

Consumption Taxes and Electronic Commerce: A Survey and Analysis

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Introduction

¶1 Canada is one of the most wired countries in the world. In 2003, sixty-four percent of Canadian households had at least one member who regularly used the Internet.¹ Members of Canadian households spent 3 billion dollars online in 2003.² In combined private and public online sales Canadian citizens, corporations and governments spent 19 billion dollars.³ These sales will only continue to increase as more and more businesses and governments make their goods and services available for purchase online. The electronic nature of the sales of goods and services, over the Internet, make it difficult for governments to tax these transactions. Inter-provincially and internationally there are a host of logistical problems that face tax authorities in their quest to generate revenue from electronic commerce. Practically, the most significant difficulties are detection and compliance enforcement.

Business-to-Business and Business-to-Consumer Transactions

¶2 There are two general types of transaction that occur over the Internet; business-to-business transactions and business to consumer transactions. The most problematic type of transaction for revenue authorities is the latter. Business-to-business transactions typically rely on self-assessment/reverse charge mechanisms. As a result, business compliance is typically high because the seller is able to claim input tax credits and the purchaser is able to deduct the purchase from their income. There is a built in economic incentive for business to self-assess. Business-to-consumer transactions have no incentive

¹ *The Daily: E-commerce: Household Shopping on the Internet* Statistics Canada, Online: <<http://www.statcan.ca/Daily/English/040923/d040923a.htm>> (Last Accessed: 13 February 2005); *The Daily: Electronic commerce and technology*, Statistics Canada Online: <<http://www.statcan.ca/Daily/English/040416/d040416a.htm>> (Last Accessed: 13 February 2005)

² *Ibid.*

³ *Ibid.*

built in to encourage self-assessment. Consumers are the designated target of consumption taxes and if they fail to report the transaction they are able to evade the tax. This evasion has little in the way of consequence for the consumer since there is currently no mechanism in place that would make it possible for revenue authorities to detect and enforce their consumption taxes in respect of purely digital transactions. This inability of revenue authorities to detect transactions and enforce compliance means that businesses that are able to deliver their digital wares online are at an advantage over their bricks and mortar competitors. If left unchecked this circumstance may lead to a distortion in the economy as economic decisions are made so as to form the transaction electronically such that any consumption tax is avoided.

¶3 It is a fundamental principle of tax policy that, generally, economic decisions ought to drive business decisions not tax considerations. The latter can be desirable if there is a strong public policy argument to favour electronic commerce over traditional forms of commerce. American Congressman John Kasich has argued before the United States Advisory Commission on Electronic Commerce that there should be no taxation of any online sales of goods or services.⁴ Proponents of a tax free Internet argue that this tax freedom is necessary to assist in the development of the Internet as a source of commerce. Not surprisingly, the Organization of Economic Cooperation and Development (OECD), along with traditional bricks and mortar businesses, and most revenue authorities reject this argument. The favourable tax treatment of a particular commercial model over another is contrary to the doctrine of neutrality and is likely to

⁴ “The Happy E-Shopper (Taxes on Internet Purchases)” *The Economist (US)*, v354 i8155 (January 29, 2000)

lead to “rent seeking.” In fact, international revenue authorities, the OECD and business all favour neutrality as an objective of any regime of indirect taxation.

¶4 There are two types of taxable online supply, but only one that is currently detectable and enforceable. The first type of taxable online supply is similar to the old style mail order model. Under this model, the purchaser contacts the seller online and arranges the purchase and delivery of a good or service. The good or service is then physically delivered to the purchaser’s residence. Payment is made online or using the telephone or some other method. If the transaction is one where the vendor and purchaser reside in different countries the customs mechanism in the purchaser’s jurisdiction will detect and tax the transaction.⁵ In the second example the purchase, sale, exchange of consideration, and delivery all occur online and the customs agency is unable to detect the transaction, and the tax is unlikely to be remitted. It is this type of transaction that is a source of concern for revenue agencies that derive a portion of their income from consumption taxes. This raises difficulties for national revenue authorities and in federal systems, where there is a division of powers, it also means potential revenue loss for provincial revenue authorities.

Canadian Inter-provincial Tax Issues

¶5 Canadian inter-provincial transactions are subject to the various provincial sales taxes, but in most jurisdictions the seller is not required to collect the tax at the point of sale where the purchaser is a non-resident and the supply will be delivered outside of the province. For example, if a purchaser in Manitoba buys a good from a seller in British Columbia the seller in British Columbia is not required to collect the Manitoba retail

⁵ In Canada s.50(1)(b) *The Excise Tax Act* R.S. 1985, c. E-15

sales tax. In our federal state, barring an agreement between the provinces, the Manitoba Government has no power to compel a resident of British Columbia to collect and remit taxes on Manitoba's behalf. However, S.2(6) of *The Retail Sales Tax Act* deems such transactions to be conducted within the province of Manitoba.⁶ Since the transaction is deemed to have occurred in Manitoba, the resident purchaser is responsible for notifying and then remitting the tax to the Manitoba government.⁷

¶6 Every sales tax act in each of the provinces has a similar provision requiring resident purchasers to notify the Minister of Revenue, or their equivalent, that a transaction has occurred between them and a seller outside the jurisdiction.⁸ The resident purchaser is then required to remit the requisite tax, at the prescribed rate, based on the fair value of the transaction.⁹ The only jurisdiction that does not have such a requirement is Alberta where the provincial government, flush with oil and gas royalties, does not levy a sales tax on its residents. As of January 2005 the provincial sales tax rates are as follows: British Columbia 8%, Alberta has no sales tax, Saskatchewan 7%, Manitoba 7%, Ontario 8%, Quebec 8%, New Brunswick, Nova Scotia and Newfoundland and Labrador have a harmonized sales tax (HST) administered by the Canada Customs and Revenue Agency it is 15%, 8% of which is portioned to the provincial governments and the

⁶ Ss. 1(1.2), 2(6) and 22.2(2) *The Retail Sales Tax Act* C.C.S.M. c. R130

⁷ *Ibid.*

⁸ British Columbia s.11(1) of the *Social Service Tax Act* R.S.B.C. 1996, Chapter 431; Saskatchewan s.9 of the *Provincial Sales Tax Act* R.S.S. 1978, c. P-34.1; Manitoba ss. 2(6) and 22.2(2) *The Retail Sales Tax Act* C.C.S.M. c. R130; Ontario s.18 *Retail Sales Tax Act* R.S.O. 1990, c. R.31; Quebec ss.7 and 7.0.2 *Retail Sales Tax Act* R.S.Q., c. I-1; Nova Scotia s.6(1) *Sales Tax Act* S.N.S. 1996, c. 31; New Brunswick s.22(2) *Harmonized Sales Tax Act* Chapter H-1.01; Prince Edward Island s.9(3),(4),(5) *Revenue Tax Act* Chapter R-14; Newfoundland and Labrador s.17(1) *Retail Sales Tax Act* R.S.N.L. 1990 Chapter R-15

⁹ British Columbia s.1 *Social Service Tax Act* R.S.B.C. 1996, Chapter 431; Saskatchewan ss.3(1)(n), 5(16), (17), (17.1), (17.2) *The Provincial Sales Tax Act* R.S.S. 1978, c. P-34.1; Manitoba s.1(1) *The Retail Sales Tax Act* C.C.S.M. c. R130; Ontario s.1(1) *Retail Sales Tax Act* R.S.O. 1990, c. R.31; Quebec s.2(7) 7(a),(b),(c),(d) *Retail Sales Tax Act* R.S.Q., c. I-1; New Brunswick, Nova Scotia s.123(1) *The Excise Tax Act* R.S.C. 1985, c. E-15; Prince Edward Island s.1(d) *Revenue Tax Act* Chapter R-14; Newfoundland and Labrador s.2(e) *Retail Sales Tax Act* R.S.N.L. 1990 Chapter R-15

remaining 7% is the federal Goods and Services Tax (GST), Prince Edward Island 10%, the federal government charges 7% on nearly all consumer transactions.¹⁰

¶7 How many consumers are aware of the requirement to remit the sales tax to their resident province for purchases they have made inter-provincially? Arguably, almost no one is aware of this requirement. Inter-provincial sales of goods are simply not monitored, except in rare circumstance, by the various provincial governments.¹¹ In the typical example, where a good is purchased outside of one province and delivered to a resident within another province, the provincial tax authorities have almost no coercive power to enforce their sales tax acts in respect of these transactions. Similarly, online sales of digital media are most certainly occurring under the radar of provincial tax authorities. British Columbia for example does not monitor the Internet.¹² Internet sales of digital media, like music or software, can occur completely online. The purchase and sale, the exchange of consideration, and the delivery can all occur through the electronic network without the parties meeting, or any physical good being delivered. Unless each jurisdiction is willing to monitor the internet and its citizen's online commercial habits, a seemingly impossible task at the moment and one with all sorts of contentious privacy issues, there is virtually no way that a provincial tax authority can compel compliance with their sales tax statutes in these circumstances.

¶8 The only province that has thus far been able to ensure sales tax is remitted is Prince Edward Island and their law is easily circumvented and only catches resident

¹⁰ *The Excise Tax Act* R.S.C. 1985, c. E-15 ss.218 and 218.1 compel Canadian resident purchasers of goods and services internationally to remit the GST to the Canadian government.

¹¹ In 1994 the province of Manitoba began monitoring its eastern border to stem the illegal trade in cigarettes from Ontario after the eastern provinces lowered their taxes on tobacco.

¹² *Taxing e-commerce: In an Increasingly Wired World, Whose Doorbell Should the Tax Man Ring?* Hollie Shaw: The Canadian Press 20 March 2000 Toronto.

sellers. Resident purchasers remain undetected and the tax is probably not collected. Where a resident seller transacts with a non-resident buyer, Prince Edward Island forces the resident seller to collect the provincial sales tax at the time of purchase, and the money is held by the vendor until such time as the “other party” to the transaction can demonstrate to the government that, for the purposes of the act, they are not a purchaser. A purchaser is defined in the act as a consumer who acquires goods at a retail sale within the province. To be a purchaser and subject to the act a party must meet all four requirements.

1. The buyer must be a consumer and not a re-seller.
2. The buyer must acquire “goods” and not services.
3. The acquisition must occur at a retail sale.
4. The transaction must occur within the province.

If the buyer does not meet these requirements then they are not considered a purchaser and by applying to the provincial government they can get the tax returned to them. This positive duty on the buyer is probably enough to frustrate the typical consumer and in most circumstances buyers simply do not bother to try and get their money returned.

¶9 A more typical circumstance found in every other Canadian provincial jurisdiction is where a resident purchaser buys from a non-resident seller. In this circumstance, the Province’s legislation relies on self-assessment by the purchaser to ensure compliance. The federal nature of our political institutions in Canada has typically resulted in little cooperation between the provincial jurisdictions in respect of sales tax policies. This lack of cooperation generally means that consumers are able to easily avoid a tax that they are required to pay.

¶10 The federal government, on the other hand, is more successful with the GST. This omnipresent tax applies to nearly every consumer purchase. The Goods and Services Tax is always collected except in limited circumstances. This means that the provincial jurisdiction of the buyer and seller do not permit avoidance of the tax. However, this tax is also not without its enforcement issues.

Canada, the GST and International Business-to-Consumer Transactions

¶11 The federal GST, while not avoidable by resident Canadian purchasers dealing with resident Canadian sellers, is avoidable by Canadian consumers where the transaction occurs between a foreign seller and a resident Canadian purchaser. Recall that such a transaction can occur completely online. Even though s.218 of *The Excise Tax Act* requires the Canadian resident purchaser to remit the tax how is the federal government supposed to detect and enforce compliance?¹³ In the circumstances the government relies on self-assessment. Currently, the purchase and sale internationally of digital media online internationally is completely undetectable by both the federal government and their provincial counter parts. Self-assessment, in the circumstances, means that resident Canadian purchasers simply are not remitting the tax.

¶12 The CCRA also relies on self-assessment where the Canadian purchaser downloads a copy of intangible personal property in another country onto their laptop and then returns to Canada with the intangible personal property on their hard drive. This importation of the intangible personal property may also be subject to the provincial sales tax. For example, if the purchaser is an Ontario resident and they return to Canada from abroad through Lester B. Pearson International Airport they are required to remit the GST

¹³ *Supra*. At note 10.

to the federal government and the PST to the Ontario government. If the purchaser is a resident of Manitoba they are required to notify the Minister of Revenue upon their return to Manitoba and remit the requisite sales tax at that time and at the moment they re-enter Canada they are only obliged to declare the transaction and remit the GST.

¶13 Where a Canadian seller makes a supply of intangible property to a non-resident purchaser who is not registered in Canada under the *Excise Tax Act* the supply is taxable but it is zero-rated.¹⁴ S.123(1) zero-rates all supplies listed in Schedule VI. Intellectual property, which is considered intangible, is listed in Part V of schedule VI at s.10. Zero rating of the supply allows the resident supplier, or supplier with a permanent establishment, to receive any input tax credits that are available in the circumstances. The Canadian government does not apply the GST to exports. The OECD and its signatories have long held that the appropriate jurisdiction to levy a consumption tax is where the good is consumed not where the supply originates. This prevents double taxation, is more economically efficient and does not unnecessarily inhibit international trade.

The European Union and the VAT

¶14 The European Union has its own consumption tax. The European Union's twenty-five members have levied a Value Added Tax (VAT) to consumable supplies of goods and services that occur within their borders.¹⁵ The VAT was first introduced in 1970 under the first and second VAT directives and later harmonized in 1977 under *Directive 77/388/EEC*. If a resident of the EU purchases a good or service from a seller in their jurisdiction then they have to pay the VAT on the purchase. For example a Briton from London buys a good from a business located in Manchester, the Londoner must pay the

¹⁴ S.123(1) and s.10 of Part V of Schedule VI of *The Excise Tax Act*, *supra* at note 5.

¹⁵ The VAT applies to nearly every supply however, there are certain rate reductions on various items. Books in the UK are zero-rated and other items that are culturally significant are subject to the reduced VAT.

UK VAT at a rate of 17.5% on the fair value of the transaction. The business must be a registered business and have a VAT registration number in order for it to lawfully collect the tax on behalf of the government.¹⁶ This is similar to the Canadian GST and PST systems whereby the seller must have a tax number in order to lawfully collect the tax.¹⁷ The European Union's VAT uses the place of consumption criteria similar to the Canadian Goods and Services Tax and the provincial sales taxes for goods. The minimum VAT that a country can levy is fifteen percent of the fair value of the good or service.¹⁸ The European VAT rates are summarized in the table below.

<u>EU Member</u>	<u>Standard VAT</u>	<u>Reduced VAT</u>
Austria	20%	10%
Belgium	21%	12%
Cyprus	15%	5%
Czech Republic	19%	5%
Denmark	25%	
Estonia	18%	0-5%
Finland	22%	17%
France	19.6%	5.5%
Germany	16%	7%
Greece	18%	8%
Hungary	25%	12%
Ireland	21%	
Italy	20%	10%
Latvia	18%	9%
Lithuania	18%	0-9%
Luxembourg	15%	5-9%
Malta	18%	6%
Netherlands	19%	
Poland	22%	6%
Portugal	19%	7%
Slovakia	19%	4-5%
Slovenia	20%	10%
Spain	16%	8.5%
Sweden	25%	7%
United Kingdom	17.5%	0-5%

The reduced VAT applies to goods and services that are culturally important to the

¹⁶ To combat sellers from fraudulently charging buyers the tax they must have a registration number. Consumers charged the tax can verify the validity of the registration number by visiting the European Union's website at http://www.europa.eu.int/comm/taxation_customs/vies/en/vieshome.htm (last accessed: 07 February 2005)

¹⁷ Subdivision d, s.240(1) of Division V of *The Excise Tax Act* and for example s.5(1) of the *Manitoba Retail Sales Tax Act*.

¹⁸ *Article 1 s.(3)(a) European Council Directive 2001/41/EC* 19 January 2001. The minimum rate of 15% is applicable until December 31, 2005.

member state.

¶15 The EU has decided that as a matter of tax policy digital media will not be treated, as a good. Instead, it is treated as a taxable service. For that matter, all intangibles are now treated as services instead of goods. The rules that apply to the taxation of services are slightly different than those that apply to the taxation of goods. This policy was laid out in *Council Directive 2002/38/EC* on July 1, 2003 in an attempt to deal with problems arising from electronic commerce. Prior to this directive digital media were treated as a good and the place where a good is consumed determines the tax rate and what revenue authority has jurisdiction over the transaction. The change in tax policy treating the sale of digital media as a service works as follows:

- For specified electronically delivered services, when supplied by a non-EU operator to an EU customer, the place of taxation is within the EU and accordingly they are subject to [the] VAT;
- when these services are provided by an EU operator to a non-EU customer, the place of taxation is where the customer is located and they are not subject to [the] EU VAT;
- when an EU operator provides these services to a business in another Member State, the place of supply is the place where the business customer is established;
- where the EU operator provides these services to a private individual in the EU or to a taxable person in the same Member State, the place of supply continues to be where the supplier is located;¹⁹

¹⁹ VAT: *Special Arrangements Applicable to Services Supplied Electronically*, European Union Online: <<http://europa.eu.int/scadplus/leg/en/lvb/l31044.htm>> (Last accessed 07 February 2005)

¶16 This is not particularly helpful. One of the problems with the EU's VAT is that within the twenty-five different jurisdictions there are twenty-five different rates and the tax as it is currently applied lacks neutrality, and arguably simplicity, both desirable characteristics of any tax regime. The VAT, argues the EU, must focus on four principle objectives: simplification, modernization, a uniform application of existing regulations and a fresh approach to administrative cooperation.²⁰ In practice these principles are not being achieved.

¶17 The VAT rates vary from 15% to 25% of the fair value of the good or service purchased. The difficulty is that the tax treats businesses engaging in similar transactions differently depending upon whether or not they have a permanent establishment (PE) in a particular EU jurisdiction. For example, a Canadian Company, without a PE in the EU, selling software to a consumer in the Netherlands is obliged to collect the VAT at the Dutch rate (19%) and remit the money collected to the Dutch revenue authority. Another Canadian company selling software to a consumer in the Netherlands with a PE in Spain is only required to collect the VAT at the Spanish rate (16%). Here we have two similar companies involved in two similar transactions yet for tax purposes each of their Dutch customers is charged a different rate of tax. In fact, the company without the PE in a EU member state probably will not collect or remit the tax. Registration in this circumstance is voluntary. However, assuming full compliance the tax scheme benefits the consumers who deal with companies that have offices in the EU and discriminates against companies that do not. Why? Because the current rules require that the tax rate applicable is the one where the supplier of the service resides if they have a PE in the EU. In the

²⁰ *Indirect Taxation: Introduction*, Online: European Union <<http://europa.eu.int/scadplus/leg/en/lvb/l31001.htm>> (last accessed: 07 February 2005)

case of a company that does not have a PE the rate applicable in the customer's jurisdiction applies.²¹

¶18 The tax also favours consumers who purchase from businesses that have PE's in the EU in the jurisdiction with the lowest VAT rate. This encourages "rent seeking" on the part of businesses wanting a "competitive" pricing advantage over their competitors. Business, in this circumstance, does not compete on economic principles but instead by taking advantage of differences in the taxation regime violating the principle of neutrality.

¶19 The other difficulty, for corporations, is that the VAT requires them to know the differences in rates among the twenty-five current EU members. This was problematic when the EU was limited to fifteen members with the addition of the ten eastern European countries businesses now have to contend with twenty-five different rates and develop a mechanism to determine the residency of their customers where they lack a PE in an EU member state. This violates another of the lauded creeds of tax policy: simplicity. The other glaring problem from a revenue authorities perspective is how do you enforce such a tax? The EU countries do not currently have any ability to detect online purchases of electronic media. It doesn't matter whether they call them services or goods they simply have no ability to detect these transactions and therefore the VAT, as it applies to the sale of digital goods and services online, is easily avoidable by foreign companies.

²¹ See European Union Directives 77/388/EC and 2002/38/EC.

The United States of America, Consumption Tax and E-Commerce

¶20 The Americans currently have no national sales tax. The state revenue authorities levy the sales taxes. In the United States there are roughly 7600 different jurisdictions that levy some sort of consumption tax in state, county, and city jurisdictions.²² The State revenue authorities share similar jurisdictional issues with their Canadian provincial counterparts. The problem however, is exacerbated by a 1992 decision of the Supreme Court where the court held that states did not have the authority to force out-of-state companies to collect taxes, on their behalf, unless that company had a sufficient “nexus” within the state where they are exporting their wares.²³

¶21 The use tax was levied on all property purchased for storage, use or consumption within the state.²⁴ North Dakota argued that the company did have a sufficient nexus with the state such that it was obligated to collect the tax on North Dakota’s behalf. The Quill Corporation had 3000 customers in the state that generated annual revenue for the company of one million dollars. At trial the court found in favour of the Quill Corporation. They held that there wasn’t a sufficient nexus with the state such that it could compel the corporation to collect and remit the state’s use tax. The decision of the trial court was over turned on appeal at the North Dakota State Supreme Court. This court held that “the mail-order house's economic presence in North Dakota depended on services and benefits provided by the state--such as creating an economic climate that fostered demand for the mail-order house's products, maintaining a legal infrastructure which protected that market, and disposing of the [twenty-four] tons of solid waste

²² “The Internet Tax Trap” *Wall Street Journal (Eastern Edition) (New York, New York)*, (February 18, 2003. p. A22)

²³ *Quill Corporation v. North Dakota* 504 U.S. 298; 112 S. Ct. 1904; 119 L. Ed. 2d 91; 1992 U.S. Lexis 3123; 60 U.S.L.W. 4423 (U.S.S.C.)

²⁴ *Ibid.*

generated annually by the mail-order house's mailings--and therefore generated a constitutionally sufficient nexus to justify imposition of the duty to collect the use tax.”²⁵

The United States Supreme Court over turned the decision of the State Supreme Court and found no such nexus. They argued that the Federal Constitution's commerce clause (Art I, 8, cl 3) required more than simply a connection with the state through a common carrier or the United States Postal service.²⁶

¶22 The United States Supreme Court acknowledged that the federal government, through congress, could revisit this decision and impose any sort of obligation to collect use taxes on interstate commerce it saw fit. In light of the current potential impact on state revenues the Supreme Court’s decision may have to be examined and a remedy developed by the federal government. The current state system requires consumers to pay a use tax. However, like in Canada, the requirement to notify and remit “forthwith” any sales tax resulting from the importation of goods from outside a province, or state, relies on self-assessment. Therefore, this is a tax that is avoided by nearly everyone. In the U.S. most people are unaware of the requirement to pay the use tax. Even if they were aware of the law they would simply avoid the tax and not pay because the state has no ability to enforce the rule.

¶23 American state governments that face detection and enforcement issues, as they relate to the sale of online digital media on inter-state transactions, also face the same issue as the Canadian federal government in respect of the application of the GST. These transactions, whether they are made between foreign companies and state residents or state residents and out of state American companies, are undetectable and therefore a loss of

²⁵ *Ibid.*

²⁶ Article I, 8 clause 3 *The Constitution of the United States of America*

revenue for state governments. In 1998, in the face of uncertainty the U.S. Government passed the *Internet Tax Freedom Act*.²⁷ The act prohibited any new taxes on the Internet for a period of three years. Specifically contemplated were taxes on Internet access and commercial transactions. In the long term this tax-free status is not sustainable. The State governments are not sitting on their hands. The State governments are cooperating, or at least attempting to do so. Thirty-nine of the U.S. states have signed onto the Streamlined Sales Tax Project (SSTP).²⁸ The SSTP is designed to act much like the VAT or the GST in Canada by unifying the basic set of rules so that at least someone is generating tax revenue from these online sales transactions. However, a foreign company transacting with a resident of one of the thirty-nine states would still be able to sell their digital media tax-free. American companies that rely on the *Quill* decision to exempt them from collecting the tax would likely be caught in the taxman's web.²⁹ What is clear is that the current system where there are a vast number of jurisdictions with different tax rules is problematic for state revenue agencies. The only workable solution is for these revenue authorities to cooperate and work together to find a solution to a problem that might only get worse.

¶24 The European shift from classifying software as a service rather than a good might work in the United States. As outlined earlier the EU taxes services at the applicable rate of VAT where the supplier is located. This source of supply test is attractive to the taxman in the United States. The United States is a net exporter of digital media and this leaves revenue authorities hungry for a piece of the action. The trouble is

²⁷ Pub L. 105-277 Div C, Title XI

²⁸ William G Jens Jr, Monica Jeancola, *Taxing Internet Sales-The Meter Is Running*, Journal of State Taxation Greenville: Spring 2004. Vol. 22, Iss. 4, p. 46-52.

²⁹ *Supra*. At note 22.

that by imposing such a tax the American firms might become less competitive and decide to move their operations to countries where there is no tax on the supply of services.³⁰

Commentators on Taxation and E-Commerce

¶25 From the foregoing it is clear that revenue authorities in various jurisdictions are facing challenges taxing electronic commerce. Numerous commentators have proposed various solutions. Perhaps one of the least attractive options proposed has been a “bit tax.” In practice the tax would be levied on consumers based on how much digital information is transmitted to them. This approach is technically feasible and Internet service providers have the capability to monitor their available bandwidth and who is consuming it. They could be given the authority to collect a tax based on bandwidth usage. However, this tax approach is problematic. First, the tax may have a negative effect on the development of electronic commerce by inhibiting Internet use as the tax liability for connecting online rises. Local access pricing is already an issue between jurisdictions. In Europe local access pricing is considerably more expensive than it is in the United States.³¹ Second, it is not clear that the target of the tax ought to be those who consume bandwidth. There is no evidence to suggest that these consumers of bandwidth are necessarily engaging in commercial activity. If a consumption tax on goods and services is the desired method of raising revenue then governments should tax consumption of goods and services not the conduit that facilitates that consumption. While the Internet is a service and should be taxed, it should be taxed in the same way as other services. To not do so invites the potential strangulation of the conduit and decline

³⁰ *Supra* At note 4.

³¹ *Local Access Pricing and E-Commerce*, OECD Online:
http://www.oecd.org/searchResult/0,2665,en_2649_34225_1_1_1_1_1,00.html (Last Accessed: 18 February 2005)

in online commercial activity. Ironically, this might have the net effect of reducing growth in electronic commerce as a commercial activity and thereby reducing tax revenue.

¶26 It is also not clear that online commercial transactions use up excessive bandwidth and even if these transactions did use up excessive bandwidth savvy Internet users could develop compression technology and become more efficient so as to avoid the tax. If the tax can be avoided by businesses and consumers with the money to develop the technology to compress their data streams it puts others without the money to develop this technology at a competitive disadvantage violating the principle of neutrality. The OECD has argued that the existing framework for taxation is sufficient and no new taxes are required. Governments must simply adapt existing tax structures to detect and enforce current consumption taxes on electronic commerce.

¶27 Some American commentators, for example Hal Varian of the University of California at Berkeley, have proposed a shift from consumption taxes to increased income taxes to counter the threat of electronic commerce on state tax revenues.³² The tax base would be an individual's annual income minus any savings and existing consumption taxes would presumably be eliminated. This would have the same effect as a sales tax in that it would only tax the portion of a taxpayer's income that was "consumed." This is a radical departure from existing methods of taxation based on a combination of consumption and income taxes. In principle the tax looks to be neutral, efficient, and simple. It would also have the desirable effect of turning taxpayers minds to their savings. Currently, savings rates in the United States and Canada are at a historical

³² *Supra* at note 4.

low and consumer debt levels are quite high such a tax might have the desirable effect of causing taxpayers to increase their savings. Moreover, the method has administrative advantages in that taxpayers would self assess and do the work for the revenue authorities.

¶28 In the United States this sweeping reform would require unprecedented cooperation between federal and state governments. In Canada, the federal nature of the division of powers would require provinces to give up indirect taxation and rely on their ability to negotiate a deal with the federal government. The politics in the Canadian circumstance and the very nature of the Canadian constitution would make this a difficult task. The other issue, in regions with significant tourist economies, is how would such a scheme enable governments to extract tax revenue from non-residents tourists? Non-resident tourism in Canada is annually worth fourteen billion dollars.³³ Visitors to Canada raise money for all levels of government. The Varian tax makes this tax base difficult to tap. In Canada, visitors to the country can apply to have the GST they have paid returned to them when they leave.³⁴ The provincial governments aren't quite as generous and offer no such refund and it is this revenue stream that flows into provincial coffers that is threatened under the Varian model. Ultimately, sound tax policy requires balance. This means that governments should not derive their tax revenues, or be overly reliant on any single type of tax.³⁵ In essence like a good portfolio manager governments must also diversify to ensure they have a stable source of revenue to fund the myriad of services they provide their citizens.

³³ "National Tourism Indicators" Statistics Canada, Online: <<http://www.statcan.ca/Daily/English/050110/d050110b.htm>> (Last accessed 14 February, 2005).

³⁴ Part IX, Division VI s.252(1) *The Excise Tax Act*, *Supra* at note 5.

³⁵ P. Hogg, J. Magee, J. Li, *Principles of Canadian Income Tax Law* (Carswell: Toronto, Canada 2002 at p.29.)

¶29 The Governor of Utah has proposed that the responsibility of tax collection be shifted from the seller to “trusted” third parties.³⁶ In his view credit card companies, and presumably others like Paypal, could be used to collect the tax on electronic transactions. However, this scheme is also problematic. The billing address where the consumption occurs, and the credit cardholder’s address might not be the same. How does the credit card company know which rate to charge? The SSTP could assist here if the states adopt a uniform rate of sales tax and develop similar tax rules. In that case the consumers residence does not determine the rate charged, but it still leaves open the question of which state will receive the revenue if the place of consumption cannot be determined. Credit card companies would have to have some mechanism to determine state residency for tax purposes; this inquiry would be costly. Who would pay for the associated compliance costs and any errors? The credit card companies are not likely to absorb this cost; they would likely pass this fiscal burden onto the consumer and drive up credit costs. The trick is to develop an approach that does not distort the market and respects the laudable tax principles of neutrality, efficiency, simplicity, and fairness. A task that is easy to lay down in principle but one that is hard to employ in practice.

OECD Comments on Electronic Commerce and Taxation

¶30 In 1998 members of the OECD met in Ottawa to discuss the challenge to their revenue authorities that is electronic commerce. As a result of that meeting the OECD adopted the Ottawa Tax framework Conditions. The OECD and its signatories argue that any system of taxation, and particularly the system currently being designed for e-commerce must have five qualities.

³⁶ *Supra* at note 4.

1. Neutrality
2. Efficiency
3. Certainty and simplicity
4. Effectiveness and fairness
5. Flexibility³⁷

Neutrality

¶31 Unintentional non-taxation of normally taxable supplies is a source of concern for the OECD, bricks and mortar businesses, and revenue authorities. The principal of neutrality requires that consumers making similar purchases should be taxed similarly. It should not matter how a consumer purchases software, music, a movie or a book the tax liability ought to be the same. The relative merits of a product ought to drive the purchase and sale of a particular good or service not how it is taxed. Of course, governments often use tax policy as a method by which to drive the purchase and sale of particular products or services. Normally, this is done when there are valid public policy reasons to do so. In Canada, cigarettes and certain Canadian domestic investments respectively, have high relative levels of taxation and favourable dividend tax credits to encourage consumers of these products to either limit their purchases, in the case of cigarettes, or to encourage Canadians to invest in domestic markets.³⁸ If Canadians, through their governments want to encourage electronic commerce then lower rates of taxation, or no taxation on electronic commerce might assist in achieving this goal. However, so far there has been

³⁷ *Electronic Commerce Implementing the Ottawa Framework Conditions Committee on Fiscal Affairs*, The Organization for Economic Cooperation and Development, Online: <<http://www.oecd.org/dataoecd/40/49/2752211.pdf>> (Last accessed: 14 February 2005) and for a good summary see *U.S. and International Taxation of the Internet: Part 2*, Janet E. Moran, Jefferey Kummer. Computer and Internet Lawyer Frederick: May 2003. Vol. 20, Iss. 5, p. 16-23

³⁸ Ss.82(1)(a) and 121 *Income Tax Act* R.S.C. 1985, Chapter 1

little in the way of considered reasons for establishing this as a desirable public policy goal. In fact the OECD and its members rejected this position at the Ottawa conference.³⁹

¶32 Typically, there are advantages for business to encourage their consumers to transact with them online and the travel industry has led the way in this respect. Currently, Air Canada *et al* have enabled their customers to purchase tickets on line, download an itinerary, select a seat the day of their flight and check-in; this can all be accomplished online.⁴⁰ This makes their business more efficient because it is then able to rely on its customers doing for themselves what airline employees used to do for them. For the customers effort they usually receive a nominal discount on their fare and receive a little more control over their seat selection and check-in and they do not have to show up as early for their flight. The airlines become more efficient as they are able to do more with fewer people drawing salaries and benefits. There is little evidence to suggest that lowering or eliminating consumption taxes on this form of transaction is in the public's interest to such a degree that their governments should give up the revenue. While different that neutrality equity is also an important consideration. The existing circumstance punishes retail businesses that operate in the traditional way violating any sense of tax equity.

Efficiency

¶33 Efficiency is another quality that must be embodied in any system of taxation that aims its sights on e-commerce. It is important to consider whether or not a particular stream of tax can be efficiently administered and inexpensively complied with, by both the tax authority and the businesses that are required to collect and remit the tax.

³⁹ OECD Report: *The Application of Consumption Taxes to the Trade of Intangible Services and Intangibles*, OECD Online: <<http://www.oecd.org>> (Last Accessed: 12 February 2005).

⁴⁰ See Air Canada, Online Air Canada: <<http://www.aircanada.com/en/home.html>> (last accessed: 12 February 2005)

Compliance costs must be minimal or taxpayers will seek out methods by which to avoid the tax, or they might simply ignore it all together. The EU's VAT, the various Canadian provincial sales taxes, the GST, and the State sales taxes in the United States are all, to some degree, difficult to comply with. The effect? Where the transaction is between jurisdictions without bi-lateral or multi-lateral agreements they are ignored. The burden is particularly heavy in the EU where there are twenty-five different rates that must be applied. This leads to increased costs on the part of foreign businesses, transacting with residents of the EU, who must determine the residency of the purchaser and remit the tax under the VAT registration system. Under the existing system businesses wishing to transact with citizens of the EU can register in the jurisdiction of their choice and get a VAT registration number. With this number they can collect the tax on behalf of the EU. They must still determine the residency of their purchaser and apply the purchaser's rate of VAT to the purchase of the intangible property. Why would they do so? The fact is that there is no method by which the EU can compel foreign corporations doing business online with EU residents to collect this tax. They do not have any jurisdiction to compel the corporations to collect and remit the tax, and they have no means to enforce compliance.

Certainty and Simplicity

¶34 It is a goal of any properly structured tax scheme to ensure that the tax isn't so complicated and difficult to administer or comply with that it results in a deadweight loss to the economy.⁴¹ If a tax is complicated and difficult to comply with it necessarily creates an industry of people who take the time to learn the rules and apply them in

⁴¹ T. Edgar, J. Li, D. Sandler, *Materials on Canadian Income Tax*, (Scarborough: Carswell, 2000 at 71.)

practice. Tax lawyers charge large sums of money to apply their knowledge. These lawyers create nothing and contribute little to the economy; they merely assist those that do create usable goods and services to navigate the complicated world of taxation. They are a drain on enterprise and the economy and a tax system that incidentally requires “experts” to comply the various tax acts is poorly designed. The system should be as simple as possible so that those entrepreneurs and their employees can operate efficiently creating their goods and services with minimal assistance. Moreover, the scheme of taxation must be relatively certain. This means that the application of the scheme should be “determinable, [and] predictable.”⁴² Where the tax applies should be obvious and when it applies should be consistent. Under the current schemes in Europe, the United States and Canada there is some level of unintentional non-taxation of otherwise taxable supplies of goods and services.

Effectiveness and Fairness

¶35 A tax system should be difficult to avoid and evade.⁴³ At the moment the existing structure is easily avoided for the reasons outlined above. The tax as it currently exists is unfair. It isn’t being enforced against those transacting electronically. In the United States existing bricks and mortar businesses are considering setting up separate legal entities to engage in e-commerce and place the permanent establishment for these online companies in jurisdictions that have no consumption taxes. The PE requirement and the nexus criterion would be avoided and as a result of *Quill* they would not be responsible for the collection of the various state consumption or use taxes. The taxman isn’t about to allow that to happen and any move on a corporation’s part down this road will ultimately lead

⁴² *Ibid.*

⁴³ *Ibid.*

to a dead end as the legislation eventually catches up with the technology. Wal-Mart and other traditional bricks and mortar retailers have not been collecting tax on sales that originate from their website. These retailers, unlike the company in *Quill*, do have permanent establishments in the states in which they have sales from their electronic commerce business. There is in fact a “nexus” between the company and the retailer other than the link between the retailer and the consumer by a carrier, or the United States Postal service. These companies have not been collecting and remitting these state taxes. Recently, they have begun to apply the rules and collect the tax on behalf of the states in which they operate.⁴⁴

Flexibility

¶36 Flexibility is the final criteria that the OECD recommends in any new scheme to tax the Internet. In practice this means that the tax regime is able to be flexible to meet challenges resulting from changes in technology and commercial practice. In principle consumption taxes are a desirable method to raise tax revenue. “Personal income connotes, broadly, the exercise of control over the use of society’s scarce resources.”⁴⁵ Simons, the author of those words was a vocal proponent of progressive income taxation. In practice however, modern governments utilize a combination of income and consumption taxes to not only raise revenue for public purposes but to give effect to their social policies. Consumption taxes are desirable in that they leave money in the hands of the taxpayers until such time as they decide to consume resources. If you do not spend money consuming goods and services then you can avoid paying taxes. As a matter of public policy, and as was discussed above, Canadian governments use consumption taxes

⁴⁴ *Supra* at note 22.

⁴⁵ Henry C. Simons, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy*, (Chicago: University of Chicago Press, 1938).

to discourage the consumption of certain goods, like cigarettes, where the use or consumption of the good has a high social cost. In the circumstances the consumption tax model isn't broken it just needs some re-engineering to catch up with technology and emerging commercial practices. In this way consumption taxes meet the fifth criteria of the Ottawa Framework Conditions namely flexibility.

Permanent Establishment (PE) and Consumption Taxes

¶37 This concept has proven to be a source of some consternation in the EU, the U.S. and Canada. The PE concept is important for both indirect taxation and direct taxation. Whether or not a business has a PE in a particular jurisdiction can determine whether they must pay income tax and what tax rate they must apply if the jurisdiction has a VAT. The single greatest issue surrounding the PE concept has been whether or not a server in a particular location constitutes a PE for tax purposes. The OECD and most governments have said no.⁴⁶ Some governments have argued that if a firm conducts business over the internet and the transaction was done through a server located in the country then the corporation had a PE in the country and was subject to any of the usual tax rules that apply to any other business in the jurisdiction. The OECD rejected this as the test instead they have argued, and Canada has agreed, that generally a PE requires something more than computer equipment or a website. The Canadian policy is as follows:

- A web site would not, in itself, constitute a permanent establishment.
- A web site hosting arrangement typically would not result in a permanent establishment for the enterprise that carries on business through the web site.

⁴⁶ *Clarification on The Application of the Permanent Establishment Definition in E-Commerce: Changes to the Commentary on the Model Tax Convention on Article 5* OECD, Online: <<http://www.oecd.org/dataoecd/46/32/1923380.pdf> (Last Accessed: 20 February 2005) and *Revised GST/HST policy Statement P-208R, Permanent Establishment* Canada Revenue Agency, Online: <<http://www.cra-arc.gc.ca/E/pub/gi/notice193-e.html>> (Last Accessed: 20 February 2005)

- A place where computer equipment, such as a server, is located may in certain circumstances constitute a permanent establishment, where the functions performed at that place are significant and an essential or core part of the business activity of the enterprise.
- A permanent establishment could exist at a location even though no personnel of the enterprise are required to carry on its business at that location.
- The fixed place of a business of a particular person's Internet service provider would normally not constitute a permanent establishment of that person.⁴⁷

The Canada Revenue Agency has left themselves some room to maneuver and the choice of definition is sufficiently broad such that whether or not a particular business is said to have a PE in Canada will likely be determined on a principled yet case-by-case basis.

OECD's Recommendations

¶38 The working groups at the OECD have recommended various measures to assist tax authorities in their quest to capture tax revenue from electronic commerce. In summary these recommendations are as follows:

1. Encourage countries to reduce the current obstacles to international trade through an agreed framework of principles;
2. Develop, with appropriate business input, a Guidance Series that translates the framework principles into a set of workable "rules".
3. Develop a dispute resolution mechanism to deal with differences that may arise, between countries, in the application of the framework principles.

⁴⁷ *GST/HST and Electronic Commerce: A Discussion Paper for Public Comment on the Administration of the Goods and Services Tax/Harmonized Sales Tax in an Electronic Commerce Environment*, Online: Canada Revenue Agency <<http://www.cra-arc.gc.ca/tax/technical/ecommerce-e.html>> (Last Accessed: 07 February 2005)

4. Continue to monitor electronic commerce and identify and analyze obstacles to effective taxation that arise as new technologies or business models develop.⁴⁸

Framework of Principles

¶39 Many of the problems that arise in the administration of value added taxes result from different jurisdictions applying different definitions to similar concepts, or not applying these common concepts at all. These jurisdictional issues beg for some sort of multi-lateral agreement adopting common tax law principles. Without international cooperation various jurisdictions simply end up being exploited by tax savvy enterprises that are able to identify holes in a countries tax law. Uniformity, across national boundaries, would lessen the presumably unintended effects of unintentional non-taxation and double taxation. The OECD has argued that, in the same way that multi-lateral or bi-lateral tax treaties often eliminate double or triple taxation of the same good or service, it will be these same measures that eliminate unintentional non-taxation of normally taxable supplies of goods and services. This is sound advice. The only way that countries will be able to continue to exercise their authority to tax the consumption of goods and services sold online is by cooperating with one another.

Guidance Series

¶40 Translation of the Ottawa Framework Principles into a set of workable rules is essential. Tax law is easily conceived of in theory but very difficult to implement in practice. There is a large amount of work that must be done to get from here to a place where the principles identified in Ottawa in 1998 are a set of practical tax rules.

⁴⁸ *Supra* at note 39.

Currently, the OECD through its Technical Advisory Groups is working on developing a body of practical rules.

¶41 In the domestic Canadian context one of the first things that provinces can do is to uniformly adopt the rule in Prince Edward Island that requires sales taxes to be automatically collected by vendors regardless of who the buyer might be. The buyer must then prove to the government that they are not a purchaser, as contemplated under the act, and their tax will be returned to them. This positive duty on buyers is a good first step and will, in the context of inter-provincial transactions, ensure that sales tax is collected. Provinces must also agree that where a province, for example Manitoba, collects the tax from a purchaser on an inter-provincial transaction involving an Ontario resident the tax collected is forwarded to Ontario. The place of consumption concept is a good one and where the good is consumed is where the tax ought to be remitted. If the purchaser is not a consumer then the tax ought to be rebated in the same way that the GST is rebated under the *Excise Tax Act*.⁴⁹ This can be done through declarations or actual collection and rebate depending upon the circumstances. In the long term the strategy taken by the three eastern provinces harmonizing their provincial sales taxes with the GST is likely the most effective method of thwarting the problem of unintentional taxation.

¶42 The OECD has heard from business interests that rebate/refund systems are undesirable because they increase the costs of compliance. This need not be the case. Technology is driving the development of electronic commerce and technology can be developed to automate any of these compliance requirements. In fact, using encrypted digital certificates the entire process from establishing a business not to be a purchaser

⁴⁹ *Supra* at note 34.

under the act, to the remittance of the tax to the proper government, if applicable, could be automatically accomplished. This would be possible where businesses practicing electronic commerce were certified to do so under a common registration scheme, established and operated, by a consortium of federal and provincial revenue authorities.

¶43 Provincial and federal governments, and their revenue ministers, need to sit down together and create an agreement similar to the one that exists between the federal government and all of the provinces, in respect of the collection of provincial sales tax, where a good is brought into the country by a Canadian resident from abroad. Currently, the federal government, through the customs bureaucracy, collects and remits the provincial sales tax on the province's behalf. This agreement could be expanded to give the Canada Revenue Agency the obligation to collect and remit the provincial sales tax to the appropriate province no matter in what jurisdiction the resident returns to Canada. Manitoba residents returning to Canada via Ontario, through the Lester B. Pearson Airport, should not be able to evade their provincial sales taxes on imported tangibles, as is now the case.

¶44 Provincial and federal consumption tax systems require that enterprise within the jurisdiction must register and obtain a tax number to conduct any business above a certain dollar threshold. Businesses are the main focus of the government's tax law in these circumstances. Albert Radler has proposed that every person on the planet ought to be issued a number that identifies them, and everything about them, which is necessary for governments to identify and administer programs and services in respect of these individuals.⁵⁰ This of course, causes anybody who has read Orwell to denounce this as a

⁵⁰ Radler, Albert J. 2000. "The Future of Exchange of Information." In Victor Uckmar, ed., *L'evoluzione dell'ordinamento tributario italiano*. Milan: CEDAM.

radical idea that will extinguish any shred of individual privacy. This is probably true if the registration scheme is broadly construed. However, the idea in principle could be used, in a limited way, with little risk of cascading into a full-blown Orwellian nightmare.

¶45 Consumption tax laws could be amended to require that electronic businesses, within the jurisdiction, be barred from transacting with any person that has not registered in one of the provincial jurisdictions. These individual consumers would be required to produce a valid electronic commerce tax number. In the same way that business VAT numbers are clumsily verified by consumers on the EU website the whole process in Canada could be similarly managed. However, instead of relying on a time consuming individual verification of a particular number on a website the entire verification process could be automated. The numbers could be verified online by reference to a government database or in the same way Social Insurance Numbers are validated by way of an algorithm. The verification process could be scripted so as to be completely seamless and automatic with no need to jump between websites to verify the number as is now the case in Europe.

¶46 Governments in Europe and Canada have committed themselves to the concept of personal privacy as expressed through legislation such as the *Personal Information and Protection of Electronic Documents Act* (PIPEDA).⁵¹ This commitment to the protection of personal information should allay any fears that privacy advocates have about the misuse of the information collected by governments where a consumer is required to register for a electronic commerce tax number. In fact, should this idea be adopted by governments in Canada, PIPEDA and the act that gives effect to the individual electronic

⁵¹ *Personal Information Protection and Electronic Documents Act*, S.C. 2000, c. 5

commerce number program must include a series of allowable and prohibited uses for the information contained therein. Improper use of the information must attract sufficient penalties to discourage identity theft and other associated perils.

Jurisdictional Disputes

¶47 In both the international and provincial arenas there must be a developed and certain mechanism to deal with any disputes that may arise over entitlement to a particular collection, or the interpretation of a principle that affects entitlement to a collection or potential collection of tax revenue. Where money is concerned disputes inevitably arise. The OECD recommends the development of such a mechanism for international disputes and that model should also inform provincial or state disputes over taxation issues. Traditionally, the courts have been the arbitrator of provincial or state disputes and this might be an appropriate forum as long as the particular court rendering judgment has sufficient expertise in tax matters. In the international context, a body of technically savvy, legally trained tax arbitrators, and a mechanism to efficiently settle disputes among nations is also a necessary requirement.

Continued Monitoring by Revenue Agencies and the OECD

¶48 The OECD and revenue agencies need to continually monitor the development of technology and new commercial forms of exchange that develop as a result. By critically listening to what business and other informed commentators are saying governments can ensure that the methods they use to raise tax revenue are flexibly applied to sufficiently fund their political and social goals.

Conclusion

¶49 The Internet has created a new conduit for commerce. This new conduit has posed many challenges for revenue authorities that have relied on a generally static commercial system for decades. This innovation, while currently a source of difficulty for revenue authorities, is also the solution to those difficulties. Tax authorities, in order to sustain their revenues, must adapt to these new challenges that arise from this exciting new system of trade. This requires revenue authorities to be creative, technically literate, and informed about emerging commercial models, and the changes in the technology that are driving these new ways of doing business. Tax collectors do not have the luxury of time. Already technological changes are afoot that may radically alter the long distance telephone business. Voice over Internet protocol (VOIP) is threatening traditional bricks and mortar telecom businesses and by implication, the tax revenue they generate for their governments.⁵²

¶50 Revenue authorities must embark on a hitherto unprecedented level of cooperation with their counterparts in other jurisdictions. The OECD and other learned commentators have thematically identified this as “the” challenge. Cooperation among the different jurisdictions will be the foundation upon which the solution to these taxation problems is built. Without multi-lateral agreements myopic governments risk losing their ability to raise revenue and govern. Business will always try and find a way to maximize profits and this goal ought not to be achieved at the expense of public revenues that are needed, ironically, to support the infrastructure that makes the pursuit of profit possible. Good governments need money to operate and they need efficient tax administrations to

⁵² “Beyond Janet Jackson’s Breast: The Case for Michael Powell, America’s Controversial Media and Telecoms Regulator”, *The Economist (US)* v374 i8410 (January 22, 2005 at 64).

collect that revenue. Just as globalization of trade has brought us closer and requires cooperation for our mutual benefit, it is this same globalization, expressed through electronic commerce, which requires governments to cooperate to ensure a stable well-funded infrastructure. It is government's support of infrastructure that is required to facilitate a continuing increase in our mutual prosperity.