Canadian companies that conduct business internationally should continue to follow the developing multilateral approach for taxing the digital economy. 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 outline that revises its previous proposals on 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. In the new outline, which is endorsed by the Inclusive Framework of 137 countries, the OECD clarifies that the tax regime would apply to automated digital businesses and consumer-facing businesses, among other outstanding issues.

The OECD is continuing to study the economic and potential overall effects of its digital economy proposals, and intends to deliver a multilateral, consensus-based long-term solution by the end of 2020. In this release, the OECD advises that it also continues work on Pillar Two of its proposals, including addressing questions of the fixed minimum tax percentage under the income inclusion rule and blending tax rates.

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 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.

The OECD released a consultation paper on Pillar One in October 2019 that proposed 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 discussed possible features of a multilateral approach and expressed concerns that jurisdictions may introduce uncoordinated unilateral tax measures where a global consensus is not reached. The OECD proposal called for the introduction of a three-tier mechanism for allocating profit, which consists 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.

- **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 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.

Amount A, as described by the OECD, reallocates to the market the right to tax a defined portion of the deemed residual profits of a multinational group (without regard to the application of the arm’s-length standard), while allocating the remaining profit of the group in accordance with the existing arm’s-length standard. For more details, see *TaxNewsFlash-Canada 2019-42, “Digital Economy — OECD Proposes Unified Tax Approach”*. For KPMG’s submission on this proposal, see *TaxNewsFlash-Canada 2019-49, “Digital Economy — KPMG on OECD’s “Pillar One” Proposal”*.

The OECD also released a consultation paper on Pillar Two, the Global Anti-Base Erosion (GloBE) proposal in November 2019. This pillar addresses remaining BEPS challenges by ensuring that the profits of internationally operating businesses are subject to a minimum rate of tax. For more details, see *TaxNewsFlash-Canada 2019-51, “Digital Economy — OECD Explores Minimum Rate of Tax”*. For KPMG’s submission on this proposal, see *TaxNewsFlash-Canada 2019-54, “Digital Economy — KPMG on OECD’s Minimum Rate of Tax”*.

**OECD clarifies aspects of its Pillar One proposals**

**Scope**
The OECD’s new outline specifies that the scope of Pillar One is intended to include two categories of businesses — automated digital businesses and consumer-facing businesses. The OECD confirms that certain automated digital businesses would fall under the rules, such as:

- Online search engines
- Social media platforms
- Online intermediation platforms
- Digital content streaming
- Online gaming
- Cloud computing services
- Online advertising services

In addition, the OECD clarifies that these rules would affect consumer-facing businesses that sell goods and services that are commonly acquired by individuals for personal use. The OECD clarifies that the scope of these rules would not extend to intermediate products and components of finished goods sold to consumers, with possible exceptions. The OECD says the rules would also apply to businesses that generate revenue from licensing rights over trademarked consumer products or through licensing a consumer brand (i.e., a franchise model). In addition, the OECD advises that there would be exemptions for extractive industries, most commercial financial services (including insurance), and airline and shipping businesses.

The OECD advises that it is still considering some issues related to the scope of the rules, including:

- The level of segmentation required when applying Amount A to groups with diverse activities, including within individual business lines (e.g., in-scope and out-of-scope activity)
- Carve-outs for consumer-facing business lines within the financial services sector (including insurance activities)
- Whether special treatment is required for digital peer-to-peer lending platforms and other unregulated elements of the financial services sector
- Certain size limitations and thresholds, such as:
  - Whether the EUR 750 million group gross revenue threshold for the purposes of Country-by-Country reporting is appropriate for Pillar One
Nexus

The OECD’s new outline clarifies that it will base the new nexus rules for consumer-facing businesses on indicators of a significant and sustained engagement with a certain market, based on sales revenue, among other factors. Although the OECD notes that a sales revenue threshold would be proportionate with market size, it has not yet determined exact figures for an absolute minimum amount. For automated digital services, the OECD states that nexus will be determined only based on the revenue threshold.

The OECD states that the proposed nexus regime will not create a new nexus for businesses that sell consumer goods but that do not have sustained interaction with the market. Further, these rules would exclusively apply to the new taxing rate, and would not create nexus for any other taxes.

The OECD further indicates that it is also considering nexus issues related to:

- Additional nexus factors such as targeted advertising and physical presence
- Simplified reporting and registration-based mechanisms
- Exclusive filing in the ultimate parent jurisdiction.

Profit allocation

The OECD says that the preferred profit measure to calculate the “deemed residual” profit in Amount A is profit before tax (PBT), according to submissions it received. These rules will apply to both profit and losses, and will include loss carry-forward rules. The OECD further confirms that Amount A will be based on a measure of profit derived from the consolidated group financial accounts. However, the OECD says that it is still considering whether to weigh the quantum of Amount A to account for different degrees of digitalization (i.e. applying different percentages for different businesses), and how double taxation can be eliminated under Amount A, including addressing the need for a new multilateral convention that includes a double taxation relief mechanism where this issue is not addressed by existing treaties. Further, Amount A will be distributed among the eligible market jurisdictions based on sales that generate nexus.

The OECD also notes that, under Amount B, it intends for the fixed return for certain baseline marketing and distribution activities taking place in market jurisdictions to approximate the remuneration determined according to existing rules (i.e., the arm’s-length principle).
The OECD confirms in the new outline that it is considering the option to implement Pillar One on an opt-in basis so that a multinational group could decide, on a global basis, whether it will be subject to Pillar One (i.e., the “global safe harbour system”).

Dispute prevention and resolution

The OECD proposes to develop a new multilateral mechanism that is mandatory and binding to prevent and resolve disputes. This mechanism would be intended to provide certainty before tax assessments are made, to prevent disputes from arising. The OECD notes that participating tax administrations could provide early tax certainty for Amount A, for example, by setting-up representative panels to review and resolve issues of certainty.

KPMG observations

The OECD notes that the recent U.S. proposal to include a safe harbour rule in Pillar One has raised concerns in some jurisdictions, and that it will defer its final decision on this proposal until later in the process. In addition, some jurisdictions have taken issue with the OECD’s proposal that the dispute resolution mechanism should be binding.

Canada is an active participant in the OECD, and businesses should anticipate that Canada could implement the unified proposal if global consensus can be reached. Although the Liberal Party indicated it may levy a 3% digital services tax on certain revenue that international tech companies generate in Canada as an interim measure in the 2019 federal election, Canada has also reiterated that a multilateral approach is needed. We are anticipating that Finance will provide further information on its intended direction in the upcoming Canadian federal budget. Although it’s not yet known whether there will be a public consultation on this issue, we strongly encourage companies to discuss their concerns with the government.

Some European Union member states also appear to be holding back on unilateral approaches to digital taxation, pending further work by the OECD. In particular, recent reports indicate that France, which enacted a similar 3% tax in 2019, would defer collecting its own digital services tax payments due in 2020. This change follows a U.S. Trade Representative determination that France’s tax was an “unfair trade practice” and announced the Unites States would apply additional duties on certain French products in response.

We can help

Your KPMG adviser can help you assess the effect of the OECD’s proposals on your business and provide guidance on how this might impact you going forward. For more details, contact your KPMG adviser.

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