

# **Claiming Scientific Research and Experimental Development**

Guide to Form T661

Blind or visually impaired persons can get this publication in braille and large print, and on audio cassette and computer diskette. To order, please call 1-800-267-1267 weekdays between 8:15 a.m. and 5:00 p.m. (Eastern Time).

In this guide, we use plain language to explain the most common tax situations. If you need more help after reading this guide, you can contact us (see later on this page) or use our other services.

In this guide, legislative references are to the *Income Tax Act* (the Act) and regulatory references are to the *Income Tax Regulations* (the Regulations).

La version française de cette publication est intitulée *Demande pour la recherche scientifique et le développement expérimental – Guide pour le formulaire T661*.

## What's New

### Changes to Form T661

**Part 2 – Scientific or technological project information –**  
This part of Form T661 was rewritten to clarify the technical requirements of the SR&ED Program, and how the questions on Form T661 are intended to help you provide the necessary technical information that we require to process your claim.

**Part 3 – Summary of SR&ED Expenditures –** This part of Form T661 was restructured for claims of various expenditures on a series of schedules:

- Schedule A – Third-Party Payments
- Schedule B – Special Situations
- Schedule C – Non-Arm's Length Transactions
- Schedule D – Calculation of Salary Base and Prescribed Proxy Amount

### Simplified Form T665

This form was cancelled.

### Application policies

When this guide was printed, we had issued or revised the following new application policies in the years 2001 and 2002:

- SR&ED 2002-03 – *Taxable Supplier Rules*
- SR&ED 2002-02R – *Experimental Production and Commercial Production With Experimental Development Work – Allowable SR&ED Expenditures*
- SR&ED 2002-01 – *Expenditures Incurred for Administrative Salaries or Wages – “Directly Related” Test*
- SR&ED 2001-02 – *Multinational Clinical Trials*
- SR&ED 2001-01 – *Research Chairs*
- SR&ED 2000-04R2 – *Recapture of Investment Tax Credit*
- SR&ED 2000-01 – *An addendum dealing with Water and Energy Sources as Materials was added to this policy paper*

Application policies are posted on the SR&ED Web site as soon as they are finalized. Also, a list of application policies issued in previous years can be found on the Web site.

### SR&ED Web site – [www.ccra.gc.ca/sred/](http://www.ccra.gc.ca/sred/)

A number of guides and documents have been developed to clarify SR&ED issues and are available on the Web site:

- *Recognizing Experimental Development* (September 23, 2002)
- *Cross-Sector Shop Floor Guidance Document* (July 29, 2002)
- *Guide to Supporting Technical Aspects of a Scientific Research and Experimental Development (SR&ED) Claim* (July 25, 2002)
- *Guide to Conducting a Scientific Research and Experimental Development Review* (January 14, 2000)
- *SR&ED Project Definition – Principles and Q and A Sheet for Project Definition Paper* (March 20, 2000)
- *Introducing the SR&ED Program's Preclaim Project Review Service* (May 29, 2001)
- *Introducing the Account Executive Service for the Scientific Research and Experimental Development (SR&ED) Program* (May 29, 2001)

### Upcoming seminars

Consult the CCRA Web site at [www.ccra.gc.ca/sred/](http://www.ccra.gc.ca/sred/) for upcoming seminars in your area.

### SR&ED coordinating offices

A list of the SR&ED coordinating tax services offices and the offices they serve is included at the end of this guide.

### New and revised forms/publications

- T661(E) *Claim for Scientific Research and Experimental Development carried out in Canada*
- T4052(E) *An Introduction to the Scientific Research and Experimental Development Program*
- T4119(E) *Scientific Research and Experimental Development – Economic Development Through SR&ED Tax Incentives*
- RC4290 *Refunds for Small Business R&D*

## Proposed changes to the legislation

On December 20, 2002, the Department of Finance released Draft Technical Income Tax Amendments. The proposed changes are implemented at their effective dates:

- Effective after February 23, 1998, subclause 37(8)(a)(ii)(B)(V) of the Act and related sections are amended to allow costs of “materials transformed” when using the proxy method. However, only claims that are within the 18-month rule are affected by the proposed changes and claimants are not permitted to change the method elected when filing their claims.
- Applicable after announcement date December 20, 2002, paragraphs 127(27)(b) and (c) and the text after paragraph (d) are amended to recapture an investment tax credit (ITC), where ITC is claimed for SR&ED on disposition or conversion to commercial property, even though the expenditure for the property is unpaid under subsection 127(26), including shared-use equipment.
- **February 18, 2003 Budget** – The budget proposes to adjust the phase-out as taxable income in the preceding year is between \$300,000 to \$500,000 (previously \$200,000 to \$400,000). This will apply generally for 2004 and subsequent taxation years.

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## General Information

### Legislative references

#### Income Tax Act

Sections 37 and 127.1

Subsections 96(2.4), 96(3), 127(5), 127(8), 127(9), 127(10.1), 127(10.3), 127(10.4), 127(11.1) to (11.8), 127(13) to (35), 194(2), and 248(1)

Paragraphs 12(1)(t), 12(1)(v), 12(1)(x), 20(1)(hh), 96(1)(e.1), and 96(1)(g)

See other references in the current version of Interpretation Bulletin IT-151, *Scientific Research and Experimental Development Expenditures*.

#### Income Tax Regulations

Sections 2900, 2902, 2903 and 8201

Paragraph 1102(1)(d)

### Internet access

You can find SR&ED Program information, policies, publications, draft papers for comments, and other useful information on our Web site at [www.cra.gc.ca/sred/](http://www.cra.gc.ca/sred/).

### Our publications

The following publications will help you complete your SR&ED claim. We recommend that you review the current version of these publications.

**T4119**, *Scientific Research and Experimental Development – Economic Development Through SR&ED Tax Incentives* – This leaflet explains the advantages of the SR&ED Program in general terms.

**T4052**, *An Introduction to the Scientific Research and Experimental Development Program* – This brochure describes the scope of the incentive program and explains how to receive the program's benefits.

**Interpretation Bulletin IT-151**, *Scientific Research and Experimental Development Expenditures* – This bulletin discusses the provisions of the Act and the Regulations dealing with SR&ED expenditures and investment tax credits.

**Information Circular 86-4**, *Scientific Research and Experimental Development* – The information circular clarifies what constitutes SR&ED under subsection 248(1) of the Act.

**Information Circular 97-1**, *Scientific Research and Experimental Development – Administrative Guidelines for Software Development* – The information circular helps claimants and our staff to interpret how the tax incentives apply to software development.

### Forms related to SR&ED claims

You can obtain a copy of these forms and the schedule from our Web site or from your local Tax Services Office.

**Form T661**, *Claim for Scientific Research and Experimental Development (SR&ED) Carried out in Canada*.

**Form T1145**, *Agreement to Allocate Assistance Between Persons not Dealing at Arm's Length for Scientific Research and Experimental Development (SR&ED) Expenditures Carried out in Canada*.

**Form T1146**, *Agreement to Transfer Qualified Expenditures Incurred in Respect of Scientific Research and Experimental Development (SR&ED) Contracts Carried out in Canada*.

**Form T1174**, *Agreement between Associated Corporations to Allocate Salaries or Wages of Specified Employees for Scientific Research and Experimental Development (SR&ED) Carried out in Canada*.

**Schedule T2SCH31**, *Investment Tax Credit – Corporations*.

**Form T2038(IND)**, *Investment Tax Credit (Individuals)*.

### Provincial and territorial tax incentives

Provincial and territorial incentives may also be available for your SR&ED expenditures. Contact your provincial tax authority to determine whether such incentives are available. You will find the telephone number of the provincial and territorial authority in the government section of your telephone book. For more information, see page 1 of Form T661.

### Advisory services

There are a number of advisory services provided to SR&ED claimants to enhance awareness of program requirements and to help SR&ED claimants submit successful claims. These services include:

1. **First-time SR&ED claimant service** – This service provides information and assistance for companies new to the program. On request, one of the SR&ED's representatives can call new claimants to answer questions. If necessary, an SR&ED representative can arrange a personal visit to explain the program and documentation requirements in more detail.
2. **Public information seminars** – New claimants are invited to attend one of SR&ED Program's public information seminars that are held regularly at locations throughout Canada. Contact your local tax services office if you wish to attend a seminar, or visit our Web site at [www.cra.gc.ca/sred/](http://www.cra.gc.ca/sred/). The first-time claimant service and the public information seminars greatly aid new or potential claimants to better understand their entitlements under the SR&ED Program.

3. Preclaim Project Review (PCPR) – The PCPR service provides businesses with an up-front review and a preliminary opinion on the eligibility of projects for SR&ED investment tax credits, before the claim is filed. A key aspect of the service is direct communication between a claimant’s personnel, who understand the technical issues of the project, and a SR&ED science advisor. The service helps claimants understand the SR&ED Program, including substantiation requirements, and it addresses concerns before a claim is made – related publication, RC4271, *Introducing the SR&ED Program’s Preclaim Project Review Service*.
4. Account Executive service – This service provides claimants with a designated contact person. A claimant can call the account executive for help with various SR&ED Program areas, including technical or financial issues, as well as get help to access other services such as PCPR. The account executive will ensure that the appropriate assistance is provided. Through ongoing contact, the account executive helps the claimant better understand the program – related publication, RC4270, *Introducing the SR&ED Program’s Account Executive Service*.

You are encouraged to use these services, which are available through most CCRA tax services offices across the country.

## Your opinion counts

We review this guide regularly. If you have comments or suggestions that would help us improve the explanations in this guide, we would like to hear from you. Send your comments to:

SR&ED Directorate  
 Canada Customs and Revenue Agency  
 875 Heron Road  
 Ottawa ON K1A 0L8

## How to Complete Form T661

### Filing requirement

If you have expenditures for SR&ED carried out in Canada, you must complete Form T661 and send it with your tax return, along with any related schedules and attachments. You have to file Form T661 whether or not you claim an investment tax credit (ITC) in the current year.

#### Notes

Form T661 applies only to SR&ED carried out in Canada. Expenditures for SR&ED conducted outside Canada should be claimed with other business expenditures. If you want more information on how to treat these expenditures, read the current version of Interpretation Bulletin IT-151, *Scientific Research and Experimental Development Expenditures*, available on the CCRA Web site.

Generally, these out-of-country expenditures are deductible under subsection 37(2) and are treated in the same way as other business expenditures (that is, you

deduct current expenditures in the year you incur them, and add capital expenditures to the appropriate capital cost allowance class). Expenditures for SR&ED conducted outside Canada do not qualify for an ITC.

Technical personnel should complete Part 1 and Part 2 of the form, and financial personnel should complete Part 3 and schedules where applicable. Part 4 may need information from both financial and technical personnel.

You have to file an original or revised Form T661 and Schedule T2SCH31, or Form T2038(IND) for the year, no later than the day that is 12 months after the filing due date of the return of income for the year. For a corporation, as a general rule, you have 18 months from the end of the tax year in which you incurred the expenditures to report them. If you do not report an expenditure by the reporting deadline on Form T661, you cannot deduct the expenditures for SR&ED purposes. As well, if you do not report your SR&ED expenditures within the same reporting deadline on Schedule T2SCH31 or Form T2038 (IND), you will not be allowed to claim any ITC for the expenditures.

However, a corporation exempt from Part I tax under paragraph 149(1)(j) has to file Form T661 on or before the filing due date for the year or it will be subject to a penalty.

Under exceptional circumstances, if your claim is filed late, you may apply to the Director of your tax services office under the fairness provisions to have your claim accepted.

Information circulars 92-1, 92-2, and 92-3 contain information and guidelines on the fairness provisions and examples of how they may be applied. In general, the comments in these circulars also apply to cases where the deadline prescribed in subsection 37(11) of the Act has not been met.

In general, fairness provisions could apply when exceptional circumstances beyond the claimant’s control have prevented the claimant from meeting a legal obligation or paying a specified amount by the required deadline. The claimant must have shown reasonable diligence in his efforts to comply with the Act.

### General filing requirements for partnerships

If the partnership members have to file Form T5013 Summary, *Partnership Information Return*, the partnership’s T661 form and accompanying information should be filed with the *Partnership Information Return*. A T5013 slip, *Statement of Partnership Income*, must be filed with each partner’s tax return. For more information, see the *Guide for the Partnership Information Return* (T4068), which is available on the CCRA Web site or at any tax services office.

When the partnership members do not have to file Form 5013, each partner has to file Form T661 and financial statements for the partnership with his or her income tax return for the year. Each partner also has to file an explanation of how the SR&ED allocation of income or loss was calculated for each partner for tax purposes, and for the ITC.

The expenditures listed in Part 3 are the total SR&ED expenditures at the partnership level, and not just a particular partner’s share of those expenditures.

Partnerships cannot carry forward an SR&ED expenditure pool balance to a later year. For more information on SR&ED expenditures and the ITC of a partnership, read the current version of Interpretation Bulletin IT-151, *Scientific Research and Experimental Development Expenditures*.

## How to speed up the processing of your claim

To ensure we can process your current year claim as quickly as possible:

- use the latest version of Form T661 (see the CCRA Web site);
- file a complete claim. Filing an incomplete claim, or using a previous version of Form T661 to file a current year claim, will delay the processing of your return;
- place the completed Form T661 on top of your corporate tax return for quick identification;
- keep all technical and financial information to support your claim;
- file the SR&ED claim at the tax centre (filing your claim at your local tax services offices may delay the processing of your claim);
- respond in a timely manner to our requests for more information; and
- check off the appropriate box on the T2 return requesting a direct deposit of your refundable ITC.

## Complete claim

Subsections 37(1) and 127(9) (definition of “qualified expenditure”) require that the claimant supply the prescribed information on the prescribed forms.

A complete claim is one that supplies the information asked for on Form T661 and Schedule T2SCH31 or Form T2038(IND.) (used to claim ITC on qualified SR&ED expenditures) on the version of the forms that apply to the year of the claim. Form T2 is also required for a claim to be complete.

You must complete all parts of Form T661, the schedules, and all parts of Schedule T2SCH31 or Form T2038(IND), and you must sign where required. For Form T661, you must indicate whether you used the proxy or traditional method to determine the SR&ED expenditures and related ITC. A checklist of required information is provided with Form T661.

**Even if a claim is complete, it must conform to the definition of “scientific research and experimental development” contained in subsection 248(1) of the Act, and also meet the rules under sections 37 and 127 of the Act. All forms and schedules should be filed within the prescribed 18-month period.**

## Classified projects

If a federal agency has designated one of your project descriptions as “classified information” for national security reasons, follow these instructions:

- Prepare and keep on file a fully completed T661 form, including all project descriptions in Part 2, Step 2.
- Send a letter c/o Research and Technology Section at the following address:  
SR&ED Directorate  
Canada Customs and Revenue Agency  
875 Heron Road  
Ottawa ON K1A 0L8
- In the letter, explain that certain project descriptions are classified information, and that they are available on request.
- Send a copy of the letter with your income tax return, along with the completed Form T661, without the descriptions of the classified project(s).

## How Form T661 is structured

We have divided the form into four parts:

### Part 1 – General Information

Provide the information required and sign the “Certification and Election” area on page 1 of the form.

### Part 2 – Scientific or Technological Project Information

#### Step 1 – Detailed project description

Provide project descriptions for the expenditures you claimed in Part 3. Remember to have the individual responsible for technical work complete this part.

#### Step 2 – Project summary information

Provide information for each SR&ED project you claim in the tax year. You have to indicate the total current expenditures and the capital expenditures you claimed for each project.

### Part 3 – Summary of SR&ED Expenditures

Provide expenditure information on all claims for SR&ED carried out in Canada. This part represents the total cost for all projects. Keep in mind that you also have to provide individual project cost information in Part 2 of the form.

You should keep records of costs and explanations of cost allocations associated with individual projects. These records should be made available during the claim review.

**Step 1 – Allowable SR&ED expenditures for SR&ED carried out in Canada** – In this section, list the total allowable SR&ED expenditures that you made in the year, both current and capital, for SR&ED carried out in Canada.

**Step 2 – Pool of deductible SR&ED expenditures** – In this section, you will calculate the SR&ED expenditure pool deduction that is available in the year, starting with the amount of allowable expenditures for SR&ED carried out in Canada determined on line 400, the deduction claimed in the year, and any balance of the SR&ED expenditure pool deduction you can deduct in future years.



**Step 3 – Qualified SR&ED expenditures for ITC purposes** – In this section, you will determine the SR&ED expenditures that qualify for a federal ITC.

## Part 4 – Background Information

This information on your business is required for the administration of the program and to process your SR&ED claim.

**Checklist** – Review the checklist to confirm the information required is filed.

### Schedule A – Third-Party Payments

Provide the information requested on this schedule as indicated. Use other copies of this schedule if you are claiming more than one third-party payment.

### Schedule B – Special Situations

This schedule contains adjustments to the deductible expenditure pool, and to the qualified expenditures. Report the amount(s) on Form T661 as required.

### Schedule C – Non-Arm's Length Transactions

Complete this schedule if you have one or more non-arm's length transactions described in this schedule. Report the amounts on Form T661 as required.

### Schedule D – Calculation of Salary Base and Prescribed Proxy Amount (PPA)

If you elected to use the proxy method on page 1 of the form, complete this schedule to calculate the salary base and the PPA.

## Line-by-Line Explanations

The following section explains the information you have to provide on each line of Form T661. We recommend that you read each explanation as you complete the form.

## Part 1 – General Information

### Name and complete address of claimant

Enter the registered business name, address, Web site address (if available), and postal code. If you have to file a *Partnership Information Return* (Form T5013 Summary), enter the name of the partnership.

### Return for tax year

Write the dates of the beginning and the end of the tax year for which you are submitting the claim.

## Business identification

Enter the appropriate identification number that pertains to you.

## Lines 100, 105, and 110 – Contact person

Write the name, telephone number, and fax number of the person best suited to provide information about the overall submission.

## Lines 142, 145, and 150 – Partnership information

Answer questions on lines 142, 145, and 150 if you are entitled to a share of the SR&ED expenditures incurred by a partnership, and the partnership does not file a *Partnership Information Return* (Form T5013 Summary).

## Lines 160 and 162 – Choice of method

You can choose the traditional method and claim all SR&ED expenditures you incurred during the year, or you can elect to use the proxy method for the year. The proxy method provides another alternative way to determine your SR&ED expenditures and investment tax credit for overhead expenditures.

The proxy method involves calculating a substitute amount for overhead expenditures using a formula, rather than specifically identifying and allocating these expenditures, as you would with the traditional method. Table 1 gives the treatment of expenditures eligible under each method.

To determine your qualified SR&ED expenditures for ITC purposes, calculate the amount representing the overhead expenditures as a fixed percentage (65%) of the salaries or wages of the employees directly engaged in SR&ED. This amount becomes the prescribed proxy amount (PPA). Special rules apply to restrict the amount of salaries or wages of specified employees you can include in the salary base. For more details, see the explanation for line 502. The PPA may be eligible for the 100% ITC refund.

You do not include the PPA in the SR&ED expenditure pool, and you do not deduct it when calculating income. It represents the amount of overhead expenditures for SR&ED, and is used only to determine your ITC for these overhead expenditures. The PPA is treated as a qualified expenditure for ITC purposes. The actual overhead expenses represented by the PPA are ordinary business expenses.

**Table 1**  
**Treatment of expenses under the proxy and traditional methods**

Expenditure	Traditional method	Proxy method
Direct SR&ED salaries or wages	<ul style="list-style-type: none"> <li>■ eligible for ITC</li> <li>■ deductible under 37(1)(a) (see line 300)</li> </ul>	<ul style="list-style-type: none"> <li>■ eligible for ITC and base for the PPA (see line 502)</li> <li>■ deductible under 37(1)(a) (see line 300)</li> </ul>
Overhead expenditures directly related and incremental to SR&ED	<ul style="list-style-type: none"> <li>■ eligible for ITC (see line 360)</li> </ul>	<ul style="list-style-type: none"> <li>■ not specifically identified</li> <li>■ covered in the PPA (see examples below)—PPA is eligible for ITC.</li> <li>■ deductible as regular business expenses only—not deductible under 37(1)(a)</li> </ul>
Other expenditures claimed separately: <ul style="list-style-type: none"> <li>■ materials consumed or transformed (after February 23, 1998) in performing SR&amp;ED</li> <li>■ lease costs of SR&amp;ED equipment</li> <li>■ expenditures for SR&amp;ED directly undertaken on your behalf</li> <li>■ third-party payments</li> </ul>	<ul style="list-style-type: none"> <li>■ eligible for ITC</li> <li>■ deductible under 37(1)(a)</li> </ul>	<ul style="list-style-type: none"> <li>■ eligible for ITC</li> <li>■ deductible under 37(1)(a)</li> </ul>
The PPA covers overhead expenditures such as: <ul style="list-style-type: none"> <li>■ office supplies</li> <li>■ general purpose office equipment</li> <li>■ heat, water, electricity, and telephones</li> <li>■ support staff salaries or wages</li> <li>■ travel and training</li> <li>■ property taxes</li> <li>■ maintenance and upkeep of SR&amp;ED premises, facilities or equipment</li> <li>■ any other eligible expenditures directly related to the prosecution of SR&amp;ED that you would not have incurred if the SR&amp;ED had not been carried out</li> </ul>		

You have to elect or choose a method for each tax year for which you want to claim SR&ED expenditures. You have to make your choice of a method when you first file Form T661 for the year. Therefore, whether you elect to use the proxy method or you choose the traditional method, your choice is irrevocable for the year.

If you are a member of a partnership that elects to use the proxy method to calculate the income from the partnership, the election is only valid if you made it on behalf of all the members of the partnership and, as an authorized partner, you had the authority to act for the partnership.

The following table describes the advantages and disadvantages of each method.

<b>Table 2</b> <b>Advantages and disadvantages</b> <b>under the proxy method and the traditional method</b>		
<b>Method</b>	<b>Advantages</b>	<b>Disadvantages</b>
<b>Proxy method</b>	<ul style="list-style-type: none"> <li>■ You get ITCs on the PPA, which is 65% of directly engaged SR&amp;ED salaries and wages in the salary base.</li> <li>■ It is easier to determine the PPA once you establish the salary base.</li> <li>■ No need to track SR&amp;ED overhead expenditures.</li> </ul>	<ul style="list-style-type: none"> <li>■ The PPA may be less than the actual overhead expenses incurred.</li> <li>■ You have to calculate the salary base on which a 65% rate will apply.</li> <li>■ You may have to calculate an overall cap on the PPA.</li> <li>■ You cannot include in the SR&amp;ED expenditure pool the expenditures that the PPA represents.</li> </ul>
<b>Traditional method</b>	<ul style="list-style-type: none"> <li>■ You calculate ITCs on the actual overhead expenditures you incurred.</li> <li>■ The actual overhead expenditures may be greater than the PPA.</li> <li>■ There is no salary base to calculate and no PPA to determine.</li> <li>■ There is no overall cap to calculate.</li> <li>■ Overhead expenditures are added to the SR&amp;ED expenditure pool.</li> </ul>	<ul style="list-style-type: none"> <li>■ You have to demonstrate that the overhead expenditures are incremental to the SR&amp;ED.</li> <li>■ Using this method could be a complex and uncertain exercise, especially when SR&amp;ED and other work are carried out in the same facility (e.g. shop-floor SR&amp;ED).</li> <li>■ You have to specifically identify and allocate which overhead expenditures are for SR&amp;ED work.</li> <li>■ You have to explain how you determined the amount and you have to provide support for the determination.</li> <li>■ Your allocation of overhead must be reasonable.</li> </ul>

## Lines 165 and 170 Authorization and date

The individual, an authorized signing officer of the corporation, or an authorized partner, will certify the information on Form T661, the related schedules, and the attachments. That person also has to indicate the choice of method to calculate the SR&ED expenditures and related ITCs for the year.

## Part 2 – Scientific or Technological Project Information

In this part of the T661 form we seek the technical information on the work for which you are claiming a tax credit under the SR&ED Program. The following is an explanation of the technical requirements of the SR&ED Program and how the questions on the T661 form are intended to help you provide the necessary technical information that we require to process your claim. As some of the questions are interrelated, you should read this entire section before answering any of the questions on the T661 form to avoid preparing information that may not be needed.

When we use the term “project,” we are referring to the work that falls within the definition of Scientific Research and Experimental Development (SR&ED) contained in the Act. The definition of SR&ED requires that the work must be a systematic investigation or search that is carried out in a field of science or technology by means of experiment or analysis. The work can be basic research, applied research or experimental development. For the purpose of this discussion, we will refer to basic and applied research as “scientific research.” The definition of SR&ED makes a distinction between scientific research and experimental development. Where the work meets the requirements of the definition of SR&ED we say that it is “eligible.” For Scientific Research, the work must be undertaken for an advancement of scientific knowledge: it is normally carried out in a laboratory setting and seeks to discover new scientific knowledge. New scientific knowledge includes the results of unsuccessful work. Whether or not the work achieved its objective is not relevant in determining its eligibility. On the other hand, Experimental Development requires that the work be undertaken for the purpose of achieving a technological advancement to develop new

technology for creating new, or improving existing material, devices, products or processes. Experimental development is normally done in an industrial setting. As in the case of scientific research, there is no requirement that the attempt to achieve technological advancement be successful for the work to be eligible. As it is quite possible that your project involves both scientific research and experimental development, answer the questions as appropriate.

Projects can be distinct and well defined with a clear beginning and end with a set of well-defined specific and/or technological objectives and uncertainties or large multi-year projects. Any project and especially the large projects can contain interrelated work of a support nature that may include routine development, routine engineering, routine programming, design, etc. This interrelated work must be an integral part of an eligible project and commensurate with its needs to be eligible as SR&ED. This work of a support nature may not qualify as stand-alone SR&ED projects but can qualify as support work by virtue of the contribution it makes to the overall SR&ED project even when it is the only project work done in a particular year.

Generally, the work of an R&D program dedicated to advancing a particular technology, product, process by experimentation or analysis will inherently be SR&ED. A program's technological or scientific objectives are broader and, conceptually, the advancement sought is described at a higher level than that of a project. In these situations, the issue of what work is eligible is whether the allocation of the work attributed to the particular program reflects the contribution to the program's technological or scientific objectives. It is important that you establish the relationship and contribution of the work claimed as SR&ED to the program's technological or scientific objectives. In addition, you should be able to explain the process you use to differentiate SR&ED from non-eligible work. You are required to contact the CCRA **prior to** claiming your work at the program level as opposed to individual projects. The CCRA will work with you to establish how you are to proceed.

The discussion that follows assumes that your claim is being made on a project basis.

## Step 1 – Detailed project description

The questions listed in Part 2 of the T661 are intended to help you prepare the specific project information we need to process your claim. We recommend that personnel who are familiar with the technical content of the work you are claiming prepare this part of the submission. The description should be made in the technical language and style used by the personnel participating in the actual work or who understand and are familiar with the work. Your answers should concentrate on the relevant technical facts that illustrate the experimental or analytical nature of the work. Although there is no limit to how much information you may provide, most project information can be provided in four pages or less.

The questions on the T661 have been structured to help you present sufficient information about your work to enable the CCRA to do an initial review of the work you are claiming. Thus, your project description must provide enough information to indicate that the work you are claiming meets the SR&ED Program requirements. For both scientific research and experimental development work, the project description should provide sufficient information to show a systematic investigation or search in a field of science or technology by means of experiment or analysis. In addition, for experimental development work, it is necessary to show that the purpose of the work was to achieve a technological advancement for creating new, or improving existing, materials, devices, products or processes. For scientific research work, it is necessary to show what advancement in scientific knowledge is being sought or was made.

If your company conducted more than 20 projects during the course of your fiscal year, you may provide descriptions only for the 20 largest projects with your submission. You may however be required to provide descriptions for any of the remaining projects depending on how we review your claim. Note that you must provide a summary listing of all your projects you are claiming in Step 2 of Part 2 regardless of whether you are claiming on a program basis, or if you have 20 or more projects.

If you prepared a project description for the Preclaim Project Review (PCPR) service, you can use this information in submitting your claim if it represents the work that was actually done and provides the necessary information as outlined in "A" to "E" below.

If you have an Industrial Research Assistance Program (IRAP) project, in lieu of completing questions "A" to "E" for the project, you may submit a copy of the approved project description of the IRAP proposal, the Statement of Work, and progress reports showing what work was done, as long as it will provide us with the equivalent information.

If you continue projects from a previous year, it is sufficient to update the current claim and describe only the work undertaken this year for which you are claiming a tax credit.

Market research, research in the social sciences or the humanities, prospecting, exploring or drilling for or producing, minerals, petroleum or natural gas are specifically excluded from the program. Activities such as financing, marketing, customer demonstration, quality control testing, patent search and registration, and preparation of submission documents for licensing agencies, certification agencies, or regulatory authorities are not eligible.

As stated earlier, the eligibility requirement for scientific research work is different from that of experimental development work with respect to the advancement being sought. For simplicity, the same questions are used on the T661 form for both scientific research work and experimental development work. Respond to the part of the question that best reflects your work.

A. **Scientific or technological objectives** – For each project, state the overall scientific or technological objectives. For example, if you undertook scientific research, what new scientific knowledge were you attempting to discover? Or, if you undertook experimental development, what technological advancement were you attempting to achieve? What required you to undertake scientific research or experimental development? How does the objective relate to or involve the application of technology, or what was the scientific aspect of your work? In terms of product or process development, the objectives must relate to the underlying technology, not to any financial or marketing goals. Price/cost reduction may involve eligible work. The technological objectives may be expressed in terms of new capabilities incorporated in the product or process being developed. The scientific or technological objectives help put the work claimed into the proper technical perspective of what it will mean for your business. These objectives also provide an indication of when the project is complete. The scientific or technological objectives you state must be specific and verifiable.

If possible, give the indicators or measures you will use to determine whether you meet the scientific or technological objectives. If this project continues from the previous year and has not changed in direction, simply restate the scientific or technological objectives. However, if you made a change in direction, you should explain and clarify the new objectives.

B. **Technology or knowledge base level** – A requirement of experimental development work is that it is undertaken to seek a technological advancement. Seeking a technological advancement means attempting to increase the technology base or level from where it was at the beginning of the systematic investigation or search. The technology base or level includes all the technological resources within your business as well as all the knowledge on the technology that is reasonably available in the public domain. The technological resources within your business comprise the level of technology, the proprietary technological “know-how”, and the experience of its personnel. To establish that this requirement is met, it is necessary to know the level of your company’s capabilities with the technology before the work was started. We need to know for example what your company was able to do with the technology before the SR&ED work was started. Presenting the level of technology in your company before the work was started helps us to understand why the work was done and how it will be or could be a technological advancement for your company. It also ensures that a common starting point is taken when CCRA reviews your claim with respect to the technological advancement you were seeking.

Similarly, for scientific research work, to establish that your work was undertaken to seek a scientific advancement, it is necessary to determine the current scientific knowledge that is reasonably available to you before you started the research. It is not intended for you to provide proof of an exhaustive search and the actual knowledge available but rather a synopsis of the

state-of-the-art knowledge you reached as the result of a literature search or first hand knowledge and experience in the field of science that your work is in. If you are working in a new area state that this is new ground.

C. **Scientific or technological advancement** – A requirement of SR&ED is that the work must be undertaken to achieve an advancement of scientific knowledge or a technological advancement. Even if you were unsuccessful, this requirement will be met in the sense that you gained new technological or scientific knowledge useful for guiding future work. For example, in scientific research, determining that a hypothesis is incorrect also represents new scientific knowledge. Similarly, in experimental development, discovering that a certain methodology does not work adds to your technological knowledge base. Generally, work undertaken to remove an element of scientific or technological uncertainty through a process of systematic investigation or search will result in a scientific or technological advancement. Thus when your work consists of a systematic investigation or search and was undertaken by experimentation or analysis to resolve a technological uncertainty, the program requirements of attempting to achieve a scientific advancement will be met. This approach is particularly useful to show how the technological advancement requirement is met if the advancement sought is only slight or incremental, or if the work is unsuccessful.

Solving technical problems or trouble shooting using generally available scientific or technological knowledge or experience does not meet the requirements of the program. The work must be undertaken with the intention to advance the underlying technology. The problem must relate to whether or not the objective that you stated in Step 1 “A” can be achieved, and/or how to achieve it, is not known or cannot be determined on the basis of your technology/knowledge base level that you stated in Step 1 “B”. What problems were you trying to solve that you could not solve by using commonly available experience and knowledge? Were the problems due to design constraints that needed to be overcome? Include enough detail to show that these were other than routine problems.

In terms of product or process development, a technological advancement may be achieved if a new capability was incorporated into the product or process that enhances its performance. The new capability that was incorporated into the product or process must be accomplished through a systematic investigation or search. The product or process may be new or an improvement of an existing one. If it was accomplished through the purchase of rights or licence, or through the adaptation of known principle or knowledge, then it would not represent a technological advancement. To help establish the eligibility of the work, describe the new capability incorporated into the product or process that enhances its performance. Explain why the new capability represents a technological advancement in terms of the underlying technology in the context of the

technological resources of your business or the current state-of-the-art. It is not necessary that you provide or explain the scientific principle that the technological advancement is based on. You must show how the work undertaken would be a technological advancement relative to the technology base your business was starting from. All the work to produce the product or run the process is not eligible, only the part of the work that is directly involved in achieving the technological advancement will meet the program requirements.

If your work is primarily undertaken to advance the scientific knowledge, indicate what field(s) of science the new knowledge is in and why the new knowledge resulting from your work is an advancement relative to the scientific knowledge that is available to your business. How are the results of your experiments or analysis an advancement of scientific knowledge?

It is useful to give the field(s) of science or technology in which your work has taken place to place your work in the proper perspective. Specifying the field(s) of science or technology of the advancement will help put your work in the business context that your business is operating in and the eligibility of your work will be examined relative to the fields of science or technology that your business is operating in.

- D. **Description of work in this taxation year** – Describe the approach you used, your project plan, the new designs attempted, the experiments and/or analysis conducted, the interpretation of the results and the conclusions. Was the project completed this year? If not indicate when the project is expected to be completed. What progress was made towards the objectives described in “A” as a result of this work?

Eligibility is generally determined at the highest possible level to properly recognize the technological advancements attempted. For multi-year projects, when the work extends beyond one taxation year, eligibility of the work ceases, when the specific scientific or technological objectives are met. Therefore, it is important that you describe what work was actually carried out in this taxation year. In this description, the focus should be on the pursuit of the scientific or technological advancement. It must also include the results you obtained and the conclusions you made. If the project continued from the previous year, describe the current year’s work and explain how it relates to the scientific or technological advancement stated in “C” above.

- E. **Supporting Information** – To substantiate that your work was carried out as described in Step 1 of Part 2, you must have evidence of the work done to support your claim. Usually, the documents produced over the course of doing SR&ED will be sufficient; it should not be necessary to specifically prepare documents of the work for CCRA to be able to substantiate the work claimed. List the supporting information that you could use to substantiate the work described in Step 1 of

Part 2. Technical records that were created at the time the work was performed provide the most ready form of documentation. Examples of suitable documentation are planning documents, documents describing project objectives, descriptions of the problems to be solved, contract work statements, notes of discussions dealing with unexpected obstacles encountered, minutes of the meetings, records of trials, observations, project notebooks, lab notebooks, test records, and quantitative measurement data. Even the new products, hardware, prototypes, pictures of prototypes, or a combination of any of these, new genetic material, business records, employee activity records, etc. can serve to substantiate the work.

## Step 2 – Project summary information

Provide the information requested in Step 1 and Step 2 on separate sheets of paper, and submit them with the T661 form. This information is used by CCRA in the management of the program.

### Line 200

Provide the total number of projects being claimed in this tax year.

### Line 206 – Industrial Research Assistance Program (IRAP) –

The National Research Council of Canada offers technical and financial assistance through its IRAP to small and medium-sized Canadian companies (up to 500 employees) that already have technological capabilities and wish to strengthen and enhance them. Indicate the amount of assistance, if any, received by the corporation from IRAP for the project(s) claimed in the year.

### Table of projects claimed

**Project identification: code and name** – List all the SR&ED projects claimed. The internal reference code is your code used to track the project and its costs. If you do not use a code to track the projects and costs, then give an equivalent identifier. The project name is your internal name or title you have given the claimed project.

#### Note

If you do not have an established system of project coding, number them in sequence and use these numbers throughout your claim.

**Start date** – The date when you started work on the SR&ED project.

**Finish date** – The date when the SR&ED project’s initial scientific or technological objectives were achieved. If the project is not finished in this taxation year, give the expected finish date.

**Total labour expenditures in current tax year** – This may be an actual amount or a reasonable allocation and relates to the amount to be reported on line 300 to 310.

**Total cost of materials in current tax year** – These may be actual amounts or reasonable estimates if costs are not specific to the project. If you use an estimate, maintain a copy of the rationale you used to make your estimate.

**Total contract expenditures in current tax year** – If some of the project work was contracted out, provide the actual contract amounts. Do not include the subcontract costs (see lines 340 and 345.)

Whenever you allocate or estimate costs, maintain the basis on which they are made in case we need to verify how they were made.

Other information such as the names of the qualified personnel must be maintained and provided upon request.

It should be noted for multi-year projects that the expenditures must be claimed in each year to meet the deadline for filing requirements. Claiming all the expenditures at the end of the project will result in expenditures being denied.

## Part 3 – Summary of SR&ED Expenditures

We have divided Part 3 of this form into three steps. You must round all amounts you report in this part to the nearest dollar.

### Step 1 Allowable SR&ED expenditures for SR&ED carried out in Canada (lines 300 to 400)

Usually, SR&ED current expenditures are those that do not result in the acquisition of land, a leasehold interest in land, or property that would otherwise have been your depreciable property.

Current SR&ED expenditures involve three types of expenditures:

1. **Cost for performing SR&ED:** costs you incurred when you directly undertake the SR&ED (in-house SR&ED). These costs are basically wages, materials, and overhead costs.
2. **Cost for SR&ED on your behalf:** costs associated with having SR&ED performed on your behalf (“contract payments”).
3. **Third-party payments:** payments to certain third parties, such as approved associations or approved institutions (“third-party payments”) to be used for SR&ED undertaken by these third parties. See line 370 for more details.

### Salaries and wages

#### Line 300 – Employees’ salaries and wages

On line 300, include in your pool of deductible SR&ED expenditures the portion of salaries or wages and taxable benefits you incurred for your employees who are directly engaged in SR&ED in Canada, which can reasonably be considered to relate to the time they spent in the prosecution of SR&ED in Canada.

Determine the SR&ED portion of the employee’s salary according to the time that person spends on SR&ED work. Employees directly engaged all or substantially all their time (at least 90%) in SR&ED will be considered to spend all their time in SR&ED.

#### Example

If you incur \$100,000 in wages for an employee who spent 90% of his or her time directly engaged in SR&ED, then \$100,000 is considered to be directly engaged wages for that employee.

We explain below the meaning of “salary or wages” and “directly engaged in SR&ED.”

#### Line 305 – Specified employees salaries and wages

Separate the amount of salaries or wages for employees who are **specified employees** (see glossary) and those who are not.

For a specified employee, do not include bonuses or remuneration based on profits in your pool of SR&ED expenditures.

For SR&ED purposes, the maximum amount of salaries and wages per specified employee is limited to five times the year’s maximum pensionable earnings (YMPE) determined for purposes of the Canada Pension Plan. The YMPE are \$39,900 for 2003 and \$39,100 for 2002. Therefore, the maximum amount of salaries and wages per specified employee that you can include on line 305 is \$199,500 ( $\$39,900 \times 5$ ) for a tax year that ends in 2003, and \$195,500 ( $\$39,100 \times 5$ ) for a tax year that ends in 2002.

The maximum amount is prorated by the number of days in the tax year in which the employee is a specified employee. If a specified employee is also performing SR&ED for an associated corporation, the maximum amount must be allocated between the associated corporations using Form T1174, *Agreement Among Associated Corporations to Allocate Salaries or Wages of Specified Employees for Scientific Research and Experimental Development (SR&ED) Expenditures*.

#### Lines 310 and 315 – Unpaid salaries, wages, and other remuneration

Subsection 78(4) generally applies to accrued salaries, wages, and other remuneration that you still have not paid 180 days after the end of the year in which you incurred the expense. It deems the expense not to have been incurred in the year, but rather in the year the amount is paid.

Enter unpaid subsection 78(4) amounts on line 315 of Form T661, even though the expense is not deductible for the year. Make sure you do not include the amount entered on line 315 to line 300 or 305. Later, in a following tax year, if you satisfy the reporting requirement, you can deduct such an expense on line 310 of Form T661 for the tax year in which you actually paid the expense.

#### Definition of “salary or wages”

“Salary or wages” as defined in subsection 248(1) is income from an office or employment as calculated in sections 5 to 8 of the Act. Therefore, salary or wages of an employee includes such amounts as vacation pay, statutory holiday pay, sick leave pay, as well as a taxable benefit to the employee under section 6. Since you have to incur the expenditure to claim it as SR&ED, do not include benefits for which you have not incurred an expenditure such as benefits under subsection 6(9) for interest-free loans.

Do not include as salary or wages an expenditure for **related benefits**. Related benefits include the employer's share of payments to the Canada Pension Plan (CPP) or Quebec Pension Plan (QPP), Employment Insurance (EI), Worker's Compensation Board (WCB) or the Commission québécoise de la santé et de la sécurité au travail (CSST), an approved employee pension plan, and employee medical, dental, or optical insurance plans.

You may be able to deduct related benefits on line 360 if you use the traditional method.

Do not include as salary or wages an expenditure for extended vacation or extended sick leave of an employee. We consider extended leave to be leave in excess of the usual annual leave an employee earns.

#### **Definition of "Directly engaged in SR&ED"**

Whether an employee is directly engaged in SR&ED is a question of fact based on the duties the employee performs and not on the employee's job title.

We consider the time employees, including supervisors and managers, spend to carry out the following tasks as time during which the employee is directly engaged in SR&ED:

- preparing equipment and materials for experiments, tests, and analyses, but not for maintaining equipment;
- experimenting, testing, and analyzing;
- collecting data for experimentation and analysis; and
- directing the course of the ongoing SR&ED work being claimed in the year.

We consider time other employees spend to carry out the following tasks, to the extent that the tasks are required as part of an SR&ED project, to be time during which the employee is directly engaged in SR&ED:

- recording measurements, making calculations, and preparing charts and graphs;
- conducting statistical surveys and interviews;
- preparing computer programs; and

- working in the areas of engineering or design, operations research, mathematical analysis, computer programming, data collection, testing or psychological research.

We do not consider employees providing a service to SR&ED staff, including clerks, secretaries, and receptionists engaged in activities in such areas as accounting, payroll, finance, legal, purchasing, sales, human resources, shipping, inventory control, maintenance, and word processing, to be directly engaged in SR&ED.

We consider the time supervisors or managers are directly involved in the technical aspects of the ongoing SR&ED work as time spent directly engaged in SR&ED.

We do not consider the time managers and supervisors spend on the non-technological management aspect of work, such as long-term strategic planning, contract administration, and other decision-making functions that do not directly influence the ongoing SR&ED work, to be time during which they are directly engaged in SR&ED.

Usually, we do not consider work performed beyond the first-line supervision level as directly engaged. If you claim time for employees beyond the first-line supervision level, you will be asked to provide details of the duties the employee performed in the time claimed as directly engaged in SR&ED, and to demonstrate how these duties are directly engaged as described above.

An employee performs a series of tasks in carrying out his or her duties of employment. You should view these tasks in terms of how they correlate to the primary reason for employment when you determine whether the salary and wages are directly engaged in SR&ED.

#### **Note**

The eligibility of the salary and wages is subject to meeting all the relevant conditions set out in sections 37 and 248 of the Act and section 2900 of the Regulations, and may vary depending on the facts of each case.



We have designed the following table, which will help you determine how to handle the salary and wages for various tasks and duties.

<b>Salary and wages for various tasks and duties</b>			
<b>Duty</b>	<b>Directly engaged in SR&amp;ED</b>	<b>Overhead and other expenditures</b>	<b>Non-SR&amp;ED expenditures</b>
Experimentation and analysis	X		
Technical-support work (under paragraph 248(1)(d) of the definition of SR&ED under the Act)	X		
Non-specialized employees: <ul style="list-style-type: none"> <li>■ operating a machine for the purposes of an experiment that requires the use of this machine;</li> <li>■ feeding raw materials into a machine;</li> </ul> provided that the non-specialized employee's work is supervised by staff who has scientific or technological qualifications.	X		
Direct supervision of employees performing experimentation and analysis (directing the ongoing SR&ED work)	X		
Technological planning for ongoing SR&ED projects you claimed in the year such as: <ul style="list-style-type: none"> <li>■ assignment of technological personnel</li> <li>■ job priority</li> <li>■ development of technological strategies</li> <li>■ quality of material used</li> </ul>	X		
Long-term planning for future SR&ED projects, e.g.: <ul style="list-style-type: none"> <li>■ prototype vs. commercial scale</li> <li>■ project selection</li> </ul>		X	
Human-resource activities such as technological staffing		X	
SR&ED contract administration (technical input only)		X	
Technological training for ongoing SR&ED projects you claimed in the year		X	
Administrative training			X
Technological documentation for internal use	X		
Preparation of user manuals			X
Clerical and other administrative support, such as personnel, accounting, maintenance, and purchasing, if such duties involve performing non-technological functions that aid the ongoing SR&ED you claimed in the year, and if the salaries and wages of these employees are: <ul style="list-style-type: none"> <li>■ directly related and incremental to the prosecution of SR&amp;ED</li> <li>■ not incremental to the prosecution of SR&amp;ED</li> </ul>		X	X
Other support, such as equipment maintenance or repairs, as long as such duties involve performing non-technological functions that aid the ongoing SR&ED work you claimed in the year, and the salaries and wages are directly related and incremental to the prosecution of SR&ED		X	
Preparation of the T661 by employees for SR&ED projects carried out in the current year		X	

**Supporting documents**

You must be able to explain how you determined the amount you claimed and to provide supporting documentation (e.g., supervisor summaries, Gantt charts, planning documents, documents describing project objectives, resource allocation records, written correspondence, minutes of meetings, project notebooks,

lab notebooks, personal notebooks, progress or final reports, time sheets, T4 slips, job descriptions). For salary and wages, this involves identifying the time you allocated to SR&ED and the work the employee performed during that time. Keep in mind that the amounts you allocate to SR&ED must be reasonable.

### **Line 320 – Materials consumed**

Enter the cost of materials consumed in the prosecution of SR&ED. If you incur a liability for materials that you will use later for SR&ED, we consider the cost of these materials to be an SR&ED expenditure in that later year in which you will consume the materials. Be sure all costs are the net laid-down price after you deduct trade discounts and add acquisition costs (e.g., transportation costs). Refer to Application Policy SR&ED 2000-01 – *Cost of materials for SR&ED*, issued March 1, 2000, and its addendum which deals with water and other sources of energy as materials.

The phrase “materials consumed in the prosecution of SR&ED” basically means that you destroyed the materials or rendered them virtually valueless as a result of the SR&ED. For example, in the following situations, not all materials were consumed in the prosecution of SR&ED (see line 325):

- developing assets to sell (custom products);
- developing assets to use in the commercial operations of the performer (commercial assets); and
- sale of experimental production.

### **Line 325 – Cost of materials transformed into another product**

You can claim the costs of materials transformed into another product, if the expenditure is all or substantially all, or directly attributable to the SR&ED. The costs of materials transformed into a product is considered directly attributable to the prosecution of SR&ED if the materials are transformed in the prosecution of eligible SR&ED. For more details, refer to Application Policy 2002-02R – *Experimental Production and Commercial Production with Experimental Development Work – Allowable SR&ED Expenditures*. There will be an ITC recapture as an addition to your tax payable under Part I when you sell or convert the property to commercial use after February 23, 1998.

On December 20, 2002, the Finance Minister issued Draft Technical Income Tax Amendments to allow materials transformed when using the proxy method, effective February 23, 1998. However, this proposed change to subclause 37(8)(a)(ii)(B)(V) will apply only to SR&ED claims within the 18-month period of the claimant. As the latter is a proposed change to the legislation, the CCRA will accept SR&ED claims for materials transformed under the proxy method as if it was law. If the proposed legislation does not pass, the CCRA will make an adjustment to your SR&ED claim as required.

### **Lines 340 and 345 – SR&ED contracts**

On a separate sheet, enter expenditures you incurred and the name of contractors or subcontractors carrying out SR&ED on your behalf. See the explanation for line 370 if you need details about the difference between third-party payments for SR&ED and SR&ED undertaken on your behalf.

It is important that you separate the SR&ED contract expenditures between arm’s length contractors and non-arm’s length contractors. When someone performs SR&ED on your behalf and you do not deal with each other

at arm’s length, your SR&ED expenditures do not qualify for ITC purposes. In addition, the amount the performer receives will not be considered to be a contract payment. See the explanations for lines 526 (expenditures for non-arm’s length SR&ED contracts), 534 (contract payments), and 508 and 510 (transfer of qualified SR&ED expenditures between non-arm’s length parties).

### **SR&ED performed on behalf of a person**

The key element in determining if an amount is a contract payment is whether the payer requested the contractor to perform SR&ED on his behalf under the contract terms. You can only make this determination based on the terms of the contract read as a whole, and by reviewing all the facts surrounding the particular situation.

### **Meaning of “arm’s length”**

The current version of Interpretation Bulletin IT-419, *Meaning of Arm’s Length*, expresses in general terms the criteria we consider when determining whether persons deal with each other at arm’s length.

#### **Note**

When an expenditure relates to a contract for services to be performed after the year-end, the amount for those services does not qualify as an SR&ED expenditure until the year in which the services are actually performed.

### **Line 350 – Lease costs of equipment: allowable SR&ED expenditures**

On line 350, enter a lease expense that was all or substantially all (90%) attributable to the use of equipment for the prosecution of SR&ED in Canada. You must determine the SR&ED usage as a percentage of the total operating time. Generally, operating time means the time the equipment usually runs or functions.

If you use the proxy method, do not include lease cost expenditures for general-purpose office equipment or furniture (see glossary).

### **Lease costs of building: not an allowable SR&ED expenditure**

An expense you incur for leasing a building does not qualify for SR&ED. A lease expense for a building is any expense you incurred to use a building, or to have the right to use a building.

#### **Other**

In certain cases, a lease expense that was all or substantially all attributable to using premises or facilities other than a building may be allowable. For example, the lease expense for a structure may be allowable.

### **Line 355 – Lease costs primarily for SR&ED**

On line 355, if you use the proxy method, enter 50% of the lease costs of equipment, other than general-purpose office equipment or furniture, that is primarily used (more than 50%, but less than 90%) for SR&ED.

You should determine the SR&ED usage as a percentage of the total operating time. Generally, operating time means the time the equipment usually runs or functions.

Enter “0” on line 355 if you use the traditional method. Lease costs of equipment you use primarily for SR&ED may be allowable under line 360 as overhead or other expenditures if you meet certain conditions.

### Line 360 – Overhead expenses and other expenditures

On line 360, enter “0” if you use the proxy method. If you use the traditional method, enter overhead and other expenditures you did not list on lines 300 to 355. Usually, “overhead and other expenditures” are expenditures that are:

- directly attributable to the prosecution of SR&ED in Canada; or
- directly attributable to the provision of premises, facilities, or equipment for the prosecution of SR&ED in Canada.

### Directly attributable to the prosecution of SR&ED in Canada

You can claim the following types of expenditures:

1. Other salaries and wages of employees who directly undertake, supervise, or support the prosecution of SR&ED. You can only claim an expenditure for an employee on line 360 if you meet all the following conditions:
  - you do not claim the SR&ED portion of the salaries or wages of the employee on line 300, 305, or 310 of Form T661 as directly engaged salaries or wages;
  - the employee directly undertakes, supervises, or supports the prosecution of SR&ED (the employee requires a strong technical background);
  - the employee’s salary or wages can reasonably be considered to be for the prosecution of SR&ED.

Examples of tasks for which you can claim an expenditure for salaries or wages on line 360:

- performing non-technological management activities or decision-making functions that do not directly influence the course of the SR&ED but that relate to the SR&ED (e.g., long-term planning for future SR&ED projects or contract administration);
  - preparing a technical feasibility study relating to SR&ED projects carried out.
2. Other expenditures directly attributable to the prosecution of SR&ED in Canada. Include an expenditure, or portion of the expenditure, that is directly related to the prosecution of SR&ED and that would not have been incurred if such prosecution had not occurred (incremental costs).

Other expenditures that may be directly attributable to the prosecution of SR&ED include:

- lease costs of equipment used less than 90% of the time for SR&ED;
- salaries or wages of clerical employees performing non-technological functions that aid the ongoing SR&ED claimed in the year;

- related benefits, such as the employer’s share of payments to the Canada Pension Plan (CPP) or Quebec Pension Plan (QPP), Employment Insurance (EI), the Worker’s Compensation Board (WCB) or the Commission québécoise de la santé et de la sécurité au travail (CSST), an approved employee pension plan, and employee medical, dental, or optical insurance plans;
- travel and training; and
- other costs (e.g., utilities, long-distance telephone charges, or supplies).

### Incremental costs for the prosecution of SR&ED

Expenditures directly related to the prosecution of SR&ED must also be incremental to the SR&ED. For that purpose, we do not necessarily consider a percentage of an expenditure to be incremental. You must be able to demonstrate that the expenditure would not have been incurred if the prosecution of SR&ED had not occurred. Overhead costs for the prosecution of SR&ED have to be specifically identified and allocated to SR&ED. The method you use to allocate overhead expenditures to SR&ED must be reasonable.

#### Note

Costs incurred for work described in paragraph 248(1)(d) of the definition of scientific research and experimental development are not incremental, but could qualify in themselves as SR&ED expenditures.

#### Example

Corporation A incurs travel costs of \$40,000 in its 2002 tax year. SR&ED employees represent 25% of the total personnel of the corporation. Corporation A cannot claim \$10,000 as incremental SR&ED expenditures for the prosecution of SR&ED. It must demonstrate that the expenditure is directly related to the prosecution of SR&ED and is incremental. For this purpose, Corporation A would need to identify each trip, have evidence that each is attributable to SR&ED, and allocate the appropriate costs to SR&ED.

### Directly attributable to the provision of premises, facilities, or equipment for the prosecution of SR&ED in Canada

1. Costs directly attributable to the provision of premises, facilities, or equipment for the prosecution of SR&ED in Canada, include the cost of maintaining premises, facilities, or equipment provided for SR&ED in Canada (e.g., the costs of cleaning, painting, and servicing equipment).
2. Other expenditures, or portions of expenditures, directly related to the provision of premises, facilities, or equipment for the prosecution of SR&ED in Canada and that would not have been incurred if these premises, facilities, or equipment had not existed (incremental). Include, for example, taxes and insurance for a building that you own and that you use for the prosecution of SR&ED.

### Incremental costs for the provision of premises, facilities, or equipment

These other expenditures directly related to the provision of premises, facilities, or equipment for the prosecution of SR&ED in Canada must also be incremental to the SR&ED. For that purpose, we consider a reasonable percentage of an expenditure to be incremental.

#### Example

If you own a building and use it for the prosecution of SR&ED, we consider a reasonable portion of the municipal taxes or the cost of insurance for the building to be directly attributable to the provision of premises, facilities, or equipment for the prosecution of SR&ED.

The method you use to determine the portion that is directly related to the SR&ED has to be reasonable. You can base it, for example, on the square meters of the building you used for SR&ED over the total square meters of the building. You can use other methods to determine the portion of an expenditure that is directly related to the provision of premises, facilities, or equipment for the prosecution of SR&ED, as long as they are reasonable in the circumstances. In all cases, whichever method you use, you have to be able to provide proof that it is reasonable.

On line 360, do not include capital cost allowance, general administrative expenses, or factory overhead expenses that you would have incurred if you had not conducted the SR&ED.

#### Supporting documents

You have to identify each overhead expenditure specifically and allocate a reasonable amount to SR&ED. At the time of the financial review, you may be asked to explain how you determined the amount, to provide support for this determination, and to demonstrate that the overhead expenditures are incremental to the SR&ED.

#### Line 370 – Third-party payments

Complete one copy of Schedule A for each third-party payment as indicated.

On line 370, include the total of all third-party payments you made to the organizations listed below. The payments must be used for SR&ED carried out in Canada that is related to your business, and you must be entitled to exploit the results of the SR&ED:

- a) approved associations that undertake SR&ED;
- b) an approved university, college, research institute, or other similar institution;
- c) non-profit SR&ED corporations resident in Canada and exempt from tax under paragraph 149(1)(j) of the Act;
- d) an approved organization (granting councils) that makes payments to an association, institution, or corporation described in a) to c) above;
- e) corporations resident in Canada provided the SR&ED was performed.

#### Note

To determine whether the Minister of National Revenue has approved an institution or association, you can consult the Appendix to Interpretation Bulletin IT-151, *Scientific Research and Experimental Development Expenditures*, for a partial list of approved entities for SR&ED purposes, or contact the organization in question.

The amounts you report on line 370 are usually referred to as third-party payments for SR&ED. They do not include payments for SR&ED undertaken on your behalf that you report on lines 340 or 345. For example, third-party payments for SR&ED could include payments to participate in arrangements such as industry-wide SR&ED undertaken by SR&ED associations, non-profit SR&ED corporations, or universities. In such cases, the payer does not control the actual work performed.

Table 3 shows the usual differences between the two concepts.

<b>Characteristics</b>	<b>SR&amp;ED contracts</b>	<b>Third-party payments</b>
Control of SR&ED	Payer	Performer
Rights	Exclusive	Non-exclusive (generally published)
Number of funders	Usually limited to one payer	Multiple funders
Type of SR&ED	Commercially focused	Often basic or applied research
Tax treatment	Accrual	Cash basis

You cannot include all payments to organizations such as SR&ED associations and universities as expenditures on line 370, since you could contract with such organizations to perform SR&ED on your behalf. For example, if you need a particular type of expertise, you can contract with these organizations to perform specific tasks for you. In this case, the work is performed on your behalf, and you should report the expenditures on line 340 or 345.

For a corporation, include on line 370 any payments you made to a non-profit SR&ED corporation resident in Canada for basic or applied research carried out in Canada. For more details on such payments, see the current version of Interpretation Bulletin IT-151, *Scientific Research and Experimental Development Expenditures*.

The amount of your payment eligible for SR&ED may be reduced if the recipient uses the funds to acquire a building, a leasehold interest in a building, or to pay rent for a building.

See instructions for Schedule A further on.

## **Line 390 – Capital expenditures for SR&ED carried out in Canada**

On line 390, include in the pool of deductible SR&ED expenditures under paragraph 37(1)(b) any capital expenditures for SR&ED carried out in Canada and related to a business of yours. For purposes of subsection 37(1), capital expenditures on SR&ED are only those that result in the acquisition of depreciable property other than buildings and leasehold interest in buildings. Generally, only capital expenditures for new equipment are allowable. You cannot include non-depreciable assets in the pool. We recommend keeping a list of capital items acquired in the year, should the CCRA need to review it.

### **Example**

A claimant acquires land, a building, and equipment to be used all or substantially all for the prosecution of SR&ED. The expenditure pool will only be affected by the equipment expenditure, as land is a non-depreciable asset, and buildings are generally excluded (see below).

The only difference in determining capital expenditures under the traditional method and the proxy method is that you cannot include general purpose office equipment or furniture if you use the proxy method.

An SR&ED capital expenditure is an expenditure you made to acquire property that you intended either to:

- use the property during all or substantially all (90% or more) of its operating time in its expected useful life for the prosecution of SR&ED in Canada; or
- consume all or substantially all of the value of the property in the prosecution of SR&ED in Canada.

You determine a property's eligibility when you make the expenditure. However, when we determine eligibility, we look beyond the use of the property in the year you make the expenditure and we consider the intended use over the life of the asset.

We cannot consider that you have made a capital expenditure until the property you acquired becomes available for your use.

### **Note**

If you are allowed an SR&ED deduction for the depreciable property, you cannot also claim capital cost allowance on the same property.

When you sell the SR&ED property, the tax treatment of the proceeds may vary. What you do depends on whether you have previously claimed a deduction for the property. For more details, see the explanation for line 440 of Form T661.

### **ITC recapture**

There will be an addition to your tax payable under Part I when you sell equipment that was used all or substantially all of the time to carry out SR&ED or when you convert it to commercial use after February 23, 1998. For more details, see Application Policy SR&ED 2000-04R2 – *Recapture of Investment Tax Credit*, issued December 7, 2000.

The recapture rules on ITC will also apply to a disposition or conversion relating to property acquired pursuant to an expenditure that would have been a qualified expenditure incurred in a taxation year had it not been for the application of the 180-day-unpaid-amount rule in subsection 127(26) of the Act, effective after December 20, 2002.

### **Buildings and land**

Expenditures you incurred to acquire buildings and leasehold interests in buildings (other than prescribed special-purpose buildings) do not qualify as SR&ED expenditures. Expenditures to acquire land and leasehold interests in land are also excluded.

Prescribed special-purpose buildings are defined in section 2903 of the Regulations. They are buildings the Department of Finance approves on a building-by-building basis.

### **Line 400 – Allowable SR&ED expenditures**

Allowable SR&ED expenditures are the total current and capital expenditures you made in the year. On line 400, enter the total of the amounts on lines 380 and 390.

## **Step 2**

### **Pool of deductible SR&ED expenditures (lines 430 to 470)**

Starting with the amount of allowable SR&ED expenditures entered on line 400, calculate the SR&ED expenditure pool deduction that is available in the year, the deduction claimed in the year, and any balance of the SR&ED expenditure pool deduction you can deduct in future years.

### **Line 430 – Government and non-government assistance**

Assistance refers to both government and non-government assistance for SR&ED. Government assistance includes forgivable loans, grants, subsidies, deductions from tax, investment allowances, or any other form of assistance, excluding the federal ITC. It also includes assistance for SR&ED from a provincial government, a municipality, or a public authority. This includes provincial SR&ED tax credits when they apply. Non-government assistance includes inducements and assistance you obtained from other persons that you do not include in your taxable income because of some other provision (e.g., the general provisions of section 9).

Super allowance benefit amount: Certain provinces have introduced "super-deductions" that allow corporations to deduct over 100% of SR&ED expenditure costs for provincial tax purposes. Even though these deductions provide for a similar level of provincial assistance, as compared to provincial ITCs, they were not considered to be government assistance and did not reduce the expenditures for federal ITC purposes.

For tax years beginning after February 2000 and ending after 2000, paragraph 37(1)(d.1) provides for the reduction of a corporation's pool of deductible SR&ED expenditures for a tax year by its "super allowance benefit amount" in respect of a province for the year and preceding tax years.

Under subsection 127(9), the term “super allowance benefit amount” of a corporation in respect of a province for a tax year is calculated using the following formula:

$$(A - B) \times C$$

where

A is the amount in respect of an SR&ED expenditure incurred in a particular year that the corporation is, or becomes, entitled to deduct in computing its income or taxable income for purposes of calculating its provincial income tax payable for any tax year;

B is the SR&ED expenditures otherwise determined (without reference to provincial income tax credits); and C represents the provincial rate of tax to be applied to convert the excess of A - B into an income tax credit equivalent. Where a corporation’s expenditure limit for the year (see ¶ 81) is nil; or

C is the maximum provincial corporate income tax rate applicable to active business income earned in that province for the year. Otherwise, C is the rate of provincial income tax applicable to a corporation that is not associated with any other corporation in the year and that has taxable income for the year of less than \$200,000 earned from carrying on an active business in that province.

The amount calculated is called the “super allowance benefit amount” and must be included in the corporation’s Part I tax payable in the year. The super allowance benefit amount will reduce the corporation’s deductible expenditure pool for SR&ED for the year and preceding tax years. The super allowance benefit amount will also reduce the qualified expenditures for purposes of calculating the ITC.

For more details, refer to Application Policy SR& ED 2000-03 - *Government Assistance - Treatment of Provincial and Territorial R&D Assistance*, issued October 31, 2000.

If, at the filing due date of your tax return for the tax year, you have received, are entitled to receive, or can reasonably expect to receive assistance, your pool of deductible SR&ED expenditures will be reduced.

If you are using the proxy method, do not deduct the assistance for expenditures that the prescribed proxy amount replaces.

Ontario’s R&D Super Allowance was suspended indefinitely, beginning with the first tax year for which the federal super-deduction provision would apply to the corporation, and, in its place, allows corporations to exclude from Ontario taxable income the portion of the federal investment tax credit that relates to qualifying Ontario SR&ED expenditures.

The province of Quebec has cancelled its superdeduction effective for tax years beginning after February 2000.

#### Line 435 – ITC claimed in prior year

An ITC for SR&ED expenditures that you claimed in a prior year does not reduce your pool of deductible SR&ED expenditures for the current year. Rather, it will be deducted from the pool of deductible SR&ED expenditures in the next year. An ITC you claimed in a prior year can include the following:

- ITC refunds;
- ITC you carried back to previous years;
- ITC on the prescribed proxy amount;
- ITC on qualified SR&ED expenditures transferred to you from a non-arm’s length performer under paragraph 127(13)(e).

However, an ITC on shared-use equipment cannot be included.

When an ITC deducted or refunded may reasonably be considered to relate to a property acquired in a preceding year as shared-use equipment, it will reduce the capital cost of the property acquired.

For partnerships, you have to reduce the balance in the pool of deductible SR&ED expenditures by the amount of ITC in the same year the partnership makes the related SR&ED expenditures.

#### Line 440 – Sale of SR&ED assets and other deductions

If you sold an SR&ED asset (capital equipment you purchased for SR&ED) during the year, and the amount on line 450 includes unclaimed expenditures for the asset, include on line 440 the sale proceeds or the amount of unclaimed expenditures for the asset, whichever amount is less.

If the sale proceeds are more than the unclaimed balance of SR&ED expenditure for the asset, include the difference in your income up to the amount of recapture of capital cost allowance (CCA). If the sale proceeds are more than the original cost of the asset, the difference is either a capital gain or income, depending on the facts of each case.

#### Example

Facts	(1) Unclaimed SR&ED expenditures balance carried forward from the previous year (line 450) .....	\$ 500
	(2) Asset you sold during the year:	
	Original cost.....	\$1,000
	Proceeds of disposition.....	\$ 100
	Unclaimed expenditures for the asset that are included in the line 450 amount.....	\$ 50
Solution	(1) Determine the line 440 amount, whichever amount is less: the proceeds of disposition.....	\$ 100

or	
	the amount of unclaimed expenditures for the asset..... \$ <u>50</u>
	The line 440 amount ..... \$ <u>50</u>
(2) Determine the recaptured CCA, whichever amount is less: cost.....	\$1,000
or	
	proceeds of disposition ..... \$ <u>100</u>
	\$ <u>100</u>
Minus the reduction to the line 440 amount .....	\$ <u>50</u>
Recapture of CCA (include this amount in your income for the year) ...	\$ <u>50</u>

**Note**

In certain cases, other deductions may be required to be made to the SR&ED expenditure pool (e.g., expenditures a corporation renounced for the purposes of Part VIII tax, and amounts deducted under section 61.3).

**Line 450 – Prior year balance**

Enter the unclaimed balance in the pool of deductible SR&ED expenditures you are carrying forward from the previous year. For a partnership, enter “0” on line 450.

**Line 453 – Recapture of ITC**

Any ITC recaptured under new subsections 127(27), (29), (30) or (34) for the previous tax year, will increase the amount of the taxpayer’s subsection 37(1) SR&ED pool for the current year.

Generally, the circumstances that will reduce a taxpayer’s SR&ED ITCs are disposition or conversion to commercial use of a property (after February 23, 1998), where the cost of that property was previously claimed as an SR&ED cost for ITC purposes. Refer to Application Policy SR&ED 2000-04R2 for more information on ITC recapture.

The recapture rules on ITC will also apply to a disposition or conversion to commercial use related to property acquired pursuant to an expenditure that would have been a qualified expenditure incurred in a taxation year had it not been for the application of the 180-day-unpaid-amount rule in subsection 127(26) of the Act, effective after December 20, 2002.

**Line 454 – Adjustments to the pool of deductible SR&ED expenditures incurred in Canada.**

Refer to the instructions below on how to complete section 1 of Schedule B.

If the amount on line 454 of Schedule B is positive, enter that amount on line 454 of Form T661. If the amount on line 454 is negative, include the amount in your income for the year.

**Line 460 – Deduction claimed in the year**

Enter the deduction you claim in the year from the pool of deductible SR&ED expenditures. You can deduct all or a portion of your expenditures for SR&ED carried out in

Canada in the year you make the expenditures, or you can accumulate them and carry them forward to deduct in future years. The deduction is optional, and can be any amount up to the current year’s line 455 amount, subject to the following restrictions:

- If the claimant is a corporation and an acquisition of control has previously occurred, the total amount on line 455 may not be available for deduction in the year or in a later year. You have to use special rules to determine the amount you can deduct. Usually, these rules operate like the non-capital loss restrictions in subsection 111(5) for an acquisition of control. For more details, see the current version of Interpretation Bulletin IT-151, *Scientific Research and Experimental Development Expenditures*.
- A partnership cannot carry forward SR&ED expenditures to a subsequent year.

**Line 470 – Balance of deductible expenses**

This amount is your unclaimed balance in the pool of deductible SR&ED expenditures at the end of the year and, subject to the restrictions noted at line 460, you can deduct it in future years. For a partnership, enter “0” on line 470.

**Step 3**

**Qualified SR&ED expenditures for ITC purposes (lines 500 to 570)**

In this section, you will determine the SR&ED expenditures that qualify for a federal ITC. Not all expenditures for SR&ED carried out in Canada will earn an ITC. Use Step 3 to determine the base of SR&ED expenditures that earn an ITC.

You should break down your expenditures between current and capital expenditures. This will help you calculate your refundable ITC.

**Line 500 – Unpaid amounts from prior years**

On line 500, enter unpaid amounts from previous years you paid in the year and that are deemed to be an expenditure you incurred in the year under subsection 127(26).

Under subsection 127(26), SR&ED current expenditures that you do not pay within 180 days of the end of the tax year in which you incurred them are deemed not to have been incurred in that year for ITC purposes but only at the time you paid them. This applies to all unpaid amounts for SR&ED current expenditures except unpaid salaries, wages, or other remuneration under subsection 78(4). See explanation for line 310.

The Draft Technical Amendments to the *Income Tax Act*, dated December 20, 2002, propose that if there is a disposition or conversion of property acquired pursuant to an expenditure that would have been a qualified expenditure incurred in a taxation year had it not been for the application of the 180-day-unpaid-amount rule in subsection 127(26) of the Act, the recapture rules on ITC apply, effective after December 20, 2002.

**Note**

Even if your unpaid amounts under subsection 127(26) do not qualify for ITCs until the time you paid them, they are still allowable SR&ED expenditures deductible in the year you incurred the expenditures. Make sure to include your unpaid subsection 127(26) amounts in your allowable SR&ED expenditures within the period allowed to file Form T661. If you do not, they will not be qualified expenditures in the year you pay them.

**Example**

In its tax year ending on December 31, 2000, Corporation A incurs SR&ED expenditures of \$100,000 for consulting fees payable to Corporation B. Corporation A still has not paid the expenditure 180 days after the end of the 2000 tax year. The expenditure is only paid in November 2002.

- Corporation A must identify the expenditure in the SR&ED expenditure pool on Form T661 within the reporting deadline. It is an allowable SR&ED expenditure deductible in 2001.
- Corporation A has to deduct the unpaid amount on line 520 of Schedule B for the 2001 tax year. For ITC purposes, the expenditure is deemed not to have been incurred in 2001.
- When Corporation A pays the expenditure in the 2002 tax year, enter the amount that is paid on line 500 of Form T661 for that year.

**Line 502 – Prescribed proxy amount**

Enter “0” on line 502 if you use the traditional method.

Complete Schedule D to determine the salary base and the prescribed proxy amount and attach to Form T661.

The PPA for a tax year is 65% of the salary base. In certain situations, an overall cap on the prescribed proxy amount may limit the amount you would otherwise determine.

**Salary base** – The salary base for the proxy method is composed of salaries and wages of employees who are directly engaged in SR&ED in Canada. The directly engaged salaries and wages are those you entered on line 300 for non-specified employees, and on line 305 of Form T661 for specified employees. However, special rules apply to restrict the amount of salaries or wages of specified employees that you can include in the salary base.

The salary base does not include taxable benefits under sections 6 and 7 of the Act, bonuses, remuneration based on profits, or an amount deemed incurred in the year under subsection 78(4).

Table 4 illustrates the differences between the salaries or wages expenditure you include in the SR&ED expenditure pool, and the salary base you use to calculate the PPA.

<b>Table 4</b>		
<b>Salaries and wages expenditures included in the salary base</b>		
	<b>Salaries or wages expenditure</b>	<b>Salary base</b>
Directly engaged salaries or wages other than taxable benefits under sections 6 and 7, bonuses, remuneration based on profits, an amount deemed incurred under subsection 78(4)		
– for non-specified employee	Yes (included on line 300)	Yes
– for specified employee	Yes (on line 305) amount is restricted *	Yes, amount is restricted **
Taxable benefits (section 6) incurred	Yes (lines 300 and 305)	No
Remuneration based on profits, bonuses	Yes for non-specified employees (line 300)	No
Amount deemed incurred in the year under subsection 78(4)	Yes (line 310)	No
Related benefits (employer’s contributions to certain plans)	No (see explanations for lines 300 to 315)	No
* 5 x YMPE		
** 2.5 x YMPE		

**Line 504 – Shared-use equipment (SUE)**

Equipment used primarily (more than 50% of its operating time) for the prosecution of SR&ED in Canada qualifies for a partial ITC. One half of the expenditures on equipment used primarily for SR&ED is eligible for an ITC at the rate that would have applied if the expenditure had been all or substantially all attributable to SR&ED.

This shared-use treatment could apply to equipment used for dual purposes in the same year, or equipment whose use changes over time, for example, when a company performs SR&ED in a shop-floor setting and uses equipment for both SR&ED and production activities.

You earn the partial credit over time. You earn one half of the partial credit at the end of the first tax year that follows the first 12-month period of your acquiring the equipment. You earn the other half of the credit at the end of the first tax year that follows the first 24-month period of your acquiring the equipment. For that purpose, the equipment is deemed not to have been acquired until it has become available for use.



The test of whether the equipment qualifies for the partial credit begins when you acquire the equipment and it is available for use, and ends in the tax year in which the relevant test period ends. The test is based on how you use the equipment during the entire period up to the end of that tax year. You should be prepared to provide documentation to substantiate the percentage of time you use the equipment for SR&ED.

The shared-use rules are for ITC purposes only. The equipment does not form part of the SR&ED pool, but is depreciated under the regular capital cost allowance rates and rules.

On line 504, enter the expenditures on first term SUE plus the expenditures on second term SUE.

### First term shared-use equipment

To qualify, the equipment must be:

- depreciable property;
- equipment that does not qualify as capital expenditure which you entered on line 390 of Form T661 (capital expenditure all or substantially all attributable to SR&ED);
- an asset that is not, according to subsection 2900(11) of the Regulations, a prescribed depreciable property (PDP). Basically, PDP prevents equipment in a facility, a plant or a line that is going to be used for commercial production or commercial processing from being treated as SUE even if it is used primarily for SR&ED in the first and second term periods. (PDP also includes a building, a leasehold interest in a building and equipment used in the assembly, construction or commissioning of a commercial facility, plant, or line);
- equipment other than general purpose office equipment or furniture (see glossary);
- new (it must not have been used or acquired for use or lease, for any other purposes before you acquired it); or
- equipment that is used primarily (more than 50% of its operating time) for SR&ED in Canada during the period starting with the time the property was acquired and available for use, and ending at the end of the first tax year ending at least 12 months after that time.

Generally, operating time means the time the equipment usually runs or functions. Whether you use the equipment for SR&ED during its operating time is a question of fact that can only be determined on a case-by-case basis. However, we usually consider time you spend to set up equipment for SR&ED work, and time you spend to switch the equipment back to another use to be operating time in which you used the equipment for the prosecution of SR&ED, as long as it is reasonable in the circumstances.

You can claim as expenditure, 1/4 of the capital cost of the equipment after certain adjustments; you may need to make adjustments to the capital cost if you purchased the equipment from a non-arm's length supplier (see explanations for lines 522 and 524). However the capital cost of the equipment is not reduced by the amount of the related assistance or contract payments; rather, such assistance and contract payments reduce the qualified expenditures on lines 534 and 536 of Form T661.

### Second term shared-use equipment

Second term shared-use equipment is a property that was first term shared-used equipment that you used primarily (more than 50% of its operating time) for SR&ED in Canada, during the period starting with the time you acquired the property and it was available for use, and ending with the first tax year that ends at least 24 months after that time.

#### Example

On November 30, 1998, Company A purchased a new milling machine for \$100,000, to be used in SR&ED and in manufacturing and processing (M&P) over its expected useful life. The capital expenditure does not pass the all or substantially all test. The company has a June 30 year-end. The machine ran 8 hours a day, 5 days a week. The operating time of the machine for SR&ED and M&P is as follows:

Time period	Total machine hours	SR&ED	M&P
December 1, 1998, to June 30, 1999	1,200	1,000	200
July 1, 1999, to November 30, 1999	800	600	200
December 1, 1999, to June 30, 2000 (end of first period)	1,200	800	400
July 1, 2000, to November 30, 2000	800	200	600
December 1, 2000, to June 30, 2001 (end of second period)	1,200	400	800
<b>Total</b>	<b>5,200</b>	<b>3,000</b>	<b>2,200</b>

**For the tax year ending June 30, 1999** – You should capitalize the asset's cost in the regular capital cost allowance (CCA) class.

**For the tax year ending June 30, 2000** – The machine was used primarily in SR&ED (2,400/3,200 or 75%) for the period from the time the machine is available for use (December 1, 1998) to the end of the first tax year ending at least 12 months after that time (June 30, 2000). Therefore, it is first term SUE, and you can include 25% of 100,000 (\$25,000) as a qualified expenditure.

**For the tax year ending June 30, 2001** – The machine was used primarily in SR&ED (3,000/5,200 or 58%) for the period from the time the machine is available for use (December 1, 1998) to the end of the first tax year ending at least 24 months after that time (June 30, 2001). Therefore, it is second term SUE, and you can include 25% of \$100,000 (\$25,000) as a qualified expenditure.

#### Notes

To qualify for SUE, the property must not have been used or acquired for use or lease, for any other purposes before it was acquired by the claimant.

Any ITC you earned and claimed for shared-use equipment reduces the CCA class in the year after the claim.

Table 5 below compares equipment all or substantially all (ASA) for SR&ED (line 390 of Form T661) and shared-use equipment.

<b>ASA equipment used for SR&amp;ED</b>	<b>Shared-use equipment</b>
<ul style="list-style-type: none"> <li>■ relates to equipment intended to be used in SR&amp;ED throughout its useful life</li> <li>■ included in subsection 37(1) expenditure pool and earns ITC</li> <li>■ ITC is earned when you make the capital expenditure</li> <li>■ you earn ITC on full cost</li> <li>■ includes general purpose office equipment or furniture under the traditional method only</li> <li>■ eligibility is based on intent</li> </ul>	<ul style="list-style-type: none"> <li>■ relates to equipment you use for SR&amp;ED and some other purpose</li> <li>■ only earns ITC – Capital cost is included in CCA schedule in usual manner</li> <li>■ you earn the partial ITC over time</li> <li>■ you earn ITC on one-half of the cost</li> <li>■ excludes general purpose office equipment or furniture under both the traditional and proxy methods</li> <li>■ eligibility is based on actual use</li> </ul>

**Lines 508 and 510 – Transfer of eligible expenditures**

If someone carries out SR&ED on your behalf and the two parties are not dealing at arm’s length, your expenditures for the contract do not qualify for ITC purposes. In addition, the amount received or receivable by the performer of the SR&ED is not considered to be a contract payment. However, the performer can transfer qualified expenditures to you up to a maximum of the contract amount.

Subsection 127(13) provides for the transfer of qualified expenditures between non-arm’s length claimants. A partnership cannot be a party to such a transfer, since it is not considered to be a person for the purpose of this paragraph.

To effect such a transfer, the two parties (the payer and the performer) must file a joint agreement on Form T1146, *Agreement to Transfer Qualified Expenditures Incurred in Respect of Scientific Research and Experimental Development (SR&ED) Contracts Carried out in Canada*.

The amount that the performer can transfer for a tax year is the least of the following three amounts:

- the amount specified by the parties in their agreement;
- the performer’s SR&ED qualified expenditure pool at the end of the year before deducting the transfer of qualified expenditures to the payer; and
- the total of all amounts that would be contract payments if the two parties were dealing at arm’s length (notional contract payments) that are:
  - for performing SR&ED for or on behalf of the payer;
  - paid by the payer to the performer on or before the day that is 180 days after the end of the particular year; and
  - for a qualified expenditure the performer incurred in the particular year (not considering subsections 78(4) and 127 (26)) for that portion of the SR&ED that was performed when the performer did not deal at arm’s length with the payer, and is paid by the performer on or before the day that is 180 days after the end of the particular year, or for an amount transferred to the performer in respect of the SR&ED.

The least of the three amounts is transferred out of the performer’s SR&ED qualified expenditure pool for the year (enter amounts you transferred on lines 544 and 546) and into the payer’s SR&ED qualified expenditure pool for its first tax year ending at the same time, or after, the end of the performer’s year in which the transfer is made (enter amounts transferred to you on lines 508 and 510).

**Example**

Corporation C performs SR&ED for a related corporation, Corporation D, according to a contract for services. Both corporations have the same December 31 tax year-end. The contract price is \$1,000, which Corporation D paid fully in 2000.

Corporation C performed 80% of the SR&ED in 2000 and incurred \$784 of qualified expenditures in 2000. However, Corporation C only paid \$392 of the qualified expenditures by the 180th day after December 31, 2000. Corporation C paid the remaining \$392 in 2001. Corporation C completed the SR&ED in 2001 and incurred an additional \$196 of qualified expenditures in that year. Corporation C paid that amount at the end of that year. Corporation C also incurred and paid qualified expenditures of \$100 in 2000 and \$100 in 2001 for other SR&ED projects.

Corporation C and Corporation D want to file an agreement to transfer qualified expenditures from Corporation C to Corporation D for 2000 and 2001. They have to use Form T1146.

<b>Calculation</b>	<b>2000</b>	<b>2001</b>
<b>Line 100 of Form T1146</b>		
Corporation C’s SR&ED qualified expenditure pool at the end of the year, before reducing for the transfer of qualified expenditures to Corporation D	\$492	\$688
\$392 + \$100 = \$492		
\$588 + \$100 = \$688		

**Line 102 of Form T1146** \$400 \$200  
 Calculation of line 102 amount  
 $\$392 \div \$784 \times \$800^* = \$400$   
 $\$196 \div \$196 \times \$200^* = \$200$

**\*Notional contract payment for**

**2000:** \$800 (\$1,000 less \$200 under paragraph 18(9)(a) – that is 20% of \$1,000)

**2001:** \$200 (the paragraph 18(9)(a) amount of \$200 in 2000, is deemed incurred in 2001)

**Line 104 of Form T1146**

Maximum amount that can be transferred: the amount on line 100 or 102, whichever amount is less \$400 \$200

Corporation C can transfer to Corporation D an amount up to the amount on line 104.

**Lines 534 and 536 – Government or non-government assistance**

Assistance will reduce only the SR&ED expenditures to which they relate. We illustrate this with the following example.

**Example**

	Project 1	Project 2	Project 3
Allowable SR&ED expenditures	\$125	\$250	\$125
<b>minus:</b>			
Contract payments	(\$ 50)	0	(\$100)
Government assistance	(\$100)	0	(\$ 50)
Non-government assistance	0	(\$ 50)	0
Qualified expenditures	0*	\$200	0*

\* The excess funding received for Projects 1 and 3 (\$25 each) does not reduce the Project 2 expenditures that are eligible for an ITC.

The amount of qualified expenditures is reduced by any government assistance, non-government assistance and contract payment that the claimant or a person or partnership not dealing at arm’s length with the claimant has received, is entitled to receive, or can reasonably expect to receive.

For a brief overview of what constitutes **government and non-government assistance**, see the explanation for line 430. However, for ITC purposes, assistance for expenditures that the prescribed proxy amount replaces is also included on lines 534 and 536.

Usually, an amount a claimant received or that is receivable is considered to be a **contract payment** if:

- the amount is from a taxable supplier;
- the amount is for SR&ED;

- the SR&ED is performed for, or on behalf of, a person or partnership entitled to deduct the amount because of subparagraph 37(1)(a)(i) or (i.1); and
- the claimant and that person or partnership are dealing at arm’s length when the SR&ED is performed.

**Note**

When an amount received is not for SR&ED done on behalf of the payer, it will not reduce the qualified expenditures of the performer.

For more details on contract payments, see the current version of Interpretation Bulletin IT-151, *Scientific Research and Experimental Development Expenditures*.

**Non-arm’s length SR&ED contract**

For a non-arm’s length SR&ED contract, the payer does not have any qualified expenditure in respect of the contract amount for SR&ED. Also, the contract amount is not a contract payment to the payee.

**Rules for reducing qualified expenditures**

Subsection 127(18) reduces the qualified expenditures of a claimant (including a partnership) by any government assistance, non-government assistance, or contract payments (assistance) you received. It applies when you have received, are entitled to receive, or can reasonably expect to receive assistance for SR&ED on or before the filing due date for a tax year. Provincial tax credits related only to an R&D program will reduce the qualified expenditures and the deductible expenditure pool for SR&ED for the year.

The qualified expenditures you incurred in the year that relate to SR&ED are reduced by the assistance that relates to SR&ED, minus all amounts applied for preceding tax years to reduce your qualified expenditures or the qualified expenditures of some other claimant that does not deal at arm’s length with you (see below).

**Example 1**

Company A receives \$30,000 of assistance for SR&ED in its 2001 tax year. It incurs \$50,000 of qualified expenditures before any reduction under subsection 127(18) for that year.

Subsection 127(18) requires that Company A’s qualified expenditures be reduced by the \$30,000 of assistance it received. As a result, Company A can only claim an ITC based on the remainder of \$20,000.

**Example 2**

Company A spends \$20,000 on shared-use equipment (SUE). This is the only SR&ED expenditure the company incurred. Company A receives \$6,000 of assistance for SR&ED to acquire the SUE. The qualified expenditure determined before the reduction for the assistance received is \$5,000 in 2000 (the first term SUE, 1/4 of \$20,000) and \$5,000 in 2001 (the second term SUE).

Subsection 127(18) states that the portion of the assistance that is for the SR&ED (\$6,000) must reduce qualified expenditures incurred in the year for the SR&ED. In 2000, the assistance of \$6,000 will fully offset the qualified expenditures of \$5,000 for first term SUE. Since Company A did not incur other qualified SR&ED expenditures in that

year, it has to apply the remaining \$1,000 to reduce the qualified expenditures for second term SUE to \$4,000 in 2001.

In certain cases, assistance received or receivable by a non-arm's length party may also reduce your qualified expenditures under subsection 127(19). This subsection applies when the assistance is **greater** than the total qualified expenditures incurred in the year by the recipient and the non-arm's length party for the SR&ED. Bear in mind that from the assistance received, you must subtract all amounts relating to it that applied for a preceding year to reduce the qualified expenditures of the recipient and the non-arm's length party. When the assistance is greater than the expenditures, your qualified expenditures with respect to the SR&ED will be eliminated.

### Example 3

Company D receives a contract payment of \$120,000 for SR&ED from an arm's length party in its 2000 tax year. Company D contracts out part of this SR&ED to its subsidiary, Company E, which has the same December 31 year-end.

Company E completes its portion of the SR&ED in its 2000 tax year and incurs \$48,000 of qualified expenditures relating to the SR&ED before any reduction because of assistance. Company D incurs qualified expenditures of \$20,000 for the SR&ED in its 2000 tax year, and \$40,000 for the SR&ED in its 2001 tax year before any assistance reduction. All of the SR&ED is completed by the end of year 2001.

Under subsection 127(18), Company D's qualified expenditures it otherwise incurred in its 2000 tax year, \$20,000, are reduced to nil. Under subsection 127(19), Company E's \$48,000 of qualified expenditures it otherwise incurred in 2000 are also reduced to nil because of the contract payment by Company D received.

In 2001, subsection 127(18) requires that the difference between \$120,000 and \$68,000 (the sum of \$20,000 and \$48,000 that reduced the qualified expenditures of Company D and Company E for their 2000 tax year) be applied to reduce to nil the qualified expenditures that Company D incurred in 2001 for the SR&ED.

Since Company D incurs only \$40,000 more qualified expenditures in 2001 before completing the SR&ED, it would have no qualified expenditures for the SR&ED in 2001. The unapplied amount of the contract payment, \$12,000 (\$120,000 - \$68,000 - \$40,000), would not affect the amount of qualified expenditures that Company D or Company E incurred for other SR&ED.

If there is an amount of unapplied assistance, it will reduce the qualified expenditures **each** non-arm's length person incurred for the SR&ED, as long as the following conditions apply:

- when each member of a non-arm's length group performs the SR&ED;
- each member is not dealing at arm's length with the recipient of the assistance; and

- section 127(19) does not apply to the assistance in respect of a particular year.

However, to avoid the multiple qualified expenditures reduction, the recipient can make an allocation of the remaining assistance under subsection 127(20).

### Lines 552 – 554 – Adjustments to qualified expenditures

Refer to instructions below on how to complete Schedule B.

### Lines 555 – 556 – Non-arm's length adjustments

Refer to instructions below on how to complete Schedule C.

### Line 559 – SR&ED qualified expenditure pool

You use the amount in this pool at the end of a taxation year to calculate the ITC for that year.

In general, the amount in the SR&ED qualified expenditure pool at the end of a taxation year is equal to the qualified expenditures you incur in the year, plus any amount transferred to you under paragraph 127(13)(e), (amounts on lines 508 and 510), and minus any amount you transferred to another person under paragraph 127(13)(d) (amounts on lines 544 and 546).

### Line 560 – Repayments made in the year

Amounts that can reasonably be considered as repayments of government assistance, non-government assistance, or contract payments that previously reduced SR&ED expenditures eligible for an ITC are also eligible for an ITC.

On line 560, enter any repayments that you made during the year of assistance and contract payments for qualified SR&ED expenditures, including expenditures the prescribed proxy amount replaced. Also, add on this line amounts that are considered to be assistance you repaid in the year. These include the amount of assistance that reduced the amount of a qualified expenditure that was not received, and ceased to be an amount that you can reasonably expect to receive.

Also include on line 560 the repayments of assistance for first and second term shared-use equipment.

### Line 570 – Total SR&ED qualified expenditures

This is the total of the SR&ED qualified expenditure pool and the repayments of assistance and contract payments. Add the amounts of lines 555 and 560, and enter the total of line 570. To claim an ITC on this amount, use Schedule T2SCH31 – *Investment Tax Credit – Corporations*, or form T2038(IND) *Investment Tax Credit – Individuals*, as applicable.

## Part 4 – Background Information

We ask for background information in this part of Form T661. This information on your business is needed to process your SR&ED claim.

### A. Sources of funds for SR&ED (lines 600 to 618)

Estimate the percentage distribution of the sources of funds for SR&ED performed within your organization. Use the total SR&ED expenditures you entered on line 605 (make

sure that the total of lines 600 to 618 equals 100%). Give the percentage distribution of the following sources of funds for your SR&ED efforts.

#### **Line 600 – Internal funding**

Internal sources include funds that originate from internal company funding, loans, and income tax refunds used for SR&ED you performed in this fiscal period.

#### **Lines 602 and 604 – Funding from parent, subsidiaries, affiliated companies**

Enter funding from parent companies, subsidiaries, and affiliated companies. Identify both Canadian and foreign funding.

#### **Line 605 – Expenditures for SR&ED performed by you**

Line 605 is the total allowable expenditures for SR&ED performed within the company.

#### **Line 606 – Federal grants**

Enter federal grants for SR&ED, and the SR&ED portion of any other federal grants. Exclude funds or tax credits from SR&ED tax incentives.

#### **Line 608 – Federal contracts**

Enter federal contracts for SR&ED, and the SR&ED portion of any other federal contracts.

#### **Line 610 – Provincial funding**

Include provincial funding for SR&ED, as well as SR&ED contracts and the SR&ED portion of any other provincial grants or contracts. Exclude funds or tax credits from SR&ED tax incentives.

#### **Lines 612 and 614 – Contracts for other companies**

Exclude funds from companies reported on lines 602 and 604. Identify both Canadian and foreign funding.

#### **Lines 616 and 618 – Other funding**

Include funds from universities, other levels of government, private non-profit organizations, individuals, and foreign governments. Identify both Canadian and foreign funding.

### **B. Business personnel (lines 630 to 638)**

#### **Line 630 – Number of employees**

Enter the average annual number of employees on your organization's payroll.

#### **Lines 632 to 638 – Scientists, engineers, technologists, technicians, managers, administrators and technical supporting staff**

Include the number of people who work solely on SR&ED projects, plus a full-time equivalent (FTE) for people who work only part-time on SR&ED. (To arrive at the total personnel effort devoted to SR&ED, estimate the FTE of the people working only part-time on SR&ED.)

#### **Example**

If, out of five scientists engaged in SR&ED, one works solely on SR&ED projects and the remaining four devote only one-quarter of their working time to SR&ED, then:  $FTE = 1 + \frac{1}{4} + \frac{1}{4} + \frac{1}{4} + \frac{1}{4} = 2$  scientists.

### **C. Nature of SR&ED work (lines 650 to 664)**

#### **Lines 650 to 664 – Basic science, applied science, development of new products, process and technical services; improvement of existing products, processes and technical services**

In this section, estimate the approximate distribution of your SR&ED, using the total SR&ED expenditures you entered on line 605 (make sure that the total of lines 650 to 664 equals 100%).

#### **Lines 658 and 664 – Technical Services**

Technical services are new or existing services that either support or complement the production or use of the technology.

### **D. Specialized field of research (lines 670 to 674)**

#### **Line 670 – Software Development**

Indicate the percentage of the amount on line 605 attributed to software development. Software development is defined as work relating to programming the encoded instructions executed by electronic devices including computers for performing operations and functions. See Information Circular 97-1, *Scientific Research and Experimental Development – Administrative Guidelines for Software Development*, on the identification of SR&ED in software development.

#### **Line 672 – Biotechnology**

Indicate the percentage of the amount on line 605 attributed to **biotechnology**. Biotechnology is defined as work using biological agents. "Biotechnology's multidisciplinary nature encompasses a range of techniques dealing with recombinant DNA (Deoxyribonucleic Acid), cell fusion, plant and animal cell cloning, monoclonal antibodies, tissue culture, and bioprocess engineering. What distinguishes the new biotechnology from the one used to make bread, beer or cheese is the enormous expansion of our power to manipulate biological agents through the transfer, modification, and control of genetic material." (Science Council of Canada, *Enabling Technologies*)

#### **Line 674 – Environmental Protection**

Indicate the percentage of the amount on line 605 attributed to environmental protection. Environmental protection is defined as the field of work devoted to the reduction or elimination of pollutants and wastes (including prevention, treatment, and reuse of pollutants and wastes). SR&ED made in order to improve employee health and workplace safety are excluded.

## Schedule A – Third-Party Payments

Provide the required information for each entity to which you made payments for SR&ED carried out in Canada, and that you reported on line 370. Read the preamble of Schedule A to know what third-party payments are.

Use copies of Schedule A for each payment.

## Schedule B – Special Situations

This schedule contains adjustments to the deductible expenditure pool, and to the qualified expenditures that you will report to Form T661 as indicated.

### Section 1 – Adjustments to the pool of deductible SR&ED expenditures incurred in Canada

#### Line 445 – Repayments of assistance

If an amount of assistance has reduced your balance in the pool of deductible SR&ED expenditures (see line 430), add any repayments of that assistance to the pool on line 445. Also, if an amount of assistance receivable has reduced your expenditure pool balance and you did not receive the amount, nor do you expect to, the amount is considered to be a repayment of assistance that you can add to the pool on line 445.

#### Line 452 – Amalgamation and wind-up

For information on how amalgamation and winding-up affect the pool of deductible SR&ED expenditures, read Interpretation Bulletin IT-151, *Scientific Research and Experimental Development Expenditures*.

**Line 454** – Calculate the total of lines 445 and 452 and report to line 454 on Form T661.

### Section 2 – Adjustments to qualified expenditures for ITC purposes

#### Line 520 – Unpaid amounts

On line 520, deduct unpaid amounts deemed not to be an expenditure incurred in the year under subsection 127(26).

##### Note

Even if your unpaid amounts under subsection 127(26) do not qualify for ITCs until the time you paid them, they are still allowable SR&ED expenditures deductible in the year you incurred the expenditures. Make sure to include your unpaid subsection 127(26) amounts in your allowable SR&ED expenditures within the period allowed to file Form T661. If you do not, they will not be qualified expenditures in the year you pay them.

#### Example

In its tax year ending on December 31, 2000, Corporation A incurs SR&ED expenditures of \$100,000 for consulting fees payable to Corporation B. Corporation A still has not paid the expenditure 180 days after the end of the 2000 tax year. The expenditure is only paid in November 2001.

- Corporation A must identify the expenditure in the SR&ED expenditure pool on Form T661 within the reporting deadline. It is an allowable SR&ED expenditure deductible in 2000.

- Corporation A has to deduct the unpaid amount on line 520 of Form T661 for the 2000 tax year. For ITC purposes, the expenditure is deemed not to have been incurred in 2000.
- When Corporation A pays the expenditure in the 2001 tax year, enter the amount that is paid on line 500 of Form T661 for that year.

#### Line 528 – Expenses paid to a non-taxable supplier

You cannot claim an ITC on any allowable SR&ED current expenditure, claimed on lines 300 to 370, that is paid or payable to or for the benefit of a person or partnership that is not a taxable supplier in respect of the expense. **Taxable supplier** in respect of an amount usually means a resident of Canada, a Canadian partnership, or a person or partnership that pays or receives the amount in the course of carrying on a business through a permanent establishment in Canada.

This rule does not apply to an expenditure on SR&ED that you directly undertake. It usually applies in situations where a payer contracts out its SR&ED to an arm's length performer. If the SR&ED contract expenditure is paid or payable to or for the benefit of a non-taxable supplier, it is not a qualified expenditure for ITC purposes. Read Application Policy 2002-03, *Taxable Supplier Rules*.

#### Example

Company A, a Canadian corporation, contracts out its SR&ED to Company B, another Canadian corporation, for \$100,000. Company A and Company B deal with each other at arm's length throughout the period in which the SR&ED is performed. However, Company B does not actually perform the SR&ED. Instead it contracts out the SR&ED to a foreign company, Forco, for a contract price of \$95,000. Forco, in turn contracts it to a third Canadian company, Company C, for \$90,000.

Because \$95,000 of the \$100,000 paid or payable by Company A to Company B was, in turn, paid or payable to Forco, who is not a taxable supplier in respect of the amount, \$95,000 of the \$100,000 is considered to be paid or payable to, or for the benefit of, a corporation that is not a taxable supplier in respect of the amount. Enter \$95,000 on line 528 of Appendix B. Company A may still be able to claim \$5,000 of qualified expenditures, since the SR&ED is performed in Canada.

Company B, on the other hand, would not have any qualified expenditures for two reasons. First, the \$95,000 paid or payable to Forco is also considered to be paid or payable to, or for the benefit of, a corporation that is not a taxable supplier in respect of the \$95,000. Second, there is a contract payment of \$100,000 paid or payable to Company B.

#### Lines 530 and 532 – Prescribed expenditures

Enter the total prescribed expenditures that Section 2902 of the Regulations does not allow for ITC purposes. The most common prescribed expenditures are:

- interest and other financing costs;

- a legal or accounting fee; and
- expenditure for the acquisition of used equipment.

Read the current version of Interpretation Bulletin IT-151, *Scientific Research and Experimental Development Expenditures*, for more details.

### Lines 548 and 550 – Other deductions

On lines 548 and 550, enter any qualified expenditures incurred in the course of earning income that will not be subject to Part I tax. Subsection 127(9), which defines the term **investment tax credit**, ensures that an investment tax credit will be generated only when the income from the business to which a particular expenditure relates is subject to Part I tax.

Enter also expenditures renounced for the purposes of Part VIII tax. For more details, read the current version of Interpretation Bulletin IT-151, *Scientific Research and Experimental Development Expenditures*.

**Line 552** – Total of lines 520, 528, 530, and 548. Report the total amount to line 552 of Form T661.

**Line 554** – Total of lines 532 and 550. Report the total amount to line 554 of Form T661.

## Schedule C – Non-Arm’s Length Transactions

Complete this schedule if you have non-arm’s length transactions described in this schedule and report the amounts as indicated to Form T661.

### Lines 522 and 524 – Purchase of goods and services from non-arm’s length suppliers

Special rules apply to how you determine the expenditures for purchases of goods and services from non-arm’s length parties.

Basically, if an SR&ED performer purchases goods or services for SR&ED from a person with whom the performer does not deal at arm’s length, the amount eligible to the performer for an investment tax credit is limited to the cost to the non-arm’s length person who provides the goods or services.

Under subsection 127(11.6), the amount of an expenditure you incur for the service or property and the capital cost of the property is deemed to be:

1. in the case of a service rendered to you, the lesser of the expenditure you actually incurred and the **adjusted service cost**; and
2. in the case of a property sold to you, the lesser of the capital cost to you otherwise determined and the **adjusted selling cost** to the supplier of the property.

The definitions of **adjusted service cost** and **adjusted selling cost** are found in subsection 127(11.7).

Subsection 127(11.8) provides additional rules relating to non-arm’s length purchases of goods and services. One of these rules is that any cost to a supplier cannot include any

amount that would not be a qualified expenditure if the ultimate purchaser or user of the goods or services incurred the amount directly. Under another rule, leasing a property is deemed to be rendering a service.

On lines 522 and 524, enter the difference between the amount you included in your pool of deductible SR&ED expenditure for the purchases of goods and services from non-arm’s length suppliers and the deemed amount of the expenditure under subsection 127(11.6).

If the property is shared-use equipment, the amount of the expenditure for SUE you enter on line 504 of Form T661 is based on the **adjusted selling cost** of the property.

The current version of Interpretation Bulletin IT-419, *Meaning of Arm’s Length*, expresses in general terms criteria which we consider in determining whether persons deal with each other at arm’s length.

### Line 526 – Non-arm’s length SR&ED contracts

Expenditures for SR&ED performed on your behalf by a person or a partnership at a time when you and the performer do not deal with each other at arm’s length do not qualify for ITC purposes. On line 526, deduct the amount you entered on line 345 for non-arm’s length SR&ED contracts.

#### Note

Expenditures you incurred for non-arm’s length SR&ED contracts are not considered to be either qualified expenditures or a contract payment to the performer for ITC purposes. However, you and the non-arm’s length performer can file a joint agreement so that all or a part of the performer’s qualified expenditures for SR&ED, up to a maximum of the contract amount, can be transferred to the payer for ITC purposes. For more details, see explanations for lines 508 and 510, and lines 534 and 536.

#### Example

A Canadian corporation, Parentco, contracts with its wholly-owned Canadian subsidiary, Subco, for Subco to perform SR&ED on Parentco’s behalf. An amount of \$100,000 is payable by Parentco under the contract. This SR&ED is subcontracted out by Subco to an arm’s length party, Performco, for \$95,000. Performco completes the work in 2001 and all contract amounts are paid in full in 2001.

Since the work is performed at a time when Subco is not dealing at arm’s length with Parentco, Parentco’s \$100,000 expenditure is not a qualified expenditure. Under the definition of **contract payment**, the \$100,000 is not a contract payment paid or payable to Subco. As a result, Subco has a qualified expenditure of \$95,000, which it can transfer back to Parentco by filing a joint agreement. Performco, however, has to reduce the qualified expenditures it incurred for the SR&ED by the \$95,000 contract payment from Subco.

### Lines 538 and 540 – Allocation of assistance

Subsection 127(20) provides a way to allocate assistance for SR&ED that was unapplied to the recipient's qualified expenditures among the members of a non-arm's length group in situations where:

- each member of the group performs the SR&ED when the member is not dealing at arm's length with the recipient of the assistance; and
- subsection 127(19) does not apply to the assistance for the tax year in which the allocation can be made (i.e., the amount of the government assistance, net of the amount applied against qualified expenditures in previous years, is less than the total qualified SR&ED expenditures incurred in the year by the recipient and by the non-arm's length persons).

#### Example

Company A, Company B, and Company C are related corporations that have the same December 31 year-end. Company A contracts out its SR&ED to Company B and Company C. Company B and Company C will each perform half of the SR&ED for \$50,000.

In June 2000, Company A receives government assistance of \$40,000 for the SR&ED. Company B and Company C each incur \$15,000 of qualified expenditures for the SR&ED in 2000 and \$33,000 in 2001. They pay for all their qualified expenditures by the end of each year to which the expenditures relate.

In 2000, subsection 127(19) applies to the government assistance in respect of Company A's 2000 tax year. As a result, Company B and Company C's qualified expenditures of \$15,000 each that they incurred in 2000 is reduced to nil. Since there remains \$10,000 of government assistance that has not been applied to reduce qualified expenditures for the SR&ED, that amount reduces qualified expenditures that Company B and Company C incurred for the SR&ED in 2001.

In 2001, subsection 127(19) does not apply for Company A's 2001 tax year, since the amount of government assistance – \$40,000 – is less than the sum of: the total amounts previously applied under subsection 127(19) – \$30,000; and the total qualified expenditures – \$66,000 – that Company B and Company C otherwise incurred in their tax years that end in Company A's 2001 tax year.

Under such a scenario, the companies should allocate the remaining assistance among themselves. Subsection 127(20) permits the three companies to allocate the remaining \$10,000 of assistance to reduce the qualified expenditures of Company B, Company C, or both, which they incurred in 2001. If they don't allocate the remaining \$10,000 of assistance under subsection 127(20), subsection 127(21) will operate to reduce both B and C's qualified expenditures.

Company A and Company B can file an agreement with the CCRA specifying that the \$10,000 remaining assistance should be applied to reduce Company B's \$33,000 of qualified expenditures to \$23,000. Consequently, the amount of qualified expenditures that Company C incurred in 2001 would still be \$33,000.

To make the allocation, use Form T1145, *Agreement to Allocate Assistance Between Persons Not Dealing at Arm's Length for Scientific Research and Experimental Development (SR&ED) Expenditures Carried out in Canada*.

### Lines 544 and 546 – Transfer of qualified expenditures

If someone carries out SR&ED on your behalf and the two parties are not dealing at arm's length, your expenditures for the contract do not qualify for ITC purposes. In addition, the amount received or receivable by the performer of the SR&ED is not considered to be a contract payment. However, the performer can transfer qualified expenditures to you up to a maximum of the contract amount.

Subsection 127(13) provides for the transfer of qualified expenditures between non-arm's length claimants. A partnership cannot be a party to such a transfer, since it is not considered to be a person for the purpose of this paragraph.

To effect such a transfer, the two parties (the payer and the performer) must file a joint agreement on Form T1146, *Agreement to Transfer Qualified Expenditures Incurred in Respect of Scientific Research and Experimental Development (SR&ED) Contracts Carried out in Canada*.

The amount that the performer can transfer for a tax year is the least of the following three amounts:

- the amount specified by the parties in their agreement;
- the performer's SR&ED qualified expenditure pool at the end of the year before reducing the transfer of qualified expenditures to the payer; and
- the total of all amounts that would be contract payments if the two parties were dealing at arm's length (notional contract payments) that are:
  - for performing SR&ED for or on behalf of the payer;
  - paid by the payer to the performer on or before the day that is 180 days after the end of the particular year; and
  - for a qualified expenditure the performer incurred in the particular year (not considering subsections 78(4) and 127(26)) for that portion of the SR&ED that was performed when the performer did not deal at arm's length with the payer, and is paid by the performer on or before the day that is 180 days after the end of the particular year, or for an amount transferred to the performer in respect of the SR&ED.

The least of the three amounts is transferred out of the performer's SR&ED qualified expenditure pool for the year (enter amounts you transferred on lines 544 and 546) and into the payer's SR&ED qualified expenditure pool for its first tax year ending at the same time, or after, the end of the performer's year in which the transfer is made (enter amounts transferred to you on lines 508 and 510).

#### Example

Corporation C performs SR&ED for a related corporation, Corporation D, according to a contract for services. Both corporations have the same December 31 tax year-end. The contract price is \$1,000, which Corporation D paid fully in 2000.



Corporation C performed 80% of the SR&ED in 2000 and incurred \$784 of qualified expenditures in 1999. However, Corporation C only paid \$392 of the qualified expenditures by the 180th day after December 31, 2000. Corporation C paid the remaining \$392 in 2001. Corporation C completed the SR&ED in 2001 and incurred an additional \$196 of qualified expenditures in that year. Corporation C paid that amount at the end of that year. Corporation C also incurred and paid qualified expenditures of \$100 in 2000 and \$100 in 2001 for other SR&ED projects.

Corporation C and Corporation D want to file an agreement to transfer qualified expenditures from Corporation C to Corporation D for 2000 and 2001. They have to use Form T1146.

<b>Calculation</b>	<b>2000</b>	<b>2001</b>
<b>Line 100 of Form T1146</b>		
Corporation C's SR&ED qualified expenditure pool at the end of the year, before reducing for the transfer of qualified expenditures to Corporation D	\$492	\$688
\$392 + \$100 = \$492		
\$588 + \$100 = \$688		
<b>Line 102 of Form T1146</b>		
Calculation of line 102 amount	\$400	\$200
\$392 ÷ \$784 × \$800* = \$400		
\$196 ÷ \$196 × \$200* = \$200		
<b>*Notional contract payment for</b>		
<b>2000:</b> \$800 (\$1,000 less \$200 under paragraph 18(9)(a) – that is 20% of \$1,000)		
<b>2001:</b> \$200 (the paragraph 18(9)(a) amount of \$200 in 2000, is deemed incurred in 2001)		
<b>Line 104 of Form T1146</b>		
Maximum amount that can be transferred: the amount on line 100 or 102, whichever amount is less	\$400	\$200

**Corporation C can transfer to Corporation D an amount up to the amount on line 104.**

### Total non-arm's length transactions

**Line 555** – Total of lines 522, 526, 538, and 544. Report the total amount to line 555 of Form T661.

**Line 556** – Total of lines 524, 540 and 546. Report the total amount to line 556 of Form T661.

## Schedule D – Calculation of Salary Base and Prescribed Proxy Amount

Complete this schedule to calculate the salary base and the prescribed proxy amount if you have elected to use the prescribed proxy method on page 1 of Form T661.

### Section A – Salary Base

Enter the amount from line 300 to line 1 of this schedule. This amount is the total wages or salaries of personnel directly engaged in SR&ED, for employees other than specified employees.

On line 2, enter the bonuses, remuneration based on profits, and taxable benefits under sections 6 and 7 of the Act that you included on line 300.

On line 4, enter the amount of wages or salaries of specified employees directly engaged in SR&ED that qualify to be included in the salary base.

The amount of salaries or wages for a specified employee that you can include in the salary base for the proxy amount is subject to certain restrictions outlined in subsection 2900(9) of the Regulations. Calculate this amount in Section C.

On line 5, indicate the total of lines 3 and 4 to arrive at the salary base.

### Section B – Prescribed proxy amount

Calculate the proxy amount determined by multiplying 65% of the salary base of section A and report to line 502 of Form T661.

### Section C – Salaries and wages of specified employees

In this section, you determine the salaries and wages of specified employees that can be included in the salary base. Table 6 illustrates the rules for specified employees. In column 1, write the name of each specified employee.

In column 2, enter the total amount you incurred in the year for salaries or wages of the specified employee. This amount is 100% of the expenditure for salaries or wages of the employee, not only the SR&ED portion. Do not include taxable benefits under sections 6 and 7, bonuses, remuneration based on profits, or an amount deemed incurred in the year under subsection 78(4).

In column 3, enter the percentage of time the employee is directly engaged in SR&ED in Canada, up to a maximum of 75%.

In column 4, enter the results of the amount in column 2 multiplied by the percentage in column 3.

In column 5, enter the maximum amount allowed for the year. To determine the maximum amount allowed for the year, use the formula  $2.5 \times A \times B \div 365$ . In this formula, **A** is the year's maximum pensionable earnings (section 18 of the *Canada Pension Plan*) for the calendar year in which your tax year ends. The maximum pensionable earnings are \$39,900 for year 2003 and \$39,100 for year 2002. **B** is the number of days in the tax year that you employ the individual.

If the specified employee is also employed by a corporation with which you are associated, the maximum amount allowed cannot be more than  $2.5 \times A$ , minus the amount the associated corporation has included in its salary base for its tax year ending in the same calendar year.

In column 6, enter the salary allocated to SR&ED for each specified employee and carry the total to line 4 in section A. The salary allocated to SR&ED is the amount in column 4, or the amount in column 5, whichever amount is less.

Table 6 below illustrates the rules applicable to salaries and wages of specified employees:

<b>Table 6</b>					
<b>Illustration of rules for salaries and wages of specified employees</b>					
Column 1	Column 2	Column 3	Column 4	Column 5	Column 6
Name of specified employee	Total salaries or wages for the year (SR&ED and non-SR&ED). Do not include taxable benefits under sections 6 and 7, bonuses, remuneration based on profits, or an amount deemed incurred in the year under subsection 78(4).	% of time spent in SR&ED in Canada (maximum 75%)	Amount in column 2 multiplied by % in column 3	2.5 × A × B/ 365 A= \$39,900 B= no. days	Amount in column 4 or 5, whichever amount is less
Employee 1	\$ 50,000	50%	\$25,000	\$99,750**	\$25,000
Employee 2	\$ 50,000	75% *	\$37,500	\$99,750	\$37,500
Employee 3	\$100,000	60%	\$60,000	\$99,750	\$60,000
Employee 4	\$100,000	75% *	\$75,000	\$99,750	\$75,000
Employee 5	\$150,000	70%	\$105,000	\$99,750	\$99,750
<b>Carry the total amount of column 6 to line 4 of Section A of Schedule D</b>					<b>\$297,250</b>
* Although 80% of actual time was directly engaged in SR&ED in Canada, enter only 75% in column 3 (maximum % allowed).					
** This is the maximum allowed for the 2003 year (as determined by the formula 2.5 × \$39,900 (in 2003) × 365/365, if you employed the employee for the whole year).					

On line 6, enter 65% of line 5 and report this amount to line 502 of Form T661.

In certain situations, an overall cap on the prescribed proxy amount may limit the amount otherwise determined.

**Overall cap on prescribed proxy amount** – For most claimants, the prescribed proxy amount is 65% of the total of the eligible portion of salaries of employees directly engaged in SR&ED in Canada. However, in certain situations, an overall cap on the prescribed proxy amount may limit the proxy amount you have otherwise determined. Usually, the overall cap will not restrict the prescribed proxy amount if you have deducted more than \$65 of non-SR&ED expenses (other than rent for a building, capital cost allowance, interest and financing costs, allowance for doubtful accounts, and all other amounts deductible under section 20) for each \$100 of eligible salary you included in the salary base.

Use Table 7 to help you calculate this amount.

<b>Table 7</b>	
<b>Overall cap on prescribed proxy amount</b>	
Enter the total amounts you deducted when calculating your net income for tax purposes from your business for the year (include the cost of goods sold in the total amounts you deduct) .....	6) _____
Enter the deductions you claimed in the year under sections 20 (e.g., capital cost allowance, interest, bad debts), 24 (if you cease to carry out a business), 26 (for a bank), 30 (improving land for farming), 32 (if your business is that of an insurance agent or broker), 37 (for SR&ED expenditures), 66 to 66.8 (e.g., exploration and development expenditures), and 104 (for a trust) .....	7) _____
Enter the amount of expenditures you incurred for the use of, or the right to use, a building (other than a prescribed special-purpose building) .....	8) _____
Enter the amount from line 6, minus the amounts on line 7 and line 8.....	9) _____

The prescribed proxy amount to enter on line 502 is either 65% of the amount on line 5 in section A of Schedule D of Form T661, or the amount on line 9 of Table 6, whichever amount is less.

## Glossary

**Directly engaged in SR&ED** – See the explanations for lines 300 to 315 in the guide for the meaning of “directly engaged in SR&ED.”

**General-purpose office equipment or furniture** – General-purpose office equipment or furniture (GPOEF) includes all furniture, such as desks, chairs, lamps, filing cabinets and bookshelves. It also includes photocopiers, fax machines, telephones, pagers, typewriters, word processors, teletypes and calculators. Computers, including hardware, software, and ancillary equipment, are not considered to be GPOEF.

**Pool of deductible SR&ED expenditures** – You can pool expenditures of a current and capital nature on SR&ED you carried out in Canada and deduct them when you calculate the income from a business you carried out in the year you made the expenditure or in any later year. For more details, see the current version of Interpretation Bulletin IT-151, *Scientific Research and Experimental Development Expenditures*.

**Prescribed proxy amount (PPA)** – If you elect under clause 37(8)(a)(ii)(B), you can calculate a prescribed proxy amount (PPA) under subsection 2900(4) of the Regulations. Your PPA is a notional amount. You do not include this amount in the pool of SR&ED expenditures and you do not deduct it when calculating your income. It represents the amount of overhead expenditures related to SR&ED and is used to determine the claimant’s investment tax credits for these overhead expenditures. The PPA is treated as a qualified expenditure for ITC purposes. The actual overhead expenses the PPA represents are ordinary business expenses. Although you do not include the PPA in the pool of SR&ED expenditures, any investment tax credit you claimed in a previous year that can reasonably be considered to be for a PPA of a previous year will reduce the pool of SR&ED expenditures. For most claimants, the PPA for a tax year is 65% of the salary base.

**Salary base** – The salary base is the portion of salaries and wages of employees who are directly engaged in SR&ED carried out in Canada that can reasonably be considered to relate to such work having regard to the time spent on the SR&ED. However, the amount of an employee’s salaries and wages that you can use to determine the salary base cannot include an amount described in sections 6 or 7 of the Act, an amount deemed incurred under subsection 78(4), remuneration based on profits, or bonuses. In addition, the amount of salaries and wages that you can take into account may be further restricted for a specified employee.

**Scientific research and experimental development (SR&ED)** – See the current version of Information Circular 86-4, *Scientific Research and Experimental Development*, for technical guidelines clarifying what constitutes SR&ED according to subsection 248(1) of the *Income Tax Act*.

**Shared-use equipment (SUE)** – Equipment you used primarily (more than 50%) for the prosecution of SR&ED can earn investment tax credits on a portion of the cost. For more details, see the explanations for line 504 in the guide.

**Specified employee** – A specified employee is defined under subsection 248(1) of the Act and, in a particular year, includes an employee who does not deal at arm’s length with the employer or who owns directly or indirectly, at any time during the year, 10% or more of the issued shares of any class of the capital stock of the employer or of any corporation related to the employer (for this purpose, shares owned by a person with whom the employee does not deal at arm’s length are included).

## Tax Services Offices

The CCRA delivers the SR&ED Program through 10 coordinating Tax services offices.

### Tax services office

**Calgary** 220-4th Avenue South East  
Calgary AB T2G 0L1  
Telephone: (403) 691-6452  
Fax: (403) 691-6625

**Halifax** 1313 Barrington Street  
Halifax NS B3J 2T5  
Telephone: (902) 426-7875  
Fax: (902) 426-4727

**Hamilton** 150 Main Street West  
Hamilton ON L8N 3E1  
Telephone: (905) 572-2650  
Fax: (905) 570-8247

**Laval** 3400 Avenue Jean-Béard  
Laval QC H7T 2Z2  
Telephone: (514) 338-4198  
Fax: (514) 338-4564

**Montréal** 305 René-Lévesque Boulevard West  
Montréal QC H2Z 1A6  
Telephone: (514) 496-1317  
Fax: (514) 496-6607

**Ottawa** 333 Laurier Avenue West  
Ottawa ON K1A 0L9  
Telephone: (613) 598-2106  
Fax: (613) 952-1856

**Québec** 94 Dalhousie Street  
Québec QC G1K 4B8  
Telephone: 1-866-204-0101  
(418) 648-5663  
Fax: (418) 648-5663

**Toronto Centre** 1 Front Street West  
Toronto ON M5J 2X6  
Telephone: (416) 973-2249  
Fax: (416) 952-8334

**Toronto West** 3rd floor  
5800 Hurontario Street  
P.O. Box 6000  
Mississauga ON L5A 4E9  
Telephone: (905) 566-6148  
Fax: (905) 566-6754

**Vancouver** 1166 West Pender Street  
Vancouver BC V6E 3H8  
Telephone: (604) 666-8589  
Fax: (604) 666-0222

### For offices in:

Calgary, Edmonton, Northwest Territories, Regina,  
Saskatoon, Winnipeg

Bathurst, Charlottetown, Halifax, Moncton,  
Saint John, Newfoundland and Labrador, Sydney

Hamilton, Kitchener/Waterloo, London,  
St. Catharines, Windsor

Laval, Abitibi-Outaouais

Montréal, Montérégie/Rive-Sud

Belleville, Kingston, Nunavut, Ottawa,  
Peterborough, Sudbury, Thunder Bay

Chicoutimi, Québec, Rimouski, Sherbrooke,  
Trois-Rivières

Toronto Centre, Toronto East, Toronto North

Toronto West

Burnaby, Northern B.C. and Yukon,  
Southern Interior, Vancouver, Vancouver Island