

Imperial Tobacco Limited/Limitée



April 16, 1980

Dr. L.C.F. Blackman
Westminster House
7 Millbank
London SW1P 3JE
England

Dear Lionel:

Your letter of March 24 to L.E. Ricard has been referred to me for further clarification directly with you. You will recall the discussion about taxation we had at Torquay when it was acknowledged that formulas for definition of and joint payment for group research would have to pass the scrutiny of tax auditors in the countries involved. The concerns voiced then have now proven to be well founded. The rapid escalation of our GR & DC bill is currently under question by government tax auditors and we are not at all certain that the 1978 bill will be allowed as a legitimate business expense. If disallowed the effect will be a loss of 42% of the bill from our profit. The tax auditors are giving us a hard time with respect to 1978, so when we look at the change from \$160,000 before 1978 to about \$830,000 for the current fiscal year we are apprehensive indeed.

The concept of cost sharing group research rather than commissioning and paying for specific projects has been agreed and we believe can pass tax auditor scrutiny provided certain conditions are met:

- (1) We have a research agreement that defines and commissions the work and shows the basis for payment.
- (2) We have sufficient information to demonstrate that we pay only for our share of the costs of GR & DC activity that conforms to the definitions of "group research" as written into the agreement. This means we must be able to demonstrate that the GR & DC bill does not represent a hidden transfer of funds to BAT for work that does not represent an allowable business expense by our company.
- (3) The group research arrangement can be defended as being beneficial to Canada.

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These conditions add up to the need to have very good documentation as exhibits. To meet the first requirement, Bob Bégin has been corresponding with K. Etherington to arrive at a suitably worded research agreement. Concerning the second need, I realize that the introductory pages and cost breakdowns contained in "1980 Programme and Resource Allocation" were prepared to communicate the programme in terms noted on p. 3 of "Notes on R & D Conference," London 1979, but it seems clear that we shall need a different breakdown that ties in directly with the terms and wording of the agreement. It appears to me (and to government tax auditors) that GR & DC serves several masters. Both the agreement and the kind of cost analysis we need must demonstrate that the "participants," and only the participants (of which BAT is one) control group R & D, and that the cost to be shared covers only direct costs of group R & D plus a reasonable proportion of overheads like technical and supporting services.

Although I don't want to interfere with the drafting of the agreement, I have taken the latest draft and modified it so as to prompt your clarification of the elements of GR & DC to be within the scope of the agreement. If this can be done and the words used are equally well understood on both sides, drafting the final version of the agreement should be straightforward and I hope it would then be possible for you to furnish cost breakdowns that fit the agreement and its terminology.

(See attached amended version of page 1 of draft agreement)

Although perhaps I ought not to try to relate the costs given with the 1980 programme to an agreement that does not yet exist, the following appear in whole or in part to be beyond its scope.

Millbank
Sponsored
a portion of "applied"
Millbank Product Dev. Advisors
BAT Bridon Joint Development Project
Patents (incl. BAT Head Office Legal Fees)
A proportionate amount of Supporting Services
and Technical Functions as related to non-
Participant activity.

Concerning terminology, we have difficulty here with "Millbank" as opposed to "B.A.T.," and "operating companies" as compared to "affiliates."

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Apart from the problem of dealing with the tax people I do have some difficulty in fielding the question "Do you agree that the value of group research is worth the cost?" I am regularly warned that not only the tax people and our own management, but also the Imasco Audit Committee and Imasco's external auditors might take notice of the escalation in the GR & DC bill, and ask the same question. I feel committed to that part of GR & DC activity that has been agreed in the give and take of group research conferences but am really in a weak position to defend the figure established for cost sharing purposes.

A letter of this type is certainly a departure from the past, but there seems to be no doubt that an inevitable consequence of the decision to draw substantial support for GR & DC from participants is the need to document the intended arrangement, and how it is practised, in ways that will pass external scrutiny. As a matter of fact, Bob Bégin, in attempting to get tax authority approval for the 1978 bill, has had to promise better documentation for subsequent years.

With kind regards,

Yours sincerely,

R. M. Gibb

enclosure

Postscript:

The foregoing letter to you was reviewed at Imasco and I attach the comments from that source. They refer to the text of the agreement rather than my letter. As I mentioned in my letter, I think the actual drafting of the agreement is best handled by those who now have the job, viz. Bégin and Etherington, but I suppose you have a role to play in this, even as I do here.

Can you arrange to have these points considered for the guidance of the two who are drafting the agreement? Bob Bégin is on the point of writing Etherington and he will copy my letter and these comments to him so we'll all know what's going on.

9.5.80

cc: R. Bégin
R. M. Gibb
S. Etherington

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