



September 28, 2012

SR&ED Consultations
Department of Finance
140 O'Connor Street
Ottawa, ON K1A 0G5

Dear Sir/Madam:

Subject: Consultation regarding the impact of contingency fees on the effectiveness of the Scientific Research and Experimental Development (SR&ED) tax incentive program

We appreciate the opportunity to submit our response to the Department of Finance and Canada Revenue Agency's consultation on the impact of contingency fees within the SR&ED program.

Our clients are sophisticated businesses who make informed decisions when entering into business arrangements, such as whether to use a contingency fee arrangement or a fee-for-service arrangement when hiring external advisers to help prepare their SR&ED claims.

Our experience does not suggest that limiting the use of contingency fees in the SR&ED program would reduce compliance costs for taxpayers. Rather, Canadian businesses use contingency fee arrangements to reduce actual and perceived risks associated with claiming SR&ED benefits.

We have set out our response to the specific matters of interest noted in the consultation paper and would be delighted to discuss these issues in greater detail.

We consent to the disclosure of this response on your website.

Please feel free to contact me at 416 869 2424 should you have any questions or comments.

Yours truly,

A handwritten signature in blue ink that reads "PricewaterhouseCoopers LLP".

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PwC response to consultation regarding contingency fees within the SR&ED program

Our clients' use of contingency fees for scientific research and experimental development (SR&ED) engagements in Canada is driven primarily by their desire to reduce their risk associated with claiming SR&ED benefits. This risk arises primarily due to the program's interpretive nature and complexity, resulting in a significant amount of uncertainty for our clients – the SR&ED performers – as to whether they can realize benefits under the SR&ED program. Furthermore, the audit and assessment practices of the Canada Revenue Agency (CRA) around eligibility of SR&ED claims can sometimes create a significant compliance burden for taxpayers.

The delivery of our SR&ED services is governed at all times by strict professional codes of conduct and the highest standard of care, regardless of the nature of the fee arrangement. We do not agree that the use of a contingency fee arrangement increases the compliance costs of the SR&ED program. Rather, however, the use of contingency fees appears to be part of the marketplace reaction to other issues (such as lack of predictability of benefits), which remain largely unaddressed within the SR&ED program. Indeed, far from being harmful, contingency fees increase the efficiency and effectiveness of the SR&ED program by extending its reach to companies that otherwise would not make claims for their eligible work.

The rationale for contingency fees

1. The Government would like to better understand why certain SR&ED performers use the services of third-party tax preparers on a contingency-fee basis to prepare their claim forms

Uncertainty and risk: Many SR&ED performers who enter into contingency fee arrangements cite a pervasive uncertainty about multiple aspects of the SR&ED program. This uncertainty translates into a strong perception of risk within the program. Aspects include:

- the interpretive nature and complexity of the SR&ED program, particularly related to scientific and technological eligibility rules;
- lack of predictability concerning eligibility, in which the CRA's sometimes inconsistent application of its own published policies and guidelines further impairs the SR&ED performers' ability to confidently develop their own consistent understanding of the rules;
- strong perceptions that there is no truly independent or objective mechanism for revising or appealing an unfavourable opinion about a claim; existing alternative mechanisms within the CRA are assumed to be not independent, and legal remedies are slow and extremely expensive to pursue, effectively limiting access;

- unsatisfactory experiences with the program together with the absence of predictable benefits makes many performers prefer not to invest the time and expense required to support robust internal processes and programs for identifying, claiming and supporting SR&ED;
- reluctance to develop an internal process to claim credits because the relative significance of the credits may vary year over year, even being entirely absent in some years; and
- many SR&ED performers' preference to devote internal resources to advancing products, processes and services, and to improving the bottom line, in the belief that the CRA SR&ED audit process is too onerous and fraught with risk – and therefore better supported by specialists.

Although committed and involved throughout the SR&ED claims process, SR&ED performers are increasingly inclined to delegate such perceived risks to external SR&ED claim experts – whether on a fee-for-service or contingency fee basis – a trend that is increasing as competitive market forces have largely reduced contingency fee rates. Cash flow and affordability concerns are eliminated by the contingency fee option. In the current market, SR&ED performers are assured of paying lower fees for the claim service, payable only when a benefit is actually realized, so that most of the perceived risks are carried by the external SR&ED claim experts.

2. The Government is interested to learn why some SR&ED performers prefer to pay for these services on a contingency-fee basis rather than a more traditional billing method.

In addition to the reasons noted in (1) above, many SR&ED performers lack the cash flow or approved budget to pay on a fee-for-service basis. They would prefer to manage risk and cash flow by making payment only after success is realized. Contingency fee arrangements offload the risk of an adverse finding almost completely to the preparer and competitive market pressures on contingency rates continue to erode any level of risk-compensating premium that might once have been implicit in such arrangements.

3. The Government is also interested to learn more about the size of the fees being charged and whether businesses are more likely to hire tax preparers on a contingency fee basis only for a first-time claim or on a recurring basis.

In our experience, contingency fee structures tend to range from 7.5% to 25%. The size of fees will depend on the competitive pressures within local markets, the claimant's own level of internal expertise and support, and a number of other factors affecting the engagement, including:

- the complexity of the claim;
- the taxpayer's record-keeping methods and supporting documentation;
- the taxpayer's past SR&ED claims and their experience with SR&ED claim reviews by the CRA; and

- the nature of the industry sector in which the claim is made.

We have detected no particular pattern that suggests first-time claimants are more inclined than experienced or recurrent SR&ED performers to prefer a contingency fee. Nor is there any assurance that recurrent claimants necessarily develop increased internal capabilities for claiming SR&ED, or an increased interest in doing so. The perceptions of inherent risk are the leading driver for contingency fees across all segments and sizes of the SR&ED performer market.

4. The Government would also like to understand the motivations of tax preparers for charging on a contingency-fee basis, and the relative importance of this type of revenue for tax preparers.

It is the SR&ED performers that drive the demand (and preference) for contingency fee arrangements, out of their desire to reduce risks and to obtain cash flow benefits. Our clients are well-informed businesses that assess our standard hourly rates, and, based on the effort required and risks involved with their claim, decide to hire a tax preparer on either a contingency fee or on a fee-for-service basis. In other words, taxpayers make thoughtful decisions based on their cost-benefit analysis.

We attach no particular importance to the fee type beyond the need to provide excellent professional service within a highly competitive marketplace. Our professional reputation is maintained only by continued excellence in the efficient delivery of comprehensive SR&ED services. The mechanisms for engagement do not alter this focus.

Qualified accountants who belong to a recognized accounting body follow a professional and ethical code of conduct. Professional engineers and certain other consultants engaged in the technology and science side of the program are equally bound by strict ethical codes of conduct from their respective professional associations. PwC policy is to file claims that are compliant, based on the CRA's published policies and the legislation, whether the services are provided on a fee-for-service or contingency fee basis.

The nature of the fee arrangements are largely neutral for us. That is, contingency fees are not arbitrary amounts. Rather, they are based on the estimated effort required to prepare a claim on behalf of our clients. In general, we tend to realize lower overall margins on contingent fee arrangements than on fee-for-service arrangements. As for the importance of this type of revenue, contingency fees constituted less than 40% of our overall SR&ED practice revenues in our latest fiscal year.

The effects of contingency fees

5. The Government is seeking input from stakeholders in order to assess the impacts of contingency fees on the cost-effectiveness of the SR&ED tax incentive program in meeting its objective of providing broad-based support for the performance of R&D. In particular, the Government is interested in stakeholder views about whether contingency fees systematically result in higher costs to the SR&ED performer compared to the more traditional billing methods.

Compliance and administration costs are a concern to all SR&ED stakeholders, whether fees paid are contingency based or fee-for-service. Far from increasing compliance costs, the use of contingency fees actually improves the efficiency and effectiveness of the SR&ED program by extending the program's reach, with minimal risk, to those who would not otherwise claim their eligible work.

Taxpayers make decisions based on cost benefit analysis – value of time that employees need to invest in learning the SR&ED rules, preparing and filing timely claims, supporting their claims during possible lengthy CRA reviews and the opportunity cost of doing other critical work, versus the fees they will have to pay to an external advisor. As a part of the decision-making process they will also link the certainty of having the claim approved to the amount of fees they are prepared to pay.

Factors affecting the cost of compliance: The cost of compliance depends on many factors, regardless of whether they are on a contingency fee basis or fee-for-service. The primary factors include:

- complexity of the claim;
- the taxpayer's experience with the program and related CRA audits;
- the taxpayer's record-keeping methods and supporting documentation; and
- the nature of the industry sector in which the claim is made.

In certain contingency fee arrangements, a cap is placed on the contingency fee. The amount of the fee will be the lesser of the time spent by the SR&ED preparer (at standard hourly rates) in preparing and supporting the claim or the amount of the contingency fee. This cap arrangement limits the cost of compliance but still places the risks on the service provider.

Generally, the contingency fee will closely resemble the cost of a fee-for-service approach to prepare a claim. However, when a CRA review is undertaken, the fee-for-service approach will typically result in higher fees than under a contingency arrangement. Under a contingency fee arrangement, if a claim is reduced (or denied altogether), the SR&ED performer's associated compliance costs are confined to the internal time spent assisting with the preparation of the claim and support through a CRA audit.

Therefore, we consider it incorrect to conclude that the use of contingency fees systematically increases the cost of delivering the SR&ED program. The experience of our own practice across

Canada contradicts such a conclusion. In our latest fiscal year, for example, our recovery on contingent fee assignments was substantially lower than our recovery on fee-for-service arrangements.

6. The Government is also interested in understanding the potentially positive impacts associated with contingency fees, including an increased awareness of the SR&ED program and greater accessibility.

The remediation of risk to SR&ED performers through the use of contingency fees yields a number of benefits for both the SR&ED claimant and the SR&ED program as a whole:

- taxpayers participate in the program rather than forego their legitimate entitlement;
- consultants provide taxpayers with education and training about the SR&ED program at no cost;
- taxpayers can better manage risk and cash flow; and
- SR&ED program funding allows taxpayers to carry out more SR&ED.

Restrictions on contingency fees in Canada and other countries

7. The Government is interested to learn the views of stakeholders on the various types of restrictions that currently exist in Canada and other jurisdictions and whether one or some of these approaches (or others types of restrictions) could or should be considered in the context of contingency fees charged by tax preparers in Canada for the preparation of SR&ED claims.

The government's current concern with SR&ED contingency fees, as evidenced by this consultation, appears to be a response to media reports that link contingency fees with abuse. Granted, the potential exists for some isolated abuse. However, existing income tax laws should be able to provide sufficient corrective mechanisms to address this. Given that we believe contingency fees are in fact an enabler for the SR&ED program, restricting their use would be ill-advised.

We are not aware of any evidence to show that contingency fees are the cause of abusive claims and/or systematically result in higher costs to the SR&ED performer. These consultations may provide evidence that confirm or refute any perceived concerns with such a fee arrangement. We look forward to the continuation of an open dialogue about the program's effectiveness.

We do not believe that limiting the use of contingency fees will address the underlying concerns of SR&ED performers, namely that the benefits under the program are unpredictable and that the time/effort of the compliance burden placed on claimants by the CRA can be significant.

8. In addition, the Government is interested in stakeholders' views about whether other actions could limit the use of contingency-fee arrangements, for example through further initiatives by the CRA to assist firms in completing their claims, or through other forms of disincentives to the use of contingency fees.

PwC supports initiatives that will reduce the cost of compliance to the SR&ED performer. As noted above, we do not believe that contingency fees increase the cost of compliance, but may in fact reduce it.

Perceptions of risk have not been greatly relieved by the increased emphasis in recent years on the pre-claim project review (PCPR) process. Growing experience from that process has led many to conclude that an early opinion provides little advantage to a SR&ED performer, because even favourable opinions are not binding, while pursuing the PCPR option creates an increased risk of presenting a project too early, where a negative finding is presumed to taint all future possible claims for the reviewed work.

An open and ongoing dialogue, encompassing taxpayers, taxpayer representatives, the CRA and the Department of Finance, to clarify SR&ED project eligibility rules and policies could help make claims more predictable, and therefore ultimately reduce the cost of compliance to the taxpayer even more.