throughout a taxation year, with taxable income of \$200,000 or less in the preceding taxation year, qualify for a 35% ITC on the first \$2,000,000 of SR&ED expenditures incurred in the year. The portion of this ITC related to current expenditures is fully refundable. The portion related to capital expenditures is partially refundable. ITC is earned at 20% on amounts above \$2,000,000. The ITC earned at 20% is partially refundable. These claimants can also deduct 100% of current and capital expenditures incurred for SR&ED carried on in Canada, or defer claiming these expenditures to a future year. For these claimants, CCRA's objective is to complete the reviews within 120 days of receiving a complete claim.

Non-refundable claimants

The SR&ED program also provides a non-refundable investment tax credit for claimants who do not qualify for refundable tax credits. These claimants are usually larger corporations. These claimants can deduct 100 per cent of current and capital expenditures incurred for SR&ED carried on in Canada or defer claiming these expenditures to a future year. Generally, qualified SR&ED expenditures will be eligible for an investment tax credit of 20 per cent. The objective for completing the reviews for non-refundable claims is within one year of receiving a complete claim.

Claims may be processed in advance of these timeframe objectives if a full review is determined not to be required by SR&ED program staff.

CCRA's SR&ED Review Team

The SR&ED program is delivered by CCRA's technical and financial review staff, who are located in offices across Canada. Functional responsibility for the program rests with the program's headquarters staff, which provides program coordination, and financial, technical and administrative policy directives.

The technical and financial review staff members in the field offices work closely as a team to provide fair and timely tax credits and refunds to SR&ED claimants. This is essential to ensuring that the program remains an effective incentive for companies to invest in scientific research and experimental development.

SR&ED Criteria

The work that is being claimed as SR&ED must meet the definition of SR&ED in subsection 248(1) of the ITA (Appendix E). To help establish this, three criteria are used: scientific or technological advancement, scientific or technological uncertainty, and scientific and technical content.

The SR&ED program is primarily legislated by sections 37, 127, 127.1, 164 and subsection 248(1) of the ITA and sections 2902 and 2903 of the Income Tax Regulations. This legislation defines the scope of SR&ED work and expenditures.

Information Circular IC86-4 (Appendix B) provides the eligibility guidelines and criteria of the SR&ED program in detail. There are also guidelines available for specific industries (Appendix C).

The Review Process in Brief

The review of a SR&ED claim takes place along two tracks. The work is evaluated to determine if it meets the criteria to be eligible as scientific research and/or experimental development. The costs associated with the projects are reviewed to ensure they are eligible as SR&ED expenditures. The sequence of activity will vary from case to case, but the technical and financial staff work closely together on each case to ensure consistency and fairness throughout the entire review process.

A CCRA financial reviewer examines the costs associated with the claimed projects, whereas a CCRA science advisor (Science Advisor) or a consultant engaged by CCRA reviews the technical work.

The consultant must have the credentials, relevant SR&ED experience and the appropriate security clearance needed to evaluate the scientific or technological work outlined in the claim, and is bound by the rules of confidentiality (see Chapter 3). An understanding of the business context of the claimant's SR&ED efforts is also essential. CCRA will not use consultants that are in a conflict of interest and requires that consultants that are hired declare all situations that could reasonably be regarded as constituting a conflict of interest (e.g. relationships with competitors, investment interest).

The Science Advisor is responsible for the management of the consultant and maintaining the objectivity of the review. The consultant's role is to provide an opinion on eligibility of the technical work claimed, drawing on their expertise in that field. In performing this role, they are to be governed by the principles of objectivity, fairness, and materiality. The regional science manager (Regional Science Manager) has overall responsibility for the technical component of the SR&ED reviews.

Chapter 2

The SR&ED Review Process

The key to completing a clear and consistent review in a timely manner is effective teamwork among the entire CCRA review team assembled to undertake the review as well as the cooperation of the claimant.

Although each SR&ED claim is unique in terms of scope and content, the eligibility review of SR&ED claims from a scientific or technological perspective usually consists of some combination of the seven steps outlined below. The respective responsibilities of CCRA SR&ED staff and consultants are also described.

Step 1 – Information Collection and Review by SR&ED Staff

The first step to conduct an eligibility review is for the SR&ED staff to assemble, organize and analyze all the relevant information submitted as part of a SR&ED claim. This includes reviewing:

- the completed T661 SR&ED Claim(s), including project descriptions, technical information, and any other attachments, for the period(s) under review to ensure that the claimed period and costs of each claimed project are clear;
- SR&ED reports from previous years to understand the multi-year aspect of each project claimed, and the nature of the claimant in order to achieve the objectives of the program.

Primary reference material used by reviewers include T661 Claim Guide (Appendix D), Information Circular 86-4 (Appendix B) and Industry Specific Application Guidelines (Appendix C).

Based on the project descriptions, the SR&ED reviewer should be able to:

- determine that the work claimed is potentially in the domain of SR&ED; and/or
- determine the risk of the work not being SR&ED in a material sense; or
- determine whether more information or a more detailed review is required to determine eligibility, in which case the following steps may be required.

Please note that the Science Advisor will select processes among the following steps as needed. All of the following steps may not be required to determine eligibility.

Step 2 – Determining the Scope of the Technical Portion of the SR&ED Review

The Science Advisor determines the scope of the technical portion of the SR&ED review. In situations where a large number of projects are involved, the review of a subset of the claimant's projects may be the most appropriate method of determining compliance.

Of the selection and review options available, certain ones are preferred depending on the case under review. The following are general recommendations with respect to reviews.

- When a claimant has a proven track record in terms of self-assessment and compliance, review a sample of projects included in the claim to verify compliance.
- Consult with the financial reviewer who could have specific recommendations regarding project selection, because of financial materiality and application of expenditure rules.
- A project that is unique because of its costs or the type of work involved may be appropriate to review, but findings would not be extrapolated to other projects.
- For repeat claimants, the primary focus for reviews should be on projects that are new or have substantially changed. Often it is not necessary to review projects that are continued from past years without substantial changes and that have already been reviewed and accepted.
- The Science Advisor should discuss the focus of the review with the claimant.

Step 3 – Request for Information

Upon review of the submission, it may be necessary to ask the claimant to clarify some details regarding the work outlined in the claim. All correspondence with the claimant, including Requests for Information, or RFIs, are to be effected through Science Advisors.

A RFI is to be clear and succinct. Specific questions about specific projects to determine eligibility are asked and generalities are avoided. This enables the claimant to provide clarification quickly and renders the review process more efficient. Chapter 3 of this guide explains in more detail how correspondence with claimants is to be handled.

Step 4 – Consultants

A consultant may be contracted by CCRA to provide an opinion on the eligibility of a claim. The consultant will review the "Request for Consultant" or "Briefing Notes for Consultant" prepared by the Science Advisor that outlines the specific issues that require resolution. As well, the Science Advisor will verbally brief the consultant. See Chapter 3 of this guide for information regarding confidentiality.

Step 5 – Site Visit/Interview

A visit to the claimant may be required to obtain more information. The visit provides the opportunity for the claimant to present and discuss with the reviewer the technical or scientific aspects of the project work described in the claim. If the reviewer is a consultant, the Science Advisor is to accompany the consultant on the visit.

The review is to be conducted with the understanding that the SR&ED Program is an incentive program intended to encourage SR&ED in Canada. The purpose of the review is to clarify what is eligible and ineligible. If during the process of the review additional eligibility is revealed or areas where eligibility could be improved are identified, the technical reviewer will communicate this to the claimant. The consultant should work with the claimant to achieve the objectives of the program. The reviewer should direct discussions with the claimant to areas in which the documentation provided by the claimant is unclear or those areas where the process in which the claim was developed needs to be better understood.

Roles and responsibilities

During the on-site visit with the claimant, the reviewer's role is to:

- understand the process that supports SR&ED claims within the claimant's organization. For example, if the claimant's process for identifying SR&ED projects to be included in the claim shows that they understand the claiming requirements, then there is a greater certainty that the projects being claimed will be compliant;
- obtain a clear understanding of the claimant's position with respect to technological advancement and uncertainty;
- work with the claimant to obtain the key facts and factors that support their position;
- identify whether the projects claimed were documented on an on-going basis as this would indicate that the claimant understands how to properly substantiate SR&ED claims;
- ensure the project cost allocations have taken place;
- identify whether the project's start and end dates are appropriate to the scope of the project;
- identify the qualifications of the personnel that worked on the projects, and
- identify the availability of contemporaneous documentation of the claimed projects.

The Science Advisor and/or Financial Reviewer and sometimes the consultant will provide education as needed concerning the information requirements for SR&ED claims.

Interview protocols

A telephone call by the Science Advisor to the claimant's technical representative is usually sufficient to arrange a mutually convenient date for the on-site interview. However, the Science Advisor should follow-up with the claimant in advance of their meeting with an agenda and the specific questions that will be discussed during the meeting to help establish eligibility. It is important to also remind the claimant that, since this is a technical review, the company's technical people are best equipped to answer technical questions at the meeting. This is a very effective way to expedite the SR&ED review process.

During the meeting, the reviewer should first describe the purpose of the review and his or her role as well as further familiarize themselves, if necessary, with the claimant's company, its history, markets, products and areas of expertise.

If it's unclear in the claim, the reviewer will ask questions about the scientific or technical objectives of the projects being reviewed in the business as well as the specific technological advances attempted through the projects. Asking questions about the business objectives of the project and/or the company's R&D will help the reviewer understand the business context. If desirable, a request for a demonstration of the prototype or finished device, product or process may help to show the presence of the underlying advances in technology. The reviewer will attempt to ascertain the unknowns as well as the support work involved and whether or not it is directly in support of or commensurate with the SR&ED work. In order to accomplish this, the reviewer will require access to contemporaneous documentation to substantiate the claim.

The reviewer may also examine the credentials and roles of the key technical and management staff involved in each project being verified.

At the end of the meeting any additional items that should be considered to determine the eligibility of the work included in the claim should be covered. Issues concerning eligibility of projects claimed are to be discussed with the claimant to provide opportunities for further clarification and to keep the claimant aware of the claim process.

The reviewers are to provide recommendations that they may have on how a claimant can improve the documentation of their claims in the future. They will discuss with the claimant a follow-up course of action to obtain any outstanding documentation and to explain how long the remaining review activity will take.

Step 6 – Follow-up

Before a site-visit takes place with a claimant, the Science Advisor's responsibility is to ensure that the claim is complete, and also workable in determining issues that impact the eligibility of the projects claimed. However, as new issues or questions may arise during the review of the claim, it may be necessary to issue additional RFIs after the site visit or

occasionally, to request a return site visit. It is important not to overburden the claimant with excessive demands for additional detail.

As stated above, if there are new eligibility issues as a result of the follow-up, these are to be discussed with the claimant to provide opportunities for further clarification and to keep the claimant aware of the claim process.

Step 7 – Preparing the SR&ED Review Report

The SR&ED review report on eligibility serves a number of critical purposes in addition to the purpose of being a basis for determining entitlement. It is used by the financial reviewer to link SR&ED work to eligible expenditures. It explains to the claimant and future reviewers the reasons behind the eligibility decision. It also serves to educate the claimant on documentation and eligibility requirements. A report may include information on the process that supports SR&ED claims within the claimant's organization.

The Science Advisor provides a determination on eligibility that may be based on the expert opinion from a consultant and the accompanying report is submitted to the financial reviewer for determination of expenditures in the claim as needed. The financial reviewer is responsible for determining all aspects of the refunds or credits to which, in CCRA's opinion, the claimant is entitled. Any discussions that may be required to resolve expenditure and final refund/credit issues are the responsibility of the SR&ED financial reviewers who may consult the technical reviewers as needed. The financial reviewer will identify issues and advise the technical reviewer on matters relating to the financial review that will be addressed as part of the technical review. In addition, the technical reviewer will advise the financial reviewer of expenditure issues that may affect the financial review.

Directive 97-03 or Scientific Research and Experimental Development (SR&ED) review report (Appendix F) describes the form and content of the report in detail. The following outlines its essential requirements.

- The report must be complete in itself. To understand the report, it must not be necessary to refer to other documents.
- The technical reviewer will provide a rationale and supporting evidence that proves ineligibility.
- Situations may arise where the work being claimed in a particular year relates to ongoing work from previous years. The status of the work in the current year and the relationship to the prior year's claim must be taken into account when determining eligibility.
- A technical review by a consultant must be conducted with objectivity. The consultants must base their opinion strictly on the technical issues as these are understood with reference to the ITA. Furthermore, this opinion must be independent of any other opinion on eligibility that may be held by any other CCRA official.

- Where the business environment is critical to the determination of eligibility, then the report must demonstrate that the business environment has been taken into consideration. Should another organization have started or completed comparable SR&ED work earlier than the claiming company such work would not necessarily be ineligible for the claiming company. This is the case if the results of the comparable SR&ED work were unavailable to the claiming company when the claiming company's work was undertaken.
- Statements throughout the report must be consistent.
- The report must be based on the facts. Preferably, these will be mutually agreed-upon facts between the reviewer and the claimant. If agreement can not be achieved on the facts, an explanation for the reviewer's position on the facts is to be provided.
- Record the facts and issues as seen by the claimant and the reviewer. The report is to identify whether the claimant agrees or does not agree on the facts and/or issues. Where there is disagreement, the claimant's reasons must be documented.
- The report must provide a clear rationale and methodology for arriving at conclusions.
- The report must be based on judgement that was impartial and fair.
- The report should not criticize any previous SR&ED review report, the claimant, or advisors of the claimant in any way.
- An explanation is required when restructuring of the claim is performed.
- In the case where there are eligibility issues, the contentious issues will be communicated to the claimant as early as possible in the review process to enable the claimant to address the issues and to provide new information if available. This is to ensure that there are no surprises to the claimant.

The preliminary opinion on the eligibility of an activity or project is verbally communicated to the claimant by the Science Advisor. The science advisor will provide a draft copy of the technical report to the claimant as soon as the preliminary opinion has been established to facilitate early resolution of potential issues.

Step 8 – Final Interview/Release of Report

The final interview is meant to review and where possible, reach agreement on any outstanding issues prior to the finalization of the report and CCRA's proposal letter.

If there are eligibility issues, there may also be expenditure issues. The final interview will be held with the joint participation of the Science Advisor and the financial reviewer (in person or by teleconference) where there is a full and frank discussion of all the issues. Where the technical review was performed by a consultant, the consultant will participate as well. The consultant's role is to present CCRA's findings and recommendations from the position of a technical expert. The final report prepared following the meeting will take into consideration any further information and evidence the claimant provides. A report prepared by a consultant is not considered a final report until it has been approved by the Science Advisor. This final report will subsequently be provided to the claimant with a proposal letter that has joint sign-off by the Science Advisor and the financial reviewer.

Chapter 3

Communications

Confidentiality

There are legislative provision and stringent rules in place for protecting the confidentiality of all claimants' records and there are harsh penalties for any CCRA employee or any consultant working on behalf of CCRA for violating these rules. These provisions regarding communications of information are outlined in the Income Tax Act (section 241) as are the penalties for offenses (section 239(2.2)) - Appendix E). The consultant, as outlined under Section 231 of the Income Tax Act, is authorized to inspect, review or examine the books and records of the claimant with respect to SR&ED claims. If the claimant has questions regarding confidentiality, the questions should be directed to the Science Advisor. As an incentive program, the SR&ED Program seeks to ensure that the confidentiality of Canadian R&D companies is protected. There is great concern that this topic is treated too lightly. The penalties need to be commensurate with the (potential) damage to the company. Many small companies, and some larger ones, don't claim things because of this concern.

Violations of confidentiality agreements can also result in libel suits against employees, consultants, the Crown and users of the confidential information.

Disclosure of qualifications

Before a consultant is contracted, the claimant should be advised. If the claimant has a concern regarding the consultant under consideration, this concern should be communicated to the Science Advisor. The Science Advisor and their management must endeavour to resolve the concerns raised by the claimant. The decision on consultant selection rests with CCRA's management.

The consultant must agree that his or her curriculum vitae, specifying educational and professional qualifications as well as work experience, may be released by CCRA to the claimant concerned. As previously noted, CCRA will not use consultants that are in a conflict of interest and requires that consultants that are hired declare all situations that could reasonably be regarded as constituting a conflict of interest (e.g. relationships with competitors, investment interest).

Communicating with claimant

The results of the SR&ED review report should not be a surprise to the claimant. The consultant and SR&ED reviewers should work together to ensure that the issues are clear and understood by the claimant during the course of the review. The Science Advisor coordinates communication between the consultant and the claimant. As coordinator of the review being performed by the consultant, the Science Advisor will help to clarify issues in discussions with the claimant, coordinates RFIs, and will help explain SR&ED eligibility decisions to the claimant.

The Science Advisor must be kept informed of the claim's progress by the consultant. The consultant will maintain complete records of all correspondence and conversations with the claimant.

Communicating with CCRA

The consultant will notify the Science Advisor of the progress on the file at agreed upon intervals and notify the contract administrator if any of the contract limitations (time/money) are approaching the end. The consultant will communicate any issues that pose difficulties to the Science Advisor.

Consultants and Science Advisors must maintain close communications with the financial reviewer to ensure that issues of mutual concern are addressed effectively.

Security of Records, Retention and Destruction

Consultants are generally not assigned space in CCRA offices to carry out their work. As a result, copies of SR&ED claims and other material may be released to the consultant. The consultant must securely store these paper records at all times. If a consultant has any concerns regarding maintaining the security of documents, the documents must be turned over to the Science Advisor for safekeeping. In any case Claimants retain ALL RIGHTS to ALL confidential information.

Copies of all out-going correspondence, plus the originals of all incoming correspondence, must be kept for CCRA files. The correspondence is given to the Science Advisor with the final report. If a briefing is required, or further action arises on the case, the Science Advisor may request that the consultant retain copies until the contract is completed. Once the case is completed, however, all paper-based or electronic originals and copies relating to the work must be turned over to CCRA.

The consultant is required to take all necessary security precautions to ensure that the research, intellectual property and trade secrets of any claimant, obtained during the performance of the contract, are secure at all times from use not permitted by the contract, by any person whatsoever, including the employees and subcontractors of the contractor.

Letter of Authorization

The consultant must have a letter of authorization from CCRA to enter the claimant's premises for the SR&ED review. The authorization letter is to be taken on all site visits.

Chapter 4

Review Diary and Administration

To facilitate the effective monitoring of a SR&ED review and to address questions that may arise after completion of a review, consultants must maintain a diary of each review that they conduct. A sample form is provided in Appendix J.

Basically, the diary should include all of the consultant's activity and their results as well as references to specific documents. It is especially important to record the following activities in the diary:

- The receipt and review of correspondence from the claimant;
- The review of the initial project descriptions and other material;
- Telephone calls to and from CCRA and the claimant's staff;
- Preparing and sending outgoing memos, letters, and facsimiles;
- Traveling to and meeting with CCRA personnel to discuss the case;
- Traveling to and meeting with the claimant on site;
- Carrying out supplementary investigations;
- Maintaining the case diary, case files, preparing status reports, invoices and other contract administration;
- Drafting and completing the report on eligibility;
- Preparing for and delivering briefings on the case;
- Complying with CCRA security and confidentiality provisions;
- Finalizing and returning all correspondence for CCRA files.

Appendix G provides a sample time report and invoice that is required from a consultant by CCRA. Interim invoices may be submitted on a monthly basis.

List of Appendices

The list of appendices will be added at a future date.

CCRA SR&ED Program website: www.rc.gc.ca/sred/

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