Canada’s Discriminatory & Burdensome Digital Services Tax Proposal Harms U.S. Exporters

Canada is now finalizing legislation for a Digital Services Tax (“DST”) that will disproportionately impact and significantly burden U.S. companies, to a tune of up to $1 billion CAD annually. Like highly similar schemes in the EU, Canadian policymakers have explicitly targeted U.S. firms, and by design sought to shield local Canadian competitors. Incremental adjustments or modifications to certain of these elements would not remedy the harm or discriminatory or burdensome impacts of the proposed DST. A Section 301 investigation, leading either to direct remedies or dispute settlement under USMCA, is the appropriate mechanism to enforce U.S. trade laws and hold Canada accountable for trade commitments.

Background on Digital Services Taxes

U.S. digital product and services suppliers are among the most competitive businesses in the global digital trade sector. These firms provide customers access to a vast array of goods and services, provide a platform for small and medium-size enterprises to compete against larger companies and expand to foreign markets, and enable communications, data transfer, and data storage globally. Their services underpin the U.S. economy in many ways and act as an accelerant for U.S. workers, manufacturers, and service providers.

In response to this success, many jurisdictions outside the United States have pursued DST schemes specifically designed to target these U.S. companies while minimizing financial or regulatory burdens on non-U.S. competitors. Foreign officials have been unambiguous about targeting U.S. digital technology companies and structured the tax regimes to have a disproportionate impact on them, through use of arbitrary thresholds, and the exclusion of competing services supplied non-digitally. Canada is the latest country to approve a DST and seek to obtain additional tax revenue from U.S. technology companies through the Digital Services Tax Act, incorporated into a broader budget bill, C-59.

The U.S. Government Should Utilize the Tools At Its Disposal to Address the DST’s Harms

The Office of the U.S. Trade Representative (“USTR”) has investigated many foreign DST regimes and found that they discriminated against U.S. companies, were otherwise unreasonable or burdensome, and actionable under Section 301 of the Trade Act of 1974 (“Section 301”). These investigations included investigations and tariffs—eventually suspended after agreements were reached—with countries including France, the United Kingdom, and Turkey. The tariffs were ultimately paused as part of global tax negotiations at the Organisation for Economic Cooperation and Development. These negotiations resulted in 138 countries agreeing to suspend DSTs pending implementation of any final agreement.
Canada’s DST proposal warrants investigation and action under Section 301 to determine whether the DTSA violates any trade agreement commitments by Canada and is otherwise discriminatory, unreasonable, or burdensome toward U.S. commerce. A Section 301 investigation will allow USTR to assess the extent to which Canada’s DST proposal violates Canada’s obligations under the United States-Mexico-Canada Agreement (“USMCA”). As explained below, Chapters 14, 15, and 19 of the USMCA prohibit Canada from discriminating with respect to cross-border trade in services, investment, and digital trade. A Section 301 investigation will also allow USTR to examine the discriminatory, unreasonable, and burdensome aspects of the DST proposal with respect to U.S. companies.

The Details Behind Canada’s Digital Services Taxes

- **Covered services.** The definitions exclude Canadian competitors that provide like services through non-digital means. The proposed DST applies to revenues derived from:
  1. Online marketplace services,
  2. Online advertising,
  3. Social media services, and
  4. User data, sectors where U.S. companies are very competitive relative to Canadian and other non-U.S. companies.

- **Monetary thresholds.** Canada’s proposed DST applies only to entities that earn:
  1. Annual revenues of €750 million globally and
  2. C$20 million in “Canadian digital services revenue,” which primarily captures U.S. companies while carving out Canadian competitors.

- **Application to gross revenues.** Canada’s proposed DST applies to gross revenues of the targeted U.S. companies rather than income or profits. This is inconsistent with internationally accepted tax principles, including because this approach does not account for costs. Thus, the proposed DST can cause U.S. companies to incur tax liability—even if they are not profitable—and, in some cases, to be subject to double taxation on any income.

- **Calculation of tax.** Revenues are deemed Canadian-sourced based on a vague “reasonableness” test. That is, if it is reasonable to conclude that the user of a covered digital service is in Canada—based on data available to the taxpayer—the revenue derived from those transactions are considered Canadian digital services revenue. Also, each covered service sector has specific revenue calculation methodology.

- **Reliance on user location data.** To determine revenue subject to the tax, the proposed DST introduces a novel requirement for companies to collect and track user location rather than rely on the company’s location. This makes the DST very difficult to calculate and administer for U.S. companies subject to the tax, including because users often use virtual private networks to mask their location or indicate an inaccurate physical location.
• **Retroactive payment.** Tax liability under the proposed DST would be payable with respect to revenues retroactively to January 1, 2022, contrary to generally accepted tax principles. This requirement is unusually burdensome for affected companies (primarily American) that will now be required to implement new reporting and accounting systems to determine tax liability, including with respect to periods where such systems were not in place.

• **Application to entities with no nexus to Canada.** The proposed DST provides that entities part of a consolidated group may be held jointly and severally liable for the tax obligations of the other entities in the group, even if such an entity has no presence or activity in Canada.