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Bits, Bytes, and Taxes: VAT and the Digital Economy in Canada

As purchasing digital goods and services over the Internet grows in popularity, domestic providers are at a significant disadvantage compared to foreign-based businesses that don't have to collect and remit GST/HST.

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The Study In Brief

The digital economy is expanding access to global markets and changing the way Canadians access content, order taxis, find accommodations and shop for goods. It has also made it possible to purchase digital goods and services over the Internet directly from suppliers located outside Canada just as easily as from domestic vendors. While this is useful for consumers, it complicates tax collection and raises competitive pressures for both domestic and foreign businesses.

In particular, providers of digital products and services, ranging from e-books and online games to streaming services such as Netflix and Spotify, are not obligated to collect and remit sales tax if they are not "carrying on business" in Canada. Instead, the consumers of the service are responsible for determining and paying the associated GST/HST, though in practice they rarely do. This creates two major problems: Canadian businesses are being put at a disadvantage relative to their foreign competitors who are not paying GST/HST and governments are missing out on significant amounts of tax revenue.

To address both problems, Ottawa should amend the *Excise Tax Act* to apply to businesses that supply digital goods and services for consumption within Canada regardless of where the company is located, in compliance with International VAT/GST Guidelines. There are many countries already employing policies that balance both coverage of the digital economy and the reporting requirements they impose on foreign businesses. Canada can learn from these policies and implement changes that work with our existing excise tax regulations. Delaying policy changes only prolongs the disadvantages that Canadian businesses face within their own borders and leaves tax revenue on the table at the expense of the Canadian economy.

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The Internet is changing how Canadians access content, order taxis, find accommodations and shop for goods and services. It has also made it possible to purchase digital goods and services over the Internet directly from suppliers located outside Canada just as easily as if the vendors were domestic.

While this is useful for consumers, it complicates tax collection and raises competitive pressures for both domestic and foreign businesses. In particular, providers of digital products and services, ranging from e-books and online games to streaming services such as Netflix and Spotify, are not obligated to collect and remit sales tax if they are not "carrying on business" in Canada. Instead, the consumers of the service are responsible for determining and paying the associated GST/HST. This creates two major problems.

1. Among general consumers, compliance is virtually nonexistent. This leaves significant amounts of tax revenue uncollected, but enforcement at the individual level would be prohibitively expensive and, likely, incredibly unpopular.
2. Since the sales tax is not being paid, foreign suppliers have a competitive advantage over domestic companies that are required to collect and remit the GST/HST on behalf of consumers. Sales taxes collected by domestic suppliers add 5 percent to 15 percent to the price of their products. Therefore, foreign vendors can extract more revenue, while charging the same final price as a domestic company, by not charging GST/HST.

These inequities also cover the myriad fees collected for using digital platform and network services. At the core of the issue is what, exactly, is meant by "carrying on business," as defined by the *Excise Tax Act*. If a non-resident firm carries on business in Canada, is sufficiently large, and supplies taxable goods, services or other intangibles, then it must register for GST/HST purposes. However, if a non-resident does not "carry on business" in Canada, then any supplies provided in Canada by the non-resident are deemed to be made outside Canada and consequently the non-resident does not collect and remit GST/HST.

The CRA's interpretation of "carrying on business" is heavily dependent on some sort of physical presence, be it the location of goods, staff, offices or bank accounts. This interpretation has become problematic, as the digital economy has allowed for new and creative business models that can separate the business structure into components that need not be physically connected to consumers.

To address both problems, Ottawa should amend the *Excise Tax Act* to reflect the Organisation for Economic Development and Co-operation's (OECD) International VAT/GST Guidelines for

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determining the place of taxation for cross-border services and intangibles (OECD 2015a). The main goal should be to level the playing field for domestic and foreign providers of digital products and services in Canada. This can be achieved by requiring that foreign sellers register, collect and remit tax on the sales of digital goods and services in the jurisdiction where the final consumer is located. Canada's current policy of determining jurisdiction of taxation by "place-of-supply" rules will become more problematic with time as the digital economy expands.

The rules in the *Act* governing what business activities are considered to be taking place in Canada when a company, located in Canada, is associated with an international company and trades with its affiliates should also be amended to ensure that it is not possible to exploit exceptions through fragmentation of business activities or other artificial arrangements using subsidiary or agent companies (OECD 2015b).

Canadian tax policy was not designed to deal with imports that do not physically cross borders, or businesses that can have significant market share in Canada without a physical office in the country. Indeed, the disparity in value-added tax (VAT) treatment between domestic and foreign firms with respect to digital products and services is a well-established international tax problem. Countries around the world face the same competitiveness and enforcement challenges that are experienced in Canada. The European Union, Norway, Australia, Japan and other countries have already implemented changes in their tax rules to address these challenges. There is no reason for Canada to delay reform any longer at the expense of Canadian businesses and the national economy.

Value-Added Tax in Canada and Imports of Intangibles

Value-added tax is designed to be just what its name suggests – a tax on the value added at each stage of production. In Canada, this tax comes in the form of the federal goods and services tax (GST) or harmonized sales tax (HST), which combines the federal and provincial GSTs, and ranges from 5 percent to 15 percent, depending on the province.[1] Businesses in Canada charge GST/HST on taxable products and services ("taxable supplies") that they sell in Canada, whether to another business or a consumer, and remit this tax to the government on behalf of the consumer (or business). Businesses then reclaim the GST/HST paid on purchases related to their commercial activities in the form of input tax credits. This mechanism ensures that GST applies only to the value added at each stage of production and is not compounded through the production process.

Generally, goods and services exported from Canada are not subject to GST/HST, as they are not consumed in Canada. However, imports are subject to the federal GST rate of 5 percent at the time of entry. While this doesn't sound particularly complicated, it leads to the question, how does GST apply to digital goods and services that physically don't cross borders?

1 British Columbia, Saskatchewan and Manitoba have Retail Sales Taxes (RSTs) in addition to the GST. An RST differs from a VAT in that it does not have input tax credits or refunds. Therefore, producers cannot deduct the tax portion of purchases related to their commercial activities. Quebec administers GST in combination with its Quebec Sales Tax (QST). The QST is a VAT similar to GST and not a retail sales tax: businesses receive input tax refunds for QST paid on property or services used in their commercial activities. Since provinces with RST have similar issues to the federal government when it comes to taxation of digital goods and services, they will have to amend their tax legislation in addition to any changes at the federal level.

Imported services and intangible property are subject to GST/HST if less than 90 percent is used for commercial purposes. But if the company selling the service or intangible is not "carrying on business" in Canada, then it is not required to charge and remit GST/HST on behalf of the purchaser. In this case, it is the responsibility of the importer to report and remit the necessary tax, even if the importer is not registered for GST/HST. This means that end consumers are responsible for reporting their imports of digital products and services purchased from non-resident vendors.

Most consumers are unaware that they are supposed to fill out a "GST/HST Return for Imported Taxable Supplies, Qualifying Consideration, and Internal Exchange Charges" form every month to report purchases of intangible goods or services from non-resident entities that do not carry on business in Canada and do not charge the relevant taxes to the consumer. According to the CRA, in 2015, non-registered entities filed just 410 returns on "imported taxable supplies," bringing in $3.2 million (CRA 2016a).[2] These returns are not only filed by consumers, but by any non-registered entity such as small firms, charities or public service bodies that don't pass the threshold that requires them to register for GST/HST. Meanwhile, Netflix has more than five million Canadian subscribers.

"Carrying on Business" in Canada

At the core of the issue is what, exactly, is meant by "carrying on business" in Canada. This specific phrase is important because a company that is not physically located in Canada must register for, collect and remit GST/HST if it is carrying on business here.[3] If business is not being carried on, then the non-resident business currently has no VAT obligations to the CRA, even if it supplies goods or services to Canadians.

The *Excise Tax Act* describes "business" as an activity that "includes a profession, calling, trade, manufacture or undertaking of any kind whatever." The *Act* does not require that the activity be for profit or that the firm have any physical location in Canada. The definition covers most businesses. Indeed, it would be rather hard to argue that any activity falls outside the realm of an "undertaking of any kind whatever." So assuming that an activity constitutes a "business," is that business being "carried on" in Canada?

The CRA lists a number of factors to determine whether a business is carrying on in Canada for the purposes of GST/HST (CRA 1999):

- the place where agents or employees of the non-resident are located;
- the place of delivery;
- the place of payment;
- the place where purchases are made or assets acquired;
- the place from which transactions are solicited;
- the location of assets or an inventory of goods;
- the place where the business contracts are made;
- the location of bank accounts;
- the place where the non-resident's name and business are listed in a directory;
- the location of a branch or office;

2 "Imported taxable supplies" include digital and non-digital goods and services. Tax filers are not required to provide detailed information on which taxable supplies are being reported, so it is not possible to isolate the returns filed exclusively for digital goods and services.

3 The definition of "carrying on business" differs with respect to individual provinces' RST legislation, the *Excise Tax Act* and the *Income Tax Act*. The phrase is not explicitly defined in the *Excise Tax Act* and, as a result, determination of its application has fallen to CRA policy and court decisions.

- the place where the service is performed; and
- the place of manufacture or production.

These characteristics are not prioritized and are provided as guidance to the CRA's interpretation of the *Excise Tax Act*.[4] Digital goods and services providers can fail to meet any of the characteristics of carrying on business in Canada. Indeed, an asset or a digital good or service can be acquired from an Internet platform based anywhere. The location of digital goods is unclear, as they do not necessarily have a physical location that is relevant to either the location of the business or the consumer. Similarly, the location of offices and branches can be disconnected from delivery of services and goods through digital platforms.

The CRA's interpretation of "carrying on business" is heavily dependent on some sort of presence in Canada, be it the location of goods, staff, offices or bank accounts. This interpretation has become problematic, as the digital economy has allowed for new and creative business models that can separate the business structure into components that need not be physically connected to consumers.

How to Supply Canadian Consumers without Carrying on Business in Canada

There are numerous ways that a business can organize its activities so that it can supply services and intangible goods in Canada without, technically, doing business in Canada. The following section investigates these business models with a focus on how they result in tax-treatment disparity between foreign and domestic suppliers.

The safest way for a business to ensure that the CRA will not deem it to be carrying on business in Canada is to simply not be physically located in Canada. For example, a digital streaming service that collects payments in a foreign bank account, does not have any physical location in Canada and houses its content on foreign servers is very unlikely to be deemed to be making supplies from within Canada (Figure 1).

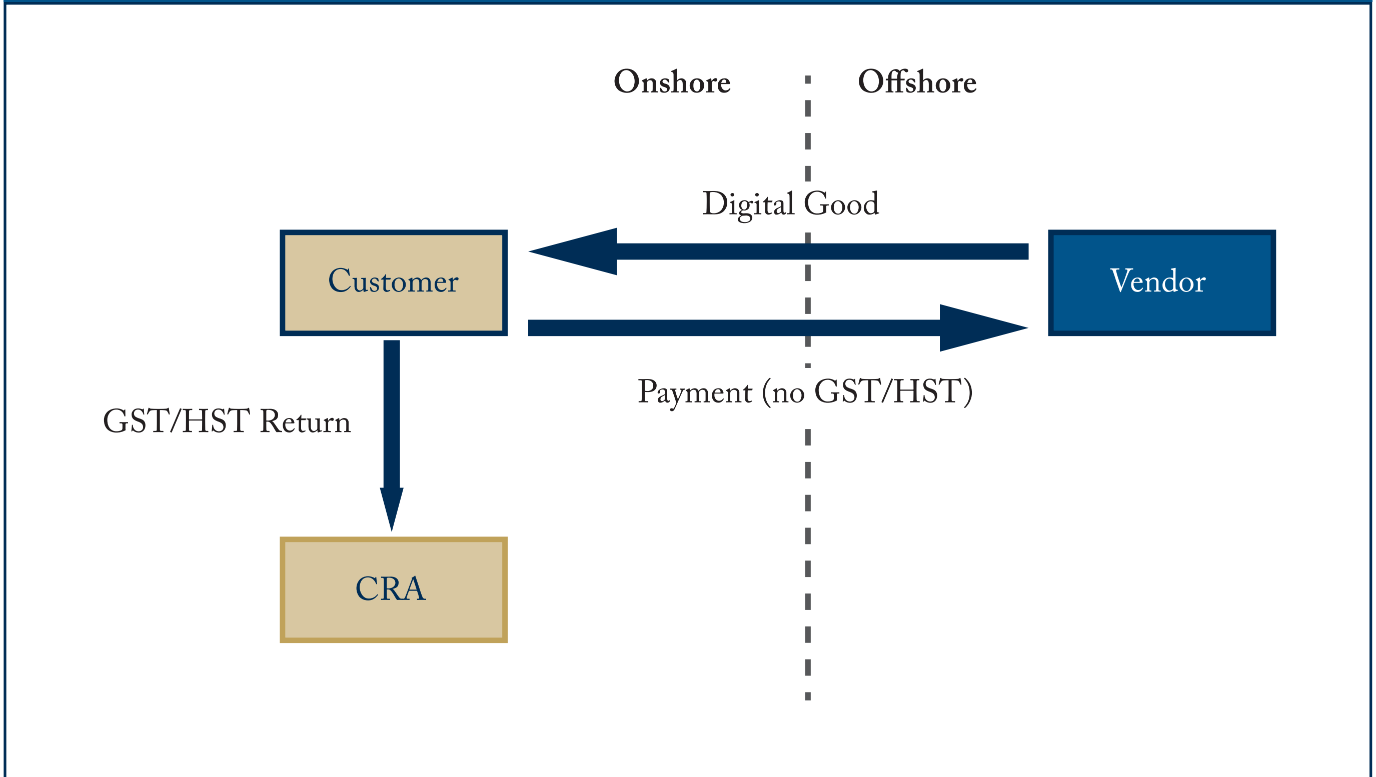
It is possible for a supplier to have a physical presence in Canada while still not, technically, carrying on business here. This situation is a little more complicated, as the product or service supplied needs to be separate from the physical presence of the company. If a non-resident company has a "permanent establishment" in Canada, then it must register for and remit GST/HST but only in respect of the activities carried on through that establishment.[5] For example, a company may sell both digital and physical goods. If the company sells physical goods through one Canadian-based marketplace and digital goods through another, non-Canadian-based marketplace, then it is possible that the company would have to charge and remit GST/HST only on the physical goods sold in Canada but not on the digital ones (Figure 2). This would be an example of fragmenting the business in a way that results in beneficial tax treatment.

Another business model that separates physical presence and the supply of goods/services

4 The courts have held that to be carrying on business, the activities in question must be considered to occur on a regular or continuous basis. However, there are no definitive criteria or thresholds to establish how many activities constitute "regular," or how long a period is necessary to be "continuous." Each case must be determined on its particular facts, including the history of the person's activities and intentions.

5 For a person to have a permanent establishment, they must have both a fixed place of business and make supplies through that fixed place of business. A non-resident who has a permanent establishment in Canada is considered to be a Canadian resident (for the purposes of the *Excise Tax Act*) in respect of, but only in respect of the person's activities carried on through that establishment (CRA 1991, CRA 1995).

Figure 1: Non-Resident Vendors of Digital Goods



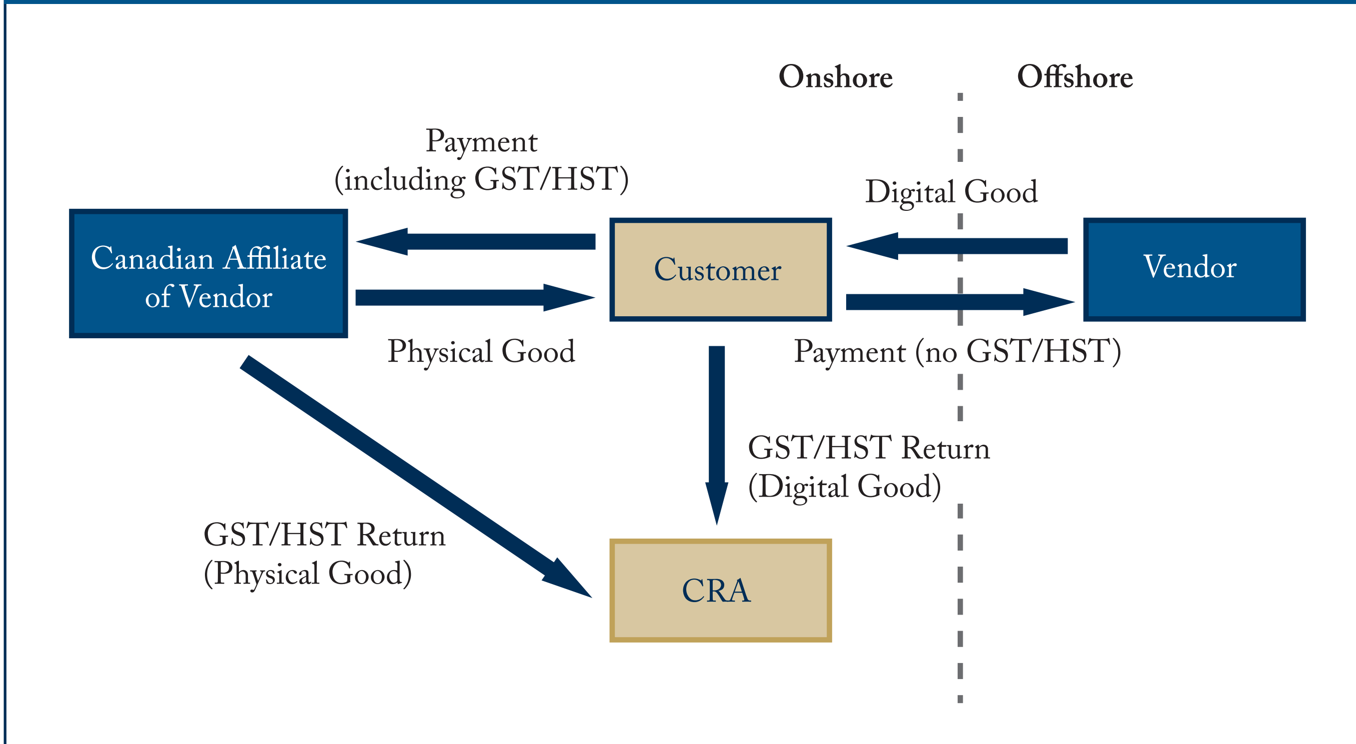
Source: Author's compilation.

differentiates activities related to the business. For example, an online platform that charges service fees and is not carrying on business in Canada may have an affiliate company that does marketing and customer service related to the product in Canada (whether or not the company supplies the product directly or is a platform for independent contractors).[6] In this case, the company has offices and staff in Canada, but since the service itself is not delivered through the permanent establishment, it can be deemed to be made from outside Canada.

Some businesses do not actually sell anything themselves, but instead operate a marketplace for other vendors and charge users service fees for transacting in the marketplace (Figure 3). The businesses selling the digital goods or supplying services are not employed by the platform, so they are not responsible for collecting and remitting GST/HST on the transactions. Instead, this responsibility lies with either the consumer, in the event of importing an untaxed service (Figure 3, Case 1), or individual sellers, if they sell in excess

6 Here "affiliate company" is a corporation, resident in Canada, that is part of the same corporate group as the non-resident corporation but not a branch of the non-resident company. If a non-resident business has a branch in Canada, that means it has a permanent establishment here. Whether or not the business is responsible to collect and remit GST/HST on the digital goods it sells would depend on whether the supplies are deemed to be made through the permanent establishment, determined on a case-by-case basis.

Figure 2: Fragmentation of Digital and Physical Business Activities



Source: Author's compilation.

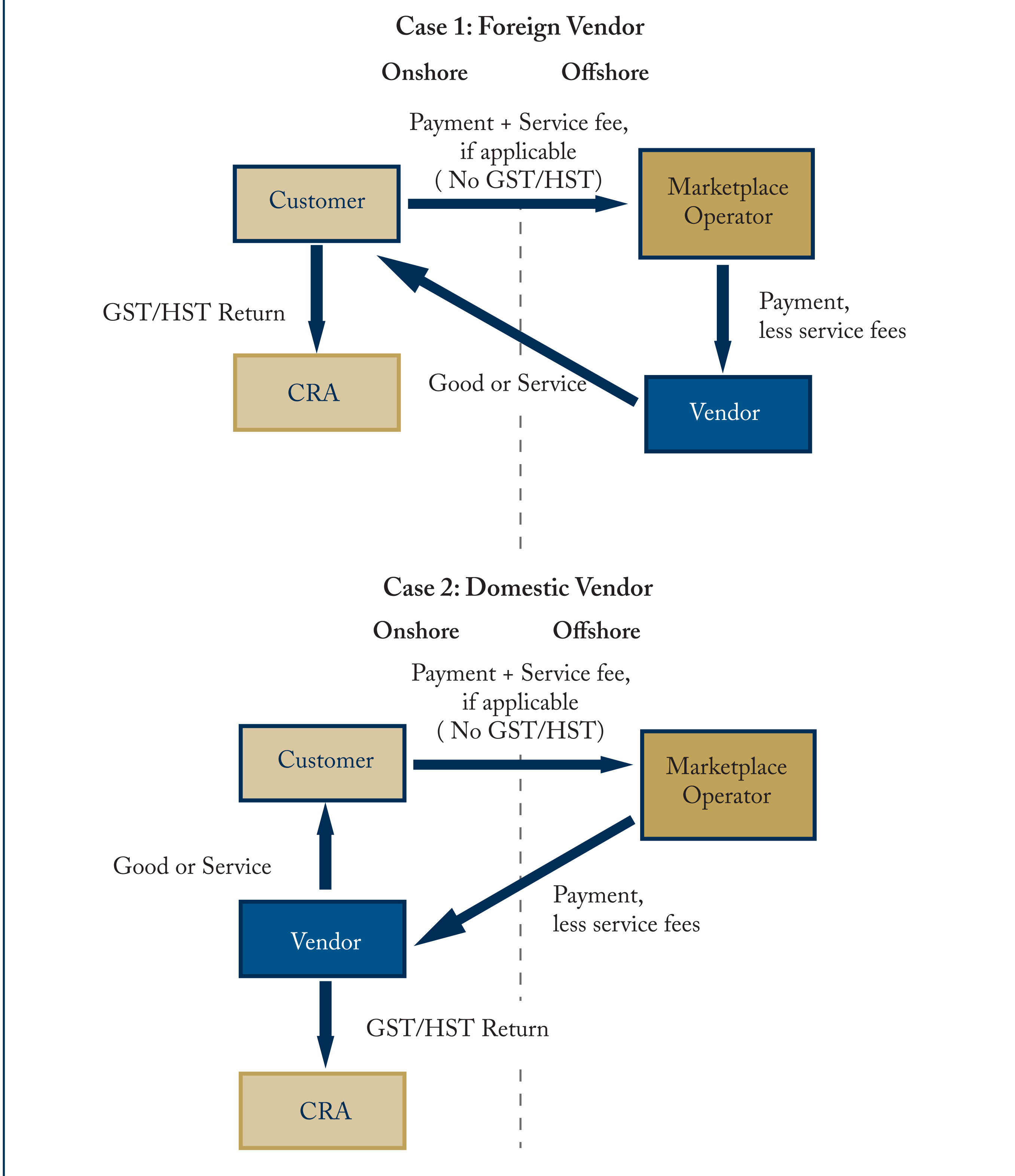
of $30,000 annually and are thus required to remit GST/HST on behalf of their customers (Figure 3, Case 2).[7] The platform operator, if operating from outside Canada, is unlikely to be deemed to be carrying on business.

The above examples and explanations are an over-simplification of the possible ways to supply digital goods and services to Canadians without doing business in Canada. There are many potential ways to design or fragment business practices in a digital and globalized economy, and there are many reasons to do so. The devil is certainly in the details as the above examples stem from interpreting the meanings of "permanent establishment" and "carrying on business."

Companies that can supply digital goods and services to Canadians without having to collect and remit taxes on behalf of their consumers are simply avoiding an administrative hassle that wouldn't benefit them. It is possible that their business models have less to do with avoiding the CRA and more to do with the logistics of handling a globalized enterprise. Nonetheless, businesses that are structured so they do not have to collect and

7 When a Canadian vendor sells a good or service through a non-resident marketplace to another Canadian, the vendor may run into challenges in collecting the applicable tax. If the marketplace operator does not collect taxes on behalf of the vendor, then the vendor will need to deduct the necessary GST/HST from its earnings. This represents a shifting of the tax burden from the consumer to the seller and results in an incentive to supply non-resident consumers over domestic ones.

Figure 3: Marketplace Operators



Source: Author's compilation.

remit GST/HST have an advantage over domestic companies since selling the same good for the same price results in a lower price for the final consumer when bought from a foreign company because no GST/HST is applied.

Case Studies: Who Charges Sales Tax and Who Doesn't

So far, this discussion has been rather abstract, but the problem itself has tangible impact on real businesses. As discussed above, there are numerous ways that a business can organize its activity so that it can supply services and intangible goods in Canada without, technically, carrying on business in Canada.

The following case studies are by no means an exhaustive list of the foreign companies that do not, currently, have to remit GST on behalf of consumers. The amount of GST/HST that each company "should" pay is the amount they would have to remit on behalf of consumers if they were carrying on business in Canada. These examples are intended to illustrate the breadth of services affected and the numerous business models currently employed that result in Canadian companies being at a disadvantage—they have to remit tax on behalf of consumers, so they do. The companies examined are categorized as vendors of digital goods, marketplace operators or a hybrid of both.

Vendors of digital goods

Companies that sell digital goods are perhaps the most obvious candidates for illustrating the disparity in tax treatment since these products generally have a tangible counterpart in the physical-goods market. While an imported good would normally be charged GST/HST when it crosses the border into Canada, this is not the case with digital goods, as they don't physically cross any borders and don't require shipping, storing and eventual land delivery to Canadian consumers. Digital-goods vendors can theoretically deliver goods anywhere in the world while being physically located in only one place.

Netflix

Netflix is an Internet television network with some 86 million subscribers in more than 190 countries. It broadcasts more than 125 million hours of TV shows and movies per day (Netflix 2017). As of April 2016, an estimated 5.2 million Canadian households subscribed to Netflix (Jackson 2016).[8] For comparison purposes, CraveTV, owned by Bell, and Shomi, co-owned by Rogers and Shaw, both launched in 2014, were together estimated to have 740,000 customers. Shomi discontinued service in November 2016 citing changes in the online video marketplace (Rogers 2016).

Netflix's annual revenue from Canadian subscriptions likely exceeds $620 million, which translates to about $31 million in federal GST. However, if we include the provincial portion of harmonized sales taxes, the combined total in uncollected tax revenue is approximately $52 million.[9]

8 This is an increase from 4.7 million in December 2015 and 4.1 million in June 2015.

9 This figure represents the annual subscription of paying Netflix subscribers divided into provinces by the percentage of market penetration in each region, multiplied by that region's tax rate (GST/HST). Given that estimated market penetration is over double the amount of paying customers, I assume that the average subscription is for standard service, which includes the ability to watch on two screens at the same time. Results are similar when one calculates the average price per screen; with GST/HST payable estimated to be $56 million.

Spotify

Spotify is a music-streaming service with more than 50 million paying subscribers in 60 countries. Its catalogue numbers more than 30 million songs. The company currently does not appear to charge GST/HST for each $9.99/month subscription to Spotify Premium in Canada. Unfortunately, there are no data available as to how many paying subscribers there are in each country as Spotify releases only global figures. Canada's GDP is 2.1 percent of the total GDP of the 60 countries in which Spotify operates. This corresponds to about 1.05 million paying Canadian subscribers, more than $126 million in annual revenue and $9.4 million in GST/HST. It is likely that Spotify's annual revenue from Canadian subscriptions is higher than this amount since western, developed nations have a relatively higher share of cross-border trade, driven largely by the retail of digital products (books, movies, games and music).

Marketplace operators

Companies that operate online marketplaces do not provide any of the goods or services that consumers purchase from the marketplace. These companies offer a platform that matches buyers with sellers and then charges either or both parties for using its platform. Generally, at least one of the parties conducting the transaction will be in Canada, and the good or service involved may be tangible.

Marketplace operators have different involvement levels in the provision of the good or service. Companies can operate the platform and process transactions while offering minimal customer service or support to those selling wares. Some offer transportation or warehousing and even production services. Some operate in ways that resemble traditional business structures and are already well covered by existing tax laws, while others operate in ways that make their obligations less clear.

Marketplace fees would be taxed if the operator were a Canadian business.[10] It would charge GST/HST on service fees charged to both the buyer and seller, if both were located in Canada. The seller could then claim the GST/HST paid on the transaction against their income from the sale through input tax credits (assuming they are eligible). If the marketplace operator is located outside Canada, then only the importer is responsible for reporting and remitting GST/HST. In this case, only the buyer on the marketplace would have to remit GST/HST on service fees, assuming the seller is using the marketplace for commercial purposes.

Uber and ridesharing

Uber is a ridesharing platform that connects passengers with independent drivers. It operates in more than 500 cities in 60 countries. In Canada, Uber operates in more than 40 communities. Since Uber drivers are independent contractors, it is their responsibility to register with the CRA for GST/HST purposes and remit tax on the whole amount of each fare. Uber sets the fare structure and collects between 20 percent and 30 percent of the total as a service fee from the driver. Company policy is that Uber drivers are not permitted to set prices, and

10 There are some notable exceptions where service fees are either exempt from GST/HST or are zero-rated. These services include most of those provided by financial institutions, such as lending money or operating deposit accounts, services provided by charities or public institutions and some transportation services where the origin or destination is outside of Canada.

the GST/HST for the entire fare is implicit in the fare.[11] Indeed, the responsibility to collect and remit GST/HST does lie with drivers as they provide the taxable supply.

The 2017 Federal Budget amends the definition of a "taxi business" to include providers of ridesharing services. This change requires all drivers of ridesharing services to register for, collect and remit GST/HST on behalf of riders. Previously, these drivers were required to register for GST/HST only if they supplied more than $30,000 in services annually.[12] More importantly, this change does not require Uber (or other non-resident transportation network platform operators) to collect and remit GST/HST on behalf of drivers.

This is not the case in Quebec. Since September 2016, Uber driver-partners must register for GST/QST and hold a Taxi and Limousine driver's license. But Uber collects and remits GST/QST on behalf of its drivers and rebates to them 6 percent of their weekly earnings to compensate for the GST/QST drivers pay on business expenses such as vehicle maintenance, gas and service fees. It is unclear whether drivers outside of Quebec will be able to claim the GST/HST paid on business expenses associated with platform service fees, as the ability to claim input tax credits will depend on the documentation that Uber provides drivers.

Canadian adults spent $241 million on ridesharing services in the 12 months preceding October 2016 (Statistics Canada 2017). There are other ridesharing services included in this figure, but Uber remains the dominant player in the Canadian market.[13] The GST/HST associated with a 20 percent to 30 percent service fee charged by ridesharing companies would be $4.9 million to $7.4 million annually.[14] If Uber (and other ridesharing services) were "carrying on" business in Canada, it would collect and remit this amount to the CRA. However, the amount would not have a material impact on government revenue as drivers could claim the GST/HST paid through input tax credits. If ridesharing companies were to be treated similarly in the rest of Canada as they are in Quebec, then they would be obligated to collect and remit more than $24.5 million of GST/HST on behalf of their drivers.

Airbnb and room-sharing

Airbnb is an online short-term rental marketplace that matches homeowners with people seeking

11 Uber's terms of service do not expressly forbid drivers from requesting additional money from passengers to cover GST/HST. However, Uber's community guidelines warn that drivers can lose access to their account for soliciting payment of fares outside the Uber system (Uber BV, 2017). The terms of service state that drivers "retain the right to (i) charge a fare that is less than the pre-arranged Fare; or (ii) negotiate, at your request, a Fare that is lower than the pre-arranged Fare (Rasier Operations B.V. 2017)."

12 The federal budget shows only a $3 million increase in tax revenue in 2017/18 and a total revenue increase of $20 million over five years. Notably, this is equivalent to about 25 percent of the GST associated with ridesharing services in 2016. Since the vast majority of ridesharing drivers would previously have fallen below the small-supplier threshold for registration, one can infer that the federal government is not particularly confident about drivers actually complying with this change.

13 Other Canadian ridesharing companies, such as RideCo, BlancRide and Pop, are included in this figure. However, it is unclear if any of these services surpasses the $30,000 annual sales threshold that would require them to charge and remit GST/HST.

14 Estimate represents GST/HST payable on service fees (20 percent to 30 percent of total Canadian spending on ridesharing services). GST/HST rate is the provincial rate weighted by the distribution of users (10.17 percent).

short-term accommodation. The company has more than two million listings in some 34,000 cities in 191 countries around the world. It has more than 35,000 Canadian listings, ranging from a shared room to entire 4+ bedroom houses. Airbnb charges both the hosts and the renters service fees for using its marketplace. Guest service fees range from 6 percent to 12 percent of the reservation amount (the larger the amount, the lower the fee percentage). Airbnb does not list the fees it charges hosts and directs hosts to determine the fees they have been charged by looking at their past transactions.

Airbnb does not currently collect or remit tax on behalf of Canadian consumers. Hosts are responsible for remitting any GST/HST associated with reservations and revenues. However, Airbnb does collect VAT or a VAT equivalent on its service fees in countries that tax "Electronically Supplied Services." Currently, that includes all countries in the EU, Switzerland, Norway, Iceland, South Africa, Japan and Albania (Airbnb).

In 2016, Canadians spent $367 million domestically on private accommodation services, like those listed on the Airbnb marketplace (Statistics Canada 2017). The related service fees would be about $22 million to $44 million, which would translate to $1.9 million to $3.8 million in GST/HST.[15] The service fees charged to Canadian hosts (assuming a fee of 6 percent of host revenue) would be associated with additional GST/HST payable on business services, up to a further $1.8 million.[16]

Hybrid marketplace operators

Some companies operate marketplaces and also sell some of the digital goods or services available through that marketplace. Customers may purchase goods and services from the operating company or an external business selling through the operating company's marketplace. If a Canadian business sells goods or services on the marketplace any service fees charged by the marketplace operator are considered imported business services (in this case, use of the marketplace) and are not taxable as the service is a business input that is wholly used for commercial purposes. However, it is the responsibility of the domestic business to remit the necessary GST/HST on its sales to purchasers located in Canada.

If digital goods and services are purchased by the Canadian consumer directly from the marketplace operator, then it is the customer's responsibility to remit GST/HST if the marketplace is not operated domestically.

Kindle e-books (Amazon.com)

Amazon.com is both a marketplace and a retailer with 11 distinct country websites and customers in 180 countries. It is the world's largest digital retailer and the eighth largest retailer in general, according to the *Forbes* Global 2000 index. The e-commerce behemoth presents myriad international tax compliance and regulation issues. I focus on Amazon's relatively humble origins as an online book retailer. The company manufactures an

15 This includes accommodation sharing beyond the Airbnb marketplace and includes domestic accommodation sharing marketplaces like CanadaStays. GST/HST rate is the provincial rate weighted by the distribution of users (8.53 percent).

16 If the marketplace facilitator is located outside Canada, then the service fees charged to hosts are not taxable, as they are an imported business service used for commercial purposes. However, if the marketplace operator is located inside Canada, then these fees are taxable.

e-reader called Kindle and offers more than 4.9 million on Amazon.com (Statista 2016a).

In 2016, North American e-book sales through the Amazon marketplace were running at a rate of more than one million paid downloads per day, with more than 100,000 of these sold by Amazon directly (Author Earnings 2016). This corresponds to about $3 billion in annual sales for all e-books on the marketplace and about $327 million for Amazon-published titles. Given the relative size of the Canadian e-book market (Statista 2016b), we estimate that approximately $50 million of Amazon's annual e-books revenues are attributable to the Canadian market, $12 million of which is from Amazon-published titles. If these books were to be purchased from a supplier doing business in Canada, then this would correspond to $890,000 in GST/HST charged and remitted to governments. This represents only the portion that would have to be remitted by Amazon.com directly and not from the other publishers that sell through the marketplace. If sufficiently large publishers on the marketplace are included, the GST/HST that would be charged and remitted is $10.2 million.[17]

StubHub

StubHub is the largest online ticket marketplace in North America. It is a secondary market platform that connects people who wish to buy with those who wish to sell event tickets. In the US market, StubHub has more than 50 percent of the ticket-resale market share, followed by Ticketmaster, which has 11 percent. In February 2016, StubHub also became a ticket vendor for some events, including in Canada. In November, it became the official ticket marketplace for the Ottawa Redblacks, though it sells tickets to the games in US dollars from its US web domain (StubHub 2016).

StubHub does not collect taxes on any transactions in its secondary market and clearly states in its Seller's Policy that "as a seller, you are responsible for collecting and remitting any and all applicable international, federal, state, or municipal taxes in connection with ticket sales." StubHub charges service, delivery, fulfillment or other fees for using the service (either as a buyer or seller) and reserves the right to change fees at any time it deems appropriate (StubHub 2015).

Given the variable nature of StubHub's fee structure and the lack of information about sales to Canadian events, it is nearly impossible to measure the amount of GST/HST that StubHub would have to remit if it were deemed to be carrying on business in Canada. From a selection of tickets available at the time of writing in the spring of 2017, the service fee charged to consumers is around 22 percent on top of the listed ticket price. This is in line with StubHub's revenue being about 20 percent of its 2015 gross-merchandise volume. Assuming the Canadian market is proportional to the US market by population, the approximate amount of uncollected GST/HST associated with

17 This is based on annual Amazon.com marketplace sales of e-books published by small, medium and large publishers and excludes independently published works. It is also important to note that it is unknown what portion of this amount is currently collected. If the publisher is located in Canada, then it likely reports and remits GST/HST/PST. Currently, only suppliers of e-books from Canadian publishers are required to remit sales tax. Since Amazon, itself, and other non-domestic publishers that do not have permanent establishments and are not "carrying on business" in Canada, the Canadian consumer is responsible for remitting the sales tax.

StubHub's service fees in 2015 would be about $5.6 million.[18]

Putting it All Together

The companies examined above illustrate a few of the digital products and services that can be delivered to Canadians from foreign companies that are not obligated to collect and remit GST/HST on behalf of consumers. They also illustrate the various ways that a business can be organized (whether intentional or not) to avoid this obligation.

It is important to note that this is not an exhaustive list of either the companies that sell intangible goods and services to Canadians without doing business here or the types of business arrangements that allow for it.

These case studies do, however, illustrate the magnitude of the problem. If tax policy were amended in such a way that the companies examined would become obligated to collect and remit GST/HST, then they would collectively remit approximately $97 million to the federal and provincial governments annually (Table 1). It is important to note that this does not necessarily translate to an equivalent increase in government revenues, as some of this amount is reclaimable by businesses in the form of input tax credits.

Table 1: Summary of GST/HST that Case Study Companies Would Potentially Remit if They Were Carrying on Business in Canada

Company	GST/HST that Would be Remitted
Vendors	
Netflix	$52 million
Spotify	$9.4 million
Marketplace Operators	
Uber and Ridesharing	$4.9 – $24.5 million
Airbnb and Room-sharing	$3.7 – 5.6 million
Hybrid Vendors and Market Operators	
Kindle e-books	$10.2 million ($0.9 million directly from Amazon published titles)
StubHub	$5.6 million
Total	**$85.8 million to $107.3 million**

Sources: Author's calculations.

Why a Change is Necessary

Large Amounts of Potentially Uncollected Tax Revenue

Just because a company isn't obligated to collect and remit GST/HST on behalf of consumers doesn't mean that the government isn't intent on taxing the goods and services that it sells. For all of the case studies above, there are millions of dollars in uncollected tax revenues and potentially millions of Canadians, technically, evading taxes since they are responsible for reporting and remitting the necessary GST/HST, even if they are not registered.[19]

Most consumers are unaware that they are supposed to fill out a "GST/HST Return for Imported Taxable Supplies, Qualifying Consideration, and Internal Exchange Charges" (GST/HST 59) form monthly to report and pay taxes on purchases of any intangible goods or

18 This estimate should be taken with extreme caution. It is a best guess given the available information about the ticket resale market, which was estimated to be $6.5 billion with StubHub having a 50 percent market share. The estimate assumed that the ticket resale market in Canada is proportional to that in the US with an average service fee of 20 percent. The VAT rate is the average combined federal and provincial VAT weighted by the population in each region (7.5 percent).

19 If the taxes payable on imported services amount to less than $2 monthly, then the tax is deemed to be zero.

services from non-resident entities that do not carry on business in Canada. As noted above, in 2015, only 410 GST/HST 59 returns were filed, bringing in $3.2 million in revenue. To make matters worse, these returns are not filed exclusively by private consumers; they are also filed by businesses that are not obligated to register for GST/HST purposes.[20] Furthermore, these returns are for all imported taxable supplies, not just digital ones.

It is clear that the reported GST/HST 59 returns don't come close to a realistic total of the tax moneys owing. Indeed, the returns filed by all non-registered entities in 2015 are just about 3 percent of the GST/HST associated with the digital goods and services supplied by the case study companies in the previous section. In fact, all the GST/HST 59 returns for the decade to 2015 amount to less than $57 million (CRA 2016a).

The current VAT system in relation to imported intangible goods and services has not been effective and leaves significant amounts of revenue uncollected.[21] This is due to a combination of factors ranging from consumer lack of awareness about tax obligations to the significant changes in how people acquire and consume goods and services.

The Competitive Canadian E-commerce Environment

E-commerce in both goods and services is growing. In 2014, business-to-consumer (B2C) e-commerce sales were estimated to exceed $1.8 trillion worldwide, an increase of nearly 20 percent from 2013. Indeed, these sales are estimated to jump another 75 percent to $3.15 trillion by 2018 (OECD 2015a). As e-commerce expands in general, so too will cross-border trade of these goods and services. In North America, B2C cross-border e-commerce is expected to grow to more than $230 billion and globally to $1.3 trillion by 2020 (Chan 2016). Western developed nations have a relatively higher share of cross-border trade, driven largely by digital products (books, movies, games and music).

Canadians are spending their fair share online, with such spending forecasted to reach $39 billion by 2019, or 9.5 percent of all retail purchases in Canada (Sheldon et. al. 2014). The trend in increased spending online extends to Canadian businesses, with virtually all (95 percent) of small business owners reporting that they make purchases online. Indeed, Canadians spend more hours online (36.7 per month) than anyone else in the world (CIRA 2016). Online gaming, entertainment, news and retail account for 37 percent of this time (West 2015). Canadians also consume a large amount of online content: 68 percent stream audio and 79 percent stream video daily (CIRA 2016).

With the massive expansion in the e-commerce economy, it is in the best interests of Canadians that domestic businesses remain competitive in this global environment. Even in the global marketplace, the majority of Canadian consumers prefer to support Canadian businesses when shopping

20 "Non-registered entities" include businesses that consistently have revenues of less than $30,000 per year, charities and public institutions that are small suppliers (generally, less than $250,000 in revenue and less than $50,000 in taxable supplies annually) and individual consumers.

21 It is nearly impossible to determine the total amount of GST/HST that should be collected as data are not available on whether services are imported for business or personal consumption. Furthermore, businesses do not have to report imported taxable supplies for GST/HST purposes if they are used for commercial purposes. Even when businesses and individuals file GST/HST returns for imported taxable supplies, they do not have to detail the type of service, making it impossible to determine if the return is for a digital intangible or some other service such as for overseas lawyers or consultants.

online, with the most important reasons for this support being greater trust in domestic suppliers and that it benefits the Canadian economy (CIRA 2016). Despite this strong consumer support, Canadian businesses still lag behind international counterparts for embracing e-commerce: less than one-half of all small- and medium-sized businesses have a website, let alone sell their products and services online (CIRA 2014). In the face of an already daunting competitive environment, Canadian businesses should not be placed at a disadvantage by inequitable tax treatment.

Lessons from Around the World

The problem of how to tax cross-border intangible trade is global in scope, and any solution needs to be effective in the face of the ever-increasing types of businesses that operate in geographically fragmented ways to take advantage of various tax discontinuities. The larger tax-avoidance issues are the focus of a joint OECD/G20 effort to address base erosion and profit shifting (BEPS). Action 1 of the BEPS project focuses on tackling the tax challenges of the digital economy. Australia, Norway, the EU, Japan and other countries have already implemented tax-policy changes aimed at correcting the competitive disparity between foreign and domestic companies within their own borders.

BEPS Action 1 recommends adopting the OECD International VAT/GST Guidelines which follow well-established economic principles of taxation (See Box 1). The main focus of these guidelines is neutrality. Ideally, businesses in similar situations carrying out similar transactions in any given jurisdiction should be subject to similar taxation levels, and VAT rules should be framed so that they are not a primary influence on business decisions. With respect to taxation levels, foreign businesses should not be disadvantaged or advantaged compared to domestic businesses in the jurisdiction where the tax may be due or paid.

Adopting the recommended "destination principle" can achieve neutrality in the taxation of cross-border supplies of services and intangibles. Put simply, the location of the customer, as opposed to the location of the supplier, should determine the jurisdiction of taxation. Under these guidelines, the VAT rate applied to a digital product or service is the same in a given jurisdiction, no matter where the supplier is located. (Exports would continue to be tax exempt.)

The disparity in VAT treatment between domestic and foreign firms with respect to digital products and services is a well-established international tax problem. Canadian tax policy was not designed to deal with imports that physically do not cross borders or with businesses that can have a significant Canadian market share without a physical office in the country. However, many other countries have implemented tax changes in response to this challenge. And some companies, such as Airbnb and Uber, as we have seen, have exhibited a willingness to cooperate. Airbnb, for example, collects VAT on its service fees in the EU, Switzerland, Norway, Iceland, South Africa and Albania. Uber has complied with the requirement that drivers in Montreal provide a GST and QST number and rebates drivers for the sales tax paid on the business expense of using the platform.

Methods used and the scope of digital products and services covered varies by country. The EU since 2003 has required that non-EU-based suppliers register for and remit VAT on electronic downloads and similar products. In 2015, the rules were amended to cover EU-based suppliers, and the scope was broadened to cover most broadcasting and telecom services.

The types of transactions covered and where the compliance burden lies also varies by jurisdiction. Some countries' policies cover business-to-business (B2B) transactions while others do not. Where B2B transactions are not covered, the burden of reporting and remitting the appropriate taxes rests with the domestic business that imports the digital

Box 1: The Ottawa Taxation Framework Conditions

Neutrality: Taxation should seek to be neutral and equitable among forms of electronic commerce and between conventional and electronic forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.

Efficiency: Compliance costs for businesses and administrative costs for tax authorities should be minimized as far as possible.

Certainty and simplicity: The tax rules should be clear and simple so that taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where and how the tax is to be assessed.

Effectiveness and fairness: Taxation should produce the right amount of tax at the right time. The potential for tax evasion and avoidance should be minimized while keeping counteracting measures proportionate to risks involved.

Flexibility: Taxation regimes should be flexible and dynamic to ensure that they keep pace with technological and commercial developments.

Source: OECD (2001)

service. While this measure puts a more onerous compliance burden on domestic relative to foreign companies, there are established enforcement methods of domestic laws on domestic companies.

However, the actual means of enforcement, should a foreign company decide not to comply with domestic law, is less clear. South Korea and Norway both operate simplified online VAT registration and reporting systems for non-resident firms to encourage compliance and ensure a low administrative burden. If a company in Norway does not comply with VAT rules through the simplified e-services platform, the Norwegian Tax Administration can require it to register through the standard system, which has additional administrative requirements.

The EU, South Korea and Australia hold marketplace operators (as opposed to the vendors using the marketplace) liable for the collection and remission of VAT on digital goods and services traded through the platform. This liability approach has its own complications associated with determining whether an entity is the supplier of the service or a delivery intermediary. (See the Appendix for a further discussion of the various issues associated with determining liability for VAT taxation in this context.) The liability method does, however, have the benefit of monitoring tax compliance of one identifiable entity as opposed to potentially millions of smaller non-resident suppliers. Individual country policies for the determination of VAT liability attempt to balance administrative feasibility (for businesses and tax authorities) with ensuring that tax authorities can identify and pursue businesses that do not comply with VAT rules.

Canada's Options

There are a number of policy options Canada can implement to address the tax challenges presented by the importation of intangible goods and services. To begin, Canada should make foreign companies equal to domestic companies, tax-wise, with the same registration and reporting requirements. However, the ability of the government to enforce these requirements varies between foreign and domestic companies. Still, the CRA has a number of tax-law enforcement measures in its toolbox. These range from withholding a person's GST/HST sales tax credit payment, to the garnishing of personal income. In more extreme cases, the CRA can obtain a ruling from a federal or provincial court to seize and sell assets and/or hold a third-party jointly responsible (for example, a business partner or director of a corporation) (CRA 2016b).

However, these tools can become problematic when the tax holdout is located outside Canada. Even if the CRA obtains a court order for the seizure of assets, they may be located safely in another country. The CRA may have extraterritorial enforcement tools through tax treaties.[22] Still, collection of taxes from other countries may require significant administrative resources beyond what would be necessary if the company were located in Canada.

The CRA's limited ability to pursue debts from foreign entities means that any new tax policy needs to be balanced so as to not create an excessive administrative burden on the affected businesses. For example, many countries (EU, Norway, Japan) require foreign entities to remit VAT only on B2C, and not on B2B, transactions and assign taxation responsibility for the B2B transactions to the importing (domestic) business. What constitutes a B2B transaction can be determined by the type of services provided or by requiring that foreign businesses obtain business registration numbers for the transactions for which they do not charge VAT.[23]

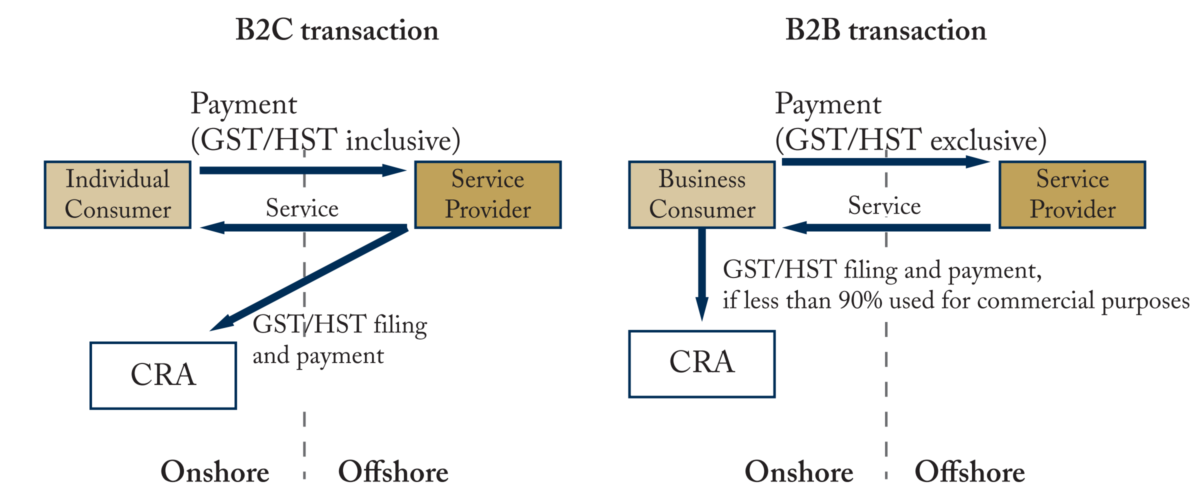
In Canada, the burden of taxation currently lies with Canadians for either type of transaction; purchasers, whether consumers or businesses, are supposed to remit GST/HST through a tax return when importing intangible non-commercial services from a non-resident provider. If Canada were to require foreign entities to report and remit GST/HST on B2B transactions, there would be increased administrative burdens on the foreign suppliers, domestic business customers and the CRA, with little increase in revenue, since the taxes might be reclaimed by businesses through input tax credits.

Ideally, a system compatible with differing treatment (for GST/HST purposes) between B2C and B2B transactions with offshore service providers, as described in Figure 4, would maintain the taxation liability for B2B transactions on domestic businesses and shift the liability for B2C transactions from consumers to the non-resident business providing the taxable product. This would provide the CRA more enforcement tools than would otherwise be available since the taxation burden for business imports would rest within Canada. Non-resident service providers would be obligated to report and remit GST/HST on all B2C transactions but not on B2B sales. However, if the administrative burden of determining what is and is not a B2B transaction is heavier than that of charging and remitting GST/HST on all B2B transactions, then the differing tax treatment based on transaction type would be costly. In this case, all transactions should be treated similarly,

22 At the time of writing, Canada had tax treaties in force with 93 countries and regions.

23 Japan has opted to classify types of services as either consumer or business. An "offshore service provider" that makes sales of digital services classified as B2C services to a Japanese consumer must charge and remit VAT, even if sold to a business consumer (unless the company providing the service restricts individual consumers from buying the product/service).

Figure 4: Proposed System of Taxation for Intanglble Digital Goods and Services



Source: Author's compilation.

and domestic businesses could reclaim GST/HST paid on their commercial inputs through input tax credits.

A VAT reform initiative needs also to determine the liability and obligations of marketplace operators. In the EU, Australia and South Korea, marketplace operators are generally classified as the final supplier of the good or service, and operators must register for, collect and remit VAT on behalf of the consumers and businesses that transact on their marketplaces. This treatment of marketplace operators as suppliers has its own complications in terms of assigning liability and then collecting tax revenue from that entity. (See the Appendix for a brief discussion.)

With respect to the scope of taxable services covered, differences exist among countries. For example, the EU defines "digital services" as being telecommunications, radio and television broadcasting, along with electronic services (European Commission 2014). This includes TV subscriptions, downloadable software and digital media. Japan, on the other hand, defines a "digital service" to be the provision of copyright articles (and licensing of such articles) and other services delivered via a telecommunications network (PwC 2015). Japan's definition puts telecommunications carrier services and software outside the taxation scope.

Neither the EU nor Japan includes architectural or legal services imported via the Internet as "digital services." However, these services are included in Australia's application of GST to imported digital products and services (Australian Taxation Office). The differences in what constitutes a digital service among jurisdictions are a matter of choice for each country. However, the universal goal is to cast a broad net on taxing services without adding undue burden to either foreign or domestic businesses. The choice of coverage is also affected by the reporting requirements and division of taxation liability employed in each country.

Canada could define the scope of taxable digital services to include consumer services but need not include services that are predominantly provided for business purposes, since these are not taxable anyway (when actually used for commercial activities). This balance would keep reporting requirements of businesses and individuals low while achieving coverage of services intended for consumption. Broader coverage could be achieved by defining "digital services" inclusive of business services imported for personal consumption and requiring non-resident service providers to charge and remit GST/HST or provide a Canadian business number for the transaction. However, given the limited ability of the CRA to pursue outstanding tax debts outside of Canada, any policy that increases the reporting requirements of non-domestic companies should be carefully designed to encourage their cooperation.

Conclusion

The digital economy expands access to global markets and with it, increases the products and services available to Canadian consumers and business alike. While this is greatly beneficial on the whole, it has resulted in Canadian businesses being put at a disadvantage relative to their foreign competitors with respect to GST/HST. It has also resulted in significant amounts of lost tax revenue.

To address both problems, Ottawa should amend the *Excise Tax Act* to apply to businesses that supply digital goods and services for consumption within Canada regardless of where the company is located, in compliance with International VAT/GST Guidelines. Whether or not a business has to report and remit GST/HST should be based on the consumer's, not the supplier's, location. In the digital economy, the physical location of goods, offices, staff, bank accounts or production may have very little to do with where goods and services are consumed.

Therefore, the scope of digital products and services covered, and the explicit requirements to be placed on non-resident businesses, should be designed with the focus on applying GST/HST to domestic consumption. Any policy change needs to balance the application of new measures with minimizing the additional administrative burden placed on both foreign and domestic businesses. In this regard, there are many countries already employing policies that balance both coverage of the digital economy and the reporting requirements they impose on foreign businesses. Canada can learn from these policies and implement changes that work with our existing excise tax regulations. Delaying policy changes only prolongs the disadvantages that Canadian businesses face within their own borders and leaves tax revenue on the table at the expense of the Canadian economy.

Appendix

Where does Liability Lie? Marketplace Operators as Suppliers

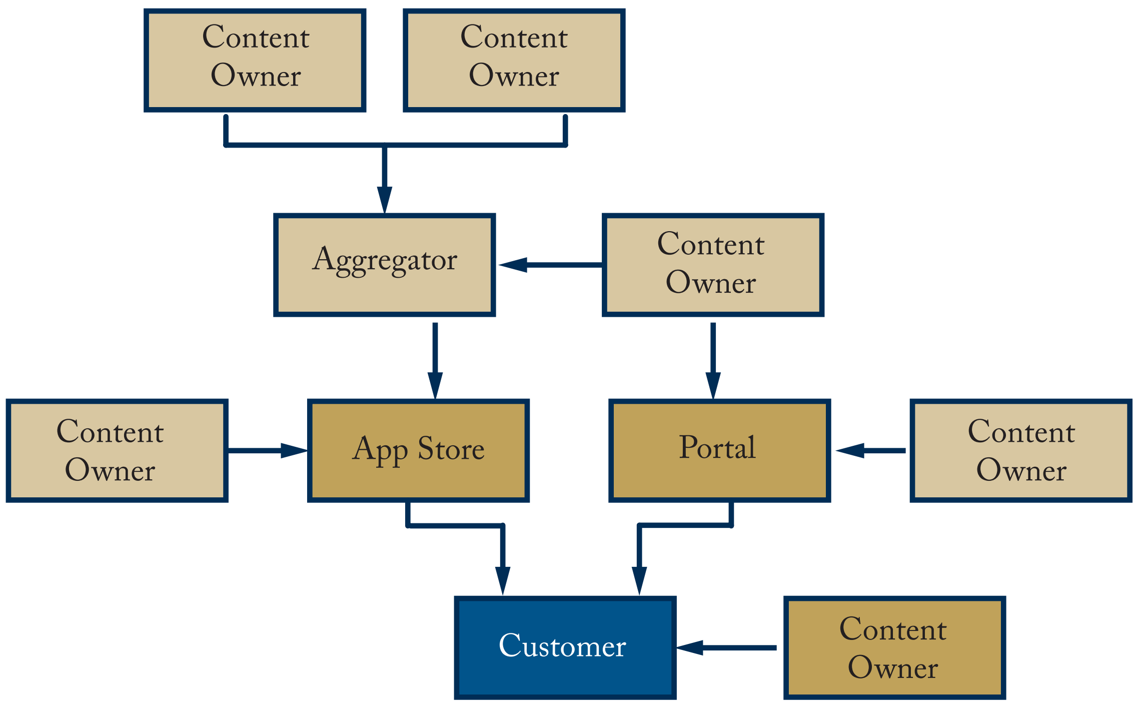
As noted, some countries (South Korea, Australia and the EU) hold marketplace operators liable for the collection and remission of VAT on digital goods and services traded through a platform or marketplace. This liability system has the benefit of holding one identifiable entity responsible for the VAT associated with many small businesses transacting through a marketplace instead of requiring each of those individual small businesses to register and remit VAT on behalf of their customers. This means significantly less administrative burden for those small businesses and the tax-administration authority, although it significantly increases the responsibilities of marketplace operators. It also ensures that the responsibility to remit the VAT does not lie with the final consumer in most cases, making it clearer to consumers and likely significantly improving compliance, given that few Canadian consumers actually remit the GST/HST payable on imported taxable supplies.

Essentially, the domestic or non-resident marketplace operator would be considered the supplier of the good or service and would be responsible for collecting and remitting the relevant VAT. However, there are complications associated with determining whether an entity is the supplier of the service or an ancillary intermediary in delivery. In the digital economy, the number of parties involved in the distribution of a service can vary significantly. A transaction can be as simple as a vendor selling directly to a consumer. But it can also be significantly more complicated when it involves licensing of software, authorization of payments or delivery of service. In general, a marketplace operator or content aggregator such as Google Play or PlayStation Network would be seen to have received and then subsequently supplied the content to the final consumer and would be responsible for collecting and remitting VAT. A content owner is responsible for collecting and remitting VAT only if it sells directly to consumers (Figure A-1).

As with other aspects of applying VAT to digital intangibles, jurisdictions around the world that require intermediaries in the supply chain to charge and remit VAT have varying approaches to determining who is a supplier. Europe has adopted an inclusive framework that includes platform operators and content aggregators in the supply chain, unless specific conditions are met. Australia has adopted a similar framework but does not require non-resident suppliers of digital services to charge and remit GST on B2B transactions and has less binding conditions for determining whether a platform operator is liable as a supplier. In South Korea, a "platform company" is responsible for collecting and remitting VAT on services delivered in that country, and Korean Tax Office policy is that this obligation is triggered if the intermediary receives the consumer payment on behalf of the content owner. Both existing rules in South Korea and those that come into force this year in Australia have significant complications associated with reporting requirements of resident and non-resident businesses in relation to B2B transactions and input tax credits.

If the Canadian *Excise Tax Act* is amended to shift responsibility for remitting GST/HST from the consumer to non-resident suppliers, the question of when to hold intermediaries responsible for this obligation and how to treat B2B transactions will need to be addressed. In this regard Canada can learn from other jurisdictions and potentially avoid some of the pitfalls they have experienced in attempting to design a robust system to tackle complex supply chains that stretch across borders.

Figure A1: Liability for VAT in Digital Marketplaces



Note: Arrows show different ways content is delivered to the final consumer. Generally, the entity closest to the consumer transaction is responsible for VAT (dark gold, emphasis added by author). This flow chart does not include considerations for payment processing.

Source: EU Commission 2014b.

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