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The Canadian Digital Services Tax

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Abstract

The Digital Services Tax (DST) may never be enacted in Canada. At least that seems to be what most Canadian tax professionals hope for: the draft Digital Services Tax Act (DSTA), released by the federal government in December 2021, has received little meaningful commentary; likely few Canadian taxpayers potentially affected by the DSTA (and their tax advisors) have attempted to learn from experiences of DST compliance in other countries; and the world also has little to learn from Canadian taxpayers' preparation for a potential DST.

This essay highlights three ways in which this collective dismissal of Canada's proposed DST is remarkable. First, the Canadian DST is much broader in scope than its U.K. and French counterparts. Ironically, this significantly larger scope not only has drawn no attention from commentators, but also seemed to generate no greater opposition to the DST than elsewhere. The usual opponents of the DST copied and pasted the same accusations against the Canadian DST as they had launched against other DSTs, even though the accusations are manifestly inapplicable. Second, the DSTA raises important new questions about DST design, especially in connection with taxing business-to-business and social media platforms, that may not be just technical in nature but require debate on the DST's purpose. Such debate has not transpired in Canada. Third, since the DST's first enactment in 2019, the world has been plagued by other larger, and seemingly intractable, trade disputes. Yet the global tax profession continues to be fixated on the pettier trade dispute that DSTs have generated: this ability to mentally separate international taxation from larger economic realities may explain why global tax cooperation seems to unite the global tax profession more than anything else.

Keywords: digital services tax, international taxation, Pillar One, trade wars.

Introduction

On December 14, 2021, Canada's federal Department of Finance released a draft Digital Services Tax Act[1] (DSTA or the Act), thereby giving legal form to the long-anticipated introduction of the digital services tax (DST) in Canada. As of January 2023, the DSTA has not yet been enacted as final legislation.[2] Even if Parliament does enact the DSTA in 2023, the federal DST would not be collected earlier than January 1, 2024. If the DSTA does come into effect, however, the DST will be payable in respect of

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[1] Canada, Department of Finance, *Notice of Ways and Means Motion to Introduce an Act to Implement a Digital Services Tax*, (Ottawa: Department of Finance, December 2021), online: <fin.canada.ca/drleg-apl/2021/bia-leb-1221-1-l-eng.html> [DSTA].

[2] However, DST revenue projections were included in the federal government's 2022 Fall Economic Statement. Canada, Department of Finance, *Fall Economic Statement 2022*, (Ottawa: Department of Finance, 3 November 2022), online: <budget.canada.ca/fes-eea/2022/home-accueil-en.html>.

revenue earned after January 1, 2022. In other words, if and when the Canadian DST is imposed, DST liabilities would have accrued from the beginning of 2022.

The government opened a brief period of public comments on the proposed Act (which ended on February 22, 2022). An earlier round of public consultation occurred after April 2021, when the federal government outlined the proposed DST in its 2021 Budget.[3] However, the Canadian DST has received little meaningful published commentary. This is probably because the Canadian government regards the DST as a unilateral and therefore sub-optimal tax policy instrument. As Finance's backgrounder for the proposed DSTA explicitly states:

> The government has a strong preference for a multilateral approach to addressing the tax challenges arising from today's digital economy. Therefore, the DST was proposed from the outset as an interim measure, to apply until an acceptable multilateral approach comes into effect. In international negotiations, 137 members of the OECD/G20 Inclusive Framework agreed to an October 8, 2021 Statement on a two-pillar plan for international tax reform. The Statement was subsequently endorsed by G20 Leaders and Finance Ministers. Canada is working with international partners to bring the multilateral agreement into effect.
>
> In the interim, to protect the interests of Canadians, the government is moving forward with legislation for the DST. Consistent with the [October 2021 OECD] Statement, the DST would not be imposed earlier than January 1, 2024, and only if the treaty implementing the Pillar One tax regime under the multilateral approach has not come into force . . . The government hopes that the timely implementation of the new international system will make this unnecessary.[4]

Given the government's own reservations about the DST, it is unsurprising that Canadian professional commentaries, published mostly in the weeks after the proposed Act's release, are perfunctory and provide little insight on the DST's potential application in Canada. Media coverage of the DST is also scant.[5] Indeed—as explained in Section 1 below— arguably the most surprising feature of Canadian public discourse about the DST in the past year, given some very distinctive features of the Canadian DST, is who did *not* join the discourse.

This chapter analyzes the DSTA from a sharply different perspective than the Canadian government's and tax professions' positions on the DST. Its underlying premise is that the DST, both as outlined in the DSTA and in versions implemented in the U.K., France, and certain other countries, is a sound tax policy instrument. In particular, the DST is a sector-, product-, or business-model-specific excise tax that captures economic rent realized by digital platforms characterized by non-rival technology, zero marginal cost of production, and multi-sided business models. Moreover, the economic

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[3] Canada, Department of Finance, *Budget 2021: A Recovery Plan for Jobs, Growth, and Resilience*, (Ottawa: Department of Finance, 19 April 2021), online: <budget.canada.ca/2021/home-accueil-en.html> [Canada Federal Budget 2021].

[4] Canada, Department of Finance, "Digital Services Tax Act: Backgrounder" (14 February 2022), online: *Government of Canada* <canada.ca/en/department-finance/news/2021/12/digital-services-tax-act.html>

[5] For a typical discussion, see Bill Curry, "US Climate Bill Sets Stage for Trade Fight with Canada Over Digital Sales Taxes", *The Globe and Mail* (11 August 2022), online: <theglobeandmail.com/politics/article-us-inflation-reduction-act-climate-change/>.

rent so captured can be traced to particular locations in a principled manner.[6] In permitting the taxation of sector- and location-specific rent in an eminently administrable fashion, the DST is best analogized to royalties charged on natural resource extraction, which Canadian provinces and national governments elsewhere have long relied on for generating revenue, to little international controversy.[7]

According to this theoretical perspective, the DST may have tariff-like effects, but such effects need not be any more pronounced than those associated with many other familiar tax policy instruments, e.g. the value added tax, the corporate income tax (including withholding taxes), and resource rent tax and royalties themselves.[8] Because DSTs are generally applied to markets characterized by imperfect competition, their incidence is likely to be borne jointly by platform operators and platform users.[9] The DST is clearly compatible with existing international law, including multilateral trade agreements and bilateral income tax treaties.[10] Indeed, should countries need to coordinate on their DSTs in the future, they should find it easy to do so because of the DST's transparency and targeted nature.

Taking the foregoing perspective, this chapter evaluates the Canadian DST in terms of DST design in general—that is, in the DST's own terms. Consequently, it focuses on the Canadian DST's distinctive features, and is brief in summarizing common features between Canada's DST and the U.K. and European DSTs. Section 1 examines the Canadian DST's most notable feature: its size threshold. It also briefly discusses how this threshold sheds light on political rhetoric surrounding DST adoption. Section 2 highlights several new design issues that have emerged from the desire to have a broad-based DST, including especially the taxation of marketplaces for business-to-business (B2B) transactions and social media platforms.

It is difficult to comment on the international politics of DST adoption and the DST's relation to the OECD's proposed multilateral agreements under Pillar One and Pillar Two without entering into debates about a much larger range of issues regarding the nature of international tax cooperation. That is beyond the scope of this chapter.[11] Nonetheless, in this moment of global debates about the DST, it is critical to document certain ways in which the international discourse about the DST has evolved. Therefore, Section 3 will briefly comment on how the DST should be understood in relation to other recent trade disputes.

1. The DST's Size Threshold

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[6] See Wei Cui, "The Digital Services Tax: A Conceptual Defense" (2019) 73:1 Tax L Rev 69.
[7] See Wei Cui, "The Superiority of the Digital Services Tax over 'Significant Digital Presence' Proposals" (2019) 72:4 Nat'l Tax J 839.
[8] See Wei Cui, "The Digital Services Tax on the Verge of Implementation" (2019) 67:4 Can Tax J 1135; Wei Cui, "What Is Unilateralism in International Taxation?" (2020) 114 AJIL Unbound 260.
[9] See Wei Cui & Nigar Hashimzade, "The Digital Services Tax as a Tax on Location-Specific Rent" (2019) CESifo Working Paper No 7737.
[10] See Chris Noonan & Victoria Plekhanova, "Taxation of Digital Services Under Trade Agreements" (2020) 23:4 J Intl Econ L 1015; Daniela Hohenwarter et al, "Qualification of the Digital Services Tax Under Tax Treaties" (2019) 47:2 Intertax 140.
[11] For an initial discussion, see Wei Cui, "New Puzzles in International Tax Agreements" (2022) 75:2 Tax L Rev 201 [Cui, "International Tax Agreements"].

The draft DSTA would impose the DST on companies that, as self-standing companies or as a corporate group, have (1) annual gross revenue of 750 million euros or more, and (2) Canadian digital services revenue of more than $20 million.[12] The €750 million threshold has been adopted by many countries for country-by-country reporting under Action 13 of the OECD's Base Erosion and Profit Shifting project, and is currently proposed for adoption to implement the OECD's "global minimum tax" under Pillar Two. Yet this threshold defines a scope of application for the DST that is much wider than the DSTs adopted by the U.K., France, and other countries, which set thresholds based on annual revenue from *taxable digital services*. There are many more multinational companies (MNCs) with annual total revenue greater than €750 million than MNCs with annual digital services revenue greater than €750 million. For example, retailers like Home Depot, Walmart, and Target are MNCs with global revenue in the billions. They are rarely thought of as tech companies, but all have developed their own online marketplaces. If they earn sufficient Canadian digital services revenue, they would be subject to the Canadian DST. Of course, this holds true for Canadian retailers such as Canadian Tire, Loblaws, Hudson's Bay, etc. as well.

a. Rationales and implications of broad base

The revenue size threshold represents one of the most fundamental design choices for the DST. The Canadian government has not furnished any explicit justification for its choice. But in principle, using a size threshold based on all business revenue, instead of only digital services revenue, can easily be justified. The principal rationale for setting a threshold before the DST begins to apply is to limit the taxpayer population to MNCs with strong tax compliance capacity. Such compliance capacity is more likely a function of total business revenue than of total digital services revenue. In contrast, the DST's ability to target sector- or product-specific rent that is location-specific does not assume that revenue earned from digital services is very large. Hence, there are few justifications other than administrative and compliance costs for setting a substantial threshold for imposing the DST.

A further argument in favor of the DSTA's choice of threshold is that it renders the Canadian DST more broad-based and neutral. Using the examples above, the DSTA could apply to all online marketplaces that have significant Canadian presence and that are operated by large MNCs, regardless of whether online marketplaces are a main source of business revenue for the MNC (e.g. Amazon) or only a subsidiary source (e.g. Home Depot). Similarly, the DST could apply to all revenue from social media platforms regardless of whether the MNC primarily engages in the social media business (e.g. Meta) or only offers such services as one of many lines of business (e.g. Advanced Publications, which owns Reddit). Arguably, such a broad-based approach has the advantage of creating a level playing field for fast-evolving sectors of the digital economy.[13] One might also note that Canada is itself in a unique position in levying the DST. It is an advanced economy geographically most adjacent to the U.S.; there is substantial economic integration and mutual penetration between the two countries. This means the taxation of digital platforms is a policy area exposed to the rapid evolution of relevant sectors, and not

[12] See DSTA, *supra* note 1, s 10(1).

[13] It is worth noting that when DSTs were first proposed in 2018 and 2019, crypto exchanges were rarely mentioned as potential taxpayers. Yet the U.K. HMRC listed "cryptocurrency marketplace or exchange" as a potential type of in-scope business in 2022. See U.K., National Audit Office, *Investigations into the Digital Services Tax* (Report) by the Comptroller and Auditor General (London: National Audit Office, 2022), online: <nao.org.uk/reports/investigation-into-the-digital-services-tax/> [NAO Report]. Whether crypto exchanges will continue to represent a major type of DST taxpayer is yet to be seen after the collapse of several exchanges in 2022.

just a matter of taxing a few politically salient MNCs. Canada's choice appears to suggest that if a DST is to be enacted at all, it would benefit from starting with a broad base.

A threshold based on total business revenue represents, however, a bold choice with many implications. First, along with the broader tax base also comes greater revenue potential. The Canadian government projected DST revenue of $700-800 million a year during 2022-25.[14] Judging from the recent U.K. experience, this may be an under-estimate. The U.K. DST has a lower, 2% tax rate (compared with the DSTA's 3% rate). It has a much higher size threshold for taxable persons, as well as a narrower tax base (as discussed further in Section 2 below), than the Canadian DST. Yet His Majesty's Revenue and Customs (HMRC) collected £358 million (equivalent to CAD 582 million) in DST revenue for the 2020-21 tax year, which was 30% more than forecasted.[15] Therefore, even though U.K. GDP is 50% larger than Canada's, it would not be surprising if the Canadian DST raised a billion dollars a year from the get-go.

Second, the broad base of the Canadian DST means that it would apply to many Canadian and foreign MNEs already subject to the corporate income tax in Canada. Some critics of the DST instantly declare this to be objectionable, but they neglect the fact that the best rationalization of DST is as a tax on economic rent. Sector-specific profit taxes on top of a generally applicable corporate income tax are familiar tax policy instruments used by national and subnational governments alike. Moreover, they are consistent with sound policy design. Indeed, much economic research in the last 15 years points to an approach for improving the Canadian tax system by increasing the tax rate on corporate rent while lowering (even to the extent of eliminating) the tax rate on the normal rate of return.[16]

Third, a broad-based DST will apply to many taxpayers, and therefore can be expected to generate a greater demand for legal certainty and administrative competence than a narrowly-based DST. Notably, as a self-standing act, the DSTA (with a length exceeding 30,000 words) already contains extensive provisions on administrative procedure. The substantive provisions of the DSTA are also more detailed than the statutory rules of the U.K. DST. Further, Canada's Department of Finance also published certain Explanatory Notes[17] for the draft DSTA. Nonetheless, it is likely that substantially more investment in developing the details of the DSTA will be required.[18]

b. Responses (or lack thereof) to the Canadian DST's scope

One might have anticipated two further implications of the Canadian DST's broad base to manifest in 2022. The Canadian DST potentially applies to a large set of MNCs—Canadian, other non-US, as well as U.S. MNCs—that are not subject to the DSTs in U.K., France, and elsewhere, due to the latter's thresholds being set by reference to digital services revenue instead of all business revenue. On the one

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[14] See Canada Federal 2021 Budget, *supra* note 3, at 316 (Table 10.1). This implies CAD 25 billion of in-scope revenue. While the basis of this projection was not disclosed, it appears quite reasonable given, for example, Canadian online advertising revenue alone is reported to be in excess of CAD 10 billion each year.

[15] See NAO Report, supra note 13 at 20. The report further discloses that "[m]ost digital business groups who are paying the [DST] now pay more in DST than they do in Corporation Tax. The introduction of the [DST] has meant that most groups affected are paying significantly more tax as a result": *ibid* at 7.

[16] See Robin Boadway & Jean-Francois Tremblay, "Modernizing Business Taxation" (2016) CD Howe Institute Commentary No 452.

[17] *Explanatory Notes for the Draft Digital Services Act*, (Ottawa: Department of Finance, February 2022), online (pdf): <fin.canada.ca/drleg-apl/2021/bia-leb-1221-1-n-eng.pdf> [Explanatory Notes].

[18] The DSTA contemplates further regulations (the "Digital Services Tax Regulations").

hand, given the negative light in which the DST has been cast by governments (including governments that have adopted the DST), the global tax profession, and global media, one would have expected the DST's broad scope in Canada to provoke an especially strong backlash, with many more businesses joining opposition to the DST. On the other hand, a broad-based DST ought to make it easier to communicate with the public about the tax. MNCs with annual business revenue of €750 million or more already engage with tax authorities in Canada and elsewhere for country-by-country reporting and are on alert of potential further compliance obligations under Pillar Two of the OECD proposal. Moreover, the Canadian government should be able to deflect misguided accusations that the DST is discriminatory against U.S. companies by pointing to the common threshold with OECD requirements, in addition to the fact that MNCs from many countries are potentially in scope.

Yet both these predictions were belied by observations from 2022. First, nearly all published professional commentaries failed to note the distinctively wider scope of the Canadian DST. There is also no sign that more MNCs joined the opposition to the DST than already existed to the U.K., French and other European DSTs. Specifically, while several industry associations that consistently lobbied against DST in the past few years submitted comments on Canada's proposed DST,[19] no additional industry associations or individual companies that otherwise actively lobby in respect of tax policy (e.g. associations of wholesalers and retailers, gaming associations, etc.) appear to have participated in the 2021 and 2022 DST consultations. That is, the many potentially "newly-in-scope" MNCs—those that would not have been subject to DSTs elsewhere—were conspicuously absent.

This apparent non-response may of course be interpreted in many ways. Perhaps many MNCs detected a lack of enthusiasm for the DST on the part of the Canadian government, and predicted that the tax would not ultimately be imposed. Alternatively, the Canadian DST may simply not represent enough of a new business cost for many MNCs for lobbying to be worthwhile.[20] Yet a third possibility is that some such MNCs have been poorly advised and continue to perceive the DST as targeted only at businesses specializing in digital platform operations.

If this last explanation has any merit, the disinformation campaign carried out by DST opponents in the last few years could be partly to blame. The Canadian DST introduced more twists to such campaigns. On the comical side, industry lobbies accused the Canadian DST of being a discriminatory tax just as they had of DSTs elsewhere. Consider for instance the following passage from the U.S. Chamber of Commerce's submission to the Department of Finance:

> [T]hresholds in the DST proposal are set at a level that captures large U.S. technology companies while sparing Canadian industry almost entirely. The proposed DST will apply only to companies with "global revenue from all sources of €750 million or more (the threshold for country-by-country reporting under an OECD standard) in the previous calendar year; and in-scope revenue associated with Canadian users of

[19] These include, for example, the American Chamber of Commerce, the Computer & Communications Industry Association, the Information Technology Industry Council, and Internet Association (all based in Washington, DC).
[20] A preliminary search of the 2021 annual reports and 2022 quarterly reports of large MNCs with significant Canadian operations in the online marketplace, online advertising, and gaming sectors shows that few discuss DSTs in general, and none discusses the pending Canadian DST in particular.

> more than $20 million in the particular calendar year." While a number of U.S. firms would be impacted, it is unclear if any Canadian companies would be.[21]

Likewise, the U.S. Senate Finance Committee sent a letter to the U.S. Trade Representative (USTR) claiming that the Canadian DST would subject "U.S. innovators in the digital industry" to "targeted, discriminatory taxation."[22] Perhaps the authors of such missives have not heard of Shopify, Loblaws, Canadian Tire, Hudson's Bay, and other Canadian MNCs, nor of TikTok, Etsy, Shein, Sony or other non-U.S. MNCs that operate in the platform space. Perhaps they are also unaware of Home Depot, Walmart, and other American companies' large Canadian operations.[23] But more plausibly, they have merely robotically recycled prior soundbites against DSTs enacted elsewhere, not noticing the discrepancies between the facts about the Canadian DST they cite and the charges hurled at it.

Less comically, the U.S. government directly filed comments on the DST through the Office of Trade Representatives. The one-age submission states in its concluding paragraph:

> As Canada is fully aware, the United States has serious concerns about measures that single out American firms for taxation while effectively excluding national firms engaged in similar lines of business. Based on previous communications from the Canadian Government and its officials, the United States understands that the Canadian DST proposal will duplicate most aspects of the DSTs adopted in France, Italy, Spain, Turkey, and the United Kingdom. The United States found these DSTs (and others) to be actionable under Section 301 of the United States Trade Act of 1974 and concluded that these DSTs are discriminatory and burden U.S. commerce. Any tax adopted by Canada would be assessed against the same standard.[24]

Like the industry lobbyists, the USTR seemingly rushed to copy and paste its previous complaints against DSTs and completely failed to consider that the size threshold of the Canadian DST is not only identical to the Pillar Two threshold but demonstrably covers a wide range of Canadian and non-U.S. companies. What is disturbing is that this is the U.S. government agency that makes determinations regarding what constitutes "discriminatory" trade practices against the United States (and applies

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[21] "Chamber Comments on Canada's Proposed Digital Services Tax Act" (22 February 2022) at 3, online (pdf): <uschamber.com/assets/documents/220222_Comments_DSTproposal_Dept.ofFinance-Canada.pdf>

[22] Letter from Ron Wyden and Mike Crapo to Ambassador Katherine Tai (12 January 2022) at 2, online (pdf): <finance.senate.gov/imo/media/doc/2022.01.12%20Wyden-Crapo%20Letter%20to%20USTR%20Tai%20on%20USMCA%20Implementation%20and%20Enforcement.pdf>.

[23] Ironically, another opponent of the DST, the Tax Executive Institute, seemed to believe that the Canada DST was not "discriminatory" enough, and recommended in June 2021 that "the worldwide income threshold of €750 million in global revenue from all sources should be determined via reference to in-scope revenue only": "TEI Comments on Canadian Government's Proposed Digital Services Tax" (18 June 2021) at 2, online (pdf): <tei.org/sites/default/files/advocacy_pdfs/TEI%20Comments%20-%20Proposed%20Canadian%20Digital%20Services%20Tax%20-%20FINAL%20to%20Department%20of%20Finance%2018%20June%202021.pdf>.

[24] "Comments of the Office of the United States Trade Representative (USTR) on Canada's proposed Digital Services Tax Act" (22 February 2022) at 1, online (pdf): <ustr.gov/sites/default/files/USTR%20Cmts%20on%20Canadian%20DST%20Proposal.2022.02.22.pdf>. Like the U.S. Chamber of Commerce's comments, the USTR's submission repeated the fact that the Canadian DST's threshold is based on total gross revenue rather than in-scope revenue, but did not seem to recognize that this sharply distinguished the tax from the pre-existing DSTs.

"retaliatory" tariffs).[25] Especially since such determinations are often bound by no rule of law, factual accuracy would seem to be critical to their legitimacy. Therefore, the gross inaccuracies of the USTR's accusations of the Canadian DST suggest that on DST issues, the agency has become a mere mouthpiece for U.S. industry lobbies.[26]

2. New DST Policy and Legal Issues

The Canadian DST has not only a lower revenue threshold for taxable persons, but also a wider base in terms of the scope of taxable digital services revenue. Like the U.K. and French DSTs and the DST proposed as an EU directive, revenue from online marketplaces is in-scope under the DSTA. Unlike the U.K. DST, but similarly to the French DST (and the proposed EU DST directive), all targeted online advertising revenue and user data revenue are in-scope. Finally, unlike the French DST (and the proposed EU DST directive), but similarly to the U.K. DST, all social media services revenue is in scope. Overall, therefore, the Canadian DST has a significantly broader tax base than its peers. This broad base raises two important policy issues in DST design, which this section first examines before turning to certain refinements of DST legal concepts.

a. Online marketplaces and B2B transactions

DSTA s. 2 broadly defines an "online marketplace" as "a digital interface that allows users to interact with other users and facilitates the supply of property or services, including digital content, between those users, but does not include a digital interface (a) with a single supplier of such property or services; or (b) the main purpose of which is to provide payment services by facilitating the electronic transfer of funds, grant credit, or facilitate the supply of financial instruments."[27] "Digital interface" is defined even more broadly to mean "a website, application or any other electronic medium through which data or digital content is collected, viewed, consumed, delivered or interacted with."[28] One therefore expects much of the work of delineating taxable digital services to be done by terms such as "online marketplace" and "social media platform", and not by the term "digital interface". For example, a computer operating system (e.g., Microsoft Windows) is an "electronic medium through which data or digital content is collected, viewed, consumed, delivered or interacted with."[29] One expects to find out whether Windows, as a digital interface, is deemed to provide a taxable service by applying other terms of the DSTA.

This last example in fact presents an important policy question. It has long been noted that computer operating systems are "multi-sided business models" that generate network effects: they

[25] See US, Congressional Research Service, *Section 301 of the Trade Act of 1974: Origin, Evolution and Use*, by Andres Schwarzenberg, (R46604) (2020) [Schwarzenberg].

[26] Recent experience elsewhere has demonstrated the difference between a DST that is designed according to principles and the frequently portrayed DST that is arbitrary and targeted only at a few politically salient MNCs. Upon reviewing the first year of DST implementation, the U.K. government reported that HMRC under-estimated the applicable scope of the U.K. DST (narrow as such DST is in comparison with Canada's) by two thirds. See NAO Report, *supra* note 13.

[27] DSTA *supra* note 1, s 2 (definitions).

[28] *Ibid.*

[29] *Ibid.*

bring together developers of applications, end users, and even makers of computer hardware.[30] Should this kind of "digital platform" be subject to the DST as an online marketplace? On the one hand, the answer seems to be yes: revenue from consumer app stores offered by Apple and other companies are already subject to the DST; they are "online marketplaces" just as much as eBay, Amazon Marketplace, Expedia, Uber, etc. are. On the other hand, it is not known that Microsoft, Apple, and others are subject to the DST from the sale of operating systems. Whether this discrepancy is justified in terms of either policy or law is still an open question.

The DSTA appears to confront this important question because of the interesting business model of one of Canada's leading tech companies, Shopify. Shopify is often mentioned as a competitor to Amazon, eBay, etc. in the sphere of e-commerce,[31] but it in fact offers a type of software-as-service to help small and large businesses carry out retail sales. Like Amazon Marketplace and eBay, Shopify helps merchants with payments, deliveries, and other aspects of online sales. But unlike these other platforms, consumers do not go to Shopify to shop; nor would they find customer reviews and comparisons of different products. Shopify's interface is instead directed at merchants, who go there to access different kinds of software and services (including from third-parties)—but not customers. To the extent Shopify acts as an intermediary between merchants and third-party app and service providers, it is a marketplace for merchants engaged in B2B transactions.

The drafters of the DSTA appear to want to exempt Shopify from the DST. The Explanatory Notes injects an unexpected element into the "digital interface" notion: it is suggested that one must count or individuate digital interfaces by reference to business purpose.[32] This is confusing, because it is natural to think that a single digital interface can have multiple business purposes, or at least multiple lines of revenue that are usefully distinguished under the DSTA. Facebook's single digital interface, for example, may generate revenues both as a social media platform and by providing online advertising services (both taxable). Amazon.ca's single digital interface, likewise, may both operate an online marketplace (taxable) and conduct online retail sales of its own inventory (non-taxable). It seems that according to the Explanatory Notes, to say that Facebook (or Amazon.ca) has one "digital interface," one must invoke such a notion of "business purpose" that each "purpose" can encompass different sources of revenue and possibly different business models.

An obvious question is why it is necessary to count "digital interfaces" under the DSTA (and implicitly, count business purposes). The only place where this exercise (and the notion of "business

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[30] David Evans & Richard Schmalensee, "The Antitrust Analysis of Multisided Platform Business" in Roger Blair & Daniel Sokol, eds, *Oxford Handbook on International Antitrust Economics*, vol 1 (Oxford: Oxford University Press, 2015).

[31] Stephen Baldwin, "The Invisible Selling Machine" (15 March 2017), online (pdf): <stbaldwin.files.wordpress.com/2011/07/sho-w-03-15-17-xmit.pdf>.

[32] Described in Explanatory Notes, *supra* note 17 at 8:

> Connected web pages, or parts of an application, which together constitute one business enterprise, such as an online marketplace, social media platform or online search engine, are considered to be one digital interface. The specific inclusions of ‘~~“~~website’~~”~~ and ‘~~“~~application’~~”~~ are intended to express this concept. If a taxpayer engages in more than one business enterprise, it is possible for the taxpayer to have more than one digital interface. Such a taxpayer would delineate the scope of each of its digital interfaces by grouping the components (for example web pages or parts of applications) with a common business purpose taking into account relevant considerations such as the kinds of revenue earned, the users, and whether or not particular components can be operated, in a business sense, independently from the others."

purpose") appears again in the Explanatory Notes is Example 2 under the definition of "online marketplace".[33] The example seems to argue that a taxpayer offering "website hosting services" supporting online retailers does not count as an online marketplace, because each retailer's webpage is a separate digital interface. This seems confused. If each retailer is considered a taxpayer, then the relevant digital interface *of the taxpayer* is clearly its webpage, not the digital interface of a distinct taxpayer that offers website hosting services to multiple retailers. And there is little ambiguity that a retailer's digital interface is not an online marketplace (if it is the retailer's own inventory that is sold.) By contrast, the digital interface of the taxpayer *that offers website hosting services* is likely the app or program by which individual retail websites are created. It seems wrong to say that because the *retailers'* digital interfaces are distinct and individually not online marketplaces, the website hosting service provider's digital interface is not an online marketplace.

Shopify is clearly a web-hosting service: each retail website created using Shopify is a distinct digital interface of the retailer. These retail websites are mostly not online marketplaces. Shopify's app, however, is Shopify's digital interface, which may indeed be an online marketplace, to the extent the app facilitates users—retail merchants and third-party providers of software and services used by retail merchants—transacting with one another. In such cases, Shopify's revenue from retailers' subscription fees may be appropriately treated as online marketplace revenue. But if Shopify is taxable—as seems to be the case based on the plain language of the DSTA—the question of whether operating systems are taxable becomes more urgent.

b. Taxing "social media platforms" and the main purpose test

DSTA s. 2 defines "social media platform" as "a digital interface the main purpose of which is to allow users to find and interact with other users or with user-generated digital content."[34] However, the "main purpose" test is vague and can potentially lead to many disputes. When a similar test of what constitutes a "main purpose", as opposed to an incidental purpose, is offered under other bodies of tax law, such as the Income Tax Act, individual adjudications based on an open-ended set of facts and circumstances are usually anticipated. This raises the question of whether the federal government expects, and is prepared for, a substantial number of disputes at the onset of Canadian DST collection regarding what falls within the scope of the term "social media platform".

The potential uncertainty implied by the main purpose test are illustrated by the examples offered by the Explanatory Notes.[35] We are first told that "many online gaming platforms with an interactive component allow users to find and interact with other users or with user-generated digital content, but often such features of the game are incidental to the main purpose (i.e., the service of providing a gameworld). However, if the interactive component of an online game is the game's main

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[33] *Ibid* at 10; Example 2 seems clearly to apply to Shopify without naming it:

> A taxpayer provides website hosting services to many entrepreneurs. The taxpayer's business model involves providing pre-made website templates which can be tailored by entrepreneurs into personalized online stores. Since the various websites provided by the taxpayer are each for an unconnected business purpose, that is, the business of each entrepreneur, each one would be a separate digital interface. Additionally, a prospective purchaser visiting the website of one such entrepreneur would not be connected to the websites of the other entrepreneurs since the websites operate independently. Each of these digital interfaces would only have one supplier; as such, they would not meet the definition of "online marketplace."

[34] DSTA *supra* note 1, s 2.

[35] See Explanatory Notes*, supra* note 17 at 13.

purpose, the game would be a social media platform."[36] How should we expect the distinction between these two types of gaming platforms to be developed? Would it be through litigation, and if so, what guidance should courts follow? For example, whether the interactive component is the main purpose of a platform may change over time, and there may be differences between platform design and user preference: users may value the interactive component even when the latter is not designed as the main function of a platform. Which factors should courts give greater weight to?

The Explanatory Notes also mention the example of document management systems and state that they may be excluded from the definition of "social media platform" if their main purpose is "to provide software tools that improve work productivity and provide cloud storage".[37] However, storage and productivity enhancement are functions that can be offered simultaneously with the aim of promoting user interactions. Productivity enhancement may occur *as a result of* user interactions: Tableau Public and Github are two leading examples. Indeed, many educational sites (e.g., Scratch) introduce social media functions as a part of their interface design. To ask whether the social media features of platforms are "incidental" or the main purpose begs the question of what perspective we are taking to analyze this distinction.

The U.K. DST also deploys a "main purpose" test for determining whether something constitutes a "social media service", and it is useful to consider the U.K.'s approach for resolving the ambiguities of the test.[38] On the one hand, the HMRC's DST Manual[39] explicitly state multiple factors that might be considered in an open-ended inquiry.[40] On the other hand, some examples are offered to illustrate how the government might apply these factors.[41] It is not clear whether such guidance is in fact adequate for taxpayers (let alone courts). In the U.K., what may have prevented related disputes from significantly hampering revenue collection is likely the very high revenue threshold (£500 million of taxable digital service revenue) that results in relatively few MNCs being subject to the U.K. DST. By contrast, in Canada, where the revenue threshold is much lower ($20 million of Canadian digital services revenue), the weakness of this "all facts and circumstances" approach is likely to be quickly exposed.

One possible solution to this problem is to more directly identify what constitutes a "social media platform", instead of relying on generic features such as the promotion of user interaction and engagement with user content. For example, if a digital interface is licensed to businesses for use by employees, the subscription fees paid by the business customers (employers) are unlikely to reflect the value of the collaborative tool as a social media device for the employees (even if some such value exists). Thus, subscription fees from business users may be excluded from social media platform revenue (unless making such an interface available for employee use may be deemed to be an employee benefit under the Income Tax Act).

c. Illustrative legal refinements

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[36] *Ibid.*
[37] *Ibid.*
[38] The U.K. DST only requires *one of the main purposes* of a service to be the promotion of user interaction. This sometimes can result in an easier determination than of what is *the* main purpose.
[39] U.K., HM Revenue and Customs, *Digital Services Tax Manual* (19 March 2020), online: <gov.uk/hmrc-internal-manuals/digital-services-tax>.
[40] See *Ibid* at DST14500 ("Indicators of when there is a Main Purpose of Promoting User Interaction").
[41] See *Ibid* at DST14800 ("Social Media Examples").

Some of the obvious design questions initially confronted by the U.K. and French DSTs are addressed from the outset in the DSTA. For example, revenue earned from a constituent entity of a consolidated group of which the taxpayer is a member is generally excluded.[42] Online targeted advertisement revenue is reduced to the extent of any payment to another entity if the payment is in respect of the online targeted advertisement, and the payment is online advertising services revenue of the other entity.[43] Social media platform revenue excludes revenue "from the provision of private communication services consisting of video calls, voice calls, emails and instant messaging, if the sole purpose of the platform is to provide such services."[44]

A basic assumption of the DST designed as a tax on revenue but which may still reach economic rent is that the marginal cost of the digital service provided is near zero. This is true of many algorithmically-powered services—which the United Nations and OECD have called "automated digital services"—but it is distinctively false of ancillary fees charged by some platforms such as shipping and storage fees and cleaning fees. DSTA s. 13(2)(a) sensibly excludes storage and shipping fees from online marketplace revenue, but it leaves out cleaning fees and other possible fees that represent significant marginal costs associated with individual transactions. The U.K. DST fails to exclude such fees altogether (for example by explicitly including cleaning fees in digital services revenue), which is arguably incorrect. It thus appears that the DSTA may need to expand the s 13(2) carveouts before implementation.

The proposed DSTA takes a distinctive and thoughtful approach to determining how digital services revenue is to be attributed to Canada. For example, for online marketplace revenue, DSTA s. 14 requires apportionment to Canada to be done for each online transaction unless the transaction involves the delivery of service in physical form in Canada.[45] Similarly, in the computation of online advertising revenue, DSTA s. 16 requires the identification of advertisements targeted at users with particular locations. Since the digital services revenue from individual supplies (e.g., commission from sales) and individual advertisement contracts can vary widely across supplies and contracts, this approach has the advantage of capturing this variation, instead of assuming all transactions are of equal value. In conceptual contrast to this "bottom-up" approach, DSTA s. 14 takes the position that the value of subscription fees, premium services, etc., is not traceable to individual payers of such fees but the total amount of activity on the platform.

It is not easy to evaluate the technical requirements for sourcing revenue on a per-transaction basis. The feasibility of sourcing at the level of individual supplies for online marketplaces seems supported by the collection of the U.K. DST, which also takes a "bottom-up" approach. On the other hand, the U.K. DST sources advertising revenue entirely by user views, not by user targets, which is less accurate in reflecting the pricing variation in digital services.

The DSTA approach does seem to enjoy an important advantage in reducing the likelihood of "double taxation" when other jurisdictions enact DSTs. It is useful to contrast it with the method adopted under the U.K. DST. Sales commissions are sourced entirely to the U.K. if there is one U.K. party in the transaction. For this reason, the U.K. DST does not need to distinguish between transactions involving one as opposed to two U.K. parties. However, to mitigate the risk of double taxation, the U.K.

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[42] See DSTA *supra* note 1, s 13(2)(b).
[43] See *Ibid*, s 15(2)(b).
[44] *Ibid*, s 17(2)(b).
[45] In other words, only revenue in respect of transactions in services physically performed in Canada is attributed entirely to Canada.

DST requires taxpayers to identify foreign parties in transactions, and if a foreign party comes from a country that has adopted a DST, then the revenue from that transaction is reduced by half for purposes of the U.K. DST. This approach requires not only transactional-level sourcing, but also the identification of the particular countries in which foreign users are located. In addition, the U.K. government needs to determine whether other countries have adopted DSTs, which itself is subject to the ambiguity of what constitutes a DST. It therefore seems that the DSTA's approach, by aiming from the start to not make the revenue base over-inclusive, presents a simpler and more effective design.

3. The DST's Relation to Trade Disputes and International Law

As the previous section's discussion suggests, many interesting DST design issues are not intrinsically international in nature. But the DST has mainly been cast as a controversial subject in international taxation—indeed requiring resolution through new global agreements. By situating the DST controversy alongside certain other recent or ongoing international trade disputes, this section aims to underscore how odd this understanding should be seen as.

Many members of the public (including most journalists) know little about the DST except that it would "provoke trade wars". Yet this association between the DST and trade tensions—which immediately problematizes DST enactment—involves a peculiar circumlocution or indirection, as it omits a most obvious fact, namely that the threat of trade wars provoked by DSTs comes exclusively from the United States. And the U.S. is indeed currently the source of a number of other major trade disputes. In early December 2022, the World Trade Organization (WTO) releases panel reports ruling that the U.S.' "Section 232" tariffs on steel and aluminum imports from China, Norway, Switzerland, and Turkey are in violation of U.S. obligations under the General Agreement on Tariffs and Trade (GATT).[46] The U.S. immediately rejected the WTO reports and declared that it would not change its policy, because "issues of national security cannot be reviewed in WTO dispute settlement and the WTO has no authority to second-guess the ability of a WTO Member to respond to a wide-range of threats to its security."[47] Later in the month, the U.S. rejected another WTO panel report that found U.S. origin marking requirement imposed on Hong Kong products to be in violation of WTO rules.[48] These latest developments merely continue and intensify other recent U.S. trade measures that had been declared WTO-non-compliant.[49]

Even more ominously, the U.S. Inflation Reduction Act (IRA) of 2022 contains strong protectionist measures that offer several hundreds of billions of dollars of subsidies often available only

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[46] See WTO, "WTO Circulates Dispute Panel Reports Regarding US Measures on Steel and Aluminum Products" (9 December 2022), online: *WTO* <wto.org/english/news_e/news22_e/544_552_556_564r_e.htm>.

[47] USTR, Press Release, "Statement from USTR Spokesperson Adam Hodge" (9 December 2022), online: *USTR Press Releases* <ustr.gov/about-us/policy-offices/press-office/press-releases/2022/december/statement-ustr-spokesperson-adam-hodge>.

[48] USTR, Press Release, "Statement from USTR Spokesperson Adam Hodge" (21 December 2022), online: *USTR Press Releases* <ustr.gov/about-us/policy-offices/press-office/press-releases/2022/december/statement-ustr-spokesperson-adam-hodge-0>. For the panel report, see *United States —Origin Marking Requirement* (2022), *WTO* Doc WT/DS597/R (Panel Report), online: *WTO* <docs.wto.org/dol2fe/Pages/SS/directdoc.aspx?filename=q:/WT/DS/597R.pdf&Open=True>.

[49] See e.g. WTO, "WTO Pane; Issues Report Regarding US Tariffs on Chinese Goods" (15 September 2020), online: *WTO* <wto.org/english/news_e/news20_e/543r_e.htm>; Bryce Baschuk, "WTO Grants China a $645 Million Tariff Weapon Against U.S.", *Bloomberg* (26 January 2022), online: <bloomberg.com/news/articles/2022-01-26/wto-grants-china-a-645-million-tariff-weapon-against-the-u-s>.

to U.S. producers, presenting a new, enormous source of trade tensions among the U.S. and its allies.[50] The trade disputes it has generated will take decades to resolve.[51] For anyone interested in international trade, these recent trade tensions—and their U.S. origin—are hard to miss. In fact, the DST trade disputes are puny in magnitude compared to these and other disputes that now feature in news headlines with a regrettable frequency.[52]

An interesting question, therefore, is how the international tax community so readily developed a diplomatic vernacular, by consistently omitting mention of the fact that if it wasn't for the U.S., DSTs would be very unlikely to have become an international trade issue. A leading instance of the practice of this delicate vernacular is the OECD's Economic Impact Assessment of the Two Pillar Blueprint in 2020. To model what would happen to the world if the "Two Pillar Solution" was not adopted, the OECD assumed that all countries except for the U.S., China, and Hong Kong enact DSTs—presumably, not because the world collectively wanted to spite the U.S., but instead because countries find DSTs sensible to adopt. It is further assumed, not unrealistically, that only the U.S. retaliates against DSTs. The model then assumes that all countries targeted by U.S. tariffs would enact proportionate counter-tariffs against the U.S.: again, presumably, the tariffs are assumed to be proportionate because they would be allowed under the WTO. The OECD then presented this scenario where the U.S. is at war against the rest of the world, while all other countries are entirely at peace among themselves, as a catastrophe not for the U.S., but for the world.[53]

The U.S., of course, is far from being a unique perpetrator of policies that harm trade partners or a unique victim of such policies. Instead, to properly put the DST controversy in context, the following perspective may be helpful. It is not unreasonable to expect that countries, in the pursuit of trade and international tax policies, aim to advance their own national interests. This not infrequently comes at the expense of other countries. In particular, although protectionism does not generally maximize national income—in that sense, protectionist policies are not generally in nations' self-interest—there are many circumstances countries can individually gain by adopting import tariffs, domestic subsidies, and other trade measures the cost of which is largely shifted onto foreigners. Indeed, the range of such measures is vast and indefinite, taking both fiscal and regulatory forms.[54]

Given such pervasive incentives and opportunities for countries to pursue trade policies that advance their national self-interest even while the policies impose negative externalities on others, it would be naïve, or, alternatively, disingenuous, to postulate that the international community will always stand ready to censure such policies. Instead, it is more reasonable to expect that countries cooperate to refrain from pursuing such policies only if there is sufficient mutual gain. A central example

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[50] See Andy Bounds, "EU Accuses US of Breaking WTO Rules with Green Energy Incentives", *Financial Times* (6 November 2022), online: <ft.com/content/de1ec769-a76c-474a-927c-b7e5aeff7d9e>; Bryce Baschuk, "WTO Urges US, EU to Avoid 'Race to the Bottom' in Subsidy Spat", *Bloomberg* (7 November 2022), online: <bloomberg.com/news/articles/2022-11-07/wto-urges-us-eu-to-avoid-race-to-the-bottom-in-subsidy-spat/>.

[51] David Kleinman et al, "How Europe should answer the US Inflation Reduction Act," *Policy Contribution* 04/2023, Bruegel.

[52] For example, the Section 301 tariffs the U.S. imposed against France in retaliation for the DST covered $1.3 billion of French imports. By contrast, in 2019 the U.S. imposed tariffs on $7.5 billion of imports from the EU in the Large Civil Aircraft dispute, and in 2017, $370 billion of U.S.-China trade was affected by the Section 301 tariffs. See Schwarzenberg *supra* note 25 at 29, 32.

[53] For further discussion, see Cui, "International Tax Agreements", *supra* note 11, Part I.B.

[54] For a discussion of and citations to the relevant literature on the theory of optimal tariffs and the "terms-of-trade theory" of international trade agreements, see *ibid*, Part III.

of this is the GATT regime, which would not have come into being if advanced economies had not been levying substantial tariffs on one another. It was the possibility of mutual gain from the reciprocal reduction of tariffs that gave GATT its purpose. And the existential threats that the WTO system currently faces amply demonstrate the fragility of such cooperation.

The worst charge that has been made against the DST is that it discriminates against U.S. MNCs. This charge is false both as a matter of fact—at least when applied to the Canadian DST—and as a matter of international law.[55] But even if it were true, it would hardly make the DST very special from the perspective of trade relations. Indeed, it should not at all be surprising that DSTs are generally compatible with the existing WTO regime, i.e. the General Agreement on Trade in Services (GATS). GATS itself was very limited in its success in removing barriers to the services trade; and because DSTs are new policy instruments, countries never had the occasion before to negotiate their elimination or reduction.

Conclusion

Many governments (including Canada) and much of the global tax community appear eager to see DSTs go away through agreements on Pillar One. Yet such eagerness seems only to suggest the discourse on international taxation occupies its own universe. Over 140 countries are brought together to agree on the settlement of one of the world's pettier, more transient trade spats. Moreover, this remarkable collective goodwill is summoned by the desire only to appease currently the world's most intransigent trade provocateur. Pillar One aspires to develop an unprecedented international tax legal order with massive international cooperation, just to manage the taxation of residual profits of at most a few hundred MNCs. Meanwhile, its proponents seem happily oblivious of the imminent collapse of the WTO trade law regime, which has long handled a much greater volume of disputes of regarding a much greater portion of the global economy, and which, if allowed to continue to function, could have well managed whatever trade issues is raised by the DST. The most obvious question for Pillar One, it would seem, is not whether it would succeed. Instead, it ought to be what it's all for.

Intellectually interesting as the DSTA may be, the DST may never be enacted in Canada. Some may consider Canada already lucky to have received somewhat favorable treatment under the Inflation Reduction Act, where certain provisions originally requiring production in the U.S. were loosened to allow production in "North America". They would argue that the revenue gains for Canada from the DST are small compared to what the country stands to lose, in this age of protectionism (and "friend-shoring"), if it falls out of its neighbor's favor. The extent of Canadian domestic political support or pressure to adopt the DST, in any case, was never clear. During the 2019 federal election, four major political parties brought the "digital services tax" enactment onto their platforms almost simultaneously, within just a few weeks before the election.[56] But it was unclear whether either politicians or the public understood by it a new tax, or just extending the Goods and Services Tax on imported services.[57] Due to the sudden breakout of the pandemic, there was also no public discussion of the DST between the end of the October 2019 election and the government's December 2020 Fall Economic Statement, which

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[55] For the compatibility of DST with international trade law and tax treaties, see *supra* note 10.
[56] See Jonathan Montpetit, "How it Suddenly Became Chill to Tax Netflix and Other Web Giants", *CBC News* (16 October 2019), online: <cbc.ca/news/canada/montreal/netflix-tax-2019-federal-election-1.5318942>.
[57] For an element of Canada's reformed GST that effectively taxes digital platform profits, see Wei Cui, "Reforming GST Rules for Foreign Digital Suppliers" (19 January 2021), online: *Finances of the Nation* <financesofthenation.ca/2021/01/19/reforming-gst-rules-for-foreign-digital-suppliers/>.

first indicated that DST legislation was being seriously considered. Nor is evidence abundant for strong public sentiments that foreign MNCs are not paying their “fair share” of tax in Canada.

Such considerations, however, are all extrinsic to the basic rationales for adopting the DST. In that sense, no one is wiser if the Canadian DST does not come to pass.