G. Summary of TAG discussions

218. Although the table clearly shows the variety of characterizations proposed for the various transactions considered, it does not really reflect the fact that the divergences or convergences of opinion among members of TAG resulted from a relatively limited number of arguments. For example, we have detected three major trends in TAG’s preliminary conclusions. Firstly, there is a set of income types for which there is a consensus that they are business profits. Second, there is a consensus that another set of income types should be characterized as royalties. Lastly, there is a set of income types for which no consensus has yet been reached but within which two distinct approaches can be seen. Our comments on these trends are set out below.

1. Income types constituting business profits

219. It may seem encouraging that TAG reached this characterization for these items, which account for 2277 of the 27 income types considered. For most of them, the underlying commercial operation either corresponds to a traditional type of transaction such as the sale of a movable tangible product, one of the aspects of which, for example payment, is administered electronically, or else is a type of service which constitutes or can be assimilated to a traditional type of service but one which is also administered, wholly or partially, electronically. Examples here are data storage services or online auctions.

220. An attentive reading of the table reveals that some operations cannot be assimilated to operations in the real world. These are applications hosting on a Web site and supplying access to applications (or the right to use them). If, for example, hosting of an Internet site can be compared to the operation of a commercial lease, the analogy is much less evident in the case of applications hosting, since logic would dictate that what is involved is royalties or rent, as the charges for use would appear at first sight to cover the use of an intangible C the software.

221. This is not, however, the position adopted by TAG. It came to the conclusion that in these cases the user is in the same situation as if he had acquired the software and chosen to install it on the host’s server rather than on his own computer. We are thus back at the analogy of the

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77 Although 27 operations were identified, the distinctions made by TAG mean that we actually have to distinguish 33 such categories. They are as follows: 1 Electronic order processing of tangible products, 2ai Electronic ordering and downloading of general software, 3a Software updates and add-ons if supplied on a physical medium or 3b if supplied electronically, 4a Limited duration software and other digital information licenses if supplied on a physical medium or 4b software if supplied electronically, 6a Applications hosting under separate license and 6b bundled contract, 7 Applications service provider (ASP), 8 ASP licence fees, 9 Web site hosting, 11 Data retrieval, 15 Advertising, 16 Electronic access to professional advisory services, 19 Subscription access to an interactive Web site, 20 Online shopping, 21 Online auctions, 22 Sales referral service, 23b Content acquisition transactions if intended to create new content, 24 Streamed (real time) Web-based broadcasting, 25 Broadcasting rights.
commercial depot or premises where the purchaser would use his own equipment. Here, too, some members of TAG expressed reservations because in some tax treaties the definition of royalties includes "payments for the use, or the right to use, industrial, commercial or scientific equipment." TAG thus based its view on the criteria set out in article 7701(e) of the United States Internal Revenue Code, concluding that such payments were remuneration for services rendered rather than rental payments.

2. Income types constituting royalties

222. There are three of these, and it may be said that TAG chose for this characterization only more or less indisputable cases involving the use, against monetary payment, of intellectual property.

3. Income types on which there is no consensus

223. It goes without saying that this is the heart of the debate. These are products and services which either are delivered in entirely digital form or provided entirely over the Internet. Six of the 27 income types are covered by this discussion. As mentioned earlier, these divergences revolve around two categories which result from two distinct approaches. They may be described as follows:

   a) Downloading of products other than software

   b) Services providing access to databases and information

224. The cause of the divergence between the majority and minority positions on income from these types of operation lies in the fact that the minority position has changed since the distribution of the first report, and it now agrees to accept the revised commentaries on article 12 of the Model Convention covering software. In so doing, it accepts the idea that software should

78 TAG report, op. cit., footnote 75, paragraph 36.
79 They are: Ordering and downloading of digital products with copyright, 17 Technical information, 23a Content acquisition transactions if intended to acquire the right to post documents protected by copyright.
80 As explained in footnote 77, there are actually 33 sub-categories of transactions among the 27 main categories. They concern the following income types: 2aii Ordering and downloading of digital products other than general software, 3bii Updates and add-ons for products other than software if supplied electronically, 4bii Limited-duration software and other digital information licences, except software, if supplied electronically, 13 Data retrieval, 14 Delivery of exclusive or high-value data, 18 Information delivery.
be treated in the same way, whether it is downloaded or supplied on a physical medium. More specifically, the fact that downloaded software implies the transfer of limited reproduction rights in order to use it does not result in characterization as royalties, since the consideration attaching to this right is minimal and is, moreover, only an accessory to the principal service. The latter typically consists of contractual rights such as usage or service rights, and in any event rights other than copyright.82

225. Strangely, the minority takes a different view when considering a digital product other than software. Here it sees a source of royalties mainly because the product exists for the user only from the time when it is copied onto one of his memory units.

226. In more specific terms, this approach considers that the downloading of a digital product does not provide the purchaser with a copy of that product, because at that moment he is not in possession of movable tangible containing the file. This does not occur until the time when the file is transcribed onto a hard disk or any other physical medium. Consequently, the argument is that what is being paid for is not ownership of a file copy but the right to make a file copy on a physical medium. According to this approach, the fact of copying is a central element in the transaction and therefore gives rise to royalties, because the price relates to the right of reproduction and not any other right.83

227. Fortunately, there are many critics of this line of argument. One of the basic precepts of the revision of the commentaries to the Model Convention is fiscal neutrality, i.e. identical tax treatment of transactions which are fundamentally identical. The question does indeed arise as to what is the difference between the sale of software and the sale of an MP3 music file.

228. A counter-argument to that put forward by the minority is the fact that the scope of reproduction rights agreed by the seller84 is so small, compared with the right to use the product, that the proportion of the payment relating to reproduction rights is infinitesimal.85 The object of the transaction is therefore considered to be the transfer of the right to use a copy rather than the right to reproduce an original subject of intellectual property, since the method of transmission chosen by the seller serves only to increase efficiency and cut contribution costs.86 Another argument put forward by the majority is that the economic substance of the transaction lies in the acquisition of a digital product for personal use or the user’s entertainment and that, in this sense, the sale of a piece of music, a text or a picture cannot be dissociated from that of software.87

82 TAG report, op. cit., footnote 75, paragraph 21.
83 Id., paragraph 24.
84 Typically, as for software, the right to make copies for personal use and not for resale.
85 This is the position taken by Australia in its report, see ATO report, op. cit., footnote 2, section 5.4.50.
86 TAG report, op. cit., footnote 75, paragraph 23.
87 Id., paragraph 22.
229. It can thus be seen that the path taken by TAG is strewn with pitfalls. Although a majority of members do not hesitate to characterize as business income payments resulting from most of the transactions identified, a minority nevertheless refuse to support this analysis. Even more worrying is the almost obstinate inclination expressed by this minority to question the validity of the principle of fiscal neutrality by making the distinction relate not to the method of transmission of the digital product (physical medium or downloading) but to the type of file transferred (for example, an .exe file rather than a .mpg, .txt or .tif file).

230. These conclusions were echoed in the commentaries of the Electronic Commerce Tax Study Group, which recommends the adoption of a simple criterion to distinguish between royalties and business profits: the criterion of commercial exploitation. If a product is digitized to enable it either to be incorporated into a new product or to be commercially exploited directly, the payments relating to its provision will be royalties. If not, they will be business profits. This solution is the same as that developed by OECD in its revised commentaries to article 12, mentioned above. It is to be hoped that this is the solution that will ultimately be adopted by TAG, because so far it is the only one that both is simple to apply and respects the principle of neutrality.

4. Permanent establishment

231. As we have emphasized above, a taxpayer earning an income from a business through establishments situated in a country with which Canada has signed a tax treaty is liable to tax in the foreign administration if its presence meets the criterion of permanent establishment.

232. The definition of permanent establishment covers factories, branches, headquarters and other forms of physical presence. In the context of electronic commerce, physical presence as currently set out in the existing treaties is probably not necessary.

233. A communications server of Web site is sometimes the only "physical presence" in a country. The emphasis in relation to permanent establishment for e-commerce is therefore on these factors.

234. On 3 March 2000, OECD published its revised commentaries on the permanent
establishment concept in the context of electronic commerce. This document is one of reflection in which the sometimes contradictory positions of member countries are put forward.\textsuperscript{90} The revised draft asked for commentaries to be sent to the Working Party by 15 June 2000 to enable it to formulate a final position for its next meeting, scheduled for September 2000.

235. As a first step, OECD states that a Web site and the algorithms that lie at its heart cannot, in and of themselves, constitute a place of business. However, a server, which has a physical presence, could be considered a place of business in certain circumstances. For example, as the server is fixed, it could constitute a permanent establishment. On this point, OECD mentions that, for a server to be considered as a fixed place of business, it must in fact be situated in a fixed place for a given period. Thus, if the server can be, but is not, moved, it could be regarded as a permanent establishment in the light of that particular situation. OECD did not specify the period of time needed to characterize a server as a fixed place: is it one year, six months...?\textsuperscript{91}

236. In a situation in which, in accordance with the guidelines set out above, a server could be considered to be a fixed place, it would subsequently be necessary to determine whether a business was operated, wholly or partially, by means of the server. On this question, several important principles are being discussed, including:

\begin{itemize}
  \item[a)] Can there be an independent computerized permanent establishment
  \item[b)] Does the level of human intervention have to be considered?
  \item[c)] In what situations are the activities of an electronic business preparatory or auxiliary in terms of the definition of permanent establishment?
\end{itemize}

5. **Independent computerized permanent establishment**

237. Some member countries believe that the first question has already been dealt with adequately in the OECD Model Convention, in which certain computerized procedures are regarded as being capable of constituting a permanent establishment. In the commentaries to article 5 of the OECD Model Convention, the case of automatic vending machines and gaming slot machines is considered, and it is stated that "if the activities of the business are carried out principally by means of automatic machinery, while the activities of the staff are limited to assembling, starting, monitoring and maintaining that machinery,"\textsuperscript{92} they would constitute a permanent establishment unless the vending machines were simply assembled for subsequent

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\textsuperscript{90} Revised commentaries on the permanent establishment concept, op. cit., footnote 34.
\textsuperscript{91} For its part, the ATO report, op. cit., footnote 2, section 5.3.18, supports the idea that a period of six months is sufficient to make a presence fixed. This period is often the threshold from which tax treaties consider that certain building or installation activities can constitute a permanent establishment.
\textsuperscript{92} Paragraph 10 of the commentary to article 5 of the OECD Model Convention.
rental. The application of this principle to a communications server hosting software that carries out certain functions could therefore lead us to conclude that a permanent establishment does exist, the level of activities sometimes being broad enough for more than the sale, for example, of a bar of chocolate by a vending machine. For other member countries, the situs of a server for an electronic business is not relevant. An example is the situation of the sale of goods on the Internet. In this case, the place where business is carried on is not the place where the server is situated, but rather where its offices, depots, research centres, etc. are located. It is, however, also pointed out that when the server carries out all economic activities (accepting the contract, payment and delivery of products or services), it would seem that the company is carrying on its business by means of the server. In our view, this approach to e-commerce activities shows some contradiction, and the question arises whether the principle of fiscal neutrality is being respected. An electronic business selling tangibles (for example music CDs) would not be regarded as carrying on a business through its transactional server, whereas one selling the same "product" in digital and downloadable form (for example music in MP3 form) would be regarded as doing so. Moreover, this approach appears to suggest that a server must both be a transactional server and store the digital product, a situation which, in our experience, will hardly be frequent.

238. In response to the Working Party's commentaries, a New Zealand author, Mrs. Mara Fischer, proposed a different approach. As article 5 was drafted at a time when the emergence of electronic commerce had not been foreseen, it is wrong to try and apply its principles literally. In this sense, she considers that extending the scope of article 5 to the mere physical presence of a server runs counter to the article's purpose. A teleological approach is therefore proposed, under which article 5 does more than identify a source of income and attribute it to a physical presence. It sets a notional tax threshold in a country. The author deduces that to go beyond this threshold, the physical presence must also be a centre of economic activity, and not merely an extension of the parent company. A server is not a place of business, but rather a conduit; the profit is created at the place where the server's software was designed, while the income is obtained where the client is situated. The author therefore concludes that, for the purposes of the Model

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93 For example, software used in e-commerce can reach a level of computerization such that it would be able to carry out all the functions listed below: 1) solicit orders from target recipients using e-mail; 2) provide detailed information on the digital products or services on offer; 3) provide an electronic order form; 4) obtain the digital product and transmit it to the client; 5) register the sale and transmit the necessary information to head office; 6) process the payment (credit card or electronic currency) and transmit the deposit to the appropriate financial institution; and 6) periodically provide registered clients with updates and information on the product or service.

94 Since the MP3 business could store digital versions on a transactional server which would carry out the sale cycle.


96 There is therefore no correlation between the place where the server is situated, the
Convention, a server is not an independent centre of economic activity but merely an automated machine which, unlike a vending machine, does not have to be situated in the jurisdiction of the consumer. The Swiss business community expressed similar views in a letter to the Working Party. It concluded that in no case could a server used to carry on electronic business constitute a permanent establishment.

6. **Human intervention**

239. For some member countries, intervention is not necessary to conclude that a server is a permanent establishment. On this point, an analogy is drawn with the situation of a pipeline not requiring any human intervention, which is regarded in German jurisprudence as a permanent establishment for the purposes of a tax treaty, and reference is made to the commentaries discussed above concerning the case of automatic vending machines and gaming slot machines.

240. According to other member countries, a level of human intervention is necessary with respect to a server for a permanent establishment to exist. These countries therefore reject jurisprudence over pipelines and the OECD position on automatic vending machines and gaming slot machines. Although they agree on the concept of human intervention, several associated questions remain to be discussed:

a) What level of intervention is necessary?

b) Must the intervention be that of employees of the business or other persons (for example sub-contractors)?

c) Must the intervention be by persons situated in the country where the server is situated or can it be remote (for example by modem)?

d) What type of intervention should be taken into account: at the time of establishment or at the time of regular activities such as the updating of files and databases?

241. The Swiss comments considered that the discussion of human intervention was not relevant because, in their view, intervention is not a determining criterion concerning permanent establishment with respect to a server.

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7. Preparatory or auxiliary activities

242. Under the usual definition of permanent establishment, an establishment carrying on so-called "preparatory or auxiliary" activities is not deemed to be a permanent establishment. Thus, a server could be regarded as a fixed place of business without constituting a permanent establishment. In the OECD revised commentaries on the permanent establishment concept, it is stated that the determination of whether a given activity is preparatory or auxiliary in nature must be made in each individual case. However, some particular activities have been identified as being, in most cases, preparatory or auxiliary:

a) Information-gathering;

b) Provision of market information;

c) Advertising of goods or services;

d) Use of a "mirror" server for efficiency (for example, server array technology) or security;

e) Provision of a communication link between suppliers and clients in a context of e-procurement.

243. Although the above activities are, a priori, regarded as being preparatory or auxiliary, the OECD revised commentaries on the permanent establishment concept state that, if the activities represent the very essence of the business, they could nevertheless be deemed not to be preparatory or auxiliary. Let us take the example of an electronic auction business. In this type of business, the gathering and provision of information, like advertising, represent the very essence of the economic activities of the business, and such a business would be considered to have a permanent establishment from a threshold different to another business selling tangible and digital property.

244. The first three activities listed above merely repeat ideas already found in the exception for preparatory or auxiliary activities in the OECD Model Convention.

245. With regard to the use of a mirror server for efficiency or security, we believe it appropriate to consider it as auxiliary since the extent of the activity is not the essence of the business (i.e. this exception is aimed at activities such as "back-up").

246. The last activity listed above appears to relate to a server used in the context of e-procurement activities, one of the most important activities for businesses moving towards e-commerce. In our experience, computerization of procurement activities over the Internet produces substantial savings for businesses. For example, a multinational group could plan e-procurement activities in a controlled foreign affiliated company in order to reduce its tax charge, attributing procurement savings to it. Thus, in the light of the principles advanced in
Clearly, in a Canadian context, consideration must be given to the application of the determining rule to subparagraph 95(2)(a)(i) of the Act with respect to procurement for Canadian operations.

An analysis of transfer prices would of course have to support the level of profit attributed to the e-procurement business.


OECD revised commentaries on the permanent establishment concept, op. cit., footnote 35, p. 6.

The positions put forward by the OECD revised commentaries on the permanent establishment concept represent a significant advance over the first OECD discussion draft on this issue. On the one hand, the European positions (independent computerized permanent establishment) can be seen to have been included in this revision. However, the hesitation of some other member countries to endorse that position is also evident. The discussion on permanent establishment in the context of e-commerce will therefore have to face considerable challenges because of the contradictions to be found in the present draft.

The Swiss business community has stated its view that no attempt should be made to ascertain the capabilities or functionalities of a server to establish whether there is a permanent establishment. It expresses its disagreement with paragraph 13(12) of the revised commentaries on article 5 of the Model Convention, which suggests that a case-by-case study is needed to resolve the matter. In its view, the presence of a server can be seen, at most, as a preparatory or auxiliary activity, even where the server enables fully automated transactions to take place. For its part, the United Kingdom has declared in a public statement that a Web site or the hosting of a Web site on a server is a presence that is insufficient in itself to constitute a permanent establishment. In addition, the fact the server is owned directly, rented or otherwise made available to a business has no effect on the determination.

8. Central management

Clearly, in a Canadian context, consideration must be given to the application of the determining rule to subparagraph 95(2)(a)(i) of the Act with respect to procurement for Canadian operations.

An analysis of transfer prices would of course have to support the level of profit attributed to the e-procurement business.


OECD revised commentaries on the permanent establishment concept, op. cit., footnote 35, p. 6.


For a more detailed discussion of this question, see Income-taxes.ca.com Part 2, loc. cit., footnote 31, 1395-1396.
250. The improvements made to various communication technologies (videoconferencing and electronic communications, including the Internet) have increased the frequency of meetings of governing boards in which the directors are physically located in different jurisdictions. The new technologies also help to facilitate the monitoring of operations abroad and, in some cases, their execution in another administration. It then becomes difficult for tax authorities to apply the traditional criterion of central management to determine the residence of a company. Similarly, taxpayers with CFACs could find it difficult to prove that the central management is not in Canada.

251. Some have suggested that a new residence criterion is needed for companies with only a "virtual" existence (a criterion which would apply to the country of residence of the auctor intellectualis of the product, idea or concept106), but it would not seem appropriate to make such a fundamental change to a basic principle of international taxation.

252. The Revenue Canada Advisory Committee has noted the difficulties of applying the traditional criterion of central management resulting from the new technologies, and has indicated that there will probably be an increase in the number of companies with dual residence. It makes two recommendations on the subject. Firstly, it recommends the publication of an interpretation bulletin on the factors to be taken into consideration in determining the central management of a business, which would presumably take account of complex matters such as the impact of teleconferencing and videoconferencing. Secondly, as reference to the competent authority process enables cases of dual residence to be resolved (there is a notable exception in the Tax Treaty between Canada and the United States, where it is the country of incorporation of a company that is the decisive factor), it is recommended that Canada, in cooperation with its tax partners, should try to find ways of shortening the process of appealing to the competent authority, especially for medium-sized enterprises.107

253. In its report, the Revenue Canada Advisory Committee went into some detail on the main questions of international taxation relating to treaties. It does not arrive at any final conclusion, but it nevertheless makes a recommendation that Canada should not abandon the existing principles without examining alternative or new concepts.108 According to the United States


107 Revenue Canada Advisory Committee, op.cit., footnote 2, section 4.2.2.1. We believe that it would be appropriate to shorten the competent authority process for all the taxpayers concerned. On the first recommendation, Revenue Canada started in the Reply of Revenue Canada, op. cit., footnote 2, section 6.3.2.1, that it would not start an interpretation bulletin on the concept of residence. This position of the Canadian tax authority is in accordance with that of OECD as announced in Ottawa in October 1998. See Ottawa working document, op. cit., footnote 2, paragraph 52.

108 Revenue Canada Advisory Committee, id., section 4.2.2.4.
Treasury document, changing taxation by source to taxation by place of residence is both desirable and inevitable because of the changes made in electronic commerce and telecommunications.\textsuperscript{109} One would expect the United States to be a net exporter of digital goods and services and to continue to have a favourable trade balance in this area in the short term. A change to taxation by place of residence would probably be advantageous to the United States Treasury. It will come as no surprise that the Revenue Canada Advisory Committee has recommended that more information should be obtained in order to assess the impact of any change in the balance existing between source-based taxation and taxation based on place of residence.\textsuperscript{110}

H. Transfer prices

254. Electronic commerce is a relatively recent and constantly changing phenomenon. The complexity of the technical language and the various technological functions needed to carry on e-commerce activities can be so closely integrated that it may become difficult to assess their components. In addition, modern means of communication facilitate greater international cooperation, and the growing interaction between entities opens up possibilities for moving revenue among administrations. Because of these factors, the traditional case-by-case approach\textsuperscript{111} and the distribution of revenue among administrations become difficult. The Canadian administration's preference for transaction-based methods of determining transfer prices (particularly the method of comparable price on the free market) over profit-based methods\textsuperscript{112} could cause problems for Canadian taxpayers, especially in view of the requirement for meticulous documentation and the penalties for non-compliance.\textsuperscript{113}

255. The Revenue Canada Advisory Committee has singled out the issues which it considers important with respect to electronic commerce and transfer prices:

\begin{itemize}
  \item[a)] Determination of comparable market prices;
  \item[b)] Establishment of the appropriate yield for each type of activity which can be identified;
  \item[c)] Attribution of operations, profits and expenditure to the various administrations;
  \item[d)] Impact on the Canadian tax base.\textsuperscript{114}
\end{itemize}

\textsuperscript{109} United States Treasury document, op. cit., footnote 2, section 7.2.5.
\textsuperscript{110} Revenue Canada Advisory Committee, op. cit., footnote 2, section 4.2.2.4.
\textsuperscript{111} OECD Turku report, op. cit., footnote 3, paragraph 123.
\textsuperscript{112} Revenue Canada Advisory Committee, op. cit., footnote 2, section 4.2.2.7.
\textsuperscript{113} For a detailed discussion of these rules, see François Vincent and Ian M. Freedman, "Transfer Pricing in Canada: the Arm's-Length Principle and the New Rules," (1997), vol. 45, no. 6, Canadian Tax Journal, 1243-1275.
\textsuperscript{114} Revenue Canada Advisory Committee, op. cit., footnote 2, section 4.2.2.7.
256. The problems which a company carrying on e-commerce activities must face in respect of transfer prices, and which our tax administration has singled out, are not peculiar to this sector, but they raise certain issues on transfer prices which are the most complex ones that could arise.

257. As in any other situation relating to transfer prices, the first stage in determining a transfer price consists in obtaining information on the main economic variables and the manner of doing business which may influence the distribution of income and profits between the businesses concerned. It is therefore necessary to determine which affiliated companies (or branches) carry out or support the following activities and are the owners of certain active elements:

- a) who is the owner of intangible goods? (trade name or trademark, clients database, right to digital product source code and right of distribution);
- b) who bears the financial risks with regard to collection;
- c) what is the level of computerization of the activities and what are they?
- d) who bears the guarantee costs (for example, the cost of software updates and alterations)?
- e) who provides technical support for users (help-line for users, drafting of FAQs, etc.)?
- f) who performs accounting and financial tasks such as updates of sales data, registration of transactions?
- g) where are "stocks" held?
- h) what is the nature and type of transactions between affiliated companies (or branches)?

258. The next stage is the choice of method for determining the most appropriate transfer price in the light of the elements listed above and the economic and functional analyses carried out.

259. Firstly, it is necessary to determine whether comparable data exist. As e-commerce is a recent phenomenon, it may be difficult to find reliable data from third parties. Moreover, the integrated nature of e-commerce and the fact that various risks and activities can be distributed in

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115 For example, similar questions to those which arise for businesses specialized in technology also arise for financial institutions trading at the global level.

116 This may be a factor of minor importance if a business deals exclusively in electronic currency, the equivalent in reality of a business where the credit risk is nil or almost nil.

117 Frequently asked questions.
many different ways make it very difficult to obtain relevant data. Consequently, it is probable that the available information does not meet the comparability standard generally required. In these circumstances, the business itself may well be the best source of information. This would be the case, for example, when the organization has moved on from "conventional" trading to e-commerce. In addition, the non-availability of information could be short-lived. If forecasts of the volume of e-commerce activities prove wholly or partially correct, there would be strong growth in e-commerce and available comparable data would increase accordingly. Businesses and tax administrations will, however, probably not wish to wait until information becomes available, since the absence of guidelines could have an important impact on maintaining existing fiscal bases of assessment. In addition, the possibility that different administrations could prepare incompatible guidelines could increase the risk of double taxation. The premature adoption of strict guidelines, on the other hand, could harm the development of e-commerce.

260. There are several ways of formulating and supporting a policy for establishing a business−−transfer prices. At present, and as mentioned above, transaction-based methods may be regarded as inadequate with respect to e-commerce. In this connection, it was pointed out at the OECD Turku conference in 1997 that methods based on profit-sharing could well be applied more broadly in the context of e-commerce. Interestingly, the Revenue Canada Advisory Committee considers that Canadian taxpayers may encounter major difficulties as a result of the incoherent application and acceptance of the method of comparable profits in Canada and the United States, and that the problem must be solved. The committee did not wholly endorse the use of methods based on profit margin, but Revenue Canada seems to be aware of the heavy burden of compliance on the shoulders of Canadian taxpayers because of the fact that Canada and the United States have different positions concerning methods of establishing transfer prices. These are harbingers of possible changes in the positions adopted by the Canadian administration that are likely to be well received and could facilitate the task of businesses working in e-commerce and struggling with transfer-price problems.

261. We shall now turn to some specific aspects of e-commerce, particularly intangibles and global trading of financial instruments, which could be considerably facilitated by the new technologies.

1. Intangibles

262. As stated earlier, it is possible that, in the light of a consensus that might emerge, companies engaged in e-commerce activities could find themselves with permanent establishments in the administrations in which they have servers. In the context of e-commerce, the use and creation of various intangible elements may well be important. If there is a

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118 See the OECD Turku report, op. cit., footnote 3, paragraph 125.
119 Id. paragraph 135.
120 Id. paragraph 134.
121 Revenue Canada Advisory Committee, op. cit., footnote 2, section 4.2.2.7.
proliferation of "electronic branches," the results could be surprising. The fact that OECD believes that intangibles are not taken into account at the branch level (except their contribution to costs) could raise a number of complex problems. The question was brought to light in the OECD Global Trading Paper as follows:

"With respect to intangible rights, the commentary to the OECD Model Convention states that the rules concerning the relations between enterprises of the same group (e.g., payment of royalties) cannot be applied in respect of the relations between parts of the same enterprise. This is because legal ownership of the intangible cannot be attributed to any particular part of the enterprise. Accordingly, the costs of creating intangible rights are regarded as attributable to all parts of the enterprise making use of the intangible. Therefore, the current view reflected in the OECD Model Convention and its commentary is that internal or intra-entity payments made by a permanent establishment in consideration for the use of intangibles (as opposed to a contribution towards the cost of developing an intangible) are not recognised."122

263. In some cases, the value of intangibles could be important for the income-generating activity of the permanent establishment. The application of the above principles to an electronic branch could result in substantial net income at the level of the branch which, at least in an economic perspective, would seem inappropriate. In this connection, the following appears in the Turku report:

"The tax treatment of permanent establishments, when their existence can be shown to be in the context of e-commerce, may well be different from that of branches engaged in similar activities. This raises the problem of knowing whether permanent establishments and branches should be treated differently with respect to taxation when they are engaged in economically similar activities."123

264. Thus, if the threshold for a permanent establishment is set at a relatively low level for e-commerce, the international community should reflect on the most appropriate way of taking the intangibles into account. This is clearly a very complex question at a time when intangibles are being used more and more and it is becoming even more difficult to quantify their effect when several kinds of intangibles are involved.124

2. Global trading of financial instruments

123 OECD Turku report, op. cit., footnote 3, paragraph 131. This position on intangibles will probably be adopted by the Canadian tax administration as a result of Cudd Pressure Control Inc. v. Canada [1999] 1 C.T.C. 1 (C.A.F.).
124 OECD Turku report, id., paragraph 132.
265. In its discussion of transfer prices at the Turku conference, OECD noted that the principles put forward in its Global Trading Paper could be applied to e-commerce. The extent to which its commentaries could be relevant to a business engaged in e-commerce should be examined.

266. Briefly, activities for the global trading of financial instruments concern the international investment activities of a financial institution’s client and the institution’s own global trading activities. The inherent characteristics of these activities, which raise problems similar to those encountered by e-commerce, are:

   a) Global trading activities go on everywhere in the world, 24 hours a day. A trader may therefore have to delegate its powers (to negotiate, buy or sell) to affiliated entities (subsidiaries or branches).

   b) Global trading activities are integrated. The distribution of profits is therefore a challenge. The issue is made palpably more complex by the fact that different administrations may apply different methods of income assessment.

   c) Since capital is increasingly mobile, anticipated profits or losses may be transferred from one administration to another. Because of the complexity of financial instruments, verification of transactions is in itself difficult.\(^{125}\)

267. The reports assesses whether advance transfer price agreements might be a solution. It concludes, quite rightly, that such agreements are probably insufficient because they are voluntary and few taxpayers consider them to be a viable solution in view of the direct and indirect costs (informing the tax administration) involved.\(^{126}\) It is also possible that taxpayers engaged in e-commerce activities feel the same way.

268. The place where the transaction is effected is not necessarily an appropriate indication of the place where the profit should be entered in the accounts.\(^{127}\) This is a consideration similar to that mentioned previously in the context of the use of servers.

269. In view of the nature of global trading in financial instruments, it is considered that profit-sharing methods are probably the best solution and that, because of the great variety of ways in which these activities are carried out, each situation should probably be considered separately. Two conditions need to be met for a profit-sharing method to be used:

   a) Sharing must be common practice in the administrations concerned (i.e. internal regulations should lay down relevant procedures);

\(^{125}\) Id., paragraphs 95-97.

\(^{126}\) Id., paragraphs 103-107.

\(^{127}\) Id., paragraph 133.
b) The results must be compatible with the principle of full competition set out in article 7 of the OECD Model Convention.\textsuperscript{128}

270. There are two difficulties in the application of this approach. Firstly, with respect to the first condition, most administrations probably do not provide for any profit-sharing methods at present and a concerted effort by various countries to change their domestic tax laws would therefore be needed. Second, it may prove difficult to conclude that the results of applying a profit-sharing method comply with full competition.

271. The report contains a number of interesting observations regarding the factors which have to be taken into account in income and expenditure sharing:

\begin{itemize}
\item Should activities with only a remote link to global trading of financial instruments be entitled to a part of the profits?
\item Which income should be attributed under profit-sharing?
\item How should expenditure be broken down (on the same basis as gross or net income; should a distinction be drawn between international and local expenditure?)\textsuperscript{129}
\end{itemize}

272. Similar questions will inevitably arise when e-commerce activities are analysed. The report then considers and comments on the various factors (volume, capital, head office, negotiation risk, remuneration paid to negotiators) that may have an effect on profit-sharing. It states that the identification, choice and weighting of these factors are always difficult and that each situation should be examined in all objectivity.\textsuperscript{130} The application of profit-sharing methods to a business engaged in e-commerce activities will certainly be no less arduous.

273. As noted earlier, the transfer-price issues which a business engaged in e-commerce has to face are not new, but they are certainly among the most complex. Taxpayers, tax advisers and tax administrations will become more familiar with them over the next few years, and this will help a consensus to emerge. It is nevertheless probable that in the near future taxpayers and their advisers will ask their tax administration for guidelines. It is also to be hoped that countries will cooperate in preparing and interpreting guidelines in order to minimize cases of double taxation.

I. Review of other recent developments

1. OECD

274. In addition to the amendments made to article 12 of the OECD Model Convention and the positions taken on the permanent establishment concept, the Ottawa conference highlighted what

\textsuperscript{128} Id., paragraph 134.\textsuperscript{129} Id., paragraphs 156-160.\textsuperscript{130} Id., paragraph 195.
is at stake in e-commerce and the problems to which it gives rise, without putting forward any recommendations. OECD thus gave itself the means to study the issues in greater detail and consult those involved, namely, OECD member countries, OECD non-member countries and taxpayers. Five technical advisory groups (TAGs) were established in January 1999 to study the issues. They will have two years to gather all the necessary information. The five TAGs and their mandates are:

a) **Income characterization**

To examine the characterization of various sources of e-commerce income for purposes of tax treaties and, where necessary, to formulate recommendations for changes to the commentaries on the Model Convention.

b) **Taxation of business profits**

To examine how the current standards will apply to e-commerce and analyse proposals for alternative rules (for example bit tax, distribution by formula, etc.) in order to make recommendations.

c) **Consumption taxes**

To examine the feasibility of mechanisms, such as the use of self-liquidation, self-assessment or equivalent mechanisms for the sale of digital products to businesses. To examine ways of simplifying registration and payment obligations.

d) **Technology**

To list and evaluate Internet developments to identifying the challenges and opportunities for tax administrations: taxpayer identification, verification of taxpayer information and facilitating tax collection.

e) **Data access**

To review the methods used by business to verify the reliability, identity and completeness of data with a view to adapting these procedures and methods for tax administrations.

275. Lastly, it is possible to join a discussion group on the matters raised above and obtain some of the documents used by the TAGs. All that is needed is to go to the OECD Internet site and register.

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131 The mandates of the TAGs may be consulted at oecd.org/daf/fa/e-com/tag.htm.
132 At oecd.org/daf/fa/e_com/e_com.htm.
2. United States

276. A very important piece of legislation, the Internet Tax Freedom Act (IFTA),\textsuperscript{133} has been adopted in the United States. Under it, a moratorium of three years has been imposed on state, county and urban taxes on internet access, except those which were in force on 1 October 1998, and all multiple or discriminatory taxes on electronic commerce. "Discriminatory tax" means, inter alia:

   a) A tax levied by a state, country or town which is not generally levied or may not be payable for transactions relating to products, goods, information or similar services;

   b) A different rate of tax for transactions relating to products, goods, information or similar services;

   c) A tax liability which is different from that for transactions relating to products, goods, information or similar services.\textsuperscript{134}

277. IFTA set up an Advisory Commission on Electronic Commerce (ACEC), which has studied issues relating to the taxation of e-commerce and access to the Internet. In its report to Congress submitted in April 2000,\textsuperscript{135} the Commission did not arrive at any meaningful consensus on most of the matters entrusted to it, as a two-thirds majority was needed under its statutes for its recommendations to be submitted to Congress. Since this was not achieved on most cases, new United States legislative measures cannot be expected in the near future. The renewal of the moratorium for a further three or five years is at most uncertain. Although the House of Representatives has adopted a bill to this end, it is far from clear that the Senate will wish to do likewise. Mention may be made in this connection of the bill tabled by Senator Dorgan entitled "Internet Tax Moratorium and Equity Act." Although it has not yet been adopted, this bill has received the support of the Multistate Tax Commission and proposes an extension to the moratorium of four years, together with the establishment of a system for levying state sales tax on all taxable sales made on the Internet. It goes without saying that this bill is diametrically opposed to that adopted by the House of Representatives, which provides for the continued exclusion of Internet sales from sales tax.

278. Lastly, the United States Treasury Department has announced in a communiqué\textsuperscript{136} that it would publish a report on the regime of controlled affiliated foreign companies, particularly their e-commerce activities. No news has been published on that study.

\textsuperscript{133} Internet Tax Freedom Act, Title XI of P.1. 105-27, Omnibus Appropriations Act of 1998. These laws may be consulted at ecommercecommission.org/IFTA.htm.
\textsuperscript{134} Id., art. 1134(2).
\textsuperscript{135} The document is available in pdf format at www.ustreas.gov/press/releases/ps289.htm.
3. **Canada**

279. Like OECD and the United States, Revenue Canada has set up technical advisory groups. Their mandates are quite similar to those of the OECD TAGs and are as follows:

   a) Improvement of services to taxpayers
   b) Tax assessment and administration
   c) Consumption taxes
   d) Interpretation and international cooperation

280. Each technical advisory group is chaired by a representative of Revenue Canada and the members come from business and tax professionals. The groups work together and in cooperation with the OECD TAGs. Lastly, we understand that an advisory group of provincial representatives will be established to ensure that infra-national concerns are taken into account.

281. The term of the technical advisory groups’ mandates is two years. It is therefore unlikely that tax professionals in Canada will have any indication of the positions taken by Revenue Canada before 2001.

4. **Quebec**

282. On 11 May 2000 the Quebec Government announced the establishment of Electronic Commerce City.\(^{137}\) It is modeled rather closely on the tax credit programme for companies in the multimedia city,\(^{138}\) and establishes tax incentives for employment in the form of reimbursable tax credits granted on condition that the Quebec Ministry of Finance issues a visa.

283. For eligible companies, a reimbursable tax credit, equal to 25 per cent of the wages agreed and paid to eligible employees, will be available until 2010. There is, however, a ceiling of $10,000 per year and employee. Eligible companies must obtain a certificate of eligibility, for which they must be able to show that they have at least signed a lease for premises within Electronic Commerce City and at least 75 per cent of its activities are eligible.

284. The activities targeted by this measure fall into two categories. Firstly, there are advisory services associated with technology and electronic business solutions and activities relating to the

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\(^{138}\) Loi sur les impôts, L.R.Q., c. 1-3, art. 1029.8.36.0.3.28 and ff. And 1129.4.3.13 and ff.
development and integration of information systems and technological infrastructures. The second category consists of activities associated with the operation of electronic business solutions. It is not the advisory service that is specified here but the performance of the activity itself, such as, for example, the maintenance or management of systems or applications. Activities associated with "equipment," such as maintenance, manufacture or assembly of installations, are excluded.

285. From an international taxation standpoint, this measure is not intended merely to simplify the problems of multiple taxation which can result from e-commerce activities, as we have seen. The idea might have been to establish a tax-free zone such as that established for international financial centres, but it seems that the Government has taken a different view. It remains to be seen whether the evolution or divergence of discussions on the adoption of joint international tax measures on the taxation of electronic commerce will favour the adoption of incentive or compensatory tax measures with respect to the multiple taxation of income.

5. **Europe**

286. The Commission of the European Communities recently submitted a draft Council Directive amending the rules governing liability to Value Added Tax (VAT). At present, if a service provider is situated outside the European Union (EU), its services rendered inside the EU do not incur VAT. This naturally creates a competitive advantage for providers abroad, since the same service would be liable for VAT if provided by a business inside the EU. The proposals put forward therefore seek to remedy these distortions and to establish a simplified system for administering VAT. There are two sets of measures, depending on their purpose.

287. Measures concerning the rules governing liability:

288. In accordance with the guiding principles adopted by the Council, deliveries of digital products are deemed to be services for the purposes of VAT and services consumed on EU territory are thus liable to VAT. The rules proposed can be summarized as follows:

a) Services provided by an operator established outside the EU to an EU client will be deemed to be rendered in the EU and will now be subject to VAT.

b) In the opposite case, when services are rendered by an EU operator to a foreign client, the place of taxation will be the client’s place of establishment.

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139 For a general presentation of what constitutes an international financial centre, see the text by Bernard Barsalo entitled *Congé fiscal accordé aux nouvelles sociétés*, in APFF, Colloque 68: Colloque 68 C Déductions, Crédits d’impôts et Aides Gouvernementales.


141 The ECOFIN Council, at its meeting of 6 July 1998 following the Ottawa Conference.
c) If an EU operator provides services to a person who is liable (one who is TPS/TVQ-registered), the place of provision and hence the rate of taxation will be determined by the place of establishment of the person liable.

d) If the same operator provides a service to a (non-registered) individual established in the EU, it is once again the place of establishment that determines the place of provision and the applicable rate.

289. Measures to facilitate administration:

a) Commercial clients are liable to VAT for services (taxable supplies) rendered to them. It will therefore be necessary to register only if the services are provided to private clients.

b) Small tradesmen: a threshold of 100,000 euros will be established for sales to individuals.

c) A single registration venue is provided for in the case of businesses that are not established in the EU. They will thereby be able to fulfill all their obligations through one tax authority and will thus be on an equal footing with EU operators.

d) Possibility of carrying out all VAT registration formalities and submitting declarations electronically.

e) Establishment of permanent mechanisms enabling operators to verify the status of their clients (EU establishment, registered for VAT).

290. Canadian businesses interested in trading electronically with the EU should note that they will have to register in the first member State in which they provide a service. It should be pointed out that it is then to their advantage to choose an EU member State which has a low VAT rate, because this will subsequently be in their favour in relation to their EU competitors.

291. This point was also raised by the European e-Business Tax Group\textsuperscript{142} in its preliminary comments on the draft Council Directive.\textsuperscript{143} While this measure provides an advantage to foreign businesses wishing to engage in e-commerce on EU territory, it will disadvantage European businesses.

\textsuperscript{142} Referred to below as "EeTG." This is a European discussion group made up of representatives of important players in electronic commerce. The firms represented are: ABB, ICL, KPN, Microsoft, Omnitel, Proctor & Gamble, Sony and TNT Post Group. PricewaterhouseCoopers is responsible for support and administration of the EeTG secretariat.

\textsuperscript{143} EeTG, Indirect tax treatment of electronic commerce: Preliminary comments on the European Commission\textsuperscript{=}draft Directive, 4 July 2000.
businesses already established in member States whose VAT rate is higher. Moreover, the proposed "small trader" threshold is higher than that for business established in the EU. EeTG therefore emphasizes here a potential distortion in competitiveness on the European market. In addition, EeTG suggests that the final Directive should be clearer as to the interpretation of "place where a service is consumed" and "residence," so as to ensure uniformity in their application by member States and thus to avoid cases of double taxation.

More generally, although these measures show a healthy desire to integrate VAT into the realities of e-commerce, they have certain weaknesses with respect to means of monitoring conformity. Knowing the anonymity of the Internet and the virtual impossibility of tracing the source of communications, we can guess the technological challenges that the solutions put forward by the Commission lay down. A suffix such as ".ca" does not in itself guarantee that the owner of that address is a Canadian resident, and it is even less of an indication of where that person is at the time when he or she decides to access online services or to order a digital product. As in many other cases, we see that the integration of the taxation of electronic commerce is as much a question of principle as one of technological feasibility. In the final analysis, the declared political will to arrive at a fiscally neutral solution requires that the usual rules governing liability should be applied in the context of e-commerce. As basic premises of these rules such as the client=s situs or nationality are virtually irrelevant governing liability may need to be adjusted to the new reality if they are not to fail. Moreover, if other jurisdictions react to the European proposal and oblige non-residents to register for the purposes of their consumption taxes, a heavy burden of compliance may well arise.

6. Other developments

Indian advance ruling: increase in source-based taxation?

In April 1999, the counterpart of Revenue Canada=s Department of Decisions, the Indian Authority for Advanced Ruling (AAR), published an advance ruling on tax which raises interesting problems for companies using the new technologies.

The facts considered in the advance ruling were as follows:

a) An Indian company, "IndiaCo," was providing technical services (data management, data analyses, etc.) to a group of companies, the ABC Group, which was carrying on a credit-card business in Asia, Europe and elsewhere.

b) A United States company, "UsCo," was operating a telecommunications processing system such as SABRE.

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145 Id. According to the authors, the advance ruling could also apply to a flight reservation system such as SABRE.
centre located in the United States. To this end, UsCo had super computers in the United States which were used by its clients for very high speed data storage and processing. UsCo's clients used the super computers to process certain payments. IndiaCo used UsCo's super computers to complete some of the data processing which it was carrying out. UsCo was also using super computers located in Hong Kong through a dedicated very high speed network. IndiaCo had access to this network also in order to obtain certain information and process data.

c) IndiaCo signed a contract with UsCo providing that it should pay for access to and use of the super computers and access to the network. That access enabled it to use certain software. The contract provided that the sum to be paid could, if appropriate, be reduced by the applicable withholding tax.

d) When a credit-card or traveler's cheque holder performed a transaction, it was transmitted to a computer in the country concerned. When the transaction took place in India, it was carried out by IndiaCo when the information had been channeled to it by modem or microwave. This information was then sent to UsCo and, once processed, sent back to IndiaCo by a satellite connection.

295. According to UsCo, the sums it received from IndiaCo were business profits and, for the purposes of the tax treaty between the United States and India, no withholding tax was payable. In addition, the sums in question could not be taxed in India because UsCo did not have any permanent establishment there; the processing activities were carried out by super computers in the United States and Hong Kong.

296. The Indian tax authority maintained that the sums paid by IndiaCo were royalties under the tax treaty between the United States and India, and consequently, a deduction at source was payable.

297. AAR upheld the position of its colleagues, stating that the characteristics which categorized a payment of royalties were:

a) The payment is made in consideration of the acquisition of a right;

b) The payment is made to the owner of that right;

c) The consideration payable is determined in terms of use.

298. In the case of the payments made to UsCo, AAR determined that, in view of the nature of the business and the type of service provided, especially the fact that the confidential nature of the information processed requires the use of UsCo's sophisticated software (inter alia, encryption), the payments in question were made "for granting the use of a secret design or model, plan or formula or process." AAR thus upheld its colleague's position and a withholding tax was payable under Indian law, as amended by the relevant tax treaty.
299. This advance ruling raises significant questions for electronic commerce. For example, where an Internet surfer pays a sum of money to play an interactive game with other surfers, the sum paid is for a single use of the game software. In this case, the question arises whether AAR reasoning can be applied to make the surfer’s payment for use liable to withholding tax under domestic laws. On this point, the Ministry of Revenue has dealt with a similar question in which it had to consider whether the charges for telephone or satellite access to a database situated in the United States were covered by the withholding tax provided for in subparagraph 212(1)(d) of the Act. The Ministry was unable, when asked for a technical interpretation, to adopt a final position.

300. Thus, depending on the nature of the business carried on over the Internet, withholding taxes could apply at source. For the recipient of the payments, it is possible that the sum withheld might not be recovered under a country’s current system for reimbursing foreign taxes.

7. Doernberg Study

301. The International Fiscal Association (IFA) recently published a detailed analysis of electronic commerce and international taxation. The Doernberg Study will no doubt be a reference tool for tax experts and tax administrations, since it considers the various alternatives available for taxing electronic commerce and sets out their advantages and disadvantages. The authors make no final recommendation in the study concerning the optimum method of taxing e-commerce. They do, however, highlight the fact that e-commerce considerably reduces physical presence in the source jurisdictions and could therefore cause a significant erosion of those countries’ tax bases. In an earlier work, Mr. Doernberg stated that the use of a standard rate of withholding tax for e-commerce activities would potentially be the only solution for taxing e-commerce. This approach is recommended for two reasons: it constitutes an acceptable solution for countries that are importers of technology and digital products, and difficult questions of income characterization are avoided. On this last point, Mr. Doernberg believes that income characterization as between products for sale, royalties, services, interest and dividends is not necessary provided that a mechanism for reimbursement of the withholding tax deducted is put in place by countries of residence.

302. The Doernberg approach is a revolution in the taxation principles of both domestic legislation and tax treaties. An extraordinary consensus among the various jurisdictions, as well as a mechanism for amending tax treaties in a timely and appropriate manner, would therefore be needed to implement such a proposal. In addition, the United States would probably oppose such a move. We find it difficult to imagine that such a consensus can be achieved.

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V. CONCLUSION

303. For an electronic business, tax matters are clearly highly complex. Moreover, the task is colossal in many respects, because tax administrations have to take account of a range of administration subjects (tracking and risk of non-disclosure), national and infra-national taxation concerns, transfer-price issues and, lastly, consumption taxes. In view of the expected current importance of the "new knowledge economy," several countries want to make sure that their decisions with respect to fiscal policy will not give rise to a competitive disadvantage for their businesses. Lastly, it may well be difficult to reach a consensus because the various countries might have irreconcilable concerns. For example, countries that are importers of the new technologies will prefer source-based taxation in order to maintain their tax assessment base (income tax, withholding tax and sales tax). For their part, countries that are exporters of the new technologies will find residence-based taxation more interesting. Lastly, any solution must be feasible and take account of the burden of conformity for businesses. It is hard to imagine that a business selling digital products on the Internet that has no presence in several jurisdictions would want to register for VAT in all those jurisdictions and pay its taxes there! So it is not surprising that OECD and its members have not succeeded in finding a consensus to reach a fair and feasible conclusion.

304. For the tax expert advising e-commerce, it is unlikely that any final positions will be taken by the tax authorities in the near future. He will therefore have to come to terms with the current tax laws, which do not contain any detailed consideration of the characteristics peculiar to e-commerce. In this context, of course, he will have to cope with a high level of uncertainty. This means that taxpayers face risks. Tax advisers who can avoid or lessen the risks and exploit structures optimised for their clients will give them a competitive advantage.

148 See paragraph 7.1.5 of the United States Treasury document, op. cit., footnote 2.