1. INTRODUCTION

In November 2001, the Canada Customs and Revenue Agency (the “CCRA”) released a discussion paper (the “GST E-Commerce Report”) on the direction Canadian tax policy should take with respect to collecting the Goods and Services Tax on e-commerce transactions. The GST E-Commerce Report clarifies the application of traditional GST rules and principles to the e-commerce environment. The main focus of the report is placed on the collection of GST on cross-border e-commerce transactions because this area presents the greatest challenges to the GST regime.

The first part of this article discusses the background behind these GST reform efforts and overviews how the GST is used to tax international transactions. The second part reviews some of the main elements of the GST E-Commerce Report and discusses proposed changes to GST rules. The last part suggests a more radical tax policy approach is needed to ensure that the CCRA can effectively collect GST on cross-border consumer e-commerce transactions from large foreign companies — big fish — with significant sales into Canada.

2. THE GST AND CANADIAN E-COMMERCE TAX POLICY

I. CANADIAN AND INTERNATIONAL REFORM EFFORTS

In 1997, the CCRA began a serious study of tax issues surrounding the Internet. Two reports were released in 1998 that considered a variety of tax issues, including GST, income tax and tariff issues. Following these reports, the Canadian government hosted an Organization for Economic Co-operation and Development (“OECD”) Ministerial Conference on Global E-Commerce in Ottawa in October 1998 where the OECD attempted to bring consensus to many emerging international e-commerce issues, including tax issues. The OECD member states (which include Canada and 29 other nations) reached an agreement entitled “Taxation Framework Conditions” that set out guiding principles to govern e-commerce tax policy and, more importantly, suggested that OECD countries
II. THE GST AND CROSS-BORDER TRANSACTIONS

The GST is imposed at a seven per cent rate on the purchase (i.e., “taxable supply” in GST jargon) of most goods and services within Canada. Certain goods or services are “zero-rated” and are taxable at a rate of zero per cent. The GST is imposed all along the value-adding economic chain from the supply of raw materials to ultimate consumption by an end consumer. For business-to-business transactions, businesses are charged GST and can collect a credit (referred to as an “input tax credit”) for the amounts paid to their suppliers when accounting to the CCRA for the GST they have charged their customers.

End consumers, however, do not get the credit and must generally pay the GST at a rate of seven per cent on the purchase price. For domestic purchases, a retailer (other than a small supplier) is legally obligated to register with the CCRA and charge and collect the GST on behalf of the consumer. Hence the business intermediary plays a critical function in the collection process for domestic purchases.

With respect to international transactions, the GST is imposed on the import of most tangible goods at the border by Customs agents. Exports leave Canada tax free: the export is zero-rated. For many business-to-business transactions, the Canadian-based purchaser of a good from a foreign supplier similarly must assess the amount of GST owed and can later claim an input tax credit for this amount: the Canadian company hence has an incentive to report the transaction in order to secure the credit.

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Things get much more complicated for international consumer transactions. A foreign e-commerce company can post a web site and directly transmit a digital product or service to a Canadian consumer without resort to any domestic Canadian business intermediary or physical passage through a Canadian border. Nevertheless, in many circumstances Canadian consumers have a legal obligation to self-assess the correct amount of GST owed on the transaction and remit this amount to the Canadian government. The problem: individual consumers rarely comply with this collection obligation, raising the specter of diminished tax revenues to the feds (and provinces under the HST).

3. THE GST E-COMMERCE REPORT

The report focuses on four areas of concern:

1. the carrying on business in Canada test;
2. the permanent establishment test;
3. taxable supply issues; and
4. tax collection mechanisms.

I. THE CARRYING ON BUSINESS IN CANADA TEST

Under the Excise Tax Act, a non-resident (other than a small supplier) that is carrying on business in Canada and which makes taxable supplies in Canada is required to register for GST purposes and must charge, collect and remit GST payments to the Canadian government. A facts and circumstances test is used to determine whether a business is being carried on in Canada. Under existing GST policy, the CCRA scrutinizes two predominant factors to help determine whether the carrying on business in Canada test is met:

1. the place where the contract is made; and
2. the place where the operations from which profits arise take place.

The GST E-Commerce Report recommends that a “place of operations” approach be used to determine whether the non-resident business should register for GST purposes. Under this approach, taxpayers and Canadian tax authorities would scrutinize a number of factors — none of them predominant — to determine whether the requisite threshold test has been met.

These factors include:

1. the place where agents or employees of the non-resident are located;
2. the place of delivery;
3. the place of payment;
4. the place where purchases are made;
5. the place where the service is performed; and
6. the place from which transactions are solicited.

The list of factors provided was said to be non-exhaustive and new factors may become relevant in the future.

II. THE PERMANENT ESTABLISHMENT TEST

A non-resident company that maintains a “permanent establishment” in Canada is treated as a Canadian resident and is subject to the same GST collection obligations as a domestic company. The term permanent establishment is defined in s. 123 of the Excise Tax Act to include a “fixed place of business” such as a branch, office or place of management through which taxable supplies are made.

The GST E-Commerce Report reviewed a recent change in tax policy whereby the OECD accepted that permanent establishments for income tax purposes under bilateral tax treaties would include computer servers (i.e., computers networked to the Internet) within the category of permanent establishments. Under this tax policy change, the OECD has amended its Commentary to the OECD model tax treaty to state that servers can fall within the permanent establishment definition if the server performs integral aspects of a cross-border transaction.

In a somewhat unusual move, the GST E-Commerce Report advocates a similar definition for GST purposes despite the fact that the GST is a consumption tax and not an income tax. Accordingly, foreign taxpayers would be subject to GST collection obligations if they own or lease servers within Canada and performed integral aspects of the cross-border transaction through the server. For example, a foreign e-commerce company that owned a Canadian-based server that posted a web site, took orders from Canadian consumers, processed payment for a digital good and transmitted this good to the end consumer would likely be forced to register for GST purposes under the proposed changes. The move is unusual because countries typically legislate more expansive tests for cross-border value-added tax purposes in comparison to the tests developed for income taxes.
III. SUPPLY ISSUES

The GST E-Commerce Report focuses on three supply issues. Is the digital transmission a supply of goods or services? Should the supply be further characterized as a supply of telecommunications services, which calls for special tax treatment? Finally, does the supply take place in Canada?

a. Initial Characterization

First, the GST E-Commerce Report notes that the appropriate characterization of a supply is fundamental to the application of the GST because it assists with the determination of the place of supply, the rate of tax applicable, the manner in which the tax is collected and the timing of liability for the tax. The transfer of digital goods and services are normally considered to be the supply of intangible personal property or services. In order to find out whether the supply should be characterized as the supply of intangible personal property, the GST E-Commerce Report proposes that taxpayers determine whether the digital transfer involved, inter alia, a sale of a pre-existing product or right to use a product (e.g., a copyright).

In addition to digital goods, e-commerce companies can sell automated services that were traditionally performed by human intermediaries. According to the GST E-Commerce Report, the supply of a service should result if there was human involvement in the transfer of the digital product or service or whether the supply involves specific work that is performed for a specific customer (without transferring any rights to any underlying assets).

The report reviews 28 examples of e-commerce transactions in order to determine whether a supply of intangible personal property or services has taken place. For instance, the payment of a subscription fee to permit downloading of digital products should be characterized as a supply of intangible personal property because the subscriber is acquiring a right to download the products. On the other hand, online consulting such as the provision of legal advice by a lawyer via videoconferencing should be viewed as a supply of a service.

b. Telecommunications Services

The GST E-Commerce Report notes that an additional complicating factor surrounds the supply of telecommunication services where GST rules impose different tax rates and place of supply rules for such services. The report seems to strive to distinguish between the supply of a telecommunication service that materially adds value to a particular transaction and the mere use of telecommunications facilities to enable an e-commerce transaction.

A supply of telecommunication service arises, according to the GST E-Commerce Report, when, among other indicators, the predominant purpose of the supply is to provide for the emission, transmission of signals such as voice or data through a telecommunications network. Examples of such supplies include Internet access services, e-mail services and streamed web-based broadcasting.

On the other hand, a supply of a telecommunication service will not arise if, inter alia, the predominant purpose of the supply is other than the provision of a telecommunication service. Examples of such supplies include web site hosting and the provision of digital goods.

Of interest to tax advisors, the GST E-Commerce Report presents two examples involving tax preparation and filing. In the first example, a company is retained by an approved EFILE tax return preparer to electronically file income tax returns. The return preparer completes the tax return and submits it to the company for e-filing. The company then performs a few minor checks to the return and then e-files the returns with the CCRA. According to the report, the services provided by the return preparer in these circumstances will not be characterized as a supply of telecommunication services because the predominant purpose of the supply is the preparation of the tax return.

c. Place of Supply

The GST is only applicable to supplies of goods and service in Canada. Goods and services consumed outside of Canada are not subject to the GST. Place of supply rules determine whether a supply is made in Canada. Under current rules governing the supply of intangible personal property, a supply is generally said to be made in Canada if the property “may be used in whole or in part” in Canada. The report notes that the term “may be used” should be interpreted to mean “capable of being used” hence capturing situations
where the intangible personal property was not actually used in Canada.

The GST E-Commerce Report additionally suggests that any contract between the parties will assist with the determination of the place of supply, including “any restrictions on [the product’s] use published on Web sites.” Purchasers of digital goods sometimes are requested by a commercial web page whether they agree to a set of terms and conditions by clicking on “I agree.” It is worth noting that at least one Canadian court has indicated that the web user is bound by the terms, including a choice of forum clause, of this so-called clickwrap agreement.

With respect to the provision of services, GST rules indicate that a service is supplied in Canada if it is “performed” in whole or in part in Canada. While the term “performed” is not defined in the Excise Tax Act, the place of performance has traditionally been the geographic location where the individual who is doing the work is located.

For digital services, the GST E-Commerce Report recommends a facts and circumstance test to assist with the determination of place of supply although the following factors will suggest that a service is performed at least in part in Canada:

1. the service requires an individual to perform a task and this individual is situated in Canada at the time the task is conducted; or
2. the service includes operations performed by the supplier’s computer equipment and this equipment is located in Canada.

IV. METHOD OF TAX COLLECTION

As previously discussed, the point of collection for a taxable supply is becoming an increasingly important issue with respect to collecting the GST on digital imports from e-commerce activities originating in foreign countries. The GST E-Commerce Report proposes that Canada continues to use traditional tax collection mechanism for e-commerce and the GST. As touched on earlier, these traditional cross-border tax collection mechanisms include using Customs agents to collect the GST on imported goods, forcing foreign suppliers who are required to register in Canada for GST purposes to collect the tax and requiring Canadians to self-assess how much GST they owe and send this amount to the government. The report suggests that Internet technology-based solutions for the automated collection of the GST may present options for the future and that Canada will continue to follow OECD efforts in this area.

4. ANALYSIS: THE NEED FOR A RADICAL RE-EVALUATION

1. PROBLEMS WITH PHYSICAL PRESENCE TESTS IN CYBERSPACE

As noted previously, the main area of concern is to ensure that GST is collected and remitted on international consumer transactions. The GST E-Commerce Report continues to emphasize traditional physical presence tests such as the doing business in Canada test and the permanent establishment test. The main problem with these traditional approaches is that significant remote economic activity is now enabled by the Internet and foreign companies can exploit the Canadian marketplace without resort to any traditional physical presence within Canada.

Consider the use of a server/permanent establishment test to assist in determining whether a foreign company should register and collect GST. A server is merely a part of the Internet’s infrastructure and the server need not necessarily have any geographic connection to the consumption of a good or service in a jurisdiction where customers are located: foreign companies can transmit goods and services to Canadian consumers without a Canadian-based server. Alternatively, foreign e-commerce companies can ensure that their Canadian-based servers do not constitute a server/permanent establishment by:

1. hosting their web page on unrelated Canadian ISPs; or
2. ensuring that the server does not perform integral aspects of the cross-border transaction (e.g., by using a mirror server to transmit data).

The following two examples will illustrate the problems surrounding the use of physical tests for cross-border transactions. First, consider a hypothetical retailer based in Ottawa called CANCO that sells $100 million in software products to Canadian consumers. As a domestic company, CANCO must register for GST purposes to collect the tax and requiring Canadians to self-assess how much GST they owe and send this amount to the government. The report suggests that Internet technology-based solutions for the automated collection of the GST may
consumers are charged an additional seven per cent for the products and the feds collect $7,000,000.

In the second example, a hypothetical e-tailer (“USCO”) located in the United States sells digital software products to Canadian consumers exclusively through USCO’s web site. USCO does not maintain any physical facilities in Canada nor does it have any agents or employees within Canada. USCO enters into hosting agreements with Canadian ISPs whereby USCO leases server space in order to display its web page and facilitate the downloading process to its Canadian consumers. USCO advertises its software products through web-based marketing campaigns that are sometimes directed to the Canadian market. During the fiscal year, USCO sells $100 million worth of software products to Canadian consumers who download these products directly from USCO’s web site to the hard-drives of their personal computers.

Under existing GST rules or the ones proposed by the GST E-Commerce Report, can the CCRA force USCO to charge, collect and remit the GST on these consumer transactions? Under the traditional “carrying on business in Canada” test, the CCRA looks at a number of factors. The two predominant factors are:

1. the place where the contract is made; and
2. the place where the operations from which profits arise take place.

USCO can make sure that the contract is made in, say, the state of California through a choice of forum clause in the clickwrap agreement which, as previously discussed, has been held to create a binding contractual provision by a Canadian court. Where do profits arise? Pursuant to the Canada-United States tax treaty, Canada has agreed to only tax cross-border profits that are attributable to a “permanent establishment” in Canada. USCO does not maintain a traditional permanent establishment in Canada and, under the recent OECD changes, the servers will not constitute permanent establishments because they are not owned or leased by USCO (hence USCO cannot be said to control these physical assets within Canada).

Under the GST E-Commerce Report’s proposed “place of operations” approach that emphasizes different factors such as the place where employees are located or the place of delivery, it does not appear that USCO will be under a legal obligation to register for GST purposes. Using a similar example to the USCO hypothetical, the GST E-Commerce Report indicates that the “place of operations” approach would not give rise to a determination that the non-resident was located in Canada. In fact, the report acknowledges that the proposed “place of operations” test may make it less likely that non-residents will be required to register for GST purposes than under the traditional rules. Accordingly, USCO will not have to charge the GST on its Canadian sales and the CCRA loses out on a potential $7 million in revenues.

The two examples reveal the main policy deficiencies of the current GST regime or the one proposed in the GST E-Commerce Report. Both the current and proposed regimes lead to non-neutral tax treatment between domestic and foreign companies. First, tax treatment between e-commerce and traditional commerce varies because sales by foreign e-commerce companies will not be subject to the GST whereas traditional goods that cross the border will be taxed because the latter situation does not depend on consumer self-assessment. Second, the policy discriminates against Canadian companies that must charge GST on the sale of tangible or intangible goods and services. The result of this state of affairs is:

1. Canadian businesses will be at a competitive disadvantage in comparison to foreign e-commerce companies who can charge lower prices;
2. the CCRA will suffer revenue losses due to its inability to effectively collect tax on international e-commerce consumer transactions; and
3. market distortions will result (e.g., a U.S. web business will not acquire a Canadian affiliate because of potential GST liability) that inhibit overall economic growth in Canada and harm Canadian economic welfare.

II. TOWARD ECONOMIC PRESENCE TESTS

The solution to these problems could involve forcing foreign e-commerce companies to register for GST purposes when they have significant sales into Canada. The GST E-Commerce Report, however, is clear that mere sales into Canada from a foreign e-commerce company will not suffice to meet the proposed “place of operations” factor test to determine whether a foreign company is doing business in Canada. The report indicates that “this option does not appear to be supportable based on the
existing jurisprudence on ‘carrying on business in Canada’.”

Nevertheless, e-commerce tax policy within other major trade partners appears to be slowly moving toward what can be called “economic presence” tests. For example, the European Union is developing tax laws that would force non-European Union companies to charge and collect European Union value-added taxes (“VATs”). An earlier EU proposal strived to force all non-European Union companies with aggregate consumers sales that exceed 100,000 Euros to register within the European Union for VAT purposes. The registrant would then be subject to the same VAT collection obligations as European Union domestic suppliers. The United States has informally opposed the European Union’s proposals, mainly as a result of concerns that United States’ businesses will have to incur significant compliance costs.

Despite these admonitions, the United States is moving toward economic presence tests at the sub-federal level. The United States does not have a federal VAT but its states and local governments often impose sales taxes. These sub-federal governments have formed the Streamlined Sales Tax Project (“SSTP”) that, at this writing, is supported by 35 of the 45 states that impose sales taxes. Under the SSTP, states are working toward implementing economic presence tests where out-of-state retailers will be subject to the same sales tax collection obligation as local companies. At this writing, an SSTP pilot project is underway with four states (Kansas, Michigan, North Carolina and Wisconsin) where the use of automated Internet technologies are being explored to charge, collect and remit sales tax payments.

III. TENTATIVE PROPOSAL: CATCHING THE BIG FISH

The Canadian government should consider adopting rules similar in nature to the ones under contemplation within the European Union. Under a potential “economic presence” test, foreign companies — big fish — that have sales into Canada beyond a stipulated threshold (e.g., $100,000) would have to register for the GST and charge, collect and remit GST payment to the CCRA. Accordingly, only large e-commerce companies which presumably have the resources to comply with foreign tax rules would be subject to this system. Smaller start-up operations — small fish — would be exempt from the system as long as they have below threshold sales and hence these smaller companies would not have to spend resources to ensure they do not unwillingly fall within the facts and circumstances test under the “carrying on business in Canada” or the “permanent establishment” provisions. In other words, the approach should be designed to catch the big fish while letting the small fish off the GST hook.

In fact, the Excise Tax Act already makes a similar distinction between large and small fish by permitting all domestic or foreign “small suppliers” to be exempt from GST registration requirements. Small suppliers are defined to include businesses that generate annual gross worldwide revenues of $30,000 or less. In addition, traditional GST rules already sometimes try to nab non-residents without any physical presence in Canada. For example, non-residents who solicit orders in Canada to supply property such as books, magazines or newspapers to be sent by mail to Canadian consumers are considered to be “carrying on business in Canada” and must register for GST purposes.

The suggested approach is admittedly not without problems. Non-neutral tax treatment would exist in certain circumstances because traditional goods imported into Canada would still be subject to the GST even when foreign retailers have below threshold sales into Canada. There would be problems identifying sales into Canada as well as when the sales threshold has been surpassed. An automated tax collection system where an online intermediary would identify sales into Canada and charge, collect and remit the GST payment to a CCRA database would assist with many of these problems. There is no reason why Canada should not be at the forefront in the development of these technologies.

5. CONCLUSION

The CCRA’s proposals, if legislated, will clear up a number of areas of uncertainty surrounding the application of provisions within the Excise Tax Act to GST transactions involving e-commerce. For the most part, the paper represents a fairly conservative attempt to apply existing GST principles to cyberspace transactions. The CCRA noted that a “Canadian approach” in isolation would likely not be viable and that the Minister of National Revenue had committed the CCRA to working together with other revenue agencies to address e-commerce challenges.

While the CCRA is sensibly striving to avoid antagonizing major trade partners, the existing or proposed GST solutions were created for traditional
commercial activities and are often ill suited to the more nebulous world of cyberspace transactions. This article has argued that existing principles (even under the proposed tweaking) will not defend against tax base erosion as foreign e-commerce companies sell GST-free digital goods and services to Canadian consumers. In the long run, significant revenue losses may occur and the CCRA will likely be forced to consider more radical alternatives. In addition, Canadian businesses should not tolerate a situation where they find themselves at a competitive disadvantage as a result of tax reasons and not out of any real business rationales.

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1 An earlier draft of this paper has been submitted to the CCRA in response to the CCRA’s solicitation of comments from the public on GST e-commerce issues.


3 See Electronic Commerce and Canada’s Tax: A Report to the Minister of National Revenue Administration from the Minister’s Advisory Committee on Electronic Commerce (April 1998); Electronic Commerce and Canada’s Tax Administration: A Response to the Advisory Committee’s Report on Electronic Commerce by the Minister of National Revenue (September 1998).

4 OECD Committee on Fiscal Affairs, Taxation Framework Conditions (October 1998).

5 R.S.C., c. E-13, s. 1.


11 At this writing, the rules for the proposed European Union regime remain unclear although the European Union’s Council of Economic and Finance Ministers (“ECOFIN Council”) announced on February 12, 2002 that such a regime is forthcoming and will go into effect on July 1, 2003. The ECOFIN Council had previously sent back an earlier VAT directive, which permitted non-European Union businesses to register and collect VAT at the rate of one European Union country. See Commission of the European Communities, Proposal for a Council Directive Amending Directive 77/388/EEC, COM (2000) 349 final (June 7, 2000).


13 Section 148(1) of the *Excise Tax Act*.

14 Section 240(4) of the *Excise Tax Act*. 
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