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Digital economy and strengthening Australia's corporate tax system – Treasury discussion paper released

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October 4, 2018 Tax Month - October 2018 By John Morgan

On Tuesday 2.10.18, the Government released a discussion paper seeking views on options to strengthen the integrity of the corporate tax system, in the age of the digital economy.

The Treasurer also noted (in his media release):

- the Government is concerned that some very profitable, highly digitalised companies pay very little tax in the countries in which they do business [read: Google and Facebook]
- the G20 and the Organisation for Economic Co-operation and Development (OECD), to develop sustainable, multilateral responses to address the challenges to our tax systems arising from digitalisation. Member nations are, also, proposing some short term 'sales tax' style taxes, as an interim measure, such as the 3% EU proposal. (See related Tax Technical EU article and Global Review).

- Australia has already taken steps to ensure that GST applies to some on-line/digital supplies, into Australia – with the amendments to apply to low-cost imports and digital products.
- Further to this, Australia will host the fifth meeting of the OECD Global Forum on Value Added Taxes in March 2019. This will showcase our GST reforms (mentioned above).
- This is in addition to many amendments to protect the direct tax base from multinational transactions (including the Multinational Anti-Avoidance Law, Diverted Profits Tax, Country by Country Reporting, signing the Multilateral Instrument Convention and reinforcing our transfer pricing laws).

The Discussion Paper on taxing the digital/digitised economy

1. Digitalisation of the economy

The paper discusses what 'digital' services are and their reach into Australian life.

It repeats the OECD three factors common to digital businesses.

- *Cross-jurisdictional scale without mass*: Digitalisation has allowed businesses in many sectors to locate various stages of their production processes in different countries and access customers around the globe. Digitalisation also allows some highly digitalised enterprises to play a significant economic role in a country without any, or only limited, physical presence.
- *Reliance on intangible assets*: Digitalised businesses are often characterised by investment in intangible assets, including brand names, patented inventions, trade secrets and algorithms.
- *Data, user participation and network effects*: Data, user participation, network effects and user- generated content are commonly observed in the business models of more highly digitalised businesses. Search engines and social media businesses rely heavily on gathering data

aboutusers' preferences in order to sell highly targeted advertising services to businesses. Networkeffects occur when the usefulness of a service grows exponentially with the number of users.

2. The corporate tax framework

The paper notes that a tax system must have rules as to whether income earned by a company should be taxed in Australia (or somewhere else or no-where – which we can't control. I recites the well know rules about: source; residency; permanent establishments and double tax agreements; transfer pricing rules; and withholding tax regimes for payments of dividends, interest and royalties, to non-residents; thin capitalisation; and anti-avoidance rules such as the MAAL and Diverted Profits Tax.

The paper also traverses the basis on which GST or VAT style taxes apply, which is to broadly tax at the point of consumption, avoiding (largely, but not entirely) the problems associated with taxing income from digitalised businesses.

The problem with taxing digitalised businesses is that they can (and typically do) have the ability to access a market via technological means without necessarily having a physical presence or a significant number of employees in that market – generating its income through things like 'algorithms' which might not even be property and might not even have a place where they are situated. All of this can result in a business having a significant economic presence in Australia, whilst paying only a small amount of tax here (or no tax).

Digital disruption might seem to attack Australia's business base and thus the taxes that can be levied, but this is an overly static view. Airbnb, for instance, has lead to much more accommodation being on the market. Likewise, Uber has resulted in many more cars being hired by passengers for short trips.

Things like Google and Facebook, however, use participant data to identify preferences and sell highly targeted advertising (all from overseas). Though data is provided by Australians (as an essential part of this business model) their data/prefences is not yet recognised as a basis for imposing income tax.

3. Integrity of the Australian tax system

The G20 and OECD Action Plan on BEPS (Base Erosion and Profit Shifting) – gets early treatment in the Paper. It notes that BEPS Project aimed to develop a multilateral package of reforms that addressed the following themes.

- *Coherence* (Action Items 2, 3, 4 and 5): ensuring coherence in international tax rules, that is, preventing companies from taking advantage of inconsistencies in domestic laws to pay less tax.
- *Substance* (Action Items 6, 7, 8, 9 and 10): ensuring that taxing rights better align with economic substance – e.g. preventing companies from routing payments through certain jurisdictions in which they have very little or no economic activity, purely for tax benefits.
- *Transparency* (Action Items 11, 12, 13 and 14): enhancing the transparency of the international tax system.

Taxing a digitalised market place, was the subject of BEPS Project, Action Item 1. It has not got anywhere yet. However, neither Action Item 1, nor the BEPS Project more broadly, sought to change the underlying principles of the international tax framework. Nor was the BEPS Project intended to address broader challenges related to taxing value creation in the digital economy.

Australia has been diligent in implementing the BEPS recommendations and in some cases has pre-empted those recommendations or gone further than recommended (or both). There is a table of all the Action Items, showing Australia's response.

On Action Item 1 (digital economy) – the only action Australia has already taken are the GST changes mentioned above.

4. International trends

4.1 Increasing international pressure

The paper talks about rising international pressure to do something about this (which there is).

It talks about reports in the following forums.

1. *The OECD Digital Action item* task force produced an interim report in March 2018, which acknowledges that Countries' views diverge on whether there is a problem with the existing nexus rules (which determine when a country has taxing rights) or profit attribution rules (which determine how much of a business' profits can be taxed in that country). The 2020 FinalReport will include the TFDE's recommendations for potential changes to those rules – but don't hold your breath: not only are the technical issues complex and require judgement, but there is the politics of 'hearing' nations to consensus. The Digital Taskforce also canvasses interim options.
2. *The European Commission* have issued a paper in March 2018, exploring a longer term reform of international rules to attribute profits to a 'virtual permanent establishment'. It also discusses an interim (sales style) tax on defined digital sales, as an interim measure.
3. *The United Kingdom* have issued a position paper in November 2017 (updated in March 2018) favouring 'reform of the international corporate tax framework to reflect the value of user participation'. The UK is happy to work with other nations on interim taxes. Separately, it has also announced its intention to extend royalty withholding tax to transactions between two non-residents, a measure that it says will predominantly affect digital businesses.

4.2 Should taxing rights change to reflect user-created value?

Some countries have called for user-created value to be recognised as a basis for allocating a taxing right to the country where these activities occur as highly digitalised businesses may benefit from user-created value in several ways:

- *User data*: data collected from consumers allows advertising to be targeted specifically to consumers that are likely to be interested in the advertised goods or services, thereby increasing the value of these advertising services to businesses;
- *User-generated content*: users contribute to digital economy businesses in a variety of ways, including, for example, providing reviews, ratings, photographs or live biographical updates. This content adds credibility and trust, and attracts additional users; and
- *Network effects*: as more users participate in a particular online platform, it becomes more attractive to businesses to participate (and vice versa), which can in turn see the platform attract more users or businesses.

The international discussion regarding user-created value may be linked to ‘the idea that a country that provides the market where a foreign enterprise’s goods and services are supplied on its own provides a sufficient link to create a nexus for tax purposes’. However, some countries distinguish ‘users’ from ‘customers’, seeing users as a key part of the supply chain of a digital business.

If user data or user contributions were to create taxing rights, significant work would need to be undertaken on how profits derived from user-created value would be allocated to a country, as there is presently no agreed mechanism to estimate the value of user data or user-generated content. The profits of businesses that derive value from user participation are the result of a range of inputs, including intellectual property and the contribution of capital by the owners of the relevant businesses. Furthermore, newer digital business models, that rely on artificial intelligence and machine learning, may be less reliant on user participation, so the source of any problem may change quickly.

There may also be an element of ‘be careful what you wish for’. Currently Australia exports vast quantities of mined commodities to various countries, without them wanting tax – just because they bought the goods.

4.3 Should taxing rights change to reflect value associated with intangibles?

Some of the features that the OECD observed are common to highly digitalised businesses can also be observed in other businesses and the changes should go wider.

One alternative could involve a focus on intangibles based on the view the country where consumers are, can be regarded as the 'source' country for returns to marketing intangibles (such as trademarks and brand names), whereas patents and copyrights may be able to be more closely linked with the place where an invention was made or a work was created.

The taxation of intangibles presents challenges for the international tax system; for example, in attempting to arrive at an arm's length value 'unique' intangibles.

Such difficulties have lead some to suggest that profits of multinational entities should be allocated across countries based on a formula (perhaps like the old Californian 'Unitary Tax').

4.4 Potential changes to existing profit attribution rules

Current rules focus on physical presence as an indicator of economic presence and the location of value creation but digital businesses don't play by those rules. Where a business has a significant economic presence, with little or no physical presence, in terms of tangible assets or personnel, it would not be possible to allocate profits, to that country, under existing rules.

The OECD's Action 1, 2015 Report set out possible approaches to attributing profits to a virtual PE, including a deemed profit system.54 This could involve, for example, determining 'deemed net income by applying a ratio of presumed expenses to the non-resident enterprise's revenue derived from transactions concluded with in-country customers'. But there are any number of problems with deeming some rate.

The UK recognises that user participation is a key driver of value creation and it should be taxed in the country where that participation occurs. But how much do you tax? The UK thinking is based around allowing some routine degree of profitability, and treating the residue as available to be taxed as the user participation component. It's an idea, but again, the hard part is what degree of profitability to allow, in order to create the residue.

EU Member states would be allowed to tax profit on digital supplies to people in that country, once they passed a certain threshold, so as to have a 'virtual PE'. Profits would be attributed to the Virtual PE, base don its 'economically significant functions or activities – such as include collection, processing and sale of user data, the collection, processing and display of user-generated content, the sale of online advertising space and making third-party created content available on an online marketplace (what ever all that means). Profit splitting (attributed to the virtual PE) might be based on the number of users in a Member State, the amount of data collected in a Member State, and research and development and marketing expenses.

4.5 Potential changes to existing nexus rules

The nexus rules need to be changed, to allow what ever the attributed profit is, to be taxed.

The OECD 2015 Action 1 Report analysed options that countries could consider, including the introduction of rules that would confer taxing rights over digitalised businesses that have a 'significant economic presence', but lack a physical presence, in a country. There is no shortage of ways to measure the threshold for a virtual PE, but no consensus amongst member nations on what they would be.

4.6 Can changes only apply to highly digitalised businesses?

It's theoretically cogent to not limit concepts of 'significant economic presence' to just digital business. The OECD has observed, 'the digital economy is increasingly becoming the economy itself'. But then the hard practical matter emerges of the tests one might prescribe for this threshold.

4.7 Options for broader reform

The paper discusses options for broader reform, in the context of Australia relying more heavily on corporate income tax than comparable OECD countries. Around 20 to 25 per cent of Commonwealth tax revenue (excluding GST) comes from company tax. This may mean we are particularly exposed as a result of globalisation and digitalisation.

It is short of any concrete suggestions, save to observe that several countries have introduced or considered significant tax reforms. The United States, for example, recently introduced a suite of tax reforms, not limited to digitalised businesses. This included a proposal for a destination-based cash flow tax (as more fundamental reform). I'm not sure what this is but it sounds like a tax on the money paid, in the destination country, for the particular supply.

5. Interim options

The EU has perhaps the most detailed interim measure, as a proposal. Its Digital Services Tax (**DST**):

- would be levied on revenue from digital services where user-created value is central, such as digital advertising and intermediation activities,and from the sale of data from users' engagement with digital interfaces.
- The proposal explicitly excludes:
  - communication and payment services,
  - e-commerce and
  - supply of digital content via a digital interface.
- The DST would apply to companies with gross revenues (net of VAT) derived from the provision of taxable services, at a rate of 3 per cent, and

- apply only to businesses with total annual worldwide revenues exceeding €750 million and EU taxable revenues exceeding €50 million.
- Member States, where users were located would have taxing rights and
- revenues would be allocated to the Member State according to set criteria. For example, for digital advertisements – the number of times an ad appears on users' devices, in a set period, would be considered when allocating revenues to that State.

SUBMISSIONS are due by 30 November 2018.

Editorial Comment

For what it's worth, the ideas that come to mind, for me, are the following.

1. Deem income from certain supplies (currently only digital) to have an Australian 'source' – for the purposes of our domestic law – so it can be taxed here.
2. Expand the definition of a 'permanent establishment' (in our Double Tax Agreements/DTAs – perhaps through the Multilateral Instrument) to include a 'virtual PE' based again on the size of their digital presence in Australia and elsewhere in the world, so that Australia is not excluded from taxing profits attributed to that Permanent Establishment.
3. When calculating the amount of profit to be allocated to the virtual PE, both our domestic law and the DTAs should require the economic value 'user data' in that business model, should be taken into account.
4. Some measures to make such nebulous calculations workable, would need to be put in place. They might be like 'Advance Pricing Agreements' that the ATO will give taxpayers for transfer pricing requirements on cross-border transactions.
5. Other approaches could be a deemed rate of profit, on the relevant 'virtual/digital' revenues, which can be reduced by lodging returns with suitable justification.

6. DTA's could include 'caps' on the deeming rates, that individual nations can impose.
7. The existing GST law, that applies to non-residents, could be leveraged to impose additional GST on the relevant digital/virtual supplies – say the normal 10% and an additional 10%.

[Treasury website: Consultation Page, Discussion Paper, Media Release; LTN 189, 2/10/18; Tax Month – October 2018]

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