

# Developments\*

Information and updates on scientific research and experimental development

## Revised Form T661: Implications for Your Company's SR&ED Claim

November 13, 2008

### Introduction

A revised version of Form T661, *Scientific Research and Experimental Development (SR&ED) Expenditures Claim*, was released on November 10, 2008. Our recent *Developments* "Revised SR&ED Claim Form (Form T661): What to Expect" (November 5, 2008) turned out to be an accurate description. The major changes are in Part 2 of the form, which deals with project information. As well, for clarity, plain language has been used throughout revised T4088 Guide to Form T661.

This edition of *Developments* provides details on the nature of the changes and the implications for taxpayers that make SR&ED claims.

### Background

The Scientific Research and Experimental Development (SR&ED) legislation allows a taxpayer carrying on a business in Canada to deduct certain current and capital expenditures incurred in Canada and certain salaries and wages incurred outside Canada in respect of SR&ED carried on in Canada. In 1985, the federal budget proposed several changes to the legislation affecting the SR&ED program. One was to amend the legislation, introducing the requirement that SR&ED claimants file prescribed Form T661 (containing information with respect to expenditures relating to SR&ED) with their income tax returns.

The Canada Revenue Agency (CRA) subsequently has, on many occasions, amended Form T661 to reflect legislative changes, and also altered the form's format, with the aim of simplifying the form and making SR&ED claims easier to file.

In the late 1990s, the CRA introduced a Short Form T661 to assist small and medium-sized business when preparing an SR&ED claim. However, this form was withdrawn, primarily because many small and medium-sized taxpayers did not take advantage of the simplified short form, instead continuing to use the general version.

In April 2007, the CRA's task force on small business issues emphasized the need to reduce the compliance burden on small business and identified over fifty CRA initiatives aimed at achieving that objective and improving communication. One initiative was to simplify the claim (Form T661) for the SR&ED Program.

In June 2008, the CRA issued an “SR&ED Small Business Action Plan Update” which included:

- releasing a simplified Form T661 in the fall of 2008, including a web version with links to explanations in the simplified T4088 Guide to Form T661;
- making available an enhanced “Complete Claim Checklist” to ensure that claims are filed correctly;
- introducing a clear format for submitting SR&ED project details to determine project eligibility; and
- introducing an online eligibility self-assessment tool that businesses could use to determine if their SR&ED projects qualify.

The CRA is also expected to introduce electronic filing of SR&ED project descriptions.

## Summary of Changes to Form T661 and the Guide

Key changes to Form T661 and to the Guide are as follows:

- 1) Most of the changes to revised Form T661 are in Part 2 – Project Information. In short, a significant amount of additional information will be required for each project.
- 2) The previous version of the form allowed SR&ED claimants to provide technical project descriptions of only the twenty largest SR&ED projects in terms of dollar value. The revised form requires technical project descriptions for all projects to be reported at the time of filing.
- 3) The revised form requires the claimant to complete and file a separate Part 2 section for each project claimed. Part 2 of the revised form requires significantly more information than the previous form. A project filed without Part 2 will not meet the filing requirements, and if Part 2 is not submitted by the eighteen-month filing deadline the CRA will consider the information to be incomplete, and therefore will disallow the project.
- 4) The previous criterion “technological uncertainty” has been replaced with a new criterion called “***technological obstacle***.” (New terms are shown in bold and italic type in this document.)
- 5) The SR&ED claimant must explain in no more than 700 words the technological advancement (350 words) and the technological obstacles (350 words) that the claimant was trying to achieve. The work that was performed to overcome the technological obstacles also must be explained in no more than 700 words. This requires SR&ED claimants to be more concise, clear and direct when explaining the SR&ED work carried out in the year.
- 6) An SR&ED claimant that makes a “third party” payment to fund SR&ED projects must complete a new form (T1263), because this information is no longer part of the revised Form T661.
- 7) A claimant that has an Industrial Research Assistance Program (IRAP) project must now complete the Part 2 – Project Information section of the revised form. (The previous Guide specifically provided relief by allowing the SR&ED claimant to submit a copy of the approved IRAP proposal that contained the equivalent required project information in lieu of a project description.)
- 8) The revised form includes the recent legislative change to allow certain salary and wages for SR&ED work carried on outside Canada that is required and in support of a project being performed in Canada.
- 9) The revised form now requires SR&ED claimants to provide additional information to help the CRA improve their screening process and allow them to determine whether an audit of the claim is required.
- 10) SR&ED claimants currently enrolled in the “Process Review” program should consult with the CRA to determine how the new filing requirements will affect their current agreements with the CRA.
- 11) The CRA has changed its policy on accepting claims at the program level. The revised form does not allow SR&ED claimants to file large complex multi-year SR&ED projects at the program level.
- 12) Part 2 of the previous form provided guidance to SR&ED claimants on the type of scientific or technological information to be included in the project descriptions. Although the previous guide also provided further supplemental information about preparing project descriptions, the revised Guide simply refers claimants to Information Circular 86-4R3, *Scientific Research and Experimental Development*, Application Policy papers and the *Income Tax Act*.

## Detailed Explanation of the Changes to the Guide and Form T661

### Previous Schedules A to F

The many schedules that were part of the previous form are now included in different parts of the revised form, with one major exception: the previous Schedule A for third-party payments is now presented in new Form T1263.

### SR&ED project definition

The revised Guide incorporates the definition of an “SR&ED Project” as explained in the *SR&ED Project Definition – Principles* guidance document. It also clarifies that the project must be viewed at the “highest level possible to properly recognize all the work required for the attempted scientific or technological advancement.” There is no need to break down projects into sub-projects to identify multiple advancements that may take place in a project.

### Sensitive and confidential information

The revised form states that SR&ED claimants must not include any commercially sensitive or confidential information when completing Section B. However, there is no explanation of what is considered sensitive and confidential information, or of how and when such information can be conveyed to the CRA.

## Section A – Project Identification

### Field of science – Line 206

The previous Form T661 provided no specific box to identify the field of science. In the revised Form T661, the claimant must choose a field of science from a pre-specified list found in Appendix 1 of the revised Guide. The claimant is limited to one choice per project, which will require careful consideration.

### Work carried out – Lines 222 to 229

The previous Form T661 contained no specific boxes to identify the type of environment in which the work was performed. In the revised Form T661, the claimant must identify that environment.

### Purpose of the work – Line 230

In the revised form, by checking a box the claimant must indicate whether the project is experimental development (line 230) or scientific research (line 232). Revised Form T661 and the revised Guide seem to suggest that one project can no longer comprise both elements. A claimant that is attempting to achieve a technological advancement for the purpose of creating new materials, devices, products or processes or improving existing ones, must check box 230 (experimental development), even if the attempted **improvement is not substantial**. The previous guide stated that the “technological advancement requirement is met if the advancement sought is only slight or incremental or if the work is unsuccessful.” The *Income Tax Act* refers to “incremental improvements.” In addition, when SR&ED work is unsuccessful, new knowledge is gained and advancement could be achieved.

#### Comment

The CRA has commented that the change in terminology should not affect the way the criterion of technological advancement is determined.

## Section B – Experimental Development

### Objective of Technological Advancement – Lines 235 to 238

The previous form and Guide required claimants to specifically identify the scientific or technological objectives. The revised form now requires claimants to categorize the technological objectives to support their technological advancement. The revised form also includes boxes that must be checked off to identify the objectives of the technological advancement when carrying out experimental development.

### Technological Advancement – Line 240

Technological advancements that the claimant is trying to achieve must be written in a maximum of 350 words. The revised guide places strong emphasis on “**improved capability**” or “**new capability**.” This section of the revised Guide does not specifically indicate that the advancement will be viewed within the business context of the claimant. However, the definition of “technological advancement” in the glossary included in the revised Guide alludes to the business context/technology base level of the claimant when the project commenced. In addition, the revised form does not require a separate section to explain the

“Technology Base or Level” of the taxpayer. However, the claimant must describe the technological problems that could not be removed through the application of the Technology Base or Level that existed at the start of the experimental development project when describing the technological obstacles.

The revised guide also requires SR&ED claimants to explain why the new capability represents a technological advance in terms of the underlying technology. This could imply that the CRA would require the claimant to advance new engineering and technological principles. If so, this would appear to narrow the existing interpretation of a technological advancement as defined in IC 86-4R3.

#### Comment

The CRA confirms in Q10 of its Q&A document for the revised Form T661 and Guide that the program’s application policies and other technical publications remain in force.

### Technological Obstacles – Line 242

The technological obstacles that were overcome to achieve the technological advancement must be written in a maximum of 350 words. The term “**technological obstacles**” refers to “technological uncertainties” that is found in all the CRA technical publications, and also in jurisprudence dealing with the eligibility of SR&ED projects. The revised guide requires the claimant to describe the technological problems and **unknown elements** that had to be removed while attempting to achieve the technological advancement(s). It is not clear what the CRA means by the term “**unknown elements**,” which is not explained in the glossary included in the guide.

In the revised Guide, SR&ED claimants must describe the shortcomings and/or limitations of the current state of the technology that prevented the SR&ED claimant from developing the new or improved capability. Therefore, it would appear that the SR&ED claimant must carry out an extensive research of the current state of the technology. The previous Guide required SR&ED claimants to show only the base level knowledge within their business as well as all the knowledge that is reasonably available to them in the public domain.

The glossary under “**Technological obstacles/uncertainties**” states that “Uncertainty of achieving the project objective is not a technological uncertainty.” This statement seems to conflict with what

is stated in Information Circular 86-4R3 (section 2.10.2) under the “criterion of scientific or technological uncertainty”:

“Specifically, a scientific uncertainty may occur in either of two ways:

- it may be uncertain whether the goals can be achieved at all; or
- the taxpayer may be fairly confident that the goals can be achieved, but may be uncertain which of the several alternatives (i.e., paths, routes, approaches, equipment configurations, system architectures, circuit techniques, etc.) will either work at all, or be feasible to meet the desired specifications or cost targets, or both of these.”

#### Comment

The CRA confirms in Q9 of its Q&A document for the revised Form T661 and Guide that the new terms do not change the technical or policy requirements of the program.

## Section D – Additional Project Information

### Evidence Documents – Lines 270 to 282

In the previous Form T661, no specific boxes identified the type of evidence that was available to support the SR&ED project. In the revised Form T661, the claimant must check all boxes that apply to available pieces of supporting evidence.

## Calculation of SR&ED Expenditures

### Salary and wages – Lines 300 to 309 and Line 360

The definition of “directly attributable” in the glossary included in the revised Guide states that “expenditures directly attributable to the performance of SR&ED include the portion of salary and wages of employees who directly undertake, supervise or support the performance of SR&ED (other than directly engaged salary or wages included on lines 300 to 309).” Based on this definition, it would appear that the CRA is instructing claimants to report portions of salary or wages of employees who carry out SR&ED work defined in paragraph 248(1)(a) to (d) of the *Income Tax Act* on line 360 as overhead. This is a departure from the current practice of reporting these expenditures on lines 300 to 309. (This interpretation may require further clarification from the CRA.)

Salary or wages of administrative support staff whose work is considered directly related and incremental will continue to be included on line 360.

## What is the Significance of the Revised Form?

For a project to qualify for the SR&ED tax incentive, as before, the three eligibility criteria must be met. Therefore, claimants must show that the work claimed qualifies as SR&ED, as they have done in the past. However, the revised form requires claimants to prepare project descriptions in a more clear and concise manner, because they are now limited in the number of words that can be used to describe the SR&ED work carried out. SR&ED claimants will also have to become accustomed to new terms (e.g., “**obstacles**,” “**not substantial**,” “**unknown elements**” and “**improved capability**”) and the new questions posed by the CRA to make SR&ED claimants more specific in their responses in Sections B and C of Part 2 of the revised form.

To shorten the Guide, valuable information that was in the previous Guide to assist claimants in determining project eligibility is no longer available in the revised Guide. SR&ED claimants are now directed to the *Income Tax Act*, Information Circular 86-4R3, Application Policy papers, or may have to refer to other CRA Guidance Documents if further information is required.

New Form T661 has introduced many check box options that the CRA can use to screen SR&ED claims more rapidly and determine if an audit is required.

The web-based Eligibility Assessment Tool, when introduced, may assist small and medium-sized SR&ED claimants to determine if the research and development work they carried out has a *probability* of meeting the SR&ED project eligibility requirements. With the CRA moving towards electronic filing of SR&ED project descriptions, completing Part 2 of the revised form electronically will assist claimants.

The revised version of Form T661 is effective as of November 10, 2008, its date of publication, and must be used for all claims prepared for taxation years ending after December 31, 2008.

Changes to Form T661 and to the Guide may suggest that the CRA has revised some of the interpretations that have been underlying the SR&ED program for many years with respect to project eligibility, in an effort to simplify both documents. The CRA, however, has stated that this is not the case. Ultimately, taxpayer experience will decide.

PricewaterhouseCoopers' national SR&ED practice has significant experience with helping organizations prepare, file and support SR&ED claims. To discuss how the revised Form T661 will affect your organization and how we can help you prepare your SR&ED claims, please contact your local PwC SR&ED professional (listed on the next page).

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