2009 IFA TRAVELLING LECTURESHIP ON ROYALTIES BY NATHAN BOIDMAN
APPENDICES TO LECTURE OUTLINE

APPENDIX 2 (CTJ ARTICLE BY DUNCAN OSBORNE)

Material:

Duncan Osborne, "Revisiting Royalties in the Age of Electronic Commerce", *Canadian Tax Journal*, Volume 47, Issue Number 2, 1999, p. 410

Reproduced with the permission of the Canadian Tax Foundation from, Duncan Osborne, "Revisiting Royalties in the Age of Electronic Commerce" (1999) vol. 47, no. 2 *Canadian Tax Journal* 410-55.

1999, Volume 47, Issue Number 2 / *Numéro 2*

CANADIAN TAX JOURNAL
REVUE FISCALE CANADIENNE

181 ***Special Report, Part 1: Proceedings of a Conference on Personal Income Tax Reform—The Framework for Reform***

182 **Tax Reform and Tax Reduction: Let's Do the Job Right**—***Robert D. Brown***

206 **Comments on the Paper by Robert D. Brown**—***Edwin C. Harris***

210 **Base Reforms and Rate Cuts for a Revitalized Personal Tax**—***Jonathan R. Kesselman***

242 **Why and How Governments Support R & D**—***Gordon Lenjosek and Mario Mansour***

273 **Current Cases:** ***(FCA) Will-Kare Paving & Contracting Limited v. The Queen; (FCTD) Harris v. The Queen; (Ont. Gen. Div.) The Queen v. L. Saplys and Axiom Designs Incorporated***

291 **International Tax Planning:** ***Foreign Affiliates Under Siege: An Update***

305 **Personal Tax Planning/Planification fiscale personnelle :** ***The Taxation of Non- Resident US Athletes Employed by Canadian-Based Professional Sports Teams: Attracting Athletes to Canada***

341 ***L'imposition de sportifs américains non-résidents employés par des équipes professionnelles de sport du Canada : Intéresser des sportifs au Canada***

382 **Selected US Tax Developments:** ***Lessons in Avoiding Transfer-Pricing Penalties: DHL Corp.***

391 **Current Tax Reading**

408 ***1997-98 Award-Winning Student Paper/Lauréat du concours du meilleur texte d'étudiant pour 1997-98***

410 **Revisiting Royalties in the Age of Electronic Commerce**—***Duncan Osborne***

MKT **Marketplace**

Revisiting Royalties in the Age of Electronic Commerce

Duncan Osborne*

PRÉCIS

L'incidence du commerce électronique sur les notions fiscales traditionnelles est un sujet abordé de plus en plus fréquemment dans la littérature fiscale internationale. On s'inquiète en particulier de la possibilité que les approches traditionnelles à la qualification du revenu ne puissent plus convenir parce que le commerce électronique rend les limites de compétence de plus en plus artificielles et que les habitudes commerciales sont de plus en plus difficiles à caractériser. Les contribuables risquent ainsi d'être assujettis à une double imposition. De même, les administrations fiscales pourraient assister à l'érosion de leurs assiettes d'imposition.

Le présent article met l'accent sur la qualification du revenu gagné au Canada par des non-résidents à titre de redevances. Il y est particulièrement question de l'interprétation et de l'application de l'alinéa 212(1)d) de la Loi de l'impôt sur le revenu. Comme de nouvelles formes d'opérations commerciales sans paiement pour l'acquisition de biens corporels ou pour des services sont monnaie courante, l'application possible de l'alinéa 212(1)d) deviendra de plus en plus importante. Après avoir passé en revue l'interprétation et l'application du droit interne et des dispositions pertinentes des traités, l'auteur conclut que l'application de la règle canadienne et des dispositions des traités est pour le moment difficile à prévoir. Cette imprévisibilité sera particulièrement notable dans le contexte des opérations par commerce électronique. Par conséquent, une modification destinée à limiter l'application de la disposition canadienne sur les redevances, qui pourrait nous fournir une plus grande certitude quant à l'imposition d'opérations commercialement équivalentes, pourrait être justifiée.

ABSTRACT

A topic of growing concern in the international tax literature is the impact of electronic commerce on traditional tax principles. In particular,

* Of Davies Ward & Beck, Toronto, and a recent graduate of the Faculty of Law, The University of Western Ontario. Special thanks are due to Daniel Sandler of the Faculty of Law, The University of Western Ontario, who supervised the writing of this article. Thanks are also due to Tim Edgar, also of the Faculty of Law, The University of Western Ontario, for his comments.

concerns have been raised that traditional approaches to revenue characterization may become unworkable as the trend toward electronic forms of commerce makes jurisdictional boundaries increasingly artificial and commercial behaviour increasingly difficult to characterize. Should these traditional approaches become unworkable, taxpayers may be subject to international double taxation. Similarly, tax authorities may encounter an erosion of domestic tax bases.

This article focuses on the characterization of income earned in Canada by non-residents as royalty income. In particular, the article focuses on the interpretation and application of paragraph 212(1)(d) of the Income Tax Act. As new forms of commercial transactions, involving neither payments for the acquisition of tangible goods nor payments for services, become commonplace, the potential application of paragraph 212(1)(d) will become increasingly significant. After reviewing the interpretation and application of the domestic provision and the applicable treaty provisions, this article concludes that, thus far, the application of the domestic and international royalty provisions has been difficult to predict. This unpredictability of application will be exaggerated in the context of electronic commerce transactions. As a result, an amendment of the domestic royalty provision that would narrow its application, thereby providing greater certainty in the taxation of commercially equivalent transactions, may be warranted.

INTRODUCTION

Many papers have been written that focus on the impact of global electronic commerce on traditional tax principles.[1] The general assumption

[1] Typically, these papers have surveyed the topic and highlighted emerging issues. See, for example, Jeffrey Owens, "The Tax Man Cometh to Cyberspace" (June 2, 1997), 14 *Tax Notes International* 1833-52; Alan S. Bloom and Robert S. Giusti, "International Tax Implications of Electronic Commerce on Outbound Transactions" (Fall 1997), 23 *International Tax Journal* 45-61; Peter A. Glicklich, Sanford H. Goldberg, and Howard J. Levine, "Internet Sales Pose International Tax Challenges" (June 1996), 84 *Journal of Taxation* 325-30; Peter A. Glicklich, Howard J. Levine, Sanford H. Goldberg, and Ellen Seiler Brody, "Electronic Services: Suggesting a Man-Machine Distinction" (August 1997), 87 *Journal of Taxation* 69-75; Allyn Yamanouchi, "International Tax Issues Affecting Electronic Commerce and Banking" (May 19, 1997), 14 *Tax Notes International* 1619-24; and Pierre J. Bourgeois and Luc Blanchette, "Income_taxes.ca.com: The Internet, Electronic Commerce, and Taxes—Some Reflections: Part 1," International Tax Planning feature (1997), vol. 45, no. 5 *Canadian Tax Journal* 1127-49 and ". . . Part 2," International Tax Planning feature (1997), vol. 45, no. 6 *Canadian Tax Journal* 1378-1415. The governments of several countries have begun to study the tax impact of electronic commerce. In this regard, see, for example, United States, Department of the Treasury, Office of Tax Policy, *Selected Tax Policy Implications of Global Electronic Commerce* (Washington, DC: Department of the Treasury, November 1996) (herein referred to as "the US Treasury paper"); Australian Taxation Office, *Tax and the Internet: Discussion Report of the Australian Taxation Office Electronic Commerce Project* (Canberra: Australian Government Publishing Service, August 1997) (herein referred to as "the Australian report"). In the

(The footnote is continued on the next page.)

underlying these papers is that the trend away from a manufacturing-based national economy toward an information-technology-based global economy necessitates revisiting several of the distinctions central to our tax system. For example, many authors suggest that the principles underlying the characterization of revenue for tax purposes—whether as income from the sale of goods, income from services, capital receipts, or royalties—must be rethought. These are not new issues. However, the distinctions may become increasingly important as governments, particularly capital-importing nations, concern themselves with defending their share of tax revenues in a global economy largely devoid of meaningful national boundaries. Simply put, as jurisdictional boundaries become increasingly artificial and as it becomes increasingly difficult to characterize commercial behaviour, governments and tax authorities are discovering that traditional views of revenue characterization may be unworkable.

The characterization of income is particularly important in the international context. Under Canada's bilateral tax treaties, royalty income is generally subject to withholding tax in the source state, whereas income from the sale of goods or income from services is generally exempt from tax in the source state in the absence of a permanent establishment or fixed base. Similarly, revenue that is classified as a capital receipt, assuming that the property disposed of is not real property situated in the source state, is not taxable in the source state in the absence of a permanent establishment or fixed base to which the property may be attributed.

The absence of a clearly articulated definition of a royalty results in claims by multiple jurisdictions of the right to tax the income arising from a particular transaction. Where the revenue authorities of those jurisdictions are unable to agree on the meaning of the treaty definition of royalties, or where the revenue authority of the resident state refuses to recognize the withholding tax paid, double taxation will result. In a 1996 study of the tax impact of electronic commerce, the US Treasury department warns that income from cross-border electronic transactions is at risk of multiple or "quixotic" taxation and that "[i]f these technologies are to achieve their maximum potential, rules that provide certainty and

[1] Continued . . .
spring of 1997, Revenue Canada appointed a task force, the Advisory Committee on Electronic Commerce, with the following mandate: to review domestic and international trends in electronic commerce; to identify the potential growth and use of electronic commerce; to identify the implications and associated risks of these trends and their effect on tax compliance; to examine the approaches being taken by other countries; and to recommend the measures that Revenue Canada should consider to ensure compliance in light of identified trends, risks, and international approaches: Revenue Canada, "Revenue Minister Announces Advisory Committee on Electronic Commerce," *Release*, no. 24T97, April 10, 1997. The report of the Advisory Committee on Electronic Commerce was released in the spring of 1998: Canada, *Electronic Commerce and Canada's Tax Administration: A Report to the Minister of National Revenue from the Minister's Advisory Committee on Electronic Commerce* (Ottawa: Revenue Canada, April 1998). Canada also hosted an OECD meeting in Ottawa in October 1998 whose purpose was to discuss the taxation of electronic commerce.

prevent double taxation are required."[2] Ultimately, a general move away from source-based taxation toward residence-based taxation may be inevitable, given the growth of new communications technologies and electronic commerce.[3] However, in the meantime, as it becomes increasingly unnecessary to have an actual physical presence in the source state, issues arise as to how countries will continue to apply existing revenue characterization regimes.[4] Will capital-importing nations expand the scope of transactions considered to give rise to royalty income in an effort to defend a shrinking tax base?[5] As the US Treasury department has acknowledged, the application of existing principles to electronic transactions is not clear and, for the most part, those principles will have to be "adapted and reinterpreted" as technologies develop and, in extreme cases, may have to be replaced by new concepts.[6]

---

[2] US Treasury paper, supra footnote 1, executive summary, at 1.

[3] Ibid., at paragraph 7.1.5. The policy rationale for determining source by reference to geographical factors has been weakened by advances in both travel and communications.

[4] Specifically, it has become increasingly difficult to characterize payments that lie along the boundaries between royalties, income from services, income from sales, and capital receipts. Where, for example, an entertainer enters into a recording contract with a company pursuant to which copyright in the recording is held by the company and the entertainer receives a percentage of the company's sale proceeds from the recording (the agreement may or may not refer to this amount as a "royalty"), is the amount royalty income or income from services? Alternatively, if a Canadian corporation pays an amount for the exclusive right to purchase and market a foreign company's products in Canada or pays an amount based on the number of goods it acquires from the foreign company, is that amount a royalty, capital gain from the disposition of property, or income from the sale of goods? If a foreign company provides associated companies with training, marketing, and other industry-related assistance in return for an "association" fee and the fee is based on the number of outlets that the associated company has established and is subject to fixed minimums and maximums, is the amount paid as an association fee a royalty or income from services? More generally, if a foreign corporation sells computer software to Canadian customers over the Internet, does the foreign corporation earn royalty income or income from sales?

[5] The recent adoption of the third protocol amending the Canada-US income tax treaty suggests that the opposite has occurred. That protocol, in an effort to facilitate the free flow of goods and services, actually narrowed the scope of the payments that would be subject to withholding tax under article XII (royalties) of that treaty. See the Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, and July 29, 1997 (herein referred to as "the Canada-US treaty").

[6] US Treasury paper, supra footnote 1, at 4. For example, the US Treasury department observes that technological developments have necessitated a re-examination of existing income classification principles in light of the ease with which digitized information may be perfectly reproduced and disseminated. The department notes, "Classifying transactions involving digitized information may require a more complex analysis that disregards the form of the transaction—without regard to whether tangible property is involved—in favour of an analysis of the rights transferred. This is necessary to ensure neutrality between the taxation of transactions in digitized information and transactions in traditional forms of information, such as hard copy books and movies, so that decisions regarding the form in

(The footnote is continued on the next page.)

Before considering possible reforms of the income tax system in light of the new economy—particularly the increasing volume of electronic commerce—a comprehensive review of the issues surrounding the tax treatment of the various forms of income is necessary. The recent attention paid to the characterization of income from electronic commerce has generated many suggestions, but quick fixes should not be adopted at the expense of reasoned long-term solutions. Great care should be taken to avoid premature decisions.[7] The electronic commerce industry is still in its infancy. Consequently, the amount of tax currently at stake is relatively small, though increasing at an exponential rate, and tax authorities should not feel compelled to make instantaneous decisions to prevent tax base erosion. The first step should be a careful review of the existing principles of income characterization, including an examination of those transactions that will give rise to royalty income.[8] The international tax literature to date has not provided this groundwork. This article is intended to begin to fill that void.

This article focuses on the taxation of royalty income earned by non-residents of Canada. The article begins by reviewing the meaning of the term "royalty" under Canadian domestic law and then considers the definition in Canada's bilateral tax treaties, as well as the various model tax conventions. Generally, "royalty" has been interpreted to mean any payment, including a single or lump-sum payment, for the right to use any property in Canada, whether or not the amount would properly be considered a

[6] Continued . . .
which information is distributed are not affected by tax considerations." Ibid., at paragraph 7.3.1. With new developments in technology, any type of information that can be digitized (such as computer programs, books, music, or images) can be transferred electronically and then inexpensively and accurately reproduced by the purchaser. For example, a taxpayer could, via the Internet, communicate with a computer in a foreign jurisdiction and download a computer program or digitized image in exchange for a fee. The purchaser's rights in the information transferred would vary according to the contract between the parties. Depending upon the surrounding facts and circumstances, the transaction may be the equivalent of the purchase of a physical copy or copies of the subject matter or it may result in royalty income because it involves payments for the use of or the right to use property: ibid., at paragraph 7.3.1. The above situation is problematic because it is not always clear how the definition of royalties in tax conventions and legislation applies to the sale of digitized information. It is evident that some transactions, such as the electronic purchase of computer programs, are simply substitutes for conventional transactions involving physical objects.

[7] Poor decisions on reform may result if specific rules are formulated before business practices have developed adequately. In this respect, not only must income characterization principles be better understood before any reform is considered, but so must electronic commerce and the issues it raises. This article focuses on the characterization of income as royalties and is thus only a small piece of the puzzle.

[8] This review is critical, at least in the Canadian context, because the royalty article in the Canada-US treaty is arguably the most important provision regulating the cross-border flow of technology between Canada and the United States: Catherine A. Brown, "The 1995 Canada-US Protocol: The Scope of the New Royalty Provisions" (1995), vol. 43, no. 3 *Canadian Tax Journal* 592-609, at 608.

rent, royalty, or similar payment. As a result, the application of the domestic and international royalty provisions has been difficult to predict.

This article concludes that if a restrictive interpretation of the domestic royalty provision is adopted—one that imposes withholding tax not on *any* payment for the use of property in Canada, but rather only on *royalty* payments for the use of property in Canada—many of the difficulties encountered in applying the provision are obviated. This approach to the domestic royalty provision would not only provide certainty with respect to determining when a payment to a non-resident would attract withholding tax, but also would help to ensure that commercially equivalent transactions receive comparable tax treatment.

A ROYALTY UNDER CANADIAN DOMESTIC LAW

Legislative Background and Early Jurisprudence

Taxpayers resident in Canada are taxed under part I of the Income Tax Act.[9] Non-residents who are employed in Canada, carry on business in Canada, or dispose of taxable Canadian property are also taxed under part I. In addition, non-residents who receive certain investment income from sources situated in Canada are taxed under part XIII of the Act.[10] In part I of the Act, royalties are taxed under paragraph 12(1)(g).[11] In part XIII of the Act, royalties are taxed under paragraph 212(1)(d).[12] Paragraph

---

[9] RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.

[10] Part XIII imposes a flat rate of withholding tax (generally 25 percent) on the gross amounts specified therein. The tax rate may be reduced under an applicable tax treaty.

[11] Under paragraph 12(1)(g), a taxpayer must include in income from business or property "any amount received by the taxpayer in the year that was dependent on the use of or production from property whether or not that amount was an instalment of the sale price of the property, except that an instalment of the sale price of agricultural land is not included by virtue of this paragraph."

[12] Paragraph 212(1)(d) provides, in part, that every non-resident person must pay an income tax of 25 percent on every amount received from a Canadian resident that is a

> rent, royalty or similar payment, including, but not so as to restrict the generality of the foregoing, any payment
>
> (i) for the use of or for the right to use in Canada any property, invention, trade-name, patent, trade-mark, design or model, plan, secret formula, process or other thing whatever,
>
> (ii) for information concerning industrial, commercial or scientific experience where the total amount payable as consideration for that information is dependent in whole or in part on
>
> (A) the use to be made of, or the benefit to be derived from, that information,
>
> (B) production or sales of goods or services, or
>
> (C) profits,
>
> (iii) for services of an industrial, commercial or scientific character performed by a non-resident person where the total amount payable as consideration for those services is dependent in whole or in part on

(The footnote is continued on the next page.)

212(1)(d) contains a subparagraph generally similar to paragraph 12(1)(g), but the former provision is much more comprehensive.[13]

While the payments caught within the scope of paragraphs 12(1)(g) and 212(1)(d) are different, there is some overlap. The focus of this article is on royalty income earned by non-residents of Canada. Consequently, the article concentrates on the interpretation and application of paragraph 212(1)(d). However, insofar as there is overlap between the two definitions, the jurisprudence considering the interpretation and application of paragraph 12(1)(g) and its predecessors is useful in analyzing paragraph 212(1)(d).

The word "royalty" was originally used to describe rights belonging to the Crown *jure coronae*. However, over time, it has taken on a more expansive meaning: first, as applied to mining grants, and most recently, as applied to payments for intangible rights. The Judicial Committee of

[12] Continued . . .

(A) the use to be made of, or the benefit to be derived from, those services,

(B) production or sales of goods or services, or

(C) profits,

but not including a payment made for services performed in connection with the sale of property or the negotiation of a contract,

(iv) made pursuant to an agreement between a person resident in Canada and a non-resident person under which the non-resident person agrees not to use or not to permit any other person to use any thing referred to in subparagraph (i) or any information referred to in subparagraph (ii), or

(v) that was dependent on the use of or production from property in Canada whether or not it was an instalment on the sale price of the property, but not including an instalment on the sale price of agricultural land.

There are a number of exceptions to paragraph 212(1)(d). Withholding tax is not imposed on royalties paid for a copyright in respect of the production or reproduction of any literary, dramatic, musical, or artistic work. This includes some payments for computer software (see infra footnote 38 and accompanying text). Similarly, withholding tax is not imposed on certain payments made under bona fide cost-sharing arrangements, or payments made to arm's-length persons to the extent that the amount paid is deductible in computing the income of the payer under part I from a business carried on by the taxpayer in a country other than Canada. Finally, no withholding tax is imposed on payments to arm's-length parties for the use of or the right to use an aircraft or parts of an aircraft, nor is withholding tax imposed on payments for the use of railway rolling stock.

[13] The need for a more detailed provision in part XIII of the Act stems from the fact that a payment not caught by that provision escapes tax in Canada. If a payment is not caught within the meaning of paragraph 12(1)(g), it will likely be taxed as another form of income under section 3. Note that with respect to subparagraph 212(1)(d)(i), the government, in the April 26, 1993 federal budget, announced its willingness, in its tax treaty negotiations, to eliminate withholding tax on arm's-length payments in respect of rights to use patented information or information concerning scientific experience. Subsequently, the 1995 protocol to the Canada-US treaty amended article XII to exempt from withholding tax in Canada payments for the use of, or the right to use, computer software and payments for the use of, or the right to use, any patent or any information concerning industrial, commercial, or scientific experience. Other recent treaties into which Canada has entered contain similar exemptions (see infra footnote 126).

the Privy Council remarked as early as 1883 that the word "royalties" does not bear the original meaning ascribed to it (as rights belonging to the Crown *jure coronae*); rather, it has a special sense when used in mining grants or licences "signifying that part of the reddendum which is variable, and depends upon the quantity of minerals gotten."[14]

Thus, the term was originally expanded to capture a transaction whereby property (for example, minerals) was sold but the purchase price was contingent on the future value to the purchaser of the property. In this sense, a transaction structured as one giving rise to royalties was an attempt by parties, faced with a speculative adventure, to allocate the risk arising from the transaction. Used in this sense, a royalty is indistinguishable from other financial instruments that are commonplace in today's economy.

The expansion of the term to include such transactions involved the transmutation of certain amounts from capital receipts to income receipts and was not readily accepted. Since, before 1972, capital gains were not taxed in Canada, this transmutation had the effect of taxing amounts that would otherwise have been tax-free.[15] In *Minister of National Revenue v. Spooner*,[16] the Judicial Committee of the Privy Council held that amounts received from the realization of property rather than for its use were payments of a capital nature, assuming that the realization did not occur in the course of carrying on business. The taxpayer had sold land, including minerals, for a cash sum, shares in the purchaser corporation, and a royalty of 10 percent of all oil produced. At issue was whether the 10 percent royalty was an annual net profit or gain within subsection 3(1) of the Income War Tax Act.[17] The Judicial Committee acknowledged that capital might be expended in the acquisition of a right or entitlement to

[14] *Attorney-General of Ontario v. Mercer* (1883), 8 AC 767, at 777 (PC), on appeal from the Supreme Court of Canada. Henry J, writing for the Supreme Court of Canada (1881), 5 SCR 538, at 666, said, "'Royalties' as to mines is well understood in England to be the sums paid to the Sovereign for the right to work the royal mines of gold and silver; and to the owner of private lands, for the right to work mines of the inferior metals, coal, etc."

[15] The word "royalty," as it is now interpreted in Canadian law, applies to a payment of an income or capital nature provided that the payment is computed with respect to either the production derived from the use of assets, the profits of a business, or the gains generated by the exercise of certain rights; whether the occasion for the payment is the use of or the disposition of tangible property of a business or of incorporeal rights is irrelevant for the purposes of characterizing the payment as a royalty. Thus, royalties may involve a consumption or partial realization of capital property rather than merely yielding a return in the form of income from property. In the paradigm royalty transaction—mining leases—where the soil consists of minerals, the minerals are not just used but are taken away, and where any profit à prendre is granted in return for a portion of the value of what is taken, the grantor has effectively disposed of an interest in land that is real property: *Grenville-Nugent v. Mackenzie*, [1900] AC 83 (HL). See also *J.O. Pallett v. MNR* (1959), 22 Tax ABC 40.

[16] [1933] AC 684 (PC), aff'g. [1931] SCR 399.

[17] RSC 1927, c. 97.

income but nonetheless held that the royalty was not income but rather a part of the sale price of the land and hence of a capital nature.[18]

In response to the *Spooner* decision, the government enacted paragraph 3(1)(f), the predecessor of paragraph 12(1)(g) of the Act. As originally introduced, paragraph 3(1)(f) included in income

> rents, royalties, annuities or other like periodical receipts which depend upon the production or use of any real or personal property, notwithstanding that the same are payable on account of the use or sale of such property.[19]

This provision therefore sought to tax amounts that, in its absence, would have been non-taxable capital receipts. The provision was effective. In *Ross v. Minister of National Revenue*,[20] a taxpayer sold real property for consideration that included $60,000 payable out of 10 percent of the production of oil and gas. The taxpayer contended that this amount was part of the purchase price. In response to the taxpayer's contention, Cameron J stated that "[t]hat fact might have been of some importance prior to the enactment of [paragraph 3(1)(f)]" but that it was no longer relevant.[21]

---

[18] This decision was in direct conflict with English jurisprudence at the time. In *William John Jones v. The Commissioners of Inland Revenue* (1919), 7 TC 310, at 314 (KB), Justice Rowlatt had articulated the principle that "there is [no] law of nature, or any invariable principle, that because you can say a certain payment is consideration for the transfer of property, therefore it must be looked upon as the price in the character of principal." In that case, the taxpayer had sold an interest in a patent for a lump sum, to be paid in cash instalments, plus a royalty of 10 percent on the price of all machines manufactured and sold under the patent for a period of 10 years. The court held that the royalty was income, not a capital payment on the sale of the patent. The court stated, ibid., at 315, "The property was sold for a certain sum, and in addition the Vendor took an annual sum which was dependent, in effect, on the volume of business done; that is to say, he took something which rose and fell with the chances of the business. I think, when a man does that, he takes an income." See also *Chadwick v. Pearl Life Insurance Co.*, [1905] 2 KB 507; and *Egerton-Warburton v. Deputy Federal Commissioner of Taxation* (1934), 51 CLR 568 (HC).

[19] The complete legislative evolution of paragraphs 12(1)(g) and 212(1)(d) is illustrated in table 1, below.

[20] 50 DTC 775 (Ex. Ct.).

[21] Ibid., at 780. This decision, while it illustrates the impact of paragraph 3(1)(f), is probably incorrect insofar as it held that the payments were caught within the wording of the provision. Cameron J considered several authorities and derived a definition of royalties in respect of mines and oil wells that implied periodic payments, dependence upon production, and variability according to production. However, Cameron J determined that the payments received by the taxpayer were royalties notwithstanding the fact that the purchase price was fixed and it was merely the timing of the payments that varied according to production. This result has been rejected by subsequent courts. For example, in *Huffman v. MNR*, 54 DTC 383 (TAB), a taxpayer sold five mine leases for a fixed sum. The purchase price was payable in instalments of 25 percent of the gold removed until the full purchase price was paid. The taxpayer received amounts in 1946, 1947, 1948, and 1949. The court held that the amounts received in the first three years were not royalties within the meaning of that term in paragraph 3(1)(f) and therefore were not taxable as income. The better view is that the parties to the transaction had adopted a method of

(The footnote is continued on the next page.)

The Supreme Court of Canada reached a similar conclusion in *MNR v. Wain-Town Gas Ltd.*[22] The case illustrates the difficulty that arises in characterizing payments of a capital nature as royalties. In *Wain-Town*, a utility company sold its franchise to supply a town with natural gas in consideration for a percentage of the annual gross sales of gas under the franchise. In the Exchequer Court,[23] Anger J held, notwithstanding the earlier English authorities and paragraph 3(1)(f), that the absolute sale of the gas franchise resulted in the vendor's receipt of capital by instalments rather than of income. Furthermore, Anger J held that the payment did not depend upon the production or use of the franchise, which was the property sold, but rather upon the production of the gas, and therefore, the receipts were not income.

The Supreme Court, in a split decision, disagreed. The majority of the court held that the term "royalty" in paragraph 3(1)(f) was broad enough to include the payment because that term had acquired an extended meaning by force of commercial usage. Further, even if the payment was not a "royalty," it was an "other like periodical receipt."[24]

---

[21] Continued . . .
determining the amount of the instalment payment to be made in each year, and that method did not bring the amounts within paragraph 3(1)(f). The court did hold that the amount received in 1949 was a taxable income receipt based on the wording of paragraph 6(1)(j) applicable to that year (see table 1 below). The court interpreted that provision to be much broader in its application than its predecessor, paragraph 3(1)(f). The court determined that paragraph 6(1)(j) was broader because it included *any amount* received in the year that was dependent upon the use of or production from property; such amounts did not have to be rents, royalties, annuities, or other like periodic payments. In the court's opinion, the unqualified words "amounts received" were broad enough to include a payment that was dependent upon the use of or production from property even where a portion of it was received on account of the purchase price. It is submitted that this interpretation of paragraph 6(1)(j), while technically feasible, is too expansive. The reasoning of the court overlooks the fact that the amount of the payment was still not dependent upon the use of or production from the property; only the timing of the payments was dependent upon such use or production. The court's approach to paragraph 3(1)(f) should have applied equally to paragraph 6(1)(j).

Revenue Canada's administrative position is that where a contract calls for a fixed price that cannot be varied but the timing of instalments of that fixed price does vary depending upon production or use, paragraph 12(1)(g) does not apply since it is only the timing of payments that is dependent upon production or use, and not the price itself: *Interpretation Bulletin* IT-462, "Payments Based on Production or Use," October 27, 1980, paragraph 8.

[22] [1952] CTC 147 (SCC).

[23] [1950] CTC 355 (Ex. Ct.).

[24] In his reasons, Rand J, writing for the majority, distinguished the decision of the Supreme Court in *J.E. Wilder v. MNR*, [1951] CTC 304, in which a taxpayer had sold his business for consideration that included the purchaser's undertaking to pay him an "annuity" during his lifetime of $1,000 per month. Although paragraph 3(1)(b) of the Income War Tax Act brought within income "annuities or other annual payments received under the provisions of any contract," the Supreme Court in *Wilder* had held that the legislature

(The footnote is continued on the next page.)

The majority of the Supreme Court in *Wain-Town* was of the view that payments made in consideration for the sale of a capital asset could fall within the meaning of the word "royalties," or at least within the meaning of the phrase "other like periodical receipts." Accepting that the *Spooner* and *Wilder* decisions were correct insofar as they characterized the payment as being capital in nature, royalties, such as those in *Wain-Town*, paid in consideration of a sale are of a capital nature.[25]

Since a royalty may be either a capital or an income receipt, it is unique to Canadian law: it disregards a fundamental distinction in Canadian law between transactions that give rise to income receipts and those that give rise to capital receipts. As the Exchequer Court stated in *H. Gingras v. MNR*, "[c]et article [paragraph 6(1)(j), the successor to paragraph 3(1)(f)] est très large dans son application."[26] This gives rise to a tension in characterizing a payment as a royalty: there is no clear rationale for characterizing an amount that is otherwise a capital receipt as an income amount.

Table 1 illustrates the historical development of paragraphs 12(1)(g) and 212(1)(d). The table highlights the piecemeal manner in which the provisions (particularly paragraph 212(1)(d)) have been amended. These amendments have generally been ill-conceived reactions to judicial

[24] Continued . . .
intended to tax income receipts and not capital payments. The fact that the annuity payments were made as part of the consideration for the transfer of capital assets conclusively characterized them as capital. Rand J was of the view that *Wilder* was wrongly decided and that the grounds upon which that decision was made were expressly met by the language "notwithstanding that the same are on account of the use or sale of any such property" contained in paragraph 3(1)(f). It is troublesome that the monthly payments in *Wilder* could be considered instalments of the purchase price since they were of uncertain duration and total amount. Most likely, the majority of the Supreme Court was reluctant to tax any amount as income that it perceived to consist of some capital element. The majority of the court refused to adopt the principle that the proceeds of sale of a capital asset could be transmuted into an income amount; rather, the majority judgment suggests that whenever a variable periodic payment is received as consideration for the transfer of a capital asset, it is to be regarded as consisting entirely of capital. Note as well that the inclusion in paragraph 3(1)(f), as in current paragraphs 12(1)(g) and 212(1)(d), of periodic amounts that constitute instalments of the purchase price has not settled the issue entirely. Locke J, dissenting in the *Wain-Town* decision, was of the opinion that the *Wilder* decision was correct. Locke J held that the word "royalties" in paragraph 3(1)(f), in the absence of a statutory definition, was to be assigned its ordinary and natural meaning and that the word describes an amount paid for the right to use a copyright or patent, or to exercise some incorporeal right, or some payment to be made from the production from property the ownership of which remains vested in the grantor. Locke J was of the opinion that a royalty "in its ordinary meaning does not describe, or extend to, a payment such as was stipulated for in the agreement between the parties in this matter, where the payment is made as part of the purchase price of the outright sale of personal property transferred without reservation": *Wain-Town*, supra footnote 22, at 158.

[25] It may be said that the royalty provisions trespass on the principle that "income is the fruit and not the tree."

[26] [1963] CTC 194, at 198 (Ex. Ct.).

pronouncements. As will be discussed below, many of the difficulties in interpreting and applying paragraph 212(1)(d) can be attributed to the awkward provision that has resulted.

The piecemeal drafting of paragraph 212(1)(d) hinders its predictable application. This will be increasingly troublesome as new forms of commercial transactions, involving neither payments for the acquisition of tangible goods nor payments for services, become commonplace and the potential application of paragraph 212(1)(d) becomes increasingly significant.

The principal concern is whether a payment must be a "rent, royalty or similar payment" to attract withholding tax under paragraph 212(1)(d) or whether it is enough that the payment falls within the wording of subparagraph 212(1)(d)(i) or (v). In this respect, is any payment for the right to use property taxable under subparagraph 212(1)(d)(i), or must the payment first be a royalty? To this end, it is necessary to determine when a receipt will be a royalty.[27]

Generally, a payment will be a royalty if it is computed with respect to the production derived from the use[28] of the assets, the profits of a business,[29] or the gains generated by the exercise of certain rights, whether or

[27] This article is focused on the meaning of royalties and does not consider the meaning of rents. It is difficult to draw a clear distinction between royalties and rental payments. In *Vauban Productions v. The Queen*, 75 DTC 5371, the Federal Court—Trial Division referred to royalties as being akin to rents. To this extent, it appears that the word "rent" adds little to the application of paragraph 212(1)(d). Further, the problems that arise in characterizing transactions under Canada's bilateral tax treaties as those subject to withholding tax under article 12 and those giving rise to business profits suggest that rents and royalties should be treated separately domestically as well as internationally. Rental payments should be the subject of a separate provision in part XIII of the Act. This would not only simplify the deciphering of paragraph 212(1)(d) but would have the added benefit of more accurately mirroring the treatment of rental income in Canada's tax treaties. Under the OECD model convention (Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital* (Paris: OECD) (looseleaf) (herein referred to as "the OECD model convention")), upon which Canada's treaties are modelled, rents from real property are dealt with under article 6, rents from personal property are dealt with under article 7 (or possibly under article 21 if the profits are not business profits), and royalties are dealt with under article 12.

[28] The concept of "use" is a subject of debate. The decision in *Grand Toys Ltd. v. MNR*, 90 DTC 1059 (TCC), suggests that selling property is not using property.

[29] This meaning has been applied rather broadly by some courts. For example, in *Mr R v. Minister of National Revenue*, 50 DTC 398 (TAB), the court held that proceeds of sale of a medicinal formula where part of the fixed purchase price was to be paid in instalments based on the sale of the preparation were taxable under the predecessor of paragraph 12(1)(g). Similarly, in *Ross*, supra footnote 20, the court held that proceeds of the sale of oil and gas rights where the payment of a fixed purchase price was to be paid in instalments dependent upon a percentage of the production derived from the use of the rights were taxable under paragraph 6(1)(j). See also *Huffman*, supra footnote 21, and *No. 288 v. MNR*, 55 DTC 522 (TAB). This broad application is difficult to rationalize (see the discussion at footnote 22, supra). See also Revenue Canada's stated administrative position set out above (supra footnote 21).

Table 1 The Historical Evolution of the Treatment of Royalties in Part I and Part XIII of the Act

Statute	Amendment	Paragraph 12(1)(g)	Paragraph 212(1)(d)
Income War Tax Act	1934, c. 55, s. 1 and 13	Subsection 3(1) [income includes] (f) rents, royalties, annuities or other like periodical receipts which depend upon the production or use of any real or personal property, notwithstanding that the same are payable on account of the use or sale of such property	Subsection 27(1) Any non-resident person who lets or leases anything used in Canada, or who receives a royalty or other similar payment for anything used or sold in Canada, shall be deemed to be carrying on business in Canada and to earn a proportionate part of the income derived therefrom in Canada
	1941, c. 18, s. 22		Subsection 27(1) In addition to any other tax imposed by this Act, an income tax of fifteen per centum on non-resident persons is imposed, without any exemption or deduction, in respect of the gross amount of all rents, royalties or similar payments for the use in Canada of real or personal property, patents, or for anything used or sold in Canada
1948 Income Tax Act (the language of paragraph 6(1)(j) is substantially the same as that of paragraph 12(1)(g) in its current incarnation)	Enacted under SC 1948, c. 52	Subsection 6(1) Without restricting the generality of section 3, there shall be included in computing the income of a taxpayer for a taxation year . . . (j) amounts received by the taxpayer in the year that were dependent upon the use of or production from property whether or not they were instalments of the sale price of the property, but instalments of the sale price of agricultural land shall not be included by virtue of this paragraph	

(The table is concluded on the next page.)

Table 1 Concluded

Statute	Amendment	Paragraph 12(1)(g)	Paragraph 212(1)(d)
(An identical paragraph was included as paragraph 106(1)(d) of the 1952 Income Tax Act)	1951, c. 51, s. 31		Subsection 96(1) [withholding tax is imposed on any] (e) rent, royalty or a similar payment, including, but not so as to restrict the generality of the foregoing, any such payment (i) for the use in Canada of property, (ii) in respect of an invention used in Canada, or (iii) for any property, trade name, design or other thing whatsoever used or sold in Canada but not including (A) a royalty or similar payment on or in respect of a copyright, or (B) a payment in respect of the use by a railway rolling stock as defined by paragraph (25) of the Railway Act
1952 Income Tax Act	1968-69, c. 44, s. 29(1)		Paragraph 106(1)(d) was repealed and the wording that is now found in paragraph 212(1)(d) was substituted

not the payment would normally be a capital receipt. As Addy J pointed out in *Vauban Productions v. The Queen*:

> The term "royalties" normally refers to a share in the profits or a share or percentage of a profit based on use or on the number of units, copies or articles sold, rented or used. When referring to a right, the amount of the royalty is related in some way to the degree of use of that right. . . . Royalties, which are akin to rental payments, have invariably been considered as income since they are either based on the degree of use of the right or on the duration of use to be made of it, while a lump sum payment for the absolute transfer of a right, without regard to the use to be made of it, is of its nature to be considered a capital payment, although it may of course be taxable as income in the hands of the recipient if it is part of that taxpayer's regular business.[30]

Similarly, Rowlatt J in *Jones*,[31] in describing a royalty payment, emphasized the fact that the amount of the payment varied with the chances of the business of the purchaser.

These broad definitions of a royalty payment are not easy to apply. For example, in *Grand Toys Ltd. v. MNR*,[32] a taxpayer entered into an agreement with a Hong Kong company for the exclusive right to distribute and sell certain dolls in Canada. The taxpayer was to pay the Hong Kong company a "buying commission and royalty" of 52 cents per unit for a guaranteed number of units. The taxpayer claimed that the total amount of $250,000 was not a royalty but rather part of the purchase price of goods acquired for resale. The minister relied upon Addy J's comments, set out above, in *Vauban Productions*. Specifically, the minister contended that the payments made represented a share in the profits as described by Addy J.

The court rejected this proposition. The profits referred to by Addy J in *Vauban Productions* were the profits of the payer, not the payee. In *Grand Toys Ltd.*, contrary to the minister's contention, the payments were the payee's profits and were unrelated to the taxpayer's profits; they were

---

[30] *Vauban Productions*, supra footnote 27, at 5372. Similarly, in determining that a payment was not a royalty in *The Queen v. Farmparts Distributing Ltd.*, [1980] CTC 205, the Federal Court of Appeal held (at 212), "The payment made . . . was a lump sum payment, a 'one-time' payment for the duration of the agreement renewable for a further 15 years . . . without payment of any additional fee; the payment was to be made irrespective of the extent of use by the [payer] under the agreements and was unrelated to the profits made by the [payer] as the result of any use." This decision directly contradicts the stated position of Revenue Canada. Revenue Canada has stated that any payment, including a lump-sum payment, made to a non-resident for the right to use property in Canada is subject to tax under paragraph 212(1)(d) whether or not the payment is a royalty: *Interpretation Bulletin* IT-303, "Know-How and Similar Payments to Non-Residents," April 8, 1976, paragraph 10. See also *Mouat v. MNR*, 58 DTC 694 (TAB), in which the proceeds of the sale of standing timber for a purchase price that was fixed on a per tree basis were not taxable as a royalty payment under the predecessor of paragraph 12(1)(g).

[31] Supra footnote 18.

[32] Supra footnote 28.

also not related to the taxpayer's gross sales of the units. The payments really represented a lump sum, and the court observed that whether the taxpayer sold all of the dolls or none of them, whether it earned profits or not, the amount of the payments was the same. In the court's words:

> There was no element of contingency in the payments in question and *an element of contingency is the essence of a royalty payment* [emphasis added].[33]

Notwithstanding the import given by the courts to the element of contingency and the relationship of the payment to the payer's profits, payments based on the production from or the use of property raise several issues. First, what may be the subject matter of a royalty payment? Second, when is a payment made in respect of incorporeal property a royalty?[34] Payments in respect of incorporeal property raise several issues: when does a payment in respect of a patent or copyright give rise to royalties; when are payments for the provision of knowhow royalties; when is a payment not a royalty but rather a payment for the provision of services; and when do payments in respect of exclusivity agreements give rise to royalty income? When these issues are understood, the application of paragraph 212(1)(d) to emerging transactions, such as those involving digitized information, can be better understood.

The Subject Matter of a Royalty Payment

Generally, a royalty is a payment dependent upon the use of or production from property. "Property" is defined in subsection 248(1) to mean

> property of any kind whatever whether real or personal or corporeal or incorporeal and, without restricting the generality of the foregoing, includes
>
> (a) a right of any kind whatever, a share or a chose in action.

Subparagraph 212(1)(d)(i) specifies that a royalty payment may include a payment "for the use of or for the right to use in Canada any property, invention, trade-name, patent, trade-mark, design or model, plan, secret formula, process or other thing whatever." Subparagraphs 212(1)(d)(ii), (iii), and (v) are best considered as deeming provisions in the sense that

---

[33] Ibid., at 1063.

[34] The taxation of payments for incorporeal property has taken on more significance as the economy has become increasingly technology-based. Tangible property is becoming less and less important. Consequently, an understanding of the principles that determine the tax treatment of transactions involving incorporeal property has never been so critical. Generally, notwithstanding the unique nature of incorporeal property, the same principles apply as in the case of payments for corporeal property. For example, in *R. Brosseau v. MNR*, [1986] 1 CTC 2558 (TCC), a partner leaving an accounting firm sold his "list of clients" to the remaining partners for the greater of $100,000 and 20 percent of the gross professional income received from his former clientele for the five years following his departure. The partner received payments totalling $125,000. The Tax Court held that the amount in excess of the $100,000 minimum had a direct relationship to the use of or production from the property and was a royalty within the meaning of paragraph 12(1)(g). The rest was a capital receipt.

they expand the definition of "royalty" for the purposes of part XIII of the Act to include payments that would not otherwise be royalties.[35] Subparagraphs (ii) and (iii) ensure that royalty payments for knowhow or showhow are caught by paragraph 212(1)(d).[36] Subparagraph (v) mirrors paragraph 12(1)(g) and has the same effect. That provision ensures that payments based on the production from or the use of property, which in its absence might be considered capital receipts, are caught by paragraph 212(1)(d).[37]

Payments in Respect of Patents and Copyrights

Patents and copyrights are "property" both at common law and within the definition of that term in subsection 248(1). For greater certainty, subparagraph 212(1)(d)(i) extends the withholding obligation to every resident paying a rent, royalty, or similar payment to a non-resident for the use of or for the right to use in Canada any patent. Subparagraph 212(1)(d)(vi), however, limits the application of paragraph 212(1)(d) in respect of payments for copyrights. Payments for a copyright in respect of the production or reproduction of any literary, dramatic, musical, or artistic work are not subject to withholding under paragraph 212(1)(d).[38]

The characterization of a payment for a patent or copyright depends upon the manner in which the rights that make up those intangible properties are exploited.[39] In this regard, payments in respect of patents and

---

[35] It is suggested below that paragraph 212(1)(d) is drafted in a confusing way and should be clarified. Subparagraph 212(1)(d)(i) should not be considered to expand the part XIII definition of royalties. However, subparagraphs (ii), (iii), and (v) may be considered to expand the definition. This issue is discussed below and a revision of paragraph 212(1)(d) proposed.

[36] See below. It was not always clear that these were royalty payments within the scope of paragraph 212(1)(d) since there is some debate as to whether knowhow is property.

[37] In this respect, subparagraph (v) is a provision that prohibits parties to a transaction from disguising a royalty by dressing it up as a capital payment.

[38] The Federal Court of Appeal has held that software programs are protected by Canadian copyright legislation as "literary" works: *Apple Computer, Inc. v. Mackintosh Computers Ltd.* (1990), 71 DLR (4th) 95 (SCC), aff'g. (1987), 16 CIPR 15 (FCA), aff'g. (1986), 28 DLR (4th) 178 (FCTD). Furthermore, amendments to the Copyright Act in 1988 included computer programs within the definition of a "literary work." In light of these developments, Revenue Canada has conceded that payments under a licensing agreement to produce or reproduce software are exempt from withholding tax under paragraph 212(1)(d): Revenue Canada document no. 9502165, April 26, 1995.

[39] The owner of a patent may assign it to another, thereby conveying to the assignee the exclusive right to make, use, and sell the invention throughout the entire territory of the patent; an undivided part or share of that exclusive right; or the exclusive right under the patent within a specific portion of the territory covered by the patent: sections 42 and 50, Patent Act, RSC 1985, c. P-4, as amended. Anything less than such an assignment is a licence under which the licensee has the right to use the patent to the extent therein allowed but does not confer any title in the patent and no right to sue at law for its infringement (except for infringement of the licence by the licensor). Similarly, a copyright may be assigned subject to territorial limitations, or assigned for all or a portion of the whole term of the copyright. Alternatively, the owner may grant a licence of the copyright permitting

(The footnote is continued on the next page.)

copyrights may be considered in two broad categories: those payments that represent a payment for the alienation or partial alienation of the patent or copyright, and those payments that are for the use of or the right to use the patent or copyright. The question when a payment is made for use and when it is made in consideration for an alienation is one of fact.[40]

---

[39] Continued . . .
the licensee to use the copyrighted matter; in this case, no change in the ownership of the copyright is involved: section 13, Copyright Act, RSC 1985, c. C-42, as amended. As a practical matter, granting an exclusive licence to use a patent or copyright within a certain territory and an assignment of the patent or copyright for that district are virtually identical. The licensor cannot, having granted an exclusive licence, make any profit out of the patent or copyright in that district without obtaining the consent of the licensee. The one significant difference is that the licensor who grants a licence does retain the right to sue for infringements since no rights arise as between the licensee and the public.

[40] For example, in *Commissioners of Inland Revenue v. British Salmson Aero Engines, Ltd.* (1938), 22 TC 29 (CA), an English company acquired the exclusive licence to manufacture and sell airplane engines made by a non-resident company. The licence was granted for a period of 10 years in consideration for £25,000; £15,000 was payable on the execution of the agreement, £5,000 in six months, and £5,000 in one year. The English company was also required to pay a "royalty" of £2,500 per annum for 10 years. The court held that the first £25,000 amount was a capital payment. In reaching that conclusion, the court noted, ibid., at 39, "it is not merely an agreement under which the English Company receives the right to use a patent: under this agreement the English Company is entitled to restrain the patentees themselves from exercising the patent in the territory, and it is entitled to call upon the patentees to take steps to prevent others from exercising the invention within the territory. Now those rights are . . . different from the mere right of user." The court examined the exact nature of the rights obtained by the licensee in determining that the transaction was an alienation of a patent. Strangely, the yearly "royalty" payments were held to be royalties even though the court had determined that the patent had been sold and the amounts were in no way dependent upon the use of or production from the patent. The court appeared to give considerable weight to the parties' characterization of the amount as a royalty in the agreement. This issue is considered below under the heading, "Use of the Word 'Royalties' by the Parties."

In *Nethersole v. Withers (HM Inspector of Taxes)* (1948), 28 TC 501, at 510, the English Court of Appeal suggested, although did not adopt, the following test for distinguishing between payments for alienation and revenue payments: "where a piece of property, be it copyright or anything else, is turned to account in a way which leaves in the owner what we might call the *reversion in the property*, so that upon the expiration of the rights conferred, whether they are to endure for a short or a long period, the property comes back to the owner intact, the sum paid as consideration for the grant of rights, whether consisting of a lump sum or of periodical or royalty payments, should be regarded as of a revenue nature."

A similar conclusion was reached in *CIT v. Davy Ashmore India Ltd.* (1991), 190 ITR 626 (Calcutta HC), considered in Nishith Desai, "'Royalty' Under India-U.K. Treaty Explained" (October 1991), 3 *Tax Notes International* 1080-81. That case involved an agreement entered into with a UK company for the supply of drawings and designs. The court, in examining a royalties article somewhat different from that in the OECD model convention, held that, because there was an outright transfer of the property rights in the drawings and designs, the payment was not a royalty. The court considered it the essence of a royalty that the recipient retain the rights in the property subject to the royalty payment. It held that a royalty is merely a payment in consideration for the allowed use of such rights. However, in *Ross*, supra footnote 20, the court rejected the argument that "royalty" implies a retention of property ownership by the payee such as arises in a lessor-lessee relationship.

If the transaction involves an alienation of the patent or copyright, it will not be a royalty unless the amount of the payment is dependent upon the use of or production from the property. In such a case, regard should be had to the jurisprudence that has considered the meaning and application of paragraph 12(1)(g) and subparagraph 212(1)(d)(v).[41] If the payment is for the use of or the right to use the patent or copyright within the scope of subparagraph 212(1)(d)(i), difficult issues arise as to the proper interpretation and application of that provision; specifically, will *any* payment for the right to use a patent or copyright attract withholding tax under subparagraph 212(1)(d)(i), or must the payment be a royalty or similar payment?[42]

Where a non-resident receives a payment from a Canadian for the right to use a patent or copyright, that payment should be characterized as royalty income only if it is dependent upon the use of or production from the patent or copyright. The Federal Court of Appeal, in *The Queen v. Saint John Shipbuilding & Dry Dock Co. Ltd.*,[43] held that it would unduly stretch the word "royalties" to conclude that the payment, even if for the right to use, should be considered to be a royalty when it was not dependent upon the extent of use, production of goods, or the benefit derived. In that case, the court determined that a lump-sum payment made to a non-resident for the supply of and the right to use certain computerized, non-secret information was not taxable under paragraph 212(1)(d). The court came to this decision notwithstanding the fact that paragraph 106(1)(d) (the predecessor to paragraph 212(1)(d)) included "any payment for the . . . right to use in Canada any property, invention . . . ."

[41] The decision of the House of Lords in *Nethersole*, supra footnote 40, illustrates the distinction between an alienation and a payment for the use of a copyright. In that case, the taxpayer had acquired from Rudyard Kipling the exclusive right to dramatize his novel *The Light That Failed*. The copyright in the novel remained vested in Kipling. Eventually, for commercial reasons, it was determined that the two copyrights should be brought under the same control. Consequently, an agreement was entered into pursuant to which both copyrights would be held by Kipling. In return, one-third of the gross amount of all payments received for the rights was to be paid to the taxpayer. Subsequently, Kipling granted the sole and exclusive motion picture rights in both the novel and the play in return for a lump-sum payment. The House of Lords held that the one-third share received by the taxpayer was a capital receipt in return for the assignment of property. The determination of the court is troubling in the sense that the payment was certainly dependent upon the use of the property, being one-third of the future proceeds derived by the payee from the property. *Nethersole* should not be interpreted as a statement that an amount may be characterized solely on the basis of the formal distinction between assignment and licence. In the case of a payment for an exclusive licence to use the patent or copyright for its duration, the owner would realize the property as effectively by this means as by way of assignment: this was one of the issues before the English Court of Appeal in *British Salmson Aero Engines, Ltd.*, supra footnote 40.

[42] This issue arises in respect of most payments. Generally, paragraph 212(1)(d) is poorly drafted, and its interpretation is therefore difficult. General conclusions as to the correct interpretation are set out below, along with a suggested redrafting of the provision.

[43] [1980] CTC 352 (FCA).

A consistent result was reached in *Pope Appliances v. Min. Customs & Excise*.[44] In that case, the taxpayer owned patent rights on inventions related to the production of paper and granted licences to use these inventions. In consideration for the grant of licences, the taxpayer was paid "royalties" that were dependent upon the amount of paper produced through their use. The taxpayer argued that the licensing of the patents was the equivalent of a sale with deferred payment. The court rejected this argument and summarized the law in the following manner:

> The payment or royalty is in respect of the user of the inventions measured by the quantity of production of paper which may vary according to the machine to which the invention is attached, the speed, etc. That is the substance of the arrangement. The bargain is that the licensee pay . . . a sum dependent on the volume of paper produced, and which would vary according to market demands and other factors. What the [taxpayer] receives is income from the earnings or use of the inventions. . . . [The payments] are clearly income.[45]

However, where the licence of a patent or copyright is effectively equivalent to the partial assignment of that patent or copyright, it will not generally give rise to royalty income for Canadian tax purposes unless the payment is based on production or use and caught by subparagraph 212(1)(d)(v). In determining when a licence should be treated as a partial alienation, the factors considered by the English Court of Appeal in *Rustproof Metal Windows Co.* may be helpful.[46] In that case, the court cited

---

[44] [1917-27] CTC 315 (Ex. Ct.).

[45] Ibid., at 318.

[46] *Commissioners of Inland Revenue v. Rustproof Metal Windows Co., Ltd.* (1947), 29 TC 243 (CA). The case involved a taxpayer that owned a patented galvanizing process and granted a licence to use the process to another company in return for a "capital sum" of £3,000 and a royalty dependent upon the extent to which the patent was used. The licence granted was restricted, both as to its duration and as to the use to which the process might be put. The English Court of Appeal examined the facts and determined that the £3,000 lump sum was a royalty. However, the lump-sum payment was unrelated to the extent of the use of the patent. Consequently, it is submitted that the payment should not have been characterized as a royalty. Other decisions suggest that there may be some judicial support for the characterization of a lump-sum payment as a royalty. For example, in *Saint John Shipbuilding & Dry Dock Co.*, supra footnote 43, the court concluded that a lump-sum payment was not a royalty when it was paid for an indefinite term of unlimited use, but the court left open the question whether a more restricted transfer for a lump sum could give rise to royalty income. In *Farmparts Distributing Ltd.*, supra footnote 30, the Federal Court of Appeal held that a lump-sum payment was caught under paragraph 212(1)(d). In *The Commissioners of Inland Revenue v. Longmans Green & Co., Ltd.* (1932), 17 TC 272 (KB), the owners of the copyright on a French book entered into an agreement with an English company whereby the latter, in return for an exclusive licence to publish the book in English translation, agreed to pay Fr500,000 for the right to publish the first 28,000 copies and an annual royalty on all additional copies sold. The court held that the Fr500,000 was a royalty, not a capital receipt, on the basis that the remainder of the transaction showed that it was an accumulated lump-sum discharge of what was a royalty payment on the estimated use of the copyright. It is submitted that a distinction should be drawn between payments merely for the use of a licence and payments dependent upon the extent

(The footnote is continued on the next page.)

four factors that were determinative of the characterization of a payment as a royalty in respect of a licence as opposed to a payment in respect of an alienation. First, because the licence was a non-exclusive licence, the licensor's right to exploit the patent by the grant of other licences was not impaired. Second, the licence was granted for the specific purpose of enabling the licensee to fulfil a particular contract. Third, the use of the patent was limited to the extent of a specified level of production. Finally, the time during which the use of the patent was licensed was limited to the time required for the licensee to manufacture the allowed products.

In conclusion, the proper characterization of a payment must be determined by the particular facts of each case, including the contractual relationships between the parties. Two factors weigh heavily in the determination: first, the relationship between the payment received and the use to be made of the patent or copyright; and second, the extent to which the patent or copyright ownership is surrendered for the payment in question.

Payments for Knowhow

The main purpose of the 1968-69 amendments to paragraph 106(1)(d) of the 1952 Act was to remove any doubt that payments made to non-residents for technical assistance and knowhow were taxable in the same manner as royalties.[47] The revision of paragraph 106(1)(d) involved the inclusion of a detailed list of payments taxable in the same manner as royalties for the provision of knowhow. That list, now found in subparagraphs 212(1)(d)(ii) and (iii), remains unchanged.

What Is Knowhow?

The nature of knowhow has been described by the English House of Lords as "an ambience that pervades a highly specialized production organization."[48] More particularly, as defined by the OECD, knowhow is the

---

[46] Continued . . .
of the use of the licence. Consequently, a lump-sum payment should not be a royalty. Decisions such as *Rustproof Metal Windows Co.* should instead be interpreted as highlighting the distinction between those transactions that involve the transfer by licence of the capital element of the licence and those transactions that do not. In the first case, the licensee might acquire an exclusive right to use the property for a particular period of time or within a particular territory. In the second, the licensee merely acquires the right to use the property along with others. Thus, certain payments may be of an income nature, but this should not necessitate a determination that the payment is royalty. Characterization of a payment as a royalty should be reserved for those payments that depend upon the use of or the production derived from the property in respect of which the payment is made. Revenue Canada itself interprets royalties broadly, and the reference in paragraph 212(1)(d) to "any payment" is considered broad enough to include lump-sum payments: Memorandum of the Reorganizations and Foreign Division, February 13, 1992, reported in *Window on Canadian Income Tax* (North York, Ont.: CCH Canadian) (looseleaf), paragraph 1744, confirming Revenue Canada's administrative position set out in paragraph 10 of IT-303, supra footnote 30.

[47] See table 1 above and Rocco Bonzanigo, *Canadian Taxation of Business and Investment Income of Non-Residents* (Frankfurt: Lang, 1973), 52.

[48] *Rolls-Royce Limited v. Jeffrey*, [1962] TR 9, at 12 (HL).

> undivulged technical information, whether capable of being patented or not, that is necessary for the industrial reproduction of a product or process, directly and under the same conditions; inasmuch as it is derived from experience, know-how represents what a manufacturer cannot know from mere examination of the product and mere knowledge of the process or technique.[49]

Revenue Canada has defined knowhow payments to include payments for special knowledge, skills, or techniques that are considered beneficial in the conduct of a business.[50] Such payments may be for expertise flowing from experience, ability, or research that may be reflected in blueprints, drawings, specifications, plant layouts, designs, secret processes, and formulas.[51] The provision of knowhow raises two issues: first, is knowhow property; and second, are payments for knowhow royalties or income from services?[52]

As discussed above, to constitute a royalty, a payment has to flow from property that may be tangible or intangible and includes property rights. Consequently, a payment for knowhow will not be a royalty unless knowhow is property. *Evans Medical Supplies, Ltd. v. Moriarty (HM Inspector of Taxes)*[53] concerned the tax treatment of a lump-sum payment for information. In the course of its analysis, the House of Lords held that secret processes and information constituted property and were indeed valuable assets of a business. In *Rolls-Royce Limited v. Jeffrey*,[54] the House of Lords confirmed that knowhow is an asset.

In *Technical Tape Corp. v. MNR*,[55] the Tax Appeal Board stated, in obiter, that, without a doubt, knowhow is "property" within the meaning of that term in paragraph 139(1)(ag),[56] the predecessor of the definition of "property" in subsection 248(1). The Exchequer Court came to a similar conclusion in *Western Electric Company Inc. v. MNR*.[57] In that case,

---

[49] Paragraph 12(11) of the commentary on the OECD model convention, quoting l'Association des Bureaux pour la Protection de la Propriété Industrielle.

[50] IT-303, supra footnote 30, at paragraph 3.

[51] Ibid.

[52] Of course, subparagraphs 212(1)(d)(ii) and (iii) make it clear that knowhow is taxable under paragraph 212(1)(d). This discussion is necessary in order to illustrate the conceptual difficulty that arises in recognizing a payment for knowhow as a royalty in the absence of specific legislation.

[53] (1957), 37 TC 540 (HL).

[54] Supra footnote 48.

[55] 64 DTC 428 (TAB). In that case, a Canadian company obtained knowhow—technical and engineering assistance—from a US company. The Canadian company paid a fixed amount in some years and a percentage of sales in other years. The latter payments were held to be royalties because they were calculated on the basis of the use made of the knowhow.

[56] The current definition of "property" remains substantially the same. Paragraph 139(1)(ag) read, "'[P]roperty' means property of any kind whatever whether real or personal or corporeal or incorporeal and, without restricting the generality of the foregoing, includes a right of any kind whatever, a share or a chose in action."

[57] 69 DTC 5204 (Ex. Ct.).

confidential technical information and manufacturing drawings and specifications were supplied by a non-resident to a Canadian company in return for payments calculated on the basis of sales. The court held that the information constituted trade secrets[58] and was "other like property" within the meaning of the 1948 Canada-US tax treaty. Therefore, the payments were royalties for the use of technical information.

Despite these clear pronouncements, other Canadian decisions suggest that the issue is not without some conceptual difficulty. In fact, two years before the *Western Electric Company* decision, the Exchequer Court came to a different conclusion in *Quality Chekd Dairy Products Assoc'n (Co-op) v. MNR.*[59] The court rejected the argument that there was a distinction between knowhow as property and knowhow as a service; knowhow was not property, and therefore there could not be royalty withholding tax payable.

The uncertainty regarding the state of the law evidenced by the conflicting judgments in the *Western Electric Company* and *Quality Chekd Dairy Products* decisions was the catalyst for the amendments to paragraph 106(1)(d) referred to above. The inclusion of specific situations in which payments flowing to non-residents are considered to be royalties or similar payments was intended to avoid any doubt as to the application of the withholding tax to transfers of knowhow. The provisions of paragraph 212(1)(d) now expressly describe as royalties or similar payments those fees computed on a proportional basis for technical information and services.[60] Whether this broad description of royalties can be reconciled with the provisions of Canada's tax treaties is one issue that is discussed below. An even more fundamental issue still remains. Has paragraph 212(1)(d) resolved the uncertainty that existed? Are courts observing subparagraphs 212(1)(d)(ii) and (iii)? *Brad-Lea Meadows Limited v. MNR*[61] suggests that courts may not recognize a payment for knowhow as a royalty.

---

[58] The analogous term in paragraph 212(1)(d) would be "secret process."

[59] 67 DTC 5303 (Ex. Ct.). See also *Rapistan Canada Ltd. v. MNR*, 74 DTC 6426 (FCA), aff'd. [1976] 1 SCR vi, in which a taxpayer sought to claim capital cost allowance on "knowhow." The Federal Court of Appeal held that the asset that the taxpayer had acquired was the knowledge of how to commence and carry on the particular manufacturing operation. The court held that the knowledge was an asset of the business but was not property; "knowledge or ideas, as such, do not constitute property" (ibid., at 6428).

[60] Whether a second provision, subparagraph 212(1)(d)(iii), dealing with services was even necessary is debatable. Arguably, the services described in that provision would be subsumed within subparagraph 212(1)(d)(ii). In fact, the commentary on the UN model convention states that the phrase "information concerning industrial, commercial or scientific experience" could be interpreted to mean specialized knowledge having intrinsic property value relating to industrial, commercial, or managerial processes, conveyed in the form of instructions, advice, teaching, or formulas, plans, or models, permitting the use or application of experience gathered on a particular subject. See the commentary on article 12(3) of the United Nations Model Double Taxation Convention Between Developed and Developing Countries, UN publication no. ST/ESA/102, 1980.

[61] 90 DTC 1269 (TCC).

Taxation of Payments for the Transfer of Knowhow

In *Brad-Lea Meadows Limited*, the Tax Court of Canada held that an affiliation fee was not a royalty. The taxpayer owned and operated a motel that was associated with a non-resident corporation. The non-resident corporation provided a package of services to its members, including the provision of a computerized reservation system, related training, and assistance with marketing and advertising. In return, its members paid an "affiliation fee" based on the number of motel units and subject to fixed minimums and maximums. The court held that the fee consisted of several components, including a fee for service. The court then considered subparagraph 212(1)(d)(i) and in that respect concluded that many of the items described in the fee paid did not involve any "use" but were services that the taxpayer might or might not take advantage of as needed or wanted.[62] Consequently, the package of services did not consist of all-inclusive items contemplated by subparagraph 212(1)(d)(i). Since no separation was made (that is, no allocation of the payment to services and items contemplated in the provision), the fee was not in any part a royalty.[63]

The *Brad-Lea Meadows Limited* decision disregards the 1968-69 amendments. The court appears to have ignored subparagraphs 212(1)(d)(ii) and (iii), which appear to contemplate the payment in question. Consequently, whether the fee was a royalty should have been decided on the basis of whether the payment for information and assistance was dependent in whole or in part upon the use to be made of the information and services, notwithstanding the fact that the payments were probably not based on the use to be made of the information.[64]

---

[62] Ibid., at 1271.

[63] This aspect of the decision is discussed below.

[64] Perhaps the court did not turn its mind to these provisions as a result of the way that the case was argued. The court noted that the minister did not provide any evidence to counter the taxpayer's statement that the affiliation fee was not a royalty. Nonetheless, the *Brad-Lea Meadows Limited* decision demonstrates no evolution in the judicial approach to payments for information and services; in fact, it represents a "devolution." The decision of the court closely parallels that of the Tax Appeal Board in *Warsh and Co. Ltd. v. MNR*, 62 DTC 247, which predated the 1968-69 amendments. It appears that no headway has been made. In *Warsh and Co.*, a Canadian company obtained the exclusive Canadian rights to the dress designs of a non-resident for an annual base payment plus a percentage of the sales proceeds. The agreement provided that the "lessor" would also furnish some information, help, and advice. The Tax Appeal Board decided that the rights and services were indivisible, and that the full payments, the fixed base plus the percentage, were royalties or similar payments. Similarly, in *Gingras*, supra footnote 26, the Exchequer Court expressed the view that the amounts received by the taxpayer might have been regarded as being in respect of services rendered to the purchaser in the preparation of the sales system for its use. Nonetheless, the court held that the entire amount was a royalty.

When Does the Transfer of Knowhow End, and When Does the Provision of Technical Services Begin?

The *Brad-Lea Meadows Limited* decision highlights another difficulty that arises when payments for knowhow are taxed as royalties.[65] The taxpayer had argued that the affiliation fee was paid as part of a "package deal" and that even if a part could be considered a royalty payment, there was an obligation on the minister to show what portion of the fee was a royalty fee. The court held that since the minister did not allocate the payment between the part that was a royalty and the part that was a fee for services, no withholding tax could be payable. The court relied upon the decisions in *Saint John Shipbuilding & Dry Dock Co.*[66] and *Farmparts Distributing Ltd.*[67]

Revenue Canada's administrative position is that where only a portion of a payment may be regarded as being subject to tax under paragraph 212(1)(d), the full amount of the payment is subject to withholding tax.[68] Revenue Canada states that it will review the matter if the taxpayer can provide satisfactory evidence that a portion of the payment should not be subject to tax.[69] However, the Federal Court of Appeal in both *Saint John Shipbuilding & Dry Dock Co.* and *Farmparts Distributing Ltd.* has suggested that it is the minister who must allocate the payment between the amount that is a royalty and the amount that is a fee for services. When this is not done, even if it is clear that some portion of the payment is a royalty for the transfer of knowhow, the taxpayer will not be subject to withholding tax under paragraph 212(1)(d).

Assistance in distinguishing royalty payments for the transfer of knowhow from the provision of technical services may be found in the following OECD commentary on article 12 of the model convention.[70] To distinguish the transfer of knowhow from the provision of services, the commentary provides:

> In the know-how contract, one of the parties agrees to impart to the other, so that he can use them for his own account, his special knowledge and experience which remain unrevealed to the public. It is recognized that the

---

[65] This issue gives rise to considerable difficulties in applying bilateral tax treaties, as discussed in detail below.

[66] Supra footnote 43.

[67] Supra footnote 30.

[68] IT-303, supra footnote 30, at paragraph 25.

[69] Ibid.

[70] See also IT-303, supra footnote 30, at paragraphs 22 and 23. Revenue Canada's administrative position is that where fees are charged on a per hour, per diem, or similar basis, it is a question of fact whether the amount depends upon the use to be made or the benefit to be derived from the services. Revenue Canada suggests the following as payments that may fall within subparagraph 212(1)(d)(iii): fees for technical or production services where the amount of such fees depends in any way upon performance or productivity; and charges for product development and marketing knowhow or research that vary in accordance with production or sales.

> grantor is not required to play any part himself in the application of the formulas granted to the licensee and that he does not guarantee the result thereof. This type of contract thus differs from contracts for the provision of services, in which one of the parties undertakes to use the customary skills of his calling to execute work himself for the other party. Thus, payments obtained as consideration for after-sales service, for services rendered by a seller to the purchaser under a guarantee, for pure technical assistance, or for an opinion given by an engineer, an advocate or an accountant, do not constitute royalties within the meaning of paragraph 2. Such payments generally fall under Article 7 or Article 14. In business practice, contracts are encountered which cover both know-how and the provision of technical assistance.[71]

The OECD test appears to make the distinction a straightforward one. It is also consistent with the domestic provisions in subparagraphs 212(1)(d)(ii) and (iii). Under a technical service contract, the payments will typically not be determined by reference to the extent of the use of or production from the information or service. The onus will still be on the minister to establish the portion of the payment reasonably considered a royalty in respect of knowhow. If this is not done, the entire payment will not be considered a royalty subject to withholding tax.

Royalties and Income from Services

The discussion of payments in respect of knowhow illustrates the difficulties that arise in distinguishing royalty income from income from services. The distinction is not just difficult to make in the context of transfers of knowhow but may present difficulties in other situations. For example, the distinction between those payments to performers that constitute royalties and those that are payments for independent personal services has proven problematic.

This issue arose in *Pierre Boulez v. Comm.*,[72] a dispute involving a concert conductor resident in West Germany who had entered into an agreement with a US recording company to record certain performances in the United States for payments described in the agreement as "royalties." Under the contract, copyright in the recordings was vested in the recording company. The taxpayer claimed that the payments were royalties and therefore were exempt from withholding tax under the US-Germany tax treaty. The United States challenged the characterization of the payments as royalties and sought to tax them as personal services income. After failure of the competent authorities to resolve the dispute, the taxpayer appealed the US tax assessment. The US Tax Court held that the payments were income from personal services performed in the United States. The taxpayer did not have an ownership interest in the recordings, and therefore there was no property the licensing or sale of which could give rise to

[71] Paragraph 12(11) of the commentary on the OECD model convention.

[72] 83 TC 584 (1984).

royalty income.[73] The fact that the payments were based on a percentage of future sales did not disturb this determination.

The assertion that a payment could be a royalty when it was not for the transfer of any property or property right is clearly incorrect.[74] A payment for the performance of services will not be royalty income because a royalty is a payment for the acquisition of, use of, or right to use property where the payment is dependent upon the extent of the use of the property or profits to be derived therefrom. This was the focus of the debate, before the enactment of subparagraphs 212(1)(d)(ii) and (iii), over whether a payment for knowhow could constitute a royalty. The same principles apply to a case such as *Pierre Boulez*. Had the copyright vested in Boulez, the amount would have been a royalty; it would have been a payment for the right to use a copyright, and the payment would have been based on the future sales under the copyright. In fact, the commentary on article 12(2) of the US model convention specifies that if an artist retains a copyrighted interest in a recording and receives payments for the right to use the recording based on the sale or public playing of the recording, then the amount is a royalty. Thus, services income may be distinguished from royalty income on the basis of the nature of the subject matter of the payment. Where the payment, whether or not it otherwise appears to be a royalty, is not in respect of corporeal or incorporeal property, it will not be a royalty.

The US Treasury department has voiced concern that electronic information may "further complicate existing difficulties" in distinguishing services income from sales or royalty income, and that "new technologies will blur these distinctions."[75] The US Treasury paper compares a one-time purchase of a set of CD-ROMs with a periodic payment for an online encyclopedia service. It suggests that the CD-ROM transaction may result in sale of goods income but hints that the online transaction might be characterized as giving rise to services income on the basis that the transaction involves the provision of professional services culminating in the provision of a document. However, the online transaction might also be characterized as giving rise to royalty income.

---

[73] The US Tax Court held, ibid., at 591, "Before a person can derive income from royalties, it is fundamental that he must have an ownership interest in the property whose licensing or sale give rise to the income." See also *Ingram v. Bowers*, 57 F.2d 65 (2d Cir. 1932). In that case, so-called royalty payments paid to a performer were held to be income from performance of personal recording services. The determining factor was the fact that the performer had no legal interest in the masters he recorded.

[74] West Germany had accepted that the amounts were royalties and had taxed them as such. The problem arose because, under the treaty, royalties were taxable only in the resident state and therefore West Germany would not receive the tax levied in the United States. Note that in the international context, the distinction between income from services and royalty income is made more troublesome by paragraph 12(18) of the commentary on the OECD model convention, which suggests that payments for the sale of recordings of a performance should be classified as royalties and dealt with under article 12.

[75] US Treasury paper, supra footnote 1, at paragraph 7.3.4.

Income characterization is a threshold issue for electronic services. In one sense, the entire experience of communicating with an electronic network can be viewed as involving new and different "services." However, it is submitted that this is not an accurate statement. Many new electronic interactions, such as that in the example provided by the US Treasury department, merely involve more efficient communication. In recognition of this, it has been suggested that there should be a distinction drawn between two types of electronic services.[76] The principal feature of a "type I" service is that a human being provides a significant aspect of the service.[77] "Type II" services involve the use of electronic data bases that are largely mechanized and do not involve significant direct human input. This second type of service may simply be a substitute for purchasing books or magazines, renting a videotape, or paying for access to an index.[78] Glicklich et al. suggest that "type II" services should be subject to the international tax rules applicable either to the exploitation of intangible property or to the disposition of tangible or intangible property, depending upon the particular "type II" service involved. This may be the best way in which to analyze the growing number of transactions in electronic commerce that appear to straddle the distinction between services and sales or royalties.

This type I/type II characterization is essentially achieved when a restrictive interpretation of Canada's domestic royalties provision (as well as of the royalties article in Canada's tax treaties) is adopted.[79] The first requirement is that property or rights in property are transferred. This will not typically be the case where strictly personal services are provided. In this determination, regard would be had to *Pierre Boulez*. Where there is a transfer of property or the right to use property, the relevant determination returns to that which dominated the characterization of payments for patents and copyrights. First, is there an outright disposition of property, and if so, does the payment fall within the language of subparagraph 212(1)(d)(v)? If not, is the payment one for the use of property that is dependent upon the extent of that use or the production from that property?

Returning to the example above, the characterization of a subscription fee to an online encyclopedia service should focus on the nature of what is transferred and the nature of the payment itself. Since the amount of the subscription fee will not generally relate to the extent of the use of the service or the profits derived therefrom, it will not be a royalty. The true threshold issue should be whether the provision of the service to

---

[76] Glicklich, Levine, Goldberg, and Brody, supra footnote 1.

[77] This would envelop such transactions as the delivery of professional services over the Internet. For example, a lawyer might provide legal advice to a client over the Internet rather than rely on traditional means of delivering services (that is, actual meetings, telephone conferences, and faxes).

[78] Glicklich, Levine, Goldberg, and Brody, supra footnote 1, at 70.

[79] Such an interpretation is discussed below.

Canadians over the Internet constitutes "carrying on business in Canada," and if so, whether the income is referable to a fixed base or permanent establishment in Canada.

Payments in Respect of Exclusivity

In *Grand Toys Ltd.*,[80] the court considered whether amounts paid for exclusivity of distributorship could constitute royalties. That such a payment could represent a royalty is expressly provided for in subparagraph 212(1)(d)(iv). That provision states that a royalty or similar payment includes a payment made pursuant to an agreement between a person resident in Canada and a non-resident under which the non-resident agrees not to use or permit another person to use any property or knowhow referred to in subparagraph 212(1)(d)(i) or (ii). Subparagraph 212(1)(d)(iv) would appear to include the exclusivity of distributorship agreement executed by the parties in *Grand Toys Ltd.*

The court in *Grand Toys Ltd.* ultimately concluded that the payments, assuming that they could properly be considered to have been paid for exclusivity, were not royalties. It is not entirely clear why the court made this determination. It appears that the court may have considered that the payments were part of the cost of the goods sold and, since they were not contingent in any way, they could not be royalties. If this is indeed the case, the decision suggests that the payment for exclusivity of distributorship must be based on the profits to be derived from the right of exclusivity in order to be a royalty. Where the payment for the exclusivity is unrelated to the extent of the use of the exclusivity, that amount will be considered either a capital receipt or business profits.

There are two issues that must be considered with respect to payments for exclusivity. First, a payment for exclusivity is not a payment in respect of property. In fact, the payment is made in consideration for the undertaking of the payee not to use the property or to allow anyone else to use the property in a particular area. In this sense, a payment for exclusivity is not a royalty proper, since it is not a payment for property, nor is it based on the use of the property. Consequently, the inclusion of payments for exclusivity within the scope of paragraph 212(1)(d) is most accurately considered a deeming rule. Second, the interpretation of subparagraph 212(1)(d)(iv) articulated by the court in *Grand Toys Ltd.* appears to be inconsistent with the court's interpretation of subparagraph 212(1)(d)(i). The court appears to have insisted that the payment for exclusivity relate to the profits derived in respect of the exclusivity, whereas the court was prepared to find a payment within the scope of subparagraph 212(1)(d)(i) notwithstanding the fact that it was not contingent on the use of the property and was therefore not a royalty proper.[81] Nonetheless, in

[80] Supra footnote 28.

[81] See infra footnote 91 and accompanying text.

light of the manner in which some courts and Revenue Canada interpret subparagraph 212(1)(d)(i), the application of subparagraph (iv) should be clarified.

Use of the Word "Royalties" by the Parties

The use of the word "royalty" in an agreement is not determinative but may be considered relevant when characterizing income from a particular transaction. The court in *Grand Toys Ltd.* was of the view that the use of the word "royalty" by the parties themselves was a factor to be considered, but that its use did not mean that the payment was necessarily a royalty.[82] The court stated that the use of the term "royalties" is relevant only insofar as it is evidence of the true intent of the parties. The court held that

> what an obligation is called may be of some assistance in interpreting the nature of the obligation but it does not mean that because someone has called an obligation something, that [sic] this resolves the nature of the obligation. The nature of a contractual obligation is determined by trying to ascertain from a careful review of the agreement, what was the intent of the parties, what was the nature of their undertakings or in other terms what is the agreement about.[83]

Ultimately, the court concluded that there was no explanation for why the payment was referred to in the agreement as a royalty. The true intention of the parties was that the payment was the amount that the Hong Kong company wanted to receive over its actual cost. The Hong Kong company agreed to accept the taxpayer as its distributor because the latter agreed to pay in advance a substantial amount. The use of the term "royalty" did not dissuade a court convinced by the testimony of witnesses and the surrounding circumstances that what was intended by the parties was not a royalty but a lump-sum payment calculated as a per unit payment.[84]

[82] The court was influenced by the statement that "the fact that people who . . . know all about it choose in their agreement to refer to these annual sums . . . as 'royalties,' is a matter not to be entirely neglected." *British Salmson Aero Engines, Ltd.*, supra footnote 40, at 35.

[83] *Grand Toys Ltd.*, supra footnote 28, at 1061. This determination is consistent with that made by Lord Greene MR in *Rustproof Metal Windows Co.*, supra footnote 46, at 267. In that case, Lord Greene spoke disdainfully of the "magic force" that the lower court had attributed to the word "royalty."

[84] The Tax Court of Canada recently came to a similar conclusion in *Entre Computer Centers Inc. v. The Queen*, [1997] 1 CTC 2291. In that case, a taxpayer contended that he had not received a payment contemplated by paragraph 212(1)(d) despite the wording to the contrary in the agreement pursuant to which payment was made. The Tax Court agreed with the taxpayer that the commercial reality of the transaction was more important than the nomenclature used by the parties to describe the arrangement. The court adopted, ibid., at 2304, the words of the House of Lords in *Commissioners of Inland Revenue v. Wesleyan and General Assurance Society* (1948), 30 TC 11, at 25 (HL): "the name given to a transaction by the parties does not necessarily decide the nature of the transaction."

Conclusions

As commercial transactions evolve in the international setting, the potential application of paragraph 212(1)(d) will be increasingly important. However, as stated earlier, the piecemeal drafting of the provision hinders its predictable application. The principal concern is whether a payment must be a "rent, royalty or similar payment" to attract withholding tax under paragraph 212(1)(d) or whether it is enough that the payment fall within the wording of one of subparagraphs 212(1)(d)(i) to (v). In this respect, is any payment for the right to use property taxable under paragraph 212(1)(d), or must the payment first be a royalty?

Revenue Canada's Administrative Practice

Revenue Canada's administrative position is that the opening words "including, but not so as to restrict the generality of the foregoing, any payment" has the effect of bringing within the scope of the provision any payment described in subparagraphs 212(1)(d)(i) through (v), which need not be a rent, royalty, or similar payment.[85] In effect, Revenue Canada extends the application of subparagraph 212(1)(d)(i) to include any payment, including a single or lump-sum payment, for the right to use, in Canada, any property, etc., whether or not the amount would be considered a rent, royalty, or similar payment.[86]

This interpretation cannot possibly be correct. If *any* payment for the use of, or the right to use, property is subject to withholding under subparagraph 212(1)(d)(i), there is no purpose behind the inclusion of the words "rent, royalty or similar payment."[87] Furthermore, the language of the provision does not support Revenue Canada's interpretation. The words "including, but not so as to restrict the generality of the foregoing, any payment" suggest that the payments in subparagraph 212(1)(d)(i) cannot be broader than those implied by the opening words. Revenue Canada's interpretation has the opposite result.

Judicial Pronouncements

Saint John Shipbuilding and Dry Dock Co. involved a taxpayer that had made payments to a non-resident corporation for the use, for an indefinite

---

[85] IT-303, supra footnote 30, at paragraph 9.

[86] Ibid., at paragraph 10.

[87] It is worth noting that Thurlow CJA, in *Saint John Shipbuilding & Dry Dock Co.*, supra footnote 43, interpreted article 6(a) of the protocol to the 1942 Canada-US tax convention, which defined rentals and royalties as including rentals or royalties for the use of patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other like property. The Court of Appeal rejected the appellant's argument that the inclusion of the phrase "including rentals or royalties for the use of" expanded the definition of rentals and royalties. The court held that the phrase and ensuing list only served to clarify the sorts of things in respect of which the rentals or royalties are paid. There was no justification for interpreting the definition so as to distort the ordinary meaning of either word.

period of time, of computer tapes containing technical data relating to shipbuilding. The Federal Court of Appeal held that the taxpayer was not subject to withholding tax pursuant to the provisions of the 1942 Canada-US treaty since the moneys in issue were lump-sum payments for a non-exclusive licence allowing unlimited use of a software system, and therefore were not rents or royalties. As discussed above, the court held that a payment, even if for the right to use, was not a royalty when it was not dependent upon the extent of the use, the production of goods or services, or the benefit derived.[88]

Unfortunately, the Federal Court of Appeal, in *Saint John Shipbuilding and Dry Dock Co.*, declined to deal conclusively with the scope of subparagraph 212(1)(d)(i) (then subparagraph 106(1)(d)(i)). The court made a passing comment that the scope of subparagraph 106(1)(d)(i) read on its own could be very broad. In the court's words, "it is not easy for a payment of the kind described to escape the definition of 'any payment . . . for the use of or right to use in Canada any property . . . or other thing whatever.' "[89] The court, however, held that it was not necessary to reach a definite conclusion on the scope of the domestic provision since the Canada-US treaty would prevail in any case; and, since the payments in question were not royalties within the meaning of the term contained in the treaty, that was the end of the matter. *Saint John Shipbuilding & Dry Dock Co.* is therefore disappointing in that it represents a missed opportunity to restrict the scope of the domestic provision.

Grand Toys Ltd. suggests that there is some support among the judiciary for Revenue Canada's interpretation of subparagraph 212(1)(d)(i). In that case, the court determined that amounts paid to a non-resident supplier were not royalties.[90] Having made this determination, the court then turned its attention to whether the payments were for the use of or the right to use in Canada any property, invention, trade-name, patent, trademark, design or model, plan, secret formula, process, or other thing whatever. The court held that no property was used in Canada. Nothing was manufactured by the distributor using the trade-names; rather, the acquired property was simply sold in Canada.

The analysis of the court is alarming. The reasoning of the court suggests that a payment held not to be a royalty or similar payment may still be subject to withholding tax under subparagraph 212(1)(d)(i) if it is a payment for the use of property. Or did the court simply state, in obiter, that selling property is not using property? If the court did intend that the payment might still attract withholding tax notwithstanding the fact that

[88] Supra footnote 43, at 357. The decision of the Federal Court of Appeal in *Saint John Shipbuilding & Dry Dock Co.* was handed down four years after Revenue Canada released its interpretation of paragraph 212(1)(d) in IT-303, supra footnote 30.

[89] Supra footnote 43, at 356.

[90] See the text accompanying footnote 32 for a discussion of this aspect of the decision.

it had determined that the payment was not a royalty, it appears that the court misinterpreted *Saint John Shipbuilding and Dry Dock Co.*, upon which it had relied.[91]

The Recommended Interpretation

Subparagraph 212(1)(d)(i) should be viewed as a legislative clarification of the various types of payment that may be a royalty payment that attracts withholding tax. Nowhere in the language of the provision is there any wording that could have the effect of expanding the definition of "rent, royalty or similar payment" in paragraph 212(1)(d) by including payments that do not have the characteristics ordinarily associated with rent, royalties, or similar payments. Consequently, the determination of the court in *Grand Toys Ltd.* that the payment was not a royalty should have made irrelevant the determination of whether the payment was for the use of property. The proper analysis of a payment under paragraph 212(1)(d) involves a determination of whether the payment is a royalty or similar payment.[92] Of course, legislators have determined that certain other payments should be within the scope of paragraph 212(1)(d)—particularly, payments in the form of royalties for knowhow and payments disguised as income amounts received on the disposition of property. These should still be within the scope of the royalty provision of part XIII, but they should be included by specific deeming rules since they are not royalties proper. This recommendation is elaborated on below.

If Revenue Canada's interpretation were correct, the result would be commercially untenable. Revenue Canada's interpretation would result in commercially equivalent transactions receiving different tax treatment, and the resulting uncertainty would impede technological development in the electronic commerce marketplace.[93] These consequences suggest that Revenue Canada's interpretation is not the better view, nor what was intended by Parliament.

Consider the following example. Suppose a Canadian consumer could purchase an edition of *The New York Times* each morning from a corner

---

[91] While the court appears to have been prepared to accept that a payment within the scope of subparagraph 212(1)(d)(i) did not have to be a royalty in order for tax to be withheld, the court was not prepared, in considering whether any royalties were paid for the exclusivity of distributorship, to accept that a payment within the scope of subparagraph 212(1)(d)(iv) did not have to be a royalty. The court did not explain why it interpreted the similar wording of subparagraphs 212(1)(d)(i) and (iv) differently.

[92] If one examines the predecessor provision, paragraph 106(1)(d) of the Income Tax Act, RSC 1952, c. 148 (see table 1 above), it is clear that the provision was intended to apply to rent, royalties, or similar payments for the use in Canada of the property listed in subparagraph 212(1)(d)(i). The inclusion of "such payment" instead of "any payment" alleviated any doubt that the payment for the use of property had to be a royalty. The removal of the word "such" may well form the basis for defending Revenue Canada's position.

[93] The US Treasury department asserts that rules that provide certainty are necessary for new technologies to achieve their maximum potential. US Treasury paper, supra footnote 1, at 4.

store for $1.00. There is clearly no obligation on the consumer to withhold 25¢ tax under paragraph 212(1)(d). With technological advances, that consumer could instead subscribe to *The New York Times*' e-mail delivery service and receive the morning edition of the paper by e-mail. Is the subscription fee a payment for the right to use property in Canada? If so, the consumer would be obliged to withhold tax on the outward bound payment. If there is no statutory requirement that the payment be in the form of a royalty, this payment may in fact attract withholding tax. However, the two transactions are commercially equivalent. If part XIII withholding tax applies only to payments in the form of a royalty or similar payment, there is no withholding requirement and the two transactions are effectively treated as they should be: as two forms of the same transaction.

Consider again the example provided in the US Treasury paper.[94] A consumer in Canada could purchase a CD-ROM encyclopedia for use on his/her home computer. Alternatively, that consumer could subscribe to an online encyclopedia service. If the consumer has a sufficiently fast modem connection, there is little practical difference between accessing the online service and using the CD-ROMs. The sale of the CD-ROMs produces income from the sale of goods. However, the classification of the income arising from the provision of the online service depends upon whether it is a payment for the right to use property in Canada. Revenue Canada's interpretation of subparagraph 212(1)(d)(i) suggests that it is. Thus, two substantially equivalent transactions would receive different tax treatment. However, if the payment for the right to use must be a royalty or similar payment in order to attract withholding tax, there is no withholding requirement, and the two transactions are treated similarly.

In conclusion, it is submitted that Revenue Canada's interpretation of subparagraph 212(1)(d)(i) is incorrect. Not only does it render the opening words of the provision meaningless, but it will result in an increasing likelihood that similar commercial transactions will be treated differently. The following principles should be applied in characterizing a payment as a royalty for Canadian income tax purposes:

- A royalty is a form of payment for the acquisition of, use of, or right to use property. As such, a royalty will arise only where the payment is made in respect of a property or property rights.
- Payments of an income or capital nature may be royalties.
- A royalty will typically be characterized by an element of contingency. Generally, a payment will be a royalty if it is computed with respect to the production derived from the use of the property transferred, to the profits of the business, or to the gains generated by the exercise of certain rights.

[94] Ibid., at paragraph 7.3.4.

• Whether a payment in respect of a patent or copyright is a royalty depends upon the extent of the rights transferred. Where the entire patent or copyright is transferred, the payment will typically be in respect of an alienation and not a royalty. However, that payment may still be subject to withholding under paragraph 212(1)(d) if it is determined by reference to the use made of the rights, the profits of the business, or the gains generated by the exercise of the rights. The question when a payment is made for use and when it is made for ownership is essentially one of degree.

• A licensing of rights, as opposed to an assignment of rights, may give rise to royalty income. However, the facts and circumstances of the licensing arrangement must still be considered.

• Knowhow may be the subject matter of a royalty payment. However, difficult issues arise where the payment is for a combination of knowhow and technical services. This is particularly the case where the payment for the services is not computed by reference to the use to be made of those services or the benefit derived from them, the production or sales of goods or services, or profits. Where the minister does not apportion the payment between the knowhow and the services, the entire amount will be exempt from withholding tax under paragraph 212(1)(d).

• Payments for exclusivity may constitute royalties under subparagraph 212(1)(d)(iv), which is best considered a deeming rule. It is unclear whether the payment must be based upon the extent of the use of the exclusivity.

• Characterization of a particular amount as a royalty by the parties to the transaction is not determinative of the character of the payment for tax purposes. Nonetheless, courts may attribute some weight to the terminology used by the parties.

With a view to applying these principles in statutory form, the following redraft of paragraph 212(1)(d) is proposed:[95]

> 212(1) Every non-resident person shall pay an income tax of 25% on every amount that a person resident in Canada pays or credits, or is deemed by Part I to pay or credit, to the non-resident person as, on account or in lieu of, or in satisfaction of . . .
>
> (d)(i) any payment
>
> (A) for the use of or for the right to use in Canada any property, invention, trade-name, patent, trade-mark, design or model, plan, secret formula, process or other thing whatever,
>
> (B) for information concerning industrial, commercial or scientific experience, or
>
> (C) for services of an industrial, commercial or scientific character performed by a non-resident person,

[95] As stated earlier, rents should be dealt with in a separate provision; see supra footnote 27 and accompanying text.

where the total amount payable is dependent in whole or in part on

(D) the use to be made of, or the benefit to be derived from anything referred to in clause (i)(A), the information or service,

(E) production or sales of goods or services, or

(F) profits,

(ii) any payment made pursuant to an agreement between a person resident in Canada and a non-resident person under which the non-resident person agrees not to use or not to permit any other person to use any thing referred to in clause (i)(A) or any information referred to in clause (i)(B), or

(iii) any payment that was dependent on the use of or production from property in Canada whether or not it was an instalment on the sale price of the property, but not including an instalment on the sale price of agricultural land,

but no income tax shall be imposed on

(iv) a payment on or in respect of a copyright in respect of the production or reproduction of any literary, dramatic, musical or artistic work, including a payment in respect of the production or reproduction of computer software,

[subparagraphs (v) through (ix) would be the same as existing subparagraphs (vii) through (xi)]

The first feature of the redraft worth noting is the absence of the term "royalty." Given the confusion that has arisen around the use of the term, it is preferable simply to describe the types of payments that are subject to withholding rather than leave it to the courts to determine what might constitute a "royalty." This redraft of paragraph 212(1)(d) ensures that the provision is applied narrowly and therefore predictably. Consider the redrafted provision as it would apply to a transaction involving payments in respect of computer software not excepted from withholding under existing subparagraph 212(1)(d)(vi), a transaction that has been the subject of considerable discussion in recent literature.[96] The difficulty in characterizing computer software payments arises out of the myriad of ways in which the transfer may be effected and the ease with which the property may be perfectly reproduced.

The proper analysis of a payment for computer software requires the determination of the same questions as were raised in respect of patents, copyrights, and knowhow. First, what rights are being transferred? Second, is the payment related to the extent of the use of the software? In this respect, it is worth considering the 1992 OECD report that dealt with the characterization of payments for computer software under article 12 of the OECD model convention.[97] That report essentially highlights many

[96] See supra footnote 1.

[97] Organisation for Economic Co-operation and Development, *Model Tax Convention: Four Related Studies*, Issues in International Taxation no. 4 (Paris: OECD, 1992).

of the factors outlined in this article. The main guiding principles of the report relevant to this article have been summarized as follows:[98]

- Payments for software are royalties only where there is a limited grant of rights for the commercial development or exploitation of the software.
- Payments for software acquired for personal or business use are not royalties.
- Payments in respect of the alienation of all rights attached to software are not royalties.[99]
- Payments made for the acquisition of some, but not all, rights attaching to software may constitute an alienation. In that case, the consideration paid is not a royalty.

These principles are the same as those developed in characterizing payments for the use of, or the right to use, patents and copyrights. If those principles are followed, the scope of the payments for computer software that may be considered to give rise to royalty income, as distinct from payments for the alienation of a copyright or income from the sale of goods, is quite narrow. If the payment is also required to be based upon the extent of the use of the software or the profits derived therefrom, the category of software payments that will be subject to withholding tax is even narrower. This is a desirable result. It will, to a large extent, ensure that commercially equivalent transactions are treated similarly for tax purposes.[100] This is especially the case with payments for digitized information.[101]

---

[98] Catherine A. Brown, "The Canadian Income Tax Treatment of Computer Software Payments" (1994), vol. 42, no. 3 *Canadian Tax Journal* 593-613, at 595.

[99] Of course, where the payment is dependent upon the production from or the use of the software, it may be deemed to be a royalty by subparagraph 212(1)(d)(v) for Canadian tax purposes.

[100] The OECD model convention recommends that withholding tax not be imposed on payments for computer software where the payment is made "on or in respect of a copyright in respect of the production or reproduction of any literary, dramatic, musical or artistic work." Revenue Canada's position is that payments for prepackaged software programs that are sold subject to restrictive licensing agreements that allow the purchaser to use the program on only one computer at a time (known as "shrink-wrap computer software") are exempt from withholding under part XIII because these payments are considered to be proceeds from a sale of tangible goods: Revenue Canada document no. 9502165, supra footnote 38. Whether payments for other software are exempt from withholding depends upon whether the payment is for the right to produce or reproduce the software and whether the payment is dependent upon the use of or production from the copyright. According to Revenue Canada, a taxpayer who has the right to make copies for his or her own use "is not making use of a copyright but is merely exercising his right to use under the licensing agreement. In such a case, since the taxpayer does not have the right to produce or reproduce the computer program, the exemption provided in subparagraph 212(1)(d)(vi) . . . will not apply": Robert D'Aurelio, "International Issues: A Revenue Canada Perspective," in *Report of Proceedings of the Forty-Second Tax Conference*, 1990 Conference Report (Toronto: Canadian Tax Foundation, 1991), 44:1-19, at 44:4.

[101] Digitized information may give rise to difficult issues for a number of reasons, one of which is the ease with which it can be perfectly reproduced. In the past, a person who

(The footnote is continued on the next page.)

Transactions involving computer software or other digitized information should be considered either transfers of copyright rights, transfers of copies of the copyrighted program, the provision of services for the development or modification of a computer program, or the provision of knowhow regarding computer programming techniques.[102] Once this initial characterization were made,[103] it would be relatively simple to determine whether the payment was based on the extent of the use of the property transferred or the profits derived therefrom. Such an approach would borrow from the principles set out above in respect of payments for copyrights and patents and payments for knowhow, and it would appear to be both workable and flexible in the sense that it would be more easily adapted to new forms of computer software transactions.

MEANING OF ROYALTY IN CANADA'S BILATERAL TAX TREATIES

Article 12: The Royalty Provision

The stakes associated with characterizing an amount as a royalty are particularly high in the international context since any income characterized

[101] Continued . . .
wished to own 10 copies of a book acquired 10 copies of that book from a publisher. However, a person who desires 10 copies of a computer program may well purchase only 1 copy and then reproduce it nine times. The second transaction might be considered to give rise to royalty income because the right to make reproductions is a right reserved to the copyright holder. When someone is allowed to make copies of a program, the payment is in consideration for the right to use the copyright. On the other hand, the second transaction may also be viewed as a substitute for the purchase of 10 copies of the program.

Consider as well the following situation. Instead of licensing a software disk, a nonresident developer could transmit the information through the use of a modem and telephone lines. Access to the program could be based on either a user fee or an annual fee. The nonresident developer could also act as a service provider, providing access to a variety of computer software and support services. Logically, the liability for withholding should not depend upon whether the software is purchased in disk form or transmitted over telephone lines: Brown, supra footnote 98, at 609. However, such a transaction raises a number of issues. What is being paid for? Is the payment for the use or right to use in Canada? And, most important, should the payment be considered a royalty? It is submitted that these issues need not be difficult to resolve. As set out above, the payment should not be a royalty unless it is tied to the extent of the use of the copyright. If the purchaser purchases a program and then reproduces it without licence from the developer to do so, that is a matter for copyright law. The characterization of an amount should not be determined by a fear that a purchaser might easily violate copyright laws. The fact that a purchaser could acquire a copy and then easily, although illegally, duplicate it should not transform sales income into royalty income. If, however, the purchaser acquires the right to reproduce the program and the payment is dependent upon the use of the copyright, it should be a royalty.

[102] This is the approach adopted in the proposed US Treasury regulations: prop. Treas. reg. section 1.861-18(b)(1). On the other hand, the current position of Revenue Canada (supra footnote 99) is overly technical in the sense that it attempts, at least to a certain extent, to distinguish payments for computer software on the basis of whether the property transferred is tangible or intangible.

[103] In making this determination, reference would be had to the principles articulated above under the heading "The Recommended Interpretation."

as a royalty generally attracts withholding tax under Canada's tax treaties.[104] Since royalty withholding tax is imposed on the gross amount paid to the non-resident recipient,[105] even withholding at a modest percentage can constitute a large percentage of the net income of the recipient.[106]

Canada, for the most part, has adopted the OECD model convention definition of a royalty.[107] That definition includes[108]

- amounts paid as consideration for the use of, or the right to use, copyrights of artistic or scientific works;
- amounts paid as consideration for the use of, or the right to use, patents, designs, plans, processes, formulas, or trademarks;
- amounts paid as consideration for the use of industrial, commercial, or scientific equipment;[109] and

---

[104] Canada has chosen not to follow the OECD model convention in this regard. Under article 12(1) of the OECD model, the residence state has exclusive jurisdiction to tax royalties. Arguably, this approach is more appropriate since it does not result in withholding being imposed on certain transactions while other commercially equivalent transactions escape source state taxation.

[105] Subsection 214(1).

[106] For example, consider a US corporation that earns gross revenue from sales of computer software in Canada of $500. If the costs and expenses of developing, manufacturing, and distributing the software are $400, the corporation's net income before taxes is $100. If the revenue derived in Canada is characterized as a royalty, a 10 percent withholding tax will amount to half of the corporation's net income.

[107] The definition is somewhat narrower than Canada's domestic definition in that it will include only some of the payments described in paragraph 212(1)(d) as payments in respect of incorporeal property. However, payments received for the alienation of intangible property or rights that are contingent on the productivity, use, or subsequent disposition of such property or rights are within the scope of article XII(2) of the Canada-US treaty. The definition of a royalty in article 12(2) of the OECD model convention provides that, for the purposes of the article, royalties "means" the payments listed. The use of the word "means" ensures that the definition is exhaustive. Consequently, article 3(2) cannot be invoked to expand the meaning of royalties to the meaning of that term under Canadian domestic law.

[108] Note that the definition does not include payments in respect of real property. Amounts received for the disposition of real property may be subject to withholding tax under the domestic provision (specifically subparagraph 212(1)(d)(v)) where the payment received is dependent upon the use of or production from property whether or not that amount was an instalment of the sale price of the property. Canada's jurisdiction to tax these amounts is not affected by its bilateral tax treaties. For example, Canada retains its jurisdiction to tax these amounts as the source jurisdiction under article VI of the Canada-US treaty. Pursuant to article VI(1), income derived by a US resident from real property situated in Canada may be taxed in Canada. For greater certainty, paragraph 3 of that article provides that the article applies to income derived from the direct use, letting, or use in any other form of real property and to income from the alienation of such property.

[109] Article 12(2) of the OECD model convention was amended by deleting the words "or for the use of or right to use, industrial, commercial or scientific equipment" by the report entitled "The Revision of the Model Convention," adopted by the Council of the OECD on July 23, 1992, on the basis of paragraph 23 of the report entitled "The Taxation

(The footnote is continued on the next page.)

• amounts paid for information concerning industrial, commercial, or scientific experience ("knowhow").

A strict reading of the treaty definition of a royalty suggests that the payment need not be related to the extent of the use to be made of the property; the payment need only be for the use or the right to use. The treaty definition appears to contemplate, for example, a lump-sum payment for the right to use property—a payment that the Canadian domestic jurisprudence would suggest is not, generally, a royalty payment.[110]

As noted earlier, however, the Federal Court of Appeal, in *Saint John Shipbuilding & Dry Dock Co.*, determined that payments for the use of property had to be in the form of royalties, as that term was understood in its ordinary meaning, in order to fall within the scope of article 12. The

[109] Continued . . .
of Income Derived from the Leasing of Industrial, Commercial or Scientific Equipment" (adopted by the Council of the OECD on September 13, 1983): see commentary on article 12 of the OECD model convention. However, payments for the use of industrial, commercial, or scientific equipment are still included in the definition of royalties in many of Canada's tax treaties. The inclusion of these payments can cause significant difficulties. Debate may arise as to their proper characterization since the payments may also represent business profits to the non-resident from the leasing of such equipment. The characterization of payments for the use of equipment as royalties is difficult to rationalize, particularly where the leasing and maintenance of machinery and equipment is an integral part of the non-resident payee's business. Ignoring the royalty article, the income from the leasing of tangible personal property would be business profits. Catherine Brown describes a Malaysian case that illustrates the difficulties that can arise: *WW(S) Pte Ltd. v. Director General of Inland Revenue* 1988, Malaysian and Singapore Tax Cases, 319 (Special Commissioners of Income Tax, Rayvan no. PKA 432 Kuala Lumpur High Court, 1988), IMSTC 2104, cited in Catherine A. Brown, *Tax Aspects of the Transfer of Technology: The Asia-Pacific Rim*, Canadian Tax Paper no. 87 (Toronto: Canadian Tax Foundation, 1990), 22. In that case, a Singapore company, in the business of hiring out construction equipment, rented equipment to a Malaysian company. The income received by the Singapore company was considered business income for Singapore tax purposes. However, Malaysia also imposed withholding tax on the basis that the payments were "consideration for the right to use industrial, commercial or scientific equipment" under the royalty article of the Singapore-Malaysia tax treaty. Consequently, the Singapore company was subjected to double taxation on the rental income. The Singapore company appealed the assessment of withholding tax. The Malaysian High Court held that the construction equipment was industrial, commercial, or scientific equipment within the meaning of the tax convention and therefore payments for its use were subject to withholding tax. The better view would be that, since the payments were not dependent upon the extent of the use of the construction equipment, they were not royalties and should not have been subjected to source state withholding tax. This would resolve the characterization problem. Alternatively, the resident state should have abided by the source state's characterization and provided relief from double taxation. In this regard, see John F. Avery Jones et al., "The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model—I" [1984], no. 1 *British Tax Review* 14-54, at 48-54.

[110] For example, the technical interpretation of the definition of royalties in the Canada-US treaty states that " '[r]oyalties' means *payments of any kind* received as consideration for the use of or the right to use" certain intangible property [emphasis added]. See United States, Treasury Department, Technical Explanation of the Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital, April 26, 1984.

court held that it would unduly stretch the word "royalties" to conclude that a payment, even if for the right to use, should be considered a royalty when it was not dependent upon the extent of the use, production of goods, or the benefit derived.

Interestingly, the original League of Nations model convention required that a payment be a royalty, not just a payment for the use of certain property. The 1946 draft of the Model Bilateral Convention for the Prevention of the Double Taxation of Income prepared by the League of Nations[111] (which originally dealt with royalties from real estate, patents, and copyrights) referred to royalties derived by a non-resident in consideration for the right to use certain intellectual property.[112] That royalty article required that a subject payment be a payment in the form of a royalty. No definition of royalty was provided, and the domestic law definition would be relied on. Thus, the payment would have to be computed by reference to the production from or the extent of the use of the property.

The 1961 draft of the model tax convention of the Organisation for European Economic Co-operation (OEEC), however, introduced a royalties article that contained a definition of royalties substantially the same as that which appears in the OECD model convention.[113] Consequently, as of 1961, at least under one model convention, a royalty included any type of payment for the right to use certain intellectual property.

Article 13C of the 1942 Canada-US tax treaty[114] referred to "[r]oyalties for the right to use copyright or in respect of the right to produce or reproduce any literary, dramatic, musical, or artistic work." Like the 1946

[111] Reproduced in United States, Congress, Joint Committee on Internal Revenue Taxation, *Legislative History of United States Tax Conventions*, vol. 4, *Model Tax Conventions* (Washington, DC: US Government Printing Office, 1962), 4378.

[112] Article 10(2) of the 1946 League of Nations model tax convention read, "Royalties derived . . . in consideration for the right to use a patent, a secret process or formula, a trade-mark or other analogous right, shall not be taxable in the former State."

[113] The definition in article 22(2) of the OEEC model convention read, "The term 'royalties' as used in this Article means payments of any kind received as consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience." See Organisation for European Economic Co-operation, *The Elimination of Double Taxation: Fourth Report of the Fiscal Committee* (Paris: OEEC, August 1961), annex C. In its commentary on article 22, the OEEC distinguished the 1946 League of Nations model convention as drawing a distinction between royalties and amounts received as consideration for the right to use certain properties. This statement may represent the awareness of the OEEC that the 1961 draft royalty article would apply to payments that were much broader than royalties proper.

[114] Convention and Protocol Between Canada and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion in the Case of Income Taxes, signed at Washington, March 4, 1942, applicable as and from January 1, 1941.

League of Nations model convention, the US model convention originally applied to payments for the use of property that were in the form of royalties. Furthermore, paragraph 6(a) of the 1942 protocol provided that "rentals and royalties" included

> rentals or royalties arising from leasing real or immovable, or personal or movable property or from any interest in such property, including rentals or royalties for the use of or the privilege of using, patents, copyrights, secret processes and formulae, goodwill, trade marks, trade brands, franchises and other like property.

Implicit in this definition is the understanding that there is a distinction between rental payments and royalties. More important, the definition suggests that there is a distinction between royalty payments for the right to use property and other types of payments for the right to use property. In *Saint John Shipbuilding & Dry Dock Co.*, Thurlow CJA interpreted the treaty definition as follows:

> That definition appears to be intended to expand the scope of what would be covered by the ordinary meaning of rentals and royalties but it seems to me that the expansion is not in the meaning of the words but is by reference to the sorts of things in respect of which the rentals and royalties are paid. The expression is to include "rentals or royalties" from leasing of both real or immovable and personal or movable property (all apparently of a corporeal nature) and is to include as well "rentals and royalties" for the use of or for the privilege of using a list of items of incorporeal property. Nowhere, however, is there any wording which could have the effect of expanding the definition by including payments that do not have the characteristics ordinarily associated with rentals or royalties.[115]

Nonetheless, the model conventions currently refer to royalties as any payments for the right to use certain properties. Notwithstanding this potentially broad approach to royalty payments, the payments that will attract withholding tax in Canada must be included under paragraph 212(1)(d) since a treaty cannot expand Canada's jurisdiction to tax. If the recommended approach to interpreting paragraph 212(1)(d) is accepted, the only payments that would attract withholding tax under both the domestic legislation and Canada's bilateral tax treaties are payments in the form of a royalty proper: those that are determined by reference to the extent of the use of the property or to the production from the property.

Payments Received as Consideration for Computer Software

As a result of a series of studies that culminated in the 1992 OECD report,[116] in July 1992, the OECD Committee on Fiscal Affairs released significant amendments to the 1977 OECD model convention. Consequently, the tax treatment of royalties with respect to computer software has now been specifically addressed in the OECD model convention. In

[115] *Saint John Shipbuilding & Dry Dock Co.*, supra footnote 43, at 356.

[116] Supra footnote 97.

September 1992, the OECD issued a revised commentary on article 12 of the model convention outlining its position on the characterization as royalties of amounts received as consideration for computer software.

The OECD commentary focuses on whether rights have been transferred. It draws a distinction between payments for a product delivered for internal use by the customer and payments for the rights necessary to commercially exploit the software (for example, the right to reproduce for the purposes of distribution). The former payments represent business profits; the latter are royalties. Thus, the OECD commentary is generally consistent with the approach outlined in this article: an amount is classified as a royalty provided that the payment is dependent upon the actual exploitation of the software.[117] The narrow scope of computer software transactions that will now be subject to withholding tax under article 12 is consistent with the view that whether a payment is a royalty should depend upon the extent of the rights transferred and the extent to which the payment is based on the use to be made of the property, or the profits to be derived therefrom.

Exemptions from Article 12

In contrast to paragraph 212(1)(d), treaty article 12 provides a more restricted list of property that may be the subject matter of a royalty payment. While subparagraph 212(1)(d)(i) includes royalties paid "for the use of or for the right to use . . . any property . . . or other thing whatever," the property in respect of which a royalty is paid under Canada's tax treaties is limited to certain intellectual property rights. For example, payments for the use of real or personal property, for inventions, or for exclusivity, all of which might be subject to part XIII tax under paragraph 212(1)(d), are excluded from withholding tax under article 12 (although they may be subject to withholding tax under article 6 or 21).[118]

The treaty definition of royalties is also narrower than the domestic provision in respect of payments for knowhow and related services. Unlike paragraph 212(1)(d), the treaty definition of royalties includes payments for "information concerning industrial, commercial or scientific experience"; it does not separate payments for information concerning industrial, commercial, or scientific experience from payments for services of an industrial,

[117] Although, where the ownership rights are transferred and the payment is determined by the extent of the use of the rights or the profits derived therefrom, the transaction should be considered to give rise to royalty income under subparagraph 212(1)(d)(v). This approach is adopted in the Canada-US treaty. The definition of royalties in that treaty includes gains from the alienation of any intangible property or rights in respect of copyright, patent, trademark, or other similar right to the extent that such gains are contingent on the productivity, use, or subsequent disposition of such property or rights. See the discussion of the Canada-US treaty below.

[118] Paragraph 12(9) of the commentary on the OECD model convention states that payments for the use of industrial, commercial, or scientific equipment should be regarded as business profits. Payments for the sale of such property would be gains from the alienation of property under article 13.

commercial, or scientific nature. However, the word "experience," as used in the treaty, may be broader than "information" and may include services. For example, the technical explanation of article XII of the Canada-US treaty issued by the US Treasury department states that technical service fees (or even management fees)[119] may constitute information concerning "industrial, commercial or scientific experience" within the meaning of article XII where the payment is periodic and the quantum depends on productivity or some similar measure.

Certain other payments are exempt from withholding under some of Canada's tax treaties. These include

- payments for "copyright royalties and other like payments in respect of the production or reproduction of any cultural, dramatic, musical or artistic work" (other than motion picture and videotape royalties, provided that the non-resident payee is subject to tax on those payments);[120]
- payments for the use of patents or for information concerning industrial, commercial, and scientific experience; and
- computer software.

The Canada-US Treaty Definition of Royalty

The third protocol to the Canada-US treaty, signed on March 17, 1995, introduced significant changes to the withholding tax treatment of payments for the use of or the right to use industrial, commercial, or scientific information, computer software, and patents. The rationale behind the changes stemmed from the general view that the treaty negotiated more than a decade earlier was out of step with the current agenda of facilitating the free flow of goods and services.[121] The treaty was perceived as creating trade barriers through the imposition of withholding tax on a wide range of intellectual property rights, as well as computer software payments.[122]

The definition of a royalty in the Canada-US treaty is somewhat broader than that contained in Canada's other bilateral tax treaties. The definition in the Canada-US treaty includes as a royalty any payment for the right to use tangible personal property and gains from the alienation of any intangible property or rights in respect of a copyright, patent, trademark, or other similar rights to the extent that such gains are contingent on the productivity, use, or subsequent disposition of such property or rights.[123]

---

[119] Subject to withholding tax in Canada under paragraph 212(1)(a) of the Act.

[120] These payments are substantially the same as those exempt from withholding under subparagraph 212(1)(d)(vi).

[121] Brown, supra footnote 8, at 593.

[122] Ibid.

[123] This approach is consistent with the discussion above under the heading "Payments in Respect of Patents and Copyrights."

As noted above, the OECD model convention removed the leasing of industrial, commercial, or scientific equipment from the royalty article. This category of asset is, however, included under the more general wording of tangible personal property in article XII of the Canada-US treaty. In this respect, Canada has refused to follow the OECD provisions. Notwithstanding the OECD recommendations that this type of income be taxed as business profits under article 7, such payments remain subject to withholding tax under article XII of the Canada-US treaty.

Exemptions from Article XII of the Canada-US Treaty

The Canada-US treaty contains a number of exemptions from withholding tax. The following are now exempt:

- payments for the use of, or the right to use, computer software;
- payments for the use of, or the right to use, any patent or any information concerning industrial, commercial, or scientific experience;[124] and
- payments with respect to broadcasting as may be agreed for the purposes of the treaty in an exchange of notes.

The first two of these exemptions are the most important for the purposes of this article. The exemption of payments for the use of or the right to use computer software is consistent with the 1992 OECD recommendations.[125] These exemptions represent a tacit recognition that artificial distinctions that result in differing tax treatment of commercially equivalent transactions are difficult to apply, or to justify, and should be discarded. It remains to be seen to what extent similar changes will be made to Canada's other bilateral tax treaties.[126] Further, it remains to be seen whether other amounts currently subject to source state taxation under article XII of the Canada-US treaty will be exempted.[127]

Summary of Tax Treaty Considerations

The definition of royalties in Canada's tax treaties narrows the category of property in respect of which a royalty payment may be made. Nonetheless, the treaty definition of royalties appears to be quite broad in that it

[124] This exemption does not apply to any such information provided in connection with a rental or franchise agreement.

[125] Brown, supra footnote 8, at 597, argues that a specific exemption was not required since under the interpretation in the OECD commentary, software payments would rarely constitute royalties. This is also suggested by the jurisprudence discussed above.

[126] Similar exemptions can now be found in the Convention Between Canada and the Republic of Iceland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, signed at Reykjavik on June 19, 1997 and in the Convention Between Canada and Switzerland for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital, signed at Berne on May 5, 1997.

[127] For example, the rationale behind not exempting payments in respect of designs, models, plans, secret formulas, or processes and payments in respect of trademarks or trade-names is unclear.

generally considers any form of payment a royalty if it is a payment for certain properties described in that definition. However, if the general principles outlined above that govern the characterization of an amount as a royalty are respected domestically, the payments to non-residents subject to withholding tax under paragraph 212(1)(d) and treaty article 12 will be those that are royalties proper. A tax convention cannot expand a country's jurisdiction to tax; it may only limit that jurisdiction.

CONCLUSIONS

The approach to interpreting and applying the domestic royalties provision that this article recommends requires that the payment contemplated in that provision (particularly in subparagraph 212(1)(d)(i)) be a payment in the form of a royalty.[128] Payments that are not in the form of a royalty proper should not be considered royalties, except where they are specifically deemed to be royalties. To this end, a payment for the use of or the right to use patents, copyrights, knowhow, or anything whatever should not be subject to withholding tax unless the payment is based on the extent of the use to be made of the property or on the profits to be derived therefrom. Other payments for the use of or the right to use those properties should be considered business profits. Consequently, the relevant determination domestically would be whether the non-resident is carrying on business in Canada.[129] Internationally, the relevant determination would be whether the non-resident has a permanent establishment or fixed base in Canada to which those profits relate.

Rather than adopting a piecemeal approach to interpreting and applying the domestic royalties provision in what will become increasingly futile efforts to keep pace with new technologies, paragraph 212(1)(d) should be redrafted in order to narrow and clarify its application. Technological development—particularly the development of electronic commerce—requires rethinking that goes beyond determining what payments should be caught as royalties. Rather, careful attention needs to be paid to the future meaning of both "carrying on business in Canada" and "permanent establishment."

---

[128] Such an approach has several benefits. Foremost is greater certainty, which avoids difficulties in planning and structuring international transactions and thereby facilitates technological and economic progress.

[129] For example, in *Atlas-Gest Inc. et al. v. MNR*, [1985] 2 CTC 2066 (TCC), payments for the use of construction equipment necessary for the construction of a sewer system were held to be exempt from withholding tax because they were considered to be income from a business carried on in Canada. See also *GLS Leasco Inc. et al. v. MNR*, 86 DTC 1484 (TCC).