Hun-Medipharma Research Inc. v. The Queen

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Judges and Taxing Officers:	Louise Lamarre Proulx
Subjects:	Income Tax Act

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Docket: 97-2305-IT-I

BETWEEN:

HUN-MEDIPHARMA RESEARCH INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on January 12, 1999 at Montréal, Quebec, by the Honourable Judge Louise Lamarre Proulx

Reasons for judgment

Lamarre Proulx, J.T.C.C.

[1] This appeal concerns scientific research and experimental development expenses ("R & D expenses") claimed by the Appellant for the taxation year 1994.

[2] The assumptions of fact made by the Minister of National Revenue (the "Minister") in disallowing part of the claimed R & D expenses are described at paragraphs 1 and 3 of the Reply to the Notice of Appeal (the "Reply"):

1. Except as otherwise specifically admitted, he denies any allegations of facts and conclusions of law contained in the Notice of Appeal, except as hereinafter set forth.

...

3. In so assessing the Appellant, the Minister made the following assumptions of fact:

a) for the taxation year 1994, the Appellant claimed only salaries as SR & ED expenditures and qualified expenditures for ITC;

b) after evaluation of the projects for which the Appellant claimed SR & ED and ITC, our scientist came to the conclusion that part of the projects were not qualified as SR & ED projects;

c) consequently, for the taxation year in litigation, the Minister refused the following amount as SR & ED expenditures:

Current Expenditures

Wages and Salaries refused $ 8 357

Less consequently adjusted

Quebec Tax Credit ($ 3 343)

Total SR & ED Expenditures refused $ 5 014

d) for the taxation year in litigation, the Minister also refused the following amount as qualified expenditures for ITC and reduced the allowable Appellant's ITC consequently:

SR & ED Expenditures refused $ 8 357

Consequently prescribed

proxy amount refused $ 151

Less consequently adjusted

Quebec Tax Credit ($ 3 343)

Expenditures not qualified for ITC $ 5 165

Reduction in ITC allowable:

$ 5 165 x 35% = $ 1 808

[3] In my view, it is doubtful that the Reply conforms with paragraph 6(1) of the *Tax Court of Canada Rules (Informal Procedure)*. It is not possible from its reading to determine the findings or assumptions of fact made by the Minister when making the assessment. It is not sufficient to say only that the scientist advisor to the Minister refused the Appellant's claim.

[4] It appears that the Appellant itself had changed its views as to the exact nature of the work done from the time of the presentation of its claim (Form T661) to the time of the claim's review at the appeal division. This is no reason for the Respondent not to describe the facts in detail as the Minister understood them at the time of the assessment and at the time of the ratification.

[5] The Appellant's Notice of Appeal, among other things, stated the following:

For Project 1/b – Anti-stress Tablet (for human use)

In contrary to the Scientific Reviewer's Report we did not claim expenditures (as eligible R & D activity) for

- preparation of a DIN Application to Health Canada

· for administration or

· for meeting people for business purposes

But we claimed manpower expenses as eligible activity for R & D for the scientific and medical **analysis and conclusion of** available published and from the originator non published **technical, preclinical, and clinical data**, in order to

1. identify the first medical-clinical indication, suitable and feasible for registration and later for medical marketing purposes in Canada and the USA and

2. from the drawn conclusions in taxation year 1994 to allow a logical conceptual work and systematic program design for the technical and clinical program in the future necessary for registration and for medical marketing in Canada and the USA.

...

Project 2: Medical Skin Care Products (for human use)

As the Scientific Reviewer Dr. A. Michaelidou was informed personally during the review meeting that the Microsomes Formulations of the 4 medical skin care products were designed first in Canada, based on the project leader's (Dr. A.T.A. Fazekas) R & D activities, own experience, knowledge and contacts in pharmaceuticals and dermatologicals.

DIN is the drug identification number which is obtained from the Health Protection Branch ("HPB") of Health Canada.

[6] Evidence was adduced by the president of the Appellant, Mr. Attila T.A. Fazekas, and by an expert witness on behalf of the Respondent, Ms. Aliki Michaelidou Dansereau.

[7] The Appellant's claim (Form T661) for R & D expenditures carried on in Canada was introduced as Exhibit R-3. Respecting Project No. 1/b, the following were the objectives:

1.2. Objectives

The ultimate goal of the total project is to establish pharmaceutical formulations and final product/s for human use which are clinically effective and safe in increasing stress tolerance and/or stress management and in preventing and/or managing stress-related disorders in humans, such as nervousness, anxiety, fatigue, loss of concentration, sleeping disorders, constipation, digestive problems, male and female sexual dysfunctions, etc.

After stage 1 (finding the principal medically active ingredient), and stage 2 (pharmaceutical product development), the objectives of this reporting year was to prepare and to submit a drug submission to the Canadian Health Protection Branch.

Under the heading "Progress to date", it is stated as follows:

3.0. PROGRESS TO DATE

After formulation development appropriate products were found, product samples were produced in earlier years.

A drug submission was prepared and submitted to the Canadian Health Protection Branch for approval in this reporting year.

[8] An eligibility report was completed by Ms. Aliki Michaelidou Dansereau, the scientist advisor on behalf of Revenue Canada. With respect to Project 1/b, the report stated:

Project evaluation

Project 1/b Anti-stress medication (human use)

In project 1/b the only activity claimed in the fiscal year 1994 was the preparation of a drug submission which, during the visit was identified as a DIN application submitted on the 11 of February 1994, received by HPB on the 23. However, in the log book of the company 13 to 14 day activities are claimed and they include file evolution which, according to Dr. Fazekas, involves the review of published and unpublished data pertaining to the substance to be claimed for R & D purposes, clinical indication search, first clinical indication identification and administration which includes secretarial work, meeting with people for business purposes etc. In my opinion, because there has been no other activity but the DIN application which alone is not an eligible activity, the project is not eligible for the requirements of the *Income Tax Act*.

[9] Ms. Michaelidou Dansereau stated that she rejected the Appellant's project for the Anti-Stress Tablet because it consisted only of a review of the literature on a certain subject in the preparation for a DIN application to HPB. Also, there were no clinical trials conducted. She made the same comments with respect to the project on skin care, although she stated that there was conceptual work done on the project. She also advised that she did not doubt the Appellant's credentials.

[10] Mr. Fazekas explained that the data had been gathered in Germany for the use of a drug used for a certain purpose. The Appellant's purpose was different and that the analysis was for that purpose. Mr. Fazekas produced many documents to evidence the fact that the analysis was systematic.

[11] In the first application, the Appellant claimed that all of the expenditures for Project 1/b were in relation to the preparation for the DIN application. However, at the review level by Revenue Canada and at the hearing of this appeal, the Appellant held that in fact, no expenditures were claimed for that work. If it had said so in the first place, it is that it thought that the project should be completed, otherwise it would not be a proper R & D project. Mr. Fazekas stated that the work completed was for the analysis of data for the advancement of medical sciences. He also added that contrary to what had been stated by the scientist advisor in her report, there were experimental activities that followed the analysis.

[12] Paragraph 2900(1) of the *Income Tax Regulations* (the "*Regulations*") reads as follows:

(1) For the purposes of this Part and paragraphs 37(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,

(*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*) 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,

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

(*d*) market research or sales promotion;

(*e*) quality control or routine testing of materials, devices or products;

(*f*) research in the social sciences or the humanities;

(*g*) prospecting, exploring or drilling for or producing minerals, petroleum or natural gas;

(*h*) the commercial production of a new or improved material, device or product or the commercial use of a new or improved process;

(*i*) style changes; or

(*j*) routine data collection.

[13] The Appellant submitted that the above regulation does not require the scientific research and experimental development to be carried out by experiment made by the claimant and may be carried out by analysis. Mr. Fazekas believed that it was systematic investigation carried out in the field of science or technology by means of analysis. It was an applied research, namely work undertaken for the advancement of scientific knowledge with a specific practical application in view. He referred to the Information Circular 86-4R3 and which reads, in particular at paragraph 5.1:

5.1. For activities associated with collecting or monitoring data to qualify, the data must be collected directly for the purpose of resolving a scientific or technological uncertainty associated with an eligible activity. Often, the analysis of large collections of survey data can be used to resolve a technological uncertainty, even if the data are not specifically or directly collected for the needs of the eligible scientific research or experimental development activity. In these cases, only the activities associated with analyzing the data would be eligible, not the actual data collection. For the activities to be eligible, a systematic approach to collecting (study design) must be followed which provides only the amount of data needed for the specific scientific or technological uncertainty being studied. In other words, systematic study design will be focussed on providing the amount of information appropriate to resolving the issue. Specifically, the dimensions or size of data collections, for which the collection costs qualify, should agree with the requirements that can be determined from well-established statistical considerations for developing good experimental designs.

[14] Counsel for the Respondent referred to the decision of Judge Sarchuk of this Court, in *Sass Manufacturing Limited v. M.N.R.*, 88 DTC 1363, where he stated at page 1371:

The evidence falls far short of establishing the existence of any systematic investigation or search carried out in a field of technology by means of experiment or analysis. In my view Regulation 2900 requires an appellant to adduce cogent evidence of such investigation or search. Systematic investigation connotes the existence of controlled experiments and of highly accurate measurements and involves the testing of one's theories against empirical evidence. Scientific research must mean the enterprise of explaining and predicting and the gaining knowledge of whatever the subject matter of the hypothesis is. This surely would include repeatable experiments in which the steps, the various changes made and the results are carefully noted. ...

Counsel for the Respondent was of the opinion that a systematic investigation would certainly require some form of clinical experiments. He also stated that there were no such experiments completed by the Appellant during the relevant period.

[15] The hearing of this appeal would have been more purposeful had the assumptions of fact been well defined in the Reply to the Notice of Appeal as to what was at issue: (i) the technological or scientific uncertainty; (ii) the investigatory means and its value; (iii) or other pertinent points as to why the R & D expenses were disallowed.

[16] I am of the view that the R & D expenses claimed by the Appellant appear, on a balance of probability, to be within the meaning of paragraph 2900(1) of the *Regulations*. They were incurred for the systematic investigation carried out in the field of science by means of analysis for the advancement of scientific knowledge with a specific practical application in view. The Respondent relied on the fact that the Appellant did not conduct clinical experiments. It does not appear that paragraph 5.1 of the Information Circular 86-4R3 makes such a requirement. Above all, my interpretation is that the text itself of paragraph 2900(1) of the *Regulations* does not require that the systematic investigation be made by both experiment and analysis. It can be made by experiment or analysis, provided it is in fact a systematic investigation.

[17] The appeal is allowed without costs.

Signed at Ottawa, Ontario, this 22nd day of January, 1999.

"Louise Lamarre Proulx"

J.T.C.C.