Section 3(a) of the Income Tax Act\(^1\) stipulates that the income of a taxpayer for a given taxation year is, without limitation, his income for the year from each office, employment, business and property.

Section 248 of the Income Tax Act defines the word "property" as meaning property of any kind whatever whether real or personal or corporeal or incorporeal and, without restricting the generality of the foregoing, includes:

- a) a right of any kind whatever, a share or a chose in action,
- b) unless a contrary intention is evident, money, and,
- c) a timber resource property.

Patents, industrial designs, trade-marks and copyrights (hereinafter referred to as: "Intellectual Property") are to be included in the kind of property described as incorporeal. It follows that income derived therefrom will be taxable under the Income Tax Act.

**PATENTS, FRANCHISES, CONCESSIONS OR LICENSES**

Since the income derived from intellectual properties will be taxable, all expenses incurred to acquire them should be deductible under Section 18(1)(a) within the limits imposed by Section 18(1)(b) of the Income Tax Act.
Section 18(1)(a) authorizes the deduction of expenses to the extent that they were made or incurred by a taxpayer for the purpose of gaining or producing income from a business or property.

Section 18(1)(b) stipulates that no deduction shall be made in respect of an outlay, loss or replacement of property, a payment on account of capital or an allowance in respect of depreciation, obsolescence or depletion except as expressly permitted by the Act.

An intellectual property is a capital asset, therefore, no deduction will be allowed for expenses incurred to obtain or acquire it, except as expressly provided by the Act.

Section 20(1)(a) states that in computing a taxpayer's income for a taxation year from a business or property, there may be deducted such part of the capital cost to the taxpayer of the property, if any, as is allowed by Regulation.

Regulation 1100(1)(c) permits the deduction of a capital cost allowance with respect to property of Class 14. That Regulation reads as follows:

“For the purposes of paragraph 20(1)(a) of the Act, there is hereby allowed to a taxpayer, in computing his income from a business or property, as the case may be, deductions for each taxation year equal to such amount as he may claim in respect of property of Class 24 in Schedule II not exceeding the lesser of:

(i) the aggregate of the amounts for the year obtained by apportioning the capital cost to him of each property over the life of the property remaining at the time the cost was incurred, and

(ii) the undepreciated capital cost to him as of the end of the taxation year (before making any deduction under this subsection for the taxation year) of property of the Class”.

Class 14 in Schedule II enumerates the property which is covered by the Class and it reads as follows:

“Property that is a patent, franchise, concession or license for a limited period in respect of property, except:

(a) a franchise, concession or license in respect of minerals, petroleum, natural gas, other related hydrocarbons or timber and property relating thereto (except, a franchise for distributing gas to consumers or a license to export gas from Canada or from a Province) or in respect of a right to explore for, drill for, take or
remove minerals, petroleum, natural gas, other related hydrocarbons or timber,
(b) a leasehold interest, or
(c) a property included in Class 23”.

Therefore, patents and more generally franchises, concessions or licenses are depreciable on a straight line basis by apportioning the capital cost of each property over the life remaining thereon at the time the cost was incurred. If a patent, at the time it was purchased, had ten years to live before falling into the public domain, then, the purchaser will be permitted to take an allowance representing 10% of his capital cost every year for the next ten years. The inventor of a newly obtained patent could amortize his cost by taking a depreciation representing 1/17 of his cost for the following 17 years.

In the case of Weinberger v. M.N.R. (1964) C.T.C. 103, the Exchequer Court held that the capital cost to an inventor included all costs incurred for the development of the invention during a period of 20 years. It was then decided that the capital cost included not only the legal fees and other accessory costs of registration, as it had been decided by the Tax Appeal Board, but included all the expenses incurred in order to arrive at the invention and to improve it.

It is to be noted that capital cost allowance can only be permitted if an invention is patented. Therefore, an inventor who did not succeed in obtaining a patent, could not claim any deduction with respect to the expenses incurred to realize his invention. Such a principle was upheld by the Tax Appeal Board Number 244 v. M.N.R. 12, Tax A.B.C. 371. In this case, a payment had been made for the purchase of a patent pending. The Board held that the cost was not depreciable because patent pendings did not form part of property described in Class 14 as long as the patent was not granted.

The Department of National Revenue is of the opinion that the cost of a property of Class 14 must be apportioned equally between each day remaining in the life of the asset. “For example, if a one year franchise were purchased by a taxpayer on a calendar year basis on December 31, 1979, only 1/365th of the capital cost of the franchise would become available for depreciation in 1979”.

A different point of view has been expressed by some authors. They take the position that capital cost allowance for a whole year can be deducted even though a patent was acquired only on the last day of the taxation year.

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3 MacDonald, Cronkwright, INCOME TAXATION IN CANADA, paragraph 21,448.
Regulation 1100(9) provides a special method for the depletion of certain patents. Regulation 1100(9) reads as follows:

"Where a part or all of the cost of a patent is determined by reference to the use of the patent, in lieu of the deduction allowed under paragraph 1(c), a taxpayer, in computing his income for a taxation year from a business or property, as the case may be, may deduct such amount as he may claim in respect of the property of Class 14 in Schedule II not exceeding the lesser of:

(a) the aggregate of:
   (i) that part of the capital cost determined by reference to the use of the patent in the year, and
   (ii) the amount that would be computed under paragraph 1(c)(i) if the capital cost of the patent did not include the amounts determined by reference to the use of the patent in that year and previous years, and

(b) the undepreciated capital cost to him as of the end of the taxation year (before taking any deduction under this subsection for the taxation year) of property of the Class.

This special provision for amortizing the capital cost of a patent can be used if it is to the advantage of the taxpayer. This Rule is applicable when part or all of the cost of a patent is based on its use. Under such circumstances, the cost of the patent is apportioned between that part of the cost which is dependent on use and that part of the cost which is fixed. The part of the cost which is subject to change can be claimed as a deduction in the year in which it is incurred. That part of the cost which is incurred once and for all will be subject to the general rule which provides that property of Class 14 is depreciable on a straight line basis while the patent is in force.

Section 20(16) of the Income Tax Act states that a terminal loss arising at the time when a taxpayer disposes of all his property of Class 14 must be deducted in computing his income for the year and cannot be deferred.

The franchises, concessions and licenses referred to in Class 14 can be considered inter alia as franchises, concessions and licenses of patents, copyrights, trade-marks and industrial designs. The sale of a patent or its concession under license will have, for the parties concerned, tax implications not to be neglected. The sale of a patent can give rise to a capital gain and to recapture of capital allowance. Under special circumstances, the sale of a patent can generate business income.
The criteria to be used to determine if a sale of a patent generates a capital gain or business income.

The criteria to be used in determining if a sale of a patent generates a capital gain or business income are the same as those established by the jurisprudence where assets of a different nature were involved. The Courts agree that the applicable rule was well summarized by Lord Justice Clerk in Californian Cooper Syndicate Ltd. v. Harris, where his Lordship wrote:

"It is quite a well settled principle in dealing with questions of assessment of Income Tax that where an owner of an ordinary investment chooses to realize it, and obtains a greater price for it than he originally acquired it at, the enhanced price is not profit (...) assessable to Income Tax. But, it is equally well established that enhanced values obtained from realization or conversion of securities may be so assessable where what is done is not merely a realization or change of investment, but an act done in what is truly the carrying on, or carrying out of a business. The simplest case is that of a person or association of persons buying and selling lands or securities speculatively, in order to make gain, dealing in such investments as a business, and thereby seeking to make profit. There are many companies which in their very inception are formed for such a purpose, and in these cases it is not doubtful that, where they make a gain by a realization, the gain they make is liable to be asset for Income Tax".  

Each case will always be decided upon its own merit. If it can be shown that a person deals with patents as others deal with stock in trade, then, the benefit realized upon the disposition of such patents will be taxable as profit from a business.

Certain contracts take the form of a deed of sale but are really in substance license contracts. In this type of contract, it will generally be stipulated that the purchase price of the patent will be established on the basis of the number of patented units sold. In these cases, the courts have found that the payments made on instalments are really royalties and not part of the sale price. In the case of Mr. R. v. Minister of National Revenue, an agreement had been entered into between a taxpayer and a company by which the taxpayer sold his interest in an invention for $1,000.00 cash and $999,000.00 to be paid at a certain rate for each unit of the invention sold by the company. Pursuant to the agreement, the taxpayer received $6,382.00 in 1946 but did not include it in his income for that year on the ground that it was a capital receipt and therefore not taxable. The Minister of National Revenue assessed the taxpayer as having received such sum as income. It was found by the

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4(1904), 5 Tax Cas. 159 page 165.
Tax Appeal Board that the instalments were royalties or were like periodical receipts and so constituted income under Section 3(1)(f) of the Income Tax Act.\(^5\)

In a license agreement, it is possible to have part of the sums received as royalties and part of the sums received as capital payment. This is in fact what Canadian Industries Ltd. had tried to demonstrate to the Federal Court of Canada. In that case, the Federal Court of Appeal maintained a judgment of the Trial Division which in its turn had maintained a decision rendered by the Tax Review Board. The facts of this case can be summarized as follows:

In 1960, C.I.L. had acquired from a Swedish company certain non-exclusive rights to a patent and in some technical data which aimed at improving the manufacture of dynamite. Before 1967, the Government of the United States was practically the only client of C.I.L. as far as the dynamite was concerned. During that year, C.I.L. had granted to the Government of United States the non-exclusive rights to use for a period of ten years the American patents owned by the Swedish company. It was also agreed that C.I.L. would provide information, know-how and technical assistance for the manufacture of dynamite. Under the terms of the agreement, C.I.L. received a lump sum payment in two instalments. Subsequently, the American Government stopped buying dynamite from C.I.L. The issue before the Court was whether the payment received by C.I.L. in 1967 was a capital receipt of an income receipt. The Tax Review Board and the Trial Division of the Federal Court held that it was income. Mr. Justice Le Dain, who rendered the unanimous decision of the Court of Appeal, dismissed the appeal and maintained the judgment of the Trial Division. The appellant had argued that the amount received had to be of capital nature since it represented the consideration for having abandoned a capital asset of the company. It was therefore argued that the payment received under the license contract had been paid once and for all and had no link with the use of the patent and of the know-how. Furthermore, it was argued that because the license had been granted, C.I.L. lost all its sales of dynamite for military purposes to the United States Government.

On the other hand, the respondent argued that to understand the true nature of the payment received by C.I.L., one had to go back to the original agreement between C.I.L. and the Swedish company. The license agreement between C.I.L. and the United States Government

\(^5\) Tax A.B.C. 364.
was non-exclusive and because of that, C.I.L. still had the right to make similar arrangements with other parties in the United States.

The conclusions of Mr. Justice Le Dain are as follows:

"What emerges from this analysis is that it is not sufficient that there be the stipulation of a lump sum payment unrelated to the extent of the anticipated use of the patent in order for such payment to be capital in nature; the license for which it is consideration must amount to a disposition or sale of part of the patent rights. (…)

It is my opinion, therefore, based on this line of authority, that the fact the lump sum payment in the present case was given for a license to use patents as well as for "know-how" does not add any significant force to the appellant's contention that the sum must be considered to be capital. While the United States patents are clearly capital assets, the license, which is non-exclusive, for a limited purpose (to the United States Government for military or non-commercial purposes) and for a limited term, cannot be considered, on the analysis to be found in the cases, to be a parting with or disposition of the patent rights. (…)

Insofar as the license to use the "background data" or "know-how" is concerned, it is quite clear on the authority of the Rolls-Royce and English Electric cases that the fact a lump sum payment for such "know-how" is unrelated to the extent of use is not sufficient by itself to make it a capital receipt. The appellant's case then comes down to the final analysis to the contention that it reflects the essential distinguishing features of Evans Medical Supplies - namely, that the "know-how" was of a secret or confidential character, that the agreement under which it was imparted was a single or isolated transaction, and that the importing of it resulted in a loss to the appellant of a substantial part of its business. I am prepared to regard the appellant's "know-how" as the equivalent, for purposes of an analysis, of the "secret processes" in Evans Medical Supplies and Wolf Electric, but that does no more than give it a character of a capital asset analogous to patent rights. As to the evidence that the license agreement was the only one of its kind that C.I.L. had entered into, I think there is this important distinction: While it may have been obligated to enter into this agreement by the position of the United States Government, agreements of this kind were contemplated by the C.I.L.-Chematur agreement as a form of business to be shared in by the parties. They were contemplated as a deliberate policy, to use the distinction that was emphasized in Rolls-Royce and English Electric. It comes down then in my opinion to the essential question: Does the evidence show that C.I.L. lost its business for military T.N.T. with the United States Government as a direct and
necessary result of entering into the license agreement? In my opinion, it does not."\(^6\)

It can be derived from this judgment that to be considered as a capital receipt, a taxpayer must show that he has received a lump sum payment in consideration for the disposition of a part of its patent right (or know-how) or that as a result of the agreement, a taxpayer lost a substantial part of its business.

In a recent case, Canadian General Electric Company Ltd. and Her Majesty The Queen\(^7\), the facts of the C.I.L. case were distinguished by Mr. Justice Mahoney:

> "The facts peculiar to this case distinguish it from C.I.L. and from the other authorities considered in C.I.L. While the plaintiff does grant licenses of its patents in the ordinary course of its business and does, on occasion, sell its know-how, this transaction was not in the ordinary course of its business. Neither was it an adventure in the nature of trade. It was not undertaken with a view to realizing a profit. Rather it was essentially a salvage operation, a realization of a capital asset which, in the circumstances, was a considerable immediate value to AECL and of no apparent future value to the plaintiff in the Canadian market.
> The payment in issue was received by the plaintiff on account of capital."\(^8\)

To summarize the first part of this paper, it may be said that patents, concessions or licenses are generally capital assets which can be the object of capital cost allowance. If a patent, concession or license is sold, it will generally generate a capital gain unless the transaction can be considered as being in the normal course of trade of the vendor or unless the sale is really a disguised license agreement (or sub-license agreement). The only licenses or concessions that can be amortized are those licenses or concessions which are for a determined period of time. The agreement must not be cancellable at will by the licensor. It has been decided in the case of M.N.R. v. Kirby Maurice Co. Ltd.\(^8\)

> "But not all franchises are within Class 14; only those that are "for a limited period of time" are within the Class. The intention of Parliament in using these words "for a limited period" seems to me to be quite clear. Unless the duration of the franchise is definitively ascertained

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\(^{6}\)Canadian Industries Ltd. v. Her Majesty The Queen (1980) C.T.C. 222.


\(^{8}\)(1958) C.T.C. 41 p. 46.
and limited, there is no yardstick by which the value of the franchise can be ascertained. Further, it would be impossible to ascertain the life of the property or franchise, a matter which must be known in order to make the computation required in paragraph (i) of subsection (c) of Section 1 of Regulation 1100, namely: "By apportioning the capital cost to him of each property over the life of the property remaining at the time the cost was incurred."

The licensee who under the license agreement of a limited period has to pay a lump sum as entering fee, will have to consider this amount as a capital payment because it was made once and for all and for the lasting benefit of the business. This principle was well stated by Viscount Cave in the case Atherton v. British Insulated and Helsby Cables Ltd.:9

"When an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think that there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital."

Generally speaking, the amounts paid under a franchise or a license agreement which are not deductible in the year in which they were incurred, will be amortizable as eligible capital expenditures.

**COPYRIGHTS**

In order for a property to be of the Class 14, such a property must be a patent, franchise, concession or license for a limited period of time. A copyright is a right which exists during the life of the author and for 50 years after his death. The life of an author being an undetermined period of time, a taxpayer can only include in Class 14 the copyrights acquired after the death of the author. It must be remembered however that a license granted during the life of an author for a limited period of time (50 years or less) will be a property of Class 14 and as such, depreciable.

The Income Tax Act is rather silent with respect to copyrights. It can therefore be said that the price received upon the disposition of a copyright shall be dealt with in the same manner as the price received for the disposition of any other asset. Therefore, the amount received will normally be considered as a payment of capital, except where an author has disposed of his copyright in the normal course of his business. It can also be said that an author who sells

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910 T.C. 155, page 192.
his copyrights for a price depending upon use, the amounts received will be
considered as income as we have seen earlier. If instead of selling his
copyrights, the taxpayer grants a license, then, the royalties received will be
income. Any lump sum payment initially paid to obtain the license if such a
license is for a fixed period of time, will be amortizable under Section 20(1)(a)
of the Act and under By-Law 1100(1)(c).

NON-RESIDENTS

Part XXIII of the Income Tax Act deals with non-resident persons. Section
212(1)(d) states:

"Every non-resident person shall pay an income tax of 25% on every
amount that a person resident in Canada pays or credits, or is deemed
by Part I to pay or credit, to him as, on account or in lieu of payment of,
or in satisfaction of, rent, royalty or similar payment (other than an
incremental resource royalty or an incremental production royalty
within the meaning of subsection 75(1) of the Petroleum and Gas
Revenue Tax Act) including, but not so as to restrict the generality of
the foregoing, and payment (i) for the use of or for the right to use in
Canada any property, invention, trade name, patent, trade-mark,
design or model, plan, secret formula, process or other things whatever,
(ii) for information concerning industrial, commercial or scientific
experience where the total amount payable as consideration for such
information is dependent in whole or in part upon (a) the use to be
made thereof or the benefit to be derived therefrom, (b) production or
sales of goods or services, or (c) profits, (iii) for services of an industrial,
commercial or scientific character performed by a non-resident person
where the total amount payable as consideration for such services is
dependent in whole or in part upon (a) the use to be made thereof or
the benefit to be derived therefrom, (b) production or sales of goods or
services, or (c) profits, but not including a payment made for services
performed in connection with the sale of property or the negotiation of
a contract, (....)"

It is to be noted that the 25% withholding tax will be reduced by different
international conventions existing between Canada and most industrialized
countries of the world. This tax must be withheld under Section 215(1) by the
Canadian resident who actually makes the payment. If the Canadian
resident omits or neglects to withhold the tax, he then become personally
liable to pay the tax on behalf of the non-resident person and he is entitled to
recover from the non-resident person any amount paid by him as tax under
Part I of the Act.
If a licensor is a non-resident person and if the license agreement provides for the payment of a lump sum payment as entering fee, will the Canadian licensee be under the obligation to withhold 25% on account of tax as seems to indicate Section 212(1)(d)? The answer to be given to this question is not clear. Each case will have to be studied on its own merit. It could be said that no withholding tax should be imposed on such a lump sum payment since it is neither rent, royalty nor a similar payment. The words "rent" or "royalty" are expressions referring to use of an asset for a certain period of time. Since the entering fee is a lump sum payment made once and for all, not subject to variation, which has no relation with the use of the property licensed, it could be argued that such a payment is not subject to the withholding tax.

The Department of National Revenue in its Interpretation Bulletin No. IT-303 expresses the contrary opinion:

"This provision (Section 212(1)(d)(i)) extends to any payment, including a single or lump sum payment, made to a non-resident for the right to use, in Canada, any property, invention, trade-mark, design or model, plan, secret formula, process, trade name, patent or other things whatever. Such a payment will be subject to tax whether or not it falls within the category of rent, royalty or a similar payment."\(^{10}\)

The Department will not consider as being payments falling within the provisions of paragraph 212(1)(d)(i) those payments that are:

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

In the latter case, however, payments required to be made to the licensor under the terms of the license may be subject to withholding tax. If the payments under (a) or (b) are dependent upon the use of or production from the patent or license, tax is payable under sub-paragraph 212(1)(d)(v).\(^{11}\)

**CONCLUSION**

It is difficult in a short paper to summarize all the tax implications of intellectual and industrial property. The Interpretation Bulletins issued by the Minister of National Revenue bearing No. 143-R, 303 and 477 can be very useful to any

\(^{10}\)Interpretation Bulleting IT-303 paragraph 10.

\(^{11}\)Idem paragraph 12.
practitioner dealing in the field of intellectual property. These Bulletins can be obtained free of charge by writing to the Department of National Revenue.
ROBIC, a group of lawyers and patent and trademark agents dedicated since 1892 to the protection and the valorization of all fields of intellectual property: patents, industrial designs and utility models; trademarks, certification marks and indications of origin; copyright and entertainment law, artists and performers, neighbouring rights; computer, software and integrated circuits; biotechnologies, pharmaceuticals and plant breeders; trade secrets, know-how, competition and anti-trust; licensing, franchising and technology transfers; e-commerce, distribution and business law; marketing, publicity and labelling; prosecution, litigation and arbitration; due diligence; in Canada and throughout the world. Ideas live here.