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This paper contains advice that has been prepared by the Tax Working Group Secretariat for consideration by the Tax Working Group.

The advice represents the preliminary views of the Secretariat and does not necessarily represent the views of the Group or the Government.

Coversheet: Update on Taxing the Digital Economy

Background Paper for Session 14 of the Tax Working Group
July 2018

Purpose of discussion

This paper seeks to update the Group on recent international developments concerning the taxation of the digital economy.

Key points for discussion

- Does the Group agree that New Zealand should continue to support an OECD-led change to international tax frameworks to allow appropriate taxation of the digital economy?

- Does the Group agree that the adoption of an equalisation tax requires further consideration, especially in light of trends and developments internationally?

- Does the Group wish to make any comments on the taxation of the digital economy as part of its interim report?

Recommended actions

We recommend that you:

- **Note** the Secretariat's view is that New Zealand should continue to participate in the discussions at the OECD, with a view to supporting a consensus for change to the international tax framework that would allow appropriate taxation of the digital economy.
- **Note** the Secretariat's view that an equalisation tax is something that can be considered further in New Zealand, but the desirability of moving in this direction depends on the following circumstances eventuating:
  - a critical mass of other countries also adopt an equalisation tax (particularly Australia);
  - New Zealand companies are not unduly affected by the tax; and
  - the tax will not just be passed on to New Zealand consumers.
- **Indicate** whether the Group agrees with the Secretariat's view.
- **Indicate** what the Group would like to say about the digital economy in its interim report.

Update on taxing the digital economy

Background Paper for session 14
of the Tax Working Group

July 2018
Prepared by the Inland Revenue Department and the Treasury

1. Update on Taxing the Digital Economy

1.1 Introduction and Summary

1. The Tax Working Group has previously received an overview of the challenges of taxing the digital economy and has asked the Secretariat to report back on international developments, particularly the possible use of equalisation taxes for the digital economy. Accordingly this paper discusses the current problems with taxing the digital economy and outlines recent international developments concerning a possible solution to them (including equalisation taxes).

2. In summary, there is an issue with the taxation of the digital economy, both in New Zealand and internationally. Under the current international tax framework it is possible for digital companies to derive significant income from a country without being liable for income tax there.

3. There are two ways to address the problem. One is to change the current international income tax framework (which would require substantial amendment of double tax agreements). The other is to apply a separate tax (often called an equalisation tax, or a digital services tax) to digital transactions.

4. The OECD is providing a forum for international discussion of the issue through its Inclusive Framework (which is open to non OECD members). The OECD recently provided its interim report on these discussions, which noted that there is still significant disagreement. Notably, however, the OECD's interim report established a consensus for countries to work together and find a common long-term solution by 2020. The work will focus on amending the international tax framework. The OECD's measures are likely to benefit New Zealand, as a net consumer of digital services.

5. In the meantime, the European Commission and UK have announced their support for an "equalisation tax" as an interim measure while a more permanent solution is being explored at the OECD. The EU proposal is for a new 3% equalisation tax on gross revenues from certain digital activities where users play a major role in value creation and which are the hardest to capture with current tax rules. The tax would be removed when a long term international solution is implemented. There is significant disagreement within the EU about the desirability of an equalisation tax. The OECD interim report did not recommend an equalisation tax, due to a lack of consensus.

6. An equalisation tax would be a way of collecting some tax from some digital companies which have been paying little tax in New Zealand or overseas. However there are disadvantages to an equalisation tax. The desirability of moving in this direction is likely to depend significantly on what happens internationally over the next 6 to 12 months. In the meantime New Zealand will continue to participate in the discussions at the OECD about changing the international tax framework to allow appropriate taxation of the digital economy.

7. Finally, it should be noted that some concerns in relation to the digital economy in respect of online sales of goods and services are addressed by the introduction of GST on remote services in 2016 and proposed changes to impose GST on low value imported goods. The concerns with taxing the digital economy discussed in this paper are particular to income tax.

1.2 Content and scope

8. The "digital economy" is a term used to refer to economic activity that is significantly reliant on information and communication technology. It broadly includes e-commerce (including the sale of both digital and physical products and services over the internet or via apps etc), online advertising, social networks, and intermediation platforms (such as AirBnB and Uber).

9. The OECD has noted that most business models are becoming digitalised to some extent. Consequently it would be difficult to completely ring-fence the digital economy from the rest of the economy for tax purposes[1]. Following this, most of the analysis and potential solutions have focussed on highly digitalised business models. These business models are typified by:

    - cross jurisdictional scale without mass (the ability to be heavily involved in the economic life of a country without a significant physical presence there);

    - heavy reliance on intangible assets; and

    - the importance of data and active user participation to value creation.

10. This means that most of the focus so far has been on taxing certain limited types of digital companies, rather than taxing the entire digital economy.

1.3 The problem

11. There has been recent concern from governments and the public about the low levels of income tax paid by digital companies (i.e. companies operating through highly digitalised business models). Under most current double tax agreements (DTAs[2]), it is possible for digital companies to derive significant income from a country without being liable for income tax there. This is because the companies can transact with customers over the internet without having the taxable presence (e.g. a permanent establishment ("PE")) necessary for income tax to be charged in the country.

12. The current definition of a PE in most DTAs requires a taxpayer to have a physical presence in the country. The definition is now generally seen (by many

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[1] *Addressing the Tax Challenges of the Digital Economy* (Action 1: 2015 Final Report), page 11.

[2] DTAs allocate the right to tax income between the country in which the taxpayer is resident and the country from which income earned by the taxpayer is sourced. A minimum level of presence/activity, known as a permanent establishment, is needed before the country of source is permitted to tax business income of a taxpayer. A "permanent establishment" is defined for each DTA, but usually follows the OECD model.

governments and commentators) as outdated and in need of amendment to address the non-physical digital economy. Also, there is a concern in some countries that the rules for attributing profits to a PE do not recognise the significant value digital companies derive from user participation and contributions (e.g. Facebook becomes more valuable the more people sign up to it, and Google's value increases with its number of its users). This means that even if a digital company did have a PE in a country, that country could not tax the value generated there by the active participation of the company's users.

13. As a result of these issues, digital companies pay significantly less tax than ordinary companies. In Europe, the traditional international business model has an average tax rate of 23.2%, whereas the average tax rate for a digital company is only 9.5%[3]. This under-taxation (compared with ordinary companies) detracts from: public confidence in the fairness of the tax system; the sustainability of Government revenues; and a level playing field for businesses.

14. The OECD's base erosion and profit shifting (BEPS) recommendations do not directly address the problem. This is because those BEPS recommendations only prevent multinationals from avoiding the current international tax rules. However taxing the digital economy requires a change to those rules.

15. The digital economy is generally subject to GST in New Zealand. The problems with taxing it are specific to income tax. In particular, New Zealand introduced GST on remote services in 2016 (which applies to most online purchases of services by New Zealand consumers from offshore), and has announced plans to impose GST on low value imports (which should apply to most online purchases of goods by New Zealand consumers from offshore).

1.4 The size of the "digital economy" globally and in New Zealand

16. The projections for growth in the digital economy are significant.

17. The total global e-commerce market was estimated to be worth USD$7.7 trillion in 2018[4] (including both the retail and business to business (B2B) market). The retail ecommerce market (which excludes the B2B transactions) was estimated to be worth USD$2.3 trillion in 2017, with a projected rise to nearly USD$4.5 trillion by 2021.

18. In New Zealand, the total consumer online shopping expenditure (i.e. excluding business to business) in 2015 was estimated at $4.7 billion (excluding GST). This was comprised of $3.5 billion in goods and $1.2 billion on services. Of this, $1.6 billion was spent on goods and $0.5 billion was spent on services supplied from offshore. In addition, online shopping has an average year on year growth rate of 18% (with offshore sales growing faster than domestic)[5].

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[3] See the EU Commission's Impact Assessment for its digital services tax (SWD(2018) 81 Final), page 18.

[4] https://www.statista.com/study/44442/statista-report-b2b-e-commerce/.

19. For online advertising, the total New Zealand market for 2017 was $923 million, which was 36% of New Zealand's total advertising market ($2.561 billion) and an increase of 9.7% over the previous year[6]. Search advertising accounted for 59% of total online advertising in Q4 2017[7]. It is not clear exactly what proportion of online advertising is supplied by non-residents, however it is likely to be between 50% to 75%.

20. Further details regarding the size of the digital economy are included in the Appendix.

1.5 The potential solutions

21. There are two ways to address the problem of taxing the digital economy. One is to change the current international income tax framework. The other is to apply a separate tax (often called an equalisation tax or digital services tax) to digital transactions.

22. An equalisation tax is a flat tax on gross revenue from digital transactions. For example, an equalisation tax of 5% would require an offshore digital company to pay $5 of tax for every $100 it received from New Zealand customers for certain transactions (with no deduction for expenses). An equalisation tax would need to be designed as an excise tax, so it would not be subject to most double tax agreements, which only apply to income taxes (except for a few treaties with Australia, Mexico and Japan which contain broad non-discrimination articles applying to all forms of taxation). However it would then be subject to New Zealand's WTO and free trade agreement obligations.

23. Changing the current international tax framework is recognised as the better long term solution, however its implementation requires countries to reach a consensus on how the framework should be changed and then to agree to the resulting modification of their DTAs. The introduction of an equalisation tax is seen by some countries as a practical interim measure as it allows countries to tax digital companies in the short term and also incentivises countries that benefit from the current tax framework to agree to change that framework (as the idea is that an equalisation tax would be repealed once those changes were made). However there are issues with equalisation taxes, which we discuss later in this paper.

The OECD's role

24. The OECD is providing a forum for international discussion of the issue through its Inclusive Framework (which is open to non OECD members). The OECD recently provided its interim report on these discussions, which noted that there is still significant disagreement. The OECD did not recommend an equalisation tax, due to a lack of consensus. However it noted that several countries supported one and set

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[6] New Zealand Advertising Industry Revenue Report 2017 (http://www.asa.co.nz/wp-content/uploads/2018/04/ASA-2017-Media-Turnover.pdf)

[7] IABNZ Ad-Spend Report Q4 2017 9 http://www.iab.org.nz/wp-content/uploads/2018/04/IABNZ-Q4-2017-Report_FINAL.pdf)

out some “least harm” type guidelines should countries adopt one. The two most important of these are that the tax is temporary (i.e. it is removed when a global solution is implemented) and it is consistent with DTAs (i.e. it is not an income tax).

25. Significantly, the interim report established a consensus for countries to work together on the issue and find a common long-term solution by 2020. The work will focus on amending the international tax framework to permit the appropriate taxation of the digital economy.

26. Finding a commonly agreed solution at the OECD will be challenging, given the divergent interests of participating countries. The issue is currently very contentious, with some countries committed to pressing ahead with an equalisation tax prior to any OECD consensus, and other countries opposed to any changes at all. There is also a third group of countries that see digitalisation as part of a broader tax problem posed by globalisation and want wider measures.

27. Even if a broad consensus is achieved by 2020, it will be several more years before the global solution can be designed in detail and implemented. There is unlikely to be anything operational before 2025. Nonetheless, if equalisation taxes are developed, they may have a limited lifetime.

The scope of the proposed solutions

28. It is important to note that, while there is no consensus on how the digital economy should be taxed, the most developed proposals (from the UK and the European Commission) only call for the taxation of a relatively small proportion of the digital economy. In particular, these proposals only call for the taxation of digital companies that derive a significant part of their value from active user participation (as discussed further below). The proposals would not apply to the online sale of goods, for example.

29. It is possible that the OECD will agree on broader changes to the international tax framework – and some countries are pushing for this. However it is too early to tell where the OECD will arrive on this.

1.6 Changing the international tax framework

30. The OECD has stated that upcoming discussions on changing the international tax framework will focus on the definition of a PE, and the profit allocation rules[8]. The detail of these broad proposals has yet to be discussed at the OECD. However they will probably involve:

    - expanding the definition of a PE to include a substantial digital presence; and

[8] See the interim report of the OECD’s Task Force on the Digital Economy (March 2018), Chapter 5, paragraph 28.

- amending the profit allocation rules, either to recognise the value created by active user participation in a country, or to allow for a partial allocation of income from intangible assets to PEs in market jurisdictions.

31. The European Commission has independently proposed changes to the tax frameworks of its members in a draft directive[9]. Because these changes would only affect transactions between EU members (or transactions in respect of which no DTA applied), it is acknowledged that they would not address the taxation of the digital economy as a practical matter, even for EU members. Instead, the draft directive is intended to influence discussions about changing the international framework at the OECD level, by setting out the EU's agreed position. In this regard the draft directive is useful, as it sets out in more detail a possible approach for changing that international framework.

32. Under the draft directive, an internet company will no longer need to have a physical presence in a country to be subject to taxation there on its digital services. Instead the definition of a PE will be widened to include non-physical "digital presences", but only in respect of digital services. A non-resident will have a digital presence in an EU country if it (together with its associated parties) fulfils any of the following criteria:

    - it exceeds a threshold of €7 million in annual revenue in the country;

    - it has more than 100,000 users in the member state; or

    - over 3,000 business contracts for digital services are created between the company and business users in the country in a taxable year.

33. The draft directive also proposes changing the profit allocation rules to allow for profit from digital services to be allocated to the digital presence. This will allow the state in which the digital presence is located to tax a share of the profits from user data (e.g. placement of advertisements), services connecting users (e.g. online marketplace platforms for the sharing economy) and other digital services (e.g. subscriptions to streaming services). Significantly, the draft directive provides for the profit split method to be used in attributing profit to these activities (unless the taxpayer can prove that another method is more appropriate). The profit split method would allow the digital PE to share in the overall profits of the enterprise (called the "residual profits" in transfer pricing terminology), rather than allocating it a set percentage return over costs, or a fixed percentage of gross sales income (as with other methods).

34. These changes will apply only in respect of "digital services". A digital service is a service that is delivered over the internet or an electronic network, the nature of which renders their supply essentially automated and involving minimal human intervention on the part of the supplier. A digital service does not include the mere

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[9] See Com(2018) 147 final and C(2018) 1650 final

sale of goods or services over the internet. So the EU's proposed changes would not apply to books sold by Amazon for example.

35. The UK has also proposed changes to the international tax framework in its position paper on taxing the digital economy[10]. The UK approach is consistent with the EU approach, but sets out how profits would be allocated in more detail.

36. There is a group of countries that are pushing for broader changes to the international tax framework than those proposed by the EU and the UK. However it is still too early to tell what the OECD will agree on (if it can agree at all).

1.7 Equalisation taxes

37. In the last few months, the European Commission and UK have announced their support for an "equalisation tax" as an interim measure while a more permanent solution is being explored at the OECD. This is partly intended to pressure the OECD to come up with a solution to the issue.

38. In particular the European Commission proposed in March this year a new 3% equalisation tax on revenues from certain digital activities where users play a major role in value creation and which are the hardest to capture with current tax rules. The tax applies to both business to business and business to customer transactions. The tax will apply to revenue only from:

    - online advertising services (e.g. Google, Facebook, Twitch);
    - digital intermediary platforms, which allow users to interact and transact with each other (e.g. eBay, Uber, AirBnB); or
    - the sale of data generated by user-provided information.

39. The tax would not apply to sales of goods or services (other than advertising or data) over the internet. So it would not apply to products sold online by Apple or Amazon for example. Instead the tax is aimed at capturing the value generated for certain digital companies by the active participation of their users in a particular country.

40. The equalisation tax applies to all companies with total consolidated annual worldwide revenues of at least €750 million and EU revenues of at least €50 million. This includes companies tax resident in the relevant country itself (and so already paying income tax there). The wide application of the tax is to ensure it complies with EU obligations, which prevent a country from taxing non-residents less favourably than residents.

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[10] See HM Treasury's updated position paper *Corporate Tax and the digital economy* (March 2018) - https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/689240/corporate_tax_and_the_digital_economy_update_web.pdf

41. Interestingly the tax is not levied by reference to the revenues derived from each member state. Instead it is levied by reference to where the users of the relevant platform are located. This is intended to capture user-generated value. An affected digital company's consolidated global gross revenues (net of VAT) will be apportioned between the EU members and other non-EU states by reference to the proportion of total users in each country. The relevant user is different for each type of digital service captured – e.g. for advertising, the user is a person who views a copy of an ad on their device, with each separate view counting as a separate user. The revenue attributable to a member state under this process will then be subject to tax at 3%.

42. For example suppose a digital company had $10 billion of total gross global revenue and 5% of its total global users in EU State A. The revenue attributable to EU State A would be $10 billion x 5% = $500 million. EU State A would then charge 3% tax on its allocated $500 million of revenues, for total tax of $15 million.

43. One issue with the EU's approach, if adopted more widely, is that different users might be worth different amounts in different countries. For example a user in highly developed country x might be worth $1.00 to the digital company, while a user in developing country y might be worth only $0.50. A possible way to address this would be to use the actual contribution of users in a particular country to a digital company's gross revenues. Some digital companies already calculate this; however it may be more difficult for others to do. This is an issue that would need to be consulted on in designing any equalisation tax.

44. The equalisation tax will be a deductible expense for income tax purposes (in order to mitigate, but not eliminate, the risk of double taxation). It is not possible to make the tax creditable without risking it being covered by a DTA. The European Commission estimates that the equalisation tax could raise €5 billion. The tax is intended to be removed when a comprehensive solution to the taxation of the digital economy is implemented.

45. There is disagreement within the EU about the desirability of an equalisation tax. At one stage 20 countries were reported to be in favour and 8 opposed.[11] However the number of countries opposed may have grown since then. In particular Denmark, Sweden and Finland announced their opposition to an equalisation tax in a joint statement on 1 June 2018. Countries opposing the tax argue that any solution to the issue should be agreed at the OECD. Consequently the European Commission's proposed equalisation tax is unlikely to become an EU-wide tax. However France, Spain and some other EU countries could adopt some form of tax on internet companies, either unilaterally or under the "enhanced cooperation" process (which only requires 9 EU members to agree). The approach in the UK paper is broadly consistent with the EU draft directive, although the UK paper goes into much less detail. However, there are reports that UK Chancellor of the Exchequer Philip Hammond is having second thoughts as to the merits of an

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[11] This was stated by the EU Tax Commissioner, Pierre Moscovi, at an April 16 American Enterprise Institute event in Washington DC. His statements were reported in *Tax Notes International,* April 23 2018, on page 569.

equalisation tax versus a multilateral solution at the OECD[12]. The UK Government has not published anything confirming this.

Other countries

46. India introduced an equalisation tax in 2016. This is levied at the rate of 6% on payments by Indian businesses for online advertising where the advertiser does not have a taxable presence in India. The tax must be withheld by the Indian resident when it makes the payment to the advertiser.

47. Italy has enacted a 3% equalisation tax on payments to both residents and non-residents by Italian residents for services carried out through electronic means. The type of services will be more precisely defined (by a decree issued subsequently), but they will be services the nature of which makes the performance completely automatic, with minimum human intervention and for which the information technology component is essential. It is subject to a 3,000 Italian transaction de minimis. It only applies to business to business transactions. The tax applies from 1 January 2019 (although it might be replaced by the European Commission's proposal before it comes into force).

48. Chile has recently stated that it intends to introduce legislation to tax goods and services provided by foreign e-commerce companies. It singled out Netflix, Spotify, AirBnB, and Uber and mentioned the possibility of an equalisation tax. However there are no details on how the tax would work[13].

49. Australia is currently considering whether it wants to adopt an equalisation tax. We expect the Australian Government to issue a paper on the subject in the next few months for public consultation. The Australian Treasurer stated that the paper will explore options for taxing digital business in Australia[14].

50. Some other countries also widened their domestic income tax framework in order to capture some of the profits earned there by highly digitalised companies (including India, Italy, Uruguay and Slovakia). However as the current protection from taxation enjoyed by digital companies arises under DTAs, such domestic law changes will not be effective unless there is no applicable DTA.

1.8 Next steps

51. The OECD will provide a further update on progress in 2019 and a final report in 2020 (although there have been suggestions that the final report could be brought forward to 2019). Even if consensus is achieved by 2020, it will likely be several more years before it can be implemented.

1.9 Relevance for New Zealand

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[12] *Tax Notes International*, May 7 2018, page 776.

[13] https://www.reuters.com/article/us-chile-economy-ecommerce/chile-planning-new-ecommerce-tax-for-multinationals-finance-minister-idUSKBN1JH2X7

[14] The Australian Treasurer's budget night speech on May 8 2018 - https://www.budget.gov.au/2018-19/content/speech/index.html

52. In principle, we expect any changes to the international income tax framework agreed at the OECD to benefit New Zealand overall. This is because New Zealand imports more highly digitalised services than it exports. However we will need to wait until the OECD develops its proposed changes in more detail before we can come to any firm conclusions about this.

53. An equalisation tax would be a way of collecting some tax from some digital companies that have been paying little tax either in New Zealand or overseas. This is because an equalisation tax would overcome the current issues with the international tax framework that prevent us from effectively taxing such companies. In this regard, much of the recent public concern about the under-taxation of multinationals has focussed on high-profile internet companies that do not have a physical presence in New Zealand (and so are not subject to income tax). As an EU-style equalisation tax does not require a company to have a physical presence, it would apply to some of these digital companies (but not all of them). Further, an equalisation tax would be simple to calculate and hard to avoid.

54. This would have benefits for both revenue raised and the perceived fairness of the tax system (which is an important factor supporting voluntary compliance). In addition, the size of the digital economy is growing as a proportion of the total economy. Consequently it will become increasingly important for New Zealand to ensure that it is taxed appropriately.

55. An EU-style equalisation tax is unlikely to be a big revenue earner. In terms of tax revenue, if we adopted a 3% equalisation tax of the kind proposed by the EU, we would raise approximately $16m to $24m from online advertising. We would also raise some revenue from other digital companies deriving significant value from online user participation (excluding advertising), such as Airbnb, Uber and Twitch. This is difficult to estimate, although we would expect the amount raised to be less than for online advertising. All up we would expect revenue of around $30m as a very rough, bottom up estimate.

56. However there are a number of issues with an equalisation tax. We would need to consider these carefully before we could decide whether or not to adopt such a tax. The main issues are outlined below.

57. The consistency of the tax with other tax settings. The equalisation tax does not mesh in well with other elements of our tax system. At times it might mean that compliant firms (including possibly some compliant domestic firms) are being double taxed.

58. The consistency of an equalisation tax with our international obligations. The tax could be designed as an excise tax (as with the EU proposal), in which case it would not be covered by most of our double tax agreements (except for Australia, Mexico and Japan). However the tax would then be subject to World Trade Organisation (WTO) and free trade agreement (FTA) non-discrimination obligations. These obligations prohibit taxes that discriminate between 'like' foreign or non-resident digital service suppliers and resident or domestic digital service suppliers by treating

the former less favourably. The consistency of a tax with international trade obligations would need to be considered in light of the specific design features and policy rationale before we could give a firm view on this.

59. The economic incidence of the tax. The issue here is whether the tax would be passed along by the non-resident suppliers to New Zealand customers. There are arguments each way on this. On the one hand digital companies might be expected to have very low marginal costs. In that case an equalisation tax is similar to a tax on profits. If the digital company is earning infra-marginal returns ("economic rents"), then a tax on those profits might be very efficient and not be passed on to New Zealand customers. On the other hand if some services are more competitively supplied and there is low substitutability of the services, the tax might be expected to be mostly passed on[15].

60. The EU's Impact Assessment for its proposed equalisation tax briefly considered the economic incidence issue and considered that there was no single answer for the variety of digital services such a tax would apply to. However in general it was likely that some but not all of the tax would be passed on. In particular the EU Impact Assessment referred to studies finding a 1/3rd and 50% pass-on rate for non-comprehensive VAT rate changes (although the 50% result was considered to be imprecise)[16].

61. The effect on FDI and New Zealand's reputation as a good place to do business. As a small open economy, we generally try to keep our tax policy settings within the bounds of international norms to provide a stable and certain environment for cross-border investment. There is also a risk of retaliatory action by other countries (mainly the US and China) if we adopted an equalisation tax, although we would need to do more work to assess the likelihood of this. .

62. The period of time an equalisation tax would be applicable. The OECD expects that any equalisation taxes adopted by countries would be repealed once countries implemented the OECD's agreed changes to the international framework. Accordingly if agreement was reached quickly at the OECD, then it may not be worth designing an equalisation tax that would only apply for a short period of time.

1.10 The view of the Tax Working Group Secretariat

63. In terms of changing the international framework, the Secretariat considers that New Zealand should continue to participate in the OECD discussions, with a view to supporting an agreement for changes that would address the current issues with taxing the digital economy.

64. In terms of an equalisation tax, the issue is more uncertain. The amount of revenue an EU-style equalisation tax would raise is small compared to the size of the online

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[15] This is less of a concern with the proposals to change the international tax framework, as those proposals involve broadening the application of income tax to the digital economy. Accordingly the economic incidence of any tax raised by those proposals should be the same as for income tax generally.

[16] SWD(2018) 81 Final, page 75.

market in New Zealand. This illustrates the limited scope of the current EU approach, which only seeks to tax the value of active user participation in a country. They are not proposing giving a country broader "market based" income tax rights for online sales made to its residents.

65. In this regard, the EU's and the OECD's proposals represent a refinement of the current international tax framework, rather than a fundamental departure from it. The proposals still adhere to the central principle that only value added in a particular country should be subject to income tax there. This reflects the traditional distinction between income tax – which only taxes the factors of production – and GST – which taxes consumption. Given this, it is arguable that the current proposals do not really address the more fundamental problems posed by digitalisation to the current income tax system.

66. However an EU-style equalisation tax might improve public confidence in the fairness of the tax system. Such confidence is an important factor supporting voluntary compliance. Further the revenue raised would not be so low as to be insignificant. Finally, an EU-style equalisation tax would at least partially address some of the current problems with the taxation of the digital economy. Accordingly there may be benefits in adopting an EU-style equalisation tax in the following circumstances:

    - a critical mass of other countries also adopt one (particularly Australia);
    - New Zealand companies are not unduly affected by the tax; and
    - the tax will not be just be passed on to New Zealand consumers.

67. If only some of these circumstances are met then it may still be worth adopting an equalisation tax, but it becomes increasingly less attractive.

68. At this stage it is not clear whether other countries will adopt an equalisation tax (the first criteria) or whether the OECD will be successful in agreeing changes to the international tax framework (the last criteria). However we expect the position to become much clearer in the next 6-12 months. Further, this is an area where it seems better for New Zealand to be a fast-follower rather than an early adopter. Being a fast-follower would:

    - Significantly reduce the reputational risks of adopting an equalisation tax.
    - Allow us to design our equalisation tax to be consistent with that adopted by others (to reduce the risk of double taxation). For example it would be beneficial for any equalisation tax New Zealand introduced to apportion revenue to New Zealand on the same basis as any Australian equalisation tax apportioned revenue to Australia to support the Single Economic Market agenda.

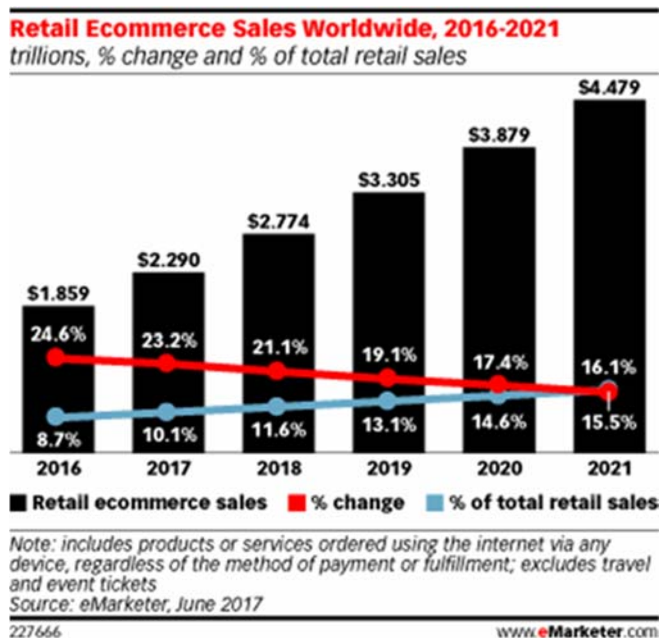
- Allow us to benefit from the detailed consultation and policy design that the first adopter of the tax would need to undertake.

69. Accordingly our view at this time is that we should continue to closely monitor developments in the area for the next 6 -12 months before reaching a decision on whether or not to adopt an equalisation tax.

Appendix: The Size of the Digital Economy

Global e-commerce

1. The total global e-commerce market was estimated to be worth USD$7.7 trillion in 2018[17] (including both the retail and business to business (B2B) market). The retail ecommerce market (which excludes the B2B transactions) was estimated to be worth USD$2.3 trillion in 2017, with a projected rise to nearly USD$4.5 trillion by 2021. The following diagram sets out the anticipated size of the retail e-commerce market, together with its growth rate and share of total retail revenue:



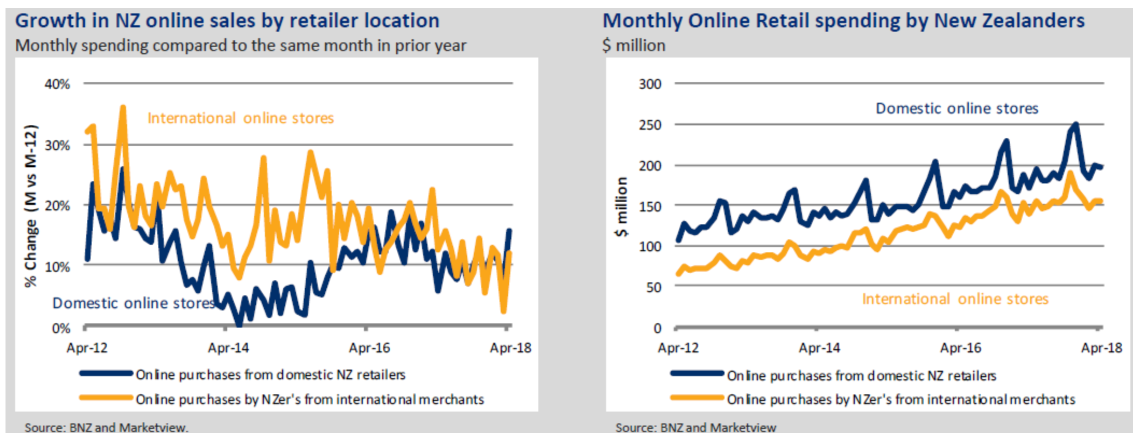
2. Business to business ecommerce sales are estimated to be worth 2.3 times the total retail sales[18]. This would produce a total estimated ecommerce market of nearly USD$10.5 trillion in 2021.

New Zealand online shopping

3. For New Zealand, the total consumer online shopping expenditure (i.e. excluding B2B) in 2015 was estimated at $4.7 billion (excluding GST). This was comprised of $3.5 billion in goods and $1.2 billion on services. Of this, $1.6 billion was spent on goods and $0.5 billion was spent on services supplied from offshore. The GST collected from online services suppliers in the last 12 months was $131m. This implies total revenue (including GST) from imported online services of $1.0b for the year ending 1 March 2018.

4. The following tables set out the growth rate for the online retail sales of goods (but not services) in New Zealand.

[17] https://www.statista.com/study/44442/statista-report-b2b-e-commerce/.



Online shopping has an average year on year growth rate of 18% (with offshore sales growing faster than domestic)[19]. By contrast New Zealand's general retail market has grown from 4-6% each year since 2012 - significantly less than the online market[20].

5. We do not have figures for B2B online transactions in New Zealand. However we can use the existing global estimate that the B2B market is 234% of the B2C market to estimate a B2B online market in New Zealand for 2015 of $11 billion, and a total online market of $15.7 billion in 2015. Approximately $7 billion of this would be paid to offshore suppliers, if they made up the same proportion as they do for B2C supplies. Assuming an 18% growth rate, this would produce a total market of $25.8 billion in 2018, with supplies from offshore worth $11.5 billion. Given the assumptions required, these figures are unlikely to be very accurate, but they do give a ballpark indication of the size of the "digital economy" in New Zealand.

New Zealand online advertising

6. For online advertising, the total New Zealand market for 2017 was $923 million, which was 36% of New Zealand's total advertising market ($2.561 billion) and an increase of 9.7% over the previous year[21]. Search advertising accounted for 59% of total online advertising in Q4 2017[22]. It is not clear exactly what proportion of online advertising is supplied by non-residents, however it is likely to be between 50% to 75%.

7. The following diagram shows the composition of the New Zealand advertising market in 2017[23]:

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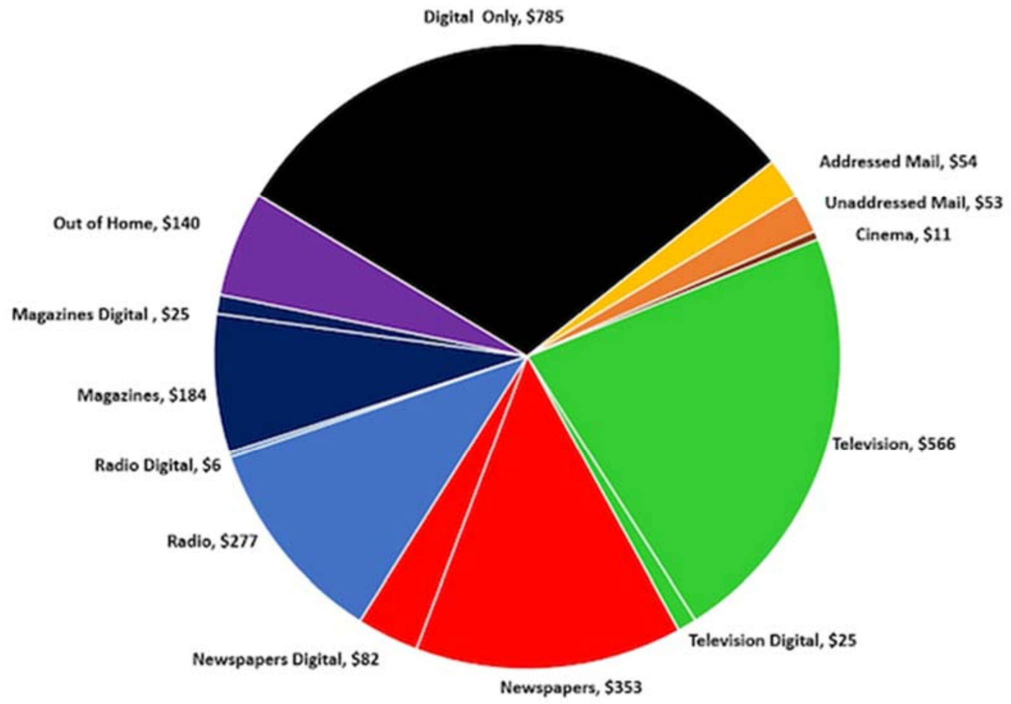
[21] New Zealand Advertising Industry Revenue Report 2017 (http://www.asa.co.nz/wp-content/uploads/2018/04/ASA-2017-Media-Turnover.pdf)

[22] IABNZ Ad-Spend Report Q4 2017 9 (http://www.iab.org.nz/wp-content/uploads/2018/04/IABNZ-Q4-2017-Report_FINAL.pdf)

[23] http://www.asa.co.nz/wp-content/uploads/2018/04/ASA-2017-Media-Turnover.pdf


New Zealand Advertising Industry Revenue Report 2017 ($m)
Digital Only, $785
Addressed Mail, $54
Unaddressed Mail, $53
Cinema, $11
Out of Home, $140
Magazines Digital , $25
Magazines, $184
Radio Digital, $6
Radio, $277
Television, $566
Television Digital, $25
Newspapers Digital, $82
Newspapers, $353