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4 December 2018

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Dear Natasha

SUBMISSION TO THE TREASURY DISCUSSION PAPER ON THE DIGITAL ECONOMY AND AUSTRALIA'S CORPORATE TAX SYSTEM

The Corporate Tax Association (**CTA**) welcomes the opportunity to make a submission on the Treasury Discussion Paper "The digital economy and Australia's corporate tax system" (**the DP**).

The CTA's membership consists of 125 of the largest corporations in Australia with approximately 75% listed on the Australian stock exchange. CTA members cover all industry sectors (including domestic and foreign owned digital businesses). CTA members account for approximately 54% of all corporate income tax collections for businesses covered by the ATO's public tax transparency disclosures at around $21 billion. A list of members can be found on our website at http://corptax.com.au/member-companies/.

Background observations

The CTA acknowledges Australia should have a right to tax profits a multinational derives from activities undertaken and value generated in Australia. It is however far from clear in the context of the digitalised economy whether highly digitalised business require special international tax rules than others, whether user participation or data is in fact the source of value or in fact if it is the user that creates the value or the digitalised business intangible. Like most things, the answer probably lies in a combination of user participation and the digitalised business intangible that is the source of value. In fact, the "pure" tax answer to the tax issues facing an increasing digitalised economy may lie in taxing the user via indirect taxes such as the imposition of GST on the taxable supply to the user rather than trying to tax the digitalised business (or individual user) via an income tax.

As the OECD interim paper notes, some countries view data collection from user participation and the provision of user generated content as transactions between the users and the highly digitalised business with the digitalised business providing

financial or non-financial compensation to the users in exchange for the data by providing data hosting, email services or digital entertainment. This line of thinking leads to the conclusion that such transactions should be subject to income tax imposed on the user rather than the digitalised business.[1] Income tax is paid by the digitalised business based where the value is created, maintained, improved and protecting the underlying algorithms and intangibles on the same basis as other intangibles.

In terms of the drivers behind the need for taxing digital services, the short-term political imperative to introducing an interim measure effectively targeting US based digital platforms has clearly waned. BEPS Actions and US tax reform measures have helped address what some would argue is the raison d'etre for an interim measure, or in fact an OECD based consensus solution at all given other BEPS Actions have been progressed. Moreover, Australia has already targeted integrity rules with the Multinational Anti-Avoidance Law (MAAL) and Diverted Profits Tax (DPT) to address local income tax integrity concerns and implemented changes to GST rules to reflect OECD BEPS standards on taxing the supply of digital services and intangibles.

Given these changes, it is not surprising the BEPS Action 1 issues are extremely complex and require serious deliberation. In our view, this emphasises the need for Australia to be cautious and not pre-emptive and why is it is prudent to await the outcome of OECD deliberations on BEPS Action 1 rather than potentially fuelling current trade conflicts with the imposition of an interim digital services tax (DST), however politically expedient it may be to impose a tax on the pretext of being tough on multinationals.

Summary of Recommendations

In our view, regardless of the political imperative of being seen to be dealing with alleged tax avoidance in the highly digitalised economy:

1 Australia should await the outcome of OECD deliberations on the tax challenges arising from digitalisation and not introduce an interim DST.

2 If an interim DST is to be introduced it should:

a. be set at a low rate (definitely at lower rates suggested in the UK or EU) and be narrowly targeted. It should definitely not include online market places or financial services;
b. have carve outs or safe harbours to ensure low profit margin businesses are not impacted. An alternative minimum tax concept (or non-refundable DST tax offset) could be adopted to ensure any DST is not doubling-taxing profits already subject to Australian income tax;
c. not be introduced until an assessment is made of the practical impacts of any UK DST on digital businesses; and
d. have a sun-set clause to operate when OECD consensus is reached.

[1] See paragraph 159 of the OECD Interim report

Detailed Comments

In what follows we provide more detailed comments, and where relevant, incorporate comments on the various consultation questions raised in the DP.

Australia should await OECD deliberations on the tax challenges arising from digitalisation

We already rely too heavily on taxing corporate profits

Australia is in a vastly different corporate tax paradigm than other countries contemplating a DST.

Unlike the vast majority of the OECD, Australia relies significantly more on corporate tax revenues than other countries and less on indirect tax revenues such as the GST. As such, we must be more conscious of increasing that burden as a small capital importing country, particularly in a discriminatory manner. Latest OECD figures show Australia's corporate tax to GDP ratio is 4.3% compared to an OECD average of 2.8%. The IMF recently commented on the need for a rebalancing of Australia's tax mix and the need to reduce, not increase effective corporate tax rates [2] .

The average OECD headline corporate tax rate for 2018 is 23.7% with only France and Portugal having higher combined corporate tax rates than Australia [3] France however is proposing to reduce its corporate tax rate to an effective rate of 28.3%[4]. The EU average rate which is contemplating an interim DST is only 21%[5]. We also note the UK are introducing its DST to coincide with a corporate rate reduction from 19% to 17%, whereas Australia has retained a 30% corporate income tax rate for entities with turnover greater than $50 million. Whilst at one level it could be said Australia is more at risk due to the larger potential international tax arbitrage, Australia has addressed these income tax integrity concerns with the introduction of the MAAL and DPT and supplemented revenue streams by imposing GST on digital supplies.

Apart from the BEPS Actions mentioned in the DP to address integrity concerns, Australia is also proposing income tax changes increasing the effective tax rate for Australian companies, including digitalised businesses. The proposed reduction in the research and development incentive for businesses with turnover above $20 million has the effect of reducing the incentive by more than 50% in the overwhelming majority of cases. Many resident digitalised businesses will be impacted by these changes at the same time a potential DST is introduced.

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[2] See https://www.imf.org/en/Publications/CR/Issues/2018/02/20/Australia-2017-Article-IV-Consultation-Press-Release-Staff-Report-and-Statement-by-the-45631

[3] See https://stats.oecd.org/Index.aspx?DataSetCode=TABLE_II1

[4] See https://home.kpmg.com/xx/en/home/insights/2017/09/tnf-france-tax-proposals-in-2018-draft-budget.html

[5] See https://home.kpmg.com/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online/corporate-tax-rates-table.html

Our integrity rules are robust as they currently stand

The current nexus and profit allocation rules underpinned by the domestic law and tax treaties as supplemented by the Multilateral Instrument, the MAAL and the DPT are more than sufficient to deal with the tax integrity issues associated with the digital economy until such time as international consensus is reached on the whether new international tax rules are required to deal with tax challenges associated with the value creation generated in part by user participation. Even if that international consensus is not reached, the MAAL and DPT provide sufficient targeted protection of the Australian revenue base, and do not need supplementing with an interim measure. These rules are highly targeted principle-based income tax integrity measures, not an in-substance excise tax measure dressed up as a targeted income tax measure which causes with it unquantified collateral damage.

Our culture of compliance and an effective ATO are dealing with the integrity issues

It is also worth noting the most recent ATO tax gap data and ATO pronouncements indicate that Australia's large business tax gap is small by international comparisons and voluntary tax compliance is world best practice. [6].

All indications from the ATO is the tax gap figure to be released in December 2018 is reducing off the back of a general culture of tax compliance, BEPS related tax integrity measures and increased ATO compliance activity. The ATO has also indicated its continual focus on the e-commerce sector. [7]

As the DP notes in relation to significant global entities (SGEs):

- the MAAL has been effective resulting in 44 multinational groups without a permanent establishment in Australia prior to the MAAL reorganising their supply chains to ensure more than $7 billion per annum in sales has been "on-shored". The ATO has indicated this has raised $100 million in extra income tax per annum collected.[8]
- The DPT targets arrangements where a SGE enters into a scheme with the principal purpose of shifting profits to tax regimes with effective tax rates of less than 24%.

Whilst we understand under WTO/FTA obligations Australia cannot discriminate between domestic and foreign entities if a tax is in substance an excise, the collateral damage to domestic digital businesses or foreign owned digital business who have an existing taxable presence in Australia raises the question as to whether a DST is warranted.

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[6] See https://www.ato.gov.au/About-ATO/Managing-the-tax-and-super-system/In-detail/Insight--big-pictures/Medium-and-large-businesses--the-big-picture/

[7] See page 6 of ATO submission 139.2 at https://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Corporatetax45th/Submissions

[8] See ATO submission number 139.2 to the SERC inquiry into corporate tax avoidance at https://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Corporatetax45th/Submissions

The MAAL (and the DPT) have been successful in dealing with multinationals that may not have had a taxable presence in Australia. In our view, imposing an interim measure that impacts corporates doing the right thing that have a taxable presence in Australia is plainly not warranted in principle or practice.

Complications in Designing an Interim Measure

Since the release of the DP, HM Treasury has released its consultation paper on the DST[9]. The consultation paper highlights the complications and likely compliance costs (for both the government and taxpayers) inherent in designing a targeted interim proposal. These includes (but are not limited to):

- Impacting domestic based businesses with an existing taxable presence in the UK
- Raising complicated law design issues around "in scope" businesses and appropriate parameters.
- Its potential to adversely impact those companies with low profit margins given its design is focused on gross revenue, not profit and is thus a regressive tax.

Discussions around the potential design of a DST in the EU also continues to encounter roadblocks, with several EU countries and Nordic Finance ministers consistently voicing concerns about its potential breadth and impact[10][11]. The concerns raised reflect those being raised in Australia - the DST's deviation from sound tax principles and the need for broader international agreement prior to action.

<u>Pass on impacts need to be carefully considered</u>

In our view the government needs to be extremely conscious of the impact on domestic users of digital platforms if market conditions allow the DST to be passed on to domestic users who pay for advertising as an increased commission or fee to cover the increased DST cost as happens with other excise taxes imposed on alcohol, petroleum and tobacco. Moreover, imposing an excise on a business which doesn't have negative externalities is, in our view, bad tax policy and should be avoided. As the DP notes, there have been huge benefits associated with digitalisation and a DST could arguably be seen as a double taxing that positive externality.

The government also needs to be conscious of the market distortion a DST may create if some digitalised businesses can pass on the cost whilst others have to absorb it (due to size). This is one of the reasons we would recommend assessing the impact of any UK DST before Australia contemplates a similar move.

[9] See https://www.gov.uk/government/consultations/digital-services-tax-consultation
[10] See https://taxfoundation.org/eu-pause-digital-tax/
[11] See https://euobserver.com/opinion/141966

The regressive nature of a DST is concerning

A DST based off gross revenue is a regressive tax if it cannot be passed on to those advertising on digital platforms. For example, assuming a UK styled 2% DST, a company making a profit margin before tax of 5% has a 40% reduction in before tax profits to 3%, whereas a company having a profit margin of 50% has a 4% reduction to 48%. The following table shows the outcome for companies with varying pre-tax profit margins on the same level of gross revenue assuming a 2% DST and the DST not being passed on.

Pre tax profit margin	5%	10%	15%	20%	25%	50%
Revenue	100,000,000	100,000,000	100,000,000	100,000,000	100,000,000	100,000,000
Pre-DST costs	95,000,000	90,000,000	85,000,000	80,000,000	75,000,000	50,000,000
Profit pre DST	5,000,000	10,000,000	15,000,000	20,000,000	25,000,000	50,000,000
DST (say 2%)	2,000,000	2,000,000	2,000,000	2,000,000	2,000,000	2,000,000
Profit after DST	3,000,000	8,000,000	13,000,000	18,000,000	23,000,000	48,000,000
Profit as % of sales	3%	8%	13%	18%	23%	48%
% reduction in profit margin	40%	20%	13%	10%	8%	4%

The outcome is that low margin businesses will suffer more under a DST unless, like the UK, thresholds and safe harbours are applied. If those with higher margins can absorb the DST, the likelihood will be smaller (ostensibly domestic) players will have to follow suit and not pass on the DST. This could produce the perverse result of large digital players without a physical PE in Australia obtaining more digital market share as smaller players can't compete. This would also mean less corporate tax revenue on which Australia is heavily reliant.

If an interim DST is to be introduced, it must set at a low rate and be very narrowly targeted.

Given the likely impact of a DST on domestic and non-resident businesses with permanent establishments, and the fact that the DST by design needs to be an excise (thus presumably be unfrankable albeit deductible), the risk of double tax is high if the DST cannot be passed on. We note the 2% UK DST proposal is happening concurrently with a corporate rate reduction from 19 to 17%, whereas Australia's corporate rate for SGEs remains at 30%, with proposed R&D incentive changes also increasing decreasing effective tax rates.

We note that the issues raised in the UK consultation paper illustrate the compliance cost on both governments and corporates from the development, administration and compliance of rules that try to mimic an income tax under the guise of an excise. Compliance costs will also be impacted if interim measures are developed in other countries and different definitions of in scope business, thresholds and safe harbours are inevitably developed.

Suggestions on "in scope" businesses

In our view, any interim DST should not tax the provision of an online market place where the marketplace is matching third party buyers and sellers and the intermediary receives a commission or fee. To tax such intermediaries conceptually favours vertically integrated businesses and those with a digital presence that take

title to goods or directly provide services and use a digital platform to sell or provide them rather than an intermediary model. Where the provider of the online market place has a permanent establishment, the commission received is taxed in Australia in any event.

We note that the UK DST is not intending to have the provision of financial and payment services in scope as they are not considered to generate significant value from user participation. We are aware of some wholly Australian digital businesses that provide ancillary intermediation services and derive commission on financial service facilitations. These should be similarly out of scope.

An alternative minimum tax concept (or non-refundable tax offset) could be adopted to ensure any DST is not doubling-taxing profits already subject to Australian income tax.

Given OECD concerns on the impact of an interim DST on start-ups, small business and low margin businesses (with similar concerns expressed in the UK and EU), "double barrelled" thresholds seem a reasonably practicable way to manage some of the collateral damage a DST would inevitably produce. Whilst Australia has thresholds existing in the income tax laws for SGEs ($1 billion annual turnover) and the $50 million turnover threshold for the lower corporate rate, we do not consider that as a justification for adopting similar thresholds for the DST given its interim nature. In order to minimise double taxation and to reflect the DST as an interim measure, any thresholds adopted at a global and local level should be set significantly higher.

For those that may fall outside such thresholds, DST design should minimise the impact of double taxation, which could be accommodated by a safe harbour or alternative minimum tax concept (like the UK), or potentially a non-refundable, non-carry forward DST tax offset to the extent a taxpayer otherwise has paid Australian income tax on profits derived from their digital business.

Should you wish to discuss any aspect of this submission in further detail, please do not hesitate to contact myself or Michelle de Niese of this office.

Regards

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