Cultures Laflamme (1984) Inc.
v. Canada (Minister of National Revenue - M.N.R.)

[**1992] T.C.J. No. 370**

93 D.T.C. 597

93 D.T.C. 603

Action No. 89-2514(IT)

Tax Court of Canada

Montreal, Quebec

Lamarre Proulx J.C.J.

Heard: March 13, 1992

Judgment: June 17, 1992

*TRANSLATED FROM FRENCH *

Paolo Carzoli, for the Appellant.

Daniel Marecki, for the Respondent.

LAMARRE PROULX T.C.J.:-- The appellant instituted an appeal from the assessment of respondent, the Minister of National Revenue (the "Minister"), for its 1986 taxation year.

The points in issue are (a) whether the sums received from the sale of a product during the scientific research and experimental developmental phase of that product must be deducted in the calculation of the amount of qualified expenditures of a current nature for the investment tax credit, and (b) whether all or substantially all capital expenditures are attributable to the prosecution of scientific research and experimental development.

Concerning the first point in issue, the provisions of the Income Tax Act (the "Act") of more particular application are paragraph 37(1)(a), subsections 127(5) and 127(9) for the definitions of "investment tax credit" and "qualified expenditure", and subsection 127(11.1) of the Act and section 2900 and subsection 2902(a) of the Income Tax Regulations (the "Regulations").

Concerning the second question, the same provisions are applicable, with the exception of paragraph 37(7)(a) of the Act and subsection 2902(a) of the Regulations. Paragraph 37(7)(b) of the Act and subsection 2902(b) of the Regulations apply to this question.

The appellant described the facts of this affair in its notice of appeal, as follows:

1. Les Cultures Laflamme (1984) Inc. is a company specializing in the production of oyster mushrooms.

2. During its fiscal year ended November 30, 1986, the company was involved in a scientific research and experimental development project.

3. Revenue Canada recognized that the company conducted scientific research and experimental development during its fiscal year ended November 30, 1986.

4. The company claimed a research and development investment tax credit of $55,710 for the year 1986.

5. Revenue Canada agreed that 80% of the current expenditures, that is $85,104, was related to research and development.

6. In its notice of assessment of September 16, 1988, Revenue Canada reduced the amount of research and development expenditures of $85,104 by the income from the sale of experimental production, that is $96,979.

7. The company filed a notice of objection dated December 9, 1988, claiming the investment tax credit of $55,710.

8. On August 29, 1989, the Appeals Branch ratified the notice of assessment for the year 1986.

The appellant's reasons are, in particular, the following:

(a) The purpose of section 37 of the Income Tax Act (hereinafter "the ITA") is to enable a taxpayer who carries on a business to deduct certain expenditures in respect of scientific research and experimental development which otherwise might not be deductible, either because they were not incurred for the purpose of gaining income within the meaning of paragraph 18(1)(a) ITA or because they are capital expenditures which would not be deductible under paragraph 18(1)(b) ITA.

(b) The deduction for scientific research and experimental development is calculated under subsection 37(1) ITA. There is nothing in this subsection or elsewhere in the Act or Regulations which requires scientific research and experimental development expenditures to be reduced by the income from the sale of experimental production.

(c) The scientific research and experimental development in which "Les Cultures Laflamme (1984) Inc." is involved consists in finding a process for achieving a constant and continuing production of oyster mushrooms. The sale of these mushrooms is one of experimental production, incidental to the research, and should not therefore reduce the amount of scientific research and experimental development expenditures for the purposes of computing the investment tax credit.

In his Reply to the Notice of Appeal, the respondent admitted paragraphs 1 to 8 of that Notice. On the subject of paragraph 5, he added:

> "...this percentage of 80% was that used by the appellant in its financial statements."

The respondent described the facts and reasons which led him to assess in the manner in which he did, as follows:

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(a) the appellant was incorporated on November 28, 1984 under Part 1A of the Quebec Companies Act, and its fiscal year ends on November 30 of each year;

(b) the appellant, inter alia, carries on a business of purchase and resale of mushrooms, the commercial production of oyster mushrooms, and 80% of its activities are oriented toward scientific research, that is the development of an experimental oyster mushroom production process;

(c) very briefly, the purpose of the process is to control and limit the spread of oyster mushroom spores; the appellant's technique for doing this consists in covering the inside of its building with metal slats; the technique also consists in covering logs of wood with perforated plastic bags, and mushrooms grow out of the logs at the places thus perforated;

(d) consequently, in conducting this scientific research, the appellant obtains a mushroom production, which it resells and which represents 80% of the appellant's total sales, which totalled $121,224 during its 1986 taxation year;

(e) since the income from the experimental production of oyster mushrooms is enough "to cover" the qualified expenditures of a current nature in respect of scientific research, there is no surplus of qualified expenditures to permit a calculation of the investment tax credit for scientific research, the whole as more amply calculated in Schedule 1, which forms an integral part of this paragraph;

(f) as regards the capital property or capital expenditures for the purpose of calculating the scientific research investment tax credit, the maximum amount to be considered does not exceed $34,777, but this amount does not enter into the calculations because, in 1986, the appellant did not incur any qualified capital expenditures since this property was not all or substantially all used or intended, for scientific research, but in fact was used for production;

13. The Minister of National Revenue submits:

A. With regard to the current expenditures of a current nature:

(i) the qualified expenditures of a current nature in the calculation of the investment tax credit in respect of scientific research must exceed the income from the sale of experimental products;

(ii) the purpose of the investment tax credit for scientific research is not to subsidize experimental research which manages to finance itself through the sale of the experimental production of goods;

B. With regard to the capital expenditures:

(i) besides the fact that they are too great for the purposes of calculating the investment tax credit in respect of scientific research, they are excluded from the calculation of that credit because they are not a qualified expenditure by reason of the fact that the facilities are not all or substantially all devoted and used during their useful life to scientific research;

From the start of the hearing, counsel for the appellant admitted the respondent's method of calculating the refundable investment tax credit within the meaning of the definition of that expression given in subsection 127.1(2) of the Act. Since there was agreement on this aspect, I here reproduce paragraph 7 of the Reply to the Notice of Appeal, as amended during the hearing, and which describes the calculation:

7. Consequently, even admitting that the appellant may be right, the investment tax credit should be computed as follows:

Calculation of possible refundable ITC $39,181.03 (34,312.25 + 4,868.78)

CURRENT EXPENDITURES Less Government assistance Labour	$100,271.00 $ 2,236.00 ----------
Total Refundable portion [100%] of ITC	$ 98,035.00 35%[1] ---------- $ 34,312.25

CAPITAL EXPENDITURES $ 85,622.00 Less

Expenditures already deducted in 1985 as current expenditures $ 19,125.00 ----------

(Note 1) Capital assets 1986 $ 66,497.00 Less

Government assistance received $ 26,720.00 and to be received 5,000.00 ---------- Capital balance $ 34,777.00 Refund rate 40% of 35%

Refundable ITC	$	4,868.78
Non-refundable ITC	$	7,304.00

Note 1: This same amount of $66,497 is the new amount capitalized by the Department in class 6.

THE FACTS

The description of the facts is of no importance since they were, on the whole, admitted. They were described in the above-mentioned Notice of Appeal. The only point to be noted concerning the evidence is that the president of the appellant stated that all the capital expenditures which the appellant claimed as qualified were incurred, substantially, in respect of the purposes of research for the industrial production of oyster mushrooms.

According to the witness of the respondent, the latter had excluded them from the calculation of qualified expenditures because the appellant had indicated that 80% of its current expenditures were incurred for research. The respondent therefore concluded that the same percentage should apply to the capital expenditures.

ANALYSIS

Concerning the first matter in dispute, counsel for the respondent pointed out to the Court, that, according to the respondent, the tax credit in respect of scientific research and experimental development is available only to those who cannot finance their own scientific research with proceeds of disposition. It is economic assistance intended to stimulate scientific research and experimental development, and this assistance must be granted only in cases where there is no income from that research. It was thus in order to comply with the object of the Act that the respondent deducted from the amount of qualified current expenditures the income from the sale of the products that arose from the research. However, counsel said, and I textually quote:

> "It is correct and in no way denied that nowhere in the Income Tax Act, in particular in these sections, will you find any mention that you must take income into account."

Counsel for the respondent raised two arguments, in what he said was in support of the respondent's position, concerning the object of the Act, but which appear to me rather additional arguments, that is one argument drawn from the theory of matching, which should apply in the context of the calculation of the tax credit in order to determine the amount of qualified current expenditures, and one argument drawn from the text of subsection 2900(h) of the Regulations.

For a better understanding of the debate on the question, I reproduce subparagraph 37(1)(a)(i) and paragraph 37(7)(b) of the Act:

> 37(1) Where a taxpayer files with his return of income under this Part for a taxation year a prescribed form containing prescribed information, carried on a business in Canada and made expenditures in respect of scientific research and experimental development in the year, there may be deducted in computing his income for the year the amount, if any, by which the aggregate of
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> (a) such amounts as may be claimed by the taxpayer not exceeding all expenditures of a current nature made in Canada by the taxpayer in the year or in any previous taxation year ending after 1973

(i) on scientific research and experimental development related to the business and directly undertaken by or on behalf of the taxpayer;

37(7)(b) "scientific research and experimental development" has the meaning given to that expression by regulation;

Section 37 is a provision of the Act which permits the deduction of expenditures incurred for research purposes in the calculation of income. Section 2900 of the Regulations determines the parameters to be set for such research.

While section 37 of the Act permits the deduction of these expenditures in the calculation of income, subsection 127(5) of the Act makes it possible to request an investment tax credit, a tax credit which, in certain circumstances, may be refundable under section 127.1 of the Act.

The respondent did not agree with the appellant concerning the calculation of the refundable investment tax credit. However, the dispute in fact concerns the calculation of the investment tax credit, since the calculation of the refundable investment tax credit depends first on the calculation of the investment tax credit.

"Investment tax credit" is defined in subsection 127(9) of the Act, which provides that, in the circumstances of the present appeal, the investment tax credit means a percentage of a qualified expenditure. "Qualified expenditure" is defined in the same subsection 127(9) of the Act and reads as follows:

...means an expenditure in respect of scientific research and experimental development made by a taxpayer after March 31, 1977 that qualifies as an expenditure described in paragraph 37(1)(a) or subparagraph 37(1)(b)(i), but does not include
(a) a prescribed expenditure, nor
(b) in the case of a taxpayer that is a corporation, an expenditure specified by the taxpayer for the purposes of clause 194(2)(a)(ii)(A);

The definition of qualified expenditure thus refers to the expenditures contemplated in paragraph 37(1)(a) of the Act. One must also examine subsection 127(11.1) of the Act, which concerns the application of the said definition of investment tax credit of subsection 127(9) of the Act:

(11.1) (...) For the purposes of the definition "investment tax credit" in subsection (9).

(c) the amount of a qualified expenditure made by a taxpayer shall be deemed to be the amount of the qualified expenditure, determined without reference to subsections 13(7.1) and (7.4), less the amount of any government assistance, non-government assistance or contract payment in respect of the expenditure that, at the time of the filing of the return of income for the taxation year in which the expenditure was made, the taxpayer has received, is entitled to receive or can reasonably be expected to receive;

It should be noted that the expression "contract payment in respect of the expenditure that the taxpayer has received, is entitled to receive or can receive", in the above paragraph is defined in subsection 127(9) of the Act and does not include the payments received for experimental products.

As mentioned above, counsel for the respondent argued first that income from scientific research must be taken into account in the calculation of qualified expenditures of a current nature for the purpose of the investment tax credit and that this is consistent with the object of the Act and in agreement with accounting principles.

The respondent did not contest the deductions made under section 37 of the Act, concerning either the expenditures of a current nature or the capital expenditures. Nor did the respondent question that the appellant had conducted scientific research and experimental development within the meaning of the Regulations.

The respondent's position was that, considering the income from production or scientific research, given that income exceeded current expenditures, there was no right to the investment tax credit.

As regards the theory of matching, counsel for the respondent referred to a number of decisions[2] indicating that accounting principles apply in the calculation of income in the absence of provisions of the Act to the contrary. This causes no difficulty, but none of the decisions submitted to me stated that the amounts from the sale of the products must, under the principle of matching, be deducted in the calculation of expenditures. As far as I know, there are two distinct headings, one entitled expenditures, the other receipts, and no passage was cited to me from an accounting textbook that confirmed the proposition of counsel for the respondent.

Counsel for the appellant referred, in this connection, to the article by Mr. Peter M. Farwell, C.A., entitled, "Scientific Research and Experimental Development",[3] more particularly to the following passage, at pages 7:20 and 7:21:

> On a related matter, Revenue Canada requires that any revenue earned from the sale of prototypes, pilot plants, or scrap be netted against SR & ED expenditures. There appears, however, to be no specific technical support for this position, since the Act does not require any such netting. Revenue Canada's reasoning seems to be that if a capital asset recovers more than 10 percent of its original cost, the asset was not used "all or substantially all" for SR & ED. This particular argument is, I suggest, weak; and given that there is no specific requirement in the Act to net such revenue against SR & ED expenditures, the taxpayer appears to be in a strong position should he choose not to do so.

He also referred to the article by Tom C. Routley, C.A., entitled, "Research and Development Tax Incentive Policy: A Call to Action",[4] at page 24:13:

> Qualifying R & D expenditures should not be reduced by the proceeds of sale of any prototypes, scrap material, or experimental "production". All R & D expenditures are incurred for the purpose of generating income. There is no justification for considering the proceeds of these sales as a reduction to the funds put at risk on R & D.

He also drew the Court's attention to the definitions of "expenditure" and "expense" in Black's Law Dictionary:

> Expenditure. Spending or payment of money; the act of expending, disbursing, or laying out of money; payment. ...
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> Expense. That which is expended, laid out or consumed. An outlay; charge; cost; price. The expenditure of money, time, labour, resources, and thought. ...
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> Business expense. One which is directly related to one's business as contrasted with personal expenses incurred for personal or family reasons. See Tax deduction, infra.
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> Current expense. Normal expense incurred, for example, in daily operations of a business. See Operating expenses, infra.

In relation to the remarks of the two accountants cited above, counsel for the respondent referred to those of Mr. Kenneth J. Murray:[5]

> Revenue Canada's position in this matter has not been sanctioned in law, but appears reasonable in the circumstances. The alternative for Revenue Canada would be to treat the activity of producing the product as commercial production (a prescribed activity) so as to disallow all the costs.

From a reading of the remarks by the accountants cited above, this proposition by counsel for the respondent that the deduction from qualified expenditures of a current nature of sums received from the sale of experimental products concords with the accounting principles of matching thus appears to me to be in no way supported by the accountants themselves. I therefore conclude that this proposition concerning matching has no foundation in the circumstances of the present appeal and must be dismissed.

As regards the argument that this administrative policy is consistent with the object of the Act, I must say that, even though it may appear reasonable, to borrow the expression of Mr. Murray cited above, it is not consistent with the object of the Act as expressed in the text of the Act itself. I believe that the text is manifestly clear and requires no interpretation. When Parliament wanted to exclude certain sums from the amount of qualified expenditures, it took the care to indicate so clearly, as it did in subsection 127(11.1) of the Act cited above.

Regarding the interpretation of a manifestly clear text, I wish to cite the remarks of author Pierre-André Côté, in his book the "Interpretation of legislation in Canada",[6] at pages 254 and 255:

> The emphasis placed on the letter of the law remains important, for the reasons already given: by insisting on manifest rather than real intention, the discretion of the judiciary is limited, and the citizen thereby protected from judgments that could not have been predicted by reading the legislation in its context. As for the purpose of the law, it contributes to a determination of the true meaning, and cannot be ignored without running the risk of seriously compromising the quality of the legal message. The letter of the law should be clarified by its context.

> At the end of the last century, François Gény expressed what is today called the "modern principle" of interpretation:
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> ... it is a fruitless exercise to oppose ... the grammatical interpretation to the logical one. It is all too clear that they necessarily complement each other, and that rational inferences applied with basic common sense will lead to a full comprehension of that intent whose expression, when analysed grammatically, can only represent its skeleton. Nor is it appropriate for the reader to choose childishly between the text and the spirit of the law. As the object of the exercise is to recreate the will of the legislator, the search for his intention must necessarily predominate: but the text intervenes as an authentic and solemn expression of the spirit of the law, a spirit which it serves to promote and from which it is inseparable.

The executive cannot add conditions which do not exist. It must respect a text which is manifestly clear because it is that manifestly clear text which expresses the object of the Act. I therefore conclude that the respondent's position with regard to the object of the Act is without foundation.

I now turn to the argument drawn from the text of subsection 2900(h) of the Regulations. This subsection reads as follows:

> For the purposes of this Part and paragraphs 39(7)(b) and 37.1(5)(e) of the Act, "scientific research and experimental development" means systematic investigation or search carried out in a field of science or technology by means of experiment or analysis, that is to say,
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> (a) basic research, namely, work undertaken for the advancement of scientific knowledge without a specific practical application in view,
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> (b) applied research, namely, work undertaken for the advancement of scientific knowledge with a specific practical application in view, or
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> (c) development, namely, use of the results of basic or applied research for the purpose of creating new, or improving existing, materials, devices, products or processes,
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> and, where such activities are undertaken directly in support of activities described in paragraph (a), (b) or (c), includes activities with respect to engineering or design, operations research, mathematical analysis or computer programming and psychological research, but does not include activities with respect to
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> (h) the commercial production of a new or improved material, device or product or the commercial use of a new or improved process; (my emphasis)

The argument drawn from this text by counsel for the respondent is that a person is in a commercial production phase if that person produces products which are sold. This is becoming very complicated. It seems to me quite clear that the respondent cannot say, on the one hand, that certain expenditures are related to the scientific research phase and, on the other hand, that those same expenditures are related to a commercial production phase.

Information Circular 86-4R2 clearly makes this distinction between the project phase and the commercial production phase in paragraph 4 of Appendix B.2, entitled, "Food and Beverage Application Paper":

> When new processes and products move from the status of experimental development to commercial scale production, it is sometimes difficult to determine when studies to resolve technological uncertainty have been completed. As stated in Part 7.7 of this circular, a project is complete when the technological objectives have been met. Ongoing commercial production is not included at this stage.

This argument is therefore not logical and cannot be considered.

I conclude that the sums received from the sale of experimental products do not have to be deducted for the purposes of calculating the amount of qualified expenditures within the meaning of subsection 127(5) of the Act.

Regarding capital expenditures, the relevant parts of paragraph 37(1)(b) and section 2902 of the Regulations read as follows:

> 37(1) Where a taxpayer files with his return of income under this Part for a taxation year a prescribed form containing prescribed information, carried on a business in Canada and made expenditures in respect of scientific research and experimental development in the year, there may be deducted in computing his income for the year the amount, if any, by which the aggregate of
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> ...
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> (b) such amount as may be claimed by the taxpayer not exceeding the lesser of
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> (i) the expenditures of a capital nature made in Canada (by acquiring property other than land) in the year and any previous year ending after 1958 on scientific research and experimental development relating to the business and directly undertaken by or on behalf of the taxpayer, and
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> (ii) the undepreciated capital cost to the taxpayer of the property so acquired as of the end of the taxation year (before making any deduction under this paragraph in computing the income of the taxpayer for the taxation year),...

Prescribed expenditures are defined in section 2902 of the Regulations. This section reads as follows:

> For the purposes of the definition "qualified expenditure" in subsection 127(9) of the Act, a prescribed expenditure is
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> (a) an expenditure of a current nature by a taxpayer in respect of
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> (i) the general administration or management of a business...
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> ...
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> (b) an expenditure of a capital nature incurred by a taxpayer in respect of
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> (i) the acquisition of property, except any such expenditure that was incurred for and was all or substantially all attributable to the prosecution, or to the provision of premises, facilities or equipment for the prosecution, of scientific research and experimental development.

The respondent excluded the expenditures of a capital nature from the calculation of qualified expenditures because the appellant had indicated that 80% of its expenditures of a current nature were incurred in respect of research and had concluded that the same proportion should apply to the expenditures of a capital nature. Since, for the purposes of the investment credit, as required by subsection 2902(b) of the Regulations, these expenditures are qualified in that they are all or substantially all attributable to the prosecution of a scientific research, the respondent excluded them. According to the evidence, however, the expenditures of a capital nature which the appellant claimed as qualified were all incurred for the purposes of the research laboratory. There was no evidence against the statement by the president of the appellant, nor was any doubt cast on it. The percentage established by the respondent on the same basis as the expenditures of a current nature is therefore not based on the facts and cannot be considered as valid.

Consequently, the appeal is allowed, with costs.

1 The percentages of 100% and 40% appear in subsection 127.1(2) of the Act in the definition of "refundable income tax credit". That of 35% appears in subsection 127(10.1) of the Act.

2 These decisions are: Cormie Ranch Ltd. v. M.N.R, 71 D.T.C., 464; Bank of Nova Scotia v. The Queen, F.C.T.D. [1980] 57; The Queen v. Metropolitan Properties Co., F.C.T.D. [1985], 169; West Kootenay Power and Light Co. v. Canada, F.C.T.D. [1991], 327.

3 Corporate Tax Management Conference, Canadian Tax Foundation, 1987.

4 Conference Reports, Canadian Tax Foundation, 1986.

5 Corporate Tax Management Conference 1988, page 6:9.

6 Second edition, Les Éditions Yvon Blais Inc., 1992.