

1994 Report of the Auditor General of Canada

Chapter 32. Department of Finance and Revenue Canada - Income Tax Incentives for Research and Development

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Introduction

Encouraging research and development through the tax system

32.9 There are many ways for the government to achieve its economic and social objectives. The most visible is direct government spending on programs, grants and subsidies. The government also pursues its policy objectives through measures (such as tax deductions, credits, exclusions and income tax deferrals) contained in the income tax system. Because those measures represent alternative forms of government assistance, with financial implications similar to those of direct expenditures, they are generally referred to as tax expenditures.

32.10 As part of its investment in science and technology, the federal government has encouraged research and development in the private sector for many years through various income tax

provisions. [Exhibit 32.1](#) sets out a brief history of tax incentives for research and development.

32.11 The Department of Finance (Finance), which is responsible for overall policy relating to the tax system, has set out certain objectives for research and development tax incentives at various times over the past 12 years. The most comprehensive

statement of objectives is found in the 1983 paper entitled *Research and Development Tax Policies*. In summary, these objectives are:

- to encourage research and development by the private sector in Canada;
- to promote research and development activities that conform to sound business practices;
- to provide tax incentives for research and development that, as much as possible, are of immediate benefit to businesses; and
- to provide tax incentives for research and development that are as simple to understand and comply with and as certain in application as possible.

Design of the tax incentives

32.12 The federal tax incentives currently available for qualifying research and development activities essentially consist of:

- deductions for eligible current and capital expenditures related to scientific research and experimental development undertaken in Canada directly by, or on behalf of, the taxpayer and related to the taxpayer's business. Eligible expenditures each year are added to the taxpayer's pool of expenditures for scientific research and experimental development. Amounts in the pool can be written off at the taxpayer's discretion, up to the total amount in the pool.
- investment tax credits on eligible current and capital expenditures made in Canada. These can be claimed at rates of 20, 30 or 35 percent; they are refundable in some cases. (The 1994 Budget proposes to eliminate the 30 percent rate.) Investment tax credits deducted from taxes payable or refunded must be deducted from the pool of eligible expenditures in the subsequent year.

32.13 Determining qualifying activities. The incentives are directed to scientific research and experimental development (SR&ED), which is defined under regulation 2900 of the Income Tax Regulations to

mean a "systematic investigation or search carried out in a field of science or technology by means of experiment or analysis." The regulation goes on to indicate that work undertaken to advance scientific knowledge or to achieve technological advancement for the purposes of creating new, or improving existing, materials, devices, products or processes will qualify. Certain activities, such as those related to market research or sales promotion, are specifically excluded from the definition.

32.14 Revenue Canada, in consultation with Finance and other federal departments and agencies and with industry representatives, has developed three criteria to help it and taxpayers determine whether particular activities fall within the definition and therefore qualify for the incentives. Those criteria are:

- scientific or technological advancement -- the activity must generate information that advances our understanding of scientific relations or technologies;
- scientific or technological uncertainty -- whether a given result or objective can be achieved and how to achieve it are not yet known or able to be determined on the basis of generally available scientific or technological knowledge or experience; and
- scientific and technical content -- the activity must incorporate a systematic investigation and be carried out by qualified personnel.

32.15 Qualifying activities do not have to be carried out in a laboratory by scientists. Many occur in manufacturing plants, on the shop floor or in an office. For example, incremental improvements to existing products, improvements to the way products are manufactured and new software programs may all qualify if they meet the criteria set out above. Activities such as data collection and testing that are required to carry out qualifying activities are also eligible for the tax incentives. [Exhibit 32.2](#) gives an indication of the range of activities that may qualify for the tax incentives if the requirements of the Income Tax Regulations are met.

32.16 Determining eligible costs. Generally, expenses that are directly attributable to qualifying activities (for example, salaries, benefits, materials and appropriate overheads) are eligible for the tax incentives. In December 1992, the government proposed a proxy method for dealing with overhead expenses related to scientific research and experimental development activities, to reduce the burden on taxpayers and Revenue Canada for determining eligible

overhead expenses. This proposal was passed into law on 12 May 1994. Revenue Canada allowed taxpayers to use the proxy method for taxation years ending after 2 December 1992 if they elected to do so.

32.17 Safeguarding federal revenue s. One of the key controls built into the design of these incentives is that the company must spend the funds first before receiving any tax incentives. This also helps guard against government funding of research and development that the marketplace would not support otherwise.

32.18 Provincial incentives. Several of the provinces have additional tax incentives for research and development. In most cases these incentives are deducted from the base on which the federal incentives are calculated.

Take-up of the investment tax credits

32.19 Exhibits 32.3 and 32.3 provide information on the level of take-up of the investment tax credits for scientific research and experimental development. Taxpayers who carry out qualifying activities and incur eligible costs can claim investment tax credits. These investment tax credits can be deducted from income taxes otherwise payable. Canadian-controlled private corporations can also receive cash refunds of investment tax credits claimed that cannot be deducted from taxes otherwise payable, if they meet certain criteria. In all other situations, investment tax credits claimed that cannot be deducted can be carried forward 10 years or back three years to be deducted from the taxes payable in those years.

32.20 As can be seen from [Exhibit 32.3](#), Canadian-controlled private corporations (CCPCs) steadily increased the investment tax credits they claimed between 1988 and 1992. As well, the number of CCPCs claiming credits rose from just over 4,000 in 1988 to 5,500 in 1992. The exhibit reveals that the dollar amount of investment tax credits deducted by these corporations has remained relatively stable over the period. The exhibit also shows that the amount refunded to these corporations has increased steadily, reaching \$250 million in 1992. In other words, many of these corporations were not able to deduct any or all of the credits they claimed in a particular year, often because they were not in a taxable position. However, they were eligible for a cash refund of those credits.

32.21 [Exhibit 32.4](#) shows the situation for corporations other than CCPCs, such as public companies. The number of those

corporations claiming investment tax credits remained quite stable over the five years, at about 1,000. Again, the amounts claimed increased between 1988 and 1992, exceeding \$750 million in 1992. However, the amounts deducted from income taxes otherwise payable have remained relatively stable. For those corporations, investment tax credits claimed but not deducted can be carried forward or backward. Revenue Canada's data base shows that, at the end of 1992, corporations claiming scientific research and experimental development tax credits were carrying forward over \$2.5 billion of these and other investment tax credits. Some portion of these credits will likely be deducted from income taxes in future years.

Audit Objectives, Scope and Criteria

32.22 The purpose of this audit was to examine, assess and report on how well the tax incentives for scientific research and experimental development are being delivered, monitored and evaluated. We were particularly interested in learning how the Department of Finance assesses, analyzes and reports on the results being achieved with the incentives.

32.23 We focussed on the investment tax credit portion of the incentives. We conducted our audit work in the Department of Finance and in Revenue Canada's head office and five district offices.

32.24 The audit criteria we used are set out in [Exhibit 32.5](#).

Observations and Recommendations

Department of Finance

Department's role and responsibilities

32.25 The Department's Tax Policy Branch analyzes and makes recommendations on tax policy and legislation. With respect to the tax incentives for research and development, the Branch is responsible for developing, monitoring and evaluating incentives that will meet government objectives.

Costs of the incentives in revenue foregone are open-ended

32.26 In common with most tax provisions, the tax incentives for scientific research and experimental development are demand-driven. Every taxpayer who complies with the incentive provisions in

the *Income Tax Act* is entitled to the benefits. But the total amount of tax revenue foregone (the "cost" of the incentives) depends on how taxpayers respond. Low levels of eligible spending by taxpayers result in low costs. High levels of spending by taxpayers result in high costs. The tax credits cannot be withheld by the government simply because the amount of tax revenue foregone has exceeded the amount originally forecast.

32.27 Think of the investment tax credit for scientific research and experimental development in terms of a direct spending program. Suppose the government agrees to pay all those who carry out qualified research and development 20 percent of their costs. There are no spending limits -- all who qualify, no matter how much they spend, get a cheque from the government for 20 percent of their eligible costs. The investment tax credit for scientific research and experimental development works in a similar way for all taxpayers who can deduct the credit from taxes payable and for those who receive refunds of their credits.

32.28 For other taxpayers, there are restrictions on the amount of investment tax credits that can be used in a particular year and, therefore, limitations on the cost of the incentives. For example, until 1993 there were limitations on the amount of investment tax credits that could be deducted from taxes otherwise payable in a particular year. Any amount not deducted could be carried forward or backward.

32.29 As noted in Exhibits 32.3 and 32.4, there has been a steady growth in the dollar amount of investment tax credits for scientific research and experimental development claimed over the past five years. In 1992, companies claimed over \$1 billion in investment tax credits. Of this amount, approximately \$470 million was deducted from income taxes otherwise payable and about \$250 million was refunded to taxpayers. The balance was carried forward to future years or back to prior years. As of 30 June 1994, Revenue Canada had over \$1.2 billion of investment tax credits in claims where the review had not been completed. As long as the taxpayers making these claims do so within a specified time period and qualify for the credits, they will receive them. We also note that, of the \$4.4 billion in investment tax credits claimed during the 1988 to 1992 period, \$1 billion was claimed by less than one percent of the companies making claims. We note this not to suggest that there is a problem with the claims, but to illustrate that there are no explicit limits on the amount that one company can claim.

32.30 In addition, the design of the tax system means that the government does not know exactly how much will be claimed until it receives a tax return -- up to 30 months after the eligible expenditures are actually incurred. To suggest that companies provide information to the government ahead of time would be unrealistic. It would be contrary to one of the advantages of using the tax system to deliver programs -- administrative ease and efficiency. However, as pointed out above, all taxpayers who make claims within a specified time period and who qualify for the credits will receive them.

32.31 The demand-driven nature of the incentives and the time lag until the government knows how much has been claimed are characteristics that are common to most tax provisions. However, they could result in high amounts of revenue foregone. They could also make it difficult for Finance to forecast, for budget purposes, how much revenue will be foregone in the future.

32.32 In our view, ongoing and thorough monitoring of the incentives is required to properly manage them. As discussed in paragraphs 32.41 to 32.45, we believe Finance needs to strengthen its monitoring activities.

Taxpayer-requested adjustments have resulted in large costs

32.33 Many taxpayers learned about the incentives for scientific research and experimental development only in recent years and realized that they had been carrying out qualified activities in prior years but had not filed a claim. They have refiled their tax returns, for those prior years that are not statute-barred, to claim the investment tax credits for scientific research and experimental development. These refilings are referred to as taxpayer-requested adjustments. Furthermore, some of the activities were carried out in taxation years that are now statute-barred. In those cases, taxpayers have used the carry-forward provisions for the investment tax credits to carry the credits forward to a year that is not statute-barred. For example, a company learns in 1994 that it had been carrying out qualified activities in 1988 but had made no claim for investment tax credits in that year; that year is now statute-barred. Under the *Income Tax Act*, the company can calculate the investment tax credits that it would have claimed and then carry them forward to be deducted against taxes paid in a year that is not statute-barred, such as 1992.

32.34 Consistent with regular assessing practices, taxpayers are also entitled to receive interest on approved claims. For example, a

taxpayer files a claim in 1994 for scientific research and experimental development expenditures incurred in 1990 and requests that the related investment tax credit be deducted from the income taxes paid in 1990. This will result in a refund to the taxpayer equal to the investment tax credit plus interest. In accordance with the *Income Tax Act*, interest is calculated from 1990 rather than from the date the claim was filed in 1994. This applies to all taxpayers except those who are eligible for cash refunds of investment tax credits. They receive interest only from the date the claim was made.

32.35 Several companies in one particular sector recently filed taxpayer-requested adjustments for scientific research and experimental development expenditures made in years back to 1986. These claims totalled over \$300 million in investment tax credits. The research and development claimed was in the field of computer software. Our discussions with technical experts at Revenue Canada who had been assigned to review the claims indicated that most of the activities claimed are, or may be, qualified scientific research and experimental development under the Income Tax Regulations .

32.36 It is important to note that under the rules that existed prior to the 1994 Budget, taxpayers who carried out qualifying scientific research and experimental development activities were entitled to the incentives.

32.37 The February 1994 Budget proposed changes restricting expenditures that qualify for the tax credits to those that the taxpayer identifies no later than 18 months after the year in which the expenditures were incurred. The Budget states: "The government intends to focus the scientific research and experimental development tax incentive on encouraging new research and development rather than on providing an incentive to reopen the calculation of tax credits for expenditures made in prior years." The change will also enable Finance to monitor the costs of the incentives more closely. A transitional provision was included for expenditures incurred in taxation years ending before the Budget date. Taxpayers were given up to 90 days after royal assent to identify the expenditures. This provision received royal assent on 15 June 1994 and so the final date for filing claims relating to previous taxation years was 13 September 1994.

32.38 [Exhibit 32.6](#) shows the taxpayer-requested adjustments assessed up to 31 March 1994. In addition, at that date, Revenue Canada had approximately 2,100 more claims waiting to be reviewed and audited, representing over \$425 million in potential investment tax credits.

32.39 Subsequently, Revenue Canada received a large number of additional claims up to the 13 September 1994 filing deadline referred to in paragraph 32.37. At the time this report was written, Revenue Canada had not finished entering all of those claims in its data base. We note, however, that the Department had recorded over 9,000 claims. The Department informed us that the information in its data base on the dollar amount of investment tax credits relating to those claims was unreliable, because it had to be edited and it represented only the amounts claimed by taxpayers. The claims have to be reviewed and audited and this could result in adjustments to the amounts claimed. However, it appears that the dollar amount of investment tax credits relating to the claims is likely to be significant.

32.40 When the government makes changes to a tax provision it cannot necessarily make them effective immediately; it can therefore incur transitional costs in foregone revenue. Taxpayer-requested adjustments for investment tax credits related to scientific research and experimental development have likely resulted in significant transitional costs. In our view, better monitoring of the situation by Finance and an earlier determination that changes were needed could have resulted in fewer claims and lower transitional costs.

Monitoring needs to be strengthened

32.41 The division of responsibilities between Finance and Revenue Canada has caused some difficulties in monitoring the tax incentives for research and development. Revenue Canada has the main responsibility for administering the incentives and has the most direct contact with the users. However, Revenue Canada is primarily involved with ensuring compliance with the *Income Tax Act*, and approves all claims that comply with the definitions and rules set out in the Act. It is the responsibility of Finance to ensure that the definitions and rules specify qualifying activities and eligible costs that will achieve the government's objectives. But Finance is not involved in the day-to-day administration of the incentives and depends on Revenue Canada to supply it with information to assist in its monitoring activities.

32.42 Ongoing and thorough monitoring of the tax incentives for research and development is needed to control their costs in foregone revenue and to ensure that the types of activities that qualify under the definitions and rules are those that the government intends to encourage.

32.43 We found that, until recently, Finance has not been monitoring these incentives on a systematic basis, partly because of the data collection problems outlined in paragraphs 32.74 to 32.78. With respect to costs, Finance has been monitoring the investment tax credits originally claimed by taxpayers. It has also been monitoring, to a lesser extent, the credits assessed by Revenue Canada and whether the assessed credits were deducted from taxes, refunded or carried forward. Finance has not made projections of expected costs for comparison with actual costs. The information Finance has on types of activities is mostly anecdotal, based mainly on discussions with Revenue Canada and the public consultations that were conducted during 1992.

32.44 The information needed to monitor the incentives adequately would include data on such things as eligible expenditures incurred, by type of activity qualifying under the definitions and rules and by industry sector; amount of investment tax credits claimed, deducted from tax, refunded, carried back or forward; the number of taxpayers in each of these categories; the type, number and value of audit and appeal adjustments; and the costs to administer the incentives. To supplement these data, particularly on the types of activities that qualify, we believe it would be beneficial for officials from Finance to interact more directly with Revenue Canada's scientists and auditors.

32.45 The Department of Finance should monitor the tax incentives for scientific research and experimental development more thoroughly and systematically and should develop projections of revenue foregone for comparison with the actual amounts.

Department's Response: Investment tax credits for scientific research and experimental development (SR&ED) are provided in recognition of the fact that the benefits of SR&ED accrue beyond the SR&ED performer to other participants in the economy. These credits are intended to encourage firms to perform SR&ED in Canada and are important given the key role of SR&ED in the emerging new economy. The current system of tax credits for SR&ED provides significant income tax relief.

The importance of SR&ED for the Canadian economy and the cost of SR&ED tax credits necessitate that timely, accurate and useful information be available to monitor and evaluate the performance of federal income tax incentives for SR&ED. In conjunction with Revenue Canada, we have taken steps to ensure that the information available on SR&ED tax incentives meets these

requirements. We will also continue to review our ability to monitor these incentives in an effective manner, and will move expeditiously to complete our evaluation studies of income tax assistance to SR&ED and publish the results.

No evaluation has been done to determine the impacts and effects of the incentives

32.46 Tax expenditures, like direct expenditures, need to be evaluated periodically to determine their impacts and effects, to assess whether their objectives are being met economically and efficiently, and to determine whether there is a continuing need for them. At the time of our audit, no formal evaluation of the tax incentives for research and development had been done.

32.47 The Department of Finance and Revenue Canada have plans to evaluate jointly the research and development tax incentives. The issues that will be evaluated have been identified. An evaluation plan is being developed for presentation to and approval by the Department of Finance's Tax Evaluation Advisory Committee.

32.48 We have reviewed the potential evaluation issues identified by Finance. In our view, they address important issues related to the tax incentives.

32.49 We are encouraged by the fact that Finance is now moving to evaluate the tax incentives for scientific research and experimental development but we are concerned that it has taken over 10 years to start such an evaluation. These are expensive incentives and, especially in a time of fiscal restraint, it is important to know whether they are achieving their objectives and whether they are still needed.

Information to Parliament is inadequate

32.50 In many ways, tax expenditures are not different from direct expenditures. They represent a transfer of funds from all taxpayers to those taxpayers who are performing a desired activity, in this case scientific research and experimental development. Every dollar of investment tax credits allowed to one company must be paid for by all other taxpayers. Seen in this light, it is important that Parliament hold the government to account for this spending through the tax system.

32.51 In order to do this, Parliament needs information: it needs to know what the tax incentives for research and development are expected to accomplish, how much they are expected to cost, what they actually have accomplished and what they actually cost. It is

important that this information be available at the same time as the Estimates and Public Accounts are being considered so Parliament can get a full picture of planned and actual government spending in support of research and development.

32.52 Finance's Part III for 1994-95 is silent on its responsibilities for the operational and financial aspects and the results of the tax incentives for research and development. We believe that Finance needs to include in an accountability document, such as its Part III or the tax expenditure report, an overview of the tax incentives for research and development, and references to where more detailed information can be found. At a minimum, this information would include a description of the incentives, their objectives, their expected costs and their actual costs. As well, information about actual results would be desirable.

32.53 Information provided. Parliament received a paper for consultation in 1983 on research and development tax policies. That paper reviewed the incentives for research and development that existed at the time and proposed changes to those incentives. The paper contained some information on expected results and expected costs. Since then there have been references to the research and development tax incentives in budget documents when changes were being proposed. The information provided generally described the changes being made and the rationale for them.

32.54 The tax expenditure report published in 1993 (the previous one containing corporate data was published in 1985) gave amounts of revenue foregone for the years 1989 and 1990. However, it did not provide any comparison of actual revenue foregone to projections, or any information on what had been accomplished.

32.55 In our view, this information is not sufficient to allow Parliament to exercise its oversight role or to hold the government accountable for its spending through the tax system on the tax incentives for research and development. This conclusion is echoed in Chapter 9, which says that current reports do not provide parliamentarians with the information they need to assess whether the government's investment in science and technology reflects Canadians' needs and opportunities.

32.56 The Department of Finance should improve its accounting for the tax incentives for scientific research and experimental development by providing consolidated information on the projected costs and actual costs and the results, in any

regularly published accountability document such as Part III of the Estimates or the tax expenditure report.

Department's response: As indicated in our response to the recommendation in paragraph 32.45, we will continue to review our ability to monitor these incentives in an effective manner. At this time, focussing efforts on improved monitoring is a more effective use of the Department's limited resources than projecting estimates and comparing them to actual tax expenditures.

Revenue Canada

Department's responsibilities and administrative organization

32.57 Revenue Canada's mandate is to administer the *Income Tax Act* and other Acts. With respect to the tax incentives for research and development, the Department is responsible for ensuring that all claims by taxpayers for incentives comply with the rules set out in the Act and in the Income Tax Regulations . To help accomplish this, Revenue Canada provides information and assistance to taxpayers in a number of different ways. The Department also promotes the incentives.

32.58 Within Revenue Canada, the Verification, Enforcement and Compliance Research Branch has overall responsibility for administering the incentives. A small group at head office develops guidelines and monitors the work done in the district offices across the country.

New approaches taken to deliver the incentives

32.59 One of the first steps Revenue Canada took in delivering these incentives was to recognize that its auditors were not trained to make decisions on whether a particular activity was scientific research or experimental development as defined in the Income Tax Regulations. It therefore hired science advisors with industrial research and development experience who were able to make such judgments. Currently, the Department has over 60 such science advisors on staff. In addition, it hires experts on a contract basis, as necessary, to supplement its in-house expertise. Claims are reviewed by a science advisor for the technical aspects and by an auditor for the related costs. The activities undertaken by the taxpayer must first qualify under the Income Tax Regulations before the costs can be considered.

32.60 Another step was to raise public awareness about the incentives. Public seminars were organized to inform taxpayers about the incentives and how to apply for them. Both science advisors and auditors participated in these seminars. Departmental statistics indicate that during the period 1 April 1993 to 31 March 1994, there were 205 seminars held with over 5,500 participants.

32.61 A third step was to publish information about the program. There is an Interpretation Bulletin, an Information Circular, a guide to the claim form and several promotional brochures. In addition to the Information Circular, which sets out in general terms what qualifies as scientific research and experimental development under the *Income Tax Act*, six industry papers have been published. These papers give practical indicators of which activities in a particular industry would and would not qualify.

32.62 The Department has also consulted with the user community on an ongoing basis. It used participants from industry to help write the papers referred to above, as well as other interpretive documents. Also, a committee of industrial users advises the Deputy Minister on issues related to the Department's administration of the incentives.

32.63 These steps have meant a cultural shift for many employees of the Department, particularly its auditors. In the past, auditors have tended to focus on issues of non-compliance with the *Income Tax Act*, which frequently lead to increased tax revenues. With the tax incentives for research and development, science advisors and auditors are encouraged, within the confines of the *Income Tax Act*, to inform potential claimants about the incentives and to ensure that all claimants receive their full entitlements.

Revenue Canada's review process has changed

32.64 The Department's process for reviewing claims for investment tax credits related to scientific research and experimental development has changed several times in recent years. In our view, these changes represent improvements. Ordinarily, the Department assesses returns when they are filed based on the information provided in the return, and relies on subsequent audits to verify that information.

32.65 With the investment tax credits for scientific research and experimental development, that process is modified. Until 1993, some claims, mainly those requesting a refund, were audited before

they were assessed. Others, however, were assessed in the regular way and often had to wait several years to be audited. Some were never audited.

32.66 Now all claims are subjected to a desk review by a science advisor and an auditor when they are filed. This review is designed to determine whether the activities being claimed meet basic eligibility requirements and whether the costs are reasonable. Revenue Canada is committed to reporting the results of the review to the taxpayer within 120 days of receiving a complete claim. As a result of the desk review, the claim either is accepted as filed or is audited. If the claim is accepted, the taxpayer will receive a letter confirming this and explaining that no audit of the claim will be done in the future, in normal circumstances. If an audit is required, the Department is committed to conducting it within 120 days for claims requesting a refund or within one year for other claims, unless the taxpayer requests otherwise. This new process is designed to give taxpayers certitude as early as possible about the status of their claims.

32.67 We believe this change is a positive step and has a further benefit. In our view, a dollar of tax revenue intentionally foregone is much the same as a dollar spent. Therefore, it is important that all claims be subjected to some minimum verification to determine whether the activities undertaken qualify and whether the costs of those activities are eligible. Claims that do not pass this test can then be audited. We are encouraged that Revenue Canada is now subjecting all claims to some minimum verification.

High numbers of claims are putting pressure on Revenue Canada

32.68 As indicated in paragraphs 32.33 to 32.40, there has been a large increase in the number of taxpayer-requested adjustments received by Revenue Canada over the past few years. As well, the Department's statistics show that the number of annual claims is increasing. Furthermore, as discussed above, the Department is now reviewing all claims when they are filed and is committed to notifying the taxpayer about the results of the review within 120 days of receiving a complete claim.

32.69 This increased workload is putting pressure on Revenue Canada's ability to administer the incentives in a timely and consistent manner, one of its main objectives. Resources allocated to administering the incentives were increased in 1993-94 but are expected to remain the same for 1994-95.

32.70 Revenue Canada has taken steps to manage this situation. All taxpayer-requested adjustments are exempt from the 120-day guideline, although employees are still expected to process them as expeditiously as possible. As well, the changes in the *Income Tax Act* relating to taxpayer-requested adjustments mean that the intake of such claims should be significantly reduced after 13 September 1994.

32.71 The Department found in the past that it often spent more time reviewing the first claim that a taxpayer submitted than it spent on subsequent claims. It now provides a service to first-time claimants to help them with their first claim, with a view to reducing the time it spends reviewing them.

32.72 The decentralized way in which the incentives are administered means that the Department needs to be concerned about consistency in interpreting and applying the rules. The Department has strengthened its review mechanism to help deal with this concern.

32.73 Given the increasing workload that Revenue Canada is facing with these tax incentives, coupled with the increasing complexity of some of the claims, it will have to remain vigilant to ensure that the incentives are administered in a timely and consistent manner.

Data collection needs to be strengthened

32.74 Revenue Canada has been collecting some, but not all, of the information needed to monitor the incentives. The information is needed by Revenue Canada to monitor its administration of the incentives, and by Finance to monitor the costs and whether the types of activities that qualify under the definitions and rules are those that the government intends to encourage.

32.75 We expected to find information on how much was being claimed, deducted, refunded, carried back or forward; the number of taxpayers in each of these categories; the amount of eligible expenditures incurred, by type of activity qualifying under the definitions and rules and by industry sector; the level of audit coverage; and the type, number and value of audit and appeal adjustments.

32.76 We found information on how much was being claimed, the number of taxpayers involved, and the number and value of audit adjustments. In our view, this is not sufficient to allow Revenue

Canada to monitor its administration of the incentives effectively or to allow it to make strategic decisions about where to focus future efforts. Nor is it sufficient to allow Finance to carry out its monitoring activities.

32.77 Moreover, Revenue Canada discovered in 1993 that one of its key data bases for the information it was collecting was not completely reliable. The Department has an action plan to improve the quality and reliability of the data base and is working on it.

32.78 Revenue Canada, in consultation with the Department of Finance, should determine and collect the information needed to monitor fully and to report on the tax incentives for scientific research and experimental development.

Department's response: Consistent with the Department's action plan, the quality and reliability of the data base will continue to improve.

The Department introduced a verification process for the SR&ED form (T661) on 1 October 1993 and is completing the enhancement of existing information management systems to capture accurate and detailed information on SR&ED claims that will further assist in monitoring and evaluating the SR&ED program.

Discussions with the Department of Finance have been held to ensure that, in part, the needs of both departments are met with regard to the quantity and quality of information necessary for the monitoring and evaluation of the SR&ED program. As a result, an interdepartmental committee has been formed that will meet on a regular basis to address these issues.

Conclusion

Many 1986 observations persist

32.79 In our 1986 chapter on income tax expenditures, we concluded that the Department of Finance was not adequately managing tax-delivered programs. We called for improved monitoring, evaluation and reporting of tax expenditures. Our present observations and conclusions on the tax incentives for scientific research and experimental development are much the same.

32.80 While some progress has been made on monitoring these tax incentives, much remains to be done in order for the Department of Finance and Revenue Canada to control them. Similarly, the planned

evaluation (which in our view is overdue) should point out the impacts and effects of the incentives and determine whether they are still needed. Finally, while recognizing the progress that has been made, we stress the need for better reporting on these tax incentives. It is difficult, if not impossible, for Parliament to hold the government accountable for this spending through the tax system when it does not have proper information. In a time of fiscal restraint, it is imperative that the Department of Finance ensure that Canadian taxpayers are getting value for money from the tax incentives for scientific research and experimental development.