

ITI Response to Department of Finance Canada's Digital Services Tax Consultation

June 17, 2021

Thank you for the opportunity to provide feedback on the Department of Finance Canada's proposed approach to implementing the Digital Services Tax (DST) outlined in Budget 2021.

The Information Technology Industry Council (ITI) is the premier global advocate for technology, representing the world's most innovative companies. Founded in 1916, ITI is an international trade association with a team of professionals on four continents. We promote public policies and industry standards that advance competition and innovation worldwide. Our diverse membership and expert staff provide policymakers the broadest perspective and thought leadership from technology, hardware, software, services, and related industries.

We encourage Canada to withdraw its proposal for a DST and devote its efforts to realizing a multilateral, consensus-based solution negotiations through the Organisation for Economic Co-operation and Development (OECD)/G20 Inclusive Framework (IF). The 139 governments participating in the IF have identified mid-2021 as the deadline for reaching political agreement to address the tax challenges arising from the digitalization of the economy. As recently as June 13, leaders from Canada and other G7 governments reiterated their support for reaching consensus through the IF's negotiations. Once an agreement is reached in the IF, it is incumbent on every jurisdiction to adopt and implement the consensus agreement into domestic laws. To introduce a unilateral measure that contravenes longstanding international tax and trade norms sends a signal that Canada is not serious about its commitment to ongoing negotiations leading up to the mid-2021 deadline. Advancing a unilateral DST at this stage would also make a future implementation process more difficult and could encourage further proliferation of unilateral measures.

Canada's turn toward unilateralism is particularly problematic given the landmark digital trade provisions achieved – and now implemented – through the Canada-United States-Mexico Agreement (CUSMA). Targeting companies that are predominantly headquartered in one of Canada's most important trading partners with a tax measure that is inconsistent with prevailing international tax and trade principles and national treatment commitments contravenes both the letter and the spirit of CUSMA.

As such, we strongly encourage Canada to demonstrate its commitment to the IF and its CUSMA partners by withdrawing the DST proposal and continuing its engagement to reach a multilateral, consensus-based solution to address the tax challenges arising from the digitalization of the global economy.

Thematic Considerations

Our members have consistently supported the negotiations at the IF, including through regular technical engagement and the development of [Principles for a Solution in the OECD's Project for Addressing the Tax Challenges of the Digitalisation of the Economy](#). Global tax policy challenges require global tax policy solutions, which is why nearly 140 governments and more than a dozen

observer organisations have committed to the negotiations taking place under the auspices of the IF. We have welcomed Canada’s commitment to reaching a multilateral, consensus-based solution, and encourage Canada to continue to promote multilateral engagement as the sole means of addressing the underlying tax policy challenges identified by participating governments.

Canada’s decision to advance development of a DST is, however, fundamentally at odds with its public support for the negotiations, risks undermining the significant progress participating governments have made during the past several years, and effectively provides a green light for other governments to adopt their own unilateral tax measures. Such a scenario would lead to further fragmentation of and excessive pressure on the global tax system – exactly the outcome that participants in the ongoing multilateral negotiations are now seeking to avoid. This is indeed why the Report on the Blueprint for Pillar One includes a commitment to withdraw relevant unilateral measures “and to refrain from introducing new ones.”¹ As we have stated before, global tax policy challenges require global tax policy solutions, and a unilateral approach only serves to further complicate efforts to reach a multilateral consensus, especially at this critical time in the negotiations.

International Tax Principles

Unilateral tax measures contribute to greater fragmentation of the international tax system through the contravention of international tax and trade norms by charging a tax on gross revenue, targeting nonresident companies, operating outside of tax treaties, and attempting to isolate the digital economy.

Since the European Commission introduced the first of what would become known as DSTs in 2018, unilateral measures have not only proliferated but have also grown in scope, as dozens of governments have introduced measures – many of which take a form similar to the 2018 EU proposal – that deviate from longstanding international tax principles such as neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility. Ever more expansive digital taxes have also been introduced in markets like India, where the Equalisation Levy has recently been expanded a second time to include otherwise offline transactions by non-resident firms where only one aspect takes place online. Notably, this expansion effectively brings more Canadian industries into scope. The increasingly widespread application of targeted, unilateral taxes is perpetuating a trend that serves to undermine a functioning international tax system and compromise the predictability that system has afforded companies in North America and beyond to conduct business globally.

As noted above, DSTs and similar unilateral, targeted tax measures share several problematic characteristics, such as their application to gross revenues instead of net profits; multiple revenue thresholds and other stipulations that target largely non-resident, globally engaged companies; and a narrow scope of covered digital activities that largely excludes domestic competitors from liability.

First, taxing corporate revenue, rather than income, is inconsistent with international tax principles – as reflected, for example, in the OECD Model Tax Convention on Income and on Capital and over 3,000 bilateral tax treaties. This approach penalizes low-margin and loss-making companies and

¹ OECD, Report on the Blueprint for Pillar One at 204 (October 14, 2020), <http://www.oecd.org/tax/beps/tax-challenges-arising-from-digitalisation-report-on-pillar-one-blueprint-beba0634-en.htm>.

subjects affected companies to potential multiple taxation and significant compliance costs.² The structure of taxes on gross revenue also means the burden of the tax most likely falls on in-country consumers.

Second, subjecting companies to a tax without regard to whether or to what extent they have a permanent establishment in-country is inconsistent with the international tax laws vis-à-vis bilateral tax treaties as well as international tax principles reflected in the OECD Model Tax Convention and other instruments, and will, like taxing revenue, create the risk of multiple taxation, significant compliance costs (including for the Canada Revenue Agency), and greater uncertainty. For example, companies will need to engage in significant re-engineering of their internal business and financial reporting systems to ensure that they can accurately capture required information and comply with the DST. Companies will also need to include new filing and audit components on accounts in this jurisdiction, which creates financial risks and legal risks including with respect to taxpayers' existing legal obligations under data privacy laws. To the extent that these taxes differ in scope and thresholds across different markets, those compliance costs increase. Further, there will be very high audit uncertainty, which will lead to additional disputes and subsequent costs for taxpayers and tax administrations alike. Companies are already preparing to commit resources to the reconfiguration of systems necessary to adopt new rules pursuant to the IF's conclusions, which would benefit from the context of a multilateral agreement, the withdrawal of unilateral measures, and enhanced dispute prevention and resolution mechanisms.

The administrative burden that would be required as part of complying with Canada's DST is particularly onerous given that the IF intends to reach political agreement in mid-2021 and those outcomes will be reviewed when the G20 Finance Ministers and Central Bank Governors meet on July 9-10, 2021. The structure as proposed in the Report on Pillar One Blueprint envisions a multilateral legal instrument adopted by individual jurisdictions that would coordinate and reallocate certain taxing rights. Requiring companies and Canada's tax administration to undergo significant reconfigurations disrupts and frankly undermines the ongoing preparation by companies and tax administrations for implementing the long-term, consensus-based political agreement.

Analysis of Effective Tax Rates

The broad rationale underpinning Canada's introduction of a unilateral tax measure is predicated on a misguided premise that effective tax rates (ETRs) for digital companies are lower than those for companies operating in "traditional" industries. A study by the European Centre for International Political Economy (ECIPE) undertaken after the European Commission introduced its proposed DST in 2018 found the Commission's "selective use of firms and the obscure way of estimating effective corporate tax rate" did not allow for a comprehensive understanding of international taxation, and in fact masked the comparable diversity of profitability levels and overall tax burdens among digital

² To illustrate how DSTs as gross receipts taxes compare to corporate income taxes, a DST of 3% applied to a company with a 10% profit rate equates to a 30% effective corporate income tax rate, with limited to no availability for credits. A DST of 3% applied to a company with a 2% profit rate equals a 150% effective corporate income tax rate. This is applied in addition to corporate income taxes paid by the company. The double taxation and subsequent effective corporate income tax rate are especially impactful to companies with lower profit margins and companies with losses.

and traditional companies alike.³ The ECIPE analysis further observed that the Commission’s 2018 findings “underestimate the effective tax rates of digital companies by about 20 percentage points if average tax rates are taken into consideration.”⁴ These conclusions are echoed in a 2018 Copenhagen Economics paper that found the Commission’s claims of under-taxation can be attributed to digital companies’ substantial investments in research and development, which benefit from public policy tools to encourage such investments.⁵

We also want to draw the Department of Finance’s attention to a 2020 International Monetary Fund (IMF) working paper that concluded “the tech sectors report implied average tax rates more or less in line with the average of other Fortune Global 500 firms” and that “we can reject the widely held hypothesis that on average these companies pay zero or low corporate income taxes at the global consolidated level.”⁶ The idea that technology companies pay less in tax than companies in other industries in no way reflects the reality of taxation in the technology sector and should not be used as the basis for developing policy, in Canada or elsewhere.

Trade Impacts

In CUSMA, Canada, Mexico and the United States produced the most ambitious digital trade chapter ever negotiated in a comprehensive trade agreement, which advances cross-border innovation and boosts economic opportunities for companies and workers throughout the region. Whereas CUSMA reduces trade barriers by facilitating cross-border data flows that allow companies of all sizes and in all industries to access digital services at affordable prices, the adoption of a DST would subject many of the companies delivering those essential services to tax treatment that contravenes longstanding international tax and trade norms. Such an action contravenes both the letter and the spirit of CUSMA.

Pursuing a unilateral approach also presents serious implications for global trade and CUSMA national treatment commitments in the form of trade barriers for in-scope companies vis-à-vis domestic competitors and potential retaliation as governments respond to discriminatory tax measures. The overall impact also hurts the domestic market by making it all the harder for businesses and consumers alike to benefit from productivity-enhancing goods and services, and contributing to a less friendly business environment. Independent research⁷ has suggested that in addition to the companies directly in scope, small and medium-sized enterprises (SMEs) and other parties in the supply chain are also negatively impacted by DSTs since in many instances the cost will be directly passed on and borne by SMEs and consumers. The April 2021 OECD Secretary-General Tax Report to G20 Finance Ministers plainly states the broader trade and economic risks associated

³ Matthias Bauer, Digital Companies and Their Fair Share of Taxes: Myths and Misconceptions at 7, ECIPE Occasional Paper No. 03/2018, <https://ecipe.org/publications/digital-companies-and-their-fair-share-of-taxes/?chapter=all>.

⁴ Ibid., 8.

⁵ Helge Sigurd Næss-Schmidt et al., The Proposed EU Digital Services Tax: Effects on Welfare, Growth and Revenues, Copenhagen Economics (September 2018), <https://www.copenhageneconomics.com/dyn/resources/Publication/publicationPDF/7/457/1537162175/copenhagen-economics-study-on-the-eu-dst-proposal-13-september.pdf>.

⁶ IMF Working paper 20/76 – Tec(h)tonic Shifts: Taxing the “Digital Economy”, page 71.

⁷ Copenhagen Economics 2018 Study, [The Impact of an EU Digital Service Tax on German businesses](#). Deloitte Taj 2019 Study, [The French Digital Service Tax, an Economic Impact Assessment](#); Prometeia-Netcomm 2018 Study on the [Italian DST](#) (in Italian); IFO Institut, 2018 Study on the [German DST](#) (in German).

with pursuing unilateral approaches: “In the current context, international tax cooperation is even more important to ensure that tax disputes do not turn into trade wars, which would further harm recovery at a time when the global economy can least afford it.”⁸ These considerations reinforce the importance of forgoing a unilateral approach and focusing governments’ energy on the multilateral negotiations.

Technical Considerations

While we view withdrawing the proposal as the most prudent course of action, we have provided feedback regarding several technical aspects of the proposed DST.

Rate and Base

The DST proposal acknowledges that some of these transactions are already subject to consumption taxes and that such consumption taxes would not be subject to the DST.⁹ Considering the DST subjects the same source of income to multiple taxation and the burden of taxes on gross revenue most likely falls on in-country consumers, we would request that the Department of Finance provide greater clarification as to whether it would support expanding the relevant language to exclude from the DST’s scope any revenue subject to a Value Added Tax (VAT), Goods and Service Tax (GST), or sales tax amount. Of particular relevance to this rulemaking is the new non-resident VAT on digital transactions that applies as of July 1, 2021.

In-Scope Revenue

The Department of Finance’s proposal attempts to ring-fence the digital economy for taxation purposes. This approach would be incompatible with ongoing negotiations for a multilateral agreement and the conclusions reached to date by the IF. ITI has long agreed with the OECD and the IF that it is unrealistic to try to ring-fence the digital economy – a position that the OECD and the IF have also expressed as a key underpinning of its work to address the tax challenges presented by the digitalisation of the economy.¹⁰

It is also important to ensure the DST does not get levied multiple times in the supply chain on the same revenue. Other DSTs frequently incur multiple taxation on the same revenue as a result of revenue share agreements such as in advertising models for search engines. This is in addition to the potential for double or multiple taxation vis-à-vis other jurisdictions (including but not limited to corporate income tax) already present in DSTs.

Taxpayers

Annex 7 justifies the use of dual revenue thresholds (global revenue and in-scope revenue associated with Canadian users) as a means of targeting “larger, more mature firms [that] are more likely to be

⁸ OECD Secretary-General Tax Report to G20 Finance Ministers and Central Bank Governors at 95 (April 2021), <http://www.oecd.org/tax/oecd-secretary-general-tax-report-g20-finance-ministers-april-2021.pdf>.

⁹ “For greater certainty, revenue would not include any applicable value-added tax or sales tax amounts collected on the revenue transaction.”

¹⁰ OECD, Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report at 54 (October 5, 2015), <https://www.oecd.org/tax/beps/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report-9789264241046-en.htm> (“[B]ecause the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy.”).

profitable and able to bear the burden of a tax on revenue, which is not sensitive to profitability.” Applying a tax on gross revenue does not take into account the taxes already paid and the investments that companies have made in order to provide the relevant goods and services (including but not limited to capital investments, research and development (R&D) spending, and salaries). This approach disproportionately impacts companies’ margins and in particular companies that are not profitable. The structure of taxes on gross revenue also means the burden of the tax most likely falls on in-country consumers.

Additionally, the narrow scope of covered services and revenue thresholds operate together to functionally select a subset of large, non-Canadian companies for taxation, while leaving domestic companies and would-be competitors untaxed. There is no non-nationality-based explanation for this approach, as these untaxed domestic companies may be identical in nearly all respects to their taxed foreign companies in terms of their domestic footprint (*e.g.*, numbers of customers, amount of revenue).

Revenue Sourcing

Revenue sourcing should be based on the existing data that companies already have, rather than requiring companies to collect new data solely for the purposes of compliance with the DST. For example, if a company tracks advertisement clicks but does not track views, then clicks should be an acceptable sourcing method. Taking this approach also reduces the likelihood of creating conflict with data privacy laws.

User Location

We appreciate the language included in the proposal that engenders flexibility by allowing several indicators to serve as proxies for user location, such as “billing address, delivery address (where relevant) and telephone area code.” Taking this approach enables companies to rely on information they are already collecting for purposes of carrying out the transaction. Additionally, the flexibility acknowledges that IP addresses can be an unpredictable means of determining the residential status of an e-commerce supply or service recipient. For example, a customer may be accessing e-commerce websites through a virtual private network (VPN), or the e-commerce operator may have difficulty ascertaining the residential status of a customer for other reasons.

Treatment for Income Tax Purposes

The negative impact of the DSTs will be exacerbated by the absence of any exemption from the tax for any portion of local in-scope revenue. This results in a cliff effect whereby a domestic company with taxable revenue just underneath the local threshold is fully exempt, but a U.S. company with revenue just over the local threshold has 100% of the revenue over the threshold subject to tax. This is especially impactful for low-margin companies or companies that are not profitable, particularly considering that gross revenue-based taxes such as DSTs can translate to a much higher effective corporate income tax rate depending on the level of a company’s profitability.

In the limited instances in which a domestic company may be required to pay the DST, the disproportionate impact of the measures on non-Canadian companies still provides compelling evidence to support a determination that the measure is discriminatory, particularly coupled with the evidence of discriminatory intent discussed above. An individual example of a domestic company being treated the same as a foreign one does not erase the many examples in which domestic and

foreign companies that supply the same services and compete against each other are treated differently.

Administration

In addition to added tax costs, there are also substantial administrative burdens in terms of compliance costs and greater uncertainty. Companies will need to engage in significant re-engineering of their internal business and financial reporting systems to ensure that they can accurately capture required information and comply with the DST. Companies will also need to include new filing and audit components on accounts in Canada, which creates legal and financial risks. Further, there will be very high audit uncertainty, which will lead to additional disputes and subsequent costs. As noted earlier, all of these impacts would be exacerbated in the case of Canada's DST as companies are already preparing to comply with a global approach to addressing the tax challenges arising from the digitalization of the global economy. In addition, the Canada Revenue Agency will need to expend significant resources to build the appropriate compliance systems for what is likely to be a very short-term tax measure assuming the OECD/G20 Inclusive Framework reaches a global agreement.

We appreciate the proposal's language that a group would be able to identify an entity to file a DST return.

Conclusion

Our members are committed to the success of the work taking place under the auspices of the IF, and see a multilateral, consensus-based solution as the only sustainable outcome to the tax policy challenges arising from the digitalisation of the global economy. Advancing towards political agreement in time for review and validation by G20 Finance Ministers during their July 9-10 meeting requires a full embracing of multilateralism. This entails refraining from advancing unilateral measures that actively undermine the pursuit of a sustainable multilateral solution, especially now at such a crucial moment in the negotiations and considering that any agreement would include a standstill and rollback of unilateral measures. We would encourage Canada to reiterate its active support for the IF's negotiations by discontinuing its consideration of a DST and redoubling its efforts to achieve political agreement.