Blue Wave Seafoods Inc. v. R.

Blue Wave Seafoods Incorporated, Appellant and Her Majesty the Queen, Respondent

D'Eon Fisheries Limited, Appellant and Her Majesty the Queen, Respondent

Tax Court of Canada [General Procedure]

Miller T.C.J.

Heard: April 26-30, 2004

Heard: May 3, 2004

Judgment: August 11, 2004

Year: 2004

Docket: 2001-2140(IT)G, 2002-1248(IT)G, 2002-1249(IT)G

Counsel: David G. Coles, James D. MacNeil for Appellant

John W. Smithers for Respondent

Government of Canada identified silver hake as underutilized species and sought proposals for development of Canadian silver hake fishery — Taxpayers, D Ltd. and B Inc., two connected corporate entities, took steps to develop that industry throughout 1990s

Although taxpayers started bringing fresh, as opposed to frozen, silver hake to shore for processing in 1995, it was not until 1997 that most of taxpayers' efforts went to marketing ultimate final product of whole round fresh silver hake.

Up to that point, taxpayers had been trying to improve processed products such as surimi (form of gel from which fish balls and fish cakes could be made) with fresh product.

Taxpayers submitted scientific research and experimental development ("SRED") claims for years 1995 through 1998.

Minister determined that neither ongoing surimi project nor broader project of developing inshore silver hake industry constituted SRED for years 1997 and 1998.

B Inc.'s 1995 and 1996 claims were partially accepted by Minister as SRED in connection with development of surimi project only.

Taxpayers appealed. Appeals for 1996-1998 dismissed; B Inc. appeal for 1995 allowed. In 1997 and 1998, taxpayers knew they could get fresh silver hake to plant and they knew what to do with it once there. Evidence was not convincing that procedure adopted by taxpayers of dumping fish on to stainless steel tables, sorting it and packaging it was not known process.

Evidence suggested that 1995 renovations of $19,708 were intended to be solely in connection with surimi project and therefore qualified as SRED

Cases considered by *Miller T.C.J.*:

> Consoltex Inc. v. R. (1997), 1997 CarswellNat 196, [1997] 2 C.T.C. 2846, 97 D.T.C. 724 (T.C.C.) — distinguished
>
> Northwest Hydraulic Consultants Ltd. v. R. (1998), 1998 CarswellNat 696, 98 D.T.C. 1839, [1998] 3 C.T.C. 2520 (T.C.C.) — followed

Statutes considered:

Can. *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.)

Generally — referred to

s. 37(8)(a) — considered

s. 37(1)(a)(i) — considered

s. 37(8)(a)(i)(B) — considered

s. 37(8)(a)(ii)(A) — considered

s. 37(8)(a)(ii)(B) — considered

s. 37(8)(a)(ii)(B)(V) — considered

s. 37(8)(d)(i) — considered

s. 38 — considered

s. 127 — considered

s. 248(1) “scientific research and experimental development” — considered

Regulations considered:

Can. *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.)

Income Tax Regulations, C.R.C. 1978, c. 945

Generally

s. 2900(1) [renumbered SOR/86-1136]

s. 2900(2) [en. SOR/86-1136]

s. 2900(2)(c) [en. SOR/86-1136]

APPEALS by taxpayers from Minister's determinations respecting scientific research and experimental development claims respecting silver hake fishery.

***Miller T.C.J.*:**

1 Silver hake is a small, delicate white-fleshed ground fish, considered for many years by those knowledgeable in the fishing industry as a trash fish. The Government of Canada identified silver hake as an underutilized species and sought proposals for the development of a Canadian silver hake fishery. The Appellants, D'Eon Fisheries Limited and Blue Wave Seafoods Incorporated ("D'Eon" and "Blue Wave", respectively), took steps to develop that industry throughout the 1990s. Their activities in this regard in their 1995 to 1998 fiscal years are at issue. Specifically, I would frame the issue as follows:

A. For 1997 and 1998

> (i) in accordance with the definition of scientific research and experimental development ("SRED") found in the *Income Tax Act* (the "*Act*"), was there a systematic investigation or search carried out by D'Eon and Blue Wave in the field of science or technology by means of experiment or analysis that is applied research or experimental development. To answer this issue, the traditional three-pronged analysis has been expanded to the following:[1]
>
> > (1) Was there a technical risk or scientific uncertainty?
> >
> > (2) Did D'Eon and Blue Wave formulate hypotheses specifically aimed at reducing this uncertainty by:
> >
> > > (a) observation of the subject matter;
> > >
> > > (b) formulation of a clear objective;

(c) identification and articulation of the technical uncertainty;

(d) formulation of hypothesis;

(e) methodical and systematic testing of the hypothesis.

(3) Did the procedures accord with the established and objective principles of scientific method, characterized by trained and systematic observation, measurement and experiment?

(4) Did the process result in technological advancement?

(5) Was a detailed record kept of the hypothesis, tests and results?

(ii) If there was such systematic investigation constituting SRED, what qualified expenditures did Blue Wave and D'Eon make in accordance with section 38 of the *Act*?

2 As I find there was no SRED carried on by Blue Wave and D'Eon in 1997 and 1998, it is unnecessary to address this second branch of the inquiry.

B. For 1995 and 1996

3 Given that the Respondent has acknowledged there was systematic investigation constituting SRED by Blue Wave in 1995 and 1996, the issue is what qualified expenditures did Blue Wave make in those years in accordance with section 38 of the *Act*?

4 I find the only qualified expenditures incurred by Blue Wave over and above those already allowed by Canada Revenue Agency (CRA) were renovations of $19,708 in 1995.

Facts

5 The context for the development of the silver hake fishery comes primarily from the evidence of Mr. Robert Sciocchetti, an official with Department of Fisheries and Oceans (DFO) from 1985 to 1998, who, in 1995 and 1996 was in charge of management of the development of the silver hake industry. In 1998, Mr. Sciocchetti became an employee of D'Eon.

6 In the late 1980s, there was no Canadian component in the silver hake fishery; only foreign fleets, primarily Russian and Cuban, fished silver hake. Silver hake was fished mainly in the Scotian shelf (50 to 125 miles offshore). It was fished with a small mesh gear. Due to its skeletal nature it was a difficult fish to process by hand. DFO believed that the fish could not be landed fresh, but must be frozen at sea, which is what the foreign vessels in fact did.

7 In 1986, DFO identified silver hake as one of 21 species of underutilized fish and for the ensuing four years considered how to develop a silver hake fishery. With the decline of the cod and haddock industry, the Government introduced a ground fish development program, a program which included silver hake. DFO went to industries seeking proposals with respect to fishing silver hake, setting out certain requirements such as the vessels to be used, the quantity sought, the ability to handle, onshore processing, marketing, capital investment, etc. The successful applicant would require a fishing agreement with a foreign fleet to catch the fish. DFO would then issue a licence under its developmental program with certain terms and conditions. This type of licence is distinguishable from a commercial licence which is granted in established industries only. In the established industries, a total allowable catch (TAC) is set by species, by area and by inshore and offshore or within vessel categories. According to Mr. Sciocchetti, such quota does not apply to a developmental fishery, though a TAC was set for silver hake in the years in issue.

8 The Appellants made a successful proposal to DFO. Their first attempt to work with silver hake was a disaster, according to Mr. Sciocchetti, as the Canadian crew required to be aboard foreign vessels was more interested in extracurricular activities than learning how to fish silver hake.

9 In 1990, under a Memorandum of Agreement with a Norwegian fleet, the Appellants did not fare much better due to reliance on inappropriate gear. DFO was at this time still operating on the understanding that the fish had to be frozen at sea. With such little success, DFO had to change criteria and moved away from Canadian crew requirements to a requirement that 10% of the fish had to be processed in Canada. The Appellants then contracted with a Cuban fleet on this basis and proceeded in 1991 to land frozen fish in Canada. The Appellants would thaw the fish once landed and then rely heavily on machinery to head and gut the fish, repack and ship it.

10 In October 1992, DFO issued a report entitled “1991 Silver Hake Processing Experiments” describing the experimental strategy to produce as many types of products as possible, and then identify the most desirable form of product. The following are some of the conclusions from the 1992 report:[2]

Catches were stowed, well-iced, in pens with shelves. At the plant the fish were ... dumped into large insulated containers (Xactic boxes) of slush ice, made up of flaked (freshwater) ice with a lesser amount of seawater. ... some fish also were stored in ice only Xactic boxes, while others others were iced in small ... plastic boxes, ...

A comparison of boxed iced storage versus slush ice holding of silver hake was conducted .... Slush ice holding of the catch was considered superior to boxing ....

All of the processing was carried out at Blue Wave Seafoods Inc. ... The equipment tested for processing silver hake ...

This report was based on an exploratory inshore catch between August 21 and September 24, 1991. This provided fresh fish for processing trials at the Appellants' plant. The conclusion of the processing experiments in 1991 was that the most promising option was mince.

11 In 1993, due to the blockade of a Russian vessel by Canadians to attempt to increase their haddock quota, DFO instituted restrictions on foreign vessels. This led to a three-day conference in November 1993 attended by both government and industry representatives to consider the future of the silver hake fishery. A number of recommendations resulted from those meetings in 1993:

> (i) The introduction of the concept of a separator grate in the gear which would reduce the risk of excessive by-catch (a catch of a non-licenced species) (I heard evidence that the Appellants introduced this type of gear even before these recommendations);
>
> (ii) Identification of a fishing area for silver hake;
>
> (iii) Adjustment of an acceptable percentage of incidental catch;
>
> (iv) The creation of a committee to develop the industry.

12 In 1994, the “Silver Hake Canadianization Committee” was formed, again with government and industry represented, including representation from the Appellants. The Committee had a mandate in 1995, according to a study by Coopers and Lybrand Consulting, to Canadianize and eventually commercialize the silver hake fishing industry in Nova Scotia. The Coopers and Lybrand report[3] was submitted to the government to seek funding to achieve this mandate. It proposed a three-year project intended to “clearly demonstrate the silver hake resource is of interest to Canadian harvesters and not excess to Canadian harvesting requirements”. It also stated that the reason for seeking funding is because the silver hake fishery is still in the research and developmental stage, and that there was insufficient information about the resource for fishers to provide the fish efficiently and cost effectively. This proposal of January 1995 was never implemented.

13 In 1995, the Appellants recognized that to market a top-quality product it would be necessary to land fresh silver hake. They also understood that to get Canadian fishers to fish silver hake, it would be necessary to offer considerably more than the $0.08 per pound market price. So, Mr. Sylvain D'Eon determined to offer Canadian fishers $0.15 a pound. He received offers from two entities at that price. These companies were issued exploratory conditions attached to their original ground fish commercial license. DFO created two areas for the execution of this fishing license: in the LaHave basin and in the Emerald basin. These were new areas for silver hake fishing, areas considered to be an inshore fishery, as opposed to the offshore fishery conducted by foreign vessels.

14 DFO had insufficient funds to properly monitor the exploratory licensing in connection with the silver hake fishery. As Mr. Sciocchetti indicated, it would be necessary for DFO to observe 25% of the fleets' trips, but it was only able to observe two to five percent. The log books kept by the fishers under observation were insufficient to get reliable information on which to determine the overall viability of the fishery. The fishers were required to keep track of their time in and out on a trip, the type and the amount of catch.

15 With respect to the products that could be produced by silver hake, there was the whole fish, a headed and gutted fish, a basic mince, a surimi (a form of gel resulting from sapping the water out of the fish) and tempura, a product developed from surimi. With surimi, the Appellants could produce a variety of fish balls and fish cakes. The 1992 DFO report suggested that the process for mincing silver hake was known as early as 1991, as foreign fleets had been doing it for years, although from silver hake frozen at sea, not from fresh silver hake.

16 The preceding was a general overview of the early years of the silver hake fishery. Mr. Sylvain D'Eon, the president of both Appellants, elaborated on the Appellants' role specifically in the development of the industry. He was certainly a man of some experience having developed new fisheries in the early 1970s with respect to offshore lobster fishing, and in the late 1970s, in shifting the herring fishery from a fish meal to a food operation. He described how the haddock, cod and pollock stock were depleted in the late 1980s, yet foreign vessels continued to catch 100,000 tonnes per year of silver hake. He saw an opportunity, so that when DFO sought proposals to fish silver hake, Mr. D'Eon incorporated D'Eon Fisheries Limited to apply. He found some financial backing through an individual who owned Blue Wave. As this individual did not foresee sufficient profits, Mr. D'Eon bought him out of Blue Wave, thus ending up with the two connected corporate entities involved in these appeals.

17 Mr. D'Eon confirmed that the Appellants first effort in connection with silver hake in 1990 was unsuccessful due to the use of inappropriate mid-water gear. The second effort with Cuban vessels required landing of 10 to 15% of the catch in Canada. These fish were frozen at sea in 15-kilogram blocks, thawed onshore, headed and gutted and shipped to Portugal in two-kilogram frozen packages. Portugal was, according to Mr. D'Eon, not enthused with the product.

18 In the early 1990s, the Appellants worked with the Technical University of Nova Scotia to determine how whole fish or fillets would keep, to determine how quality would be affected by freezing, and to determine susceptibility to parasites. The Appellants invested in machinery from Baader including three filleting machines, three conveyors and three mincers. The Appellants leased a plant to process silver hake. The machinery was not designed specifically for silver hake so required adaptation. The mince produced was not well received by National Sea Products, the Appellants primary customer for the mince. Mr. D'Eon indicated that the mince was never sold at a profit. He also testified that regulations precluded him from simply processing the silver hake into fish meal.

19 Still in the early 1990s, the Appellants attempted to have Baader design a machine to butterfly fillet the silver hake. The result was unsuccessful. The Appellants worked in conjunction with the Japanese in building equipment to remove water from the fish, resulting in a form of sea meat used to make fish balls and fish cakes. It was around this time (1995) that Mr. D'Eon knew that quality demanded a fresh fish. This was the recommendation of the Canadian Silver Hake Committee as well.[4] Mr. D'Eon confirmed that it was in 1995 that he made the 0.15¢-pound offer to Canadian fishers as, according to him, it was the only way to get them out. He had invested a lot of money to this point and believed he needed fresh fish to be successful. It was apparent the fresh fish would have to come from a Canadian fishery. He was thus prepared to pay a significantly greater amount per pound to obtain the fresh fish from Canadian fishers. As Mr. D'Eon put it, he was not in the business of developing a frozen silver hake industry. He did still, however, continue to acquire fish from the foreign vessels. He also testified he could not process all the fish landed into mince, but would have to freeze and inventory the excess.

20 Mr. D'Eon maintained that from 1995 to 1998, there remained a lot to learn about the whereabouts and size of the silver hake stock. There had been a view that silver hake were only in the LaHave and Emerald basins a few months a year. He believed it necessary to fish at different times of the year. He also described the handling of the fish at sea once caught. They were first kept in pans in the hold, alternating fish and ice. This squashed the fish, so they moved to a system of shelves which helped, though they still received complaints from the Spanish, their main customer for fresh fish. They then went to a system of tote bags or pans, about three feet by one and one-half feet, which would hold 100 pounds of fish in a slushy ice-water mixture. Mr. D'Eon testified that someone had simply suggested this to him. This best preserved the quality of the fish. Mr. Wesley James D'Eon, the son of Mr. Sylvain D'Eon, later testified that by 1997, the tote bags were being used in the silver hake industry, though tote bags were known prior to that period.

21 With respect to what Mr. Sylvain D'Eon called the “science” of silver hake, he believed it was left primarily to industry to determine, as DFO had insufficient funds to pursue all 21 underutilized species which they had identified. So, Mr. D'Eon's companies collected their own data. They would obtain information from every boat load including size, sex, weight and length. Initially, they had not determined the sex of the fish until Mr. Mark Showell, an expert produced by the Respondent, had visited the Appellants' plant and had indicated to the Appellants' employees how to determine the sex of the fish and measure them correctly. As well, fishers were required by DFO to keep a logbook to record catch rates. Mr. D'Eon was uncertain as to exactly what analysis was done with this information, indicating he left that for others. His general overview was clearly that the information was necessary to develop a Canadian silver hake fishery. He admitted that he believed simply because DFO held the program out to be developmental, and not commercial, he was still engaged in SRED.

22 Mr. Wesley D'Eon described in considerable detail the processing of the fish from the early attempts at mince in the early 1990s to the later and current efforts of marketing whole fresh fish. There are several relevant matters that emerged from Mr. Wesley D'Eon's explanation. First, the Appellants, from 1990 to 1998, tried a variety of products: mince from frozen silver hake (offshore—foreign), mince from fresh silver hake (inshore—Canadian), surimi, tempura, headed and gutted, fish fillet, and whole fresh fish.

23 For each product, new machinery had to be acquired and adapted. For example, with the technical assistance of a Mr. Shimako, machines, including a silent cutter and moulder, were acquired from Japan to process surimi and tempura. These products had never previously been made from silver hake. The process required dehydrators and freezers. This was all developed prior to 1997. By 1997, the Appellants were less interested in making surimi and tempura as, according to Mr. Wesley D'Eon, they were not able to market the products successfully. Only limited production of such products took place thereafter, though mince continued to be produced in both 1997 and 1998.

24 In discussing the process of dealing with fresh silver hake, for purposes of selling whole round fresh, Mr. Wesley D'Eon described how, once the fish arrived at the plant in totes, they would be dumped onto stainless steel tables and be sorted for size and quality. They would then be weighed, iced, packaged and placed on pallets for export. The plant moved from sorting on such flat tables to the use of a conveyor, which Mr. D'Eon suggested was in 2000. Also in 2000 or 2001, the plant added water chillers to chill the seawater used to spray and wash the fish.

25 Mr. Wesley D'Eon advised that in 1994 the plant operated with around 10 employees. The number of employees went up as more fresh fish were brought to the plant. He advised that today, with fresh fish being caught almost 12 months a year, they will process every week. They now employ up to 70 people, processing fresh silver hake only, which they ship internationally, primarily through Montreal.

26 Turning to the financial side of the Appellants' claim, Mr. Nelson Burbidge, a chartered accountant and a minority shareholder, director and secretary-treasurer of the Appellants' testified that he was hired in 1990 to control costs in the development of the silver hake industry. He indicated that the principals were not thinking profitability at that point. A plant was set up at considerable cost in 1991 through the auspices of Blue Wave, the company that was to handle the manufacturing and processing side of the operation. Given his training with a major chartered accounting firm, Mr. Burbidge was aware of the research tax credit program and was instrumental in the Appellants' submissions of seven claims for the years 1991 to 1994, three for Blue Wave and four for D'Eon. The Government had set a September 1994 deadline for past SRED claims, which produced a flood of claims, with a consequential stress on the system.

27 Before reviewing the 1991 to 1994 claims, it is useful to know how CRA deals with an SRED application. It goes through an initial vetting by a technical (non-science) advisor who determines if a review is necessary from the audit side. If so, the file then flows down two streams: a scientific review and a financial review. The scientific advisor determines if the project for which SRED credits are sought is indeed SRED. The auditor determines what costs qualify as expenditures on SRED. For example, in 1997 and 1998 the science advisor, Mr. Brian Neil, determined that none of the project claimed as "development of the silver hake fishery" qualified as SRED. The auditor, Mr. Bruce Harnish, therefore logically attributed no costs to SRED.

28 I return now to the 1991 to 1994 SRED claims submitted by the Appellants. The Appellants, in their technical description (T661) submitted with their claim, identified their objective as "to develop the fishery by first creating methods to harvest the fish, and secondly developing methods to process the fish commercially".[5] CRA's science advisor, Mr. John Whitaker found that part of the project constituted SRED. The financial auditor, Mr. Harnish, then determined that about 10% of the costs qualified for deduction as expenditures incurred on SRED. Mr. Harnish sent seven proposal letters, one for each of the claims, to Mr. Burbidge, advising him of this preliminary conclusion and also advising him that "consideration is being given to levying the penalties". The penalties were substantial. Mr. Harnish testified that he made this proposal as the amounts claimed were so much greater than the amounts CRA was prepared to allow. Mr. Harnish was aware that CRA was at this time looking at the question of proposals containing references to penalties. Mr. Burbidge testified that he was shocked by the denial of the claims, but more so by the penalties. He met with Mr. Harnish and an agreement was reached slightly increasing the claim and dropping all the penalties, upon an assurance from the Appellants they would not appeal the matter.

29 Mr. Burbidge submitted SRED claims for each of the Appellants for the years 1995 through 1998. The 1995 and 1996 D'Eon claims were accepted without review; that is, the two-person tag team of science and finance advisors never became involved with respect to those two claims. The remaining six claims are the subject of these appeals. The 1995 and 1996 Blue Wave claims were partially accepted as SRED in connection with the development of the surimi and tempura project only, not in connection with the project being viewed generally as the development of a Canadian silver hake industry. The following is a summary of the expenditures in dispute in 1995 or 1996:

Blue Wave Seafoods

July 31, 1996

	SR&ED		
	Filed	Review	Appeals
(A) Wages & Salaries	$46,409	$46,997	$46,997
Materials consumed	17,979	8,865	52,863*
Third Party Payments (fish)	481,599	0	0
Contractors	0	4,424	4,424
Total Current Expenses	545,987	60,286	104,284
65% of wages/Proxy amount	$30,166	$30,548	$30,548

Blue Wave Seafoods

July 31, 1995

	SR&ED		
	Filed	Review	Appeals
(A) Wages & Salaries	$43,853	$31,949	$41,174
Materials	12,471	2,791	27,967*
Contractors	27,914$	0	0
Third Party Payments (fish)	63,045	0	0
Total Current Expenses	147,283	34,740	69,141
65% of wages/Proxy amount	$28,504	$20,767	$26,763

Notes:

* Includes portion of costs of fish which went through surimi/tempura process

S Renovations to accommodate surimi production ($19,708) plus equipment (fire extinguishers, tables and trays - $8,206)

30 The issue in 1996 is whether the cost of the fish is a qualified expenditure on SRED, while in 1995 the issue is the cost of the fish and the cost of the contractors.

31 There was extensive evidence as to how the claims from 1995 to 1998 were handled by CRA. Mr. Harnish was the auditor, that is on the financial side, for the 1995, 1997 and 1998 claims. Mr. Neil was the science advisor on the 1996, 1997 and 1998 claims. Both Mr. Neil and Mr. Harnish testified.

32 Mr. Neil's background was in information technology, having received a Bachelor of Science in 1995. Upon joining CRA he attended training sessions in connection with the SRED program. He also was provided in-house training in the form of supervised file reviews from his supervisor, Mr. Sim. None of this training involved the fishing industry. Mr. Neil acknowledged he had no business or fishing experience. He also acknowledged that he was not a specialist in fisheries.

33 In his 1996 science report, Mr. Neil indicated that no technical documentation was available for review. He went over the 1995 science advisor's report and acknowledged in his report that "this project is a continuation of work carried out last year". The project was described as "development of silver hake products for the Japanese market". He also met with DFO, having sought and obtained the Appellants' consent to do so. However, his meetings with DFO were to obtain general information on the silver hake fishery, as opposed to discussing the Appellants' particular claim. For 1996, Mr. Neil concluded "This project satisfies the requirements of *Regulations* 2900(1) of the *Income Tax Act*. The claim should be adjusted according to what the claim can substantiate as being ASA[6] consumed materials for the project".

34 Mr. Neil confirmed that the qualified expenditures were those that went into developing surimi and tempura, recognizing that processing silver hake was difficult due to the characteristics of the fish. In describing the requirements that he found were met in 1996, Mr. Neil stated there were:

> (i) uncertainties; in this case the uncertainty was whether 100% perfect quality product could be achieved;

(ii) technical advancements: this was the understanding and developing of a process for a fish with such different characteristics from other fish, used to create surimi and tempura products.

35 He recognized that in 1996, the plant did not have capacity to process into surimi or tempura all fish caught, but that a considerable portion would need to be frozen. In determining the yield ratio, that is how many pounds of fish would be required to produce one pound of surimi, Mr. Neil believed wastage was accounted for; in this sense, wastage only arose from product that was put through the surimi process. He was not aware at the time of his report of any regulations detailing what could or could not be done with the caught silver hake; for example, that the fish could not be produced into fish meal. He was also not aware at that time of the DFO's emerging fish policy which was developed in 1996.

36 For the 1997 and 1998 science reports, Mr. Neil broke the project down into two components; first, the ongoing surimi project and second, the broader project defined as the development of an inshore silver hake industry. It was only on this latter basis that the Appellants filed their 1997 and 1998 claims. Mr. Neil believed that the previous project was still ongoing. He ultimately determined neither project constituted SRED for 1997 and 1998.

37 Mr. Neil indicated that, after visiting the Appellants' plant, he was concerned that nothing appeared to have been done with the data collected, that the claimed third-party payments purported to have been made to the Silver Hake Canadianization Committee seemed unusual, and that the Appellants simply bought and sold a lot of fish. He also explained that in carrying out his review, he attempted to identify the scientific and technological uncertainties, or as he described it, the gap between what technology could currently do and what the Appellants wanted to do. He then tried to determine what actual work, by way of systematic investigation, was undertaken to overcome that gap.

38 This matter of uncertainty was addressed by the Appellants in their technical description of the project. In connection with the 1997 and 1998 claims, the technical description read as follows:[7]

... there are the following uncertainties:

(i) What gear should be utilized?

(ii) Where to deploy to the gear at various times of the year?

(iii) How to handle the fish to ensure acceptable quality?

(iv) Can a catching-effort be achieved that will provide an economic return to the fishing boat?

(v) Can equipment be developed to reduce the by-catch to the regulation level?

(vi) Can processes be developed that allow cost targets to be achieved? Presently the cost of round silver hake obtained from the experimental inshore fisheries is $0.28 per pound as opposed to $0.05 per pound for the commercial quota available from Cuban fishing vessels. Silver hake mince produced from the experimental inshore fishery cost $0.81 per pound and the average selling price for 551 metric tonnes (over a two-year period, calendar 1997 and 1998) (was $0.57 per pound).

(vii) Can sufficient larger fish be caught?

(viii) Will the larger openings necessary to reduce the amount of smaller fish retained, increase the by-catch to an unacceptable level?

39 Mr. Neil's testimony in reply to the above was that:

(i) DFO had published information regarding gear prior to 1997 and 1998;

(ii) Mr. Showell's report had already answered this question;

(iii) Previous years' fishing experience had likewise already answered this question;

(iv) This was an economic rather than scientific or technological uncertainty;

(v) Same as answer (i);

(vi) An economic uncertainty;

(vii) This was just a question of where the fish are;

(viii) This was within the purview of DFO, and the actual fishers; he had no evidence that the Appellants had done anything in that regard in the year in question.

40 Mr. Neil determined that the third-party payments to the Silver Hake Canadianization Committee claimed on the SRED claims were actually the costs of the silver hake paid to the fishers. He further concluded that, as the fish in 1997 and 1998 had not gone through any experimental process, they could not be considered to be consumed, or rendered valueless in SRED. He further believed that the purchase of fish was "standard practice". He simply did not consider the purchase of fish was SRED in this context.

41 As indicated earlier, the review at CRA goes down two streams—the science review, which in this case was undertaken by Mr. Neil for 1996, 1997 and 1998, and the financial review which was undertaken by Mr. Harnish for 1995, 1997 and 1998.

42 In 1995, the science review approved the process for the development of surimi as eligible, and Mr. Harnish proceeded to identify related expenses by reviewing production records, general ledgers, landing slips and various invoices. He calculated the amount of fish used in surimi production based on a yield factor and an inventory report of pounds used in mince. He acknowledged that fish that were not part of the surimi process were sold or frozen in inventory. He did not include the cost of such fish as qualifying for SRED.

43 In 1997 and 1998, because Mr. Neil determined there was no eligible SRED project, Mr. Harnish was unable to identify any expenditures as qualifying.

44 Mr. Harnish and Mr. Neil visited the Appellants' plant on October 14, 1999. They were taken by Wesley D'Eon on a tour of the plant. Mr. Harnish recalled that Wesley D'Eon had advised him that he was in constant contact with brokers, and before the boats are sent out the catch is 80% pre-sold. Wesley D'Eon's testimony on this point went as follows:

> Q. Well, perhaps you can tell me then, did you send the boats out or ask the fishermen to go out on speculation to catch fish? Or did you already have an order for fish and then send the boats out to fill that order?
>
> A. Sales was not my—I wasn't doing the sales. I wouldn't know.
>
> Q. You don't know that?
>
> A. No. I told you earlier I wasn't doing sales on frozen.
>
> Q. So if I suggested to you that 80 percent of the fish landed at your plant is pre-sold before it's ever caught, what would your response be?
>
> A. My response would be that I wasn't into sales so I don't know.

(Transcript page 67 lines 21-25, page 68 lines 1 to 10)

Appellants' counsel did not recall Wesley D'Eon in reply, nor cross-examine Mr. Harnish on this point.

45 Both parties produced experts: Dr. George H. Winters for the Appellants and Mr. Mark Showell for the Respondent. Both were well-qualified to discuss the methodology of silver hake stock assessment. With the greatest of respect to each of them, for they were indeed impressive in their knowledge and understanding of the subject matter, their evidence was of limited assistance in addressing the issue before me of the scientific nature of the Appellants' activities. Mr. Showell, the Respondent's expert, produced a number of reports dealing with the assessment of the Scotian Shelf or 4VWX silver hake population for the years 1995, 1996, 1997 and 1998. The Appellants' expert, Dr. Winters, presented a report dated January 2004 evaluating the reliability of Mr. Showell's survey as an indicator of silver hake abundance. Dr. Winters concluded:[8]

The RV survey provides an inconsistent and possibly biassed index of silver hake abundance in 4VWX. If confirmed, this conclusion would explain the current contradictions in health indices contained in the index. Interpretations of vital rates derived from this index, especially as it relates to the larger silver hake, should be viewed with some uncertainty and greater weight given to the simpler indices. Additional research on the variety of issues is clearly needed.

In the text of Dr. Winters' report, he identified the type of additional research that might be required:[9]

... Such a list might include (but would not be restricted to) trawl-acoustic surveys, seasonal surveys, pelagic trawl surveys, additional studies of silver hake abundance in the continental slope zones, feeding studies of adult hake, stock discrimination studies including mark-recapture approaches, as well as more general studies describing the distribution characteristics of the various life stages of silver hake and their interaction with shifts in prey abundance.

46 Interestingly, Mr. Showell confirmed in his testimony that the longer he worked with the assessment model, the less reliable he realized it was. Ultimately, he could not accept the results. Rather than ignore the results or develop a new model, Mr. Showell's approach was to assess the bias and adjust the results.

47 There was considerable discussion with the experts about the definition of terms such as “commercial”, “developmental”, or “experimental”, as Mr. Showell, specifically had used such expressions. Defining such terms was not the experts' area of expertise, and I attach little weight to evidence of Mr. Showell that after 1995 the fishery was “commercial”, nor to the evidence of Dr. Winters that by 1998 the silver hake fishery was still exploratory and not in the commercial phase.

48 As well as being presented as an expert, Mr. Showell also had firsthand knowledge of the Appellants. In 1997, on a visit to the Appellants' plant he noted they were measuring the fish. He requested and obtained such information with respect to length from the Appellants, which he analyzed and used in his determination. He did not get any information from the Appellants in 1998.

49 Finally, Mr. Showell's report verified the TAC as well as actual catches for the years 1988 to 1999, broken down between inshore (Canadian) and offshore (foreign). For the years 1995 to 1998 the figures were as follows (in tonnes):

	1995	1996	1997	1998
TAC	50,000	60,000	50,000	55,000
Catch	17,000	26,000	16,000	16,000
Canadian	300	3,473	4,203	9,979
Foreign	16,835	22,442	11,961	6,251

Legislation

50 Although there was some change in the legislation during the relevant period, it does not impact on the framing or the analysis of the issues. The definition of scientific research and experimental development is found in subsection 248(1) applicable to work performed after February 27, 1995. Prior to that, the definition was found in the *Regulations*. For purposes of this appeal the relevant sections are as follows:

37(1) Where a taxpayer carried on a business in Canada in a taxation year, there may be deducted in computing the taxpayer's income from the business for the year such amount as the taxpayer claims not exceeding the amount, if any, by which the total of

> (a) the total of all amounts each of which is an expenditure of a current nature made by the taxpayer in the year or in a preceding taxation year ending after 1973
>
> > (i) on scientific research and experimental development carried on in Canada, directly undertaken by or on behalf of the taxpayer, and related to a business of the taxpayer,

37(8) In this section,

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

(i) where the references occur in subsection (2), include only

(A) expenditures each of which was an expenditure incurred for and all or substantially all of which was attributable to the prosecution of scientific research and experimental development, and

(B) expenditures of a current nature that were directly attributable, as determined by regulation, to the prosecution of scientific research and experimental development, and

(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

(I) an expenditure of a current nature all or substantially all of which was attributable to the prosecution, or to the provision of premises, facilities or equipment for the prosecution, of scientific research and experimental development in Canada,

(II) an expenditure of a current nature directly attributable, as determined by regulation, to the prosecution, or to the provision of premises, facilities or equipment for the prosecution, of scientific research and experimental development in Canada, or

(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, and

(B) where a taxpayer has elected in prescribed form and in accordance with subsection (10) for a taxation year, expenditures incurred by the taxpayer in the year each of which is

(I) an expenditure of a current nature for, and all or substantially all of which was attributable to, the lease of premises, facilities or equipment for the prosecution of scientific research and experimental development in Canada, other than an expenditure in respect of general purpose office equipment or furniture,

(II) an expenditure in respect of the prosecution of scientific research and experimental development in Canada directly undertaken on behalf of the taxpayer,

(III) an expenditure described in subclause (A)(III), other than an expenditure in respect of general purpose office equipment or furniture,

(IV) that portion of an expenditure made in respect of an expense incurred in the year for salary or wages of an employee who is directly engaged in scientific research and experimental development in Canada that can reasonably be considered to relate to such work having regard to the time spent by the employee thereon, and, for this purpose, where that portion is all or substantially all of the expenditure, that portion shall be deemed to be the amount of the expenditure,

(V) the cost of materials consumed in the prosecution of scientific research and experimental development in Canada, or

(VI) …

248(1) In this *Act*

“scientific research and experimental development” means systematic investigation or search that is carried out in a field of science or technology by means of experiment or analysis and that is

> (a) basic research, namely, work undertaken for the advancement of scientific knowledge without a specific practical application in view,
>
> (b) applied research, namely, work undertaken for the advancement of scientific knowledge with a specific practical application in view, or
>
> (c) experimental development, namely, work undertaken for the purpose of achieving technological advancement for the purpose of creating new, or improving existing, materials, devices, products or processes, including incremental improvements thereto,
>
> and, in applying this definition in respect of a taxpayer, includes
>
> (d) work undertaken by or on behalf of the taxpayer with respect to engineering, design, operations research, mathematical analysis, computer programming, data collection, testing or psychological research, where the work is commensurate with the needs, and directly in support, of work described in paragraph *(a)*, *(b)*, or *(c)* that is undertaken in Canada by or on behalf of the taxpayer,
>
> but does not include work with respect to
>
> (e) market research or sales promotion,
>
> (f) quality control or routine testing of materials, devices, products or processes,
>
> (g) research in the social sciences or the humanities,
>
> (h) prospecting, exploring or drilling for, or producing, minerals, petroleum or natural gas,
>
> (i) the commercial production of a new or improved material, device or product or the commercial use of a new or improved process,
>
> (j) style changes, or
>
> (k) routine data collection;

Although not applicable directly, I will refer to the following regulation in my analysis.

Regulation 2900(2)

For the purposes of clause 37(8)*(a)*(i)(B) and subclause 37(8)*(a)*(ii)(A)(II) of the *Act*, the following expenditures are directly attributable to the prosecution of scientific research and experimental development:

> (a) the cost of materials consumed or transformed in such prosecution;
>
> (b) where an employee directly undertakes, supervises or supports such prosecution, the portion of the amount incurred for salary or wages of the employee that can reasonably be considered to be in respect of such prosecution; and
>
> (c) other expenditures, or those portions of other expenditures, that are directly related to such prosecution and that would not have been incurred if such prosecution had not occurred.

51 While a finding of any qualified expenditures with respect to SRED leads to the application of section 127 and the availability of tax credits, that legislation itself is not pertinent to the resolution of the issues argued before me and is therefore not reproduced.

Analysis

(A) For 1997 and 1998

(i) Was there a scientific or technological uncertainty in 1997 and 1998?

52 Mr. Coles, for the Appellants, argued that it was imperative to put the analysis in the context of what was going on in the fishing industry generally throughout the 1990s. Traditional stocks were low, and DFO was looking to develop what it considered underutilized species. According to the Appellants, everything about such species, and specifically silver hake, was unknown and therefore uncertain: where were the fish, how many were there, how should they be caught, how can they be handled once caught, what products can be marketed from frozen fish, what products could be marketed from fresh, and ultimately how could whole round fresh silver hake get to market? I was urged to consider the development of the fishery over the decade of the 1990s in addressing these uncertainties and, as will be discussed shortly, addressing the technological advancements made over that period.

53 I appreciate why the Appellants have taken this approach as it certainly highlights from 1990 to 2000 the remarkable strides taken by the Appellants in developing a silver hake fishery. Witnesses were unanimous in their praise of Mr. D'Eon for his achievements. Taking this approach renders it less critical to nail down exactly when the Appellants accomplished what, for whatever they accomplished occurred over that 10-year span. This strategy assists the Appellants because the evidence was not clear as to the timing of events and accomplishments. Indeed, both Mr. Sylvain D'Eon and Mr. Wesley D'Eon were not certain when specific SRED activities took place, nor indeed what constituted SRED. This is not a criticism, nor is it surprising. They are not scientists nor researchers as such. They simply believed they were in an exploratory stage of developing the silver hake fishery and, therefore, any activity must constitute SRED. I do not accept this global approach as the correct interpretation of how the *Act*, as interpreted by the Courts, has managed the determination of SRED. I believe it is necessary for the Appellants to have explicitly identified the scientific and technological uncertainties facing them in 1997 and 1998. It is not sufficient to rely on the premise that nothing was known about the fishery and, therefore, there were no techniques, procedures or data that could be used to determine if the fish could be caught and marketed. That may have been an acceptable general overview of the problem in 1990, but it is not an accurate assessment of the situation in 1997 and 1998—a great deal was known by then.

54 It is important to keep in mind that there is a scientific or technological uncertainty only if the resolution to the problem is not reasonably predictable using standard procedure or routine engineering. What then are the possible uncertain scientific or technological uncertainties facing the Appellants in 1997 and 1998?

55 By 1997, Canadian fishers were fishing over 4,000 tonnes of silver hake. They were not freezing the fish but were attempting to bring fresh fish to shore. Also by 1997, the Appellants were effectively out of the surimi and tempura products. While still producing some mince, they were intent on pursuing the marketing of whole round fresh fish. Any uncertainties, therefore, at this stage must have related to the landing of fresh silver hake and getting it to market. Further, issues of appropriate mesh and use of separator grates in the catching of the fish had already been determined. Notwithstanding the technical description as drafted by the Appellants (see paragraph 39), I find that there were only three possible scientific or technological uncertainties facing the Appellants in 1997 and 1998:

> (i) Could silver hake be stored on board as fresh fish without deterioration of quality?
>
> (ii) Were there sufficient silver hake in the LaHave and Emerald basins to support a year-round Canadian silver hake fishery?

(iii) Once on shore as fresh fish, could the silver hake be processed as whole round fresh fish to market without deterioration of quality?

56 With respect to the first possible uncertainty, the evidence suggests that the use of totes and a combination of ice and seawater resolved this problem. Mr. Coles extrapolated from the evidence that the totes were not developed for the silver hake fishery until 1997, but acknowledged that even if they were developed before then they were not utilized in the silver hake fishery until 1997 as only then was there a transition to a fresh fishery. I am not convinced on this point. Mr. D'Eon started paying Canadian fishers for fresh silver hake in 1995. Granted it was still at a time when surimi and tempura were being produced, but Mr. D'Eon believed fresh fish would enhance those products. Only later was it determined the optimal product would be whole round fresh silver hake. But the fishers, as early as 1995, were attempting to bring fresh silver hake to shore. Nobody's evidence was conclusive when totes were first used by the Canadian fishers, though use of totes was known in the fishing industry in the early 1990s. The only evidence as to the reason for their use with respect to silver hake was because someone (nobody was identified) suggested at some point (no time was identified) to Mr. Sylvain D'Eon that they might work. I am satisfied the totes were being used at sea in 1997 and most likely before then. Consequently the uncertainty, if any, was resolved by then.

57 Even if I found the totes were not used in the silver hake fishery until 1997, there are still two hurdles for the Appellants to overcome. First, it was not the Appellants themselves who were testing different methods of handling the silver hake at sea. It was the fishers who were doing this. There was no suggestion that the price paid for the silver hake was paid for the fishers to conduct research and development. That was simply the amount that Mr. D'Eon considered would sufficiently motivate the Canadian fishers to attempt to catch silver hake.

58 Second, I am not convinced that simply trying the use of totes at someone's suggestion is anything other than routine or standard practice. Reliance on totes that are already known in the fishing industry generally, but not specifically in connection with silver hake, strikes me as standard procedure that is reasonably predictable to solve the problem of fish being squished. This would not therefore constitute a scientific or technological uncertainty.

59 The second possible uncertainty is how many silver hake are there and where are they? The answers would enable the Appellants to reach a commercial decision as to the economic viability of a year-round silver hake fishery. The Respondent's position is that there is uncertainty in any fishery and the uncertainty is a business uncertainty, not a scientific or technological uncertainty. The Appellants claim that the expert's evidence support the view that it would take several seasons to properly address this uncertainty, and that even as late as 1997 and 1998, there was insufficient research to determine if silver hake stock could support a year-round Canadian fishery. While I agree that the resolution of the problem and the uncertainty would enable the Appellants to make a commercial decision, the uncertainty was a scientific one. Indeed the scientist, the Respondent's own expert, Mr. Showell, devoted considerable effort to addressing just this uncertainty in a manner that can only be described as scientific, notwithstanding the results achieved in the years 1995 to 1998 became less and less reliable, ultimately to the point that Mr. Showell himself could express no confidence in their accuracy of estimating the silver hake population. This however makes it no less scientific.

60 Was the resolution to the problem reasonably predictable using standard procedure or routine engineering? This is a more difficult issue to assess. There is no doubt scientists such as Mr. Showell and Dr. Winters have considerable experience and expertise in determining fish populations. Dr. Winters' report rattled off several examples of the type of research needed to yield a more accurate assessment. Could such activities be considered routine or standard in assessing fish populations? More pertinent was whether the Appellants activities in addressing this issue were standard or routine, and if so, was the resolution to the problem reasonably predictable based on such efforts.

61 According to Mr. Coles, the Appellants' efforts in addressing this uncertainty was to send Canadian fishers out at different times and to collect data. I see nothing extraordinary in these activities to suggest that this constitutes anything other than standard or routine practice, certainly from the fishers' perspective. That is what they do. The fact however that the Appellants, after instructions from Mr. Showell, started to keep data on the sex of the fish, once the fishers unloaded the fish at the Appellants' plant, suggest additional information-gathering beyond the normal data collection in the fishing industry. Yet, I can glean nothing from Mr. Showell's report to suggest that the sex of the fish was critical in the determination of the assessment of the population. Indeed, he did not seem to think it necessary to obtain such information in 1998 from the Appellants. Neither did Dr. Winters' suggestions of additional research specifically identify the assessing of the sex of the fish as critical in any population analysis.

62 Finding that the procedures were routine, was the resolution to the problem reasonably predictable? How “reasonably predictable” can an assessment of quantity and location of a fish stock be? It was clear from Mr. Showell's own reports, and Dr. Winters' analysis of them, that predictions are not always reliable. Yet in assessing fish stock population, accuracy cannot be the test in determining whether the resolution to the problem was reasonably predictable. What was reasonably predictable was that scientists relying on standard and routine procedures could make an estimate. The Appellants knew that based on the estimates, DFO would determine the TAC. That procedure was reasonably predictable. The result, regardless of the accuracy, was the best resolution of the problem achievable, and a TAC was set for silver hake in the years in question. Under these circumstances, I find the problem of fish population assessment was resolvable by standard or routine procedures. I therefore find there was no scientific uncertainty facing the Appellants in this regard.

63 The third possible uncertainty was the onshore handling of fresh fish to ensure whole round fish could get to market. Although the Appellants started bringing fresh, as opposed to frozen, silver hake to shore for processing in 1995, it was not until 1997 that most of the Appellants' efforts went to marketing the ultimate final product of the whole round fresh silver hake. Up to that point, the Appellants had been trying to improve processed products such as tempura or surimi with a fresh product, although it was noted some fresh whole round was sold in the last couple of months of fiscal 1996. By 1997, it was recognized the optimal product was the whole round fresh silver hake. Given the delicacy of the fish and the fact that it had not been successfully marketed fresh to that point, I find there was a technological uncertainty in this respect.

(ii) Did the Appellants formulate hypotheses specifically aimed at reducing this uncertainty by:

64

(a) observation of the subject matter;

(b) formulation of a clear objective;

(c) identification and articulation of the technological uncertainty;

(d) formulation of hypothesis;

(e) methodical and systematic testing of the hypothesis.

65 In 1997 and 1998, the Appellants continued to acquire fresh silver hake from Canadian fishers. Totes were on use on board fishing boats to ensure the fish arrived fresh and in good shape at the plant. The dilemma was how to then process the fresh fish to get a quality fresh product to the customer. The Appellants' objective was clear, as was the uncertainty. But what were the hypotheses aimed at reducing the uncertainty, and what was the methodical and systematic testing of those hypotheses? Or, as Mr. Smithers put it, what was occurring at a technical level? I find that, in connection with the handling of fresh silver hake on shore, nothing in the nature of testing any hypotheses was occurring. The fish were dumped on steel tables, sorted, iced, packaged and shipped. Not until 2000 or 2001 were any innovations introduced to this process. There is no evidence of any methodical or systematic testing of different methods of handling the fish in 1997 and 1998. The evidence is that in 1997 and 1998, the fish were simply processed by sorting, cleaning, packaging and shipping. This was not an experiment on how to handle fresh fish expediently before quality deteriorates. It was processing fresh fish for sale.

66 If I move to the next step in the analysis, this conclusion is solidified. Did procedures accord with established and objective principles of scientific method, characterized by trained and systematic observation, measurement and experiment? As Justice Bowman pointed out in *Northwest Hydraulic Consultants* :[10]

(a) It is important to recognize that although the above methodology describes the essential aspects of SRED, intuitive creativity and even genius may play a crucial role in the process for the purposes of the definition of SRED. These elements must however operate within the total discipline of the scientific method.

(Emphasis mine)

67 After working with the fish on steel tables for three years, someone suggests a conveyor belt might be more efficient—this may be the type of intuitive creativity to which Justice Bowman was alluding. However, it stretches my understanding of scientific method to conclude that such an idea, under such circumstances, arose within the total discipline of the scientific method described above. The work in connection with the onshore handling of fresh silver hake was not characterized by trained and systematic observation, measurement and experiment. It was plant workers sorting and packaging fish for shipping to customers.

68 Mr. Coles argued that because fresh silver hake had not been handled prior to the 1995 to 1998 period, nothing the Appellants did in connection with fresh silver hake was a known process; all efforts therefore constituted procedures in accordance with established and objective principles of scientific method. I do not accept this broad-brush approach. This is in no way to discount the valuable achievements accomplished by the Appellants; indeed, quite the opposite. They are to be commended for creating an industry where it was presumed no such industry was possible. But in 1997 and 1998, those efforts were not, in my view, SRED. In 1997 and 1998, the Appellants knew they could get fresh silver hake to the plant and they knew what to do with it once there. There was no suggestion from the D'Eons that dumping the fish on to stainless steel tables, sorting it and packaging it was not a known process. It may have been the first time silver hake was handled in this manner, but that has not convinced me the procedure was therefore not a known process. I conclude that for 1997 and 1998 the Appellants activities did not constitute SRED. It is therefore unnecessary for me to address the question of what expenditures in those years qualified for SRED.

(B) For 1995 and 1996

69 Blue Wave's claims for 1995 and 1996 raise the second element of a SRED inquiry—what expenditures qualify as having been spent on SRED, given the Respondent accepted some of Blue Wave's activities constituted SRED? The activities the Respondent determined constituted SRED were in connection with the development of the new products, surimi and tempura, not in connection with the development of the silver hake fishery as a whole. Mr. Coles, for the Appellants, suggested it did not matter whether I considered the SRED as limited to surimi-tempura development or to the broader project, as the primary expenditure at issue was the cost of the 0.15¢ per pound paid to Canadian fishers for silver hake, and that the whole cost should qualify, regardless of the definition of the SRED project. According to Mr. Coles, it should qualify because the Appellants had no choice but to take all the silver hake the Canadian fishers caught; and once landed as fresh silver hake, the Appellants could not dump it nor turn it into fish meal but they had to find some way to sell the excess. Mr. Coles described his client having to buy fish from the Canadian fishers at an economically disadvantaged rate so that he could develop a superior product. Any fish not put through the surimi process, which was the vast majority of fish, was still, according to Mr. Coles, a waste from the SRED process: it had all been consumed. Mr. Coles also put it in another way by suggesting the fish, not converted into tempura, not only is rendered valueless, but is rendered an economic loss to the Appellants, as the Appellants could only sell the fish not used in the tempura process at a loss. The fish, he maintains, are still a necessary input cost to the SRED of product development carried out by the Appellants.

70 The Respondent argues that the excess fish were not consumed in the prosecution of SRED. He relies on Mr. Harnish's comments that Mr. Wesley D'Eon advised him that 80% of the catch was sold before the fishers went out. Mr. D'Eon did not confirm this in his testimony. If the comment was made, it was made during Mr. Harnish's visit to the plant in 1999, and the comment pertained to 1999. This does not support a position that in 1995 and 1996, in the early stages of the Canadian fishers fishing the silver hake, such an arrangement existed. There was little evidence of what arrangement did exist between the Appellants and the Canadian fishers in 1995 and 1996. No fishers testified. It is known that catches fell short of the TAC for those years. It is known that the plant did not have sufficient capacity to process into surimi or tempura all the silver hake purchased from the Canadian fishers. It is known the excess was sold in a different form or placed frozen in inventory, although in the last couple of months of fiscal 1996, it appears that some fish were sold as whole fresh round.[11]

71 To find the costs of materials qualify, the materials must be consumed in the prosecution of the SRED; that is, in this situation, consumed in the prosecution of the surimi/tempura project, in accordance with subclause 37(8)*(a)*(B)(V). It is important to note here that the Appellants elected under clause 37(8)*(a)*(B) and are consequently governed by the application of the provisions therein. This precludes the operation of clause 37(8)*(a)*(ii)(A). This is significant as clause 37(8)*(a)*(ii)(A) references expenditures of a current nature as determined by regulation. *Regulation* 2900(2) identifies both “the cost of materials consumed” and “expenditures directly related to such prosecution and that would not have been incurred if such prosecution had not occurred”. This latter phrase does not form part of clause 37(8)*(a)*(ii)(B).

72 Associate Chief Justice Bowman had the following to say with respect to the term “consumed” in *Consoltex Inc. v. R.* :[12]

I think it would put a strained interpretation on the word “consumed” to say that the yarn that is turned into product that is sold was “consumed”. It is precisely because it was not consumed, but was sold, that the matter is before the court. The yarn is a material that is not consumed within the meaning of paragraph 2900(2)*(a)*. Does this exclude it from paragraph 2900(2)*(c)*, on the theory that paragraph *(a)* deals with materials and if the cost of materials is to be treated as an SR & ED expenditure it must fall within paragraph *(a)*? Such a conclusion in my view has no basis as a matter of statutory construction. The cost of yarn is directly related to the prosecution of SR & ED and would not have been incurred if such prosecution had not occurred.

73 Clearly, Associate Chief Justice Bowman decided this issue in *Consoltex* 's favour, not on the basis of materials having been consumed, but on the basis of the applicability of *Regulation* 2900(2)*(c)*; that is, that the cost of the yarn was an expenditure directly related to the prosecution of SRED that would not have been incurred if such prosecution had not occurred. Bowman A.C.J. attached a common-sense meaning to “consumed”.

74 Simply because the Appellants had to buy the whole catch from the Canadian fishers does not mean the fish were “consumed” or used up at that point. In fact, they were sold, or inventoried frozen and sold, albeit at a loss, but they were certainly not rendered valueless. The ordinary meaning of the words “consumed in the prosecution of SRED” leads to just one clear conclusion—only the fish that went through the prosecution of processing into surimi or tempura were consumed or used up in the prosecution of SRED. The fish that were otherwise sold or inventoried were not so consumed. They were not made waste by the process—they were excess to the capacity of the SRED process, but they retained a value.

75 Although *Regulation* 2900(2) does not apply in the situation before me, the Appellants suggested I could, in addressing the prosecution of SRED, look to this regulation for “general interpretation guidance”. Given this suggestion, given Mr. Coles' emphasis on the position that his clients had to buy all the fish, and given his reliance on *Consoltex* , I will address *Regulation* 2900(2) *(c),* which is not a matter of whether all the fish were “consumed” in the prosecution of SRED, but:

> (i) was the cost of the fish directly related to the prosecution of SRED? and
>
> (ii) would the costs for the fish have been incurred if such prosecution of SRED had not occurred?

76 Dealing with the second branch of the question first, I find that in 1995 the Appellants would not have bought fresh silver hake from Canadian fishers at 0.15¢ per pound if not for the ongoing development of their surimi/tempura product. That remained the focus of the Appellants' operation.

77 By the end of fiscal 1996, I find the Appellants had started to market whole round fresh silver hake. By 1997, that became their focus. So, for some period in 1996 the fish were being purchased both for ongoing experimentation with the production of surimi/tempura and also for moving to marketing of fresh whole fish. I find, therefore, that the vast majority, though not all, of the cost of the fish in 1996 would not have been incurred but for the SRED in connection with the surimi/tempura project.

78 Turning to the second aspect of the *Regulation* 2900(2)*(c)* requirements, amounts will only qualify as expenditures if they are "directly related to the prosecution" of the surimi/tempura SRED. Although the distinction may be considered a fine one, there is a distinction between materials consumed in the prosecution of SRED and expenditures directly related to the prosecution of SRED. I have found, on a ordinary meaning of "consumed", that not all the fish were consumed in the prosecution of SRED. Can materials not consumed in the prosecution of SRED still be *directly related* to the prosecution of SRED? This is exactly what Bowman A.C.J. found in *Consoltex* , though, in *Consoltex*, the materials were actually involved in the production process that constituted SRED. In the Appellants' case, the cost of the fish disallowed represents fish that did not go through the surimi/tempura process, but were otherwise sold or inventoried. Is the cost of such fish directly related to the development of the surimi/tempura product? Unlike in *Consoltex* , the material in this case is not used in the SRED. I would not find that it is directly related to the SRED.

79 Mr. Coles appears to be looking on the second part of the *Regulation* 2900(2)*(c)* as the whole test in determining what is consumed. That is just not how the *Regulation* reads, and, to borrow Associate Chief Justice Bowman's phrase, it would be a strained interpretation to read it so. The cost of the fish not used in the actual process of the development of surimi and tempura is not directly related to that process, but is directly related to the sale of product other than surimi/tempura. The fact that sale of excess fish, whether directly or from inventory, takes place at a loss does not transform the direct connection between such fish and that sale, into a direct connection between the fish and the surimi/tempura project. So, even looking at *Regulation* 2900(2) as some "guidance" in wrestling with "consumed", I find it has not helped the Appellants. I find the cost of fish in 1995 and 1996 over and above that already allowed by the Respondent does not constitute "qualified expenditure".

80 With respect to the cost of contractors in 1995 of $27,914, the evidence was that $19,708 related to renovations for surimi production, and $8,206 related to equipment such as fire extinguishers, tables and trays. There was no testimony as to whether the latter amount pertained to the surimi/tempura production process. I find such amount does not qualify.

81 Regarding the $19,708 for renovations, it does relate to the surimi/tempura SRED. CRA assessed it as capital expenditures on a leasehold interest, precluded for consideration as a qualified expenditure by subparagraph 37(8)*(d)*(i).[13] My reading of subparagraph 37(8)*(d)*(i) suggests that the cost precluded must pertain to the acquisition cost of a building or a leasehold interest therein. The little evidence presented on this point suggests that these were not acquisition costs of a leasehold interest in a building, but were capital expenditures on renovations to the leased building. I believe there is a distinction. For capital expenditures to qualify, it must be intended that they will be used during all or substantially all of their operating time in their expected useful life for the prosecution of SRED. The evidence suggests that these renovations were intended to be solely in connection with the surimi/tempura project and therefore I find they do qualify.

Conclusion

82 The Appellants were most certainly involved in the development of a Canadian silver hake industry, leading to what Mr. Coles called the "Holy Grail" of whole fresh silver hake to the customer. And, yes, there were over the years qualified expenditures on SRED, especially in the earlier stages of the development of the fishery. In 1995 and 1996, such SRED constituted the development of a process for producing surimi or tempura and the expenditures allowed by the Respondent were those attributable to the prosecution of such SRED. The excess fish purchased does not qualify.

83 By 1997, the Appellants knew a great deal about a silver hake fishery. I find that by then they knew:

> • how best to catch silver hake to reduce by-catch (by use of separator grates for example);
>
> • how best to keep silver hake on board to maintain freshness (by use of totes for example);
>
> • TAC was relatively stable.
>
> Apart from the onshore handling of fresh silver hake (which I have found was not subjected to any systematic testing), there remained no scientific or technological uncertainty which the Appellants were addressing in a manner that constituted SRED. They were contracting with fishers to catch fish they were attempting to market fresh. The process of the plant in dealing with such fresh fish was not extraordinary. There may well have been some commercial uncertainty, but I have not been satisfied such would be any different for anyone in the fishing industry.

84 I wish to address the Appellants' approach that if it is not “commercial”, it must be SRED. I heard the experts and other witnesses talk about “commercial”, “exploratory” and “development”. Reliance on the finding that DFO may not have labelled the fishery “commercial” does not render the Appellants' activities SRED. For purposes of the *Income Tax Act*, it is not a test of default. It is a test requiring the elements that I have already canvassed, and I therefore do not find it necessary to be drawn into an argument of labels.

85 Finally, a word about the Appellants' approach with respect to the Government's science advisor, Mr. Neil. Both he and Mr. Harnish were cross-examined at length; I have covered some of their testimony in the review of the facts. I have not been convinced by the Appellants that Mr. Neil's lack of business and fishery experience has resulted in an incorrect assessment. The Appellants may have had some justification for feeling their case was not given to the most appropriately qualified individual for this particular science audit. If the Appellants are of the view there has been some abuse of process, prior to commencement of this action, that is not a matter to be brought before this Court. This Court is interested in the correctness of the assessments.

86 In summary, I dismiss the appeals for 1996, 1997 and 1998. I allow the appeal for Blue Wave for 1995 and refer the matter back to the Minister for reassessment on the basis that the amount of $19,708 is a qualified expenditure on SRED.

87 Costs to the Respondent.

Order accordingly.

[1] See the requirements as set out by Associate Chief Justice Bowman in *Northwest Hydraulic Consultants Ltd. v. R.* (1998), 98 D.T.C. 1839 (T.C.C.) .

[2] Exhibit R-1, Book 3, Tab 439.

[3] Exhibit R-1, Tab 545, page 27.

[4] See Exhibit R-1, No. 443, the Silver Hake Canadianization Committee Final Report February 1994 to September 1995.

[5] Exhibit A-1, No. 5.

[6] All or substantially all.

[7] Exhibit R-1, Tab 591C.

[8] Exhibit A-5 page 27.

[9] Exhibit A-5, page 26.

[10] *supra*, at page 1841.

[11] See Exhibit R-1, Tab 140.

[12] (1997), 97 D.T.C. 724 (T.C.C.) at page 735.

[13] 37(8)*(d)* notwithstanding paragraph *(a)*, references to expenditures on or in respect of scientific research and experimental development shall not include

> (i) any capital expenditure made in respect of the acquisition of a building other than a prescribed special-purpose building, including a leasehold interest therein,