

Federal Court of Canada — Appeal Division

LGL Ltd. v. R.

LGL Limited, Appellant and Her Majesty The Queen, Respondent

Robertson, Rothstein, McDonald JJ.A.

Heard: December 2, 1999

Judgment: February 7, 2000

Docket: A-139-99

Counsel: *Mr. Russell Laisniew*, for Appellant.
Ms Alexandra Brown, for Respondent.

McDonald J.A.:

1 This is an appeal pursuant to section 27 of the *Federal Court Act*, R.S.C. 1985, c.F-7, from a decision of the Tax Court of Canada in which the Tax Court Judge dismissed the appellant's appeal from assessments made under the *Income Tax Act*, R.S.C. 1952, c.148 (the "*Act*") for the 1991, 1992 and 1993 taxation years.

2 The sole issue in this appeal is whether the Tax Court Judge erred in holding that the costs of scientific research and experimental development ("SR&ED") activities conducted by the appellant outside of Canada are not expenditures "on scientific research and experimental development carried on in Canada..." within the meaning of subparagraph 37(1)(a)(i) of the *Act*. As a result of this finding the appellant was denied a refundable investment tax credit which is available in respect of expenditures on SR&ED carried on in Canada.

Facts

3 The relevant facts may be briefly stated. The appellant LGL Limited is a Canadian company, owned and managed by Canadians. The company conducts research on behalf of governments, industry and other organizations in the areas of environmental effects analysis, planning and assessment, resource management, ecological research into terrestrial, freshwater and marine systems, and bird hazards to aircraft.

4 During the taxation years in question, the appellant carried on four separate SR&ED projects relating to the environmental effects of offshore oil and gas development on whales, birds and fish. The appellant's evidence is that all four projects were designed, managed and based in Canada. In each case, observations were made and data collected on the target species in parts of coastal Alaska where oil and gas has been extracted and transported. The data was then brought back to the appellant's premises in Canada to be

analyzed and included in its reports. At trial, the Tax Court Judge made the following factual findings which are found at paragraph 44 of his judgement:

- a) the work in question involving the collection of data had to be done outside Canada. It could not have been done in Canada;
- b) the work done outside Canada, by itself, was not SR&ED. It only became SR&ED when it was assimilated into and made part of the overall project(s);
- c) the assembly of data was an essential and necessary part of the overall project;
- d) if it is relevant to designate the projects, looked at in their entirety and not piecemeal as “Canadian” or “non-Canadian” it would be more accurate to describe them as Canadian. The work was done by a Canadian company, using Canadian researchers and personnel and the core scientific work, that is to say, the analysis of the data, the formulation and testing of hypotheses, the formation of conclusions and the preparation of reports were all done in Canada. All that was done outside of Canada was the collection of data.

Analysis

5 At issue in this appeal is whether the direct cost of the data collection and allocable overhead for the work done outside Canada comes within subparagraph 37(1)(a)(i) of the *Act* which applies in respect of expenditures for SR&ED carried on in Canada. As stated earlier, if the expenditures in question can be found to come within subparagraph 37(1)(a)(i), they will qualify for the refundable investment tax credit under subsections 127(5) and 127(9) of the *Act*. If the expenditures do not come under subparagraph 37(1)(a)(i), they will be subject to less favourable tax treatment under subsection 37(2), which deals with expenditures for SR&ED undertaken outside of Canada and does not give rise to the refundable investment tax credit.

Relevant Legislation

6 Subsection 37(1) of the *Act* provides:

37.(1) Where a taxpayer carried on a business in Canada in a taxation year and files with his return of income under this Part for the year a prescribed form containing prescribed information, there may be deducted in computing his income from the business for the year such amount as he may claim not exceeding the amount, if any, by which the aggregate of

(a) the aggregate 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,

(ii) by payments to

(A) an approved association that undertakes scientific research and

experimental development,

(B) an approved university, college, research institute or other similar institution,

(C) a corporation resident in Canada and exempt from tax under paragraph 149(1)(j),

(D) a corporation resident in Canada, or

(E) an approved organization that makes payments to an association, institution or corporation described in any of clauses (A) to (C) to be used for scientific research and experimental development carried on in Canada, related to a business of the taxpayer, and provided that the taxpayer is entitled to exploit the results of such scientific research and experimental development, or

(iii) where the taxpayer is a corporation by payments to a corporation resident in Canada and exempt from tax under paragraph 149(1)(j), for scientific research and experimental development that is basic research or applied research carried on in Canada

(A) the primary purpose of which is the use of results therefrom by the taxpayer in conjunction with other scientific research and experimental development activities undertaken or to be undertaken by or on behalf of the taxpayer that relate to a business of the taxpayer, and

(B) that has the technological potential for application to other businesses of a type unrelated to that carried on by the taxpayer.

The Position of the Parties

7 Both parties agree that the projects at issue in this appeal constitute SR&ED as defined in section 2900 of the Regulations made under the *Act*. Further, it is common ground between the parties that the expenditures in question are of a current nature.

8 Where the parties disagree is as to whether or not the portions of the projects done outside of Canada constitute expenditures on SR&ED carried on in Canada. The appellant claims that the expenditures for the necessary data collection work done outside Canada fall within paragraph 37(1)(a) of the *Act* because each of the four projects were in all other respects “carried on in Canada”. Thus, the activities in Alaska were essential to the SR&ED projects, each of which, taken as a whole were, as determined by the Trial Judge, carried on in Canada.

9 The respondent argues that the expenditures in respect of activities undertaken outside of Canada cannot be construed as SR&ED carried on in Canada within the meaning of the *Act*. The respondent submits that both the plain meaning of the language

and the context of paragraph 37(1)(a) and subparagraph 37(1)(b)(i) support their interpretation that the words “carried on in Canada” mean to “conduct” or “engage in” in Canada. The respondent further contends that applying the plain language meaning, research conducted in the United States cannot be said to have been “carried on” in Canada. Furthermore, the respondent rejects the appellant’s argument that once a project qualifies as SR&ED it must be looked at integrally and a determination made as to whether the project, *taken as an indivisible whole* is carried on in Canada or outside Canada.

10 The appellant submits that paragraph 37(1)(a) includes work done outside Canada so long as that work is necessary and constitutes an essential part of an SR&ED project carried on in Canada. The appellant’s argument is premised on the claim that a SR&ED project must be considered as a whole and cannot be looked at piecemeal.

Analysis

11 In my view, this is the proper approach to the initial determination of whether or not a project is SR&ED under Regulation 2900. However, I agree with the Tax Court Judge that this approach is not appropriate for deciding the subsequent issue of whether SR&ED is carried on in Canada within the meaning of paragraph 37(1)(a).

12 Once a project is deemed to be SR&ED under Regulation 2900, subparagraph 37(1)(a)(i) requires a determination as to which parts of the SR&ED are carried on in Canada and which parts are not. This section does not expressly say that SR&ED expenditures made outside Canada, and part of a larger project clearly within Canada, are to be separated out. Nor, however, does subparagraph 37(1)(a)(i) expressly indicate that expenditures for SR&ED are to be grouped in relation to “projects” which in turn are to be considered as an indivisible whole. In fact, the words in 37(1) implicitly indicate the contrary. Paragraph 37(1)(a) refers to “all amounts, each of which is an expenditure of a current nature....” This is indicative that the focus of the provision is on individual SR&ED expenditures, not on the project as a monolithic whole.

13 I am in agreement with the Tax Court Judge that the language of paragraph 37(1)(a) is clear and that there is no basis for the appellant’s claim that SR&ED projects must be looked at as indivisible wholes. Using this approach the only possible determinations would be that the project is either entirely inside Canada or entirely outside Canada. Such an approach would stretch the plain meaning of the language in the *Act*.

14 In addition, the approach to SR&ED projects put forward by the appellant would require the courts to determine when parts of a project which are undertaken in Canada are sufficiently “integral” to justify calling the entire project “Canadian” for the purposes of subsection 37(1) of the *Act*. This would inevitably lead to uncertainty for taxpayers whose SR&ED projects involve undertakings both inside and outside of Canada. Furthermore, such an approach could result in the disallowance of current expenditures clearly related to SR&ED carried on in Canada on the basis that a greater portion of the project as a whole is undertaken outside of Canada. In my view, this result would run contrary to the intent of the SR&ED provisions of the *Act*, which is to provide an incentive for research and development activities within Canada.

15 I am in agreement with the Tax Court Judge that in the face of clear wording in the

Act the principles of statutory interpretation cannot be used to strain the plain meaning of the words. The words “aggregate of all amounts each of which is an expenditure of a current nature” in paragraph 37(1)(a) in relation to the words “on scientific research and experimental development carried on in Canada” as used in subparagraph 37(1)(a)(i) are clear and comprehensible. In cases where part of a SR&ED project is carried on in Canada and another part is carried on outside Canada, the only criteria for determining which expenditures come under subsection 37(1) is whether the expenditures were made for SR&ED activities carried on in Canada.

16 As this applies to the facts of this case I find the Tax Court Judge’s reasoning (at paragraph 55 of his judgement) persuasive and compelling:

Here the inescapable fact is that a substantial part of the project was performed outside of Canada. What principle of interpretation would permit or compel me to conclude that the work forming part of the SR&ED project outside of Canada was carried on in Canada?

17 My answer to this question is the same as the Trial Court Judge’s, namely, that such an interpretation is simply not warranted or possible given the clear wording of the Act.

Other Tax Court Jurisprudence

18 This interpretation is at odds with two recent decisions in the Tax Court of Canada, *Tigney Technology Inc. v. R.* (1997), 97 D.T.C. 414 (T.C.C.) and *Data Kinetics Ltd. v. R.* (1998), 98 D.T.C. 1877 (T.C.C.). The decision in *Tigney Technology Inc.* was also appealed to this Court and was heard in tandem with this appeal. The Tax Court Judge in *Data Kinetics Ltd.* agreed with the Tax Court Judge’s reasoning in *Tigney Technology Inc.* that the activity in question should be looked at as a whole and not subdivided into its constituent parts. These decisions rely on the fact that the wording in subsections 37(1) and 37(2) do not refer to “that *portion* of SR&ED” or similar language that would support the division of projects in applying the provisions. Further, the Tax Court Judge in *Data Kinetics Ltd.* reasoned that if SR&ED projects could be subdivided for these purposes it is uncertain whether each particular part of the project would continue to constitute SR&ED.

19 For the reasons I have stated above I cannot agree with the decisions in *Data Kinetics Ltd.* and *Tigney Technology Inc.* The words “carried on in Canada” must be read in the context of the rest of the subsection which clearly contemplates the assessment of individual expenditures as it refers to “...the *aggregate of all amounts each of which* is an expenditure of a current nature made by the taxpayer on scientific research and experimental development carried on in Canada”.

20 As to the concern that once subdivided for the purpose of the *Act*, the component parts might no longer qualify as SR&ED under Regulation 2900, I think this concern is unfounded. The assessment of SR&ED expenditures according to whether they are for activities carried on inside Canada or outside Canada for the purpose of the refundable tax credit does not affect the status of the project as a whole as SR&ED. The determination of whether a project is SR&ED under Regulation 2900 is made prior to the determination of whether an SR&ED expenditure was for work carried on inside or outside Canada. The

project is to be taken as a whole at the initial stage of determining whether or not it is SR&ED under Regulation 2900. At this initial stage it is irrelevant whether the project is carried on inside Canada or outside Canada or both. The matter of what takes place inside Canada or outside Canada becomes relevant when determining whether a given expenditure within the SR&ED project is eligible for the tax credit.

21 The Tax Court Judge foresaw little difficulty in reasonably dividing the costs in this case. Further he found this to be “a more reasonable result than attempting to decide whether a project that is carried on both inside and outside Canada is essentially ‘Canadian’ or essentially ‘non-Canadian.’” I am in total agreement with his finding.

22 For these reasons the appeal is dismissed with costs.

Appeal dismissed.