

Options for taxing the digital economy

A Government discussion document

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Options for taxing the digital economy – a Government discussion document.

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The document is available at
<http://taxpolicy.ird.govt.nz/publications/2019-dd-digital-economy/overview>

CONTENTS

| | | |
|-------------------|--|-----------|
| Chapter 1 | Introduction | 1 |
| | Summary of options | 2 |
| | Submissions | 3 |
| Chapter 2 | Background | 4 |
| | New Zealand's current taxation of multinationals – the international tax framework | 4 |
| | The international response | 6 |
| | The Australian approach | 8 |
| | Other measures for taxing the digital economy | 9 |
| Chapter 3 | Should New Zealand adopt a digital services tax as an interim measure? | 10 |
| | International context | 10 |
| | Overview of the digital services tax | 11 |
| | OECD's view on a digital service tax | 11 |
| | Tax Working Group's view on a digital services tax | 12 |
| | Design considerations for a potential digital services tax | 12 |
| | New Zealand's proposed digital service tax | 13 |
| | Compliance with our international obligations | 20 |
| | Should New Zealand adopt a digital services tax? | 22 |
| | Repeal of a digital services tax | 27 |
| Chapter 4 | The OECD's measures | 28 |
| | Summary of OECD measures | 28 |
| | Measure 1 – Reallocation of taxing rights | 29 |
| | Measure 2 – Minimum tax measure | 42 |
| | Likelihood and timing of an OECD solution | 46 |
| | Revenue impacts of the OECD measures | 47 |
| Chapter 5 | Conclusion | 48 |
| | Next steps and timing | 48 |
| Appendix 1 | Size and importance of the digital economy | 49 |
| Appendix 2 | New Zealand's policy for taxing multinationals | 57 |

CHAPTER 1

Introduction

- 1.1 The Government wants to build a productive, sustainable and inclusive economy, while at the same time supporting a sustainable revenue base to fund improvements to the wellbeing of New Zealanders and their families. This means it is important for everyone to pay their fair share of tax in New Zealand.
- 1.2 There has been significant international concern over the under-taxation of the digital economy, and digital multinationals in particular. This under-taxation is mostly caused by deficiencies in the current international tax rules, which have not kept up with digitalisation and other modern business developments.
- 1.3 The “digital economy” is a term used to refer to economic activity that is significantly reliant on information and communication technology. It broadly encompasses e-commerce, including the sale of both digital and physical products and services over the internet or via apps, online advertising, social networks, and intermediation platforms (such as Airbnb and Uber).
- 1.4 The digital economy provides many benefits to New Zealanders, and it is an important source of future growth for the country. However, its under-taxation impacts the sustainability of Government revenues and the fairness of the tax system. It also distorts investment in favour of digital multinationals, which pay lower worldwide income tax compared with other industries.
- 1.5 The Government is committed to ensuring everyone pays their fair share of tax, including digital multinationals. Achieving this will require changes to the current tax rules. There are two options for this:
 - The first option is to apply a separate digital services tax (DST) to certain digital transactions. A DST taxes at a low rate (for example, 2% to 3%) the gross turnover of certain highly digitalised businesses that are attributable to the country.
 - The other option is to change the current international income tax rules, which have been agreed to by countries (usually referred to as “the international tax framework”). Countries have been discussing different ways of achieving this at the OECD.
- 1.6 The Government supports an internationally agreed solution at the OECD, but it will seriously consider a DST if the OECD cannot make sufficient progress this year.
- 1.7 This discussion document seeks feedback on two options for taxing the digital economy. The Government will take this feedback into account when it decides how to tax the digital economy.
- 1.8 Appendix 1 sets out some background information on what the digital economy is, along with its importance and size in New Zealand and globally. Appendix 2 sets out New Zealand’s policy for taxing multinationals, some

recent tax measures aimed at multinationals, and explains how the measures in this document fit in with our economic framework for international tax.

Summary of options

Digital services tax

1. The DST would be a flat tax charged at a low rate (2–3%) on gross turnover from certain digital platforms (to the extent they are attributable to the users in the relevant country). A DST applies to digital platforms whose value is dependent on the size and active contribution of their user base. Specifically, the DST proposed in this document would apply to:
 - intermediation platforms, which facilitate the sale of goods or services between people (like Uber and eBay);
 - social media platforms like Facebook;
 - content sharing sites like YouTube and Instagram; and
 - search engines and the sale of user data.
2. This means the DST is narrowly targeted at certain highly digitalised business models. It would not apply to sales of goods or services (other than advertising or data) over the internet, such as accounting services delivered via the cloud.
3. The DST will likely need to also apply to some New Zealand companies, in order to comply with our international obligations. We expect the impact of this to be limited in practice, because of the kinds of activities to which a DST applies.
4. The DST is an interim measure for taxing the digital economy. The Government would look to repeal it if and when the OECD's international solution was implemented.

OECD proposals

5. There are two broad measures being considered at the OECD:
 - **A measure to allocate greater taxing rights over a multinational's profits to market countries.** The measure would not require the multinational to have a physical presence in the country. Three proposals have been considered for this purpose (only one of which would be adopted):
 - A limited proposal for digital services only, focusing on social media, digital advertising, intermediation platforms (also known as multi-sided platforms) and data.
 - A broader proposal, which would allow greater taxing rights to market countries (such as New Zealand) based on certain marketing intangibles created there by multinationals. This would apply beyond the digital economy.

- A proposal which provides for apportionment of a multinational's profit from ecommerce to market countries in which it has a significant economic presence. The apportionment would be based on an agreed formula and would depend on certain factors such as sales, assets and user participation.

It is possible that the OECD may adopt an option that incorporates elements of more than one of the three proposals, or an alternate proposal not yet considered.

- **A minimum tax measure.** This proposal would apply beyond the digital economy and would ensure that multinationals pay a minimum level of tax on profits earned in low tax countries. This measure could be adopted in addition to one of the three proposals above.

Submissions

- 1.9 The Government seeks submissions on the proposals set out in this discussion document.
- 1.10 Submissions should include a brief summary of the major points and recommendations. They should also indicate whether it would be acceptable for Inland Revenue and Treasury officials to contact those making the submission to discuss the points raised, if required.
- 1.11 Submissions should be made by Friday **18 July 2019** and can be emailed to policy.webmaster@ird.govt.nz with "Options for taxing the digital economy" in the subject line.
- 1.12 Alternatively, submissions may posted to:

Options for taxing the digital economy
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
Wellington 6140
- 1.13 Submissions may be the subject of a request under the Official Information Act 1982, which may result in their release. The withholding of particular submissions, or parts thereof, on the grounds of privacy, or commercial sensitivity, or for any other reason, will be determined in accordance with that Act. Those making a submission who consider that there is any part of it that should properly be withheld under the Act should clearly indicate this.
- 1.14 In addition to seeking written submissions, Inland Revenue and Treasury officials intend to discuss the issues raised in this discussion document with key interested parties.

CHAPTER 2

Background

- 2.1 This chapter sets out some important background information about the taxation of the digital economy. It explains New Zealand's current taxation of multinationals and outlines the recent measures the Government has taken to improve this taxation. It explains the current problems with taxing the digital economy, and sets out the previous international response to them.

New Zealand's current taxation of multinationals – the international tax framework

- 2.2 New Zealand's ability to tax multinationals on their New Zealand income is determined by both our domestic tax rules and by the double tax agreements (DTAs) we have entered into with other countries.
- 2.3 The rules imposed by our DTAs, together with the related OCED guidance, form the international tax framework which countries have agreed to follow. Under our DTAs New Zealand can only tax a multinational on its business income if:
- the multinational has a sufficient taxable presence in New Zealand; and
 - some of the multinational's profit is attributable to that taxable presence.
- 2.4 For a multinational to have a taxable presence, it must operate in New Zealand either through a New Zealand resident subsidiary (in which case the subsidiary is taxable on its income) or through a permanent establishment (PE) of a non-resident group member. For a PE to exist, the multinational must have some kind of physical presence in New Zealand – either a fixed place of business, or a dependant agent which enters into contracts for it.¹ This is generally referred to as the nexus requirement.
- 2.5 If a non-resident does have a PE in New Zealand, then under our DTAs New Zealand can only tax the income that is attributable to that PE. The OECD has published detailed guidelines on how to attribute income to a PE, to which countries have agreed. The guidelines aim to attribute income to a PE by reference to the value generated by the non-resident at that PE, compared to the value it generates overseas. To do this, the guidelines look at the assets of the PE and the activities carried on through the PE by its personnel.
- 2.6 The effect of this is that a non-resident's business income is only taxable in New Zealand under our DTAs to the extent the non-resident has assets or personnel here. If the non-resident has no assets or personnel here, they are not taxable on their New Zealand income.

¹ The latest OECD model treaty only requires that the dependant agent play a principal role leading to the conclusion of contracts by the non-resident, provided they are routinely entered into without material modification. However, this provision does not appear in most of our DTAs. In addition, section GB 54 of the Income Tax Act 2007 also contains an anti-avoidance provision, which can deem a non-resident to have a permanent establishment in New Zealand in certain circumstances.

- 2.7 These are referred to as the profit allocation rules. While the rules limit New Zealand’s ability to tax non-residents that do business here, they also benefit New Zealand by limiting the rights of other countries to tax New Zealanders who do business there.
- 2.8 Since these nexus and profit allocation rules are contained in New Zealand’s DTAs, we cannot change them unilaterally – it would require the consent of the other countries. In addition, the nexus and profit allocation rules in most DTAs are based on a common standard published by the OECD or the UN, which in turn reflect a consensus on international taxation established nearly a century ago. It would be difficult to fundamentally diverge from these nexus or profit allocation standards in our DTAs (although most DTAs diverge in some less significant respects).
- 2.9 Appendix 2 sets out New Zealand’s policy for taxing multinationals, some recent tax measures aimed at multinationals, and our economic framework for international tax.

The problem

- 2.10 The main problem is that the international tax framework was established nearly a century ago and has not kept up with modern business practices. These modern business practices, and digitalisation in particular, mean that a company can be significantly involved in the economic life of a country without being subject to income tax there. The OECD has identified that this is caused by three main factors:²
- **Scale without mass.** Digital companies can transact with customers over the internet without having the physical presence (a PE) required by DTAs for income tax to be charged in the customers’ country. This is a problem for both the nexus and the profit allocation rules – even if the digital company was deemed to have a PE in the country, the lack of activities carried out in the country by the multinational means there would be no profit to attribute to that PE.
 - **User value creation.** Even where a digital company does have a PE, the profit allocation rules do not recognise the new kinds of value that digital companies can generate in their market countries. Digital companies can derive significant value from the active participation of their users, from data generated by the users, and from network effects. None of this value is recognised by the current profit allocation rules.
 - **Intangible assets.** Much of the value of digital companies can be attributed to intangible assets, such as trademarks and other intellectual property. These intangibles are hard to value. They are also mobile, meaning the income attributable to them can be easily moved to low tax countries.³

² For example, see OECD’s *Tax Challenges Arising from Digitalisation – Interim Report 2018*, Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, 2018, paragraphs 3.83–3.86.

³ The use of intangibles for this purpose was considered as part of BEPS Actions 8–10, which attempted to align taxation more with the economic substance of a multinational’s activity. However, many countries are concerned Actions 8–10 did not prevent a multinational from allocating significant profits to intangibles located in low tax countries.

- 2.11 These factors are not all unique to digital companies – for example, many non-digital companies have valuable intangible assets. For this reason, some countries consider that the current problems with the international tax framework are not limited to the digital economy. However, all the above factors have been exacerbated by digitalisation, with the result that the problems with the international tax framework are particularly acute for digital companies.
- 2.12 As a result of these problems, multinational digital companies generally 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%.⁴
- 2.13 This under-taxation of the digital economy impacts the sustainability of Government revenues and public perceptions of the fairness of the tax system. It also provides a competitive advantage to overseas digital companies compared to local businesses, which are subject to full income tax.
- 2.14 New Zealand’s previous measures to tax multinationals do not address these problems with the international tax framework. This is because those measures only prevent multinationals from avoiding the current international tax framework. However, taxing the digital economy requires a fundamental change to that framework.
- 2.15 For the same reason a diverted profits tax, of the kind adopted by Australia and the United Kingdom would not solve the current problems with taxing the digital economy. This is because a diverted profits tax also just prevents multinationals from avoiding the current international tax framework (similar to the changes in the Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018).
- 2.16 It is important to note that 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).

The international response

- 2.17 The taxation of the digital economy was first widely addressed at a 1998 OECD Ministerial Conference on electronic commerce in Ottawa. The OECD Secretariat presented a report for the conference, *Electronic Commerce: Taxation Framework Conditions*.⁵ The report basically concluded that the existing international tax framework was sufficient to address the digital economy. This conclusion was repeated in 2005 by the OECD’s Business Profits Technical Advisory Group.

⁴ See the European Commission’s Impact Assessment for its digital services tax (SWD(2018) 81 Final), page 18, https://ec.europa.eu/taxation_customs/sites/taxation/files/fair_taxation_digital_economy_ia_21032018.pdf

⁵ Available at <https://www.oecd.org/tax/consumption/1923256.pdf>

- 2.18 However, concerns with the taxation of the digital economy have grown with the digital economy's increasing size. The OECD considered the taxation of the digital economy again as part of its BEPS project. The OECD's 2015 BEPS report noted the current problems with taxing the digital economy⁶ and considered three possible solutions:
- Widening the definition of a PE to include a non-physical significant economic presence.
 - A withholding tax on payments to internet companies.
 - A DST (referred to as an equalisation tax in the report).
- 2.19 The OECD did not recommend adopting any of these solutions at the time. This was due to a lack of consensus and because the OECD wanted to see whether the other BEPS measures would mitigate the issues.⁷ Accordingly the OECD initially stated it would reconsider the taxation of the digital economy in 2020, but countries could adopt any of the solutions provided they respected existing treaty obligations.⁸
- 2.20 However, pressure to find a solution increased following the issue of the OECD's 2015 report. Several countries began considering unilateral measures. In particular, the European Commission proposed a DST for the European Union on 21 March 2018 and the United Kingdom also issued a position paper supporting a DST in November 2017.
- 2.21 In response to this pressure, the OECD accelerated its further consideration of the digital economy and released an interim report on the taxation of the digital economy in March 2018⁹ (Interim Report).
- 2.22 The Interim Report noted that countries had different views on the digital economy. One group considered that the digital economy created unique problems for the international tax framework, which should be addressed by targeted changes to the nexus and profit allocation rules. Another group considered that the problems with the international tax framework went beyond the digital economy, and so required a broader solution. Finally, a third group considered that the current rules were working well following the OECD's BEPS project and so no changes were required.
- 2.23 As a result of this disagreement, the Interim Report does not make any recommendations or reach any firm conclusions on taxing the digital economy. There was agreement, however, that a consensus solution was preferable to countries adopting unilateral measures. Accordingly, countries committed to achieving a consensus based long-term solution by 2020. This solution will involve changes to both the nexus and the profit allocation rules.

⁶ OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, 2015, <https://doi.org/10.1787/9789264241046-en>

⁷ The 2015 OECD report also considered the application of VAT (or GST) to the digital economy and made several recommendations. These recommendations have since been widely adopted, meaning the 2015 report was a success in terms of VAT.

⁸ Although the first two proposed solutions were inconsistent with most DTAs.

⁹ OECD, *Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, 2018, <https://doi.org/10.1787/9789264293083-en>

- 2.24 The Interim Report did not recommend that countries adopt DSTs. However, it did recognise that some countries may want to introduce them as interim measures before a consensus solution was reached. The report set out some least harm type guidelines that countries should follow (discussed in chapter 3 of this discussion document).
- 2.25 The OECD has continued working on an international solution following the interim report and has developed two measures. One measure would reallocate more taxing rights to market countries, while the other measure would ensure that multinationals paid a minimum level of tax on its profits from low tax countries. These measures are discussed in chapter 4 of this document.
- 2.26 The measures have been developed on a without prejudice basis, meaning that, while the participating countries have agreed to them being further developed and discussed, they have not committed to ultimately supporting them. The OECD is aiming to obtain approval of the G20 group of large economies for its preferred measures at the G20's meeting from 28–29 June 2019.
- 2.27 The progress made at the OECD has not been sufficient to allay the concerns of several countries, who have announced or introduced DSTs as unilateral interim measures to tax the digital economy. The United Kingdom recently announced it would introduce a 2% DST from April 2020. Austria, the Czech Republic, France, India, Italy and Spain have also enacted or announced DSTs. The European Commission introduced a proposal for a DST in March 2018, but it has not been able to achieve the support of all European Union members yet.¹⁰
- 2.28 The DSTs announced so far are not intended as alternatives to the OECD's international solution. Instead they are intended to be an interim measure, which would cease to apply when an OECD solution was achieved. This reflects the fact that the countries which support DSTs still consider an international agreement at the OECD to be the best long-term solution to the issue. They are just sceptical of the OECD's ability to achieve this solution in a reasonable timeframe. To reinforce this preference, all the countries which have announced a DST (other than India) have stated that they will repeal them if and when an international solution is achieved.

The Australian approach

- 2.29 The Australian Government released a discussion document on the taxation of the digital economy on 2 October 2018. The document set out the Australian Government's views on the digital economy, explored new options for taxing it (being the introduction of a DST and the proposals being considered at the OECD), and invited public feedback on those options.
- 2.30 The Australian discussion document observed that digitalised businesses provide significant 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-

¹⁰ The European Commission DST has recently been narrowed to apply only to digital advertising, in an attempt to reach consensus.

sharing and accommodation platforms, multi-sided platforms (like eBay), and digital advertising.

2.31 On 20 March 2019 Australia announced that it would not adopt a DST at this time. Instead it will focus on achieving a multilateral solution at the OECD. The announcement noted that:

- the Australian Government firmly believes that digital firms, like all firms, must pay their fair share of tax;
- the submitters overwhelmingly supported Australia continuing to engage in the ongoing multilateral process at the OECD; and
- many submitters raised significant concerns about the potential impact of an Australian DST across a wide range of Australian businesses and consumers, including discouraging innovation and competition, adversely affecting start-ups and low margin businesses and consumers, and the potential for double taxation.

Other measures for taxing the digital economy

2.32 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 Chile, Colombia, India, Israel, Italy, Slovakia and Uruguay). However, such domestic law changes will not be effective unless there is no applicable DTA.

Questions for submitters

- Do you agree that there are problems with taxing the digital economy or with the current international income tax framework? If so, are the problems with the current international tax framework limited to the digital economy, or do they apply more broadly?
- Are there any other measures New Zealand should consider to address these problems?

CHAPTER 3

Should New Zealand adopt a digital services tax as an interim measure?

- 3.1 This chapter sets out the international context of a DST and an overview of how it works, followed by the OECD's and Tax Working Group's views on DSTs. Next, it sets out some general design principles for a DST and describes a potential DST for New Zealand. Finally, it sets out how a DST complies with New Zealand's international obligations, and discusses the advantages and disadvantages of a DST.

International context

- 3.2 A proposal to adopt a DST needs to be evaluated in the context of international developments – particularly at the OECD.
- 3.3 As things stand, New Zealand's current options for taxing the digital economy are:
- continue to participate in the OECD discussion, with the aim of supporting an internationally agreed multilateral solution but do nothing in the interim; or
 - introduce a DST as an interim measure in 2020–21 if an OECD consensus is taking longer to emerge.
- 3.4 The Government supports an internationally agreed solution at the OECD. The advantages of an OECD solution are that it would:
- address the problems with the international income tax framework directly (rather than indirectly, via a separate tax);
 - require a tax credit to be given for any additional tax payable in market countries and avoid double taxation; and
 - involve a single set of rules that would be applied by all participating countries.
- 3.5 We canvass the options currently being considered and progressed at the OECD in chapter 5. The Government wants to understand the effect of the measures being considered at the OECD on New Zealanders. This will help the Government develop its view on these options, which it can then take into account in its contribution to the OECD discussions.
- 3.6 However, there is a risk in simply waiting to see whether the OECD can achieve an international solution that receives broad international support from members of the inclusive framework. Doing so would significantly delay consideration of a DST, if no international solution could be found. In addition, any international solution achieved by the OECD may not take effect until 2025, even if it was achieved in 2020.

- 3.7 DSTs have recently been adopted by other countries as unilateral interim measures to tax the digital economy. The Government needs to now decide whether to join these other countries in adopting a DST as an interim measure while discussions continue at the OECD.
- 3.8 The Government will seriously consider a DST if the OECD cannot make sufficient progress this year. We explore the design of a DST and the implications for New Zealand in this chapter. The expectation is that any DST adopted would be temporary, and the Government would look to repeal it once an international solution was achieved and implemented.

Overview of the digital services tax

- 3.9 A DST is charged at a low rate on the gross turnover attributable to a country from certain highly digitalised business activities. A DST is not an income tax for DTA purposes. Consequently, countries can introduce a DST unilaterally, without the need for international agreement.
- 3.10 The United Kingdom recently announced it would introduce a 2% DST on the profits of certain digital companies that would apply from April 2020. Austria, the Czech Republic, France, India, Italy and Spain have also enacted or announced DSTs. The European Commission has proposed a 3% DST for Europe, however it has not been able to achieve the support of all European Union members. Australia consulted on a DST as an option for taxing the digital economy, but subsequently decided in March 2019 not to proceed with one at this time (deciding to instead focus on an OECD solution).

OECD's view on a digital service tax

- 3.11 The OECD Interim Report noted that there was no consensus on the desirability of a DST among countries. It noted that many countries are opposed to DSTs due to their risks and adverse consequences.¹¹ Other countries acknowledge these issues but consider that they do not outweigh the need to adopt DSTs as interim measures. These latter countries also consider that the downsides of a DST can be at least partially mitigated through careful design. Because of this lack of consensus, the OECD report did not recommend for or against a DST.
- 3.12 The OECD Interim Report did however set out several guidelines that countries in favour of DSTs consider should be taken into account by countries wishing to adopt a DST. These guidelines are intended to limit the adverse consequences of a DST and provide a degree of uniformity to the DSTs adopted.
- 3.13 The guidelines state that any DST should:
- Be compliant with a country's international obligations. This means the DST could not be an income tax (or creditable against an income tax), but it could be an excise tax. The DST would also need to comply with

¹¹ The OECD report included an overview of these risks and adverse consequences. We have incorporated this into our discussion of the downside of a DST.

any obligations of a country under its free trade agreements or the World Trade Organisation.

- Be temporary – it should be repealed once an international tax solution is implemented.
- Be targeted at business models which pose the greatest challenge to the current international income tax framework, namely those with scale without mass and which rely heavily on user participation and network effects (for example, social media, search and intermediation platforms). The DST should not apply to the sale of ordinary goods or services over the internet.
- Minimise over-taxation (for example, be charged at a low rate).
- Minimise its impact on start-ups, business creation and small business more generally. Any DST should have *de minimis* thresholds so it only applies to large businesses (for example, over €750 million consolidated annual global turnover) with a sufficient level of revenue from the relevant country.
- Minimise cost and complexity, which could be by having meaningful *de minimis* thresholds and using existing GST collection mechanisms.

Tax Working Group’s view on a digital services tax

3.14 The Tax Working Group (TWG) also considered the current issues with taxing the digital economy. In its final report, the TWG concluded that New Zealand should continue to participate in the OECD discussions on changing the international income tax framework but should also stand ready to implement a DST if a critical mass of other countries move in that direction, and it is reasonably certain the New Zealand’s export industries will not be materially impacted by any retaliatory measures.

Design considerations for a potential digital services tax

3.15 In designing a DST for New Zealand, we would aim to comply with the OECD guidelines discussed above, and our international obligations in particular.

3.16 There would also be real benefits to aligning our DST with the DSTs adopted by other countries. This would have several advantages. It would:

- reduce the risk of the same amount of revenue being subject to multiple DSTs;
- make it easier for multinationals to comply with our DST if it applies on the same basis as those adopted by other countries;
- allow us to benefit from the design and implementation work done by other countries on their DSTs; and
- reduce the risk of any reputational damage of New Zealand adopting a DST.

New Zealand's proposed digital service tax

- 3.17 New Zealand's DST would be a flat tax charged at 3% on the gross turnover attributable to New Zealand of certain digital businesses. It would be applied on a consolidated group basis. That is, it will be applied by treating a multinational group as a single entity, ignoring the legal separation of the various group members. Intra-group transactions would be ignored.
- 3.18 The application of New Zealand's DST to a multinational group would involve these steps:
- Determine if the DST applies to the group. The DST would apply if both:
 1. the group's business includes any of the activities defined to be in-scope; and
 2. the group exceeds both the two *de minimis* thresholds for the DST.
 - If the DST applies, the group would calculate and pay its DST liability. This would involve these further steps:
 3. the group determines the annual gross global revenue attributable to its in-scope business activities;
 4. the group determines the proportion of those revenues attributable to New Zealand;
 5. the group calculates the DST payable on those attributable revenues at the 3% DST rate; and
 6. the group returns and pay the DST to Inland Revenue by the due date.
- 3.19 We explain each of these steps in the next section.

Does the digital services tax apply?

Step 1 – Are the group's activities within scope?

- 3.20 New Zealand's DST would apply to the services provided by business activities whose value is dependent on the size and active contribution of their user base. Specifically, the DST would apply to supplies made through:
- intermediation platforms, which facilitate the sale of goods or services between people (like Uber and eBay);
 - social media platforms like Facebook;
 - content sharing sites like YouTube and Instagram; and
 - search engines and the sale of user data.
- 3.21 This means the DST would be narrowly targeted at certain highly digitalised supplies. It would not apply to:
- The sales of ordinary goods or services (other than advertising or data) over the internet. It would not apply to goods sold online (for example, by Amazon itself).
 - The provision of online content, such as music, games, TV shows and newspapers. This means it would not apply to Netflix for example. The

DST would apply to a platform which facilitated the sale of goods, services or content between buyers and sellers, such as Apple music. In this case, the DST would apply to the platform owner, but not to the people who made or supplied the good, services or content over the platform.

- Services delivered directly through the internet, such as accounting services delivered via the cloud.
- Information and communications technology (ICT) providers, such as telecommunication companies and internet service providers.
- Standard financial services, such as credit cards and EFTPOS providers.
- Television and radio broadcasting.

3.22 The above services do not derive as much of their value from active user participation, so it is not appropriate to include them within the scope of a DST.

3.23 The DST will likely need to apply to both New Zealand residents and non-residents. This is for reasons of consistency with New Zealand's obligations under our World Trade Organisation (WTO) and free trade agreements (FTA) to not provide less favourable treatment to non-New Zealand service suppliers as compared to like New Zealand service suppliers. This is the same approach taken by most other countries that have recently announced or adopted DSTs.

Step 2 – Are both de minimis thresholds exceeded?

3.24 The DST would have meaningful *de minimis* thresholds, below which it would not apply. The OECD Interim Report notes the importance of *de minimis* thresholds to reduce compliance and administrative costs, increase the chance of the DST applying to profitable businesses, and reduce its impact on start-ups and small businesses. The OECD Interim Report recommends two separate *de minimis* thresholds (both of which would need to be exceeded in the previous tax year in order for the DST to apply):

- A threshold based on the size of the group. For this purpose, the OECD Interim Report recommends the current threshold for country by country reporting, which is €750 million of consolidated annual turnover.¹² The European Commission's original DST also used this threshold and the DSTs proposed by Austria, France, Italy and Spain all use this €750 million global turnover threshold. The United Kingdom DST has a similar threshold of £500 million of consolidated annual global turnover.
- A threshold based on the amount of the digital group's global revenue that is attributable to NZ users.¹³ The European Commission's original DST had a €50 million local threshold, while the United Kingdom has an effective threshold of £50 million. For their respective DSTs, Austria has a €10 million local threshold, France has a €25 million local threshold, Italy has a €50 million local threshold and Spain has a €3 million local threshold.

¹² Paragraph 450 and following.

¹³ This would be determined the same way as in steps 3 and 4.

- 3.25 For New Zealand, we propose the following:
- Also using the Country-by-Country reporting threshold of €750 million of consolidated annual turnover. This threshold is already used in the Income Tax Act 2007 for provisions targeted at large multinationals (such as the permanent establishment anti-avoidance rule in section GB 54) and it would make sense to apply it here as well. All of the DSTs announced so far also use a €750 million consolidated annual turnover threshold (other than India's and the United Kingdom's – and the United Kingdom uses a comparable figure).
 - Including a New Zealand specific threshold of \$3.5 million a year – which would produce approximately \$100,000 of DST. All of the DSTs announced so far also include a local country threshold, which varies with the size of the countries.
- 3.26 Both these thresholds would need to be exceeded in the previous income year for a DST to apply in the current income year.
- 3.27 The setting of these thresholds also needs to consider New Zealand's international obligations under FTAs and the WTO. As these thresholds would apply to both New Zealand and foreign companies they do not explicitly discriminate against non-New Zealanders. However, they could still contravene our obligations if in practice they modify the conditions of competition in favour of New Zealand companies as compared to like non-New Zealand companies. Accordingly, we may need to change the size of the thresholds.

Calculate and pay the digital services tax

Step 3 – Determine the in-scope global revenue

- 3.28 The next step is to determine the global revenue for the group's in-scope business activities.
- 3.29 The DST would apply to any revenue from in-scope business activities. For example, it would apply to:
- revenue from advertising provided through social media platforms and search engines; and
 - commissions charged on transactions carried out through intermediation platforms.
- 3.30 If the group carries on both in-scope and out of scope business activities, then only the revenue from in-scope business activities would be included. Accordingly, the group would need to apportion its total revenues between in-scope and out of scope activities.
- 3.31 The revenue is the gross amount received, without any deduction for expenses. This reflects the fact that a DST is charged on the supply of the relevant services. It is not charged on the profit made by the supplier for those services.
- 3.32 To simplify this step, the DST could allow a group to use the revenues from its financial accounts.

Step 4 – Determine the amount attributable to New Zealand

- 3.33 A group's in-scope global gross turnover would be apportioned to New Zealand. This could be done based on the proportion of global users in New Zealand.
- 3.34 For example, suppose a digital group had \$10 billion of total gross global revenue and one percent of its total global users in New Zealand. The revenue attributable to New Zealand would be $\$10 \text{ billion} \times 1\% = \100 million .
- 3.35 In attributing the global revenue, it is only the location of the users that is relevant, not the location of the customers paying the digital group for its services. Therefore the \$100 million of revenue in the example above would still be attributed to New Zealand under the DST even if no actual payments were made to the digital group from New Zealand.
- 3.36 One issue with this global attribution method 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.
- 3.37 Another option for addressing this would be to use the actual contribution of users in a particular country to a digital company's gross turnover. We understand that some digital companies already calculate this, however it may be more difficult for others to do.
- 3.38 An important consideration for New Zealand will be the consistency of our attribution method with those adopted by other countries. At this stage the original European Commission DST proposed formulaary apportionment and the DSTs proposed by European countries also seem to adopt this approach. On the other hand, the current United Kingdom proposal uses the actual revenues attributable to United Kingdom users (although the United Kingdom Government is consulting on this point). It is not clear if there will be a consistent method adopted by countries.
- 3.39 Regardless of the method used, attribution of turnover to New Zealand users will require a definition of a "user", and a way of determining the location of that user.
- 3.40 The definition of a user would primarily be anyone who used the platform or service, however the exact definition would vary depending on the type of platform and revenue. For example, for advertising revenue, a user would be anyone who views or clicks on the advertisement (with the same person possibly counting as multiple users if they view or click on it multiple times). For intermediation platforms, a user could be a person who enters into a transaction using the platform (to either buy or sell), with each transaction counting as a separate user. In any case the definition of a "user" for each type will need to be something that the relevant digital business can easily determine.
- 3.41 In order to determine the location of the user, we propose using the same method as currently used for the supply of cross border online services under the Goods and Services Act 1985. Section 8B(2) of that Act provides this list

of indicators that can be used to determine whether a recipient of a supply should be treated as a New Zealand resident:

- the person's billing address;
- the internet protocol (IP) address of the device used by the person or another geolocation method;
- the person's bank details, including the account the person uses for payment or the billing address held by the bank;
- the mobile country code (MCC) of the international mobile subscriber identity (IMSI) stored on the subscriber identity module (SIM) card used by the person;
- the location of the person's fixed landline through which the service is supplied to them; or
- other commercially relevant information.

3.42 These indicators aim to identify whether the recipient of a supply is a resident of New Zealand, rather than whether the recipient is in New Zealand at the time of supply. Accordingly, the indicators would apply to New Zealand residents that use a platform while they were out of the country, and they would not apply to non-residents who used a platform while they visited New Zealand. However, this is an area where the Government considers certainty may be more important than absolute precision. It would also simplify the application of the DST for non-residents that are also subject to GST on their online supplies to New Zealanders. The Government welcomes feedback on this point.

Step 5 – Calculate the DST payable

3.43 The DST would be paid on the revenues attributable to New Zealand at 3%. For example, if an in-scope business had \$100 million of revenue attributable to New Zealand users, New Zealand would charge 3% tax on that \$100 million of revenue, for total tax of \$3 million.

3.44 The proposed United Kingdom DST includes an alternative safe harbour DST calculation method. Under this method, a group can elect to pay DST at a higher rate on its profit (rather than its gross turnover). This method is intended to ensure a DST does not place a disproportionate burden on taxpayers with losses or low profit margin.

3.45 The safe harbour method uses this formula:¹⁴

$$\text{Profit margin} \times \text{Attributable revenues} \times \text{Rate}$$

Where:

- **Profit margin** is the profit margin made on transactions with United Kingdom users. Since this method allows costs to be deducted in order to determine the profit, it would require an agreed approach to determine which costs were deductible, and how to apportion global or regional

¹⁴ We have simplified this by removing the allowance component, which functions as part of the United Kingdom's *de minimis* threshold.

overheads to United Kingdom users. It would also need to exclude extraordinary items. Alternately the global consolidated accounting profit margin could be used, although this would be less accurate.

- **Attributable revenue** means the revenue attributable to United Kingdom users. This would be the same as for the standard United Kingdom approach.
- **Rate** is the rate at which the DST would be charged under this method. The United Kingdom have proposed a rate of 80%, to ensure the method is only attractive where there are very low profit margins. However, it is consulting on this.

3.46 At this stage the Government does not propose including a similar safe harbour in New Zealand's proposed DST. We consider that such a safe harbour would significantly complicate the DST. However, the Government welcomes feedback on this point.

Step 6 – Return and pay the DST

3.47 Finally, the DST would need to be paid to Inland Revenue. This raises some questions about how a DST would be administered.

3.48 At this stage we propose using an online supplier registration model, similar to that used for GST on remote sales. This would require a group to register with Inland Revenue and file a short return with their DST liability.

3.49 We would also need to determine the period over which a DST is assessed and the frequency of payments. We currently allow non-residents to pay GST on their online supplies on a quarterly basis. It may make sense to align the DST and GST reporting and payment requirements, so that companies paying GST could incorporate the satisfaction of their DST obligations into their existing GST return and payment process. Quarterly filing also aligns with common commercial practices for foreign businesses to produce quarterly accounts and with VAT/GST filing periods for several overseas jurisdictions.

3.50 Alternately we could make DST payable on an annual process, aligned with a group's financial reporting balance date. This would make it easier for a group to use its financial reporting information to determine its DST liability.

3.51 We note that the United Kingdom has proposed that its DST payment and reporting be aligned with its income tax. This means the DST reporting period would be the tax year, and the DST would be payable in four quarterly instalments (as with income tax for large companies).

3.52 The Government does not propose to follow the United Kingdom's approach at this stage – it seems to us that a DST is more closely aligned with GST than income tax, so it would make more sense to align a DST's calculation and payment requirements with GST. However, we would welcome feedback on this point.

3.53 The digital group will need to nominate a member to return and pay the DST. All group members will be jointly and severally liable for the DST until it is paid.

Interaction with income tax – creditability and deductions

3.54 New Zealand's DST would not be an income tax. This means the DST could not be credited against our income tax either. The DST would however be considered a business expense, and so would be deductible in accordance with the ordinary income tax deduction rules.

Example 1: Application of the proposed New Zealand digital services tax

SocMed is a multinational group that operates a popular social media platform. It derives its income from providing targeted advertisements on this platform.

SocMed's total global annual revenue is €20 billion dollars according to its financial statements. It has 0.5% of its global user base in New Zealand.

Application of the proposed New Zealand DST to SocMed would involve these steps.¹⁵

Determine if the DST applies to the group

Step 1: Does the group's business includes any of the activities defined to be in-scope? In this case SocMed's only activity is operating its social media platform, which is an in-scope business activity.

Step 2: Does the group exceed both the *de minimis* thresholds for the DST? In this case the *de minimis* thresholds are:

- €750m consolidated global annual turnover – SocMed exceeds this as it has €20 billion in annual turnover.
- NZ\$3.5 million in turnover attributable to New Zealand users. In this case SocMed has €20 billion turnover × 0.5% global users in New Zealand = €100m turnover attributable to New Zealand users. €100 million = NZ\$167 million (converted at a 0.6 NZD/EUR spot-rate). Therefore, SocMed will exceed this threshold.
- Therefore, the DST will apply to SocMed.

Calculate and pay the amount of the DST

Step 3: Determine the annual gross global revenue attributable to in-scope business activities. In this case, SocMed's only business activities are in-scope. Therefore, its in-scope revenue will be its total gross turnover of €20 billion, as shown in its financial statements.

Step 4: Determine the proportion of those revenues attributable to New Zealand. This is determined by reference to the proportion of the Group's total global users that are located in New Zealand. In this case 0.5% of the Group's total users are in New Zealand, so 0.5% of its global gross turnover is also attributable to New Zealand. This means that the revenue attributable to New Zealand is €20 billion × 0.5% = €100 million. This is then converted into NZD at the applicable spot rate (0.6 NZ/EUR) to give total NZD attributable revenues of €100 million ÷ 0.6 = NZ\$167 million.

Step 5: Calculate the DST payable. This is determined by multiplying the total revenues attributable to New Zealand (in New Zealand dollars) by the 3% DST. This gives \$167 million × 3% = \$5 million DST payable.

Step 6: Return and pay the DST by the due date. SocMed would need to return and pay the DST via an annual return,¹⁶ which would be due on a date following the publication of its annual financial statements.

¹⁵ These steps assume that DST will be payable on annual basis rather than a quarterly basis (which has not yet been decided).

¹⁶ The Government is also considering whether DST should be payable quarterly, like GST on remote sales.

Compliance with our international obligations

3.55 The DST would be designed to comply with our international obligations. These consist of our obligations under our DTAs, and our obligations under the WTO and our FTAs.

Compliance with double tax agreements

3.56 The DST would be payable by a non-resident even if it did not have a physical presence in New Zealand. New Zealand's DTAs require a non-resident to have a physical presence before we can impose income tax on their sales income. However, Article 2 of our DTAs state that they only apply to income taxes or taxes substantially similar to an income tax.¹⁷ This means that a DST would not conflict with New Zealand's DTAs, provided the DST is not an income tax or substantially similar to an income tax.

3.57 The starting point here is that Article 2 of our DTAs is clearly not intended to cover all taxes. For example, it is clear that our DTAs do not apply to GST. The question then is whether the New Zealand DST is substantially similar to an income tax, or whether it is more like other types of tax, such as excise taxes and GST.

3.58 The OECD's Interim Report¹⁸ notes that taxes on income focus on the recipient of the income, rather than on the consumer of a supply of specific goods or services, and usually look at the characteristics and economic situation of the recipient of the income (for example, profitability). This reflects the fact that an income tax is generally a tax on profits, rather than gross turnover. Consequently, if a DST was imposed on the supply itself (rather than the supplier) and focussed on the expenditure side of the payment (that is, the nature and value of the supply) it would more likely not be considered an income tax.

3.59 However, as the Interim Report notes, tax on gross turnover can still be an income tax in some circumstances. For example, a gross withholding tax that is creditable against the income tax liability of the recipient. We consider the key factor here to be that a tax levied on gross turnover must affect the person's income tax liability in some way (other than by deduction) in order to be an income tax, for example by being creditable against the income tax liability, or by being charged in lieu of income tax.

3.60 Bearing this in mind, the Interim Report considers that a DST would be less likely to be an income tax where it is:

- levied on the supply of a certain defined category or categories of e-services and imposed on the parties to the supply without reference to the particular economic or tax position of the supplier;
- charged at a fixed rate, calculated by reference to the consideration paid for those services (without reference to the net income of the supplier or the income from the supply); and

¹⁷ The non-discrimination articles in our DTAs with Australia, Mexico and Japan apply to all taxes, and so would potentially be within the scope of a DST. We discuss the impact of these articles in the next section, as they are similar to our WTO and FTA obligations.

¹⁸ Paragraph 6.3.1.

- not creditable or eligible for any other type of relief against income tax.
- 3.61 Based on this guidance, we consider that our proposed DST would not be an income tax. It would be levied on the supply of narrowly defined services (being those provided by in-scope business activities), it would be charged at a fixed rate by reference to the consideration paid (that is, the gross turnover attributable to the in-scope business activities) and not the net profit of the recipient, and it would not be creditable against New Zealand income tax. In particular the DST would be paid in addition to our income tax, so it is not in any way in lieu of income tax.
- 3.62 This conclusion is consistent with the United Kingdom’s view on their proposed DST. In its November 2018 consultation paper,¹⁹ the United Kingdom Treasury argued that, as their proposed DST was not a listed tax under their DTAs, nor identical or substantially similar to any listed taxes, the question of whether the DST was an income tax had to be resolved with reference to the ordinary concept of income.²⁰
- 3.63 In this regard, the United Kingdom paper considers the concept of income to be a measure of the net accretion to a taxpayer’s wealth between two points in time, calculated by measuring the taxpayer’s gross receipts and deducting the relevant costs and expenses incurring in generating those receipts.²¹ On this basis, the United Kingdom DST would not be a tax on income, as it would be a tax on gross receipts from certain digital business activities rather than net income.
- 3.64 The United Kingdom paper also notes that, although there are examples of taxes applied to gross receipts which meet the definition of an income tax, these typically arose where the taxation of gross receipts was in lieu of income tax. The United Kingdom paper does not consider that its proposed DST meets these criteria, as its DST will apply separately to, rather than in lieu of, its income tax.²² Furthermore, the United Kingdom DST will not be creditable against United Kingdom income tax.
- 3.65 We consider the United Kingdom paper’s views on their DST apply equally to our own proposed DST, given their very similar design features.
- 3.66 Finally, we note that the United States has criticised the DSTs proposed by the United Kingdom and the European Union, but they have not alleged that the DSTs were income taxes charged in contravention of DTAs.

Compliance with WTO and FTA obligations.

- 3.67 New Zealand has international obligations under the World Trade Organisation and free trade agreements that require us to accord equivalent treatment to overseas service suppliers as we accord to like New Zealand service suppliers. New Zealand also has similar obligations under the non-discrimination articles of our DTAs with Australia, Mexico and Japan. These

¹⁹ HM Treasury and HM Revenue & Customs, *Digital Services Tax: Consultation*, November 2018, <https://www.gov.uk/government/consultations/digital-services-tax-consultation>

²⁰ Page 32.

²¹ Page 32.

²² Page 33.

will need to be taken into account in the design and structure of any DST as well as the setting of relevant thresholds.

Should New Zealand adopt a digital services tax?

Benefits of adopting a DST

- 3.68 As discussed above, there is a problem with the current international tax framework. A DST would be a way of collecting some tax from those types of businesses that present the greatest challenge to this framework, and which have been paying little tax either in New Zealand or overseas. Further, a DST should be relatively simple to calculate and administer compared to income tax. 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 the digital economy is taxed appropriately.
- 3.69 A DST is unlikely to be a significant revenue earner in New Zealand. As a rough estimate, we expect a 3% DST would raise between \$30 million and \$80 million of tax,²³ depending in part on how it is designed.
- 3.70 While the revenue raised would not be large, a DST could have other benefits. Much of the recent public concern about the under-taxation of multinationals has focussed on high-profile digital companies that do not have a physical presence in New Zealand (and so are not subject to income tax). By taxing these companies, a DST could improve public confidence in the fairness of the tax system, which is an important factor underlying voluntary compliance.
- 3.71 In addition, there is a risk in simply waiting to see whether the OECD can achieve an international solution. Doing so would significantly delay consideration of a DST, if no international solution could be found. Further, any international solution achieved by the OECD may not take effect until 2025, even if it was achieved in 2020. In the meantime, digital multinationals would continue to be unfairly taxed.
- 3.72 In addition, there are some upsides to adopting DSTs in terms of the OECD's solution. DSTs incentivise countries to agree to an international solution that would otherwise make their residents worse off, as the international solution would result in the repeal of a DST.
- 3.73 There is also an issue as to the adoption of any internationally agreed solution. This solution will require amendments to DTAs, which will ultimately need to be optional (as there is no way to force a country to change its DTAs). Accordingly, New Zealand might still want to introduce a DST even if an international solution is found, in order to tax digital companies operating out of countries that do not implement that solution.

Issues and potential drawbacks of a digital services tax

- 3.74 There are potential issues with a DST.

²³ This is based on a rough bottom-up estimate of what we think a DST would raise in New Zealand, combined with top down estimates based on what the European Union and United Kingdom have forecast their DSTs to raise, adjusted for differences in GDP and exchange rates.

Double taxation and over-taxation

- 3.75 The DST would need to apply in addition to income tax. This could result in both DST and income tax applying to the same income of some firms (including possibly some domestic firms). We consider that this is mainly an issue for any New Zealand businesses, as they are already taxed here on all their income. Non-resident digital businesses pay low rates of income tax generally and are not currently subject to New Zealand income tax on any income attributable to users in New Zealand.
- 3.76 Another issue is that, as a tax on gross turnover, the DST would apply to firms in loss, or with low margins. This is something that can be partially mitigated with high *de minimis* thresholds, as the larger firms tend to be more profitable. A lower DST rate also helps to mitigate this issue. However, these features cannot eliminate the issue altogether.

Impact on investment, innovation and growth

- 3.77 As with any tax on the supply of particular services, a DST will increase the cost of capital, reducing the incentive to invest with a resulting negative effect on growth. As a measure that only applies to digitalised sectors, a DST risks slowing down investment in innovation for those businesses that are subject to the tax or indirectly affected by it. Although the effect will also depend on the financing of the investment, without proper constraints, like an exemption for SMEs, a gross basis tax could effectively penalise start-ups and other growing firms with losses or limited profitability and provide a competitive advantage to mature profitable incumbents, helping to create a barrier to entry that cements the dominance of established firms.
- 3.78 The digital sector has important benefits for New Zealand, and the Government is committed to supporting it. Accordingly, it is important that any DST does not reduce the growth of the digital sector in New Zealand, particularly start-ups and SMEs. For this reason, any DST would need robust *de minimis* thresholds, to ensure it only targets established and profitable digital businesses.

Impact on welfare

- 3.79 The OECD Interim Report notes that an additional hurdle with a tax on a gross basis is that it is equivalent to a tax on inputs. This implies that it is likely to distort firms' choices of inputs thus distorting production itself. In other words, when such a tax is introduced, either production could decline or more resources will need to be employed to reach the same level of production. Consequently, according to the OECD Interim Report, there is likely to be a negative impact on the overall welfare of an economy and on its output. The size of the effect will depend on elasticities of substitution and will be smaller the more targeted the measure is.
- 3.80 In response to this issue, we note that the current international tax rules favour investment in the digital sector. This unequal tax treatment compared with more traditional businesses is inefficient, as it incentivises investment into certain digital firms (which can most benefit from the flaws with the current rules). As a DST is intended to reduce the unfair tax advantages enjoyed by

such digital businesses, we would expect a DST overall to improve economic efficiency, and thus welfare.

The economic incidence of the tax

- 3.81 The issue here is whether a DST would just be passed on to New Zealand customers. Given the importance of this issue, we consider it in some detail below.
- 3.82 Some digital multinationals provide a free service to end-users, which they monetise through payments from other parties, for example, for online advertising. To the extent the cost of a DST was passed on, we would expect it to be passed on to the parties currently paying the digital multinational for its services. We would not expect a DST to result in a digital multinational charging consumers for a service that is currently free. For example, consider a social media platform that is currently free to end-users and which raises revenue through online advertising. We would expect any costs from the DST to be passed on to the persons buying advertising from the multinational, and not the end-users of the platform (who should continue to enjoy a free service).
- 3.83 There are arguments each way on the extent to which a DST would be passed on to consumers. On the one hand, digital companies might be expected to have very low marginal costs. In that case a DST is similar to a tax on profits. If the digital company is earning infra-marginal returns (economic rents that is, the amount above the return that the investor needs in order to make the investment), 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.²⁴
- 3.84 The European Commission's Impact Assessment for its proposed DST 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. The Impact Assessment notes that:²⁵

There is scarce evidence on the pass-on effect of a new tax on turnover, but economic theory and experiences with VAT indicate that there is no uniform answer for the variety of digital services considered. As a proxy, one could look into the effect of an increase in the VAT rate on consumer prices. Economic theory suggests that the pass-through of a VAT increase on consumer prices is influenced by several factors: competition setting, the elasticity of demand and other factors (for example, country-specific ones). The higher the price elasticity of demand, the lower the degree to which a VAT rate increase can be shifted into final consumer prices. An increase in the VAT rate would thus translate to different degrees in higher consumer prices or reductions in suppliers' profit margins, depending on the market conditions. On average, for a rather broad range of goods and services, Benedick et al. (2015) found that only around one-third of a VAT change is passed on to consumer prices.²⁶ In the case of paper-based books and e-books, a

²⁴ 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.

²⁵ SWD(2018) 81 Final, page 75.

²⁶ See Benedek et al., 2015, page 16, <https://www.imf.org/external/pubs/ft/wp/2015/wp15214.pdf>

Commission-ordered study documented a pass-on rate of one-half, which was however considered imprecise.²⁷

For online retail, there is some evidence that consumers purchasing online are price sensitive and react strongly to price increases – this would limit the possibility for companies to pass additional tax onto consumer prices.

Existing work on internet tax sensitivity dates back to the influential work of Goolsby (2000). Sales taxes that are directly passed onto prices of products sold online have been shown to strongly reduce demand. More recently, Einar et al (2014), using data from eBay which accounts for 11–13 percent of Internet retail commerce in the U.S., estimate that on average, the application of a 10 percent sales tax reduces purchases by 15 percent among buyers who have clicked on an item.

- 3.85 The Impact Assessment to refers an IMF study on the pass through of VAT increases (Benedek et al). This study looked at the VAT reforms in the Eurozone from 1999–2013 (which involved 1,231 VAT changes – 1,009 VAT increases and 222 decreases) and their effect on consumer prices. The study found:
- changes in standard VAT rates which affect most goods and services, have a one hundred percent pass through rate or more;
 - changes in reduced VAT rates, which only affect a few types of goods or services, have only a thirty percent pass through rate (meaning only thirty percent of the extra cost or saving was passed on to consumers); and
 - reclassification of goods (that is, moving a particular good from a reduced rate to standard rate and vice versa), which had the narrowest application, had pass through rate of close to zero.
- 3.86 This shows a strong association between the share of consumption affected by a VAT reform, and total pass-through. Pass through is relatively small for VAT reforms that affect a small consumption share and is highest (close to full) for VAT reforms affecting around half of all consumption.²⁸ In particular, pass through is not significantly different from zero when the VAT applies to a consumption share less than ten percent.
- 3.87 A DST would only affect a small share of consumption. If the results above holds, the pass-through rate for a DST (which, as a tax on gross turnover, has a similar economic impact to a VAT) would be similar to the pass through rate for a VAT reclassification or reduced rate – that is thirty percent (or lower).
- 3.88 In addition, the pricing structure of some digital services mean the cost of a DST could not be passed on. For example, where online advertising is priced under a bid system, it might be difficult to increase the final price by the amount of DST charged.

²⁷ See European Commission, *Economic Study on Publications on all Physical Means of Support and Electronic Publications in the context of VAT*, 2012, page 98, https://ec.europa.eu/taxation_customs/sites/taxation/files/docs/body/economic_study_vat_on_publications_finalreport.pdf. The pass-on rates vary also country-wise – see pages 95–96.

²⁸ The study also found that pass through is again smaller for VAT reforms affecting more than a fifty percent share of consumption, although there were not enough data points for such VAT reforms to be confident of this conclusion.

- 3.89 Based on the above, we would roughly expect between thirty and fifty percent of the cost of a DST to be passed on to New Zealand consumers.

The effect on New Zealand's reputation as a good place to do business

- 3.90 New Zealand is a small open economy and we compete for capital with the rest of the world. That means we want New Zealand to be an attractive place for non-residents to do business. Imposing a DST may create a negative impression of New Zealand in this regard.
- 3.91 We consider that this risk would be reduced to the extent other countries adopt or announce DSTs (which some have already done).

The potential effect on our export sector

- 3.92 The implications of adopting a DST for our export sector would also need to be considered. Some trading partners, particularly the United States, would likely express continued opposition to any unilateral approach to digital taxation. Members of the United States Congress and United States tech industry players have previously claimed that DST proposals by the United Kingdom and the European Commission would amount to double taxation, and that proposed turnover thresholds would result in discrimination against United States companies in breach of World Trade Organization (WTO) national treatment provisions. The United States preference is likely to be to continue efforts to tackle the issue within the OECD.

The period of time for which a DST would be applicable

- 3.93 The OECD expects that any DSTs would be repealed once a multilateral solution is achieved. Other countries that have recently proposed DSTs have also said they will do this. 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

- 3.94 This is particularly an issue given that a DST is not expected to raise significant revenue. In addition, given a DST would be expected to (at least predominantly) apply to companies outside of New Zealand, there are fewer tools available to Inland Revenue to enforce the tax.
- 3.95 On the other hand, a DST is simpler than an income tax, and so would be easier to administer and comply with. The Government would also aim to make the DST as simple to comply with as possible. There would be real benefits here of aligning New Zealand's proposed DST with those adopted by other countries so that multinationals did not have an additional set of DST rules to comply with.
- 3.96 In terms of enforcement, this could be addressed in part by making any wholly owned group member of the multinational in New Zealand jointly and severally liable for the DST. In addition, we have found multinationals generally willing to comply with local laws (where they minimise tax, they do so by structuring their affairs to reduce the tax legally payable, rather than by ignoring our tax laws altogether). For example, there has been high compliance

with the recent GST on remote services, which applied to many non-residents with no physical presence in New Zealand.

Repeal of a digital services tax

3.97 The DST is intended to be an interim measure. Accordingly, the Government would repeal the DST if an international solution at the OECD was achieved. In terms of timing, the DST would be repealed when the international solution took effect for tax purposes, which could be four to five years after it is first agreed.

3.98 However, it may be the case that not all countries adopt the OECD's international solution. If this was the case, then the Government would consider retaining the DST for residents of those countries that have not adopted the international solution.

Questions for submitters

- What do you think of the proposed DST?
- To what extent do you expect it would be passed through to New Zealand consumers?
- Do you think it would comply with New Zealand's international obligations?
- What impact do you expect it would have on New Zealand's international relationships (particularly in light of other countries already moving in this direction)?
- Do you agree with the advantages and disadvantages set out above?
- How do you think it would affect New Zealand businesses and consumers?
- How would the proposal affect the development of the digital economy in New Zealand and globally?
- Do you agree with the scope of the proposed DST?
- How easy would it be to comply with?
- What technical and administrative issues do you see arising from the proposed DST?
- What other design features should it incorporate?
- Is there anything else we should consider?

CHAPTER 4

The OECD's measures

- 4.1 This chapter sets out the measures being considered at the OECD, so the public can understand them and submit their feedback.
- 4.2 The OECD measures at this stage are high level proposals that have not been developed in detail. Accordingly, there is still uncertainty as to how they would apply in practice.

Summary of OECD measures

- 4.3 There are two broad measures currently being considered at the OECD:
- **A measure to allocate greater taxing rights over a multinational's profits to market countries.** The measure would not require the multinational to have a physical presence in the country. There are three proposals being considered for this purpose (only one of which would be adopted):
 - A limited proposal for digital services only, focussing on social media, digital advertising, multi-sided platforms and data.
 - A broader proposal, which would allow greater taxing rights to market countries (such as New Zealand) based on certain marketing intangibles created there by multinationals. This would apply beyond the digital economy.
 - A proposal which provides for apportionment of a digital multinational's profit to market countries in which it has a significant economic presence. The apportionment would be based on an agreed formula and would depend on certain factors such as sales, assets and user participation.

It is possible that the OECD may adopt an option that incorporates elements of more than one of the three proposals, or an alternative proposal.

- **A minimum tax measure.** This proposal would apply beyond the digital economy and would ensure that multinationals pay a minimum level of tax on profits earned in low tax countries. This proposal addresses some remaining base erosion and profit shifting (BEPS) issues and is not specifically directed at the digital economy (although it would also apply to digital companies).
- 4.4 Most of the proposals are not specifically targeted at the digital economy. With the exception of the first profit allocation proposal, they all apply more broadly, which reflects the views of many countries that the problems with the international framework are not limited to the digital economy. Accordingly, while these proposals arose out of the OECD's work on the digital economy, they represent a wider reform of the international tax framework. For this

reason, the OECD's proposed measures have also been referred to as BEPS 2.0.

- 4.5 We describe these proposals in more detail in the next sections. The OECD's February 2019 consultation paper, *Addressing the tax challenges of the digitalisation of the economy*,²⁹ contains further explanation and details of the measures. Consultation closed on this paper in March 2019 with over 200 submissions received.

Measure 1 – Reallocation of taxing rights

- 4.6 This measure seeks to address the ability of multinationals to be significantly involved in the economic life of a country without being subject to income tax there. It involves fundamental changes to the existing nexus and profit allocation rules, in order to expand the taxing rights of market countries over such multinationals.

- 4.7 There are three proposals being discussed at the OECD for this measure, each supported by a different group of countries. The proposals have significant differences, including in their scope and rationale. However, they all have the same objective – to allow the taxation of value created in a market country that is not recognised under the current framework. Some of the proposals also share similarities, such as the use of a simplified residual profit split method to allocate profits in the user participation and marketing intangibles methods. Therefore, the proposals could be combined or more closely aligned by the OECD going forward.

Proposal 1 – User participation approach

- 4.8 This is the narrowest of the proposals. It considers that the main problem with the international tax framework is that it does not recognise the value generated in a country by the active participation of certain digital companies' users. This active user participation contributes to the value of the company's brand, the generation of valuable data and the establishment of a critical mass of users which increases the value of the company for other users. However, this value creation is not recognised under the current profit allocation rules, as those rules only consider the activities of the taxpayer (and not those of its customers) in determining where value is created.
- 4.9 Examples of valuable active user contribution include user generated data and user generated content – such as videos posted on YouTube and pictures posted on Instagram. In addition, some platforms derive much of their value from the size of the user base. That is, the more people that use the platform, the more useful and valuable it becomes. For example, a social media platform with a single user would be worth very little, while another social media platform, with identical functionality but with one billion users, would be very useful and valuable. This increase in value of the digital platform in proportion to the size of its user base is referred to as a network effect.

²⁹ Available at <http://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf>

- 4.10 The proposal would only apply to those types of business activities for whom user participation is a significant source of value. These are:
- social media platforms;
 - search engines; and
 - online market places.
- 4.11 Accordingly, the proposal would only apply to a narrow subset of digital companies.
- 4.12 The proposal would work by:
- deeming some of the profits from these in-scope business activities to be attributable to their users in a particular country; and
 - giving that country the right to tax those profits, regardless of whether the company had a permanent establishment or other physical presence there.
- 4.13 The user participation proposal considers that the value contributed to a company by its users is generated in the market countries where those users reside. Therefore, the market countries should be able to tax the company on the value generated by those users.
- 4.14 Mechanically, the proposal would involve these simplified steps:
1. The residual profit of the group from its in-scope business activities needs to be calculated. The residual profit is a transfer pricing term, and it refers to the profit of a company that remains after all of the routine activities of the company (or group) have been compensated on an arm's length basis. It can be thought of as the entrepreneurial profits of the company. The proposal acknowledges the existing challenges with determining residual profit under the current transfer pricing principles. Accordingly, the calculation of the residual profit under this proposal may require the use of simplified formulas.
 2. A portion of this residual profit would need to be attributed to active user participation. This allocation could be determined by looking closely at the relevant business and considering the value contributed by users in that particular case. Alternatively, it could be determined under simple pre-determined percentages, which could vary by the particular type of business.
 3. The residual profit attributable to users' participation would be allocated between the various countries where the users were located. This would be determined according to an agreed metric or metrics, such as the numbers of users in each country and the revenue derived by the multinational from the country.
 4. The countries would be given the right to tax those profits, regardless of the degree to which the multinational was physically present in that country.
- 4.15 The residual profit attributable to the market countries would be determined by treating a multinational as a single entity – that is, it would look through the separate legal identity of the various subsidiaries and try to allocate the

total profit of the entire group, rather than the profit of each separate company. However, mechanically the proposal would need to reallocate some of the residual profit currently earned by specific companies in the group to market countries (as the current income tax framework does not apply to groups on a consolidated basis). A tax credit would be given by the home country of the company earning those residual profits.

- 4.16 This proposal would not affect the allocation or taxation of the routine profit earned by members of the group. It would only affect the companies earning residual profits under the current transfer pricing rules.
- 4.17 The proposal could incorporate a range of additional restrictions based on the size of the business to further reduce the administrative burden for tax administrations and taxpayers.
- 4.18 Further information on the proposal and its background are set out in the OECD's public consultation paper, and in a United Kingdom position paper on corporate tax and the digital economy.³⁰

Example 2: User participation proposal

In this example a digital group (Sales Co, Digital Co and Marketing Co) are all outside New Zealand. They collectively earn \$5 billion of global profits. Principal Co operates the platform and retains the group's residual profit. Sales Co and Marketing Co carry out routine activities, the arm's length remuneration for which is \$500 million each. New Zealand has one percent of Principal Co's global users.

The process for determining the amount of income to be allocated to New Zealand in these circumstances would involve these mechanical steps:³¹

Step 1: Determine the global profit of the group on a consolidated basis. In this case the global profit of Sales Co, Principal Co and Marketing Co is \$5 billion.

Step 2: Determine the profit allocable to the routine activities of the group. In this case Sales Co and Marketing Co are allocated \$500 million of profit each to reward them for their routine activities.

Step 3: Determine the residual profit by subtracting the routine profit from the total profit. In this case \$5 billion total profit less \$1 billion routine profit equals \$4 billion residual profit.

Step 4: Determine the share of residual profits attributable to global user participation. In this case, the share is twenty five percent, meaning \$1 billion of residual profits need to be allocated to global user participation ($25\% \times \$4 \text{ billion} = \1 billion).

Step 5: Determine New Zealand's share of the residual profits allocated to global user participation. This is determined in accordance with the proportion of the group's global users that are in New Zealand. In this case one percent of the group's global users are in New Zealand, so \$10 million of profit is allocated to New Zealand (1% of \$1 billion).

Step 6: New Zealand taxes its share of the profit. New Zealand is given the right to tax its \$10 million share of the group's profits at New Zealand's standard corporate tax rate, regardless of whether Principal Co has a PE or other physical presence in New Zealand. Country B gives Principal Co a tax credit for the New Zealand tax paid.

³⁰ HM Treasury, *Corporate tax and the digital economy: position paper update*, March 2018 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/689240/corporate_tax_and_the_digital_economy_update_web.pdf

³¹ We have broken down some of the steps from paragraph 4.14 into multiple steps to make the example easier to follow.

Comments

- 4.19 The user participation proposal has some benefits. The notion that users create value for particular businesses is plausible. In allowing countries to tax this value, the proposal is consistent with a fundamental principle of the current international framework – aligning taxing rights with value creation.
- 4.20 The narrow scope of the proposal has advantages and disadvantages. On the one hand the proposal is narrowly targeted at those business types which create the most difficulties for the current tax framework. This narrow focus means most businesses would not be affected by the changes. In addition, we would expect the proposal to benefit New Zealand overall, given we import more highly digitalised services than we export.
- 4.21 However, the narrow scope of the proposal means that it does not fully address the wider tax challenges of digitalisation. It does not apply to the sale of goods or ordinary services over the internet for example, meaning non-residents could continue to supply goods to New Zealanders online without income tax being payable, while our own retailers are fully taxable on their profits.
- 4.22 The proposal also involves ring-fencing the digital economy, which the OECD recommended against. This is on the basis that, given increasing digitalisation, the digital economy is rapidly becoming the economy.³² Arguably therefore any solution to the tax challenges of digitalisation needs to apply more broadly. In addition, a tax measure targeted at a small part of the digital economy may be less fair or efficient than a broader proposal. This is because a narrow measure may disincentivise involvement in that part of the economy compared to the other parts, which may equally be able to benefit from the current problems with the international tax framework.
- 4.23 There is also the question of how other advancing technologies will affect the international tax framework in the future, such as artificial intelligence, robotics and 3D printing. A solution narrowly targeted at user participation does not seem capable of addressing the potential future challenges posed by these technologies.
- 4.24 There are also technical issues with the proposal that would need to be addressed (as with all the proposals). Even determining the profit of a multinational is not straightforward, given the different countries in which it operates. Determining both the residual profit and the allocation of that residual profit to user participation is also inherently complex and subjective. If transfer pricing type principles were used, then the proposal would be difficult to administer (particularly for developing countries) and subject to dispute. For this reason, we consider that the proposal may need to use fairly simple formulas. However, these formulas would necessarily be inaccurate to some degree, as they would not reflect the particular circumstances of individual businesses.

³² This was also the conclusion of the Australian and New Zealand Productivity Commissions, as discussed in chapter 2.

Questions for submitters

- What do you think of this proposal?
- Is it too narrowly targeted?
- Is user value creation an appropriate basis on which to allocate profit to a country?
- How do you think it would affect New Zealand businesses and consumers?
- What kind of *de minimis* thresholds and restrictions do you think should apply to the proposal?
- What do you think of the method for determining and allocating income?
- Would simpler formulas to calculate this be better?
- What kind of technical issues do you see arising if the proposal was implemented?
- How would the proposal affect the development of the digital economy in New Zealand and globally?
- What kinds of additional details would you like to see included in further development?

Proposal 2 – Marketing intangibles

- 4.25 This proposal has some similarities to the user participation approach, but it would not be limited to a subset of highly digitalised businesses.
- 4.26 The supporters of this proposal view the main challenges to the international tax framework as being scale without mass, and the importance of mobile intangibles. While these features are exacerbated by digitalisation, they are not limited to the digital economy.
- 4.27 These features mean that a multinational can essentially reach into a country, either remotely or through a limited presence, and develop a customer base and other marketing intangibles. These marketing intangibles represent a significant source of value creation in the market country, but this value is not currently taxable in the market country.
- 4.28 For example, a well-known online retailer with no physical presence in a country can develop a large customer base in that country and know more about those customers' shopping preferences than the local bookshop. The same is true for many branded consumer goods companies that can directly and digitally engage with their customers. Whereas previously a company would need a local presence to develop a market, high value sales and marketing activities can now be carried out online, from another country.
- 4.29 To address this issue, the proposal would change the international tax framework to require marketing intangibles and their corresponding risks to be allocated to the market country. This allocation would occur independently of the current transfer pricing rules, and so it would not depend on the current transfer pricing factors used to allocate income from intangibles. The market country would also be given the right to tax the allocated income, regardless of whether the multinational had a physical presence there. The market country would also be able to tax the profit allocated under the proposal if the

multinational had a subsidiary in the country carrying out only low value activities (for example, a limited risk distributor).

- 4.30 The proposal would directly not tax marketing intangibles themselves (or their transfer). Instead it would require a portion of the multinationals profit to be apportioned to the market country by reference to the value of the marketing intangibles located there.
- 4.31 The marketing intangibles covered by this proposal would include intangibles that relate to marketing activities in the country, or which aid in the commercial exploitation of a product or service or have an important promotional value (such as brands and trade names used in a country, customer data, customer relationships and customer lists).
- 4.32 The proposal would treat these kinds of intangibles as linked to the market country. This is because the positive attitudes in the mind of its customers are created by, and the customer information and data are acquired through, the active intervention of the multinational in the market. Accordingly, the proposal is presented as being consistent with the existing principle of aligning taxing rights with value creation.
- 4.33 In this regard, the proposal differentiates marketing intangibles from favourable demand conditions in the market country that exist independently of the actions of the multinational.³³ Marketing intangibles are also differentiated from trade intangibles, such as patents and other technology related intangibles generated by research and development. This is because trade intangibles are not seen as having an intrinsic link with market countries.
- 4.34 This proposal is expected to apply to highly digitalised businesses, given their reliance on marketing intangibles. In this context, marketing intangibles could include those generated by free search services, free email, free data storage and the like. Accordingly, the marketing intangible proposal could produce a similar result in practice for highly digitalised firms as the user participation proposal.
- 4.35 However, the proposal would also apply to non-digital companies with significant marketing intangibles in a country, unlike the user participation proposal. For example, it could apply to a fast-moving consumer goods company whose ability to set prices and shift products is significantly dependant on its brand value and consumer regard.

Mechanics

- 4.36 The mechanics of the proposal have not been developed in any detail. In general however, this proposal would function similarly to the user participation proposal, in that it would ignore existing transfer pricing rules and involve a simplified residual profit split. The proposal would likely involve these simplified steps:

³³ There are some countries that think such demand conditions should entitle the market country to taxing rights. An important subtext of the marketing intangibles approach is that it seeks to expand a market country's taxing rights, without supporting the right of countries to tax a multinational simply by virtue of providing the market for its products.

1. The residual profit of the multinational group would be determined by deducting the profit attributable to the group's routine activities from its total profits (as with the user participation proposal).
 2. Part of that profit would then be allocated to marketing intangibles. This allocation would not include any profit attributable to trade intangibles. This allocation could be done under traditional transfer pricing principles, or it could be based on a simplified residual profit split method, which would use mechanical approximations.
 3. The profit allocated to marketing intangibles would be allocated between the various markets countries in which the multinational operates. This would be based on agreed metrics, such as sales or revenues. This would occur regardless of which entity in the multinational group held legal title to the marketing intangibles, regardless of which entity carried out the functions related to those intangibles, and regardless of how the current transfer pricing rules would ordinarily allocate the income from the intangibles.
 4. The market countries would be given the right to tax their share of those profits, regardless of the degree to which the multinational was physically present in that country.
- 4.37 Double tax is intended to be prevented (or at least minimised) by means of a tax credit granted by the countries where the residual profit was returned under standard transfer pricing principles.
- 4.38 The OECD consultation paper acknowledges that the scope of this proposal would need to be subject to some restrictions and limitations. The idea is that the proposal should only apply to businesses where the contribution of marketing intangibles to profits is substantial. These limits could include materiality thresholds (for example, cost ratios, size of customer base), *de minimis* exclusions, exclusion of certain industry sectors, exclusion of commodities, and so on. However, there is no detail on any of these yet.

Example 3: Marketing intangibles proposal

This example indicates how the proposal could work if it used simple formulas. The particular formulas are indicative only.

SM Group is a multinational which operates a social media platform with users around the world. The group provides free access to the platform and raises revenue by selling advertising on it. The head office in Country A developed and owns all of the platform's technology.

According to its financial statements, SM Group has \$27 billion of consolidated group revenue for the year, \$15 billion in expenses and \$12 billion in total profits. The Group's expenses comprise \$4 billion in cost of goods sold, \$4 billion marketing and sales costs, \$6 billion research and development costs, and \$1 billion in overheads and administration.

The SM Group generates ten percent of its revenue from Country B. It has a subsidiary in Country B which provides marketing services and sales support. All of SM Group's residual profit is returned in Country A under the current transfer pricing rules.

The application of the marketing intangibles proposal would involve these mechanical steps:³⁴

Step 1: Determine the total amount of SM Group's profit. The SM Group's financial statements would be used for this purpose. These show a total profit of \$12 billion.

Step 2: Determine the profit attributable to routine activities (that is, the routine return): The routine return is assumed to be ten percent of all expenses, other than cost of goods sold. This means the routine return is calculated as \$11 billion expenses (excluding cost of goods sold) \times 10% = \$1.1 billion.

Step 3: Determine the residual profit, by subtracting the routine return from total profits. The total profits are \$12 billion and the routine return is \$1.1 billion. This means SM Group's residual profit is \$10.9 billion.

Step 4: Determine the proportion of residual profit attributable to marketing intangibles. A formula is used to do this. The formula divides the residual profit between the marketing intangibles and the trade intangibles. It does this by comparing the costs incurred by SM Group for each type of intangible – that is, it compares SM Group's marketing and sales (M&S) costs with its research and development (R&D) costs. In addition, the formula assumes that expenditure on R&D contributes twice as much value as expenditure on M&S for social media groups like SM Group. Based on this, the residual profit allocated to marketing intangibles is calculated as follows:

$$\begin{aligned} & \frac{\$4 \text{ billion M\&S cost}}{\$4 \text{ billion M\&S cost} + (2 \times \$6 \text{ billion R\&D cost})} \times \$10.9 \text{ billion residual profit} \\ &= 0.25 \times \$10.9 \text{ billion} \\ &= \$2.725 \text{ billion residual profit allocated to marketing intangibles} \end{aligned}$$

Step 5: Allocate the marketing intangibles profit to market countries. SM Group's marketing intangibles profit is allocated between its market countries in proportion to SM Group's revenue from each country. Country B contributes ten percent of SM Group's total revenue, so Country B will be allocated ten percent of SM Group's marketing intangibles profit. This means that country B will be allocated $10\% \times \$2.725 \text{ billion} = \$272.5 \text{ million profit}$.

Step 6: Market countries tax the profit allocated to them. Country B will tax SM Group on \$272.5 million at its ordinary corporate tax rate, regardless of whether SM Group has a physical presence in Country B. Country A will give SM Group a credit for this tax.

³⁴ We have broken down some of the steps in paragraph 4.36 into multiple steps to make the example easier to follow.

Comments

- 4.39 The proposal has the advantage of addressing the problems posed by scale without mass and reliance on intangibles, without trying to ring-fence the digital economy. Its broader scope means that it could be a solution to the wider tax problems proposed by digitalisation.
- 4.40 On the other hand, the proposal's expanded scope means that it would apply to a much wider group of companies, and therefore the impact of any compliance costs or technical problems would also be magnified. For this reason, the proposal should arguably include strong limitations and exclusions to ensure it is targeted at large companies that derive significant value from their intangibles. However, these limitations and exclusions have not been developed yet.
- 4.41 One issue is that it is still unclear how the proposal would apply to highly digitalised (and non-digitalised) companies in practice. These would also need to be appropriately taxed by the proposal in practice for it to be an effective solution.
- 4.42 This proposal would also affect more New Zealand companies than the user participation model. The Government would be concerned if the proposal had a serious adverse effect on our export sector. This possibility of this adverse impact is a real downside of the proposal (in its current form) from a New Zealand welfare perspective. Another concern is the potential increase in compliance and administration from the proposal (although this is something the OECD will try to mitigate in its design of the proposal). The Government is currently doing some work to ascertain the likely economic impact of the proposal on New Zealand, including our export sector. However, we will need to wait until the proposal is more detailed before we can come to any firm conclusions about this.

Questions for submitters

- What do you think of this proposal?
- Is it too broadly targeted?
- Are marketing intangibles an appropriate basis on which to allocate profit to a country?
- Do you think marketing intangibles are sufficiently linked to a country to permit local profit allocation?
- How do you think it would affect New Zealand businesses and consumers?
- How would it affect New Zealand's export sector?
- What kind of *de minimis* thresholds and restrictions do you think should apply to the proposal?
- What do you think of the method for determining and allocating profits?
- Would simpler formulas to calculate this be better?
- What kind of technical issues do you see arising if the proposal was implemented?

- How would the proposal affect the development of the digital economy in New Zealand and globally?
- What kinds of additional details would you like to see included in further development?
- Should the proposal be combined with the user participation proposal, and if so, how?

Proposal 3 – Significant economic presence

- 4.43 The final proposal was submitted more recently by the OECD. For this reason, it has less detail.
- 4.44 The rationale for this proposal is that the digitalisation of the economy and other technological advances have enabled business enterprises to be heavily involved in the economic life of a country without needing a significant physical presence. This has rendered the existing nexus and profit allocation rules ineffective.
- 4.45 The proposal would apply to any multinational that developed a significant economic presence in a country through technology or other automated means. This means the proposal would apply to the digital economy in the broadest sense of the word – but it would not apply beyond the digital economy. Accordingly, the proposal is broader than the user participation proposal, but narrower (in principle) than the marketing intangibles proposal.
- 4.46 Whether a multinational had a significant economic presence would depend on a variety of factors. At a minimum, the multinational would need to generate revenue from a country on a sustained basis. One or more digital factors would then also need to be present. The other factors could include things like the existence of a user base, a minimum volume of digital content, billing in the local currency, a website in the local language, the presence of delivery or support services in the country, marketing activity, and so on.
- 4.47 Once a significant economic presence was established, profit would be allocated to that presence using a fractional apportionment method. This method involves four simplified steps:
1. The definition of the tax base to be divided. For example, the tax base could be determined by using the total group profits for accounting purposes.
 2. The determination of the allocation factors for dividing that tax base between countries. These factors could include sales, assets, employees and users (where relevant).
 3. The weighting of these allocation factors – that is, the factors could all be treated as equally important, or some factors may be given a higher weighting than others.
 4. The allocation of the tax base between the market countries, using the weighted allocation factors.

Example 4: Significant economic presence proposal

This example illustrates general fractional apportionment methods. The actual method used under this proposal will likely differ in some details.

Ship Group operates an online platform selling various goods around the world. Customers order goods on Ship Group's website or app. The goods are then shipped by Ship Group from the nearest regional warehouse to the customer. Ship Group is headquartered in Country A, which is also where all of its R&D is carried out. Ship Group's residual profit under existing transfer pricing rules is returned in Country A (50%) and Country Z (50%).

Ship Group's consolidated financial statements show that it has total worldwide assets of \$30 billion, total worldwide employees of 15,000, total revenue of \$20 billion and total profits of \$12 billion.

Ship Group has no assets or employees in Country B. Ship Group derives \$500 million of revenue from Country B.

The amount of Ship Group's profit allocated to Country B is determined through these mechanical steps:

Step 1: Determine Ship Group's tax base. In this case Ship Group's tax base is its consolidated group profits for accounting purposes, which is \$12 billion.

Step 2: Determine the allocation factors. In this case, the allocation factors, which will be used to divide Ship Group's profit between its market countries, are assets, employees and sales.

Step 3: Weigh the allocation factors. Each factor has an equal weighting.

Step 4: Allocate Country A a share of Ship Group's tax base using the allocation factors. The OECD consultation paper does not discuss this step. However, it could involve dividing Ship Group's tax base between the allocation factors, and then further dividing its tax base between countries by reference to each allocation factor. This could be calculated as follows:

- Divide Ship Group's tax base between the allocation factors. Ship Group's tax base is its \$12 billion profit, and the three allocation factors have equal weighting, meaning that each factor is allocated \$4 billion of Ship Group's profit.
- Allocate the profit attributable to each factor to Country B. This would be done by reference to Country B's share of each allocation factor, that is, its share of Ship Group's total assets, employees and revenues. This would be calculated as follows:
 - Ship Group does not have any assets or employees in Country B, so Country B is not allocated any of the \$8 billion (in total) of Ship Group's tax base that is allocated to these factors.
 - For the \$4 billion allocated to revenue, Country B's share would be:

$$\frac{\$0.5 \text{ billion revenue from Country B} \times \$4 \text{ billion}}{\$20 \text{ billion total revenue}}$$

$$= 0.025 \times \$4 \text{ billion}$$

$$= \$100 \text{ million}$$

- Add Country B's share of the tax base allocated to each of the three factors together – so \$0 million (assets) + \$0 million (employees) + \$100 million (revenue) = \$100 million.

Country B would tax Ship Group on \$100 million at Country B's ordinary corporate rate, regardless of whether Ship Group had a physical presence in Country B. Country A would give Ship Group a foreign tax credit for fifty percent of the tax payable in Country B and Country Z would give Ship Group a foreign tax credit for the remaining fifty percent.

4.48 This proposal may also involve consideration of other simplified methods for allocating profit, such as the deemed profits measures. Deemed profit measures deem certain types of business to have a predetermined profit margin. The taxpayer's gross turnover is then multiplied by this profit margin,

to give its net taxable income. For example, if a profit margin of ten percent was deemed for an industry and a non-resident made \$10 million of revenue from that industry type in Country A, then the non-resident would have net taxable income in Country A of \$10 million \times 10% = \$1 million.³⁵

- 4.49 Finally, withholding taxes could be used under the proposal as a collection mechanism and enforcement tool. One possibility would be to have a gross withholding tax at a low rate, with the multinational able to elect to file a tax return and claim a refund for any excess tax withheld.

Comments

- 4.50 This proposal would apply to the digital economy in the broadest sense of the word, so it would be a comprehensive solution to the problems posed by digitalisation (unlike the user participation approach). On the other hand, it also involves ring-fencing the digital economy, which would be contrary to the views of the OECD and the New Zealand and Australian Productivity Commissions.
- 4.51 The proposal also involves the most radical departure from the current profit allocation rules. A fractional apportionment method would not allocate taxing rights strictly on the basis of value creation. Instead it would move closer to a destination-based tax, where countries are entitled to tax the profits of a company based on the amount of goods sold there.
- 4.52 In this regard, consumption in a country is already taxed by goods and services taxes. Income tax on the other hand has traditionally taxed the factors of production (that is, the assets and activities of the taxpayer which produce, sell and deliver the goods or services). This implies that income taxing rights should be allocated by reference to where the factors of production are located, rather than where consumption occurs.
- 4.53 On the other hand, the inclusion of other allocation factors, such as employees or assets would offset this destination bias to some degree (although these other factors also give rise to avoidance opportunities, which suggests they may need to be given a lower weighting).³⁶
- 4.54 Further, it could be argued that the country providing the market is making a real contribution to the value of the multinationals which sell their goods there. This is on the basis that both supply and demand are required for a company to ultimately create value, and therefore both supply side and demand side locations should be allocated part of a multinational's profits.
- 4.55 In addition, in selling into a market, a multinational is benefiting from the public infrastructure and legal system which effectively creates and supports that market. Supporters of the proposal argue that the Government that provides this infrastructure should therefore have the right to tax some of the profit of the multinationals that benefit from it.

³⁵ New Zealand currently uses the deemed profit method to tax non-resident general insurers, who are deemed to derive income equal to ten percent of their New Zealand sourced premiums (section CR 3 of the Income Tax Act 2007).

³⁶ For a discussion of the issues with these apportionment factors, and with formulary apportionment methods in general, see J Andrus and P Oosterhuis, *Transfer Pricing After BEPS: Where Are We and Where Should We Be Going*, Taxes: The Tax Magazine, March 2017.

- 4.56 In addition, this method would be much simpler to administer than the current rules. It would also largely remove the current strategies multinationals can use to avoid tax (although care would need to be taken that new avoidance opportunities were not created).
- 4.57 The proposal would in principle affect most New Zealand businesses that export goods or services online (although we would expect the proposal to provide an exemption for smaller businesses as it is developed). It would also allow New Zealand to tax most multinationals that sell goods or services to New Zealanders online.
- 4.58 One concern is that the more radical nature of the proposal may prevent it from gaining sufficient support from other countries. However, the proposal would have a better chance of acceptance if it was supported by businesses.

Questions for submitters

- What do you think of the proposal?
- Is it too wide?
- Are the proposed allocation factors of sales, assets, users and employees sufficient?
- How would it affect New Zealand consumers and businesses?
- Would it be beneficial or harmful to New Zealand?
- What technical issues can you see arising from it?
- What further details (such as *de minimis* thresholds) would you like to see if the proposal was developed?

Other proposals

- 4.59 The OECD may also consider other proposals for reallocating profit. For example, the pharmaceutical and healthcare company Johnson & Johnson submitted an alternative proposal at the recent OECD public consultation on 13 and 14 March 2019. This provided for a fixed benchmark return to market countries (for example, 3% of sales), which could be increased or decreased depending on certain factors such as overall group profitability and marketing expense.
- 4.60 Participants were impressed by this alternative method, including businesses and the OECD Secretariat. Given the enthusiasm expressed for this approach there is a chance this method will also be considered by the OECD, alongside the existing three proposals. Johnson & Johnson's proposal is available online along with all of the other OECD public submissions.³⁷

³⁷ Available at <https://www.dropbox.com/s/hou6dvuckmahoft/OECD-Comments-Received-Digital-March-2019.zip?dl=0>

Measure 2 – Minimum tax measure

- 4.61 The other measure being discussed at the OECD would ensure that multinationals pay a minimum amount of tax on their profits from low tax countries. This measure could be adopted in addition to one of the three proposals for measure 1 discussed previously. This measure could apply much wider than digitalised multinationals.
- 4.62 The rationale for the measure is that, while the OECD’s BEPS measures closed many of the gaps in the international tax framework, they did not provide a comprehensive solution to the problem of shifting profits into low tax countries. In particular:
- BEPS Actions 8–10 (Aligning Transfer Pricing Outcomes with Value Creation) sought to align taxing rights with value creation, and so prevent the use of artificial structures to shift profit. While this prevented the use of aggressive tax avoidance structures, it is still possible to shift profits to low tax countries, provided a minimum level of economic activity is carried out there.
 - BEPS Action 2 (Neutralising the Effects of Hybrid Mismatch Arrangements) sought to prevent multinationals from exploiting differences in countries’ domestic tax regimes to generate double deductions or avoid paying tax. While these rules are effective against hybrid arrangements between two normal tax countries, it is still possible to generate the same overall result by inserting a low tax jurisdiction between the two countries.³⁸
- 4.63 These issues are particularly acute for intangibles, which are prevalent in the digital economy, but they also apply in a broader context. For example, a group finance company can be located in a low tax country. This finance company could then generate un-taxed profits from providing internal loans to other group members. Those loans would in turn reduce the tax payable by the other group members in their home countries (though a deduction for the interest payments).
- 4.64 Furthermore, the current system facilitates a race to the bottom, where countries lower their corporate tax rates in order to be more attractive to foreign investors than other countries. This risks shifting the taxes needed to fund public goods onto less mobile sources, such as labour and consumption.
- 4.65 For these reasons, while the minimum tax measure would be effective in addressing the profit shifting strategies which digital companies are ideally placed to use, the measure would not be limited to the digital economy.
- 4.66 The measure comprises two rules:
- **An income inclusion rule.** This would allow a country to tax its residents on income earned by their foreign branches or subsidiaries if insufficient foreign tax was paid on that income.

³⁸ Although the anti-avoidance rules of some countries may prevent this in some cases.

- **A base eroding payments rule.** This would deny a deduction and/or treaty benefits for certain payments to foreign companies if the payment was not subject to a minimum effective rate of foreign tax.

Income inclusion rule

- 4.67 This would apply to a resident taxpayer with a direct or indirect interest in a foreign company over a specified percentage (for example, twenty five percent). It would require the taxpayer to return its share of the net income of the foreign company or branch if that net income was not subject to a minimum rate of tax. For example, if the taxpayer held fifty percent of a foreign company with net income taxed at below the minimum rate, the taxpayer would return fifty percent of the foreign company's net income.
- 4.68 The minimum tax would be a single, fixed rate that would apply across all countries (and would be lower than most countries' domestic tax rates). If a multinational's effective tax rate was below the minimum rate, then it would pay top up tax to that minimum rate (and not its domestic rate). For example, suppose a company was attributed with \$100,000 of income under the rule, on which \$5,000 (5%) of foreign tax was paid. The company's domestic tax rate was 20% and the minimum effective tax rate under the rule was 10%. In this case, as the \$100,000 of income was taxed at 5%, the company would need to pay additional top up tax of \$5,000 under the rule, which would bring its total tax payable up to the 10% minimum rate. The company would not need to pay a further \$10,000 to bring its tax up to its 20% domestic rate.
- 4.69 The amount of net income used to calculate a group's effective tax rate would in principle be calculated under the parent company's controlled foreign company rules or their domestic tax rules and would include a credit for any tax paid in the foreign country. However, to simplify the rules the OECD will also consider using a group's financial accounts to calculate its net income.
- 4.70 For taxpayers with a foreign branch, the rule would achieve the same effect as for a taxpayer with a wholly owned foreign subsidiary. The rule would make the branch net income taxable in the taxpayer's home country, with a credit for the foreign tax paid in the country where the branch is located.
- 4.71 There is little detail available yet about the rule, and a number of design features still need to be considered, including the minimum effective tax rate that would apply. Further important details are:
- How the effective tax rate paid on the income in the foreign country would be calculated – for example, how would loss offsets (if any) be taken into account?
 - Whether the minimum tax rate should be calculated on a global basis (which would allow the blending of tax rates paid in low-tax and high-tax countries in calculating the multinational's global effective tax rate), a country basis (so it would allow the tax rates of different group members in a country to be blended to calculate the effective tax rate paid by the multinational in that country) or a single entity basis?
 - The scope of the rule – the rule could be limited to only certain kinds of entities and payments.

- The role of economic substance in applying the test. While the OECD paper states it would apply regardless of economic substance, this proposition has not been agreed yet and several countries have already signalled their opposition to it.
- Safe harbours and *de minimis* thresholds.

4.72 The minimum tax measure is similar to the current United States global intangible low taxed income (GILTI) rule, and the measure will likely draw on elements of the GILTI rule as it is developed further.

4.73 The GILTI was enacted by the United States in its recent Tax Cuts and Jobs Act (December 2017). The GILTI taxes United States shareholders on the income of their foreign companies to the extent that income exceeds a certain threshold (ten percent of the value of the company's tangible assets). The United States shareholder pays tax on this excess income at the rate of 10.5%, which is half the United States 21% corporate tax rate. Tax credits are allowed for eighty percent of the foreign tax paid, meaning the GILTI applies where a United States multinational pays tax of less than 13.125% on its overseas profits.

Example 5: The income inclusion rule

This example is indicative of how the income inclusion rule could work. It assumes some important details, such as a minimum effective tax rate of 12.5%, and that any income attributed under the rule will be taxed at the shareholder's ordinary corporate tax rate.

Shareholder is resident in New Zealand. Shareholder owns fifty percent of ForeignCo, which is resident in Country B. ForeignCo earns \$200 million of income, which it only pays a 1% effective tax rate on in Country B.

This 1% tax rate is below the income inclusion rule's 12.5% minimum effective tax rate. Therefore, Shareholder is attributed with its share of ForeignCo's income. Since Shareholder owns fifty percent of ForeignCo, Shareholder is attributed with fifty percent of ForeignCo's \$200 million income, or \$100 million. Shareholder then returns this \$100 million of income in New Zealand and pays tax on it at 28% (New Zealand's ordinary corporate rate). Shareholder can claim a foreign tax credit in New Zealand for the 1% tax paid by Foreign Co in country B.

Base eroding payments rule

4.74 The rule would apply to a broad range of payments. This rule would deny a deduction for payments to a related party (for example, twenty five percent common ownership) unless the payment was subject to a minimum level of tax. Tax for this purpose would include both tax paid in the related party's country and also any withholding tax paid in the resident's home country.

4.75 The rule could alternately deny treaty benefits to payments unless the payment was subject to a minimum tax rate. For example, the rule could deny the benefit of Article 7 of a DTA, which prevents a country from taxing the business profits of a non-resident except to the extent they are attributable to a permanent establishment in the country. This would mean that, if a payment from one country was not subject to a minimum effective rate of tax in the other country, the first country would still be able to tax the payment even if it was not attributable to a permanent establishment.

- 4.76 Again, there is little detail available yet about this rule, and similar design issues arise as for the income inclusion rule. In addition, the rule would need to be modified in its application to dividends, to ensure that these were not double taxed. There would also need to be ordering rules to stop the base eroding payments rule and the income inclusion rule from both applying to the same income.

Example 6: Base eroding payments rule

This example indicates how the base eroding payments rule could work. It assumes some important details, such as a minimum effective tax rate of 12.5%.

SubCo is resident in New Zealand. SubCo makes a \$100 million interest payment to its parent, ParentCo. ParentCo is resident in Country B, and pays no tax on the interest payment in Country B. New Zealand charges withholding tax of 15% under its domestic law, but this is limited to withholding tax of 5% under the DTA between New Zealand and Country B.

Total tax is payable at the rate of 5% on SubCo's interest payment to ParentCo (5% withholding tax charged in New Zealand + 0% income tax charged in Country B). This is lower than the rule's 12.5% minimum effective tax rate, so New Zealand denies SubCo a deduction for its interest payment to ParentCo.³⁹

Comments

- 4.77 A minimum tax measure seems to be a promising solution to the problem of tax avoidance by multinationals. It would significantly reduce the ability and incentive for multinationals to engage in global tax avoidance. A multinational will have less incentive to avoid local taxes if it must pay a minimum level of tax on those profits elsewhere. It would also remove the competitive benefits of countries lowering their tax rates (or providing preferential tax regimes), as tax forgone by a multinational in one country would still be payable in another.
- 4.78 Global minimum taxes have also been supported by some economists, such as Joseph Stiglitz,⁴⁰ as a way of solving the current problems with global tax avoidance. The United States' adoption of a minimum tax with its GILTI is also a significant endorsement.
- 4.79 The effectiveness of the OECD's measure would depend on several factors, most importantly the rate at which it was set. There are also several technical issues that would also need to be addressed, not least of which is how to determine the effective foreign tax rate.
- 4.80 There is also a question of compliance and administrative costs. The OECD's minimum tax would need to be significantly easier to administer than the United States GILTI for example, particularly if it is to be applied by developing countries.

³⁹ It is not clear at this stage whether the base eroding payment rule would deny both a deduction and DTA benefits to the same payment – however it seems unlikely they would do both where the result of denying DTA benefits was to tax the payment at above the minimum effective tax rate.

⁴⁰ For example, see <https://www.project-syndicate.org/commentary/corporate-tax-avoidance-end-transfer-pricing-by-joseph-e-stiglitz-2019-02>

- 4.81 Therefore, while the OECD's proposed minimum tax has potential, it needs to be developed in more detail.

Questions for submitters

- What do you think of the proposed minimum tax rate?
- What should be the minimum effective tax rate?
- Should application of the rules be subject to some kind of substance or avoidance test?
- Should the rules be limited to certain kinds of payments (for example, interest) or entities?
- How do you think the rules would affect New Zealand businesses and consumers?
- What details and design features would you like to see included in the rules going forward?

Likelihood and timing of an OECD solution

- 4.82 The Government is hopeful that there will be an OECD solution in a reasonable timeframe, but this will be challenging. While countries have agreed to reach a consensus solution by 2020, they still disagree on what should be done. The OECD is making progress on developing a potential solution, but this is currently being done on a without prejudice basis. This means that countries are not committing to ultimately support the technical solutions being developed. On the other hand, the increasing adoption of unilateral measures is making a strong case for a multilateral solution, while incentivising countries that benefit from the current framework to agree to changes.
- 4.83 The OECD is aiming to get G20 approval of its preferred measures in June 2019. If approval is given, then an OECD solution is more likely. On the other hand, failure to receive G20 approval would be a serious, perhaps fatal blow to an OECD solution (in a reasonable timeframe at least). Therefore, we should have a better idea of the chances of an OECD solution after the June G20 meeting.
- 4.84 If an OECD solution was achieved in 2020, it may be at a fairly high level and require further development. In addition, any agreed solution would still need to be implemented. This would require changes to DTAs, with a multilateral instrument needing to be agreed and drafted for countries to sign.
- 4.85 If we look at what happened previously in the BEPS project, the OECD made its final recommendations in October 2015, and the DTA related BEPS changes have just started coming into effect from 2019 (with the changes for many DTAs not applying until 2020).
- 4.86 Based on this, we consider that any OECD solution for the digital economy would not take effect for another three to five years after that solution was agreed. This means that if a solution is reached at the OECD in 2020, it may not be effective until 2025.

Revenue impacts of the OECD measures

- 4.87 It is not possible to estimate the revenue impact of the OECD proposals. This is because they lack critical details, such as their precise scope and *de minimis* thresholds.
- 4.88 The revenue impact is only one factor that the Government will consider it evaluating the proposals. Other important factors include the effect of the proposals on compliance costs, and their impact on New Zealand's economic efficiency and wellbeing.

CHAPTER 5

Conclusion

- 5.1 The Government supports an OECD led international solution to the problems of taxing the digital economy. This would integrate the taxation of the digital economy into the income tax system, and so avoid the need for a separate DST with all its related issues. An international solution would also allow any income tax payable in New Zealand to be credited overseas, thus avoiding double taxation. Finally, it would provide a common international basis for the taxation of the digital economy, rather than a patchwork of separate taxes.
- 5.2 Therefore, the Government proposes continuing to participate in the OECD discussions with a view to supporting an international solution (bearing in mind its effect on our export sector).
- 5.3 However, the Government will seriously consider adopting a DST if the OECD cannot make sufficient progress this year. Factors to be considered in making this decision are:
- whether the OECD can make sufficient progress on an international solution this year;
 - whether a critical mass of other countries also adopts DSTs (to reduce the reputational risks of adopting a DST);
 - whether New Zealand companies would be unduly affected by a DST; and
 - whether a DST would all be passed on to New Zealand consumers.

Next steps and timing

- 5.4 The Government will use the feedback received on this discussion document to make its final policy decisions. At this stage, we anticipate a decision on the adoption of a DST in the second half of 2019.
- 5.5 If the Government does decide to adopt a DST, then its introduction would go through the generic tax policy process. This means the public would have a further opportunity to submit on the design of the DST (either at the Select Committee stage, or earlier). The legislation for any DST would probably be introduced in 2020.

Question for submitters

- Do you agree with the Government's assessment of the best ways to address the current problems with taxing the digital economy?

APPENDIX 1

Size and importance of the digital economy

This appendix sets out background information on what the digital economy is, along with its importance and size in New Zealand and globally.

What is the digital economy?

The digital economy is a term used to refer to economic activity that relies significantly on information and communication technology. The term does not refer to the provision of the information and communications infrastructure itself, but to the economic activities carried on over the top of that infrastructure (and so is sometimes referred to as over the top activities). The term broadly encompasses e-commerce, including the sale of both digital and physical products and services over the internet or via apps, online advertising, social networks, and intermediation platforms (such as Airbnb and Uber).

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. Following this, some of the analysis and potential solutions have focussed on highly digitalised business models. These business models are typified by the factors that create the most problems for the current international tax framework:

- cross jurisdictional scale without mass;
- heavy reliance on intangible assets; and
- the importance of data and active user participation to value creation.

A DST would only apply to these kinds of business models. However, the OECD is considering proposals that would apply more broadly, including beyond the digital economy altogether.

The importance of the digital economy in New Zealand

The digital economy provides many benefits to New Zealanders. The Ministry of Business, Innovation and Employment (MBIE) estimates that people who shop and bank online can save nearly \$1,000 each year. MBIE's initial calculations suggest achieving universal digital inclusion in New Zealand could deliver economic benefits of over \$1 billion a year.⁴¹

The digital economy also increases the productivity of New Zealand businesses. New Zealand businesses with high intensity information and communications technology use are six percent more likely to improve productivity.⁴² Nearly a third of overall industrial output growth in Europe is attributable to the uptake of digital technologies.⁴³

⁴¹ See the report *Digital New Zealanders: The Pulse of our Nation*, Digital inclusion research group, 2017.

⁴² See MBIE's report *Information and Communications Technology*, 2017.

⁴³ See the European Commission's Impact Assessment on a DST – SWD(2018) 81 final, page 10, https://ec.europa.eu/taxation_customs/sites/taxation/files/fair_taxation_digital_economy_ia_21032018.pdf

Recently the Australian and New Zealand Productivity Commissions issued a report on the digital economy.⁴⁴ The report notes that digital technologies have transformed many aspects of daily life, bringing benefits to consumers (more choice, lower prices, better information and greater convenience) and disrupting a number of industries and business models. In fact, given the ubiquitous nature of digital in everyday life, the report notes that there is little to differentiate the digital economy from the broader economy; in other words, the digital economy is the economy. However, digital innovation is putting many regulatory regimes under pressure – including tax.

The report broadly recommends that the Australian and New Zealand Governments create an environment that can enable the growth of the digital economy by:

- designing regulatory regimes to enable innovation while controlling harms;
- using data and digital technologies to improve the efficiency and effectiveness of government services to firms; and
- working together to develop and promote regional and global standards that enable greater use and diffusion of digital technologies.

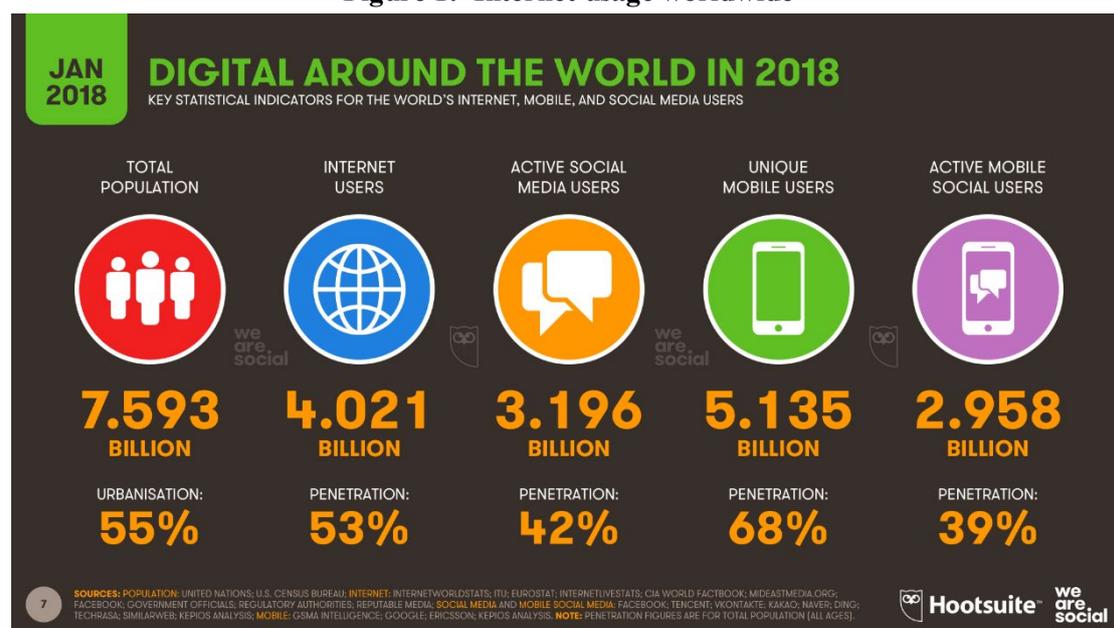
The Government is committed to developing the digital economy in New Zealand and ensuring access to it for all New Zealanders. The Government’s cross-agency Digital Economy Work Programme aims to support all New Zealanders to fully participate in the fast moving digital economy. However, it is also important that the digital economy is fairly taxed.

The size of the digital economy

Internet usage

Internet usage worldwide is becoming increasingly ubiquitous, as figure 1 from Hootsuite and we are social shows.⁴⁵

Figure 1: Internet usage worldwide



⁴⁴ Australian Productivity Commission and New Zealand Productivity Commission, *Growing the digital economy in Australia and New Zealand. Maximising opportunities for SMEs*, 2019.

⁴⁵ <https://wearesocial.com/blog/2018/01/global-digital-report-2018>

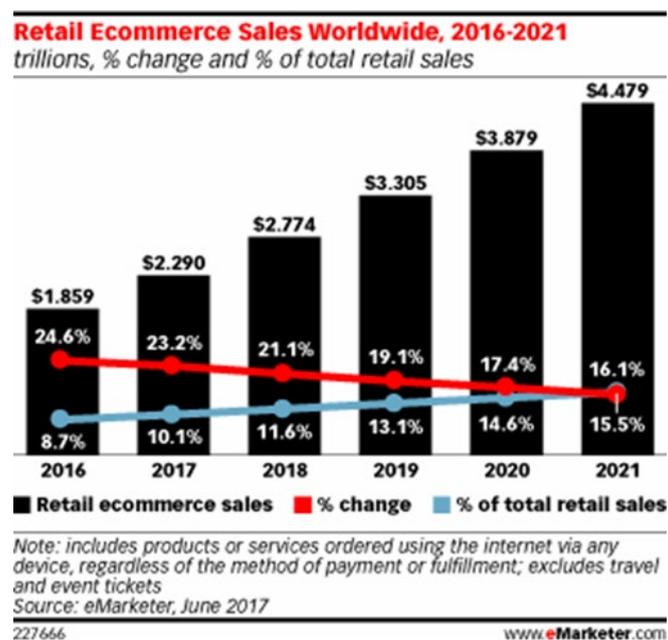
Internet use is also widespread in New Zealand. Currently 93.8% of New Zealanders use the internet, including 97% of New Zealanders under 65. Of these only 9% are classified as being low level users.⁴⁶ In addition, two-thirds of New Zealand internet users visit social media every day,⁴⁷ with the average time spent per day being 1 hour 53 minutes.⁴⁸ MBIE estimates that, of New Zealand’s economically significant firms:⁴⁹

- 100% use the internet;
- 98% have a website;
- 53% use it to make internet sales;
- 44% have internet sales of more than 10% of total sales;
- 62% have sales outside New Zealand;
- 96% use the internet for online ordering; and
- 97% use the internet for finance.

Overall size of the digital economy

The total global ecommerce market was estimated to be worth US\$7.7 trillion in 2018⁵⁰ (including both the retail and business to business market). The retail ecommerce market (which excludes the business to business transactions) was estimated to be worth US\$2.3 trillion in 2017, with a projected rise to nearly US\$4.5 trillion by 2021. Figure 2 sets out the anticipated size of the retail ecommerce market, together with its growth rate and share of total retail revenue.

Figure 2: Anticipated size of the retail e-commerce market



⁴⁶ Diaz Andrade, A., M.R., Karimikia, H. & Techatassanasoontorn, A., *World Internet Project: The Internet in New Zealand 2017*. New Zealand Work Research Institute, Auckland, 2018.

⁴⁷ World Internet Project New Zealand.

⁴⁸ Hootsuite, we are social, 2018, <https://www.slideshare.net/wearesocial/digital-in-2018-in-oceania-part-2-east>

⁴⁹ Ministry of Business, Innovation and Employment, *Information and Communications Technology*, 2017.

⁵⁰ <https://www.statista.com/study/44442/statista-report-b2b-e-commerce/>

Business to business ecommerce sales are estimated to be worth 2.3 times the total retail sales.⁵¹ This would produce a total estimated ecommerce market of nearly US\$10.5 trillion in 2021.

Some figures for Europe show that:

- In 2006 only one tech company was in the top 20, accounting for 7% of market capitalisation. In 2017, nine out of the top 20 were tech companies, accounting for 54% of market capitalisation (out of the top 20).
- Between 2008 and 2016 the revenue of the top five e-commerce retailers grew by 32% a year on average. During the same period, revenue in the entire EU retail sector grew on average by only 1% a year.
- In the last seven years, the average annual revenue growth for the top digital firms was around 14%, compared to 3% for information technology and telecoms firms and only 0.2% for other multinationals.

For New Zealand, the total consumer online shopping expenditure (that is, excluding business-to-business (B2B)) in 2015 was estimated at \$4.7 billion (excluding GST). This consisted 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.

Further, online shopping had an average year on year growth rate of eighteen percent up to 2016 (with offshore sales growing faster than domestic).⁵² By contrast New Zealand's general retail market has generally grown from 4–6% each year since 2012 – significantly less than the online market.⁵³ For 2017, New Zealand Post estimates that the sale of goods online grew at a rate of 13% compared to a growth rate of only 1% for goods sold by bricks and mortar retail. This was made up of a 9% growth in domestic online sales, and a 23% growth in online cross border sales.

Currently ecommerce makes up 8.1% of all retail sale of goods in New Zealand (in China by comparison it is already 23.1%).

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 and cross border digital services provided to New Zealand consumers, of approximately \$2.7 billion in 2018. 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.

Of these figures, the \$2.7 billion for cross border services is the most relevant for a proposed DST. This is because the DST would not apply to the supply of goods or most domestically provided e-services (given the nature of e-services provided in New Zealand). Instead it would apply to a subset of the \$2.7 billion of cross border services.

⁵¹ <https://www.shopify.com/enterprise/global-ecommerce-statistics>

⁵² These figures are taken from an unpublished MBIE report in August 2017. The MBIE figures are based on information published by the BNZ (<https://www.bnz.co.nz/business-banking/support/commentary/online-retail-sales-index>) and Nielsen (<http://www.nielsen.com/nz/en/insights/news/2016/new-zealanders-open-their-laptop-lids-instead-of-their-wallets.html>).

⁵³ <https://www.focus-economics.com/country-indicator/new-zealand/retail-sales>

Multi-sided platforms and online advertising are particularly important elements of the digital economy for the purpose of this document. This is because a DST would apply to them (subject to *de minimis* thresholds). Accordingly, we discuss them specifically next.

Intermediation – the sharing and gig economies

An intermediation platform (or a multi-sided platform as it is also called) generally refers to platforms used to facilitate the buying and selling of goods and services between unrelated persons. Digitalisation has allowed people to quickly and relatively cheaply connect and transact on these platforms, including across countries and in an increasing range of areas.

Intermediation platforms form both the sharing economy (which is linked with assets) and the gig economy (which is linked with services). These include travel platforms like Uber, accommodation platforms like Airbnb and peer to peer lending platforms like Harmony. Increasingly they also allow the self-employed to supply many other types of services to consumers and also businesses, such as house hold repairs and furniture assembly.

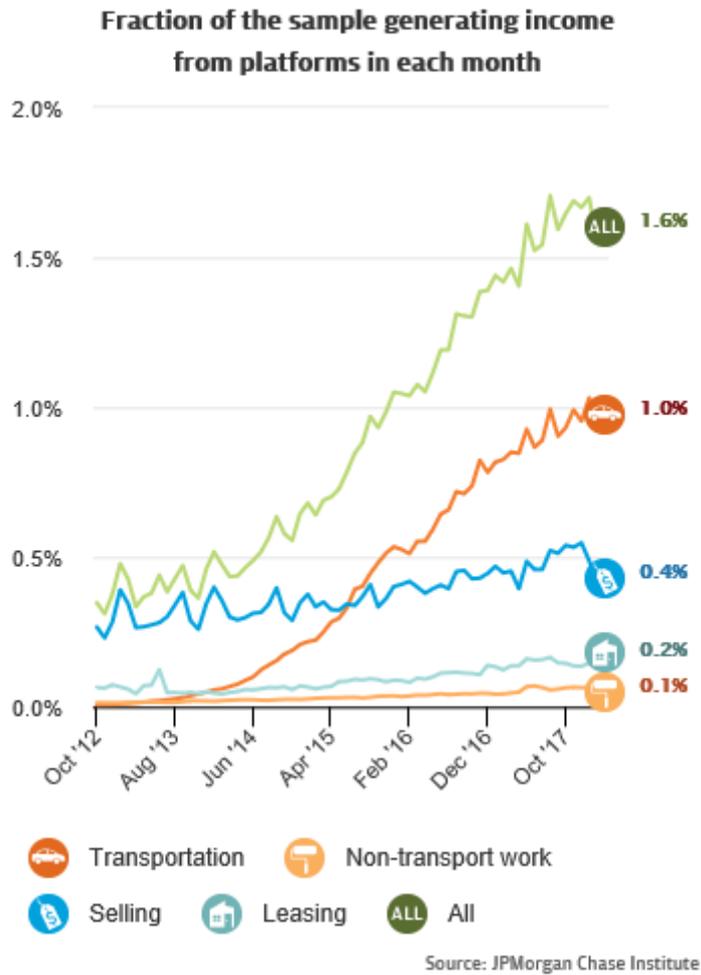
Currently the sharing economy makes up a small share of the economy on most estimates. In 2014, the global sharing economy was estimated to be worth US\$14 billion. However, it has been growing rapidly and is forecast to increase to US\$335 billion by 2025.⁵⁴

Figures from the United States show that transport platforms dominate the sharing and gig economies, both in terms of payments and users. This is followed by asset sharing and selling platforms. Labour supply platforms make up a very small proportion of the sharing economy currently. This is shown in figure 3 prepared by JP Morgan Chase & Co Institute. They examined the proportion of payments into 2.3 million distinct Chase checking accounts from the different kinds of sharing platforms.⁵⁵

⁵⁴ <https://www.statista.com/statistics/830986/value-of-the-global-sharing-economy/>

⁵⁵ Farrell, Diana, Fiona Greig, and Amar Hamoudi, *The Online Platform Economy in 2018: Drivers, Workers, Sellers and Lessors*, JPMorgan Chase Institute, 2018, <https://www.jpmorganchase.com/corporate/institute/report-ope-2018.htm>

Figure 3



We expect the sharing and gig economies in New Zealand to follow a similar pattern.

The JP Morgan Chase & Co Institute study also shows that the sharing and gig economies are not replacing traditional work for most people but are being used to supplement their earnings from it. This also seems consistent with the New Zealand experience, as the self-employment rate here has been declining moderately since 2000.⁵⁶

We do not have many statistics in New Zealand for the sharing and gig economies. For accommodation, Airbnb is the main provider in New Zealand. Airbnb guests spent \$781.4 million in 2017, representing 2.8% of all tourism expenditure in New Zealand.⁵⁷

For transport platforms, Uber is the main provider in New Zealand. Uber has not publicly released its revenue for New Zealand, but it notes that New Zealand riders travelled a combined 83,158,994 kilometres using the Uber app in 2018 – the equivalent of travelling to the moon and back 108 times.⁵⁸ Uber’s global revenue for 2018 (including from Uber Eats, its food delivery business) was \$11.4 billion (up 43% from

⁵⁶ <https://ecoprofile.infometrics.co.nz/auckland/Employment/SelfEmployment>

⁵⁷ Deloitte, *Economic effects of Airbnb in New Zealand*, 2018.

⁵⁸ <https://www.uber.com/en-NZ/newsroom/nz2018review/>

2017) on gross driver bookings of \$50 billion (up 43%). Uber is still loss making, with \$1.8 billion of adjusted losses (down 15%).⁵⁹

Trademe is the main platform New Zealanders use to buy and sell goods to each other. For its financial year ended June 2018, Trademe's annual revenue was \$250.4 million (up 6.6% from 2017) with net operating profits of \$96.6 million (up 3.9%).⁶⁰

There are some concerns with the sharing economy however. It can undermine traditional business sectors, such as the taxi and hotel industries. Workers in the gig economy also lack employment protections (as they are classified as independent contractors) and may earn uncertain and/or low income.

Online advertising

Online advertising is the other important component of the digital economy for tax purposes.

According to the OECD, time on the Internet has overtaken time spent on traditional media channels in many countries. This is largely driven by growth in the use of mobile devices, with mobile searches outstripping desktop searches in the last few years. Traditional avenues for reaching consumers (especially younger consumers) are becoming less relevant and are being replaced by online channels. Recent growth in advertising revenue has been largely driven by double digit growth in online advertising, and for the first time in 2017, global expenditure on online advertising outstripped television advertising expenditure. To give an idea of the importance of advertising to some of the biggest tech companies, advertising is Google's primary revenue source, accounting for US\$79 billion in 2016.⁶¹ Kiwis are now spending around half of their media consumption time online.⁶²

For New Zealand, the total online advertising 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.⁶³

⁵⁹ <https://www.cnn.com/2019/02/15/uber-2018-financial-results.html>

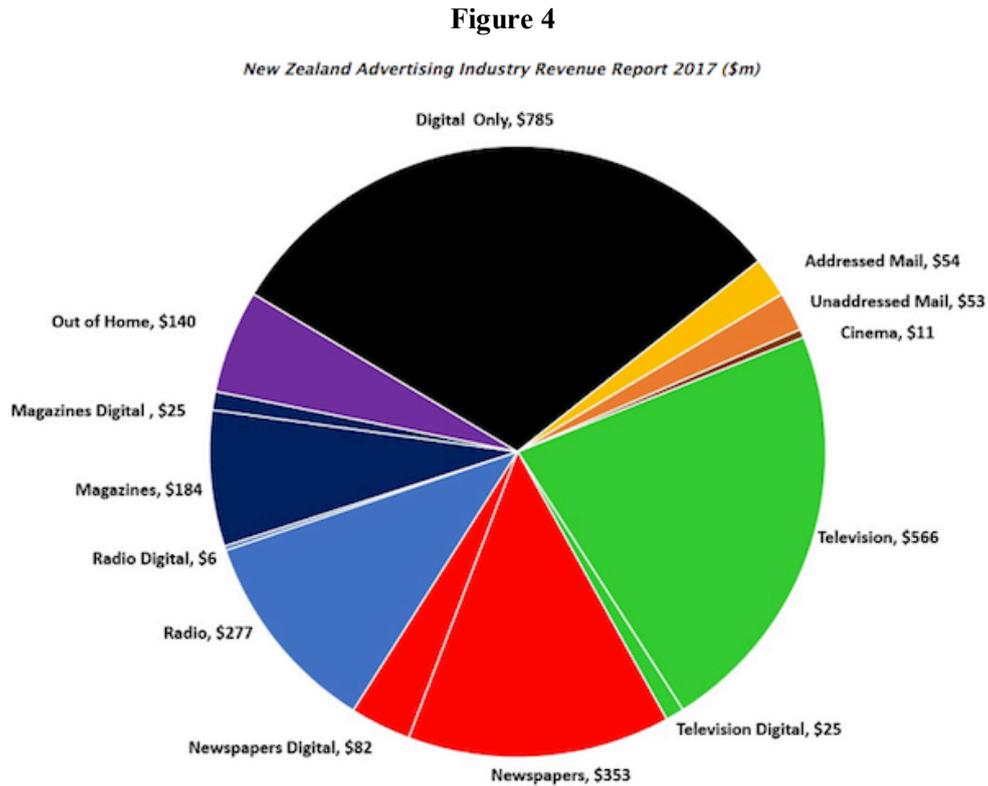
⁶⁰ Although Trade Me would not be caught by a DST if it had a €750 million global turnover *de minimis* threshold.

⁶¹ OECD, *Online Advertising: Trends Benefits and Risks for Consumers*, January 2019.

⁶² Mosh Social Media, *The New Zealand Facebook Report 2017*, 2017.

⁶³ New Zealand Advertising Industry Revenue Report 2017, <http://www.asa.co.nz/wp-content/uploads/2018/04/ASA-2017-Media-Turnover.pdf>

Figure 4 shows the composition of the New Zealand advertising market in 2017.⁶⁴



Search accounted for 62% of total online advertising in the third quarter of 2018⁶⁵ and the total online advertising revenue for the quarter was \$266 million (\$1.064 billion on an annualised basis). It is not clear exactly what proportion of online advertising is supplied by non-residents, however it is likely to be between 60–75%.

⁶⁴ <http://www.asa.co.nz/wp-content/uploads/2018/04/ASA-2017-Media-Turnover.pdf>

⁶⁵ IABNZ Ad-Spend Report Q3 2018, <https://www.iab.org.nz/news/q3-2018-interactive-revenue-grows-13-yoy/>

APPENDIX 2

New Zealand's policy for taxing multinationals

This appendix sets out New Zealand's policy for taxing multinationals, some recent tax measures aimed at multinationals, and our economic framework for international tax.

Policy for taxing multinationals

New Zealand's policy for taxing multinationals has been guided by two main considerations:

- New Zealand is a small open economy and we compete for capital with the rest of the world. This means we want New Zealand to be an attractive place for non-residents to invest and do business. However, we also want our fair share of tax. Our rules for taxing multinationals attempt to balance these competing objectives.
- New Zealand's tax policy is constrained by the international tax framework – we cannot unilaterally adopt tax measures which conflict with that framework.

Recent measures to tax multinationals

New Zealand has enacted several measures in recent years to improve our ability to tax multinationals. Many of these are in response to the OECD's BEPS project.

The OECD's BEPS project arose out of significant global media and political concern about evidence suggesting that some multinationals paid little or no tax anywhere in the world. This problem is referred to as base erosion and profit shifting or BEPS. BEPS tax planning strategies exploit gaps and mismatches in countries' domestic tax rules to avoid tax.

The OECD/G20 BEPS Action Plan was finalised in October 2015. The Action Plan consists of 15 reports that contain recommendations to counter BEPS activities in three key areas:

- more robust tax laws;
- international agreements and co-operation; and
- improving transparency and exchange of information.

The recently enacted Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018 is dedicated to countering multinational's BEPS activities in New Zealand. The measures in the Act prevent multinationals from using:

- artificially high interest rates on loans from related parties to shift profits out of New Zealand;
- hybrid mismatch arrangements that exploit differences between countries' tax rules to achieve an advantageous tax position;
- artificial arrangements to avoid having a taxable presence (a permanent establishment) in New Zealand;

- related-party transactions (transfer pricing) to shift profits into offshore group members in a manner that does not reflect the actual economic activities undertaken in New Zealand and offshore; and
- certain tactics to stymie an Inland Revenue investigation, such as withholding relevant information that is held by an offshore group member.

In addition, New Zealand signed the OECD's Multilateral Instrument on 7 June 2017, which amends most of New Zealand's bilateral DTAs to prevent them from being used to facilitate BEPS activities. These measures (together with our existing law) address all of the BEPS issues identified by the OECD. New Zealand's response to BEPS is also generally aligned with Australia's. The only significant differences are that Australia has adopted a separate diverted profits tax, while we have gone further than Australia in limiting high-priced debt (which was identified as our number one BEPS issue).

These measures are only the latest in a series New Zealand has undertaken to strengthen our laws for taxing multinationals. Other measures include:

- applying GST to cross border services – including e-books, music, videos and software purchased from overseas websites;
- introducing legislation to apply GST to the cross-border supply of low value goods to New Zealand customers;
- strengthening non-resident withholding tax rules (to ensure non-residents cannot claim interest deductions without also being required to withhold tax on that interest within a reasonable period);
- limiting the use of look-through companies as conduit vehicles for investment by non-residents (to prevent them from being used to arbitrage New Zealand and foreign tax laws);
- clarifying that New Zealand's general anti-avoidance rule overrides DTAs; and
- improving exchange of information between tax authorities, in particular by implementing the OECD's exchange of cross-border rulings and Country-by-Country reporting initiatives under which tax authorities exchange certain information on large multinationals.

New Zealand's economic framework for international tax

The measures set out in this discussion document are consistent with New Zealand's economic framework for international tax.

New Zealand has a general broad-base low rate (BBLR) tax framework, which aims to minimise distortions and promote economic efficiency. A robust company tax rate is an important component of this framework. The company tax rate should apply to both residents and non-residents who derive income from New Zealand sources.⁶⁶ It should not favour some taxpayers or some types of economic activity.

⁶⁶ There are a number of reasons for applying the company tax rate to non-residents, such as ensuring that location-specific economic rents are taxed, maintaining current taxation of sunk investments and land, ensuring an equal playing field for local and non-resident competitors, and the availability of tax credits for New Zealand tax in the non-resident's country (which effectively reimburses the non-resident for the New Zealand tax charged).

The current inability to fully tax the value generated in the digital economy that is paid to non-residents implies that this source of income is often taxed at a lower rate than other sources. This distortion can lead to unfairness and the substitution of low-taxed businesses for tax-paying businesses – specifically favouring foreign investors who can benefit from the current issues with the international tax framework.

As the income generated from the digital economy is in part specific to the market location and the value generated by the users of that product, the overall reduction in investment or national income from the taxation of this source of income may be limited.

For government spending initiatives, the tax revenue that is lost from an inability to tax the digital economy appropriately needs to be made up from other sources. As a result, the higher tax burden on other sectors of the economy will come with real economic costs.

The proposed measures protect New Zealand’s BBLR tax base from these distortions and should ensure a more appropriate level of tax is paid by all taxpayers on their economic activities in New Zealand. They are consistent with New Zealand’s general approach to taxing inbound investment.

Further information on New Zealand’s international tax framework and the economic impact of such base maintenance measures is set out in *New Zealand’s taxation framework for inbound investment*.⁶⁷

⁶⁷ Available at <http://taxpolicy.ird.govt.nz/publications/2016-other-nz-framework-inbound-investment/overview>