

Docket: 2014-4749(IT)G

BETWEEN:

AG SHIELD CANADA LTD.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on October 19, 2016 at Winnipeg, Manitoba

Before: The Honourable Justice Steven K. D'Arcy

Appearances:

Counsel for the Appellant: David E. Silver
Travis Delaronde, Student-at-Law

Counsel for the Respondent: Julien Bédard
Nalini Persaud

JUDGMENT

In accordance with the attached Reasons for Judgment:

1. The appeal with respect to a reassessment made under the *Income Tax Act* for the Appellant's taxation year ending on December 31, 2010 is allowed, and the reassessment is referred back to the Minister of National Revenue for reconsideration and reassessment on the basis that the \$38,880 of wages paid by the Appellant to Tom McCrea and Gary McCrea constitute an expenditure on or in respect of scientific research and experimental development; and
2. Costs are awarded to the Appellant. The parties shall have thirty days from the date of this judgment to make submissions with respect to the costs awarded.

Such representations shall not exceed 10 pages. If no submissions are received, costs shall be awarded to the Appellant as set out in the Tariff.

Signed at Ottawa, Canada, this 27th day of April 2017.

“S. D’Arcy”

D’Arcy J.

Citation: 2017 TCC 68
Date: 20170427
Docket: 2014-4749(IT)G

BETWEEN:

AG SHIELD CANADA LTD.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

D'Arcy J.

[1] The Appellant has appealed a reassessment in respect of its taxation year ending on December 31, 2010 (the “2010 taxation year”). The sole issue before the Court is the amount of salary or wages paid to the two shareholders of the Appellant that constitutes an expenditure on or in respect of scientific research and experimental development (“SR&ED”).

[2] The parties filed a partial agreed statement of facts (“PASF”). I heard from three witnesses: Mr. Tom McCrea who, together with his brother, owned the Appellant during the relevant period; Mr. Dennis Kowal, the Appellant’s accountant; and Mr. Glenn Schur, a Canada Revenue Agency (“CRA”) auditor.

I. Facts

[3] Unless otherwise noted, the following facts are taken from the PASF. A copy of the PASF is attached as Appendix A to these reasons for judgment.

[4] Since 1984, the Appellant has been engaged in the business of researching, designing and manufacturing agricultural implements. Since 1993, it has filed SR&ED claims under the relevant provisions of the *Income Tax Act* (the “Act”).

[5] Tom McCrea and his brother, Gary McCrea, each own 50% of the shares of the Appellant. They are the only officers and directors of the Appellant.

[6] Tom McCrea testified that, during the relevant period, he was the general manager of the Appellant responsible for employees, production and new product development. Gary McCrea was in charge of marketing and sales.¹

[7] In the 2010 taxation year, the Appellant claimed SR&ED expenditures in relation to eight projects.

[8] Tom McCrea was directly engaged in SR&ED activities for 1094.5 hours and in non-SR&ED activities for 1,905.5 hours. Gary McCrea was directly engaged in SR&ED activities for 201.5 hours and in non-SR&ED activities for 2,798.5 hours.

[9] In summary, the parties agree that Tom McCrea worked 3,000 hours in 2010, of which 1094.5 were spent on SR&ED activities, and Gary McCrea worked 3,000 hours, of which 201.5 were spent on SR&ED activities.

[10] The Appellant paid Tom McCrea wages of \$26,940 and Gary McCrea wages of \$11,940.

[11] As noted on page 12 of Exhibit A/R-3, the Appellant paid dividends of \$62,400 in the 2010 Taxation Year. As 50% shareholders, Tom McCrea and Gary McCrea each received \$31,200 of such dividends.

[12] Tom McCrea explained that he and his brother had agreed to receive relatively low compensation from the Appellant and to look to the increased value of the company as their retirement program. He stated the following:

We're both going to come to work. Work diligently to the best of our abilities all year long and at the end of the year we pray the company is worth more.²

[13] He explained that, on the basis of advice they had received from Mr. Kowal, the Appellant paid them salary and wages for their time spent doing SR&ED, and

¹ See also PASF, paragraphs 9 and 10.

² Transcript, page 59.

any other amounts removed from the Appellant were paid as dividends. Normally the salary and wages were split equally between the two brothers.

[14] Mr. Kowal explained his advice as follows:

The advice that I gave them was that pursuant to the *Income Tax Act*, the *Income Tax Act* says that specified shareholder -- specified employees, which they are as shareholders, could be paid for SR&ED work and as such if they were paid for SR&ED work, that constituted a valid input tax credit pursuant to the *Tax Act*. That's what I advised.

...

. . . the only wages that we accrued for them were for those hours that pertain to SR&ED work. They were not compensated for any other work that they performed for the company because essentially they were -- they -- they took a draw from the company, if I can get into that? They took a draw from the company and that draw was simply something they needed for their own livelihood.

And at the end of the year, those drawings were then put through as dividend income. No different than any other shareholder of a corporation would receive to offset his drawings.³

[15] Tom McCrea testified that he and his brother determined that the Appellant should pay them \$30 per hour for the SR&ED work. They based that hourly rate on the hourly rate the Appellant paid third parties who performed similar SR&ED work for the Appellant.

[16] Tom McCrea testified to the effect that the Appellant paid to him and his brother salary and wages for the 2010 taxation year calculated as follows:

Total hours Tom and Gary McCrea worked on SR&ED – 1,296
(1094.5+201.5)

Times \$30 hourly rate

Equalled total salary and wages of \$38,880.⁴

[17] Tom McCrea testified that for the 2010 taxation year it was determined that the salary and wages would not be split 50/50 but rather would “be skewed some to

³ Transcript, pages 91-92.

⁴ See also PASF, paragraphs 7 and 8.

recognize that I'd made a different level of contribution".⁵ Exhibit A/R-2 evidences what occurred: the Appellant paid the first \$15,000 of salary and wages to Tom McCrea and split the remaining \$23,880 equally between Tom McCrea and Gary McCrea, i.e., \$11,940 each.

[18] As noted in the PASF, this resulted in Tom McCrea receiving \$26,940 of salary and wages and Gary McCrea receiving \$11,940 of salary and wages.

[19] In reporting its income for the 2010 taxation year, the Appellant claimed qualified SR&ED expenditures in the amount of \$297,968, which included 100% of the salary and wages paid by the Appellant to Tom McCrea and Gary McCrea.

[20] The Minister assessed the Appellant to reduce the claimed SR&ED expenditures by a portion of the salary and wages paid to Tom McCrea and Gary McCrea. When assessing the Appellant, the Minister assumed that only a portion of such salary and wages was paid in respect of SR&ED.

[21] Mr. Schur testified that, when determining the amount of salary and wages that qualified as an SR&ED expenditure, the Minister took into account the total amount of time Tom McCrea and Gary McCrea worked during the year.

[22] He stated that, since Tom McCrea worked 1,094.5 hours on SR&ED and 3,000 hours in total, the Appellant was only entitled to claim as an SR&ED expenditure 36.5% (1,094.5/3,000) of the \$26,940 of salary and wages paid to Tom McCrea. Similarly, since Gary McCrea worked 201.5 hours on SR&ED and 3,000 hours in total, the Appellant was only entitled to claim as an SR&ED expenditure 6.7% (201.5/3,000) of the \$11,940 of wages paid to Gary McCrea.

[23] As a result, the Court must determine if the Appellant is entitled to claim 100% of the salary and wages paid to Tom McCrea and Gary McCrea, or the lower percentages determined by the Minister.

II. The Law

[24] Paragraph 11 of the PASF states: "The Appellant used the proxy method of claiming overhead costs for its SR&ED claim in the 2010 Taxation Year." Counsel for the Appellant confirmed that the parties are referring to the election that is made under clause 37(8)(a)(ii)(B) and subsection 37(10) of the Act.

⁵ Transcript, page 55.

[25] With respect to salary and wages, since the Appellant made the so-called proxy election, it was only entitled, under subclause 37(8)(a)(ii)(B)(IV), to include as an expenditure on or in respect of scientific research and experimental development “that portion of an expenditure made in respect of an expense incurred in the year for salary or wages of an employee who is directly engaged in scientific research and experimental development in Canada that can reasonably be considered to relate to such work having regard to the time spent by the employee thereon . . . ”.

III. The Court’s decision

[26] The Respondent does not accept that the \$38,880 of wages that the Appellant paid Tom McCrea and Gary McCrea was only paid for the time those two individuals spent performing SR&ED. As discussed previously, it is the Respondent’s position that the salary and wages relate to all of the work that Tom McCrea and Gary McCrea performed for the Appellant. This would include the 1,905.5 hours Tom McCrea spent and the 2,798.5 hours Gary McCrea spent “performing director or management activities” for the Appellant.

[27] I do not accept the Respondent’s position. It is not consistent with the facts before the Court.

[28] It is clear from the PASF and the argument of counsel for the Respondent that the Respondent accepts that during the 2010 taxation year:

- The Appellant was engaged in SR&ED.
- Tom McCrea and Gary McCrea were engaged directly in SR&ED.
- Tom McCrea spent 1094.5 hours and Gary McCrea spent 201.5 hours carrying out SR&ED.
- The Appellant paid Tom McCrea wages of \$26,940 and Gary McCrea wages of \$11,940.
- The total wages of \$38,880 (\$26,940 + \$11,940) paid to Tom McCrea and Gary McCrea were calculated on the basis of the total hours spent by Tom McCrea and Gary McCrea working on SR&ED, i.e., 1,296 times an hourly rate of \$30.

[29] Thus, the Respondent accepts that Gary McCrea spent 1094.5 hours directly engaged in SR&ED and that Tom McCrea spent 201.5 hours directly engaged in SR&ED. In addition, the Respondent did not present any evidence to challenge the

reasonableness of the \$30 per hour rate the Appellant applied to these hours to determine the total salary and wages that it paid to Gary McCrea and Tom McCrea.

[30] The evidence before me was that the Appellant based the \$30 per hour rate on the hourly rate charged by arm's length third parties. I accept that it was a reasonable hourly rate for the work performed by Gary McCrea and Tom McCrea. My conclusion does not change simply because the \$30 hourly rate was not used to split the \$38,880 between Gary McCrea and Tom McCrea. The method used to split the \$38,880 did not result in the Appellant paying Gary McCrea an unreasonable hourly rate.

[31] In summary, the undisputed evidence before me is that the Appellant paid Gary McCrea and Tom McCrea wages of \$38,880 solely for the work Gary McCrea and Tom McCrea performed conducting SR&ED. As a result, 100% of those wages can reasonably be considered to relate to SR&ED and they represent an expenditure on or in respect of SR&ED.

[32] Counsel for the Respondent argued that, if I accept that the Appellant paid the \$38,880 of wages solely for SR&ED, then Gary McCrea and Tom McCrea did not receive any compensation for the significant time they spent "performing director or management activities" for the Appellant.

[33] I do not accept this conclusion. The evidence before me was that Gary McCrea and Tom McCrea received compensation for such work in the form of dividends. As the controlling shareholders of the Appellant, Gary McCrea and Tom McCrea could cause the Appellant to pay them dividends, or remuneration in the form of salary and/or bonuses, for their contributions with respect to directing and managing the Appellant. As the controlling shareholders and managing directors of the Appellant, they chose to receive dividends in lieu of salary and/or bonuses. This was their choice and did not require a formal agreement.

[34] The Respondent also relies on the decision of this Court in *Ergorecherche et Conseils Inc. v. The Queen*⁶. That appeal involved a situation where the owners of a company performed SR&ED on six projects and tried to allocate their salary and wages to three of the six projects. The three projects chosen were the only ones eligible for investment tax credits.

[35] That case can be distinguished from the current appeal. The salary and wages paid to the two individuals in *Ergorecherche* were not calculated on the

⁶ 98 DTC 1710.

basis of the hours the individuals spent on specific SR&ED projects, rather “the salaries paid to the two shareholders were based not on the hours they worked, but solely on the appellant’s liquid assets at the end of the year.”⁷

[36] This is not the fact situation before the Court here. In the current appeal, the Appellant based the total salary and wages paid to Tom McCrea and Gary McCrea on the hours they worked on specific SR&ED projects.⁸

[37] For the foregoing reasons, the appeal is allowed and the reassessment is referred back to the Minister of National Revenue for reconsideration and reassessment on the basis that the \$38,880 of wages paid by the Appellant to Tom McCrea and Gary McCrea constitute an expenditure on or in respect of scientific research and experimental development.

[38] Costs are awarded to the Appellant. The parties shall have thirty days from the date of this judgment to make submissions with respect to the costs awarded. Such representations shall not exceed 10 pages. If no submissions are received, costs shall be awarded to the Appellant as set out in the Tariff.

Signed at Ottawa, Canada, this 27th day of April 2017.

“S. D’Arcy”

D’Arcy J.

⁷ *Ibid.*, page 1712.

⁸ See Exhibit A/R-1 and PASF, paragraph 7.

APPENDIX A

2014-4749(IT)G

TAX COURT OF CANADA

BETWEEN:

AG SHIELD CANADA LTD.,

Appellant,

- and -

HER MAJESTY THE QUEEN,

Respondent.

AGREED STATEMENT OF FACTS

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2014-4749(IT)G

TAX COURT OF CANADA

BETWEEN:

AG SHIELD CANADA LTD.,

Appellant,

- and -

HER MAJESTY THE QUEEN,

Respondent.

AGREED STATEMENT OF FACTS

1. The Appellant, A.G. Shield Ltd. is a corporation existing under the laws of the Province of Manitoba whose principal place of business is located in the village of Benito in the Province of Manitoba.
2. Tom McCrea (“Tom”) and Gary McCrea (“Gary”) are two brothers, each of whom owns 50% of the shares in the Appellant.
3. Tom and Gary are the only officers and directors of the Appellant.
4. Since 1984, and at all material times, the Appellant has been engaged in, *inter alia*, researching, designing and manufacturing agricultural implements.
5. The Appellant has filed scientific research and experiment development (“SR&ED”) claims with the Respondent since 1993.

The Claims

6. In its taxation year ending December 31, 2010 (the “2010 Taxation Year”), the Appellant claimed SR&ED expenditures in relation to eight projects.

7. In the 2010 Taxation Year, Tom was directly engaged in SR&ED Services for the Appellant for 1,094.5 hours, and Gary was directly engaged in SR&ED Services for the Appellant for 201.5 hours.¹

8. In the 2010 Taxation Year, Tom was paid wages by the Appellant in the amount of \$26,940.00 and Gary was paid wages by the Appellant in the amount of \$11,940.00.

9. In addition to the 1094.5 hours Tom Spent on SR&ED activities, Tom spent 1,905.5 hours performing director or management activities for the Appellant, for a total of 3000 hours for the Appellant in the 2010 Taxation Year.

10. Gary was in charge of marketing, sales representatives and customer service on behalf of the appellant. In addition, to the 201.5 hours Gary spent on SR&ED services, Gary spent 2,798.5 hours performing director or management activities for the Appellant in the 2010 Taxation Year.

11. The Appellant used the proxy method of claiming overhead costs for its SR&ED claim in the 2010 Taxation Year.

12. In reporting its income for the 2010 Taxation Year, the Appellant claimed qualified SR&ED expenditures in the amount of \$297,968.00 and corresponding investment tax credits (“ITC’s”) of \$122,852.00. The qualified SR&ED expenditures claimed included 100% of the wages paid by the Appellant to Tom and Gary in the 2010 Taxation Year.

¹ Paragraphs 11(j) and (n) of the Reply indicate that Tom spent 1045 hours directly engaged in SR&ED and Gary spent 152 hours directly engaged in SR&ED. However, in its calculations, the appellant inadvertently overlooked a project in which Tom and Gary were directly engaged in SR&ED for 99 hours. The parties agree that Tom and Gary were each directly engaged in SR&ED for an additional 49.5 hours.

13. The Minister of National Revenue assessed the Appellant with respect to the 2010 Taxation Year, disallowing \$21,119 of the claimed total allowable SR&ED expenditures and corresponding ITCs of \$7,391, as the Minister's position is that the wages received by each of Tom and Gary were paid for all of the services Tom and Gary provided to the Appellant, not just for SR&ED services provided by Tom and Gary.

October 18, 2016

PITBLADO LLP

Per: "David E. Silver"
David E. Silver,
Counsel for the Appellant

October 18, 2016

William F. Pentney, Q.C.
Deputy Attorney General of Canada
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Per: "Julien Bédard"
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PLACE OF HEARING: Winnipeg, Manitoba

DATE OF HEARING: October 19, 2016

REASONS FOR JUDGMENT BY: The Honourable Justice Steven K. D'Arcy

DATE OF JUDGMENT: April 27, 2017

APPEARANCES:

Counsel for the Appellant: David E. Silver
Travis Delaronde, Student-at-Law

Counsel for the Respondent: Julien Bédard
Nalini Persaud

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