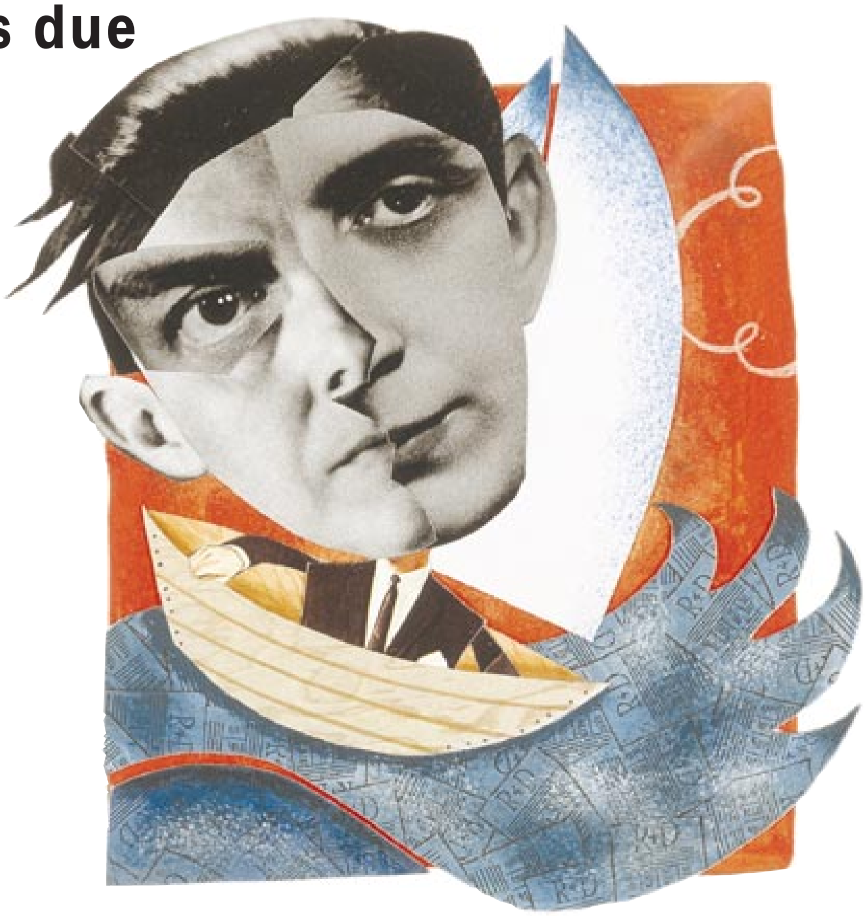
TAXATION

Credit where it's due



Overwhelmed by the number of applicants, Revenue Canada is giving short shrift to companies claiming retroactive R&D tax credits

By Peter Weissman

It seems unlikely that companies would ignore tax incentives to which they were entitled. Yet that is exactly what is happening with the Scientific Research and Experimental Development (R&D) tax credits. Owing to uncertainty about the application of the program, some taxpayers are reluctant to apply for incentives they may be due.

Although the R&D program dates back to 1944, the current tax incentives were put in place in 1983. Since then, they have continued to evolve, with the most notable changes taking place after September 13, 1994. That was the last day that taxpayers could make retroactive R&D claims back to 1983, and thousands of claims flooded in to Revenue Canada. In an internal paper, the department states that "the review of taxpayer requested adjustments involving retroactive SR & ED claims has been a significant drain on resources. Since resources are limited and a priority must be given to processing current claims and providing service to new claimants, minimizing the time spent on taxpayer requested adjustments is an objective."

> "The onus is entirely with the claimant to establish entitlement"

Because there is a lack of supporting documentation for many of the retroactive claims, the department's position is that "since the situation was caused by the claimant, the onus is entirely with the claimant to establish entitlement to the SR & ED incentives being requested. If the claimant does not provide the necessary evidence within a 30-day time frame, the request should be denied."

Still, the Department of Finance is committed to the R&D tax credit program, as a May 1996 paper by the department's Gordon Lenjosek made clear. It said: "The key economic rationale for governments to assist R&D is that the benefits of R&D extend beyond performers themselves to other firms and sectors of the economy, and the value of these benefits is not fully captured by the R&D performer. These 'spill over' benefits mean that, in the absence of government support, firms would likely perform less R&D than is desirable from the economy's point of view."

While the intentions are sincere, experience produces a different picture. Although assessing practices and policies are intended to be administered consistently across the country, decentralization of the audit process has made this hard to achieve. Administration of the program varies from one district office to the next and access to the incentives has become more difficult. As a result, the program is riddled with uncertainty for the applicant and taxpayers are starting to think that the incentives are not worth the bother required to obtain them. Such an attitude poses a serious problem when, in Ontario for example, the tax incentives can amount to a refundable credit of more than 40% and an additional deduction from taxable income. As practitioners, we can help our clients overcome their reluctance to apply for R&D tax incentives by monitoring the policy changes, understanding the process and seeking professional guidance when necessary.

Before 1994, R&D audits were educational and positive experiences for most claimants. Auditors spent much of their time explaining how claimants could enhance their claims. They even helped

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claimants understand the documentation required to support the R&D. In most R&D audits today, this practice is no longer followed. Because the definition in the Income Tax Act is vague, the department has taken a hard line as to what represents eligible R&D. Generally, however, if a claimant can show that there was a technological advance to the claimant (not to the industry as a whole), that there was technological uncertainty involved in achieving this advance and that the process was carried out systematically by qualified people, the project has the makings of eligible R&D.

In the past, the area where Revenue Canada was most lenient (probably because of taxpayers' difficulty in adhering to the test) was that of documentation. Where complete documentation was not available, the department looked for corroborating evidence in order to determine whether the R&D was carried out in a systematic manner. It is a change in this philosophy that has caused most of the difficulties with current and retroactive R&D tax credit claims.

In its Application Policy Number SR & ED 94-01, Revenue Canada states that "the strategy is focused towards concentrating our resources to client service oriented activities to current and prospective SR & ED claims with the view to enhancing future compliance." This is understandable, given the number of retroactive claims submitted. What is disconcerting to claimants, however, is that this higher level of diligence is now being applied to current and future claims with no grace period. Without any warning, taxpayers who have previously claimed R&D tax incentives under this program are finding that the procedures and practices they followed in the past no longer entitle them to the incentives. For example, whereas in prior years Revenue Canada acknowledged that most of Canada's R&D took place on the shop floor rather than in laboratories, the new documentation requirements demand laboratory-like records.

As an illustration, let us look at two recent situations in which the taxpayers failed to obtain tax credits to which, in my opinion, they were entitled. The first case involves a plastics polymers company that was not aware of the R&D incentives in prior years. Accordingly, before the September 13, 1994 deadline, it submitted claims dating back to 1989. Revenue Canada did not review the eligibility of the activities until June 1996, following which the taxpayer's representatives and employees (a total of seven people) spent three days with a technical auditor discussing all aspects of the activities claimed. To the extent that it was available, the taxpayer also provided documentation explaining the activities. There were no concerns or questions from the auditor after the technical audit was completed, but in September 1996, the taxpayer received a proposal from Revenue Canada stating that 50% of the activities were deemed ineligible. Financial adjustments were made that reduced the taxpayer's claim by more than 90%. During this process there was no contact by Revenue Canada nor any opportunity for discussion. The taxpayer's request for meetings with Revenue Canada was flatly rejected. As a result, the taxpayer must now either accept the finding or incur more costs in Revenue Canada's appeals process.

The second example involves an auto-
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PERSONAL FINANCIAL PLANNING

Insider's argot

How not to get fleeced on the stock market and sound like an investment whiz when you talk to your broker

By Ian Davidson

As a chartered accountant, you have a professional language with some rigour — terms like "generally accepted," "material," and "accrual" all have assigned meanings familiar to each and every practitioner. The investment industry should be so lucky. Unfortunately, if you and your broker or financial adviser don't seem to be speaking the same language, there's no association guidebook to turn to for help. That can result in all sorts of misunderstandings — some with legal implications.

As I write this, the Bre-X saga has come to its sorry end (or, at least, the value of the stock has). What is a financial adviser's liability to the client in such a case? In practical terms, it comes down to the "know your client" rule, and that necessarily means understanding each other. Advisers must act in accordance with the summary of client information documented at the first meeting and signed by both the client and the adviser (or broker). For example, if certain shares are recommended to a conservative client (someone primarily concerned with income and capital preservation), questions could arise concerning the suitability of the investment. In the case of Bre-X, a number of shareholder lawsuits are now wending their way through the courts. Most want to test the question of whether the broker and/or the investment firm should have recognized that the shares were speculative.

Within this context, I thought it might be useful to provide a short lexicon of my own — half "insider's argot" and half an attempt to describe some of the background to the investment game. After reading this, you should be able to scare your broker with your "behind the scenes" knowledge of the industry.

STOCKBROKER: The intermediary to a sale or purchase of stocks or bonds, whose earnings are based upon the number of securities traded. Despite what you might see on the television show *Traders*, a broker's main fiduciary responsibility is to

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parts manufacturer. Although the taxpayer hired a professional engineer to review the projects before they were submitted, Revenue Canada's technical advisers deemed many of them to be ineligible. However, the company was offered the chance to submit a written rebuttal as to why it disagreed with the department's conclusions. Accordingly, the taxpayer forwarded its written explanation to the Science Advisor and informed the financial auditor that the report had been sent. However, the Science Advisor neither responded to the taxpayer's rebuttal in a timely way, nor contacted the financial auditor to acknowledge receipt of the rebuttal. As a result, the financial auditor processed the reduced claim and an assessment was issued without the rebuttal ever being considered. The department has now acknowledged the receipt of the technical rebuttal but the period for objecting to the assessment has lapsed. Partly because of a miscommunication between the financial and technical auditors, the client's potentially eligible claim has been disallowed.

As a footnote to this case, it is important to note that the financial auditor will process any adjustments, including the effect of scientific reviews. Therefore, by directing all correspondence to the financial auditor, it is possible to avoid this type of situation.

In fairness, I have to say that in my own experience most audits are handled reasonably. In some cases, the auditors have even gone beyond the normal course of duty to assist the claimants. For example, one taxpayer that required its R&D tax credit refund as soon as possible for financing reasons was able to receive a pre-assessment refund within the time frame needed.

What do these examples show with respect to the R&D program? Specifically, they show that the program is in the midst of change. As a professional adviser, your job is to steer your clients through this change and help them comply with the more stringent program guidelines. You also have a responsibility to ensure that your clients' claims are reasonable so that the integrity of the program is not undermined.

The formula for a healthy R&D claim now includes many components. First, your client should know the rules, both technical and financial, before submitting a claim. After you review these rules with your client, you may conclude that there is not enough supporting documentation for the claim under Revenue Canada's new administrative guidelines. In particular, if your client does not have documentation that would make the R&D process "repeatable," Revenue Canada will probably deem the project ineligible. Make sure that the client's calculations and supporting documentation are reasonable and can withstand scrutiny. Lack of documentation can hurt the credibility of your client's claim and if credibility is compromised, the likelihood of your client receiving credits is reduced.

You should also assess whether you need to engage an R&D technical and/or financial specialist to help you. There are many situations where a general knowledge of the R&D tax incentive programs is not enough to deal with specific issues. For example, while certain non-R&D advantages may be realized by using independent contractors, the benefit of the proxy method of calculating overhead is lost. Bonusing out of manufacturing and processing profits may be appropriate in order to maximize the credits. In addition, new rules may require taxable capital planning in order to avoid the reduction of your client's entitlement.

Perhaps the most value you can add is in helping clients develop an information reporting system that integrates the documentation required to support the nature of R&D activities and the calculation of the costs associated with those projects. Without adequate descriptions and documentation, your client's eligibility for these incentives will be questionable. If the activities are disallowed, all the tax planning you've done for these incentives will be for naught.

With the proper documentation and accounting information, you will find that an R&D audit can still be an educational and rewarding experience for you and your client. The R&D tax incentive program is here to stay and the rules are constantly changing. Only with proper understanding and communication will the program's benefits warrant the efforts.

Peter Weissman, CA

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performing quite differently from those on the stock market indexes.

MANAGED MONEY: A term that now refers to both mutual funds and certain types of investment counselling. Mutual funds are unit trusts in which various funds are pooled and managed by a professional. Capital gains and income are allocated annually to each unit-holder. The advantage of all managed money is that it is tougher to "blow your brains out" or lose your investment. Diversified portfolios have less "security" risk, although it takes 30 or more stocks to avoid the risk of one real stinker contaminating the entire return. Managed money fees are based on the assets under administration, so there is less tendency for the adviser to "churn and burn" (see next entry). Typical fees are about 1%, with brokerage and custody fees on top of that. For the first million dollars placed with an investment counsellor, total fees will run 2% to 3%.

CHURNING AND BURNING: The churn refers to the rapid turnover of an investor's assets; the burn to his or her subsequent loss of money. The greater the turnover of the securities held by an investor, the higher the commission the adviser makes. Although this pastime had widespread appeal in the 1980s (when brokers bragged about their "stock jockey" status), it has since passed out of favour. Today, one can expect about 25% to 33% of a portfolio to be turned over in a year.

ASSET ALLOCATION: Ten years ago, few investors had ever heard of this term. Since then, it's become another cliché. Depending on which study you read, as much as 90% of a portfolio's return comes from the asset allocation, and diversification is the name of the game when it comes to reducing risk. There are two main patterns: (1) tactical asset allocation, in which you try to figure out which asset class will do best in a given year, and tilt your asset diversification accordingly; and (2) strategic asset allocation, which means that annually — or more frequently — you adjust asset allocations back to targeted percentages set out in a plan for the asset mix. This periodic rebalancing ensures that you are selling high and buying low.

RISK DRIVES RETURN: The more equities you have in your portfolio's asset allocation, the higher the risk and volatility — and, potentially, the higher the return.

RANDOM WALK: With $18 billion (US) in personal wealth and counting, Warren Buffet is the most successful individual investor of the modern age. His strategy is to buy quality stocks and to hold onto them for long periods. Buffet has actually managed to beat the market over the long term — and, perhaps as a result, has never been invited to address his alma mater's business school, Columbia University. That's because, as every good academic knows, it's impossible for an investor to beat the market. The random walk theory states that market fluctuations and historic results don't mean anything because they're not predictive. According to this theory, the best investment strategy is to buy market indexes (called "passively managed accounts"). As a CA, however, you know that holding a Canadian stock for long periods of time (à la Buffet) offers certain advantages: dividends are tax preferred, and capital gains are deferred until the ultimate sale of the security. Ownership of securities may provide some tax advantages over holding an index.

MARKET DECLINE: Occasionally, the market goes on sale. Unfortunately, we categorize this as a "decline," which prevents many investors from seeing the sale for what it really is — a buying opportunity. There are only two logical responses to a decline: invest more or invest monthly. In the past 65 years, the US stock market has increased 200 times. Gains are permanent; losses are temporary.

FINANCIAL PRESS: You can read three newspapers a day if you wish, but bear in mind that it's not every day that something happens. Or, you can safely ignore the financial press for long stretches, as long as you remember to check periodically on the financial results of companies. In the end, stock prices are reflections of profits earned or expected to be earned; beyond that concern, you are reading for pleasure.

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