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BETWEEN:

CLEVITE DEVELOPMENT LIMITED ..APPELLANT;

AND

THE MINISTER OF NATIONAL REVENUE ..................... } RESPONDENT.

*Revenue—Income—Income tax—Foreign business corporation—Royalties received from licenses of European patents—No active business effort by licensor—Whether "business operations" carried on—The Income Tax Act, R.S.C. 1952, c. 148, s. 71(1) and (2)(c)(i)(ii)(iii).*

The appellant is the wholly-owned subsidiary of an Ohio corporation. Prior to 1957 it carried on business in Canada as a manufacturer of engine bearings and had acquired from its parent corporation a number of British and European patents pertaining to engine bearings. The British patent was subject to a licensing agreement made by the parent the benefit of which was transferred to the appellant. Under it royalties were payable by the licensee and the parent agreed to supply technical and other assistance to the licensee. The appellant licensed a German company to manufacture and sell products under the German patents and undertook to furnish the latter with technical information and other aid and to allow the licensee's technicians to visit the plant of the appellant in Canada and those of its parent in the United States to study methods and techniques. In 1956 the appellant ceased manufacturing and sold its plant and Canadian patents to an affiliated corporation but retained its British and European patents. Under the British patent licensing agreement the appellant was under an obligation to its parent to supply the services required by the licensor although in practice they had been rendered by the parent. There was no clear evidence that anything was required or done in 1957 by either corporation. As to the German licensing agreement, in 1957, if not in most other years as well, nothing was done by the appellant and, so far as anything was required, the obligations were carried out by the parent corporation.

The appellant claimed exemption for the year 1957 under s. 71 of the *Income Tax Act* as a foreign corporation. The Minister ruled that it did not so qualify. On an appeal from the assessment.

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*Held:* That s. 71 of the *Income Tax Act* is an exempting provision and must be strictly construed. To qualify under clause (c)(i) of s-s. 2 thereof a corporation's business operations must be of an industrial, mining, commercial, public utility or public service nature and its operations must have been carried on entirely outside of Canada.

2. That prior to the sale of its plant the appellant's business included the development and manufacturing of bearings and the licensing of patents and servicing of the agreements was part thereof and the income received therefrom part of the income of the business which might have been carried on in Canada and elsewhere.
3. That after the sale the holding of the patents and licensing agreements and doing what was necessary to perform them continued to be a business of a commercial nature within the meaning of s. 71(2)(c)(i) of the Act and the royalties received by the appellant in 1957 should be regarded as income from its business rather than income from property.
4. That in using the expression "business operations" however the statute contemplates more than a situation in which nothing of an active nature is done in the material period by the party by whom the business is carried on.
5. That here after the sale of its manufacturing plant the role of the appellant was essentially passive. No "business operations" were carried on by it anywhere and accordingly it was not entitled to exemption as a foreign business corporation. *Inland Revenue Commissioners v. Desoutter Brothers Ltd.* [1946] 1 All E.R. 58; *Tootal Co. Ltd. v. Inland Revenue Commissioners* [1949] 1 All E.R. 261, referred to.

APPEAL under the *Income Tax Act*.

The appeal was heard before the Honourable Mr. Justice Thurlow at Toronto.

*G. D. Watson, Q.C.* for appellant.

*Terence Sheard, Q.C.* and *J. D. C. Boland* for respondent.

THURLOW J. now (March 23, 1961) delivered the following judgment:

This is an appeal from an assessment of income tax for the year 1957, the issue between the parties being whether the appellant was during that year a foreign business corporation and thus entitled to exemption from taxation pursuant to s. 71 of the *Income Tax Act*, R.S.C. 1952, c. 148.

The material part of s. 71 is as follows:

(1) No tax is payable under this Part upon the taxable income of a corporation for a taxation year when it was a foreign business corporation.

(2) In this Part, a "foreign business corporation" is a corporation that during the whole of the taxation year in respect of which the expression is being applied

(*a*) [not in issue]

(*b*) [not in issue]

(*c*) complied with one of the following conditions:

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(i) its business operations were of an industrial, mining, commercial, public utility or public service nature and were carried on entirely outside Canada (except for management and the designing, purchasing and transportation of goods if the goods were not acquired for resale in the course of trading and were acquired for the operations so carried on outside Canada) either directly or through ownership of shares in or control of subsidiary or affiliated corporations and its property, except securities and bank deposits, was situate entirely outside Canada,

(ii) it was the wholly-owned subsidiary of a corporation that complied with the conditions in subparagraph (i) and was wholly engaged in carrying on business outside Canada, or

(iii) its business was of an investment or financial nature and was carried on entirely outside Canada, its shares had been offered for public subscription or were listed on a recognized stock exchange in Canada or elsewhere and its property (except bank deposits and shares of other corporations that were entitled to exemption under this section) were situate entirely outside Canada; . . .

(*d*) [not in issue]

The appellant is an Ontario corporation incorporated in 1949, under the name of Clevite Limited, and is a wholly-owned subsidiary of Clevite Corporation, an Ohio corporation with its head office in Cleveland. The head office of the appellant is at St. Thomas, Ontario, but only one of its directors lives in Canada. The others live in the United States, where all directors' meetings and shareholders' meetings are normally held.

Prior to 1957, the appellant had carried on business in Canada as a manufacturer of automobile-type bearings, principally engine bearings, and had acquired from its parent a number of British and European patents pertaining to bearings or bearing metals. When acquired by the appellant, the British patent was subject to a licensing agreement made in 1933 by the parent corporation with O & S Bearings Limited, the benefit of which was also transferred to the appellant. Under this licensing agreement, royalties were payable by the licensee and the parent had agreed to supply the licensee with technical information, drawings, specifications, and other data to enable the licensee to manufacture and sell its products, to supply the licensee with samples, duplicates of plant tools, dies, fixtures or equipment, and complete bushings or bearings or any component part thereof. By an agreement made in

1954, the appellant also licensed a German company to manufacture and sell products under its German patents. In this agreement, it was recited that the appellant

> for a period of many years has been engaged in the development and manufacture of metal bearings, particularly strip type bearings, and has acquired extensive technical information with respect to such products and their manufacture

and by paragraphs 3, 4, and 6 the appellant undertook to furnish the licensee with technical information concerning bearings then and thereafter manufactured by the appellant and its parent corporation, to assist the licensee in securing necessary metals and equipment to enable it to manufacture strip type bearings, and to send, upon the licensee's request, competent technicians to the plant of the licensee for the purpose of advising and assisting the licensee in its bearing operations, the salaries of such technicians to be paid by the appellant. By paragraph 7, it was also agreed that the licensee might cause its technicians or representatives to visit the plants of the appellant in Canada and those of the parent corporation in the United States from time to time for the purpose of observing, studying and being trained in the methods, equipment and technique used by the appellant in the manufacture of bearings.

In 1956 the appellant sold to Paxol Limited, later renamed The Clevite Limited, a sister or affiliated corporation, for approximately two and a half million dollars, its manufacturing plant and Canadian patents, together with its other physical assets, and thereupon discontinued its own manufacturing and selling operations. It retained, however, its British, German and other foreign patents and the licensing agreements pertaining thereto.

Subsequently, in August, 1957, the appellant was reorganized under the name of Clevite Development Limited. Following the agreement of 1933, shipments of material, equipment and machinery were made from time to time to O & S Bearings Limited by the parent corporation, but there is no clear evidence that any shipment pursuant to the contract was ever made by the appellant, or that any shipment was made by anyone in 1957. It was, however, stated in evidence that no shipment was made from Canada in 1957.

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Nor is the evidence clear as to what, if anything, was done in 1957 under paragraphs 3 and 4 of the German patent licence. A witness called on behalf of the appellant stated that none of the services provided for in these paragraphs were performed in Canada in 1957 and that what was required to perform them was done in Ohio or in Germany, but he was unable to say that anything had been required in 1957.

He did, however, say that personnel came from Germany two or three times each year, including 1957, to visit the plant of the parent corporation in Cleveland pursuant to paragraph 7 of the agreement and that personnel of the parent corporation visited the German plant two or three times a year, including 1957, pursuant to paragraph 6.

During 1957, the appellant's assets in Canada consisted entirely of bank deposits, a demand note of The Clevite Limited, dated October 31, 1956, for $2,525,982.34 bearing interest at 4 per cent per annum, given in payment of the selling price of the manufacturing plant and assets, and two short-term notes bearing 5 per cent interest, dated in November and December, 1957. Besides the President, who was resident in Canada and was treasurer of The Clevite Limited, there was one employee in Canada engaged on a part-time basis in working on the appellant's books and records, which were kept in St. Thomas, and the President's secretary was sometimes used to type letters in connection with the appellant's affairs. Neither in Cleveland nor anywhere else was there any other person employed by the appellant.

On these facts, it was contended that for 1957 the appellant was qualified as a foreign business corporation since, throughout that year, its business operations, namely, the holding of the patents and licensing agreements and the performing of the obligations of the licensor under these agreements, were of a commercial nature within the meaning of clause (*c*) of s. 71(2), that such business operations were carried on entirely outside Canada, and that the appellant's property was situate outside Canada except for the bank deposits in Canada and the three promissory notes which were securities within the meaning of s. 71(2)(*c*)(i). It was not suggested that the appellant could qualify under any other part of this subsection. In support of the assessment,

counsel for the Minister submitted that s. 71 is an exempting provision which is to be strictly construed and that the appellant did not qualify as a foreign business corporation within the definition in s. 71(2), first because its business operations were not of commercial but of a financial or investment nature, secondly because whatever the nature of the appellant's business was, no part of that business was carried on outside Canada, and thirdly because the three promissory notes held by the appellant in Canada were not securities within the meaning of s. 71(2)(*c*)(i).

In my opinion, s. 71 is an exempting provision and must be strictly construed. *Toronto General Trusts Corporation v. City of Ottawa*[1], *Lumbers v. Minister of National Revenue*[2]. The section in question appears to me to define and apply to a narrow class of corporations which carry on business operations outside Canada but to whom (but for the exemption) Part I of the *Income Tax Act* would apply on the basis of their being resident in Canada. Clause (*c*)(i) of s-s. (2) is peculiar. To qualify under it, the corporation's business operations must be first of an industrial, mining, commercial, public utility or public service nature and, second, they must have been carried on entirely outside Canada. Nowhere, however, is it expressly stated that the corporation must be one that has "business operations." That feature is left to be implied, as I think it must be, for I can see no scope for the application of the section to a corporation which is resident in Canada and derives income from property but engages in no business operations anywhere. Such a corporation could readily be said to carry on no business in Canada, but it would not seem to comply with the requirement that its business operations be of an industrial, etc., nature and that they be carried on entirely outside Canada.

In the present case, the scope of the appellant's functions became so restricted following the sale of its manufacturing plant that it becomes necessary to consider, first, whether what was left can be regarded as a business at all, as opposed to a mere holding of property and receipt of revenue therefrom.

[1] [1935] S.C.R. 531.
[2] [1943] Ex. C.R. 202.

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The problem whether royalties received through holding and licensing patents and performing patent licensing agreements should be regarded as profits of a trade was considered by the Court of Appeal in England in *Inland Revenue Commissioners v. Desoutter Brothers Ltd.*[1] There the problem was twofold; first, whether the royalty was profit from the trade, and second, whether the royalty was income from an investment within the meaning of a particular statutory provision which would conceivably have applied even though the receipts in question were part of the profits of a trade. Lord Greene M.R. said at p. 61:

> To my mind, it is obvious that a patent in the hands of a manufacturer is quite a different type of property, both in the business and in the practical sense, to a patent in the hands of somebody who is a mere passive owner of the monopoly right. For instance, a member of the Bar, who was fortunate enough to have bequeathed to him a patent, or who had purchased a patent, the validity of which had been established by the court, might continue, without any active participation in manufacturing himself, merely to exploit that monopoly by granting licences. He would then be merely passive; he would be the passive recipient of income from that particular piece of property. In such a case it might very well be, and I strongly suspect it would be, held, if members of the Bar were subject to excess profits tax, that the income from that patent could properly be described as income from an investment. But directly the patent is held by a manufacturer of the patented article, it seems to me that the situation is entirely changed. When you have a manufacturer who is exploiting his monopoly right, not merely by excluding all competitors, but by letting one competitor in on terms, to say that the profits so derived are profits from an investment seems to me to be a misuse of language. It is contrary to what one may call the popular conception of the word "investment," which is not a word of art, but has to be interpreted in a popular sense. The contrast, I venture to think, is brought out exactly in the two examples I have put. One is that of a private individual not concerned with manufacture at all, but merely holding a patent, as he might hold a copyright in a book, and simply drawing the income from the royalties payable under the copyright. He would merely be a passive person drawing the income which flows from that particular chose in action. That is one example. The other example is the manufacturer who can, if he likes at any moment, exploit his monopoly in a number of different ways—either by manufacturing himself, or by vending himself, or by allowing somebody else to manufacture and vend or manufacture but not vend, or to vend but not manufacture. The mere granting of such licences does not seem to me to take the income out of the category of income of the business.
>
> I have said that what I was proposing to say on this argument would dispose also of the second argument, namely, the question whether the income is profits of the business. It will be seen that the considerations which I have mentioned, if they are right, answer that question just as much as they answer the question whether or not it is to be regarded as income from an investment.

[1] [1946] 1 All E.R. 58.

At pp. 62-3, he also said:

I have dealt with this question so far without reference to the special argument which counsel for the respondents put forward in connection with the particular agreements under which the income is derived in this case . . . The argument is this. The profits derived by the company in the present case cannot be said to be derived entirely from the mere ownership of the patents, but are attributable also to certain other obligations which the company undertakes under these agreements.

The first agreement of June 3, 1937, recites the granting of a sole and exclusive licence, and goes on to say that:

> . . . it is witnessed that in consideration of the royalties hereinafter reserved and of the mutual promises of the parties hereto, the owners agree . . .

The first paragraph of the undertakings given by the owners is:

> To grant to the licensee sole and exclusive licence and authority to manufacture and sell [in a number of countries] the drills made in accordance with the inventions of the patentees.

Then comes this obligation of the owners:

> To supply to the licensee drawings of the drills and of any tools used by them in the manufacture of drills or component parts thereof, and to give to the licensee information of their manufacturing methods, and to permit a representative of the licensee to inspect the manufacture of the drills and their component parts at their works at Hendon.

That undertaking could only be given by a company which itself was manufacturing in accordance with this invention. No mere passive holder of the patent could give an undertaking of that kind. Although it is a type of undertaking extremely common in patent licences, it is none the less an undertaking which the owners of the patent are giving, and can only give, by virtue of the fact that they are manufacturing and can give to the licensee valuable manufacturing information and experience which would otherwise not be available to them. That also brings out the difference between exploitation of a patent in the hands of a mere passive owner and the exploitation of a patent in the hands of a manufacturer.

* * *

The effect of these agreements in these respects is purely a matter of construction of the agreements. In my opinion, that circumstance alone, even if I were wrong on the major proposition which I discussed a moment ago, would be sufficient to justify, and, indeed, compel, the court to say that the profits in question are not income from investments, but they are the income of the trade or business, and are not excluded as being income from investments under para. 6 of the Schedule.

In *Tootal Co. Ltd. v. Inland Revenue Commissioners*[1], the question was whether "income described as royalties received by the appellant company under three separate agreements relating to patent rights, and admittedly part

[1] [1949] 1 All E.R. 261.

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of the appellant's business profits, [were] also" income from investments "within the meaning of" a particular statutory provision. Lord Simonds said at p. 264:

It is possible, as was pointed out in the *Desoutter* case by *Lord Greene*, M.R., that a particular kind of asset might in the hands of one trader be, and in the hands of another not be, an investment, though a less likely form of investment for any trader to make than a patent cannot readily be imagined.

Lord Normand said at p. 266:

It is conceivable that an ordinary trading company as well as an individual might enjoy an income from investments in the form of royalties under patent licences, but it would be a rare occurrence, and a company claiming to be in the enjoyment of such an income must satisfy the income tax commissioners, or the court on appeal, that it is not merely a profit of the business but truly of the nature of an income from investment.

Lord Morton of Henryton said at p. 267:

I agree with the views expressed by LORD GREENE, M.R., in *Inland Revenue Comrs. v. Desoutter Bros., Ltd.* that the word "investment" in this context is not a word of art, and that the question whether or not a particular piece of income is "income received from an investment" must be decided on the facts of each case. I think that the question must be approached from the standpoint of an intelligent man of business, and, in my view, such a man, being informed of the facts set out in paras. 3, 4(*a*) and 5 of the Stated Case, and being shown the agreement which is exhibit A, would not think that the royalties received under that agreement were aptly described as "income received from investments." I think he would rightly say that the royalties were income received from a commercial agreement, conferring advantages on each of the parties to it, and entered into as a part of the company's business.

Lord Macdermot also said at p. 268:

My Lords, I do not think any business man would describe the income so obtained as "income received from investments." He would be bound to admit that the purpose of the agreements was a trade purpose, but I do not think he would look on this alone as conclusive against so describing the income, and in that, I apprehend, he would be right, having regard to the decision of this House in *Gas Lighting Improvement Co., Ltd. v. Inland Revenue Comrs.*, [1923] A.C. 723. He would, no doubt, find difficulty in giving a precise definition of "investments" as the word is used in the relevant enactment, but I think he would be prepared to go the length of saying something like this: "If, in the course of carrying on my business, I make active use of a business asset—be it my factory building, a piece of machinery, a patent, or my working capital—that asset is not an investment. Whatever else a business investment may have to be, it is an asset for the time being held intentionally aloof from the active work of the business. It is none the less an asset of the business and may have great business value. For instance, it may enable me to survive bad times and take advantage of good, or it may help me to control supplies or

competition. And if it produces income that is income of the business. But I do not earn that income by my business efforts. The part I play there is essentially passive. I cannot, of course, afford to neglect my investment. I may have to preserve it and, on occasion, change its form, but normally I just hold it and receive what it brings in.

Following the reasoning of the passages cited and having regard also to the meaning of the word "business", which is broader than that of the word "trade", which in turn is itself a very wide term, I have come to the conclusion that in this case the holding, licensing and performing of the patent licensing agreements can be regarded as a business. Prior to the sale of its manufacturing plant, the appellant had a business which included the development and manufacture of bearings, and I should have thought the holding and licensing of the patents and the servicing of the agreements then was clearly a part of that business and that the income received therefrom was not merely income from property but part of the income of the business. So far as I can tell from the evidence, this was also a part of the business which might have been carried on both in Canada and elsewhere for, even assuming that all other obligations arising under the agreements would be discharged elsewhere, the German agreement refers to visits to be made to the appellant's plant in Canada. Nor do I think that the sale of the plant and discontinuance of the appellant's manufacturing operations would necessarily change the character of the remainder of what had been the appellant's business to a mere matter of property holding. After the sale of the manufacturing plant, the holding of the patents and licensing agreements and doing whatever was necessary to perform them was all that was left of the appellant's business, but the purpose of the agreements and of the performing of them did not change, and in my view that purpose throughout was to obtain revenue in the form of royalties by licensing the use of the patented inventions and by assisting the licensees to exploit them by doing the things provided for in the agreements. This, I think, is an enterprise or business and is one of a commercial nature within the meaning of "commercial" in s. 71(2)(*c*)(i). I do not think it should be regarded as a mere property holding and

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receipt of revenue therefrom, nor do I think it would be properly classed as a business of a financial or investment nature, as submitted by counsel for the Minister. Accordingly, I think that the appellant should be regarded as having had a business in 1957 and that the royalties received by the appellant in that year should be regarded as income from its business, rather than as income from property.

It does not, however, necessarily follow that what the appellant did in 1957, even though capable of being characterized as a business, amounted to "business operations," for I think it is readily conceivable that one may carry on a commercial business and yet for an appreciable time do no act whatever which can be characterized as a "business operation." In using the expression "business operations" the statute appears to me to contemplate something more than a situation in which nothing of an active nature is done in the material period by the party by whom the business is carried on. In the present case, the appellant's activities, if not entirely non-existent, were at a low ebb throughout 1957, and the questions thus arise whether there was anything at all in what the appellant did in 1957 which should be regarded as "business operations" and, if so, whether such business operations were carried on entirely outside Canada.

Now during this period there were no manufacturing or selling activities on the part of the appellant, nor is there evidence of anything whatever being done with respect to its Italian or French patents.

With respect to the British patent, as previously mentioned, there is no clear evidence that anything was required or done in 1957 by either the appellant or its parent to fulfil the licensor's obligations under the licensing agreement. And while, as between the appellant and its parent, the appellant was under an obligation to render the services therein provided for, these services when required were in practice rendered by the corporation, and on the evidence I see no basis for a finding that any of them was ever carried out by the appellant. Moreover, in 1957, if not in most other years as well, the appellant's obligations under the

German licensing agreement, so far as anything was required, were carried out not by the appellant but by the parent corporation. No charge was made by the parent to the appellant for such services, and I do not think it is a fair conclusion on the facts that the appellant procured the rendering of such services by its parent. Rather, I think the correct inference is that the appellant had nothing to do and did nothing in 1957 in performance of the agreement or to assist or promote the business of the licensee, because the parent went ahead and did everything that the contract required the appellant to do or which was considered desirable or advantageous. No doubt, if the parent had not done what was required, the appellant might have been called upon to perform its agreement or might have regarded it as in its interest to assist the licensees in the ways referred to in the agreements, and if this had occurred what was done might well have been characterized as business operations. But the evidence leaves me unsatisfied that the appellant at any material times did anything in performance of the licensor's obligations under the agreements or that anything that was done by the parent corporation was done on behalf of the appellant as its agent or at its instance. It is not established that the parent corporation did not itself have a contract with the German licensee pursuant to which the services were performed, and, in my opinion, the parent cannot be regarded as an affiliated corporation under the control of the appellant within the meaning of s. 71(2)(*c*)(i). In my view, the situation during the material time was in some respects similar to that referred to by Lord Macdermott in the passage cited above. The appellant may be regarded as having had a business, and the royalty income may be regarded as income from that business. But the royalties were not earned by active business efforts on the part of the appellant. After the sale of the manufacturing plant, the role of the appellant was essentially passive. It simply held the agreements and received the income, doing nothing to perform the agreements or to enhance the royalties so long as all that was necessary for that purpose was being effectively done by its parent. I do not think this

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falls within what is meant by "business operations" in s. 71(2)(*c*)(i), nor do I think it can be said to follow from the fact that nothing of an active nature capable of being described as a business operation was done in Canada during the material time, that the appellant's "business operations" were entirely carried on outside Canada within the meaning of s. 71(2)(*c*)(i), for the fact is that during the material time no "business operations," as therein referred to, were carried on by the appellant anywhere.

Apart from this view, however, it appears to me that, if in this passive situation anything can be described as "business operations," the receipt of the royalties (a feature which in more active situations might well be disregarded) is as important a part of them as is anything else, and it was not disputed that the royalties were received from the licensees by the appellant in Canada. In addition, the situation may, I think, be viewed as one in which the appellant had carried on its business operations in Canada, and the evidence, while indicating that no business operations took place in Canada during the material period, fails to establish that business operations were carried on anywhere else. There is thus nothing to establish any change in the locality in which the appellant's "business operations," when it has any, are carried on.

I am, accordingly, of the opinion that the appellant was not entitled to exemption as a foreign business corporation and that its appeal fails. In view of this conclusion, it is not necessary for me to deal with the further point as to whether the promissory notes held by the appellant were "securities" within the meaning of s. 71(2)(*c*)(i).

The appeal will be dismissed with costs.

*Judgment accordingly.*