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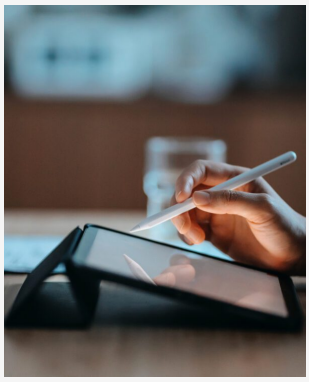
Federal government releases draft digital services tax legislation

DECEMBER 21, 2021 8 MIN READ



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In this update:

- Draft legislation for the proposed digital services tax (DST) was released on December 14, 2021
- The DST is not expected to apply if a multilateral Pillar One agreement is reached by the end of 2023
- The DST will be a 3% tax on Canadian-source revenue relating to digital services in excess of $20 million earned by an individual entity or consolidated group with at least €750 million in global revenue
- Any taxpayer that has Canadian digital services revenue in a calendar year and meets or is part of consolidated group that in that year or any prior calendar year as of 2022 (i) meets the €750-million global revenue requirement and (ii) earns at least $10 million of Canadian digital services revenue will have to register under the DST
- A consolidated group may designate a constituent member to comply under the DST on behalf of all taxpayers in the group
- The earliest any DST will become payable by a taxpayer is mid-2025, but that first payment will be for DST on Canadian digital services revenue earned throughout the 2022-2024 calendar years

On December 14, 2021 the federal government released draft legislation to implement a digital services tax (DST). The DST was originally proposed in the 2021 Federal Budget. As explained in Budget 2021, the DST is only intended to apply in Canada until a multilateral agreement is reached that addresses the taxation of digital services. The Economic and Fiscal Update 2021 also released on December 14, 2021 reiterates the federal government's intention to apply the DST only until a multilateral agreement comes into effect.

Canada's expectation is that its work with the OECD, the G20 and members of the Inclusive Framework will result in a consensus on a new right to tax under the OECD's Pillar One proposals for countries where multinational corporations are providing digital and certain

other consumer-facing services to consumers. A high-level agreement on Pillars One and Two was reached in Fall 2021 by 137 countries.

The Canadian DST is not expected to apply if a multilateral Pillar One agreement is reached by the end of 2023. The federal government prepared the draft DST legislation as an alternative if no such agreement is reached. The draft *Digital Services Tax Act* (DSTA) is a self-contained statute for computing and imposing the DST, including all necessary enforcement, assessment, collection and other administrative provisions. The earliest the DST will come into force is January 1, 2024 — though if it does come into force, the DST will apply to applicable Canadian digital services revenues earned as of January 1, 2022, which was the coming-into-force date proposed in Budget 2021.

Structure of the DST

The draft legislation confirms the Budget 2021 proposal that the DST will be a 3% tax on a taxpayer's taxable Canadian digital services revenue in a calendar year in excess of $20 million. Taxpayers include trusts, partnerships, corporations and other bodies of persons, but exclude individuals and Crown corporations. The DST applies to both individual entities and consolidated groups, meaning two or more entities that are required to prepare consolidated financial statements for financial reporting purposes under acceptable accounting principles, or would be so required if equity interests in any of the entities were traded on a public securities exchange. The DST will apply in a calendar year to an individual entity or members of a consolidated group that, in a prior calendar year not earlier than 2022, has global revenue of at least €750 million, and in the particular calendar year has more than $20 million of in-scope revenue from Canadian users. Revenue amounts are determined as reported in financial statements prepared in accordance with acceptable accounting principles (e.g., IFRS), or that would have been prepared in accordance with IFRS if no such statements exist.

Canadian digital services revenue is defined as revenue from four categories of activities. Revenue from each category is based on a formula that takes into account the proportion of users who are located in Canada versus outside of Canada (as determined based on user data such as billing, delivery/shipping address, phone number and other available information).

- Online marketplace services: revenue from providing access to or use of the marketplace; commissions or other fees to facilitate the making of supplies between users (plus ancillary services); premium services, preferential treatment or other optional enhancements; and other sources prescribed by regulation. This category does not include revenue from providing storage or shipping services at a reasonable rate of compensation.
- Online advertising services: revenue from facilitating or providing online targeted advertisements, plus other sources prescribed by regulation.
- Social media services: revenue from providing access to or use of social media platforms; premium services or other optional enhancements; facilitating interactions between users or with user-generated content; and other sources prescribed by regulation. This category does not include revenue from the provision of private communication services where that provision is the sole purpose of the platform.
- User data: revenue from the sale of or access to user data gathered from any of the three prior categories, plus other sources prescribed by regulation.

The four categories are mutually exclusive: online advertising services revenue is defined to

exclude online marketplace services revenue; social media services revenue excludes the first two categories; and user data revenue excludes the first three categories. The four categories generally exclude intra-group payments. Where one member of a group provides the relevant service or user data and another member of the group earns the revenue, the revenue earner is deemed to have also provided the service or user data.

Taxable Canadian digital services revenue is the total amount of Canadian digital services revenue minus, generally, $20 million. The $20-million exclusion is shared between members of a consolidated group according to their proportion of Canadian digital services revenue earned by the group.

Anticipated coming into force

The earliest time the DSTA will come into force is January 1, 2024. However, whenever it comes into force, the DST will apply to all taxable Canadian digital services revenue earned from January 1, 2022 onward (assuming the €750-million/$20-million conditions are met). The intention of this delayed coming into force reflects the government's preference to rely on a multilateral approach to digital services rather than the domestic DST.

Once the DSTA comes into force, a taxpayer must apply to register under it by January 31 of the calendar year following the calendar year not earlier than 2022 in which it earns Canadian digital services revenue, and it or their consolidated group meets the €750-million or more global revenue requirement and the taxpayer has more than $10 million of Canadian digital services revenue (half of the qualifying amount). The Minister of National Revenue (Minister) can also unilaterally register a taxpayer upon serving notice, unless the taxpayer satisfies the Minster that no registration is required.

Taxpayers must file a return under the DSTA for a calendar year and pay any taxes owing by June 30 of the following year if they earn Canadian digital services revenue in the year and meet the €750-million group revenue/$20-million Canadian digital services revenue conditions in respect of the calendar year.

A constituent member of a consolidated group may elect to designate another constituent member to represent such member for purposes of the DST. The designated member then acts on behalf of the electing taxpayers for purposes of the DST. It is not clear however that the designation would permit consolidated reporting. Members of a group are jointly and severally liable for DST owed by other members of the group.

Administrative rules

The DSTA includes rules for assessments, appeals, audit, collection, enforcement, penalties, offences and all other aspects for the administration of the DSTA. It also contains an anti-avoidance provision similar to the general anti-avoidance rule of the *Income Tax Act* (Canada) (ITA). The DSTA anti-avoidance rule applies to deny a tax benefit resulting from an avoidance transaction or a series of transactions that includes an avoidance transaction if the avoidance transaction would otherwise result in a misuse or abuse of the DSTA, the regulations thereunder or other relevant enactments.

In general terms, the administrative provisions of the DSTA mirror those in the ITA. There are notable differences that reflect the fact that the DST could apply to non-resident entities with little or no Canadian material presence, which may present collection and enforcement challenges. In particular, the Minister may assess any constituent member of a consolidated group for a tax liability of any other constituent member of the group, pursuant to which

each such member becomes jointly and severally liable for the tax liability. The general reassessment limitation period for a calendar year is seven years after the required return for the period is filed. The general retention period for keeping necessary records is eight years, compared to six years under the ITA (assuming the taxpayer has filed the required return).

Interestingly, the DSTA includes a new rule that where a taxpayer has initiated an appeal to the Tax Court of Canada, the government can also apply to the court to award an additional amount of up to 10% of any amount in dispute if the court determines (1) in respect of that amount, "there were no reasonable grounds for the appeal", and (2) the purpose of the appeal was to defer payment of any amount owing under the DSTA.

Conclusion

There will no doubt be many challenges to be addressed in both the administration and enforcement of the DSTA. Taxpayers that do not operate on a calendar-year basis will face difficulties in computing and reporting income, for example. The practical realities of identifying which users are or are not in Canada — and the related evidentiary burden should any audit or reassessing activity occur — is also likely to prove challenging. Finally, there is a serious risk that domestic DSTs from different countries will overlap and result in double taxation. Conversely, the government may face its own enforcement challenge of actually collecting the DST from some taxpayers given the so-called "revenue rule", which generally provides that the courts of a country will not enforce a tax debt claim of another country. These challenges all support and reflect the fact that the DST is likely viewed by the federal government as a placeholder for a more suitable multilateral outcome from the OECD process.