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September 28, 2012

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To whom it may concern:

Enclosed please find our submission to the federal government on the impact of contingency fee arrangements with third-party preparers on the effectiveness of Canada's tax incentive program for scientific research and experimental development (SR&ED).

Canada's Chartered Accountants welcome the opportunity to put forward our views on this important topic. As we discuss in our submission, we believe that contingency-based fee arrangements have become a vital component of the tax incentive system for promoting innovation among Canadian businesses. Such arrangements play a valuable role in encouraging more taxpayers to participate in the program and ultimately increase their investments in SR&ED.

We grant permission to post this submission on the Finance Canada website.

We look forward to working with you to ensure the effectiveness of Canada's SR&ED tax incentive program. If you have questions or would like further elaboration of the views in our submission, please contact me.

Best regards,

A handwritten signature in black ink, appearing to read 'Gabe Hayos'. The signature is written in a cursive, flowing style.

Gabe Hayos, FCA, ICD.D  
Vice President, Tax  
Canadian Institute of Chartered Accountants



**Impact of Contingency-based Fees on the Effectiveness of the  
Scientific Research & Experimental Development  
Tax Incentive Program**

**A Submission to the Department of Finance Canada**

Canadian Institute of Chartered Accountants

September 2012



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## Executive Summary

Canada's Chartered Accountants are pleased to put forward our views to the Department of Finance Canada and Canada Revenue Agency (CRA) on the impact of contingency fee arrangements with third-party preparers on the effectiveness of Canada's tax incentive program for scientific research and experimental development (SR&ED). This submission responds to questions and concerns raised in the Invitation for Comments and Backgrounder issued by Finance Canada on August 2, 2012.

This submission was developed in consultation with an SR&ED Working Group composed of SR&ED specialists with Canada's seven largest accounting firms. In addition to gaining their insights about this topic, we polled these representatives for confidential data regarding the nature and extent of contingency-based billing practices in use for their firm's SR&ED work (see Appendix B). We also sought the views of Canada's CAs working in industry through an online survey of CICA members conducted in September 2012 (see Appendix C).

Based on these investigations, we believe that contingency-based fee arrangements have become a vital component of Canada's tax incentive system for promoting SR&ED. For the following reasons, such arrangements play a valuable role in encouraging more taxpayers to participate in the program and ultimately increase their investments in innovation.

- **Nominal cost** – Our poll of Canada's seven largest professional services firms shows that the portion of SR&ED credits paid to these firms' preparers under contingency-based arrangements is nominal—a mere 2.3 percent of the SR&ED program's annual \$3.6 billion cost. In fact, total SR&ED revenue under all types of arrangements earned by these firms was only 3.7 percent of the program's annual cost. These figures are in stark contrast to unsubstantiated claims made in the press, which have suggested that the size of fees paid to consultants represent 30 percent of SR&ED claims annually.
- **Equivalent to other fee arrangements** – When compared to hourly-based or flat fees, contingency-based fees are comparable to fixed fee and hourly rate fee engagements of equivalent scope. Based on our poll, contingency-based fees are estimated to be on average 58 percent of standard billing rates (fixed fee arrangements were on average charged at 65 percent of standard billing rates). Thus contingency-based fees do not appear to increase either the consultant's fee or the claimant's compliance costs.
- **Promoting more claims** – In response to CICA's survey of members in industry, almost half of those who had paid contingency-based fee would have been unlikely to make an SR&ED claim under some other fee arrangement. Thus contingency-based fees increase the number of claims filed and the amount of funding available for future innovation.
- **Assisting small and medium-sized businesses** – By engaging third parties on a contingent-fee basis, many small and medium-sized companies that do not have specialized in-house resources can still participate in the program without any upfront cash outlay.
- **Financing innovation** – Such arrangements can offer a form of innovation financing, allowing companies to devote more funds to innovation projects without the risk that they will incur losses on fees for SR&ED claims that are not accepted by CRA on audit.

- **Adequacy of CRA's existing enforcement tools** – Contingent-based fees, in themselves, are not the root cause of overly aggressive claims. CRA already has the means to deny ineligible claims and curtail perceived abuses. Any action to target contingent-based fees directly would only serve to eliminate a valuable avenue for obtaining claims assistance and potential financing for small and medium sized businesses.
- **Promoting transparency and accountability** – If the government thinks it necessary, it could take steps to promote transparency and accountability among third-party preparers. Such steps could include adopting legislation to make it compulsory on the SR&ED tax credit claim form to name any third party who has provided any form of paid assistance to the taxpayer in the preparation of the SR&ED claim, with penalties for non-compliance. The government could also require claimants to state on their SR&ED tax credit claim forms whether such third party is a member of a self-regulating professional body (e.g., CICA, Canadian Society of/for Professional Engineers) that has appropriate codes of conduct (e.g., related to fraud) and effective enforcement mechanisms.

The views expressed in this submission represent the position of the CICA. While our recommendations reflect our consultations with the SR&ED Working Group and external stakeholders, our views do not necessarily represent those of the individual Working Group members or stakeholders. We thank these individuals for contributing their insights to this important debate.

## Introduction

For Canada to stay competitive and create employment opportunities for an educated workforce, investment in innovation is essential. Canada's SR&ED tax incentive program aims to foster such investment by providing broad-based support for SR&ED performed in every industrial sector in Canada and particularly among small and medium-sized businesses. As Finance Canada notes in its Invitation to Comment, the rationale for this tax support is that the benefits of SR&ED activities extend beyond the performers themselves to other businesses and sectors of the economy.

However, the eligibility criteria and process for claiming SR&ED tax credits are detailed and complex. Taxpayers do not have certainty over the ultimate amount of their SR&ED benefits until after their costs have been incurred and their claims for the relevant taxation year have been processed. The federally appointed Expert Review Panel on Research and Development called for greater simplicity within the program, and the federal government's Budget 2012 acknowledged that changes to the program are needed "to make it simpler, and more cost effective and predictable." CRA and Finance Canada, through Budget 2012, are taking steps toward these ends, for example, by improving guidance for claiming eligible costs and investigating the feasibility of implementing a formal pre-approval process.

While such steps are welcome, we believe that third-party tax preparers have, and will continue to have, an important role in the effective operation of the SR&ED tax credit system. The federal government's statistics, as presented in the Invitation to Comment, show that businesses of all sizes are seeking assistance in making SR&ED claims, and two-thirds of them rely on third parties to prepare their SR&ED claims. CICA's member survey supports this finding.

These statistics indicate that businesses do not have sufficient in-house resources with the highly specialized mix of scientific and tax knowledge needed to assess the eligibility of their activities and costs or to prepare the claim and supporting documentation. We believe these businesses, and the system's overall administration, benefit from the greater certainty and improved quality of SR&ED claims that results from detailed, specific advice from knowledgeable, experienced third-party preparers.

Concerns have been raised that the integrity of the system may be compromised when third-party SR&ED preparation services are provided on a contingency-fee basis. Unlike flat or hourly-based fees, contingency-based fees are only payable if the result is favourable to the client, and they are generally calculated as a percentage of the amount of the SR&ED tax credits the client receives. Some have suggested that such arrangements may result in an undue proportion of government stimulus spending on innovation being paid to third-party consultants, diminishing the impact of SR&ED tax incentives to Canadian businesses and the economy.

On the contrary, given the size and complexity of the SR&ED program, we believe that the amount of contingency-based fees paid to third-party preparers is small and not unreasonable. Based on CICA's confidential poll of Canada's seven largest accounting firms, which we believe are the predominant providers of this service, SR&ED consultant fees amounted to only \$133.9 million, or 3.7 percent of the government's total \$3.6 billion annual SR&ED credits paid. Of these fees, contingency-based fees amounted to \$83.27 million, or only 2.3 percent of SR&ED credits paid. We can find no substantiation for media reports that a much higher proportion of the federal SR&ED spend is being paid to third-party preparers.

Further, we believe that the ability to engage third-party preparers on a contingency-fee basis often allows companies to increase their spending on SR&ED activities, in keeping with the SR&ED program's primary objective.

## Assessing the Impact of Contingency-based Fees

### *Rationale for contingency-based fee arrangements*

Third-party tax preparers may provide their services through various payment structures, including contingency fees, hourly-based fees, flat fees, or a combination of contingency and other types of fees. As part of its consultations, Finance Canada seeks to understand why companies would prefer to engage third-party preparers on a contingency-fee basis, rather than another basis.

As noted earlier, many companies do not have the resources to identify qualifying activities and prepare the necessary claim documents. In response to CICA's member survey, the most common reason for entering into a contingency-based fee arrangement—named by 47 percent of respondents—was a lack of confidence over the claim's outcome due to the SR&ED program's complex eligibility requirements.

By engaging third parties on a contingency-fee basis, these companies can participate in the program without any upfront cash outlay, allowing them to identify the full range of qualifying costs and secure their entitlement under the program. Reluctance to assume the risk of claim costs was the second most common reason cited for the use of contingency-based fee arrangements, named by 23 percent of respondents.

In effect, such arrangements can offer a form of innovation financing. Companies can devote more funds to innovation projects without the risk that they will incur losses on fees paid to third parties in respect of SR&ED claim costs that are not accepted by CRA on audit. Further, successful SR&ED claims often give companies the confidence to boost their eligible SR&ED spending in subsequent years.

Eliminating contingency-based fees would be particularly onerous for those companies that are filing their first SR&ED claims, such as start-ups, growth companies and foreign companies that are not familiar with the program. Many first-time filers are not aware that they have activities that qualify. Given their unfamiliarity with the system and uncertainty over their eligibility, they may be reluctant to risk paying a fixed fee to a third party to prepare their claim, and they could be discouraged from filing any SR&ED claim at all. If first-time filers do not claim SR&ED benefits, the company and the Canadian economy would lose the benefits that would arise if the company were to invest those forgone SR&ED credits in its future innovation activities.

Viewed in this light, it is apparent that contingency-based fees have become important in encouraging companies to take part in the SR&ED program and ultimately increase their SR&ED investment. When contingency-based fee payers were asked whether their organization would have been likely to make an SR&ED claim on some other fee basis, 39 percent of respondents probably would not have made the claim and 9 percent definitely would not have made the claim.

Further, over half of the industry members responding to CICA's survey agreed SR&ED credits promote higher R&D investment in their own or their client's organizations.

## ***Prevalence of contingency-based fees***

As noted, according to CICA's confidential poll of Canada's seven largest accounting firms, the firms had combined SR&ED revenues of \$133.9 million for their most recent fiscal periods, which amounts to a mere 3.7 percent of the total \$3.6 billion in government SR&ED spending in 2011. Of these fees, 62 percent, or \$83.27 million in total, are contingency-based, and so these fees are only 2.3 percent of government SR&ED spending.

These results contradict media reports that have suggested that contingency-based fee arrangements are causing up to 30 percent of the government's total annual SR&ED spending to go to consultants rather into innovation.<sup>1</sup> As these seven firms are Canada's predominant SR&ED service providers and earn the majority of SR&ED fee revenue, our findings indicate fees paid to consultants as a percentage of total government SR&ED spending are much less than reported and are reasonable for the services provided.

## ***Impact on SR&ED claim preparation costs***

Finance Canada's Invitation to Comment raises the concern that contingency fees may increase costs for successful claimants. In fact, when compared to hourly-based or flat fees, contingency-based fees are comparable for engagements of equivalent scope. In our poll of accounting firms, respondents estimated that contingency-based SR&ED fees were recovered at 58 percent of standard billing rates on average, while fixed fee billings were recovered at 65 percent of standard rates. Thus contingency-based fees do not appear to increase either the consultant's fee or the claimant's compliance costs.

Additionally, for the reasons noted above, contingency-based fees can provide a net benefit to the taxpayer, by optimizing the scope and amount of their claim while improving the efficiency and quality of its preparation.

Restricting contingency-based fees would reduce the amount of government SR&ED spending earned by third-party consultants. As noted, however, many contingency-based fee payers say they would have been unlikely to make an SR&ED claim on some other fee basis. Thus, restricting these fees would reduce both the number of claims filed and the amount of funds available to these companies to invest in innovation, which is contrary to the SR&ED program's objectives.

## ***Potential restrictions***

Contingency-based fees relate to the size and result of the claim. Finance Canada notes that, as a result, this billing practice has been criticized on the basis that "it provides an incentive for tax preparers to encourage their clients to take aggressive positions that push the bounds of the law and its interpretation." Finance Canada questions whether restrictions should be placed on the use of contingent-fee arrangements.

In our view, such restrictions are unnecessary. While some may believe there is a perceived conflict of interest, in the experience of our members, SR&ED claim preparers would take the same positions on filing the claim regardless of the fee arrangement. Indeed, it is in the joint interests of the client and the consultant to file complete and accurate SR&ED claims in order to expedite the claim's review and processing so the client can obtain the financing for its innovation and operations. Further, most consultants are concerned about their

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<sup>1</sup> See, for example, Barrie McKenna, "Dubious claims diminish R&D tax credit", *The Globe and Mail*, February 6, 2011.



reputations with the tax authorities and in the marketplace. Contingent-based fees, in themselves, are not the root cause of overly aggressive claims, and CRA already has the means to deny ineligible claims and curtail perceived abuses. Any action to target contingent-based fees directly would only serve to eliminate a valuable avenue for obtaining claims assistance and potential financing for small and medium sized businesses.

If the federal government thinks it necessary, it could take steps to promote more transparency and accountability among third-party preparers. Such steps could include adopting legislation to make it compulsory on the SR&ED tax credit claim form to name any third party who has provided any form of paid assistance to the taxpayer in the preparation of the SR&ED claim, with penalties for non-compliance. The government could also require claimants to state on their SR&ED tax credit claim forms whether such third party is a member of a self-regulating professional body (e.g., CICA, Canadian Society of/for Professional Engineers), with appropriate codes of conduct (e.g., related to fraud) and effective enforcement mechanisms.

## Conclusion

Contingent-fee arrangements arose from a need in the market among all sizes of companies for a cost-effective means of financing the costs of preparing complex SR&ED tax credit claims. Over time, contingency fees have become integral to the SR&ED system's smooth operation by reducing risk for first-time claimants and by helping them ensure they receive the benefits to which they are entitled.

As a result, these arrangements enhance the overall tax system's fairness, effectiveness and efficiency, without significantly diverting an undue proportion of government funding for innovation. In fact, we believe this billing practice may help the SR&ED program achieve its objectives by helping create the foundation for companies to increase the overall amount of funds invested in qualifying SR&ED projects in Canada.

To address concerns that such arrangements could encourage some third-party preparers to artificially inflate SR&ED claims, CRA should employ its existing anti-avoidance and enforcement tools. If the federal government considers that further action is needed, it should institute new ways to monitor and promote accountability among third-party preparers.

## Appendix A – CICA SR&ED Working Group

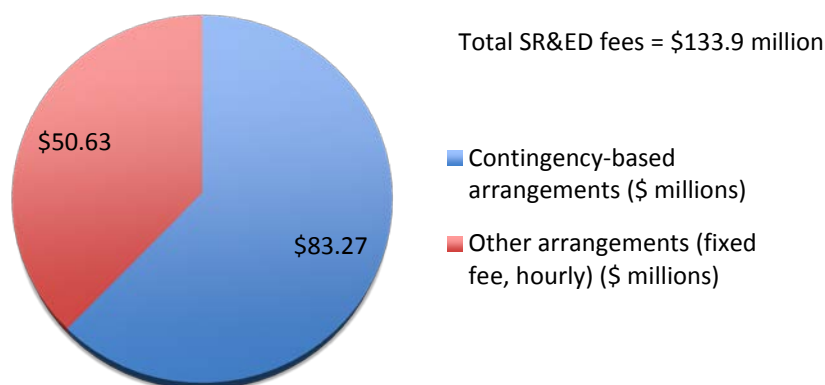
<b>Gabe Hayos</b> , FCA, ICD.D	Chair, CICA Tax Policy Committee Vice President – Taxation, CICA
<b>Albert Baker</b> , FCA	Partner, International Tax Deloitte
<b>Susan Bishop</b> , CA	Canadian Leader - SR&ED and Business Tax Ernst & Young
<b>Carlo Ciaramitaro</b> , CA, CFP	National SR&ED leader KPMG
<b>Ken Douglas</b>	Leader, SRED practice Grant Thornton LLP
<b>Paul Hickey</b> , CA	Partner, National Tax KPMG LLP
<b>Michael C. McCreight</b> , CA	National SR&ED Partner BDO Canada LLP
<b>Elly Meister</b>	Director, Government Relations CICA
<b>Michel Rheault</b> , M. Sc.	Leader, SRED practice Raymond Chabot Grant Thornton
<b>Vik Sachdev</b>	Tax Services, National SR&ED Tax Practice Leader, PwC

## Appendix B – Accounting Firm Data: Nature and Extent of SR&ED Contingent Fee Arrangements

The table below shows the results of our confidential poll of Canada’s seven largest professional services firms regarding the nature and extent of their contingency-based billing practices related to SR&ED claim preparation.

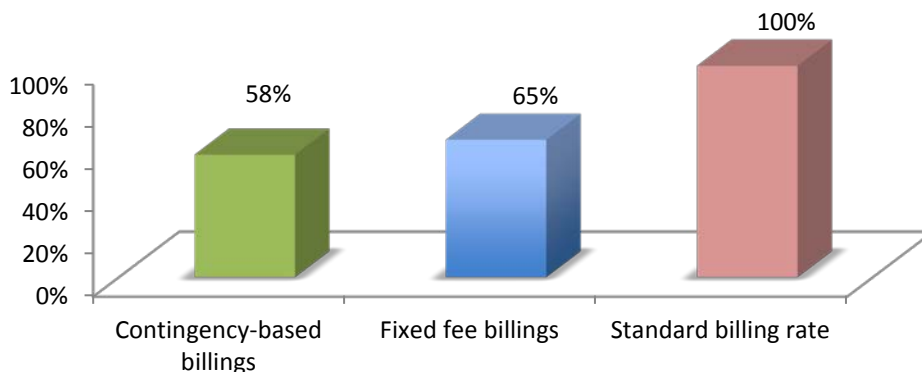
These results represent the consolidated annual results for the most recent fiscal years of BDO Dunwoody LLP, Deloitte & Touche LLP, Ernst & Young LLP, Grant Thornton LLP, KPMG LLP, MNP LLP and PricewaterhouseCoopers LLP.

### Fees charged for SR&ED services



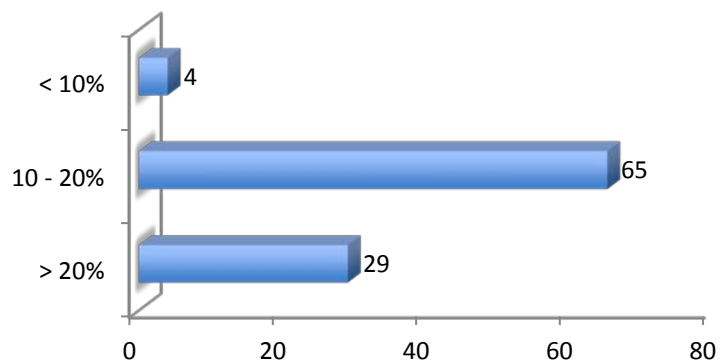
Note: breakdown of fee types based on weighted average of individual firm’s results.

### Recovery of fees charged for SR&ED services, as a percentage of standard billing rates



Note: Based on weighted average.

**Contingent fee rate charged for SR&ED services, as a percentage of the SR&ED claim**

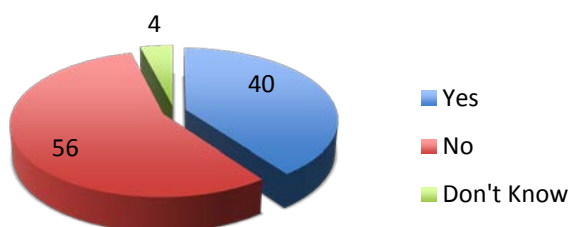


*Note: Based on average of rough estimates.*

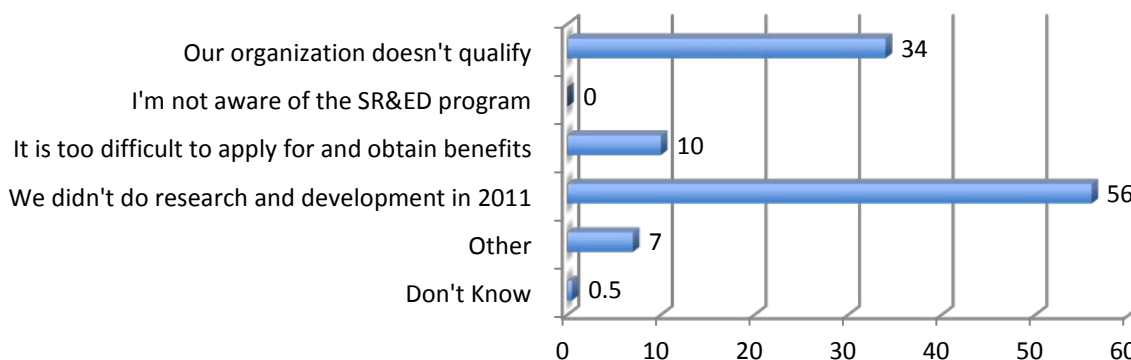
## Appendix C – CICA Member Survey: Nature and Extent of SR&ED Contingent Fee Arrangements

In September 2012, CICA conducted an online survey of its members to help determine the nature, extent and impact of the use of contingency-based fee arrangements on the effectiveness of Canada’s tax incentives for scientific research and experimental development. The survey was completed by approximately 350 CAs working in industry (see page 16 for details about the respondents). Key survey questions and responses are set out below.

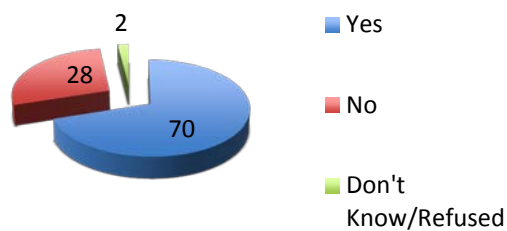
1. Did your organization claim SR&ED tax credits for the 2011 tax year?



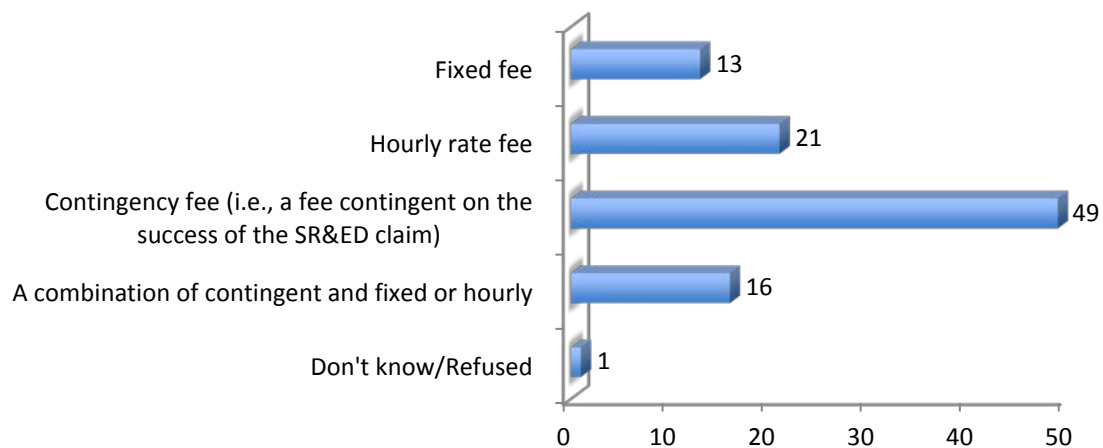
2. If not, why didn't your organization claim SR&ED tax credits for the 2011 tax year?



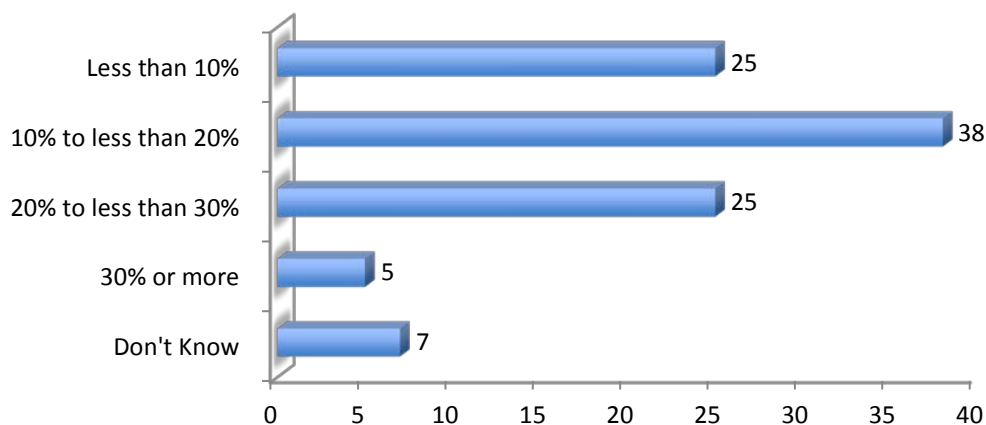
3. If so, did your organization use a third-party consultant to assist in making the claim?



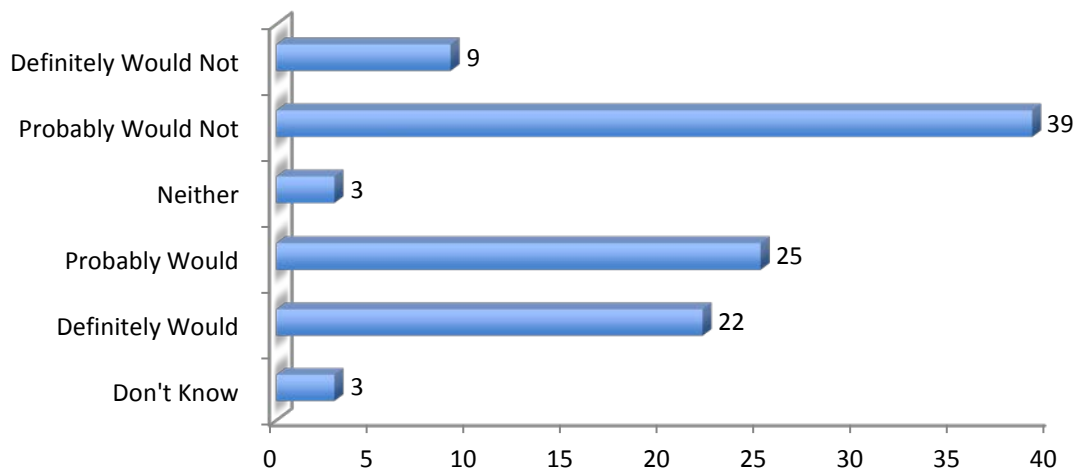
4. How were the fees determined for this engagement?



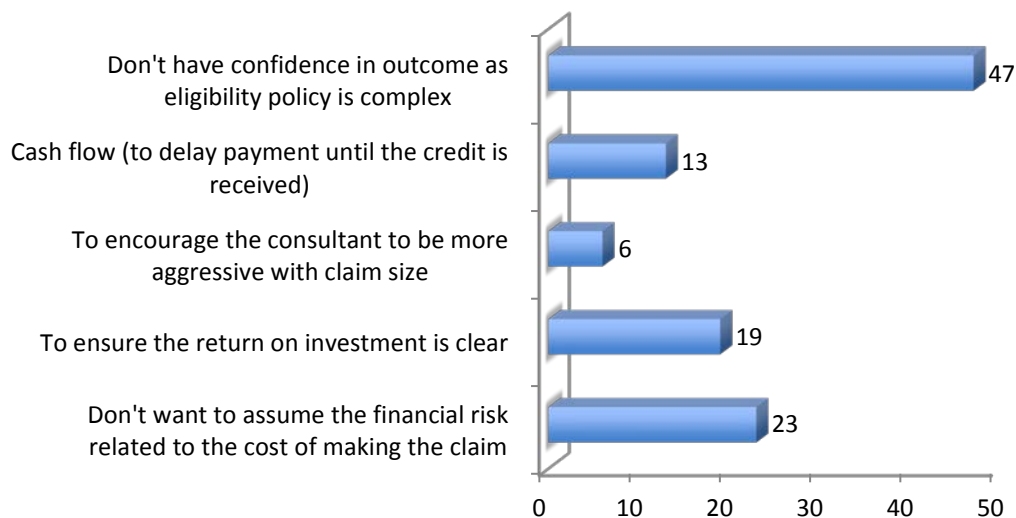
5. *If a contingent arrangement was used, what proportion of the SR&ED tax credit did the fee paid to the third-party consultant represent?*



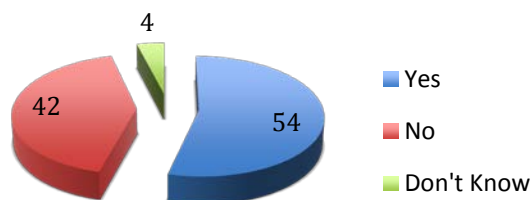
6. *If a contingent arrangement was used, how likely would your organization have been to claim the SR&ED tax credits if the fees of the third-party consultant were not contingent on the success of the claim?*



7. If a contingent arrangement was used, which of the following are reasons why your organization chooses to engage a third-party consultant that charges a contingency fee for SR&ED claims?



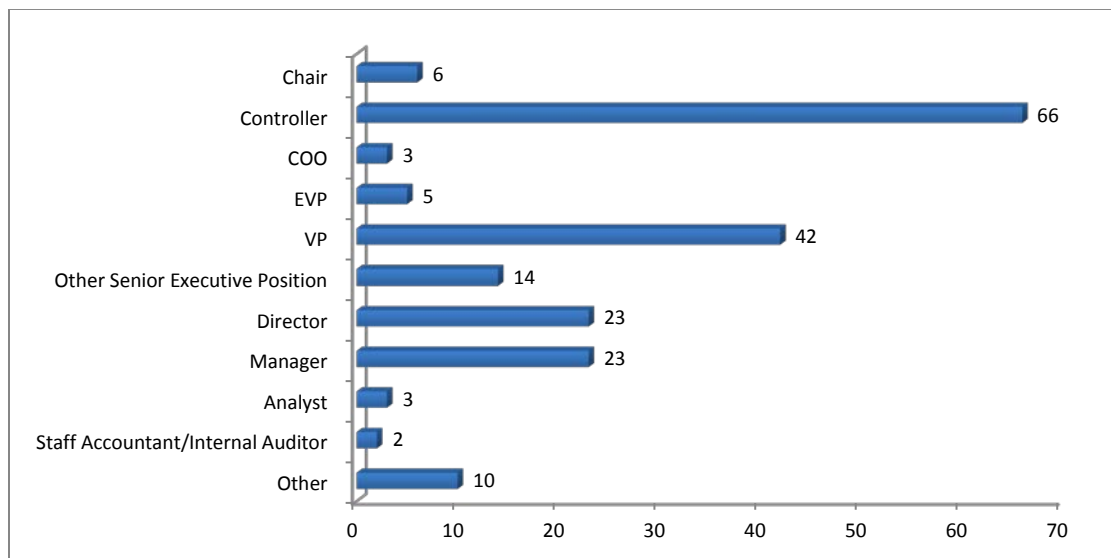
8. Do SR&ED tax credits encourage your organization to invest more in research and development?



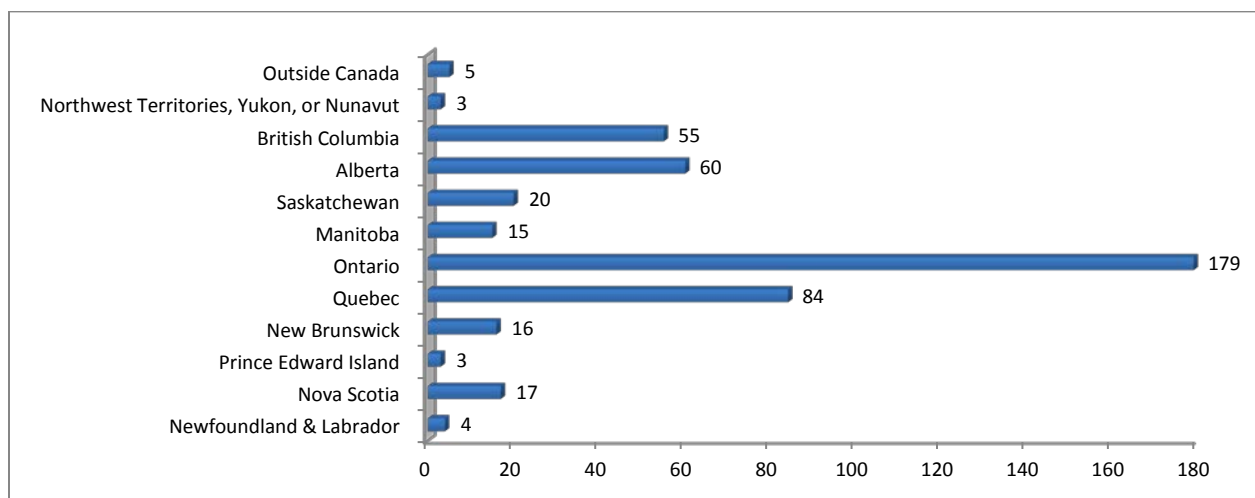


**Demographic questions**

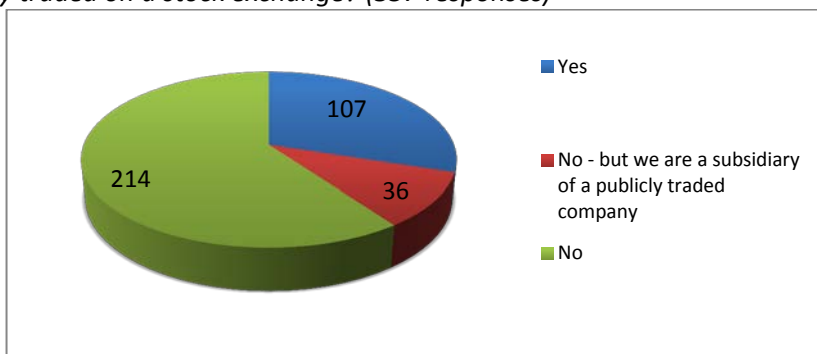
9. Which of the following describes your current job title? (357 responses)



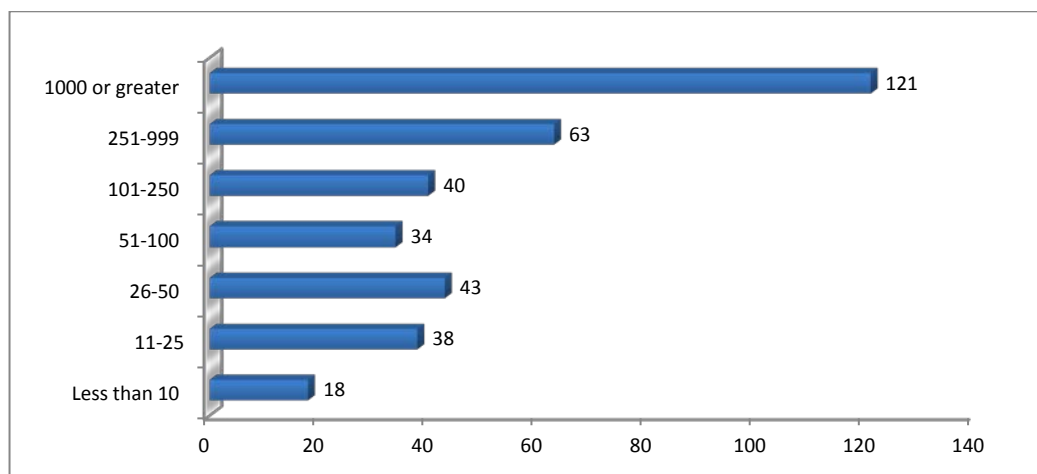
10. Which of the following best describes your place of residence? (461 responses)



11. Is your company traded on a stock exchange? (357 responses)



12. How many individuals does your company employ globally? (357 responses)



13. Which of the following industry sectors describes your company's primary business (total: 357 responses)

