Intelligence MEMOS

From: Jon Johnson

To: Finance Minister Chrystia Freeland

Date: August 31, 2023

Re: **Canada Goes it Alone on a Digital Services Tax. Issues Loom**

The federal government is pushing ahead with a digital services tax (DST) despite agreement among 138 of 143 members of the OECD/G20 Inclusive Framework on Base Erosion and Profit-Shifting (BEPS) – including every non-Canadian OECD member – that such taxes be postponed until December 31, 2024, conditional on sufficient progress of the BEPS initiative.

The federal government's proposal for a 3-percent tax on digital service revenue above certain thresholds was originally set out in a **notice** of Ways and Means Motion in December 2021. On August 4, the government replaced this with a **draft** *Digital Services Tax Act* along with explanatory **notes** and related regulations. Its **consultation period** ends next week.

The US – home to most of the world's tech behemoths – has consistently objected to the introduction of DSTs by other countries. Indeed, it has **negotiated** with a number of countries that introduced one, such as the UK, France and other major EU economies, a credit for DSTs collected so far, against taxes collected under a future BEPS agreement, in exchange for the US dropping duties it had threatened in retaliation, following a so-called Section 301 investigation.

However, because Canada is a party to CUSMA, the US may have a stronger case for directly challenging a Canadian DST because CUSMA Chapter 19 sets out obligations specifically directed at taxes imposed on digital products.

It defines a "digital product" as "a computer program, text, video, image, sound recording, or other product that is digitally encoded, produced for commercial sale or distribution, and that can be transmitted electronically."

CUSMA Article 19.3(1) prohibits the imposition of "customs duties, fees, or other charges on the importation or exportation of digital products transmitted electronically." The tax imposed by the draft *Digital Services Tax Act* will apply to "Canadian online marketplace services revenue," "Canadian online advertising services revenue," "Canadian social media services revenue" and Canadian user data revenue." Any of these (all defined in the draft legislation) that include "digital products transmitted electronically" that are imported or exported would be prohibited by CUSMA Article 19.3(1).

At the same time, however, CUSMA Article 19.3(2) provides that Article 19.3(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" (i.e., CUSMA).

If the *Digital Services Tax Act* becomes law and Canada begins imposing a DST, the US may invoke the dispute settlement procedures in CUSMA Chapter 31 on the basis that the DST is inconsistent with Article 19.3(1).

Canada will argue that its DST is covered by Article 19.3(2) because it is not discriminatory and applies to Canadian generated digital services as well as digital services provided by suppliers based in other countries. The US will likely point to the high thresholds in the *Digital Services Tax Act*, namely that the tax will only apply to businesses with global annual revenues of €750 million more and with Canadian digital services revenue of more than C$20 million.

If no Canadian business providing digital services exceeds these thresholds, and, more particularly, if the only businesses providing digital services that meet these thresholds are US businesses, the US will have a compelling argument that Canada's DST is *de facto* discriminatory, is not covered by Article 19.3(2), and violates Article 19.3(1). If there is at least one Canadian company providing digital services that meets these thresholds, the *de facto* argument will not apply.

There is also the complication that Article 19.3(2) is subject to the caveat: "provided that those taxes, fees, or charges are imposed in a manner consistent with this agreement." The US may argue that Canada's DST is inconsistent "with this agreement" because of the prohibition in Article 19.3(1). Canada's response to this could be that such a finding would lead to a result "which is manifestly absurd or unreasonable," contrary to Article 32 of the *Vienna Convention on the Law of Treaties*, by rendering Article 19.3(2) meaningless.

If the panel finds for the US, Canada may have no choice but to repeal its DST or face US retaliation. If the panel finds in Canada's favour, Canada may continue to apply its DST.

However, such CUSMA proceedings are unlikely to be the end of the matter. The US would retain the option of initiating action against Canada under Section 301 of its Trade Act, as it did against other countries, among other reasons for unfairly penalizing US companies, and imposing the tax retroactively (as Canada proposes to do). Even if Canada wins its case under CUSMA, it should consider the effects of swimming against the OECD tide on this matter.

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