[OFFICIAL ENGLISH TRANSLATION]

2000-3931(IT)I

BETWEEN:

CHRISTIANE AURAY-BLAIS,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeals heard on common evidence with the appeals of ***Jean-François Blais*** **(2000-3934(IT)I)** on September 5, 2001, at Sherbrooke, Quebec, by

the Honourable Judge Louise Lamarre Proulx

Appearances

For the Appellant: The Appellant herself

Counsel for the Respondent: Marie-Aimée Cantin

JUDGMENT

The appeals from the assessments made under the *Income Tax Act* (the "*Act*") for the 1996 and 1997 taxation years are allowed, without costs, and the assessments are referred back to the Minister of National Revenue for reconsideration and reassessment on the basis that, for 1996, the acquisition of a tractor is an expenditure on or in respect of scientific research and experimental development within the meaning of subclause 37(8)(*a*)(ii)(A)(III) of the *Act* but is not property qualified for the investment tax credit within the meaning of subsection 127(9) of the *Act*.

For 1997, the interest expense is an expenditure within the meaning of paragraph 37(8)(*a*) but, being a prescribed expenditure, is not qualified for the investment tax credit and the appellants' agreement concerning the sharing of the profits and losses of the business is reasonable.

The whole in accordance with the attached Reasons for Judgment.

Signed at Ottawa, Canada, this 8th day of January 2002.

"Louise Lamarre Proulx"

J.T.C.C.

[OFFICIAL ENGLISH TRANSLATION]

2000-3934(IT)I

BETWEEN:

JEAN-FRANÇOIS BLAIS,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeals heard on common evidence with the appeals of ***Christiane Auray-Blais*** **(2000-3931(IT)I)** on September 5, 2001, at Sherbrooke, Quebec, by

the Honourable Judge Louise Lamarre Proulx

Appearances

For the Appellant: The Appellant himself

Counsel for the Respondent: Marie-Aimée Cantin

JUDGMENT

The appeals from the assessments made under the *Income Tax Act* (the "*Act*") for the 1996 and 1997 taxation years are allowed, without costs, and the assessments are referred back to the Minister of National Revenue for reconsideration and reassessment on the basis that, for 1996, the acquisition of a tractor is an expenditure on or in respect of scientific research and experimental development within the meaning of subclause 37(8)(*a*)(ii)(A)(III) of the *Act* but is not property qualified for the investment tax credit within the meaning of subsection 127(9) of the *Act*.

For 1997, the interest expense is an expenditure within the meaning of paragraph 37(8)(*a*) but, being a prescribed expenditure, is not qualified for the investment tax credit and the appellants' agreement concerning the sharing of the profits and losses of the business is reasonable.

The whole in accordance with the attached Reasons for Judgment.

Signed at Ottawa, Canada, this 8th day of January 2002.

"Louise Lamarre Proulx"

J.T.C.C.

[OFFICIAL ENGLISH TRANSLATION]
Date: 20020108

Docket: 2000-3931(IT)I

BETWEEN:

CHRISTIANE AURAY-BLAIS,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent,

AND

Docket: 2000-3934(IT)I

JEAN-FRANÇOIS BLAIS,

Appellant

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

Lamarre Proulx, J.T.C.C.

[1] These appeals were heard under the informal procedure on common evidence.

[2] The points for determination for 1996 are:

(1) whether the acquisition of a tractor was an expenditure on or in respect of scientific research and experimental development ("SR & ED") within the meaning of subclause 37(8)(*a*)(ii)(A) (III) of the *Income Tax Act* (the "*Act*"); and

(2) whether the acquisition of a tractor that had previously been used for two years but was sold with a new tractor warranty is property qualified for the investment tax credit within the meaning of subsection 127(9) of the *Act.*

[3] The points for determination for 1997 are:

(1) whether an interest expense of $5,410 was a prescribed expenditure under section 2902 of the *Income Tax Regulations* (the "*Regulations*") and, consequently, not qualified for the investment tax credit (the "ITC");

(2) whether that interest expense was an expenditure on or in respect of scientific research and experimental development within the meaning of paragraph 37(8)(*a*) of the *Act*; and

(3) whether the sharing of the business's losses as amended by the Minister of National Revenue (the "Minister"), that is on a 50/50 basis between the partners, under the authority conferred on him by subsection 103(1.1) of the *Act*, is reasonable in the circumstances.

[4] In making his reassessment of the appellant Auray-Blais dated May 8, 2000, the Minister relied on the facts described in paragraph 8 of the Reply to the Notice of Appeal (the "Reply") as follows:

[TRANSLATION]

(a) during the period in issue, the appellant and Jean-François Blais were partners in a business engaged in SR & ED (hereinafter the "business");

(b) based on the analysis of the SR & ED project, the Minister disallowed the following expenditures within the business's SR & ED:

1996

(i) a certain property was deemed to be not qualified for the investment tax credit (hereinafter the "ITC") and not deductible as an SR & ED expenditure; that was a tractor in respect of which an amount of $36,000 was included in computing the SR & ED expenditure account;

(ii) the appellant agreed with the disallowance of the ITC on the tractor since it was used;

1997

(iii) an interest expense of $5,410, which the Minister:

· deemed not deductible in respect of SR & ED;

· deemed not qualified for the ITC since it was a prescribed expenditure under section 2902 of the *Income Tax Regulations* (hereinafter the "*Regulations*");

· considered that expense as an operating expense;

(iv) the appellant agreed with the disallowance of the ITC in respect of the interest expense;

(v) the sharing of the business' losses was amended so that the losses were shared on an equal (50-50) basis between the partners;

(vi) at no time was the appellant able to provide documents to prove the allocation of work time between the partners;

(vii) consequently, the Minister issued the notices of reassessment dated May 8, 2000, to the appellant for the taxation years in issue.

[5] With respect to the appellant Blais, the Reply gives an additional reason explaining the Minister's refusal to consider the tractor as a capital expenditure on or in respect of scientific research and experimental development within the meaning of paragraph 37(8)(*a*) of the *Act*. Subparagraph (b)(iii) of the Reply reads as follows:

[TRANSLATION]

. . . the tractor's useful life is longer than the duration of the SR & ED project.

[6] With respect to the sharing of the business' losses for 1997, subparagraph (b)(vi) of the appellant Blais' Reply states the following:

[TRANSLATION]

ten percent of the business's loss was allocated to the appellant, as he reported it in his income tax return for the 1997 taxation year;

[7] On this point, counsel for the respondent stated that, if the decision were to confirm the Minister's equal sharing, 50 percent of the business's loss would be allocated to the appellant Blais for the 1997 taxation year.

[8] The Notices of Appeal are identical:

[TRANSLATION]

. . .

Following is the statement of the dispute over the position of the Revenue Canada staff concerning the Christiane and Jean-François Blais research company: for the notices of assessment for 1996, scientific expenditures respecting certain instruments (used exclusively for research) the useful life of which was deemed by Revenue Canada to be longer than the life expectancy of the research project were disallowed. Therefore, those instruments could not be included as research expenditures. From the decision rendered concerning the notice of objection, although confusing, we cannot conclude that the instruments in question do not qualify as scientific research expenditures. By that very fact, the calculation of the figures provided does not give us information about the Department's position.

We would therefore like the Court to render a decision on the definition of useful life and its application (using the time for project realization as useful life or other factors such as depreciation, asset valuation (material value, technological value, economic value), market value after a few years, etc.) with respect to instruments used solely for scientific research.

For the notices of assessment for 1997, we do not agree with Revenue Canada's agents that they can do as they please with respect to the partnership agreement for the sharing of profits and losses as well as the allocation of salaries to partners.

Furthermore, we would like the Court to apply a single borrowing rate for the taxation period for 1996 and 1997 for each of the notices of assessment because it should be considered that a partnership of individuals has a communicating vessel effect on the amounts of the notices of assessment of each partner and that the difference between the borrowing and lending rates undoubtedly penalizes the partnership. We would also like to be able to present our appeal jointly.

. . .

[9] The two appellants testified. Both are biochemists.

[10] The appellant Blais worked for Agriculture Canada from 1972 to 1983 and left to attempt a career as a consultant. He is now in research. The appellant Auray-Blais is currently working for the Centre Hospitalier de l'Université de Sherbrooke ("CHUS").

[11] The appellant Blais explained that, in 1997, he was taking part in two research projects, that of the Christiane and Jean-François Blais partnership and that of Innovations et Intégrations Brassicoles Inc. It is the first project that is in issue here.

[12] As to the second project, in 1997, a $15,000 National Research Council grant was awarded to the corporation, not to the appellant because, as he claimed, the National Research Council gives grants only to corporate entities. However, that corporate entity could pay the senior researcher the amount of the grant as salary, and that was how the appellant Blais had income of $15,000 for 1997.

[13] The appellants' research project concerns the development of hops and barley plants capable of resisting certain diseases and infections. The Minister did not dispute the fact that this project was an SR & ED activity.

[14] With respect to the sharing of the losses of the partnership's business, the appellant Blais filed Exhibit A-1, which consisted of documents prepared for the purposes of the hearing. Those documents included the appellants' income tax returns showing the difference in incomes. The appellant Auray-Blais' income in 1997 was double the income of the appellant Blais. In previous years, it had been even greater, as a result of which, according to the appellant Blais' calculations, for the years from 1994 to 1997, his salary had

of which, according to the appellant Blais' calculations, for the years from 1994 to 1997, his salary had ranged from 88 percent to 12 percent of the salary of the appellant Auray-Blais. The documents in that exhibit also included general descriptions of the work performed and an overall compilation of hours worked. The appellant Auray-Blais purportedly worked 508 hours in 1997, whearas the appellant Blais worked 51 hours. The appellant Blais stated that he had worked 2,300 hours for Innovations et Intégrations Brassicoles Inc. in 1997 and that he had devoted only 51 hours to the joint research project. The documents do not include a description of the work done on a day-to-day basis or indicate who performed the work. Nor were there any tables showing the financial contributions of each of the two appellants.

[15] The appellants stated that they had purchased the tractor in order to do the cultivation work required for the SR & ED activities in an experiment that might last 10 to 15 years. The appellant Auray-Blais said that she would not have acquired the tractor had it not been for research and development projects.

[16] The appellant Auray-Blais explained that they had previously purchased one tractor in 1997 and another in 1996, a tractor which had been reconditioned. She admitted that the tractor could occasionally be used for the work of the corporation for which her husband was the researcher. She also admitted that it was her husband who had used the tractor most often.

[17] She also mentioned that she and her husband owned 195 acres of land, of which four acres were devoted to the joint project. The appellants also carried on farming activities.

[18] According to the appellant Auray-Blais, the business's most active period was from April to October, 30 weeks, during which she had purportedly worked 10 hours a week.

[19] The interest expenses concerned two loans, one for $33,000 to purchase the Landini tractor, and the second for $60,000 for equipment supplies and installation expenses. There was no detailed description of

the $60,000 amount. The appellants testified that it had included computer and other purchases made in previous years, but no document was filed to explain that total of $60,000.

[20] The appellants explained that the loans had been made jointly but that repayments had been made in proportion to their incomes.

[21] Jean-Guy Paquet is a regional scientific adviser for the Canada Customs and Revenue Agency ("CCRA"). In his view, the purchase of a tractor could not be considered as a capital expenditure on or in respect of SR & ED activities because the tractor itself was not subject to experimentation. It was not a prototype that was used in the context of SR & ED activities. He also mentioned that the purchase of the tractor was excessive. As an example, he cited the purchase of a Boeing aircraft by a person experimenting with the surfacing of airstrips.

[22] Gaétan Descheneaux, an auditor, explained that he had inquired about the lifetime of the project and that of the tractor. The project's lifetime was 10 years, and the tractor's lifetime was 20 to 25 years. It was on that basis that he had refused to consider it as an expenditure on or in respect of SR & ED activities. With respect to the investment tax credit, the tractor was not qualified property since it was not new. As to the interest expenses, they were not deductible under section 37 if the purchase of the tractor was not an SR & ED expenditure. As regards the ITC, interest is not a qualified expenditure since, under section 2902 of the *Regulations*, it is a prescribed expenditure.

[23] Furthermore, in computing the income from the farming business, capital cost allowance was allowed for the tractor for 1996 and 1997 as well as interest.

[24] Exhibit I-5 was filed at the time of Mr. Descheneaux's testimony. This is the report on objection, which reads as follows concerning the tractor expenditure and the sharing of the profits and losses of the partnership formed by the appellants:

[TRANSLATION]

1996 -

We confirm the assessment in that the tractor acquired in 1996 for $36,000 is not a qualified SR & ED expenditure. The auditor inquired with the tractor dealer as to the selling price of a 10-year-old tractor of the same make and the dealer replied that it was approximately $20,000. It is therefore clear that 90 percent of the tractor will not have been consumed after the 10 years of SR & ED.

1997 -

We confirm the assessment resulting from the 50-50 sharing in the partnership, since the taxpayer has no document that might prove to us that he worked 90 percent of the time, whereas his partner worked only 10 percent.

. . .

[25] Bertrand Provencher, a technical adviser, explained that, in 1997, the appellant Auray-Blais had worked at CHUS on a full-time basis and the appellant Blais had worked on his own research project. It is therefore reasonable to believe that the two worked equally on the partnership's project. The financial contributions of each were not specifically revealed. There are no reasons why it would not be a 50-50 sharing.
[26] Marcel Vaillancourt, a CCRA appraiser, testified. He explained that the economic life of a tractor is usually 15 to 20 years. A tractor does not lose much value. Useful life means economic life.

Arguments

[27] The appellants referred to Judge Hamlyn's decision in *Com Dev Ltd. v. Canada*, [1999] T.C.J. No. 141 (Q.L.):

28 Section 37 of the Act is designed to encourage scientific research in Canada (*Consoltex Inc. v. The Queen*, 97 DTC 724, T.C.C.). The tax incentive of performing SRDE in Canada is twofold. First, SRED expenditures are given preferential treatment under section 37. Expenditures that qualify under section 37 are fully deductible in the year they are incurred or can be pooled and deducted in later years. Secondly, an ITC is available under subsection 127(5) of the Act.

29 Subsection 127(5) of the Act allows a taxpayer to claim a deduction for an amount that is based on the taxpayer's ITC for the year. The ITC for the year is defined under subsection 127(9) of the Act. The definition of an ITC under subsection 127(9) of the Act includes, among others, a percentage of a taxpayer's "qualified expenditures" made in the year. The term "qualified expenditure" is also defined under subsection 127(9) of the Act. The Respondent admits that the amounts in question are "qualified expenditures" of the Appellant within the meaning of subsection 127(9) and would qualify for the ITC under subsection 127(9) if that definition was read without reference to subsection 127(11.1)(c) of the Act.

[28] The appellants stated that the provisions of section 37 of the *Act* are measures to encourage research and must be liberally interpreted. They said that the tractor had been used 100 percent for SR & ED activities and that its useful life will coincide with the anticipated duration of their project, that is, 10 or 15 years. At the end of the research project, property used 100 percent for SR & ED activities will no longer be of any use.

[29] Counsel for the respondent argued that the tractor will have considerable residual value at the end of the project and that the proportion in which the tractor was used by the appellant's research project is vague: the appellant has his own research project for which he also used the tractor and there are also the appellants' farming activities. In counsel's view, section 37 of the *Act* does not apply in this case.

Conclusion

[30] Subclause 37(8)(*a*)(ii)A(III) reads as follows:

37(8) **Interpretation** - In this section,

(a) references to expenditures on or in respect of scientific research and experimental development

...

(ii) where the references occur other than in subsection (2), include only

(A) expenditures incurred by a taxpayer in a taxation year (other than a taxation year for which the taxpayer has elected under clause (B), each of which is

...

(III) an expenditure of a capital nature that at the time it was incurred was for the provision of premises, facilities or equipment, where at that time it was intended

1. that it would be used during all or substantially all of its operating time in its expected useful life for, or

2. that all or substantially all of its value would be consumed in, the prosecution of scientific research and experimental development in Canada, ...

[31] To determine the application of this provision, one must consider the time at which the capital expenditure is incurred. The equipment acquired must meet one of the following two conditions. It must be used all or substantially all of the time for SR & ED activities during all or substantially all of the time it is in normal operation. Second, all or substantially all of the equipment's value must be consumed in SR & ED activities.

[32] The appellants spoke of a 10-year term for their research project. They also said that their research could extend over a period of 15 years. They further mentioned that they believed the tractor would no longer have any value or use at the end of the experimental period.

[33] The regional scientific adviser appeared to give two reasons for disallowing the expenditure. The first concerned the condition of section 37, that the useful life of the property was greater than the duration of the experiments or that the value of the property would not be consumed by the experiment. Certain witnesses also expressed the opinion that the tractor was not used during all or substantially all of its operating time in SR & ED activities. The second reason apparently given by the regional scientific adviser was that he thought the purchase of the tractor was clearly excessive for the research purposes pursued by the appellants. The second reason, which may be a valid reason, is not the one that was given to the appellants.

[34] I must note that the reason given to the appellants was that the useful life of the tractor exceeded that of the project. That is the only reason that I must consider, and it is the one that is expressed in the Reply. The difficulty in this appeal is the lack of details in the Reply to the Notice of Appeal concerning what the Minister considered to be the useful life and the residual value of the tractor after 10 or 15 years of SR & ED activities. Figures were stated by the respondent's witnesses, who said that the tractor might be worth $20,000 after its 10 or 15 years of use and could still have some 10 years of normal operating life at the end of the research activities. Those figures should have been stated in the Reply. They are important facts on which the Minister relied. They can be seen stated in the report filed as Exhibit I-5. However, those figures do not appear to have been transmitted to the appellants. No letters to the appellants providing this information were filed in evidence. They were simply told that the useful life of the tractor exceeded the

duration of the project. I believe that greater clarity on this point was needed.

[35] It is not clear at first glance that substantially all of the value of a tractor would not be consumed in the context of SR & ED activities prosecuted in Canada at the end of a 10- to 15-year project. Specific data must be stated in the letters to the appellants and in the Reply so that a valid and fair debate may be conducted in Court. The same is true if the respondent wishes to argue that the equipment is substantially used for activities other than the SR & ED activities or that the expenditure is not reasonable in the circumstances; these are allegations that must be stated in the Reply. Since the appellants' proposal is not, on the face of it, unreasonable as regards the useful life of the tractor, and in view of the absence of allegations of any other arguments raised by the respondent's witnesses at the hearing, I must conclude that the acquisition of the tractor is a capital expenditure on or in respect of SR & ED within the meaning of paragraph 37(8)(*a*) of the *Act*.

[36] As to the investment tax credit, subsection 127(9) of the *Act* defines "qualified property" as follows:

In this section,

...

"qualified property" of a taxpayer means property (other than an approved project property or a certified property) that is

(a) a prescribed building to the extent that it is acquired by the taxpayer after June 23, 1975, or

(b) prescribed machinery and equipment acquired by the taxpayer after June 23, 1975,

that has not been used, or acquired for use or lease, for any purpose whatever before it was acquired by the taxpayer and that is

(c) ...

[37] The appellants admitted that the tractor had previously been used for two years before it was acquired by them. They stated that the warranty offered them on the tractor was identical to the warranty offered on a new tractor. However, I find that the text of the *Act* is quite clear. The machinery or equipment must not have been used or acquired for use or lease for any purpose whatever before acquisition. The tractor therefore is not property qualified for the investment tax credit within the meaning of those definitions in subsection 127(9) of the *Act*.

[38] As to interest, counsel for the respondent argued that the interest would be acceptable as a research and development expenditure under subsection 37(8) if the tractor expenditure were allowed. She made no distinction with respect to the purpose of the interest payable, that is to say, whether it was interest on the loan taken out for the acquisition of the tractor or for the acquisition of computers in the previous years. I shall make none. The interest must thus be considered an expenditure of a current nature attributable to SR & ED within the meaning of section 37 of the *Act*.

[39] Counsel for the respondent stated, however, that these were prescribed expenditures with respect to the ITC. She referred to section 2902 of the *Regulations* and paragraph 20(1)(*c*) of the *Act*, which concerns interest. The relevant portion of section 2902 of the *Regulations* reads as follows:

2902 For the purposes of the definition "qualified expenditure", in subsection 127(9) of the Act, a prescribed expenditure is

(a) an expenditure of a current nature incurred by a taxpayer in respect of

(i) the general administration or management of a business, including

...

(C) an amount described in any of paragraphs 20(1)(*c*) to (*g*) of the Act,

...

[40] I find that counsel's views are consistent with the *Act*. The interest is a prescribed expenditure. Consequently, it is not a qualified expenditure. I refer to the decision by Judge Mogan of this Court in *Minicom Data Corp. v. Canada (Minister of National Revenue - M.N.R.)*, [1992] T.C.J. No. 417 (Q.L.), at pages 4 and 5:

In my view, there is no ambiguity in the provision which I am required to construe because the language in Regulation 2902 (a)(i) is clear and unequivocal in its description of a "prescribed expenditure"....

...

... A common sense reading of Regulation 2902(a)(i) indicates that the items listed in clauses (A) to (H) are not merely examples of a current expenditure "in respect of the general administration or management of a business". The word "including" directly following that phrase is expansive in and of itself. In my opinion, it was the draftsman's intention that each item in clauses (A) to (H) would be a prescribed expenditure if it was of a current nature without regard to whether it was in respect of the general administration or management of a business.

[41] A similar decision was reached by Judge Kempo of this Court in *Spectron Computer Corp. v. Canada (Minister of National Revenue - M.N.R.)*, [1993] T.C.J. No. 700 (Q.L.).

[42] As to the sharing of the partnership's income, subsection 103(1.1) of the *Act* reads as follows:

103(1.1) **Agreement to share income, etc., in unreasonable proportions.** Where two or more members of a partnership who are not dealing with each other at arm's length agree to share any income or loss of the partnership or any other amount in respect of any activity of the partnership that is relevant to the computation of the income or taxable income of those members and the share of any such member of that income, loss or other amount is not reasonable in the circumstances having regard to the capital invested in or work performed for the partnership by the members thereof or such other factors as may be relevant, that share shall, notwithstanding any agreement, be deemed to be the amount that is reasonable in the circumstances.

[43] Although an employee of CHUS, the appellant Auray-Blais devoted her free time and summer vacation to research. The appellants stated that, during 1997, since the appellant Blais had his own research project, the appellant Auray-Blais devoted many more hours to the joint research project than her husband. They also claimed that she devoted more financial resources than her husband because they had each contributed in accordance with their income. The Minister's agents stated in their testimony that they had not seen an itemized account of each partner's financial contributions or the hours they worked. I do not have in evidence letters to the appellants specifically requesting such information from them. In their testimony, the appellants adduced evidence of greatly differing individual incomes and explained the difference in the number of hours worked. In the circumstances, I find that, in view of the financial contributions made and work performed by the partners, their income sharing agreement for 1997 was reasonable in the circumstances.

[44] The appeal is allowed, without costs, on the basis of the conclusions described above.

Signed at Ottawa, Canada, this 8th day of January 2002.

"Louise Lamarre Proulx"

Louise Lamarre Proulx

J.T.C.C.