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By email: corporatetax@treasury.gov.au

Dear Sir/Madam

The digital economy and Australia's corporate tax system

Introduction

The Taxation Committee of the Business Law Section of the Law Council of Australia (**Committee**) welcomes the opportunity to make a submission in response to the Treasury Discussion Paper "The digital economy and Australia's corporate tax system", dated 2 October 2018 (**Discussion Paper**).

We recognise that the Discussion Paper addresses two different issues which are the subject of international tax policy developments globally, in which Australia is participating. The first is Australia's overall position in relation to the commercial developments in the digitalisation of business described in the paper (**the main body**), and the second is the need for and possible design of any "interim measure" (in Appendix A).

As follows we provide our observations in relation to both, by reference to the questions asked.

Executive Summary

The issues covered in the Discussion Paper raise fundamental issues of international taxation and Australia's economic future. The allocation of taxing rights between production and market (or residence and source) date back at least to the League of Nations discussions which underpin the modern tax treaty system. However, modern technology developments, which span not just the "digital economy", but all aspects of the economy, call for a re-evaluation of that allocation.

Australia needs to consider its long-term economic future in its own assessment of that allocation. That can only be done with a long-term perspective based on a strategic and economic analysis. Australia's position on tax law should follow from this analysis. That position should not be limited to an assessment of Australia's corporate tax system, but also include its considered position in relation to value-added or consumption taxes.

In that context, Australia should continue to actively participate in multi-lateral efforts to influence any new broad-based redesign of the international tax system. Australia should not pursue unilateral measures as this creates uncertainty and might undermine multi-lateral initiatives.

Our responses are limited because we know that these issues are subject to major international tax policy negotiation and research, led by the Organisation for Economic Co-operation and Development (OECD), with policy development to be presented to G20 and other leaders in 2019.

The multilateral policy development reflects the clear understanding from G20 leaders, and OECD members, that any significant revisions to the international tax framework, which has operated for over a century, should involve a consensus-based approach.

Responses to the main body

- 1 Question 1: 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?**
- 1.1 It is important to accept that recognition of user participation as a basis for taxation would represent a major new development in the existing international tax order, potentially a fundamental revision of the tax base. It must be addressed from this perspective, rather than through *ad hoc* attempts to modify the existing system “at the margins” in order to satisfy the demands of participating jurisdictions.
- 1.2 The debate is about whether the value created in such business models is attributable to the insights (and resulting intellectual property) which creates the platform on which the activity occurs or whether it is attributable to the legal, social and technological infrastructure that creates the population of users who have the skill and ability to engage with the platform. In crude language, is it the platform, or the user who represents the value?
- 1.3 While it is true that value cannot exist without both producers and consumers, there are strong grounds to consider that by far the most significant part of the value should be attributable to the intellectual property assets which represent the platform. This perspective is consistent with the global intellectual property rights systems which reward innovators with exclusive use (giving them the entirety of the value attributable to innovations).
- 1.4 The international tax system offers a structured approach, using the transfer pricing rules and in particular the arm’s length principle, to regulate the apportionment of value in situations of cross-border business activity, assuming independent parties negotiating across borders.
- 1.5 The recognition of user participation and its value raises issues of recognition of the source and its value, together with the application of transfer pricing rules and other avenues to tax that value, such as through value added taxes.
- 1.6 The Discussion Paper in Part 4 acknowledges the diversity of views within member nations which confirms the fact that proposals to tax user participation are a departure from the existing international tax order. As noted, these issues are under active consideration by the OECD in a major multilateral policy development process in which

Australia is participating, seeking to develop international consensus to provide certainty for businesses, tax administrators, and consumers.

- 1.7 We consider that the OECD is the only forum within which such fundamental changes should be pursued. It is appropriate for Australia to participate in this process, and for Australian policies to then await and evolve from the outcomes of the OECD work.

2 Question 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?

- 2.1 Currently, in the context of transfer pricing, the value of intangible assets is analysed by having regard to their DEMPE functions (development, enhancement, maintenance, protection or exploitation). The recent BEPS work has provided further guidance specifically in the area of marketing intangibles, picking up earlier Australian Taxation Office (**ATO**) commentary issued some years before.

- 2.2 The transfer pricing rules will apply if the relevant marketer has a relevant presence in the location of the customer (e.g. permanent establishment or residence through incorporation).

- 2.3 At a high level this method is appropriate to recognise the value of intangible assets including “marketing intangibles”, albeit no doubt the application of these rules continues to be tested.

- 2.4 In addition, digitised transactions can be taxed at source through value added taxes. Examples of this are the recent amendments in relation to low value imported goods (**LVIG**) particularly offered through Electronic Distribution Platforms (**EDPs**).

- 2.5 Plainly, the above does not capture transactions or value chains where the user/consumer does not make an acquisition, so as to be outside the GST net, and the platform operates without a traditional taxable presence. In our view, changes to the corporate tax system are unnecessary if the relevant value is otherwise brought within the tax net.

- 2.6 Expansion or alteration of existing concepts raises major boundary issues. If the rules applicable to intangible assets were to be revised, how does this affect intangible assets related to the production of physical goods, or services, across the broad spectrum of international trade? In a similar way, how would such a change to rules flow through into country domestic tax systems, tax compliance processes, interactions among tax administrators and businesses, consumer pricing and related issues? All of these issues would need to be addressed, before undertaking any changes.

- 2.7 Any steps taken to address these issues need to consider not just the issue of taxable presence but also, if the taxable presence exists, how the transfer pricing rules should then apply. This is dealt with below.

3 Question 3: Are the current profit attribution rules ‘fit for purpose’? If not, how should profits be attributed?

- 3.1 For the reasons given in our response to question 1, the existing rules are appropriate. If the OECD consensus considers otherwise, then this will present practical issues. This is why an OECD consensus approach is necessary, so that any departure from

current principles is accompanied (as occurred with the BEPS initiative and revised international transfer pricing guidelines) with:

- (a) agreed-upon principles which can be implemented by countries, tax authorities and taxpayers;
- (b) clear mechanisms for compliance with the new rules; and
- (c) integration into domestic tax systems.

3.2 Unless major policy revisions are implemented in this manner, the risks are large as the OECD has identified and as the discussion paper references.

3.3 The existing “arm’s length transaction” basis for transfer pricing appears to become increasingly uncertain in relation to such questions. To provide certainty would require the use of an arbitrary global profit split approach using a “formulary” approach. In the end, the value of the “asset” represented by users in a market (whether as contributors of content to a platform or participants in a market) must logically be measured by reference to the revenue stream they drive.¹ Therefore, the only logical basis for apportionment is with reference to the relative contribution of a country’s revenue stream to the overall group profit. This will present enormous practical issues around determining the actual profitability of the revenue stream from each jurisdiction.

4 Question 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?

4.1 Please refer to our previous answers.

4.2 As a general matter, the allocation of residual profits, wherever made, should be made clear in order to avoid uncertainty.

4.3 The adjustments to the transfer pricing guidelines arising from the BEPS initiative, which impact on the rights of countries to tax international business activities, involved extensive discussion papers and development of globally-agreed changed rules to enable domestic tax systems and tax authorities to supervise the changes. The purpose of this process was to develop consensus, and to provide guidance and clarity on the intention and operation of the changes. The same process should accompany any changes to the allocation of taxing rights in relation to residual profits.

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

5.1 Please refer our previous answers and the need for OECD-led multilateral policy development and implementation.

5.2 For example, the adjustments to the definition of permanent establishment for tax treaty purposes, which impact on the rights of countries to tax international business activities, involved modifications to the existing model treaty, adoption of the changes using the multilateral instrument (which is still being implemented globally), extensive public discussion papers and an implementation schedule to enable domestic tax

¹ This is consistent with the approach of the latest UK announcement:
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752172/DST_web.pdf

systems and tax authorities to supervise the changes. The same process should accompany any changes to the nexus rules.

6 Question 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?

6.1 The impact of digitalisation extends across the value chains of all industries.

6.2 The use of digital tools is yet another significant technological development which is incorporated into ordinary business practices. In previous waves of technological innovation, including:

- (a) improved international transport;
- (b) improved international communications;
- (c) development of advanced computer technology; and
- (d) the spread of computer technology,

there were early adopters but the innovations were taken up by business generally and used to broaden their value chains, as is now occurring with digitalisation and enhanced use of data.

6.3 The impact is a disaggregation of the elements of value chains. However, that disaggregation is no different from developments such as easier global transportation which enabled cross-border value chains for manufactured products, easier global communications which enabled cross-border partnerships and teaming in relation to computer technology and IT projects. Previous such changes have been incorporated into the international tax systems, Australia's tax system, and tax administration.

6.4 It is clear that the changes wrought by these technologies on existing businesses, and the development of new business models are processes that are not yet finished.

6.5 Therefore, to define existing proposals with respect to specific existing business models is an unsound "schedular" approach as the integration of digital tools into ordinary businesses makes it impossible to segment these activities in the same way as occurs, for example, in relation to shipping and airline transport profits which have warranted special rules. Seeking to isolate the digitalisation of business into different tax rules will not only lead to categorisation difficulties but will also lead to ongoing international disputes about the need for further change.

7 Question 7: Can and should any changes to the international nexus and profit attribution rules be ring-fenced to apply only to highly digitalised businesses? If so, how?

7.1 Any changes to the nexus and profit attribution rules should aim to be consistent with the design principles identified by the Henry Review, namely: (a) equity; (b) efficiency; (c) simplicity; (d) sustainability; and (e) policy consistency.²

² Henry, K. R. et al (2010a) Australia's Future Tax System: Report to the Treasurer, Part One, Overview, Commonwealth of Australia, Canberra at Box 2.1.

- 7.2 As noted in the Discussion Paper and as explained above, the digital economy is increasingly becoming the economy itself, and therefore it will be increasingly difficult to quarantine the effect of any changes to highly digitalised businesses. Attempts to ring-fence the rules are likely to result in significant complexity, including giving rise to difficulties in effectively and simply identifying a “highly digitalised business.” This is likely to give rise to the risk of double taxation, tax disputes, and difficulties in administration and compliance.
- 7.3 Furthermore, ring-fencing may result in distortions in decision-making (by taxpayers and/or customers) and potentially inconsistent tax treatment of similar businesses and transactions.
- 7.4 Attempts to define a “highly digitalised business” by reference to specific indicia will require careful attention, to address any scope for tax avoidance by structuring around and/or out of the indicia. If it were considered necessary (as raised in the United Kingdom (**UK**) consultation paper) to limit scope for tax avoidance by structuring around and/or out of the indicia, development of such rules would need extensive consideration to limit complexity and overreach.
- 7.5 In light of this, any changes to the rules should avoid ring-fencing and instead extend beyond highly digitalised businesses. Furthermore, to the extent possible, changes should aim to be broad and flexible enough to cater for any foreseeable future developments in both the digital space and the economy more broadly.
- 8 Question 8: Are there changes other than to nexus and profit attribution rules that should be made to the existing international corporate tax framework and/or Australia’s tax mix to address the challenges presented by globalisation and digitalisation?**
- 8.1 As set out above, the response of Australia to the challenges presented by globalisation and digitalisation needs to be not limited to corporate tax but also take into account other tax measures such as value added taxes.

Responses in relation to the interim options

- 9 Question 9: What does the experience of other countries that have introduced interim measures or that are contemplating them mean for Australia?**
- 9.1 The OECD has acknowledged that there is no consensus on whether the digitalisation of the economy presents a problem for the existing international tax framework, how to respond to such a problem, or a timeframe for such action.
- 9.2 In considering whether New Zealand should implement a digital services tax, the New Zealand Tax Working Group took a “wait and see” approach: they would consider it further if “a critical mass of other countries also adopt[ed] an equalisation tax (particularly Australia)”.³
- 9.3 Such a recommendation from New Zealand suggests that the implementation of a digital services tax (**DST**) in one jurisdiction may trigger a domino effect in other

³ Tax Working Group, Update on Taxing the Digital Economy, July 2018
<https://taxworkinggroup.govt.nz/sites/default/files/2018-09/twg-bg-3985453-update-on-taxing-the-digital-economy.pdf>.

jurisdictions, without each State having proper regard to its particular needs or circumstances.

- 9.4 The European Community (**EC**) has been seeking to develop and propose an EC interim digital services tax (**ECDST**) for an extended period. However, that proposal has divided the countries in the EC, with some, notably Germany, disagreeing with the risks inherent in such a tax, and the risk of retaliatory action by other jurisdictions, including in relation to existing businesses which are adding digital features to their production of goods and services. We understand that, at time of writing, the EC DST is subject to further discussion and development and is to be discussed further in December 2018.
- 9.5 We also understand that the UK has proposed its own UK digital services tax, with a much narrower scope of affected transactions and affected businesses than under the EC DST. The UK approach involves a large number of complex issues which are outlined in the UK discussion paper of November 2018, and it is significant that the UK considers the UK DST could not be operational before mid-2020.
- 9.6 The OECD Interim Report states that:

*the proliferation of unilateral approaches is likely to have adverse impacts on investment and growth, and risks increasing double taxation and complexity for taxpayers and tax authorities alike.*⁴

- 9.7 In this regard, we agree with the OECD position.

10 Question 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?

- 10.1 As outlined in our responses to question 9, the development of interim digital taxes raises hugely complex issues, major lead times and apparently quite low revenue collections.
- 10.2 The Discussion Paper provides no comments about the potential revenue to be collected from any moves from interim digital taxes of an indirect tax nature. The UK DST is proposed to collect small amounts of revenue, relative to the size of the UK economy.
- 10.3 We have seen media comments suggesting potential Australian tax collections of less than \$200 million per annum, although we are not in a position to review any such estimates. It is surprising that Treasury could be seeking responses to a fundamental question of the imposition of a new tax without any public consideration of the potential revenue impacts, and the cost-benefit analyses involved.
- 10.4 The complexity of the issues involved as discussed above and below, the claimed temporary nature of such a tax impost, and the potentially small amount of revenue to be collected, point away from Australia pursuing interim options, in the absence of strong policy reasons, backed by revenue modelling, and cost-benefit analysis.
- 10.5 Please also refer to our responses below.

⁴ OECD 2018, Tax Challenges Arising from Digitalisation –Interim Report 2018: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris ('Tax Challenges Arising from Digitalisation – Interim Report 2018'), at [511].

- 11 Question 11: What indicators could be used to identify businesses that benefit most from user-created value? Would an interim measure applied to digital advertising and/or intermediation services accurately target that value? How broadly or narrowly should ‘digital advertising’ and ‘intermediation services’ be defined?**
- 11.1 Our comments below are very limited in scope, because the issues involved are being discussed as part of the multilateral OECD policy development process in much more detail. Therefore, we can provide only limited input, consistent with our view that it would not be a cost-effective project to introduce an interim digital tax in Australia.
- 11.2 The discussion of the proposed interim measure is “schedular” in approach both in Australia and overseas.⁵ This at least recognizes that these measures are designed to identify particular targets at a particular point in time, and do not purport to be a principles-based resolution of a perceived problem.
- 11.3 One critical issue is the practicality of any proposal. We emphasise that any interim digital taxes of an indirect tax nature will require significant new data to be obtained by each business in relation to each customer or recipient of digital services, which we understand may not be currently captured or captured in sufficient detail.
- 11.4 We saw in the recent measures relating to GST for cross border sales to Australian consumers that Treasury recognized the substantial systems issues companies faced and delayed the start date by 18 months to enable adaptation and compliance. We acknowledge the comments in the Discussion Paper suggesting that any proposal will try to leverage those GST changes. We understand that this may not be an easy task or even possible. We also understand that the data records required to identify user locations are not those required to identify advertiser location, and that these records are not usually linked to, or able to be addressed by the accounting system.
- 11.5 Enterprises will face an almost identical level of systems changes and require as long to again adapt. This means that Australia should seek to announce proposals which are identical to at least one other jurisdiction which has already implemented similar measures in order to enable the same data points to be used across multiple jurisdictions. Australia should also work to develop a consensus on interim measures (we note the latest UK proposal is closer to the EU Proposal 2⁶ that was its predecessor).
- 11.6 We should also seek to standardize the “total global turnover” and “local revenue” thresholds for the application of the measure.
- 11.7 Consideration will need to be given to whether the new tax is creditable (unlikely) or deductible, and whether it accumulates in the value chain of multinationals operating through “buy/sell” structures in Australia in a way that creates an excessive overall tax rate.
- 11.8 It is relevant that any proposed future start date for an interim measure, which allows time for systems change, will probably post-date the OECD report. This must put into question the appropriateness of an interim measure, since it will potentially result in taxpayer expenditure to meet a redundant measure.

⁵ The UK has at least clearly signalled that online business models which permit enterprises to directly engage, from offshore, with UK customers is not a variation of traditional business models that should be addressed by its proposal, or perhaps at all, outside the scope of traditional OECD measures. At paras 1.13 to 1.14, 2018 Paper.

⁶ https://ec.europa.eu/taxation_customs/business/company-tax/fair-taxation-digital-economy_en

11.9 One final point is that we also understand that, if the measure is effectively set as a percentage of the relevant revenue, the cost will simply be passed through to Australian customers. This is relevant not only from a broader policy perspective, but also in the context of the legislative and technical design of the measure, such as in relation to administration and collection. For example, with respect to “digital taxes” some countries have sought to implement joint-liability on customers⁷ - this is something that we consider should only be contemplated after careful consideration and consultation.

12 Question 12: The choice of ‘nexus’ for an interim measure (or a longer-term ‘virtual’ PE proposal) involves significant trade-offs between ease of administration and the risk of avoidance. Which nexus option strikes the best balance between these considerations?

12.1 Ease of administration is of significant importance - simplicity will assist with compliance and enforcement. In this regard, when it comes to the nexus options, those that focus on payments being made by Australian businesses and/or consumers would appear to be the simplest options, from an administrative and compliance perspective, as they would offer a relatively understandable bright-line test and a workable audit trail.

12.2 It would be preferable if any measure did not require apportionment, as this will result in additional complexity, as well as creating a fertile ground for tax disputes (domestic and international). Experience with the transfer pricing rules and associated disputes highlights the issue.

12.3 Any interim measure should be proportionate, targeted, and designed in such a way as to require the least amount of system changes and allow for any future “unwind” of the measure. In terms of legislative implementation, the measure should seek to rely on concepts and terms which already exist within the tax provisions, to assist with clarity, certainty and ease of implementation.

12.4 With respect to the collection mechanisms and compliance processes, to the extent that this is possible, adapting and/or relying on existing mechanisms/processes, should be the preferred approach. Lessons from and experience with the recent changes to GST for cross border sales to Australia, should assist and inform the design of the same.

13 Question 13: What are your views on thresholds for an interim measure, taking into account the need to meet Australia’s international trade obligations?

13.1 We agree with the observations in the Discussion Paper that any thresholds for the interim measure should be consistent with Australia’s WTO and FTA obligations, and Australia’s tax treaties.

13.2 We also consider that following OECD guidance on these types of issues should be the preferred approach, given the international dimension of the measure and to minimise the compliance costs and complexity. As noted above, the OECD does not favour interim tax measures, and the EC direction is not clear at the date of this submission, so we do not comment further on international alignment at this stage.

⁷ OECD 2018, Tax Challenges Arising from Digitalisation –Interim Report 2018: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris (“Tax Challenges Arising from Digitalisation – Interim Report 2018”), at [362].

Thank you for the opportunity to provide this submission.

Please contact Clint Harding, Chairman of the Taxation Committee of the Business Law Section on (02) 9226 7236 or charding@abl.com.au, in the first instance should you have any queries.

Yours sincerely

A handwritten signature in black ink, appearing to read 'RMS', written in a cursive style.

Rebecca Maslen-Stannage
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