Canada's DST Shows Impatience With Pillar 1 Rules, 2023 Law360 209-236

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Summary

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Pillar One's delayed timeline may test the tradeoff that Canada and nearly 140 other jurisdictions agreed to in 2021, when they vowed to hold off on enacting new digital services taxes in exchange for a regime designed to redistribute taxing rights among countries. (iStock)Pillar One's delayed timeline may test the tradeoff that Canada and nearly 140 other jurisdictions agreed to in 2021, when they vowed to hold off on enacting new digital services taxes, or DSTs, in exchange for a regime designed to redistribute taxing rights among countries. Most nations recently signed on to an extended DST standstill (*2023 Law360 192-201*) as they continue to negotiate a treaty to carry out Pillar One, while the Canadian government announced plans to dust off its proposed digital measure.

Chrystia Freeland, Canada's deputy prime minister and minister of finance, said in July that the country is at a disadvantage (*2023 Law360 193-218*) relative to nations that have continued to collect revenue under their preexisting DSTs. Given the number of countries in Canada's position, more unilateral measures could emerge during Pillar One treaty negotiations and possibly linger even if the new rules ultimately take effect, specialists say.

While some jurisdictions are getting revenue from their preexisting DSTs, others have modified their value-added tax systems to cover online sales from remote companies, according to Leopoldo Parada, an associate professor in tax law at the University of Leeds. The question is whether other jurisdictions should wait until the end of Pillar One treaty negotiations to start collecting their own slice of the revenue cake, he said.

"That's the question that Canada is raising," Parada said. "And that's the question that many countries will start raising as well."

Canada's DST, Then and Now

The Canadian government first announced plans for a DST in November 2020, followed by draft legislation in December 2021. The legislation outlined a 3% levy that would apply to large companies' Canadian digital services revenue, including online advertising and social media services.

Shortly before releasing the draft legislation, Freeland announced that the country would impose its DST starting in January 2024, but only if the Pillar One treaty hadn't come into force yet. The Pillar One deal, which countries agreed to in principle in October 2021, would reallocate a portion of large companies' profits to market jurisdictions where businesses have customers but not a physical presence that would trigger taxation under existing norms.

Countries initially agreed to hold off on applying new digital measures through 2023 before ultimately eliminating existing ones under Pillar One, which is part of a two-pronged corporate tax overhaul that includes a 15% minimum effective rate. The Pillar One agreement also included a first-of-its-kind multicountry treaty (*2021 Law360 244-116*) that was initially set to be ready for jurisdictions to sign in 2022 followed by the new taxing rights taking effect in 2023.

The treaty — known as the multilateral convention, or MLC — is now expected to be ready for signature before the end of 2023, according to the Paris-based Organization for Economic Cooperation and Development, which led negotiations on the overhaul. Manal Corwin, director of the OECD's Center for Tax Policy and Administration, told reporters in July that countries are still working toward agreement on a few technical aspects regarding the new taxing rights.

Corwin also announced at the time that countries had agreed to extend their standstill on new DSTs through 2024. This extended pause will occur if the MLC is signed before the end of 2023 by at least 30 jurisdictions accounting for at least 60% of ultimate parent entities of companies that fall within Pillar One's scope, she said.

On July 13, the EU Tax Observatory, a think tank funded by the European Union, released research showing that the U.S. will need to sign and ratify the treaty for the critical mass (*2023 Law360 200-222*) of jurisdictions to be met.

Corwin also noted that five countries — Belarus, Canada, Pakistan, Russia and Sri Lanka — hadn't formally approved an outcome statement that included the standstill agreement.

Canada's priority and preference has always been a multilateral agreement, said Katherine Cuplinskas, senior communications adviser and press secretary for Canada's Office of the Deputy Prime Minister and Minister of Finance. The country strongly supports international efforts to end the corporate tax race to the bottom and to ensure that all corporations, including the world's largest, pay their fair share, she told Law360.

"The Canadian government has been clear for several years that it would move forward with its own digital services tax if a global agreement is not reached," Cuplinskas said. "And we are committed to protecting Canada's national economic interest."

As some see it, Canada no longer wants to pay the price for delaying its DST compared to countries that enacted digital measures prior to the Pillar One deal.

Shortly after the OECD announced the 2021 tax pact, five jurisdictions — Austria, France, Italy, Spain and the U.K. — announced they had arrived at "a political compromise (*2021 Law360 294-27*)" with the U.S. regarding their existing digital measures. According to a joint statement from the governments, the countries could continue to apply their DSTs until the global rules were implemented, at which point they would owe tax credits if they collected more than they took in under the new regime.

In addition to Canada, other countries are likely ruing the fact that they didn't get their DSTs in place before the moratorium on new measures, according to Michael Lebovitz, a partner at Mayer Brown LLP.

"The longer this gets delayed, the longer the Canadas of the world are not going to collect the revenue they're expecting from the eventual Pillar One deal," he said.

As part of the compromise involving preexisting DSTs, the U.S. government agreed to cancel the trade actions it had proposed against the five jurisdictions. Any DST from Canada would be assessed under the same standard

(*2022 Law360 53-130*) the U.S. used when concluding that other countries' digital measures discriminated against U.S. companies, according to February 2022 comments from the Office of the U.S. Trade Representative.

According to Lebovitz, although Canada is the U.S. government's biggest trading partner, it's likely that the USTR would propose tariffs if Canada followed through with its DST.

"It's been a tool that has been brandished in the past," he said. "There is a somewhat tried-and-true path to resisting DSTs by the U.S."

Current and Future Measures

While several countries are currently taking in revenue under their preexisting DSTs, others have begun applying sales taxes to online services from nonresident companies.

Several Latin American nations have modified their value-added tax systems to apply to sales of digital services provided by companies without a physical presence. Similarly, Quebec in 2019 began collecting a tax aimed at nonresident sellers of digital products.

Known as the "Netflix tax," (*2018 Law360 99-103*) Quebec's measure requires online sellers with no physical presence to collect and remit sales taxes for property and services supplied in the Canadian province.

While DSTs impose income taxes on remote companies, Quebec's measure updated its sales tax system to apply to streaming services in the province, according to Marc André Gaudreau Duval, a partner at Davies Ward Phillips & Vineberg in Montreal. While both measures are connected to jurisdictions' desire for additional revenue, he said, a sales tax may not be as effective because it's the customers who ultimately pay.

"You're taxing your citizens instead of taxing the foreign entities," Gaudreau Duval said. "There's probably more possibility for backlash."

The revenue that jurisdictions are already picking up under preexisting DSTs or sales taxes may prompt other nations to move forward with unilateral measures — particularly if the Pillar One MLC isn't ratified after countries sign it. The ratification requirement has raised doubts (*2021 Law360 288-149*) about whether this process will advance in countries such as the U.S., where tax treaties need approval from two-thirds of the Senate.

Citing skepticism that the U.S. will be able to ratify the MLC, Parada at the University of Leeds noted that the issue behind DSTs and the Pillar One agreement was the notion that market jurisdictions couldn't get revenue from remote companies under current tax treaty rules. With countries like Canada watching jurisdictions that are already collecting revenue, "there is a tendency for these unilateral measures," he said.

Even if the MLC is ratified, the OECD's proposed implementation plan has spurred skepticism about whether countries will ultimately scrap their DSTs in exchange for the new taxing rights.

Pillar One is designed to cover only about 100 large multinational corporations — specifically, those with global sales above €20 billion ($22 billion) and profitability above a 10% margin — that earn significant profits remotely. For those companies, 25% of profits above the 10% threshold would be reallocated to market jurisdictions under a provision known as Amount A.

According to a consultation document (*2022 Law360 354-20*) released by the OECD in December, an MLC provision called Article 38 would deny Amount A allocations to countries that apply DSTs. The proposal was met with criticism from streaming companies, which told the OECD that the guardrail would give countries too much discretion (*2023 Law360 55-169*) to depart from the ban against DSTs and similar measures.

If implementing a DST is going to collect more revenue than Amount A, there needs to be a disincentive, according to Anne Gordon, vice president for international tax policy with the National Foreign Trade Council. Otherwise, countries won't care about not getting Amount A if they're going to get more from a DST, she said.

"There needs to be a mechanism and a pretty steep penalty beyond just not getting Amount A as a disincentive to do DSTs," Gordon said.

In a similar vein, Mayer Brown's Lebovitz said Article 38 essentially allows countries to make an economic decision about whether they want a DST or to be in Pillar One. Accordingly, it's unlikely that the world will uniformly adopt Pillar One, he said.

"My own view is that when you look at how much tax gets collected on a global basis under Amount A and how that gets spread around the countries, there are going to be countries that are disappointed in their split," Lebovitz said. "And they're going to switch back to DSTs."

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