

Australian Treasury Discussion Paper on the digital economy and Australia's corporate tax system: A detailed review

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Executive summary

An Australian Treasury Discussion Paper ([TDP](#)) released on 2 October 2018 explores a corporate tax system for the digital economy in Australia as announced in the 2018-19 Federal Budget.

The TDP does not provide any recommendations nor expresses a clear preference for any particular measure for taxing the digital economy either on a long-term structural basis or an interim basis. However, it implies that an interim digital services tax (DST) may be warranted given the likelihood that no long term global solution is in sight. Taken together with recent similar comments out of the United Kingdom (UK) Government on this issue, this should raise concerns for taxpayers. This is a significant business issue to be addressed.

The TDP includes a detailed discussion on long-term solutions being explored and interim solutions being proposed. These include some European Union (EU) and other countries' considerations of a turnover tax on digital activities. Long-term solutions such as defining a digital presence and the appropriate attribution of profit will take time.

It suggests, significantly, that an international adoption of a DST would not be a short-term measure and would be kept in place until a structural global response is put into place, if this is ever achieved.

The TDP is seeking feedback on a series of open-ended questions by 30 November 2018.

Thirteen discussion questions cover input on issues such as:

- ▶ Cross-border taxation of user-created value and value associated with intangibles
- ▶ Changes to existing profit attribution rules and nexus rules for cross-border digital activities
- ▶ Options for broader reform and design considerations for interim options

Detailed discussion

Overview

Some form of DST is under active consideration in various jurisdictions and the TDP notes a future changed environment with Hungary, India and the Slovak Republic cited as front runners.

Australia has a strong record as a leader in tax policy initiatives internationally including its adoption of Base Erosion and Profit Shifting (BEPS) actions and two measures largely unique to Australia and the UK, namely the multinational anti-avoidance law and diverted profits tax.

Political momentum for a DST will accelerate if EU proposals to introduce a gross turnover tax succeed or failing this, Italy and Spain announce their intention to introduce interim measures in 2019 aligned with the European Commission proposal.

The TDP including its open-ended questions will invite submissions from tax advocacy organizations and public interest groups, especially on the broader super profit taxation and formulary apportionment concepts noted in the paper.

The TDP is seeking input on various aspects of implementation of a future tax. Recognizing the debate about the efficacy or wisdom of such a tax, it acknowledges issues around competitiveness, consumer and compliance costs as well as trade and tax treaty obligations.

The TDP may also be relevant in the upcoming Australian Federal Election. This makes engagement in the policy debate more important for potentially affected businesses.

TDP chapter by chapter

Chapter 1 is seeking to explain and define the digital economy and the impact of digitalization on the economy.

Chapter 2 provides an overview of the Australian corporate tax system followed by how this translates to the taxation of highly digital businesses in Australia.

Chapter 3 recaps how the Australian tax system has reacted to integrity issues revisiting the G20/Organisation for Economic Co-operation and Development (OECD) BEPS project and Australia's actions beyond the BEPS project.

Chapter 4 traverses international trends and increasing international pressure to act and contains 8 out of a total of 13 consultation questions (CQ).

Chapter 5 looks at interim options with 2 CQs and the remaining 3 CQs are on more detailed design considerations for an interim DST explored in an Appendix to the TDP.

International trends and options for reform

Chapter 4 contains the bulk of the detailed CQs and raises the following high level issues and questions.

Should taxing rights change to reflect user-created value?

CQ #1: Is user participation appropriately recognised by the current international corporate tax system? If not, how should value created by users be quantified and how should it be taxed?

Should taxing rights change to reflect value associated with intangibles?

CQ #2: Is the value of intangible assets including 'marketing intangibles' appropriately recognised by the current international corporate tax system? If not, how should value associated with intangibles be quantified and how should it be taxed?

Potential changes to existing profit attribution rules

CQ #3: Are the current profit attribution rules 'fit for purpose'? If not, how should profits be attributed?

CQ #4: What are your views on allocating taxing rights over residual profits associated with: (i) user contribution to 'user' countries, or (ii) 'marketing intangibles' to market countries?

Potential changes to existing nexus rules

CQ #5: Should existing nexus rules for determining which countries have the right to tax foreign resident companies be changed? If so, how?

Can changes only apply to highly digitalised businesses?

CQ #6: From a tax perspective, do you consider that the digitalised economy is distinguishable from traditional economy? If yes, are there economic features of the digitalised economy that present special challenges in the context of taxation? How are these features relevant for assessing the costs and benefits of various models of taxation?

CQ #7: Can and should any changes to the international nexus and profit attribution rules be ring-fenced to apply only to highly digitalised businesses? If so, how?

Australia's options for broader reform

The current discussion of the tax challenges arising from the digitalization of the economy is part of a broader concern about whether existing corporate tax frameworks remain fit for purpose.

Australia relies more heavily on corporate income tax than comparable OECD countries. Around 20% to 25% of Commonwealth tax revenue (excluding Goods and Services Tax (GST)) comes from company tax. This may mean Australia is particularly exposed as a result of globalization and digitalization. At the same time, revenue collection from consumption taxes like GST/Value Added Tax is significantly lower in Australia than OECD countries given the lower GST rate at 10%.

So the TDP goes on to ask for input on long-term policy.

CQ #8: Are there changes other than to nexus and profit attribution rules that should be made to the existing international corporate tax framework and/or Australia's tax mix to address the challenges presented by globalisation and digitalisation?

Tax policy design considerations for an interim measure

The OECD acknowledges international consensus for a longer-term solution will be challenging and accepts that countries may go ahead with interim solutions. As the TDP outlines, the OECD Interim Report in March 2018 on *Tax Challenges Arising from Digitalisation* suggests any interim measure should be:

- ▶ Targeted at businesses that benefit most from user-created value
- ▶ Designed to minimize cost and complexity
- ▶ Narrowly targeted to avoid over-taxation

- ▶ Designed to minimize impact on business creation, start-ups and small business
- ▶ Consistent with countries' international obligations, including World Trade Organisation (WTO) obligations, free trade agreements (FTAs) and tax treaties
- ▶ Apply only until such time as a consensus-based solution is developed

Implications for businesses and consumers

The OECD has concerns about imperfect policy measures, and that any interim measure:

- ▶ Would need to apply to both domestic and foreign businesses (to comply with WTO and other international obligations), and so could result in over-taxation overlaid onto Australian corporate tax
- ▶ May increase the cost to Australian businesses and consumers of digital products and services that are covered by the interim measure
- ▶ May have an adverse impact on investment, innovation and welfare, for example by distorting the choices of Australian consumers and businesses, or by changing the way in which digital products and services are provided
- ▶ May have relatively high compliance and administrative costs

Australia's tax policy design

There are two high level questions on Australia's tax policy design considerations for an interim measure:

CQ #9: What does the experience of other countries that have introduced interim measures or that are contemplating them mean for Australia?

CQ #10: Should Australia pursue interim options ahead of an OECD-led, consensus-based solution to address the impacts of the digitalisation of the economy on the international tax system?

The appendix to the TDP explores the scope of a potential interim DST in more detail raising the following questions:

What digital services could be more appropriately taxed?

CQ #11: What indicators could be used to identify businesses that benefit most from user-created value? Would an interim measure applied to digital advertising and/or intermediation services accurately target that value? How broadly or narrowly should 'digital advertising' and 'intermediation services' be defined?

What nexus would highly digitalised businesses need to have with Australia?

CQ #12: The choice of 'nexus' for an interim measure (or a longer-term 'virtual' PE proposal) involves significant trade-offs between ease of administration and the risk of avoidance. Which nexus option strikes the best balance between these considerations?

Would an interim measure only apply to businesses above certain thresholds?

CQ #13: What are your views on thresholds for an interim measure, taking into account the need to meet Australia's international trade obligations?

EY initial points of view

EY will make a submission responding to the scoping questions raised by the TDP and will assist businesses make representations. The responses will be framed by some high level points of view on tax policy design issues as outlined below.

Australia has already been very active in taxing digital as well as other transactions:

- ▶ The introduction of the Multinational Anti-Avoidance Law from 1 January 2016 goes beyond the scope of the BEPS project, and the Tax Office's comprehensive compliance program has seen additional AU\$7 billion in sales revenue.
- ▶ GST law changes covering business to consumer digital transactions by nonresidents (both for supplies of goods and intangibles), settlements arising from the Australian Taxation Office (ATO) tech sector audit program which has been running for at least five years, and the introduction of the Diverted Profits Tax (effective 1 July 2017), have already extended Australia's taxing authority over digital sales.
- ▶ Australia's strong tax policy and administration initiatives have brought multinational companies into audit settlements or advance pricing agreements with the ATO. In some cases digital sales that would be targeted by a digital services tax are already being included in the Australian revenue base and subject to tax here creating double or over-taxation with limited prospect of getting credits under tax treaties.

All new taxes must be fully considered, and their broader impact tested, before being implemented. That's why G20 leaders have as a high priority, a unified approach to digital taxation as has been the case with BEPS project, as opposed to uncoordinated unilateral measures.

The heavy reliance on corporate and personal income taxes should also be considered, as the issue of BEPS can in part be mitigated through reducing income tax rates and increasing consumption taxes, like the GST.

Digital taxes introduced unilaterally by any country also affect investment confidence and international reputation. Taxes which target nonresidents and operate as a country market access fee also risk breaching WTO obligations as flagged by the TDP.

If market access is used to justify digital taxes in the countries where digital products are consumed, then source or origin countries might consider imposing new and complementary excise taxes on other products, even bulk commodities or resources, which naturally would hurt Australia.

If Australia is to take a lead role in this space as it did with BEPS, it should seek to help develop a broad consensus-based long-term solution rather than a short-term interim measure which may have issues of unilateral taxation associated with it.

The TDP will be seen internationally and will hopefully lay the foundation for a genuinely constructive consultation process to fully canvass the options and weigh the risks as the G20 and Australia develop their approaches to global digital taxation. But Australia must avoid short term, unilateral or politically motivated reactions to global digital taxation. If it does not, it risks creating double taxation, WTO concerns and retaliatory risks, especially from the United States (US) which granted Australian steel exporters an exemption from US steel tariffs recently.

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