Minimum Royalties Under Section 12(1)(g) of the Income Tax Act

One of the judicial responses to the broad sweep of section 12(1)(g)[1] of the *Income Tax Act* has been to distinguish between dependent periodic payments and non-dependent lump sum payments.[2] Such a distinction is a difficult one to make since all payments may be considered "dependent upon use of property" if the words are given a wide enough meaning. A lump sum payment dependent only on the right to use property falls within such a broad concept. For example, on this reasoning, a payment for the grant of a leasehold interest which is coupled with periodic rentals or production payments would not be considered a capital receipt but rather income. At the other extreme, partial payments in satisfaction of an obligation fixed as to amount could be viewed as "dependent" as well.[3]

Canadian tax jurisprudence has failed to resolve satisfactorily the issue of whether the phrase "payments dependent upon ... use of property" extends beyond production payments[4] and refers to those dependent on the mere fact of use of property rather than on the extent of such use. The uncertainty arises out of a failure to

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[1] *Income Tax Act*, S.C. 1970-71-72, c.63; formerly R.S.C. 1952, c.148, s.6(1)(j); formerly S.C. 1948, c.52, s.6(1); formerly R.S.C. 1927, c.97, s.3(f), added by S.C. 1934, c.55, s.1. The section creates an artificial "source" of income:

> "12. (1) There shall be included in computing the income of a taxpayer for a taxation year as income from a business or property...:
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> ...
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> (g) any amount received by the taxpayer in the year that was dependent upon the use of or production from property whether or not that amount was an instalment of the sale price of the property (except that an instalment of the sale price of agricultural land is not included by virtue of this paragraph) [.]"

[2] See, *e.g.*, *Ross* v. *M.N.R.* (1950) 50 D.T.C. 775, [1950] C.T.C. 169 (Ex.) *per* Cameron J. (lump sum plus dependent payments up to a fixed amount); *Ade* v. *M.N.R.* (1963) 63 D.T.C. 23, 30 Tax A.B.C. 326 *per* Fisher (lump sum plus dependent payments with no ceiling); *cf. Gingras* v. *M.N.R.* (1963) 63 D.T.C. 1142, [1963] C.T.C. 194 (Ex.) *per* Noel J. (dependent payments which are instalments of a fixed sale price).

[3] *E.g.*, instalments of a fixed amount or production payments which are cut off when an agreed upon amount has been reached.

[4] The expressions "production payments" and "dependent payments" are used as shorthand references to receipts which are brought into income by operation of s. 12(1)(g).

recognize what the word "dependent" refers to in section 12(1)(g). If "dependent" modifies "an amount received by the taxpayer", then the phrase taken as a whole would bring into income only those "amounts" that are calculated by reference to the extent of use of, or production from, the taxpayer's property. If "dependent" modifies "received" then any payment which is obtained for a right to use, or produce from, property would come into ordinary income.

Two recent Canadian decisions — *Lackie* v. *The Queen*[5] and *Porta-Test Manufacturing Ltd* v. *M.N.R.*[6] — adopted the broader reading of section 12(1)(g) while ruling on novel issues of fact. Both taxpayers entered into transactions which required that a minimum royalty be paid, independent of the actual extent of use of or production from the property owned by the taxpayer. In *Porta-Test*, the corporation was granted an exclusive licence to manufacture and sell the taxpayer's product over a specified geographic territory in exchange for a five per cent royalty. However, the contract also provided that if the royalties based on actual sales did not amount to $150,000 in the first three years, the licensee was required to remit the difference anyway. In *Lackie*, the contract provided that the user would take out "the minimum quantity of 50,000 tons of gravel"[7] each year, and if less was extracted in any year the user had to remit "the difference in value between the quantity actually removed and the quantity stipulated to be removed".[8]

Payment arrangements such as these have been the object of litigation for some time. In *Hoffman* v. *M.N.R.*,[9] the taxpayer had sold all of his marketable standing timber for $8,400. The Minister argued that the payment was for a *profit à prendre* and was therefore income by operation of section 12(1)(g). Mr Weldon rejected the Minister's interpretation of events only because a *profit à prendre* denotes "a continuing activity — one that goes on from year to year".[10] In *Mr R.* v. *M.N.R.*[11] a fixed amount of cash received for the sale of a pharmaceutical invention was treated as a capital receipt while the percentage royalty was classified as income.[12]

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[5] (1978) 78 D.T.C. 6128 (F.C.T.D.) *per* Dube J.
[6] (1977) 77 D.T.C. 222, [1977] C.T.C. 2279 (T.R.B.) *per* St-Onge.
[7] *Supra*, note 5, 6129.
[8] *Ibid.*
[9] (1965) 65 D.T.C. 617, 39 Tax A.B.C. 220 *per* Weldon.
[10] *Ibid.*, 623.
[11] (1950) 50 D.T.C. 398, 2 Tax A.B.C. 364 *per* Monet and Fisher.
[12] *Income War Tax Act*, R.S.C. 1927, c.97, s.3(f), added by S.C. 1934, c.55, which is similar in language to the present s. 12(1)(g).

The taxpayer in *Pacific Pine Co.* v. *M.N.R.*[13] also sold a right to cut timber on land he owned, but the contract provided for a minimum payment which was subject to refund if less than the amount of timber paid for had actually been cut. In *Hazlett* v. *M.N.R.*[14] and *Randle* v. *M.N.R.*[15] the receipt of damages or compensation for the removal of clay and injury to land was held to be a capital transaction.[16] In contrast to the *Pacific Pine Co.*, *Hazlett* and *Randle* cases, *Huffman* v. *M.N.R.*[17] held that the sale of a mine for the fixed sum of $25,000, to be computed out of the mine workings on a percentage basis, gave rise to income under section 12(1)(g). Mr Fisher reasoned that the use of a ceiling on production payments was not sufficient to bar the application of the section.[18]

These decisions emphasize the form of payment and have not provided an adequate basis upon which to predict the treatment of minimum royalties. The issue has been obscured by an earlier line of cases led by *M.N.R.* v. *Lamon*;[19] the *Lamon* decision suggests that the mere transfer of a right to use property is itself a "use of property", as the phrase is employed in section 12(1)(g), and therefore any payment in exchange for the "right to use" the property will be income and not a capital receipt. *Mouat* v. *M.N.R.*[20] expands this interpretation, ruling that payments for even the "*slightest* use" of the "right to use" will be income. Thus the logical extension of the *Lamon* and *Mouat* decisions is that the extent of use of the property

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[13] (1961) 61 D.T.C. 95, 26 Tax A.B.C. 41 *per* Fisher.

[14] (1965) 65 D.T.C. 511, 39 Tax A.B.C. 54 *per* St-Onge; see also *Corrigan* v. *M.N.R.* (1965) 65 D.T.C. 513, 39 Tax A.B.C. 52 *per* St-Onge; *Salt* v. *M.N.R.* (1951) 51 D.T.C. 14, 3 Tax A.B.C. 180 *per* Fisher and Monet.

[15] (1965) 65 D.T.C. 507, 39 Tax A.B.C. 46 *per* St-Onge.

[16] *Cf. Rebus* v. *M.N.R.* (1953) 53 D.T.C. 1237, [1953] C.T.C. 452 (Ex.) *per* Cameron J., who held that payment in compensation for royalty arrears on a blown well that was put under government control fell within the then s.6(1)(j).

[17] (1954) 54 D.T.C. 383, 11 Tax A.B.C. 167 *per* Fisher.

[18] Arrangements for participating royalties up to a fixed amount do have tax avoidance overtones. For example, payments to a company president for his copyright on a sales catalogue were to be equal to 3.5% of the corporation's gross sales therefrom until $200,000 (reduced from $1.5 million) was reached. Noel J. held that s. 12(1)(g) would still apply because the total sale price was fixed in an arbitrary manner and without any apparent regard to the value of the asset (*Gingras* v. *M.N.R.*, *supra*, note 2).

[19] (1963) 63 D.T.C. 1039, [1963] C.T.C. 68 (Ex.) *per* Cameron J.; see also *Mouat* v. *M.N.R.* (1963) 63 D.T.C. 548, 32 Tax A.B.C. 269 *per* Fisher; *Ladouceur* v. *M.N.R.* (1968) 68 D.T.C. 771, [1968] Tax A.B.C. 1057 *per* St-Onge.

[20] *Supra*, note 19.

owned by the taxpayer is irrelevant so long as a "right to use" has been granted.[21]

The simple fact that the purchaser will have acquired some right of use over property — whether by itself or as an attribute of a larger interest in the property — should not transform payments that would otherwise be capital receipts into ordinary income. Unfortunately, the jurisprudence has left the issue unsettled, and now the *Porta-Test* and *Lackie* decisions indicate that section 12(1)(g) may be given a broader scope of application than was intended.[22]

In both *Porta-Test* and *Lackie,* the crucial point was the lack of an apparent intention to dispose of a capital asset for a lump sum payment, although the parties evidently intended to do so for at least an agreed amount in participating royalties. While the crucial contract term is not set out in *Porta-Test,* it is apparent that Mr St-Onge attached considerable importance to the parties' characterization of all of the payments as "royalties":

> Nowhere is mention made in the document of the lump sum payment for an exclusive right. On the contrary, there are many mentions of royalties and the document does not state a minimum *payment* but a minimum *royalty* of $150,000.[23]

In addition, one of the corporation's employees testified that the purpose of the clause was to ensure that the licensee would actively exploit the product.[24] Mr St-Onge interpreted the testimony as supporting his conclusion that all of the payments were ordinary income. This overlooks the fact that the character of the payment was not important to the licensee and an obligation to pay $150,000 would provide an incentive to recover the investment. Viewing it as a royalty rather than a payment would not affect that incentive.

In *Lackie* v. *M.N.R.*,[25] clause 3 of the agreement characterized the contract as a "lease" stipulating five annual payments of $10,000, with an offset of $0.20 per ton of gravel removed. Clause 4 provided that if the value of the gravel removed exceeded the amount of the minimum sum payable, the value of the gravel removed would be due. Under this arrangement the taxpayer received a total of $50,000

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[21] Apparently it does not matter whether the "right" which is transferred is a proprietary or nonproprietary interest. See Jackson, *Principles of Property Law* (1967), 28.

[22] This would be especially true if the cases are viewed in light of the form of the payments in question rather than the contractual terms giving rise to them.

[23] *Supra,* note 6, 224 [emphasis added].

[24] *Ibid.,* 223-24.

[25] *Supra,* note 5.

whereas only $28,000 worth of gravel was removed. The taxpayer argued that receipt of an amount for granting a "right to use" the property by removing gravel is not receipt of an *amount* which was "*dependent* upon the use of or production from property"[26] as required by section 12(1)(g).

In short, the case turns on the meaning of "dependent" as it is used in section 12(1)(g). If "amount received ... that was dependent upon the use of ... property" encompasses any consideration for a right of use, then the receipts should be treated as ordinary income. If the language requires that the amount received be dependent upon the *extent* or frequency or nature of the use of property, then the payments in question should not be included in ordinary income unless they fall within the common law concept of "income from property", such as rental income. The definition of the word "dependent" in *The Shorter Oxford English Dictionary* indicates that the meaning of the phrase is more consistent with the second interpretation — that the amount will be income only if it is dependent on the extent, frequency or nature of use. "Dependent" is defined as "having its existence contingent on, or conditioned by, that of something else".[27]

This issue has never been fully appreciated in Canadian jurisprudence, although *obiter dicta* in a few cases have touched upon it. In the leading case of *Orlando* v. *M.N.R.*, the majority of the Supreme Court held that amounts received for topsoil sold in small lots and in one large lot were income from a "scheme of profit-making"[28] or an adventure in the nature of trade, thus obscuring the section 12(1)(g) issue. However, Mr Justice Cartwright, in a dissenting opinion, interpreted the section as catching payments for *profits à prendre* but not capital payments:

> [T]he payments of $2 per cubic yard of top soil ... were payments *for the granting* to the company *of a licence,* analogous to a *profit à prendre,* permitting it to enter the lands of the appellant and take therefrom for its use a portion of the soil subject to payment therefor at the price agreed: from this it follows that the amounts so paid constituted taxable income of the appellant as being *amounts received* by her *from the use of her property* but not as profits from a business.[29]

Although this passage suggests that the consideration is for the "right" of removal, the true character of the payment is described

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[26] *Ibid.*, 6132.

[27] *The Shorter Oxford English Dictionary* 3d ed. (1973), vol.1, 521.

[28] (1962) 62 D.T.C. 1064, 1068, [1962] C.T.C. 108, 116 (S.C.C.) *per* Abbott J., Cartwright J. dissenting.

[29] *Ibid.*, 1069 [emphasis added].

by contract as "payment [for the removal of soil] at the price agreed" or as depending in quantum on the amount of soil taken. Thus the further description of the amounts received as being "for the use of her property" is overly broad and imprecise; the amount is determined by the extent of use.

A similar understanding of the meaning of "dependent" is displayed in *Morrison* v. *M.N.R.*,[30] in which the taxpayer agreed to sell rock to a contractor for $0.025 a ton, but the parties later agreed to an amount based on an approximation of the quantity taken. Thurlow J. held that the sum received, in satisfaction of the taxpayer's contractual rights, was paid in settlement and not as a dependent amount. In addition, he was of the opinion that even if the payments were for the material itself, the section still could not apply:

> [The amounts] were not dependent upon the quantity taken, since this never was ascertained and ... dependence upon the extent or quantity of production or use and the application thereto of some rate or standard appears to me to be an essential qualification of amounts which fall to be taxed under section 6(1)(j).[31]

In the *Lackie* decision however, unlike *Morrison*, the amount paid was determined by contract — not settlement plus property damages. Thurlow J. chose to infer that a substantial portion of the settlement was attributable to the damage done to the taxpayer's property. However, he did express the view that even if the remittance was based on an approximation, it might have been "in lieu of payment of, or in satisfaction of"[32] dependent amounts since it encompassed:

> ... the unknown quantity of rock in respect of which he was entitled to payment at the rate of 2½ cents per ton but had no way of knowing what that would amount to or whether it would be more or less than the losses which the removal of the rock entailed.[33]

However, he pointed out that the words "in lieu of ..." had not been employed to extend the scope of section 12(1)(g). Since the taxpayer had contracted for a minimum payment of $50,000 which would be received whether or not any rock was actually extracted, the parties must have contemplated that a large, though unknown, quantity would be removed. Since the key feature of *Morrison* is the indeterminate amount of material to be extracted, it is possible

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[30] (1966) 66 D.T.C. 5368, [1966] C.T.C. 558 (Ex.) *per* Thurlow J., *rev'g* (1965) 65 D.T.C. 25, 37 Tax A.B.C. 164.

[31] 66 D.T.C. 5372; [1966] C.T.C. 564.

[32] *Ibid.*

[33] *Ibid.*

to compare the two cases on that basis even though the legal obligation to pay arose under a contract in *Lackie* and was based on liability for damages in *Morrison.*

Lackie and *Porta-Test* should have been decided on the basis that the extent or quantity of use under the contract was unknown, and even though the minimum royalty may have been fixed in anticipation of the approximate extent, the *amount* of the payment was not contingent or dependent on that approximation. The scope of section 12(1)(g) — which is broader than it need be in any event — should not be extended to cases in which it is not clearly applicable. Where the taxpayer is able to show that his or her characterization of the source of the payment is consistent with the essence of the transaction, that explanation should be sufficient to exclude the application of the section. In both *Lackie* and *Porta-Test,* the transactions in question involved the grant of an exclusive licence in exchange for a fixed sum and a participating royalty, subject to the fulfilment of certain specified conditions.[34]

The shortcoming of these two decisions, particularly *Lackie,* is their reliance on the reasoning in *Mouat* v. *M.N.R.*[35] and *M.N.R.* v. *Lamon,*[36] even though the *Lamon* case was expressly rejected in the later *Morrison* case. In defence of these two decisions, however, it should be noted that there is no overriding principle to assist the courts in their application of this particularly troublesome statutory provision. Section 12(1)(g) was formulated to reverse the tax consequences of cases in which capital property was exchanged for a participating interest,[37] but the language employed was far broader than was needed, with no discernible limit. Despite pleas to reform the provision,[38] the government has not responded. Thus decisions such as these will undoubtedly become more frequent in the future.

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[34] The obvious weakness of this view is that some cases have held that a fixed capital sum will be transformed into income when paid in the form of participating payments. See, *e.g., Ross* v. *M.N.R., supra,* note 2.

[35] *Supra,* note 19.

[36] *Ibid.*

[37] See *Spooner* v. *M.N.R.* (1931) 1 D.T.C. 211, 213, [1928-34] C.T.C. 178 (S.C.C.), *aff'd* (1933) 1 D.T.C. 258, [1928-34] C.T.C. 184 (P.C.).

[38] See, *e.g.,* Dickerson, "Tax Accounting *v.* Financial Accounting" in (1974) 25 Tax Conf. Rep. 343, 345: "Perhaps the most obvious candidate for deletion from the Income Tax Act is paragraph 12(1)(g), the notorious 'production or use' provision. This rule is so unconscionably harsh and unnecessary that it is probably irrelevant that it is also out of accord with accounting principles."

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