

Federal Court of Canada — Appeal Division

**Her Majesty The Queen, Appellant and Tigney Technology Incorporated,
Respondent**

Robertson, Rothstein, McDonald JJ.A.

Heard: December 2, 1999
Judgment: February 7, 2000
Docket: A-70-97, A-303-97

Counsel: *Mr. Robert Gosman*, for Appellant.
Ms Priscilla Kennedy, for Respondent.

Subject: Income Tax (Federal)

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 allowed the respondent's appeal from assessments made under the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.) (the "*Act*") for the 1993 taxation year.

2 The sole issue in this appeal is whether the respondent taxpayer is entitled to investment tax credits for scientific research and experimental development ("SR&ED") expenditures associated with work done outside Canada. In other words do these expenditure constitute "qualified expenditure" within the meaning of subsection 127(9) of the *Act* enabling the respondent to claim a refundable investment tax credit. In order to qualify the expenditures must be made "on scientific research and experimental development carried on in Canada..." within the meaning of subparagraph 37(1)(a)(i) of the *Act*.

Facts

3 The relevant facts may be briefly stated. The respondent was engaged in research and development of technology for the purpose of separating elemental components from fibrous materials such as wood and straw. This work involved the development of pressure vessels in which the separation process could occur, computer software, and new ways to carry out the extraction of components of plant material. The expenditures at issue in this case were made for experiments conducted in Kentucky. According to the respondent it was necessary to conduct these experiments in Kentucky to the fresh tobacco needed for the chemical extraction process. The Trial Judge accepted, as a matter of fact, that it was necessary to conduct the experiments in Kentucky.

4 The respondent undertook all the research and development of the pressure vessel in Alberta and delivered the equipment to Kentucky. In its return for the 1993 taxation year, the respondent claimed refundable investment tax credits in respect of SR&ED expenditures including amounts associated with the Kentucky operation. It is these amounts, connected with the work in Kentucky, which are the subject of this appeal.

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 the taxpayer's return of income under this Part for the year a prescribed form containing prescribed information, there may be deducted in computing the taxpayer's income from the business for the year such amount as the taxpayer may claim not exceeding the amount, if any, by which the total of

(a) the total 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 because of 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.

Decision of the Tax Court Judge

7 In allowing the appeal the Tax Court Judge found that the Kentucky experiment was part of the continuous scientific research on tobacco that the Appellant had commenced in 1990. The Tax Court Judge reasoned 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 systemic investigation which was on-going in Canada.

He concluded:

By my reading, the relevant sections and regulations of the *Act* are broad enough to encompass the SRED conducted by the Appellants... It is therefore, my conclusion that these sums are *qualified expenditures* for the purposes of ITCs.

8 With respect I cannot agree with the Tax Court Judge's finding in this case. For the reasons I have given in *LGL Ltd. v. R.* (February 7, 2000), Doc. A-139-99 (Fed. C.A.), which was heard in tandem with this appeal, I am of the opinion that the language of paragraph 37(1)(a) cannot support the interpretation given to it by the Tax Court Judge in this case.

9 The words "total 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. **In cases where part of a SR&ED project is carried on inside Canada and another part is carried on outside Canada only those expenditures made in respect of the SR&ED inside Canada will be eligible for the refundable investment tax credit.**

10 In accordance with my decision in *LGL* and for the reasons given, this appeal must be allowed with costs in this Court and in the Tax Court of Canada. **The judgment of the Tax Court should be set aside to the extent of directing that the amounts of \$405,967.00 be excluded from those “qualified expenditures” established and used for calculation of refundable investment tax credits, for the respondent’s 1993 taxation year.**

Appeal allowed.