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## **REVENUE CANADA'S**

### **ADVISORY COMMITTEE ON ELECTRONIC COMMERCE**

**April 30, 1998**

#### **Introduction**

Revenue Canada and International tax authorities are starting to catch up with the challenges posed by the rapid emergence of electronic commerce. Generally, electronic commerce refers to the delivery of information, products, services or payments by telephone, computer or other automated media.

The latest contribution to the analysis and development of tax policy for cross-border electronic transactions is the recently released report of Revenue Canada's Advisory Committee on Electronic Commerce (the "Committee").

The Committee's mandate was to review and report on trends in electronic commerce to determine the implications for revenue administration and recommend changes to ensure continued compliance with Canada's tax laws. This memorandum summarizes some of the Committee's findings and recommendations.

#### **The Committee's Recommendations**

To help Canadian businesses make the most of the opportunities that electronic commerce presents, the Committee says that government policy should adhere to a broad set of governing principles based on the Committee's belief that countries and businesses have much more to gain by stimulating economic commerce than by inhibiting it.

According to these principles, governments should avoid unduly regulating and restricting electronic commerce and let the private sector take the lead. Where

government involvement is needed, its aim should be to support and enforce a predictable, consistent and simple legal environment.

Governments should impose no new taxes (such as the so-called “bit tax”) on electronic transactions and should avoid placing additional compliance burdens on taxpayers, suppliers or supporters, the Committee says. Functionally equivalent transactions should be treated the same whether they’re concluded electronically or otherwise.

### **Central Mind and Management**

International transactions are usually taxed on the basis of a business’s residency status for tax purposes and the jurisdiction in which profits from the transaction arise. Traditional residency concepts are based on criteria such as physical presence, incorporation and place of central mind and management (i.e. where the board of directors meet and where the corporation is effectively managed).

New communications technologies such as the Internet and video conferencing make it difficult, if not impossible, to pinpoint the location of a corporation’s central mind and management. For example, directors no longer need to be physically present to participate in board meetings. Global organizations relying on telecommunications run the increasing risk of being considered resident in more than one country. Multiple taxation can result.

Revenue Canada should cooperate with its tax treaty partners to find ways to shorten the lengthy “competent authority” process for negotiating relief from double taxation with competing tax authorities. Revenue should also publish administrative guidelines on the significance of new technologies for central mind and management and other concepts of residency.

## **Carrying on Business in Canada**

Subject to modification by Canada's tax treaties, non-residents of Canada are taxable in Canada on their profits from "carrying on business in Canada," a broadly defined phrase that includes producing, manufacturing, packing or improving anything in Canada, and offering anything for sale in Canada through an agent.

According to the Committee, electronic commerce raises concerns about where business is transacted and what degree of electronic activity constitutes carrying on business in Canada. For example, is the location of a file server a factor in determining the situs of a transaction for tax purposes or is the server simply a conduit for the parties to the transaction, like a telephone? Can a computer that solicits orders or manages transactions constitute an agent for purposes of the carrying on business definition?

Although established legal principles governing the situs of a transaction may continue to apply to electronic transactions, the Committee says that certainty is required regarding the role of computers in determining where a transaction occurs. Revenue should publish administrative guidelines addressing the significance of new technologies on the concept of carrying on business in Canada.

## **Permanent Establishment under Tax Treaties**

Under Canada's tax treaties, which are generally based on the OECD model, Canada will tax the Canadian-source income of a non-resident only if the business has enough presence to have a "permanent establishment" in Canada. Generally, a permanent establishment is a fixed place of business or management or a permanent representative with the authority to enter into contracts. Facilities that are solely for advertising, storage or certain other purposes are generally excluded.

The OECD is studying issues related to its model tax treaty and is expected to revise it to reflect electronic commerce issues. Among issues under review are whether a file server or other central computer can be a permanent establishment or fixed place of business, and, if so, whether the facility exists solely for advertising or another excluded purpose. Does a permanent establishment exist if a file server acts as a virtual office or employee by authorizing and accepting contracts, processing or accepting orders, collecting fees and making digitized deposits?

The Committee recommends that Canada should continue working with the OECD to address electronic transactions and the status of file servers for permanent establishment purposes. Once changes to the OECD model tax treaty are made public, the Committee says Revenue and the Department of Finance should move quickly to re-negotiate Canada's existing tax treaties. Further, Finance should monitor the foreign tax credit rules to ensure they provide appropriate relief for electronic commerce.

### **Taxation Among the Provinces**

Each Canadian province has the right to tax a portion of an enterprise's income if the business has a permanent establishment (similar to the concept discussed above in Permanent Establishment under Tax Treaties) in that province. If a permanent establishment exists in the province, a portion of the business' net income is allocated to the province based on the proportion of gross revenues earned and the remuneration paid in the province compared to the overall total of such amounts paid by the business.

The Committee states that the advent of electronic commerce will require a re-examination of the concept of permanent establishment to take file servers into consideration. Further, both related federal and provincial regulations should be reviewed and harmonized to ensure the income is fairly and consistently allocated among the provinces to prevent either tax avoidance or multiple taxation. Consideration should be

given to broadening the allocation formula to include, for example, assets deployed within the province, similar to the U.S. states formula. A broader-based allocation formula would allow a more accurate determination of electronic commerce revenue related to a particular permanent establishment. Strong federal-provincial co-operation will be necessary to implement these changes.

### **Characterization of Income**

How a transaction is characterized is crucial for determining income tax and withholding tax obligations. Electronic commerce raises a number of characterization issues that governments will need to address. Three of several such issues raised by the Committee are discussed below.

1) Withholding taxes -- Distinguishing goods and services. The Committee points out that electronic commerce is blurring the dividing line between goods and services, creating inconsistencies in the imposition of withholding tax. For example, no withholding is required on payments to non-residents for subscriptions to newspapers delivered by air mail since newspaper is tangible property. But for electronic newspaper subscriptions, the payment's nature could be re-characterized as a payment to a non-resident for the use of information. As such, the payment would attract withholding tax, even though the purchaser is receiving an equivalent item in a different format. The Committee says the government should provide clear guidelines for characterizing electronic transactions. The Committee also calls for changes to the withholding tax rules to ensure payments for electronic subscriptions and similar transactions are treated as equivalent to the purchase of tangible goods.

2) Withholding taxes -- Performance of services. Currently, the Canadian payer for services performed by a non-resident is required to withhold tax from the payment if the service was performed in Canada. This obligation on the Canadian payer exists even if

such taxes are ultimately refundable to the non-resident by virtue of one of Canada's tax treaties. Many of the services that formerly required a presence in Canada to be completed can now be rendered electronically from outside of Canada, thereby avoiding Canadian withholding tax. The Committee suggests that Revenue should clarify its position on when withholding tax is applicable as a result of non-residents providing services into Canada electronically.

3) Small business deduction -- Distinguishing active and passive income. The Committee expects to see more Canadian businesses involved in developing products for use through the Internet. Increasingly, payments for the use of these products will be in the form of royalty payments rather than product sales. The shift from product sales that generate active business income to royalty receipts that usually generate passive or "specified investment business" (SIB) income will result in a tax increase for smaller businesses. That's because SIB income is not normally eligible for the small business deduction on the first \$200,000 of active business income earned in Canada. SIB income is only eligible for the small business deduction if more than five employees are used to conduct the business. The Committee suggests that this requirement is less likely to be satisfied in the future as businesses continue to automate and need fewer employees. As a result, the Committee says that the income of small businesses engaged in electronic commerce will be taxed at a higher rate than competitors engaged in more traditional forms of commerce. To ensure that small businesses engaged in electronic commerce remain competitive, the government should consider revising the definitions of "active business income" and "specified business income" and review the suitability of the five-employee test.

### **Commodity Taxes GST/HST Collection**

The Committee is suggesting a shift in the traditional collection responsibility for sales tax from vendors to third parties such as financial intermediaries (e.g., credit card

companies) or transaction intermediaries (e.g., Internet service providers). The Committee believes the government should work with these third parties to develop software to correct problems created by software. Both the U.S. and Germany recently made similar statements regarding shifting the responsibility for sales tax collection.

GST/HST on imported goods is currently collected at the border by Canada Customs. The growth of electronic commerce will enable Canadians to acquire more electronic goods and services from non-residents directly, bypassing the usual collection points. Where GST/HST is not collected by Customs or the vendor, consumers are required to self-assess and remit the tax but compliance is increasingly difficult to monitor. Significant GST/HST revenue loss could result from this “disintermediation.”

The Committee says the government should resist the impulse to impose new collection and registration requirements on electronic vendors. Rather, Revenue should educate businesses and consumers about their GST/HST obligations and inform businesses about the potential benefits of GST/HST registration.

### **“Place of Supply” Rules Displaced**

Electronic commerce also creates difficulties in applying the “place of supply” rules that determine whether an international transaction is subject to GST/HST. In addition to issues related to the concepts of “permanent establishment” and “carrying on business in Canada” discussed above, the Committee points out that it is becoming more possible for businesses to split their activities among various linked sites in different jurisdictions. Increased cross-border traffic of digitized products and their components will result.

This trend will make it increasingly difficult to determine where a supply is made, where the supplier or recipient is resident and whether the supply is destined for foreign

consumption and thus properly zero-rated for GST/HST purposes. The Committee says that Revenue and Finance should monitor the GST/HST place of supply rules to ensure that they can continue to be applied with ease and certainty and that only services and intangibles that are consumed or used in Canada are included in the GST/HST base.

### **Customs Duties and Tariffs -- Need for “Customization”**

Customs duties and tariffs are traditionally levied on tangible goods. The continuing evolution of electronic commerce will transform more tangible goods into electronic products and transactions, eroding the tax base for Customs purposes. The Committee’s view is that after a change in the nature of goods to an electronic product or transaction, the goods should not be treated preferentially to similar goods that remain in tangible form. Accordingly, the government should change the rules to zero-rate tangible goods that are equivalent to those delivered electronically.