The Canadian Income Tax Treatment of Computer Software Payments

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PRÉCIS

Le traitement fiscal des paiements de logiciels informatiques fait l'objet de controverses, tant au Canada qu'à l'étranger. À l'échelle internationale, l'Organisation de coopération et de développement économiques (OCDE) a conclu que le paiement d'un logiciel constitue rarement un paiement de redevance au sens du modèle de convention, en particulier si l'acquéreur achète le logiciel pour son usage personnel ou un usage commercial. La position actuelle du Canada est diamétralement opposée : le Canada exige que l'impôt soit retenu en vertu de la partie XIII de la Loi de l'impôt sur le revenu en se basant sur l'hypothèse que les paiements visent l'utilisation d'une formule ou d'un procédé secrets. Il est possible de demander une exemption limitée lorsque le droit de produire ou de reproduire le logiciel est accordé. Cette exemption découle d'une décision rendue par la Cour suprême du Canada en 1990 dans laquelle il est établi que les logiciels informatiques sont protégés par le droit d'auteur en vertu de la common law.

Le traitement fiscal des paiements de logiciels informatiques est examiné dans cet article. Il y est conclu que les producteurs non résidants de logiciels et les résidents canadiens tenus de remettre l'impôt retenu de la partie XIII doivent être prudents lorsqu'ils structurent des opérations transfrontalières visant des paiements de logiciels informatiques. La manière dont la position actuelle du Canada sur la retenue à l'égard des paiements de logiciels peut toucher les cédants canadiens qui exportent de la technologie est également examinée dans cet article.

ABSTRACT

Controversy surrounds the tax treatment of computer software payments, both in Canada and abroad. Internationally, the Organisation for Economic Co-operation and Development (OECD) has concluded that a payment for software will rarely be a royalty payment within the meaning of the model convention, particularly if the software acquired is for the personal or business use of the acquiror. Canada's current position is exactly the opposite: Canada requires withholding under part XIII of the Income Tax Act on the basis that payments are for the use of a secret formula or process. A limited exemption is available where the right to produce or reproduce the software is also granted; the exemption is available because of a 1990

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Supreme Court of Canada decision establishing that copyright exists in computer software at common law.

This article examines the Canadian tax treatment of software payments and concludes that non-resident software producers and Canadian residents liable to remit part XIII withholding tax should exercise caution in structuring cross-border transactions involving computer software payments. It also discusses how the current Canadian position with respect to withholding on software payments may affect the treatment of Canadian transferors exporting technology.

INTRODUCTION

In the last decade, the tax treatment of payments for computer software has undergone extensive review, criticism, and change, both in Canada and internationally. This article outlines the 1992 Organisation for Economic Co-operation and Development (OECD) model treaty proposals for the future tax treatment of software receipts; discusses the historic and current Canadian tax treatment of withholding tax on software payments (with particular emphasis on US licensors); and finally, presents commentary, criticism, and planning options for structuring transfers of computer software into Canada.

WHAT IS BEING TRANSFERRED?

Computer software can be viewed as either goods, a service, or intellectual property. When computer software is transferred, therefore, both domestic withholding tax and the applicable treaty provisions will depend on how the software is characterized (that is, what is being transferred), how the transfer occurs, and how it is paid for.

Any particular transaction might involve a number of factors. If the transaction or sale is for software alone, for example, it will be important to determine whether the software is prepackaged, custom-created, or adapted for use by the end user on a fee-for-service basis. If the software sale is coupled with a hardware or "firmware" sale (that is, "bundled"), a breakdown of the component parts may be required.[1]

Another question is, what rights are being transferred in the software? Does the transfer agreement permit the transferee merely to use the program, for example? Or does the agreement also grant a right to reproduce the program? Other issues, such as the exclusive or non-exclusive nature of any licence for either a definite or an indefinite term, may also require consideration.

Many software transactions include a right to receive improvements or updates to the software, payment for which may form part of the original software package or may be the subject of additional or ongoing fees.

[1] A distinction must also be drawn between payments for the use of equipment and payments for purchase.

Specific services may also be offered by the software developer or distributor, including installation, maintenance, performance review, or staff training. It is important to know where such service, assistance, or training will be provided, and by whom.

Given the variety of issues that might arise in any software transfer, the confusion over the appropriate tax treatment is not surprising.

THE OECD REPORT AND REVISIONS TO THE MODEL CONVENTION

The OECD first reported on international tax issues regarding the development and transfer of software in 1985.[2] Later, a study entitled "Tax Treatment of Software" was one of the four topics reviewed in a 1992 OECD report.[3] On the basis of that 1992 report, on July 23, 1992, the OECD Committee on Fiscal Affairs released two significant amendments and several minor revisions to the 1977 model convention. In particular, the tax treatment of software has now been specifically addressed in the OECD treaty. The related commentary has also been revised.

The 1992 report concluded that, although the subject of software payments did not raise new issues of principle, it clearly highlighted once again the difficulties in determining the scope of the OECD treaty royalty article and, in particular, the rules for determining the source of royalty income.[4] The 1992 report also sets out specifically how the royalty article should be interpreted in relation to software payments. Its major guiding principles are summarized as follows:

1) Payments made in connection with software represent royalties only where there is a limited grant of rights (not amounting to a change in ownership) for the commercial development or exploitation of the software.

2) Payments for software (whether "bundled" or not) that is acquired for the personal or business use of the acquiror do not represent royalties.

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[2] Organisation for Economic Co-operation and Development, Working Party on Information, Computer, and Communications Policy, *Software: An Emerging Industry* (Paris: OECD, 1985). The report was prepared for the Committee for Information, Computer, and Communications Policy by an ad hoc group of experts from member countries.

[3] See Organisation for Economic Co-operation and Development, *Model Tax Convention: Four Related Studies*, Issues in International Taxation no. 4 (Paris: OECD, 1992) (herein referred to as "the 1992 report").

[4] Article 12 of the OECD model convention is the treaty royalty article. Under article 12(2), royalties are defined as "payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience." Under article 12(1), the right to tax royalties arising in a contracting state, and paid to a resident of the other contracting state who is the beneficial owner, is allocated to the state of the beneficial owner. See Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital* (Paris: OECD) (looseleaf) (herein, "the OECD model convention").

3) Payments made for the alienation of all rights attached to software do not represent royalties.

4) Payments made for the purchase of some, but not all, of the rights attaching to software may result in an alienation, depending on the precise terms of the relevant contract. In those circumstances, the consideration paid does not represent a royalty.

5) If payments are made under mixed contracts (such as sales of hardware with built-in software, or sales of services with a right to use software), either the payments should be apportioned to the component parts, or, where some of the parts are ancillary to the principal part, the treatment of the principal part should prevail.

6) Where a double taxation agreement provides for source taxation in respect of some, but not all, royalties, software payments that have the characteristics of royalties will normally be characterized as paid in respect of copyright.

These principles or conclusions are carried forward to the OECD commentary. As a result, the revised commentary now provides that a payment in respect of software will rarely be a royalty payment within the meaning of the model convention. Instead, when the ownership rights to software are transferred in full or in part,[5] the payment received should be regarded as either capital gains, business income, or personal service income, depending on the circumstances. Even when less than full ownership is transferred, the commentary states that "the consideration is likely to represent a royalty only in very limited circumstances."[6] (One example given of payments that are royalties is the grant by the author of software to another person to enable the development and distribution of that software.) Further to its statement that in most cases income from the sale of rights to software should be regarded as business income, personal service income, or capital gains, the commentary says, "[i]t is of no relevance that the software is protected by copyright or that there may be restrictions on the use to which the purchaser can put it."[7]

THE CANADIAN POSITION[8]

Canada and several other countries have, however, asserted their intention to treat payments for the use of software as royalties.[9] Canada's position

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[5] An example of the partial transfer of ownership is the transfer of the exclusive right to use software in a limited geographic area.

[6] Supra footnote 4, commentary 12(13).

[7] Ibid., commentary 12(14).

[8] See generally, Martin L. O'Brien, "Payments for the Use of Property - Royalty - Know How - Computer Programs" (September 7, 1979), issue 36 *Canadian Current Tax* 377; T.E. McDonnell, "Withholding Tax—Computerized Data Provided for a Fee—Canada-U.S. Tax Treaty—Rentals or Royalties," Current Cases feature (1980), vol. 28, no. 5 *Canadian Tax Journal* 607-22, at 615-17; Paul Tamaki, "Withholding Tax on Computer Software Payments to Residents of the United States" (December 1983), 1 *Canadian Computer Law*

([8, 9] Continued on the next page.)

with respect to the treatment of an end user of software acquired for business or personal use is in fact exactly opposite to the OECD recommendation. Canada has maintained that payments made by such a user, pursuant to a contract that requires that the source code or program be kept confidential, are payments for the use of a secret formula or process, and are thus royalties.[10]

Liability to Tax

Non-residents may be taxable under either part I or part XIII of the Act.[11] Under part I, subsection 2(3) imposes liability where a non-resident is employed, carries on business, or disposes of a taxable Canadian property at any time in the year or a previous year. For the purpose of determining whether a non-resident is carrying on business, an extended definition includes soliciting orders or offering anything for sale in Canada through an agent or servant.[12] Non-residents who are residents of countries with which Canada has a tax treaty are generally exempt from Canadian tax on business profits earned in Canada except to the extent that they are attributable to a permanent establishment in Canada.

Tax may also be imposed under part XIII on income earned in Canada by non-residents. Specifically, a 25 percent tax, enforced by way of a withholding required of the licensee or the acquiror, is due on rents, royalties, or similar payments. This amount may be reduced by treaty.[13] A non-

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[8, 9] Continued . . .

Reporter 23-25; Richard G. Tremblay, "Canada-US Cross Border Computer Software 'Fees'" (September 1986), vol. 1, no. 33 *Canadian Current Tax* C163-68; Robert D. Brown, "Tax Aspects of Technology Transfers Between the United States and Canada: A Canadian Viewpoint" (1986), 11 *Canada United States Law Journal* 227-46; William D. Anderson, "A Potpourri of Elements in Computing Business Income: Part 2," in *Current Developments in Measuring Business Income for Tax Purposes*, 1987 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1987), 6:1-31, at 6:29; Paul Tamaki, "Revenue Canada's New Position on Withholding Tax on Computer Software Royalties" (April 1989), 6 *Canadian Computer Law Reporter* 71-73; Robert D'Aurelio, "International Issues: A Revenue Canada Perspective," in *Report of Proceedings of the Forty-Second Tax Conference*, 1990 Conference Report (Toronto: Canadian Tax Foundation, 1991), 44:1-19.

[9] Australia, Italy, Portugal, Spain, and the United States also set out the conditions under which they would regard computer software income as royalties. Supra footnote 4, commentaries 12(28) to (30), (36), and (37).

[10] Ibid., commentary 12(27).

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

[12] Section 253.

[13] For example, article XII(3) of the Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocol signed at Ottawa on June 14, 1983 and the protocol signed at Washington on March 28, 1984, reduces this rate to 10 percent for "copyright royalties and other like payments in respect of the production or reproduction of any literary, dramatic, musical or artistic work." (This convention is referred to herein as "the 1980 Canada-US tax convention," or "the 1980 treaty.")

resident's liability for Canadian tax will therefore depend on the method chosen to enter the Canadian market.

Software usually reaches Canadian end users in one of three ways: the software developer sells directly to the Canadian customer; he or she sells indirectly through a distributor (who is often independent); or he or she licenses a third party to produce or reproduce the program for ultimate distribution to the end user.

Historical Overview

The general mandate to withhold an income tax of 25 percent under part XIII of the Act on every amount paid or credited to a non-resident "on account of or in lieu of or in satisfaction of . . . a rent, royalty or similar payment" was and continues to be tempered by several important exceptions. For example, subparagraph 212(1)(d)(vi) of the Act exempts from Canadian withholding tax "a royalty or similar payment on or in respect of a copyright in respect of the production or reproduction of any literary, dramatic, musical or artistic work." Such payments were also considered exempt under article XIII C of the then Canada-US income tax convention[14] (1942) as "[r]oyalties for the right to use copyrights." In consequence, rental or royalty payments that were made to non-residents for the right to produce or reproduce computer software programs, and payments made to US treaty partners for the use of computer software, were exempt from withholding tax.

This exemption disappeared as of July 1, 1983.[15] Suddenly, Canadian residents who made payments to residents of the United States for computer software were required to withhold federal tax at the reduced treaty rate of 15 percent of the gross amount of such payments.[16] Revenue Canada's abrupt reversal appeared to rely on a conclusion that computer software was not copyrightable in Canada, and that therefore payments for it did not qualify for either the exemption in subparagraph 212(1)(d)(vi) or the exemption available under article XIII C of the old treaty. The charge to

[14] Article XIII C of the Income Tax Treaty Between Canada and the United States (herein referred to as "the old treaty"), signed at Washington, DC, on March 4, 1942, reads as follows: "Royalties for the right to use copyrights or in respect of the right to produce or reproduce any literary, dramatic, musical, or artistic work (but not inclusive of rents or royalties in respect of motion picture films) derived from sources within one of the contracting States by a resident or corporation or other entity of the other contracting State not engaged in trade or business in the former State through a permanent establishment shall be exempt from tax imposed by such former State." Articles XIII A, XIII B, and XIII C were added by a supplementary convention signed at Ottawa on June 12, 1950.

[15] The official policy withdrawing this exemption was set out in *Information Circular* 77-16R2, November 26, 1983.

[16] It was already well settled that lump-sum payments of this kind were exempt under the 1942 Canada-US tax convention; see *The Queen v. Saint John Shipbuilding & Dry Dock Co. Ltd.*, 80 DTC 6277 (FCA) (referred to herein as "*St. John Shipbuilding*"). Therefore, Revenue Canada's new position applied only to royalties for "the use of software" and not to lump-sum payments made under agreements without time limitations.

tax was therefore found in part XIII of the Act, specifically subparagraph 212(1)(d)(i).[17] It provides, among other things, that a withholding tax be charged on any "rent, royalty or similar payment, including, but not so as to restrict the generality of the foregoing, any payment (i) for the use of or for the right to use in Canada any property, invention, trade name, patent, trade mark, design or model, plan, *secret formula*, *process* or other thing whatever."[18]

For a US software licensor, therefore, the only hope of relief from withholding was to be sought in the courts. In *St. John Shipbuilding*,[19] the federal court had found that the old treaty created a clear exception to the liability for withholding tax for lump-sum payments for the use of computer software. The court had concluded that neither "rentals" nor "royalties," in the ordinary sense of those words, included lump-sum payments for the use of, or the right to use, property indefinitely. Since the amounts in question then fell into the category of industrial and commercial profits, they were exempted under article 1 of the convention.

The 1983 decision of Revenue Canada's—to impose withholding tax on all payments for the use of US computer software—was made before three historic events had taken place. First, the new Canada-US convention (the 1980 treaty), although signed, was not yet in force. Second, the Supreme Court of Canada had yet to determine (in 1990, in the *Apple Computer* case)[20] that common law copyright protection existed in computer software. Finally, the Canadian Copyright Act had not yet been amended;[21] as of June 8, 1988, however, that Act expressly included computer software under the definition of "literary work."

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[17] Notably absent from the charging section was *copyright*. Perhaps ironically, in its reply to the 1992 OECD royalty revisions questionnaire Canada referred specifically to software as a secret process. See supra footnote 3, at appendix 2.

[18] Emphasis added.

[19] Supra footnote 16, at 6274. In *St. John Shipbuilding* the taxpayer made payments to a non-resident corporation in 1971, 1972, and 1973 for the use, for an undefined period of time, of computer tapes containing technical data relating to shipbuilding. The Federal Court of Appeal held that the taxpayer was not subject to withholding tax pursuant to the provisions of the 1942 convention, since the monies in issue were lump-sum payments for a non-exclusive licence allowing unlimited use of a software system, and therefore were not rent or royalties. The payments were, in fact, considered to be part of the non-resident's industrial and commercial profits and were protected from tax in Canada pursuant to article I of the 1942 Canada-US tax convention. The amounts could only be made subject to Canadian non-resident tax if they were taxable under subparagraph 212(1)(d)(i) and fell within the exception from industrial and commercial profits provided in article II with respect to "income in the form of rentals and royalties" as defined in the protocol. Thurlow J also commented in the context of section 212 that "[i]t is not easy for a payment of the kind described to escape the definition of 'any payment . . . for the use of or for the right to use in Canada any property . . . or other thing whatever'" (ibid., at 6274). That is, he implied that, in the absence of the treaty, the payment would have been subject to withholding tax.

[20] *Apple Computer, Inc. v. Mackintosh Computers Ltd.* (1990), 71 DLR (4th) 95 (SCC), aff'g. (1988), 16 CIPR 15 (FCA), aff'g. (1986), 28 DLR (4th) 178 (FCTD).

[21] On June 8, 1988, Bill C-60, An Act To Amend the Copyright Act and To Amend Other Acts in Consequence Thereof, was given royal assent (SC 1988, c. 15).

The Canada-US Convention (1980)

As a result of the decision in *St. John Shipbuilding*, it had been widely assumed that lump-sum payments for the use of computer software would escape withholding tax because of the court's interpretation and application of the old treaty. However, the provisions of the 1980 treaty probably ended that exception. Paragraph 6(a) of the protocol to the old treaty provided that the phrase "rentals and royalties" as used in article II included "rentals or royalties arising from leasing real or immovable, or personal or movable property or from any interest in such property, including rentals or royalties for the use of, or for the privilege of using, patents, copyrights."

It was on the basis of this wording that the Federal Court of Appeal in *St. John Shipbuilding* concluded that the old treaty's definition of rentals and royalties required that payments be based on time and use or production. The 1980 treaty, however, provides that the term royalties means "payments of any kind received as a consideration for the use of, or right to use" any copyright.[22]

The adoption of the phrase "payments of any kind" significantly widened the scope of the 1980 treaty. That phrase is also very similar to the phrase used in the Act to impose withholding tax on "rent, royalty or similar payment, including . . . any payment," a phrase the court in *St. John Shipbuilding* implied would have caught the payments in question if not for the old treaty.[23] It is this phrase upon which Revenue Canada also relies in taxing a broad range of software sales under subparagraph 212(1)(d)(i).

The courts have not interpreted the new wording in the 1980 treaty.[24] However, in reviewing a situation in which both lump-sum and periodic payments were made to a US resident under a licence agreement, Revenue Canada commented:[25]

> It is our view that payment for the use of, or the right to use computer software is a payment for the use of or the right to use, a secret formula

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[22] The 1980 Canada-US tax convention, article XII(4).

[23] Revenue Canada's current interpretation of article XII(3) of the 1980 Canada-US tax convention now suggests that the exemption in paragraph 3 is coincidental with the exemption in subparagraph 212(1)(d)(vi). It has been suggested that this may be an overly restrictive interpretation of the convention provision, since it refers to "copyrights, royalties and other like payments," whereas subparagraph 212(1)(d)(vi) refers to "a royalty or similar payment on or in respect of a copyright," which expressly limits the exemption to payments in respect of copyright, a limitation not found in the treaty provision. See also the memorandum of the Reorganizations and Foreign Division (formerly, the Reorganizations and Non-Resident Division), March 4, 1992, reported in *Window on Canadian Tax* (Don Mills, Ont.: CCH Canadian) (looseleaf), paragraph 1781.

[24] Several decisions have, however, dealt with the meaning of rent, royalty, or other like payments. See, for example, *MNR v. Wain-Town Gas Oil Co. Ltd.*, 52 DTC 1138 (SCC); *United Geophysical Co. of Canada v. MNR*, 61 DTC 1099 (Ex. Ct.); *Vauban Productions v. The Queen*, 75 DTC 5371 (FCTD); *Société Nouvelle de Cinématographie Inc. v. MNR*, 79 DTC 802 (TRB); *The Queen v. Farmparts Distributing Ltd.*, 80 DTC 6157 (FCA); and *Grand Toys Ltd. v. MNR*, 90 DTC 1059 (TCC).

[25] Memorandum of the Reorganizations and Foreign Division, February 13, 1992, reported in *Window on Canadian Tax*, supra footnote 23, at paragraph 1744.

> or process and is a payment described in subparagraph 212(1)(d)(i). . . . In addition, it is our view that such payments meet the definition of "royalties" in the 1980 Treaty. This view is supported by the Department of Finance.
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> Accordingly, payments made under a License Agreement fall under the provisions of subparagraph 212(1)(d)(i). Payments made after the coming into effect of the Canada-United States Income Tax Convention (1980), Article 12, would reduce the applicable rate of tax from 25% to 10%.

The exception formerly available under the treaty for lump-sum payments for the use of software for an indefinite period thus appears to be gone.[26]

Apple Computer

The news was not to be all bad. In 1986, a case before the Trial Division of the Federal Court provided the first major opportunity to challenge Revenue Canada's 1983 withholding tax interpretation for computer software payments. In its decision in *Apple Computer*,[27] the Federal Court concluded that software programs were protected by Canadian copyright legislation as "literary" works. As a result, it could be argued that subparagraph 212(1)(d)(vi) provided an exemption from withholding tax payments on some software royalties. Unfortunately, neither the trial level decision in *Apple Computer*, nor the Federal Court of Appeal decision upholding it, deterred Revenue Canada from maintaining its official position requiring withholding tax on *all* payments for computer software programs under section 212 and under the 1980 treaty, including payments for the right to produce or reproduce property subject to copyright.

The Copyright Act

In 1988 Revenue Canada changed its official position with the coming into force on June 8 of amendments[28] to the Copyright Act that specifically recognized copyright in computer software by including computer programs within the definition of a "literary work." Revenue Canada's new position recognized a limited exemption from withholding tax under subparagraph 212(1)(d)(vi) where a payment was made to a non-resident in respect of the right to produce or reproduce computer software. Consistent with Revenue Canada's earlier view, however, the exemption would not apply where the Canadian payer merely had the right to use a computer program under a licence agreement. Payments made before June 8, 1988, including those for the right to reproduce the software, were to remain subject to the withholding tax.

At the time that this new position was adopted by Revenue Canada, the June 1990 Supreme Court of Canada decision in *Apple Computer*[29]

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[26] For a contrary view, see Jeffrey A. Chapin-Fortin, "Revenue Canada Hard on Software" (December 1993), 126 *CA Magazine* 30-33.

[27] Supra footnote 20.

[28] Supra footnote 21.

[29] Supra footnote 20.

affirming common law copyright protection for software programs had, of course, not yet been released. When that Supreme Court decision was released, Revenue Canada conceded that payments under a licence agreement to produce or reproduce software, regardless of when they were made, would be exempt from the withholding tax. However, on January 4, 1991, the Reorganizations and Non-Resident Division of Revenue Canada noted that it was too late to request a refund under subsection 227(6) for payments made before June 8, 1988 that might otherwise have been exempt under the *Apple Computer* decision.[30]

Report to the OECD

In 1992 Canada also made known its view and reservations to the OECD.[31] Specifically, Canada maintained its position that "payments by a user of computer software pursuant to a contract that requires that the source code or program be kept confidential, are payments for the use of a secret formula or process and thus are royalties."[32] Notwithstanding this defence of the right to tax, the Honourable Don Mazankowski, then minister of finance, in the April 26, 1993 Canadian federal budget, announced the government's intention in its treaty negotiations to reduce or eliminate the withholding tax on a variety of cross-border payments, including those for computer software. Specific reference was made to the protocol to the Canada-Netherlands treaty signed on March 4, 1993, which exempts "payments for the use of or the right to use computer software" from withholding tax.[33]

The rationale for the government's decision was as follows:

> Eliminating the withholding on these payments will reduce the cost to Canadian firms of accessing technology developed by foreign firms. As any such exemption will be negotiated on a bilateral basis, it will also make it more attractive for Canadian firms to export technology they have developed. These factors should enhance the ability of Canadian firms to keep pace with innovative developments abroad and should expand the overseas market for Canadian technology.[34]

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[30] In the same technical interpretation, it was suggested that US residents could still apply to the competent authority under articles XXVI and XXV of the 1980 Canada-US tax convention if they were denied a tax credit in the United States in respect of part XIII tax withheld. Technical interpretation of the Reorganizations and Non-Resident Division, January 4, 1991, reported in *Window on Canadian Tax*, supra footnote 23, at paragraph 1086. The "tax fairness" provisions were announced after this, and they may permit a refund beyond this period.

[31] See "Tax Treatment of Software," in the OECD 1992 report, supra footnote 3, at 65-101; the OECD model convention, supra footnote 4, commentary 12(7); and the discussion above.

[32] The OECD model convention, supra footnote 4, commentary 12(27). The commentary is with respect to paragraph 2 of the royalty article, however the wording is almost identical to that in section 212.

[33] See article IV(A)(ii) of the protocol to the Convention Between Canada and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at The Hague on May 27, 1986, as amended by the protocol signed at The Hague on March 4, 1993.

[34] Canada, Department of Finance, The Budget 1993, April 26, 1993, 78.

Current Tax Treatment of Software Payments to Non-Residents

Where does this leave the Canadian situation a decade after Revenue Canada's initial decision to require a withholding tax on all software payments?

The Right To Use

Under current law, any payment made to a non-resident for the use of a software program is subject to withholding. Subparagraph 212(1)(d)(i) of the Act imposes a 25 percent withholding tax on payments "for the use of or the right to use in Canada, any property, invention, trade name, patent, trademark, design or model, plan, secret formula, process or other thing whatever." This amount is reduced to 10 percent under article XII of the 1980 treaty, which provides for withholding "on any rent, royalty, or similar payment" made to a US resident.

Withholding is not required where a royalty or similar payment is made "on or in respect of a copyright in respect of the production or reproduction of any literary, dramatic, musical, or artistic work." This exemption under subparagraph 212(1)(d)(vi) of the Act is unfortunately not available to eliminate the withholding requirements for many software transactions.

The problem lies in the rights that are usually granted. Most prepackaged or "canned" software programs are sold subject to a restrictive licence that allows the purchaser to use the program on only one computer at a time. Other typical contractual terms might prohibit renting or leasing the program or otherwise assigning the right to use the program. These restrictions are designed to protect the copyright interest in the program. Unfortunately, this form of standard "shrink-wrap licence" has firmly entrenched Revenue Canada's view that Canadians who make payments for a "licence," the terms of which are well documented as part of the software sale, may not rely on the exemption provided in subparagraph 212(1)(d)(vi), and are therefore obligated to withhold.

Although some authority for Revenue Canada's position may be found under subparagraph 212(1)(d)(i), it seems curious that this charge to tax does not include copyright in the lengthy list of intellectual property rights. Nonetheless, a specific exemption for certain copyright payments was carved out in subparagraph 212(1)(d)(vi). The answer may simply be that payment for most copyrighted articles, such as books, records, or photographs, would normally be viewed as payment for goods rather than for secret formulas or processes. Thus the purchase of a single copyrighted article would not normally be subject to withholding. A number of Canada's treaty partners, either formally or informally, view a transfer of prepackaged software as a sale of goods.[35] This approach makes sense when one con-

[35] In reply to the OECD questionnaire on the tax treatment of software, member nations were asked under what circumstances they would classify a payment for the use of software (other than a capital payment) either as a payment for goods and services or as a royalty
(The footnote is continued on the next page.)

siders payments for a licence for prepackaged software from a commercial standpoint. What has occurred is a sale of the software in perpetuity with a restrictive covenant. Since the mere existence of a restrictive covenant has not affected the characterization of other sales—land, for example—it seems surprising that such a covenant would play so important a role in software taxation.

Canada's position is also in marked contrast to the OECD 1992 report, "Tax Treatment of Software,"[36] and to the 1992 commentary and revisions to the OECD model convention. In the OECD report, an important distinction was drawn between "the acquisition of software for the personal or business use of the purchaser," and the acquisition of software for commercial development or exploitation. In the former case, it was "considered that the purchaser had done no more than purchase a product." It was not considered relevant that the product was protected by copyright and that there were restrictions on the use to which the purchaser could put it.[37] Were this not the case, the mere purchase of any product or good protected by copyright or patent would result in the payment of a royalty for the use of the product under treaty definitions. This appears to be Revenue Canada's view, with respect to software payments, despite the seeming absurdity of this interpretation. To make an analogy, consider the situation where a US author or copyright holder wished to sell his book in Canada. If the book were sold directly to a Canadian reader, a 10 percent withholding would be required. However, if one manuscript were sold to a Canadian publisher, copied 100 times, and sold to a Canadian reader, the payment from the publisher would be exempt from withholding tax.

On January 4, 1991, the Reorganizations and Non-Resident Division followed this interpretation with respect to software distributors.[38] In its view, payments made to a non-resident by a distributor operating in Canada,

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[35] Continued . . .
payment. Ireland, Sweden, the United Kingdom, and Denmark replied that they would treat the amount as payment for goods if it was for stock. Australia has also issued a ruling to that effect—taxation ruling 9312, issued May 13, 1993. See supra footnote 3, at appendix 2.

There have apparently been some indications that the US Internal Revenue Service (IRS) is of the view that, in the case of the sale of prepackaged software, the transaction should be treated as a "sale." See Nathan Boidman, "Continuing Cross-Border Software Controversy" (February 11, 1994), 23 *Tax Management International Journal* 90-94. Mr. Boidman also indicated in his article that US software developers are not in agreement as to the appropriate treatment of software, some fearing that copyright laws do not provide adequate protection and that licensing is required.

[36] Supra footnote 3.

[37] Ibid., at 75, paragraph 43. Canada specifically excluded itself from this interpretation of software payments. It instead took the following position: "In Canada, payments by a user of computer software pursuant to a contract that requires that 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." OECD model convention, supra footnote 4, commentary 12(27).

[38] "Non-Resident Withholding Tax—Computer Software" (June 1981), preliminary report no. 3 *The Tax Window* 15-16.

pursuant to an agreement in which the distributor acquired the right to sell or sublicense the software to end users or other subdistributors in Canada, would be subject to withholding by virtue of subparagraph 212(1)(d)(i). Revenue Canada went on to add that where payment was both for the right to produce to reproduce the software program and for another right not within the exception, the total must be allocated on a reasonable basis and part XIII tax withheld on the non-exempt amount.

If the right to "produce to reproduce" will result in an exemption from withholding, one of the obvious questions will be how this requirement may be met. Subparagraph 212(1)(d)(vi) formerly read "a royalty or similar payment on or in respect of copyright,"[39] leading to the conclusion that something more than a payment for the use of the copyright is expected. What is not clear is exactly what more is required. According to Revenue Canada, a taxpayer who has the right to make copies for his or her own use "is not making use of the copyright but is merely exercising his right under the licensing agreement. In such a case, since the taxpayer does not have the right to produce or reproduce the computer program, the exemption provided in subparagraph 212(1)(d)(vi) again will not apply."[40]

This position is difficult to rationalize when one considers copyright law. According to section 3 of the Copyright Act,[41] "'copyright' means the sole right to produce or reproduce the work or any substantial part thereof." The owner may assign the right, either wholly or partially, and either generally or subject to territorial limitations, and either for the whole term of the copyright or for any part thereof, and may grant any interest in the right by licence.[42] Any person who produces or reproduces a copyrighted software program must therefore have a right, albeit limited, to produce or reproduce the program. Alternatively, the individual reproducing the software program must "own" it. Section 27(2) of the Copyright Act outlines the circumstances under which a software program can be reproduced. It provides that the following acts will not be considered to infringe copyright:

> (l) the making by a person who owns a copy of a computer program, which copy is authorized by the owner of the copyright, of a single reproduction of the copy by adapting, modifying or converting the computer program or translating it into another computer language if the person proves that
>
> (i) the reproduction is essential for the compatibility of the computer program with a particular computer,
>
> (ii) the reproduction is solely for the person's own use, and
>
> (iii) the reproduction is destroyed forthwith when the person ceases to be the owner of the copy of the computer program; and

[39] It was amended in 1977.

[40] D'Aurelio, supra footnote 8, at 44:4.

[41] RSC 1985, c. C-42, as amended.

[42] Ibid., section 13(4).

> (m) the making by a person who owns a copy of a computer program, which copy is authorized by the owner of the copyright, of a single reproduction for backup purposes of the copy or of a reproduction referred to in paragraph (l) if the person proves that the reproduction for backup purposes is destroyed forthwith when the person ceases to be the owner of the copy of the computer program.

In summary, reproducing the software will violate Canadian copyright law unless either the right to reproduce has been granted by the copyright holder, or the end user "owns" the software within the meaning of the Copyright Act. In either case withholding should not be required, since the right to produce or reproduce the work exists in the former case,[43] and an alienation has arguably occurred in the latter.

Revenue Canada, however, appears to be seeking a much broader meaning for the right to "produce" than a mere copying. Some guidance may be found in examining Revenue Canada's position with respect to the deductibility of acquisition costs to the purchaser. For these purposes, a clear distinction is drawn between the right or licence to buy and resell software and the licence to use it.[44] If one were to compare this distinction to withholding requirements, it would be easy to conclude that Revenue Canada's minimum expectations to avoid withholding would include the transfer of a right in the licence to reproduce and sell the copyrighted software. Nonetheless an agreement in which the non-resident distributor allowed the Canadian end user to make a predetermined number of copies for internal use—for example, at a number of office terminals—can be argued to qualify for the exemption.

Additional Contract Items

In addition to the software, the transfer agreement may also provide for a range of services, such as installation, maintenance, and review. Staff training and (perhaps most important) improvements and updates might also be included. These additional contract items may be viewed either as part of the software contract, and taxed as royalties, or as separate elements, which should be subject to distinct income tax treatment.

If the services provided were viewed as integral to the licensing of the software program, the entire payment would be subject to withholding under part XIII. This is apparently Revenue Canada's general view where there is no breakdown in the payment and allocation to component parts. In the OECD's questionnaire on the tax treatment of software, the following question was asked and answered about payments made by a resident to a non-resident in a non-treaty country:[45]

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[43] See *Mansell v. Star Printing & Publishing Co.*, [1937] 4 DLR 1 (PC). It does not matter whether the reproductions of the works are destined for public or for private use.

[44] Technical interpretation of the Business and General Division, August 14, 1992, reported in *Window on Canadian Tax*, supra footnote 23, at paragraph 2118.

[45] In "Tax Treatment of Software," OECD 1992 report, supra footnote 3, at 79 and 87.

> Where payments are for a right to use and for services under a contract requiring advice and information to be provided without any separately stated consideration, would you in any circumstances, break down the total consideration into the separate elements of payment for services and royalty payment respectively?
>
> Canada's response was, "No, usually treat as royalty."

Where an allocation or breakdown is made between the component contract parts, the alternative provisions in part XIII must be considered. Subparagraphs 212(1)(d)(ii) and (iii) impose tax liability for rent, royalty, or similar payments in respect of information concerning industrial, commercial, or scientific experience (knowhow) or services (showhow) where the total amount payable is dependent in whole or in part upon use, production, or profits. When either provision applies, it does not matter where the services are performed, withholding may be required.[46]

It is also apparently Revenue Canada's policy that, if a resident of Canada enters into a software licensing agreement with a non-resident for the use of a computer program and also enters into a maintenance agreement for that program, payments for services under the maintenance agreement may be subject to tax under part XIII unless certain conditions are met. A technical interpretation issued by the Reorganizations and Non-Resident Division on March 6, 1991 provides as follows:

> It is our position that the following two conditions must be met in order for payments for any services, including a hotline service, provided in connection with the use of computer software not to be considered part of the software license fee which is subject to Part XIII tax:
>
> (i) The acquisition of the services should be optional. That is, if the failure to enter into the cancellation of, or the failure to renew an agreement to acquire the services would cause the loss of the right to use the licensed software, we usually would consider the payments for the services to be part of the software license fee subject to Part XIII tax;
>
> (ii) The payments for the services should be reasonable in relation to the software license fee. Any unreasonable portion of the service payments would be viewed as a portion of the license fee subject to Part XIII tax.[47]

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[46] For a discussion of this issue, see Scott L. Scheurmann, "Income and Commodity Tax Aspects of Acquiring and Exploiting Technology," in *Report of Proceedings of the Forty-Third Tax Conference*, 1991 Conference Report (Toronto: Canadian Tax Foundation, 1992), 45:1-69, at 45:37. The determination whether payments are made for information concerning industrial, commercial, or scientific experience or for services of an industrial, commercial, or scientific character will not always be easy to make, and, in many cases, there will be overlap where the services provided result in the transfer of information. Whether subparagraph 212(1)(d)(ii) as opposed to (iii) applies is important when payments are made to residents of treaty countries, because the definition of royalty in most treaties does not extend to services.

[47] Technical interpretation of the Reorganizations and Non-Resident Division, March 6, 1991, reported in *Window on Canadian Tax*, supra footnote 23, at paragraph 1136. Even where these conditions are met, the technical interpretation provides that payments under the maintenance agreement would be subject to withholding under regulation 105 if the services were performed in Canada.

If the payment is not dependent on production or use, neither of these provisions would apply. However, paragraph 153(7)(g) of the Act and regulation 105(1) still require that every person paying a fee, commission, or other amount to a non-resident where the services are rendered *in Canada* must withhold 15 percent of the fee.[48]

The division's view is that the following arrangements would not constitute the rendering of services in Canada:[49]

1) *Service performed in the United States*: the services contracted for would be completed by the Canadian customer's sending the program to the US corporation in the United States for maintenance;

2) *Shipping of materials from the United States*: the services would be completed by the US corporation's sending the Canadian customer various disks, manuals, or instructions that tell how to do the maintenance;

3) *Maintenance instructions given via telephone line*: the US corporation would send the maintenance instructions by phone line originating in the United States. On the basis of these instructions, the Canadian customer would do the maintenance itself.

Applying these guidelines, it would appear that any withholding problem could be avoided by having training sessions in the United States with telephone followup as required. If, however, the maintenance or other activities were performed in Canada by an agent or employee of the US developer, regulation 105 withholding would be required.[50] Services rendered outside of Canada (for example, by telephone or electronic mail hotline) would also avoid regulation 105(1). There should also be no Canadian tax liability under part XIII of the Act, unless the fee charged varied with production or use.[51] However, this conclusion may not apply to updates.[52] Software updates or improvements, according to Revenue Canada,

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[48] Reference should also be made to regulation 805. If the non-resident carries on business in Canada and is not operating through a permanent establishment, the non-resident is potentially liable for both part I and part XIII tax. The maximum amount payable if the amount is a royalty within the meaning of the 1980 Canada-US tax convention is 10 percent of the gross payment.

[49] Technical interpretation of the Reorganizations and Non-Resident Division, April, 6, 1990, reported in Claude Désy, ed., *Access to Canadian Income Tax* (Markham, Ont.: Butterworths) (looseleaf), paragraph C180-018.

[50] Notwithstanding that withholding may be required, the department will waive the requirement if certain conditions are met. See *Information Circular* 75-6R, "Required Withholding from Amounts Paid to Non-Resident Persons Performing Services in Canada," January 15, 1988, paragraphs 10-16.

[51] Revenue Canada has stated that services rendered outside Canada, even where the information derived from the assistance is used in Canada, would not be subject to withholding. Technical interpretation of the Reorganizations and Foreign Division, March 16, 1993, reported in *Window on Canadian Tax*, supra footnote 23, at paragraph 2478. See also Tremblay, supra footnote 8, at C164.

[52] Revenue Canada has neatly avoided the question of where such "services" are performed. Tremblay, supra footnote 8, at C165, makes the following comments: "What if the

(The footnote is continued on the next page.)

would not be viewed as a service at all, but rather as the same in nature as the original software licence payment, and would therefore be subject to part XIII tax.[53]

Transmitting Software Via Telephone Lines or Satellite

Instead of licensing a software disk, the US developer could transmit the information either by private cable system or through use of a modem and telephone lines. Access to the program could be based on either a user fee or an annual fee. The non-resident developer could also act as a full-service centre, providing quick access to a variety of computer software and support services.

Logically, liability for withholding should not depend upon whether the software is purchased in disk form or transmitted over cable or telephone lines.[54] However, where access to the computer data is by cable or telephone only, and the actual software program is not transferred to the end user's computer, several issues arise. First, what is being paid for? Is it the right to use a "secret formula, process, or other thing whatever"? Even if we assume that is the case, is the payment "for the use of or right to use in Canada"? It could be argued that the formula or secret process is not in Canada at all, but rather in the US developer's office.

Access to the system may also be viewed as a service. For Quicklaw, for example, or some other search systems, a fee is paid on the basis of the computer time used. Clearly, if raw data were sent by mail or facsimile to the United States for translation, that translation would be considered the provision of a service. Should the matter be viewed any differently if the service is provided through a computer link?[55]

When the question was raised in the context of maintenance contracts, Revenue Canada determined that no withholding would be required, be-

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[52] Continued . . .
programmer regularly updates the software by phoning into the user's system and making amendments? Similar issues arise in computer time-sharing. Does a non-resident with a computer in Bermuda render services in Canada when Canadian users plug into the non-resident's computer system and carry out work?"

[53] Supra footnote 49.

[54] Tremblay, supra footnote 8, at C165, makes the following comments: "When the relevant inquiry is as to the location of use of property, i.e., ITA subparagraph 212(1)(d)(i), the mode of transmission has little or no relevance assuming the programme will be copied or available in Canada and used within the Canadian user's system. However, if a user can somehow access offshore software without having to 'download,' then perhaps an issue arises. For example, let us take the case of computer time-sharing. If the software never leaves the offshore computer but the Canadian can manipulate his data within the offshore computer from his terminal in Canada, is he paying for the use of or the right to use in Canada the property that is the software (or indeed the computer)?"

[55] Supra footnote 47 and *Interpretation Bulletin* IT-303, "Know-How and Similar Payments to Non-Residents," April 8, 1976, paragraph 22. It provides that, where fees are charged for services on a per-hour, per-diem, or similar basis, it is a question of fact whether the amount depends on the use to be made or on the benefit to be derived.

cause no service was performed in Canada since the instructions were given by telephone calls originating in the United States.[56] That interpretation was based on two things: first, the Canadian customer did the maintenance on the basis of the instructions provided; and second, the US corporation had no agent in Canada who performed the maintenance service. It is not clear what the response would be if some other combination of instructions, servicing, and searching were provided.

This discussion of service fees also assumes that a service is being performed. The situation would be different, however, if the payments were viewed as royalties; royalty payments, according to Revenue Canada, have their geographical source where the related right is used or exploited.[57]

In each transfer or licence agreement, the specific facts will determine whether payments are for services or are royalties, leaving substantial doubt in some cases about the territorial source of payments, especially when copyright payments are coupled with service income. Therefore, some overlapping of taxing jurisdiction may result. This is not a new problem.[58] Perhaps in anticipation of these kinds of difficulties, Canada has reserved the right, "in order to fill what [it] considers as a gap in the Article," to include a provision in its tax treaties defining the "source" of royalties by analogy with the provisions of paragraph 5 of article 11, which deals with the same problem in the case of interest.[59]

Even where payment for online access to the program is viewed as a royalty, can it be argued that, if the acquiror has the right to access and produce that program at his or her own terminal or at the terminal of a client, the exemption from withholding with respect to the right to produce or reproduce in subparagraph 212(1)(d)(vi) has be met? This would not likely be Revenue Canada's view, but it presents an alternative argument on the withholding issue.

Unrestricted Transfers, Mixed Payments, Lump-Sum Payments, and Alienations

Where the Canadian resident is given an unrestricted right to produce or reproduce a software program, the exemption from withholding in subparagraph 212(1)(d)(vi) would clearly apply. Payments for service viewed as part of that licence payment would also be exempt. Revenue Canada seems to support this position where the contract does not separate payments into component parts.[60]

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[56] Supra footnote 49.

[57] *Interpretation Bulletin* IT-270R2, "Foreign Tax Credit," February 11, 1991, paragraph 32.

[58] See, for example, A. Peter F. Cumyn, "Tax Planning for Licensing of Canadian Industrial Property Rights to Unrelated Foreign Persons," in *Report of Proceedings of the Twenty-Ninth Tax Conference*, 1977 Conference Report (Toronto: Canadian Tax Foundation, 1978), 247-54.

[59] OECD model convention, supra footnote 4, commentary 12(43).

[60] Supra footnote 44.

If the payments for services are separated under the software contract, the question arises whether the service fee is dependent in whole or in part on the use to be made of the software. If that is the case, withholding is required.[61] This situation could arise, for example, when the fee is waived after a certain length of time, or after a certain number of sublicensees have been found.

A lump-sum payment made by a Canadian resident for the exclusive right merely to distribute the program in Canada for a certain number of years, which does not include reproduction rights, is not eligible for the exemption and will be subject to withholding. Revenue Canada interprets the words "rent" and "royalty" broadly, and the reference to "any payment" in section 212 is considered broad enough in scope to include single or lump-sum payments.[62] Royalties are also defined in the 1980 treaty, for purposes of article XII, to include "payments of any kind" received as consideration for the use or right to use any copyright of literary, artistic, or scientific work, including any gains from the alienation of any intangible property right, to the extent that such gains are contingent on the productivity, use, or subsequent disposition of such intangible property rights.[63]

Where the ownership of rights has been alienated, it can be argued that consideration is not for the *use* of the rights but for the acquisition of the rights. This would occur, for example, if patent rights were for a term of years or for a specific geographic area. The difficult question will be, when does an alienation occur in the case of computer software? In Revenue Canada's response to the OECD, it was suggested that an outright disposal of all rights relating to the software might be viewed as a capital payment.[64] This is consistent with a technical interpretation issued by the Business and General Division of Revenue Canada.[65] It was Revenue Canada's view that an outright sale could occur only

> where there has been an absolute transfer of all intellectual property interests in the software and where the buyer obtains an unrestricted right to sell or lease the software. An outright sale does not arise where the seller or any party other than the buyer maintains proprietary rights, or where the trans-

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[61] See the discussion, supra footnote 4.

[62] See *St. John Shipbuilding*, supra footnote 16. Thurlow J concluded at 6275 that a lump-sum payment was not a "rental or royalty" under the Canada-US convention when it was for an indefinite term of unlimited use. However, he left open the question whether or not such a payment might be caught under paragraph 212(1)(d) as "any payment for the right to use in Canada any property . . . or other thing whatever." See also *Farmparts Distributing Ltd.*, supra footnote 24. That court held that a lump-sum payment was caught under paragraph 212(1)(d). It also ignored the capital income character of the lump sum when considering the application of the section. Revenue Canada has also taken this position in a recent technical interpretation of the Reorganizations and Foreign Division, supra footnote 25.

[63] Article XII of the 1980 Canada-US tax convention.

[64] Supra footnote 3, at 87, appendix 2, response to question 2.1.

[65] Supra footnote 44.

> feree has committed itself to restrictions not normally associated with ownership, such as restrictions regarding secrecy.[66]

Given this, can we assume that Revenue Canada would ever accept the idea that an alienation of software has occurred if the rights to produce or reproduce the program are not also transferred?[67] In short, it seems unlikely that Revenue Canada would consider that an alienation of the software has occurred in circumstances where the software would not already be exempt under subparagraph 212(1)(d)(vi).

SUMMARY

Where does this leave Canadian purchasers of computer software and Canadian licensors a decade after Revenue Canada's decision to tax all software payments?

Canadian Purchasers

Canadian purchasers who rely on Revenue Canada's current assessing practice may conclude the following:

- Payments for the use of software are subject to part XIII tax and are subject to withholding.
- Fees for maintenance, hotline service, and updates may not be subject to withholding if they are optional, reasonable, and severable from the software fees. Regulation 105 withholding may be required if services are performed in Canada.
- Payments for the right to produce or reproduce software are not subject to part XIII tax or withholding.
- Payments for online access to computer services outside Canada may not be subject to withholding tax.
- Payments for an insurance or maintenance package may not be subject to withholding if they are optional, reasonable, and severable from the software fees.

Canadian Licensors

The more difficult question is, where does this leave Canadians once they become the licensors, instead of the purchasers, of software programs? Canadian companies are now attempting to market their indigenous technology and software internationally, especially to nations that are less

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[66] Even a guaranteed minimum payment derived from the alienation but not the use of rights should not be considered a royalty. From "Technical Explanation of the United States-Canada Income Tax Convention," released by the US Treasury department on April 26, 1984. A release by the Department of Finance on August 16, 1984 confirmed its accurate reflection of the understandings reached regarding article XII.

[67] But see article 12 of the Convention Between Canada and the Kingdom of Thailand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Ottawa on April 11, 1984, which includes under the royalty article payments for the alienation as well as the use of or right to use any copyright.

developed technologically. Yet Canada's official position with respect to software withholding completely contradicts the demands Canadians are making of these developing countries to adhere to international standards in withholding and treaty interpretation. Not only is Canada setting an extremely poor example in treaty interpretation, it is also providing the very arguments necessary to place Canadian exporters of software in an impossible position should the same arguments be used against them in overseas markets. Territorial source of income, gross withholding, and withholding practices that are viewed as contrary to accepted treaty interpretation are major issues facing Canadian licensors. Revenue Canada should practice what it preaches in applying domestic withholding taxes in the context of treaty provisions. Moving to reduce withholding on software royalties under the treaties by negotiation may be a tiny step in the right direction.