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New Digital Services Tax Act raises trade retaliation risk for Canadian exporters

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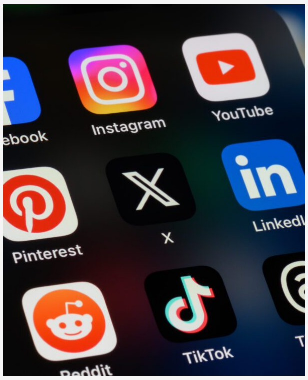

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On June 28, 2024, Canada's *Digital Services Tax Act* (the Act), introduced as part of Bill C-59, came into force. As discussed in this Update, the Act poses risks for Canadian exporters as it may prompt retaliatory tariffs or other actions by the United States.

Background

The Act and its regulations impose a 3% tax on "digital services revenue", which includes Canadian revenue earned from

i. online marketplace services (revenue earned in online marketplaces connecting buyers and sellers of goods)
ii. online advertising services (revenue earned from services aimed at the placing of online targeted ads)
iii. social media services (revenue earned by providing a social media platform that facilitates user interactions)
iv. user data (revenue earned through the sale or licensing of data gathered from online users)

While the Act sets out the legislative framework, its operation and technical details are largely implemented through regulation. In particular, and in addition to setting the taxable rate at 3%, the *Digital Services Tax Regulations* prescribe that the Act applies to any entity engaging in "digital services" with global revenue in its last fiscal year of at least €750 million, and more than C$20 million of Canadian digital services revenue. The DST is effectively retroactive: the first year of application is 2024, but the first payment will be for revenue earned from January 1, 2022, to the end of 2024.

For further details about the Act's technical operation, see Osler's prior Updates on December 21, 2021 (first draft of the Act), August 10, 2023 (revised draft), December 4, 2023 (final version in Bill C-59, as enacted on June 20, 2024), and July 4, 2024 (the Act in force and effect).

The government's decision to leave the operative provisions of the digital services tax (DST) regime largely to regulation suggests that it anticipates international pressure to amend those provisions, which generally can be done more quickly though regulatory instruments than statutory ones.

International context for digital services taxes

Canada is not the first country to implement tax measures aimed at digital services provided by multinational "tech giants". Currently, France, the U.K., Italy, Spain, Austria, Australia and certain other member states of the Organisation for Economic Co-operation and Development (OECD) have enacted similar legislation. Such DSTs have arisen against the backdrop of negotiations among members of the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (Inclusive Framework), aimed at addressing the tax challenges arising from the digitalization of the economy. The Inclusive Framework contemplates a two-pillar solution, with Pillar One focusing on providing market jurisdictions with new taxing rights over the largest multinational groups and Pillar Two introducing a global minimum tax for groups with revenues of at least €750 million. Canada has implemented Pillar Two through the *Global Minimum Tax Act*.[1]

The Canadian DST's thresholds most closely resemble France's DST, which was enacted in 2019. Like Canada's regime, the French DST levied a 3% tax rate on companies with global revenues of at least €750 million, French revenues of at least €25 million, and whose gross income from digital services is derived from "user participation".

The French DST attracted significant opposition from the United States. In July 2020, following a report from the Office of the US Trade Representative (USTR) finding that the French DST unreasonably discriminated against U.S. companies like Apple, Amazon, Google and Facebook, the U.S. announced that it would impose a 25% retaliatory Section 301 tariff on $1.3 billion in French goods including cosmetics, luxury handbags and assorted soaps — goods that made up approximately 2.3% of France's exports to the U.S. in 2019. The July 2020 announcement suspended application of the Section 301 tariffs until January 2021.

In January 2021, the U.S. extended its suspension of its Section 301 tariff against France and subsequently entered into an agreement — the Unilateral Measures Compromise — with France, Spain, Austria, Italy, the U.K. and later Türkiye. Parties to that agreement can maintain their existing digital services taxes without facing U.S. retaliatory trade actions until the earlier of the implementation of the Inclusive Framework's Pillar One and June 30, 2024.

The Government of Canada has argued that a lack of progress in the OECD's Inclusive Framework negotiations warrants its unilateral DST. While the OECD had extended its deadline to reach an agreement on the Inclusive Framework's Pillar One to June 30, 2024, no deal was reached by that date.

Potential U.S. response to Canada's Act

Similar to the USTR's earlier finding that the French DST unreasonably discriminates against U.S. digital service suppliers, the U.S. has already voiced opposition to Canada's DST. For example, the USTR has consistently voiced its opposition to Canada's implementation of a DST since at least 2021.[2] On June 20, 2024, the U.S. Chamber of Commerce (USCoC) "strongly object[ed] to the Parliament of Canada's Adoption of [the Act]" and claimed that the Act would disproportionately harm U.S. tech companies. This followed a statement on June 10, 2024, by the U.S.' Computer and Communications Industry Association, asking President Biden's administration to initiate formal consultation procedures under the Canada–U.S.–Mexico Free Trade Agreement (CUSMA) given that "key features of Canada's DST are parallel [to] those found to be unreasonable, burdensome and discriminatory in [the

Office of the US Trade Representative]'s investigation of France's and other countries' analogous DSTs".

Most recently, on July 11, 2024, the Republicans on the House Ways and Means Committee wrote a letter to the USTR requesting to "immediately initiate an investigation of Canada's [digital services taxes] under Section 301 of the Trade Act of 1974".

Should it choose to do so, the U.S. could challenge Canada's DST under CUSMA's services and digital trade chapters, or at the World Trade Organization under the General Agreement on Trade in Services. The U.S. could also disregard the dispute settlement mechanisms in those agreements and instead impose retaliatory Section 301 tariffs on politically sensitive and substitutable Canadian exports, as it did with France. These retaliatory tariffs would likely be contrary to the U.S.' treaty obligations, and Canada could challenge them including under CUSMA, but in the meantime, the tariffs could be highly disruptive to the targeted sectors. Canada might also respond in kind, as it did when the Trump Administration unilaterally imposed tariffs on Canadian steel and aluminum, further disrupting cross-border trade.

Conclusion

Given the U.S.' reaction to similar DST regimes around the world, ongoing opposition and commentary by U.S. private and state actors, and other efforts to eliminate similar measures globally, Canada's adoption of its DST regime risks provoking trade retaliation by its most important trading partner.

Osler's International Trade group is closely watching this matter and assessing how it may affect businesses engaged in cross-border trade. If you have any questions, do not hesitate to reach out to one of our team members.

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[1] For further information about the Inclusive Framework, see Osler's October 12, 2021 Update. For further information about the *Global Minimum Tax Act*, see Osler's May 2, 2024 Update.

[2] See for example, the USTR's statements on December 15, 2021, and February 22, 2022.