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Canada

Businesses — Canada Revises Digital Tax Proposals

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Large businesses should consider how they may be affected by recent revised draft legislative proposals for the new 3% digital services tax (DST). These revised proposals, which were released on August 4, 2023, introduce a new election that businesses can make to simplify their calculations of digital services revenues for the 2022 and 2023 calendar years, clarify how affected businesses can determine their amounts of in-scope revenue and introduce measures that apply to partnerships, among other changes and clarifications. Finance notes that it will accept comments on these draft legislative proposals until September 8, 2023.

This publication provides an overview of some of the changes to the revised proposals. In light of these changes, businesses should determine how they may be affected by the revised DST rules. As a reminder, starting January 1, 2024, large businesses may be subject to the new DST on certain online revenues earned effective January 1, 2022, if the OECD's Pillar One approach to international tax reform has not yet come into force.

Background
Canada originally announced the proposed DST in its 2020 Fall Economic Statement and provided the framework of the proposed new 3% DST in its 2021 federal budget. Finance first released proposed draft legislation for the new DST in December 2021.

Essentially, the new 3% DST is set to come into force on January 1, 2024, and would apply retroactively to certain revenues from online marketplaces, social media, online advertising and user data earned effective January 1, 2022, if an international multilateral treaty to implement other tax measures (i.e., the convention to implement the OECD's Pillar One solution for international tax reform) has not yet come into force.

Pillar One is intended to ensure that certain multinational businesses pay tax in countries where they have consumer-facing activities but do not have a physical presence.

Under these proposals, qualifying large businesses will generally be subject to the DST if they have global group revenue of €750 million or more in their fiscal year ending in the previous calendar year and also have more than $20 million of "in-scope" revenue related to Canadian users for the particular calendar year. However, businesses with $10 million of in-scope revenue for a particular calendar year may also be required to register under the DST rules.

Recently, Canada announced that it intended to move ahead with the new 3% DST if the convention to implement Pillar One is not in force on January 1, 2024, even though 138 other members of the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS) had agreed to potentially delay imposing new DSTs until 2025.

For details, see *TaxNewsFlash-Canada* 2021-64, "Canada Lays Out Digital Tax Proposals for Businesses" and *TaxNewsFlash-Canada* 2021-21, "2021 Federal Budget Highlights".

Simplified revenue calculation election for 2022 and 2023

The revised draft legislative proposals introduce a new election to simplify certain calculations for the 2022 and 2023 calendar years. By making this election, businesses can calculate their Canadian digital services revenue for these calendar years by using a formula that will approximate the in-scope revenue based on the Canadian digital services revenue of the first year of application of the DST (which is expected to be 2024 if the treaty to implement Pillar One has not yet come into force).

KPMG observation
Note that, according to the revised proposals, a business may only elect to use the simplified formula for 2023 if the business made the same election for 2022, among other conditions.

Also, the revised proposals do not seem to address the possibility of double taxation with respect to the DST liability and Canadian income tax payable related to the same in-scope revenues, an issue that was raised with the previous draft legislation. It appears that the DST liability would not be eligible for a credit against Canadian income tax payable. However, the DST liability may potentially be deductible in computing taxable income in certain circumstances, based on general principles.

Clarifying certain in-scope revenue

The revised proposals and related revised explanatory notes also provide certain clarifications to help businesses identify amounts of in-scope revenue that may be subject to the DST. In particular, the revised proposals provide certain details for three of the four types of in-scope revenue associated with users in Canada, each of which has distinct sourcing rules:

- Online marketplace services revenue
- Online advertising services revenue
- Social media services revenue.

Note that the revised proposals do not appear to amend the calculation of the fourth category of in-scope revenue, user data revenue. As a reminder, user data revenue is generally earned from the sale or licensing of data gathered from users of an online marketplace, a social media platform, or an online search engine.

Online marketplace services revenue

The revised proposals clarify how to determine whether online marketplace services revenues are considered entirely sourced to Canada. Generally, these revenues are earned from providing an online marketplace that helps match sellers of goods and services with potential buyers.

Under the revised proposals, qualifying online marketplace services revenues are generally considered entirely sourced to Canada if the services are:

- Physically performed and received in Canada,
- In respect of real property situated in Canada, or
- In respect of goods normally situated in Canada and situated in Canada at the time the service is performed.

Other online marketplace services revenue may be fully or partially sourced to Canada, based on the location of the business or the user.

KPMG observation
The revised proposals clarify Canadian online marketplace services that qualify as entirely sourced in Canada. For example, one of the conditions clarifies that the qualifying services are “in respect of real property situated in Canada” (and not necessarily delivered in physical form within Canada, as previously proposed). In addition, the concept of “in respect of” is generally interpreted broadly, which may clarify which revenues are entirely sourced to Canada.

However, the revised proposals also clarify that certain other services must be performed as well as received in Canada to be considered sourced entirely in Canada.

Online advertising services revenue

The revised proposals clarify that certain online advertising services revenue are not subject to the DST. In general, online advertising services revenue is earned from services aimed at the placing of online targeted advertisements, including facilitating the delivery of an online targeted advertisement and providing digital space for an online targeted advertisement. While certain revenue that can be traced directly to the display of an advertisement to a specific user located in Canada would generally be entirely sourced to Canada, other revenue may instead be sourced to Canada based on the percentage of users located in Canada to which the advertisement was displayed.

The revised proposals indicate that amounts must now be "directly attributable to an instance of a display" of an online targeted advertisement to a user to be considered Canadian online advertising services revenue.

Some revenues may be excluded from the calculations of in-scope revenues. Based on the revised proposals, it appears that, in order for online advertising services revenue paid to another entity to qualify as excluded revenue, the taxpayer is no longer required to confirm with certainty that this revenue was included in the other entity's DST reporting, among other conditions.

KPMG observation
Although the revised proposals appear to limit the type of revenue that may qualify as Canadian online advertising services revenue, they also seem to broaden the definition of "online targeted advertisement". As a result, businesses with digital services revenue should carefully review these revised proposals to determine how they will affect their calculations.

Social media services revenue

The revised proposals clarify the definition of "social media services revenue". In general, social media services revenue is earned from providing a social media platform that facilitates interactions between users, or between users and certain digital content. This includes revenues earned from providing access to (or use of) a social media platform and from premium services. The revised explanatory notes provide guidance as to when an account is considered accessed by users for purposes of calculating in-source revenue. Social media services revenue is generally sourced to Canada based on the percentage of the platform's users that are located in Canada.

Under the revised proposals, social media services revenue now includes revenue generated from facilitating interaction between a user and "digital content" generated by

other users on a social media platform. Previously, this definition referred to “user-generated content” (instead of “digital content”).

KPMG observation
This change appears to expand the types of revenue that are considered social media services revenue since “digital content” is defined broadly under the proposed DST rules.

Other proposed changes

The revised proposals also provide other new clarifications to the DST proposals and introduce:

- New provisions related to trustees and receivers
- New measures specific to partnerships
- Additional anti-avoidance measures.

We can help

Your KPMG adviser can help you determine how you may be affected by the revised draft legislative proposals related to DST, if the new tax is implemented in Canada. We can also help you manage your related compliance obligations. For details, contact your KPMG adviser.

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