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Tax Alert – Canada

Canada's DST may trigger proposed US IRC Section 899

EY Tax Alerts cover significant tax news, developments and changes in legislation that affect Canadian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor or EY Law advisor.

On 22 May 2025, the United States (US) House of Representatives passed the *One Big, Beautiful Bill Act* (OBBBA, H.R. 1), which includes the introduction of Internal Revenue Code (IRC) Section 899, which is intended to address certain "unfair" taxes imposed by foreign countries. If enacted in its current form, IRC Section 899 would increase certain federal income and withholding tax rates payable by various foreign entities by up to 20 percentage points.

As a result of the enactment of the *Digital Services Tax Act* (DSTA), Canada would be viewed as a "discriminatory foreign country" and subject to the provisions in IRC Section 899. The impact on Canadian entities receiving income from US investments and on Canadian investment in the US generally could be substantial.

Background

Canada's DSTA, which came into force on 28 June 2024, aims to ensure that large businesses pay their fair share of Canadian tax with respect to certain revenue streams. A large business may be liable for the digital services tax (DST) if its total revenue from all sources (or total consolidated group revenue) is at least €750 million during a fiscal year that ends in the preceding calendar year, and its Canadian digital services revenue (or the total of all such revenue for all entities in their consolidated group) exceeds $20 million CAD in the calendar year. Canadian digital services revenue includes revenue earned from providing online marketplace services, online advertising, social media services and the monetizing of user data.

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If a taxpayer or its consolidated group meets the required conditions, the taxpayer(s) are required to pay a tax equal to 3% on their taxable Canadian digital services revenue in excess of $20 million CAD in a calendar year. Even if tax is not payable, registration under the DSTA is required if a person's Canadian digital services revenue exceeds $10 million CAD.

While the DSTA entered into force on 28 June 2024, it applies retroactively to 1 January 2022. As a result, taxpayers may also be subject to filing and payment requirements for the 2022 and 2023 calendar years. For 2022, 2023 and 2024, the filing deadline is 30 June 2025.

Canada enacted the DSTA after the Organisation for Economic Co-operation and Development (OECD) failed to reach a multilateral agreement to implement Pillar One of the Base Erosion and Profit Shifting (BEPS) 2.0 initiative by the end of 2023.

The following EY Tax Alerts provide additional information about Canada's DSTA:

- EY Tax Alert 2023 Issue No. 36, *Canada moving ahead with its own digital service tax: revised draft legislation released*;
- EY Tax Alert 2023 Issue No. 48, *Digital Services Tax Act has been tabled in the House of Commons*;
- EY Tax Alert 2024 Issue No. 37, *Entry-into-force date set for Canada's Digital Services Tax Act*; and
- EY Tax Alert 2025 Issue No. 28, *Preparing for digital services tax filing and payment obligations*.

The US has expressed concern over the implementation of certain foreign taxes, including digital services taxes, which it views as disproportionately impacting certain US companies.

In accordance with an executive order signed by US President Trump on 20 January 2025, the "OECD global tax deal" was declared to have no force or effect in the US. The US subsequently indicated it would respond to countries that implement DSTs and other taxes that it considers discriminatory.

IRC Section 899

On 22 May 2025, the US House of Representatives approved the OBBBA, H.R. 1, which, among other things, proposes to add Section 899, "Enforcement of Remedies Against Unfair Foreign Taxes," to the IRC.

This provision would require "applicable persons" — very generally, residents of countries that impose "unfair foreign taxes" (such as a DST) on US persons — to be subject to increased rates of income and withholding tax for the following:

- The 30% tax imposed on "fixed or determinable annual or periodical gains, profits, and income", certain capital gains and certain other types of US-source income of a nonresident alien individual or foreign corporation;
- The individual income tax rates imposed on a nonresident alien individual subject to tax on income that is effectively connected with the conduct of a US trade or business (ECI), but only to the extent imposed on gains from the disposition of a US real property interest;
- The 21% corporate income tax imposed on a foreign corporation's ECI;
- The 30% rate imposed on dividend equivalent amounts of a US branch (branch profits tax); and
- The 4% rate imposed on US-source gross investment income of foreign private foundations.

The bill would increase the specified rate of tax payable by an applicable person by the "applicable number of percentage points," which would generally be 5 percentage points during the first one-year period beginning on the applicable date and an additional 5 percentage points for each ensuing one-year period. However, the rate could not exceed the relevant statutory rate by more than 20 percentage points. Notably, if lower rates apply under the Canada/US tax treaty, the increase in withholding rates could exceed 20 percentage points, though the maximum rate is limited to 50%.

The "applicable date" would be the first day of the calendar year beginning on or after the latest of:

- 90 days after the enactment of Section 899;
- 180 days after the date of enactment of the unfair foreign tax that results in a country's designation as a "discriminatory foreign country"; and
- The first day a discriminatory foreign country's unfair foreign tax begins to apply.

As noted above, the DSTA was enacted on 28 June 2024 and has retroactive effect. Therefore, Section 899 will apply if Canada does not repeal the DSTA.

An "applicable person" would include:

- Any government of a discriminatory foreign country;
- Any individual (other than a US citizen or resident) who is a tax resident of a discriminatory foreign country;

- Any foreign corporation (other than a "United States-owned foreign corporation" as defined in Section 904(h)(6)) that is a tax resident of a discriminatory foreign country;
- Any private foundation created or organized in a discriminatory foreign country;
- Any foreign corporation (other than a publicly held corporation) if more than 50% of its vote or value is owned directly or indirectly (as defined in IRC Section 958(a)) by applicable persons;
- Any trust for which the majority of the beneficial interests are held (directly or indirectly) by applicable persons; and
- Foreign partnerships, branches and any other entity identified by the Secretary of the Treasury with respect to a discriminatory foreign country.

A "discriminatory foreign country" is defined as any country that imposes an "unfair foreign tax," which would include a DST, diverted profits tax and an undertaxed profits rule under OECD Pillar Two. The Secretary could also designate certain other taxes as an unfair foreign tax, including an "extraterritorial tax" or "discriminatory tax" as defined in the bill.

Section 899 would also modify the base erosion and anti-abuse tax (BEAT) in relation to certain US corporations for which more than 50% of their vote or value is owned by applicable persons. Specifically, the corporation would be viewed as having sufficient average annual gross receipts and a sufficient base erosion percentage to be a taxpayer subject to the BEAT, subject to higher BEAT rates and subject to other calculation adjustments.

Finally, Section 899 would make the gross income exclusion in Section 892(a) inapplicable to any government (as defined in Section 892) of a discriminatory foreign country. Section 892(a) provides a tax exemption for income received by a foreign government from certain investments in the US and certain interest on US bank deposits. Entities that could be impacted by this amendment include Canadian pension plans.

For more information about the application of proposed IRC Section 899, see EY Global Tax Alert 2025-1085, *United States: New IRC Section 899 would increase tax rates and expand BEAT for certain inbound taxpayers*.

Ramifications

By virtue of having enacted the DSTA, Canada would be viewed as a discriminatory foreign country. Section 899 could thereby have a wide-ranging impact on Canadian individuals, corporations and trusts with US investments. Such entities could be subject to higher income and withholding taxes on US-source income such as dividends, royalties, capital gains on real estate and effectively connected income. As well, the BEAT could apply to a broader range of Canadian-controlled/owned US corporations.

As previously noted, the Government of Canada would also be an applicable person and potentially subject to higher taxes. For example, the current exemption (under Section 892) for income received by foreign governments from certain US investments and interest on deposits in US banks would not apply to a government of a discriminatory foreign country.

It is unclear at the time of writing how the Canadian government will respond if Section 899 is enacted in its current form.

We will continue to monitor these developments as the bill continues to make its way through the legislative process.

Learn more

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