

30 November 2018

Principal Adviser
Corporate and International Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

Attention: Ms Natasha McNamara

Dear Ms McNamara

The digital economy and Australia's corporate tax system

Deloitte welcomes the opportunity to comment on the discussion paper titled 'The digital economy and Australia's corporate tax system' (the Discussion Paper) released by the Treasury on 2 October 2018.

Introduction

The influence of the digital economy on the lives of every Australian has increased exponentially in recent years. One only needs to look around during the morning commute, or consider how we interact with each other, to understand how these changes have dramatically altered how we live and work. The benefits to our economy that have flowed from this influence should be a key consideration in any discussion on how our tax system should be adapted for the digital economy.

It is important to ensure that the digital economy, which has increasingly become the economy itself,¹ is not discouraged. Consequently, tax policy should be designed to encourage further investment, including fostering innovation and facilitating the development of intellectual property in Australia. That is not to say that change is not required.

It is this evolution of the economy that, as the Discussion Paper highlights, has allowed highly digitalised business models to achieve unprecedented global reach. These business models have been identified by the Organisation for Economic Co-operation and Development (the OECD) in its 2018 interim report on the digital economy (the OECD Report),² as having the following common factors:

- Cross-jurisdictional scale without mass
- Reliance on intangible assets
- Data, user participation and network effects.³

¹ Vitor Gaspar, 'Measuring the Digital Economy' (Speech delivered at the 5th IMF Statistical Forum, IMF Headquarters, 16 November 2017).

² OECD, 'Tax Challenges Arising from Digitalisation – Interim Report 2018' (Report, OECD, 2018).

³ OECD, 'Tax Challenges Arising from Digitalisation – Interim Report 2018' (Report, OECD, 2018), [32].

For such business models, the key issue at a global level is whether the existing international tax system appropriately allocates their value to the appropriate jurisdictions and, if not, what is the best way to do so. In considering this complex matter, and in particular whether unilateral action should be taken, thought has and should continue to be given to ensure that Australia remains a competitive and appealing home for innovation and investment.

Rushing into reactive unilateral action:

- Increases the risk that Australia will become uncompetitive, and therefore unattractive, to businesses otherwise eager to expand their services to Australia and for Australian businesses to stay in Australia as they continue to grow and innovate
- Creates undue administrative and compliance burdens for innovative organisations
- May contravene developed international tax principles and tax treaty norms.

Further, as has been evident in the responses to proposed interim measures (such as the European Commission's proposed Digital Services Tax (DST)),⁴ such action has the potential to create significant tensions between Australia and its trade and diplomatic partners.

For these reasons, which are expanded below, we consider that interim measures are not an adequate solution given the greater issues at hand. Instead, we consider that a continued focus on finding a solution through a consensus-driven approach will be the most beneficial option for the Australian economy.

We are pleased to provide our detailed submission below.

The benefits of multilateralism

While the discussion at hand is significantly directed at the digital economy, it is not the only reason underlying the evolution of business models. Globalisation generally has caused governments to rethink their tax policy approaches and, consequentially, the OECD/G20 Base Erosion and Profit Shifting (BEPS) project was pursued.

The BEPS project is a well-documented example of the value and effectiveness of a co-operative and consensus-driven approach. The BEPS project has already progressed several major tax policy projects such as Hybrids (Action 2), Harmful Tax Practices (Action 5), Transfer Pricing Practices (Actions 8-10), Country-by-Country Reporting (Action 13) and the Multilateral Convention (Action 15).⁵

Australia's active involvement in the BEPS project and adoption of OECD recommendations have resulted in a significant transformation of the corporate tax landscape through initiatives such as:

- The Multilateral Convention⁶
- Acceptance of the OECD Transfer Pricing Guidelines⁷

⁴ European Commission, Proposal for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services (2018/0073).

⁵ OECD, Action Plan on Base Erosion and Profit Shifting (Report, OECD, 2013); OECD, Model Tax Convention on Income and on Capital; Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (entered into force 1 July 2018).

⁶ Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, opened for signature 24 November 2016, (entered into force 1 July 2018).

⁷ Income Tax Assessment Act 1997 (Cth), s 815-20.

- An update of Australia's tax treaties to reflect OECD recommendations, such as the expanded permanent establishment (PE) definition featured in the Australia-German Double Taxation Agreement⁸
- The introduction of Hybrid Mismatch Rules,⁹ based on the OECD recommendations as part of Action Item 2 of the BEPS Action Plan.¹⁰

Australia has also adopted a number of complementary integrity measures in addition to OECD initiatives, primarily in the form of:

- The Multinational Anti-Avoidance Law (the MAAL)¹¹
- The Diverted Profits Tax (the DPT).¹²

These measures have significantly changed the Australian and international tax landscapes and radically altered how multinational business operate in Australia and around the world. They have been complemented by the global unity achieved through the OECD where a significant number of nations, including many of Australia's largest trading partners, have already or are in the progress of domestically implementing OECD recommended measures and adopting the Multilateral Convention.

This implementation highlights the long-term commitment to multilateralism which have ensured that these measures become firmly embedded in the international tax framework. By way of example, the primary rule / secondary rule approach in the hybrid measures facilitated a coherent outcome even if not all countries adopted the measures.¹³ The changes have achieved a longevity and robustness that would otherwise not be achievable through hasty implementation of policies that lack the collective support of the international community.

A global approach to data, user contribution and network effects

A multilateral approach has had a significant impact in combatting double non-taxation and other zero tax outcomes. However, the value of data, user participation and network effects for tax purposes remains an unresolved issue and this is most prevalent in highly digitalised business models.

When focusing on the role that user-created value has in the digital economy, key questions emerge: whether the international tax system should account for user-created value? And, if so, what is user-created value worth and how should the tax system determine where and to what extent it is attributable to a specific tax jurisdiction?

We submit that we should continue multilateral discussion and debate to address and find comprehensive answers to such unique challenges. In doing so, we acknowledge and agree with the broad consensus among countries that maintaining the relevance and coherence of the international corporate tax framework is critically important as fragmentation would lead to inefficiencies and tax-related distortions to global trade and economic activity. The importance of maintaining this consistency is affirmed in the OECD Report and the Discussion Paper.¹⁴

⁸ Agreement between Australia and the Federal Republic of Germany for the Elimination of Double Taxation with respect to Taxes on Income and on Capital and the Prevention of Fiscal Evasion and Avoidance and Protocol, signed 12 November 2015, [2016] ATS 23.

⁹ Income Tax Assessment Act 1997 (Cth), div 832.

¹⁰ OECD, 'Neutralising the Effects of Hybrid Mismatch Arrangements – Action 2: 2015 Final Report' (Report, OECD Publishing, 2015).

¹¹ Income Tax Assessment Act 1936 (Cth), pt IVA.

¹² Income Tax Assessment Act 1936 (Cth), pt IVA.

¹³ Income Tax Assessment Act 1997 (Cth), ss 832-180, 832-185.

¹⁴ OECD, 'Tax Challenges Arising from Digitalisation – Interim Report 2018' (Report, OECD, 2018), [396].

Consequently, we consider that the most apparent multilateral solution could be achieved through the existing international corporate tax framework which readily provides a considerably-developed policy framework, particularly on the concepts of taxing rights, profit allocation and double taxation.

Therefore, whilst there is a role for consumption taxes in the economy, we strongly recommend against a unilateral consumption tax that targets specific types of sales, essentially discriminating against innovative industries.

Interim measures

A trend has begun to emerge, of countries proposing to take unilateral action to address perceived tax gaps driven by highly digitalised business models. It is only natural for these discussions to also arise in Australia.

However, before any unilateral measures are undertaken, it is critical to assess the relevant risks and potential harm they could cause.

The OECD notes that unilateral action in the form of interim measures may have a negative impact on investment, innovation and welfare, may result in double taxation and involve significant compliance costs. Concerns regarding double taxation have been long discussed before.

However, merely noting that double taxation and additional compliance are undesirable consequences does not itself illustrate the negative consequences that can arise. As such, the potential negative effects and costs that could result from the implementation of an interim measure similar to the DST and the UK's recently proposed version of a DST are outlined below.¹⁵

Compliance burden

Australia has already seen an exponential increase in the amount of legislation intended to restore integrity to the tax system as well as improve the accountability and transparency of taxpayers. The necessary consequence, however, is an increasing amount of compliance and administrative costs incurred by taxpayers to ensure their compliance with the current suite of Australian tax legislation.

Small and low profitability operators

Innovation is the keystone of the digital economy. Measures which add complexity and uncertainty impede the progress of the Australia's innovative enterprises.

One proposal to ensure that unilateral measures do not unduly affect start-up companies and small businesses is for any interim measure to be designed in a way that excludes application to businesses with low revenues or profitability; such thresholds are currently proposed by HM Treasury in the UK's proposed DST.

However, based on experience, we suggest that the demarcation between start-up companies and more established digital businesses is not as simple as is implied in the design of such thresholds. For example, many start-up companies rely on investment funding from these established businesses which, in return, receive equity interests in the start-up company.

Although the established business and start-up company become associated for taxation purposes; in practice, it is often in both parties' interests that the start-up company retains its independence in terms of finances, operations and management. This is due to the actual value of a start-up lying in the individuals who are driving the innovation. In such an instance, the start-up company could be subject to additional taxes notwithstanding it having insufficient administrative functions or resources to adequately cope with the added compliance obligations, or it being independently profitable.

¹⁵ HM Treasury & HM Revenue & Customs, 'Digital Services Tax: Consultation' (Consultation paper, 7 November 2018).

Australia's Treaty and Trade obligations

There may be real risks associated with an interim measure affecting Australia's international trade and diplomatic relationships, particularly with its fellow OECD member states. We have already seen evidence of such friction globally.¹⁶

In choosing to act unilaterally, Australia may find itself contributing to a more hostile and aggressive tax approach between nations; opening this Pandora's Box may encourage each nation imposing equally or more severe unilateral actions in response to Australian and other nations' measures.¹⁷ Where such measures are outside the context of the existing tax treaty network (resulting in double taxation), this would encourage foreign nations to impose their own unilateral actions affecting Australian businesses who have expanded their reach abroad. The concerns of double taxation for Australia's global groups would not be limited to Australian "digital" companies but could extend to other Australian groups selling internationally (e.g. industrial or resource companies).

Timeframe

The OECD plans to release the final report in 2020. Australia is currently at its initial stages of consultation at the end of 2018. Even if it were to decide on a course of action in 2019, this process is likely to be interrupted by a Federal Election in the first half of that year. In practical terms, such measures may not be in place and implemented before June 2020. Given that the OECD final recommendations will be issued at or before this time, it would be appropriate to await these recommendations given the timing is concurrent.

Conclusions on unilateral interim measures

We therefore consider that unilateral measures are not an appropriate solution for Australia, whether interim or permanent, primarily due to the following reasons:

- Multilateralism has already assisted the international community to progress towards modernising the international tax system and eliminating no tax or low tax outcomes
- There are increased prospects of attaining a cohesive, implementable tax policy on user-created value through the existing international corporate tax system due to its robust existing principles and framework
- Australian businesses, and investors into Australia, are already responding to several significant changes to Australian tax law, increased compliance burdens and heightened ATO activity where additional obligations may discourage investment in Australia
- Such a measure may adversely affect Australia's international trade relationships, obligations and considerations.

If Australia does proceed with a unilateral measure, which we do not support, such a measure would require careful design to minimise the inherent risks and we would therefore recommend the following:

- A detailed economic analysis on the potential effects of any proposed tax including effects on both digital and non-digital businesses in Australia as well as consumers
- A detailed review of existing and proposed similar taxes in other OECD countries and consideration of suitable thresholds tests, concessions and exemptions to be implemented

¹⁶ United States Department of the Treasury, 'Secretary Mnuchin Statement on Digital Economy Taxation Efforts' (Secretary Statement & Remarks, 25 October 2018); Letter from United States Senate Committee on Finance to President of the European Council and President of the European Commission, 18 October 2018, 1-2.

¹⁷ Sue Hatcher, 'Australian and the Digital Economy' (Paper presented at The Tax Institute 48th South Australian Convention, Barossa Valley, 7-8 May 2015).

- Implementation after the release of the OECD final report on digitalisation (planned for 2020) to minimise disruption.

Undoubtedly, these extremely complex issues require ongoing discussion, consideration and adaption of the existing law to ensure that the corporate tax system is responding to the evolution of businesses. As is the nature of globalisation and digitalisation, it is pertinent that any action is undertaken on a multilateral basis wherever possible.

We acknowledge that we are at the early stages of this discussion and hence the generality of our comments. We welcome any subsequent opportunities to discuss these matters further with you to discuss the design of any measures in further detail. If you have any questions, please do not hesitate to contact David Watkins on 02 9322 7251, Manu Sriskantharajah on 03 9671 7310 or Cam Smith on 03 9671 7440.

Yours sincerely



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