E-COMMERCE AND SALES TAX: SQUARE PEG IN A ROUND HOLE

In its broadest sense, electronic commerce or “e-commerce” involves the selling, buying, marketing or distributing of property and services via electronic means, typically the internet. It encompasses both a way of doing business, as well as the provision of products or services in digitized format. E-commerce presents many challenges for sales tax fundamentals, and for the Canadian businesses that must apply them.

REGISTRATION/COLLECTION OF GST/HST

Registration and Basic Core Issues

For most Canadian businesses, the utilization and/or delivery of products and services via e-commerce will not affect GST/HST registration requirements. Simply put, Canadian businesses are generally required to collect a minimum of 5% GST on their taxable supplies to Canadians, regardless of whether they utilize e-commerce as part of their business model. This is because they will normally be making supplies “in Canada” in one form or another, which triggers registration and collection requirements. For such businesses, the real GST/HST questions involve the harmonized sales tax and exports—i.e. when do they also have to charge the additional 8-10% provincial component (i.e. charge a total of 13-15% HST) because supplies are considered to be “made in” one of the harmonized provinces of Ontario (13%), British Columbia (12%), Newfoundland (13%), Nova Scotia (15%) and New Brunswick (13%), and when are their supplies to non-residents relieved from all GST/HST (note that BC will be leaving the HST regime, returning to a 5% GST and a 7% separately imposed BC sales tax effective April 1, 2013; Quebec will be “harmonizing” its QST with the HST effective January 1, 2013
adding a 9.975% provincial component of the tax with different administrative measures; PEI will be harmonizing with the HST at a 9% provincial component effective April 1, 2013)?

**GST or HST?**

The answer to whether 5% GST or 13-15% HST applies requires characterizing the supply being made – i.e. is it a supply of goods, services, intangibles, telecommunication services, etc? Once the supply has been properly characterized, either 5% or 13-15% HST will apply (assuming there is no exemption or zero-rating), depending on whether the harmonized place of supply rules in Schedule IX to the Excise Tax Act and the New Harmonized Value-added Tax System Regulations put the supply inside or outside one of the harmonized provinces.

One key HST characterization question is whether certain products supplied electronically should be regarded as intangible property or services. Technical Information Bulletin B-090: GST/HST and Electronic Commerce (July 2002) contains a detailed analysis of the Canada Revenue Agency’s views. Generally speaking, the CRA considers that electronic supplies are more likely to be treated as intangibles if (i) a right in, or right to use a product, is provided, (ii) an existing product is supplied or the supplier retains ownership of a product created for a specific customer, or (iii) a right to copy a digitized product is provided. In contrast, electronic products are more likely considered to be a service where (i) no rights are provided, (ii) specific work is done for a particular customer and (iii) there is human involvement in making the supply. The Bulletin provides numerous useful examples of the analysis in various contexts, including the electronic ordering and downloading of digitized products, the supply of software maintenance, web site hosting, database subscriptions and information provided by electronic means. The answers aren’t obvious so that, for example, software maintenance can be either a service or intangible, depending on whether the “principal object” of
the supply is software updates, access to trouble shooting databases or human interaction with technicians.

Once characterized as the supply of a good, service, intangible, etc., the harmonized provinces place of supply rules in Schedule IX and the *New Harmonized Value-added Tax System Regulations* must then be applied to determine if 5% GST or 13-15% HST applies. Suppliers must be careful, as there are special rules which deem supplies to be made in a participating province in some specific e-commerce situations. For example, there are special HST rules relating to internet access, technical support services and services involving electronic storage of information and computer-to-computer transfers of information.

**Electronic Supplies to Non-Residents**

Canadian businesses concluding e-commerce supplies to non-residents of Canada must generally charge GST/HST unless their supplies are considered to be “made outside of Canada” or are zero-rated. In the case of *goods* sold via the internet, GST/HST relief will typically be available if the vendor delivers or ships the goods to the customer at a location outside Canada. While there are many important exceptions, *services* are frequently zero-rated if they are provided to a non-resident, even if they are partly performed in Canada. In contrast, *intangibles* which can be used in whole or in part in Canada are generally subject to GST/HST when supplied to non-residents, unless they are an invention, patent, trade secret, trade-mark, trade-name copyright, industrial design or other intellectual property, or the right, license or privilege to use such property, and the non-resident is unregistered. Other intangibles supplied to unregistered non-residents can also be zero-rated, but are subject to specified exceptions (e.g.
there is no zero-rating if the intangibles relate to real property situated in Canada, tangible personal property ordinarily situated in Canada or specified services).

Possible Self-Assessment for Electronic Purchases from Unregistered Non-Residents

Since the internet makes the world a local marketplace, Canadian businesses may find themselves purchasing products from suppliers outside Canada who are not GST/HST registered. Where goods are purchased and imported, the applicable GST (and duty) will normally be captured at the border on importation. For Canadian businesses claiming full input tax credits, purchases of intangibles and services electronically from unregistered non-residents for use in Canada generally do not pose any compliance issues. However, if a Canadian business, such as a bank or an insurance company, cannot claim full input tax credits, they will generally be required to self-assess GST/HST under Division IV of the Act on the acquisition of intangibles and services from an unregistered non-resident supplier. Common self-assessment situations for such businesses include, for example, downloaded software, or even potentially internet-based advertising on search engines or websites, where the non-resident supplier is not registered for GST/HST purposes.

REGISTRATION/COLLECTION OF RETAIL SALES TAXES

The registration/collection requirements for the separate provincial sales taxes imposed by the provinces of BC (7% starting April 1, 2013), Saskatchewan (5%), Manitoba (7%) and PEI (10% on the GST-included amount until March 31, 2013), which are traditional retail sales taxes, create additional challenges in the e-commerce context.

Many Electronic Products Not Taxed
At present, these provinces include mostly goods and only some services in their tax base. Accordingly, many digitized products, considered to be intangibles or services, are not taxed in these provinces.

The provision of software in an electronic format poses a conceptual challenge, although the provinces have now generally adopted clear positions, often legislated. All these provinces require retail sales tax on internet access.

The Registration Decision

The greater challenge in retail sales tax jurisdictions concerns registration – when do provinces purport to require registration of non-residents who sell taxable products to provincial residents using e-commerce techniques, and how can they enforce their rules?

Saskatchewan and PEI generally apply traditional registration tests which they each describe a bit differently. They normally require registration if a vendor has a permanent establishment or other “presence” in their province. Sometimes the registration requirement is articulated as whether business is “carried on” in the province. Applying these tests in an e-commerce environment can lead to difficult theoretical issues for businesses operating via the internet from outside these provinces – for example, when can space on a server in a province constitute a “permanent establishment” in a province?; where is a “contract concluded” in an e-commerce transaction involving electronic ordering, supplies and payments, so that it might be said that a person carries on business in a province?

BC\(^1\) and Manitoba are generally more aggressive. They have expanded their registration requirements to purport to require anyone who solicits orders to purchase goods from persons in

---

\(^1\) Rules for BC are based on their sales tax provisions prior to BC’s adoption of the HST. It is not certain whether BC will return to their pre-HST rules when it returns to a retail sales tax, effective April 1, 2013.
these provinces by advertising or other means, and who causes goods to be delivered to those provinces, to register and collect the applicable sales tax. It is understood that general solicitations via a web site accessible to anyone in the world would not in and of itself require registration (although provincial positions evolve). However, solicitation of sales by e-mail sent to BC or Manitoba residents would potentially trigger the technical requirement to register. What about advertising on a Canadian search engine or website that is intended to be accessed by BC or Manitoba residents – e.g. advertising on a local radio station’s website?

The difficulty provinces have in forcing registration on businesses operating from other jurisdictions means that non-residents frequently decide to register based on practical factors, such as whether the vendor will ever have any assets in the province, the vendor’s tolerance for risk and overall convenience to the vendor and their customers. Remember, the consumer has to still pay the tax, whether or not the vendor collects it, and this reality can sometimes be a factor in the registration decision.

**Enforcement Issues**

Out-of-province internet-based suppliers can face awkward enforcement issues. BC auditors, for example, have been known in the past to contact unregistered vendors in other provinces to advise that they will be “showing up to conduct an audit”. Such vendors face delicate issues. Should/must a vendor allow an out of province auditor in to their premises if they are not registered? If they don’t, will they face an arbitrary assessment? If assessed, do they challenge the assessment or simply ignore it? In some cases, the auditors simply appear interested in access to the vendor’s list of customers in the province, so that these customers can be assessed directly. Should the vendor provide the list? The tax due on purchases from
unregistered out of province vendors has been a favourite audit issue in many provinces for some time, and this will only increase as e-commerce continues to grow.

CONCLUSION

E-commerce creates many challenges for both vendors and sales tax administrators. It poses a minefield of compliance issues for Canadian vendors who diligently try to apply Canadian sales taxes to their businesses. It also frequently creates competitive inequities for Canadian/provincial vendors facing competition from non-resident suppliers who, rightly or wrongly, aren’t registered and don’t collect sales taxes on their transactions.

Sales tax administrators have started to discuss how to address cross border transactions, and the problems raised by e-commerce in particular. Until there is some agreement by them on many bedrock issues, and a willingness to take bold and difficult steps to act, the application of sales tax to e-commerce transactions will continue to be somewhat of a square peg in a round hole – it can sort of be made to fit, there will always be gaps and spaces around the edges, and the results will frequently not be pretty.

*The information in this article is of a general nature and is not to be construed as legal advice. Readers should consult with their professional advisors for advice regarding their particular circumstances.