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The Tax Treatment of Intangibles

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CONTENTS

INTRODUCTION

Both as a tax litigator and as a judge, Donald Bowman made significant contributions to the development of many areas of tax law, including the tax treatment of intangibles. This article discusses a select number of cases in which he participated as counsel or judge. Beyond their relevance in the area of intangibles, many of these cases have much broader application because, despite the complexity of the subject matter, they address basic income tax concepts concerning the divide between "capital" and "income," and property and services as a taxable object. Throughout Bowman's career, much of his work reflects a return to these basic notions.

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CURRENT VERSUS CAPITAL EXPENDITURES

The majority of Bowman's cases relating to intangibles dealt with the issue of whether expenses should be on current or capital account. His early cases dealing with these issues reflect the development of a generous sense of the currency of an expenditure, which may have informed some of his seminal cases both as counsel (for example, *Denison Mines Ltd. v. MNR*[1] and *Johns Manville Canada Inc. v. The Queen*[2]) and as judge (for example, *Gifford v. The Queen*[3]). These cases probe the "enduring nature" of an expenditure from the standpoint of whether it builds infrastructure or, positively or negatively, contributes to the generation of business income.

Capital Cost of a Patent

Weinberger v. MNR[4] was an appeal from the decision of the Tax Appeal Board, which had ruled that the taxpayer's cost of the patent was limited to the amount that the taxpayer spent to have the invention patented (since the legislation made no provision for a deduction in respect of the expenses incurred by an inventor in devising his invention). Bowman, as Crown counsel, had the unenviable task of defending the Crown's position at the Exchequer Court that the cost of the patent was limited to the legal expenses of obtaining it.

The Exchequer Court allowed the taxpayer's appeal in part. Apparently there had been no decided case law at that time offering any guidance on whether expenses incurred by a taxpayer in perfecting an invention formed part of the "actual capital cost" of the patent. Thurlow J found that a patent under the relevant statute is obtainable by an inventor only when he has invented something for which a patent may be obtained and has complied with the requirements of the law by disclosing the invention in the appropriate manner. It follows that the cost of a patent to an inventor would ordinarily include not only the cost to him of obtaining the patent, but also the costs that he in fact incurred in producing the invention for which the patent is sought. However, once an invention has been perfected to the point where a patent can be obtained, further expenses to turn the invention to account cannot be regarded as part of the cost of the patent.

Deductibility of Costs for a Geological Survey

In *Algoma Central Railway v. MNR*,[5] the issue to be resolved was whether the cost of a geological survey incurred by a railway company in the hope that it would lead to traffic for the company's transportation system was deductible as a current outlay or disallowed as an "outlay . . . of capital" or a "payment on account of capital" within

1 74 DTC 6525 (SCC).

2 85 DTC 5373 (SCC).

3 2001 DTC 168 (TCC).

4 64 DTC 5060 (Ex. Ct.); 60 DTC 322 (TAB).

5 67 DTC 5091 (Ex. Ct.); aff'd. 68 DTC 5096 (SCC).

the meaning of those expressions in former paragraph 12(1)(b), now 18(1)(b) of the Income Tax Act.[6] Bowman argued for the Crown that the payment was on account of capital.

Jackett P held that the usual test for determining whether a payment was on account of capital was whether it was made with a view to bringing into existence an advantage for the enduring benefit of the taxpayer's business. He further stated that, from the case law, it was clear that the advantage that was held for the enduring benefit to the taxpayer's business was the thing contracted for or otherwise anticipated by the taxpayer as the direct result of the expenditure. In other words, the "advantage" is whatever is acquired as an immediate consequence of the expenditure rather than the ultimate or broader effect on the taxpayer's business expected to flow from the expenditures. On the facts, Jackett P held that the immediate consequence of the expenditure was the information produced by the geological surveys that could be placed in the hands of interested members of the public. This information (rather than the ultimate effect on the taxpayer's business) was what the taxpayer had as an immediate and direct result of the expenditure. Accordingly, this was not a payment on account of capital.

Jackett P analogized the survey costs to the costs of an advertising campaign, which, although designed to increase the volume of business and therefore benefit the business in an enduring way, are viewed as current expenses. They are not made with a view to "bringing into existence" an "advantage" for the enduring benefit of the business. He stated:

> If this be true of advertising expenses, in my view, it is equally true of other expenses incurred while the business is running with a view to increasing the volume of that business—so long as such expenses are incurred for the purpose of gaining income in such a way that [the] deduction is not prohibited by section 12(1)(a). I can see no difference in principle between the two cases.[7]

The Supreme Court of Canada affirmed the decision of the Exchequer Court. In doing so, it held that no single test applies in determining whether the expressions "outlay . . . of capital" or "payment on account of capital" apply to any particular expenditure. There being no statutory criterion, the application or non-application of these expressions to any particular expenditures must depend upon the facts of the particular case.

Deductibility of Payments Made To Commute a Royalty Expense

In *Johnston Testers Ltd. v. MNR*,[8] the taxpayer made a lump-sum payment to cancel a patent licence agreement. The taxpayer deducted the full amount as a current

6 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.

7 *Algoma Central*, supra note 5, at 5095 (Ex. Ct.) (note omitted).

8 65 DTC 5069 (Ex. Ct.); 63 DTC 928 (TAB).

expense on the basis that it was a commutation of future recurring revenue charges. The minister disallowed the deduction as a capital outlay. The Tax Appeal Board ruled that the full amount (except for a small portion representing a deductible royalty payment) was a non-deductible capital payment. The taxpayer appealed. Bowman acted as Crown counsel at the Exchequer Court.

Gibson J found on the facts that the payment was made to get rid of an annual charge against revenue in the future, and was paid in the course of and for the purpose of continuing the business. On this basis, the court held that as a result of the payment, there was no advantage or benefit, either positive or negative, accrued to the capital account of the appellant, but instead all the advantage and benefit obtained was of a revenue character. Therefore, the payment was not a capital outlay.

Payment To Cancel a Distributorship Agreement

In *Angostura International Limited v. The Queen*,[9] the taxpayer paid $592,000 plus related legal and accounting fees to cancel distributorship agreements with a company that was distributing a number of its products. The taxpayer deducted the payment, and the minister disallowed the deduction as a capital expenditure.

Bowman, as counsel for the taxpayer, argued that the cancellation payment was a revenue expenditure because it reflected the taxpayer's deliberate choice to carry on the distributorship itself with a view to improving efficiency and profits. Although the taxpayer had the right to terminate the contracts on notice without a termination payment, Bowman maintained that the payment was made because the taxpayer wanted to preserve good relations with the distributor and its customers.

McNair J held that the payment was on revenue account since

> [the] evidence weigh[ed] in favour of a relatively transitory or short-term revenue expenditure made in the ordinary course of the plaintiff's income-earning enterprise and against the acquisition of a profit-making apparatus or structure of an enduring or permanent nature.[10]

Payment for Use of a Customer List

Gifford v. The Queen[11] dealt with whether a payment by a stock broker in respect of the use of a retiring broker's customer list (and the broker's agreement not to solicit the clients) was a capital outlay or an ordinary expense.[12] At the Tax Court of Canada, Bowman J concluded that an amount paid for exclusive access to a list of potential

9 85 DTC 5384 (FCTD).

10 Ibid., at 5391. McNair J quoted from *Algoma Central Railway* in his decision, and noted that Bowman J had relied on *Johnston Testers*, among other decisions, in his arguments.

11 2001 DTC 168 (TCC); rev'd. 2002 DTC 7197 (FCA); aff'd. 2004 DTC 6120 (SCC).

12 This case also dealt with the nature of interest expense, and is well known for its discussion on that issue.

customers for a period of 30 months was an ordinary deductible expense and not on capital account. In his view, no capital asset was acquired.

Bowman J's decision was overturned by the Federal Court of Appeal, and that decision was upheld by the Supreme Court of Canada. The appeal courts seemed unable or unwilling to distinguish the purchase of a customer list from a payment for the exclusive use of such a list for a limited period of time. Bowman J was the only judge who referred to the terms of the agreement between the parties. The appeal courts viewed the transaction as settled law without reviewing (in their decisions at least) whether the facts in prior cases were on all fours with those in *Gifford*. If those courts had concluded that the exclusive use of a customer list for 30 months was equivalent to a purchase because of the limited useful life of such a list, or that the benefit sought was the customer relationship and not revenue from the customers, the result could be more readily accepted. But both the Federal Court of Appeal and the Supreme Court appear to have viewed *Gifford* simply as a "customer list case." Bowman J's logic was based on the legal maxim *nemo dat quod non habet*—"no one can give what he does not have." He viewed the payment as being in respect of an opportunity to approach the departing broker's clients without interference from that broker. In today's parlance, the taxpayer paid for use of the list for a limited time period and for a covenant not to compete for that period.

The Federal Court of Appeal recognized that by treating the cost as a capital expense, it was producing a harsh result for the taxpayer, and suggested that Parliament change the law. It is clear that Bowman J's reasoning and decision were focused upon averting such an unjust result—no deduction for the individual taxpayer for the amount paid for access to the customer list and no deduction for interest expense incurred to borrow that amount. He distinguished the precedents on the issue by pointing out that the "vendor" in this case was also merely an employee and that he really had nothing to sell.

The case demonstrates Bowman J's strong desire to do the right thing for taxpayers. It is far from clear that he was in error.

THE CONCEPT OF PROPERTY

A current issue, for both domestic and treaty purposes, concerning intangibles is whether a conventional property association is required. The following cases reflect the importance of associating so-called transmissible value with a "property" interest that the law recognizes.

Do Knowhow Payments Constitute Payments for Property?

In *Quality Chekd Dairy Products Assoc'n (Co-op.) v. MNR*,[13] the non-resident appellant received fees for the use of its trade name and for services regarding production, quality control, advertising, and marketing. The Tax Review Board held that the

13 67 DTC 5303 (Ex. Ct.); 66 DTC 659 (TAB).

fees were taxable under former paragraph 106(1)(d) (now paragraph 212(1)(d)) and the non-resident appealed to the Exchequer Court.

As Crown counsel, Bowman argued that if the amount paid was not in whole for use of the trade name, the remainder of the payment was paid on account of rent, royalty, or similar payment for the use in Canada of knowhow, and that the knowhow was "property or . . . [an] other thing" within the meaning of former paragraph 106(1)(d).[14]

Gibson J found that the appellant was paid for a "package deal" that included a royalty for the trademark and the knowhow of the appellant with respect to the services that it rendered. Gibson J held that the knowhow provided by the appellant should be categorized as services rendered and not as "property," as that word was employed in former paragraph 106(1)(d); therefore, the part of the fees relating to the knowhow was not subject to withholding tax under former paragraph 106(1)(d).[15]

The issue of whether knowhow constitutes property was also argued by Bowman, again as Crown counsel, in *Western Electric Company Inc. v. MNR*,[16] but in that case the Exchequer Court reached a different result than in *Quality Chekd*.

In *Western Electric*, the non-resident appellant received fees for the supply of confidential information and for use of patents under a patent licence agreement. The Canadian payer withheld on amounts paid for use of the patents, but not for the confidential information. The minister assessed the appellant for withholding tax on those fees.

Counsel for the taxpayer argued that the fees for technical information and assistance were not a "rent, royalty or similar payment" for use in Canada of property within the meaning of former paragraph 106(1)(d) and further, the fees were "industrial and commercial profits" within the meaning of article II of the Canada-US tax treaty in effect at that time (and therefore exempt from tax).[17]

Dumoulin J approached this issue from the perspective of the meaning of "royalty" under the treaty.[18] Section 7(a) of the 1942 protocol to the treaty provided that the

14 Ibid. (Ex. Ct.), at 5304.

15 Because the minister did not properly apportion the fees between the trade name component and the knowhow component, the taxpayer's appeal was allowed in full.

16 69 DTC 5204 (Ex. Ct.).

17 Convention Between Canada and the United States of America for the Avoidance of Double Taxation and the Establishment of Rules of Reciprocal Administrative Assistance in the Case of Income Taxes, signed at Washington, DC on March 4, 1942, as amended by the protocols signed on March 4, 1942, June 12, 1950, August 8, 1956, and October 25, 1966 (herein referred to as "the treaty"). Article II provided that "industrial and commercial profits" shall not include income in the form of rentals and royalties.

18 In this regard, Dumoulin J cited the enabling legislation in the treaty (The Canada-United States of America Tax Convention Act, 1943, SC 1943-44, c. 21, section 3), which provided that in the event of any inconsistency between the treaty and the Act, provisions of the treaty would to the extent of such inconsistency prevail.

term "rents and royalties" included "rentals or royalties for the use of . . . secret processes and formulae . . . and other like property." Dumoulin J reasoned that there was no material difference between a trade secret, such as the confidential information that was the subject of the knowhow payments, and a secret process.[19] Dumoulin J found that the knowhow constituted property, and thus held that the payments made to the appellant for technical information constituted royalties for the use of property within the meaning of the Act and royalties within the meaning of the treaty.

It is perhaps worth noting that, largely because of the concerns raised by this case regarding the nature of "property," the wording of former paragraph 106(1)(d) was amended to (substantially) the form now appearing in paragraph 212(1)(d), so as to specifically include certain payments for the use of scientific, industrial, or commercial information.

The issue of whether knowhow constitutes property appears to have been resolved in *Manrell v. The Queen*,[20] in which Sharlow J held that payments received under non-competition agreements did not constitute property on the basis that property involved an enforceable right.

Valuation of Goodwill

In *Saab v. The Queen*,[21] the taxpayer filed an election in respect of the goodwill relating to a restaurant business that he had acquired a few years earlier. The election was meant to use his capital gains exemption balance to step up the tax basis in the property in a tax-free manner. Unfortunately, his elected amount far exceeded the actual fair market value of the goodwill of the business (nil) as determined by the Canada Revenue Agency (CRA). This resulted in the anti-avoidance component of the provision kicking in and produced a taxable capital gain.

Bowman J found that the CRA's determination of the fair market value of the goodwill at zero was erroneous. He found that the CRA's valuation was flawed because (1) it was based solely on profits for the past few years, (2) no valuation of the physical assets was made, and (3) the appraiser ignored the arm's-length agreements entered into by the taxpayer when he purchased the restaurant. Bowman J found it inconceivable that a restaurant with an established clientele would not have goodwill.

The goodwill analysis in *Saab* was undoubtedly informed by the circumstances of an unsophisticated taxpayer; Bowman J's frustration with the CRA in imposing a penalty under these circumstances was evident.

19 Curiously, Dumoulin J cited both a US case and a US Revenue ruling for the proposition that a trade secret constitutes property.

20 2003 DTC 5225 (FCA).

21 2005 TCC 331.

OTHER CASES REGARDING INTANGIBLES

Density Rights

In *The Cadillac Fairview Corporation Limited v. The Queen*,[22] Bowman J dealt with the treatment of the cost of commercial development rights (so-called density rights). The taxpayer sought to add this cost to the cost of the building for depreciation purposes. Bowman J found that the cost of modifying rights relating to what one can do with land is a cost attributable to the land and could not be added to the cost of a building; therefore, such costs were not deductible as depreciation expense. He stated:

> The cost of a modification of the restrictions of the rights that a landowner has with respect to the use of land is a part of the cost of the land. The cost of lifting restrictions on the exercise of those rights clearly relates to the cost of the bundle of rights that ownership entails. Density rights have to do with what the owner can do with the land. If a landowner is successful in improving the zoning of a parcel of land, and then sells it, it is inconceivable that the revenue authorities could demur at the inclusion of the cost of that rezoning in the cost of the land sold.[23]

Characterization of Software

In *Angoss International Limited v. The Queen*,[24] the taxpayer (a software developer) entered into an agreement that entitled it to access a computer source code program. The taxpayer paid $150,000 to retain access to the source code, and the minister assessed the taxpayer for part XIII withholding tax.

Bowman J held that the payment was exempt from withholding tax under subparagraph 212(1)(d)(vi), stating that "[i]t is clear beyond any doubt that copyright subsists in a source code computer program,"[25] and that

> [i]t follows therefore that a computer source code is a literary work in respect of which copyright subsists. It is equally clear that the payment was for the right to use or reproduce the source code and was therefore "on or in respect of a copyright in respect of the production or reproduction of any literary . . . work."[26]

Amortization of a Lump-Sum Fee for a Licence

In *Gagnon et al. v. The Queen*,[27] the taxpayer licensed software and incurred expenses as part of a joint venture. The taxpayer received a $100,000 lump-sum payment for

22 97 DTC 405 (TCC).

23 Ibid., at 413. Bowman J was faced with the same issue in *Sun Life Assurance Company of Canada v. The Queen*, 97 DTC 422 (TCC), and once again reached the conclusion that the cost of density rights is a cost attributable to the land.

24 99 DTC 567 (TCC).

25 Ibid., at paragraph 21.

26 Ibid., at paragraph 23.

27 99 DTC 845 (TCC).

the licence, which he amortized over five years on the basis that he was entitled to a reserve under paragraph 20(1)(m). The minister asserted that the taxpayer was not entitled to a reserve because the income was from property and not from a business. Prior to trial, the parties agreed in a consent to judgment that the income from the licence could be spread over five years, because it was earned over the life of the agreements.

Bowman J held that the taxpayer was entitled to the reserve under paragraph 20(1)(m).[28] Subsequent to this case, two further cases on the treatment of reserves similarly allowed the reserves when income was to be earned over a future period.[29]

With respect to the expenses incurred by the taxpayer, Bowman J rejected the notion that there is a more restrictive treatment of expenses with respect to income from property than income from a business. In any event, he found that the taxpayer earned income from a business and was entitled to deduct the expenses. In his view, the case was "a striking example of the Minister second-guessing the business acumen and judgment of experienced and intelligent businesspersons."[30]

Valuation of Software

In *CIT Financial Ltd. v. The Queen*,[31] Bowman J was required to determine the appropriate value for software. The taxpayer entered into a series of circular transactions whereby it acquired software and leased it back to the developer of the software. The purpose of the transaction was for the taxpayer to acquire capital cost allowance (CCA) deductions.

Bowman J was required to determine the value of the software. Since the software was unique special-purpose software that had been developed for a particular company, there was no available market value comparable. Bowman J expressed doubt that another steel mill would pay what the taxpayer alleged the value to be for software that had been developed specifically for another company. Because of the lack of market information for determining value, he determined the value on the basis of the replacement cost of the software. After evaluating the evidence, he determined the value of the software to be $13 million ($20 million less than the taxpayer

28 Bowman J found, ibid., at paragraph 8, that the basis set out in the consent for spreading the payment over five years (that the payment was "earned over the life of those agreements") was legally and factually incorrect. He stated that statutory authority is required to spread the payment out. In addition, Bowman J refused to accept the consent to judgment as an admission that the taxpayer was carrying on a business, since such a conclusion is one of law. Bowman J concluded independently that the income was from a business.

29 *Blue Mountain Resorts Limited v. The Queen*, 2002 DTC 1886 (TCC); and *Ellis Vision Incorporated v. The Queen*, 2004 DTC 2024 (TCC).

30 *Gagnon*, supra note 27, at paragraph 15.

31 2003 DTC 1138 (TCC).

had claimed) and used section 69 to adjust the purchase price (since the taxpayer had conceded that the parties did not deal at arm's length).[32]

Valuation of Shares

In *Corner Brook Pulp and Paper Limited v. The Queen*,[33] Bowman J considered whether the terms of a power supply contract should be taken into account in valuing shares of a subsidiary. Years before, the taxpayer had entered into a power supply contract with its wholly owned subsidiary, whereby the subsidiary would supply power to the taxpayer at what were now well below market rates. In finding that the power supply contract should not be considered in determining the fair market value of the subsidiary's shares, Bowman J stated that he was not making a conclusion of law, nor was he basing his finding on the expert opinions; instead, he was basing his finding on common sense. In his view, no intelligent buyer would have considered buying the subsidiary's shares if the contract was in place. The taxpayer would have terminated the contract if he had desired to sell the shares of the subsidiary: "It is just plain common sense."[34]

CONCLUSION

Over the course of his career, Donald Bowman dealt with a wide range of cases involving the tax treatment of intangibles. In addition to their relevance to intangibles, the cases surveyed (particularly those relating to current versus capital expenditures) form part of the building blocks of Canadian income tax principles and will have continued relevance in future decisions. As Crown counsel and in private practice, Donald Bowman was a creative and zealous advocate. As a judge, he demonstrated a compassion for honest taxpayers and sought to reach the "right" result.

32 With respect to the minister's argument that GAAR should apply to deny the taxpayer's entire CCA claim, Bowman J found that since there was a specific rule in the Act that attenuated the tax benefit that the taxpayer was seeking, there was no need to resort to GAAR, stating (ibid., at paragraph 74), "There is no need to invoke a general anti-avoidance provision to do what a specific provision can do simply and efficiently."

33 2006 DTC 2329 (TCC).

34 Ibid., at paragraph 30.