Canadian companies that conduct business internationally should consider impending changes to how the digital economy may be taxed in the future. As part of its ongoing work to address tax challenges arising from the digital economy, the Organisation for Economic Cooperation and Development (OECD) has released a new consultation paper that proposes to take a “unified approach” to ensure that certain multinational enterprises pay tax in countries where they have consumer-facing activities but do not have a physical presence. The OECD's paper discusses possible features of a multilateral approach and expresses concerns that jurisdictions may introduce uncoordinated unilateral tax measures where a global consensus is not reached.

This is the latest in a series of consultations that the OECD continues to hold on addressing challenges of tax and the digital economy. However, the OECD has indicated that it intends to deliver a multilateral, consensus-based long-term solution in 2020.

**Background**

The OECD released details of the proposals under review to address challenges of tax and the digital economy in a consultation report in February 2019, following an earlier 2018 OECD interim report based on its base erosion and profit shifting (BEPS) project.

Generally, the OECD is looking at new digital tax proposals under two specific “pillars”. The first pillar focuses on the allocation of taxing rights, including nexus issues. These proposals typically allocate more taxing rights to market or user jurisdictions where value is created through businesses’ participation in the user or market jurisdiction that is not recognized in the current framework for allocating profits. Initially, the OECD outlined three proposals to consider the allocation of taxing rights based on either:
• User participation

• Marketing intangibles, or

• Significant economic presence (in certain instances).

The second pillar addresses remaining BEPS issues and focuses on measures to achieve minimum effective rates of tax.

KPMG Global submitted its views on the OECD’s initial proposals under review in response to a previous consultation earlier in 2019 (see TaxNewsFlash-Canada 2019-07, “KPMG Weighs in on Future of Digital Tax”). Following the consultation process, the OECD said it would continue to study the economic and potential overall effects of its proposals, and emphasized the urgent need to agree the outline architecture of a unified approach to the taxation of the digital economy by January 2020.

**OECD proposes “unified approach” under first pillar**

In the new consultation paper, the OECD only addresses the allocation of taxing rights and nexus issues under the first pillar. Specifically, the OECD highlights some of the commonalities between its proposed approaches, and identifies key features that could be part of a possible long-term solution.

The OECD is expected to release another public consultation paper on a unified approach to remaining BEPS issues under the second pillar. This public consultation is currently anticipated to take place in December 2019.

**Features of proposed new digital taxation rules**

In the paper, the OECD says that the rules should cover highly digital businesses as well as consumer-facing businesses. The OECD notes that it would consider possible carve-outs including, for example, extractive industries or financial services, and businesses that do not meet certain revenue thresholds (e.g., EUR 750 million global revenues, which is consistent with country-by-country reporting requirements).

In addition, the OECD states that a unified approach could include a new nexus for taxpayers that is largely based on sales (as opposed to physical presence). This new nexus could have country-specific sales thresholds that are tailored so that smaller economies can also be included.

In considering profit allocation, the OECD further proposes to extend beyond the arm’s length principle and the physical presence limitations currently imposed on taxing rights. The OECD notes that amendments to the existing rules will be needed to ensure that profits can be allocated appropriately between jurisdictions.
**Profit allocation formulas**

The OECD acknowledges in the paper that existing profit attribution rules work well for most routine transactions, and therefore recommends retaining current transfer pricing rules along with new formula-based solutions to allow for the taxation of business activities in more complex scenarios. Specifically, the proposal calls for the introduction of a three-tier mechanism for allocating profit, consisting of:

- **Amount A** — A portion of the multinational’s “above normal” profit that is reallocated to market jurisdictions will be calculated by deducting a deemed routine return on activities from the multinational group’s operating profit. This approach would require jurisdictions to agree on:
  - A consistent measure of operating profits
  - The level of the deemed routine return to be deducted
  - The proportion of the “above normal” return that should be allocated to the market jurisdictions.

- **Amount B** — A fixed return for certain routine marketing and distribution activities taking place in market jurisdictions. These activities would remain taxable according to existing rules, although fixed remunerations would be agreed to reflect an assumed baseline activity. Amount B aims to provide certainty and is targeted at low risk distributors, which is one of the key areas of focus of transfer pricing disputes and the wider BEPS agenda.

- **Amount C** — A return that is in excess of that calculated under Amount B where marketing and distribution functions in a jurisdiction exceed the assumed baseline activity assumed under Amount B. The OECD states that any dispute between the market jurisdiction and taxpayer should be subject to legally binding and effective dispute prevention and resolution mechanisms (e.g., arbitration).

**KPMG observations**

Canada is an active participant in the OECD, and businesses should anticipate that Canada could implement a unified proposal if global consensus can be reached. As a practical matter, the OECD’s proposals will require changes to tax treaties and domestic law. It is expected that any tax treaty changes could be implemented through a similar mechanism as the Multilateral Instrument (MLI), which was recently ratified by Canada (see *TaxNewsFlash-Canada 2019-37, “MLI to Modify Canadian Tax Treaties in 2020”*).

Although Canada has not currently implemented a federal digital services tax, some provinces have already taken steps to address the challenges of digital taxation. Quebec has expanded its Quebec sales tax (QST) obligations to certain non-residents, including operators of certain digital platforms (see *TaxNewsFlash-Canada 2018-53, “Businesses Outside Quebec – New QST Rules in 2019”*). Saskatchewan also expanded its provincial sales tax (PST) rules to require businesses that do not have a
physical presence in Saskatchewan but are selling taxable goods, services and contracts of insurance to customers located in the province to register and collect PST (see TaxNewsFlash-Canada 2019-02, “Businesses – Are You Meeting Saskatchewan PST Rules?”).

In considering the OECD’s three-tier mechanism for allocating profit, the new taxing right applies to profits described in “Amount A”. The allocation of profits described in “Amount B” and “Amount C” appear to rely on existing transfer pricing rules, including the arm’s-length principle, in allocating profits to the activities performed by a multinational group in a market jurisdiction.

To illustrate at a high level how the allocation of “Amount A” could work under the proposal, assume a multinational enterprise (MNE) falls within the scope of the proposal.

- **Step 1:** Determine MNE’s profitability — For example, assume the MNE has a 35% profit margin based on its consolidated financial statements.

- **Step 2:** Identify the portion of this profit margin that represents routine profits — Assume an industry agreed fixed percentage of 10%. The excess profitability of 25% (35%-10%) is deemed to be the MNE’s non-routine or residual profits.

- **Step 3:** Split the residual profits between the portion attributable to the market jurisdictions — For example, 5%, and the portion attributable to other factors including trade intangibles, capital and risk, which would be the remainder of 20%.

- **Step 4:** Allocate the relevant portion of the residual profit (i.e., 5%) among the market jurisdictions, based on a previously agreed allocation key, such as sales — For example, if 10% of the MNE’s sales are to Country X, then Country X would get taxing rights on 0.5% (5% x 10%) of the MNE’s total profits.

**We can help**

Your KPMG adviser can help you assess the effect of the OECD’s digital tax proposals on your business. For more details, contact your KPMG adviser.
provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

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