INSTITUTE OF PUBLIC ACCOUNTANTS

Consultation Paper – The Digital Economy and Australia's Corporate Tax System

IPA - Deakin SME Research Centre

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In 2013, the IPA partnered with Deakin University to form the IPA Deakin SME Research Partnership, a first in Australia. This partnership has grown and evolved into the IPA assisting Deakin University in establishing the IPA-Deakin SME Research Centre in 2016. The goal of the Centre is to bring together practitioner insights with cutting edge SME academic research, to provide informed comment for substantive policy development.

The IPA-Deakin SME Research Centre comprises:

Chair: Professor Andrew Conway FIPA
(Chief Executive of the IPA and Professor of Accounting *honoris causa* Shanghai University of Finance and Economics)

Ms Vicki Stylianou
(IPA Executive General Manager, Advocacy & Technical)

Mr Tony Greco FIPA
(IPA General Manager Technical Policy)

Professor Peter Carey
(Head, Department of Accounting, Deakin Business School)

Professor Barry Cooper
(Associate Dean, Deakin Business School)

Prof George Tanewski
(Co-Director: IPA-Deakin SME Research Centre, Deakin Business School)

Dr Nicholas Mroczkowski, Professor of Practice; CA, FCPA, FIPA, IFA (UK),
(Co-Director: IPA-Deakin SME Research Centre Deakin Business School)

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

corporatax@treasury.gov.au

Dear Sir/Madam

Consultation Paper – The Digital Economy and Australia's Corporate Tax System

Introduction and Background

The IPA-Deakin SME Research Centre (IDSRC) is pleased to provide the following submission in response to the Federal Government's Treasury discussion paper on the digital economy and Australia's corporate tax system[1] (hereafter, discussion paper), issued in October, 2018. The IDSRC is a joint initiative of the Institute of Public Accountants and Deakin University. It exists to increase the awareness of government and the community more generally on issues related to small business by contributing to policy debates.

As we have noted with many previous Federal Government initiatives, we are most pleased with the government's willingness to work closely with the Group of 20 member countries (G20) as well as the Organisation of Economic Co-operation (OECD), on issues that will significantly impact Australians businesses, business owners and ordinary Australians. The digital economy is indeed one of those issues which has already impacted each and every Australian, and will forever continue to do so in so many way; in the way we do business, in the way that we communicate and socialise as individuals, in the way that we create and use data which in turn creates value for a range of entities operating in the digital economy; in the way that we drive our businesses without the need for physical presence, in the way that we rely more heavily on intangibles assets rather than assets of physical substance…and the list goes on, albeit in a somewhat inextricable manner. Understandably therefore, what we have before us, as clearly articulated in the government's discussion paper on taxation of the digital economy[2], is a game-changing phenomenon. And so, the time has come to review international tax laws that, while serving their purpose most

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[1] Commonwealth Government, 2018, *The digital economy and Australia's corporate tax system*[1] Treasury discussion paper, November, 2018.

[2] Ibid

effectively since their introduction in the 1920's, have now been exposed to various forms of abuse, impairment and even incongruence against a background of a rapidly changing virtual world. Arguably, multinational corporate giants engaging in profit shifting activities supported by clever transfer pricing arrangements, as well as creating new business models that are changing the 'value chain' and in so doing confusing the traditional application of defined and previously well understood terms such as 'nexus', 'arms-length', 'permanent establishment', and 'source'., have exacerbated concerns over the appropriateness of existing international tax regimes. In turn, this has heightened the need to urgently review existing cross-jurisdictional tax laws as well as tax treaties between participating countries. In this sense, the IPA is in full agreement with the Federal Government, as well as other governments working with the OECD on the digital tax agenda (such as the UK, for example)[3], that the solution to taxation of the digital economy, must by necessity, be derived multilaterally through the full co-operation of participating countries.

The IPA is also in agreement with the commentary and various options advanced in the OECD's Interim Report[4], notwithstanding that the report does not provide any clear solutions, nor does it define critical terms such as 'significant digital presence' or 'user participation'. Arguably as well, even the current definition of 'digital economy' requires further clarification in both the OECD Interim Report[5] and the Federal Government's current discussion paper[6]. We have assumed that this approach is intentional, i.e., it provides scope for latitude in the process of informed debate from which, no doubt, measured solutions can be derived by participating countries. The IPA, in collaboration with its research arm, the IPA-Deakin SME Research Centre, are supportive of the informed approach, adopted not only by the OECD, but also by the Federal Government in the current discussion paper. This is primarily because, in our view there are no immediate or easy solutions to all thirteen questions that have been posed in the discussion, whether they encompass the introduction of so-called 'interim measures' such as a 'turnover', 'equalisation' or a 'digital service tax' currently proposed by some countries (Italy, India, Hungary, the Slovakia Republic and other countries within the EU for example), or measures that completely rethink and rewrite an evidently creaking international tax regime; which would eventually be adopted multilaterally in the longer term (the preferred OECD option).

As clearly articulated in the OECD BEPS Action Plan (2013)[7], "*The digital economy is characterised by unparalleled reliance on intangible assets, massive use of data (notably*

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[3] HM Treasury 2018, *Corporate tax and the digital economy: position paper update*

[4] OECD 2018, *Tax Challenges Arising from Digitalisation – Interim Report 2018*

[5] Ibid

[6] Commonwealth Government, 2018, *The digital economy and Australia's corporate tax system*[6] Treasury discussion paper, November, 2018

[7] OECD 2013, *Action Plan on Base Erosion and Profit Sharing – Discussion Draft*

personal data), widespread adoption of multi-sided business models capturing value from externalities generated by free products, and the difficulty of determining the jurisdiction in which value creation occurs". Given the magnitude of the taxation challenges and the uncertainty brought about by the exponential emergence of the digital economy, actions recommended by the OECD and indeed implemented by many countries (including Australia) to address base erosion and profit shifting (BEPS), will not, in our view, fully address the more significant issues raised by the digital economy. The diminution of the tax base of any country is often and most likely, attributable to clever tax planning aimed at "artificially reducing tax payable by shifting profits to low-tax jurisdictions in which little or no economic activity is performed"[8]. At the core these artificial mechanisms and structures employed by multinational corporations (MNC), and most notably US MNCs[9], is tax reduction, i.e. they are tax driven, not business driven. Recent revelations of the transnational activities of Fiat, Starbucks, Apple and Google[10], are good examples of tax minimisation structures that have taken advantage of gaps in different tax systems and their cross jurisdictional interactions (also referred to as *treaty abuse*). Arguably though, activities in which companies relocate core business to low-tax jurisdictions may not in fact, be attributable to gaps in existing tax systems, but more a case of outdated rules not keeping pace with modern forms of doing business.

Notwithstanding however, BEPS problems have been well documented and duly recognised by most countries that have quickly responded by putting measures in place (and if one can be metaphoric here for a moment), to 'stop the bleeding'. Australia, for example, has been one of the front runners in addressing the BEPS issues, by introducing an extensive number of reforms, particularly the passing of the Multinational Anti-Avoidance Law (MAAL), in 2015, followed by the introduction of Diverted Profits Tax laws in 2017. The Federal Government has heralded the success of these measures in recent publicity including the current discussion paper stating that "$7 billion in sales annually is expected to be returned to the Australian tax base as a result of the MAAL", alone[11]

It should be carefully noted however, that addressing BEPS is only solving one part of the overall tax quandary resulting from the digital economy. What must be understood is that "the separation of profit and profit generating activities in the digital economy is different

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[8] Li, (2014), *Protecting the Tax Base in the Digital Economy*, United Nations

[9] Avi-Yonah, R.S., (2016), *Three steps forward, one step back? Reflections on Google Taxes and the destination based tax,* Nordic Tax,2:69-76

[10] Bradbury, D., (2018) **Base Erosion and profit Shifting**, CPA Australia

[11] Commonwealth Government, 2018, *The digital economy and Australia's corporate tax system*[11] Treasury discussion paper, November, 2018.

from BEPS because the relocation of profits may be intrinsic to the business models used in the digital economy"[12]. In essence this means, that profit shifting by companies in the digital economy is not necessarily attributable tax avoidance, but often, more a function of the modern business form, and accordingly as posited by Li (2014), we need to focus on ''the more profound issues raised by the digital economy"… that need to be addressed, ie; "how enterprise in the digital economy add value and make their profits, and how the digital economy relates to the concepts of source and residence or the characterisation of income for tax purpose"[13]

General Commentary

In view of our discussion above, the way forward requires serious thinking on a conceptual and theoretical level, far beyond issues surrounding tax base erosion and profit sharing. What is needed is a multilateral 'general consensus' on a new set of defined terms that have dramatically emerged from the digital economy, along with an impost system that reflects fairly the substance of value created via means not recognised by previous taxation systems; such as for example value created through user participation and or customer engagement, inter alia. An excellent example of a general consensus model is perhaps best illustrated through the application of International Financial Reporting Standards (IFRS) supported by more than 137 participating countries. IFRS are now the common language of global accounting and financial reporting, and as well, provide a common lexicon of defined terms, which provides consistency in financial reporting around the world, and reduces uncertainty. Indeed, commonly defined terms also helps consistency in interpretation – for example, an 'asset' in Australia and the criteria used to define and recognise an asset, are the same in Singapore as they are in Australia, or any other participating country. We argue that this type of cross-jurisdictional support for a common language encompassing a generally accepted global tax system, will not only bring stability and certainty within international tax practice in the face of the virtual world, but will also bring along with it a 'blueprint' for a fair and equitable global tax system followed consistently by all participating countries.

We also note that the new system will need to carefully consider the continuing role of tax treaties between jurisdictions and whether this area needs to be revisited by the OECD and participating countries, so as to ensure that long established principles surrounding double tax agreements are not impaired and moreover, are in line with new international tax arrangements between countries.

[12] Li, (2014), *Protecting the Tax Base in the Digital Economy*, United Nations

[13] Ibid

As for adopting interim measures to deal with the digital economy, we believe that Australia has already taken extensive measures to combat BEPS as indicated in the discussion paper[14]. More recently also, Australia introduced what has been dubbed a 'netflix tax' which in effect is a GST levied on digital products and services which applied from July, 2018. While there appears to be mounting arguments by some countries to unilaterally charge a digital service tax in order to capture tax revenue that is potentially being lost, let's not be the front runners in the race to tax the digital economy, at least not until significant further research and co-operation is undertaken with countries who have partnered with the G20 and the OECD in solving the overall problem of taxing the digital economy. Indeed, moving forward too quickly on such critical issues could result in countries embarking on a perilous journey, i.e. where double or even triple tax could be levied by retaliating countries that may also require the lodgement of additional tax returns; where current trade relations between major countries are already simmering and could be further inflamed and exacerbated; and where, in the end, consumption taxes could be passed on to consumers.

Responses to discussion questions

Where possible we have provided answers to several of the questions listed in the discussion paper, however given the unchartered nature of the digital economy from a tax perspective, and the complexity of many of the issues raised, we were unable to undertake more comprehensive research within a 60-day response period. A 90-120 day response period would have provided a more realistic timeframe to allow further detailed research and more detailed responses.

I. Is user participation appropriately recognised by the current international corporate tax system? If not, how should value created by users be quantified and how should it be taxed?

It would appear from our review of the discussion document as well as our limited review of the literature, that user participation is not adequately recognised, and yet it appears to be central to the creation of value in countries where it is most likely to occur. This in turn would arguably provide the 'nexus' and thus the source of taxable revenue, particularly if the company had a significant digital presence in the economy of another country giving rise to a 'permanent establishment'. We note however, that it might be one thing to establish that user participation can be an important value driver, but quite another to determine an appropriate metric for ascertaining value and how it would be applied in practice. The UK government's position paper on corporate tax and the digital economy[15], suggests a 'metric that approximates the value that the user base generated, e.g., monthly active users. Given

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[14] Commonwealth Government, (2018), *The digital economy and Australia's corporate tax system*[14] Treasury discussion paper, November, 2018, pp10-11

[15] HM Treasury, (2017), Corporate Tax and the Digital Economy

that user participation and data usage create digital footprints, there are already established (technical) means for tracking user participation and data usage, and thus this may be a possible solution for a value metric. However, without further research into such metrics and whether they can be applied in a practical sense, their role in the ascertainment of value for taxation purposes, remains unclear.

2. Is the value of intangible assets including 'marketing intangibles' appropriately recognised by the current international corporate tax system? If not, how should value associated with intangibles be quantified and how should it be taxed?

We are of the view that 'marketing intangibles' are not appropriately recognised by the current international corporate tax system. We also note that further research is required to determine what might be an appropriate metric for ascertaining value associated with intangibles for taxation purposes.

3. Are the current profit attribution rules 'fit for purpose'? If not, how should profits be attributed?

Given the matters raised in the discussion paper, we are of the view that the current profit attribution rules are no longer appropriate in the context of the digital economy.

4**. What are your views on allocating taxing rights over residual profits associated with: (i) user contribution to 'user' countries, or (ii) 'marketing intangibles' to market countries?**

We do not have a response to this question in the current submission, but would be happy to provide a detailed response pending further ongoing research.

5. Should existing nexus rules for determining which countries have the right to tax foreign resident companies be changed? If so, how?

As articulated in the UK government position paper[16], we believe, on the basis of information provided in the discussion paper, that the right to tax foreign resident should be changed to reflect a "right to tax foreign countries that derive value from a material and active user base within their jurisdiction even in the absence of those countries having a permanent establishment"

6. From a tax perspective, do you consider that the digitalised economy is distinguishable from traditional economy? If yes, are there economic features of the digitalised economy that present special challenges in the context of taxation? How are these features relevant for assessing the costs and benefits of various models of taxation?

[16] HM Treasury, 2017, Corporate Tax and the Digital Economy

There are several distinguishing features of the digitalised economy that clearly delineate the digital business model from the more traditional business model, as discussed in our detailed commentary above.

9. What does the experience of other countries that have introduced interim measures or that are contemplating them mean for Australia?

For reasons outlined in our commentary above, Australia should refrain from taking any lead role in the introduction of interim measures at this point in time. We believe that Australia, should seek to undertake further extensive research and develop a broad consensus-based longer-term solution, rather than engage in developing unilateral interim measures in the short term which may have undesirable consequences. Indeed we concur with the view of Ernst and Young[17], who have argued that Australia must avoid short term unilateral or politically motivated reaction to global digital taxation. If it does not, it risks creating double taxation, the WTO concerns and retaliatory risks, especially from the US which granted Australian Steel exporters an exemption from US steel tariffs recently"

10. Should Australia pursue interim options ahead of an OECD-led, consensus-based solution to address the impacts of the digitalisation of the economy on the international tax system?

Please refer to our response in consultation question 9.

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[17] Ernst and Young (2018), Australian Treasury Discussion paper on the digital economy and Australia's corporate tax system- A detailed review, Global Tax Alert, EY.

We would be pleased to respond to any additional questions or queries you may have on any of the comments made above.

Yours Sincerely

Tony Greco