Tax Working Group
Te Awheawhe Tāke

Tax Working Group Information Release

Release Document

February 2019

taxworkingroup.govt.nz/key-documents

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

Some papers contain draft suggested text for the Final Report. This text does not constitute the considered views of the Group. Please see the Final Report for the agreed position of the Group.

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Coversheet: Further update on taxing the digital economy

Position Paper for Session 23 of the Tax Working Group 22-23 November 2018

Purpose of discussion

The purpose of this paper is to advise you on developments concerning the taxation of the digital economy since the publication of the Group's interim report.

Key points for discussion

- Does the Group agree that recent developments have not significantly changed the recommendations on taxing the digital economy they made in the interim report?
- Does the Group agree with the suggested text for the final report in the appendix?

Recommended actions

We recommend that you:

a **Note** the developments outlined in this paper on the taxation of the digital economy.

b **Note** that the sub-group has reviewed a draft of this paper and agrees with its conclusions.

c **Agree** that these developments do not alter the Group's conclusions on the taxation of the digital economy, as set out in its interim report.

d **Agree** to include the text set out in the appendix in the final report.

Further update on taxing the digital economy

Position Paper for Session 23
of the Tax Working Group

November 2018

Prepared by the Inland Revenue Department and the Treasury

1. Executive summary

1. This paper advises you on developments in the taxation of the digital economy since the Group's interim report was published on 20 September 2018.

2. The main developments are that:

   - The UK announced the introduction of a digital services tax (DST), with effect from 6 April 2020. This measure will be repealed once an international solution is achieved.

   - Australia released a consultation paper on options for taxing the digital economy. This included consideration of the possibility of a DST as an interim measure.

   - The OECD is accelerating its consideration of an international solution. It has announced that it is aiming for a decision from the G20 in June 2019.

3. While these developments are important, we consider they should not significantly change the Group's recommendation in the interim report – namely that New Zealand should continue to participate in OECD discussions, but be ready to introduce an interim measure if a critical mass of other countries move in that direction. However the Group may wish to emphasise the issues with a DST in the final report.

Background

4. In the interim report, the Group concluded that:

> 24 New Zealand is very well-represented at the OECD, and the Group agrees strongly that New Zealand should continue to participate in the OECD's Inclusive Framework process.
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> 25. Nevertheless, while international agreement is desirable, New Zealand should also be ready to act in its own best interests. Alongside participation in the Inclusive Framework process, the Government should ensure it is also ready to implement an equalisation tax, if the case for such a tax arises.
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> 26. The introduction of an equalisation tax should depend on three key conditions:
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> • A critical mass of other countries also adopting an equalisation tax. (The actions of Australia will be particularly important for New Zealand.)
>
> • New Zealand companies not being unduly affected by the tax.
>
> • The tax not simply being passed on to New Zealand consumers.

2. UK digital services tax

5. The UK announced the introduction of a DST on 26 October 2018 as part of its budget. The UK announcement is a reaction to the challenges posed by the

development of the digital economy to the sustainability and fairness of the international tax system.

6. The UK reiterated its commitment to an OECD multilateral solution by stating that a reform of the global tax system is the preferred long-term answer. However, the UK consider that progress internationally has been too slow. The UK's interim measure is designed to ensure that in the interim digital businesses are not able to generate their value from UK users without paying any tax in the UK. The UK estimates that the DST will raise £1.5 billion in revenue over four years.

Design of the Digital Services Tax

7. The UK DST will be a narrowly-targeted 2% tax on the UK related revenues of certain digital business models which derive significant value from active user contribution. Specifically, these business models are:

   - search engines;
   - social media platforms; and
   - online marketplaces.

8. The UK DST will apply to the revenue generated by these digital business models to the extent it relates to UK users. The UK DST will not apply to the direct digital sale of goods or services. To illustrate how the UK DST is intended to apply the UK provided the following examples:

   - if a social media platform generates revenues from targeting adverts at UK users, the government will apply a 2% tax to those revenues;
   - if a marketplace generates commission by facilitating a transaction between UK users, the government will apply a 2% tax to those revenues; and
   - if a search engine generates revenues from displaying advertising against the result of key search terms inputted by UK users, the government will apply a 2% tax to those revenues.

9. The UK DST will have the following key features:

   - **A de minimis threshold** of £500 million a year in global revenue. The first £25 million of relevant UK tax will also not be collectible. This is intended to keep small business out of scope.
   - **A safe harbour** allowing businesses making losses or lower profit margins to calculate their liability on an alternative basis. Those making losses will not have to pay the UK DST and those with very low profit margins will face a lower rate of tax.

- **Deductible** for UK corporate tax purposes rather than creditable against UK corporate tax.

- **Exclusion** of financial payment services, provision of online content, sales of software/hardware and broadcasting services from scope.

- **A review clause** will be included requiring the Government to formally review the UK DST in 2025 to determine whether it is still required following further multilateral work. It is intended that the UK DST will be repealed when an international solution is reached at the OECD.

Next steps

10. The UK DST will be legislated for in the UK's 2019/2020 Finance Bill and will apply from April 2020. As mentioned above, it will be reviewed in 2025 and will be repealed if and when a global solution is reached at the OECD.

11. A consultation document on the design of the UK DST will be issued in the next few weeks. This will explore key questions and concerns relating to the design to ensure that when implemented it will work as intended and will not place unreasonable burdens on businesses.

12. The UK's announcement of an interim measure to address the tax issues associated with the digital economy may put pressure on other countries to introduce similar measures.

3. Australian Discussion Document

13. Australia released a discussion document on the taxation of the digital economy on 3 October 2018. The document sets out the Australian Government's views on the digital economy, explores new options for taxing it (including the introduction of a DST), and invites public feedback on those options. The consultation period ends on 30 November 2018.

14. The discussion document (Australian Document) commences by observing that digitalised businesses provide enormous benefits to Australia. However under the current international tax rules, digitalised companies can have a significant economic presence in Australia but pay little tax. This is particularly an issue with ride-sharing and accommodation platforms, multi-sided platforms (like eBay), and digital advertising.

15. The Australian Document reviews all the recent international developments concerning the taxation of the digital economy, including the OECD discussions and the DSTs proposed by the EU and the UK. It canvasses several options for solving the tax problems, without expressing a clear preference for any of them.

16. The options fall into the usual 2 categories: changing the international tax framework at the OECD through multilateral agreement; or the introduction of a unilateral DST as an interim measure.

Changing the international tax framework

17. The Australian Document notes that the definition of a permanent establishment would need to be changed in order to give a country taxing rights over a highly digitalised business. This would be achieved by expanding the definition to include a significant digital presence (without requiring a physical presence).

18. Next the profit attribution rules would need to be changed, so that some profit could be attributed to the digital presence and taxed there. The paper outlines various possible methods and asks for feedback on them. Some of the methods would apply just to highly digitalised companies, while others would apply more broadly.

19. The methods broadly are:

    - Attribute to the market country the value highly digitalised companies generate there from user-data or user generated content.

    - Attribute to the market country some of the income from a company's intangibles. This would address a broader problem with the international tax rules, which currently allow a company to allocate much of its entrepreneurial profits to mobile intangibles, and then locate those intangibles in a low tax jurisdiction. This approach would apply to more than just highly digitalised companies.

    - a "deemed profit method", which involves deducting presumed expenses from a company's sales revenue from a country and taxing the resulting profit at the corporate rate.

20. The Australian Document also raises the issue of whether more fundamental reform is required for the tax system.

A digital services tax (DST)

21. The Australian Document states that changing the international framework will require multilateral agreement. This will take some time to develop, and there is no guarantee that it will eventuate. Therefore a unilateral measure may be the only way to address concerns regarding the taxation of digital businesses in the near term.

22. Consequently the Australian Documents outlines a possible DST as another option for taxing the digital economy. This tax would have the following features:

    - It would apply to:

    - digital advertising services; and
    - digital intermediation platforms (which match unrelated buyers and sellers on websites or apps).

- It would have a threshold, below which it would not apply (eg local sales and/or global turnover).

- It would apply to both Australian and overseas businesses, in order to comply with Australia's world trade organisation and free trade agreement obligations.

- It could be removed when a long-term multilaterally agreed solution was reached.

23. The Australian Document leaves the details of these features open for consultation.

24. The Australian Document also notes several disadvantages with a DST, such as double taxation of Australian businesses, increased costs for consumers, and high compliance and administration costs.

4. Developments at the OECD

25. Discussions on a multilateral solution at the OECD are progressing, with the task force on the digital economy scheduled to meet again on December 4-5. There is still no consensus on any solution, however 3 options are now being developed on a "without prejudice" basis for the OECD's Inclusive Framework to decide on. These are:

- A limited tax on digital services, focussing on social media, digital advertising, multi-sided platforms and data.

- A broader approach, which would allow greater taxing rights to markets based on certain "market intangibles" created there by multinationals. This would apply beyond the digital economy, but we expect it to be targeted at large companies with significant intangible value in market jurisdictions. In particular, we do not expect it to apply to New Zealand's agricultural exports, however we cannot be certain of this yet. This approach would not require the multinational to have a physical presence in the country.

- A minimum tax type proposal. This would apply beyond digital transactions and would be targeted at related party transactions with low tax jurisdictions. This proposal really addresses some remaining BEPS issues and is not directly concerned with the digital economy.

26. The first two options are alternatives, and so only one of them would apply (or a combined version could be agreed on). The third option is independent of the first two, and so could apply in addition to them.

27. The OECD is putting a huge amount of effort into reaching a solution. It also appears to be accelerating its timeline and has stated that it wants to have a proposal for the G20 finance ministers to decide on in June 2019[1].

5. Other developments

28. On 6 November 2018 the EU's *Economic and Financial Affairs Council configuration* (ECOFIN Council) met to discuss details of the proposal for an EU DST.[2] There remains several technical issues to be worked out and there is disagreement as to how the EU DST should be applied in practice. Some members also clearly expressed their opposition to the EU DST as it stands. Members did agree that, if brought in, the EU DST should be temporary and no longer apply once a multilateral international solution is reached. It was suggested that the EU DST's introduction be delayed until the end of 2020, to give the OECD a chance to reach an international solution.

29. Nevertheless, the Austrian Presidency reiterated that the objective is to reach agreement on the implementation of an EU DST by the end of the year, with a political debate to be held during the next ECOFIN meeting on 4 December 2018.

30. Accordingly the situation with EU DST is much the same as it was at the time of the Group's interim report, with significant disagreement remaining between members as to the desirability of the tax.

31. However Spain has independently announced that it will introduce a DST, similar to the EU proposal, with effect from 1 January 2019.

6. Implications of developments for New Zealand

32. These developments should not significantly change the Group's assessment in its interim report:

    - There is still no consensus at the OECD, although there has been some progress and the OECD has some new momentum to develop a solution.

    - A critical mass of countries have not yet adopted a DST. The UK announcement of a DST is significant, but they maintain their position that a multilateral solution is preferable and state that their DST will be repealed once one is achieved. Further the 2020 application date still gives

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1 See the statements of Pascal Saint-Amans on October 16, as reported by Tax Notes International, October 22, 2018 on page 437.

2 The ECOFIN Council is made up of the economics and finance ministers from member states. Relevant European Commissioners also participate in meetings.

the OECD time to arrive at a multilateral solution before the UK DST comes into effect. In addition Australia has not announced that it will introduce a DST.

- The desirability of adopting a DST still depends a lot on what happens in the first half of next year – in particular whether the G20 endorses the OECD's proposed solution in June 2019.

33. However the Group may wish to emphasise the issues with a DST in their final report. These are:

    - The consistency of the tax with other tax settings. The DST would need to be designed so that it meshes with our elements of our tax system. This might still result in some double taxation of compliant firms (including possibly some compliant domestic firms).

    - The consistency of a DST with our international obligations. The tax could be designed as an excise tax (as with the EU and UK proposals), 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. This might mean the DST needs to apply to some domestic firms as well as non-residents.

    - 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. We expect some of the cost of the tax to be passed on, but not all.

    - The effect on FDI and New Zealand's reputation as a good place to do business. There is also potential for other countries to retaliate or adopt their own measures. While the total value of our annual exports for the year ended June 2018 was approximately $80 billion, a DST of the kind proposed by the UK and Europe would be unlikely to affect these exports. However the implications of adopting a DST for our export sector would need to be carefully considered.

    - The period of time for which a DST would be applicable. The OECD expects that any unilateral DSTs would be repealed once a multilateral solution is achieved. Accordingly if agreement was reached quickly at the OECD, then it may not be worth designing a DST that would only apply for a short period of time.

    - The administration and compliance costs of introducing a new tax. This is particularly an issue given that a DST is not expected to raise significant revenue.

34. In light of these issues, we recommend that the Government only consider adopting a DST if it becomes apparent that the OECD will not be able to reach a solution in a reasonable timeframe and a critical mass of other countries also adopt DSTs. In practice we expect the former to determine the latter - if a multilateral solution is not found at the OECD soon, we expect many other countries to adopt DSTs. Further any consideration of the potential net benefits of a DST should include a careful assessment of each of the issues outlined above.

Appendix – suggested text for the final report

1. There have been several developments in the taxation of the digital economy since the Group's interim report was published on 20 September 2018. The main developments are that:

    - The UK announced the introduction of a DST, with effect from 6 April 2020. Spain also announced the introduction of a DST, with effect from 1 January 2019.

    - Australia released a consultation paper on options for taxing the digital economy. This included consideration of a DST as an interim measure.

    - The OECD is accelerating its consideration of an international solution. It has announced that it is aiming for a decision from the G20 in June 2020.

2. We do not consider these developments significantly change our assessment in the interim report. The state of play is still fluid - it is still uncertain whether a multilateral solution will be reached at the OECD, and a critical mass of other countries have not yet adopted a DST (in particular, Australia has not yet adopted a DST).

3. The Group emphasises that a multilaterally agreed solution at the OECD is its preferred approach for taxing the digital economy in New Zealand (provided the effect of any such solution on New Zealand's export sector is carefully considered). A DST has several issues, which the Government would need to work through before it decided to adopt one:

    - <u>The consistency of the tax with other tax settings</u>. The DST would need to be designed so that it meshes with our elements of our tax system. This might still result in some double taxation of compliant firms (including possibly some compliant domestic firms).

    - <u>The consistency of a DST with our international obligations.</u> The tax could be designed as an excise tax (as with the EU and UK proposals), 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. This might mean the DST needs to apply to some domestic firms as well as non-residents.

    - <u>The economic incidence of the tax.</u> The issue here is whether the tax would be passed along by the non-resident suppliers to New Zealand customers. We expect some of the cost of the tax to be passed on, but not all.

    - <u>The effect on FDI and New Zealand's reputation as a good place to do business.</u> There is also potential for other countries to retaliate or adopt their own measures. While the total value of our annual exports for the year ended June 2018 was approximately $80 billion, a DST of the kind proposed by the UK and Europe would be unlikely to affect these exports. However the implications of adopting a DST for our export sector would need to be carefully considered.

- The period of time for which a DST would be applicable. The OECD expects that any unilateral DSTs would be repealed once a multilateral solution is achieved. Accordingly if agreement was reached quickly at the OECD, then it may not be worth designing a DST that would only apply for a short period of time.

- The administration and compliance costs of introducing a new tax. This is particularly an issue given that a DST is not expected to raise significant revenue.

4. Therefore, we recommend that the Government only consider adopting a DST if it becomes apparent that the OECD will not be able to reach a solution in a reasonable timeframe and/or a critical mass of other countries also adopt DSTs (including Australia). Further, any consideration of the potential net benefits of a DST should include a careful assessment of each of the issues outlined above.