

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

APPENDIX 22 (CRA ON PARAGRAPH 212(1)(d))

Material:

IT-303 (April 8, 1976) – Know-How and Similar Payments to Non-Residents

IT-303SR (September 19, 1985) – Know-How and Similar Payments to Non-Residents



Income Tax Interpretation Bulletin

IT-303 Know-How and Similar Payments to Non-Residents

NO: **IT-303**

DATE: April 8, 1976

SUBJECT: INCOME TAX ACT
Know-How and Similar Payments to Non-Residents

REFERENCE: Paragraph 212(1)(d)

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1. This Bulletin outlines the Department's position with respect to the taxation of payments by persons resident in Canada to non-residents for what is commonly referred to as "know-how".
2. It should be noted that under certain circumstances even payments to this nature made by non-residents may be subject to Canadian tax if, under the provisions of the Act, as amended by S.C. 1974/5, c.26, they are deemed to be resident in Canada for purposes of the particular payments.
3. No all-inclusive definition of "know-how" payments exists, but for the purposes of this Bulletin, the Department regards them as including payments for special knowledge, skills or techniques which are considered beneficial in the conduct of a business. Such payments may be for expertise flowing from experience, ability or research which may be reflected in blueprints, drawings, specifications, plant layouts, designs, secret processes and formulae.
4. Paragraph 212(1)(d) subjects a non-resident person to an income tax of 25% on all amounts paid or credited to him as, on account or in lieu of payment of, or in satisfaction of, rent, royalty or a similar payment, including the payments described in subparagraphs (i) through (v), but not including the payments described in subparagraphs (vi) through (x). Until 1976 but not including that year, the provisions of subsection 10(2) ITAR have the effect of reducing the rate of withholding tax from 25% to 15%. The provisions of any tax treaty to which Canada is a party may affect the rate of such tax, or even wholly exempt some payments (see paragraph 34 below).
5. Paragraph 212(1)(d) covers many payments which fall outside of "know-how" and similar payments and which are therefore beyond the scope of this Bulletin. Any rent, royalty or similar

payment, whether it be for "know-how", for the use of confidential technical information, or for any other consideration, is subject to tax under paragraph 212(1)(d) unless it falls within the exceptions described in subparagraphs (vi) through (x). This means that if an amount is rent, royalty or a similar payment, it need not fall within the specific cases enumerated in subparagraphs (i) through (v) in order to attract withholding tax.

6. In addition to the foregoing, know-how payments may be exempt from withholding tax where the non-resident carries on business in Canada (see paragraph 25 below).

7. The Department considers that the words "rent" and "royalty" are used in a broad sense and are not necessarily restricted to periodic payments, but may in certain circumstances include single or lump-sum payments. In general, a rent or royalty represents a payment made to the owner of property for the right to use such property for a given period of time. In most circumstances where a rent or royalty is paid, the owner of the property used by the person paying the rent or royalty retains ownership. However, where property in Canada is sold and payment is dependent upon the use of or production from the property, this payment will be subject to tax under subparagraph 212(1)(d)(v), unless the property is agricultural land.

8. The Department also considers that, (a) apart from the circumstances set forth in subparagraph 212(1)(d)(x) (see para. 33 below), the deductibility under Part I of a payment for "know-how" by the person making the payment has no bearing on whether it is subject to withholding tax; and (b) the taxability of the payment under paragraph 212(1)(d) does not depend upon whether or not the recipient would have been taxable in respect of the payment had he been resident in Canada.

9. The words immediately following the introductory words in paragraph 212(1)(d), namely "...including, but not so as to restrict the generality of the foregoing, any payment..." have the effect of including within the scope of the provision the payments described in subparagraph (i) through (v), which need not be rent, royalty or a similar payment.

Payments for the Right to Use in Canada (subparagraph 212(1)(d)(i))

10. This provision extends to any payment, including a single or lump-sum payment, made to a non-resident for the right to use, in Canada, any property, invention, trade mark, design or model, plan, secret formula, process, trade name, patent or other thing whatever. Such a payment will be subject to tax whether or not it falls within the category of rent, royalty or a similar payment.

11. Some common examples of payments which fall within this subparagraph are:

- (a) franchise payments which encompass the use of trade marks, trade names or industrial designs;
- (b) payments for the use of blueprints for the lay-out of plants, buildings or equipment;
- (c) payments for the right to use special procedures, processes or recipes pertaining to a business, whether or not incorporated in a franchise, patent or trade mark; and
- (d) payments for the use of or the right to use prototypes or designs for manufacture in Canada.

12. On the other hand, the Department does not regard the following payments as falling within the provisions of subparagraph 212(1)(d)(i):

- (a) payments for the outright purchase of a patent;
- (b) payments made to obtain an outright assignment of an existing licence from the licensee.

In the latter case, however, payments required to be made to the licensor under the terms of the licence may be subject to withholding tax. If the payments under (a) or (b) are dependent upon the use of or production from the patent or licence, tax is payable under subparagraph 212(1)(d)(v).

13. The Department also draws a distinction between payments which are made for the right to use property, inventions, etc. in Canada and payments which are made for services over and above the granting of the right to use such property. The former payments will be subject to tax under subparagraph 212(1)(d)(i), whereas the latter may be subject to tax under subparagraph 212(1)(d)(iii), depending upon the terms of the payments.

Payments for Information (subparagraph 212(1)(d)(ii))

14. Under this provision any payment for information concerning industrial, commercial or scientific experience will be subject to tax where the total amount payment as consideration for such information is dependent in whole or in part upon:

- (a) the use to be made thereof or the benefit to be derived therefrom;
- (b) production or sales of goods or services, or
- (c) profits.

15. Such payments will be taxable regardless of where the information is obtained or used except in the circumstances contemplated in subparagraph 212(1)(d)(x) where a portion of the amount is deductible in computing the income of the payer under Part I from a business carried on by him in a country other than Canada (see paragraph 33 below). Similarly, taxability does not necessarily rest upon the payment being dependent on use, production or profits of the person by whom the payments are made. In certain circumstances the provision will extend to cases where payment is dependent upon the use, production or profits of the recipient of the payments or a third parties.

16. For example, an agreement with a non-resident who furnishes the information may provide that the payer has the right to pass on the information to other persons who may make payments to the payer according to the use, benefit, production, sales or profits which they in turn derive. In such a case, the payments to the non-resident will be subject to tax.

17. Where an initial payment of such a fixed sum is coupled with future payments depending upon use, production or profits, the Department will normally regard the initial payments as separate. This will be a question of fact to be determined in each set of circumstances and will depend on a number of factors, including the relationship of the payer and recipient, the nature of the particular business, any history of similar payments and the degree of certainty that there will be subsequent payments after the initial payment.

18. The Department does not regard a once-and-for-all payment in a predetermined amount for such information (such as the right to attend a viewing or an exhibition) as a payment which is dependent in whole or in part upon use, production or profits.

19. For example, in the fashion design business payments may be divided into two general types; payments for the right to "view" the non-resident's styles and designs, and payments for the use of the information so obtained. In general, provided that the former payments are unqualified, do not involve the furnishing of drawings or designs and do not depend upon the use of the information obtained, they will not be subject to tax under this subparagraph. On the other hand, where the information is subsequently used and payments are made for such use, these payments may be subject to tax, depending on the circumstances, under either subparagraph (i), if designs or models are used in Canada, or (ii), if the payments are based upon use, production or profits.

Payments for Services (subparagraph 212(1)(d)(iii))

20. Under this provision any payment for services of an industrial, commercial or scientific character performed by a non-resident person will be subject to tax where the total amount payable as consideration for such services is dependent in whole or in part upon:

- (a) the use to be made thereof or the benefit to be derived therefrom;
- (b) production or sales of goods or services; or
- (c) profits

21. Such payments will be taxable regardless of where services are rendered except in the circumstances contemplated in subparagraph 212(1)(d)(x), where a portion of the amount is deductible in computing the income of the payer under Part I from a business carried on by him in a country other than Canada (see paragraph 33 below). Similarly, taxability does not necessarily rest upon the payments being dependent on use, production or profits of the person by whom the payments are made. In certain circumstances the provision will extend to cases where payment is dependent upon the use, production or profits of the recipient of the payments or of third parties. Payments for services performed in connection with the sale of property or the negotiation of contracts are expected.

22. Where fees are charged for services 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 such services.

23. Examples of payments which may fall within this subparagraph are:

- (a) fees for technical or production services where the amount of such fees depends in any way upon performance or productivity; and
- (b) charges for product development and marketing know-how or research which vary in accordance with production or sales.

24. Payments which fall within the description of management or administration fees or charges within the meaning of paragraph 212(1)(a) are not regarded as payments for services of an industrial, commercial or scientific character referred to in subparagraph 212(1)(d)(iii). Whereas the former relate to the staff, administrative or managerial functions of an operation, the latter are more directly related to its income-producing activities. For example in the case of a hotel operation, the management and administration side would include hiring and other personnel services and the designing of accounting, security, inventory and catering systems, while promotion and publicity, entertainment booking and reservation and credit card services, as such, normally fall within the category of services of an industrial or commercial character. However, if a payment is for services which are principally in the nature of management or administration, the Department will not regard it as partly for services of an industrial, commercial or scientific character even though some elements of the latter may be present. To the extent that the payment would be a management or administration fee as described in paragraph 212(1)(a), if it falls within the exempting provisions of subsection 212(4) it will not be subject to tax under either paragraph 212(1)(a) or subparagraph 212(1)(d)(iii).

Payments to Non-Residents Carrying on Business in Canada

25. Where any of the payments referred to in paragraph 212(1)(d) are made to a non-resident person who carries on business in Canada and the payments may reasonably be attributed to the business carried on by him in Canada, the non-resident person will not be subject to tax under

Part XIII of the Act, but under Part I. (Subsection 805(1), Income Tax Regulations). However, unless the person making the payments is authorized by the Minister (under subsection 805(2) of the Regulations) to make such payments without any deduction under section 215, he will be held personally liable for the tax if the non-resident recipient is found not to have been carrying on business in Canada.

Division or Allocation of Payments

26. The Department recognizes that there may be circumstances in which a payment may reasonably be regarded as being in part a payment which is subject to tax under paragraph 212(1)(d) and in part a payment which is not subject to such tax. This might occur, for example, if a payment is made for the use or right to use property in Canada and in other countries. In general, the Department will take the position that the full amount of such a payment is subject to tax, but will be prepared to review the matter where the taxpayer or the Canadian resident paying the amount can provide satisfactory evidence that a portion of any such payment should not be subject to the tax.

Payments for Exclusivity or Agreements Not to Use (subparagraph 212(1)(d)(iv))

27. This provision applies to payments made to a non-resident to ensure that certain property or information will not be used by the payee or his licensee,

(a) in the case of items described in subparagraph 212(1)(d)(i), in Canada, or

(b) in the case of information concerning industrial, commercial or scientific experience, either in Canada or elsewhere.

Copyright (subparagraph 212(1)(d)(vi))

28. Royalties and similar payments in respect of copyright are not subject to withholding tax.

Bona Fide Cost sharing Arrangements (subparagraph 212(1)(d)(viii))

29. This subparagraph excludes from the tax otherwise imposed under paragraph 212(1)(d) payments made under a bona fide cost sharing arrangement under which the person making the payment shares on a reasonable basis with one or more non-resident persons research and development expenses in exchange for an interest in all property or other things of value that may result therefrom.

30. The Department considers that for a bona fide cost sharing arrangement to exist, the following features must be present:

(a) in addition to sharing research and development costs, any benefits or income resulting from that research and development must also be shared;

(b) such costs and revenues must be shown to have been shared on a reasonable basis (the Department does not necessarily regard sales, production or profits as establishing a reasonable basis for sharing costs);

(c) while only a portion of the cost may be charged to the Canadian resident, he must receive an interest in all property or other things of value resulting from the arrangement;

(d) the Canadian resident should have title or full access to, or a real and genuine interest (and in the case of non-arm's length transactions generally an unrestricted interest) in, all property or things of value generated by the research and development, including patents and know-

how, except that:

(i) where the non-resident does not permit the Canadian resident to have title to a patent, design, etc., the latter should have unrestricted use of it at no additional cost; and

(ii) geographical restrictions would be permissible so long as the Canadian resident were entitled to use the property in question anywhere in Canada where he has a manufacturing or sales operation;

(e) double charges should not arise through charging a taxpayer for a portion of the research and development costs and also a royalty for the subsequent use of the property.

31. In each case, the Department would wish to test the propriety of the cost-sharing basis by examining the value or potential value of the arrangement to the Canadian resident and by ascertaining whether its share of the total costs was in line with the size and nature of its operations and whether it is likely to benefit from the arrangement in the light of the relationship of its size, operations and contribution to the size, operations and contribution of all the contributors taken together.

32. The words "research and development" are quite broad and are interpreted as including not only scientific research and development but also certain of the activities specifically excluded from the definition of "scientific research" contained in section 2900 of the Regulations.

Payments Deductible from Income of a Foreign Business (subparagraph 212(1)(d)(x))

33. A payment which is made by a resident of Canada to a non-resident person with whom he is dealing at arm's length and which is deductible in computing the income of the payer under Part I from a business carried on by him in a country other than Canada, is exempt from withholding tax to the extent it was so deductible (subparagraph 212(1)(d)(x)). For example, a Canadian resident who makes a deductible payment for scientific information used in the course of his business in a foreign country will not have made a payment subject to tax under paragraph 212(1)(d), even if the payment is based upon production or sales.

Tax Treaties

34. Where a person makes know-how or similar payments to a resident of a country with which Canada has a comprehensive tax treaty in force, the appropriate convention or agreement should be consulted both as to taxability of the payments and applicable rates.

35. For example, where a U.S. enterprise carries on the business in Canada of supplying commercial services, such as advertising, but does not have a permanent establishment in Canada, within the meaning of that term as defined by the Protocol to the Canada-U.S. Tax Convention, payments for such services otherwise taxable under subparagraph 212(1)(d)(iii) are exempt from Canadian tax pursuant to Article I of the Convention. However, any payment that is a rental or royalty, as defined by the Protocol, does not form part of industrial or commercial profits and is subject to Canadian non-resident tax irrespective of the absence in Canada of a permanent establishment.

36. The agreement with the United Kingdom provides another example. That agreement limits the rate of tax on royalty payments not exempted therein to 10% unless the payee has a permanent establishment in Canada and the right or property giving rise to the payments is effectively connected with a trade or business carried on through that permanent establishment.

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Income Tax Interpretation Bulletin

IT-303SR Know-How and Similar Payments to Non-Residents

NO: **IT-303SR**

DATE: September 19, 1985

SUBJECT: INCOME TAX ACT
Know-How and Similar Payments to Non-Residents

REFERENCE: Paragraph 212(1)(d) (also subsections 212(5), (13), (13.1) and (13.2))

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1. Paragraph 2 is revised to read as follows:

2. It should be noted that payments by a non-resident payor to a non-resident payee may be subject to Canadian tax if the payor is deemed by subsection 212(13) or 212(13.2) to be a resident of Canada for the purposes of section 212 or Part XIII. Where a partnership pays or credits an amount (other than a capital expenditure or other non-deductible payment) to a non-resident person, paragraph 212(13.1)(a) deems that partnership to be a person resident in Canada and therefore obligated to withhold tax as required under section 212. In addition, where a resident person pays or credits an amount to a partnership that is not a Canadian partnership because not all of its members are resident in Canada, paragraph 212(13.1)(b) deems that particular partnership to be a non-resident person and therefore subject to tax under section 212.

2. Paragraph 4 is revised to read as follows:

4. Paragraph 212(1)(d) provides for an income tax of 25% on all amounts paid or credited to a non-resident person as, on account or in lieu of payment of, or in satisfaction of, rent, royalty or a similar payment (other than an incremental resource royalty or an incremental production royalty as defined in subsection 79(1) of the Petroleum and Gas Revenue Tax Act paid or credited after 1981). The types of payments subject to tax under paragraph 212(1)(d) include, but are not limited to, those described in subparagraphs 212(1)(d)(i) to (v) but do not include those described in subparagraphs 212(1)(d)(vi) to (x). The provisions of bilateral tax agreements between Canada and other countries may reduce the rate of this tax or, in some

cases, wholly exempt some payments (see 34 and 35 below).

3. Paragraph 28 is revised to read as follows:

28. Royalties and similar payments in respect of a copyright on a literary, dramatic, musical or artistic work are not subject to withholding tax under paragraph 212(1)(d) by virtue of subparagraph 212(1)(d)(vi). However, as provided by subsection 212(5), payments for a right in or the use of a motion picture film or a film or video tape for use in connection with television that is to be used or reproduced in Canada is subject to a withholding tax of 25% (unless reduced by treaty).

4. Paragraphs 35 and 36 are replaced by the following:

35. For example, although paragraph 212(1)(d) and subsection 212(5) provide for a withholding tax of 25% on royalties or similar payments, a number of provisions in the Canada-U.S. Income Tax Convention (1980) may affect the taxation of such payments where the beneficial owner of the royalties is a resident of the United States. Article XII of the Canada-U.S. Income Tax Convention (1980) limits the rate of withholding tax on such payments to 10% provided that the property or right on which the royalties are paid is not effectively connected with a "permanent establishment" (Article V of the Convention) through which the non-resident beneficial owner carries on a business in Canada or a fixed base in Canada through which the non-resident beneficial owner performs independent personal services. Where the right or property is effectively connected with a permanent establishment or a fixed base in Canada, the royalty income, including that in respect of the production or reproduction of any literary, dramatic, musical or artistic work, is taxed under the provisions of Article VII (business profits) or Article XIV (independent personal services).

The Canada-U.K. Income Tax Convention (1978) provides rules similar to those of the Canada-U.S. Income Tax Convention (1980).

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