Federal Court of Appeal Decisions

Case name: CW Agencies Inc. v. Canada
Date: 2001-12-11
Neutral citation: 2001 FCA 393
File numbers: A-601-00

Date: 20011213

Docket: A-601-00

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CORAM: STONE J.A.

EVANS J.A.

SEXTON J.A.

BETWEEN:

C.W. AGENCIES INC.

Appellant

- and -

HER MAJESTY THE QUEEN

Respondent

Heard at Toronto, Ontario, Tuesday, December 11, 2001

Judgment delivered from the Bench at Toronto, Ontario,

on Tuesday, December 11, 2001

REASONS FOR JUDGMENT OF THE COURT BY: SEXTON J.A.

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REASONS FOR JUDGMENT OF THE COURT

(Delivered from the Bench at Toronto, Ontario

on Tuesday, December 11, 2001)

SEXTON J.A.

[1] This is an appeal from the decision of Judge Bonner of the Tax Court of Canada in which he dismissed the Appellant's appeal from the assessments of income tax for the years 1991-95 in which assessments the Minister of National Revenue had disallowed claims made by the Appellant that it had incurred current and capital expenditures on Scientific Research and Experimental Development ("SRED") in those years.

[2] At the relevant times the Appellant carried on the business of marketing tickets in government sponsored lotteries to customers in many parts of the world. The Appellant's marketing activities were conducted by telephone and computer in a number of languages.

[3] The Appellant had two to three millions customers and received as many as 25,000 purchase orders in a day which were recorded in the Appellant's computer system. The computer system was required to cope with orders which were received and, in addition, such things as the method of payment, confirmation of payment to the client, informing the client of the details of the lottery tickets purchased, communication of the winning lottery numbers to Appellant's clients, and searching of the Appellant's database to identify and arrange for payments to clients who had won.

[4] The needs of the Appellant's business were such that it was not possible to buy ready made software capable of addressing the Appellant's requirements of its computer system. Therefore, the Appellant set about to develop its own software in-house. The business objectives for the new system imposed the following system requirements: flexibility, scalability, instant response time, accuracy and reliability.

[5] The Appellant was successful in developing this customized computer application software, referred to as the International Distributed Lottery System ("IDLS").

[6] The Appellant claimed for the cost of the developers and consultants directly involved in this development process, arguing that the development of the IDLS by the Appellant constituted scientific research as defined in Regulation 2900 of the *Income Tax Act of Canada*.

[7] The Tax Court Judge found that the software developed by the Appellant did not constitute scientific research and experimental development within the meaning of Regulation 2900.

Legislation

[8] **2900. (1)** For the purposes of this Part and sections 37 and 37.1 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,

(c) experimental development, namely, work undertaken for the purposes of achieving technological advancement for the purposes of creating new, or improving existing, materials, devices, products or processes, including incremental improvements thereto, or

(d) work with respect to engineering, design, operations research, mathematical analysis, computer programming, data collection, testing and psychological research where that work is commensurate with the needs, and directly in support, of the work described in paragraph (a), (b) or (c), but does no include work with respect to

.....

(f) quality control or routine testing of materials, devices, products or processes,

.....

(k) routine data collection."

[9] The Appellant argued that the Trial Judge improperly relied on a test articulated by the expert witness produced by the Respondent and that, in any event, the evidence of that witness should not have been preferred over the evidence of the Appellant's expert.

[10] It should be noted that the Appellant did not retain documentation which might have assisted it in discharging its onus to disprove the Minister's assumptions, nor did the Appellant choose to call as a witness any person directly and personally involved in the development process. Rather, the Appellant called an expert who similarly was handicapped by the lack of reliable documentation. This expert was compelled, by the absence of a detailed project management plan, to examine the results of the Appellant's work and to arrive at conclusions regarding the problems which he thought must have been faced by the Appellant and the steps taken to solve those problems.

[11] The Tax Court Judge noted that the failure to call the project manager or some similarly placed person was never explained by the Appellant. It is certainly arguable that an inference could be drawn that calling of such evidence would not have been helpful to the Appellant.

[12] In these circumstances the Tax Court Judge had no alternative but to consider the expert evidence tendered by the Appellant and balance it against the expert evidence called by the Respondent.

[13] The Tax Court Judge made an extensive review of the evidence involved in the development process and also made an exhaustive review of the evidence of both of the experts. He preferred the evidence of the expert for the Respondent and gave detailed reasons for doing so. We are unable to conclude that the Tax Court Judge erred in this conclusion.

[14] The Appellant argued that the Crown expert improperly relied upon the business purpose for undertaking the development. However, the Tax Court Judge found that the Crown expert's conclusion did not rest on any such faulty premise. He said:

When his evidence is taken in context it is clear that Doctor Takagaki evaluated the Appellant's activity with a view to determining whether it was undertaken for the purpose of achieving technological advancement. He was not distracted by the Appellant's overriding commercial goal.

In any event, the Judge expressly rejected the notion that one can exclude from the application of Regulation 2900 all activity undertaken with a business purpose in view.

[15] The Tax Court Judge also concluded as a factual matter that the Crown's expert had not erred in making a qualitative decision based on how much technical advancement was required for the work in order to qualify under Regulation 2900.

[16] It was the prerogative of the Tax Court Judge to prefer one witness over another. We see no basis for overturning his conclusion.

[17] Both sides in front of us relied on the test outlined in *Northwest Hydraulic Consultants Limited* v. *Her Majesty the Queen*, [1998] D.T.C. 1839. In that case, Judge Bowman of the Tax Court outlined five criteria which are useful in determining whether a particular activity constitutes SRED. Those criteria have been approved by this Court in *RIS-Christie* v. *Her Majesty the Queen*, [1999] D.T.C. 5087 at page 5089. The criteria are as follows:

1. Was there a technological risk or uncertainty which could not be removed by routine engineering or standard procedures?

2. Did the person claiming to be doing SRED formulate hypotheses specifically aimed at reducing or eliminating that technological uncertainty?

3. Did the procedure adopted accord with the total discipline of the scientific method including the formulation testing and modification of hypotheses?

4. Did the process result in a technological advancement?

5. Was a detailed record of the hypotheses tested, and results kept as the work progressed?

[18] The Tax Court Judge made reference to these criteria and in our view was appropriately mindful of them in reaching his conclusions. Counsel for the Appellant emphasized the failure of the Tax Court Judge to refer in his Reasons to the existence of an uncertainty in the system which the Appellant solved when it produced the IDLS, and whether this software constituted a technological advance. In our opinion the Crown's expert specifically addressed these issues when he testified that there were no uncertainty that could not be resolved by the application of standard practices or routine engineering, and hence the software could not constitute a technological advancement. It was open to the Tax Court Judge to rely upon this evidence to support the conclusion that the Appellant's activities did not constitute SRED.

[19] In our view, there is no basis for concluding that the Tax Court Judge did not have regard to all of the evidence and its credibility in determining whether the work claimed as SRED met the test prescribed by Regulation 2900 as set forth in the jurisprudence.

[20] This appeal will therefore be dismissed with costs.

"J. E. Sexton"

J.A.

FEDERAL COURT OF CANADA

Names of Counsel and Solicitors of Record

DOCKET: A-601-00

STYLE OF CAUSE: C.W. AGENCIES INC.

Appellant

- and -

HER MAJESTY THE QUEEN

Respondent

DATE OF HEARING: TUESDAY, DECEMBER 11, 2001

PLACE OF HEARING: TORONTO, ONTARIO

REASONS FOR JUDGMENT

OF THE COURT BY: SEXTON J.A.

DELIVERED FROM THE BENCH AT TORONTO, ONTARIO ON TUESDAY,

DECEMBER 11, 2001.

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FEDERAL COURT OF APPEAL

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