Tax Court of Canada

Tigney Technology Incorporated, Appellant and Her Majesty the Queen, Respondent

Bell T.C.J.

Judgment: January 9, 1997
Docket: 95-2794(IT)G

Counsel: *Priscilla E.J. Kennedy*, for the Appellant.
Michael Curley, for the Respondent.

Judgment

1 The appeal for the Appellant's 1993 taxation year is allowed to the extent that the amounts of **$178,019, $62,411** and **$42,223** described in the attached Reasons for Judgment, are expenditures of a current nature made by the Appellant in that taxation year on scientific research and experimental development carried on in Canada by it and related to its business carried on in Canada.

2 The appeal for the 1994 taxation year is dismissed.

3 The Appellant is entitled to no further relief.

4 No costs are awarded.

5 This is an appeal of the Appellant's 1993 and 1994 taxation years[1]. Counsel for the parties had come to some agreement since the filing of pleadings and the pleadings did not, therefore, describe accurately the issues before the Court. Neither counsel was able, at the commencement of the hearing, to define clearly the issues and relevant amounts of tax. An extraordinary amount of the Court's time was spent in eliciting agreement from the parties on the issues and amounts involved. Accordingly, no definitive and useful opening statement was made by either counsel. At that time, reference to and provision of copies of, the legislation relevant to each issue in order to explain same were not produced. In result, the Court devoted much time and effort, both at the hearing and in preparation of these Reasons, to tasks that should have been performed by counsel before commencement.

6 I shall state as clearly as possible what I understand to be the parties' agreement as to the issues and the amounts involved. They are:

(1) **Did the amount of $178,019, agreed by the parties to be "scientific research and experimental development" expenditure ("SRED") described on a schedule furnished to the Court as "PILOT PLANT IN CANADA", qualify for investment tax credit ("ITC") under section 127 of the *Act*? The Respondent submits that this SRED was carried on *outside* Canada and, accordingly, was not so qualified.**

(2) Did the sum of $62,411, agreed by the parties to be SRED and described in that schedule as “PILOT PLANT IN U.S.”, qualify for ITC under section 127 of the *Act*? The Respondent submits that this SRED was carried on *outside* Canada and, accordingly, was not so qualified.

(3) Did the amount of $42,223 described as “Wages U.S.”, agreed by the parties to be SRED, qualify for ITC under section 127 of the *Act*? The Respondent submits that this sum was paid to employees while research was being done in the U.S.A. and, accordingly, did not so qualify.

(4) Was the amount of $175,628 included in the Appellant’s management fee revenue for 1993 and charged to the Appellant by its subsidiary corporation, Tigney Research Incorporated (”Research”):

(a) SRED,

(b) reasonable in the circumstances,

(c) allocable for ITC purposes in accordance with the proportion of expenditures in Canada and outside Canada?

(5) Was the amount of $32,733.94 included in the Appellant’s management fee revenue for 1994 and charged to the Appellant by its subsidiary corporation, Research

(a) SRED,

(b) reasonable in the circumstances?

No allocation question exists here.

Facts:

7 Edward Albert DeLong (”DeLong”) described himself as “self-employed” and as President and major shareholder of the Appellant. He described the Appellant as being in the business of doing research “and hopefully commercializing the results from that research.” He said that the results of that research and the focus of it was to separate the components of plant materials such as trees and straw while preserving same. He said that Research, a subsidiary of the Appellant, was set up to do all the research and to account for all research done on behalf of the Appellant. He said that

> It’s an in-out company. It spends $100 and it’s reimbursed $100 by Tigney Technology, but it does solely research.

8 DeLong described his professional history including involvement in scientific research while in the Air Force from 1954 to 1959 and then doing scientific research for Computing Devices of Canada until 1975. This involved contract work for the U.S. Navy regarding the detection and recognition of ocean traffic. In 1975 he received a contract from Agriculture Canada to do research seeking accessibility to carbohydrates in straw and

in wood without creating toxicity. This involved putting the material in a reactor/pressure vessel, raising the temperature and thereby processing it. The first reactor was purchased. A second reactor was designed and installed in Edmonton having had significant changes from the initial reactor. DeLong then described further processes in respect of which eight patents were issued in Canada and six in other countries throughout Europe, Scandinavia and the United States, such patents having been obtained by the Appellant.

9 In late 1990, the Appellant was contacted by Dr. Curt Enzell (”Enzell”), an official of Swedish Tobacco. He had heard about the Appellant's research. He was trying to produce a safer cigarette necessitating the extraction of certain chemicals from tobacco. The Appellant performed experiments in Edmonton upon material sent from Sweden. These experiments were performed on dry tobacco. DeLong testified that to extract the pharmaceuticals that Enzell wanted required that the tobacco plant be harvested and processed within two hours. He stated that the harvesting of varieties of tobacco by Swedish Tobacco was done before it matured and that none of this was done in Canada. He then said that the Appellant was "scaling up" the processing equipment from 1.4 cubic feet to 13 cubic feet for the third reactor it had designed. DeLong also described the objective of introducing a gene into a virus that only attacks tobacco and grows a pharmaceutical with a value of $30,000 an ounce, such component being used in the production of drugs. In summary he said that this production of pharmaceuticals and the extraction of chemicals which caused the mutation of healthy cells in cancer were the objectives of the research.

10 DeLong described the process of completing the design of the new reactor, engaging the services of a Canadian "genius in mechanical things" and enlisting the aid of the University of Alberta Mechanical Engineering Department. He intimated that it should be tested with steam but could only be tested with water in Alberta. He then said that the entire facility was moved to Kentucky and assembled there. DeLong went on to describe the functioning of this reactor and the transportation of materials extracted from it. The only aspects of that process relevant to this appeal were the failure of the relevant persons in Kentucky to make steam available, to furnish air for actuating the valves and to furnish electricity. None of these were provided until November, about four months after the assembly of the plant in Kentucky. DeLong testified that 33 or 34 sets of experiments were conducted in November, 1992 on tobacco which was, as indicated above, processed within two hours of harvesting. DeLong then stated that after these experiments, everyone returned to Edmonton, the last person being in Edmonton on or before December 17 of that year. He said that they continued to work with the software in anticipation of returning to Kentucky, all new designs being conducted in Edmonton and all analyses of the results of experiments being conducted in Edmonton. In fact, no one returned to Kentucky.

11 DeLong testified that he had worked in 1992 between 280 hours and 330 hours over a six month period and that had he been paid an hourly rate for same it would have been $100 per hour. He said that the Appellant paid him salary of $32,000 in its 1993 taxation year. He stated that the Appellant never employed a scientist to do what he did and now does. He said that all of his services were included in the management fee charged by the Appellant to Research. The following exchange between Appellant's counsel and Appellant illuminates the arrangement:

Q. And are any of the research coordination or research management services that you provide to Tigney Technology included in that management fee?

A. Yes, they are all included in the management fee.

In this regard, the Appellant's financial statement for its 1993 taxation year shows Management Fee Revenue of $199,289.50. Its net income of $839,322.67 was reduced by "Contract Research Fees", charged by Research to the Appellant, of $784,884.72 leaving a net income of $54,437.95. The revenue statements of Research for that period showed no revenue and total operating expenses of $784,884.72, including $199,289.50, for management fee. It was agreed by counsel for both parties that the maximum fee allowable would be $175,628. and not the sum of $199,289.50 aforesaid.[2] The management fee in issue for the 1994 taxation year was $32,733.94.

12 On cross-examination, Respondent's counsel examined DeLong respecting amounts received by the Appellant for construction and supply of the refinery, et cetera. Ultimately, the Appellant and the Swedish company ended their relationship and the reactor was dedicated to the use of some benevolent society for appropriate purposes.

13 The following exchange between Respondent's counsel and DeLong sheds some light on the management fee arrangement:

Q. Okay. Now, the next paragraph[3] says,

> TTI will pay all of TRI's costs.

That's in keeping with what you've said earlier, that Tigney Research was an in and out company. In other words, all of their costs would be charged to Technology, Tigney Technology.

A. That's correct.

Q. And then in the last paragraph that's highlighted with a circle, it says

> TTI will charge a management fee equal to 30 per cent of TRI's total costs.

A. That's correct.

Q. So essentially what you have here, sir, is that for instance if there's $100,000.00 of expenditures in Tigney Research, then Tigney Technology will charge them $30,000.00 and then the whole $130,000.00 will be charged back to Tigney Technology, would that be correct?

A. No, it's an accounting — you're asking me an accounting question. The $100,000.00 would be paid by Tigney and the management fee would be added later in the —

Q. I'm not too concerned with the timing, but just the general overall structure of how these were done.

> A. Yes. It was a mechanism for Tigney to obtain the money that was required to provide those services, or part of the money that was required for those services.
>
> Q. Well, sir, might I suggest to you that the only purpose for this contract in Exhibit R-1, Tab 11, is in fact a gross-up of expenditures to allow you to utilize more investment tax credits available from the government.
>
> A. That's not true. This device or this scheme, if you will, was devised by actively working with a major accounting firm anyway, in Ottawa, and they recommended to us that we create Tigney Research to keep all of the research costs in one pot, and then Tigney Technology would do the management, do the direction, do the planning and do the — all of the things that are pointed out here in this, in item 3.
>
> Q. Sir, there's no gain to Tigney Technology if they're charging say a management fee that's $30,000.00 to Tigney Research and then having to pay it on its way back. I mean, you'll agree to that? I mean, there's no gain to Tigney Technology to do that.
>
> A. To pay it to Tigney Research and then have —
>
> Q. Have to have it charged back to them.
>
> A. I guess not. ... I don't understand it [the question].

Analysis and Conclusion:

14 **Although the Respondent has agreed that the amounts of $178,019, $62,411 and $42,223 are SRED, the issue with respect to these amounts is whether the activities were carried on in Canada or outside Canada.** If they were carried on outside Canada, they would not be taken into account in computing investment tax credits within the meaning of section 127 of the *Act*. Subsection 127(5) provides that there may be deducted from tax otherwise payable an amount computed by reference to "the taxpayer's investment tax credit". The term "investment tax credit" is defined in subsection 127(9) as being, *inter alia*, a specified percentage of a *qualified expenditure* made in the year. The term *qualified expenditure* is also defined in subsection 127(9) to be, *inter alia*, an expenditure described in paragraph 37(1)(*a*) of the *Act*. That section reads in part, as follows:

> Where a taxpayer carries on a business in Canada in a taxation year and files with the taxpayer's return of income ... a prescribed form containing prescribed information, there may be deducted ... the total of all amounts each of which is an expenditure of a current nature made ... 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.

It was admitted by the Respondent that the Appellant carried on business in Canada.

15 The term "scientific research and experimental development" is defined in subsection 37(7) as having the meaning given to that expression by regulation. Regulation

2900 states in part that”

> ... ‘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 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 paragraphs (*a*), (*b*) or (*c*),
>
> 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.

16 In *Sass Manufacturing Ltd. v. Minister of National Revenue*, 88 D.T.C. 1363 Judge Sarchuk said at 1371:

> 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.

17 I agree with Appellant's counsel that these expenditures were made in Canada by a corporation carrying on business in Canada. I also agree that the portion of the research which did not physically take place in Canada was an isolated and relatively small part of the systematic investigation which was on-going in Canada. The evidence indicates that the only reason for the presence of the Appellant's personnel and portable plant in Kentucky was that the fresh tobacco required for the experiments conducted was not available in Canada. The experiments conducted in November, 1992 in Kentucky are not a separate and distinct "systematic investigation" but are part of the continuous scientific research on tobacco that the Appellant had commenced in 1990 and continued until 1993. The experiments in Kentucky were a small and necessary part of the research which the Appellant had been conducting. By my reading, the relevant sections and regulations of the *Act* are broad enough to encompass the SRED conducted by the Appellant as outlined above. It is therefore, my conclusion that these sums are *qualified expenditures* for the purposes of ITCs.

18 With respect to the management fee amounts of $175,678 in 1993 and $32,773.94 in 1994, the Appellant has failed to persuade me that these sums were *expenditures* made by the Appellant. No evidence, other than DeLong's statement that Research was established on the advice of accountants, was presented to explain the existence of that corporation. It did absolutely nothing that could not have been done by the Appellant. The amounts of management fees purported to have been paid by the Appellant were simply the result of book entries for it and its subsidiary corporation, Research. Appellant's counsel attempted to justify the management fee charged by the Appellant to Research by asking DeLong what his salary claim would have been had the Appellant paid him that salary instead of charging the management fee to Research. Apparently no such amount was paid by the Appellant to DeLong or to anyone else for services. That is, no money for services was actually expended by the Appellant. The sums of $199,289.50 and $32,733.94 were simply charged by accounting entry to Research and were "paid" by Research charging them together with other expenses to the Appellant. These were not expenditures incurred but were book entries only. In *Ed Sinclair Construction & Supplies Ltd. et al. v. Minister of National Revenue*, 92 D.T.C. 1163 Bowman J., at page 1169 said that:

> A mere bookkeeping entry in a loan account by itself does not constitute a taxable event unless there is something more, such as a receipt.

He then quoted Lord Brampton *from Gresham Life Society Co. Ltd. v. Bishop*, 1902 4 TC 464 at 476 as follows:

> My Lords I agree with the Court of Appeal that a sum of money may be received in more ways than one e.g. by the transfer of a coin or a negotiable instrument or other document which represents and produces coin, and is treated as such by business men. Even a settlement in account may be equivalent to a receipt of a sum of money, although no money may pass; and I am not myself prepared to say that what amongst business men is equivalent to a receipt of a sum of money is not a receipt within the meaning of the Statute which your Lordships have to interpret. But to constitute a

> receipt of anything there must be a person to receive and a person from whom he receives and something received by the former from the latter, and in this case that something must be a sum of money. A mere entry in an account which does not represent such a transaction does not prove any receipt, whatever else it may be worth.

Accordingly, I conclude that they are not *expenditures* made on SRED.

19 **In result, the appeal is allowed to the extent that the amounts of $178,019, $62,411 and $42,223 are qualified expenditures for the purpose of investment tax credits under the *Act* for the 1993 taxation year.**

Footnotes

1 June 1 in each year to May 31 in the following year.

2 The contractual arrangement between the Appellant and Research provided that the Appellant would charge Research a management fee of 30% of all Research's costs. Counsel agreed that the amount of $199,289.50 should be reduced to $175,628 because a factor of 35% had been mistakenly used.

3 of a Memorandum of Agreement between the Appellant (referred to as TTI) and Research (referred to as TRI)