

Intelligence MEMOS



From: Jon Johnson
To: Global Affairs Canada
Date: January 24, 2022
Re: **DIGITAL TAXES – A USTR SHOT ACROSS CANADA’S BOW**

In its fall fiscal update, the federal government confirmed its intention to proceed with the implementation of a 3-percent tax on revenue from certain digital services that it first announced in Budget 2021, and was discussed [here](#).

The tax will apply as of January 1, 2024 (rather than on January 1, 2022, as initially announced) on revenue earned since January 1, 2022.

But this all goes into effect only if the internationally agreed Two-Pillar plan for international tax reform has not come into force by the end of next year. Pillar One requires that large companies (more than €20 billion in revenues and a profit margin of more than 10 percent) pay tax on a portion of their profits in jurisdictions where they have sales (regardless of whether they have a physical presence there). Pillar 2 provides for a global minimum tax.

The two-pillar plan imposes a standstill on digital services taxes (DSTs) and similar measures until the earlier of December 31, 2023 (the day before the effective date for the 3-percent tax in the Update) and the coming into effect of a new multilateral convention.

In a letter dated December 22, 14 Republican US senators expressed various concerns and asserted that implementation of Pillar One must be through the formal US treaty ratification process that requires two-thirds Senate approval rather than by the simpler process of a congressional-executive agreement. The senators’ position, if correct, diminishes the likelihood that the international tax reform plan – endorsed by the 137 members of the OECD/G20 Inclusive Framework – will become effective before December 31, 2023.

And just a week earlier, in a shot across Canada’s bow, USTR Spokesperson Adam Hodge, [warned](#) against any unilateral Canadian DST. The US “continues to strongly oppose any new DSTs adopted by our trading partners,” Hodge said, citing the DST standstill and concluded: “If Canada adopts a DST, USTR would examine all options, including under our trade agreements and domestic statutes.”

The US has used Section 301 of the Trade Act of 1974 to challenge DST regimes implemented by other countries (Austria, Spain, the UK, India, Italy, Turkey, Brazil, and Indonesia). So long as the standstill is in effect, the US will have achieved its objective of the removal of DSTs by trading partners. However, if the standstill ends without a new multilateral convention or other international understanding respecting DSTs, the US may resort to Section 301, a process that is unilateral, not internationally sanctioned, and open to retaliation.

The US could challenge a Canadian DST as breaching CUSMA Article 19.3(1) that prohibits “customs duties, fees or other charges on or in connection with the importation or exportation of digital products” under the procedures in CUSMA Chapter 31, to which Canada as a CUSMA party has agreed.

Canada may be able to rely on Article 19.3(2) that says: “For greater certainty, paragraph 1 does not preclude a Party from imposing internal taxes, fees, or other charges on a digital product transmitted electronically, provided that those taxes, fees, or charges are imposed in a manner consistent with this Agreement.” The main objective of this provision seems to be to permit internal taxes such as GST/HST on digital products. However, the “imposed in a manner consistent with this agreement” caveat is vague and could be capable of a broad interpretation.

CUSMA Chapter 31 sets out a dispute settlement process that ends with a panel report. If the panel finds a breach of a CUSMA provision by Canada, and Canada does not comply (such as by repealing the measure), CUSMA Article 31.19 permits the US to suspend benefits, provided that certain requirements are satisfied. If the US wins a CUSMA Chapter 31 proceeding and complies with the CUSMA Chapter 31 requirements for suspending benefits, Canada will have nothing to complain about if the US suspends CUSMA benefits, and will have no basis for implementing countermeasures.

(Separately, the effectiveness of the CUSMA dispute settlement process is about to be tested with the recent release of the CUSMA panel report in *Canada – Dairy TRQ Allocation Measures*.)

Matters need not come to this. The DST standstill date of December 31, 2023, could be extended if resolution of outstanding issues seems reasonably certain.

However, proceeding unilaterally with a DST as Ottawa proposes invites a challenge by the US under CUSMA Article 31 that could be successful.

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