Digital Economy and Australia's Corporate Tax System: Responses to Treasury Discussion Paper

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1 The contribution of users to value added

The international tax rules were designed to tax profits of companies on the basis of residence. Residence countries ceded their right to tax to source countries where there existed economic nexus. The notion of nexus is deeply rooted in physical presence. However with digitalisation economic presence is no longer pre-conditioned on physical presence. Therefore, there is broad consensus that the existing tax rules are inadequate. The *production process* has transformed thus making a compelling case to re-examine the economic functions. This is necessary to be able to evaluate the change required in existing tax rules.

The market jurisdiction is no longer just a point of consumption. Users, not necessarily the consumers, participate or interact on digital platforms. The interactions be they economic transactions or merely exchange of information generates information that can be monetised. The process of production must be broadly understood to identify the significance of users.

The *traditional business* owned or rented means of production that are the physical capital, labour and intellectual property,to sell output to market jurisdictions. With the advent of digitalisation, intellectual property, the most mobile factor of production, is used relatively intensively. Further, among the inputs that is unique to digitalised businesses is user participation and data generated therefrom. Lastly, the output or product is an intangible or service. The service is not just the creation of market place for the execution of sales but also accurate targeting of potential buyers. Figure 1 is a

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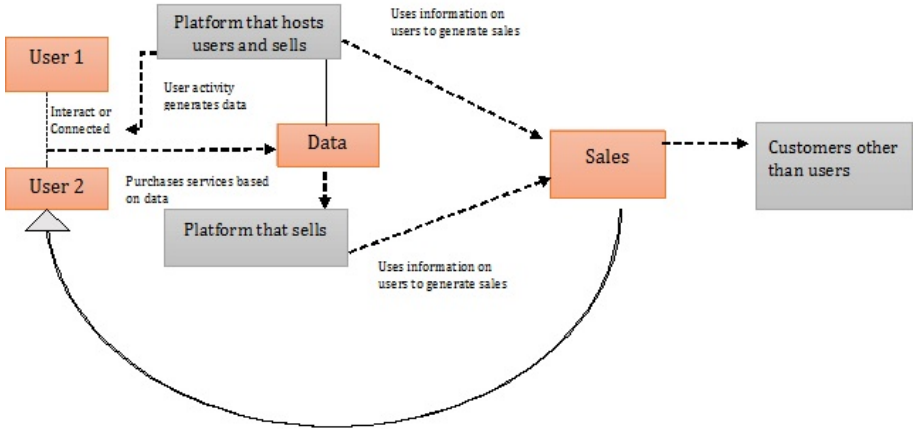
general description of some functions performed by various digital platforms.

Figure 1: Importance of user generated content



As can be seen, user performs two critical functions.The first function is straight forward, which is the sale of goods to users that are customers. Second function is to allow the business to approach potential buyers based on the information collected . That is, these platforms enable sales by bringing together sellers and buyers, allowing customers to make purchase decisions as well as customise goods/services based on predicted demand. All of these functions are performed on the basis of user generated data. Figure 1 illustrates the processes involved in service delivery by a digital platform. It may be argued that even in the service sector technical support is provided remotely based on needs of the customers. However, what distinguishes digitalised businesses is that not only are the services remotely provided or concluded but the service itself relies on the critical information available within the market jurisdiction. Therefore the service is not just customised but is specifically targeted. To further elaborate, under ordinary circumstances the two users or the user and the third party business would not have transacted or interacted. However, with the information available through network interactions this becomes possible.

Two important points emerge from the discussion. One,the platform creates a market space which may in the case of e-commerce platform connect the buyer and sellers within the same jurisdiction. In which case the service

exclusively derives value from the jurisdiction. Second, the users that contribute to the sales also provide information that is critical for the market to thrive. It is not just that it generates more sales but users generate sales that would not have been executed had there been no user generated content. Therefore the business derives revenue from the market jurisdiction not just through consumption but by estimating and targeting it.

2 Caution while valuing user contribution

Although the aforementioned points corroborate that users make an economic contribution, it is important to mention the models operate differently. This difference exists in terms of the platform's approach to creating markets, collection of data and its utilisation. For example, sharing economy brings together the supply and demand side to form a market. On the other hand, social media platforms are used for the purpose of interaction and some of this information is collated and monetised for the purpose of targeted advertisement. Further, in some cases price formation depends actively on user's revealed demand. *Surge* pricing in case of hire services or rate per click paid for search advertising are examples of price determination using data. Therefore the kinds of information collected and the manner in which it is utilised will vary. To draw such distinction the kinds of user participation and service supplied are identified and reported in Table 1.

Table 1: Features of business models

Character	Google	Facebook	Uber	Airbnb	Amazon
Sale of physical goods	x	x	x	x	Y
Sale of services	x	x	Y	Y	x
Advertising	Y	Y	x	x	Y
Networking	x	Y	x	x	x
Bridging sellers and buyers	x	x	Y	Y	Y
User review	x	Y	Y	Y	Y
Are both users located in the same jurisdiction	x	x	Y	x	x
Value of traditional service is combined with that of digital services	x	x	Y	Y	Y
Free service or features provided	Y	Y	x	x	x
Deep discounts	x	x	Y	Y	Y
Surge Pricing	x	x	Y	x	x

The foremost concern is that the digital economy does not operate in isolation. The digital businesses often supply goods and services produced by

the conventional economy. It is therefore important to unbundle the value of sales into those attributable to traditional economy and those which are exclusively the result of services provided by the digital platform. Many of the websites are used for the sale of physical goods. E-commerce platform is the classic example where such sale of goods is enmeshed with digital services. Therefore, the value generated by the platform for its services is a fraction of sales. The same is true for sharing economy, wherein the service provided is a fraction of entire sum paid to the platform.

Therefore when the value generated in a jurisdiction is estimated, it is important to segregate the value added by other businesses and that specifically attributable to the digital platform/service.

Digital platforms bring together the demand and supply end of the market. These would have otherwise remained isolated. Such function requires wider user participation for it to be economically viable. In fact many platforms use deep discounts as a strategy to prop up user participation. Similarly, social media businesses explain that the platform provides user-interface free of charge so as to be able to gain wider traction. User participation is critical for the success of the platform and for this purpose businesses incur costs. To what extent these expenses are admissible for tax purposes or tenable under various laws, such as competition law in India, is another dimension. User review, user interaction or networking as well as purchases made through a platform provide useful data that the company collects so as to better its service delivery as well as to target potential buyers through search advertising. However, not all data is valuable and to be able to structure this information so as to make it commercially useful requires the use of intellectual property such as algorithms. Further, these must be relatively accurate. It is also possible to see that there are various segments of the market that are located in different jurisdictions. For example, in the case of Airbnb the buyer and seller in many cases are located in separate jurisdictions. Therefore, the problem of establishing on the basis of users may be compounded. Lastly, the number of users vary widely across platforms.

Table 2: User base of platforms in Australia in 2018

Platform	Users (in million)
Facebook	15
Twitter	2.39
Stan	2
Youtube premium	1
Amazon prime	0.273
Fetch	0.71
Uber	3.25 travellers and 13000 drivers

To add to that the user contribution in each of these models varies. This point is especially important while setting the thresholds for the new nexus rule.

3 Existing tax rules and the change required

Broadly within the international tax framework there are specific measures through which the tax avoidance by digital companies may be addressed. The rules pertaining to permanent establishment which specify the basis for determining economic presence of a company. Transfer pricing rules ensure that the transactions between related parties of the entity are priced at *arm's length* and profits aren't shifted to low tax jurisdictions. Further,there are anti-avoidance measures.
The OECD has introduced amendments to Article 5 of the Model Tax Convention. These modifications include change in the definition of dependent agent PE (Article 5(5)) and an update to the specific activity exemptions (Article 5(4))[1]. The changes to PE definition are not sufficient to address the challenges to tax digital companies since Article 5 does not allow source-based taxation of profits earned from the provision of virtual services[2]. As a result the test for significant economic presence (SEP) that is based on number of users, revenue threshold and contracts concluded provides a practical solution. In the earlier section it was mentioned that though user participation and data are critical for service delivery the caveats must be considered. That is, not all information collected translates into value creation and the

[1] Page 94, Para 270-71, OECD(2018)
[2]Page 2, Goel and Goel (2018)

exclusion of physical goods. Further, the EU has proposed and India has already implemented the SEP through the amendment of its Income Tax Act. However, the concern remains on how the thresholds for these must be designed. From an international perspective an important question that arises is whether these should be consistent across countries or should each country adopt a threshold as per its economic characteristics[3]

Note that even if the digital business is established to have economic presence in a source country the issues of attribution will remain. There are two major concerns, there is high use of intangibles in production process. However, the intangibles may include data. Then there is concern with regard valuing the contribution. The economic problem fundamental to the discussion will have to be addressed.

Transfer pricing exercise requires comparables. However, one of the features of digital businesses is that they are prone to monopolization. Profit split therefore is superior option considering that for highly integrated transactions it can be applied but an agreement has to be reached on the allocation of profits to functions. The residual profit split would imply that *non-routine* profits must be defined and allocated to user contribution. Ascertaining non-routine profits is also a challenge since a counter-factual is not available for the company.

Among the suggested measures are equalisation levy and withholding taxes. Referred to as interim measures these are suggested only as a short term measure to tackle non-taxation. India is one of the first countries to introduce the equalisation levy through the Finance Act and is not covered by the Income Tax Act. The levy was imposed on B2B payments in excess of INR 0.1 million for digital advertising. This caused much furore since advertisers complained that it pushed up their costs. The evidence on this is yet not available but discussions suggest that the pass forward of costs to advertisers may not be complete in certain cases. That is , of the 6 per cent half is borne by the advertiser in the form of an increase in cost.

It is possible to speculate on the ramifications such a tax. Large digital companies are shown to have higher operating profit margins thus allowing the scope for such taxation. However, principally such treatment may not be neutral and in fact lead to over-taxation. In fact in recent work by Schmidt et al(2018) it is suggested that digital companies pay higher effective rates of tax.

[3]For a more detailed discussion see BEPS Monitoring Group Discussion Draft here `https://www.bepsmonitoringgroup.org/news/2018/10/10/submission-to-government-of-india-on-the-significant-economic-presence-test`.

Given that the structure of digital services market tends to be concentrated there is possibility that tax is passed forward. To segregate price changes to demand behaviour from pass forward is difficult, unless companies are asked to declare such details for transfer pricing purposes.
The anti-avoidance measures introduced in UK and Australia, are not specifically designed to target digital businesses and their application can lead to more discretionary powers. Therefore the new nexus rule may be still necessary.
In this context it is also important to flag the interaction between changes in domestic tax law and treaty provisions. Charges of levy in India is not covered by treaties and therefore no credit is available. The modification of the nexus rule would require that treaty provisions be updated. The process for updating the treaty network is expected to be long also since the new PE definition has not gained wider acceptance, more so among developed countries. Dividing the sample of countries into developing and developed it is observed that Articles 12 and 14 are adopted by a fewer proportion of developed countries as against the proportion of developing countries.

Table 3: Optional articles adopted by developing and developed countries

Article	Share of developed countries that opted-out	Share of developing countries that opted -out
Article 12	71.4	45
Article 14	75	54.1

Source: Estimated from country positions

It is interesting to note that among the jurisdictions that have not adopted the PE articles are notably Guernsey, Isle of Man, Jersey, Korea, Seychelles, Mauritius, and San Marino. Among the developing countries the most significant economy-China- has reserved the application of *all* PE articles. Therefore, changes to tax treaties where the SEP type provision is incorporated may be limited. At the moment, the test even if introduced in domestic law, will apply to corporations that have business in countries where no treaty exists. It will only be helpful if there is a jurisdiction that enables avoidance and is not a treaty partner.
In Australia's case it may be worthwhile to examine the expansion in the scope of applicability of anti-avoidance measures with such PE rule.
Another recommendation that has been made by various experts is that data be considered intellectual property. If such treatment is considered the source country can withhold taxes on a gross basis on payments made

in lieu of services based on data. Yet again valuation of this data will be essential. In the Indian experience, payments for search advertising have been contentious. More than often it is contested whether there has been a transfer of right to use. Data is processed remotely for providing services. However, this may or may not be interpreted as transfer of right to use.

Bibliogrpahy

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