SOURCE RULES FOR A DIGITAL AGE

> *"Electronic commerce may represent the most radical force of change that nations have encountered since the Industrial Revolution."*
>
> The Minister's Advisory Committee on Electronic Commerce, *Electronic Commerce and Canada's Tax Administration: A Report to the Minister of National Revenue from the Minister's Advisory Committee on Electronic Commerce* (Ottawa, 1998)

The nature and economics of global business has changed dramatically over the past decade. Cross-border business transactions can be completed instantaneously without a product physically crossing a national border. Multinational businesses rely increasingly upon exchanges of valuable intangible properties, patents, trademarks, licenses and other information goods and services to earn income in multiple jurisdictions. Moreover, the Internet has sparked the rise of new industries and businesses, such as the rapidly growing online advertising sector. In contrast to the dynamic nature of e-commerce, the jurisdictional tax rules and concepts governing the taxation of global business profits have changed relatively little since the 1960s.

The International Tax Reform Symposium held in Toronto on June 2, 2008 was beset by a bevy of proposals seeking to expand the exemption aspects of Canada's outbound business tax system. In contrast to those proposals, this submission focuses on Canada's rules for inbound taxation, favours the adoption of nexus criteria to increase Canada's share of the international business tax base, and argues for mitigation of the significance of characterization of income as active or passive.

Canada's international tax policies for the Digital Age should build upon the nation's historically strong commitment to the principle of source taxation of foreign businesses. Canada should continue to lower effective tax rates to attract global businesses and mobile capital while broadening the tax base by closing avenues that permit foreigners to avoid Canadian taxation of income earned in Canada. For Canada to broaden its share of the international tax base in a manner that enhances its tax competitiveness, Canada must improve its source rules for taxing e-commerce and other business profits earned by global enterprises in the new economy.

In my doctoral dissertation, "*Tax Paradox Of A Rich Developing Country: Rethinking The Canadian Nexus For Business Income Taxation In A Digital Age*", I criticize Canadian policymakers for failing to respond to the advent of e-commerce – the most radical force of change since the Industrial Revolution. While Canada has been a world leader in international tax initiatives such as the branch tax, the FAPI rules, tax-sparing clauses to assist developing countries, thin capitalization rules, and the deemed disposition provisions that apply when taxpayers cease to be resident of Canada, there was no indication until recently that Canadian policymakers would introduce the jurisdictional sales nexus I proposed for the taxation of business profits as the eventual replacement to the obsolete permanent establishment norm.

The Evolution of International Tax Rules

Business income includes income from the provision of independent services. The income derived from most types of digital business transactions will be treated as income from services. Currently, a non-resident business will be subject to Canadian taxation on the income derived from services completed in Canada only if a nexus can be established under Canada's source rules or its tax conventions.

To varying extents, most contemporary bilateral tax treaties rely on the definition of permanent establishment found in the OECD Model. The permanent establishment concept was developed over a hundred years ago in a world where the bulk of international trade involved the delivery of merchandise and the extraction of natural resources. The adoption of a nexus threshold based on physical criteria was sufficient to allow a source country to tax the income derived by foreigners from most business transactions completed within the country's borders.

The changing nature of modern business practices gradually eroded the effectiveness of the permanent establishment threshold. The permanent establishment nexus was forced to evolve from its rudimentary paragraphs into a complex mechanism for determining the jurisdictional taxation of international business profits. Many international tax experts expressed reluctance to discard the permanent establishment concept out of fear of administrative disruption to real-world bilateral tax treaties.

The Internet heralded an explosion of more information, global markets and an abundance of cross-border business transactions involving multinational participants. The sale and delivery of intangible products over computer networks also created great difficulties for revenue authorities around the world as more and more commercial activity escaped identification and the collection of taxes. There was widespread concern that the malleable nature of e-commerce would subvert international tax laws that relied heavily on permanent establishment criteria for the taxation of global business profits.

In 1998, the Canadian government commissioned a study to explore e-commerce and Canada's tax system. The Ministerial Committee recommended the Minister of Revenue provide elaboration regarding the application of Canada's source rules to cross-border payments, e-commerce and other deliveries of intangible goods and services.

The Fifth Protocol to the Canada-U.S. Income Tax Convention, which was concluded on 21 September 2007, added the unheralded Paragraph 9 of Article V (Permanent Establishment). Article V(9) states that income derived from cross-border services will be deemed a permanent establishment if (a) the "services are performed" by an individual that was present in the source state for 183 days or more during any 12-month period and more than half of the business revenues of the enterprise in the source state are derived from that individual's services, or (b) the "services are provided" in the source state for 183 days or more during any 12-month period in connection with a "project for customers" that are residents of the source state. The Protocol's introduction of a project-for-customers concept, for one, seems laden with prospective interpretations.

Canada to Rethink its Source Rules

Canada is entitled to exercise its authority to tax any income that is sourced in the country according to its source rules. The source country has a legitimate and primary claim to tax the profits earned by a non-resident as a result of sales and services completed in the country. Canadian tax authorities rely on source rules to connect revenues and expenses to a potential taxpayer.

The market jurisdiction has a legitimate claim to tax a share of the global business income of the non-resident because the market location contributes to the earning of sales income. Source-country taxation has often been justified on the basis that the host country provides the market as well as the means to access the market by building roads and creating the infrastructure required to conclude sales in the jurisdiction. Although markets in the digital economy can be accessed without roads and conventional infrastructure, the completion of a sale in a market jurisdiction allows a non-resident to derive an identifiable economic benefit from the jurisdiction, thereby supporting the right of the market country to tax the profits derived from the sale transaction.

The concept of nexus, also referred to as "jurisdiction to tax", relies upon the use of source rules to denote the minimum threshold for source-country taxation. A nexus test establishes the circumstances in which a country is justified in taxing non-residents on business profits. A jurisdiction's source-of-income rules must respond effectively to the tax-minimization strategies of private multinational enterprises and other instances of abusive tax planning.

To particularly respond to the advent of Internet commerce, Canada needs to clarify how existing source and nexus rules (i.e. the domestic carrying-on-business-in-Canada test and the treaty-based permanent-establishment definition) are to be applied in respect of the taxation of the business profits derived by foreign firms on sales made to Canadians. The illumination of clear source-of-income rules can be used to attract foreign capital as well as to improve the tax competitiveness of a nation because multinational enterprises routinely factor prospective tax liabilities into their global decision-making.

Canada ought to adopt source rules that connect jurisdiction to tax to the source of purchase monies in a cross-border business transaction. Such source rules would create a jurisdictional sales test that would be less malleable than the existing permanent establishment definition. Except in dealings between related persons, one would expect that remote sellers would not be able to manipulate revenues since in a competitive marketplace, it is difficult to structure a sale transaction by moving a customer outside of the market jurisdiction.

The Fifth Protocol represents a tiny step towards recognition of the need for a special test to handle income from services and e-commerce. Genuine progress will be attained when Canadian lawmakers develop source-of-income rules to determine whether "services" were "performed" or "provided" to a business or person in Canada.

The United States – The Elephant in the Tax Room

Canada's fiscal policies must, at all times, be cognizant of the importance of the nation's economic relationship with the United States. The emergence of e-commerce may signal the demise of a long-standing trade advantage for Canada; namely, Canada's geographic proximity to the United States loses significance in the digital economy.

Canadian service providers and technology enterprises – like those in many other parts of the world – struggle to compete globally with competitive U.S. technology and Internet businesses. Trade flows between Canada and the United States within the digital economy contrast sharply with the nature of conventional commercial exchanges across the border. The United States is at the forefront of the digital economy characteristically generating the vast majority of Internet revenue and wealth. Canada would gain revenues in the event of the reciprocal adoption of a rule that expands the scope of source-country taxation of Internet commerce and international service businesses.

Canada is a net importer of e-commerce and other types of information goods and services. Canada typically records an annual trade <u>deficit</u> of $4 billion strictly for services that result in the cross-border payments of royalties and license fees. While combined annual private and public sector online sales in Canada recently surpassed $50 billion, the sad reality is that Canadian individuals and businesses are increasingly purchasing goods and services from foreign e-commerce vendors. A trade deficit in intangible goods and services usually results in tax revenue losses under the permanent establishment norm.

Article V(9) of the Fifth Protocol to the Canada-U.S. Convention may improve the competitiveness of Canadian service and e-commerce businesses vis-à-vis their counterparts in the United States. Previously, a resident of the U.S. could avoid Canadian income taxation on the profits derived from sales made to Canadian businesses and individuals as long as the U.S. resident did not maintain a permanent establishment in Canada. The American vendor would thereby gain a competitive advantage in the Canadian marketplace over other businesses resident in Canada. By subjecting certain U.S. businesses to Canadian taxation on the income derived from services provided in Canada, Article V(9) attempts to level the playing field for Canadian service businesses.

The U.S. Government is considering an economic presence nexus as a result of several 2006 state appellate court decisions. In *Lanco Inc.*, the New Jersey Supreme Court held that the state of New Jersey could impose its Corporation Business Tax on an out-of-state company that did not have a physical presence in the state. In *MBNA America Bank,* the Supreme Court of Appeals of West Virginia held that "a significant economic presence test is a better indicator of whether substantial nexus exists for Commerce Clause purposes." In *MBNA*, the Court overturned the landmark *Bellas Hess* physical-presence test because "the growth of electronic commerce now makes it possible for an entity to have a significant economic presence in a state absent any physical presence there." As the U.S. Supreme Court recently denied the *certiorari* petitions of *Lanco* and *MBNA*, States are now permitted to assert their jurisdiction to tax businesses that have an economic presence in the jurisdiction.

Tax Havens and the Need to Clarify the Carrying-on-Business in Canada Test

Global enterprises are more mobile than ever before and, thus, more likely to structure their commercial activities to avoid the prescribed nexus for both source and residence taxation. Innovative technologies have combined with the globalization of capital markets to encourage the use of tax havens. A separate corporate entity can be used to isolate and divert e-commerce income to a low-tax or no-tax jurisdiction.

Tax havens constitute a significant international tax problem for Canada insofar as they are responsible for the diversion of billions of dollars of otherwise taxable business income from the Canadian treasury. Multinational enterprises in practice manipulate prevailing transfer-pricing rules to further divert business profits to relatively lower tax jurisdictions.

Multinational enterprises are using the digital economy to take advantage of new income-shifting opportunities. Due to expanding global markets, it has become much easier for companies to structure business activities to the tax-optimal choice between international locations. A multinational enterprise will likely locate its e-commerce operations to minimize the firm's global tax liability or to escape taxation altogether.

Tax havens involve non-treaty situations so Canada's tax jurisdiction is restricted to foreigners whose activities cross the domestic carrying-on-business threshold. Canadian tax authorities currently rely upon a qualitative threshold to determine whether a foreign individual or company resident in a country that has not concluded a treaty with Canada is carrying on business in Canada.

The framework for determining whether a non-resident is "carrying on business in Canada" requires interpretation of the facts relating to the non-resident's business activities in Canada, with emphasis on the place where the contracts are made and performed. The legislative provisions suffer from ambiguity and uncertainty in so far as they fail to provide guidance to Canada's tax authorities in respect of the particular level of services that satisfy the threshold.

Canada should fulfil its promise to clarify the application of the current carrying-on-business nexus to electronic commerce by issuing its much-anticipated interpretation bulletin regarding carrying on business over the Internet and the characterization of e-commerce income.

Since the benefits theory supports a nation's right to tax business income derived by non-residents on the basis that the utilization of the nation's economic resources creates such income, Canada ought to adopt a jurisdictional sales nexus that would allow Canadian tax authorities to treat the completion of a certain amount of sales to Canadian customers as tantamount to carrying on business in Canada. In furtherance of this proposal, Canadian policymakers should mitigate the lack of congruence between the treaty threshold and the domestic carrying-on-business nexus for taxing cross-border business income, thereby lessening the impact of distortions in the two nexus tests.

Harmonization Mitigates Characterization Disputes

Canada's bilateral income tax conventions rely upon the proper characterization of an item of income to determine the appropriate treatment accorded to a taxpayer and to a cross-border transaction. Most bilateral tax conventions utilize different tax rules depending on the nature of the business income. The treatment of passive income is materially different than the taxation of ordinary business income, which differs from the treatment accorded real property income and from income in respect of transportation services. Moreover, the characterization of an e-commerce good as tangible or intangible, and the description of a product delivered over the Internet as a "good" or a "service" have both given rise to discord in international trade law discussions.

From an international tax policy perspective, proposals for the distinct taxation of e-commerce income should be avoided because such approaches are likely to create economic biases and thereby detract from worldwide efficiency. The principle of tax neutrality requires that all business income, whether arising out of digital transactions or through more traditional means, be taxed in a similar manner. Hence, Internet sales must be treated in an equivalent manner to conventional business sales because distinguishing the tax treatment of ordinary business profits from the treatment of income derived from sales of intangible products creates an artificial tax bias.

The characterization of income derived from the sale or licensing of software and other intangible goods and services represents a potential minefield because of uncertainty regarding the application of existing tax rules to hybrid business payments. Software and e-commerce transactions often involve a sale or license of a bundle of rights and benefits, so it is not always clear how the income derived from such transactions should be taxed. For instance, license fees in connection with the sale of software can be treated as royalty payments because, in essence, such payments represent remuneration for the right to use copyrighted material. Conversely, the income may be treated as business income in so far as such fees constitute remuneration for the sale of inventory transacted in the ordinary course of business.

The amount of tax revenue Canada collects on a license fee paid to a foreigner could vary depending on the characterization of the license fee as either royalty income or business income. The characterization of the payment is critical because royalties are typically subject to taxation in Canada under Part XIII of the *Income Tax Act* whereas business income is taxed under Part I of the *Act*. Furthermore, unlike business profits, royalties are generally subject to a gross withholding tax.

The emergence of e-commerce heightens the implications of the royalty-or-business-profits characterization. One can expect that most taxpayers will categorize the income generated by an e-commerce transaction in the manner that reasonably minimizes their total tax liability. In the absence of clearly established rules, Canadian tax authorities will find it difficult to justify a re-determination of the taxpayer's characterization of a license fee arrangement.

The Fifth Protocol to the Canada-U.S. Convention represents a modest attempt to harmonize categories of business income. The Protocol eliminated the separate article that dealt with "independent personal services". Further harmonization of the treatment of royalties and business profits would go a long way to simplifying the framework for the taxation of the business profits of foreign enterprises. As multinational enterprises need to make decisions regarding the location of capital investments and the target of their sales activities, enhancing certainty in the proposed tax treatment accorded business activities within a jurisdiction will likely promote efficiencies in cross-border trade.

International Tax Reform Proposals Require Global Leadership

A nation's tax administration represents the country's most important line of defense in the protection of the national tax base against multinational enterprises that possess the fiscal incentive and organizational capacity to structure their business operations to lessen their aggregate tax burden. A fixed-place-of-business threshold possesses little functional relevance in an increasingly digital business environment.

The Fifth Protocol introduces a conceptually distinct form of a jurisdictional sales nexus that modestly expands the scope of source-country taxation to include in limited circumstances income derived in connection with the provision of cross-border services. Although the nexus test introduced by Article V(9) does not rely upon the existence of a permanent establishment, treaty negotiators opted to include the new provisions within the definition of permanent establishment. It is unclear why the permanent establishment norm is so revered that all source rules dealing with global business income must be presented under the auspices of the permanent establishment definition.

The international community essentially recognizes that physical criteria may no longer constitute an effective mechanism for allocating international business profits among jurisdictions. A host of administrative and fairness concerns have been expressed before the OECD and the UN in response to increasing evidence of multinational enterprises structuring operations to avoid source-country taxation of business profits.

The OECD's permanent establishment definition has strayed from its initial promise of administrative simplicity. Accordingly, existing tax conventions routinely set out a permanent establishment definition that utilizes deeming tests ranging from physical criteria (a fixed-place-of-business threshold) to habitual authority of agents (known as the dependent-agent rule) as includes exemptions for preparatory, research and auxiliary activities. The treaty definition of permanent establishment will likely have to become even more convoluted to respond to increasingly complex business practices.

Canada should promote the global adoption of a jurisdictional sales nexus through its network of tax conventions and before the OECD and U.N. as the solution for the international taxation of cross-border service and e-commerce income. There are many benefits to the use of a jurisdictional sales threshold for the taxation of global business income. First, permitting the source country to tax the profits from sales completed within the jurisdiction will likely stem the tide of international tax planning aimed at circumventing the permanent establishment norm through the use of tax havens for the completion of remote sales. Second, the adoption of a jurisdictional sales nexus for business income is consistent with the source-of-income tests that most nations use to impose withholding tax obligations in respect of royalties, interest and dividends, namely, the source of the funds. Third, an economic presence test is more likely to capture those foreign businesses that derive substantial profits from a jurisdiction without establishing a physical presence. Fourth, as long as the threshold applies to all types of business income, it offers neutral tax treatment between e-commerce and traditional commerce.

Quantifying A Minimum Value For Revenues Earned by Foreigners in Canada

Since it would not be administratively efficient for Canada to impose tax and compliance obligations on foreign vendors engaged in nominal sales activities within Canada, a jurisdictional sales threshold should require more than the completion of only a few occasional or isolated transactions in Canada. Canada should amend the *Income Tax Act* by adding a quantitative jurisdictional sales test as a factor for deeming a non-resident to be carrying on business in Canada. The quantification of a jurisdictional sales threshold makes sense because it provides an authoritative determination of the amount of sales a foreigner can conclude before becoming subject to Canada's tax jurisdiction.

The adoption of a quantitative threshold assists global businesses to plan more effectively for projects in international markets. The new Article V(9) of the Fifth Protocol lamentably fails to utilize a quantitative revenue test to determining source-country jurisdiction in respect of income from services. As the Canada-U.S. Convention relies upon quantitative amounts in the case of employment income and to determine jurisdiction to tax the income of artists, entertainers and athletes, Canada ought to pursue the adoption of a monetary threshold for source taxation of cross-border services.

Canada should adopt equivalent quantitative thresholds for direct and indirect taxation to improve international tax planning and administration. Currently, a non-resident business that has a permanent establishment or is carrying on business in Canada must register for federal goods and services tax (GST) if the value of its annual taxable supplies exceeds $30,000. Thus, Canada's adoption of a harmonized $30,000 sales nexus for Canadian taxation would reduce the possibility that a non-resident is required to register for GST purposes but not for income tax purposes.

Canada should follow the lead of the European Union, which implemented a mandatory VAT registration regime for Internet businesses in 2003. The identification and self-assessment rules for the VAT are more sophisticated than their Canadian GST counterparts, particularly as applied to non-residents that electronically deliver products to consumers resident in the taxing jurisdiction.

by Dr. Aldo Forgione

SJD, 2007 (University of Toronto Faculty of Law)
Adjunct Professor, George Brown College