

BETWEEN:

OLDCASTLE BUILDING PRODUCTS CANADA INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

[OFFICIAL ENGLISH TRANSLATION]

Appeal heard on July 6, 2016, at Montreal, Quebec.

Before: The Honourable Justice Pierre Archambault

Appearances:

Counsel for the Appellant:	Nicolas Simard
Counsel for the Respondent:	Claude Lamoureux

JUDGMENT

The appeals from the assessments made under the *Income Tax Act* (Act) for the 2010 and 2011 taxation years are allowed and the assessments are referred back to the Minister of National Revenue for reconsideration and reassessment on the basis that:

- 55% of Mr. Castonguay's variable salary amount incurred by Oldcastle in 2010 and 40% of his variable salary for 2011 constitute expenditures under section 37 of the Act and under the definition of qualified expenditure in subsection 127(9) of the Act, and also constitute such

expenditures for the purpose of calculating the prescribed proxy amount described in subsection 2900(4) of the *Income Tax Regulations*;

- Oldcastle is entitled to a proxy amount according to the data provided by that corporation to the CRA and in accordance with the findings set out in the reasons herein;
- The capital expenditure of \$22,850 claimed as a deduction for 2010 is eligible for the purpose of calculating the R&D expenditure for the 2011 taxation year.

The appellant shall file its written submissions regarding costs within 30 days of this judgment, unless the parties make, within 10 days of this judgment, a request that their submissions be presented orally.

The respondent shall file her written submissions within 15 days following receipt of the appellant's written submissions.

Signed at Magog, Quebec, this 25th day of August 2016.

"Pierre Archambault"

Archambault J.

Translation certified true
on this 1st day of November 2018.
Erich Klein, Revisor

BETWEEN:

OLDCASTLE BUILDING PRODUCTS CANADA INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

[OFFICIAL ENGLISH TRANSLATION]

REASONS FOR JUDGMENT

Archambault J.

[1] The only issue remaining in the appeals filed by Oldcastle Building Products Canada Inc. (**Oldcastle**) is whether the remuneration amount that Oldcastle incurred in 2010 and 2011 (**relevant years**) with regard to Mr. Bertin Castonguay, president of the Oldcastle Research Centre, constitutes a scientific research and experimental development (**R&D**) expenditure for the purposes of section 37 of the *Income Tax Act* (**Act** or **ITA**), for the purposes of the definition of "qualified expenditure" in subsection 127(9) of the Act and for the purpose of computing the investment tax credit (**ITC**) provided for in subsection 127(5) of the Act. The question arises because Mr. Castonguay's salary is calculated according to a formula that takes into account a percentage of the sales figures for products developed or improved by the Research Centre.

[2] It must be noted that the dispute stemming from the assessments made by the Canada Revenue Agency (**CRA**) raised other questions, which the parties resolved before the appeals were heard. Specifically, the CRA had disallowed the deduction of an amount of \$22,850 as an R&D capital expenditure for the 2010 taxation year on the grounds that this expenditure was only incurred in 2011. In the 2011 assessment under appeal, the CRA did not allow the deduction of that

expenditure. Counsel for the CRA informed the Court that he acknowledged that this expenditure was deductible in computing the tax for the 2011 taxation year.

[3] In making its assessments, the CRA assumed that Mr. Castonguay's activities were not directly related to the R&D activities of the projects that were audited.¹ Consequently, the CRA refused to consider Mr. Castonguay's salary as an R&D expenditure for the purposes of section 37 of the Act and for the purpose of computing the ITC relating to such an expenditure. Following meetings between Mr. Castonguay and CRA representatives, counsel for the respondent informed the Court, in a letter dated July 4, 2016, that the respondent was willing to acknowledge that 55% of the hours Mr. Castonguay worked in 2010 were directly related to the R&D activities of the projects audited.² He informed the Court at the beginning of the hearing that the percentage was 40% for 2011.

[4] Also, Oldcastle had elected to use the proxy method set out in clause 37(8)(a)(ii)(B) of the Act,³ but the CRA had set the proxy amount at zero. The CRA later received the information it required to calculate that amount. (See letter dated July 4, 2016). However, there still remains the issue as to whether the salary paid to Mr. Castonguay constitutes a qualified expenditure for the purpose of that calculation.

I. Background

[5] Oldcastle is a Canadian company that is part of an international group (CRH Group) based in Ireland. CRH is a construction materials multinational whose global revenues total approximately \$30 billion. In 2001, a CRH Group company purchased the Permacon Group for over \$100 million. One of the founding companies of Permacon was Bloc Vibré Inc., a Sherbrooke company that had belonged to Mr. Castonguay's family. At the time of the purchase, Mr. Castonguay, 49 years old at the time, was president of the Permacon Group, while his brother, also an important shareholder in that group, wanted to retire. From 2001 to 2003, Mr. Castonguay guided the transition of the Permacon Group companies into the CRH Group.

[6] Since Oldcastle wanted to keep Mr. Castonguay on board following the transition, his proposal to found a research centre for the development of new

¹ Paragraph 42m) of the reply to the notice of appeal.

² The eligibility of the R&D projects themselves is not at issue.

³ See paragraph 42e) of the reply to the notice of appeal.

products and processes was accepted. Oldcastle is a North-American leader in the manufacturing of concrete products for use in masonry and landscaping, as well as products distributed at retail for the construction and landscaping do-it-yourselfer.

[7] To house the Research Centre, Oldcastle built a facility in Ville d'Anjou (Montreal) at a cost of between \$6 million and \$7 million. Mr. Castonguay agreed to become its president. From 2004 to 2012, the number of employees at the Research Centre varied between 25 and 30. The conditions of Mr. Castonguay's employment contract are set out in a signed document that took effect on January 1, 2004. (Exhibit A-4). Clause 2.1 of the contract describes the nature of his services as follows:

- 2.1 As Director, Research and Development of APG's R&D Group and as Chairman of the Corporation [Oldcastle], the Executive's duties and responsibilities shall include, in addition to those inherent to the Executive's titles, the following duties and responsibilities:
- (a) hiring, organizing and managing an effective research and development team on behalf and for the benefit of the Corporation;
 - (b) executing a process for consistently producing and assisting in the launch of New Products, Modified Products and new manufacturing processes;
 - (c) creating a process to obtain, and obtaining the Corporation's senior management approval of annual research and development budget;
 - (d) managing the filing of patents concerning New Products and Modified Products and supporting litigation efforts;
 - (e) liaising with outside sources of innovation to attract and attain exclusive products/services agreements for the Corporation;
 - (f) managing the research and development budget in order to maintain tight control over funding of projects and ensure the efficient utilization of research and development resources;
 - (g) ensuring the proper care and maintenance of research and development facilities and equipment; and
 - (h) managing the delivery of ideas from third parties to obtain the best possible royalty levels for APG.

[8] In addition, the contract stipulated that any inventions developed by Mr. Castonguay belonged to Oldcastle:

- 7.2 In consideration of the Base Salary, bonus and other remuneration paid by the Corporation to the Executive hereunder, all Works (including all data and records pertaining thereto) that the Executive may invent, discover, author, originate or conceive during this Agreement with the Corporation or during the three (3)-month period following any termination of this Agreement and all Intellectual Property Rights relating thereto shall be the sole and exclusive property of the Corporation. The Executive hereby waives any and all of his moral rights in the Works or Intellectual Property Rights.

[Emphasis added.]

[9] Clause 10 sets out the remuneration to which Mr. Castonguay will be entitled:

- 10.1 For the first year of his employment with the Corporation, the Executive shall receive an annual base salary of four hundred thousand Canadian dollars (CDN\$400,000) (hereinafter, the “Base Salary”). For the second and third year of his employment with the Corporation, the Executive’s annual base Salary shall be three hundred thousand Canadian dollars (CND\$300,000), plus an amount of one hundred thousand Canadian dollars (CND\$100,000) payable if the Executive meets the objectives determined by the Corporation at the beginning of the relevant year. **After such three (3)-year period**, and subject to Section 10.6, the Executive’s annual Base Salary shall be one hundred thousand Canadian dollars (CND\$100,000). The Base salary is payable in equal monthly installments.
- 10.2 The Corporation shall pay the Executive, on a quarterly basis, a bonus based on the annual Net Sales of New Products and calculated as follows:

	Net sales of New Products	Percentage of Net Sales Payable as Bonus
(a)	US\$0 through US\$25,000,000	1.5%
(b)	US\$25,000,001 through US\$50,000,000	1.0%
(c)	US\$50,000,001 through US\$100,000,000	0.75%
(d)	US\$100,000,001 through US\$200,000,000	0.50%
(e)	US\$200,000,001 through US\$400,000,000	0.25%
(f)	US\$400,000,001 or more	0.125%

- 10.3 The Corporation shall also pay to the Executive a bonus based on the annual Net Sales of Modified Products and calculated as follows:

	Net sales of Modified Products	Percentage of Net Sales Payable as Bonus
(a)	US\$0 through US\$25,000,000	0.30%
(b)	US\$25,000,001 through US\$50,000,000	0.20%
(c)	US\$50,000,001 through US\$400,000,000	0.15%
(d)	US\$400,000,001 or more	0.10%

- 10.4 The bonuses to be paid pursuant to Sections 10.2 and 10.3 shall be paid, with respect to each product, for a period of time determined as follows: (a) if the Corporation or Affiliates thereof have filed one or more patents with respect to such product, until the expiration of all such patents, or (b) otherwise, ten (10) years after the first sale of such product. Except as set forth in Section 13.2, no bonus shall be payable to the Executive after three (3) years following the termination of his employment with the Corporation. It is also understood that no such bonus will be payable after termination for Cause of the Executive's employment.
- 10.5 During the first three (3) years following the Effective Date, the Corporation shall only pay to the Executive the portion of the bonus calculated pursuant to Sections 10.2 and 10.3 that is in excess of three hundred thousand Canadian dollars (CDN\$300,000). After the end of the first three (3) years following the Effective Date, however, the bonus shall be payable in whole, without any such deduction, subject to the other terms and conditions of this Agreement.
- 10.6 After the end of the third year following the Effective Date, the Executive's Base Salary shall be reduced by twenty thousand Canadian dollars (CDN\$20,000) for each tranche of one hundred thousand Canadian dollars (CDN\$100,000) of bonus in excess of five hundred thousand Canadian dollars (CDN\$500,000). For example, if the Executive is entitled to a bonus of six hundred thousand Canadian dollars (CDN\$600,000) for a specific year, his Base Salary for such year shall be reduced to eighty thousand Canadian dollars (CDN\$80,000). For greater certainty, the Executive's Base Salary for a specific year shall be CDN\$0.00 if the Executive is entitled to a bonus of one million Canadian dollars (CDN\$1,000,000) for such year. The Corporation may, at its discretion, offset the amount of any reduction for the Executive's Base Salary against the payment of any Base Salary installment or bonus payment.

[Underlining and bold emphasis added.]

[10] For a better understanding of the scope of the remuneration provisions, the definitions in Appendix A of the contract must also be provided, particularly the following:

(B) “**APG**” shall mean the North American branch of Oldcastle’s Architectural Product Group.

...

(J) “**Modified Products**” means significant improvements to existing products (excluding New Products) in terms of either cost reduction, functionality improvement and/or aesthetic improvement developed by APG’s R&D Group under the Executive’s direction while the Executive is employed by the Corporation. The list of Modified Products will be determined in writing and agreed by the Executive and the Corporation within thirty (30) days following each anniversary date of the Effective Date. The current list of new and modified products is attached and labeled Schedule B.

(K) “**Net sales**” shall mean, in respect of any New Product or Modified Product, the gross amount invoiced and collected by the Corporation or any of its Affiliates for such product to any Person (other than an Affiliate) in North America less (i) any discount; (ii) shipping and insurance expenses, (iii) credits or refunds and (iv) sales and other taxes and duties directly related to the sale.

(L) “**New Products**” means completely new products or systems of products developed by APG’s R&D Group under the Executive’s direction, regardless of whether or not the item originated in APG or was obtained from a third party, while the executive is employed by the Corporation and that the Corporation or its Affiliates are not producing and/or selling on the date hereof (with the exception of ISO Stone/ISO Brick which will be included). Examples of New Products developed in the past include Dufferin Stone, Gallea Brick, Mega-Bergerac and Celtik Wall. The parties agree that the product Suretouch Wall System shall constitute a New Product for the purposes of this Agreement. The list of New Products will otherwise be determined in writing and agreed upon by the Executive and the Corporation within thirty (30) days following each anniversary date of the Effective Date. The current list of new and modified products is attached and labeled Schedule B.

[Emphasis added.]

[11] During the transition period in which the Permacon Group was being brought into the Oldcastle fold, Mr. Castonguay’s salary ranged between

\$200,000⁴ and \$290,000. During that period, Mr. Castonguay was granted stock options on CRH Group shares.

[12] During the initial years in which he was president of the Research Centre, Mr. Castonguay's salary was approximately \$400,000. It was \$789,000 in 2008, \$906,000 in 2009, \$1,058,000 in 2010 and \$1,114,000 in 2011. Consequently, if one applies the formula set out in clause 10.6 of his employment contract, his base salary for the relevant years was zero, whereas his remuneration that is described as a "bonus" in the employment contract and which, for the reasons stated below, I will refer to as the "variable salary", amounted to \$1,058,000 in 2010 and \$1,114,000 in 2011.

II. Analysis

A. Relevant provisions of the Act

[13] To decide appeals such as Oldcastle's, it is always helpful to first look at the relevant statutory provisions that applied during the years at issue. There are the provisions dealing with the deduction of R&D expenditures in computing income from a business, found in section 37 of the Act, and the provisions concerning the computation of tax, and more specifically the computation of the ITC, set out in subsections 127(5) and 127(9) of the Act. The first relevant provision is subclause 37(8)(a)(ii)(B)(IV) of the Act, which states the following:

37(8) In this section,

(a) references to expenditures on or in respect of scientific research and experimental development

...

(ii) where the references occur other than in subsection (2),⁵ include only

...

(B) where a taxpayer has elected ⁶ in prescribed form . . .
expenditures . . . each of which is

⁴ This was his salary for less than 12 months.

⁵ Which deals with R&D expenditures for activities carried on outside Canada.

⁶ This refers to the election to use the proxy method.

...

- (IV) 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, and, for this purpose, where that portion is all or substantially all of the expenditure, that portion shall be deemed to be the amount of the expenditure, or

[Emphasis added.]

[14] The phrase "salary or wages" is defined as follows in subsection 248(1) of the Act:

"salary or wages", except in sections 5 and 63 and the definition "death benefit" in this subsection, means the income of a taxpayer from an office or employment as computed under subdivision a of Division B of Part I and includes all fees received for services not rendered in the course of the taxpayer's business but does not include superannuation or pension benefits or retiring allowances;

[Emphasis added.]

[15] It can be seen that the concept of salary is broad. However, for the purposes of subsection 37(8) of the ITA, subsection 37(9) states the limitations that apply in certain circumstances:

37(9) An expenditure of a taxpayer

(a) does not include, for the purposes of clauses (8)(a)(ii)(A) and (B), remuneration based on profits or a bonus, where the remuneration or bonus, as the case may be, is in respect of a **specified employee** of the taxpayer, and

(b) ...

[Underlining and bold emphasis added.]

Subsection 248(1) of the Act defines "specified employee" as follows:

"**specified employee**" of a person means an employee of the person who is a specified shareholder of the person or who does not deal at arm's length with the person.

[16] Subsection 37(9.1) of the ITA adds another limitation applicable to the salary paid to specified employees:

37(9.1) For the purposes of clauses (8)(a)(ii)(A) and (B), expenditures incurred by a taxpayer in a taxation year do not include expenses incurred in the year in respect of salary or wages of a **specified employee of the taxpayer to the extent that those expenses exceed the amount determined** by the formula

$$A \times B/365$$

where

A is 5 times the Year's Maximum Pensionable Earnings (as determined under section 18 of the *Canada Pension Plan*) for the calendar year in which the taxation year ends; and

B is the number of days in the taxation year on which the employee is a specified employee of the taxpayer.

[Underlining and bold emphasis added.]

[17] It should be noted right away that counsel for the CRA acknowledges that Mr. Castonguay is not a "specified employee" because, during the relevant years, he held no shares in Oldcastle or the CRH Group and an arm's length relationship existed between him and his employer.

[18] As we have seen, under section 37 of the Act R&D expenditures can be deducted in computing income from a business, but some of these expenditures are relevant for the purpose of the ITC computation under subsection 127(5) of the Act. The relevant provisions for resolving the dispute regarding Mr. Castonguay's remuneration include in particular the definition of "qualified expenditure" in subsection 127(9):

"**qualified expenditure**" incurred by a taxpayer in a taxation year means

(a) an amount that is an expenditure incurred in the year by the taxpayer in respect of scientific research and experimental development and is

(i) an expenditure described in subparagraph 37(1)(a)(i),⁷

...

(b) a prescribed proxy amount of the taxpayer for the year . . .

but does not include

(c) a prescribed expenditure incurred in the year by the taxpayer,

...

[Emphasis added.]

[19] The relevant provisions of the *Income Tax Regulations* (**Regulations**) that deal with the proxy amount are as follows:

2900(4) For the purposes of the definition "qualified expenditure" in subsection 127(9) of the Act, the **prescribed proxy amount** of a taxpayer for a taxation year, in respect of a business, in respect of which the taxpayer elects under clause 37(8)(a)(ii)(B) of the Act is 65% of the total of all amounts each of which is that portion of the amount incurred in the year by the taxpayer in respect of salary or wages of an employee of the taxpayer who is directly engaged in scientific research and experimental development carried on in Canada that can reasonably be considered to relate to the scientific research and experimental development having regard to the time spent by the employee on the scientific research and experimental development.

[Underlining and bold emphasis added.]

[20] Subsections 2900(7) and (9) also enact limitations:

2900(7) In determining the prescribed proxy amount of a taxpayer for a taxation year, the portion of the amount incurred in the year by the taxpayer in respect of

⁷ That subparagraph provides as follows:

37(1) Where a taxpayer carried on a business in Canada in a taxation year, there may be deducted in computing the taxpayer's income from the business for the year such amount as the taxpayer claims 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 related to a business of the taxpayer, carried on in Canada and directly undertaken by the taxpayer,

...

[Emphasis added.]

salary or wages of a **specified employee**⁸ of the taxpayer that is included in computing the total described in subsection (4) shall not exceed the lesser of

(a) 75% of the amount incurred by the taxpayer in the year in respect of salary or wages of the employee, and

(b) the amount determined by the formula

$$2.5 \times A \times B/365$$

where

A is the Year's Maximum Pensionable Earnings (as determined under section 18 of the *Canada Pension Plan*) for the calendar year in which the taxation year ends, and

B is the number of days in the taxation year in which the employee is an employee of the taxpayer.

...

2900(9) For the purposes of subsections (4) and (7), an amount incurred in respect of salary or wages of an employee in a taxation year does not include

(a) an amount described in section 6 or 7 of the Act;

(b) an amount deemed under subsection 78(4) of the Act to have been incurred;

(c) bonuses; or

(d) remuneration based on profits.

[Underlining and bold emphasis added.]

B. Bonuses or remuneration based on profits?

[21] As can be seen, in terms of the treatment of the deduction of R&D expenditures and the treatment of the computation of the ITC, similar rules exist, notably regarding the limitations on the salary paid to specified employees, but differences also exist, in particular with regard to bonuses. Thus, for the purposes of the deduction of the R&D expenditure, the limitation applicable to bonuses only applies if the bonus is paid to a specified employee but, for ITC purposes, it applies

⁸ It should be mentioned again that Mr. Castonguay was not a specified employee.

to any employee. Consequently, it is necessary to first determine whether a bonus ("gratification" in the French version of the Act and Regulations) was paid to Mr. Castonguay. It should be noted that clause 10 of his employment contract uses the term "bonus" when referring to the calculation of the salary to which he is entitled for his services.

[22] The terms "bonus" in English and "gratification" in French are not defined in the Act or the Regulations. Their common meanings must accordingly be used. Antidote⁹ defines "gratification" as a "somme versée en plus de ce qui est dû" ("amount paid in addition to what is owing"). In English, "bonus" is therein defined as "something that is given as an extra when it was not expected, necessary." (Emphasis added.) Also given as a meaning is "an extra amount of money that is given to an employee, especially at the end of the year for good work." (Emphasis added.) Here, the employment contract stipulates that Mr. Castonguay's remuneration includes two elements: a fixed salary plus an amount based on sales of "New Products" and "Modified Products," which amount I refer to in these reasons as variable salary.

[23] This variable salary resembles a [TRANSLATION] "performance bonus" that could be added to a fixed salary. In Antidote, the French term "prime" is defined as follows:

Somme d'argent payée à un employé, en plus de son salaire, pour le récompenser ou pour couvrir certains frais. Prime d'éloignement. Prime de transport, de risque. Prime d'entreprise. Prime de rendement. Chasseur de prime.

[TRANSLATION]

Amount paid to an employee, in addition to the employee's salary, as a recompense or to cover certain costs. Isolated post allowance. Transportation allowance, hazard bonus. Corporate bonus. Performance bonus. Bounty hunter.

[24] However, here, since the employment contract expressly stipulates that the base salary disappears (becomes zero) if the variable salary reaches \$1,000,000, only the variable salary is then owing. "Performance bonus" therefore does not strike me as being the most suitable term to describe the remuneration paid to Mr. Castonguay during the years at issue.

⁹ Antidote 9, bilingual, v3, 2016, Druide informatique inc., Montreal.

[25] This variable salary closely resembles remuneration paid to employees working as intermediaries, such as salespersons, sales representatives or brokers (in securities, real estate or insurance), who are often only paid by commission, which is also based on the proceeds from the sale of, manufactured goods, securities, real estate or insurance policies, for example. Antidote defines the French term "commission" as follows: "Pourcentage qui revient à un intermédiaire. Le vendeur touche une commission de 10 %. Travailler à la commission ou QUÉBEC – être payé à commission. ([TRANSLATION] "Percentage payable to an intermediary. The salesperson is paid a 10% commission. Work on commission or (QUEBEC) be paid by commission.")

[26] However, one cannot speak of commission here because the variable salary is not remuneration paid to an intermediary who is selling the employer's products or services.¹⁰ Mr. Castonguay is managing a research centre and is involved in specific R&D projects. One would think that the sale of Oldcastle's products is carried out by other employees of that company.

[27] Under the terms of the employment contract, the variable salary is not an amount that Mr. Castonguay's employer, at its discretion, pays him at the end of the year because it is satisfied with the work accomplished, a sort of gift given in addition to what is due. Here, Oldcastle is not free to pay or not pay the variable salary. It is payable in accordance with the terms and conditions of the employment contract. Moreover, the employment contract also stipulates that, when the variable salary reaches one million dollars, there is no base salary payable. Consequently, the only remuneration paid to Mr. Castonguay in 2010 or 2011 was not an "amount paid in addition to what is owing". That remuneration therefore cannot be a bonus for the purposes of the Act and the Regulations.

[28] Nor is it a remuneration based on profits since the formula set out in the employment contract provides for remuneration based on the following calculation: sales of products developed by the Research Centre less two expenses—shipping costs and insurance costs. (See the definition of "net sales" reproduced above.) Too many of the expenses incurred for the sale of these products are missing for it to be possible to determine whether Oldcastle made a profit on the sales of the products. Ultimately, the expression "variable salary" appears to me to be the most appropriate to describe the remuneration paid to Mr. Castonguay.

¹⁰ See clause 7.2 of the employment contract, reproduced above.

C. Salary expenditure incurred in the year for an employee directly engaged in R&D activities?

[29] In his argument, counsel for the respondent submitted that the variable salary paid to Mr. Castonguay was not an expenditure contemplated by section 37 of the Act because the formula for calculating the amount of that salary referred to the sale of products with regard to which R&D activities had been carried on in previous years. Consequently, such salary could not have been remuneration for R&D activities carried on by Mr. Castonguay during the relevant years.

[30] In my view, this CRA view is completely unfounded. With respect, I am of the opinion that the CRA is confusing the nature of the amount paid with the method of calculation of the amount and thereby changing the nature of the amounts paid by Oldcastle to Mr. Castonguay. It appears clear to me that Oldcastle intended to adequately remunerate Mr. Castonguay for the work he performed as president of the Research Centre, as indicated in the description of his duties in the employment contract. Other than the role—an often honorary one in the case of a subsidiary of a multinational—of Chairman of Oldcastle's board of directors, his work was entirely related to the management of the Centre and to its R&D activities. Moreover, the CRA acknowledged that 55% and 40% of his working hours in 2010 and 2011 respectively were devoted "directly" to R&D activities, and the eligibility of the R&D projects carried out by Oldcastle, and in which Mr. Castonguay participated during the relevant years, is not in dispute.

[31] The CRH Group had paid over \$100 million for the Permacon Group, and the transition whereby the latter was brought under the umbrella of that multinational was completed over the period between 2001 and 2004. However, Oldcastle wanted to keep the services of Mr. Castonguay, and Mr. Castonguay was amenable to persuasion if offered a challenge that reflected his interest and his passion. Mr. Castonguay had taken courses relating to research on concrete products at the Université de Sherbrooke. He holds 72 patents for inventions he created or processes he developed during his long career in the concrete block and architectural masonry industry.¹¹ He had the necessary qualifications and experience to be in charge of the Research Centre and successfully carry out R&D. A \$6 million research centre was built for him. The parties conducted lengthy negotiations to come to an agreement. The employment contract signed by the parties was the ninth version of the agreement. Mr. Castonguay has the mindset of an entrepreneur: he was willing to accept a lower base salary in order to earn a

¹¹ Without taking into account those that are pending.

more substantial variable salary calculated according to the results of his work. Oldcastle was clearly prepared to compensate him well for his contribution to the company's success, while at the same time ensuring that this salary took into account Mr. Castonguay's performance as president of the Research Centre.

[32] That is what is shown by the formula set out in clause 10 of the employment contract. Tying Mr. Castonguay's remuneration to the proceeds from the sale of goods produced through the work carried out at the Research Centre ensured that the R&D work would be relevant to Oldcastle's mission, which was to earn profits by offering goods that met the needs of the market. That agreement seems to have been profitable for both parties. In 2010 and 2011, the base salary was zero, but Mr. Castonguay's variable salary exceeded \$1 million and sales of products developed through the Research Centre's activities amounted to \$120 million in 2010 and \$200 million in 2015! That variable salary formula appears to me to be appropriate for fixing the value of the work Mr. Castonguay performed each year for Oldcastle. Mr. Castonguay holds no shares in Oldcastle or the CRH Group. The employment contract was negotiated by parties dealing with each other at arm's length.

[33] Nothing in the evidence suggests that the amounts paid by Oldcastle to Mr. Castonguay as remuneration were so paid for any consideration other than the work he did as president of the Research Centre. Specifically, they did not constitute a royalty for Oldcastle's right to use property, such as patented (or unpatented) inventions, since, under the employment contract, such property belonged to Oldcastle. (See clause 7.2 reproduced above.) Furthermore, if Mr. Castonguay were to be dismissed for cause, he would lose all rights to receive his variable salary following the termination of his employment¹² and, if he had been dismissed without a valid reason in 2010 or 2011, he would only have been entitled to an amount of \$100,000.¹³

[34] The amounts paid also do not constitute remuneration for the sale of Oldcastle's products because Mr. Castonguay's work was not to sell products, but rather, to develop new products at the Research Centre, to improve products or to discover new processes. The fact that the variable salary formula is based on the sale of new or modified products resulting from the Research Centre's R&D work does not mean that Mr. Castonguay must be considered as a commission

¹² See clauses 10.4 and 12.1 of the employment contract.

¹³ See clause 13.1 of the employment contract, applicable if the dismissal occurred following a period of 6 years after the date on which the contract came into force.

salesperson. In my opinion, the object of the formula is only to quantify the value of the work provided by Mr. Castonguay at the Research Centre.

[35] Even though the employment contract setting out the formula for calculating the variable salary ("bonus" according to the employment contract) for a given year stipulated that the annual proceeds from the sales made during that year of goods developed or improved by the Research Centre in previous years¹⁴ were what was to be taken into account, the fact remains that Oldcastle intended to compensate Mr. Castonguay for the work he performed during that year. Once again, the CRA is confusing the calculation formula with the nature of the amount paid and the purpose of its payment. The object was not to remunerate services provided by him in previous years.¹⁵ Mr. Castonguay had already been remunerated for the previous years. Moreover, the sales figure for the current year was taken into account to determine the variable salary for that year. In view of the difficulty in obtaining the relevant data for each quarter, a partial payment of \$300,000 was made throughout the year, and the balance owing on the variable salary was paid once the calculation of that salary could be completed.

[36] In the case of a taxpayer who has elected the proxy method under clause 37(8)(a)(ii)(B) of the Act, only that portion of the expenditure made in respect of the salary of an employee who is directly engaged in R&D activities which relates to that employee's R&D work qualifies for the favourable tax treatment created by section 37 and subsection 127(5) of the Act. Since Mr. Castonguay's variable salary constituted his salary for all, or nearly all, of his work related to R&D (and the only salary he received from Oldcastle during the relevant years) and since the CRA admitted before the Court that 55% of his working hours in 2010, and 40% in 2011, were directly related to the R&D activities of the projects audited, it is reasonable to conclude that 55% of his variable salary in 2010, and 40% in 2011, therefore qualify for the purposes of subsections 37(1) and 127(5) of the Act. These portions of the variable salary paid

¹⁴ In my view, the employment contract is not as explicit, but that is how I interpret it. The calculation of Mr. Castonguay's variable salary is based on annual sales of new products or modified products and is payable quarterly. (See clause 10.2 of the employment contract, reproduced above.) Furthermore, the formula does not exclude products developed in the current year, but one can assume that, in practice, the sale of such products would not have occurred often.

¹⁵ The only exception might be the variable salary paid under clause 10.4 of the employment contract during the three years following the termination of his employment. However, I need not decide that question because during the relevant years Mr. Castonguay continued to be employed by Oldcastle.

by Oldcastle in 2010 and 2011 are expenditures made in respect of expenses incurred in the year for the salary of an employee who is directly engaged in R&D activities that can reasonably be considered as relating to this work, having regard to the time spent by the employee thereon. There are no limitations similar to those applying to the salary paid to a specified employee,¹⁶ particularly as regards a maximum eligible amount: see subsections 37(9.1) of the ITA and 2900(7) of the Regulations, reproduced above.

[37] The position taken by the CRA before this Court is difficult to reconcile with the legislation. Its counsel acknowledges that remuneration based on Oldcastle's profits would be eligible under section 37, but submits that remuneration based on the proceeds from sales of new products or modified products developed by the Research Centre would not be! Why would remuneration based on the corporation's profits be more acceptable than remuneration based on sales of products developed by the Research Centre? There exists an even closer link between the proceeds from sales of those products and the R&D activities than between the corporation's profits and the R&D activities. Moreover, counsel for the CRA was unable to justify this contradiction.

[38] Consequently, Oldcastle's appeals are allowed and the assessments are referred back to the Minister of National Revenue for reconsideration and reassessment on the basis that:

- 55% of Mr. Castonguay's variable salary amount incurred by Oldcastle in 2010 and 40% of his variable salary for 2011 constitute expenditures under section 37 of the Act and under the definition of qualified expenditure in subsection 127(9) of the Act, and also constitute such expenditures for the purpose of calculating the prescribed proxy amount described in subsection 2900(4) of the Regulations;

¹⁶ The authors of the Canadian Tax Reporter Commentary (Wolters Kluwer Limited) wrote the following at ¶5936, under the heading "Limitations for remuneration paid to a specified employee":

...
The Department of Finance's concern is that for the purposes of the SR&ED incentives, the remuneration of specified employees should reflect the value of the SR&ED work the employees perform as opposed to the profitability of the corporation as a whole. In order to "better achieve this objective", Finance announced further restrictions for wages and salaries paid to specified employees, found in subsections 37(9.1) through 37(9.5) [...]

[Emphasis added.]

- Oldcastle is entitled to a proxy amount according to the data provided by that corporation to the CRA and in accordance with the findings set out in the reasons herein;
- The capital expenditure of \$22,850 claimed as a deduction for 2010 is allowable for the purpose of calculating the R&D expenditure for the 2011 taxation year.

[39] Counsel for Oldcastle asked that his client be given the opportunity to submit representations before the Court rules on costs. Consequently, the costs will be determined at a later date.

Signed at Magog, Quebec, this 25th day of August 2016.

"Pierre Archambault"

Archambault J.

Translation certified true
on this 1st day of November 2018.
Erich Klein, Revisor

CITATION: 2016 TCC 183

COURT FILE NO.: 2014-3152(IT)G

STYLE OF CAUSE: OLDCASTLE BUILDING PRODUCTS
CANADA INC. v. HER MAJESTY THE
QUEEN

PLACE OF HEARING: Montreal, Quebec

DATE OF HEARING: July 6, 2016

REASONS FOR JUDGMENT BY: The Honourable Justice Pierre Archambault

DATE OF JUDGMENT: August 25, 2016

APPEARANCES:

Counsel for the Appellant: Nicolas Simard
Counsel for the Respondent: Claude Lamoureux

COUNSEL OF RECORD:

For the Appellant:

Name: Nicolas Simard

Firm: Fasken Martineau DuMoulin

For the Respondent: William F. Pentney
Deputy Attorney General of Canada
Ottawa, Canada