WARNING TO THE READER

The format of this outline is, to some extent, governed by and reflects the character of the subject matter:- not necessarily internally totally consistent, uniform, coherent or complete.

FINAL VERSION

AUGUST 24, 2009

ACKNOWLEDGEMENTS
I AM GRATEFUL FOR THE ASSISTANCE OF ALEXANDRE GENEST AND BRANDON WIENER OF DAVIES WARD PHILLIPS & VINEBERG LLP, FOR RESEARCHING & ANALYZING CERTAIN ASPECTS OF THIS PAPER

Note that although the final edit of these lecture notes and appendices was completed in August (2009), developments arising after the lecture was delivered (in January and early February 2009) are not reflected in the material.

2009 IFA TRAVELLING LECTURESHIP

MONTREAL/OTTAWA/TORONTO (JANUARY 2009)

VANCOUVER (FEBRUARY 2009)

TAXATION OF ROYALTIES IN AN INTERNATIONAL SETTING

OUTLINE

NATHAN BOIDMAN

DAVIES WARD PHILLIPS & VINEBERG LLP

Table of Contents

SECTION I - INTRODUCTORY MATTERS 6

A. Overview 6
B. Structure or Lecture and Core Factors 11

SECTION II - COMMERCIAL LAW 16

A. Overview 16
B. Non-Tax Statute Definitions? 17
C. Canadian Courts 18
D. Does a royalty necessarily imply an underlying “license”? 18
E. Underlying Property Necessary? 19
F. Bundled Transactions 19
G. Natural resources - related? 19

SECTION III - TAX LAW – DOMESTIC TRANSACTIONS 19

A. Does tax law depart from or augment commercial law notions of royalty? 19

(1) In Canada? 19
(2) Elsewhere? 20
B. Treatment of parties to royalty-licence contract 20
(1) Overview 20
(2) Illustration and Basic Questions 21
(3) Governing Principles 23
(4) Suggested Answers to the Questions Raised 26
(5) Other Points 34
C. The Checkered History Of Paragraph 12(1)(g 34
D. CCPC's and ITA section 125/129 35
E. Transactions in Royalty Producing Property Rights 37
(1) Overview 37
(2) Sale/Purchase of Such Property and Related Matter of Termination of Rights/Licenses 37

SECTION IV - TAX LAW – CROSS-BORDER – ARM'S LENGTH LICENCES 39

A. Cross-border Transaction-Inbound Provision of Things or Services and OutBound Payments 39
(1) Two Regimes 39
(2) Departure from Commercial Law? 40
(a) Where Part I applies 41
(b) Where Part XIII applies? – The relevant definitions 41
(3) How is (foreign) recipient treated in Canada? – Part I 43
(a) Domestic – Part I 43
(b) Treaty – Part I 44
(c) Provincial? (not considered) 45
(4) How is (foreign) recipient treated in Canada? – Part XIII 45
(a) Domestic – Part XIII 45
(i) Basic (ITA paragraph 212(1)(d)) 45
(ii) ITA subparagraph 212(1)(d)(i) 48
a) The Statute and Overview 48
b) Threshold Context 49
c) A Threshold Issue – "use" versus "alienation or sale" 51
d) Second Threshold Issue – "bundled" transactions 53
e) Third Threshold Issue – The role of terminology in a contract 54
f) Fourth Threshold Issue – Nature or Ambit of "Property" 54
g) The Case Law: 55
i) *Saint John Shipbuilding* 55
ii) *Farmparts* 61
iii) *Grand Toy* 64
iv) Other Countries on *Saint John*? 67
h) Distributors and *Saint John* and the Ancillary Notion of Shrink Wrap 68
(iii) ITA subparagraph 212(1)(d)(ii) 71
(iv) ITA subparagraph 212(1)(d)(iii) 72

(v) ITA subparagraph 212(1)(d)(iv) 86
(vi) ITA subparagraph 212(1)(d)(v) 87
(vii) Surrogatum Principle – "In Lieu of Payment" 88
(viii) The proposed section 56.4 in the cross-Border (Part XIII) context ...89
(ix) The "pays or credits" factor 92
(x) Exemptions and special cases under paragraph 212(1)(d) 92
a) Copyright – Implications for *Saint John Shipbuilding* 92
b) Special rules for films, etc. 96
(x) Franchising 96
(xi) Other Matters 99
(xii) The Future of Part XIII and the December 10, 2008 Recommendations of the Advisory Panel on Canada's International Tax System - And a Segue To Tax Treaty Matters 100
(b) Treaty – Part XIII 102
(i) Thrust of Basic Canadian Treaty Policy and OECD Nexus 102
(ii) OECD Model 102
a) Canada's position on the Model – in general 102
b) Basic OECD Position – Article 12 103
c) Basic OECD Definition 103
d) Basic Source Rules 104
e) Position on Software and The 2008 Revised Commentary 104
f) Position on Services Versus Know-how 107
(iii) Canada 107
a) Basics 107
b) Definition of Royalties (and Influence – Effect of OECD – in General) 108
c) Definition of Royalties in Relation to Software – shrink wrap and similar 108
d) Definition of Royalties - *Saint John Shipbuilding* – related 109
e) Sourcing Rules 110
f) Beneficial Owner – Treaty Shopping and All That 110
g) Some Notes on Issues for "Withholding Agents" 111
(5) Elsewhere 114
(6) Transactions in Royalty Producing Property 114
(a) Context 114
(b) Part I – Nexus/Factors 115
B. Cross-border outbound (third party) license and inbound royalty 115
(1) Overview 115
(2) How are foreign tax credits handled? 116
(a) In Canada 116
(i) The "Credit" Rules of ITA Section 126 117
a) The Basic Dichotomy of ITA Section 126 and How It Connects to Foreign Royalties 117
b) ITA subparagraph 126(2)(2.1) – Foreign Business 117
c) ITA subsection 126(1) – Foreign ("Source") Royalty 117

d) The Nature of the Credit Provided by ITA subsection 126(1) – (and No Carry-Overs) ... 118
e) The Nature of the Credit Provided by ITA subsection 126(2) and (2.1) (and Carry-Overs) ... 118
(ii) The "Deduction" Rules Under ITA subsections 20(11) and (12) ... 119
a) ITA subsection 20(11) ... 119
b) ITA Subsection 20(12) ... 119
(b) Elsewhere ... 119
C. Canadian-owned foreign entity royalty earners involving third-party licencees-payors ... 120
(1) The Multiple Contexts and Background ... 120
(2) CONTROLLED FOREIGN AFFILIATES – ACTIVE BUSINESS INCOME – FOREIGN ACCRUAL PROPERTY INCOME ... 120
(a) Basics ... 120
(b) FAPI – INVESTMENT BUSINESS – Royalties – *Saint John* ... 122
(c) ITA paragraph 95(2)(a.3) – Trap ... 124
(3) ITA section 94.1 ... 125

SECTION V - CROSS-BORDER INTERCOMPANY ... 126

A. Cross-the Canadian border ... 126
(1) Section 247 transfer pricing matters ... 126
(a) Royalties under licenses ... 126
(i) Inbound Licenses – Outbound Royalties ... 127
a) Other Countries ... 129
b) Consequences of Outbound Royalties Not Comprising ALPs ... 129
(ii) Outbound Licenses – Inbound Royalties ... 130
(b) Transfers of ownership of intangibles - outbound ... 130
(i) General considerations ... 130
(ii) ITA paragraph 247(2)(b) Recharacterization ... 131
a) Basic Ambit – Inscrutable ... 131
b) Situations: Merck, Gildan, MacIsaac ... 133
(iii) A variation on the theme – the OECD and Business Restructurings ... 134
(c) Transfers of Ownership – Inbound ... 134
(d) Bundled transactions ... 135
(e) Cost sharing arrangements ... 138
(2) Additional Part XIII issues ... 139
(a) Related to ITA section 247 ... 139
(b) Related to ITA section 78 ... 140
B. Foreign intercompany licensing arrangements ... 141
(1) ITA subparagraph 95(2)(a)(ii) ... 141
(2) Excluded Property ... 142
C. Intracompany and Notional Deductions ... 142
(1) Overview of Matter ... 142
(2) *Cudd Pressure* and Related Factors ... 143
(3) Section 9 – Annex B of Fifth Protocol ... 145

(4) The US Treasury Technical Explanation and Related Factors 146
(5) Withholding on Notional Deductions? 147

SECTION VI - ELECTRONIC COMMERCE 147

A. Overview and Correlation to Foregoing 147
B. THE AMBIT OF E-COMMERCE AND Commercial Law Aspects 152
C. Cross Border – Arm's Length 154
(1) Inbound Transactions – Outbound Payments 154
(a) Overview 154
(b) Part XIII – Related 155
(2) Outbound Transactions – Inbound Payments 158
(3) Involving Foreign Investees 159
D. Cross Border – Intercompany 160

SECTION VII - RELATED CONTRACTUAL MATTERS 160

SECTION VIII - APPENDICES 161

SECTION I - INTRODUCTORY MATTERS

[Note that although the final edit of these lecture notes and appendices was completed in August (2009), developments arising after the lecture was delivered (in January and early February 2009) are not reflected in the material.]

A. OVERVIEW

When I was asked to do this lecture, I had two reactions. First, I owed it to King Freddie to do it. Who is King Freddie? Let me explain. Freddie is my loveable Royal poodle, who was scheduled to be the offspring (although it turned out that he wasn't) of a Luxembourg champion sire. And naturally, all I think about, when I think of that country, is "royalty". My second reaction was that after 37 years of tax practice, including some extensive file exposure to the mysteries of paragraph 212(1)(d) of the *Act*[1] - particularly subparagraph (i), which purports to tax just about anything that moves and its incomplete interpretation in the landmark case of *Saint John Shipbuilding – infra*[2] - (involving a lump sum payment by a Canadian to a U.S. party for the right to use, in perpetuity, computer programs to build ships, but where the Canadian had no right to on-sell or alienate the computer programs received), as well as doing various related writings (including paper on E-Commerce), it would be a walk in the park.

In fact, that was/is partially true in respect of the lecture itself. I probably could have done it with relatively little preparation. But preparing and providing a cogent set of lecture notes proved to not only be a much bigger challenge, and much more time-consuming than I thought,

---

1 Income Tax Act (Canada), R.S.C. 1985, Chap.1 (5th supp.), as amended (herein "the Act" or "ITA").

2 All cases referred to herein (except in excerpted materials) are listed alphabetically in Appendix i.

but more relevant, opened my eyes to a number of important factors and issues which I had never come across and therefore had never thought about. And in that respect, doing this lecture—like any writing or speaking project—has been, for me, both a voyage of discovery and a salutary learning experience.

What is this lecture all about? --Simple fare? Today, the modern, ordinary way of looking at the word "royalty" and its meaning is, <u>in my view</u>, to cite the minority decision of Mr. Justice Locke in the Supreme Court's 1952 decision in *Wain-Town Gas Ltd*, [[1952] CTC 147 SCC] where he wrote (as paraphrased and quoted by Osborne):

> "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 or personal property transferred without reservation": *Wain-Town*, supra footnote 22, at 158. "

(Osborne, *infra*, note 6, at note 24). That resonates with the ordinary "commercial" (non-tax) meaning ascribed by the court in a tax case which adopted Black's Law Dictionary: -

> "Compensation for the use of property, usually copyrighted material or natural resources, expressed as a percentage of receipts from using the property or as an account per unit produced. A payment is made to an author or composer by an assignee, licensee or copyright holder in respect of each copy of his work which is sold, or to an investor in respect of each article sold under the patent. Royalty is share of product or profit reserved by owner for permitting another to use the property. In its broadest aspect, it is share of profit reserved by owner for permitting another the use of property. […]
>
> In mining and oil operations, a share of the product or profit paid to the owner of the property."

Simple, straightforward? Unfortunately, it turns out that the relevant meaning of the word "royalty" or the statutory proxies for it (necessitated, in some cases by the absence of the word itself) and the taxation thereof (both domestically and internationally) is anything but simple and straightforward. It is, in fact, a very slippery matter and there are several reasons for that.

First, strangely the word does not even appear in the main part of our domestic tax law – that is, that portion applicable to Canadians who directly engage in transactions involving royalties (that is, under Part I of the Act). In particular, the word "royalty" only appears in Part I in relation to the rules for transactions by foreign entities in which Canadians have interests—that is, in and for the CFA[3], FA[4], FAPI[5] rules and in proposed section 94.1 (per Bill C-10 which died when Parliament was dissolved for the October 2008 election).

Second, the development of the use of the word was in totally different contexts than that now of modern business—namely, that related to the mineral resource industry and sector and most importantly, not in relation to transactions which conveyed mere use—but to those that transferred total ownership. There is a convoluted history here (well told, in an 1999 *Canadian Tax Journal* article by Duncan Osborne[6] [7] – see Appendix 2). The Privy Council, in my view, got it right in 1933 in the landmark case of *Spooner*[8], when it rejected the notion that the word

---

3 Controlled foreign affiliate, per subsection 95(1) ITA.

4 Foreign affiliate, per subsection 95(1) and (4) ITA.

5 Foreign accrual property income, per subsection 95(1), ITA

6 Duncan Osborne, "Revisiting Royalties in the Age of Electronic Commerce", *CTJ*, p.410 (1999), Vol. 47, No. 2.

7 Substantially all articles, books, papers, etc., referred to herein or contained in the Appendices are listed in Appendix ii.

8 *Spooner* (Ex. Ct.) (1), 196; (P.C) (1) 258; (S.C.C.) (1) 211.

"royalty" should apply to payments made as part of the consideration for a total acquisition of property—even where those payments are contingent on the use and profitability by the purchaser of the property. But the Canadian government did not like that result, so it bastardized the natural meanings and principles by enacting the original predecessor to today's paragraph 12(1)(g) of the Act—which picks up both:

- "royalty" as we understand them today; and
- payments to satisfy consideration for total acquisitions.

Third, to further complicate the matter, our courts misinterpreted paragraph 12(1)(g) by applying to it something different than intended, where (1) the price for the acquisition is fixed and not contingent, (2) the fixed price must be paid ultimately, but (3) the timing of payments or amounts of payments during the course of the payout period may be dependent upon use by the acquiror.[9]

Fourth, at the other extreme from Part I, Part XIII of the Act not only uses the term "royalty", but has a series of rules which seek to apply the same tax result as when a natural royalty is paid to a non-resident, to transactions which – in whole or in part - do not entail or involve the notion of royalty. Elements of the extended rules may reach payments which lack (by reason of their character or the character of the consideration received for which they are being made) the essence of the royalty (or rent) such as a fixed payments for perpetual use of rights, contingent payments where no property, and, therefore, no use of property is involved, but instead, services

9 One of the problems is that the original rule to counter *Spooner*—section 3(1) - used (unlike present paragraph 12(1)(g)) the word "royalty" in its formulation. (The intermediary rule, between the first and the current section 6(1) did not use that word.)

have been performed or information provided or where they are in consideration of full grant of rights or where they relate to restrictive undertakings.

Here, a major issue is that the courts chose (in *Farmparts*, *infra*, and noted in *Hasbro, infra*) (but did not fully decide in *Saint John*) to adopt an interpretation of subparagraph 212(1)(d)(i), which arguably may be textual, but not contextual or purposively correct. This is examined at length below.[10]

Fifth, in treaties, matters become even more arbitrary in that the typical Article 12 provision has a definition of "royalties" which simply ignores any natural meaning of that term and, instead, simply reflects certain particular objectives or views of the draftsman. In other words, the definition can be different in every separate treaty[11]. That's just to keep us on our toes.

Sixth, returning to FAPI, where the word "royalty" is used, we will see that the absence of a definition and the foregoing (and the potential impact of the decision in *Saint John*) in light of certain statutory words, clouds the picture.

What is the bottom line with respect to the meaning of "royalties"?

(a) In Part I, a definition does not matter, because except with respect to FAPI and section 94.1, the word is not used.

---

[10] Subparagraph (iii) clearly overrides the notion (seen, *inter alia*, in *Hasbro*) and in a section 125 case that the notion of royalties cannot be related to provision of services. See certain comments to that effect in Duncan's article, *supra*.

[11] Canada, for example, departs from the OECD by adding in the separate notion of rents for use of tangibles.

(i) Here further consideration is required for the role of *Saint John Shipbuilding*.

(b) In Part XIII, a definition is, in a way, largely irrelevant, because of the extra rules (e.g. subparagraph 212(1)(d)(i) et al.) probably give the same overall tax result as where the word "royalty" were defined in the broadest way possible – one far beyond its natural and normal current meaning.

(c) Then there is the e-commerce add-on where, at least in Canada, the *Saint John Shipbuilding* case is a perfect segue between "bricks and mortar" and cyberspace.[12]

B. STRUCTURE OR LECTURE AND CORE FACTORS

"Taxation of Royalties-----": - a relatively straightforward notion? Not quite. Not even in the "bricks and mortar" era. Certainly not in the software and related, but separate, "e-commerce" era, which sees a plethora of virtual or synthetic notions and transactions complicate the landscape. And even if relatively so in a purely domestic setting (in either era), definitely not in the international setting - particularly in the current era.

This lecture will examine the issues and difficulties suggested above, within the context drawn by the following parameters.

- Threshold Commercial Law Aspects;
- Tax Law:-

- Domestic Transactions;
- Cross-border–arm's length transactions
    - Inbound
    - Outbound
    - Those involving foreign investees
- Cross-border - Intercompany and Other Non-Arm's Length Transactions
    - Characterization Issues
    - Pricing Issues
    - Unpaid amounts and sections 78 and 212 of the Income Tax Act
    - Inter-affiliate and ITA subparagraph 95(2)(a)(ii)
    - Intracompany – notional deductions (*Cudd Pressure et al*)
- Electronic Commerce (and Looking at Applicable Foregoing Elements)
    - (Software – considered in (during) the discussions above – will be a bridge and segue to royalties in e-commerce)

---

[12] But there also is the oddity here that that matter was the object of much writings during the period 1996-2003, but since there appears to be very little on point.

The international focus will be developed in the context provided by a juxtaposition of the Canadian domestic, cross-border and treaty rules with comparative notions and developments in a number of other countries. This will necessarily draw upon, and draw out, the threshold role, influence and affects of multilateral initiatives - primarily but not only those at OECD.[13] (Clearly the advent of both the pan European (EC)[14] initiatives and directives and the interventionist decisions of the ECJ[15] is of interest in Canada and other countries which are not a part of the EC.)

Designed to treat the topic from the perspectives (and interest) of both the new entrant in the field of international tax practice and the grey beards in this arena, the lecture's main constraint might well only be that there is only a morning available, not a full day or two, to address the wide number and variety of factors and issues bound up in the subject matter.

The second to last section (on intercompany and other non-arm's length) could obviously be the object of, and absorb, the entire lecture - and that leaves the section on inbound arm's length as the logical focal point of the lecture – as, aside from the former, it raises the most pervasive (and broadest range of) issues on an ongoing basis. That focal point is grounded in an understanding of four basic inter-related factors.

- First, when tax law refers to "royalties", what is the natural (i.e. commercial (not tax) law) meaning thereof?

---

13 Organization for Economic Cooperation and Development, Paris

14 European Union or European Community (both terms having their own separate roles)

15 European Court of Justice

    - See Section II

- Second, when does tax law extend or otherwise redefine "royalties"?

    - This is not seen in the *Act*

- Third, when does tax law TREAT a payment—not otherwise a royalty under the prior two - in the same or similar fashion that it treats a royalty?

    - As already noted, this is a specific objective in Part XIII

- Fourth, how does tax law treat transactions in royalty-producing rights?

    - This is not a pre-occupation

In order to arrive at a discussion of those questions—and the tax consequences that result—with respect to the focal point of our topic (inbound cross-border arm's length) we have a natural progression through three stages -

- first, examining the purely commercial (non tax) law context (on which the domestic situations and cross-border will lever)

- second, examining the effect of the latter on the purely domestic tax situation (on which the cross-border situations will lever)

- third, examining the effect of the latter on the cross-border tax situation and the addition rules and considerations that arise therein.

So let's embark on this natural progression, but examining and filtering the matter thru two pervasive interrelated underlying concepts.

The first concept is that "royalties" normally arise in the context of an arrangement whereby one party gives another the right to use something for a certain period time. (But then, the same can be said about the different term "rents" – see below.)

The second concept is that, conversely, "royalties" do not arise where the full incidences of ownership are transferred.

Then there are five subordinate-ancillary concepts.

- The first is that in some cases where full ownership are transferred, the method that the price therefore is calculated may see tax treatment in a manner akin to that where a "royalty" is paid.

    - See, for example, below, paragraph 12(1)(g) and subparagraph 212(1)(d)(v).

- The second is that some situations are characterized by arrangements which see a hybrid type of right delivered --more than a use for a stipulated period of time, but less than a full conveyance of all rights-- as arose in the landmark decision in *Saint John Shipbuilding* which we will be examining at length in the focal section of the lecture.

- The third is the nature of a transaction which sees a payment made upon a termination of a pre-existing "licence" (pursuant to which "royalties " were being paid).

- The fourth is an outright sale of property rights which are subject to an existing "royalty" paying "licence".

- The fifth is a "sale"-type transaction for rights pertaining to a geographical area (including rights to be a distributor and (associated) rights conveyed by agreeing to refrain from doing something (e.g. proposed ITA section 56.4).

(Some of these areas require, for thorough examination, a lecture of their own--including, obviously the 56.4 matter.)

Now on to Section II--"Commercial", bearing in mind the role it plays in considering tax considerations.

SECTION II - COMMERCIAL LAW

To the extent that the word "royalty" and its meaning does matter, the starting point to give it meaning – given that it is not defined in the *Act* - would be reference to its meaning in commercial law.

A. OVERVIEW

Since tax law treats property and property rights and income derived therefrom on the basis of their meanings under the commercial laws or contracts that govern them - unless specific derogation or augmentation thereof—our starting point is to consider the meaning and ambit of "royalties" - and related matters under non-tax (i.e. "commercial) law.

What are the key characteristics of a royalty under commercial law? There appears to be three broad possibilities, and an added factor.

- First, perhaps it is a payment by one person to another that is calculated in a certain way, regardless of the consideration delivered by the recipient.

  - But, as discussed below it appears to require "property".

- Second, or perhaps it is a payment related to the delivery of a certain type of consideration, regardless of how it is calculated or determined.

  - But as discussed below it appears to require dependency/contingency of payment.

- Third, or perhaps it is a payment which is characterized by elements of both of the first two factors.

  - This does appear to be the case.

- Fourth, it appears to require that the property delivered to the payor be returned to the payor at the end of the arrangement.

The foregoing should indicate the nature of the underlying type of transaction that gives rise to a royalty and the type of underlying contract that will be involved.

B. NON-TAX STATUTE DEFINITIONS?

- There appears to be none of common or widespread use[16].

---

[16] Indeed, some statutes define royalties by expanding upon an undefined base. (See, for example, the *Defence Production Act*, R.S.C. 1985, c. D-1), which reads as follows:

"royalties" «*redevances* » royalties" includes

(a) licence fees and all other payments analogous to royalties, whether or not payable under any contract, that are calculated as a percentage of the cost or sale price of defence supplies or as a fixed amount per article produced or that are based on the quantity or number of articles produced or sold or on the volume of business done, and

(*b*) claims for damages for the infringement or use of any registered topography within the meaning of the *Integrated Circuit Topography Act* or of any patent or registered industrial design;

C. CANADIAN COURTS

Canadian Courts have adopted legal dictionary definitions as the base. See *Mobile*[17] (Appendix 1), which, although a tax case, adopted, in paragraphs 17 and 18, for commercial law purposes Black's Law Dictionary as follows.

> **17** The Income Tax Act does not define "royalty", and there is no jurisprudence that offers a comprehensive definition. Mobil relies on the following definition, which appears in Black's Law Dictionary, 5th ed. (St. Paul, Minn: West Publishing Co., 1979) at page 1195:
>
> Compensation for the use of property, usually copyrighted material or natural resources, expressed as a percentage of receipts from using the property or as an account per unit produced. A payment is made to an author or composer by an assignee, licensee or copyright holder in respect of each copy of his work which is sold, or to an investor in respect of each article sold under the patent. Royalty is share of product or profit reserved by owner for permitting another to use the property. In its broadest aspect, it is share of profit reserved by owner for permitting another the use of property. […]
>
> In mining and oil operations, a share of the product or profit paid to the owner of the property.
>
> **18** It is common ground that this definition is appropriate to describe the Canadian usage of the word "royalty" in the commercial context" (underscore added).

D. DOES A ROYALTY NECESSARILY IMPLY AN UNDERLYING "LICENSE"?

- Is this circular (e.g. what is a "license") or irrelevant because "license" is simply a label given to a contract involving the use of intangibles? What is the significance of the use of the word : "license"?[18]

[…]

[17] *Mobile Oil Canada Ltd. v. Canada*, [2001] FCJ No. 1656 (F.C.A.), 2001 DTC 5668.

[18] As in the case of the use of the word "royalties" the terminology employed will not turn a cat into a dog – although it will be accorded some weight. See the FCA in *Saint John Shipbuilding*, below.

E. UNDERLYING PROPERTY NECESSARY?

Does a royalty necessarily imply/require underlying property or can it be paid for services?

- There is no developed royalty notion respecting services and the definitions above clearly require property.

F. BUNDLED TRANSACTIONS

Payments made for a bundle of things – use of intangibles, for services, for know-how, etc., may give tax practitioners grey hair, but pose no particular commercial law issues.

- No commercial law notions/issues

G. NATURAL RESOURCES - RELATED?

(Not focus of lecture - needs separate lecture - raises real right platform.)[19]

SECTION III - TAX LAW – DOMESTIC TRANSACTIONS

A. DOES TAX LAW DEPART FROM OR AUGMENT COMMERCIAL LAW NOTIONS OF ROYALTY?

(1) In Canada?

There is no (general) statutory use of the term, for domestic transactions and thus, of course, no definition.

- Exceptions?

---

19 See, Osborne, page 425 (Appendix 2) for relevant comments.

- See below re: FAPI

The more generic notion of "income from property" or "income from carrying on business" and related expenditure side notions would generally govern. That approach makes royalties indistinguishable from rent.[20]

(2) Elsewhere?

Some countries – e.g. Australia, Belgium and The Netherlands - statutorily use and define "royalty" – for general purposes of their tax law. These definitions may be quite expansive and do not necessarily reflect common themes or concepts seen in Canada.[21]

Certain other countries have limited-purpose definitions, such as the UK.[22]

B. TREATMENT OF PARTIES TO ROYALTY-LICENCE CONTRACT

(1) Overview

Royalties incurred to earn income from a business or property would normally be deductible pursuant to section 9 and paragraph 18(1)(a) of the *Act*. Leaving aside uncertainties potentially raised by paragraph 12(1)(g) – discussed below – royalty income would normally be recognized when realized, that is, on a "receivable" basis unless the payee is entitled to a "cash method" approach the underlying principals which are less then clear. Moreover, the popular term or

---

20 But, in Part XIII the two are distinguished as discussed below. See, *Vauban Productions v. The Queen*, 79 DTC 5186; *Grand Toys Ltd. v. M.N.R.*, 90 DTC 1059; *Stepanoff, V. v. The Queen*, 06 DTC 2260.

21 See Appendix iii for some details.

22 There is a definition for purposes of taxation of corporate intellectual property and the EC interest and royalty directives.

terminology "cash" or "accrual" is misleading and/or simplistic as the comments below will indicate.[23]

(2) Illustration and Basic Questions

For purposes of this discussion, consider the following illustration.

- Taxpayer1 (the "**Licensor**") has a calendar taxation year end and owns an intangible property (a patent for example) that is licensed to Taxpayer2 (the "**Licensee**") which uses the intangible in carrying on a business.

- A license agreement (the "**Agreement**") is entered into by Licensor and Licensee on July 1, 2008, which requires from Licensee that he pay a 5% royalty per year of the Agreement on his sales. The royalties would be due on June 30, 2009, and would be so payable for every year in which the Agreement applies.

- The Agreement would require that Licensee pay the royalty amount within a 30-day window, *i.e.* before July 30, 2009.

- Licensor could be either an individual who owns the patent and licenses it while not carrying on business, a taxable Canadian

[23] "Cash" or "accrual" is misleading and/or simplistic. There is an amount paid. There is an amount due or owed (that is all requirements to have to pay have occurred). And there is an amount "accrued", but not yet due or owed. These differing situations can be seen in the following illustration. But which governs? Does the answer differ by reference to whether licensee is using the licensed thing in carrying on business or instead to earn income from property?

corporation that owns the patent in a way that is not related to the business carried on by it, or a taxable Canadian corporation that holds that patent in the course of carrying on business. It appears that for income inclusion purposes, the fact that either an individual or a corporation would own the patent and that the patent would be owned either in the course of carrying on business or not would not make a difference regarding the income inclusion and expense deductibility rules, as section 9 and paragraph 18(1)(a) of the *Income Tax Act* (the "**Act**") speak of "income from a business or property". It may however impact the choice of the method of computing income as discussed below. [Requires review for possible inconsistencies.]

- If the following had occurred as at December 31, 2009:

Licensee owes $10,000 of royalties to Licensor as of June 30, 2009;

On December 31, 2009, Licensee has not yet paid the amount owed as royalties and Licensor would therefore have a receivable in respect of the royalty amounts on year end; and

For patent year starting on July 1, 2009 and ending June 30, 2010, Licensee had generated sales of $1,000,000 up to December 31, 2009 and therefore $50,000 of royalties would have accrued but would not be yet due or receivable.

- <u>Questions</u>

(a) Does Licensor which is carrying on a business have to include in its income for 2009 the royalties ($10,000) receivable, owed since June 30, 2009, and still unpaid at year end?

(b) Does such Licensor have to include in its income the accrued royalties ($50,000) as at December 31, 2009, which are not yet due nor receivable?

(c) Can the Licensor is not carrying on business use the cash basis for computing its income?

(d) Can Licensee deduct the royalty payments that are owed but unpaid since June 30, 2009 from its income for 2009?

(e) Can the Licensee deduct from its income for 2009 the royalties in the amount of $50,000 that accrued as at December 31, 2008, but which are not yet due nor payable?

(f) When are royalties "incurred" for purposes of subsection 78(1) of the Act?[24]

(g) When are royalties "paid or credited" for purposes of subsection 212(1) of the Act?[25]

(3) Governing Principles

The following factors would appear to govern the answers to these questions and have been mainly drawn from a 2001 paper (set out in Appendix 3) to the Canadian Tax Foundation by Geoffrey Walker.[26]

- From the point of view of Licensor, the general rule in respect of including royalty payments in income is found in paragraph 12(1)(g) of the Act. However, this provision only targets amounts

---

[24] This question is discussed below.

[25] This is discussed below.

[26] Geoffrey Walker, "Timing and recognition of income", in *Report of proceedings of 53rd Tax Conference (2001)*, Canadian Tax Foundation, p. 29:1-29:54.

received by a taxpayer and would therefore not apply to the fact pattern discussed above.

- Paragraph 12(1)(b) of the Act applies to amounts receivable in respect of property sold or services rendered in the course of a business. Considering that royalties are paid for the use of property and not for the purchase thereof, and considering that royalties are not paid in exchange for services, paragraph 12(1)(b) would not apply to the fact pattern discussed above.

- We would therefore turn to the general rule found in subsection 9(1) of the Act: "[t]he principal that profit consists of the surplus of revenue for a year over the expenditure to earn that revenue has two aspects: first, the netting of revenues and expenses, and, second, the matching of revenues to the expenses incurred to earn them for a taxation year."[27]

- Underlying that statement are the following (according to Walker at 29:21):

> […]
>
> 7) To be recognized for tax purposes, an item of income must have attained the "quality of income."[67]
>
> […]

[27] Walker at 29:8.

Derivative Principles

[…]

2) Profits and losses are recognized when realized, subject to certain exceptions recognized in the cases.[71]

3) The use of the cash method is generally inappropriate for determining profit from a business except where permitted by the statute.[72]

4) Revenues are generally realized when they are earned, (that is, when they become receivable, whether or not they are received immediately or in the future,)[73] and they are ascertained or ascertainable.[74]

5) Revenues that are received are included in income in the year in respect of which the right of the taxpayer to the amount is absolute and under no restriction as to its disposition, use, or enjoyment.[75]

[…]

10) Expenses are recognized when incurred—that is, when the taxpayer has an immediate and not contingent obligation to pay an amount, even if payment is not immediate.[80]

11) Expenses are deductible in computing the profits of the taxation year to which they properly relate. This involves an inquiry into the specific facts to determine whether there is a causal link between a cost and specific revenues or benefits. If there is a direct link between costs and revenues, the costs are deductible in the taxation year in which the revenues are earned. If the expenditure is not referable to specific revenues or benefits arising in respect of a taxation year, and is part of the expenditure more generally incurred in running the business on an ongoing basis, it is deductible in the year in which it is incurred. If it is inconclusive on the facts as to which period the expense relates, the taxpayer is free to adopt an accepted accounting method of recognizing the expense unless the minister can demonstrate that another method provides a more accurate picture of income.[81]

12) Where there is a dispute between two methods of accounting, the method to be preferred is the one that is most appropriate to the facts of the business, is consistent with well-accepted business and accounting principles, is not inconsistent with the statute or case law

> principles, and provides the most accurate picture of income by best describing, based on the known facts, the results of the income-earning process.[82]

---

67. *Robertson* v. *Minister of National Revenue* (1944), 2 DTC 655 (Ex. Ct.). While this principle, as stated, appears to be a principle of computation, it is believed to be a foundation principle because it reflects the interpretation given the undefined term "income" that underlies the entire Act.

71. *Ostime v. Duple Motor Bodies Ltd.,* [1961] 2 All ER 167 (HL); *Canadian General Electric Co. Ltd. v. MNR,* 59 DTC 1217 (Ex. Ct.), rev'd. on other grounds, 61 DTC 1300 (SCC); and *The Queen v. Friedberg*, 93 DTC 5507 (SCC).

72. *Ken Steeves Sales Ltd. v. MNR.* 55 DTC 1044 (Ex. Ct.).

73. *MNR v. Colford Contracting Co. Ltd.,* 60 DTC 1131(Ex. Ct.); *Ikea Limited v. The Queen,* 98 DTC 6092 (SCC); *Commissioners of Inland Revenue v. Gardner Mountain & D'Ambrumenil*, (1947), 29 TC 69 (HL); and *Ken Steeves Sales, supra*, note 72.

74. *MNR v. Benaby Realties Limited,* 67 DTC 5275 (SCC).

75. *Robertson, supra*, note 67; and *Dominion Taxicab Assn. v. MNR*, 54 DTC 1020 (SCC).

80. *Fédération des Caisses Populaire Desjardins c. La Reine*, 2001 DTC 5173 (FCA).

81. *The Naval Colliery Co., Ltd. v. The Commissioners of Inland Revenue* (1928), 12 TC 1017 (HL); *Associated Investors*, 67 DTC 5096 (Ex. Ct.); and *Canderel Limited v. The Queen*, 98 DTC 6100 (SCC).

82. *MNR v. Publishers Guild of Canada Ltd.*, 57 DTC 1017 (Ex. Ct.); and *Canderel*, *supra*, note 81.

(4) Suggested Answers to the Questions Raised

Question (a): Does Licensor which is carrying on business have to include in its income for 2009 the royalties ($10,000) receivable, owed since June 30, 2009, and still unpaid at year end? The answer appears to be yes based on derivative principle # 4 quoted in paragraph 11. However, the following case must be taken into consideration as it departs from this general principle.

- In *Boosey and Hawkes (Canada) Limited v. The Minister of National Revenue*, [1984] D.T.C. 1728 (T.C.C.), the taxpayer, which was in the music publishing business, was a member of a

performing rights society which collected royalties from the users of the various copyright involved and, after deducting its own costs, distributed the balance of the royalties to its members. The calculation of the royalties to which the taxpayer, as a member, was entitled was extremely complex and took many months to complete.

- As a result of this, the taxpayer did not receive royalties to which he was entitled in respect of the July to December 1978 period until June 1, 1979, before which date the taxpayer had no way of knowing the exact amount of royalties earned from July to December 1978. The taxpayer reported its royalty income on a cash basis and had done so for 20 years without objection from the tax authorities, although it accounted for its expenses on an accrual basis. This accounting approach prevailed throughout the music industry.

- The Minister of National Revenue (the "**Minister**") included the amount received by the taxpayer on June 1, 1979 in its income for taxation year 1978, which led to the appeal of the taxpayer.

- The Court allowed the appeal of the taxpayer and found that although the royalty income was "receivable" in 1978, the taxpayer was nevertheless entitled to use the cash method of reporting this income. Even though the taxpayer was legally entitled to receive

> the amount by the end of 1978, and that all that remained was to determine the exact amount, the cash method was viewed, from an accounting point of view, as proper and necessary and common to the music industry.

Question (b): Does Licensor have to include in its income the accrued royalties ($50,000) as at December 31, 2009, which are not yet due nor receivable? The answer appears to be no based on derivative principle # 4 quoted in paragraph 11. (See also discussion below in note 28 respecting *Banner* and the related CRA TI.)

Question (c): Can a taxpayer use the cash basis for computing its income when it is not carrying on business? See the following excerpt of *528061 Ontario Limited et al. v. The Queen*, 95 D.T.C. 521 (T.C.C.) which raises the issue and in the end decides it without dwelling on the matter):

> The appeals of 608787 (facts and analysis)
>
> The Appellant 608787 is a corporation that owns the premises in which the business carried on by 528061 and 528062 is located. The wives of Mr. John Rondelez (Sr.) and Mr. Jerome Rondelez (Sr.) were the shareholders and directors of this corporation. A lease was entered into on January 31st, 1988 between 608787, and 528061 and 528062. The annual rent was set for $42,000 per year. This amount was never paid. In 1987 and in 1988, the amount of $17,880 was paid and in the year 1989, the amount of $17,930 was paid. The Appellant 608787 reported its income on a cash basis, whereas the tenants, 528061 and 528062, showed the full amounts each year as expenses.
>
> At the hearing, both parties seemed to agree that the rental income should have been reported on an accrual basis without giving any reason except to say that it was required by the Act. That is true if the income is a business income but what if it is property income. There is a presumption that income from a corporate taxpayer is income from a business but this presumption is rebuttable (Canadian Marconi Company vs. The Queen , 2 S.C.R. 522). If it were income from a property, it is interesting to read what is said in Ward's Tax Law and Planning, vol. 2 at chapter 43.1 entitled 'Timing of inclusion of property income':

Although there is not a great deal of jurisprudence on the question, it is suggested that in light of the fact that sections 12(1)(a) and (b) are not applicable to income from property and that it was considered necessary to enact specific statutory rules requiring the accrual method to be used for interest income, income from property need not generally be computed on an accrual basis. In each case, however, it would be necessary to establish that the cash method was appropriate for computing the profit from the property in accordance with the ordinary principles of commercial practice. In view of the fact that in most cases a taxpayer deriving only income from property would not have to be concerned with items such as inventory or significant accounts receivable, it would appear to be clearly arguable that the cash method is the most appropriate for the computation of such profit.

Since the point was not made by either counsel, there is no need to discuss this aspect any longer. Counsel for the Appellants said that, had the income been reported on an accrual basis, as he thought it should, a reserve for doubtful debt pursuant to paragraph 20(1)(l) of the Act would have been asked for by 608787 because 528061 and 528062 were not in a financial position to pay the full amount. Therefore in the end, he stated, the total taxable income would have been the same. Counsel for the Appellants also submitted that section 78 of the Act deals with amounts in respect of a deductible outlay that is owing by a taxpayer to a person with whom the taxpayer is not dealing at arm's length. This amount so unpaid shall be included in computing the taxpayer's income for the third taxation year following the taxation year in which the outlay or expense was incurred.

In the Reply to the Notice of Appeal, it is shown as a fact assumed by the Minister in assessing 608787 that no claim for a reserve for unpaid rental income had been made by the Appellant. Should I infer from this that if 608787 had done so, it would not have been disputed by the Minister. Asked to comment on this aspect, counsel for the Respondent informed the Court that he could not say whether a reserve would have been allowed.

Consequently, I find that I was given no reason to dismiss the appeal of 608787 and it is therefore allowed.[28]

---

[28] For a CRA view: Excerpt From *The Tax Window*, Report No. 205 pp. 9-10:

Recognition of Royalty Income

In *Banner Pharmacaps NRO Ltd. v. The Queen*, 2003 DTC 5642 (F.C.A.), the Court held that taxable dividends were included in income " when received, not when they are merely receivable". Relying on the combined application of paragraph 12(1)(j) and clause 82(1)(a)(ii)(A), the Court noted that "*Banner* was required to include the dividend in its 1996 income only if it received the dividend in that year". The decision at the Tax Court had incorrectly concluded that the dividends should be included in income on an accrual basis.

[underscoring added]

Question (d): Can Licensee deduct the royalty payments that are owed but unpaid since June 30, 2009 from its income for 2009? The answer appears to be yes based on derivative principle # 10 and 11 quoted in paragraph 11.

Question (e): Can the Licensee deduct from its income for 2009 the royalties in the amount of $50,000 that accrued as at December 31, 2008, but which are not yet due nor payable? The answer appears to be no based on derivative principle # 10 and 11 quoted in paragraph 11. However, the following cases must be taken into consideration as they depart from this general principle.

- First: see the *Boosey* case discussed above.

The issue the CRA was asked to comment on was whether the decision in *Banner* affected the CRA's view on the treatment of royalty income, which we commented on in WINDOW ON CANADIAN TAX ‘6716. As previously reported, it was the CRA's view that a taxpayer could not rely on paragraph 12(1)(g) to exclude from income a royalty, accrued in the taxpayer's financial statements, that had not been received.

It is the CRA's view that the decision in *Banner* "did not specifically address the inter-relationship between subsection 9(1) and paragraph 12(1)(g)" and, therefore, does affect the view previously expressed. The CRA also notes that proposed subsection 12(2.01) clarifies that paragraph 12(1)(g) does not provide for the deferral of amounts that would otherwise be included in income under section 9.

Technical Interpretation, Reorganizations and Resources Division

June 10, 2008 para.9553

Source:

CCH Tax/Federal Income Tax/News Tracker/Past NewsfTax WindowfTax Window Files/2008-027826117 ROYALTY INCOME - CASH V. ACCRUAL. Does the Federal Court of Appeal Decision of *Banner Pharmacaps NRO v The Queen* impact the

- Second: a different approach was followed in *Corriveau v. The Queen*, 2006 D.T.C. 2583 (T.C.C.) (which quoted approvingly *Banner Pharmacaps NRO Ltd. v. The Queen* 2003 D.T.C. 245 (T.C.C.), affirmed by F.C.A. – [2003] F.C.J. No. 1440 and *Ken Steeves Sales Ltd. v. M.N.R.*, 55 D.T.C. 1044 (Exch. Ct.)), where the Court held that the taxpayer was not entitled to use the cash method in respect of rental income and that the taxpayer had to use the accrual method for computing his income. [Review and reconsider.]

Question (f): When are royalties "incurred" for purposes of subsection 78(1) of the Act? (This is relevant to related discussions, *infra*.) See derivative principle #10 quoted in paragraph 11 and the following excerpt of CRA Interpretation Bulletin IT - 109R2 – Unpaid Amounts (April 23, 1993):

> **(a) Debtor and Creditor on the Accrual Basis**
>
> Generally, where an unpaid amount exists between a debtor and creditor who are not dealing at arm's length and both taxpayers account for income on the accrual basis, subsection 78(1) will not be invoked. An exception occurs where the unpaid amount in question appears to be part of a tax avoidance scheme which, for example, may involve transactions such as
>
> - claiming a reserve under paragraph 20(1)(l) or (n), or a deduction under paragraph 20(1)(p), or
> - deferring tax under Part XIII of the Act where the creditor is a non-resident.

---

comments contained in Document 2001-00723677 LANGINI)E DOCNUM 2008-027826117 REFDATE080610.

> Also, subsection 78(1) will not be applied to the debtor taxpayer if an unpaid amount is reported as income in the year by a creditor who is on the cash basis of reporting income.

Question (g): When are royalties "paid or credited" for purposes of subsection 212(1) of the Act? (This is relevant to related discussions, *infra*.) See the following excerpt of CRA Information Circular IC77 – 16R4 – Non-Resident Income Tax (May 11, 1992):

> 5. The words "credits" and "credited" cover any situation where a resident of Canada or, in certain cases, a non-resident (see 8 below) has set aside and made unconditionally available to the non-resident creditor an amount due to the non-resident such as where (a) a tenant or agent deposits rents in a bank account on behalf of a non-resident landlord; (b) a bank credits interest to the savings account of a non-resident; (c) an insurance or trust company deposits a pension or annuity payment in the bank account of a non-resident; or (d) the amount due is applied by the resident (or deemed resident) against an amount owing by the non-resident. When an amount is subject to tax under section 212, subsection 214(1) provides that the tax is payable on the full amount paid or credited without any deduction from the amount.

- See also following excerpt of *CRA Income Tax – Technical News No. 14* (December 9, 1998) and of *La Compagnie Minière Québec Cartier v. Minister of National Revenue*, 84 D.T.C. 1348 (T.C.C.) (quoted approvingly in *Mutuelle des Fonctionnaires du Québec v. Canada*, 97 D.T.C. 5030 (F.C. T.D.) and in *Gillette Canada Inc. v. Canada*, 2001 D.T.C. 895 (T.C.C.)):

> Income Tax Technical News No. 14:
>
> ***Meaning of "Credited" for the Purpose of Part XIII Withholding Tax***
>
> We have had several inquiries regarding the meaning of "credited" for purposes of Part XIII of the *Income Tax Act* (the Act) with respect to situations where journal entries have been made to record accrued interest payable to a non-resident creditor in the Canadian payer's books and the accrued interest is payable on demand to a non-resident who does not deal at arm's length with the payer. The Department's most recent comments on this topic are found in our response to Question 48 of the 1991 Revenue Canada Round Table which reads as follows:

"As set out in paragraph 5 of Information Circular 77-16R3, question 17 of the 1984 Round Table, and question 84 of the 1986 Round Table, an amount is 'credited where a resident of Canada has set aside and made unconditionally available to the non-resident creditor an amount due to the non-resident.' An amount is unconditionally available to the non-resident person when the non-resident has the immediate right to receive the amount -- for example, when the amount is recorded in the payer's books and is payable on demand."

This response indicates that an amount is "unconditionally available" where the payable has been recorded in the payer's books and records. However, there has been some confusion as to whether the Department considers the recording of the payable by way of journal entry to constitute an amount that has been "set aside."

It is the Department's position that the mere recording of the payable by way of journal entry, regardless that such amounts are payable on demand and the debtor has the capacity to pay such amount if such payments are demanded, does not constitute "credited" for purposes of subsection 212(1) of the Act.

While, in general, we believe that, for an amount to be "credited," an amount must be set aside and made unconditionally available for the non-resident more or less along the lines of those examples described in paragraph 5 of Information Circular 77-16R4, each case should be decided on the basis of its own particular facts. This position would seem to be consistent with the decision in Quebec Cartier Mining vs. the Minister, 84 DTC 1348 (TCC).

_ _

Québec Cartier Mining:

The Court regards an accounting system as a means of describing commercial transactions. Was the legislator in using "credit" insisting on this form ? -- or was he more concerned with substance?

The Court is inclined to accept the second alternative: and the substance of "credit" seems to be "an operation by which someone puts a sum of money at the disposal of someone else".

[…]

In short, the Court is of the view that a strict interpretation of s. 212(1)(b) leads to interpreting the word "credit" according to its substance, "making available to", and not according to the form of making an entry "on the right side of an account".

- See also following excerpt of IT – 109R2:

(d) Non-Resident Withholding Tax Requirements

There may be circumstances where an amount owing by a Canadian taxpayer is due to a non-resident with whom the taxpayer does not deal at arm's length, and if paid, the amount owing would be subject to non-resident withholding tax. In

> these circumstances, if an agreement pursuant to paragraph 78(1)(b) is filed for such an amount, the amount is subject to non-resident withholding tax at the time it is deemed to have been paid by the Canadian taxpayer. Where the agreement is filed within the prescribed time limits, it is not the Department's practice to levy a penalty or interest in respect of the withholding tax requirements provided that the amount of tax is remitted on or before the fifteenth day of the month following the month in which the agreement is filed. As subparagraph 78(1)(b)(ii) deems the amount owing to be a loan from the non-resident to the Canadian taxpayer, any subsequent payments made by the Canadian taxpayer on account of that indebtedness are regarded as loan repayments and, therefore, are not subject to non-resident withholding tax.
>
> Also, the provisions of section 78 apply to a deductible amount owing to a non-resident who does not deal at arm's length with the Canadian taxpayer even though the amount, such as a copyright royalty, is not subject to non-resident withholding tax.

(5) Other Points

- Is there mirror/symmetrical rule to ITA paragraph 12(1)(g) discussed below?
  - Probably not: Section 14 governs payor

C. THE CHECKERED HISTORY OF PARAGRAPH 12(1)(G)[29]

In certain cases the courts seemed to have misapplied the rule by misconstruing situations where only the timing of receipt was linked to performance or profitability realized by the buyer.[30]

---

[29] See background comments in Section I, A, ITA paragraph 12(1)(g) reads as follows:

> **12. (1) Income inclusions** -- There shall be included in computing the income of a taxpayer for a taxation year as income from a business or property such of the following amounts as are applicable:
>
> (g) **payments based on production or use** -- 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;

For prior versions: 1934-3(1) and 1948-6(1).

[30] This is analyzed at length by Duncan Osborne in his CTJ article (see Appendix 2). In particular, see the case of *Ross* (and *Wain-Town*, as well) discussed at page 413. Other cases rejected *Ross* and fortunately CRA also rejected *Ross*—see quote at page 419. For the modern definition of "royalty" by Justice Locke in

Note proposed subsection 12(2.01), which was included in former Bill C-10 suggests that section 9 is intended to supersede paragraph 12(1)(g). The proposal reads as follows:

> *"Paragraph [12](1)(g) does not defer the inclusion in income of any amount that would, if this section were read without reference to that paragraph, be included in computing the taxpayer's income in accordance with section 9."*

This would be consistent with the CRA view discussed above, arising out of the case of *Banner Pharmacaps NRO Ltd . v. The Queen* (See CRA, Technical Interpretations, 2008-0278261I7 and 2001-0072367.

D. CCPC'S AND ITA SECTION 125/129

(See related discussion respecting FAPI, *infra*, which picks up surprising CRA views respecting the ambit of a "specified investment business".)

A CCPC is entitled to the SBD of ITA section 125 with respect to royalty income in one of two situations.

One is where the royalty constitutes under the basic law (see above) income from business (not income from property) and a more than five full-time employee test is met (ITA subsection 125(7) – "specified investment business").

The other is where royalty is not governed by the latter, but is paid by an associated corporation in respect of which it is deductible in computing its income which constitutes active business income for purposes of ITA section 125. ITA subsection 129(6), in this case, recharacterizes the royalty as not constituting investment income for purposes of

---

his dissent in the case of *Wain-Town*, see page 420 of Duncan**.** For more appropriate decisions see, *Gingras*, *infra, Hould*, 65 DTC 624 (TAB) and *Brosseau*, 86 DTC 1412.

ITA section 129, but instead active business income for purposes of ITA section 125.

Cases that deal with the small business deduction and royalties: in *Alamar Farms Ltd. v. Canada (Minister of National Revenue – M.N.R.)*, [1992] T.C.J. No. 725 (T.C.C.), the taxpayer carried on an active farming business on land that it owned. It also received royalties from producing oil wells located on its land which were operated by someone else. The Court found that the royalty income, which was completely devoted to the taxpayer's farming activities, was incident to or pertained to the taxpayer's active farming business, and therefore was not income from a specified investment business.

In *Rogers v. Canada*, [1997] T.C.J. No. 2 (T.C.C.), the taxpayer could claim a capital gains deduction for revenues attributable to the disposition of shares only if the shares were those of a small business corporation, more than 50% of the value of the assets which were attributable to assets used in an active business. The corporation's only real asset was a shopping mall and almost all of its revenue came from rent. It was held that the corporation's principle purpose was to derive income from property, that it carried on a specified investment business and therefore was not carrying on an active business.

A case relevant to the notion that the concept of royalties is not associated with the rendering of services is *Luigi Tiengo Art & Design Inc. v. the Minister of National Revenue*, [1991] D.T.C. 1216 (T.C.C.), were it was held that the taxpayer did not receive royalties *per se*, even though a percentage method was used to calculate its revenue, but rather that the income was earned by the provision of design and other related services to the manufactures forming his client base. Such income was therefore being derived from an active business and qualified for the small business deduction.

In the section below on foreign affiliate activities (Section IV-C-(2)(b), see reference to two CRA interpretations which actually arose under section 125 respecting whether royalty income does or does not active business income.

E. TRANSACTIONS IN ROYALTY PRODUCING PROPERTY RIGHTS

(1) Overview

No discussion of "royalties" could be complete without at least some reference to the tax considerations relevant to transactions involving royalty-producing property – that is its buy/sell or cancellation of interests therein. In the domestic context, the usual issues arise. For the seller/recipient of consideration for the transaction or event is there ordinary income/profit or instead (some sort of) "capital" treatment? (There has been substantial case law here.) For the buyer/payee, is there ITA section 9/paragraph 18(1)(a) immediate deductibility or instead (some sort of) capital expenditure treatment?

- And there has been not insubstantial case law in this area
- (And as discussed below – in this intercompany cross-border context)

(2) Sale/Purchase of Such Property and Related Matter of Termination of Rights/Licenses

The cases to be considered:- *BP Canada Energy Resources Co. v. Canada*, [2002] T.C.J. No. 545 (T.C.C.); *Cafik v. M.N.R.*, 76 D.T.C. 1141 (Tax R.B.); *Canadian Industries Ltd. v. The Queen*, 80 D.T.C. 6163 (F.C.A.); *Consumers Software Inc. v. The Queen*, 95 D.T.C. 518 (T.C.C.); *Gingras v. M.N.R.*, 63 D.T.C. 1142 (Exch. Ct.); *Mr. R. v. M.N.R.*, 50 D.T.C. 398 (Tax A.B.); *No. 442 v. M.N.R.*, 57 D.T.C. 435 (Tax A.B.); *Stepanoff v. Canada*, [2006] T.C.J. No. 44 (T.C.C.), Affd., [2007] F.C.J. No. 181 (F.C.A.)]

- (It will be seen that in principle dispositions not involving contingent sale price would generally be treated by a court in the manner that applies to dispositions of any property disposed of.)

- In the inbound cross-border context (*infra*) that jurisprudence is generally not directly relevant.

SECTION IV - TAX LAW – CROSS-BORDER – ARM'S LENGTH LICENCES[31]

A. CROSS-BORDER TRANSACTION-INBOUND PROVISION OF THINGS OR SERVICES AND OUTBOUND PAYMENTS

(1) Two Regimes

There are two regimes to consider when there is an outbound royalty (or certain other) payment to a third (arm's length) party.

- Part XIII applies unless the transaction is part of a carrying on of business in Canada through a permanent establishment as defined in Part IV of the Income Tax Regulations. See ITA paragraph 212(13)(c) and current and proposed revised Reg. section 805.

- Part I should not apply where Part XIII – as above – applies.

    - But no clear rule on point.

    - There ostensibly is favourable CRA views on point.

        - Reg 805 provides there is no Part XIII tax where income is attributable to a PE through which a non-resident carries on business in Canada. Present Reg 805 requires Minister permission. Proposed Reg 805 removes that requirement. Reg 805 does not have the ambit to say that no Part I tax in opposite situation (ie where income not attributable to business carried on

[31] Considerations where e-commerce is involved is deferred until Section VI.

in Canada through PE), however CRA seems to take that position administratively. See para 12 of IT-420R3:

> 12. There is no reference in subsection 115(1) to "income from property in Canada", such as income from rent, interest or a dividend. Therefore, except for some of the items discussed in 18 below, a non-resident's income from property in Canada is generally not subject to Part I tax under section 115. Rather, the gross amount is usually subject to non-resident withholding tax under Part XIII of the Act, although in the case of rent, an election can be made under section 216 to pay Part I tax on the net income (see the current version of IT-393). It is also possible for an amount referred to in Part XIII to result in income from carrying on a business in Canada. Where this occurs and the business is carried on through a permanent establishment in Canada, the gross amount will not be subject to Part XIII tax, but rather the resulting net income will be subject to Part I tax under subparagraph 115(1)(a)(ii), by virtue of paragraph 805(1)(a) of the Regulations. Where, on the other hand, an amount referred to in Part XIII results in income from carrying on a business in Canada but not through a permanent establishment in Canada, the gross amount will be subject to Part XIII tax rather than Part I tax.

(2) Departure from Commercial Law?

Does tax law here depart from or augment the commercial law and or domestic tax law notions of royalty?

(a) Where Part I applies

- There generally is no departure. In part this stems from the fact, discussed above, that the word "royalty" is not used in Part I in respect of either domestic or on direct outbound transactions by Canadians or inbound transactions by non-residents.

(b) Where Part XIII applies? – The relevant definitions

There is no separate definition, *per se*.[32] The main rule (paragraph 212(1)(d)) employs the terms "royalty" and "rent" without defining them. The case law, (generally not specifically working off commercial law notions, but rather from what courts gleamed from other tax law decisions) has made clear that a royalty or a rent entails, in each case, three distinct factors.

In the case of "rent" (with most courts citing a definition by Mr. Justice Addy of the Federal Court Trial Division in *Vauban, supra*) the three elements are (1) there is property that is

---

[32] Duncan (Appendix 2) at page 416, has an interesting passage respecting the original meaning of "royalty". Duncan traces the development of the notion of royalty arising strangely in the context of sale of mineral property for consideration that, *inter alia*, included a percentage of profit made by the buyer. Some cases said that this was ordinary income, a "royalty". But then, there was the 1933 Judicial Committee of the Privy Council decision in *Spooner*, *supra*, which held that it was capital and as noted elsewhere, this led to the enactment of paragraph 3(1)(f), replaced later by subsection 6(1) and now by paragraph 12(1)(g). And as noted, the original version used the word "royalty" in it, whereas the other two have not. There has been much written on royalties and related matters including emerging E-commerce in the cross-border arena many of those up to 1999 are cited in various footnotes in Duncan's 1999 article (Appendix #2) and, as well, in Jinyan Li's book (Note 33) – for example, see Footnote 101, as well as her separate work, Jinyan Li, "Re-thinking Canada's Source Rules In The Age Of Electronic Commerce: Part 1", (1999) Vol. 47, No. 5, *Canadian Tax Journal*, 1077-1025. See also Pierre Gonthier, "Les déclinaisons de la notion de redevance selon l'impôt de la partie XIII: Redevance et concept élargi de redevance", Canadian Tax Journal, 2003, Volume 51, No. 5, p. 1825 and Pierre Gonthier, "Les déclinaisons de la notion de redevance selon l'impôt de la partie XIII: Redevance et concept élargi de redevance", Canadian Tax Journal, 2003, Volume 51, No. 6, p. 2119. In general, for purposes of this lecture, I have adopted the reasoning, views and conclusions of Duncan respecting the ambit and meaning of "royalty", as that word is used in the introductory portion of paragraph 212(1)(d) which are as follows. First, the word relates to a situation where there is a use of something conveyed and not an alienation. Second, royalty is determined as a function of, and dependent upon the use made of the property by the licensee. Third, the object of the use is "property". Note that there has been no substantial statutory change or case law developments since Duncan's paper in 1999.

delivered by the payee to the payor, (2) the payor is entitled to use the property for a fixed period of time and then must return it and, (3) the amount paid for that use is fixed (regardless of the intervals of payment).

In the case of royalties (as reflected by the courts in cases such as *Farmparts* and *Saint John*), the three elements are a combination of (i) the first two elements giving rise to "rent" and (ii) as to the third, rather than fixed payments for the use, payments which comprise some portion of the gross or net income or profits derived by the payor from using the property or payments depending upon some other measure production or productivity realized by the payor from using the property. (For example, in *Grand Toy*, *infra*, this factor was described as follows:- "[A] an element of contingency in the payment for the use of property is therefore the essence of a royalty payment."[33])

Of course, there had been massive confusion arising out of a chain of Canadian and U.K. decisions in the earlier part of the 20th Century (closely (and probably, painfully) parsed by Duncan in (Appendix 2) culminating with the 1933 decision of the Privy Council in *Spooner*, which properly, in this observer's view, decided the notion of "royalty" should not be considered to include a situation where there has been a total sale or alienation of property, but where the price to be paid or being paid in respect thereof is not fixed but, rather, has the same element of dependency or contingency associated with the payment of a royalty as discussed in the

---

[33] As identified by Jinyan Li in "International Taxation in the Age of Electronic Commerce: A Comparative Study", *Canadian Tax Foundation*, 2003 at page 145.

preceding paragraph. The *Spooner* case, of course, as we have already seen lead to countering legislation which today comprises paragraph 12(1)(g) of the *Act.*[34]

- But, as discussed below – extended scope of taxation

(3) How is (foreign) recipient treated in Canada? – Part I

(a) Domestic – Part I

Per A(1) – this is situation where NR receives royalties in course of carrying on a business in Canada through a permanent establishment within the meaning of either Part IV or XXVI of the ITR.

- Carrying on business? (versus income from property)
    - No specific rules
    - No case law on point

---

[34] It must be observed, however, that the clarity of this situation may not be complete given the succeeding decision of the Supreme Court in *Wain-Town.* In this respect, Jinyan. Li (*supra*) wrote at page 145:- "Thus payment may be characterized as royalty even when the form of the transaction is a "sale" or "service"." (The reference to "service", does differ from views expressed elsewhere and see, for example, *Hasbro*, which concluded that payments for service no matter how calculated do not come within the notion of royalty in the introductory portion of paragraph 212 (1)(d)). Ms. Li points to the decision in *Gingras* 63 DTC 1142 (Exchequer Court), as support for the first proposition that involved the sale of a copyrighted sales manual for a fixed price, but where the payments were based on percentage of product sold. If the latter factor only affected the timing of payments not the ultimate obligation to pay the full fixed amount then quite apart from the question of terminology that should not fall under paragraph 12(1)(g), a point fully discussed by Duncan Osborne in his 1999 work in criticizing the decisions in *Ross* and/or *Wain-Town*, *supra*.

  - In a lending context, see *Pullman*, 83 DTC 5050 (F.C.T.D.), an assessing initiative by CRA motivated by inapplicability of Part XIII, because the target borrowers were based outside Canada (in the US).
  - In the real estate rental context there is much case law which, however, is not of assistance here.[35]
  - Other analogous situation?
  - CRA?
- Permanent Establishment?
  - Usual considerations

(b) Treaty – Part I

- Treaty Protection: see below
  - [Question of difference between permanent establishment definition in relevant treaty and in ITA]

---

35 For details see Nathan Boidman, "Property vs. Business Income: Burri v. The Queen and Other Recent Developments", *Report of Proceedings of the Thirty-Seventh Tax Conference*, 1985, *Canadian Tax Foundation*, p.40:1.

(c) Provincial? (not considered)

(4) How is (foreign) recipient treated in Canada? – Part XIII

(a) Domestic – Part XIII

[This Part can apply where there is not both carrying on business in Canada and doing so through an ITA permanent establishment.]

(i) Basic (ITA paragraph 212(1)(d))

Paragraph 212(1)(d) in all of its dimensions [see Appendix 21 for the entire provision] could be seen (in light of the somewhat convoluted and complex cases that have been decided thereunder, as well as the somewhat controversial manner in which its statutory content has evolved and been enacted – for details see Duncan's 1999 article, Appendix 2) to be a extremely slippery road to hoe. However, a metaphor comes to mind that may provide a workable approach to working through this provision and **that is to view it as a pyramid**.

Like all pyramids it starts off narrowly at the top – which here is the basic rule in the paragraph without regard to its subparagraphs – and then broadens as one descends towards the bottom – which, here, are the various subparagraphs. The key to the pyramid is that the narrow top is a narrow base of taxation and the broader lower parts are a broader base of taxation with, ironically, the narrow top comprising (or, more accurately, requiring) more elements relevant to analyzing the applicable tax rule and the broader lower portions comprising (or, more accurately, requiring) a lesser number of elements relevant to the applicable tax rule.

In particular, at the top of the pyramid, the paragraph imposes a 25% tax on, generally, payments made by a Canadian or deemed Canadian resident of rent or royalty to a non-resident (that rule

also applies to so-called "similar payment" – instances of which I do not think I have yet to find). As discussed above, in order for a payment to meet the case-made law definition of a rent three distinct characteristics or elements must be extant (a property, a giving of the property to be used and then the return of the property and a fixed payment or payments for the use during that duration). And to meet the case-made law definition of royalty three distinct characteristics or elements also must be extant (a property, a giving of the property to the used and then the return of the property and a contingent or dependent form or type of payment for the use of the property).

As we will see, the pyramid broadens as we descend to the subparagraphs by reason of the removal of one or more of these characteristics or elements in order that the same tax of 25% apply. It may also be noted, that one could also say that the narrow top may not only be characterized by the two, three element sets of factors, just noted, but, as well, by the notion that a payment cannot be a rent or royalty where it relates to or is in respect of a transaction that either sees a transfer of all rights to the relevant property by the payee to the payor or as was raised in the *Saint John Shipbuilding* case a transfer of rights of use respecting property without the need that the property ever be returned, that is, rights of use in perpetuity. Overall, therefore, one may view the preamble or basic language of paragraph 212(1)(d) having the narrowest base of applicability (by reason of the requirements to characterize a payment as a rent or royalty) in relation to or in comparison to the balance of the provision (that is, the subparagraphs) that follow.

- 25% tax on gross[36] amount of "royalty"
- Cash basis, not accrual[37]
- Requires Canadian resident payor
  - Actual resident
  - Deemed resident for Part XIII
    - ITA subsection 212(13)
    - ITA subsection 212(13.1)
    - ITA subsection 212(13.2)
    - ITA subsection 212(13.3)
    - Bill C-10 proposed addition, related to proposed section 56.4, paragraph 212(1)(i) and paragraph 212(13)(g)
  - US (and other foreign) counterparts (including "cascading" theories)

---

36 *Burland* (Note 68).

37 Applies when a Canadian "pays or credits". (This is discussed elsewhere.)

(ii) ITA subparagraph 212(1)(d)(i)

a) The Statute and Overview

The definition is:

> "(d) Rents, royalties, etc. – 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,"

Here we have **the first widening or broadening of the pyramid**, a rule which has been the subject of much case law (particularly, the case of *Saint John Shipbuilding*[38]). This rule broadens the pyramid by apparently dropping one of the three requirements for a payment to be a rent or royalty. In particular, **there is no requirement that the property given for use be returned**. It is sufficient, according to, at least, *Farmparts* and *Hasbro*, (and strongly suggested, but not decided in *Saint John*), that there be only two of the requirements of a rent or royalty, namely, that property be given for use, but in the context of a transaction where there isn't a full sale of or alienation (see next section) of the property to the payor and that there be a payment of "any kind" (whether fixed or contingent) for that use. *There is no requirement that the condition of a rental that the property given in use be returned be part of the arrangement*.

But, strangely, the Federal Court of Appeal in August 1980 in the case of *Saint John Shipbuilding*, discussed below, declined to apply this formulation of the rule, although it strongly suggested it and instead decided the matter under the 1942 Canada-U.S. Treaty, notwithstanding

that six months earlier, in February 1980, the same court (but a different panel – in part?, or in total?) had clearly decided in the case of *Farmparts*, that the subparagraph could apply to an arrangement that saw a fixed payment for the use of property in circumstances where the arrangement did not amount to a rent or royalty arrangement. There is a bit of uncertainty, actually, respecting this finding in *Farmparts* and the decision in *Farmparts* in that there is a bit of a disconnect between the formulation of the principle and the facts of the case, where arguably all of the elements of rent, in fact, did arise. See discussion further below.[39]

It should be acknowledged that this paragraph does, in one sense, narrow the pyramid by requiring that the property be used in Canada in order for the tax to apply. The basic rule of the paragraph has no such limitation, although there is a carve-out in one of the subparagraph ((ix) for "…the rental payment for use of the right to use outside Canada any corporal property").[40]

b) Threshold Context[41]

It may be useful at this juncture before considering subparagraph (i) in further detail, to overview the overall relationship between the manner in which Canadian companies may access inputs from foreign persons in carrying on their businesses and the various subparagraphs in the provision. A Canadian business enterprise may make payments to non-residents in consideration

---

38 We will see below that *Saint John's* is relevant to this lecture in three distinct contexts – directly under this subparagraph as indirectly relevant in discussing the exemption under subparagraph (vi) and as a segue to our discussion of royalties in the e-commerce-internet context.

39 There is also disagreement over the proper ambit of subparagraph (i). See Duncan (Appendix 2), at page 440 to 443.

40 It might also be noted that unlike subparagraph (i), but like the preamble to this provision, subparagraph (ii) respecting so-called "know how payments" discussed in the next section, also is not restricted to use in Canada.

41 Further discussion of context is set out in below in analyzing the decision in *Hasbro*.

of receiving (for use in its business) (1) ownership interests in whatever is conveyed or (2) the right to use whatever is conveyed or (3) a service from a non-resident (either performed in Canada or abroad). The price or consideration to be paid may be totally fixed (non-contingent) and specific (e.g. a single, lump sum amount or several fixed payments), or may in whole or in part be contingent (dependent) upon use.

If whatever is conveyed is recognized as property (i.e., without either not a service or not a nothing—see the case of *Quality Checkd*, 66 DTC 659, 67 DTC 5303 (Ex. Ct.) and its conflict with the case of *Western* (note 68)), and the other conditions of "royalty", as discussed above, are met, it will be subject to paragraph 212(1)(d). Here, we deal with all other cases where the next question is whether the arrangement and the payment seem to come squarely within the specific language of subparagraphs 212(1)(d)(i)-(v) and there is no case law which suggests a contrary point of view. Let's examine the statutory language. [See above]

At first blush, the language in subparagraph (i) seems reasonably clear and specific and easy to apply—except perhaps for the three troublesome words at the end of - "...or other thing whatever". Isn't that a prescription for mass confusion because would that include "information..." (per subparagraph (ii)) and thus neutering, subject to the point made below, that subparagraph (ii)?

When "information" is provided, is there an alienation of it or the mere granting of a use? If the latter, then there is no role for (ii).

And is there any reason why one could not distinguish (1) giving something to someone (a book, manual...) and (2) performing a service for that person? [But see Duncan's footnote 60 (Appendix 2) and the question raised.]

Unhappily, the case law shows much uncertainty, although that in part is because of the content of the rules before amendment before 1968.

Subparagraphs (ii) and (iii) were added in 1968-1969 as a result of conflicts between the decisions in *Western* (note 68) (1969) and *Quality Checkd* [1967]. For discussion, see Duncan (Appendix 2) at page 432. (See also, *Rolls Royce* in 1962, *Evans* in 1953, *Technical Tape* (note 68) in 1964 and the cases specifically discussed below.)

c) A Threshold Issue – "use" versus "alienation or sale"

[Note that the following comments are substantially similar to those in a section below. But in each case they add context to the separate matter under discussion.]

Clearly, a pivotal factor in considering whether a payment is a rent or royalty or one governed by subparagraph (i), is a question of whether the underlying transaction involved a "alienation" or a "sale" as opposed to one which conveys lesser rights and, in particular, rights of "use" only. And this can be a slippery question if not addressed from the correct perspective or standpoint in that the answer may differ as between whether one is looking at the payee or conveyor of the rights or, instead, the payor or recipient of the rights. This is because it could be argued by reference, for example, to the decision is *Saint John Shipbuilding* which involved a U.S. company providing access to a Canadian to use some sort of computer programme to build ships in exchange for a lump-sum payment and with a Canadian apparently being permitted to keep and use the programme in perpetuity, that is, not having an application to return it. The point is that the Federal Court of Appeal found that the transaction could arguably be subject to subparagraph (i) as involving a "use" only because the prohibition against any disposal or alienation by the Canadian of the programme to another party meant in the view of the FCA that the arrangement

did not entail a "alienation". The court made clear but for that limitation they would have considered that there had been an alienation and that, therefore, the transaction could not come within either the definition of rent nor the provisions of subparagraph (i).[42]

The interesting point here is that regardless of how that would have been viewed in terms of alienation from the standpoint of the payor (and, as noted, it would have been viewed as an alienation from the standpoint of the payor for purposes of the provision) the transaction arguably in no way say the payee alienating anything, because it continued to own all of the property it owned before in respect of the computer programme and from its standpoint had merely given another party a copy of it for their use without diminishing in any way the property that it had started with. Therefore, in this respect, it would appear that the notion of whether there is a sale or alienation for purposes of Part XIII and as would, as just indicated, render either the preamble to paragraph 212(1)(d) or, subparagraph (i) thereof, inapplicable, is to be viewed from the standpoint of the Canadian payor in terms of what that person has received and not from the standpoint of the non-resident in terms of what they had or had not given or disposed of in relation to the rights and property that they had before the transaction with the Canadian.[43]

---

[42] CRA has (gratuitously in my view) conceded (in interpretations cited *infra*) that, in principle, Part XIII does not apply where, *inter alia*, "use" has been delivered in the context of an alienation and notwithstanding some odd caselaw to the contract, but in a totally different context...

[43] For authorities on and discussions of this pivotal point, see Duncan (Appendix 2) footnote 40 and the British cases of *British Salmon* and *Nethersole*. The first case, a 1938 U.K. decision found that an "exclusive licence" over a 10-year period was tantamount to a sale—consider this further and correlate to *Saint John Shipbuilding* which involved a non-exclusive licence. In the *Nethersole* case, as well as the *Davy Ashmore* case (India) at footnote 40, a differentiation rule (which was not adopted in *Saint John*) is of interest—that is differentiating between an alienation and a use. At page 429, Duncan refers to four factors cited in the *Rustroof* case as distinguishing between the two. In *Saint John*, the Court said there could not be an alienation if there was no right to re-sale. Can we reconcile *Saint John* on this with the cases cited above?

d) Second Threshold Issue – "bundled" transactions

Issues have arisen in applying Part XIII (and separately in dealing with inter-company transfer pricing matters, dealt with in Section V - below), where parties enter into a contract that sees more than one type of thing delivered (whether a property, a service or something which exists but is neither of the latter and the amount paid by the recipient is not allocated by the parties as between its several components, Such a situation is often referred to as entailing a "bundled" transaction. As dealt with further below, taxpayers have benefited from such an arrangement in circumstances where the provider was a non-resident, some part of the transaction would have been subject to Part XIII tax but the government in an assessing initiative brought before the Court made no effort to allocate as between those elements that would be subject to Part XIII tax and those elements that would not. See below in *Farmparts* and *Brad-Lea.*[44]

CRA in IT 303 in paragraph 25 takes the position that if part of the payment is subject to Part XIII, they will take the whole amount unless the taxpayer shows a portion should be carved out. The Courts in *Farmparts* and *Brad-Lea* rejected this position.[45]

---

44 In *Brad-Lea*, *infra*, the Court rejected the government's position because the Minister did not allocate the payments as between "royalty" and "services". In so doing, it relied on *Saint John Shipbuilding* (why?) and *Farmparts*. The Court said that CRA had the obligation to make that allocation.

45 CRA has recently (and again in my view gratuitously) conceded or acknowledged this case-made law in context of its series of memos on transfer pricing – "Transfer Pricing Memoranda". See Appendix 30. OECD in its commentary on Article 12 (Appendix 33) distinguishes the matter in a straightforward fashion—that is, between information and services—the former to be governed by Article 12 and the latter by Articles 7, etc. See discussion below.

e) Third Threshold Issue – The role of terminology in a contract

Does the use of the word "royalty" in a contract necessarily govern the determination? Obviously, it should not be determinative and that has been held to be the case in various court decisions. See Duncan's discussion of this at page 439 – Appendix 2.[46]

f) Fourth Threshold Issue – Nature or Ambit of "Property"

The issue of whether the object of a contract that may be subject to the basic provision is "property" or something else had arisen prior to an amendment to paragraph 212(1)(d) in 1968—that is at a time when that paragraph and its subparagraphs would not apply if something provided by a non-resident was not considered to be "property". The issue was highlighted by a disagreement of the courts in two cases, *Western* and *Quality*, over whether know-how is property. The court in Western considered that it is, and therefore could be subject to the rules of the provisions as they then were, while the court in *Quality* concluded the contrary. The issue was dissolved by the 1968 addition to the provision of subparagraphs (2) and (3), dealt with below, pursuant to which Part XIII can apply where a non-resident provides something which is not meet the test of being a property. See discussion further below.

Is each item in subparagraph (i) a property?

---

[46] Relevant cases include *Wain-Town* respecting "royalty" and *Saint John* respecting "license".

g) The Case Law:

i) *Saint John Shipbuilding*[47]

The discussion respecting *Saint John* that follows, begins an examination through various portions of the balance of this paper of the Canadian tax treatment of fixed lump-sum payment software (computer program) transactions involving non-residents and Canadian residents. That treatment is uncertain both because the relevant rules are uncertain and because CRA has, in my view, misinterpreted *Saint John*. The situations that will be examined are the following.

(1) NR conveys ("sells" software to end user Canadian with rights comparable to book – Canadian can reconvey, but not reproduce, copy, etc. (usually "shrink wrap")

(2) Same as (1) except "sale" is to a Canadian distributor, for resale to its customers

(3) Same as (1) except there is a piece of paper in package which excludes resale by "purchaser: who does not sign any contract with NR. (again, "shrink wrap")

(4) Same as (3) except sale is to a Canadian distributor

(5) NR conveys software to end user Canadian under a written signed contract which grants use to perpetuity but which precludes resale

(6) Same as (5) except conveyance is to a Canadian distributor who extracts, from its own customer agreement to the prohibition against alienation

---

47 *Saint John Shipbuilding & Dry Dock Co. Ltd. v. The Queen*, the Tax Review Board, 76 DTC 1283, 79 DTC 5297 (F.C.T.D.); 80 DTC 6272 (F.C.A.).

(7) Same as (6) except NR and distributor proceeds as follows: NR licenses distributor to reproduce the software (i.e. use NR's copyright in software) and on-sell-license to end Canadian user

(8) When and how does the internet and e-commerce intersect with the foregoing; and do the results change?

RESULTS?

These will be seen from examining the following.

(1) ITA

(2) Case law

(3) CRA Administrative views

(4) OECD Model – Article 12

(5) Various Canadian tax treaties

Now on to *Saint John Shipbuilding*.

This 28-year old case saw the FCA almost (but not quite) conclude[48] that the Part XIII 25% tax arose under ITA subparagraph 212(1)(d)(i) in the following circumstances. (The case was decided on treaty grounds.)

---

[48] Unfortunately, CRA has acted as though they had concluded. More on this below.

- The Canadian payor in *Saint John* had the right to use software conveyed by a non-resident in perpetuity and had no obligation to ever return it.

- But, the Canadian did not have the right to on-sell to another party the software it had been given. (**<u>Note</u>:** for purposes of an issue with CRA, I bought a piece of Microsoft software that contained a licence which permitted sale of the software disc contained in the package, but of course without the right to reproduce, etc. This would be the exact counterpart of a purchase of a published book. More on this below.)

- The reported decision by the Federal Court of Appeal in *Saint John* referred to "...a contract under which COM/COD supplied to a Canadian computer service company for the respondent (it might alternatively have been for the respondent's own computer had it had one of the kind required) tapes containing technical data or material referred to as the Autokon-I System which, when combined with input data on a specific ship's hull produced technical data for use in the construction of the hull. ... The respondent was...bound by the contract to keep the information obtained by the use of the system confidential and to use it only for the respondent's purposes. .... The contract does not purport to evidence a sale of the tapes and manuals to the respondent. Instead, it purports to be a grant of a non-exclusive license to use the system.... There is in the contract no reference to the ownership of the tapes or manuals so-supplied nor is there any provision which gave COM/COD any right in any circumstances to require that they be returned."

- The decisions of the two lower courts and the Federal Court-Trial Division shed the following additional light on the facts. The agreement was termed “Autokon License Agreement” and the agreement granted a “non-exclusive license”.

Consistent with the discussion in section (i), the single lump sum payment was found to not constitute a “royalty” (necessitating the provisions in subparagraph (i)). The key factor which almost rendered subparagraph (i) applicable is that the prohibition imposed on the Canadian payor against resale or reassignment or other conveyance of what it received ostensibly brought the arrangement within the ambit of, and only the ambit of, a “use”. (But the elephant in the room is that it clearly was a “use” that went beyond the norm.) Had the Canadian payor been entitled to re-convey what it received, the transaction presumably, would have been seen as the exact comparable to a sell-buy of a book transaction, which conveys more than a mere use – namely a right to sell the acquired book. That grants both the right to use and the right to alienate the thing received. Such a transaction is not subject to subparagraph (i), as it is one which does not come within its terms.[49]

The *FCA in Saint John* confirmed the latter. (See Appendix 26.)

CRA acknowledges the latter delineation - see above.

- Miscellaneous Points on *Saint John* and its Three Judgments[50]

---

[49] Subparagraph (i) addresses a contract to *use*, not *purchase*.

[50] See Appendix 26.

CRA's IT 303 (see Appendix 22) which takes the position almost adopted in *Saint John* was issued four years before the Federal Court of Appeal decision in *Saint John.* CRA had continued to following its thinking in IT 303 as though the Court had made that decision.

Given that the F.C.A. in *Saint John* left the matter unresolved, what is the proper interpretation of sub. 212(1)(d)(i)?

See the suggestion by Duncan Osborne some ten years ago (Appendix 2) that subparagraph (i) be read as *not standing independent of the opening words of paragraph (d)*—so that a covered arrangement is one which inherently entails a "rent, royalty or similar payment"—and that sub (i) be seen as..."a legislative clarification of the various types payment that may be a royalty payment that attracts withholding tax".[51]

The Tax Review Board found that the payment in *Saint John* was not a "rent" because there was no "use for a certain time" (as raised by the Exchequer Court in *United Geophysical*, 61 DTC 1099). It also wasn't royalties because (relying on definitional analysis by Addy, FCTD in

---

[51] (This footnote should be read together with similar comments discussed elsewhere, but in different contexts.) Note that because *Saint John* lacked a return of the property, it could not constitute a straight rental under para. 212(1)(d). But, is there potential malleability of the word "use" in sub (i)—and the thesis that, as used in that provision, it should be viewed in THREE not two different ways—TWO which are not to be governed by sub. (i)? First, a payer obtains, *inter alia*, a " use" when there is a total "alienation" transaction. But that of course is not a "use" which would trigger sub. (i). Second where a person gets a "use" of property and then has to return the property and pays one or more fixed amounts, that—if for some reason not simply a rental—would reasonably be governed by sub. (i). And if one fact in *Saint John* had been different—rather than being entitled to keep the software in perpetuity, it had to be returned, say at the end of 50 years—there presumably would have been no difficulty, in bringing it within the later. Third, now we come to *Saint John*, where one gets to keep and use something in perpetuity. That is a far different "use" arrangement than the second and much closer to the first. And if that were given statutory recognition, the issue over sub. (i) should abate—and it's probably an issue that is arising everyday in e-commerce, but is on nobody's radar screen. Or, perhaps all it really requires, in light of the Supreme Court in the GAAR cases in October, 2005, is a contextual reading by a court?

Vauban (75 DTC 5372)) the payments were not determined by reference to "degree of "use" (that makes sense) or to "duration of the use" (that is difficult to assess).

Then the analysis become murky but emerges with a finding that the Canadian may have acquired ownership of property and was of "an enduring nature and not of a temporary or of a periodic nature. And the payment wasn't taxable.

The FCTD says the Canadian neither bought anything (because it didn't have right to alienate) nor paid rent or royalty. (Same reasoning there as TRB.) The court also says that it is IRRELEVANT whether the payments constitute capital or non capital outlays to the Canadian - thus rejecting TRB.

Then the FCTD takes an interesting tactic re sub (i) - it skirts it by saying that the object of the contract (technical info) is specifically dealt with in sub. (ii), but that rule doesn't apply because there was no contingency AND having so found it wouldn't be fair ("justifiable") ..' to attempt to classify under another subpara. by virtue of which it might be taxable". (That's actually quite interesting—but the FCA rejected that thesis.)

The FCA also rejects a rental or royalty analysis—for same reasons, as the TRB .

And, but for the treaty – that is had the FCA been required to decide the case on the basis of the *Act* - it seems quite clear that the FCA was heading for a textual-based finding that sub. (i) applied.

> It will be observed that the net cast by sub-paragraph 106(1)*(d)*(i) is very broad. It includes not only "rent, royalty or a similar payment" but "any payment" for the use of or for the right to use in Canada" any "property" (a word which is defined in the broadest of terms in paragraph 139(1) (*ag*) (now a part of subsection 248(1)) or any of the items enumerated in the wording that follows it, or "other thing whatever". This very broad wording came into effect in 1968.

> Prior to that the wording had been much narrower. *Western Electric Co. v. M.N.R.* was decided on it.
>
> [...]
>
> Assuming that the wording of subparagraph (1)(d)(i) of sections 106 and 212 is to have its full scope and is not to be restricted because of the presence of the subparagraphs which follow it, I am not satisfied that the provision is not broad enough to include the payments in question. It is not easy for a payment of the kind described to escape the definition of "any payment...for the use of or for the right to use in Canada any property...or other thing whatever". (*The Queen v. Saint John Shipbuilding & Dry Dock Co. Ltd.*, pg. 6274)

But, to me, the *burning question* is why the FCA declined to pronounce on (find with respect to) subpara. (i)—in light of the clear statement by the FCA six months earlier in *Farmparts* (discussed next) that subpara. (i) is not constrained by the preamble to the paragraph? (And interestingly, two of the three judges were the same in the two cases!)

ii) *Farmparts*[52]

This decision of FCA is similar to *Grand Toy* (which came 8 years later) in that it involves payments that at least in part are for rights to be a distributor in Canada and is dissimilar in part by reference to nature of the payments. And it is similar to *Brad-Lea* for the way in which the "bundled" aspect of the arrangement defeated the Crown.

Here, under two agreements with a U.S. company ("Wonder International") ("Company"), the Canadian (Farmparts) received ((1) certain use of the company's trade name and logos (that looks likes straight rent or royalty) (2) the right to use the concept or technique of merchandising replacement automobile muffler systems using a pipe bending machine developed by the company (sounds like things desc in either of the first two) and (3) distributorship rights – i.e. the

52 *Farmparts Distributing Ltd. v. The Queen*, 79 DTC 5193 (F.C.T.D.), 80 DTC 6157 (F.C.A.).

EXCLUSIVE right to purchase and re-sell the pipe-bending machines within a defined territory to sub-distributors.[53] There were total tax payments of $115,000 made by Farmparts—and in an accompanying case, $75,000. (The second case is exactly same except payments were $75,000.) Farmpart's customers are referred to as subdistributors (not as franchisees). Farmparts devised on its own package for sale to: subDs which "package" included one machine, an "opening advertising programme" (which F had made up by its ad agency) and the U.S. company's "Wonder" decals and logo and a sign. At page 6159 the FCA writes-- "Of all of the parts of this 'package', only the exhaust pipe bending machine came from Wonder International." The FCTD noted that without specific authority granted by Company, but with its tacit approval, Farmparts granted the subD the right to "use the trade mark 'Wonder Muffler' and logos of Wonder International. However under the contract, upon termination between the Company and Farmparts the latter was to cease using them.

The lower court - FCTD- 79DTC 5193 - found that only payment for the use of the trademark "was on income account" and subject to paragraph 212(1)(d). But because the Crown failed to allocate, no Part XIII tax applied.

The FCTD (according to the FCA) found that sub (i) applied only to the right to use trade name and logo (and tacit right to on-grant) BECAUSE that was on "income account". The rest was, according to the FCTD, "on capital account". The FCA repeats the relevance of the latter.

---

[53] This seems comparable to a franchise operation where the Canadian was the head franchisee who could then appoint sub-franchisees. Didn't Canadian have to have right to do latter and train subs and provide to them everything (all info, etc.) it received? See further below respecting franchises.

But there was no way --on evidence- to allocate and the onus to do that was on Minister--- therefore the assessment falls--according to lower court.

The FCA starts with Crown's view that the language of sub (i) picks up a payment of any kind for anything referred to in that and following subparas ..."Whether or not it falls within the category of rent, royalty or a similar payment", pg. 6160. In support, the Crown pointed to a legislative change in 68 from "any such payment" to "any payment". FCA says that is "well founded". Those are a "clear indication that Parliament intended that the payments described in subpara (i) to (v) be subject to the charge of the section whether or not those can be said to be *ejusdem generis* with "rent, royalty or a similar payment" [at pg. 58].

Then FCA asks whether the payments come within the "four corners of section 212(1)(d)(i)".

FCA says there was a 'use' of the tradename. And that the merchandising plan was either a plan or process or property within sub (i) and there was a use. But the exclusive right to buy and sell (i.e. be an exclusive distributor) is not covered because it would only be covered if it were a right to use the machine --which it is not. And given the latter finding, the fact that the Crown did not allocate and the decisions in *Pillsbury* and *Conway* related to the latter point, the FCA dismissed the Crown's appeal.[54]

The FCA also rejected the alternative that the payments were rents or royalties. While its clear that they weren't royalties, given that contracts were for a fixed period (25 years plus an option

---

[54] In this respect, the FCA focused on the Crown's assumption that "....(b) Company granted rights including use of machines , (c) the payment was for rights to use Company's prop and (c) the payment was a FRANCHISE fee.....". Consider further the latter factor.

for another 15) why couldn't they be a rent (contrary to *Saint John* where there was no time limit)?

iii) *Grand Toy*[55]

The foregoing provides background to *Grand Toy*. As discussed above, the FCA expressed the clear view, in February 1980 in *Farmparts*, and strongly suggested, in August 1980 in *Saint John Shipbuilding*- (but, surprisingly, without reference to *Farmparts*), that subparagraph (i) can pick up a payment which is not characterized by the attributes or features of a rent or royalty or similar payment. It was also noted that the lower courts in both cases had, at least, implied the latter requirement as was firmly contended for by Duncan Osborne (Appendix 2).

As noted above, in the first (*Farmparts*), the FCA would have clearly found the portion of the fixed payments for the right to use the trade marks and the technical information and data [although non-royalty like (no dependant - upon factor) and arguably non-rent like (there was a term but the court seems to ignore it after identifying it)] would be taxable under Part XIII by reason of sub (i) and that liability did not arise only because the Crown failed to show what part of the overall payments related to those two items. In the second (*Saint John*), the FCA strongly signalled that it would have found that the payment for the computer programs, [although non-royalty -like not dependant) and non-rent like (no fixed term)] would be taxable under Part XIII by reason of sub (i), and that liability did not arise only because of the 1942 Canada-U.S. Treaty.

---

55 *Grand Toys Ltd. v. M.N.R.*, 90 DTC 1059.

In the cases leading up to the 1968 amendments of paragraph 212(1)(d), it appears that the same sub (i) issue did not arise *per se*. Rather the focus was on whether know how was property for sub (i) -with a conflict between *Tech Tape* (note 68) and *Western* (note 68) on the one hand and *Quality Checkd* on the other, leading to the 1968 additions---[(to paragraph 212(1)(d)] as a means of capturing contingent payments whether or not the object thereof is property or services or "nothings"[56]--- And those cases apparently did not involve fixed payments so that the subject issues did not arise.[57]

This brings us to the third (and last) case respecting the basic issue ---sub (i) and non-contingent payments-- the 1991 decision in *Grand Toy*.

This case involved payments that (like in *Farmparts*) could be viewed as fixed amounts paid by a Canadian to a non resident for the right to be the exclusive Canadian distributor of products made by the non resident. That would be in the sense that although the basic deal was that, as part of the overall price, paid for each unit of product sold by NR to the Canadian, there was to be an amount of 52 cents (identified, inaccurately and inappropriately in the contract as a "Buying Commission and Royalty Amount"), there was to be paid a minimum of $400,000 of such 52 cent amounts, even if there were no product whatsoever purchased by the Canadian from the NR. If instead the Canadian purchased at least (roughly) 800,000 units, the 52 cent amounts

---

56 Sub (ii) was added to deal with ROYALTY-like ("dependant") payments for know how (information, etc.) and sub (iii) to deal with such payments for services (particularly in light of apparent court conclusions that the definition of royalty ---tax or non tax-- sees a requirement that there be provision of the use of property which is the object to the payment and that the provision of services cannot trigger the notion of royalty *per se*). For a full discussion, see Osborne – Appendix 2.

57 See Osborne (Appendix 2) for comments and notes respecting both these cases and other pre-1980 prominent 212(1)(d) cases.

could simply be viewed as part of the price charged by the NR to the Canadian for each unit of product (which is exactly how it was viewed by the customs people at CRA). Unlike *Farmparts* there was no provision of other things (i.e. -- trade marks, technical info as might trigger Part XIII).

CRA - undoubtedly driven by the taxpayers unfortunate terminology - asserted Part XIII tax, but that, logically, was rebuffed by the Tax Court.

The reasoning of the Tax Court involved the following key elements.

First the court relied upon the Supreme Court in *Wain-Town Gas and Oil* that the use of the word "royalty" in a contract does not necessarily mean it involves royalties. (See discussion above.)

Second, the court rejects the royalty characterization by relying on the requirement stipulated by Addy J in *Vauban* and the FCA in *Saint John* that royalty requires a payment which is a share or portion or percentage of the payer's gross sales revenue or net profit or is computed as an amount for each unit of something sold or leased by the payer and rent requires a payment determined by reference to a period of use.

Third, on sub (i) the payer was not given a right to use anything in Canada. (More specifically, the products bought weren't to be used but to be resold—although see related issue below for software distribution) Fourth—(and this is a little unfortunately imprecise), court concluded that the payments shouldn't be considered to be for the distributorship, but even if they were, "....this would not make them royalties. Rather they would be capital payments." In this respect two things. First the FCA, in *Farmparts* rejected the view of the lower court that an "income versus capital" characterization is relevant to interpreting any part of paragraph 212(1)(d). Second, this

seems to ignore the specific finding of *Farmparts* that a payment for a distributorship is not a Part XIII payment. As well, even if "capital", there could be separately the issue of subpara. (v)—related to parag. 12(1)(g) discussed below.

Finally, note that Osborne (Appendix 2) expresses some reservations respecting the analysis in *Grand Toy*.

iv) Other Countries on *Saint John*?

An informal canvass of several other countries (Appendix iii) indicates that most that do tax an outbound "royalty" payment would tax the payments which arose in *Saint John* in a similar inbound-outbound transaction. In some cases that would arise by reason of a more expansive definition of "royalty" (in relation to outbound payments) and in others by reason of rules similar to subparagraph (i).

But, most also report that such domestic law would be ousted by treaty provisions. Treaties may define (under "Article 12") royalties in a way to exclude *Saint John*-type payments or payments respecting specified things (such as copyright software – as we see in treaties such as those with U.S. and The Netherlands.[58]

---

[58] Relevant would be the revised 2008 OECD Model Treaty commentaries. The pertinent revisions stem from a 2000 mandate given to an OECD "Technical Advisory Group" (TAG) to "monitor" the "existing treaty norms" respecting taxation of e-commerce business profits including matters concerning software transactions. As discussed further in Section VI – respecting e-commerce - on February 1, 2001, an OECD TAG study on treaty characterization (as between Article 7 and Article 12) of e-commerce payments concluded with a report to Working Party No. 1 ("Tax Treaty Characterization Issues Arising From E-Commerce, A Report to Working Party No. 1 of the OECD Committee on Fiscal Affairs, by the Technical Advisory Group (TAG) on Treaty Characterization of Electronic Commerce Payments, February 1, 2001). (See Appendix 82.) This report entailed recommendations for changes to the Commentary on Article 12. (See Appendix 33) An October 2, 2001 draft then set out in draft commentary the TAG recommendations respecting Article 12. See the final commentary in Appendix 33. See,

[The Indian case of *Davy Ashmore* in 1991 seems to be the obverse of *Saint John*.]

h) Distributors and *Saint John* and the Ancillary Notion of Shrink Wrap

In light of CRA's (incorrect) view that *Saint John* would tax any conveyance of software which falls short of a full alienation (as in a "book" sale), it decided to inject some reality by adopting, in 1994, a "liberal" approach. In 1994 CRA ITD issued ITP-94-07 (see Appendix 28) which treated, as a sale—not a *Saint John Shipbuilding* ITA subparagraph 212(1)(d)(i) payment,- a conveyance by a NR of "shrink wrap" software <u>not involving the signing of a license</u>, for a single straight payment, <u>even if the package contained a prohibition from assigning its contents</u>. This was a partial retreat from Revenue Canada's assessing initiatives of foreign software sellers on the basis that what they receive is not sale proceeds but rather payments for the right to use which (having regard to CRA's view of *Saint John Shipbuilding* and subparagraph 212(1)(d)(i) of the *Act*) are subject to a 25% withholding tax (on the gross) subject to treaty reduction.

Nathan Boidman and Mark D. Brender, "Canadian Taxation of Inbound Electronic Commerce (Part 1), *e-commerce,* Tax Planning International, Vol. 2, No. 3, March 2000, page 3 and Part 2, vol. 2, No. 5, May 2000, page 4**.** See also, Jinyan Li, "Rethinking Canada's Source Rules In The Age Of Electronic Commerce: Part II", 1999, 47 *Canadian Tax Journal*, at p. 1411. See, Pierre J. Bourgeois, "OECD Virtual Indecision", *Canadian Tax Highlights* (July 25, 2000); and Pierre J. Bourgeois, "OECD Virtual Redraft", in *Canadian Tax Highlights*, (October 24, 2000)." Pertinent here was a proposed extension of paragraph 14 and new paragraphs 17.1-17.4, which would cut down the ambit of Part XIII. As a result, in 2001 Canada was in a "reserve" mode (by way of an "observation") on that Article 12 commentary (paragraph 14) respecting computer software which conflicted with CRA's view of *Saint John*. But then in the June 18, 2002 Income Tax Technical Notes No. 23, CCRA stated that on March 28, 2002, the Department of Finance informed the OECD that Canada is removing the observation - subject to the special cases in paragraph 14.3. This was reiterated in the next release Income Tax Technical Notes No. 25 - October 30, 2002. (See Appendix 29.)

Three things happened which substantially diminished this issue. First, in 1994 there was the above-noted International Tax Directorate of Revenue Canada, ITP-94-07.[59] Second, many software developers of widely distributed so-called shrink wrap software no longer even seek to restrict the sale or alienation, the matter commercially probably being no different than selling a music album or CD or cassette or a book, where such sellers have never sought to prevent a buyer from reselling the single slug which has been purchased. In such case, subparagraph 212(1)(d)(i) of the Act, can have no application. Third, pursuant to a 1993 Budget treaty renegotiations between Canada and other countries, such as the United States, the Netherlands, France and others, now provide exemption from the Part XIII withholding tax where the payments are made for software even if only for the use of software and not a "sale" of the software.

Residually, however, liability to tax will arise (in the eyes of Revenue Canada) where the software is sold subject to restrictive non-assignment license, unless (in the view of Revenue Canada) in stipulated "shrink wrap" format (per ITP-94-07) or unless there is exemption under a recently renegotiated treaty. To be clear, this issue will arise whether or not such non-digitized software is sold through conventional means or through the internet. If the arrangement qualifies for "sale" [not ITA subparagraph 212(1)(d)(i)] characterization under the foregoing factors], then there is the separate question as to whether there is business being carried on in Canada and, if

---

59 As noted, this developed a safe harbour for so-called "shrink wrap", that is packaged standard software sold without the signing of a specific license notwithstanding that a license within the software package might prohibit reassignment of that single package (e.g. CD) which has been acquired. Under the safe harbour, such a transaction will not be treated as being subject to subparagraph 212(1)(d)(i) of the Act.

so, there is the further question of whether that business is carried on through a permanent establishment. This brings us to distributors.

A particularly thorny issue arising by reason of the decision in *Saint John* for U.S. developers of software sold to Canadian customers through related or independent Canadian distribution companies was eliminated (except perhaps for those U.S. entities operating through disregard or flow-thru limited liability companies) by the 1997 Fourth Protocol or 1995 Third Protocol to the Canada-U.S. Treaty. More on this in a moment. However, the issue continues for those foreign-based software developers marketing in Canada in this fashion, where either they are resident in a country that has no treaty with Canada, or has a treaty which does not feature the change made in 1995 or 1997 in the Canada-U.S. treaty.

Given the strong suggestion in *Saint John* that a conveyance by a non-resident of software to a Canadian without the attributes of a sale or alienation (e.g. where, as in *Saint John*, the Canadian may be granted use in perpetuity but not the right to dispose to a third party) for a lump sum payment is subject to tax under subparagraph (i)—and the conceptual confirmation of this by the prior decision in *Farmparts* (all of which has been discussed above), what is the analysis where there is a "middleman" – i.e. a "distributor" between the foreign maker of the software and the end Canadian purchaser-user, the arrangements are such that in the course of the "sale" by the foreign party to the distributor and the re-sale by the distributor to the Canadian end-user, there is effectuated through one means or another an undertaking by the Canadian end-user in favour of the foreign party to not resell or alienate? Is the Canadian distributor "using" the software within the meaning of subparagraph (i), or given that its only interest is in fact on selling it and not using it, that notion is not properly applicable so that the amount paid by the Canadian distributor to the foreign party do not come within subparagraph (i)?

CRA clearly takes the position that subparagraph (i) can apply. However, there are cogent arguments to the contrary.[60] One of those arguments for which there is no judicial support involves the exemptive provisions of subparagraph 212(1)(d)(vi) discussed below—namely that the distribution arrangement involves a constructive, if not actual, reproduction of the software so as to engage the exemption in that subparagraph for payments made for the right to reproduce property subject to copyright protection.

(iii) ITA subparagraph 212(1)(d)(ii)

This reads as follows:

> (d) **rents, royalties, etc.** -- rent, royalty or similar payment, including, but not so as to restrict the generality of the foregoing, any payment

---

[60] The arguments and views on both sides of the question may find support or is expressed in, *inter alia*, the following:

JURISPRUDENCE

Apple Computer Inc. v. Mackintosh Compueters Ltd. (1990), 71 DLR (4th) 95
Entré Computer Centers Inc. v. The Queen, 97 DTC 846 (TCC – no appeal filed)
Grand Toys Ltd. v. M.N.R., 90 DTC 1059 (TCC)
Qualico Developments Ltd. v. The Queen, 84 DTC 6119
The Queen V. Farmparts Distributing Ltd., 80 DTC 6157 (FCA)
The Queen v. MCA Television Limited, 96 DTC 6411 (FCA)
The Queen v. Saint John Shipbuilding & Dry Dock Co. Ltd., 80 DTC 6272 (FCA)

CRA VIEWS

Interpretation Bulletin IT-303 – *Know-how and similar payments to non-residents*
Revenue Canada Outline Views document no. 5-3485 dated July 28, 1987
Revenue Canada Outline Views document no. 9230057 dated October 9, 1992
Revenue Canada Outline Views document no. 9410765 dated November 16, 1994
Revenue Canada Outline Views document no. 9419825 dated August 17,1 995
Revenue Canada Outline Views document no. 9621950 dated February 13, 1997
Revenue Canada Outline Views document no. January 1991-244

DOCTRINE

MURRAY, Kenneth J., "Computer Software: Canadian and Cross-Border Issues", *Report of Proceedings of Forty-Fifth Tax Conference* 1993 Tax Conference (Toronto: Canadian Tax Foundation, 1994) 27:1-41

(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,

(Reproduced as part of Appendix 21.)

This subparagraph also **broadens the pyramid** by dropping the requirement for a rent or royalty or that there be "property" conveyed. This answers to the issue in the pre-1968 caselaw.[61] This rule permits taxation of payments for know-how. According to Duncan Osborne (Appendix 2, page 431), it is anything which is "on paper", or in electronic form used in carrying on a business other than those specifically protected, such as patents.[62]

For the definitive court explanation of what is contemplated, see below in the next section, the review of case—*Hasbro—where the question should never have arisen*!

This rule imposes on such a Canadian outbound payment the same tax (25% on the gross) as would apply to a conventional outbound royalty or rental payment.

(iv) ITA subparagraph 212(1)(d)(iii)

---

[61] Is know-how property—yes, according to *Technical Tape* and *Western Electric*, but no according to *Quality Checkd*.

[See text below.]

As in the case of the first two subparagraphs, subparagraph (iii) **broadens the pyramid** by potentially imposing a tax where there clearly is no property being delivered to a Canadian payor and, therefore, cannot possibly meet the base definition of rent or royalty and, instead, involves the provision of services in consideration for fees which are subject to certain contingencies.

The legislative idea appears to be to impose a Part XIII tax on any transaction where the Canadian pays over some contingent portion of their revenue or profit to a non-resident in consideration for receiving something from that non-resident (whether it is the use of a property or whether it is the use of something that does not amount to property such as in subparagraph (ii), or whether it is something that simply doesn't entail property because it comprises a service—which, obviously, cannot be returned to the service provider once received and consumed). Subparagraph (iii) reads as follows:

> "…any payment (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
>
> > (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…"

Clear, straightforward, not susceptible to controversy of interpretation? Having regard to the portion of the provision that proceeds, one would think the answer is affirmative and all would

---

[62] For definitions of know-how, also see the *Rolls Royce* case, the OECD and IT 303 at para. 3. And then see the conflicting cases involving *Quality Checkd* at Osborne, page 432.

easily agree to as what type of actual transaction it would apply. But, not so, at least, in the eyes of CRA and the Tax Court of Canada, where regard is had to the convoluted journey one must take in working through this provision in the case of *Hasbro*. That case is a testament to the spectre of how reasonable tax policy can be the object of distortive thinking.[63]

To read *Hasbro* is to see ones future if the government does not follow the advice of those including TEI who have advocated that it scrap the 94, 94.1[64] and the section 68 component of the 56.4 proposals, or is to be reminded of the trials and tribulations visited upon the business and tax communities by the rules in, for example, section 55, 88(1), 95(6) and 247(2)(b), the latter dealt with below---namely the extremely frustrating dynamic of a good tax policy initiative run amok by overbroad legislation and the spectre of distortive interpretations by CRA.

Hasbro sees a situation (payments by a Canadian to a foreign sourcing agent for typical sourcing services respecting goods or products the Canadian wishes to purchase from foreign suppliers, which payments are computed in a typical way – namely a % of the cost to the Canadian of the goods sourced by the sourcing agent) which intuitively all would know was not to be the object of Canadian tax (under rules written for royalties paid to non residents) barely (as a result of the

63 Quite apart from the particular troublesome (and in this observer's unnecessary) court proceedings issue that arose in *Hasbro*, it is worth knowing that the court in that case clearly views *Farmparts* and *Saint John* as taking the position that a payment can be subject to tax under subparagraph (i), even though it does not have the characteristic of a rent or royalty. This is seen in paragraphs 16, 17 and 18 of the judgment - See Appendix 27.

64 See, *inter alia*, recommendations on this of the December 10, 2008 final report of the government's Advisory Panel on reform of Canada's international tax rules. See Nathan Boidman, "Reforming Canada's International Tax Regime: Final Recommendations, Part 1", *Tax Notes International*, Vol. 53, No. 3, January 19, 2009, at page 247 and Nathan Boidman, "Reforming Canada's International Tax Regime: Final Recommendations, Part 2", *Tax Notes International,* Vol. 53, No. 4, January 26, 2009, at page 345.

factors noted in the prior paragraph) escaping (pursuant to the decision of the Tax Court in that case)) that result (Canadian taxation).

Background. As noted at the outset of this section, Canadian companies may acquire inputs of many types, required for their businesses, from non residents. Some situations, in terms of Canadian tax effects for the NR, have been and are the object of relatively clear and logical tax policy and rules that implement such policy - clear, although.... (without regard to tax treaty) as to the non-resident's ultimate Canadian tax liability (or as to the absence of same) and of equal importance, as to any withholding tax obligations of the Canadian acquirer of the input (whether involving the delivery, by the NR, of services or of things - including corporeal and incorporeal, tangible and intangible) and in the latter case, whether the delivery involves mere use for a fixed term or more extended use - but calling short of delivering rights of ownership of ownership rights.

For example, a Canadian may wish to buy and resell a product, designed, made and branded by a NR who simply delivers the product, and an accompanying invoice. In concept (if not in application) this presents no problem in terms of tax results. Case law and/or section 253 will tell you whether the NR is carrying on business in Canada and if negative - no Canadian tax, and if positive - there may, depending upon a number of factors, be Canadian tax. And for the buyer, there is no withholding obligations -- or uncertainties in respect thereof.[65] And these results could well make sense.

---

[65] Note the relationship between inventory, the definition of taxable Canadian property and subsection 248(1) and Section 116.

In carrying on (in Canada, only) the latter simple business, the Canadian may require the temporary use of a particular piece of equipment or other thing and may lease it from a NR---who has no other dealings in or through Canada - for a fixed period at a fixed rent. Here the tax rules would operate clearly. Para (d) would impose tax, to be withheld by Canadian party. And the result makes sense.

Or the Canadian purchases a single copy of a copyrighted book dealing with some area of its business from a NR raising the exact same tax rules as applicable to the above noted purchase of goods for resale.

Or the Canadian procures a service from an unaffiliated non-resident in consideration of a fixed fee. Whether the service is performed in or out of Canada both the substantive and compliance/withholding obligation tax results are clear---both ARISING in the first case and none in the second case.

But where the Canadian requires access to and input from a NR in other areas the picture--tax policy and rules related thereto may (as we have already seen) become unclear, murky and difficult to identify and/or comply with--leading to disputes and litigation which, unfortunately, may not even serve to conclusively clarify the issue in question. That was seen in the *Saint John* case where the treaty solution saw left undecided whether sub (i) applies to a transaction having the particular features seen in that case--although the pronouncements of the courts in *Farmparts* (above) and *Hasbro* herein , below respecting the kernel issue (that sub (i) is need not be seen as constrained by the preamble) ostensibly provides that answer to *St John*. But that conclusion is not certain because (1) the FCA in *Saint John* came after the FCA in *Farmparts* but did not refer

to it and (2) the Tax Court's view on the issue in *Hasbro* was based on *Saint John* and *Farmparts*.

Aside from the latter uncertainty respecting the ambit of sub (i) – arising out of the 68 amendments (query Finance explanatory notes at that time?) what was their intended ambit respecting services dealt with in new sub (iii) that they enacted and how did that rule lead to the litigation in *Hasbro*? What does the rule say? (See above.) Why was it enacted? Is there a clear link between the first two factors? If yes, why was there any uncertainty respecting *Hasbro*? If there wasn't, was the *Hasbro* litigation inevitable or should that case's relevant transaction (given context and purpose) been so obviously outside the parameters of the provision that it should have never been raised as an issue by the Crown?

The rule was a added thought, or add-on, to the main response by the government to the question raised by the court's conflicting decisions in *Western Electric* (and *Technical Tape*) and in *Quality Checkd* as to whether contracts which saw NR make available to a Canadian access to special/secret business knowledge or information (collectively "know how") entailed a provision of use of property as would trigger Part XIII tax (pursuant to the pre-existing provisions of section 106 - which became section 212 in the post 71 tax reform Act). Section 106 (1)(d)(ii), added in 1968, which became sub paragraph 212(1)(d)(ii) of the post 71 Act, resolved that point and made clear that, in specified circumstances (involving contingent payments) such "know how" would be taxable--if it wasn't otherwise picked up under other aspects of the rules and (as held by the FCA in *Farmparts*, overruling the lower court) that new rule--if not applicable on its face (because, for example, the payment involved is not contingent) - did not preclude the application of the more general rule of sub (i), if it fit.

That add-on or added thought was that if Canadian tax should apply where a NR licences a proprietary intangible in consideration for a royalty-type payment or provides the use of know how in consideration for a royalty type payment (per the 1968 add of sub (ii)) then if the form by which a NR provides to a Canadian input respecting business knowledge, information and experience is by way of providing or performing a service (which could, of course also see the accompanying and ancillary provision of the use of know how or of property or other things) and the payment in respect thereof is to be comprised of the same (royalty-type) features as would characterize a payment that constitutes a royalty for the preamble or a payment to be taxed by reason of new sub (ii), that should also be taxed under Part XIII. Fair enough. The concept is simple enough and really clear.

What words were used to effectuate this goal? See above.

On its face this language would seem, in general terms, to capture the policy objective. And on its face there is no reason to think that the policy objective had in mind or intended to tax the sourcing payments that were made in *Hasbro*. Nor, on its face, would a quick reading of the actual language of subparagraph (iii) provide any suggestion or indication that that language could be read--literally or purely textually--to possibly apply to the sourcing arrangements in *Hasbro*.

But there are two elephants in the room. One is the "A" part of the dependency or contingency aspect of the rule. The second is the infinite capacity to see shadows that don't exist. In that context we see CRA taking this matter to court and only barely losing----when all logic (i.e. context and purpose) tell us the matter should never have been in court and, if in court, it shouldn't even have been close.

As to the exact sourcing arrangements in *Hasbro*---see Appendix 27. The key is that the payments were required to be made once and as soon as the service had been completely rendered without regard to whether *Hasbro* ever made a sale of the goods sourced or made a profit from any sales that did ensue---although it is true that the sourcing agent might have expended effort and never be paid if *Hasbro* had decided not to purchase goods pursuant to the agent's efforts.

BUT the scheme of the provision clearly contemplates a totally different relationship between the service and the payment in respect thereof----namely that FIRST the service is completely rendered and then one waits to see what revenue or profit the payer generates from having received that service in order to measure and determine whether there is a fee to be paid or whether some part of the fee is to be paid. So why was this decision so difficult for the Tax Court to make and why did it even come close to going the other way, and indeed why did it have to be decided on an exception (involving services related to a sale of goods) to the rule?

Was (is) the problem the drafting of the rule or, instead, the Tax Court's approach and appreciation of the rule or a bit (a combination) of both?

Let's review the key elements of the judgment.

But first a couple of side bars. First, as a matter of the facts and the issue, paragraphs 11 and 12 of the agreed statement of facts (paragraph 4 of the judgment) and paragraph 4 and 10 of an exhibit (paragraph 6 of the judgment) contain conflicting facts as to the relationship between the Canadian, the agent and the suppliers (manufacturers), suggesting in part that it was agency - as gave rise to the issue - and in other part that it was principal to principal (which logically would have seen all the payments made by Canadian constituting price paid for product, which would

have eliminated any possible applicability of Part XIII). However, this does not appear to have been raised by the taxpayer or the Court.

Second, if the Crown was right, wouldn't that have made it redundant to have enacted, in 1994, the paragraph 95(2)(a.1) component of FAPI--for foreign related party sourcing activity? That was also not raised by the taxpayer or the Court.

The court starts off dismissing any claim that the payments were straight rent or royalty. Why was that necessary?

Reference is made to a favourite source of the courts on the meaning of royalty--*Vauban* and then to *Grand Toy* and the court then lends its own take on a definition, in paragraph 22,

> "22. A royalty or similar payment is therefore one made for the use of property, rights or information whereby the payments for such use are contingent upon the extent or duration of use, profits or sales by the user."

And then in paragraph 23, the court comes to the (unnecessary) conclusion that payments to the agent weren't royalties or similar payment.

And then --after a lengthy discussion of the ambit of object of sub ii, (which the court concludes is know how) including an interesting analysis of the 1968 legislative intent by reference to OECD (see paragraph 24 to 31), the court rightly and obviously rejects the (unsupportable) notion that agent was supplying sub ii information as opposed to merely providing a service (and in so doing the agent was (itself) utilizing its know how)---see paragraph 34.[66]

---

[66] See fn 7 in Osborne (Appendix 2).

> "34. More to the point, in my view, the information provided to the appellant by its purchasing agents concerning negotiations with manufacturers, price quotations, delivery schedules, shipment arrangements, etc. does not constitute know-how imparted to the appellant. This is specific information concerning the details of commercial transactions between parties situated in different countries, effected through an intermediary, nothing more. Moreover, while the agreement does say that HFE would provide "up-to-date market research and information..." and would "investigate ... activities in the Far East which relate to Hasbro Canada or which might provide additional business opportunities for Hasbro Canada ...", it is doubtful whether such information could ever be considered know-how. Finally, I must point out that the evidence presented at trial indicates that no such information was actually transferred to Hasbro. The May 12, 1995 letter from Hasbro to Mr. Daniel Anctil of Revenue Canada and the testimony given by Mr. Stark both make it clear that the purchasing agents provided services almost exclusively in the nature of arranging and supervising purchasing orders. If, indeed, the purchasing agents had a certain level of expertise and experience it would seem that they used their knowledge themselves in providing the various services to Hasbro. In my opinion, subparagraph 212(1)(*d*)(ii) simply has no application in the present case."

The taxpayer argued that sub(iii) should be restricted to "technical services" or "...services analogous to intellectual property". But such limited scope is not apparent in the language and nor required by the tax policy objective. And that was the finding by the Judge.[67] It could be argued that this was nothing more than a textual interpretation where the court (as is generally the case) is reluctant to easily depart to a contextual or purposive interpretation).

It was also argued (rightly) that sub iii required "…payments computed in a manner substantially similar to royalty payments." But the analysis gets grounded in the actual language and the court accepts what would appear to be the untenable notion that the reference point for dependency could (arguably) be <u>to the sales or profits of a person other than the payer</u>. <u>That cannot be right.</u> Though this seems to be totally without merit, it is a possibility that the court not only sees BUT

67 The judge concluded that, after taking into account a number of factors in favour of the taxpayer's position. See paragraphs 35-42 of the judgment (Appendix 27)]--bearing in mind how earlier in the piece the Judge relied on OECD in defining the scope of sub (ii)--and query there the use of subsequent Commentary. But

WHICH prevents the court from disposing of the case on the basis (which its finds in paragraph 43) that the payments by *Hasbro* clearly did not invoke clauses A, B or C in relation to its own affairs. This debate must be seen in the words of the court itself, as set out in paragraph 43 and paragraph 44 --which read as follows.

> "43. However, it is less clear whether the payments from **Hasbro** to its purchasing agents satisfy any of the criteria enumerated in clauses 212(1)(*d*)(iii)(A) through (C). These clauses require that the total amount payable to the non-resident provider of the services be dependent to some extent on the "use to be made of or the benefit to be derived from, those services" on "production or sales of goods or services" or on "profits". One interpretation of that condition is that the use or benefit, production or sales or profits referred to in these clauses should only cover those of the payer and not those of any other party. If I adhere to this interpretation of clauses 212(1)(*d*)(iii)(A) through (C), then the appeals must succeed because the payments from Hasbro to its purchasing agents were not dependent in whole or in part on the use, benefit, production, sales or profits of Hasbro. However, one problem is that this interpretation requires that I effectively read the phrase "by the payer" into these clauses. In his arguments on the phrase "in connection with the sale of property", as found in the postamble of subparagraph 212(1)(*d*)(iii), counsel for the appellant referred to the rule of statutory interpretation which mitigates against reading in extra words or phrases where a reasonable interpretation could be had without them (See *Friesen v. R.* (1995), 95 D.T.C. 5551 (S.C.C.) at page 5556; *R. v. Pongrantz* (1982), 82 D.T.C. 6200 (Fed. C.A.) at page 6203). The same should also hold true here. However, I do not think it is necessary to reach a definite conclusion on that question because even if I assume that the terms of clauses 212(1)(*d*)(iii)(A) through (C) apply to third parties that would not change the final outcome of this case because of the exclusion in the postamble of subparagraph 212(1)(*d*)(iii). While I am of the opinion that the use, benefit, production, sales and profits referred to in clauses 212(1)(*d*)(iii)(A) through (C) were intended to refer primarily to those of the payer, I recognize that it is not an unreasonable interpretation that they can sometimes refer to the use, benefit, production, sales or profits of third parties. In the present case, the phrase "dependent ... on ... sales of goods" could thus, as argued by counsel for the respondent, include payments which are dependent on the sales of goods by third parties, like the sales by the manufacturers to Hasbro . Assuming this is so, it must be decided whether or not these payments are excluded by the postamble of subparagraph 212(1)(*d*)(iii)."

---

here, for sub iii, there was no OECD material that could serve as a reference point for what Finance Minister Benson had in mind in 1968.

> 44. Counsel for the appellant submitted that the phrase "in connection with" as found in the postamble of subparagraph 212(1)(*d*)(iii) should be interpreted broadly and similar in scope to a phrase like "having to do with". According to a decision of the British Columbia Supreme Court referred to by the appellant, *Nanaimo Community Hotel Ltd. v. British Columbia (Board of Referees appointed under Excess Profits Tax Act, 1940)*, [1944] 4 D.L.R. 638 (B.C. S.C.) at page 639, "the words would include matters occurring prior to as well as subsequent to or consequent upon, so long as they are related to the principal thing". To the same effect one can also refer to *Hutchinson v. Berridge* (1922), 18 Alta. L.R. 121, 66 D.L.R. 753 (Alta. C.A.); *I.G.T.C. Ltd. v. Minister of National Revenue* (1982), 82 D.T.C. 1581, [1982] C.T.C. 2570 (T.R.B.)."

As a result of the latter findings and factors (and the failure of anybody to raise the two notions ("side-bar") discussed above), the case came down to that is was left to be resolved on the basis of whether the exclusionary postable applied to save the day for the taxpayer. And here, again, what seemingly should have been seen as a slam dunk for the taxpayer turned into a cliffhanger, with the taxpayer barely prevailing.

The first issue discussed is the scope of the triggering words "in connection with"--which the court concludes would cover the issue before the court (that is the services related to a sale of goods or negotiation of a contract)(paragraph 44 and 45).

End of case? Not quite! The Crown (to its continuing discredit in this case) argues two blocks to the conclusion. The exception, CRA argues, only applies to sale of goods by a Canadian--not to a purchase of goods. The court struggles with that for almost half of page in its judgment (paragraph 46) before (with the assistance of the Quebec Civil Code) rejecting it. The role of the Civil Code - in the words of the court -- was as follows.

> "The word "sale" and not 'purchase' is the generic term used in article 1708 of the Civil Code of Québec to describe the contract "by which a person, the seller, transfers ownership of property to another person, the buyer, for a price in money which the latter obligates himself to pay"."

Had the Crown prevailed on the latter argument, it then would have been relevant that it also argued that the other exception--for payments for services of negotiations of a contract--was not applicable because here such services were only incidental. On this the Court found that "an important part of the services performed by these purchasing agents was 'performed in connection with...the negotiation of a contract'...."And since the Crown did no allocations, and as established by the “bundling cases” – *Farmparts*. (*Grand Toy* - not noted), *Quality* and *Brad-Lea* if the Crown does not allocate , then no part of a Part XIII claim can stand. That would also have killed the Crown's claim.

All in all, a case that should have never been taken to court by the Crown, but yet where it could be said to have barely lost.

Finally, to further underscore the problem with that case, the Crown makes the following incomprehensible claim. The taxpayer is "...using the information provided by the agents and is paying for their expertise when it purchases from the foreign manufacturers."[68] The Court rightly, summarily, rejects this on the basis that it is the sourcing agent that was that in exercising its skill to provide the services.

<u>Other Points to Note</u>

In the U.S., the court rejected the notion that “royalties” can arise from providing a service. That was the case of the German conductor, Pierre Boulez (*Boulez v. Commissioner*, 83 T.C. 584

---

[68] In support of that inexplicable statement the Crown cites *United Geophysical*, 61 DTC 1099, *Warsh*, 62 DTC 247, *Burland,* 68 DTC 5220 (SCC), *Western Electric*, 69 DTC 5204 (excerpt) affirmed by SCC, 71 DTC 5068 and *TechTape*, 64 DTC 428).

(1984)), which saw him conduct an orchestra for the preparation of recordings to be owned and sold by the production company that engaged him. The fees paid to him included a percentage (royalty) of future sales of the recordings.

The taxpayer said that the payments were "royalties" for treaty purposes, and therefore exempt from U.S. tax. The U.S. and the U.S. court took the position that the payments were for services performed in the U.S. The point is that the Court concluded that to have "royalties", one must be providing use of a property and in this case, Boulez was simply providing a service and therefore the word "royalties" does not go with the performance of services.[69]

If services are picked up under subparagraph (iii), but the services were performed in Canada, how do we reconcile between Part I and Part XIII? See related threshold comments above.

To the extent, as discussed further below in the section dealing with the effect of treaties—there would be differing tax effects as between a contingent payment for know-how and a contingent payment for services—care obviously should be taken to not unnecessarily confuse the former for the latter.[70]

---

[69] For other discussions on this point, see (a) section 125 case discussed above. See also OECD Article 12 and the OECD list of 28 e-commerce type of transactions. See also Duncan (Appendix 2).

[70] This point is focused by Jinyan Li , *supra*, (pg. 147) who goes to some length to cite in her footnote 117 an article on point by Scott L. Scheuermann, (1991) 43 Can. Tax Found. 45:1-45:69; *Canadian Current Law*, Issue 9208. "Income and commodity tax aspects of acquiring and exploiting technology. Ms. Li also makes the excellent point at pg. 147 and footnote 118 that paper documents created by a professional service provider in the course of providing his/her services should not be confused with the provision of know-how. She points for example to plans that a consulting engineer might prepare in the course of providing professional engineering services.

(v) ITA subparagraph 212(1)(d)(iv)

(See text below.)

As in the case of the first three subparagraphs, subparagraph (iv) **broadens the pyramid** but in a fashion totally unrelated to the dynamic involving the base rule and the first three subparagraphs that follow. Here, the legislator decided to tax not what a non-resident receives for conveying to a Canadian, in any positive sense of making property available for use or proving a service, but rather what a non-resident promises not to do in consideration for a payment from a Canadian. In other words, a payment one might normally associate with the notion of not competing. And in this context, this rule not only is seen by CRA as applying to non-compete agreement[71], but by reason of the government's overbroad proposed section 56.4 initiative to counter the decisions in *Fortino*, 97 DTC 55, [1997] 2 C.T.C. 2184, and *Manrell*, 2002 DTC 1222, [2002] 1 C.T.C. 2543 (set out in Bill C-10 which of course has now gone to its grave) there was to be coordinating and expansive changes to Part XIII with a coordinating change to be made to subparagraph (iv). More on this below.

The provision before the amendment reads as follows:

> "...any payment (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 anything referred to in subparagraph (i) or any information referred to in subparagraph (ii)..."

---

[71] View: 2003-004435IE5 – March 24, 2004, in which CRA expresses the technical interpretation that a non-compete falls under this rule. See Michael Kandev (Appendix 38) at footnote 25, which refers to related comments by the Dept. of Finance at the May 2006 Canadian IFA Branch Annual Seminar to the effect that CRA's March 2004 interpretation is a long-standing view of the Government.

Bill C-10 would have amended the latter by carving out payments which would be subject to the proposed addition of new paragraph 212(1)(i) which imports the section 56.4 restrictive covenant proposals of Part I into Part XIII—and which is discussed in a separate section below.

The main characteristic of the present rule is that the restrictive covenants must relate to something that would otherwise have been taxed under subparagraphs (i) and (ii) had a non-resident provided the things or matters set out therein. There is no evidence of this rule before the courts, although query whether it could have been involved in *Grand Toy* or *Farmparts* respecting distributorships.[72]

(vi) ITA subparagraph 212(1)(d)(v)

Having regard to the prior discussions respecting paragraph 12(1)(g) involving a contingent price where there is a total alienation of something, the rule in subparagraph (v) will be familiar as simply be an extension of the domestic rule to the cross-border context. In particular, subparagraph (v) reads as follows—mirroring the language of paragraph 12(1)(g)--:

> "...any payment (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 is virtually no difference between the domestic provision and this provision. But there is one potential issue raised by the "……..in Canada……." words. How does the rule apply where,

---

72 See discussion by Duncan Osborne – Appendix 2.

for example, a patent is involved, the Canadian acquirer uses it to manufacture a widget in Canada, but sells the widget through a foreign selling branch and the contingent payment is linked to the sales prices realized?

(vii) Surrogatum Principle – "In Lieu of Payment"

The main substantive rules of Part XIII see a 25% tax imposed on a payment by an actual or deemed Canadian resident to a non-resident which is a straight item of the stipulated type of thing (e.g. interest on royalties, etc.). The main notion relates to straightforward items – that is - for example - a payment of an item of interest, as is required and provided in an agreement respecting a loan by a non-resident to a Canadian. The more rare and obscure notion is the payment which is not – straightforward – of interest owing by the Canadian to the non resident, but rather a payment which is "in lieu" of interest (otherwise owing).

The preamble of subsection 212(1) reads as follows:

> **212.**
>
> **(1) Tax** -- 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 payment of, or in satisfaction of,

What is the ambit and parameters of this notion – in general, and more specifically, here, in relation to royalties? As a threshold observation or question – given the pyramid nature of paragraph 212(1)(d) – as discussed above – which entails a type of "in lieu of" set of rules (by rendering payments which are not "rents" or "royalties" to the same tax burden as they were), do we really need any further expansion of the ambit of Part XIII by way of these introductory words? How much broader can paragraph 212(1)(d) be?

Cases dealing with the *surrogatum* principle and royalties: in *Bourgault Industries Ltd. v. Canada*, [2006] T.C.J. No. 350 (T.C.C. - affirmed by the Federal Court of Appeal, [2007] F.C.J. No. 1594), a lump sum payment of $6 million as a settlement amount in respect of two patent infringement actions were held to compensate the taxpayers for royalties that would have constituted income had the payment been consensual. [This is not a Part XIII case.]

In *Transocean Offshore Ltd. v. Canada*, [2005] F.C.J. No. 496 (F.C.A.), a payment of over $49 million made as consideration for the voluntary termination of a lease agreement under which **rent** would have been payable for the use in Canada of an offshore drilling rig by a consortium of oil companies was viewed as damages paid to the taxpayer to compensate for rent that would otherwise have been payable. Such payment was held to be "as, on account of, or in lieu of payment or in satisfaction of rent or a similar payment for the use of, or right to the use of a property in Canada" under paragraph 212(1)(d) of the Act. See Appendix 24 for relevant excerpts from *Transocean.*

(viii) The proposed section 56.4 in the cross-Border (Part XIII) context

As is well known, the Government's reaction, referred to earlier, to the decisions in *Fortino* (*supra*) and *Manrell* (*supra*), namely the proposed "restrictive covenant" rules of proposed section 56.4 would, if enacted, be extended to the cross-border context through two inter-related additions to Part XIII and one modification. As also noted earlier, the current rules of Part XIII already have a form of restrictive covenant rule set out in subparagraph 212(1)(b)(iv). It was also noted in discussing the latter rule, that there is a question as to whether it could apply to

payments made for the right to be a distributor in Canada, particularly if the right is exclusive.[73] However, given the clear finding by the Federal Court of Appeal in *Farmparts* that when a Canadian purchases a product or thing for resale that person (e.g. a distributor) is not making "use" of the product or thing bought for resale and therefore on the face of the language in subparagraph (iv), it should not apply to a payment made for even an exclusive distributorship.

As relatively narrow as the present subparagraph (iv) could be considered to be, is as relatively wide, unwieldy, amorphous, unfocused, untargeted and ill-defined is the proposed rule. In particular, the underlying definition of a restrictive covenant, in section 56.4, which is imported into Part XIII, reads in material part as follows:

> "...an agreement... (or)...an undertaking...by the taxpayer...that affects, or is intended to affect, in any way whatever, the acquisition or provision of property or services by the taxpayer or by another taxpayer that does not deal at arm's length with the taxpayer."

Proposed paragraph 212(1)(i) will impose Part XIII tax on an amount paid to a non-resident by either a Canadian resident or a deemed Canadian resident if that amount were:

> "...an amount that would, if the non-resident person had been resident in Canada throughout the taxation year in which the amount was received or is receivable, be required by paragraph 56(1)(n) or subsection 56.4(2) to be included in computing the non-resident person's income for the taxation year."

And as noted, this obligation can arise where a payment is made by a deemed Canadian resident which can include either a non-resident directly carrying on business in Canada [under current or proposed revised subsection 212(13.2)] or under a proposed addition, to subsection 212(13), of new paragraph (g), a situation where a payment is made by a non-resident of "an amount to

---

73 See Duncan Osborne – Appendix 2 – respecting *Farmparts* and *Grand Toy*.

which paragraph 212(1)(i) applies if that amount affects, or is intended to affect, in any way, whatever,

> (i) the acquisition or provision of property or services in Canada.
>
> (ii) the acquisition or provision of property or services outside Canada by a person resident in Canada, or
>
> (iii) the acquisition or provision outside Canada of a taxable Canadian property."

The main interest of these proposals in the context of this lecture is whether having regard to the question already posed under existing subparagraph 212(1)(d)(iv), with respect to payments for rights to distribute, this new rule would (if the current rules does not apply) pick up such payments. On the assumption that the distributorship arrangement is exclusive so that the foreign party in the course of granting the right to distribute undertakes to not grant that right to any other party, at first blush payments made for such rights would seem to be swept up in this new elephant-gun-to-shoot-a-mouse (with acknowledgements to Arnold Sherman) proposed legislation. But given that the principal effect of a distributorship is to give a Canadian a right to do something (that is what the Canadian is paying for) and as a matter of business exigencies that could see the foreign party not having an interest in granting the same right to any other Canadian, should it apply? Clearly, there is nothing in the principles underlying current paragraph 212(1)(d) that would seek to impose a tax on a payment <u>to receive the right to do something</u>. The current version of this type of rule in subparagraph (iv) could, as already noted,

arguably also apply to a distributorship and if that were found to be the case, then I suggest that that rule would be overreaching.[74]

(ix) The "pays or credits" factor

(See discussion in Section III, B.)

(x) Exemptions and special cases under paragraph 212(1)(d)[75]

Subparagraphs (vi) and (xii) of paragraph 212(1)(d) *inverts* the pyramid, by exempting payments otherwise payable as rents or royalties.[76] These include payments for rights to reproduce copyright, cost-sharing, if related to foreign business undertakings or foreign tangible property, etc.

a) Copyright – Implications for *Saint John Shipbuilding*

Subparagraph 212(1)(d)(vi) provides an exemption for royalties paid for the right to reproduce property protected by copyright law. One would naturally think of a book in this category or a recorded product or a video product. In addition, pursuant to a Supreme Court decision involving Apple Computer, the *Copyright Act* was amended to specifically protect interests of the creators of computer software.[77] Accordingly, a Canadian who is granted the right to

---

[74] For a detailed discussion of these proposed rules, both in a domestic and a cross-border context and in relation to this issue of distributors, see an article by Michael Kandev, – Appendix 38. Of particular interest is Kandev's comments on the potential reach of these rules to a situation where a foreign party grants a distributorship to another foreign party involving distribution rights that extend to Canada and the manner in which proposed paragraph 212(13)(g) can operate.

[75] Duncan (Appendix 2) discusses exemptions at page 416 and F/N 38 and related text.

[76] Do they also affect (i) – (v)?

[77] See section 2 of the *Copyright Act* which defines a computer programme and section 3 which provides the protection for the creator and owner of the programme. This is by way of extension of the notion of "literary work" to include computer programmes.

reproduce and then sell a computer programme can pay a royalty in respect thereof to the foreign licensor without Part XIII tax.[78]

However, this exemption does not, on its face, have any applicability to a Canadian who pays a royalty for the mere use of a computer programme.[79] Where the matter is uncertain (as examined above involving Canadian distributors of computer programmes) is where the Canadian payor is neither a user nor in literal terms a reproducer, but rather (like tomatoes) buys and sells, purchasing from the foreign programme developer and selling to a Canadian end user. As explained above, CRA takes the position that the "purchase" price for software paid by the distributor to the non-resident may be an amount subject to subparagraph (i). This would be the case in CRA's view where the basic rights delivered to the end user are comparable to those in *Saint John Shipbuilding*, namely the right to use in perpetuity but not the right to resell or reassign. But at the same time CRA takes the position that the Canadian distributor, although not in fact a user in any real sense of the word (thus putting into question how subparagraph (i) can apply), cannot look to subparagraph (vi) and consider her/him or itself to constructively be reproducing the software so that if the payment does come within section 212 because of subparagraph (i) it would be exempted by subparagraph (vi).[80]

---

78 This was upheld with respect to computer software in two decisions of the Tax Court of Canada. See *Angoss International Ltd.* [1999] 2 CTC in 2259 (TCC) and *Syspro Software Ltd.* [2003] 4 CTC 3001 (TCC). The notion as explained by CRA in Views document 2002-0147545.

79 See, for example, CRA at the 1988 Revenue Canada Round Table, Canadian Tax Foundation Conference Report, question 41, page 53:89-90 and the 1993 Conference Report, question 29, page 58:15.

80 See note 60.

Bear in mind, however, that the latter exposure (which is not complete, as explained above with respect to *Saint John Shipbuilding*) only arises where the software involved and the contracts for its conveyance do not either (1) comprise in contractual fact complete sales and alienations or (2) came within CRA's administrative made safe harbour for "shrink wrap" software as discussed and explained elsewhere herein.[81]

The distinction being made here can, in fact, be slippery and can evolve from misconceptions of what has taken place in the market. For example, it seems quite clear that CRA's views on pre-packaged software or "shrink wrap" (and their view that they were providing an administration exception to what they perceive to be law made in *Saint John Shipbuilding*) was based on the notion that all software including that sold in "shrink wrap" format contained a restrictive license which precluded a resale. But that, in fact, is not true, a point that I had to myself determine in dealing with a particular client matter, I went to the Eaton Centre in downtown Montréal and purchased for no more than $25 a package of Microsoft software. I opened the package and found a piece of paper that told me I shouldn't dare try to copy or reverse engineer or reproduce what was on the CD inside the package but that, as in the case of any book one would buy, I had the right to resale the package I had purchased and its contents to anybody I so chose. In other words, this was a total alienation, at least from the standpoint of me as the purchaser, and, therefore, had I paid the price directly to Microsoft U.S. or whichever Canadian had paid Microsoft U.S. would not have a payment that would be subject to tax under Part XIII.

---

[81] For CRA's various views on so-called "shrink wrap", see note 60 above as well as Revenue Canada Round Table Canadian Tax Foundation Conference Report 1994 at page 24:49-50, Technical Interpretation 2003-0016791E5, Technical Interpretation 9425035 December 15, 2994, Technical Interpretation 9502165 April 26, 1995. And see Appendix 28 and 29.

It is only where the license purports or operates in one way or another to preclude a resale by the "purchaser" that the potential issue raised by *Saint John Shipbuilding* arises and it is here where a distributor "purchasing" for "on sale" would wish to either assert before a court that there is no use being made that may trigger subparagraph (i) or if that could be considered applicable then there is a constructive reproduction taking place for purposes of subparagraph (vi).

All of this is potentially quite relevant to and, therefore, a segue to the discussions below respecting royalties and e-commerce.[82]

[82] [Note that the following comments are substantially similar to those made above or below. But in each case they add context to the separate matter under discussion.] In retrospect a point to bear in mind:- nowhere does subparagraph (i) or paragraph (d) contain the notion of the differentiating role of a "sale" or "alienation". The only word used is "used" or "use". How do we isolate those circumstances where the word "used" or "use" has been triggered for purposes of these provisions? Obviously it is not when there is a total sale or alienation even though that brings with it the right to use at the other extreme where the property must be returned, it is most appropriate to use the term although as we know from our examination of the pyramid that in that case we never really get to subparagraph (i) because we should have something which is either a straight rent or a straight royalty for purposes of the base rule in paragraph (d). The situation which is not been very fully parsed and decided although it almost was in *Saint John Shipbuilding* is the hybrid situation where a person is given the right to use in perpetuity but not the right to resell. This is clearly more than a mere use one would think of in examining the word but less than the use that goes together with all other rights where there is a total conveyance of the property in a "alienation" or "sale". The Federal Court of Appeal in *Saint John* added in their discretion to fully pronounced on this point but punted by deciding to dispose of the case by reference to the 1942 Canada-U.S. Treaty. It cannot be really said that this specific matter has been decided by the statement of principle in *Farmparts* or *Hasbro* that payment can be subject to tax under subparagraph (i) even though it does not have the character of a rent or a royalty. There are too many ways in which courts can parse or distinguish matters to make that weak claim and we already a curiosity, as already noted, that the Federal Court of Appeal in *Saint John* in handing down their decision six months after the Federal Court of Appeal in *Farmparts* and did not even refer to the principle made in *Farmparts* as would have easily provided the basis for the Federal Court of Appeal in *Saint John* to conclude in favour of the government's position under subparagraph (i) although it would have remained for the taxpayer would have won by reason that the Treaty would have prompted the Act. In considering the distinction, reference can usefully be had to the U.K. cases on related points as discussed elsewhere herein. Perhaps there is an approach to be adopted by the legislation or by CRA which is to look at the word "use" distinguish the three ways in which the word can arise (in the most normal straight forward sense, at the other extreme in a sale or alienation and the hybrid where the use comes with the first but less than the second and makes a specific determination as to which of these three cases the rule is to apply but logic says that it cannot apply in the second case in any type of analysis, however, logic also says that there is a policy case to be made to the proposition that it should also not apply in the third or hybrid situation.

b) Special rules for films, etc.

Review the cases of *M.N.R. v. Paris Canada Films Limited*, 62 DTC 1338 (Ex C.R.) and *Vauban*, 75 D.C. 5371.[83]

(x) Franchising

Issues concerning royalties in the context of franchising is special indeed if for no other reason than (or in a sense that) nowhere in Part XIII is the word used. But notwithstanding the latter, it took a front stage position in the reformulation of Article 12 of the Canada-U.S. Treaty in the third (1995) protocol which imported the exemption for, *inter alia*, software royalties and patent royalties. This Treaty factor is examined below.[84]

---

83 See Technical Interpretation 2006-017937117 involving the purchase of a script to make a motion picture which apparently was not viewed as coming within paragraph 212(1)(d) – why should it have been in the case of a total purchase? – and not yet amounting to a film could not be the subject of subsection 212(5)? See also Technical Interpretation 2006-0196191C6 where CRA indicated that payments for the right to broadcast artistic works likely were subject to subparagraph (i) (what reasoning). Similarly, a 2003 Technical Interpretation, 2003-0018975 considered that the exemption in subparagraph (vi) would not apply to payments made by a bar owner to receive a satellite radio feed which it tend displayed to its customers on its own TV screens.

84 The term "franchise agreement" is used in clause 3 of Art XII. Royalties are generally under clause 2 subject to withholding at source. However, clause 3 provides certain exceptions, including "payments for the use of, or the right to use, any patent or any information concerning industrial, commercial or scientific experience (but not including any such information provided in connection with a rental or franchise agreement)".

The Technical Explanation [1995 Protocol] provides as follows:

> "The exemption granted under subparagraph 3(c) does not, however, extend to payments made for information concerning industrial, commercial, or scientific experience that is provided in connection with a rental or franchise agreement. For this purpose, the negotiators agreed that a franchise is to be distinguished from other arrangements resulting in the transfer of intangible property. They agreed that a license to use intangibles (whether or not including a trademark) in a territory, in and of itself, would not constitute a franchise agreement for purposes of subparagraph 3(c) in the absence of other rights and obligations in the license agreement or in any other agreement that would indicate that the arrangement in its totality constituted a franchise agreement. For example, a resident of one Contracting State may acquire a right to use a secret formula to manufacture a particular product (e.g., a perfume), together with the right to use a trademark for that product and to market it at a non-retail level, in the other Contracting State.

The word and notion of franchising does appear in certain context in Part I of the Act and the regulations made thereto.[85]

> Such an arrangement would not constitute a franchise in the absence of any other rights or obligations under that arrangement or any other agreement that would indicate that the arrangement in its totality constituted a franchise agreement. Therefore, the royalty payment under that arrangement would be exempt from withholding tax in the other Contracting State to the extent made for the use of, or the right to use, the secret formula or other information concerning industrial, commercial, or scientific experience; however, it would be subject to withholding tax at a rate of 10 percent, to the extent made for the use of, or the right to use, the trademark."

There is, however, no further guidance on what constitutes a franchise agreement, nor is this provision reproduced in the OECD model. The term would have to be defined in accordance with the domestic law of Canada (assuming Canada was applying the Convention), which definition may not necessarily be consistent between Quebec and the common law provinces.

Note that Fifth Protocol Annex B (diplomatic notes, Sept. 21, 2007), agreed to form an "integral part of the Convention", states:

> "8. Royalties -- information in connection with franchise agreement
>
> It is understood that the reference in subparagraph 3(c) of Article XII (Royalties) of the Convention to information provided in connection with a franchise agreement shall generally refer only to information that governs or otherwise deals with the operation (whether by the payer or by another person) of the franchise, and not to other information concerning industrial, commercial or scientific experience that is held for resale or license."

[85] The term "franchise" is used in a few sections of the ITA (and the Regs), such as s. 20(1)(cc), which allows a deduction for "an amount paid by the taxpayer in the year as or on account of expenses incurred by the taxpayer in making any representation relating to a business carried on by the taxpayer to the government of a country [...] including any representation for the purpose of obtaining a [...] franchise [...]", and s. 256(5.1), which provides that a corporation shall not be considered to be controlled (by reason of the agreement alone) "where the corporation and the controller are dealing with each other at arm's length and the influence is derived from a franchise [...], the main purpose of which is to govern the relationship between the corporation and the controller".

As to the meaning of the term "franchise", in IT-477, the CRA indicates (in reference to Class 14 property) that:

> "11. The words " franchise , concession or licence", are not capable of easy definition. Generally, they must be given the meaning or sense in which they are normally employed by businessmen on his continent and they extend, not only to certain kinds of rights, privileges or monopolies conferred by or pursuant to legislation or by governmental authority, but also to analogous rights, privileges or authorities created by contract between private parties. Again, generally, these words are used to refer to some right, privilege or monopoly that enables the holder to carry on his business or earn income from property, or that facilitates the carrying on of his business or the earning of income from property. These words do not extend to a contract under which a person is entitled to remuneration for the performance of specified services, nor to a covenant not to compete for a limited period."

Frank Zaid, in Franchising Law, writes that:

Given the uncertain nature of the meaning of the term or notion, franchise (see two prior notes) what significance is there to the cryptic comment by the Federal Court of Appeal in *Farmparts* at the tail end of its judgment (where, as detailed above, it concluded that no Part XIII tax applied even though elements of a bundle contract would separately trigger Part XIII tax, because the Crown failed to allocate the fixed amounts paid as between their components) that the amounts

---

> "Franchising is fundamentally a form of business investment and ownership governing the distribution and sale of goods or services. In a franchise, the franchisor typically develops a business system, in association with a trade-mark, and licenses the use of that system to a franchisee, for a period of time. The franchisee is required to conform to the standards of the system and to pay consideration to the franchisor, usually as a combination of an initial fee and ongoing payments in the nature of royalties based on gross sales of the products and services associated with the franchise system."

Moreover, certain provinces, such as Alberta and Ontario, have specific legislation dealing with franchises. The Ontario Arthur Wishart Act (Franchise Disclosure), 2000, defines "franchise" as follows:

> "franchise" means a right to engage in a business where the franchisee is required by contract or otherwise to make a payment or continuing payments, whether direct or indirect, or a commitment to make such payment or payments, to the franchisor, or the franchisor's associate, in the course of operating the business or as a condition of acquiring the franchise or commencing operations and,
>
> (a) in which,
>
> (i) the franchisor grants the franchisee the right to sell, offer for sale or distribute goods or services that are substantially associated with the franchisor's, or the franchisor's associate's, trade-mark, service mark, trade name, logo or advertising or other commercial symbol, and
>
> (ii) the franchisor or the franchisor's associate exercises significant control over, or offers significant assistance in, the franchisee's method of operation, including building design and furnishings, locations, business organization, marketing techniques or training, or
>
> (b) in which,
>
> (i) the franchisor, or the franchisor's associate, grants the franchisee the representational or distribution rights, whether or not a trade-mark, service mark, trade name, logo or advertising or other commercial symbol is involved, to sell, offer for sale or distribute goods or services supplied by the franchisor or a supplier designated by the franchisor, and
>
> (ii) the franchisor, or the franchisor's associate, or a third person designated by the franchisor, provides location assistance, including securing retail outlets or accounts for the goods or services to be sold, offered for sale or distributed or securing locations or sites for vending machines, display racks or other product sales displays used by the franchisee;

paid could not be considered to be franchise fees. What if they were franchise fees? Nothing in Part XIII refers to franchise fees. Curious indeed![86]

There has been one case, *Zianul* and *Shazma Holdings Ltd.,* 2004 DTC 3015, [2004 TCC 527], [2005] 3 CTC 2140 (TCC) which dealt with a preliminary aspect of a franchising situation, namely whether Part III tax applied to a fee paid by a potential Canadian franchisee to a potential non-resident franchisor to compensation the latter for reviewing the qualifications of the Canadian for the grant of a franchise. The court found that paragraph 212(1)(d) did not apply.[87]

(xi) Other Matters

Although Ontario's separate corporation tax act is being harmonized with the federal act and administered by CRA, query whether that little known but potentially troublesome "extra 5%" effective withholding tax by way of disallowance of deductions under section 11(5) – (8) in respect of non-arm's length royalty and certain other payments to non-residents based in non-treaty countries still has any life?

Beyond the scope of this lecture are the rules in paragraph 212(1)(e) respecting "timber royalty" and paragraph 212(9)(b) respecting "exempt royalty trusts".

---

86 An examination of the lower court (FCTD) decision in *Farmparts* does not shed light on this aspect of the case.

87 See also CRA Views in Technical Interpretation 2007-0253321E5. And, separately, reference can be had to the decision in *Entré Computer*, *supra*, note 60, where CRA unsuccessfully tried to tax under Part XIII amounts that the court found were part of payments that a Canadian franchisor-distributor paid to purchase for resale computers from the U.S. franchisor-supplier. Apparently some sloppiness in either the drafting of the document or the shift from a prior business model led CRA on his futile journey to the court in this case. It appears that, fortunately, the essential facts and not perhaps misleading form governed the court's determination.

[To review further: Technical Interpretation 2007-0225861R3 respecting Reg. 805(1) and Part I versus Part XIII.]

(To review an apparent conflict with the distributor cases, (*Grand Toy* and *Farmparts)* the CRA Technical Interpretation 2004-0086631E5 which considered the exemptive provisions of subparagraph (vi) applicable to royalties based on sales of reproduced art work, but that a payment for an exclusive right to carry on that business is partially taxable under subparagraph (iv)).

(xii) The Future of Part XIII and the December 10, 2008 Recommendations of the Advisory Panel on Canada's International Tax System - And a Segue To Tax Treaty Matters

The Advisory Panel Report (*supra*, note 64) gave considerable thought to whether Canada should unilaterally reduce Part XIII taxation and especially addresses the question in relation to outbound royalty payments[88]. The Panel recommends that Part XIII be maintain as is but that Canada negotiate bilateral treaty reductions which are in Canada's overall interest.

---

[88] The Report states at paragragph 6.12:

> "The possible benefits of further reducing withholding taxes on royalties are also unknown. Canada has negotiated exemptions with its various treaty partners for royalties paid for the use in Canada of patents, know-how and software payments.[111] Payments in respect of the use of intangible property that do not now qualify for a withholding tax exemption include trademarks and trade names, movies, cultural works (in certain circumstances), data and information, and unpatented knowledge other than know-how.
>
> [111] Such exemptions were negotiated with Algeria (software and patent only), Australia (software only), Austria, Belgium, Denmark, Finland, France, Germany, Iceland, Kyrgyzstan, Luxembourg, the Netherlands, Norway, Oman, Russia, Sweden, Switzerland, Ukraine (software only), the United Arab Emirates, the United Kingdom, and the United States.]"

In this respect and as a segue to the tax treaty considerations (dealt with next) – and as an overview of the relationship between Part XIII and treaty effects consider the following correlation of paragraph 212(1)(d) and Article 12 of the OECD Model that Robert Couzin made in his Travelling Lecture for IFA a year ago.[89]

> "(1) The relationship between the treaty definition and s.212(1)(d) is complex and varies considerably amongst the treaties. The OECD Model essentially includes copyright and related royalties, and payments for the use of or the right to use any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial commercial or scientific experience. In comparing this to the domestic charge, one notes a number of divergences, the most important of which may be the inclusion of s.212 of payments for tangible property and services.
>
> > (a) Paragraph 212(1)(d) includes any payment that is a "rent, royalty or similar payment," the rest of the provision being merely inclusionary. The OECD definition is exhaustive.
> >
> > (b) The list is s.212(1)(d)(i) is similar to but wider than the OECD list. The Canadian one includes "invention" and "trade-name" and, importantly, "property" plus a catch-all "or other thing whatever."
> >
> > (c) The information category in s.212(1)(d)(ii) is the same as the OECD Model but with a notable restriction in that the domestic provision applies only if the consideration meets the defined test of being based on use, production or profits. There is no such restriction in the OECD Article 12.
> >
> > (d) Subparagraph 212(1)(d)(iii) is similar to the information provision but applies to services. There is no extension to services in the OECD Model.
> >
> > (e) Subparagraph 212(1)(d)(iv) refers to a payment for not using something. This is not in the OECD Model.
> >
> > (f) The exceptions in subparagraph (vi) to (xi) are not in the OECD Model. Two of these, subpara. (ix) and (x), are really reverse source definitions, to which we will return in a moment."

---

89 Robert Couzin, "Income Tax Treaties, Canadian Style", *2008 Canadian IFA Branch, Travelling Lectureship,* at page 80 and 81.

(b) Treaty – Part XIII[90]

(i) Thrust of Basic Canadian Treaty Policy and OECD Nexus

Both systemic factors and the Canadian courts potentially make the OECD Model treaty and its commentaries the springboard and cornerstone to the design, and understanding the design, of the rules in Canada's bilateral tax treaties.[91] This is no less so in the area of treaty rules for royalties. As a result, it is generally useful to first examine OECD concepts and then those seen in Canada's treaties.

(ii) OECD Model

a) Canada's position on the Model – in general

The OECD model treaty and its commentaries are not referred to, *per se*, in the ITA or in Canada's bilateral income tax conventions.

But the courts have made clear that where there is uncertainty respecting the interpretation or application of a Canadian treaty, reference may be had to the Model's commentaries, as an aide

90 Treaty and Part I: where Part I tax (and perhaps, in case of a NR corporation, Part XIV) applies, a treaty would exclude the full extent of such taxation if NR does not have a Permanent Establishment, within meaning of that treaty (e.g. "Article 5") - thus denoting a difference between the permanent establishment definitions in the Regulations and in the Treaty - or if it does, the income is not allocated to it (e.g. "Article 7"). In that case, it is arguable the Canada could exact an amount of tax equal to that, if any, permitted by Article XII of such treaty (e.g. say 10% of gross amount of royalty within meaning and scope of that Article XII – which, for example, would not include royalties not "sourced" in Canada according to that Article 12).

91 See David Ward on this threshold point – Appendix 31 and see the note that follows.

in dealing with the issue. This role was the subject matter of David Ward's 2006 Travelling Lectureship[92] and was referred to as well in Robert Couzin's lecture last year.

David's lecture focused particularly on the thorny question of the weight and relevance of the commentaries in interpreting a treaty which pre-dates the commentaries. In light of the revised commentaries just issued (in July 2008) which are relevant to our discussion, that aspect of the question is particularly pertinent. On that question (see Appendix 31 for brief extracts from David's book), and notwithstanding somewhat conflicting recent jurisprudence (*MIL*, 2007 DTC 5437 (F.C.A.)) and *Prevost*, 2009 DTC 5721 (F.C.A.), there appears to be a cogent position that post-treaty commentaries need not necessarily be seen to govern.

b) Basic OECD Position – Article 12

The basic OECD position is that royalty payment should be exempt, which obviously, therefore, makes it attractive, in treaties which follow this policy, to see as wide a definition of royalties as possible. (See next.) But, where as in the case of Canada, the basic "0%" is not adopted, the preference is to see as narrow a definition as possible where the payment qualifies for exemption under Article 7 (requiring that the payment constitute business profits and be earned without the use of a permanent establishment – as defined in Article 5).

c) Basic OECD Definition

The basic OECD definition of "royalties" for Article 12 is unlike the Canadian approach, not a hybrid concept. It contemplates only those payments, and underlying arrangements of the type

---

92 David A. Ward, QC, "The Interpretation of Income Tax Treaties With Particular Reference to the commentaries on the OECD Model", *IFA-Canada Branch, 2006 Travelling Lectureship Series*.

discussed above in domestic law that entail “royalties” and do not (or Canada would like) entail the separate notion of “rents”. (See Appendix 33 for definition).

d) Basic Source Rules

Where royalties are earned in an Article 12 (not Article 7) context – see preceding section – the right of a country of source to levy a tax and the right of a recipient to the limitations imposed are triggered by the “source” notion that the royalty “arises” in the source country – e.g. Canada may tax (or be precluded from taxing) a royalty received by a person who is resident of the other contracting state only if it “arises’ in Canada. That nexus generally starts with a focus on the residence of the payor and then is extended in stipulated ways.

e) Position on Software and The 2008 Revised Commentary

The OECD position on software royalties and transactions is closely linked – perhaps, interwoven is a more apt description – with its views (developed since 2000) on the relationship between Articles 5, 7 and 12 on e-commerce. (The latter is specifically considered and dealt with in Section VI on e-commerce.)

There are two basic themes *relevant to royalties in general*.

One theme is the Part I-Part XIII/Article 7-12 dichotomy and competing jurisdictions. This is covered in detail in paragraphs 11 to 11.6 in Article 12 and essentially is an attempt to distinguish services (Article 7) and know-how (Article 12). See the next section for this. The second is the definitional ambit or that which should or should not be included where Article 12-type rules are to govern. This theme, is clearly the threshold matter – to be dealt with first as a means of determining whether the second is in fact relevant. There are the two prime factors

respecting whether Article 7 has hegemony. Does the party providing software have a permanent establishment in the source country and, if so, is the item of income (and its resulting profit) allocated to the permanent establishment? If the answer is negative to at least one of those two, we come to Article 12.[93] Therefore, the following focus on Article 12 assumes that the cross-border activity either does not involve a permanent establishment or, if it does, for some reason the resulting income is not attributed to the activities of the permanent establishment.

Computer software matters are dealt with in paragraphs 12 through 17 of the revised July 2008 commentaries and may be summarized as follows.

- Paragraph 13.1, treats payments for the right to reproduce and sell software as royalties.
- Paragraph 14 (to which Canada had initially objected - see discussion elsewhere), treats payments in the context of the transactions that arose in *Saint John Shipbuilding* (see above) as not being royalties.
- Paragraph 14.2, treats "network licenses" (that is, a distribution of software within the organization of the licensee) as not being royalties.

---

[93] These questions have been under study for the past ten years or so and are reflected to (some?) extent in the July 17, 2008 revised OECD commentaries, but hardly at all in recent Canadian treaties. For example, the Fifth Protocol to the Canada-US Treaty does not mention the word "e-commerce" or "server" or "internet service provider" or "internet content provider".

- Paragraph 14.4, treats payments made by distributors to "buy" and then to "sell" software as not being royalties.

- Paragraphs 15 and 16, are worth noting in their entirety and read as follows.

> "15. Where consideration is paid for the transfer of the full ownership of the rights in the copyright, the payment cannot represent a royalty and the provisions of the Article are not applicable. Difficulties can arise where there is a transfer of rights involving:
>
> > - exclusive right of use of the copyright during a specific period or in a limited geographical area;
> >
> > - additional consideration related to usage;
> >
> > - consideration in the form of a substantial lump sum payment.
>
> 16. Each case will depend on its particular facts but in general if the payment is in consideration for the transfer of rights that constitute a distinct and specific property (which is more likely in the case of geographically-limited than time-limited rights), such payments are likely to be business profits within Article 7 or a capital gain within Article 13 rather than royalties within Article 12. That follows from the fact that where the ownership of rights has been alienated, the consideration cannot be for the use of the rights. The essential character of the transaction as an alienation cannot be altered by the form of the consideration, the payment of the consideration in instalments or, in the view of most countries, by the fact that the payments are related to a contingency."

[It should be noted that the views in this commentary conflict with the incomplete interpretation of Part XIII and in particular subparagraph 212(1)(d)(i) by the Federal Court of Appeal in *Saint John Shipbuilding*,[94] Clearly, the ambit of that possible aspect of the Canadian law would not be permitted under a treaty which is interpreted in accordance with the revised Commentary.[95]]

---

[94] *Supra.*

[95] Bear in mind, however, that while Canada had initially reserved on the commentary to Article 12 respecting computer software, it withdrew it in March 2002. [The observation reads as follows:

f) Position on Services Versus Know-how

(This is set out below in the section on E-Commerce and in particular note 128 and related text.)

(iii) Canada

a) Basics

- Varies between 10% and 0%
  - 0% seen in:
    - Canada-US
    - Canada-Netherlands
    - Others as well
  - Treaties with rates in excess of 10%?
    - a few

Canada, unlike the U.S., several other countries and the OECD model has a basic policy of taxing, under treaty, amounts arising under Part XIII. However, the rate generally is reduced from 25% to 10% and there can be some substantial exemptions as well. The ambit of those

---

> "Canada does not adhere to paragraph 14. In Canada, payment by user of computer software pursuant to a contract that requires the source code or program be kept confidential, are payments for the use of a secret formula or process and thus are royalties within the meaning of paragraph 2 of the article."]

That, of course, reflected CRA's views of the *Saint John Shipbuilding* case, which, however, does not necessarily deal with the modern approach to permitting resale of the single slug of software acquired. For

exemptions was conceptually expanded by the 1993 federal budget which announced that Canada would be willing to enter into treaty arrangements which would eliminate Canadian withholding tax on payments for patents as well as payments for know-how and for the use of software (see Appendix 32). Further to that announcement, many treaties or treaty protocols have been entered into reflecting that approach including that with the U.S. (1995), the U.K., Australia, The Netherlands. In some cases, rather than an exemption there is a rate reduced to 5%. See, for example, the yet unimplemented the 2002 treaty with Italy. Generally, Canada tries to define royalties in such a way as to protect all elements of Part XIII which is a much more expansive ambit of taxation than that contemplated by OECD which, for example, would not include as royalties rents for tangible property or payments or contingent payments for services or contingent payments where there is a full alienation of intangible property.

b) Definition of Royalties (and Influence – Effect of OECD – in General)

(See prior extracts from Robert Couzin's 2008 lecture.)

c) Definition of Royalties in Relation to Software – shrink wrap and similar

As noted above, the revised OECD commentary on Article 12 takes the position that the definition of royalties should be viewed as not including rights to acquire software. This, in effect, would exclude from "royalty" the type single payment seen in *Saint John* for the acquisition of the right to use, in perpetuity, a piece of software, but without the right to alienate

---

further relevant comment, see Scott Wilkie "Canada – Transfer Pricing Aspects of Electronic Commerce", International Transfer Pricing Journal, vol. 8, No. 1, 2001 (IBFD) page 6 at page 8.

that which is acquired. But CRA – subject to its administration tolerance of (1994) would continue to view those payments as subject to subparagraph (i). As noted above, to protect that right of taxation the Canadian Government had, initially – when the revised commentary was being developed in 2001 – reserved on the proposed revision, where it could be seen as potentially affecting the interpretation of a Canadian treaty. Then, as noted above, in 2002, CRA reversed course (in part) and said it would respect the then proposal review.[96]

Where does this leave us? On shrink wrap, the cumulative effect of the 1994 position and the OECD (and in some cases specific treaty exemptions) should mean that whether one looks at the matter without or with a treaty, Part XIII tax will not apply to single lump-sum payments for shrink wrap.

d) Definition of Royalties - *Saint John Shipbuilding* – related

But where one looks at single lump-sum payment in the circumstances that arose in *Saint John*, even with the lifting of the reservation (and given that the 1994 CRA does not protect – on the domestic front, and absent a specific exemption for software royalties – e.g. the Canada-US treaty), the OECD-related treaty position does provide absolute certainty.[97]

---

[96] See next note.

[97] What is the exact effect here of the fact that Canada lifted its "observation" respecting the emerging OECD position on software payments? This was done on March 28, 2002 and reflected in CRA's Technical News #23, June 18, 2002 as well as in Technical News #25 in October 2002, the Government previously had advised OECD that it would not apply paragraph 14 through 14.3 which would have the effect of excluding withholding on payments for computer software arising in the context of *Saint John Shipbuilding*. The act of removing the observation so as to open up the door to the OECD exempt approach is not at all absolute as indicated in the language in these technicals. The government's position, of course, assumes or takes the position that the Federal Court of Appeal in *Saint John* had in fact found that subparagraph (i) applied when in fact it punted on the question.

e) Sourcing Rules

Treaty sourcing rules for royalties, if taxable in principle, mirror to some extent, the Canadian domestic (Part XIII) bifurcation between actual Canadian resident payers (which generally for treaty purposes constitutes the prime "sourcing" rule) and deemed Canadian residents. An interesting aspect is the "cascading" notion advocated by the US for its treaties.

f) Beneficial Owner – Treaty Shopping and All That

Canada may seek to deny treaty relief-benefits respecting outbound royalties if (1) there is some random defect in the requisite (typical) "beneficial owner" aspect of Article 12[98] or (2) there is perceived "treaty shopping" involved. This entails the credo or notion-assertion that the "real" owner of the licensed property and the resulting royalty (which is otherwise subject to a 25% Part XIII tax) is a person who, himself, herself or itself, is not resident in or based in the country which is party to the relevant (relieving) treaty (e.g. in form) and is only apparently entitled to benefits of the treaty because that person has established some captive entity (e.g. holding corporation) in that treaty country, has transferred the Canadian source royalty earning property to that entity and that entity is, as a result, now making a claim for reduction of the Canadian 25% tax. And all of that "treaty shopping" is not fair and should not be allowed to succeed.

---

[98] Note curiously absent from the Article 5/7 paradigm.

That latter view of the world was asserted by CRA in two cases (not involving royalties) that have been decided by our courts – *MIL*[99] and Prevost[100] – and in both cases the attack was rejected by our courts.

Now there is a case pending that does involve royalties, the matter of *Velcro* the attack here is on the basis of lack of beneficial ownership. The facts and arguments, to date in the case are set out in Appendix 40.

g) Some Notes on Issues for "Withholding Agents"

Part XIII imposes tax on a relevant non-resident recipient of an item of income contemplated by that Part. The tax is generally paid by the non-resident at the point in time the income is received in that section. This occurs in that ITA section 215 requires the payor of the income (or certain intermediaries (agents) in the chain of payment) to withhold the 25% tax (or reduced treaty rates) and remit it to the government.

A person who fails to comply with ITA section 215 may be liable for the tax,[101] penalties [102] and interest[103]. But there should be no reason, in principle, to run afoul of these rules where both it is clear that Part XIII applies and the non-resident taxpayer does not and does not purport to reside in a country with which Canada has a treaty.

---

[99] *MIL*, *supra*, involving an "inherent" anti-treaty shopping notion and GAAR

[100] *Prevost*, *supra*, involving Beneficial Ownership

[101] Subsection 215(6).

[102] Subsection 227(8).

[103] Subsection 227(8.3).

Where, however, the Part XIII taxpayer has nexus to a treaty country, complexity may set in. In that case, the provisions of ITA subsection 10(6) of the Income Tax Act Application Rules (see below) may reduce or render uncertain the extent (amount) of a Part XIII tax obligation and thus that of the ITA section 215 withholding agent. And the content of Information Circular 12-R6 (Appendix 25) may by reason of the "limitation on benefits rule" as revised by the Fifth Protocol to the Canada-US Treaty. exacerbate uncertainty for the ITA section 215 agent. And the hybrid entity rules of the Fifth Protocol to the Canada-US Treaty may muddy the waters further. (In June, CRA announced commencement of revisions by reason of the latter.)

Consider the paradigm in the following hypothetical:

- Canadian resident pays amounts comprising royalties for purposes of Part XIII in respect of the use of trademarks to the owner licensor of the trademarks.
- Such owner purports/represents that it has been formed under the State of Delaware "limited liability company" statute and that its address is a place in the USA.
- Since the Fifth Protocol was ratified on December 15, 2008, so that it rules respecting withholding under Article XII (Royalties) have effect with respect to payments made on or after February 1, 2009 (the "effective date").
- Assume that under this license payments have been made both before and after the effective date.
- Finally, assume, as required, the following:
    - The LLC did not check the box to be treated as a corporation for the IRC.

- The LLC did so check the box.
- The LLC is owned by a resident of the Bahamas.
- The LLC is owned by a US citizen who never sets foot outside the US.

In those varying and various circumstances, there are a number of different determinations for the ITA section 215 agent that could be made, some of which could be quite esoteric and fraught with potential uncertainty and risk unless the full non-treaty withholding rate of 25% is applied. But simply taking that "safe", "conservative" approach could have its own potential cost or negatives in business terms.

The analysis would be framed against a base case, which base case is the payment to a person who is an individual who qualifies as a resident of the U.S. under Article IV of the Treat. That base case would also serve to illustrate the plain vanilla effect of ITAR subsection 10(6) and IC #12-R6 on the ITA section 215 withholding agent.[104] A comparison of the hypothetical against the base case would quickly show the difficulties which may be encountered.

---

104 The analysis involves the following: According to CRA's own guidelines set out in information circular 76-12r6, having regard to both section 215 of the income tax act and section 10(6) of the income tax application rules, if one be entitled to apply the treaty rate of 10% to a party who represents that he is a U.S.-based person and who gives you an U.S. address unless one has cause to think that such person is acting as a nominee for somebody else. For example, an LLC may or may not be a taxpayer for U.S. purposes, depending upon whether its owners have or have not carried out certain elections it would appear, although the matter, of course, has not been the object of any particular dispute or court decision that the foregoing comment applies equally to payments to a U.S. LLC. This is reflected particularly by paragraph 4 of information circular 76-12r6, which states that "the payer can accept the name and address of the payee as being that of the beneficial owner unless there is a reasonable cause to suspect otherwise. ...in any doubtful case, a certificate...is required to be completed and forwarded to the payor by the payee in order that a lower rate of withholding tax, in accordance with a tax convention, can be applied." Then this is Section 10(6) of ITAR

(5) Elsewhere

The Canadian Part I v. Part XIII pattern is seen elsewhere.

But the "pyramid" approach, seen above, is not, although expansive definitions of "royalty" may provide similar effects. As well, some countries (particularly the US under its cascading source rule) have expansive sourcing rules.

Apart from the OECD-based treaty patterns, regard should be had to the wide ambit of royalty-related taxation adopted by developing countries: see expansive UN Notions (Appendix 35).

(6) Transactions in Royalty Producing Property

(a) Context

This topic is separate from the type of transactions discussed above and seen in *Saint John,* or seen in the conveyance of "shrink wrap" software or in the conveyance of other consumer or commercial things (whether or not involving e-commerce). It contemplates the conveyance, by a non-resident, of property or property rights in respect of which the non-resident has previously

---

Limitation on non-resident's tax rate – Notwithstanding any provision of the amended Act, where an agreement or convention between the Government of Canada and the government of any other country that has to force of law in Canada provides that where an amount is paid or credited, or deemed to be paid or credited, or deemed to be paid or credited, to a resident of that other country the rate of tax imposed thereon shall not exceed a specified rate.

(a) any reference to part XIII of the amended At to a rate in excess of the specified rate shall, in respect of such an amount, be read as a reference to the specified rate; and

(b) except where the amount can reasonably be attributed to a business carried on by that person in Canada, that person shall, for the purpose of the agreement or convention in respect of the amount, be deemed not to have a permanent establishment in Canada.

How does ITAR 10(6) apply in light of the new LOB provision?

been earning amounts (e.g. "royalties") which were (unless treaty protected) subject to either Part I or Part XIII tax.

(b) Part I – Nexus/Factors

If Part I had been applying, it means that the licensed property had been used to produce income from carrying on business in Canada through a (ITA) permanent establishment. Such property would clearly, thus, constitute taxable Canadian property so that a disposition thereof would – absent a treaty exemption – be subject to Part I (and possibly Part XIV) tax.

But, ironically, even had there been no ITA permanent establishment, so that Part XIII applied to the royalty payments and (at least, administratively), Part I did not apply, the property – if used in carrying on a business in Canada, <u>even without an ITA permanent establishment</u> - would still seem to constitute TCP, so that a disposition thereof would be subject to Part I (and possibly Part XIV) tax.

B. CROSS-BORDER OUTBOUND (THIRD PARTY) LICENSE AND INBOUND ROYALTY

(1) Overview

Canadian enterprises doing royalty-earning business abroad (through electronic commerce or otherwise) or otherwise having interests in royalty-earning activities are taxed or not taxed within the parameters discussed in this section and the following section.

This section deals with Canadians which directly carry on royalty-earning business abroad (that is without a foreign subsidiary). Canadian tax applies to the resulting income, regardless of where the activities take place, where the money is made or where the money is kept. For such Canadian the issues will be twofold – will tax arise in other countries (pursuant to the type of

issues noted above in Canada for foreign content or service providers) and, to the extent of same, will such foreign taxes be fully creditable (under ITA section 126 of the Act) against Canadian taxes otherwise arising? If the latter is affirmative, then no double tax will arise for such Canadians.

(2) How are foreign tax credits handled?

In principle, Canada and most other countries seek to avoid double tax on foreign source income of a domestic taxpayer by providing relief for foreign taxes. The mechanism might be a credit or a deduction in respect of the foreign taxes. In principle, these general rules apply where the foreign source item of income happens to be a royalty or similar item.

(a) In Canada

In Canada, where a Canadian directly earns foreign source royalties, both general principles apply, with the prime relieving rule being a (dollar-for-dollar) credit of the foreign taxes against the Canadian taxes otherwise applicable to foreign source royalty, under ITA section 126 of the *Act*. However, there is a back-up "deduction in computing income" rule (under ITA subsections 20(11) and (12)), in respect of that portion of foreign taxes which may not be eligible for the prime "credit" rule. The following specific elements of these rules are of general application and therefore apply, in principle, whether the foreign income is a royalty or something else. In that respect, there is no specific reference in these rules to "royalties".

(i) The "Credit" Rules of ITA Section 126

a) The Basic Dichotomy of ITA Section 126 and How It Connects to Foreign Royalties

ITA section 126 contemplates providing a credit where either (1) pursuant to ITA subsection 126(2) and (2.1), a royalty (or other item of income) is considered to have been earned by a Canadian from directly carrying on business in another country or (2) pursuant to ITA subsection 126(1) in the absence of the latter it has (within the context of either carrying on business in Canada or simply owning the royalty-producing property, i.e. having "income from property") derived the royalty from a foreign country.

b) ITA subparagraph 126(2)(2.1) – Foreign Business

The notions of carrying on business in a foreign country and of a royalty being earned from such carrying on are not defined in the *Act*, and – as in respect of any of the other rules discussed herein - there is no case law on point (on any aspect of section 126 in relation to royalties).[105]

c) ITA subsection 126(1) – Foreign ("Source") Royalty

The notion of a royalty being derived from a foreign country is not defined in the *Act*. CRA's Interpretation Bulletin No. 270R3, dealing with source for section 126 notes that at paragraph 29:

> 29. The location of the source of a royalty payment is the country in which the related right is used or exploited. For example, a royalty payment received by a resident of Canada on the quantity of ore extracted from a mine situated in a foreign country is income from a source in that country. Or, for example, a

---

[105] CRA views – see and review "Interpretation – internal 2006-0181911I7 – Determination of foreign source business income", July 17, 2006 and CRA, "Memo 2000-0001017 – Sourcing of income and foreign tax credit:, January 11, 2001". See also relevant IT.

royalty payment received by a resident of Canada from a resident of a foreign country, on a written work created in Canada and copyright-protected in that foreign country under its copyright laws, is income from a source in that foreign country.

d) The Nature of the Credit Provided by ITA subsection 126(1) – (and No Carry-Overs)

Where foreign taxes that have been imposed on a royalty are eligible for the ITA subsection 126(1) rules, the basic formula in ITA subsection 126(1) looks at the lesser of those taxes (as taken into account for these purposes in the defined expression "non-business income taxes" in ITA subsection 126(7)), and (by formula) the Canadian taxes considered applicable to the royalty and allows, as a credit (against Canadian taxes otherwise payable) the lesser of the two. If the foreign taxes exceed the credit allowed, reference would be had to the deductibility rules of ITA subsection 20(11) – which is tied into the definition of "non-business income taxes" – or 20(12) – as discussed below. But no such excess can be used as a credit under ITA subsection 126(1) in any year other than the year in which the royalty income is reported. Finally, this is a "country by country" determination.

e) The Nature of the Credit Provided by ITA subsection 126(2) and (2.1) (and Carry-Overs)

Where the foreign business-related rules of ITA subsection 126(2) and (2.1) apply, the formulary approach seen under ITA subsection 126(1) also applies – although here there may be more complexity or uncertainty respecting the relevant components. This entails the separate ITA subsection 126(7) definition of "business income taxes".

However here, unlike the first case, any excess foreign tax credits can be carried back (three years) or forward (ten years).

(ii) The "Deduction" Rules Under ITA subsections 20(11) and (12)

a) ITA subsection 20(11)

ITA subsection 20(11) and the definition of "non-business income tax" are designed to (and operate to) limit – to 15% of the relevant item of foreign source income – the credit a Canadian resident Individual (but not a corporation) may claim under ITA subsection 126(1) in respect of foreign source "income from property". ITA subsection 20(11) then permits a deduction, in computing "income" for the excess of the foreign taxes over 15% of the item of income.

This rule is mainly aimed (without so being limited) at US citizens resident in Canada who are not entitled to Canada-US Treaty limitations on their worldwide income (including US source income). Subject to alleviating rules in Article XXIV of the Canada/US tax treaty, this obviously could result in double tax.

b) ITA Subsection 20(12)

ITA subsection 20(12) provides relief (by way of deduction) (for any Canadian resident, not just individuals) for the portion of foreign taxes which are not creditable under ITA subsection 126(1) by reason of the formulary limitations therein, and having regard to the absence of carry-over for excess ITA subsection 126(1)-related foreign taxes.

(b) Elsewhere

Although not specifically canvassed, it appears that the basic approach just outlined would generally be seen in other countries which tax world-wide income of its residents.

C. CANADIAN-OWNED FOREIGN ENTITY ROYALTY EARNERS INVOLVING THIRD-PARTY LICENCEES-PAYORS

(1) The Multiple Contexts and Background

Where a Canadian has an interest in a foreign entity which has royalty-earning activities, Canadian tax results may arise either under the CFA-ABI-FAPI rules or potentially under the current ITA section 94.1 (offshore entity) rules or the proposed (Bill C-10) ITA section 94.1-94.5 FIE rules.

(2) CONTROLLED FOREIGN AFFILIATES – ACTIVE BUSINESS INCOME – FOREIGN ACCRUAL PROPERTY INCOME

(a) Basics

Canadian enterprises which carry on business abroad through foreign subsidiaries, or other foreign (non-resident) corporations which are CFAs, will not be subject to Canadian tax on foreign profits repatriated to Canada (and will only have to "tax plan" mitigation of foreign country taxation) if:

the foreign subsidiary is located in a country with which Canada has a treaty[106]; and

the foreign operation is not considered to give rise to "foreign accrual property income" ("FAPI") – which is, in principle, passive income and certain income items that are not passive *per se* but are deemed to be passive and thereby included in FAPI.

---

106 With the proposed tax information exchange agreement ("TIEA") addition to the Part 5900 Regulations – pursuant to the controversial March 2007 Federal Budget, "treaty" now means either an income tax treaty or a TIEA. The December 10, 2008 Advisory Panel – *supra*, note 64 - has, of course, recommended that exempt surplus treatment be de-coupled (unlinked) from treaty-nexus requirements.

If both of those conditions are satisfied, then Canada does not tax such foreign subsidiary profits, either when earned or repatriated to a Canadian corporate shareholder.[107] If only the second condition is satisfied, the profits are not taxed until repatriated.[108]

The problem however is that, if the foreign subsidiary is considered to earn "FAPI", then it is immediately taxed in the hands of the Canadian shareholder, whether or not distributed, with effective relief given for foreign taxes.[109] If such foreign taxes are less than 38%[110], then no net tax is paid in Canada on such attributable FAPI. The problem is that FAPI is deemed to include income from an "investment business", which can include a business which earns profit from licensing of things (such as software etc.) unless such business employs more then five full time employees.

(As well, the "stick" side of the TIEA initiative would see what is otherwise active business income deemed to be FAPI where the CFA is resident or carrying on business in a country which has failed to enter into a TIEA with Canada within five years of being invited to do so.)

Where the foreign subsidiary earns income accepted as profit from the sale of product or profit from rendering of services, such "FAPI" treatment generally has no application and there arises the basis for operation in the free-from-Canadian-tax environment described above.

---

[107] See sections 90-95 and paragraph 113(1)(a) of the Act and the Regulations made thereunder.

[108] See sections 90-95 and paragraph 113(1)(b) of the Act and Regulations made thereunder.

[109] See section 91.

[110] Under proposed amendments to the definition of "relevant tax factor" in subsection 95(1) that would be reduced consistent with basic corporate rate reductions since first enacted.

As noted in (2), where a foreign subsidiary earns profit which is not "FAPI" but is not based in a treaty country (that is, for example, based in a tax haven) then the profit from the business is not attributed to the Canadian shareholder but, if repatriated, is subject to Canadian tax at that time. Such profit is termed "taxable surplus" as distinct from the "exempt surplus" which is considered earned where the foreign subsidiary is based in a country with which Canada has a treaty.

(b) FAPI – INVESTMENT BUSINESS – Royalties – *Saint John*

A CFA whose business involves licensing of property would engage FAPI under the definition of "investment business" (assuming the requirements for exception thereto do not arise), where the "purpose" (this is one of the elephants in the room) of the activities of the CFA is to "...derive income from property (including royalties [Note: not defined] or any similar returns [this is a second elephant in the room] or substitutes for such...royalties [this is the third elephant in the room] or profits from the disposition of investment property..." (parenthetical words added)

With respect to the first elephant, two CRA interpretations dating back to the mid-90's take a generous view and contemplate that a royalty earning business may not engage the IB definition at all. In interpretation 9507915 (License agreement revenues) dated July 14, 1995, dealing with the exact same language in the definition of "specified business" in subsection 125(7), CRA expressed the view that royalty income would constitute straight active business income in a situation where "…it could be established that…the recipient corporation is in the business of dealing in or originating the property from which the licensing income is received…". The exact same thought was expressed (in Tech Interp 9722915 – Royalty income as active business income, September 26, 1997) in relation to a hypothetical situation involving a music industry company. In considering the role of "purpose" in relation to those CRA interpretations, thought

would have to be given to analogous notions of primary and secondary intention (arising in undeveloped land cases) and, perhaps, the role of "change of use" in our tax laws.

With respect to the other two elephants in the room, while the definition of "investment property" does not contain the type of property that would be licensed in the context being discussed herein, and while a straight license that gives rise to royalties (an undefined term) would attract clear treatment, the two obvious uncertainties are just what constitutes (in relation to royalties) "similar returns" or "substitutes". Is this to be interpreted in a fashion comparable to that applicable to the term "in lieu of" in section 212 or perhaps affected by the *Surrogatum* rule discussed above? Of more direct relevance, is whether there is any relationship between the meaning to be ascribed to those words and the matters dealt with in *Saint John*? It seems reasonable to conclude, but the matter is untested, that the answer is negative and in particular that those words should not characterize or apply to a transaction and payment in respect thereof that arose in *Saint John* (that is, if the CFA were to grant a perpetual license for the use of software in return for a lump sum payment, such payment should not be considered similar to royalties or a substitute for royalties given that *Saint John* made clear that such payment would not, itself, come within the meaning of "royalties" as the definition of that word has been developed for and under Part XIII as discussed earlier.) Would a court view the meaning of "royalty" differently for this provision? Given the underlying commercial law notions discussed at the outset, there appears to be no cogent reason for that.[111]

---

[111] CRA has commented on these words (in, Interpretation – external 2004-0073431E5 – Foreign accrual property income, November 28, 2005) in relation to financing transactions where it opined that a guarantee

Furthermore, if what is being dealt in meets CRA's administrative-made definition of "shrink-wrap", (see above) CRA has expressed the view that income from "selling" or "licensing" such software would not come within the definition of "income from an investment business, but instead would be viewed as income from an active business.

(c) ITA paragraph 95(2)(a.3) – Trap

Even if a CFA's royalty earning activities do not constitute mere income from property or an investment business, FAPI will still apply if rules of ITA paragraph 95(2)(a.3) – dealing with certain Canadian source revenue – apply. This will be the case where royalties of what otherwise would be income derived from an active business are paid to the CFA by residents of Canada or non-residents carrying on business in Canada unless 90% or more of the royalties are derived from arm's length non-residents.

Although that provision refers to, *inter alia*, income from leases, not licenses, a special definition in section 95(1) incorporates/includes the latter in the former. In particular, "lease obligation" for this rule includes payments for "...use of or production or reproduction of property including information..." See also a definition of "licensing of property" which has language mirroring the latter. Given that paragraph 95(2)(a.3) refers to income from either Canadian debt or leasing obligations, it is clear that even if a CFA does not come within the definition of "investment business" in subsection 95(1) its income will be included in FAPI if its target market is Canadian resident users.

---

fee would be a similar return or substitute for loan interest. This is not particularly helpful in considering those words in relation to royalty earning activities.

On its face, however, this "trap" does not apply to royalties paid by a non-resident even if they are associated with, and deductible against, a business such non-resident carries on in Canada provided the 90% requirement is met.

(3) ITA section 94.1

Current ITA section 94.1 would, in principle, have no application to the subject matter of this lecture.

Under the much criticized[112] proposed ITA section 94.1 *et al* [the "Foreign Investment Entity" Rules (FIE) – as set out in Bill C-10, which had been passed by the House of Commons and was before the Senate when Parliament was dissolved for the October 14 election] an interest in a non-resident corporation which is not a CFA, and which is not eligible to make an election to be a CFA and the principal property of which constitutes certain royalty-producing property[113] would be a FIE unless the property were owned and used in the context of an "exempt business". If the corporation were a FIE, there would be potential income inclusions (under one of three sets of rules) unless the interest were an "exempt interest".

In considering whether there is an "exempt business", the critical factor is whether the property has been manufactured, produced, developed, or purchased and developed by the foreign corporation or a related person. This exception from the FIE rules is akin to the above-noted

---

112 See elsewhere the recommendations of the Advisory Panel (see note 64) and see a January 2009 letter by the CBA-CICA Joint Committee on Taxation to the Department of Finance.

113 The relevant property is, pursuant to proposed subsection 94.1(1), "investment property", that is, at paragraph (k), "…intellectual property within the meaning of Article 2 of the Convention Establishing The World Intellectual Organization done at Stockholm on July 14, 1967, as amended from time-to-time."

CRA' administrative position regarding the definition of investment business under the FAPI rules (whereby, as noted above, CFAs that originate or develop the IP that they license for royalties are not considered to carry on an investment business and thus do not generate FAPI.)

If the entity were a trust (without an exempt business so that it is a FIE), the question would be whether the interest is a "specified interest" – which, for example, would be the case if the trust is non-discretionary.

SECTION V - CROSS-BORDER INTERCOMPANY

A. CROSS-THE CANADIAN BORDER

(1) Section 247 transfer pricing matters

As indicated at the outset, this topic could obviously be the object of a separate lecture (or two or three), and the objective here will be to just focus on a few of the salient factors.

(a) Royalties under licenses

The most ubiquitous (if not the most challenging) issue is simply the question of whether a cross-the-Canadian border intercompany royalty has been priced in a manner that is "arm's length" – that is, meets the ITA paragraph 247(2)(a) – mandated (and international standard) of comporting with the "arm's length principle", or as stated in ITA paragraph 247(2)(a).

"(a) the terms or conditions made or imposed, in respect of the transactions or series, between any of the participants in the transaction or series differ from those that would have been made between persons dealing at arm's length, or…..".

The *Act* does not contain any rules to make this determination. Instead, it is a question of facts and circumstances (see *Hofert*) where a court will – as seen in the recent decision in *Glaxo* (involving pricing of product, not royalties) – give attention (heed) to guidelines established and published by the OECD for how one should go about doing a facts and circumstances-based enquiry into the matter. And CRA – in non-binding IC-87-2R - advocates use and reliance on OECD. [Both, with respect to royalties, are set out in Appendix 61.]

(i) Inbound Licenses – Outbound Royalties

Whether the intercompany royalty to be priced is outbound (pursuant to an inbound license (e.g. a license granted by a foreign parent to a Canadian subsidiary to use a particular intangible)) or is inbound (in the converse situation – see next section) the same [ITA paragraph 247(2)(a) – ALP] rule governs and the facts and circumstances enquiry is the same.

Logic (and this OECD, CRA, etc.) dictates that the most compelling evidence that the intercompany royalty meets the ALP is where a royalty has been paid between unaffiliated parties in the same circumstances – i.e. the tangible being licensed and all of the related terms, conditions and factors are the same – as comprises and governs the intercompany royalty. This is the so-called "Comparable Uncontrolled Price" ("CUP") method. For example, if an intangible is licensed by a foreign parent to a Canadian sub and the same intangible is also licensed to an unaffiliated Canadian – with all terms of the licensing arrangements (and relevant business environment etc.) being the same, the royalty paid by the unaffiliated party would be a "CUP" and used to test whether the intercompany royalty meets the ALP.

Unfortunately, there rarely is such clear straight comparability (note the taxpayers appeal in *Glaxo* against a CUP funding by the TC) and the parties (including OECD, CRA and the courts,

if necessary) descends into the murky and controversial waters of other (clearly subjective) “methods” for “estimating” or “guesstimating” an “arm’s length” price for the royalty.

And here no amount of theorizing or pontificating or hypothetic modelling [or bundling such process under high-sounding labels like “net transactional margin method” (TNMM) or “comparable price method” (CPM) or “profit split” (or “residual profit split”)] will eliminate the inability of either taxpayer or tax authority to “prove” to each other or to a court that they have “right” answer - that is THE ALP (price).

And even in the unlikely event that a court decision in a particular royalty pricing issue would provide a solution for another and different set of facts, there have been no Canadian decisions on the ALP in respect of royalties and no US court decisions involving units of the MNE based in high tax jurisdictions.[114] And all court decisions respecting transfer pricing issues where there is any reason that the MNE’s overall tax liability could be reduced by pricing manipulation are potentially distorted by that factor in the sense that decision may focus and address factors and comprise conclusions and findings which would not arise where the tax systems of the two countries involved in the intercompany royalty are sufficiently comparable so as to pre-empt any presumptions (by tax authority or court) of tax-motivated intercompany price manipulation).

---

[114] US Jurisprudence such as Bausch and Lomb (No. 89-4156, UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT, *933 F.2d 1084*; *1991 U.S. App. LEXIS 9877*; *91-1 U.S. Tax Cas.* (CCH) P50,244; 67 A.F.T.R.2d (RIA) 980, May 10, 1990, Argued, May 14, 1991, Decided) has involved licenses by US parent companies to subsidiaries operating in tax-favoured circumstances (such as, in Bausch and Lomb, in Ireland).

a) Other Countries

Informal enquiries with observers in eight other countries revealed no evidence of decisions respecting whether royalties met the ALP in transactions between units of the multinational which, both, were based in high tax jurisdictions. (In Germany, there have been a handful of ALP cases in the latter circumstances, but apparently not involving royalties.)

b) Consequences of Outbound Royalties Not Comprising ALPs

If the price is conceded by the taxpayer or found by a court to have been excessive, the excess (over the ALP) would not be deductible by the Canadian payer and where the Canadian party is a subsidiary of a foreign-based group, there would be a secondary Part XIII tax (on deemed dividends stemming from ITA subsection 15(1) shareholder benefits or ITA section 56 or 246 benefits). In addition there could be a 10% penalty tax under ITA subsection 247(3) unless reasonable efforts were made to use on ALP and there has been compliance with the "contemporaneous documentation" requirements of ITA subsection 247(4).

If the price is conceded by CRA or found by a court to have been less than an ALP, subject to ITA subsection 247(10), the difference between the two would be deductible to the Canadian payer.

ITA subsection 247(10) is a strange and illusive rule, which is short and reads as follows:

"(10) No adjustment unless appropriate. An adjustment (other than an adjustment that results in or increases a transfer pricing capital adjustment or a transfer pricing income adjustment of a taxpayer for a taxation year) shall not be made under subsection (2) unless, in the opinion of the Minister, the circumstances are such that it would be appropriate that the adjustment be made."

What does this mean? Reference may be had to TPM-03 (October 20, 2003).

(ii) Outbound Licenses – Inbound Royalties

In principle, the same considerations arise for inbound royalties as for outbound royalties except (1) the spectre ITA subsection 247(2)(b) – discussed below – may raise its ugly head and (2) In the usual context here that the Canadian licensor is the parent of the foreign licensee, there would be no potential Part XIII issues.

(b) Transfers of ownership of intangibles - outbound

(i) General considerations

An outbound sale of an intangible (whether or not licensed to a third party) would in concept simply raise the necessity of testing the price paid under the ALP. Canada has had no court decision on point, although the *Merck* situation (below) may raise it.

In most countries, except for the US, the considerations would be similar and there appears to be no decided cases on point.

In the US, the 1986 "super royalty" addition to Code section 482 is seen (by the legislative history or both that and section 482 "regulations") as requiring, with respect to an outbound transfer (inbound as well?) of ownership or an intangible, that (quite apart from the terms of conveyance) the transferor includes in income, in each year (from the year of transfer and forward) an amount which effectively represents some (reasonable?) portion of the income realized by the transferee from the use and exploitation of the transferred intangible, and (presumably) not report, as proceeds of disposition any amount actually paid. There is (in the view of the legislative history or Regs) very limited circumstances where the terms of the

transfer/conveyance will govern the tax results. But in any other case the effect of this interpretation of the Code is tantamount to ignoring the sale and treating the parties as if in a licensing arrangement where the ALP for the use of the intangibles is some stipulated portion of the "licensee's" income from its use.

And that, seemingly unprincipled US rule is a segue to Canada's equally unprincipled rule – ITA paragraph 247(2)(b) – discussed next.

(ii) ITA paragraph 247(2)(b) Recharacterization

a) Basic Ambit – Inscrutable

When the ALP was recodified in Canada, in 1998, with ITA section 247 replacing ITA subsections 69(2) and (3) – an unexpected ("recharacterization") rule was tacked on to the basic ALP, as follows:

> "(b) the transaction or series
>
> (i) would not have been entered into between persons dealing at arm's length, and
>
> (ii) can reasonably be considered not to have been entered into primarily for *bona fida* purposes other than to obtain a tax benefit,
>
> any amounts that, but for this section and ITA section 245, would be determined for the purposes of this Act in respect of the taxpayer or the partnership for a taxation year or fiscal period shall be adjusted (in this section referred to as an "adjustment") to the quantum or nature of the amounts that would have been determined if, ….."

What does this mean – and why is it relevant to this lecture?

If you believe the views of its principal draftsman, Brian Bloom, its singular purpose was to import into Canadian law, a singular notion of the OECD Guidelines respecting the present sale of future, not yet developed, intangibles.

See Appendix No. 63A and paragraph 1.36 and 1.37 of the Guidelines therein (OECD) which deals with the recharacterization rule recommended by the OECD. (See also section (iii) below and Appendix 65.)

See Appendix No. 63 (article by Brian Bloom).

Brian's view means that the rule would never have any application; for example, to an outright sale/transfer of existing intangibles for a single fixed price. (The ALP aspect of the net price would be tested under the principles-notions otherwise governing the ALP.)

But if reference is had to CRA initiatives, respecting the rule, you see a totally different and expansive view of the rule's ambit.[115]

---

[115] CRA deals with this on a centralized basis in Ottawa, and a recent report indicates the type of targets being pursued. See Molly Moses, who wrote:

> "**Recharacterization Referrals**. Phil Fortier, director of the CRA's International Tax Division, noted that the committee uses a three-stage approach in considering whether to recharacterize a transaction. First, it either approves or denies the auditor's request to look into the transaction; second, it decides whether to formally propose an adjustment under the recharacterization provisions in paragraph 247(2)(b) of the Canadian Income Tax Act; and finally, if the committee decides to propose an adjustment, it makes an assessment.
>
> Of the six reassessments made using the recharacterization provision, Fortier said, three involved the transfer of intangibles to low-tax jurisdictions and three involved patronage dividends – payments made to customers based on the volume of purchases that are paid from a pre-tax surplus and thus reduce the taxable income of the payor. Conditions for deductibility of those payments are set forth in section 135 of the Income Tax Act, the official said, adding that in the recharacterizations of those cases "we recharacterized the patronage dividends to be normal dividends."
>
> Of the 10 recharacterication transactions still under review, Fortier said, most involve the transfer of intangibles.
>
> While acknowledging the recent drop in referrals of recharacteriztion cases, Fortier added that "the numbers are small overall, so statistically we do not attach too much significance to them." Questioned about the seven cases that were dropped in 2008, which exceeded number received by the committee that year, the official explained that cases carry on over one or more fiscal years before final resolution. Accordingly, he said, the seven cases dropped in fiscal 2008 "likely originated in earlier fiscal years." "

b) Situations: Merck, Gildan, MacIsaac

But clearly most relevant here, is the apparent attempt to apply the rule to exactly what, in Brian's view, does not come within its ambit – an outright transfer of existing intangibles for a single, fixed, lump-sum price. This, apparently, is the pending litigation concerning the Merck group, which (according to the limited information in the public domain) saw Merck Canada make an outright transfer of the rights, to a pharmaceutical it had developed, to an offshore (Barbados) subsidiary. Apparently the Government is trying to invoke 247(2)(b) in a fashion which would work akin to the US super royalty rule. See Appendix No. 63 for related material.

Then only last week, the media[116] spotlight was put on a December 11, 2008 press release by Montreal-based Gildan, one of the World's largest suppliers of activewear, announced that "it had reached a final agreement" with CRA pursuant to which it would be paying approximately US$27M arising out of an assessment "…in respect of the restructuring of its international wholesale business and related transfer of assets to its Barbados subsidiary in fiscal 1999. [See Appendix No. 64] Although the release contains no further details, it is reasonable to assume that a significant aspect of the reassessment related to the transfer of intangibles and therefore ALP pricing issues in respect thereof. Query, also, the relationship between the actual facts of that matter and the concerns that OECD is now addressing in current studies respecting "business restructurings", dealt with in the next section.

Molly Moses, "CRA Reports Recharacterization Referrals to Penalty Review Committee Drop in 2008", *Tax Management Transfer Pricing*, Vol. 17, No. 9, September 11, 2008.

[116] See Randall Jackson "Montreal-Based Company Agrees to US$27M Tax Tab on Restructuring Transaction" *Tax Analysts*, January 9, 2009 (Tax Analyst electronic citation 2009WTD5-2, Document No. 2009368) (Appendix 64).

Finally and interestingly, even the narrow circumstances, where Brian tells us the rule is to operate (because the impugnable transaction would seemingly not have been done), may be suspect if one looks at a headline earlier this year respecting the famed Maritime fiddler – MacIsaac. He was reported to offer to sell an interest in 50% (or sell a 50% interest) of <u>both</u> his existing music properties and <u>those which he would develop in the future</u> – for a lump sum. Now is that not exactly the type of transaction that OECD (and ITA paragraph 247(2)(b)) say people, in the real world, don't do? [See Appendix No. 64 for MacIsaac Report]

(iii) A variation on the theme – the OECD and Business Restructurings

Strategies and efforts by multinationals to rationalize the way in which they conduct their global affairs, including obviously the implications thereof on the tax line on the PNL – none of which in principle could possibly raise any "new" intercompany pricing issue has attracted the attention of OECD (as though it could) sufficiently that it (OECD) put out a voluminous report this past September. [For extracts, see Appendix No. 65]. But notwithstanding the screaming headlines and the gnashing of teeth, etc., a review of the document reveals exactly what one should expect, namely, nothing new other than essentially unprincipled suggestions that the payer's transactions should be recharacterized.

(c) Transfers of Ownership – Inbound

Tax considerations usually militate against inbound intercompany transfers (whether the foreign group member owner of the intangible is parent of or subsidiary to the Canadian group member)

– and, instead, such are generally licensed to a Canadian subsidiary.[117] As a result, occasion does not often arise to deal with associated issues – which would be expected to simply be the ALP for the fixed single price to be paid, unless some type of contingent or royalty-type payment is to be made. That could not only raise different ALP issues, but Part XIII issues as well.

(d) Bundled transactions

What is a "bundled transaction" and why do we care? It is, in consumer terms, like buying a Christmas basket filled with twenty different food products and paying one lump sum price for the basket.

In commercial terms, it was encountered above (in relation to Part XIII) in the arm's length context in *Farmparts* and *Brad-Lea* and is, again, simply a transaction which sees several distinct things (property, services, use of property) delivered by one party in exchange for one overall price or consideration where such price or consideration does not result from aggregating prices or consideration separately established for each thing delivered.

Where such (bundled) transaction arises in a cross-border intercompany context, it must, in order to apply the ALP, be disassembled or delineated into its constituent parts so that a separate amount is established for each part or thing in order to assess the ALP. Or can one not argue that as long as comparable "bundles" are sold or delivered for a single price between unaffiliated persons, there is no necessity to test anything under ALP other than the single price?

---

117 However, this observer encountered and dealt with a situation where a foreign based group puts its head into the jaw of the lion (Canada's tax system) by transferring in the intangibles of a brand-name division in order to, or as a means of, extracting surplus cash of a Canadian subsidiary without incurring the tax cost

OECD says the following on this matter, at paragraphs 1.42-1.44::

> "1.42. Ideally, in order to arrive at the most precise approximation of fair market value, the arm's length principle should be applied on a transaction-by-transaction basis. However, there are often situations where separate transactions are so closely linked or continuous that they cannot be evaluated adequately on a separate basis. Examples, may include *1*. some long-term contracts for the supply of commodities or services, *2*. rights to use intangible property, and *3*. pricing a range of closely-linked produces (e.g. in a product line) when it is impractical to determine pricing for each individual product or transaction. Another example would be the licensing of manufacturing know-how and the supply of vital components to an associated manufacturer; it may be more reasonable to assess the arm's length terms for the two items together rather than individually. Such transactions should be evaluated together using the most appropriate arm's length method or methods. A further example would be the routing of a transaction through another associated enterprise; it may be more appropriate to consider the transaction of which the routing is a part of its entirety, rather than consider the individual transactions on a separate basis.
>
> 1.43. While some separately contracted transactions between associated enterprises may need to be evaluated together in order to determine whether the conditions are arm's length, other transactions contracted between such enterprises as a package may need to be evaluated separately. An MNE may package as a single transaction and establish a single price for a number of benefits such as licenses for patents, know-how, and trademarks, the provision of technical and administrative services, and the lease of production facilities. This type of arrangement is often referred to as a package deal. Such comprehensive packages would be unlikely to include sales of goods, however, although the price charged for sales of goods may cover some accompanying services. In some cases, it may not be feasible to evaluate the package as a whole so that the elements of the package must be segregated. In such cases, after determining separate transfer pricing for the seprate elements, the tax administration should nonetheless consider whether in total the transfer pricing for the entire package is arm's length.
>
> 1.44. Even in uncontrolled transactions, package deals may combine elements that are subject to different tax treatment under domestic law or an income tax convention. For example, royalty payments may be subject to withholding tax but lease payments may be subject to net taxation. In such circumstances ,it may still be appropriate to determine the transfer pricing on a package basis, and the tax administration could then determine whether for other tax reasons it is necessary to allocate the price to the elements of the package. In making this determination, tax administrations should examine the package deal between associated enterprises in the same way that they would analyse similar deals

---

(in Canada and the MNE’s home country) of extracting that cash by way of dividend payment. That up-front gain, however, gave rise to much long-term pain.

> between independent enterprises. Taxpayers should be prepared to show that the package deal reflects appropriate transfer pricing."

CRA deals with the matter in IC 87-2R (a paragraphs 36-42 and in TPM-6 ("Bundled Transactions" – May 16, 2005) which reflect the OECD thoughts. The latter is contained in Appendix 30.

The notion was raised in a *reverse way* as an element of a response by the taxpayer in the recent case of *Glaxo*.[118] Glaxo sought to “bundle” two different intercompany contracts with two different group members as a means of showing that the price on one was justified by reference to the price on the other – which itself was a bundled contract.

But the approach was rejected. (But, see T/P’s appeal.) The actual bundled contract – which was held to be irrelevant – saw a royalty-type payment (a percentage of sales) being paid by Glaxo Canada to its UK parent for a number of things: However, that contract was not in issue, *per se*, before the court and therefore the question of decomposing this bundle was not dealt with.

The bottom line on bundled transactions is that for ITA section 247 purposes, it is a question of fact as to whether they have to be disassembled, and for Part XIII purposes there are two competing factors:

> First, in concept, they should have to be disassembled for Part XIII.[119]

---

[118] *GlaxoSmithKline Inc. v. Her Majesty The Queen*, 2008 DTC 3957

[119] Is there any theory that the dominant character of a bundled transaction may govern the whole?

Second, *Farmparts* shows that the burden of doing so may be on the Crown if it wishes to successfully levy Part XIII tax.

(e) Cost sharing arrangements

Wish to avoid disputes over ALP of intercompany royalty payments, and separately where they would be outbound, Part XIII issues?

Then consider, where intangibles are to be used in both in Canada and in another country of a group member, having the intangible developed or purchased jointly whereby each member contributes funds proportionate to the expected value of the intangible in and for each relevant country. For example, if a particular patentable product is to be developed for subsequent manufacture and sale in Canada and the US by a Canadian-US group, have each side fund proportionate to the expected profitability in each country and have each side own the patent that ensues for each country. In that way, there will be no intercompany cross-border licenses and royalties.

Such arrangements are done under the rubrique of "cost sharing arrangements" where one of the parties undertakes to assemble the funds from all participants and carry out the development work with each party emerging with desired proprietary interest in the end result.

If done in a reasonably business-like basis, ITA section 247 issues should be avoided[120] and Part XIII has a specific rule[121] designed to ensure that in such appropriate circumstances no claim can

---

[120] See subsections and Section 247(4) and related definitions.

[121] See Appendices 21 and 62. Note that the IRS this past December 31, issued the long awaited temporary and proposed transfer pricing regulations addressing cost-sharing arrangements between U.S. parent

be made, where the Canadian group member is contributing funds to a cost-sharing arrangement-based development program, conducted by a foreign group member, that there is any Part XIII tax on the contributions.

(2) Additional Part XIII issues

(a) Related to ITA section 247

Certain types of intercompany transactions involving outbound payments may potentially invoke Part XIII in two different ways.

One way, already noted above, is where excessive outbound payments have been identified by and under the ALP rule and the excess is treated as a deemed dividend under the rules of ITA paragraph 214(3)(a) and ITA subsection 212(2), and either ITA subsection 15(1) or ITA subsection 56(2). [Review ITA section 246.]

The second is where the non-arm's length status of the payment invokes, by reason of that status, a Part XIII rule. For example, Part XIII tax applies, under ITA paragraph section 212(1)(a), to an "administration or management fee" as defined in ITA subsection 212(4).

The latter may exclude certain payments, but only if, *inter alia*, they are paid between arm's length practices. However, (leaving aside cost sharing dealt with above) there appears to be

---

companies and their foreign affiliates. (See, T.D. 9441, REG-144615-02) According to a report (Robert Goulder, "IRS Adheres to Investor Model In Revised Cost-Sharing Reg.", *Tax Analyst*, January 5, 2009, [2009 WTD 1-1]) "…the 193-page regulations retain the controversial 'investor model' that drew taxpayers' ire when introduced as part of a proposed regulatory package in August, 2005. The forward to the new regs, however, claims that the revised rules offer considerably greater flexibility in designing tax-efficient cost-sharing agreements (CSA's)."

nothing in Part XIII, in relation to outbound royalty or other "use" payments, which is, *per se*, triggered by non-arm's length status between the Canadian payor and non-resident recipient.

(b) Related to ITA section 78

As noted in Section IIIB, deductibility of royalties incurred in this course of carrying on a business, would normally arise on a "payable" not merely "accrual" and certainly not on a cash basis. "Payable" for these purposes means those that have become contractually owed at (as at) a prior date (whether or not a term has been granted to pay the amounts owing). But, as discussed earlier is there any theory under which there could be deducted on an "accrual" basis?[122] .

To the extent royalties are "payable" (and thus have been incurred) to a non-arm's length non-resident, but, are not paid within a specified period, the Canadian licensee has two choices – arising under ITA section 78, one of which would trigger a Part XIII liability.[123]

---

122 See question and answer in Section IIIB above which involves the situation where royalties are, for example, calculated as a percentage of sales and there have been relevant sales prior to/as of the particular time), but are not yet, as of the particular time, required to be paid.

123 As noted, central to this question is when are royalties "incurred" for purposes of subsection 78(1) of the Act. The answer depends upon whether one reads that word as consistent with derivative principle No. 10 in the Walker article dealt with in Section IIIB above, or is there room for a GAAP-based determination, which might produce a different result – one which could raise an anomalous result under section 78. The answer to this question is certainly not found in CRA, Interpretation Bulletin, IT-109R2 – Unpaid Amounts (April 23, 1993) which in a way simply muddies the waters by stating that section 78 does not apply, "…where an unpaid amount exists between the debtor and creditor for not dealing at arm's length and both taxpayers account for income on the *accrual basis*…" . [Italics added] It would be anomalous if the payor could deduct on an "accrued" basis in that that may not be sufficient to engage section 78 and thus providing a basis to deduct for Part I without a proximate matching Part XIII liability should there, for example, be a multi-year accrual period. To consider this matter further focus is required on the following key words in subsection 78(1): "deductible outlay or expense" that is "owing"…"at the time the outlay was incurred" to a non-arm's length person.

B. FOREIGN INTERCOMPANY LICENSING ARRANGEMENTS

(1) ITA subparagraph 95(2)(a)(ii)

In Section IVC, we examined the considerations where a Canadian has an interest in a foreign entity which earns royalties from transactions with unaffiliated parties. One possible result seen is that, in the case of a CFA, the income from royalty revenue would comprise part of attributable FAPI. This could, for example, entail a CFA which has nothing but one intangible which it has licensed to a single unaffiliated person and has no – (or less than "more than 5 full time") – employees. However, Canadian tax policy seeks to preserve the fundamental distinction between active business income and passive investment of CFAs and FAs even where the overall underlying activity has been bifurcated (or otherwise spread) between two (or more) foreign entities (and in particular CFAs or FAs) of the Canadian. That goal is achieved by rules which identify, and provide appropriate effects for, arrangements and transactions between CFAs or FAs, which see a CFA carrying on the basic (active) business ("OPCO") and another (HOLDCO) holding, owning property required by the former and which is made available by the latter to former by way of loan, lease or licensee. In those circumstances, interest, rent or royalties paid by one CFA to the other simply serves to "MOVE" or reallocate a portion of the profit of " OPCO." to "Holdco" and it is as appropriate that such inter-affiliate payment be treated as "active" (and not "FAPI") to the HOLDCO, as is such treatment for the underlying ABI out of which such payment is made to the OPCO. And that reclassification or recategorization is exactly what ITA subparagraph 95(2)(a)(ii) does, in relevant circumstances.

And it is in that context that we would see the royalty income in the hypothetical above – (which would be FAPI to the CFA if received from an unaffiliated licensee) – treated as <u>not</u> comprising

FAPI (but instead ABI) if the licensee is both another CFA or FA[124] of the Canadian owner of the royalty-earning CFA and uses the licensed intangible in carrying on an active business.

(2) Excluded Property

Not only would royalty income qualify for ITA subparagraph 95(2)(a)(ii) reclassification in appropriate circumstances, but as a result of a recent amendment, it is now clear that a sale of the intangible would qualify for exclusion from FAPI. In particular, such property is now specifically including in the definition "excluded property" (see paragraph (c) of the definition in subsection 95(1) and see the recharaterization to active business income of gain derived from the disposition of such property under new subparagraph 95(2)(a)(v)).

C. INTRACOMPANY AND NOTIONAL DEDUCTIONS[125]

(1) Overview of Matter

There is uncertainty for US companies carrying on business in Canada through Canadian branches as to whether a diplomatic note appended to the Protocol adequately addresses any negative inferences arising from the Federal Court of Appeal decision in *Cudd Pressure (Cudd Pressure Control Inc. v. the Queen*, 98 DTC 6630) respecting the ability of a Canadian branch to deduct notional or imputed amounts (e.g., rent, royalties or interest) for the use the branch makes of head office property. In the case of *Cudd*, it was rent.

---

124 Note the requirement for a "qualifying interest".

125 See Appendix 75 for related materials.

(2) *Cudd Pressure* and Related Factors

One of the three judges on the Federal Court of Appeal bench that heard *Cudd Pressure,* McDonald JA, decided that the 1942 Convention between the countries provided the basis for such intra-company charges, but that the particular facts in *Cudd Pressure* did not qualify for such treatment. The other two FCA judges declined to pronounce on the basic treaty question because they agreed with the lower court (the Tax Court) judge that even if there was such a rule, the facts did not trigger it (therefore arriving at the same conclusion on the facts of the case as McDonald JA).

The only discernable difference between the relevant aspects of the profit attribution rules of the 42 Treaty (in Article III) and of the 1980 Treaty (in Article VII) was the addition (in 1980) of the last sentence in Article VII(3) that reads as follows.

> "Nothing in this paragraph shall require a Contracting State to allow the deduction of any expenditure which, by reason of its nature, is not generally allowed as a deduction under the taxation laws of that State."

The Tax Court judge in *Cudd Pressure* (95 DTC, 559) was faced with a similar rule in a Canadian domestic statute dealing with treaty interpretation (the Income Tax Conventions Interpretation Act) – section 4(b) thereof which reads as follows.

> "Section 4 **Permanent establishments in Canada** – Notwithstanding the provisions of a convention or the Act giving the convention the force of law in Canada, it is hereby declared that the law of Canada is that where, for purposes of the application of the convention, the profits from a business activity, including an industrial or commercial activity, attributable or allocable to a permanent establishment in Canada are to be determined for any period.
>
> (a) …

> (b) There shall, except to the extent that an agreement between the competent authorities of the parties to the convention expressly otherwise provides, not be deducted in the determination of those profits any amount with respect to that activity that is attributable, allocable to the permanent establishment and that would not be deductible under the *Income Tax Act*, as amended from time to time, by a person resident in Canada carrying on the activity in Canada in the computation of his income from a business for that period."

The Tax Court judge (but not McDonald JA in the Federal Court of Appeal) decided that that ITCIA rule (which came into effect for tax years beginning after June 23, 1983 – before the events in *Cudd Pressure*- involving its taxation year ending June 30, 1985) governed the interpretation of the 42 Treaty (which applied to tax years beginning before 1985) and prohibited intra-company charges. McDonald JA found to the contrary. To that extent, it would appear that the add-on in 1980 to Article VII(3) – given its similarity to section 4(b) of the ITCIA - would not be a bar to the two countries confirming or agreeing to intra-company charges and that seems to be contemplated by the Fifth Protocol – see below.

Note three points respecting the above-noted addition to Article VII(3) – in 1980 - and the enactment of the above-noted ITCIA – in 1984. First, both developments predated the decisions years later (in the 90s) in *Cudd Pressure* and therefore could not be seen as having been motivated by those decisions or formulated having them in mind. Second, nothing in the 1984 US Treasury Technical Explanation respecting that addition to Article VII(3) or in the Explanatory Notes issued by the Department of Finance in conjunction with the tabling in 1984 of the ITCIA for enactment, suggested or suggest that those two developments were related to the issue of notional intra-company payments. Third, the terms of Article 7(3) of the 1986 Treaty between Canada and the Peoples Republic of China, which specifically exclude intra-company payments of "royalties, fees or other similar payments in return for the use of patents or

other rights, or by way of commission, for specific services performed or for management…." show that (1) the Canadian Government did not believe that section 4(b) of the ITCIA (which predated the treaty with the PRC) serves to deny intra-company payments, and (2) in general, without a specific restriction, the typical language in Article VII also does not serve to impose such restrictions. As well, in light of the relationship between the added portion of Article VII(3) and section 4(b), ITCIA, the PRC Treaty provision bears favourably on the notion that the 1980 addition to Article VII(3) is not to be seen, in and of itself, as serving to deny intra-company payments.

It is also useful to note that the Canadian Government has not been consistently opposed to the notion. In particular in 1992, the CRA issued an interpretation respecting a US corporation that expressed the view that a treaty provision may import the notion, in respect of intra-company dealing, of intercompany pricing rules in dealing with the transfer of goods between two branches of the same corporation thus, *inter alia*, recognizing a mark-up or profit margin for the manufacturing or wholesaling branch which is part of a corporation which carries on business both in and out of Canada. Each branch computes profits as though they were separate corps involved in an intercompany sale of goods. See, "Subsidiary Doing Business In Canada - Transfer Pricing", Revenue Canada Memorandum Rulings Directorate, 1 December 1992, note 2352 reprinted in CCH Canadian Limited, *The Tax Window*, Report No. 27, at 11.

(3) Section 9 – Annex B of Fifth Protocol

The Protocol contains the following in section 9 (*With reference to Article VII (Business Profits)* of Annex B.

> "It is understood that the business profits to be attributed to a permanent establishment shall include only the profits derived from the assets used, risks assumed and activities performed by the permanent establishment. The principles of the OECD Transfer Pricing Guidelines shall apply for purposes of determining the profits attributable to a permanent establishment, taking into account the different economic and legal circumstances of a single entity. Accordingly, any of the methods described therein as acceptable methods for determining an arm's length result may be used to determine the income of a permanent establishment so long as those methods are applied in accordance with the Guidelines…."

(4) The US Treasury Technical Explanation and Related Factors

The US Treasury Technical Explanation of the Fifth Protocol (agreed to by Canada) calls for recognizing head office or branch compensation for services performed within the arm's length pricing standard (illustrated by an example that specifically endorses the use of arm's length charges for head office expenses in lieu of cost allocations). It also goes on to suggest that notional intracompany charges are generally permissible:

> "Thus, the Contracting States agree that the notional payments used to compute the profits that are attributable to a permanent establishment will not be taxed as if they were actual payments for purposes of other taxing provisions of the Convention, for example, for purposes of taxing a notional royalty under Article XII (Royalties)."

As detailed in a discussion by David Ward and Colin Campbell in *Tax Notes International* (see Appendix 75) Canada has not entered any observation in respect of the Commentary to Article 7 of the OECD Model which was expanded substantially in 1994 after the OECD Council had adopted the November 26, 1993 OECD Report, "Attribution of Income to Permanent Establishments". That expanded Commentary supports the notion of notional deductions. The absence of a Canadian observation even after the decision of the courts in the *Cudd Pressure* case became known could (in the view of Ward and Campbell) reasonably be interpreted as an

indication that the CRA does not believe that the decision of the Federal Court of Appeal in that case constitutes any bar to the application of the internationally accepted rules for the attribution of income to a permanent establishment. And in the July 2008 revised OECD commentaries, Canada did not register an observation respecting Article 7.

(5) Withholding on Notional Deductions?

The Technical Explanation comment, set out above, brings to mind another instance where the Canadian Government took the view (albeit to try to raise tax revenue) – a view that was rejected by a court - that there can be, for domestic law purpose, an intra-company payment. See *20th Century Fox Film Corporation v. The Queen*, 85DTC 5513, where the notion was rejected that a Canadian branch of a US corporation could be considered to make an outbound (royalty) payment to the US head office of the US corporation for purposes of Part XIII.

SECTION VI - ELECTRONIC COMMERCE

A. OVERVIEW AND CORRELATION TO FOREGOING

What is "e-commerce", as the meaning thereof relates to (1) taxation generally and (2) our theme – royalties?

One approach to the question, is to delineate the players (i.e. the potential taxpayers) into two distinct groups or categories.

The first group – reasonably seen as the prime group – are what is often termed the "internet content providers" ("ICP") – that is, those who operate through the internet to sell something or provide a service or provide for the use of something to a customer, the end recipient of the goods, service or use.

Generally where the "ICP" is selling tangible goods through the internet (i.e. they are physically delivered by conventional (non-internet) means), the tax treatment that arises does not involve the rules applicable to royalties (or any rules associated therewith – such as ITA subparagraph 212(1)(d)(i), discussed above).

The same result should be apposite where the ICP provides a service which clearly is unaccompanied (not accompanied) by the provision of a use of any "thing" – through here, delineations, distinctions and categorizations or characterizations could become murkier.

Where, however, the ICP either "sells" a "digitized" thing or product (i.e. it comes to the customer through the internet and into his/her electronic receiver – laptop, BB, etc, etc.) or simply provides for a "use" of a digitized thing (already examined above to some extent in *Saint John*) the question of whether the arrangements will see the amounts paid by the customer being treated as royalties for tax purposes, or as amounts which attract tax rules similar to those applicable to royalties – again, for example, ITA subparagraph 212(1)(d)(i)).[126]

---

[126] [Note that the following comments are substantially similar to those made above. But in each case they add context to the separate matter under discussion.] CRA believes that the Canadian jurisprudence can be applied to the purchase or licensing of digital products. Where there is a purchase of a digital product, the CRA considers that the customer makes the payment to acquire the ownership of data transmitted in the form of a digital signal and any use of copyright involved in downloading the product is not an important part of the total consideration paid by the purchaser. As discussed above, CRA had considered a payment for the use of, or right to use, custom computer software to be a payment for a secret formula and within the definition of royalty in Article 12 and had an observation on this point in respect of Article 12 of the OECD Model Convention, but, then withdrew the observation on March 28, 2002. As a result, such a payment would now be considered to be within Article 7 of Canada's treaties that follow the OECD Model Convention. But, this conclusion would not apply to those of Canada's treaties that include in Article 12 a reference to a payment for the use of or right to use intangible property. In such cases, the payment for the use of or right to use a digital property would be a payment for the use of intangible property and therefore probably subject to Part XIII.

The second group are what are often termed the "internet service providers" ("ISP") – that is, those who facilitate the activities and operations of either the ICP or their customers. Since, in principle, ISP – by definition – are providing a service (and not, in concept, selling things or providing the use of things), their activities should not give rise to "royalty" related taxation. However, uncertainty can arise where their activities require – in "providing" their services – that they make use of something. Can that (the use by the ISP of something) always be distinguished from arrangements where the ISP provides, by way of use, something to their customers?

Perhaps some situations will invoke – comparatively – the difference between on the one hand, a bare boat charter (where the party to whom the boat is chartered then hires its own crew to run it) or lease of an auto (where the lessee then hires a driver to take him around), and on the other hand, a staffed, fully-crewed charter party or staffed taxi or limousine service when the owner uses the boat or auto in providing a service to a customer. E-commerce must be decomposed or delineated in the latter fashion in order to determine the tax effects and results thereof because it is subject to the same tax rules as have been written for bricks and mortar business and it has not become the object of any specific - dedicated – code of domestic tax law (in Canada – or seemingly in any other country) and, as a result of the latter, cannot become (and has not become) the object of any specific bilateral tax treaty rules – although as we will see below, OECD has been trying to adapt its Model tax treaty to aspects of e-commerce.

In terms of our topic – it will be seen that a bridge and segue to a discussion of e-commerce and royalties clearly is both the Canadian domestic development comprising the issue in *Saint John* and the treaty developments related thereto – as discussed above.

As a result, we will now briefly examine e-commerce and royalties through the prism of the format and parameters we have gone through earlier in this lecture respecting royalties in he non-e-commerce context.

Finally, by way of overview, the following can be noted respecting the specific, proactive, initiatives of the Canadian Government respecting e-commerce.

From the Department of Finance – in income tax matters, at least[127] -there has been no specific e-commerce-related legislation either enacted or proposed. As a result, it is logical that there also has been no specific e-commerce-related provisions seen in any recent new or renegotiated tax treaties. And this was conspicuously so in the Fifth Protocol to the Canada-US Treaty.

From CRA, there was a flurry of activity in the late 90s, but seemingly little since. In 1998 (April 30), CRA (then "Revenue Canada") released a report, "Report of the Minister's Advisory Committee on Electronic Commerce", containing 72 specific recommendations (see extracts in Appendix 81). Later that year (in September), the Minister of National Revenue responded to the report, "A Response by the Minister of National Revenue to his Advisory Committee's Report on Electronic Commerce" (see extracts in Appendix 81) followed by a May 31,1999 Revenue Canada press release announcing the appointment of four technical advisory groups to

---

[127] Relevant would be amendments to the legislation governing the GST - the *Excise Tax Act* (Revised Statutes of Canada, 1985. Chapter E-15, Part IX, as amended) ("ETA"). In the 1998 Revenue Canada Task Force report (Appendix 81), the committee acknowledges the difficulty in collecting GST on intangible goods traded over the Internet, particularly where sales to individual consumers are concerned. In the September 1998, Revenue Canada's response to the Committee's report (Appendix 81), Revenue Canada recognized the need for an international solution to Internet taxation, and commits itself to continue working with the OECD to find such solutions. These matters were fully discussed in "Understanding Tax Rules for the New Economy & Establishing Tax Efficient Offshore Structures", opening address presented to Strategy Institute's "What's New in Taxing Electronic Commerce" conference by Nathan Boidman on March 5, 2001, Toronto, almost ten years ago – but, in fact, little has changed since then.

provide “ongoing expert advice to Revenue Canada on electronic commerce issues” – one “on improving taxpayer service”, one “consumption tax”, one on “tax compliance and administration” and one on “interpretation and international cooperation” (see Appendix 81). The April 1998 report (and its 72 specific recommendations) essentially catalogued the issues it was thought the Government would face in achieving a fair share of tax base and revenue among jurisdictions. The Report recommended a “tax neutral position, maintenance of existing tax legislation but beefed up rules for administration and collection (including beefed up initiatives to locate non-filers and apply more vigorously penalties for non-compliance). There were no specific proposals to redefine the notion of carrying on business in Canada nor the manner in which there is to be determined the income that arises in Canada if business is carried on in Canada. The September 1998 response from the Minister essentially expressed agreement with the Advisory Committee’s recommendation. Since then CRA has issued a few releases and views including two news letters in 2002 (see Appendix 29) which have noted earlier in conjunction with lifting of Canada’s observation respecting paragraph 14 of the Commentary on Article 12. See also, Ministerial Letter 03486M8 – Whether Server is Permanent Establishment (February 17, 1999).

An interesting sidebar arose in reviewing, for this lecture, CRA’s views and some informal related discussions with the Agency. It turns out that an interpretation bulletin in preparation in the early part of this decade, but never released, is not dead. Apparently CRA is still working on it and still intends to release it in due course. This factor stemmed, in particular, from follow-up on a May 16, 2002 CRA document (2002-0135765) (reproduced in Appendix 81), which stated:

> "The Income Tax Rulings Directorate is currently working on two papers with respect to electronic commerce.
>
> 1. Position Paper Internet Commerce, with evolved from 2 sources:
>
> - a 1998 CCRA Technical Advisory Group (TAG) on Interpretation & International Cooperation; and
>
> - The "Taxation Framework Conditions", agreed upon in Ottawa in 1998 by member countries of the OECD.
>
> 2. Characterization Issues Arising From electronic Commerce, which evolved from the OECD TAG on Treaty Characterization of Electronic Commerce Payments.
>
> The above two papers have not been completed, but preliminary drafts have been forwarded to the Department of Finance for consultation purposes. Once the consultation process is completed with the Department of Finance, and once the OECD has finalized its positions on electronic commerce, the CCRA will make a decision as to how to communicate to the public the content of these two papers or, at least, how to communicate any significant discrepancies between the view of the OECD and the CCRA on this subject."

However, I could find no evidence of those ever being released. Queries to CRA in early January 2009 led to the remarkable revelation that they are still under work and review!

B. THE AMBIT OF E-COMMERCE AND COMMERCIAL LAW ASPECTS

Internet content providers (information service companies, entertainment vendors, software companies, etc.) distribute, electronically, computer software, telecommunications, movies, magazines, books, customer service, music albums, financial transactions and services, medical services, video conferencing, newspapers, educational and training materials, electronic bulletin boards, e-mail games, business data bases and miscellaneous information services. (As well, there can be direct marketing where goods and services are ordered over the Internet, but delivered by more conventional distribution channels.)

In some cases the party is a licensor (and provider of use) of information technology or other things – in digitized or non-digitized form – (including computer software, data bases, etc.), the use of which, but not the ownership of, is provided to a customer.[128]

A February 1, 2001, OECD Technical Assistant Group (TAG) Report [referred to above and set out in Appendix 82] concerning income characterization issues respecting e-commerce contained a very useful framework (in Annex 2) to consider the nature of e-commerce. That Annex sets out 28 categories of "typical e-commerce transactions" comprising (1) a "definition" of the type of transaction and (2) an "analysis and conclusions" with respect to the characterization from the standpoint of the Article 7 (business profit) and Article 12 (royalties) dichotomy and focus which is discussed below. The 28 categories are as follows: (1) electronic order processing of tangible products; (2) electronic ordering and downloading of digital products; (3) electronic ordering and downloading of digital products for purposes of commercial exploitation of the copyright; (4) updates and add-ons; (5) duration software and other digital information licenses; (6) single/use software or other digital product; (7) application hosting-separate license; (8) application hosting-bundled contract; (9) applications surface provider "ASP"; (10) ASP license fees; (11) web site hosting; (12) software maintenance; (13) data warehousing; (14) customer support over a computer network; (15) data retrieval; (16) delivery of exclusive or other high-value data; (17) advertising; (18) electronic access to professional advice (e.g. consultancy); (19) taxable information; (20) information delivery; (21) access to an interactive web site; (22) on-line shopping portals; (23) on-line auctions; (24) sales, referral programs; (25) content acquisition

128 For a detailed discussion see, "Canadian Taxation of Inbound Electronic Commerce" (Part I), e-commerce, Tax Planning International, Volume 2, Number 3, March 2000, page 7, by Nathan Boidman and Mark D.

transactions; (26) streamed (real time) web based broadcasting; (27) carriage fees and (28) subscription to a web site allowing the downloading of digital products.

C. CROSS BORDER – ARM'S LENGTH

(1) Inbound Transactions – Outbound Payments

(a) Overview

The discussion that follows sees treaties, their negotiations and folks at OECD seeking to extend to software and e-commerce the two basic themes relevant to royalties in general.

One is the Part I-Part XIII/Article 7-12 dichotomy and competing jurisdictions. The second is the definitional ambit or that which should or should not be included where Article 12-type rules are to govern. But since this is not a lecture on e-commerce *per se*, time and focus cannot be given the first theme, notwithstanding that it is clearly the threshold matter.[129] Therefore, the

---

Brender.

[129] But a few words are in order. There are the two prime factors respecting whether Article 7 has hegemony – namely does the e-commerce player have a permanent establishment in the source country and, if so, is the e-commerce items of income (and its resulting profit) allocated to the permanent establishment? Only if the answer is negative to at least one of them do we come to Article 12. These questions have been under study for the past ten years or so and are reflected to some extent in the July 17, 2008 revised OECD commentaries, but hardly at all in recent Canadian treaties. For example, the Fifth Protocol to the Canada-US Treaty does not mention the word "e-commerce" or "server" or "internet service provider" or "internet content provider".

The revised Commentary elaborates on the distinction between (1) provision of services, which may be exempt, pursuant to the to rules of Article 7 (without the use of a permanent establishment) and (2) contracts for the provision or conveyance of "know-how" (secret information concerning industrial, commercial or scientific experience) – which are subject to the rules of Article 12 and, therefore, subject to host country tax on the gross (at rates specified by Article 12 – generally, 10%) or by the terms of Article 12 exempted from such taxation. In delineating the difference between a contract of service and the provision of know-how, in the context of electronic commerce, the Commentary states in new paragraph 11.5 of Article 12, the following:

> In the particular case of a contract involving the provision, by the supplier, of information concerning computer programming, as a general rule the payment will only be considered to be made in consideration for the provision of such information so as to constitute

following focus on Article 12 assumes that the cross-border activity either does not involve a permanent establishment (e.g. captive controlled server, through which internet business is done) or, if it does, for some reason the resulting income is not attributed to the activities of the permanent establishment.

(b) Part XIII – Related

Given that neither Part XIII nor Canadian treaties specifically address e-commerce, the entire focus here is the effects of the OECD Model Treaty developments on taxes otherwise arising under Part XIII.[130]

The revised Commentary (stemming from the February 2001 TAG) comprises an extension of the comments in paragraphs 12 through 17 respecting software payments to "other types of digital products as images, sounds or texts". (Paragraph 17.1) Where a customer is permitted to

---

> know-how where it is made to acquire information constituting ideas and principles underlying the programme, such as logic, algorithms, or programming languages or techniques, where this information is provided under the condition that the customer not disclose it without authorization and where it is subject to any available trade secret protection.

Then in illustrating arrangements should be viewed as a provision of service (Article 7) and not know-how (Article 12) reference in made in paragraph 11.4 to "payments for advice provided electronically, for electronic communications with technicians or for accessing, through computer networks, a trouble-shooting data base…". Finally, in this context, paragraph 11.6 focuses on mixed contracts (which cover both know-how and the provision of technical assistance) and conclude that, in principle, such contracts should be broken down into their constituent parts but, where "…one part of what is being provided constitutes by far the principal purpose of the contract and the other parts stipulated therein are only of an ancillary and largely unimportant character, then the treatment applicable to the principal part should generally be applied to the whole amount of the consideration". In this respect see the decision in *Farmparts* (above)

130 David Sherman, editor of "Practitioner's Income Tax Act", 34th Edition,Thomson Carswell, 2008, at pg. 1322, cites CRA Income Tax Technical News No. 25 as the basis for the proposition that "payment for software downloaded from a website is not the payment of a royalty". Two points to note here. First, that the CRA document is dealing with the effects of a OECD-based treaty on the matter and does not *per se* treat the results under the Act itself. Second, CRA qualifies its taxpayer-favourable position in a manner discussed more specifically above.

electronically download digital products (software, images, sounds or text) the "main question to be addressed is the identification of that for which the payment is essentially made". (Paragraph 17.1) In making such determination the incidental use by the customer of copyright in the process of downloading is not necessarily determinative of the character of the payment. (Paragraph 17.2) Where the transaction provides for the "…customer's own use or enjoyment" of the downloaded digital product a payment is being made "…to acquire data, transmitted in the form of a digital signal…" such arrangement "…does not constitute royalties but falls within Article 7 or Article 13, as the case may be." (Paragraph 17.3)

The contrary case is set forth in paragraph 17.4 as follows:

> By contrast, transactions where the essential consideration for the payment is the granting of the right to use a copyright in a digital product that is electronically downloaded for that purpose will give rise to royalties. This would be the case, for example, of a book publisher who had paid to acquire the rights to reproduce a copyrighted picture that it would electronically download for the purpose of including it on the cover of a book that it is producing. In this transaction, the essential consideration for the payment is the acquisition of rights to use the copyright in the digital product, i.e. the right to reproduce and distribute the picture, and not merely for the acquisition of the digital content.

In summary, the essential distinction is between (1) payment for the non-reproduced use of content arising from the use of copyright (which is not royalties within the meaning of Article 12) and (2) the payment that is for the use or right to use, rights in the copyright (that is to reproduce, as illustrated in paragraph 17.4).

In line with the comments above respecting software, these views potentially conflict with Part XIII in light of the incomplete interpretation of ITA subparagraph 212(1)(d)(i) by the Federal

Court of Appeal in *Saint John Shipbuilding*,[131] which considered, but, did not fully decide that a payment for the right to use (but not to fully acquire) a computer program, was a payment within the literal words of the subparagraph. Clearly, any such ambit of that aspect of the Canadian law would not be permitted under a treaty which is interpreted in accordance with the revised Commentary. But, Canada, as already noted, has accepted this in principle.[132]

The TAG also considered changes to the commentary respecting transactions for the use of, or the right to use, industrial, commercial or scientific equipment. Note that the current model, in fact, does not permit taxation of such payments under Article 12 but instead they are covered by Article 7. Where a treaty does allow for the taxation of payments for the use of, or the right to use, industrial, commercial or scientific equipment, such is not aptly applied to payments for the use of digital products although it could apply arguably to the use of tangible computer equipment (hardware). In any event, no language was added to the Commentary respecting this matter.[133]

In principle, the overriding thrust of the study by the TAG was that Article 12 should not apply to payment made for the right to receive, enjoy and use electronically delivered software, images, sound or text. It is hard, however, to reconcile the views on know-how as set forth above in the revised Commentary and as dealt with in one of the 28 categories of e-commerce

---

131 See Section IV A(4)(a)(ii).

132 As noted earlier, Canada had initially reserved on the present commentary to Article 12 respecting computer software, but, then lifted the "observation". See Appendix 29.

133 Note that the Canada-U.S. Treaty goes further then "equipment" and permits Article 12 taxation of payments for use of any type of tangible property.

activities identified in the report,[134] (category 19) which states that a provision to a customer of undivulged technical information constitutes a royalty as a supply of know-how. On the other hand, the electronic delivery of widely available information in a custom-packaged format is, according to Category 20, to be treated under Article 7. The distinction appears to be that know-how is a very tightly controlled supply of information and thus falls under the royalty category.

Of the 28 categories of typical e-commerce transaction, only five categories entirely, or partially, are seen as coming within the definition of royalties in the OECD Model. See (1) Category 3 (electronic ordering and downloading of digital products for purposes of commercial exploitation of the copyright) (2) Category 14 (customer support over a computer network), only to the extent that the activity conveyed "undivulged technical information" (i.e. know-how) (3) Category 19 (technical information) – entailing "undivulged technical information" (4) Category 21 (access interactive web site), but only to the extent the payments for the right to use copyright in digital content which is provided to subscribers and (5) Category 25 (content acquisition and transactions) to the extent that the said operator pays a content provider for the right to display copyrighted material. Where, however, the operator pays for the creation of new content and becomes the owner, the payment cannot, of course, be royalties.

(2) Outbound Transactions – Inbound Payments

At this point, there are no particular points to be made.

---

[134] See above.

(3) Involving Foreign Investees

The Minister's Advisory Committee Report (April 30, 1998) addressed, in a somewhat surprisingly sympathetic fashion, the problem that the current rules are probably too restrictive and probably, without justification, will all too often treat electronic commerce profits as FAPI, and for the Committee's recommendations would liberalize the rules. But, that was not done[135] - except for the CRA extension of its shrink-warp safe-harbour to this area. See discussion above.

The final parameter for Canadian based business will be the lure of seeking to use tax havens in which to base components of internet commerce (perhaps servers etc.) which raises two or three other Canadian tax issues (aside from issues in the host country where customers are located).

First, there is the question of mind and management of such offshore subsidiaries and whether they are really carried on in Canada, in which case, under the dual-pronged test of corporate residency, could render such offshore companies taxable in Canada.

Secondly, there is the question of whether such foreign subsidiaries carry on business in Canada because of activities in (a Canadian) head office, where residency in Canada cannot be found.

Thirdly, there is the question of transfer pricing with respect to transactions between the Canadian parent and the offshore company and whether or not there are appropriate fees or other charges being paid by the offshore company for services or other inputs received from the Canadian parent.

---

[135] The Minister's response (in September 1998) – Appendix 81 - with respect to the thrust of these recommendations (to liberalize the foreign affiliate system for Canadian based electronic commerce players

However, that aspect of Canada's foreign affiliate system that provides for "earning stripping" arrangements [through low-taxed (e.g. tax-haven) foreign captive financing or licensing subsidiary] with subsidiaries located in high tax countries, such as the U.S. remains available, where it can be adapted to electronic commerce.

D. CROSS BORDER – INTERCOMPANY

The e-commerce factors does not raise any obvious issues not already discussed above.

SECTION VII - RELATED CONTRACTUAL MATTERS

Issues between contracting parties arising out of cross-border withholding taxes are an everyday part of commercial life. Is there an exemption? Is it unclear? If there is not or it is unclear, which party will agree to bear the costs of the withholding tax? The way in which parties work out this matter can take various forms, but where it entails the Canadian payor agreeing to compensate the foreign person in respect of any Part XIII tax (whether we're dealing with a licensing or rental or a transaction that attracts the "pyramid" effects of the subparagraphs in paragraph 212(1)(d)), an added Part XIII tax issue arises. In particular, will there be additional tax on the additional payment (the "gross-up") made by the Canadian to compensate the foreign party? And if so, one can descend into man endless round of tax determination computations and payments. CRA's views on this type of situation as set out in a technical interpretation and may be summarized as follows.[136]

---

through foreign subsidiaries) simply stated that the matter is one of tax policy, to which the Minister is sure the Department of Finance will give due consideration. (Cold comfort!)

[136] See Technical Interpretation No. 2006-021429117 (March 18, 2007) – "Part XIII and Gross-Up".

SECTION VIII - APPENDICES

See accompanying Appendices and a covering Table of Contents thereof.

Nathan Boidman

January 12, 2009 and August 24 2009

NB/nlg/ehf

Nathan Boidman, Davies Ward Phillips & Vineberg, LLP