



**Submission to Treasury Discussion Paper
on the digital economy and Australia's
corporate tax system**

November 2018

Interactive Games & Entertainment Association

Overview

IGEA is pleased to provide this submission in response to the Treasury's discussion paper on the digital economy and Australia's corporate tax system. We appreciate the Treasury's decision to consult early and openly on this issue and we welcome the opportunity to contribute to this dialogue through this process and beyond.

We are the peak industry association representing the business and public policy interests of Australian and New Zealand companies in the interactive games industry. Our members publish, market, develop and distribute interactive games and entertainment content and related hardware.

This submission argues that **the case has not been made for Australia to undertake interim measures** to address real or perceived issues relating to the taxation of the digital industry. We join the voices of many other sectors of the Australian economy and respected financial commentators in urging caution against Australia unilaterally taking interim tax measures in a highly uncertain global trade environment.

There are **many significant risks with taking interim measures** and its costs could well outweigh its unclear and limited benefits. Any move to implement a tax on revenue rather than profit strays from accepted international practice and could lead to double taxation. There is also no agreed approach on how it would even be possible to define a tax on user contributions. Finally, interim measures will have compliance costs and will stifle innovation, and could result in retaliatory measures.

We believe that to the extent that there is a need for reform, modernisation of the international tax system through **multilateral arrangements is the only approach** that will be sustainable and effective. Rather than Australia seeking to lead the world in experimenting with untested interim measures, we would rather support Australia being a global leader in progressing dialogue on a consensus-based approach that will provide equity and lasting certainty for both countries and businesses.

Despite these concerns, should interim measures not be immediately ruled out in Australia, they should be carefully scoped and highly targeted. At the very least, **digital goods and services like video games as well as platforms like digital marketplaces for games should be exempt**. They are already appropriately taxed in Australia and have been excluded from conversations about digital taxes in Europe.

Finally, we also consider that it is **too early to implement interim measures against online advertising and user contributions**. If such measures remain under

consideration, the next step must at the very most be more analysis, scoping and consultation. In particular, there is a need to define how such a tax might even work, including what specific situations it would apply in and what safeguards are needed - such as the level of any minimum profit, revenue and company size thresholds.

No compelling case for undertaking interim measures

We do not think that the Treasury discussion paper clearly articulates the problem that is needed to be addressed. Alongside the many benefits of digitalisation of the economy that are articulated well in the discussion paper, there is also a discussion around concerns with digital businesses that operate in Australia but with limited physical presence or profit-generating assets onshore. However, the discussion paper also recognises that the question of “cross-jurisdictional scale without mass” is not unique to companies with digital business models but covers a whole range of industries, with the paper specifically highlighting the automobile sector. There are ample other examples in the manufacturing, defence, retail and services industries.

We also question why there is a need for specifically targeting digital businesses. As noted in the discussion paper, foreign businesses in a range of sectors in the traditional economy operate business models where the majority of profit-generating assets and labour are located offshore. Many export-orientated goods and services share this characteristic, with offshore call centres just one example. One of the many benefits of globalisation is the ability to reach into foreign markets without significant scale and this benefit is not unique to digital businesses.

While it is clear that many digital businesses have flexibility over where they develop their intellectual property, host their services delivery and base their regional or global headquarters - this also applies to many traditional industries. Similarly, the discussion paper recognises that many businesses that have not relied on digital business models, like those that supply pharmaceuticals, rely heavily on intangible assets like patents. Despite this, the discussion paper does not articulate why only the intangible assets used by digital businesses should be the focus on attention.

Finally, the use of “user contribution” is no longer the sole domain of digital businesses but is vital to organisations right across traditional industries and the community and government sectors who leverage the information of its users. Big data is helping businesses to better serve its customers and governments to develop more informed policies. While the discussion paper argues that the leveraging of user contribution may be more prevalent among digitalised

businesses than traditional businesses, we argue this is divide is rapidly losing relevance. Once again, it is also not entirely clear why only digital businesses needs to be targeted.

Unilateral interim measures will be complex and problematic

The discussion paper does not clearly articulate the options for unilateral interim measures that the Government is considering, including how they would work, what sectors and economic activities might be targeted and what impacts and benefits could be expected. A “digital tax”, which we assume is being considered, would be highly complex to design and administer and could take years to bring into force.

A new revenue-based tax would be a particularly unorthodox and challenging approach with few precedents to provide any guidance or best practices to model on. It would stray from both conventional practices and international tax principles and Australia would have no choice but to become a brave global leader on a highly divisive and untested issue. It also remains to be seen how a revenue-based tax would avoid double taxation and comply with Australia’s double tax agreements.

Compliance costs for Australian businesses that fall within the scope of interim measures like a revenue-based tax (and even those businesses that are excluded) would be high. Businesses would need to implement complex and expensive new compliance systems, particular if they need to accommodate any new revenue-based tax. More broadly, these new rules and costs could have a stifling effect on economic growth, innovation and risk-taking at exactly the wrong time as Australia urgently focusses on diversifying and modernising its economy and works towards building up digital exports to maintain its international competitiveness in the Asia-Pacific region and the world.

The Organisation for Economic Co-operation and Development (OECD) has itself recognised similar risks and, as outlined in the discussion paper, has warned that interim measures could result in over-taxation, may have an adverse impact on investment and innovation and have high compliance and administrative costs. The OECD has also warned that interim measures may increase the cost to consumers of digital goods and services covered by such measures and may distort the choices of businesses and consumers.

Multi-lateral arrangements are the only workable path ahead

We agree that tax laws around the world may need to be modernised in light of the continued globalisation and digitalisation that has occurred this century. However, these issues will only be solved through multilateral cooperation and partnership to reform the international tax system, such as those being led by the OECD and the G20. Countries pursuing their own paths with unilateral reforms will only hinder their ability to achieve an effective and sustainable global solution.

While they may take time, genuine solutions can only be reached through multilateral agreement and there is no consensus on what interim solutions even look like. For example, there is no agreement on how “user participation” can effectively be taxed, including how the value of the audience of online advertising, user-generated content or user networking can be calculated. Multilateral agreement is also needed to address the issue of double taxation from digital taxes.

As tempting as interim measures may seem, given the measured pace of multilateral negotiations, they are unlikely to be effective and may even exacerbate the problem as countries and regions adopt incompatible policies, entrench their positions and compete with one another. It may also lead to a ‘race to the bottom’ as countries compete against each other with lower and lower digital taxes, defeating even their own flawed purposes. If the Government believes that multilateral agreement is the only viable and sustainable solution, unilateral actions will only disrupt progress.

Undertaking interim measures could also have more direct and troubling impacts on Australia’s trade relationships too. The international trade environment is currently in a troubled state and Australia is delicately negotiating free trade and economic cooperation agreements with the European Union, Gulf states, Hong Kong, India, the Pacific Alliance and countries within the ASEAN region. Any interim measures could delay or hinder these negotiations and the implementation of future agreements.

Interventions like a digital tax would also run the very real risk of being treated as protectionism and could lead to retaliatory tariffs on Australian industries such as coal, steel and agricultural exports. Specifically, any digital tax may be taken as a proxy tax largely targeting US companies and there is a real risk of retaliatory measures by the US. Such retaliatory measures could have a significantly wider and deeper impact on the Australian economy than any modest increases in receipts that could be expected to be gained from a new digital tax.

Digital game content should be out of scope

Video games businesses in Australia can broadly be placed into three categories: publishers, distributors and developers. Publishers generally market and distribute games that they or other parts of their broader organisation develop. Distributors market and distribute third party games, after having acquired the legal rights to sell those games in Australia. Developers create their own games which they publish themselves or through a publisher or distributor. Our members include most of the major game publishers and distributors in Australia and key developers.

While many interactive games are sold digitally, most of Australia's games businesses are not truly digital businesses and still rely heavily on the sale of games through physical 'boxed' products. According to our research, over a third of Australian consumer spending on video games still takes the form of physical games sold in bricks and mortar stores. Many of the digital products that our members sell are simply digital versions of physical products that are sold in stores, giving customers flexibility to purchase the versions they prefer. Clearly, games are far from being pure digital goods and should not be subject to any additional taxes.

As noted in the discussion paper, Australia's corporate tax system includes transfer pricing rules that already address how Australian subsidiaries purchase goods and services from parent or affiliated companies and on-sell them in Australia. As also noted in the discussion paper, Australia complements its transfer pricing rules with various tax integrity rules, including thin capitalisation and controlled foreign company rules, the Multinational Anti-Avoidance Law and the Diverted Profits Tax. This means that our members, including those that are subsidiaries of global interactive games and entertainment companies, are already appropriately taxed under Australian law.

Crucially, the Australian GST now applies to sales of digital goods and services to Australian consumers, including from overseas, just like it does to physical game sales. This means that GST is now being charged not only on digital games but in-game purchases and other kinds of digital content. We consider that the Australian GST system has comprehensively dealt with the issue of the taxation of digital game content.

One of the concerns of the digital economy identified in the discussion paper was that some digital businesses carry out activity in Australia with minimal physical presence, or locate most of their profit-making assets outside Australia. Our members are Australian companies that have physical offices in Australia (many even have warehouses), pay all relevant Australian taxes, contribute millions of dollars each year to the economy in local marketing activities and contribute back to society including by supporting local charities and community groups. Together,

our members employ hundreds if not thousands of Australians and indirectly support thousands more Australians who are employed in businesses around the country that develop, sell, market, support, exhibit, compete in and write about video games.

What this all means is that it is appropriate and vital that digital content be excluded from any interim measures like a digital tax. We understand that the European Commission does not consider that the sale of digital content and online sales of goods and services should fall within the scope of any future digital tax. Similarly, we note that the UK's Digital Services Tax (DST) consultation paper released in November 2018 specifically excludes video games, including games that allow people to play with or against other people, from any proposed DST.

We do not take a position on the taxation of user participation with respect to businesses that rely primarily on user data, user-generated content or network effects, as discussed in section 4.2 of the Treasury's discussion paper. But because the primary economic value of games comes from the production, design, innovation, artistry, story, mechanics and playability of games – all of which is highly expensive and labour-intensive to create – we do not believe it would be appropriate to seek any additional taxation for “user participation”, even where user data, user-generated content or network effects may be involved.

Games differ greatly from services that rely primarily on user-created value. While the UK's DST consultation paper notes the need to further reflect on the treatment of “online games that share similar features to social media and online marketplace business models”, no examples are provided and it is not clear what kinds of games the paper is even referring to. Many if not most kinds of games allow players to interact with their friends and other players as part of gameplay and it is not clear why or how these games are different to the multiplayer games that the paper has explicitly excluded from the DST. We are also not aware of any games that rely on “online marketplace business models” and there are very few (if any) games that allow players to buy and sell game content from one another in any legitimate way.

While nothing in the Treasury discussion paper suggests that the Government is considering a broad-based tax on digital goods and services, providing clarity on this issue would provide certainty for industry.

Digital game storefronts should be out of scope

Video games are often sold digitally through storefronts or marketplaces like the Sony PlayStation Store, Nintendo Game Store, Microsoft Xbox Store and the Google Play Store. Again, while there is nothing in this discussion paper that suggests that

these kinds of platforms would fall within the scope of interim measures, its discussion of “intermediation services” which match buyers and sellers is vague.

Game storefronts and marketplaces are not “intermediation services” and are not analogous to digital platforms that facilitate interaction between users like Airbnb and Uber, or aggregator platforms like travel and hotel booking websites that connect users with third parties. Rather than being a matching service that depend on user volume like some of the businesses that are considered intermediation services in the Treasury discussion paper, game storefronts and marketplaces are highly evolved products and services in their own right that develop and support complex relationships with both game publishers and players.

Game storefronts and marketplaces are far more like digital extensions of physical game stores that enable game developers and publishers to sell games, game content and related services to players of their games. To contrast even further from intermediation services, the businesses that build these storefronts and marketplaces also generally need to develop the underlying hardware, software and infrastructure to enable games to be built, sold and played on the platform. These include multiple generations of gaming consoles, peripherals, operating systems and firmware. These businesses often also publish their own games on the platform and need to work closely or in partnerships with other game developers and publishers to bring games to their platforms.

To conclude this section, we note that the European Commission shares the view that digital storefronts and marketplaces should not fall within the scope of any digital tax, explaining in its Explanatory Memorandum to COM(2018)148 that:

*“services by an entity to users through a digital interface consisting in the supply of digital content such as video, audio or text, either owned by that entity or which that entity has acquired the rights to distribute, **are not to be regarded as intermediation services** and should therefore be excluded from the scope of the tax, given that it is less certain the extent to which user participation plays a central role in the creation of value for the company”.*

Too early to tax online advertising and user contribution

This paper urges caution generally against Australia going down the path of taking interim measures. However, it remains a possibility that following this discussion paper consultation process, the Government still considers that interim measures against online advertising and user contribution are worth further consideration. If

this occurs, we think that there is significantly more analysis, scoping and consultation that is needed before any such measures can be progressed.

There are real questions about how a tax on online advertising would work, how it would be valued, how it would be implemented and how it would be enforced. There is also a danger that if the taxation of online advertising is normalised around the world, there will be serious consequences for Australian mobile game developers, who are among the most successful in the industry. The Australian games *Fruit Ninja* and *Crossy Road*, for example, have been downloaded over 1 billion and 100 million times respectively and the industry has likely brought in tens if not hundreds of millions of dollars into the Australian economy through advertising revenue alone.

As already discussed, there are even greater questions around how a tax on user contributions would work and how the value of user contributions can be calculated. As far as we are aware, no country or organisation has been able to develop any kind of effective formula that is not an indiscriminate revenue tax. There is clearly little agreement or cooperation even between the few countries that are seriously discussing interim taxes on user contributions, and they unfortunately appear to be committing the grave error of developing policy on the run.

More broadly, if Australia continues to consider a tax on user contributions in the future, it should undertake very considered planning and, ideally, try to encourage or take an internationally collaborative and coordinated approach first. In particular, there is a need to define and consult on safeguards such as minimum profit, revenue and company size thresholds as well as the precise kinds of activities that would be in or out of the scope of 'user contributions'. This will help to ensure that digital start-ups and other relevant categories of businesses are appropriately left out of the scope of any tax.

Finally, we recognise that this discussion paper is only one part of the Government inquiry. The discussion paper notes that the Government is considering the broader implications of digitalisation for the economy, jobs and employment, cyber security, consumer data and tax administration. This suggests that a broader plan is needed for the digitalisation of the economy and IGEA stands ready to inform this work.