
APPENDIX 29 (CRA AND FINANCE ON

OECD VIEWS ON SOFTWARE AND OTHER "DIGITAL" PROPERTY)

Material:

Income Tax *Technical News*, No. 23, June 18, 2002 – Computer Software

Income Tax *Technical News*, No. 25, October 30, 2002 – E-Commerce

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In This Issue

List of "approved" entities for the purpose of scientific research and experimental development

Computer software

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Computer Software

In the Commentary on Article 12 of the OECD Model Tax Convention on Income and Capital (April 29, 2000 condensed version) concerning the taxation of royalties, at paragraph 27, Canada has an observation that states:

Canada does not adhere to paragraphs 14 through 14.3. In Canada, payments by a user of computer software pursuant to a contract that requires that the source code or program be kept confidential, are payments for the use of a secret formula or process and thus are royalties within the meaning of paragraph 2 of the article.

On March 28, 2002, the Department of Finance informed the OECD that Canada is removing this observation. Accordingly, as of March 28, 2002, for the purposes of Canada's Income Tax Conventions, subject to the exceptional cases described in paragraph 14.3 of the commentary on Article 12, the CCRA will no longer view such a payment as a payment for a "secret formula" and the CCRA will apply this interpretation for the Conventions in force as of March 28, 2002 and subsequent Conventions that come into force after that date.

However, the CCRA does view such a payment as a "royalty" where the definition of "royalty" in the particular Convention refers to "payments ... for the use of, or the right to use ... other intangible property". Also, the CCRA continues to be of the view that Part XIII tax applies to such a payment pursuant to paragraph 212(1)(*d*) of Canada's *Income Tax Act* because the payment is a "rent, royalty or similar payment, including, ..., any payment (i) for the use of or for the right to use in Canada any property ... or other thing whatever", unless the payment is in respect of what the CCRA refers to as "shrinkwrap" software or the exception in subparagraph 212(1)(*d*)(vi) applies.

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This issue contains issues of current interest that were discussed at a panel at the annual conference of the **Canadian Tax Foundation** on September 30, 2002, in Toronto by Roy Shultis, Deputy Assistant Commissioner, Income Tax Ruling Directorate, Policy and Legislation Branch, Mike Hiltz, Director, Reorganizations and Resources Division, Income Tax Rulings Directorate, Policy and Legislation Branch and Marc Vanasse, Director, Business and Partnerships Division, Income Tax Rulings Directorate, Policy and Legislation Branch, Canada Customs and Revenue Agency.

E-Commerce

In 1998, the Minister of National Revenue, in response to a report "*Electronic Commerce and Canada's Tax Administration*" prepared by the Minister's Advisory Committee on Electronic Commerce, established a framework for the study of electronic commerce.

The CCRA's study dealt with the effect of E-Commerce on all aspects of Canada's tax administration: goods and services tax, customs duties and tariffs and income tax. The income tax matters included compliance and collection concerns as well as interpretive issues. The latter issues related to non-residents carrying on business in Canada, residents carrying on business abroad, transfer pricing and the characterization of electronic transactions for withholding tax and treaty purposes. The income tax interpretive study benefited from the advice of a group of eminent Canadian income tax specialists and took into account the continuing work of the Organization for Economic Co-operation and Development (OECD) with respect to electronic commerce and permanent establishments, attribution of income to permanent establishments and characterization of payments made in an E-Commerce context.

The study considered the circumstances under which a non-resident who transacts with Canadians through a Web site may be considered to be carrying on business in Canada. The factors relating to this determination will be relevant not only to non-residents carrying on business in Canada but also to foreign affiliates of Canadian residents and residents of Canada carrying on business in other countries.

It was concluded that, in some circumstances, a Web site located on a server situated in Canada can constitute a permanent establishment of a non-resident. This conclusion is consistent with the recent amendments to Article 5 of the OECD Model Convention.

The attribution of income or loss to a permanent establishment in an E-Commerce context raises difficult issues. There is no consensus among the member countries of the OECD concerning the application of Article 7 to traditional forms of commerce. The current CCRA interpretation of Article 7 of the Model Convention does not always produce a result that is consistent with the arm's length principle as developed in the Transfer Pricing Guidelines. The working hypothesis developed by the OECD to apply the Transfer Pricing Guidelines by analogy to permanent establishments is under discussion at the OECD. Given this uncertainty on this difficult issue, the CCRA will continue its current interpretation of Article 7 and will apply its interpretation in the E-Commerce environment.

The characterization of E-Commerce payments is difficult because the distinction between the different "things" that may be purchased will be elusive in many situations. The general principles of characterization set out in the *Report to Working Party No. 1* of the OECD Committee on Fiscal Affairs are instructive and will be of benefit to the CCRA in the determination of the character of payments.

The most important aspect of the E-Commerce study concerns the purchase or licensing of digital products. The CCRA is of the opinion that the existing Canadian jurisprudence can be applied to the purchase or licensing of digital products. In the case of the purchase of a digital product, the CCRA considers that the customer makes the payment to acquire the ownership of data transmitted in the form of a digital signal. Any use of copyright involved in downloading the product is not an important part of the total consideration paid by the purchaser. For this reason, the payment for the product would not be considered a royalty as defined in Article 12 of Canada's treaties that follow the OECD Model Convention.

Similarly, a payment for the use of, or right to use, a digital property would not be for the use of copyright and would not be a royalty for the purposes of Article 12. Until recently, the CCRA considered a payment for the use of, or right to use, custom computer software to be a payment for a secret formula and within the definition of royalty in Article 12. Canada had an observation on this point in respect of Article 12 of the OECD Model Convention. The Department of Finance withdrew the observation on March 28, 2002. As a result, such a payment would now be considered to be within Article 7 of Canada's treaties that follow the OECD Model Convention.

It is important to appreciate that this conclusion would not apply to those of Canada's treaties that include in Article 12 a reference to a payment for the use of or right to use intangible property. In such cases, the payment for the use of or right to use a digital property would be a payment for the use of intangible property and therefore a royalty.

In summary, the CCRA should, in general, be able to apply the same principles of taxation to E-Commerce transactions that it has applied to conventional commerce. The CCRA's view of the law is generally consistent with the view of the OECD as expressed in the amended Commentary to the OECD Model Convention and the *Report to Working Party No. 1* referred to above.

Finally, the CCRA welcomes any queries you may have with respect to any interpretive aspect of E-Commerce. The CCRA is prepared to deal with them as interpretations or rulings, in the case of proposed transactions. In short order, the CCRA will include the results of its study in an Interpretation Bulletin.