



# Allocation of Labour Expenditures For SR&ED Guidance Document

## 1. Purpose of this document

Many scientific research and experimental development (SR&ED) claimants have information systems that capture information about SR&ED projects and related costs as a project progresses. These systems can be electronic or paper based and may include a variety of methods of capturing information about the SR&ED labour for the purposes of calculating SR&ED salaries and wages. Where formal systems have not been implemented, claimants can determine SR&ED salaries and wages using appropriate labour allocation methodologies. This document is intended to provide guidance on the elements of such methodologies and to provide an illustration of a sample application.

### 1.1 Who should use this document?

This document may be used by claimants for preparing the labour expenditure portion of their SR&ED claim. Also, the Canada Revenue Agency (CRA) financial reviewers can use this document in reviewing SR&ED claims.

This document does not address technical documentation for an SR&ED project. For that topic, see the document called *Guide to Supporting Technical Aspects of a Scientific Research and Experimental Development (SR&ED) Claim*.

The allocation methods outlined here are for illustrative purposes only. Other approaches may be acceptable, as long as they are reasonable within the context of a claimant's research and development environment, are documented, and are effectively and consistently applied.

The suggested approaches can be used with either the proxy or the traditional method. The comments on indirect labour costs and overhead costs apply only to claims filed using the traditional method.

## 2. General considerations

### 2.1 Cost allocation methods

An SR&ED cost allocation method is a systematic approach to determining which expenditures, or portion of expenditures, relate to an SR&ED project. A claimant must be able to show that the cost allocation method used is based on a systematic approach, and provides a reasonable level of accuracy in calculating the SR&ED expenditures. Documentation should be kept to identify the key elements of the cost allocation method, including the controls that were used in preparing the claim.

## **Allocation of Labour Expenditures For SR&ED**

---

The level of detail and sophistication of books and records will depend on many factors, such as the size of the claimant's organization, the claimant's knowledge of SR&ED policies and practices, and the size of the claim. A small business may have less sophisticated financial control systems than a large company, due to the nature of its business or because of cost constraints. A first-time claimant may have an informal system of calculating SR&ED labour expenditures, while an experienced claimant may have a more sophisticated system. Where a large organization may rely on a combination of the methodologies discussed in this paper, some small businesses may have to rely on informal, naturally generated information to support their allocation of labour costs to SR&ED projects. In all cases, documentation of the labour effort and the related financial information is required to support the reasonableness of the expenditures included in a claim.

### **2.2 Research and development (R&D) environment**

All cost allocation methods use information and documentation that comes from the claimants' information systems. The CRA recognizes that the R&D environment will influence the way information is gathered and summarized. The nature and sources of available information will be a key consideration in developing an appropriate labour allocation method.

For illustrative purposes, the following four R&D environments are used to show appropriate labour allocation methods. The four environments discussed in detail in Part 6 are as follows:

- distinct well-defined R&D projects
- dedicated R&D environments
- early stage or start-up business
- shop floor R&D

The methods used to allocate labour expenditures to SR&ED in these four environments can be applied to other real-life R&D environments.

## **3. Rules for SR&ED labour calculations**

### **3.1 Directly engaged salaries and wages (traditional or proxy method)**

Whether an employee is directly engaged in SR&ED is a question of fact based on the duties performed by the employee and not on the employee's job title. Employees who are involved in experimentation and analysis in the performance of basic research, applied research, or experimental development are generally considered to be directly engaged in SR&ED. Employees who are performing work in direct support of such basic or applied research or experimental development will also be directly engaged in SR&ED if the work is required to meet the technological or scientific objectives of the project.

## **Allocation of Labour Expenditures For SR&ED**

---

A claimant should be able to show that the salaries and wages are for SR&ED work performed by employees of the company on activities that are considered to be directly engaged in SR&ED. Claimants should maintain information supporting the reasonableness of the allocation to directly engaged salaries and wages, including:

- a description of the allocation method used
- the rationale for the selection of the allocation method, considering the claimant's business environment
- the internal controls that are available to test the allocations

When applying the expenditure allocation in a claim under the traditional method, the information system used by a claimant must capture directly engaged time, as well as directly related and incremental time. In a proxy based claim, only the directly engaged time is included. Other labour costs are covered by the prescribed proxy amount.

### **3.2 Directly attributable (traditional method only)**

Where all or a portion of an employee's time is devoted to activities that are directly attributable to SR&ED, the related portion of the employee's salaries and wages is treated as an SR&ED expenditure (subject to the cap for specified employees). Therefore, it is necessary to develop an appropriate allocation method for labour that is in part directly attributable to SR&ED and in part attributable to non-SR&ED activities.

Salaries and wages incurred for an employee who directly undertakes, supervises or supports the prosecution of SR&ED are considered to be directly attributable to SR&ED. For the purposes of the T661 these expenditures would be treated as being directly engaged salaries and wages. Additionally, expenditures that are directly related and incremental to the prosecution of SR&ED are considered to be directly attributable to SR&ED. Salaries and wages incurred for an employee who performs clerical and administrative support work could be considered to be directly related and incremental to SR&ED depending on the facts of the case. These types of expenditures are reported on the T661 as overhead or other expenditures and cannot be claimed when using the proxy method.

### **3.3 All or substantially all (traditional or proxy methods)**

Where all or substantially all (ASA) (90% or more) of an employee's time is devoted to SR&ED activities, the employee is deemed to have spent all of the time on SR&ED. The employee's total salaries and wages are treated as SR&ED expenditures (subject to the cap for specified employees). Where this rule is applied, there should be some form of evidence to support the use of the ASA test for each employee.

## **Allocation of Labour Expenditures For SR&ED**

---

### **3.4 Proxy method**

The SR&ED salaries and wages may include expenditures for directly engaged and directly related and incremental<sup>1</sup> SR&ED activities. This refers to the level of SR&ED involvement and is particularly important when an election is filed to use the proxy method.

Under the proxy method, only directly engaged salaries or wages are allowable for SR&ED purposes. Overhead expenditures, including indirect salaries or wages, are replaced by the prescribed proxy amount, which is 65% of the salary base. The prescribed proxy amount is subject to an overall cap under the Regulations. Accordingly, the indirect salaries or wages are included in the prescribed proxy amount rather than by a labour allocation method.

### **3.5 Traditional method**

Under the traditional method, SR&ED expenditures include both “directly engaged” salaries and wages and “directly related and incremental” salaries and wages. Actual expenditures that are directly related and incremental to SR&ED should be included in the claim. The labour allocation method should provide support for the SR&ED portion of these costs to be included in the claim.

## **4. Support for labour allocation**

The labour allocation must be supported by evidence that:

- the allocation method is appropriate in the company’s environment
- the allocation method is consistent with the legislation and the administrative practices of the CRA
- the allocation system is functional throughout the year

### **4.1 Levels of information**

There are generally three levels at which information can be summarized:

- high
- medium
- low

Each level offers a different view of the SR&ED project. All the levels may provide a reasonable allocation of labour expenditures to an SR&ED project provided they are part of an information system that includes controls that can be tested to evaluate the materiality and

---

<sup>1</sup> The CRA’s position on directly engaged and directly related and incremental salaries and wages is stated in Application Policy SR&ED 96-06, *Directly Undertaking, Supervising or Supporting vs “Directly Engaged” SR&ED Salary and Wages*, and Application Policy SR&ED 2002-01, *Expenditures incurred for administrative salaries or wages – “directly related” test*.

## **Allocation of Labour Expenditures For SR&ED**

---

accuracy of the results. In some cases, it will be necessary for the CRA to review information at more than one level to properly evaluate the reasonableness of the allocation method.

### **4.2 High-level information** (corporate or strategic concept level)

The documentation of a company's overall corporate and strategic objectives is referred to as high-level information. High-level information is generated by the conceptual high-level management processes and systems that companies (especially large companies) use for project management and cost control.

For example, the strategic planning process, cost allocation and cost control systems, and project planning and project evaluation processes may all produce information that is relevant and useful in shaping and proving SR&ED claims. High-level information may provide context for the allocation method and may, in some circumstances, contain enough information to support a claim and no further review is needed. However, medium or low-level information should be available to support high-level information.

### **4.3 Medium-level information** (project level)

Information related to specific work efforts within a project or subproject is referred to as medium-level information. This includes management processes associated with specific work efforts or projects undertaken by the company. This information supports the information generated by the high-level systems. Medium-level information is generated at the project level and generally relates to a company's documentation of specific work efforts. Specific project plans that break projects into components or subprojects would be an example of medium-level information. These project plans could be revised as a result of the SR&ED process.

In some companies, these work efforts are documented using financial reports (budget to actual), Gantt charts, time lines, resource allocation or utilization summaries, specific project cost control systems, and supervisor summaries for project team members.

There should be a clear link between the SR&ED project objectives and the work undertaken by the members of the project team. Documents should identify all employees involved in an SR&ED project and should give enough information to identify SR&ED work that is included in the claim. A small sample of medium-level information should show the relevance of the high-level information and support the allocation methods that the claimant has used.

### **4.4 Low-level information** (activity level)

Information related to individual tasks is referred to as low-level information. In some cases, information may be summarized at the lower level tasks undertaken to complete major work. Tasks can be documented with such things as resource allocation or utilization summaries, time sheets, and personal logs. An effective system of documenting tasks records hours

## **Allocation of Labour Expenditures For SR&ED**

---

worked on a project-by-project basis. There should be a clear link between the SR&ED project objectives and the tasks undertaken by the members of the team.

### **5. Sources of supporting information**

The following is a list (sections 5.1 to 5.4) of potential sources of supporting information that could be used by claimants to support an allocation of labour expenditures to an SR&ED project. The objective is to provide key facts including:

- the names of the employees performing SR&ED
- confirmation of employment (hire and termination dates)
- verification that the individual is an employee and not a contractor
- identification of specified employee

In addition, appropriate allocation methodologies can be used to determine the number of hours an employee spent working in SR&ED. When appropriate and effective controls are in place, each of the sources identified below may provide the information required. In some cases, more than one source of supporting information may be required to evaluate the reasonableness of the labour allocation.

#### **5.1 Development plans**

The resource-planning element of a project schedule plan may identify the resources associated with specific work to be undertaken in the claim period. Where the work relates to the technological or scientific objectives of the SR&ED project and the plan can be compared to actual results or other controls, one may be able to rely on these planning records to allocate labour to an SR&ED project.

#### **5.2 Supervisors' summaries**

Project managers or technical supervisors often prepare periodic weekly, monthly or quarterly summaries. The summaries document the amount of SR&ED undertaken by the R&D teams for a given period. A person who has direct involvement in managing the work of SR&ED personnel should prepare such summaries. It is expected that the summaries would identify the significant SR&ED and any non-SR&ED work undertaken during the period in question. To be effective, the summaries should be updated regularly.

#### **5.3 Time sheets**

Individual time sheets that allocate time to SR&ED and non-SR&ED work are a good source of supporting information. Time sheets can be used to show the reasonableness of an SR&ED labour claim. Time sheet codes may be based on business projects that do not align to SR&ED projects. In such cases, other evidence may be required to support the SR&ED labour allocation.

### **5.4 Naturally generated information**

Claimants may rely on other information that is naturally generated while doing SR&ED. This includes:

- contracts
- planning documents
- project specifications
- project objectives and milestones
- descriptions of problems to be solved
- resource allocation records and budgets
- written correspondence with customers and suppliers
- minutes of meetings
- supervisor summaries
- project, laboratory, or personal notebooks
- progress and final project reports
- organizational charts

An allocation of labour based on naturally generated information must give the CRA a reasonable level of assurance that there is minimal risk of material error in the labour expenditure being allocated to an SR&ED project. The claimant should be able to show support for the claim in the documents and other information. However, if the relevance of the evidence is not clear, the CRA reviewer should consult with the claimant to understand the connection between the allocation method used and the documents being presented.

## **6. R&D environment**

The business environment in which SR&ED is carried out will influence the nature and sources of evidence that are available to support the labour allocation methodology. The four R&D environments identified in Part 2.2 are described below, along with sample labour allocation methods that might be appropriate in each environment.

### **6.1 Distinct well-defined R&D projects**

This environment is found in situations where the claimant's organization assigns personnel and resources to specific R&D projects. Projects have a defined start date, targeted finish date, and are based on well-defined technological objectives. Where the core project is SR&ED and support work is necessary to resolve the technological challenges, the work effort can be allocated completely to the project.

Controls to identify and segregate non-SR&ED work, such as negative time reporting, provide an indication that the labour allocation is reasonable. Supporting information in this setting may include a development plan that can be used to verify job functions. Where labour resources are used in many projects and in both SR&ED and non-SR&ED, labour allocations can be made based on such things as:

## **Allocation of Labour Expenditures For SR&ED**

---

- resource allocation or utilization summaries
- project cost control systems
- supervisor summaries
- Gantt charts
- time lines

### **6.2 Dedicated R&D environments**

In principal, these are environments where a defined group of personnel are focused exclusively on R&D for new products or processes, usually to the exclusion of all other business activities of the company. A dedicated research department may be found in any industry, but is more likely to be found in a large multidisciplinary company. It should be noted that a dedicated R&D department might be involved in SR&ED and non-SR&ED work.

Personnel in other areas of the company may also do SR&ED work. The claimant should be able to identify the SR&ED performed by the dedicated research department. The claimant should also be able to distinguish allowable SR&ED labour expenditures from the total expenditures of the dedicated research department. Additionally, the claimant should be able to provide documentation with appropriate controls supporting the allocation of SR&ED labour expenditures. A negative time reporting system that captures non-eligible labour expenditures can be quite effective in these settings. Supporting information in these environments can include such things as:

- supervisor summaries
- resource allocation or utilization summaries
- Gantt charts
- time lines
- time sheets

### **6.3 Early stage or start-up business**

Early stage or start-up companies do R&D to develop new products or processes. In some situations, personnel may be focused on one SR&ED project. If so, the simplest approach may be to identify employees working on non-eligible work and subtract that portion of labour expenditures from the total labour expenditures. In this type of environment, a claimant should be able to identify the employees performing SR&ED within the business operations.

The claimant should be able to distinguish allowable SR&ED labour expenditures from the total operating costs of the business. Additionally, the claimant should be able to give information supporting the allocation of personnel to an SR&ED project. Documentation in this setting can include such things as:

- job descriptions

## **Allocation of Labour Expenditures For SR&ED**

---

- development plans
- Gantt charts
- supervisor summaries
- time sheets

### **6.4 Shop floor SR&ED**

Shop floor SR&ED commonly occurs in a variety of industry sectors. This type of SR&ED involves creating new, or improving existing, materials, devices, products, or processes in the field or at a commercial facility.

Shop floor SR&ED can involve a variety of employees from different parts of an organization. An SR&ED project of this nature could involve shop floor supervisors, engineers, machine operators, mechanics, and welders. Individuals may report their time using time sheets, a time clock system, or other methods. Because of the variety of employees involved in shop floor SR&ED, it is advantageous to claimants to develop a process to collect information at the start of a project, otherwise difficulties may be encountered in supporting the time an employee spends doing SR&ED.

## **7. When is a labour allocation method reasonable?**

The use of an allocation method in determining SR&ED labour expenditures will generally be acceptable to the CRA, as long as there is supporting information to establish the reasonableness of the method. Allocations should be supportable through effective controls and information that can be used to test the reasonableness of the amount claimed.

The CRA is available to help claimants identify the type of supporting information and control systems needed to support a claim for SR&ED labour expenditures. The CRA will advise a claimant either orally or in writing if there is a need for additional supporting information relating to a claim for SR&ED labour expenditures. If in writing, the letter will explain that proper supporting information will have to be kept for claim periods starting after the date of the letter. The letter will also explain the types of information that will be expected by the CRA to support estimates after that period. Finally, the letter will inform the claimant that the CRA may visit the site of the business to confirm that proper documentation is being kept. If a claimant receives a request in writing but does not adequately support the SR&ED labour expenditures being claimed in a following year, these expenditures may not be treated as SR&ED.

## **8. Example of an allocation method**

### **8.1 Background information**

The following example refers to a small start-up operation, which has developed simple allocation approaches to determine its SR&ED labour costs. The approaches used in this

## **Allocation of Labour Expenditures For SR&ED**

---

example are not the only acceptable methods for allocating labour expenditures to an SR&ED project. The methods a company uses to allocate labour expenditures to SR&ED must be tailored to the way it collects and manages financial information. Other methods may be more appropriate in other industry sectors, but the concepts described in this example will be similar.

Aco is a venture-backed start-up company developing a Web-based supply chain management software program that is fully customizable by the customer. The company is developing a new architecture that will serve as the base for a family of products. The development of the initial architecture meets all the requirements to be considered SR&ED.

During the first two months after incorporation, the four founders worked together on the architecture from the home of one of the founders. During this period, each of the developers worked on source code that was annotated and accompanied by a complete revision history.

Although a great deal of progress was made, in the third month it was apparent that the seed funding would not take the company far enough. Over the next two months, one of the founders focused on approaching investors to raise more financing instead of working on the development.

By the end of the fifth month, the company had raised \$10 million dollars and they were ready to start ramping-up the company. Over the next month, 30 employees were to be hired. The first was a system architect who became responsible for the overall development of the architecture.

Three of the founders stayed heavily involved in the development. The fourth founder continued to develop the business and participated only in the technical strategy design meetings for the ongoing development.

Of the 30 employees added, 3 worked in finance and administration, 5 in sales and marketing, 3 in customer care, 1 in developing technical and user documentation, 4 in quality control, 10 in the research group, and 4 in product engineering.

The system architect knew about the SR&ED Program. During the one-month ramping period, the architect began to write periodic summaries that were to be produced monthly. The summaries allocated the work as SR&ED undertaken for the given period. The report identified both the SR&ED effort and the non-SR&ED work during the period in question.

By the sixth month, the research and development group found it necessary to use project scheduling and resource allocation tools to manage the development process. These tools permitted the team to identify the resources associated with the specific work.

Also in the sixth month, the finance group implemented a time-sheet system. The system was intended to address the overall needs of the company. The time sheet data would enable the finance group to track total hours worked along with employee vacation, holiday and sick

## Allocation of Labour Expenditures For SR&ED

leave. The data would provide the information necessary to allocate expenditures to cost centres including development (i.e., the system would be used to allocate researchers' time to projects). In addition, the system would provide the data necessary to bill customers for consulting services after the product was released.

By the eighth month, the company had signed contracts with a number of customers and the customer care group and product-engineering group were busy installing and improving an early release of the software. The company was not large enough to do a complete evaluation in house. The company needed to install the software with a customer in order to evaluate it. The product was still clearly in development, because end-user technical requirements were being developed and analyzed by both the customer care team and product-engineering team to be included in future more advanced versions of the technology.

At the end of the year the finance group was responsible for calculating the expenditures incurred in the year on eligible projects.

The following is a summary of the resources by department:

<u>Personnel</u>	<u>Number</u>
Founders	4
Research and development	10
Product-engineering	4
Customer care	3
Quality control	4
Documentation	1
Finance and administration	3
Sales and marketing	<u>5</u>
Total	34

The standard work week for the corporation is 37.5 hours. Each employee is given three weeks of vacation. The total working hours in a year are 1837.5 hours (37.5x49).

### **8.2 The approach**

Before preparing the claim, the controller familiarized herself with the *Guidance to Sources of SR&ED Evidence for Software Claims* contained in the joint industry-CRA *Software/IT Guidance Document* available on the CRA Web site.

In this particular year, there was no single system that the controller could rely on to quickly get the costing associated with the SR&ED projects. It was apparent that a variety of allocation methods and control systems would have to be used to calculate the labour expenditures associated with the projects.

The controller had access to records of the wages paid to the employees for the year from the payroll service. The controller set up a spreadsheet listing all of the employees along with

## **Allocation of Labour Expenditures For SR&ED**

---

the wage data received from the payroll service. The controller then proceeded to take a look at each employee to allocate the wages to SR&ED and non-SR&ED work. She also considered what information would be available to serve as a control should a review occur along with information on how to set up a better system in the future.

The controller planned to file a claim using the proxy method to calculate the SR&ED tax incentives.

### **8.3 The founders**

The controller determined that three of the founders worked on the architecture throughout the year. The controller explained to these individuals that for salaries and wages related to ongoing SR&ED projects claimed in the year, a number of things were considered as directly engaged. These things included:

- experimentation and analysis
- technical support activities
- direct supervision of employees performing experimentation and analysis
- technological documentation for internal use
- technological planning and analysis

The controller asked if any of the three founders did other tasks that consumed more than 10% of their effort in the year. The founders reviewed their calendars, diaries, and notebooks, and concluded that they had not performed non-SR&ED work that consumed more than 10% of their effort in the year. The controller considered these to provide a reasonable control that could serve to cross check for their conclusions during a CRA review. She concluded that these three founders were all or substantially all directly engaged in SR&ED, and therefore 100% of the effort of three of the founders should be included in the SR&ED claim.

A similar approach was used with the fourth founder. After reviewing the founder's diary, the controller noted that the founder had spent two months, 17% (2/12) of the time, working alongside the other founders on the architecture or doing SR&ED. After the first two months, the work switched to non-SR&ED business activities such as securing financing. The founder stated that he participated in all the technical strategy meetings providing technical direction and estimated that his total involvement in SR&ED was about 50% of his time. The controller recognized that this was an estimate and may not be acceptable to the CRA.

As a result, the controller tried to identify another approach to quantify the labour allocation. She noted that the technical strategy meetings occurred on Tuesday of every second week and that they typically lasted for three hours. That meant the fourth founder spent 60 hours in the last 10 months (3 x 2 x 10) involved in SR&ED or about two weeks effort. The controller confirmed the reasonableness of this approach with the founder. This was much lower than the 50% level, but did increase the level to 21% (2.5/12). Even though there were

## **Allocation of Labour Expenditures For SR&ED**

---

no time records for these meetings, the controller thought that the methodology was reasonable and claimed on this basis.

As a final step, the controller noted that each of the founders retained enough ownership interest to be specified shareholders and that this fact would need to be considered in any calculation.

### **8.4 Research and development**

The R&D group operated in a dedicated environment and only spent their time performing SR&ED work. The controller planned to cost 100% of the wages of each R&D team member to the project, but first planned to discuss her approach with the system architect to make sure the team members were not performing other activities.

The system architect reviewed his monthly summaries and agreed with the approach in general, with two exceptions. In one case, a team member took sick leave for two months and was not available for the project. The controller planned to reduce the percentage to account for the sick leave. In the second case a team member was loaned to the customer care group for three months. Again, the controller planned to reduce the percentage for that team member to account for the non-SR&ED work. Subject to those adjustments, the software architect agreed that the R&D team was directly engaged in the project, and that 100% of the wages should be allocated to the project.

### **8.5 Product engineering**

The system architect also pointed out that some of the product engineering team participated in the project. An analysis of the project scheduling and resource allocation tools used by the R&D team showed that in the last seven months each of the product engineers spent about two months helping with the architecture. The product engineering team was employed for only seven months of the year, so the controller planned to allocate 29% (2/7) of their time to SR&ED projects.

### **8.6 Customer care**

It was recognized that the customer care group was developing and collecting the technical requirements that were being incorporated into the architecture. There was plenty of evidence to show that the technical requirements were being developed, collected, and presented to the R&D team.

There was no indication of the percentage of time a customer care agent spent collecting the requirements. To determine that percentage, the controller sat with a customer care agent and reviewed the work performed by the agent in the last month. It was determined that the agent spent 20% of her time collecting and documenting technical requirements. Based on this analysis, the controller allocated 20% of the time of each customer care agent to the project as directly engaged salaries and wages.

## **Allocation of Labour Expenditures For SR&ED**

---

### **8.7 Quality control**

The quality control group performed testing and quality control functions on all codes that were written by the company, whether it came from the R&D team or the product engineering team. The controller decided to allocate to SR&ED and non-SR&ED the work of the quality control team based on the same ratio of SR&ED to non-SR&ED work performed by the R&D and product engineering teams.

### **8.8 Documentation**

The technical writer working in the documentation group spent all of his time writing documentation for external users that was incorporated into user manuals. The controller did not include this person's work in the claim.

### **8.9 Other groups**

The salaries and wages of the finance, marketing, and sales people were clearly not directly engaged and were not included in the claim.

As a final measure, the time-sheet tracking system was reviewed to identify any extended vacation, flex days, or sick leave time that should be allocated to non-eligible activities.