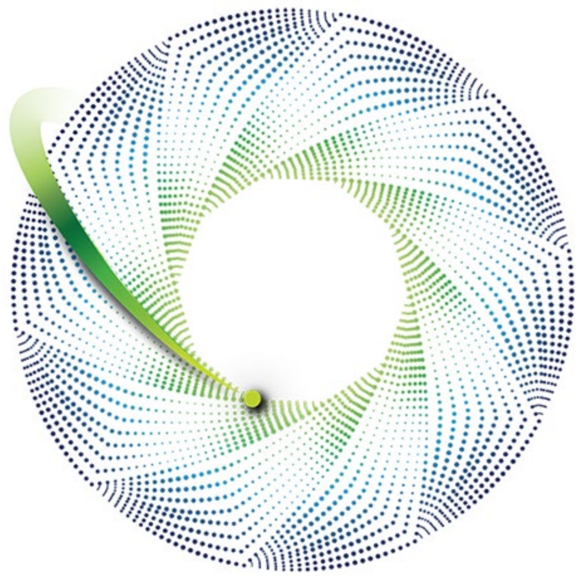

Canadian Tax & Legal Alert

Release of draft *Digital Services Tax Act* signals new era in Canadian tax

January 25, 2022

The recent release by the Department of Finance of a draft of the new *Digital Services Tax Act* (DSTA or the "draft legislation")[1] is noteworthy in many respects. Canada's digital services tax (DST) is designed to tax businesses, Canadian and non-resident, that incorporate digital technology to engage with online users in Canada. The in-scope business models listed in the DSTA target digitalized businesses. However, the broad definitions are imprecise and may inadvertently capture other business models.

As an entirely separate statute from the *Income Tax Act*[2] and the *Excise Tax Act*,[3] the DSTA introduces a completely new type of tax on revenue. As a result, businesses face significant issues and questions including the following:

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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, December 14, 2021, online: https://fin.canada.ca/drleg-apl/2021/bia-leb-1221-1-l-eng.html

[2] *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.), as amended (herein referred to as the "ITA").

[3] *Excise Tax Act*, R.S.C. 1985, c. E-15, as amended (herein referred to as the "ETA").

- The manner in which the legislation has been drafted introduces **new and complex financial reporting questions**, including how the tax is to be reported in a company's financial statements, as well as what are the reporting periods for which the tax is relevant in the first place. As further discussed below, what is clear today is the fact that no accounting for a DST liability should be required until, at the earliest, the date the legislation receives Royal Assent, which will be some time after February 22, 2022.[4]
- The **data required to be collected** in order to facilitate the computation of a company's DST liability will require organizations to carefully evaluate their information systems and obligations under relevant privacy legislation.
- The DSTA provides a template for making **GAAP concepts**, such as consolidated reporting, directly applicable to the computation of an entity's tax liability; an idea which is expected to become increasingly prevalent over the coming months and years with the introduction of other tax rules including Canada's proposed limitations on the deductibility of interest and the introduction of a proposed global minimum tax.

Overview

The DST is proposed to be a 3% tax on revenue derived from the sale of Canadian user data and the provision of digital services that implicate Canadian users in various ways. More specifically, the in-scope services include those relating to online marketplaces to facilitate third-party transactions, online advertising, and social media.

The tax will only apply to companies, both private and public, with consolidated revenue, as determined under IFRS or another set of accounting principles relevant for publicly listed companies, of at least €750 million. Only revenue from in-scope Canadian services greater than $20 million[5] would be taxed.

The draft legislation stipulates that the DST applies to businesses on January 1, 2022, but is payable in 2024. However, the amount is payable only if legislation to implement the OECD's Pillar I initiative has not come into force by 2024. It is not clear if these conditions will be met in time. Nevertheless, even with this uncertainty, businesses should already be assessing the following:

- Whether any of the activities performed by a group are considered in-scope activities;
- Revenues that are generated in connection with those in-scope activities (taking note of the newly introduced concept of consolidated group revenue);
- How much of that revenue is attributable to Canadian users;
- Accounting, legal, and systems related implications; and
- Whether the business should provide comments to the Department of Finance by February 22, 2022.

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[4] The government is inviting interested parties to provide comments on the draft legislation by February 22, 2022, and will take into account feedback received in this consultation in order to finalize the legislation, prior to its inclusion in a bill to be tabled in Parliament.
[5] All amounts are in Canadian dollars unless otherwise stated.

Global context and effective date of the legislation

As discussed in our previous Deloitte Tax Alerts, on October 8, 2021, 136 countries agreed to the OECD's proposal to reallocate taxing rights across jurisdictions and ensure that the largest companies in the world pay a global minimum corporate tax of 15%.[6] These proposals are commonly referred to as Pillar I and Pillar II, respectively.[7]

One of the clauses in this agreement states that no new DST-style taxes would be implemented if not already in force. Accordingly, any such taxes currently in force would be eliminated once the Pillar I and II proposals are fully adopted. As a result, the Canadian government announced its intention of finalizing a DST by January 1, 2022, in keeping with its commitments announced in the 2021 federal budget. However, Canada has a strong preference for a multilateral approach, and the new DSTA includes language that reflects this intention. More specifically, the DSTA will come into force only if the legislation to implement the Pillar I initiative has not come into force. In that event, the DST would be payable as of 2024 in respect of revenues earned as of January 1, 2022. This is noteworthy since it means the DSTA itself will not yet be in force, even after the legislation receives Royal Assent. The situation can thus be distinguished from one in which legislation has come into force, but may be subject to a contingent repeal.

Key issues and considerations

Taxable persons

The DST applies to businesses organized under various forms, including corporations, trusts, and partnerships. It will apply in a particular calendar year to an entity that meets, or is, during the calendar year, a member of a business group that meets, both of the following thresholds:

- Total global revenue from all sources in the fiscal year ending in the previous calendar year was equal to or exceeded €750 million; and
- In-scope revenue associated with Canadian users exceeds $20 million for the reporting period in the current calendar year.

The DST will apply only to in-scope revenue associated with Canadian users over the $20 million threshold for such entities or groups.

Taxable activities

The following activities are considered digital services:

1. *Online marketplace:* services that help match sellers of goods and services with potential buyers. This category would not include businesses that sell their own goods or services or digital interfaces where the main purpose is to:
    - provide payment processing services;
    - grant credit; or
    - facilitate the supply of financial instruments, including cryptocurrency, and commodities.

    Revenue related to the storage or shipping of goods sold through the marketplace, to the extent compensation for such services is reasonable, is also excluded from the online marketplace services revenue definition.

[6] See https://www.oecd.org/tax/international-community-strikes-a-ground-breaking-tax-deal-for-the-digital-age.htm

[7] OECD, Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy, October 8, 2021, online: https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.htm

2. *Social media:* services provided through a digital interface to facilitate interaction between users and user-generated content. This category would not include an interface whose sole purpose is to provide private communication services (telephone services, video calls, emails, and instant messaging).

3. *Online targeted advertising:* services aimed at the placing of online advertisements that are targeted at users based on data gathered from users of an online interface. This category includes sponsored content and preferential listings.

4. *User data:* services related to the generation or collection of data from a user's interaction with an online interface.

Revenue sourcing

Two methods should be used to determine an entity's in-scope revenue associated with users in Canada (as opposed to users in another jurisdiction). The tracing method applies, where possible, to associate revenues to users in Canada using information such as billing information or mailing addresses. Where tracing is not possible, a specified formulaic allocation is required. The revenue sourcing principles will vary according to the nature of the revenue. Where an entity's revenue relates to activities with Canadian and non-Canadian elements, the revenue will need to be reasonably determined based on the percentage of users that are located in Canada.

Taxable base

If the above-mentioned revenue thresholds are met, the DST will apply at a rate of 3% of taxable Canadian digital services revenue for a calendar year. Canadian digital services revenue is the total of Canadian online marketplace services revenue, Canadian online advertising services revenue, Canadian social media services revenue, and Canadian user data revenue.

Administration

Taxpayers subject to DST are required to file an annual return following the end of the reporting period, which is the calendar year or the part of the calendar year during which an entity is a constituent member of an in-scope consolidated group. The draft legislation reads that:

- One annual payment will be required after the end of the reporting period;
- A group will be able to designate an entity to file the DST return and pay the DST liability on behalf of the group by filing an election; and
- To facilitate enforcement, each entity in a group will be jointly and severally liable for DST payable by any other group member.

The penalty for failing to register is $20,000 for each calendar year in which the taxpayer was required to register. Furthermore, taxpayers are required to maintain records related to their DST liability for a period of eight years.

Deloitte's perspective

1. Accounting and systems related implications

The DST is a tax levied on revenue without the benefit of any deductions meaning it should not be considered an income tax as defined in IAS 12[8] and should not be recorded as part of the income tax expense. The accounting for the DST should be governed by IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* as further interpreted by IFRIC 21 *Levies*.[9] For a provision to be recorded in respect of DST, IAS 37 requires, among other conditions, that there be a present obligation to pay the tax arising under the law after having earned the revenues targeted by the DST. The coming into force provision for the DSTA creates uncertainty as to when a present obligation arises under that law. The earliest time to consider an accrual will

[8] International Accounting Standards, IAS 12 *Income Taxes*.

[9] International Financial Reporting Interpretations Committee (IFRIC).

arise only after the DSTA receives Royal Assent and that should not occur until sometime after the consultation period closes on February 22, 2022, but it is possible that accrual will be delayed until the DST comes into force.

In-scope taxpayers should also consider what changes will need to be made to information systems and systems of internal control to accurately capture and report digital services revenue that will be subject to the tax. As discussed below, this will require the collection and tracking of user data, possibly in real time, which raises consequential questions from a privacy perspective.

There may also be wider “knock-on” effects resulting from the introduction of the DST, such as impacts on an entity’s budgets and forecasts, liquidity position, key performance metrics, and compliance with debt covenants.

2. DST is a novel type of tax with legislation separate from both the ITA and the ETA

As a new tax, the DST is neither a tax on income or profits, nor a sales tax. Taxpayers subject to the DST should review the implications of this new tax, particularly the issue of where the DST liability should be reported in their financial statements.

3. DST liability is not eligible for a credit against Canadian income tax payable

Impacted businesses will incur a new Canadian tax alongside existing Canadian tax liabilities on profits arising from the same activities. Since the DST is imposed by separate legislation, payments made under the DSTA are not eligible to be used as a credit against amounts arising under the ITA or ETA. The only relief is that payments of DST should reduce the taxable income otherwise calculated, and may therefore reduce income taxes otherwise owing by utilizing this deduction.

4. DSTA introduces the concept of consolidated group revenue

Unlike when calculating income or sales taxes, the DSTA requires a taxpayer to consider whether or not they are a part of a consolidated group. If so, the revenues of the consolidated group are considered in aggregate when determining whether or not the thresholds for the DST are met and in calculating the amount of taxable Canadian digital services revenues earned. The DSTA defines a consolidated group as two or more entities required to prepare consolidated financial statements for financial reporting purposes under acceptable accounting principles or would be so required if equity interests in any of the entities were traded on a public securities exchange. Similar rules are expected to be relevant on the introduction of legislation to give effect to Canada’s proposed earnings stripping rules, which would limit the amount of interest that is deductible for tax purposes based on a percentage of a taxpayer’s EBITDA, or that of a consolidated group. The aforementioned proposed global minimum tax also requires taxpayers to compute their liability with reference to consolidated financial statement information, albeit with additional modifications and nuances. As such, the DSTA likely provides the template for how Canadian legislation will incorporate GAAP concepts for purposes of these other proposed rules.

5. Limited exemption for revenues derived from related party transactions from the calculation of the local and worldwide revenue thresholds and in-scope revenue

The DSTA provides only limited relief from the DST for revenues earned from related parties. If the entity from whom the revenue is earned is a constituent member of the same consolidated group of which the taxpayer is a constituent member, the revenue is excluded from the definition of taxable Canadian digital services revenues by virtue of various revenue exclusion provisions. However, where both parties are not constituent members of the same consolidated group, any revenues earned between them may meet the definition of taxable Canadian digital services revenues and may be subject to the DST, regardless of the relationship between the entities. A constituent member of a consolidated group means an entity that is included in the consolidated statements of the group, or who would be if statements were required to be prepared if any entity in the group were publicly traded or one that is excluded from the consolidated statements solely because of size or materiality.

6. **The term "user located in Canada" is introduced**

   The draft legislation clarifies that "users" for the revenue sourcing rules means users, where the real-time location of users generates online advertising or user data revenues, that are located in Canada at a given time or users that are "normally located in Canada" in all other cases. Location is based on the taxpayer's user data associated with the user. The information may include, amongst other items, billing information, IP address data, and global satellite positioning data. The new definition does create a potential issue of including "tourist users" – users who do not reside in Canada but may otherwise engage with a digital interface while visiting Canada – under the revenue sourcing rules given taxpayers must also consider the most recent location information provided by a user.

7. **The draft legislation includes relief where activity is captured under two categories of in-scope activities**

   Canada departed from other countries, such as the United Kingdom, where the concept of a "separate services test" was introduced to account for activities captured under two categories of in-scope activities. The revenue sourcing rules exclude revenues already captured under another in-scope category to calculate revenue related to online advertising services, social media services, and user data sales. The draft legislation clarifies the potential double-counting of revenues associated with the same activity.

8. **Definitions of certain in-scope activities amended to reflect feedback from previous consultations**

   Based on feedback received during the summer consultation period related to the proposed DST, the new draft legislative proposals include revisions to the definition of an online marketplace to exclude activities associated with providing payment services, granting credit, and facilitating the supply of financial instruments. However, financial institutions and other similarly regulated industries, such as telecommunications, are not explicitly exempted from the DSTA.

   Another noticeable change from earlier versions of the Canadian DST is that under the new draft legislative proposals, revenues earned from the sale of anonymous user data and the licensing of user data are not included under the definition of "user data revenue".

How can Deloitte help you?

It will be crucial for impacted taxpayers to carefully review the draft legislation to understand the potential implications to their businesses. Given the evolving nature of these draft legislative proposals, we strongly encourage entities that are expected to be impacted by the DST to continue to monitor developments.

If you have questions, please contact your Deloitte representative or any of the individuals noted in this alert.

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