Tax? What Tax?

An update on how tax authorities are catching up to the online frontier

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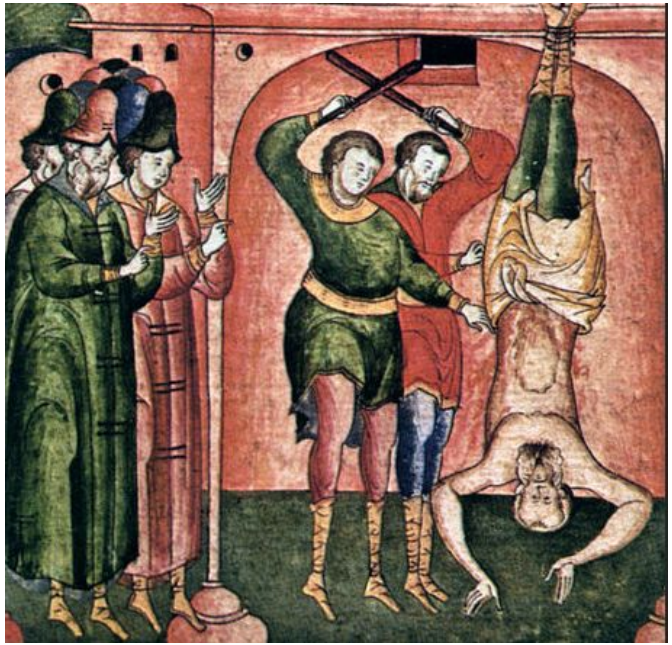
Panama

It's worth a moment before I launch into software licensing matters to reflect on the issue that haunts my entire field.

The so-called "Panama Papers" are a wake-up call to an entire industry that the long-cherished assumptions of confidentiality, security, privacy are no longer to be assumed.

Increasingly, what you do can be found out.

Panama and Tax



This isn't the only reason that tax compliance is the growing field–the behaviour of tax authorities and of governments generally also ensures it.

Governments face intransigence over tax rates but a need for greater tax funds.

For these reasons, increased *enforcement* is the preferred means. $444M for enforcement means "the beatings will continue until revenue improves".

The need to be audit-proof has never been greater.

Software Licences and the Three Rules

And so from the dizzying future to the mundane present: your software license.

There are three rules of the taxation of software licences that govern everything a taxation professional is going to tell you about how this stuff works.

The first thing is that everything has a different taxation regime, especially when you add the income and commodity tax sides together.

The second thing is that even a single payment can be made across many different tax regimes.

The third is that no one can tell you a simple answer. They don't exist. Which leads to the One Big Rule:

THREE RULES OF THE TAXATION OF SOFTWARE LICENCES:

1. Every single thing you pay for separately is probably going to be taxed differently.
2. Every single thing you pay for in a bundle is possibly going to be taxed differently.
3. Nobody knows anything.

THE ONE BIG RULE OF SOFTWARE TAXATION

Nobody Knows How Their Product Is Taxed.

That's it; that's the rule. Ask a vendor about tax and you'll get one of two responses: the first is ten seconds of uncomfortable silence, followed by a confident declaration that none of this is taxable.

The second is a one-second pause, followed by a confident declaration that none of this is taxable.

If you're stuck between vendors who are otherwise identical, go with the first one–they have, at least, discovered the concept of shame.

I don't even necessarily want to say they are wrong. It depends.

Indemnities

I could write or speak at length about the risks of relying on an indemnity, but there is no doubt they are a powerful tool.

Key to the tax indemnity is the reality of audit risk: real risks survive your agreement (and indeed your counterparty) for a very long time. These are not a substitute for tax compliance.

Make sure the indemnity tracks the best ability to measure the risk and assess the compliance, where possible. That's usually the jurisdiction that would impose the particular tax, or the recipient of the funds.

Tax Buckets

Traditionally, I think of there being three “buckets” of tax I need to worry about in analyzing a license: income tax, commodity tax, and withholding taxes (which are really a class of income tax).

Each bucket is a concern in each country the licensor is operating from, and is a concern in each country the licensee is operating in.

Each can also be a concern for any party to the agreement.

Henceforth, I am only dealing with Canadian buckets BUT don’t ignore the foreign ones. The “unknown unknowns” are what get you in the end, and what I’ve said above about enforcement is not unique to Canada; far from it.

Tax authorities love non-residents. Or rather, they love their money.

Is it a license?

All of these issues are complicated by the issue of whether what you're paying for is truly a license.

"Software as a Service" is an example of this; indeed, anything provider-hosted raises the issue of whether you are licensing. The traditional software model is of a copyright license. SaaS means you are not copying.

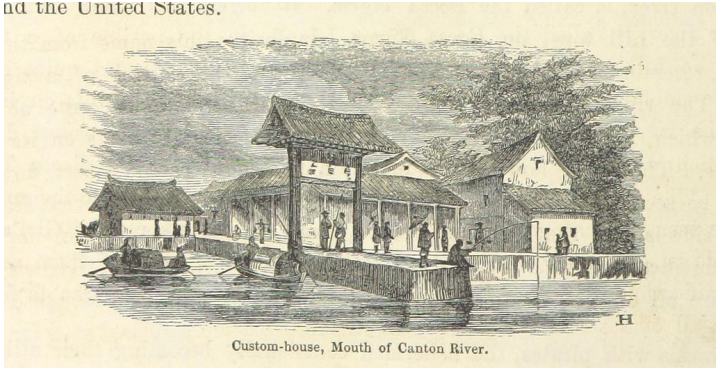
It's right in the name of the concept: your contract is for services, not for license.

Withholding taxes

The first place the "license characterization" comes up is in crossborder withholding taxes.

CRA's view is that payment to a non-resident of Canada for a "software license agreement" generally is encompassed under paragraph 212(1)(d)–a royalty subject to withholding tax–but is saved by 212(1)(d)(vi) because it is in respect of the copyright of a literary work.

However, CRA considers payments to non-residents to access digital property (the particular example was an online trading platform with a bundled access fee) not to be royalties at all. The fee was called a "Licence Fee" but CRA considers such fees generally as simply "business profits" for treaty purposes.



CRA's position on software license as copyright is contained in Tech Interpretation 2012-0441091E5

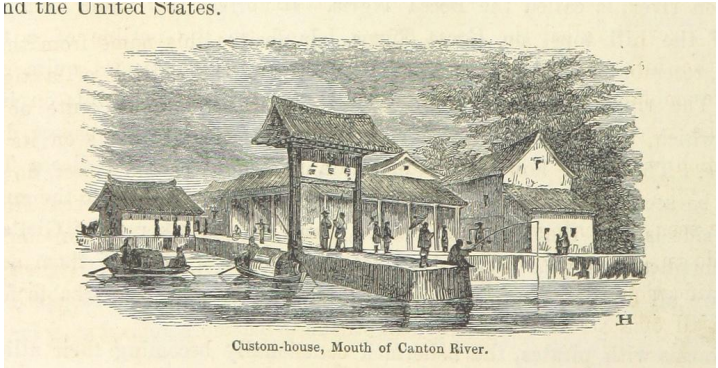
CRA's position on the right to access or use digital property is in Tech Interpretation 2011-0422781E5

Withholding taxes - cont.

CRA further considered that payment to be "[for] the provision of digital services supplied by the non-resident vendor".

This raises the second great withholding tax aspect of software licensing: Regulation 105, which imposes a 15% withholding tax on payments (a "fee, commission or other amount"–the Tax Court has said this does not cover expense reimbursement) to non-residents in respect of services "rendered in Canada". Note that the services can be provided by anyone.

When CRA provide interpretations on software matters, bundled services are often flagged as an issue and the Regulation 105 issue discussed explicitly.



Waivers can be obtained from CRA to Regulation 105 withholding tax (usually based on the business profits section of a treaty) or the tax can potentially be refunded through filing a Canadian tax return by the service provider. Obviously, this is a compliance burden.

Commodity Taxes

If you are acting for a Canadian vendor selling software overseas, you're in luck; exports of such software to *non-registrants* (yes, that concept again) are almost always zero-rated. The large number of exceptions are scary though and need to be considered each time.

While income tax issues present themselves most starkly in the form of withholding taxes, when payments (and indeed the software) crosses borders: commodity tax issues present themselves most starkly when both licensor and licensee are resident in Canada–or both are subject to a Canadian commodity tax regime.

The importer of software usually does not face a GST or HST problem in Ontario. However, in each circumstance, care must be taken to ensure the non-resident supplier is NOT a registrant for GST/HST purposes. Non-residents doing business in Canada may have registered or may have to.

I am not going to discuss the "place of supply" rules here but know that which province's sales tax or HST regime applies can be very difficult to ascertain.

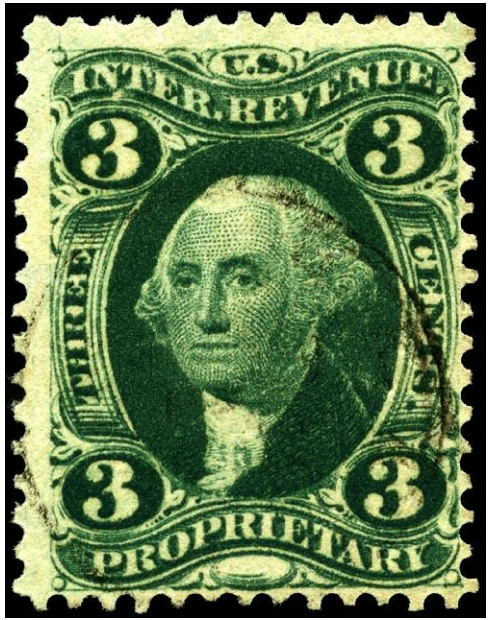
Commodity Taxes - cont.

Under a software license you may find yourself, as a Canadian purchaser, importing intangible personal property or importing services.

If the vendor is a GST/HST registrant, you are going to be stuck with the regular GST/HST treatment that would apply to the purchase from a Canadian. However, in most cases you'll buy from a non-registrant: that means if you are buying these for at least 90% use in your own commercial activities (note that "commercial activity" is a technical term of art in the HST world) then you do not need to self-report or self-assess that HST.

You may also find yourself buying these intangible personal property, or services, from another HST province. Guess what? This is a further self-assessment issue--you may be required to self-assess further tax. This is where tax advisors need to be sought.

Commodity Taxes - Overseas



Finally, a few words of warning are appropriate about the purchase and sale of software, services, or other intangibles overseas.

Very often, activity that you would least expect, has a commodity or sales tax impact on the jurisdiction that you are buying or selling with. It can't be helped, and indeed it can barely be managed. And it isn't always possible to get cost-effective advice about local commodity tax impacts. You may be put on the hook as purchaser, you may be put on the hook as vendor. Even U.S. states, which we think of as having tax systems not too foreign to our own, have bizarre rules about when you are doing business and required to collect state sales tax.

The best typical advice is to deal with these uncertainties through indemnity, tax-inclusive pricing, or other mechanisms.

Thank You

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