Docket: 2005-4039(IT)I

BETWEEN:

ARMADA EQUIPMENT CORPORATION,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on November 10, 2006, at Toronto, Ontario

By: The Honourable Justice M.A. Mogan

Appearances:

Counsel for the Appellant:	Sarah J. O'Connor
Counsel for the Respondent:	Kandia Aird

JUDGMENT

The appeal from the reassessment of tax made under the *Income Tax Act* for the 1994 taxation year is dismissed.

Signed at Ottawa, Canada, this 2nd day of May, 2007.

"M.A. Mogan"

Mogan D.J.

Citation: 2007TCC260
Date: 20070502
Docket: 2005-4039(IT)I

BETWEEN:

ARMADA EQUIPMENT CORPORATION,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

Mogan D.J.

[1] When computing income for the 1994 taxation year, the Appellant reported Scientific Research and Experimental Development (SR&ED) expenditures in the amount of $134,235 and claimed an Investment Tax Credit ("ITC") at the rate of 35% in the amount of $46,982. By Notice of Reassessment dated June 13, 1996, the Minister of National Revenue (the "Minister") disallowed a portion ($34,909) of the amount ($134,235) which the Appellant had reported as SR&ED expenditures, but the Minister allowed the remaining portion ($99,326). The Minister also disallowed (at the 35% rate) a portion ($12,218) of the ITC claimed by the Appellant.

[2] In September 1996, the Appellant filed a Notice of Objection to the reassessment described above and, after a delay of almost nine years, the Minister confirmed the reassessment. The Appellant has appealed from the 1994 reassessment and has elected the informal procedure.

[3] The amount of $34,909 which the Minister disallowed as an SR&ED expenditure has two components of $18,618 and $16,291. The issue in this appeal concerns only the $18,618 component. The question is whether the $18,618 is a

"qualified expenditure" within the meaning of subsection 127(9) of the *Income Tax Act* (the "*Act*").

The Facts

[4] The Appellant's first witness was William J. Heaps who incorporated the Appellant company many years ago. He has always had a love of equipment and all of his work experience dealt with vehicles. In 1994 (the year under appeal), the Appellant built heavy specialty equipment like drilling rigs, underground waste disposal units and vehicles to launch satellites. The Appellant would take a project from concept to design to manufacture to delivery. There were only a few workers in the office (engineers, draftsmen, secretaries, etc.) and about a dozen in the plant (welders, fabricators, etc.). The Appellant did not build or make engines, transmissions or tires. Those products had to be sourced from outside suppliers.

[5] Mr. Heaps retired two years ago but, before he retired, he was president of the Appellant company. He referred to the firm of James A. Deacur & Associates Ltd. as "our accountants". I will refer to that firm as "Deacur & Co.". Exhibit A-1 is a copy of the Appellant's unaudited final statements for the year ended March 31, 1995 as prepared by Deacur & Co. Exhibit A-2 is a copy of an invoice dated August 10, 1995 from Deacur & Co. to the Appellant in the amount of $2,343.30 for the preparation of the 1995 financial statements, 1995 corporate tax returns, and GST returns. Exhibit A-3 is a copy of a different invoice dated November 16, 1994 from Deacur & Co. to the Appellant in the amount of $30,621.26 for services in connection with documenting the 1994 SR&ED expenditures and claiming the corresponding ITCs.

[6] Allan J. Gordon (the Appellant's second witness) is a chartered accountant who was in 1994 and still is associated with Deacur & Co. In the early 1990s, he started to specialize in SR&ED claims so that he could help small Canadian companies acquire the available investment tax credits. He became an expert in the preparation and submission of SR&ED claims under the *Act*. He recognized Exhibits A-1, A-2 and A-3. He helped prepare the financial statements in Exhibit A-1. He produced Exhibit A-4, a printout from the records of Deacur & Co. showing invoices sent to the Appellant. Within Exhibit A-4, he identified Exhibit A-3 which appears as an entry for November 16, 1994. He also identified Exhibit A-2 as an entry for August 10, 1995; and a similar invoice of $2,247 dated October 31, 1994 for preparing 1994 financial statement and tax returns.

[7] Mr. Gordon described the detail required to support a taxpayer's claim for an ITC based upon SR&ED expenditures. In order to provide that detail, Deacur & Co. hired Gerry Loban, a retired engineer. Mr. Loban would visit the clients of Deacur & Co. to obtain a precise description of the research and development being done, and then assist in the writing of a technical report. According to Mr. Gordon, Gerry Loban did extensive work on the Appellant's SR&ED claim for 1994. Mr. Loban would invoice Deacur & Co. for the work he did; and Deacur & Co. would pass the cost on to its client if the ITC claim was successful.

[8] Mr. Gordon reviewed with care Exhibit A-3 which showed professional fees of $28,618 plus a GST charge of $2,003.26. Within the professional fees of $28,618, he determined that an amount of $10,000 could be reasonably allocated to "non-qualifying activity", and so should be deducted from the total fees for purposes of the ITC claim. He stated that, by deducting the $10,000, he was being extremely conservative in claiming only the amount $18,618 as a professional fee for the preparation of the ITC claim based upon SR&ED. Mr. Loban would not have been retained by Deacur & Co. if they had not been preparing ITC claims for SR&ED. Also, the Exhibit A-3 invoice would not have been sent if Deacur & Co. had not prepared the Appellant's 1994 claim for an ITC based upon its SR&ED expenditures.

[9] This appeal will depend upon the interpretation of certain provisions of the *Act* and the *Income Tax Regulations* (the "*Regulations*"). In 1994, subsection 127(5) permitted the deduction of an investment tax credit with respect to a taxpayer's qualified expenditures on SR&ED. The following definition of "qualified expenditure" appeared in subsection 127(10.1):

> 127(10.1) For the purposes of subsection (9) and (10),
>
> (*a*) …
>
> (*c*) "qualified expenditure" means an expenditure in respect of scientific research made by a taxpayer after March 31, 1977 that qualified as an expenditure described in paragraph 37(1)(*a*) or subparagraph 37(1)(*b*)(i), but does not include
>
> (i) a prescribed expenditure, and
>
> (ii) in the case of a taxpayer that is a corporation, an expenditure specified by the taxpayer for the purposes of clause 194(2)(*a*)(ii)(A);

[10] The Appellant and Respondent rely on different provisions of the *Regulations* to come within or fall outside the required terms of a "qualified expenditure". The Appellant relies on *Regulation* 2900(2)(*c*):

> 2900(2) For the purposes of clauses 37(7)(*c*)(i)(B) and (ii)(B) of the *Act*, the following expenditures are directly attributable to the prosecution of scientific research and experimental development:
>
> (*a*) the cost of materials consumed in such prosecution;
>
> (*b*) where an employee directly undertakes, supervises or supports such prosecution, the portion of the salaries or wages and related benefits paid to or for that employee that can reasonably be considered to related thereto; and
>
> (*c*) other expenditures that are directly related to such prosecution and that would not have been incurred if such prosecution had not occurred.

The Respondent relies on the definition of "prescribed expenditure" in *Regulation* 2902:

> 2902 For the purposes of the definition "qualified expenditure" in subsection 127(9) of the *Act*, a prescribed expenditure is
>
> (*a*) an expenditure of a current nature incurred by a taxpayer in respect of
>
> (i) the general administration or management of a business, including
>
> (A) administrative salary or wages and related benefits in respect of a person whose duties are not all or substantially all directed to the prosecution of scientific research and experimental development, except to the extent that such expenditure is described in subsection 2900(2) or (3)
>
> (B) a legal or accounting fee ,
>
> (C) an amount described in any of paragraphs 20(1)(*c*) to (*g*) of the *Act*,
>
> (D) an entertainment expense,

(E) an advertising or selling expense,

(F) a conference or convention expense,

(G) a due or fee in respect of membership in a scientific or technical society or organization, and

(H) a fine or penalty, or

(ii) the maintenance and upkeep of premises, facilities or equipment to the extent that such expenditure is not attributable to the prosecution of scientific research;

[11] Counsel for the Appellant argued that the amount $18,618 paid to Deacur & Co. was directly attributable to the Appellant's prosecution of SR&ED within *Regulation* 2900(2)(*c*) because that payment would not have been incurred if such prosecution had not occurred. The Respondent acknowledges that the Appellant had significant SR&ED expenditures ($99,326) in its 1994 taxation year. The uncontradicted evidence of Mr. Gordon was that the invoice (Exhibit A-3) for $28,618 (which includes the amount $18,618 in issue) would not have been sent to the Appellant and paid by the Appellant if Deacur & Co had not been preparing claims for ITCs based upon SR&ED expenditures.

[12] Counsel for the Respondent argued that the amount $18,618 was excluded from being a "qualified expenditure" under subsection 127(10.1) because it is "a legal or accounting fee" and, therefore, a "prescribed expenditure" within *Regulation* 2902(*a*)(i)(B).

[13] In my opinion, the amount in dispute ($18,618) was a "legal or accounting fee" within the meaning of *Regulation* 2900(*a*)(i)(B). That amount was paid to Deacur & Co. who Mr. Heaps referred to as "our accountants". Deacur & Co. prepared the Appellant's financial statements and tax returns. Those services are within the scope of what an accountant ordinarily does for a fee. Filing a claim for an investment tax credit is part of filing an income tax return if the taxpayer is engaged in SR&ED. Why wouldn't the outside professional (Deacur & Co.), retained to prepare financial statements and income tax returns, be the same person who would prepare and file a claim for investment tax credits which are deducted as a credit against tax otherwise payable in accordance with the tax returns? The outside professional who prepares financial statements and tax returns is the logical person to write the required report on SR&ED, to complete the prescribed form claiming investment tax credits based upon SR&ED, and to file such form as an integral part of filing an income tax return.

[14] The Appellant has a more difficult task identifying the amount in dispute ($18,618) as an expenditure directly attributable to the prosecution of scientific research and experimental development within the meaning of *Regulation* 2900(2)(*c*). Subparagraph 2(*a*) describes the cost of materials consumed in "such prosecution". Subparagraph 2(*b*) describes the cost of salaries or wages paid to an employee who directly supports "such prosecution". And subparagraph 2(*c*) describes:

> (*c*) other expenditures that are directly related to such prosecution and that would not have been incurred if such prosecution had not occurred.

[15] I cannot conclude that the amount ($18,618) paid to Deacur & Co. was an expenditure "directly related to such prosecution". In order to be "directly related", an expenditure must be incurred in the research itself or in the development itself. The amount paid to Deacur & Co. was a consequence of research and development which had already taken place. It was an accounting fee paid to the accounting firm which prepared the Appellant's income tax returns to see if certain expenditures already incurred with respect to research and development could qualify for a specific investment tax credit.

[16] Both counsel referred to the decision of this Court in *Val-Harmon Enterprises v. Her Majesty the Queen*, [1995] T.C.J. No. 1762. In the *Val-Harmon* case, Bowman J. (as he then was) was faced with a question similar to the issue in this appeal. *Val-Harmon* had engaged in SR&ED, and retained Gessat Inc. to prepare its claim for ITCs based upon SR&ED. Gessat Inc. was not an accounting firm or legal firm but a company which helped taxpayers making claims for credits based upon SR&ED. In 1993, Gessat Inc. charged a fee of $20,638 to *Val-Harmon* who then claimed an ITC of $7,223 based on that fee.

[17] At the hearing before Bowman J., the Respondent attempted to amend its pleading to argue that the fee paid to Gessat Inc. was "an expenditure of a current nature incurred by a taxpayer in respect of (i) the general administration or management of a business including (B) a legal or accounting fee" within the meaning of *Regulation* 2902(*a*)(i). When denying the proposed amendment to the Respondent's pleading, Bowman J. in his oral reasons for judgment stated:

> 8 The point is well taken, I think. It raises a serious question as to whether such expenses should be allowed or should be treated as prescribed. I did not allow the amendment because it came at a rather late stage of the proceedings and

> I felt it would be unfair to the taxpayer who came prepared to argue only the one point, and that is whether these are accounting fees.
>
> 9 I'm reluctant to deny amendments, but at this stage of the game I think it would be quite unfair because the appellant might have put in different evidence, might have come prepared with different arguments. I think that argument has to be saved for another day. The amount of money involved in this case is not substantial and I don't think it would be fair to permit an amendment and we would have to adjourn the case, I think we'll leave that for some other, for some other cases. It also raises of course the rather serious question whether what one does in preparing reports and making submissions to the Department of National Revenue falls under the general definition of scientific research expenses. It's a very good question and I think some day should be addressed but not in this case.

[18] In *Val-Harmon*, Bowman J. held that 75% of the fee paid to Gessat Inc. was a "qualified expenditure" but the Respondent in that case had failed to plead that the fee was a "prescribed expenditure" within *Regulation* 2902. In this appeal by Armada Equipment Corporation, the Respondent rests its case on *Regulation* 2902.

[19] In *Val Harmon*, it is important to note that Justice Bowman (as he then was) delivered oral reasons from the bench; and there is no indication that *Regulation* 2900(2) was brought to his attention or relied on by the taxpayer. In this appeal by Armada, the Appellant rests its case on *Regulation* 2900(2). In paragraph 14 above, I have attempted to explain why I do not bring the amount in dispute ($18,618) within *Regulation* 2900(2). In my opinion, the following words and phrases from *Regulation* 2900(2) operate strongly against the Appellant:

> "directly attributable to the prosecution of scientific research and experimental development";
>
> "such prosecution" in paragraphs (*a*) and (*b*); and
>
> "directly related to such prosecution" in paragraph (*c*).

[20] When considering SR&ED, the nouns are "research" and "development". The words "scientific" and "experimental" are only adjectives. I conclude that a "qualified expenditure" must be incurred in connection with ongoing research and development, and not incurred after-the-fact because research and development have already taken place. I do not have any doubt that the $18,618 is a current expense of the Appellant for profit and loss computation but I hold that it is not a "qualified expenditure" for the purposes of an investment tax credit. The appeal is dismissed.

Signed at Ottawa, Canada, this 2nd day of May, 2007.

"M.A. Mogan"

Mogan D.J.

CITATION:	2007TCC260
COURT FILE NO.:	2005-4039(IT)I
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APPEARANCES:

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