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The Digital Economy and Australia's corporate tax system

**Representation on the Treasury
Discussion Paper**

Dhruva Advisors LLP

December 2018



Principal Adviser,
Corporate and International Tax Division
The Treasury
Langton Crescent,
PARKES ACT 2600

December 20, 2018

By email: corporatetax@treasury.gov.au

Dear Sir,

Subject: Representation on the Treasury Discussion paper relating to the digital economy and Australia's corporate tax system

We write to you in connection with the Australian Treasury Discussion paper released in October 2018, inviting the views of the stakeholders and general public on the various aspects relating to digital economy, discussed in the report.

The Organization for Economic Cooperation and Development (OECD) Base Erosion Profit Shifting (BEPS) project has rapidly moved to the implementation phase, leaving a fundamentally changed landscape in its wake. The first and foremost Action Plan of the BEPS project was to address the tax challenges of the digital economy. Whilst various measures were considered as part of the BEPS report, none were recommended on an expectation that the measures developed as part of the BEPS project will mitigate some of the tax challenges posed by the digital economy.

The OECD and the European Union published their proposals on this topic earlier during the year. One has also seen the multitude of actions taken (few are in the process) recently by individual countries.

In line with the above, we have provided our comments to each of the discussion questions in the ensuing paragraphs.

We will be happy to answer any questions you may have regarding our comments outlined below. You could contact us on ajay.rotti@dhruvaadvisors.com.

Thanking You,

Yours sincerely,

For Dhruva Advisors LLP

A handwritten signature in blue ink that reads "Ajay Rotti".



Name: Mr. Ajay Rotti

Designation: Partner



1. Is user participation appropriately recognized by the current international corporate tax system? If not, how should value by users be quantified and how should it be taxed?

- Current international tax rules do not recognize the value created by user participation. Although, we agree that data generated or provided by an user is an important aspect of digital businesses, such data itself has no intrinsic value. Value is created by properly analyzing such data and knowing what data is of relevance, which would create value for the digital business. In our view, user participation in a jurisdiction does not in itself give rise to a taxable income in a jurisdiction and simplistic user participation does not deserve a recognition in the rules for allocating taxing rights and taxable profits between countries.
- Even if one were to conclude that user participation does create a taxable presence and profits should be allocated to jurisdictions based on user participation, the following challenges would arise-
 - The relevance and materiality of the user participation varies among business categories. Thus, not all digitalized businesses rely upon data and user participation to the same degree. Accordingly, a distinction would have to be drawn between active user participation (which would create value for the business) and passive user participation (which does not create any value for the business).
 - Further, reliability and veracity of the information would also need to be ensured, to address fraudulent accounts, multiple accounts, false information as well as bot-driven accounts.
 - It is difficult to get an estimate of how much data is created every day which is relevant, material and creates value for the digital business.
 - Users could be located in multiple jurisdictions and thus to allocate taxing rights to each such jurisdiction would not be appropriate and feasible.
 - A single individual could be accessing the digital platform or services using multiple devices (phone, tablet, laptop, etc.) and if due care is not exercised (which may not be simple), the same individual could get counted as multiple users.

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

- Identification of value associated with intangibles is not centric to only digital businesses. The reliance on intangibles can be seen across sectors including sector such as Pharma and automobiles.
- Under the current tax laws, the value of intangibles is generally allocated to the jurisdiction where ownership vests. In the context of digital economy, we believe that intangibles would create taxing rights in the jurisdiction where the intangible is developed, exploited, etc.
- In this context, we believe that the BEPS work (under Action Plan 8-10) on Intangibles would address the issues arising on account of intangibles –
 - The work provides a broad but clear definition of intangibles for transfer pricing purposes and makes clear that that any intangible item for which unrelated parties would provide compensation upon transfer must be compensated in transfers between associated enterprises. This will help ensure that transfers of hidden intangibles are not used to shift income.
 - The work ensures that entities within an MNE group that contribute value to intangibles either by performing or managing development functions or by bearing and controlling risks are appropriately rewarded for doing so. Specifically, the revised guidance ensures that legal ownership alone does not entitle the owner to premium profits, but that the group companies performing the important functions, contributing assets or assuming risks related to the development, enhancement, maintenance, protection and exploitation of intangibles will receive an appropriate return.





- Determination of valuation techniques can be used to determine arm's length transfer prices when comparable transfers of intangibles cannot be identified.

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

- Under the existing rules, allocation of profits is possible only where a business has a permanent establishment in another jurisdiction. To address the specific challenges of the digital economy, focus should be on the key features and determining which of those key features raise or exacerbate tax challenges with specific reference to constitution of a permanent establishment in an overseas jurisdiction. Once this aspect is finalised, the current attribution rules may be modified to provide for any specific situations if not already covered under the existing profit attribution rules.
- We also believe that, the other BEPS actions in combination with the current international framework for allocation of taxing rights and profits should be capable of dealing with the peculiarities of the digital economy supplemented by potential clarifications and/or amendments to the commentary to article 5 and 7 of the OECD model tax treaty. The BEPS actions which could aid in resolving the concerns in the digital economy are highlighted below-
 - **Market / source jurisdiction:** Work undertaken as part of Action 7 (Artificial avoidance of PE Status) will ensure that core activities in the digital economy cannot inappropriately benefit from the exception from PE status and that artificial arrangements relating to sales of goods and services cannot be used to avoid the PE status;
 - **Residence jurisdiction:** Work undertaken as part of Action 3 (Controlled Foreign Company) could be leveraged to ensure that CFC provisions capture the types of revenue that are typically generated in digital economy transactions such as license fees and income from sales of digital goods and services. Such an approach could limit the use of offshore structures used to defer income from tax in the residence jurisdiction; and
 - **Both market and residence jurisdiction:** Work in respect of Action 8 to 10 (Transfer Pricing) can help address BEPS challenges in the context of the digital economy by de-emphasizing the legal ownership of intangibles and by instead focusing on ensuring an appropriate return for companies performing the important functions, contributing important assets and controlling economically significant risks.

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?

- User contribution to user countries – For the reasons stated in point 1 and 3, allocating taxing rights associated with simplistic user contribution to countries would require fundamentally changing the nexus rules which we do not believe is the appropriate approach and could increase the problems of double taxation.
- Marketing intangibles to market countries - For many digitalized enterprises, the intense use of IP assets such as software and algorithms supporting their platforms, websites and many other crucial functions are central to their business models. Thus, we believe that intangible assets are important value drivers for digitalized enterprises. Having said this, in our view, market countries should be allocated taxing rights associated with marketing intangibles. Further, as discussed in point 2, the BEPS work on intangibles should help resolve issues with respect to taxing of intangibles and reallocation of profits arising on development, exploitation, etc. of intangibles.

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

- Under most tax treaties, business profits derived by an enterprise are taxable exclusively by the state of residence unless the enterprise carries on business in the other state (i.e., the source state) through a permanent establishment (PE) situated therein. This is generally referred to as the "nexus" rule, as it identifies the profits that are taxable by a country by reference to their relationship to a PE. The PE is generally defined by reference to a threshold that determines the





circumstances in which a foreign enterprise is considered to have a sufficient level of economic activity in a state to justify taxation in that state.

- In the context of the digital economy, the current nexus rules can be amended to address tax challenges with respect to certain points and concepts that are specifically relevant for the digital economy. Having said the above, we believe that the existing fundamental rules of allocating (nexus approach) should not be changed for the following reasons-
 - Changing the existing nexus rules could be impractical and impose significant risk of double taxation, given the difficulty in ring-fencing digital aspects of any enterprise, from the rest of economy. Such developments may also open discussions relating to fundamental changes in current transfer pricing and profit allocation principles.
 - Further, procurement of goods and services by the enterprises in the digital economy are no different than other traditional enterprises. Thus, the business operations remain the same, only the manner in which the business is conducted varies. Given this, we believe that a separate set of rules to a single set of business enterprises is not required.
 - Moreover, introduction of some form of virtual nexus would increase compliance costs significantly, which will be a barrier for companies to conduct cross border activities, especially for Small and Medium Enterprise companies.

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

Digitalisation has driven considerable changes in the way businesses operate. This has led to the emergence of new business models and lead to substantial transformation of old ones. There is no clearly defined and separate digital economy, instead there is an integration of digital models into traditional businesses.

There are specific economic features of the digital economy which are distinguishable from the traditional economy and which exaggerate the tax challenges in taxing a digitalised enterprise some of which are provided below:

- In a traditional economy, business would generally operate and serve a customer base within a single jurisdiction or in a limited number of jurisdictions. In a digitalized economy, the conduct of business online (with the intense use of technology), allows a business to operate globally (and not limited to a single jurisdiction), without a physical presence.
- Value generating assets, labour and capital are highly mobile in a digital economy as compared to the traditional economy.
- As there is no requirement to have a brick and mortar store, this allows digitized businesses save on the fixed costs of retail real estate – through purchase or tenancy costs - as well as the variable costs of labour to run its retail operations.
- **Platform** - Allows the company to replace a network of physical retail stores with a single online store that may be adapted to each individual consumer. These abilities rely on sophisticated technology, software and algorithms, each of which is a key source of value and competitive advantage of a digitalised business.
- **User data** - Whereas traditional resellers collected data about their potential consumers from previous orders and market research surveys, in a digital economy, the data is much more expansive in its scope and can be gathered in real time and in vast quantities. The data captured by digitalised resellers is also of higher quality because it all pertains to the patterns of behaviour and preferences of individual users.

The features discussed above on a standalone basis cannot be quantified to assess the costs and benefits of business models of taxation. Given this, and the other issues discussed under point 1, 3 and 5, in our view, these features do not themselves create taxing rights in jurisdictions. Hence, we do not see a need to have separate rules for appropriating the costs and benefits with respect to value associated with user participation.





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

As mentioned above there is no clearly defined and separate digital economy instead there is an integration of digital models into traditional businesses. Ring fencing would come with its own challenges, for instance, drawing a distinction between a digitized business and non-digitized business may not be possible and may add to further complications. Further, there could also be a situation where business in the same sector may be operated partly through digital and partly through other means. Thus, to have different set of tax rules in the same business sector for different business models would neither be appropriate nor be feasible. The specific tax issues could be addressed by focusing on the key features of the digital economy and determining which of those features raise or exacerbate tax challenges and developing approaches to address those challenges or concerns.

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 globalization and digitalization?

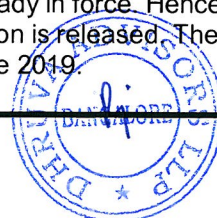
In our view, rather than introducing new digital nexus rules which could have far reaching consequences, as an interim measure, as already pointed out by OECD BEPS Action 1: Address the tax challenges of digital economy, adopting consumption taxes would be the most viable option. In this context, Australia has already expanded the scope of goods and service tax ('GST') to include cross border digital supplies within the ambit of taxation and hence at this point we believe no further changes are required.

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

- With the European Commission putting forward the proposals with respect to nexus rules and digital service tax, some of the individual countries are taking the actions positively whilst some of the European Union ('EU') countries have voiced their opposition to the Commission's proposals. These include Ireland, Luxembourg and the Nordic countries. Thus, the experience in EU, is a mixed bag.
- In India, in the context of digital economy, equalization levy and significant economic presence, have been introduced under the domestic tax laws. The equalization levy is applicable on online advertising fees paid by the Indian customers to foreign companies. The Indian government has been able to mop up tax revenues on account of equalization levy. However, the levy imposes challenges in terms of claim of tax credit under the Treaties, increased burden of cost on the Indian entity etc. The concept of significant economic presence has also been introduced in India in 2018. Though the provisions are in force, the determination of specific thresholds with respect to the transactions and number of users is not yet codified. Further, while the significant economic presence provisions are introduced by amendments to domestic tax legislations, one could still take protection under the respective Tax Treaties (which do not contain similar provisions for taxation).
- As evident from the above, although countries have introduced interim measures, such measures still require a lot of work and guidance in terms of the applicability and administrative compliances, like availability of tax credits, compliances etc. With the introduction of these measures various companies may be reluctant to do business with a country where such measures are prevalent owing to the increased cost and this could also have an impact on the international trade and commerce.
- Given the above, it may be ideal to wait for the final OECD recommendations before any further action is taken.

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

Implementation of consumption taxes in the form of GST is already in force. Hence it will be ideal for Australia to wait until the OECD led consensus-based solution is released. The OECD is also hopeful of delivering a concrete update on digitalization by June 2019.





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?

The revenue generated in a jurisdiction by way of digital means (by way of a specific threshold) and engaging in interaction with the users (number of transactions) together could be used to identify businesses that benefit from user-created value. However, these parameters would have to be determined keeping the size of the data economy in mind and the average annual revenue growth rate for such digital companies.

Withholding taxes and revenue-based taxes (corporation tax or others) are unlikely to offer a practical approach. For some businesses they will be too high relative to overall margins and for others it may be too low to provide consistent taxation with other non-digital businesses. There is also a risk that high levels of withholding taxes discourage investment and become an inhibitor to economic growth. Further, this would lead to additional costs for a business undertaking these activities. Also, it may be difficult to take a tax credit, of the taxes withheld at source, in the resident country.

Thus, in our view, an interim measure applied to digital advertising and/or intermediation services would not accurately target the value.

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?

For the reasons stated in point 5, we believe that as an interim measure, introduction of significant economic presence, or a virtual PE should not be considered. The nexus rules could be amended to provide clarifications with respect to certain points and concepts that are specifically relevant for the digital economy and which exacerbate tax challenges of the digital economy. We also believe that work on the other BEPS Action Plans would aid in resolving the digital tax concerns which have been highlighted in point 3 above.

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

- As mentioned in point 10 above, given that implementation of consumption taxes in the form of GST is already in force, interim measure could wait until the OECD led consensus-based solution is released.
- Having said that, the OECD Report on Action 1: Addressing the Tax Challenges of the Digital Economy notes that the revenue threshold for creating a taxable nexus based on a digital presence should be set at a high enough level to minimize the administrative burden for tax administrations as well as the compliance burden and level of uncertainty for the taxpayer. The Report also notes that the size of the relevant market could be a relevant factor in setting the level of the revenue threshold.
- The EU proposal also lays down specific factors with respect to determination of specific thresholds. Some of the factors that have been laid down are as follows -
 - The threshold could be determined basis the estimated costs for operating an additional permanent establishment, to exclude cases where profits attributable to a digital presence would not cover the cost incurred to carry out business in the other country.
 - Size of the data economy
 - Average annual revenue growth for digital firms
 - Average revenue per user
- In India, the determination of thresholds for transactions and users is also under discussion.

