DOING BUSINESS ON THE INTERNET—THE TAXATION OF E-COMMERCE

When Canada's first *Income Tax Act* was drafted in the early part of the 20th century, nearly all businesses were run out of brick and mortar buildings that had street addresses. Nearly 100 years later, a lot has changed. Only the very smallest of businesses can operate today without at least a presence on the Internet, and for many, sales made through a company Web site comprise the largest part of their business activity. And for some, Internet-based sales are their entire business.

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Canada's tax system has, of course, had to keep pace with these changes, if for no other reason than the huge revenue loss which would have occurred if profits derived from Internet (or e-commerce) sales were not captured in the tax base. That said, however, in many ways the very same rules apply to e-commerce as apply to more traditional means of selling goods and services. There aren't, in fact, any special "rules", as such, which apply to the computation of income or profits realized from e-commerce — business income is business income, regardless of whether it arises from a paper invoice or an electronic funds transfer on the net. The changes to Canada's tax system required to encompass e-commerce have more to do with tracking e-commerce activities and capturing the information needed to ensure that income from those activities don't escape the Canada Revenue Agency's (CRA) tax net.

What is e-business?

The CRA, not surprisingly, has a very broad take on what constitutes e-business. For them, e-business is any commercial activity which is carried out over networks which link electronic devices (by which they mean, in almost all cases, computers). And, according to the CRA, while such activity includes commercial transactions conducted on the Internet, it's not limited to that. For the CRA's purposes, e-business would include commercial transactions conducted by telephone or fax, electronic banking and payment systems, trade in digitized goods and services, and electronic purchasing and restocking systems.

When am I carrying on e-business?

Interestingly, the same question that arises in the taxation of traditional brick and mortar businesses—that is, at what point a business is being carried on—is also a starting point in the tax rules applying to e-businesses.

Literally millions of taxpayers have sold goods or services on eBay, Craigslist, and Kijiji, but of course most of them would not be considered to be carrying on an e-business or earning business income. Whether it's through a storefront or online, an activity becomes a business and taxable business income arises where there is an intention to make a profit and there is a reasonable expectation that a profit can be realized, even if it isn't forthcoming in the early days of the business. Where an individual holds a garage sale each spring and fall, for instance, he or she wouldn't be considered to be in the business of selling second-hand goods. Where, however that same individual spent time and effort on an ongoing basis to acquire used goods and then held a garage sale each weekend to sell those goods at a profit, he or she would arguably be carrying on a business. The same logic applies to sales of goods (or services) done through the Internet. Where the Internet is used periodically to sell personal property, like used textbooks or furniture, or sports equipment that has been outgrown, there's no obligation to report the income from such transactions. Where, however, those periodic transactions become regular events structured to create a profit, things change. If the student who sold his used textbooks online offered to do the same each year for every student at his school and collected a percentage fee or charge for each completed online sale, then the profit created by those fees would arguably represent business income reportable on the annual tax return.

It's apparent that there isn't a single rule or test which can determine whether a business is being carried on, in part because the question of whether there exists a reasonable expectation of profit is something which can be determined only over a period of time—sometimes years. Similarly, the intention of the person carrying out the activity can be assessed only from the conduct of the person and the nature of the activity being carried out. There are no hard and fast rules simply because each situation is different. However, it's safe to say that if time and effort is being invested in a profit-making activity which is being carried out on a regular, ongoing basis, chances are that a business exists and the profits realized constitute business income for tax purposes.

How do I report income from an e-business?

There is no specific line on the annual income tax return for reporting of income from e-business activities. For tax purposes, business income is business income, from whatever source it arises, and total (or gross) business income from an unincorporated business is reported on line 162 of the T1 (individual) tax return. Taxpayers who report business income must also file a T2125, on which expenses

incurred in order to earn business income are listed and depreciation (or capital cost allowance, in tax terminology) claimed on business assets is calculated.

Once net business income from the e-business is calculated on Form T2125, that net figure is reported on line 135 of the return. There are no special rates provided for e-business income, and any income so earned is taxed at the same tax rates as would apply to the same amount of any other kind of business income.

What costs are deductible in the computation of e-business income?

Here again, the general rule which applies to more traditional businesses when it comes to determining deductible expenses also applies to e-businesses. The general rule is that businesses can deduct, in the computation of net business income, all reasonable expenses incurred in order to earn a profit. Form T2125 provides a listing of the more usual kinds of business expenses—advertising, employee salaries, utilities costs etc., but other costs not specifically enumerated on that form may also be deducted where it can be shown that those expenses were both incurred for the purpose of earning a profit and were reasonable.

Of course, some types of costs are more likely to be incurred by e-businesses than by more traditional businesses, and the tax treatment of those costs isn't always clear-cut.

Almost by definition, an e-business must have a computer, computer software, and a Web site. The good news for e-business owners is that the cost for the acquisition or development of each of these assets is deductible in the computation of income from the e-business. However, the applicable tax treatment can be very dependent on the facts of the particular taxpayer's situation.

Where an expenditure is deductible for tax purposes, it is either fully deductible in the year the expenditure is made, or must be deducted over a period of years, generally through the tax structure's capital cost allowance system—a concept more familiar to most as depreciation. Where the cost of an asset is not deductible as a current expense (that is, in the year in which it is incurred), then the asset is assigned to a particular capital cost allowance class, and the rules applied to that class determine what percentage of the cost is deductible in each taxation year.

Like any other asset, the cost of computers and computer software can either be deducted from current year income as a deductible expense, or written off (or depreciated) under the capital cost allowance system. Generally, software must be written off over a period of years where it is of an "enduring nature" which, in the CRA's view, means that its useful life is anticipated to be beyond one year. For instance, the cost of a tax preparation program which is capable only of preparing returns for the current year is likely to be fully deductible in the year in which it is acquired and used. On the other hand, computer software which is used to calculate amortization schedules for loans and is therefore not limited in its use to a particular year is more likely to be considered an asset which is of an "enduring nature", the cost of which is to be deducted under the capital cost allowance system.

Where the cost of computer software is depreciable, the rate at which its cost can be deducted depends on whether it can be considered systems software (like operating system software) or software other than systems software. Software other than systems software is included in Class 12 of the capital cost allowance system, and deductible at a rate of 100% per year, although that deduction is limited to 50% of the usual deduction in the year the software is bought. There are multiple possible classes into which systems software can be placed, depending on its purpose and when it was acquired, and the rate of depreciation will vary, depending on the class.

The tax treatment of the cost of developing a Web site is not currently addressed in either the income tax legislation or by CRA administrative policies. However, the CRA does consider that such expenditures can similarly be considered to be either a currently deductible expense or an asset which must be depreciated over a longer period. That determination is, in the CRA's view, a "question of fact", to which the principles outlined in the Agency's Interpretation Bulletin IT-128 (available at http://www.cra-arc.gc.ca/E/pub/tp/it128r/it128r-e.html) can be applied.

Where Web site development costs are determined to be of a capital nature, and therefore depreciable over a number of years, they may be classified as either "general purpose electronic data processing equipment" or as computer software. Once again, the period over which the related costs are depreciated will be determined by the capital cost allowance class into which they are placed.

Keeping e-commerce records

All businesses are required to keep records of their purchases and sales, and e-commerce businesses are not exempt. In fact, the taxpayer's obligations for maintenance and retention of records when carrying out business over the Internet are the same as for any other type of business operation.

The tax authorities do not prescribe any specific type of record-keeping system or software. Rather, the requirement is, for all businesses, to keep records sufficient to determine and verify the taxpayer's tax obligations. Such business records must be maintained for a period of six years after the end of the taxation year to which they relate, and they must be maintained within Canada, unless the CRA provides specific permission to maintain them elsewhere.

Some specific requirements are imposed by the CRA where records (whether of e-commerce or other types of transactions) are recorded and maintained on a computerized system. Those requirements are specified on the CRA Web site as follows:

- the computerized system must be capable of providing the correct information the taxpayer needs to calculate your tax obligations and entitlements;
- computerized records must be retained and easily converted into an electronically readable format and be made available on request to CRA officials;
- computerized records (electronic data files) must be kept even when hardcopy is available;
- if the systems are stored on a Web server outside of Canada the taxpayer is responsible for arranging for the records to be made available upon request;
- if a third party is used to run the taxpayer's e-commerce business, it is still the taxpayer's

responsibility to ensure that the electronic records are complete, are retained, are readable, and that they will be made available to CRA officials upon request;

- if records have been encrypted the taxpayer must ensure that they can be decrypted and produced in an accessible and electronically readable format; and

- if the computerized record keeping system is changed - either hardware or software—the taxpayer must maintain the capability to retrieve the data already stored on the former system and provide the data in a readable format to CRA officials, upon request.

GST/HST and e-commerce

The current state of federal and provincial sales taxes across the country is something of a patchwork. Five of the provinces—Nova Scotia, New Brunswick, Newfoundland and Labrador, Ontario, and Prince Edward Island—currently impose a combined federal-provincial harmonized sales tax (HST), albeit at varying rates. In four other provinces—Saskatchewan, Manitoba, Quebec and British Columbia, the provincial government levies a provincial sales tax (PST), generally only on the sale of goods, while the federal government collects its GST on sales of both goods and services. Finally, the province of Alberta has no provincial sales tax and only the federal GST is imposed on sales of goods or services in that province.

E-commerce transactions are subject to sales tax—whether PST, GST or HST – in the same manner as any other sales transaction. When it comes to sales tax, the question of where the place of supply is located is fundamental to determining whether a tax applies, and at what rate. Where a service is performed, in whole or in part, in Canada, GST or HST applies to that supply of a service, with the rate of tax depending on the province in which the supply is made. Conversely, of course, a supply of property or services made wholly outside Canada is generally not subject to either GST or HST. However, determining the place of supply for e-commerce transactions can be particularly difficult, especially when it comes to the supply of services, which don't involve a physical transfer of goods. As the CRA points out in its Technical Information Bulletin (B-090), "[e]lectronic commerce allows services to be provided remotely. A supplier can provide a service to a customer in Canada without physically being in Canada. For example, a supplier can have a technician perform work from outside Canada by electronically accessing a customer's computer located in Canada, rather than sending the technician to Canada. Work is being performed both at the location of the service provider, as well as the location of the customer's property that is the object of the service. It is therefore necessary to take into account the location of the customer's property when determining the place of performance".

The determination of whether a service is performed in Canada, in whole or in part, is a question of fact which must be determined in on a case-by-case basis. However, the CRA has formulated a series of criteria which, if satisfied, will indicate that the service is performed at least in part in Canada. Those criteria, as outlined in Technical Information Bulletin B-090, are as follows:

- the service requires a person to perform a task (i.e., the supplier acts through one or more of its employees), and the person performing or physically carrying out the task is situated in Canada at the time the activity is done;

- the service includes operations performed by a supplier's equipment (e.g., computer equipment), and the equipment is located in Canada;

- the supply involves doing something to or with a recipient's equipment by accessing it from a remote location, and the recipient's equipment is located in Canada (however, this does not apply to a service wholly performed outside Canada, where the results are subsequently delivered electronically to a recipient's computers in Canada, e.g., a programming service carried out at the supplier's location outside Canada and e-mailed to a recipient in Canada); or

- any activity related to the performance of the service is undertaken in Canada.

How does the CRA track e-commerce transactions?

Canada's tax system is, for the most part, a self-assessing system which relies heavily on the voluntary participation of taxpayers. Each year, taxpayers must take the initiative to compile the necessary information and file an annual tax return. However, in many cases, the CRA has at its disposal sources of information which enable it to verify (or dispute) the information contained on the taxpayer's return. Employers issue (and file with the CRA) T4 slips reporting income earned by their employees and banks and other financial institutions issue and file T5 slips outlining the amount of investment income earned by a taxpayer.

The information trail which enables the CRA to confirm information provided to it by taxpayers isn't as readily available in the case of e-commerce transactions. However, the CRA has found a way to obtain such information, and Canadian courts have repeatedly held that the CRA is acting within its authority in doing so.

Several years ago, the CRA requested that eBay Canada provide it with information about Canadians who qualified for eBay's "PowerSeller" program, indicating that they had reached a certain level of sales activity online. E-Bay refused to provide the information, but the CRA sought successfully, through the courts, to enforce its request. EBay was therefore compelled, in November 2008, to release account information for such persons, including full name, user id, mailing address, billing address, telephone number, fax number, and email address, together with merchandise sales information, including gross annual sales. In 2009, the CRA made another information request to eBay, seeking information on Canadian residents who had, in any of the three previous calendar years, sales of more than $20,000 and at least 24 sales transactions, or who had sales of more than $100,000 in any of those years, regardless of the number of transactions. Once again, eBay was required to disclose personal identifying information for such persons, together with information on the selling prices (high bids) of the items sold. And, in August 2010, a Canadian businessman who had bought and resold fur coats through eBay pled guilty to charges of tax evasion and was fined an amount equal to 100% of the federal tax evaded, in addition to being required to pay the outstanding taxes, plus interest and penalties. It is unlikely that this will be the only conviction arising from the CRA's e-commerce enforcement efforts.

Conclusion

Our tax system is and has always been obliged to be somewhat reactive – to adjust to and address the effects of new commercial and financial developments, whether those developments arise in the form of novel compensation structures for employees or the latest offshore tax planning strategy. In many ways, the advent of e-commerce is simply another development which the tax system and the tax authorities have had to adjust to. Two things are, however, certain. The volume of e-commerce can only continue to grow, and the tax authorities will continue (and probably increase their efforts) to ensure that the taxable income arising from the e-commerce economy does not escape the tax net. There's simply too much money (and too much potential for lost tax revenue) involved to do otherwise.