Intelligence MEMOS

From: Lawrence Herman

To: Canadian Trade Observers

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Re: **Canada's Digital Tax Ship Still Sails Even as Rollout is Delayed**

The Fall Economic Statement confirmed the federal government's intention to eventually proceed with its Digital Services Tax (DST), a measure proposed back in 2020, even as it postponed its January 1 implementation.

Under the proposal, Ottawa would start taxing the 3 percent of Canadian revenues of large – 750 million Euros in global revenue and $20 million in Canadian sales – digital service providers like Google, Facebook, Amazon, etc., retroactive to January 1, 2022. Its oft-announced intention to begin imposing the tax in January 2024 was conditional: Canada would instead join an international tax regime if agreement was reached at the OECD on the tax issue. But that process is glacial, and even with the implementation delay last week, the federal government still appears set on acting unilaterally.

That has been causing great annoyance in Washington, with the US threats of retaliation if Canada goes ahead. There was speculation that some accommodation could be reached when Messrs. Biden and Trudeau met this month in Washington, but apparently the DST didn't come up. Backroom discussions are supposedly going on, but no information has been released on any progress. However, the postponement implicit in the Fall Statement may well have been the effective outcome of such discussions.

The OECD talks, underway for years, are attempting to reach agreement on so-called Pillar One, which allows large multinational corporations, including digital firms, to be taxed in the jurisdictions where users and customers are located. In October 2021, Ottawa agreed to delay introducing DST legislation until the end of 2023 to allow the OECD talks to reach conclusion. But the OECD is far from that, judging from the current situation.

The Americans reacted earlier to DSTs enacted by Spain, France, the UK and other EU members, threatening to retaliate under the dreaded section 301 of the *1974 Trade Act*, a tool that allows Washington to unilaterally apply trade countermeasures. After that threat, the Europeans agreed to continue with the OECD process and not to proceed unilaterally.

As to the trade dispute with Washington, as the Business Council of Canada and the Canadian Chamber of Commerce have rightly said, it's always in Canada's interest to resolve things with the Americans before getting into a full-blown trade dispute

If Canada does move ahead, the key question is whether it could counter US claims that the measure contravenes trade obligations under the World Organization (WTO) Agreement and the Canada-US-Mexico Agreement (CUSMA).

The answer revolves around Canada's obligations under the national treatment rule, one of the foundation blocks of the multilateral trading system. National treatment prohibits governments from discriminating against imported products in order to protect domestic suppliers of the same products. The rule kicks in when imported products are treated differently than the same – or "like" – domestic products. This like-to-like requirement is absolutely critical. If imported services are not the same as – i.e., not "like" – domestic operations in the same business sector, national treatment doesn't come into play.

WTO dispute panels, including the Appellate Body, have repeatedly said products are considered like when they share the same qualities and are "directly competitive or substitutable" in the same market. An imported Ferrari and an Ontario-made Honda Civic are both four-wheeled automobiles but are not, by any stretch of imagination, like products.

Applying this to the case at hand, for Canada to be offside international trade law, the DST would have to apply to imported US digital services like those provided by Google, Facebook and others, while exempting Canadian services with the same qualities and that compete directly in the same market. But does Canada's proposed DST fail these tests?

That's the central question.

Part of the answer is that the measure isn't specifically targeted to US companies or designed to protect directly competitive Canadian services, according to federal officials. Domestic firms would be taxed on the same basis as foreign ones if they meet the revenue thresholds. Shopify, Canadian Tire, Hudson's Bay, etc., are examples of providers of digital services in the same market as those in which larger platforms operate.

The legal picture is one thing, but the political dimension takes centre stage, i.e., whether Canada should risk the threat of US countermeasures when there's at least some prospect of agreement at the OECD.

Whatever the legal cover for Canada's DST project, the better route is to reach accommodation with Washington, stay onside with our OECD partners and continue along the multilateral path, deferring implementation of the DST as the talks progress.

This could imply that Canada will eschew unilateral route and work for a multilateral solution, at least for now. If there comes a point when the OECD process hits a definitive impasse, this position could be revisited, with some comfort that Canada could rely on some good legal arguments in a trade dispute with Washington if needed.

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