Business Council of Australia

SUBMISSION

Submission to The Digital Economy and Australia's Corporate Tax System discussion paper

November 2018

OVERVIEW

The Business Council of Australia welcomes the opportunity to provide a submission to The Digital Economy and Australia's Corporate Tax System discussion paper. This discussion paper is a timely opportunity for a considered debate on the issue of the digital economy and taxation arrangements.

The Business Council strongly believes that all business in Australia must meet their tax obligations and do so in a transparent way. Where arrangements do not keep pace with community norms, they should be reviewed. Australia's integrity measures, institutions and enforcement all contribute towards and complement a high level of compliance with our tax system. As the discussion paper notes, "Australia continues to have some of the most robust tax integrity rules in the world." At the same time, the tax system must ensure that the Australian economy (including the digital economy) which is heavily reliant on trade and foreign investment, remains strong and continues to grow.

Global tax issues require global solutions. How profits of companies operating internationally are taxed is a complex issue, including with respect to the digital economy. If one country acts alone, it risks unintended consequences such as double taxation, reducing competitiveness or deterring vital investment. It also risks undermining an enduring and credible long-term solution.

The Organisation for Economic Cooperation and Development (OECD) continues to be the key multilateral forum for progressing changes to global tax laws, with over 115 jurisdictions participating. A major multilateral policy development process is underway to consider appropriate long-term policy adjustments which may be required to deal with the tax challenges arising from digitalisation. This ongoing process is targeted to provide recommendations to global leaders by 2019 with potential implementation possible from 2020. Australia is a participant.

Recommendations

- The OECD's process should be supported, recognising the OECD is the key multilateral forum for developing a coordinated international approach to global taxation issues.
- Actively ensure that the OECD process reflects best practice tax principles and avoid ad hoc responses that are unilateral, ignore best practice tax principles, and undermine competitiveness and jobs.

1. DIGITALISATION OF THE ECONOMY

The new world of digital innovation in the economy

The digitalisation of business and consumer interactions has had a profound effect on all consumers and businesses around both Australia and the world, like previous waves of technological change including transportation, communications and computer applications. Individuals can more readily purchase goods and services from overseas, or invest in the shares of overseas companies, than before. Similarly, businesses small and large can more readily connect to customers locally and overseas than before. The digital economy has also

delivered benefits through new opportunities, new technologies, increased competition, efficiency improvements and the ability to develop human capital.

However, the digitalisation of business and consumer interactions, while called a digital economy, is not separate from the broader economy. As the OECD observed, “the digital economy is increasingly becoming the economy itself.”[1]

The lines between the non-digital and digital are increasingly blurred as digital tools and services are fully incorporated into normal business activity. The application of digital tools and techniques in the economy is in a constant and rapid state of change, with implications for both the tax system and broader economy. The impact varies across industries but is pervasive. For example, ACMA notes that online advertising has gone from 15 per cent of Australian advertising expenditure in 2009, to 48 per cent in 2016.[2] However, as outlined below, digitalisation of the economy has much broader implications.

Data digitalisation also delivers benefits

The digitalisation of the use of data, and associated technologies, is now commonly used to generate significant economic benefits. Better use of data can also greatly improve firms’ productivity, with some estimates suggesting an increase in the order of 5 to 10 per cent.[3] The majority of economic benefits generated by use of data goes to customers, consumers and citizens.[4] In fact, the benefit to consumers is estimated to be more than double the benefit to organisations.[5]

Some of the ways data generate an economic benefit include:

- greater automation of processes – greater use of data, and associated algorithms, can replace or support human decision making
- improved efficiency – providing and processing data in real time means that goods and services can be produced more efficiently
- improved capacity for research – broader, richer datasets mean that greater insight can be drawn than from narrow samples
- innovation of new business models, products and services
- greater personalisation – the availability of more data about the behaviour of consumers, individually and in aggregate, means that goods and services can be more personalised
- reduced information asymmetry. Asymmetry of information – between buyers and sellers, and principals and agents – is being addressed simply by having more data available.

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

[2] Australian Communications and Media Authority (2010), *Communications Report 2009-10* and Australian Communications and Media Authority (2017), *Communications Report 2016-17*.

[3] Brynjolfsson, E. and A. McAfee (2012), *Big Data: The Management Revolution*, Harvard Business Review.

[4] McKinsey Global Institute (2011), *Big Data: The Next Frontier for Innovation, Competition and Productivity*.

[5] BCG (2017), *The Value of Our Digital* Identity.

From a tax perspective, digitalisation also delivers many benefits. These include facilitating integration into the formal economy, increased growth (and hence, tax revenue), access to data, improving compliance by the ATO, and reducing the compliance burden on taxpayers.

Unique to digital?

The OECD has identified three factors common to highly digitalised business models:

- cross-jurisdictional scale without mass
- reliance on intangible assets
- data, user participation and network effects.

However, these factors are not unique to highly digitalised business models, while they may currently be more prevalent in them. The factors outlined above apply to all businesses creatively using current technologies, including:

- production of goods and services such as those produced and developed in Australia
- intermediation and broking of such goods and services.

This highlights the risks of attempting to segregate and ringfence the digital economy – which the OECD has recommended against.

The current international tax system has been developed from multilateral consensus, with many double tax treaties, guidance materials, protocols and administrative arrangements which provide clarity for governments, their tax authorities, businesses and consumers.

Policy changes aimed at the digital economy should be considered carefully, recognising the potential impacts on the digital and broader economy and risks of inconsistencies with the broader international taxation processes. For example, there is the European Commission's proposed interim Digital Services Tax. That proposal has recently stalled due to, among other reasons, concerns from Germany about its car sector and other traditional industries being levied due to their digital elements.[6]

2. COMPANY TAX IN AUSTRALIA

How does company tax work?

In Australia, company tax is a profits tax levied on a company's taxable income at a rate of 30 per cent for companies with turnover above $50 million.[7] It is calculated as assessable income minus allowable deductions. Assessable income includes income from selling goods and services, while allowable deductions include expenses incurred in carrying on the business, such as employee wages and salaries, investment, advertising and utilities.

Tax is payable on profits, which are the residual return to shareholder equity after allowable costs of production, including wages, rent, intermediate inputs and depreciation. Lossmaking

[6] Khan, M. (2018) *EU's tech tax is going nowhere fast*, Financial Times, 6 November. Available at: https://www.ft.com/content/cdbb6ce8-e16e-11e8-8e70-5e22a430c1ad

[7] The rate for other companies is 27.5 per cent, falling to 26 per cent in 2020-21 and 25 per cent in 2021-22.

companies do not pay company tax until they recoup their losses. Companies can report losses due to large investments, starting new operations or difficult trading conditions.

As the discussion paper notes, Australia's approach to taxing foreign investors in Australia and domestic companies investing offshore aligns with international conventions. The benefits from participating in this multilateral global framework are it:

- minimises double taxation
- minimises the distortion of investment decisions
- provides investors with greater certainty
- provides tax authorities greater certainty and allows for better enforcement of laws e.g. through exchanges of information.

These global tax norms have been a critical driver of global economic growth for the past 50 years by providing the certainty and stability needed to encourage long-term international trade and investment. Australia has also benefited from this approach as the profits of Australian exporters generally remain within Australia's tax base. If changes are pursued in the context of the digital economy, the implications of such a change for the rest of the economy must be carefully considered.

Australian companies pay a large amount of tax

Strong integrity measures, compliance and enforcement all contribute towards Australia's large company tax revenues. Company tax collections reached $86 billion in 2017-18 and are forecast to exceed $100 billion by 2021-22.[8] Around 2,600 companies account for 60 per cent of company tax collected, while Australia's ten largest taxpayers pay over a quarter of all company tax.[9]

Australia's company tax collections as a share of GDP are the fifth highest in the OECD, while company tax revenue as a share of total tax revenue is the third highest.[10]

Australia has strong tax integrity measures

Australia's tax integrity laws are some of the most stringent in the developed world. Indeed, the discussion paper observes that "prior to the implementation of the BEPS recommendations, Australia had some of the strongest tax integrity rules in the world. Since 2015, Australia has implemented a number of the BEPS recommendations, further strengthening our tax laws to protect against profit shifting by multinational enterprises."

Tax Commissioner Chris Jordan has said company tax compliance in Australia "is around global best practice and many countries aspire to this level of compliance".[11]

Successive governments, through bipartisan support, have sought to maintain this integrity by updating measures such as transfer pricing rules, the foreign source income anti-tax-

[8] Final Budget Outcome 2017-18 and Budget 2018-19.

[9] ATO Taxation Statistics 2015-16 and ATO Corporate Tax Transparency Report for 2015-16.

[10] OECD StatExtracts database. Accessed 30 November 2018.

[11] Chris Jordan, *Address to the National Press Club*, 5 July 2017.

deferral regime, general anti-avoidance rule and thin capitalisation rules. These measures complement each other and provide Australia with a robust and holistic set of integrity measures.

The Business Council has supported greater tax transparency and integrity measures in recent years, including encouraging members to sign the voluntary Tax Transparency Code. There are 70 Business Council members that have signed the Code, representing more than $21 billion or one-third of total company tax paid in 2015-16.

Recent changes to tax integrity

Many of Australia's integrity measures have been comprehensively amended over the past few years, including to address issues relating to the digital economy. These include:

- BEPS Action Items 7, 8, 9 and 10 (permanent establishment and transfer pricing)
- the Multinational Anti-Avoidance Law, which has resulted in 44 companies bringing $7 billion of sales back to Australia[12]
- the Diverted Profits Tax
- GST on digital imports, low value imports and offshore sellers of hotel accommodation in Australia.

The discussion paper observes that "Australia has long been a strong and active supporter of the BEPS project and has been vigilant in implementing the BEPS recommendations. And … Australia has also gone further." The changes listed above impact more than the digital economy, while other recent changes that have been announced or introduced include:

- changes to hybrid and transfer pricing rules, building on the 2013 modernisation of Australia's entire transfer pricing legislation
- country-by-country reporting
- a doubling of penalties that apply to large companies who engage in tax avoidance
- public disclosure of the tax information of large companies
- the Tax Transparency Code
- improved whistle blower protection
- a hundredfold increase in penalties for large companies which do not adhere to tax disclosure obligations
- changes to thin capitalisation
- a "good tax record" to access Commonwealth Government procurement.

[12] The Australian Government the Treasury (2018), *The Digital Economy and Australia's Corporate Tax System, Treasury Discussion Paper*, October.

The ATO is strong and capable

The ATO maintains a sophisticated and active approach to compliance. It also has extensive powers to gather information from taxpayers and from other jurisdictions, including treaty and information sharing agreements and country-by-country reports, to compare claims made to the ATO with other countries. In addition, where the ATO makes an assessment that differs from that of the taxpayer, it falls on the taxpayer to prove that the ATO's assessment is excessive. There is also a strict penalty and interest regime to encourage active compliance.

At the international level the ATO is recognised as a leading tax authority and has been an active participant in the BEPS process and on other international tax initiatives.

The ATO performs detailed one-on-one reviews of the largest 100 companies, who pay about 40 per cent of all company tax. Extra government funding has enabled the ATO, under the Tax Avoidance Taskforce, to extend these reviews to over 1,000 companies.

3. THE INTERNATIONAL APPROACH

Global tax issues require a global solution

The global economy has experienced increased globalisation, digitisation and interconnectedness over the past two decades. Global tax laws have been challenged by these phenomena.

The international community is the appropriate forum in which to agree on multilateral action on how to tax the global profits of multinational companies. Acting alone or prematurely may lead to unintended consequences – such as double taxation – to the detriment of investment, trade, jobs and growth. The risks are heightened for Australia as a small-sized, open economy that is heavily dependent on trade and foreign investment.

International tax issues are broad and complex, and a solution will take both time and a coordinated, multilateral approach. Each country confronts the challenge from a different starting point in terms of the sophistication of their tax systems, level of compliance and the structure of their economies.

A key imperative will be to ensure that responses do not result in effective double taxation, distort valid commercial arrangements and disproportionately increase the compliance burden on taxpayers. That includes developing clear rules, international agreement about application of the rules and (as occurred in the BEPS project) dispute resolution processes among countries to reduce the incidence of overlap and double taxation.

The OECD process can deliver

The OECD, despite some doubts, delivered on the BEPS final reports in a short timeframe, and implementation and review is underway. Under the OECD/G20 Inclusive Framework on BEPS, the project has expanded to now bring together over 115 countries and jurisdictions collaborating on the implementation of the BEPS package.

The Task Force on the Digital Economy was established to undertake the work on the tax challenges posed by the digitalisation of the economy. This is a significant global public policy process, and engagement and consultation are critical. It also provides the best opportunity to develop a consensus-based, credible and enduring solution, and any reforms

should be agreed through this process. The OECD's interim report on Tax Challenges Arising from Digitalisation established a consensus for countries to work together and find a common long-term solution by 2020. An update on this process is due next year.

The OECD acknowledges that if consensus cannot be reached or is delayed, some countries may go it alone in the short term. However, as the Treasury states, the OECD notes that unilateral action could negatively impact investment, innovation and welfare; lead to double taxation; and increase compliance costs. The OECD also notes that uncoordinated and unilateral interim measures may be a disincentive to countries pursuing longer-term multilateral solutions. No one country can successfully address these issues on its own. This is particularly the case for Australia, which is too small to solve this issue on its own.

A role for Australia

Australia could take a lead on developing a multilateral long-term solution instead of moving ahead with a short-term interim unilateral measure.

The Business Council is concerned that changes to the corporate tax system ahead of the outcomes of the OECD project could undermine this process. Unilateral action may encourage other countries to act alone and splinter international taxation norms.

Principles for global tax reform

The Business Council has previously proposed a set of principles to guide global tax reform, and they remain relevant in the context of taxation of the digital economy:

- supporting arrangements that are stable and predictable, and provide companies and tax authorities with certainty
- ensuring laws are easy and low-cost for business to comply with and tax authorities to administer, and to promote trust in and compliance with the system
- fostering transparency and cooperation between companies and tax authorities, intra- and inter-jurisdictionally
- supporting multilateral dispute resolution, in order to mitigate the risk of double taxation.

4. AN INTERIM MEASURE IN AUSTRALIA?

The international experience

The discussion paper puts forward several ideas for taxation of the digital economy, while also noting international moves. The UK has announced the Digital Services Tax from 1 April 2020 – when the company tax rate is also due to fall to 17 per cent. The European Commission has proposed a levy from 1 January 2020, recently this has stumbled as issues remain unresolved, such as when the interim tax should end, the scope of the tax and whether it is consistent with international tax treaties. France has also offered to delay implementation until late 2020, while there are concerns over double taxation and responses from major trading partners, including the US. In addition, if countries choose to act alone, it is plausible that different countries may try to tax the same earnings using different measures.

The challenges relating to an interim measure are similar to those in reaching a global solution, such as what to tax and where. But an interim measure comes with added risks and would, in theory, be repealed soon. New Zealand's Tax Working Group also recently recommended that New Zealand should continue to participate in the OECD's Inclusive Framework process.[13] It recommended an interim measure be considered only if a critical mass of other countries move in that direction.

There would be consequences to Australia acting alone

If countries such as Australia were to act outside the OECD process, it could present a challenge for establishing global consensus. The German Finance Minister has been publicly commenting on the risks and distractions for the global consensus-building arising from the European Commission moves to an interim tax approach.

A unilateral measure could further damage Australia's reputation as a relatively stable and predictable investment destination, while also harming our competitiveness, increasing compliance and administration costs, increasing policy uncertainty, deterring investment, and leading to double or multiple taxation.

Australian companies will also be at a disadvantage as their overseas competitors would be able to innovate and compete at home without a digital tax. These risks would be magnified if an interim digital tax did not give rise to franking adjustments under the imputation system.

There would also be practical risks in adopting a two-tiered system for allocation of profits between taxing jurisdictions – one for the digital economy and one for other businesses. Other countries may also consider new or complementary taxes in response. For example, Australian exporters pay a significant amount of tax in Australia, but do not pay much income tax into the markets of other countries where we export resources and where customers are.

Furthermore, investment is highly mobile and operates in an intensely competitive environment. Australia's company tax rate remains unchanged for companies with turnover above $50 million and there are no plans to reduce it. In contrast, other countries have been reducing their company tax rates while Australia has stood still. Indeed, further company tax rate reductions are planned for Argentina, Belgium, France, Netherlands, Sweden and the UK. This makes it more critical that Australia maintain a competitive tax system and not act unilaterally in this area.

There are multiple design issues

If an interim measure were to be pursued, this would be a complex and challenging task, with multiple design issues for a temporary measure. As the then Treasurer Scott Morrison noted, "it is more important to focus on those technical issues rather than the pot-of-gold approach, which is how much revenue can be raised."[14]

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[13] Tax Working Group, New Zealand (2018), *Future of Tax – Interim Report*, September.

[14] Cohen, L. and D. Flynn (2018) *Europeans press for digital tax at G20 meeting*, Reuters, 23 July. Available at: https://www.reuters.com/article/us-g20-argentina-digital/europeans-press-for-digital-tax-at-g20-meeting-idUSKBN1KC0YD

What is the tax base?

Digitalisation does not create new problems – it exacerbates the existing ones. Consumers and businesses have always been able to interact across borders, without a physical presence, to some degree. However, the scale of it has increased with the digital economy. The challenge is to work out where value has been created, measure it, and decide how to tax it. To illustrate, a modern multinational company has:

- shareholders scattered across the world
- a parent company resident in one country
- subsidiaries undertaking an array of activities, such as R&D, production, marketing and finance across many countries
- consumers around the world.

There is a legitimate discussion to have about what to tax and where. Indeed, the tax base under the proposed UK and European Commission digital taxes already differ. There can be genuine difficulty and complexity in both measuring, and determining, where profits from these activities are sourced – reasonable minds can disagree. As another example illustrates, if an Australian consumer sees online advertising from a Canadian company, which has been provided through a server based in the US – how should value be apportioned across countries? If Australia were to act alone, it would need to decide what share of value is part of the Australian tax base, and the basis on which to measure it. The risks from countries developing unilateral measures becomes abundantly clear, and the OECD's multilateral process is the best approach for achieving a consensus-based and enduring solution.

Existing rules rely on physical presence, but highly digitalised businesses rely on intangibles that can be located anywhere, and user participation, which is not recognised. Then Treasurer Scott Morrison said the G20 discussions were useful because they established the root of the problem: that "no one knows" how to measure for tax purposes the value of the data users of social media services created outside of the countries where those companies are based.[15] The data collected from users can be considered a raw input, which is transformed to create value – which is true of the non-digital economy as well. Companies cannot issue instructions to users as they would an employee, and the service is often provided for free – so the link to value creation is difficult to make. In addition, intangible assets created from this data reflect value that has been created, but this must be used for value to be realised.

These difficulties and complexities would apply particularly to the proposal to change taxing rights to reflect user-created value. It would be challenging to establish rules for taxing user-created value that could be applied logically across a broad base of the economy.

Revenue or profits?

The suggestions put forward have all been for a tax on revenue. However, company tax is paid on profits, not revenue, and this principle should be adhered to. Taxing revenue ignores the costs associated with sales and discourages investment, innovation and

[15] Ibid.

entrepreneurship. It punishes start-ups and new businesses, and acts as a disincentive to grow. Any measure would harm the competitiveness of Australian companies versus their overseas peers not liable for the tax. In addition, there may be risks to Australia in moving down the path of a revenue-based tax given the importance of our major export sectors, such as mining, agriculture and services.

The discussion paper notes thresholds could be designed to target businesses with the "ability to pay" and would not adversely "impact innovation, productivity or businesses creation". However, it is unclear how or why this would be the case. A two-tier digital tax, together with the existing two-tier company tax system, would introduce further complexity, harm competitiveness and act as a disincentive to growth.

The UK has announced an interim digital services tax and has proposed that this should provide safe harbours for businesses with low or nil profitability. However, this concept is complex and the UK is seeking input on how to implement this approach, which is one reason why the UK proposal is not to commence until 2020.

A temporary measure?

Any measure is proposed as temporary until international consensus is achieved. However, there is a risk this would not be the case if a country was to collect less revenue from the consensus-based solution, or if there were significant administrative and compliance costs associated with transitioning from an interim measure. In addition, questions on how a country would transition between an interim and a permanent measure are unresolved.

What is the incidence of the tax?

The economic incidence of any proposal, as well as its impacts, should be properly understood before it is proposed or introduced. For example, will the incidence fall on local customers through higher prices, or on shareholders through lower profits? If services are competitively supplied and there is low substitutability, it will probably be local customers through higher prices. The EU's Impact Assessment for its proposed equalisation tax said some of the incidence would be passed on to customers.

Similarly, this should also consider how the behaviours of consumers and businesses would change in response to the introduction of a tax. Would company structures and business models change? Would the way services be provided change? In both cases, what are the consequences?

Other issues

There are other issues to consider including:

- How would compliance and collection work in both theory and practice? For example, the UK discussion paper in relation to its proposed interim digital tax identifies that this is not integrated into international transfer pricing rules, and the impact on pricing of services within scope for tax purposes is unresolved.
- Is what has been proposed consistent with our international obligations and tax treaties?
- Is it deductible for income tax purposes (as proposed in the UK)?

- Would any tax paid come with franking credits attached to it?
- What are the implications in Australia of a digital tax together with the Consumer Data Right?
- What sort of impact would increasing complexity, compliance and administration costs have on the net benefits of such a proposal?

Conclusion

A major global multilateral policy development process is under way to deal with the tax challenges arising from digitalisation. The OECD leads this work through the Inclusive Framework on BEPS and the Task Force on the Digital Economy. It provides the best opportunity for an enduring and credible long-term solution, with recommendations due next year and possible implementation from 2020.

The Business Council recommends:

- The OECD's process should be supported, recognising the OECD is the key multilateral forum for developing a coordinated international approach to global taxation issues.
- Actively ensure that the OECD process reflects best practice tax principles and avoid ad hoc responses that are unilateral, ignore best practice tax principles, and undermine competitiveness and jobs.

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