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Use of external assistance: an entrepreneurial perspective

This paper discusses entrepreneurial participation in the Canadian Scientific Research and Experimental Development Tax Incentive Program and the use of consultants in preparing a claim. With the help of comparative data analysis it will be evaluated whether hiring consultants can be economical for small companies.

Keywords: Accounting, consulting, entrepreneurship, innovation, small business, tax incentives for research and development.

Šiame straipsnyje analizuojamas smulkaus verslo vaidmuo Kanados mokslinių tyrimų bei eksperimentinės plėtros mokestinių lengvatų programoje bei konsultacinių paslaugų naudojimas ruošiant paraiškas. Palyginamosios duomenų analizės pagalba yra aiškinamasi, ar mažoms įmonėms ekonomiškai apsimoka samdyti konsultantus.

Raktiniai žodžiai: Apskaita, konsultavimas, entreprenerystė, inovacijos, smulkusis verslas, mokestinės lengvatos tyrimams ir plėtrai.

JEL Classifications: M4/L26/H25/O3.

Introduction

In many countries, research and development (R&D) tax incentives to stimulate private-sector research make up a significant element of the technology and innovation policy. In 2005, 19 of the Organisation for Economic Co-operation and Development (OECD) members had R&D tax incentives in place. The Canadian Scientific Research and Experimental Development (SR&ED) Tax Incentive Program has been in effect since the 1980s and is one of the most generous among OECD members (Warda, 2006). It is the largest single source of federal government support in Canada designed to encourage innovation. Each year the SR&ED program provides over $4 billion in investment tax credits to over 18,000 claimants. Of these, about 75% are small businesses (Canada Revenue Agency, 2008b).

Although the SR&ED is the most generous tax incentive program in Canada, it is probably the most underused. It is estimated that there are up to $1.5 billion worth of qualified activities that are left unclaimed each year because businesses are not aware of the program, do not know what constitutes an eligible project, or find the application process too complicated, too lengthy or too cumbersome (Newman, 2008). Management consultants play a key role in increasing businesses' awareness of the program

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and in filing a successful claim. To qualify for the benefits, applicants must file two forms. In a Claimant Satisfaction Study administered by the Canada Revenue Agency (CRA) in 2006, 67% of the respondents said they used external assistance when preparing a claim (Canada Revenue Agency, 2006).

The objective of this paper is to analyze the role of management consultants in the claim process from an entrepreneurial perspective. The paper discusses the obstacles and administrative difficulties encountered by entrepreneurs when filing a claim, and how and to what extent external assistance can alleviate them. It also addresses the compliance costs and consulting fees associated with preparing a claim. This paper will conclude with an assessment of the future of consultancy with respect to the program in light of the recent (2008) major changes in the Canadian R&D program.

The significance of research and development incentives for entrepreneurs

Early neoclassical attempts of the economic growth models to explain the variations in the Gross Domestic Products (GDP) of different countries using labour and capital inputs were mildly successful. For much of the last 50 years a significant element of the residual GDP has been thought to be technological change (Acs, Storey, 2004). The key elements of technological change are education and research and development spending. As P. M. Rommer (1990) explained in his seminal work, these technological changes are endogenously determined and as a result can be influenced by economic policies. The policy rationale for the Scientific Research and Experimental Development Tax Incentive Program is that increased research and development activities lead to new products and manufacturing innovations and this, in turn, improves Canada' industrial competitiveness leading to economic growth and ultimately a higher standard of living for its citizens.

Despite the inclusion of technology in the production function, a substantial residue still remained to be explained. It is the argument of D. B. Audretsch and M. Keilbach (2004) that provides more insight into the factors explaining the variations in the GDP rates. They observed that the former Soviet Union had ample labour and capital. It also had sufficient technical skills; after all, it was the first country to send people into space, but its economic development significantly lagged behind the United States. D. B. Audretsch and M. Keilbach (2004) observed that while the United States had many entrepreneurs, the same was not true for the Soviet Union (Acs and Storey, 2004). The role of entrepreneurs in enhancing economic development is their ability to recognize an opportunity to use resources that typically yield a low return in a way that yields a higher return in which they personally gain (Casson, 1982). The clearest example of an entrepreneurial act that can lead to resource transfer is the creation of a new firm that offer products and services that were not previously available. Therefore, encouraging entrepreneurship can also impact economic growth. The Canadian Scientific Research and Experimental Tax Incentive Program has special provisions to encourage R&D investments by small firms.

Entrepreneurship – The world's oldest activity

Entrepreneurship is one of the youngest paradigms in the management sciences,

but the phenomenon of entrepreneurship is far from novel - historically it is one of the oldest activities. To identify new business possibilities and to exploit them in new ventures for economic gain has always been important in human life.

For the relatively young discipline of entrepreneurship, a long-standing difficulty is how to define the central concepts within entrepreneurship and small business research. Different studies have used various definitions, reflecting the fact that entrepreneurship is a multidimensional concept. The Entrepreneurship Research Consortium and the Global Entrepreneurship Monitor view entrepreneurship as a process. As authors William Bygrave and Charles Hofer (1991) describe, "the entrepreneurial process involves all the functions, activities, and actions associated with the perceiving of opportunities and the creation of organizations to pursue them" (p.14). Attempts to define entrepreneurship are also shaped by a focus on firm size, which is usually based on the number of employees. In this context an entrepreneur is a founder/owner of a small or medium enterprise. This paper will use these definitions and will use the terms entrepreneur and small business owner interchangeably. The Scientific Research and Experimental Development Tax Incentive Program's Small Business Action Plan targets a subgroup of small businesses, the technology-based small firms which are the subject of this paper.

Management consulting – The world's newest profession

Management consulting, called the world's newest profession by economic historian Christopher D. McKenna, traces its origin to the 19th century, with the early pioneers appearing in England and the United States. Arthur D. Little, an MIT professor, recognized the need for strategic and management advice and started the agency named after him in 1886. Even before ADL, Samuel Price, George Touch and William Deloitte gained a substantial reputation in the field of auditing. These groups of individuals and small firms were the true first generation of advisors to business. They were followed by the second generation such as Edwin Booz, James McKinsey, Tom Kearney, George Fry, Lydon Urwick and Charles Bedeaux. Their small firms were established on both sides of the Atlantic between 1910 and 1940 (Gross, Poor, and Robertson, 2004).

Researcher Robin Fincham describes consultancy as a large grouping of expert labour, some of it technical, some professional and some quasi-professional (Mohe, 2007). Consultants are parallel managers, hired from the market place to advise existing management. Management consultancy is not a profession, not equivalent to accountants or engineers. C. D. McKenna (2006) posits that management consulting was an amalgam of three professions, engineering, law and accounting, and the consultant role of merchant bankers as practiced at the beginning of the 20th century.

The SR&ED management consultants serve as subcontractors to business. As outside advisors they bring specialized knowledge, not easily available in any other way, into the organization to address problems that internal staff members could not easily resolve. Entrepreneurs decide whether or not to employ external advisors based on two distinct conditions. First is that the underlying problem is limited in scope and specialized and the internal solution to it is both slow and

costly. Second is that the consultant has experience with similar cases through previous assignments in the industry, either because of the consultant's special knowledge, or most often, because he or she has performed a similar study for a competitor (McKenna, 2006). Researcher Robert James David (2001) argues that the four models of management consulting—the industrial research form, the administrative science form, the accounting form and the information technology form—are based on different disciplinary foundations. SR&ED management consultants are knowledge brokers who solve administrative problems through the application and reformulation of existing knowledge to known problems.

Summary of the Canadian scientific research and experimental development tax incentive program

Central to the Government of Canada's long term economic plan is the idea that the private sector must be the leader in turning research and knowledge into innovation that benefits Canadians, while the most important role for the government is to ensure a competitive marketplace and to foster an investment climate that encourages the private sector to innovate (Department of Finance Canada, 2007). A key factor of this policy is the Scientific Research and Experimental Development Tax Incentive Program administered by the Canada Revenue Agency.

SR&ED tax incentives have two components: an income tax deduction and an investment tax credit (ITC). An income tax deduction allows immediate expensing of all allowable expenditures. An investment tax credit is applied to income taxes otherwise payable. A business can generally claim both the income tax deduction and the investment tax credit on the same SR&ED expenditures.

Activities eligible for SR&ED tax incentives involve systematic investigation or research carried out in a field of scientific technology by means of experiment or analysis. In general, three broad categories of activities are eligible: basic research, applied research, and experimental development. When the CRA reviews an activity to see if it falls within the scope of the SR&ED program, there are three criteria that need to be met: scientific or technological advancement, scientific or technological uncertainty, and scientific and technical content.

Most current and capital expenditures incurred in Canada with respect to SR&ED performed by, or on behalf of, a taxpayer and related to the business of the taxpayer are eligible for SR&ED tax incentives. In general, current expenses such as salaries and wages of staff performing R&D work, the cost of materials consumed while performing SR&ED, machinery and equipment purchased for doing R&D, lease costs for equipment, SR&ED related overhead costs, or a proxy for these costs, third party payments for work done in support of the development projects, scrap created during experiments or test runs, and prototypes that are not sold qualify for the tax incentives.

There are two rates of investment tax credits for SR&ED in Canada. The general rate is 20%, but there is also an enhanced rate of 35% that is provided to small Canadian-controlled private corporations (CCPCs) on their first $2 million of qualified expenditures. Unused credits earned in a year are refundable for small CCPCs that had income of $400,000 or less and taxable capital of $10 million or less in the

previous year. For these corporations, ITCs on the first $2 million of current expenses are fully refundable. ITCs on other current expenses and all capital expenditures by small CCPCs are eligible for a 40% refund. The $2 million expenditure limit is phased out if in the previous year the taxable income was between $400,000 and $600,000 or the taxable capital was between $10 million and $15 million. Unused ITCs can be carried back up to three years and carried forward up to 20 years to be applied against taxes payable in those years.

To qualify for the benefits, applicants must file two forms. Form T661, Scientific Research and Experimental Development (SR&ED) Expenditure Claim, details a company's SR&ED activities and the expenditures being claimed. Schedule T2 SCH31, Investment Tax Credit – Corporation, is used to calculate investment tax credits. These forms must be filed within one year of the filing date for the taxation year in which the company incurred the R&D expenditures. For corporations, this is 18 months after year-end (Department of Finance Canada, 2007).

The provinces and territories make the SR&ED incentives even more valuable, with all of them offering income tax deductions and nine of them offering additional tax incentives for research and development conducted within their borders (Department of Finance Canada, 2007).

The process of filing a claim – An entrepreneurial perspective

Given the intangible nature of consulting services and the information asymmetries associated with it, entrepreneurs find it difficult to establish its value. After all, they are being asked to purchase services whose true value becomes obvious only when the product is delivered. One aspect of critical consulting looks at the process by which small-business owners came to accept the need and value of consulting services (Mohe, 2007). This paper will focus on the process by which small-business owners decide to use external assistance in filing an SR&ED claim (Fig.1).

The first step of the process is to make the entrepreneur aware of the existence of the Scientific Research and Experimental Development Tax Incentive Program. In a Claimant Satisfaction Study administered by the Canada Revenue Agency in 2006, the most common reason for filing a first claim was "just became aware of the SR&ED program" (Canada Revenue Agency, 2006, p.23). The July 2002 Briefing of The Conference Board of Canada observes that "many potential users of the SR&ED program are not aware of its existence" (Gebremichael, Warda, 2002, p.5).

Consultants play a significant role in drawing attention of entrepreneurs to the program. "The majority, 60%, of new claimants found out about the SR&ED program from a professional advisor" (Canada Revenue Agency, 2006). It is common practice for consultants to call or email to small-business owners about the existence of the SR&ED program, and to suggest that their companies might qualify for it.

The second largest source of information is the Industrial Research Assistance program (13%). Other ways of finding out about the programs are through industry associations, CRA staff, publications, web sites, or public information seminars, other federal and provincial agencies, colleagues and friends, previous work experience, or through universities and colleges (Canada Revenue Agency, 2006).

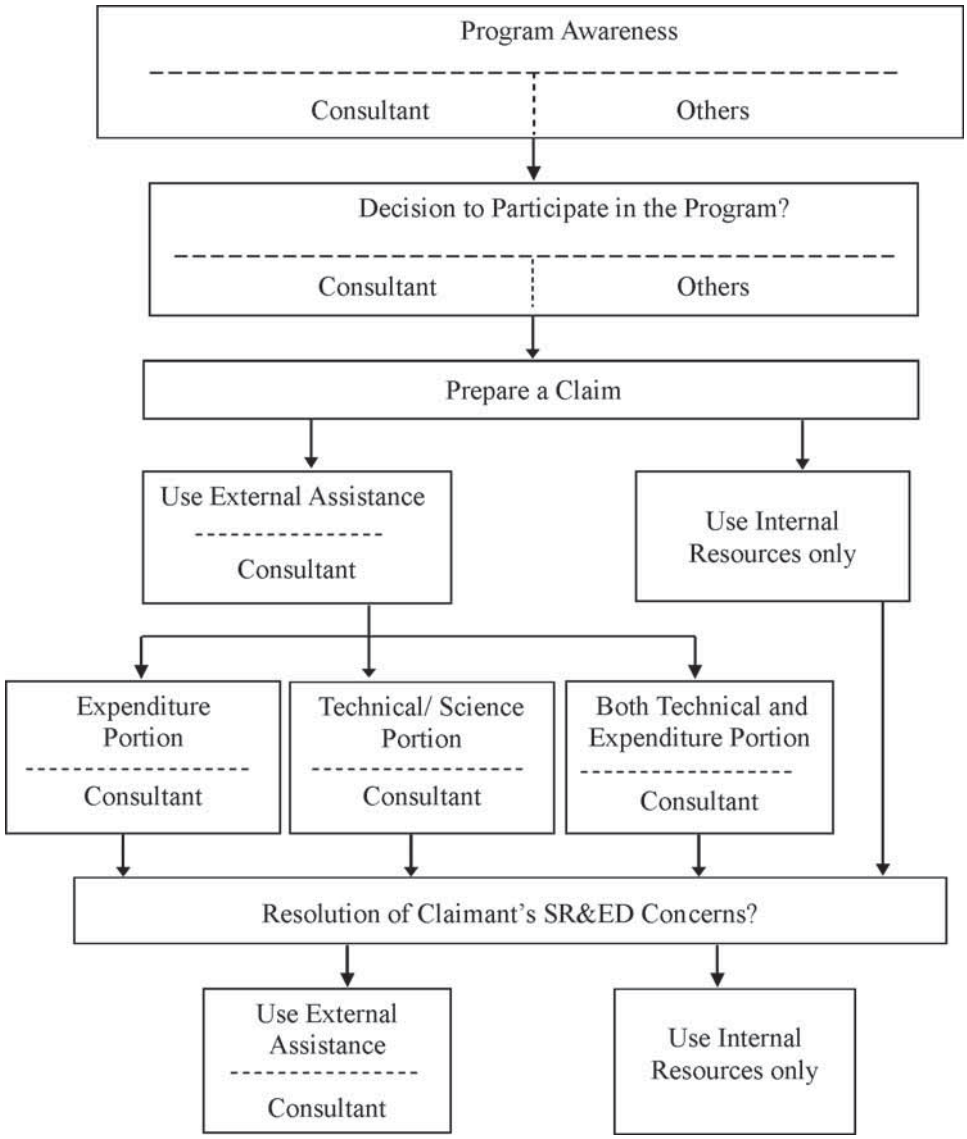

Fig. 1. **The Process of filing a claim**

The next step of the process is for the entrepreneur to decide whether to file a claim. Confusion on the part of small-business owners about what constitutes an eligible SR&ED project plays an important role in this decision. Small-business owners may not perceive their efforts as SR&ED due to the fact that the definition and interpretation of research and development differs between business and government. As a result, small-business owners assume that the probability of receiving credit for

their bona fide research and development expenses may be negligible.

Filing a claim requires considerable efforts. It can be especially hard for small, innovative companies to follow the maze of compliances when they are faced with time constraints and limited manpower. Small business owners can be especially reluctant to divert efforts at the beginning of the life cycle when almost all tangible and intangible resources are used in developing the products. Although hiring a consultant may appear financially beneficial to the company, the entrepreneur may still vacillate due to the amount of time and resources that could be involved in working with a consultant. Another consideration is the possible loss of confidentiality of research activities. Filing a claim could also lead to a government review that would consume resources and create further unwanted interruptions, which is another factor to be considered by the small-business owner.

A consultant's ability to communicate effectively with the small-business owner is crucial in selling the benefits of the claim. The major thrust of his argument is the ease with which substantial SR&ED credits can be accessed. By explaining the details of the requirements and the application process, as well as the potential amount of tax refunds, an entrepreneur may be persuaded to participate in the program. However, consultants are more reluctant to spend much effort with the entrepreneurs at the first two stages of the process because it will not result in any financial compensation if an agreement is not reached. The consultant's commitment may leave something to be improved upon, as attested to by the fact that there is an estimated $1.5 billion worth of qualified research and development activities in Canada left unclaimed each year (Newman, 2008).

Should the small-business owner decide to file a claim, the next step of the process is to decide whether to use any external assistance in its preparation. Entrepreneurs may find the requirements for filing a claim, such as the rigorous documentation, the analysis of qualifying expenditures and the technical and financial review, intricate, tedious, and especially time consuming.

When considering the above, the consultant's superior knowledge of the requirements, experiences in filling out the forms and network for additional resources makes the claim process seem more efficient and less intrusive. Another issue that may influence the owner would be the possibility of a higher claim. The consultant's extensive experience might lead to the detection of some not-so-obvious entitlements or R&D activities that may have otherwise been missed or under-claimed. They may also be able to negotiate with auditors more effectively.

The next decision of the entrepreneur is whether to hire the consultant for the scientific or the expenditure portion of the claim, or for both of them. In a Claimant Satisfaction Study administered by the Canada Revenue Agency in 2006, 67% of the respondents used external assistance when preparing a claim, 36% of the respondents used external assistance for both portions of the claim, and 31% used external assistance for either the expenditure or technical portion of it. Respondents were slightly more likely to use external assistance for the expenditure portion of the claim (Table 1). Preparing the SR&ED expenditure claim in many cases is part of the taxation returns accounting firms prepare for their clients based on the information provided by the entrepreneur.

After the claim has been filed and

Table 1

Use of external assistance when preparing the claim

	Yes	No	I don't know	Total
Expenditure Portion	60%	37%	3%	100%
Technical Portion	43%	56%	2%	100%

Source: Canada Revenue Agency, Scientific Research and Experimental Development Tax Incentive Program, Claimant Satisfactory Study, Final Report, May 10, 2006. p.26.

processed a variety of concerns may crop up. To handle these the entrepreneur has at his or her disposal a number of options, such as contacting the research and technology advisor or financial reviewer, requesting a second review, contacting the SR&ED assistant director of the tax services office, filing a notice of objection or contacting the director of the tax service office (Canada Revenue Agency, 2006). These issues can be addressed either by a consultant or by internal resources at the company. If consultants were not involved in the claim process, it is very unlikely that they would be hired at this stage unless the disputed amount was substantial. In a Claimant Satisfaction Study administered by the Canada Revenue Agency in 2006 the majority, 69% of respondents, said that they were allowed most of the amount they claimed, and 17% said that they had a concern regarding their most recently reviewed SR&ED claim (Canada Revenue Agency, 2006).

The costs of compliance and consulting fees

Entrepreneurs view the cost of compliance as the sum of the administrative cost of following government rules and the opportunity cost, an implied cost of opportunities missed due to the company's effort to comply with the regulations. Once the opportunity cost is taken into account, especially the true value of a researcher's time, claiming tax credits can be costly. It is estimated that the compliance cost for an ongoing small claim of less than $100,000 is approximately 15% of the total value of SR&ED credits claimed (Parson and Phillips, 2007). A small firm estimated that the cost of compliance could even reach 20% of the value of the tax credits claimed (Warda, 1998). The manager of another firm stated, "unless you have $2 million worth of R&D projects, it does not pay to spend your time on preparing the claim" (Warda, 1998, p.3). First time applications tend to be even more expensive than ongoing ones. SR&ED consultants usually charge 15%-25% of the total value of SR&ED credit received. If hiring a professional advisor is perceived to result in a reduction in compliance costs and even in a possible increase in the credit received, then engaging the services of a consultant becomes financially worthwhile. The owners of small, lean and fast-growing business do not have the extra time to deal with the SR&ED application process. Hiring external help in many cases makes the difference between receiving a credit and not filing a claim. Given the complexity of R&D tax claims, it is not surprising that small firms are willing to pay substantial portions of their credits to consultants at least in the

first year, when the compliance cost is the highest. Anecdotal evidence suggests that consultants more often get the business of first time claims, and less often the subsequent ongoing applications.

In light of the recent (2008) changes in the Canadian Scientific Research and Experimental Development Tax Incentive Program, particularly with respect to reducing the compliance burden, ensuring the awareness of the program, enhancing accessibility to the program by making the SR&ED publications easier to use and understand, improving accessibility to the SR&ED pages on the Canada Revenue Agency web site, and introducing a simplified SR&ED claim form and an eligibility self-assessment tool, it is reasonable to assume that in the future there might be a reduction in the use of consultants by entrepreneurs (Canada Revenue Agency, 2008a).

Conclusion

The Canadian SR&ED program is a generous, small-business oriented incentive to encourage innovations. The entrepreneur's dilemma is considerable when trying to balance practicality and economic benefits against struggling with the seemingly complicated process of participating in the SR&ED tax incentive program. It seems that for a small business it is worthwhile to retain the services of a consultant. In fact most entrepreneurs find that the benefits outweigh the cost, and a majority of them uses consulting services to file a claim. Most of the small-business owners are satisfied with the result: in a Claimant Satisfaction Study administered by the Canada Revenue Agency in 2006, 88% of the respondents indicated that they plan to continue claiming SR&ED tax credits (Canada Revenue Agency, 2006).

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IŠORINĖS PARAMOS NAUDOJIMAS: ENTREPRENERIŠKAS POŽIŪRIS

S a n t r a u k a

Siekiant paskatinti tyrimus privačiame sektoriuje, daugelyje šalių mokestinės lengvatos tyrimams ir plėtrai yra svarbus technologijų ir inovacijų politikos elementas. 2005 m. devyniolika Ekonominio bendradarbiavimo ir vystymo (OECD) organizacijos narių nustatė mokestines lengvatas tyrimams ir plėtrai. Kanados mokslinių tyrimų bei eksperimentinės plėtros mokestinių lengvatų programa veikia nuo 1980 m. ir yra tarp dosniausių Ekonominio bendradarbiavimo ir vystymo organizacijos narių. Tai yra didžiausias atskiras federalinės vyriausybės paramos šaltinis Kanadoje, sukurtas skatinti inovacijas. Kiekvienais metais Kanados mokslinių tyrimų bei eksperimentinės plėtros mokestinių lengvatų programa skiria virš 4 milijardų dolerių investicinių mokesčių pavidalu 18 000 pareiškėjų. Iš jų apie 75% yra skirti smulkiam ir vidutiniam verslui.

Nors Kanados mokslinių tyrimų bei eksperimentinės plėtros mokestinių lengvatų programa yra didžiausia mokestinių lengvatų programa Kanadoje, ji yra bemaž labiausiai nepakankamai išnaudojama. Apskaičiuota, kad egzistuoja iki 1,5 milijardų dolerių vertės paskelbtų veiklų, kurios lieka nepareikalautos, nes verslai nieko nežino apie programą, nežino kas sudaro tinkamą projektą arba mano, kad aplikavimo procesas yra per daug komplikuotas, ilgas ar gremėzdiškas. Vadybos konsultantai užima pagrindinį vaidmenį didinant verslo informuotumą apie programą ir pildant sėkmingą paraišką. Siekiant gauti išmoką, kandidatai turi pildyti dvi formas. Forma T661, Mokslinių tyrimų ir eksperimentinės plėtros sąnaudų paraiška, detalizuoja kompanijos mokslinių tyrimų ir eksperimentinės plėtros veiklas ir prašomas išlaidas. Planas T2 SCH31, Investicinių mokesčių kreditas – Korporacija, naudojamas apskaičiuoti investicinių mokesčių kreditus. 2006 m. Kanados valstybės pajamų agentūra atliko Pareiškėjų nuomonės tyrimą, kurio 67% respondentų teigė, kad naudojosi išorine pagalba ruošiant paraišką.

Šio straipsnio tikslas išanalizuoti vadybos konsultantų vaidmenį paraiškos pildymo procese, atsižvelgiant į entreprenerišką perspektyvą. Šiame straipsnyje aptariamos kliūtys ir administraciniai sunkumai, kuriuos patiria entrepreneriai, pildydami paraišką; kaip ir kokiu lygiu išorinė pagalba gali juos sumažinti. Straipsnyje taip pat paliečiami susitarimo kaštai ir konsultavimo mokesčiai, siejami su paraiškos ruošimu. Šio straipsnio pabaigoje įvertinama konsultacijų ateities perspektyva, siejant ją su programa ir pastarojo laikotarpio (2008 m.) didžiausiais pokyčiais Kanados tyrimų ir plėtros programoje.