COURT OF APPEAL

CANADA

PROVINCE OF QUEBEC

DISTRICT OF MONTREAL

No.: 500-09-030056-220

(500-80-038698-198) (500-80-038699-196)

DATE : April 5, 2024

CORAM:THE HONORABLE MARK SCHRAGER, J.A.

STÉPHANE SANSFAÇON, J.A.

PETER KALICHMAN, J.A.

MANUFACTURE KUTE KNIT INC .

Appellant

v.

QUEBEC REVENUE AGENCY

Defendant

JUDGEMENT

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[1] The appellant appeals from a judgment rendered on April 5, 2022, by the Court of Québec, District of Montreal (the Honorable Claudine Alcindor), which dismissed the appeal from two decisions on objections rendered by the respondent.[1] In these two decisions, the respondent had disallowed tax credits for scientific research and experimental development ("SR&ED") activities, which credits were intended to cover expenditures for the salaries of the supervisory staff and support staff hired by the appellant for the years 2011 and 2012.

[2] The appellant specialized in dyeing, textiles, and children's clothing. In this context, it carried out SR&ED projects, which qualified it for tax credits (37.5%) calculated on the salaries paid to certain categories of employees who worked on these projects.

[3] Under an agreement between the Canada Revenue Agency ("CRA") and the respondent, it was the CRA that determined whether the conditions relating to the scientific aspects of reported SR&ED projects had been met. In the case at bar, the CRA recognized that the projects for which the appellant sought credits for the two disputed years had met those conditions, a fact the respondent admits and one that is not at issue.

[4] The appellant claimed such credits from the respondent for three categories of employees who, according to the appellant, had participated in its SR&ED projects during 2011 and 2012, the two disputed years. After initially disallowing the entire claim, the respondent partially reversed its decision because it was satisfied with the appellant's demonstration of its method for calculating the involvement of employees in one of the three categories (the machine technicians and operators), which method made it possible to determine the number of hours they had spent on the SR&ED projects (the method being based on the quantities of textiles processed by these employees within the scope of these projects). The respondent therefore accepted the claim for these employees but maintained its refusal for the other two categories — i.e., the supervisory staff and support staff — because the appellant had not shown that the supervisory staff and support staff had actually participated in the SR&ED projects as it had reported. Consequently, the respondent sent the appellant notices of assessment, which were appealed to the Court of Québec and resulted in the judgment under appeal.

[5] The trial judge concluded that the appellant had failed to rebut the presumption of validity of the assessments.

[6] The appellant argues that the trial judge erred by failing to acknowledge that it had discharged its burden of prima facie rebutting the presumption of validity of the assessments; (i) by concluding that the appellant had not presented sufficient prima facie evidence that the percentage of hours worked by its supervisory staff and support staff was reasonable; (ii) by determining that the appellant was required to provide detailed time sheets for the work performed on the SR&ED projects by these two categories of employees; and (iii) by concluding that the appellant had presented tables that contained anomalies.

[7] More specifically, the appellant submits that the testimony of the ARQ officer acknowledging that the employees whose salaries had been disallowed had performed SR&ED work (which, indeed, the judge found to be so based on the evidence[2]) is sufficient to show that the 0% rate set by the respondent was clearly wrong and had the effect of reversing the onus of proving that some of these employees had worked on these projects. Moreover, the appellant argues, the CRA accepted these rates in 2006 and they were never subsequently put into question.

[8] The appellant further alleges that the percentages it reported were accepted by the CRA in 2006 as part of an audit, after discussions and negotiations, which gives the percentages an aura of validity.

[9] The appellant is incorrect.

[10] In Alertpay,[3] the Court, per Ruel, J.A, summarized the applicable law regarding the presumption of validity of tax assessments provided for in s. 1014 of the Taxation Act:

> [25] A tax assessment benefits from a presumption of validity . It may be rejected by the taxpayer if he presents prima facie evidence demonstrating the inaccuracy of the assessment .
>
> [26] The taxpayer's burden is to demonstrate "how the facts on which the assessment is based are incorrect. This evidence must be sufficient to convince the court, at first glance." It must also "contain a certain degree of precision and probability in its favour" to be upheld.
>
> [27] A "Clear testimony, unshaken in cross-examination and offered by a witness whose credibility has not been questioned, while no evidence to the contrary has been presented by the tax authorities " may constitute sufficient evidence to "demolish" the presumption. However, the simple denial of the facts relied on for the issuance of the notice of assessment is not sufficient to counter the presumption of validity.
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> [28] If the taxpayer meets these requirements, then the burden of proof is reversed, and it is up to the tax authority to "refute the prima facie evidence and prove the assessment made by presumption" by a preponderant of evidence.
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> [References omitted]

[11] The outcome of the present appeal hinges on correctly identifying the element of the assessment that had to be “demolished” in this way. The appellant maintains that it had the burden of proving prima facie that the 0% rate set by the respondent was unreasonable and that it met that burden given the admission by the respondent’s representative that some of the employees in these two categories had worked on SR&ED projects during the disputed years.

[12] It is mistaken.

[13] In Gervais Auto,[4] the Court had to adjudicate an appeal by a taxpayer who had claimed a 10% expense deduction for interest paid to an affiliated management company. In the course of a tax audit, the ARQ informed the taxpayer that, in its view, the taxpayer should only have been charged a rate of 3%, rather than 10%, to which the taxpayer had responded by providing an expert’s report estimating that the rate ordinarily charged in such circumstances ranged from 7.89% to 12.39%. The ARQ subsequently revised the rate from 3% to 7.89%, which it considered to be reasonable in the taxpayer’s industry. The taxpayer appealed to the Court of

Québec, which dismissed the appeal, concluding that the taxpayer had not discharged its burden of proof, which was to prima facie demolish the presumption of accuracy of the notices of assessment. The judge wrote:

> [55] Thus, in this case, at this first stage, the applicant does not have to prove the reasonableness of the 10% interest rate on the financing obtained. Its initial burden is to "demolish" the presumption of accuracy of the notices of assessment issued by presenting prima facie evidence demonstrating that the 7.89% interest rate retained by the ARQ is not a reasonable rate within the meaning of section 420 *LI*
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> […]
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> [65] In the circumstances, the applicant has not succeeded in "demolishing", by prima facie evidence, the presumption of accuracy of the notices of assessment issued on the basis of the interest rate of 7.89% and the appeal must therefore be dismissed.

[14] The taxpayer appealed the judgment. This Court allowed the appeal, setting out the taxpayer's burden of proof as follows:

> [11] The appellant proposes that the judge erred in law in holding that "it is the reasonableness of the revised rate of 7.89%" retained by the respondent in the audit report of July 28, 2016 "which is in dispute", and by imposing on it the burden of providing prima facie evidence demonstrating that this rate is not reasonable within the meaning of article 420 *LI*.
>
> [12] She is right.
>
> [13] Indeed, the appellant did not have to demonstrate prima facie that the rate of 7.89% was unreasonable, but rather that the premise on which the respondent based its assessment, namely that the 10% interest rate deducted from its income for the tax years in dispute was not "reasonable in the circumstances", was prima facie , or "at first sight", unfounded.
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> […]
>
> [18] Thus, as early as 1948, the Supreme Court specified in the judgment Johnston v. Minister of National Revenue that the burden of the taxpayer who contests the validity of a notice of assessment on appeal is to demolish "[…] the basic fact on which the taxation rested".
>
> [19] More recently, in Alertpay Incorporated v. Agence du revenu du Québec, the Court confirmed that the taxpayer's burden of proof "is to demonstrate 'in what way the facts on which the assessment is based are incorrect […]'".

> [20] However, in the present case, "the basic fact", or the element on which the respondent relied to contribute, or even the essential premise underlying its contribution, is, according to it, the unreasonable nature within the meaning of section 420 LI of the 10% interest expense that the appellant deducted from its income for the tax years in dispute. It is this fact, or this premise that the appellant had to "demolish" prima facie; it did not have to demonstrate, even prima facie, the unreasonable nature of the rate of 7.89% ultimately retained by the respondent
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> […]
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> [24] That said, and as already mentioned, the initial burden of proof assumed by the appellant is to demonstrate prima facie, or "at first sight", that the premise relied on by the respondent in support of the notices of assessment, namely that the 10% interest rate that it deducted from its business income for the years in dispute is not reasonable in the circumstances, is unfounded. [5]

[15] In the case at bar, s. 230 of the Taxation Act[6] sets out the conditions under which SR&ED expenditures can give rise to a credit:

230. Expenditures on scientific research and experimental development include only	**230.** Les dépenses relatives à la recherche scientifique et au développement expérimental ne comprennent que les dépenses suivantes :
(a) (…)	*a*) (…)
(b) in cases other than those referred to in section 226, expenditures incurred by a taxpayer in a taxation year, other than a taxation year for which the taxpayer has elected under subparagraph *c*, each of which is	*b*) dans les cas autres que ceux visés à l'article 226, les dépenses engagées par un contribuable dans une année d'imposition, à l'exclusion d'une année d'imposition pour laquelle le contribuable a fait un choix en vertu du paragraphe *c*, dont chacune représente :
i. an expenditure of a current nature all or substantially all of which was attributable to the prosecution, or to the provision of premises, facilities or equipment for the prosecution, of scientific research and experimental development carried on in Canada, or	i. une dépense de nature courante imputable en totalité ou presque à la poursuite de recherches scientifiques et de développement expérimental au Canada ou à la fourniture de locaux, d'installations ou de matériel à cette fin;
ii. an expenditure of a current nature directly attributable, as determined by regulation, to the prosecution, or to the provision of premises, facilities or equipment for the prosecution, of scientific research and experimental development carried on in Canada, and	ii. une dépense de nature courante directement imputable, selon les règlements, à la poursuite de recherches scientifiques et de développement expérimental au Canada ou à la fourniture de locaux,

(…)

[Underlining added]

d'installations ou de matériel à cette fin;

(…)

[Soulignements ajoutés]

[16] To these conditions, the Regulation respecting the Taxation Act adds the following ones:[7]

230R1. For the purposes of subparagraph ii of subparagraphs a and b of the first paragraph of section 230 of the Act, the following expenditures are directly attributable to the prosecution of scientific research and experimental development:

(a) the cost of materials consumed or processed in such prosecution of scientific research and experimental development;

(b) where an employee directly undertakes, supervises or supports such prosecution of scientific research and experimental development, the part of the expenditure incurred for the employee's salary or wages that may reasonably be considered to be related to that prosecution of scientific research and experimental development; and

(c) other expenditures or any part thereof that is directly related to such prosecution of scientific research and experimental development and that would not have been incurred if that prosecution of scientific research and experimental development had not occurred.

[Underlining added]

230R1. Pour l'application du sous-paragraphe ii des paragraphes a et b du premier alinéa de l'article 230 de la Loi, les dépenses suivantes sont directement imputables à la poursuite de recherches scientifiques et de développement expérimental:

a) le coût des matériaux consommés ou transformés dans une telle poursuite de recherches scientifiques ou de développement expérimental;

b) lorsqu'un employé entreprend, supervise ou supporte directement une telle poursuite de recherches scientifiques et de développement expérimental, la partie de la dépense engagée pour le traitement ou le salaire de l'employé que l'on peut raisonnablement considérer comme étant relative à cette poursuite de recherches scientifiques et de développement expérimental;

c) les autres dépenses, ou la partie de celles-ci, qui sont directement reliées à une telle poursuite de recherches scientifiques et de développement expérimental et qui n'auraient pas été engagées si cette poursuite de recherches scientifiques et de développement expérimental n'avait pas eu lieu.

[Soulignements ajoutés]

[17] Thus, the appellant's onus was to show with prima facie evidence that the respondent's assumption in support of the notices of assessment — namely, that the appellant had not presented tangible evidence for the expenditures it had reported for the salary or wages of the supervisory staff and support staff engaged in the pursuit of SR&ED — was wrong.

[18] The appellant, therefore, should have presented the Court of Québec with facts demonstrating, on a prima facie basis, the percentages, as reported by the appellant, of the SR&ED work performed by its supervisory staff and support staff. As the Court has pointed out, these facts had to [translation] "have a certain degree of precision and probability weighing in [the appellant's] favour, rather than being vague and ambiguous allegations. As a general rule, a simple statement by the taxpayer is not enough; it benefits from being supported by documentary or circumstantial evidence".[8] Furthermore, as the Federal Court of Appeal pointed out in this regard:

> [24] Although it is not conclusive evidence, "the burden of proof put on the taxpayer is not to be lightly, capriciously or casually shifted", considering that "[i]t is the taxpayer's business" (Orly Automobiles Inc. v. Canada, 2005 FCA 425, paragraph 20). This Court stated that the taxpayer "knows how and why it is run in a particular fashion rather than in some other ways. He [or she] knows and possesses information that the Minister does not. He [or she] has information within his [or her] reach and under his [or her] control" (ibid.).[9]

[19] The trial judge found that the appellant had presented no such evidence. The appellant has not convinced us that the judge committed a palpable and overriding error in this regard. In any event, even if the appellant had succeeded in reversing the burden of proof, the absence of a palpable and overriding error in the judge's analysis would lead to the same result — namely, that the evidence clearly does not support the reasonableness of the percentages put forth by the appellant in support of its position.

[20] The only evidence the appellant submitted was a table in which it listed the names of the employees in the two groups and attributed to each of them a percentage of the total time it stated had been spent on the SR&ED projects. Other than this table, the appellant did not file supporting documents regarding the percentages set out therein, be they time sheets, SR&ED progress reports, correspondence, minutes of meetings, internal notes or emails related to these tasks, nor did it file any other document likely to contain an indication that these employees worked on the SR&ED for the percentage of their time listed in the table. It did not call any of the employees from these two groups as witnesses to support these percentages and thereby justify, if only with prima facie evidence, the basis for those percentages. Mr. Weldon, the appellant's external consultant and principal witness, even admitted on cross-examination that he himself had done nothing to determine whether these percentages were accurate or reasonable.

[21] As for the argument that the respondent's objection officer admitted that the employees whose salaries had been disallowed had performed SR&ED work (which, as already noted, the judge determined to be so in light of the evidence[10]) and that this admission showed that the 0% rate set by the respondent was incorrect, it illustrates the appellant's misunderstanding of its burden of proof. Moreover, this admission by the respondent's objection officer contains a

clarification worth noting because it was made in a context that explains why the respondent fully refused to grant the credits claimed:

> Q. Wouldn't it have been more reasonable to say, "Well, listen, I don't have enough evidence in front of me to grant the credits you're saying, but since we know that there was research and development, because we're giving it to you for the employees and operators, we, basically, what we're prepared to do is give you - I don't know - 50% for them... rather than zero"?
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> A. I understand what you are saying.
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> Q. Wouldn't it have been more reasonable to proceed in that way?
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> A. But no, because the R&D tax credit is a relatively generous tax credit, and the administrative policies are very clear; taxpayers must demonstrate, with tangible proof, how they determined their salaries. So, I understand that perhaps the managers did R&D, I don't deny that, basically, I don't have... it's not about that; it's just that I'm not able, based on the evidence that was presented, to determine what the percentage was. So, it could be 5%, 25%, 50%. So, when we look at the administrative policies, we can... it's very clear that the test must be done annually; so, each year, we must determine what the salaries are. Then, it must be based on a method that is applied systematically each year.

[22] This so-called admission by the objection officer is no such thing: at most, she admitted that [translation] “perhaps managerial personnel had done some R&D”, but this was conditioned on the appellant demonstrating with [translation] “tangible proof” how it had determined the portions of the salary of its supervisory staff and support staff that it attributed to the SR&ED work. Without such a demonstration, it was not possible to conclude that the percentage reported in respect of each of these employees could reasonably be considered as relating to the prosecution of SR&ED.

[23] As to the argument that the percentages the appellant reported were accepted by the CRA in 2006 as part of an audit, after discussions and negotiations, which gives those percentages an aura of validity, this cannot amount to such a demonstration. First, the appellant did not file any documents showing that the CRA performed such an audit in 2006, or showing the basis on which such a determination, if any, was made. On the contrary, according to the evidence adduced at trial, the verifications carried out by the respondent with the CRA showed that no such audit had taken place in 2006. Moreover, nothing suggests that the respondent would have been bound by such a decision rendered in 2006 by the CRA.

[24] Second, establishing the portion of the expenditures incurred for the salary or wages of each of the appellant’s employees that can reasonably be considered to relate to SR&ED is an annual exercise, whereas the evidence shows that in the matter at hand the same percentages that

had been set in 2006 were simply reused year after year without the accuracy of these percentages being verified for each of these years and without regard to employee turnover.

[25] To succeed in "demolishing" the notices of assessment, the appellant was required to demonstrate, on a prima facie basis, that the respondent's premise — i.e., that the appellant had not shown that the reported portions of each employee's salary could reasonably be attributed to the prosecution of SR&ED — was false. The judge found that the appellant had not made such a prima facie demonstration, and the appellant has not shown that she committed a palpable and overriding error in this regard.

FOR THESE REASONS, THE COURT:

[26] **DISMISSES** the appeal, with legal costs.

MARK SCHRAGER, J.A.

STÉPHANE SANSFAÇON, J.A.

PETER KALICHMAN, J.A.

Mtre. Carmine A. Pontillo

PONTILLO PECHO

For the appellant

Mtre. Daniel Stock

REVENU QUÉBEC

For the respondent

Date of hearing: January 11, 2024