

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.<sup>65</sup>

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

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 gave to a Canadian in any positive sense of making property available for use or proving a service, but rather what a non-resident promised 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<sup>66</sup>, but by reason of the government's major proposed section 56.4 initiative to counter the decisions in *Fortino* and *Manuel* (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 the coordinating change to be made to subparagraph (iv). More on this below in section •.

The provision before the amendment reads as follows:

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<sup>65</sup> 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 Scheuermann (...). 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.

<sup>66</sup> 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

“...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)...”

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.<sup>67</sup>

**(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

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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.

<sup>67</sup> See discussion by Duncan Osborne – Appendix 2.

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.

**(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:**

[TO COME]

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 interesting is 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?

- The general notion

- [to come]

- The notion in relation to royalties
  - [to come]

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* (cite) and *Manrell* (cite), 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, the 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. And it was noted that there has been some surprise expressed that the government did not try to argue that rule in either *Farmparts* or *Grand Toy*.<sup>68</sup>

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

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<sup>68</sup> See Duncan Osborne – Appendix 2.

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 normal business exigencies the foreign party may not have 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 to receive the right to do something. 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.<sup>69</sup>

**(ix) Exemptions and special cases under paragraph 212(1)(d)<sup>70</sup>**

Subparagraphs (vi) and (xii) of paragraph 212(1)(d) *inverts* the pyramid, by exempting payments otherwise payable as rents or royalties.<sup>71</sup> These include payments for rights to reproduce copyright, cost-sharing, if related to foreign business undertakings on 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.<sup>72</sup> Accordingly, a Canadian who is granted the right to reproduce and then sell a computer programme can pay a royalty in respect thereof to the foreign licensor without Part XIII tax.<sup>73</sup>

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<sup>69</sup> 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.

<sup>70</sup> Duncan (Appendix 2) discusses exemptions at page 416 and F/N 38 and related text.

<sup>71</sup> Do they also affect (i) – (v)?

<sup>72</sup> 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.

<sup>73</sup> 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.

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.<sup>74</sup> Where the matter is uncertain (as examined in Section ■ 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 (iv).<sup>75</sup>

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

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<sup>74</sup> 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.

<sup>75</sup> See ■.



(2) came within CRA's administrative made safe harbour for "shrink wrap" software as discussed and explained elsewhere herein.<sup>76</sup>

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 more than \$24 a package of Microsoft software. I opened the package and found a piece of paper that told me I shouldn't dare try to recopy or reengineer 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.

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

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<sup>76</sup> For CRA's various views on so-called "shrink wrap", see note ■ 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.

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 (iv).

All of this is potentially quite relevant to and, therefore, a segue to the discussions below respecting royalties and e-commerce.<sup>77</sup>

**b) Special rules for films, etc.**

To review the cases of *Paris* and *Vauban*.<sup>78</sup>

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<sup>77</sup> 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.

<sup>78</sup> 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

(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.<sup>79</sup>

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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.

<sup>79</sup> 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. 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.

The word and notion of franchising does appear in certain context in Part I of the Act and the regulations made thereto.<sup>80</sup>

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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.”

<sup>80</sup> 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:

“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

Given the uncertain nature of the meaning of the term or notion, franchise (see note ■) 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 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!<sup>81</sup>

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

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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;

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.<sup>82</sup>

**(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".

[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

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<sup>81</sup> An examination of the lower court (FCTD) decision in *Farmparts* does not shed light on this aspect of the case.

<sup>82</sup> See also CRA Views in Technical Interpretation 2007-0253321E5. And, separately, reference can be had to the decision in *Entré Computer*, *supra*, note ■, 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.

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**

The Advisory Panel Report (*supra*, note ●) give considerable thought to whether Canada should unilaterally reduce Part XIII taxation and especially addresses the question in relation to outbound royalty payments. As seen in the excerpt of the report in Appendix ●, the Panel recommends that Part XIII be maintain as is but that Canada negotiate bilateral treaty reductions which are in Canada's overall interest.

**(b) Treaty – Part XIII<sup>83</sup>**

**(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.<sup>84</sup> 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.

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<sup>83</sup> 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).

**(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 in dealing with the issue. This role was the subject matter of David Ward's 2006 Travelling Lectureship and discussed as well in Robert Couzin's lecture last year.

David's lecture particularly focused 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* (cite) and *Prevost* (cite)), 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 exempt, which obviously, therefore, makes it alternative, 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 "02" is not adopted, this

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<sup>84</sup> See David Ward on this threshold point – Appendix 31.



preference is to (1) see as narrow a definition as possible and (2) see the payment qualify for exemption under, say, 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 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 (as already alluded to above) 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 will be specifically considered and dealt with in a section (Section VIII) on e-commerce, and here an effort (which is not totally achieved) will be made to extract and isolate those elements relevant to software.

The discussion that follows sees treaties, their negotiations and folks at OECD struggling (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. The first 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.<sup>85</sup> 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.

The second focus of the revised Commentary, comprises an extension of the comments in paragraph 14 of the existing Commentary respecting software payments to “other types of digital products as images, sounds or texts”.<sup>86</sup> Where a customer is permitted to electronically download digital products (software, images, sounds or text) the “main question to be addressed is the identification of the consideration for the payment”. (Paragraph 17.1). In making such

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<sup>85</sup> 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”.

<sup>86</sup> See note 88 (above or below) respecting Canada’s “Observation” respecting paragraph 14 and then the lifting of it.

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).

It should be noted that this view directly conflicts 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*,<sup>87</sup> 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.<sup>88</sup>

**(iii) Canada**

**a) Basics**

- Varies between 10% and 0%
  - Treaties with rates in excess of 10%

- Canada-US

- Canada-Netherlands

- Other?

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 exemptions was conceptually expanded by the 1993 federal budget which announced that

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<sup>87</sup> *Supra.*

<sup>88</sup> 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:

“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 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.

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)**

[TO COME]

**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 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.<sup>89</sup>

Where does this leave us? On shrinkwrap, 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 shrinkwrap.

**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.<sup>90</sup>

**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, which in treaty terms may have the following counterparts. [MORE TO COME]

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<sup>89</sup> See next note.

<sup>90</sup> 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 for the tail end of 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 #23 or 25. The government’s position, of

[US CASCADING THEORIES]

**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<sup>91</sup> 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.

That latter view of the world was asserted by CRA in two cases (not involving royalties) that have been decided by our courts – *MIL*<sup>92</sup> and *Prevost*<sup>93</sup> – and in both cases the attack was rejected by our courts.

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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.

<sup>91</sup> Note curiously absent from the Article 5/7 paradigm.

<sup>92</sup> *MIL* – Treaty Shopping and GAAR

<sup>93</sup> *Prevost* – Beneficial Ownership

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. It can be seen that [...].

**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,<sup>94</sup> penalties<sup>95</sup> and interest<sup>96</sup>. 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.

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<sup>97</sup> 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 revised “limitation on benefits rule exacerbate uncertainty for the ITA

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<sup>94</sup> [TO COME]

<sup>95</sup> [TO COME]

<sup>96</sup> [TO COME]

<sup>97</sup> [TO COME]



section 215 agent. And the Fifth Protocol to the Canada-US Treaty may muddy the waters further.

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 its 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.
  - The LLC makes deductible payments in respect of .....

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. [Time permitting, we examine some of these possibilities during the lecture.]

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 Treaty, and which base case will also serve to illustrate to effect of ITAR subsection 10(6) and IC #12-R6 on the ITA section 215 withholding agent.<sup>98</sup>

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<sup>98</sup> 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

**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 LOB provision?

**(5) Elsewhere**

**(a) Domestic**

- Dichotomy similar to Part I v. Part XIII?
- Compare to Part XIII?
  - Special Sourcing Rules: US Cascading Notion

**(b) US Treaty**

- Basic Policy
- Certain Exceptional Situations

**(c) UN Expansive Notion**

**(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 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, even without an ITA permanent establishment, 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 [QUOTE WORDS] 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 [QUOTE WORDS].

**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.<sup>99</sup>

**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. ●, dealing with ● notes:...

**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

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<sup>99</sup> CRA views?

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**

- (TO COME)

**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<sup>100</sup>;  
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.

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.<sup>101</sup> If only the second condition is satisfied, the profits are not taxed until repatriated.<sup>102</sup>

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.<sup>103</sup> If such foreign taxes are less than 38%<sup>104</sup>, 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

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<sup>100</sup> 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 ■ - has, of course, recommended that exempt surplus treatment be de-coupled (unlinked) from treaty-nexus requirements. For full details see (TNI Article).

<sup>101</sup> See sections 90-95 and 113(1)(a) of the Act and the Regulations made thereunder.

<sup>102</sup> See sections 90-95 and 113(1)(b) of the Act and Regulations made thereunder.

<sup>103</sup> See section 91.

licensing of things (such as software etc.) unless such business employs more than 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.

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 activities see the CFA “...derive income from property (including royalties [Note: not defined] or any similar returns [this is one of the elephants in the room] or substitutes for

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<sup>104</sup> Under proposed amendments that would now be down to 29.5% (?).

such...royalties [this is the second elephant in the room] or profits from the disposition of investment property...” (parenthetical words added)

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 [Comment re: definition and lack thereof] would attract clear treatment, the two obvious uncertainties (the two elephants in the room) 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.

Furthermore, if what is being dealt in meets CRA’s administrative-made definition of “shrink-wrap”, (See Section ●) 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.”<sup>105</sup>

**(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 more than 10% of gross royalties of what otherwise would be income derived from an active business are paid to the CFA by residents of Canada.

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 section 95(2.1).) 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 of Canadian resident users.

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.

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<sup>105</sup> See CRA Technical Interpretation (“Views Doc”) 2003-0016791E5 (Date?). (See also CRA’s Interpretation No. 9507915 (...), 9520295 (...) and 9722915 (...) respecting active business income versus investment business. [To check these out.]

**(3) ITA section 94.1**

Under current ITA section 94.1, if a Canadian owns an interest in a foreign (non-resident) corporation which is not a CFA or in a trust which is not subject to current ITA section 94 (for example, it is a non-discretionary trust and the interest is less than 10%), the principal value of the trust is a “portfolio” of royalty-producing property and one of the main purposes of acquiring or maintaining that interest – having regard to a number of factors – is to avoid or defer Canadian tax, notional income is considered to arise and is includable in income. What would constitute a “portfolio” of such property? Would that include one property, licensed to one royalty-paying party?

Under 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 royalty-producing property 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” [TO BE COMPLETED].

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 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 finding 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.<sup>106</sup> 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).

**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).

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<sup>106</sup> 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).



**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? [See TPM •]

**(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. 33 and paragraph • therein (OECD) which deals with the recharacterization rule recommended by the OECD.
- 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.<sup>107</sup>

**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 legislation 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<sup>108</sup> 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

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<sup>107</sup> CRA deals with this on a centralized basis in Ottawa, and a recent report indicates the following type of targets: [●]

<sup>108</sup> 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).

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.

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 both his existing music properties and those which he would develop in the future – 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. • 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. [MORE TO COME]

**(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.<sup>109</sup> 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

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<sup>109</sup> 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 (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.

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?

OECD says the following on this matter:

[TO COME]

CRA in IC-87-2R (and TPM) says the following about the matter:

[TO COME]

The notion was raised in a *reverse way* as an element of a response by the taxpayer in the recent case of *Glaxo*.<sup>110</sup> 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: [TO COME]. However, that contract was not in issue, *per se*, before the court and therefore the question of decomposing this bundle was not dealt with.

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<sup>110</sup> To cite

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.<sup>111</sup>
- 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.

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<sup>111</sup> Is there any theory that the dominant character of a bundled transaction may govern the whole?



Such arrangements are done under the rubric 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<sup>112</sup> and Part XIII has a specific rule<sup>113</sup> designed to ensure that in such appropriate circumstances no claim can 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(●)(●) and ITA subsection 212(2), and either ITA subsection 15(1) or ITA subsection 56(●) and ITA section 246.

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<sup>112</sup> Re: Section 247(4) and definitions.

<sup>113</sup> 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 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 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, there appears to be 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. [TO CHECK]

**(b) Related to ITA section 78**

As noted in section ●, 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?<sup>114</sup>

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.<sup>115</sup>

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the new regs, however, claims that the revised rules offer considerably greater flexibility in designing tax-efficient cost-sharing agreements (CSA's)."

<sup>114</sup> See Question #● and related answer in Section ● 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.

<sup>115</sup> 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 No. 10 in the

**B. FOREIGN INTERCOMPANY LICENSING ARRANGEMENTS**

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

In section ●, 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

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Walker article dealt with in section ● 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 year.

“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 not comprising FAPI (but instead ABI) if the licensee is both another CFA or FA<sup>116</sup> of the Canadian owner of the royalty-earning CFA and uses the licensed intangible in carrying on an active business.

Finally, not only would royalty income qualify for ITA subparagraph 95(2)(a)(ii) reclassification in appropriate circumstances, but as a result of a recent (proposed or enacted (?)) amendment, it is now clear that a sale of the intangible would qualify for the “excluded property” rules<sup>117</sup> and thus not included in “FAPI”.

## **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.

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<sup>116</sup> Note the requirement for a “qualifying interest”.

<sup>117</sup> [TO COME]

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)).<sup>118</sup>

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<sup>118</sup> 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

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

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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.

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 the 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<sup>119</sup> -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.

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<sup>119</sup> 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. See also, ● and ●.

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 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.

## **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.<sup>120</sup>

A February 1, 2001, OECD Technical Assistant Group (TAG) Report 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

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<sup>120</sup> 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. Brender.

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 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.<sup>121</sup> Therefore, the

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<sup>121</sup> See section ●:- the first theme is to be dealt with first as a means of determining whether the second is in fact relevant. In particular, 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”.

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.<sup>122</sup> (TO CHECK THE OECD REFERENCES THAT FOLLOW IN THIS

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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 11.3, 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 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 is made 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 11.5 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 *The Queen v. Farmparts Distributing Ltd.*, 80 DTC 6157 (F.C.A.)

<sup>122</sup> David Sherman, editor of "Practitioner's Income Tax Act", 34<sup>th</sup> 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

SECTION – AND IN A PRIOR SECTION WHERE THEY APPEAR - AS WELL AS THE EXCERPTED LANGUAGE AGAINST THE JULY 2008 FINAL REVISIONS OF THE OECD COMMENTARIES.)

The revised Commentary (stemming from the February 2001 TAG) comprises an extension of the comments in paragraph 14 of the existing Commentary respecting software payments to “other types of digital products as images, sounds or texts”. Where a customer is permitted to electronically download digital products (software, images, sounds or text) the “main question to be addressed is the identification of the consideration for the payment”. (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

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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 at section • .

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).

That this view potentially directly conflicts 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*,<sup>123</sup> 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.<sup>124</sup> But, Canada, as already noted, has accepted this in principal.

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

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<sup>123</sup> *Infra* note ●.

<sup>124</sup> As noted elsewhere, Canada had initially reserved on the present commentary to Article 12 respecting computer software, but, then lifted the "observation". See note:

equipment (hardware). In any event, no language was added to the Commentary respecting this matter.<sup>125</sup>

In principle, the overriding thrust of the study by the TAG is 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 activities identified in the report,<sup>126</sup> (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

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<sup>125</sup> Note that the Canada-U.S. Treaty goes further than “equipment” and permits Article 12 taxation of payments for use of any type of tangible property.

<sup>126</sup> See note ● below.

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.

**(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<sup>127</sup> - 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.

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<sup>127</sup> 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 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!).

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.

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**

[Anything special here? TO COME]

**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.<sup>128</sup>

**SECTION VIII - APPENDICES**

See accompanying Appendices and a covering Table of Contents Thereof

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<sup>128</sup> See Technical Interpretation No. 2006-021429117 (March 18, 2007) – “Part XIII and Gross-Up”.