

Comments on the  
Treasury discussion paper  
*on the digital economy and  
Australia's corporate tax  
system*

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## Background to the submission

The Australian Treasury Discussion Paper published for public consultations in October 2018 explores a corporate income tax announced in the 2018-19 Federal Budget unless a long-term solution is found at the OECD.<sup>1</sup> In other words, Australia is considering the unilateral introduction of a tax based on where the customers are based – yet only for a very narrow group of digital companies.

The proposal would be a marked departure from Australia's traditional approach of supporting a multilateral and rules-based order, which warrants a careful examination of its rationale, as well as the implications for the Australian economy. For this purpose, this submission presents new industry data and consequences for Australian exports that were hitherto overlooked.

At the onset, the claim that digital multinationals are avoiding paying a fair share of tax is a misconception on the verge of a myth. An analysis of global effective tax rates of digital and traditional companies in Australia shows that there is no systematic discrepancy in income taxes paid by digital corporations compared to their traditional peers.<sup>2</sup> While some estimates indicate that the average effective tax rate (ETR) paid by Australian businesses could be as low as 17%,<sup>3</sup> the average rate paid by US digital companies was 23%.<sup>4</sup>

It is easy to see why this myth has persisted: In accordance with international tax law, digital companies (and others) pay the majority of their taxes where the value is created rather than where they generate revenue. In other words, they can generate substantial revenues in overseas markets such as Australia, but their main profit allocation and tax liability remain in their home market – typically the US which had the highest statutory tax rates in the OECD until the recent tax reforms.

This is not at all unique to the digital sector. Data in this submission shows that Australian exporters would pay relatively little corporate tax in overseas markets despite generating large revenues abroad. And many sectors of the Australian economy have remarkably similar business models to digital companies – i.e. a high proportion of exports and a high ratio of intangible assets.

These sectors, currently paying far more tax in Australia than in overseas markets, would presumably be at risk of being treated the same way that Australia seeks to treat the digital sector. This risk may come about simply by other countries choosing to follow the same logic advanced by Australia and applying to Australian companies in other sectors.

Alternatively, given that the digital services tax would closely resemble a tariff (a levy on value applied principally to imported services), it is not a large leap to imagine the home country levying a similar tax on another sector as a form of retaliation.

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<sup>1</sup> The Treasury of the Australian Government, The digital economy and Australia's corporate tax system, 2 October 2018

<sup>2</sup> See Lee-Makiyama, OECD BEPS: reconciling global trade, taxation principles and the digital economy, ECIPE, 04/2014; Lee-Makiyama, Ferracane, The geopolitics of online taxation in Asia-Pacific – Digitalisation, corporate tax base and the role of governments, ECIPE, 01/2018; Bauer, Digital companies and their fair share of taxes: Myths and misconceptions, ECIPE, 03/2018

<sup>3</sup> US Government's Congressional Budget Office, International comparison of corporate income tax rates, 2017, accessed at: <https://www.cbo.gov/system/files/115th-congress-2017-2018/reports/52419-internationaltaxratecomp.pdf>

<sup>4</sup> *supra* note 2

## User-participation in value-creation (Discussion Questions #1, #4)

Clients contribute to value creation in many other service industries. While no precise metric exists on to what extent customers and clients contribute to the final product or service rendered in various industries, the ratio should be very high in all sectors where the degree of customisation is high. In business-to-business offerings like enterprise software, professional, consulting and various technical services, clients generate much of the value by providing various type of data that is processed or transformed by the service provider into a deliverable.

Also, in the financial sector (especially in customer-facing products like retail banking), the customers themselves perform an increasing share of the task of managing the capital they continue to own. Other analytical and data-driven services in the financial sector (e.g. the credit-rating business) are entirely based on exploiting user data.

The discussion paper also highlights the online advertising sector: The total advertising spending in Australia is at \$16 bn annually and split equally between online and traditional advertising.<sup>5</sup> However, it is also a common practice to bundle online advertising with traditional advertising, making it difficult to distinguish the digital revenues that should be subject to a digital tax.

Also, traditional media set their rates exactly like online advertising – based on the number of users they reach within a specific target group. The total number of viewers or readers are measured via audience measurement panels that monitor media consumption, which can be cross-correlated with their shopping behaviour.<sup>6</sup> Australians are also the world's most monitored (or 'metered') population by traditional broadcasting media.<sup>7</sup> In particular, media channels that are distributed free of charge to consumers – e.g. radio, free-to-air TV or *freesheets* – are evidently creating their entire value from readers and viewers who are monetised through their use.

As value creation by customers is a general phenomenon across many services industries, the United States could apply the same principle against Australia against its own online services or sectors that utilise similar principles as online advertising and intermediaries. The value of Australia's exports to the US is over 2 billion USD (2.7 billion AUD) annually.

*Figure 1 – Australia's services exports to the US at risk of retaliation, million USD*

<i>Sectors where customers contribute to value creation</i>	<i>2,050</i>
— Computer (ICT) services	207
— Other information services	23
— Advertising, market research and polling	105
— Professional services (legal, accounting, business, PR)	708
— Engineering, scientific, architectural services	628
— R&D activities	336
— Repairs and other services on physical inputs owned by others	43

*Source: US BEA, US Trade in Services, 2017*

<sup>5</sup> Zenith Advertising Expenditure Forecasts, 2018

<sup>6</sup> Television Audience Measurements (TAM) such as OzTAM, Regional TAM, Nielsen TAM.

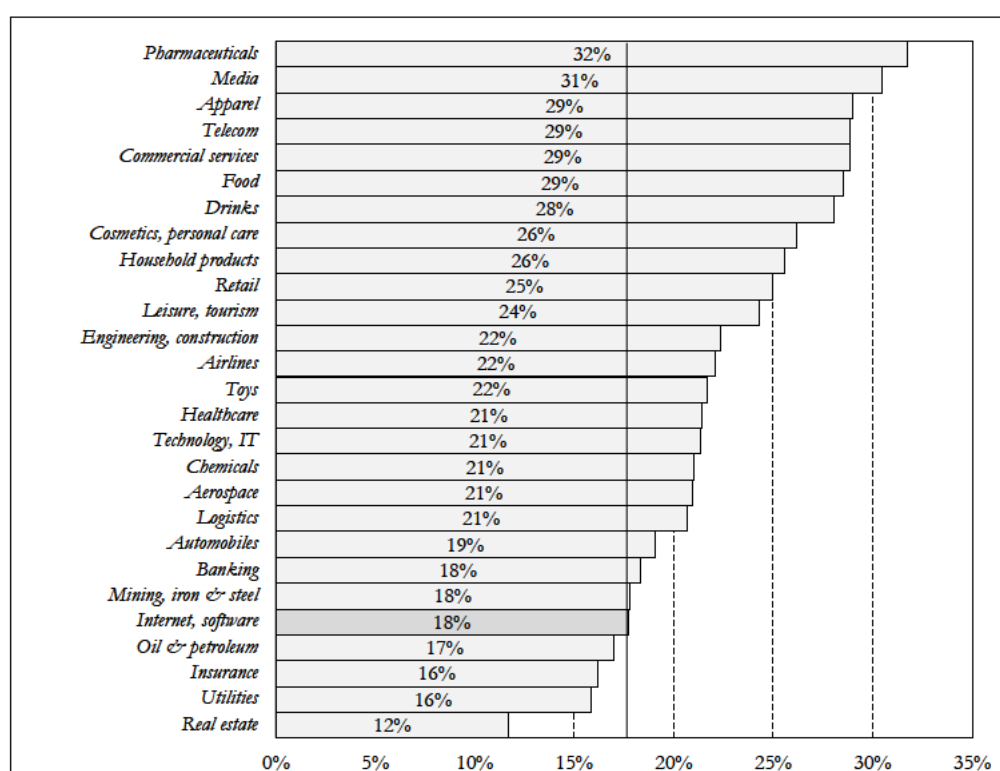
<sup>7</sup> OzTAM, accessed at: <https://oztam.com.au/AboutOzTAM.aspx>

## The use of intangibles (Discussion Questions #2, #4)

As the Treasury's Discussion Paper itself admits, the digital companies are hardly alone in using intangibles. The use of intangibles – e.g. IPRs, trademarks, databases, customer contracts, royalties, software, content –<sup>8</sup> are a common feature in sectors where the R&D cost or branding expenditure is naturally high. Such is the case in sectors like pharmaceuticals, media, apparel, telecoms, business services, or food and beverages (Figure 2).

However, firm-level data shows how digital companies rely very little on their intangible assets (including IPRs) in relation to tangible assets.<sup>9</sup> The conclusion holds even when the value of goodwill (from numerous mergers and acquisitions in the industry) is included. The rest is future market expectations or overvaluation.

Figure 2 — Internet firms have one of the lowest shares of intangibles, 2018



Source: Author's calculations (based on Brand Finance 2018 GIFT survey of world's publicly traded firms).

If the online services are taxed with the argument that they exploit intangibles, it justifies double-taxation of Australian exports to the US in other industrial sectors that rely more heavily on intangibles than the internet companies.

Amongst services, they are audiovisuals, logistics and banking, which amounts to another USD 2.7 bn per year (Figure 4).<sup>10</sup> There are also non-services sectors (in manufacturing and goods) that rely more heavily on intangibles: Australia's exports to the US in these sectors amount to USD 6.8 billion per year, where more than half originates from the

<sup>8</sup> Based on examples in the European international financial reporting standards, IFRS3

<sup>9</sup> Disclosed intangibles as a share of total assets, based on data collected by Brand Finance, Global Intangible Finance Tracker (GIFT) 2018 – an annual review of the world's intangible value, October 2018

<sup>10</sup> *ibid.*

food, agriculture and mining industries that already draw considerable political support for domestic protectionism in Australia's export markets.

In total, USD 9.5 billion per year (AUD 13 billion) could be subjected to US retaliation if intangibles are used as a justification.

*Figure 4 – Australia's exports to the US in sectors that use intangibles, million USD*

<i>Sectors with larger valued intangible assets than internet firms, IPR charges</i>	<i>2,673</i>
— Charges for using IPRs, audiovisual services	795
— Telecom services	57
— Aviation	981
— Banking	840
<i>Goods exports with larger valued intangible assets than internet firms</i>	<i>6,827</i>
— Pharmaceuticals, cosmetics (ISIC 242)	854
— Media (ISIC 221)	74
— Apparel (ISIC 181, 182, 191, 192)	29
— Food (ISIC 151-154)	2,715
— Drinks (ISIC 155)	465
— Personal care, household products (ISIC 172, 243, 293)	25
— Leisure, toys (ISIC 369)	499
— Technology, IT (ISIC 300, 321-323)	153
— Chemicals (ISIC 241)	262
— Aerospace (ISIC 353)	468
— Automobiles (ISIC 341-343)	280
— Mining, iron & steel items (ISIC 271, 272)	1,002

*Source: US BEA, US Trade in Services, 2017*

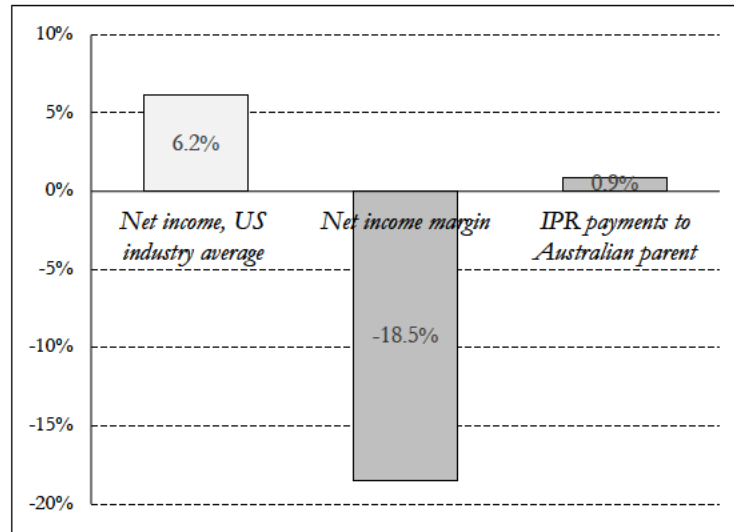
## Should existing rules for determining which countries have the right to tax foreign resident companies be changed? (Discussion Question #5)

The total sales (gross turnover) by the majority-owned affiliates of Australian businesses in the US amounts to USD 45.8 bn. The Australian subsidiaries in the US are operating at a net income margin of -18.5% on their turnover (Figure 5), which is remarkably low compared to the US industry average, at 6.2%.

Australian subsidiaries are unlikely to pay any significant income taxes in the US at today's losses. If Australia demands that foreign resident companies should pay more in its jurisdiction, the US could respond in kind, adding another USD 45.8 billion (AUD 62.6 billion) per year in the scope of US retaliation.

Moreover, Australian subsidiaries in the US also paid 0.9% (USD 426 million) of their annual turnover in IPR fees to their parent companies in Australia, some of which will be taxed in the new US tax code as Global Intangible Low-Taxed Income (GILTI).

Figure 5 – The low net income margins of Australian subsidiaries in the US



Sources: Own analysis based on US BEA, US affiliate activities – net income over sales, 2016 (preliminary release November 2018); Damodaran, A., NYU Stern (based on 7,480 firms), FY2016

## Distinguishing the digital economy from the traditional economy? (Discussion Question #6)

With the ever-increasing digitalisation, the use of data and online distribution channels will also increase, making the distinction between the digital economy from the traditional economy not just increasingly difficult, but also irrelevant – competitive firms adapt to new technologies in every sector of the economy.

The total productivity and output contribution of the online intermediaries amounts to approximately 3.2% of GDP in an industrialised economy,<sup>11</sup> making it one of the biggest productivity boosts in recent history. If Australia taxes the use of productivity enhancers like platforms, the country's global competitiveness will be reduced compared to the countries who don't.

Data, software and intermediaries are also essential inputs to most industries. Empirical studies have measured the data usages of various industrial sectors (figure 6),<sup>12</sup> which even exceeds the average net profit margins of the sectors.<sup>13</sup> In other words, fiscal measures against digital companies result in higher production costs as they must pass on their costs to the downstream sectors as higher costs across the economy.<sup>14</sup>

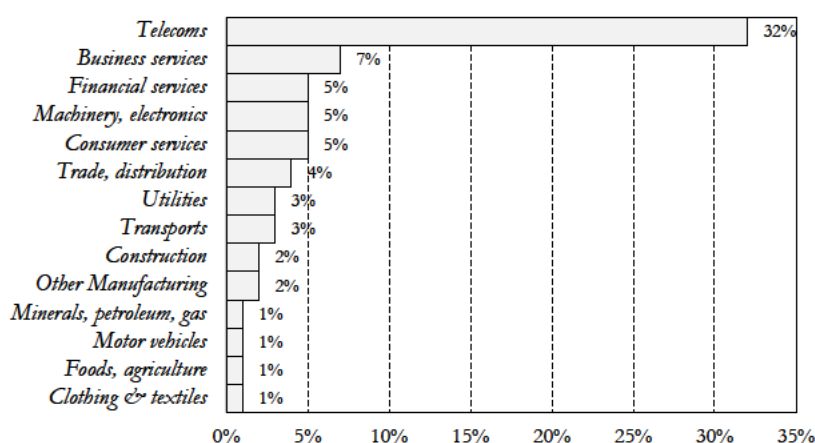
<sup>11</sup> Based on Copenhagen Economics, The impact of online intermediaries on the EU economy, 2013

<sup>12</sup> Bauer, Lee-Makiyama, van der Marel, *The Costs of Data Localisation: A Friendly Fire on Economic Recovery*, ECIPE, 2014; based on US Bureau of Economic Analysis, Input & Output Account Data, 2007

<sup>13</sup> See gross operating profits under Foreign Affiliates Statistics of US BEA, 2017 and Eurostat, 2016

<sup>14</sup> *ibid.*

Figure 6 — Importance (by value) of data, software and connectivity in production



Source: Lee-Makiyama, Bauer, van der Marel, 2014

## Can any changes to nexus and profit attribution rules be ring-fenced to digitalised business? (Question 7)?

Previous questions on user participation or intangible show how digital businesses cannot be ring-fenced. Digitalisation is a general and economy-wide transformation.

Australia would also contravene its multilateral commitments and the World Trade Organization (WTO). The inevitable consequence of the 'digital nexus' concept is that some highly mobile internet businesses are never allowed to trade through cross-border delivery. Instead, they will always be deemed as having local commercial present – which would violate the services commitments of Australia for nearly every type of online service.

Also, under WTO jurisprudence, Australia must prove that its digital taxes (and including any quantitative thresholds) are not arbitrarily set to discriminate against certain countries,<sup>15</sup> or that its digital taxes are necessary for the objective it seeks – and applies the least-trade restrictive measure to seek that objective.<sup>16</sup>

There is no obvious way Australia could argue to justify how it has singled out imported intermediaries while exempting other sectors that also make use of intangibles. This is how the US restrictions on online gambling were found to be inconsistent with WTO rules,<sup>17</sup> as it could not justify why a certain form of gambling was permitted but not others.

Furthermore, from the perspective of trade law, the concepts described in the discussion paper is likely an indirect tax on services imports, which is effectively a customs duty. However, the EU and WTO members have universally agreed on a moratorium against

<sup>15</sup> WTO GATS art XIV, 'not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail'.

<sup>16</sup> Hindley, Lee-Makiyama, Protectionism Online, ECIPE, 2009, accessed at: <http://ecipe.org/app/uploads/2014/12/protectionism-online-internet-censorship-and-international-trade-law.pdf>

<sup>17</sup> WTO Appellate Body, United States—*Online Gambling*, DS285

imposing 'customs duties on electronic transmission',<sup>18</sup> which has been renewed every two years since 1998. While it warrants a legal discussion on what the definition 'electronic transmissions' entails, it should be clear that some online services must fall under that definition.

In conclusion, ring-fencing the digital economy for fiscal purposes is not just impractical to implement – but it would also violate Australia's WTO commitments in multiple ways that allow the US and other countries to lawfully retaliate against any of Australia's exports, including agriculture and extractive industries.

## Concluding observations – Should Australia pursue interim options ahead of an OECD-led consensus-based solution? (Discussion Question #10)

To summarise, if Australia introduces a digital services tax, it will be not much different from introducing a new tariff on US businesses. It also carries the risk of impacting sectors in Australia that have very similar models to digital businesses – e.g. through the introduction of a “banking services tax”, an “aviation services tax” or a “professional services tax”.

61% of Australia's services exports to the United States would be at risk of double-taxation in the United States in the same way that Australia is proposing to put digital services exports from the United States at risk of double-taxation.

Total impacted Australian exports could total up to US\$ 57 bn per year if the retaliation also targeted the turnover of Australian businesses in the United States.

This would be serious enough if it were addressing a serious policy need, but given the research shows that the idea of tax avoidance by digital multinationals is heavily exaggerated, it begs serious questions about the wisdom of Australia taking on these issues unilaterally.

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<sup>18</sup> WTO, Ministerial Declaration of the 1998 Ministerial Conference in Geneva, 20 May 1998; also, the Ministerial Declaration of the 2001 Ministerial Conference in Doha, 14 November 2001 for the WTO Doha Round negotiations