KPMG submission

Treasury Discussion Paper

The digital economy and Australia's corporate tax system

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Executive Summary

KPMG welcomes the opportunity to respond to Treasury's discussion paper *The digital economy and Australia's corporate income tax system.*

In this Executive Summary, we seek to outline our thoughts on a very complex issue concisely.

It would seem to be broadly recognised, even by its advocates, that a Digital Services Tax (or DST) is flawed because it can lead to double taxation and has poor economic outcomes given it impacts different businesses unevenly and often not in accordance with the objectives of the tax.

Many of those advocating it, however, have argued that it is necessary as a temporary measure to bring parties to the table for a proper solution over the long term and to raise revenue.

This raises a fundamental question.

Should a bad tax be implemented to enhance the prospects of the implementation of a good tax? We think the answer to that is no. That is, what might be described as the collateral damage associated with the DST is so great that it should not be implemented.

What is that collateral damage?

First. In order to implement it in such a manner that it complies with WTO obligations, an Australian DST would in all likelihood need to apply to resident businesses that are raising Australian-taxed revenue as well as non-residents to which the DST is aimed.

This will impact a number of Australian based listed entities and many non-resident owned Australian companies operating in the Australian consumer market, which are producing taxable profits or losses.

That is, if one adopts a DST, the form of it will necessarily be a bad tax to accommodate WTO rules.

Second. Whilst there may be a top tier of companies that are impacted by the DST in a manner consistent with the intentions of those who advocate a DST, there is a large group of second level companies with low profits or indeed losses, for which a DST would be economically detrimental for the simple reason that the DST is a tax on turnover and not based on profit.

Attempts to mitigate this point by allowing a special regime for losses and low margin businesses or alternatively giving credits for DST paid in the corporate income tax, have the difficulty of rendering the DST subject to a Double Tax Treaty and thus not effective.

That is, if one adopts a DST, the form of it will necessarily be a bad tax to deal with the fact that it cannot simply be overridden by treaties.

Third. There is an additional point here and that is the potential damage to the second level entities that would be adversely impacted by a DST is not abstract and isolated but significant

and widespread. These companies will be at a competitive disadvantage to top tier companies which may have significant cash flow and relatively high margins.

The second tier companies for which the DST could cause significant damage are not exceptional in the sense that they are not outliers. Whilst many of the business plans for these second level entities are very different from one another there will be blunt rules that will have blunt impacts and damage. How will the DST impact market competition? Can the DST be passed on to consumers or will it just give rise to business models that need to absorb greater losses and cash costs?

That is, if one adopts a DST, it will be a bad tax to the extent that it impacts more powerful companies to a lesser extent and will impact second tier companies differentially.

Fourth. And related, boundaries under a DST will not be clean, but arbitrary, as they are not based on principles. Would the DST apply to intermediation where a significant provision of a physical service such as delivery is provided? What level of service is required? Would the DST apply if the same service was provided in a conventional business context?

Indeed the burdens of different jurisdictions' DST may overlap (for example a buyer and seller in different jurisdictions using a marketplace platform owned in a third jurisdiction) such that there could be triple taxation, if not more.

That is, if one adopts a DST, it will be a bad tax to the extent that economically clean lines cannot be drawn around it. It will be arbitrary in this sense.

Fifth. This is reputational and precedent-setting. If Australia were to embrace a DST, it would expand the precedent for taxation measures that are not grounded in economic principle and are not supported by a multilateral framework. It opens up for re-consideration other delineations by other nations on an ad hoc basis. Australia should be a nation that considers principles first, because it is in a world of principles that Australia will gain the most power. Not a world of large power assertion.

That is, if one adopts a DST, it will be a bad tax to the extent that it undermines the principled position that Australia typically adopts and will wish to adopt in the future.

What is the prospect of obtaining a long term solution in the absence of a DST?

It is difficult to be definitive in an answer, but one can say quite clearly that with US GILTI, the no-DST vs DST balance has changed given that US GILTI has lifted the bar of minimum tax for most US MNEs.

One can also say it is likely that a solution which is not based on ring-fencing but proper valuation creation principles is more likely to come to the fore.

This will take time and reflection. We are not there yet. The underlying issues are still evolving. But we are currently experiencing a degree of urgency on the matter that was not there 12 months ago. This is particularly important when dealing with nebulous concepts such as user participation.

Ultimately, Australia should adopt an approach based on good taxation principles. That should be the objective in its own right. We should not adopt a tax which results in a high level of collateral damage.

Detailed comments

1.0 General

1.1 KPMG welcomes the opportunity to comment on the Discussion Paper (DP): *The digital economy and Australia's corporate tax system* published by Treasury on 2 October 2018.

1.2 KPMG is committed to supporting Treasury, the Commonwealth government and international partner jurisdictions in reaching a fair and sustainable consensus solution for the taxation of multinational enterprises in an increasingly digitalised business environment.

1.3 By international standards, Australia has a relatively large percentage of its overall tax revenues at stake in the form of company income tax. While international consensus on the optimal way of taxing the digital economy may take some time to achieve, it is not impossible and would surely represent the lowest risk approach.

1.4 Australia should therefore be very active in the international debate in seeking a consensus solution. The greatest long-term benefit will be achieved by taking a principled approach, resulting in equitable outcomes that are sustainable over many years. There would be great risk in any solution that was very favourably skewed towards some countries, as this would more likely result either in a need for further renegotiation in just a few years, or the re-emergence of unilateral measures.

1.5 We have identified a number of principles which should underpin Australia's approach to the questions Treasury has posed in the discussion paper.

Underlying principles

1.6 Australia should maintain its commitment to a multilateral solution to the taxation challenges posed by the digital economy. As a capital-importing, trade-reliant economy this is surely our best option.

1.7 New measures should not result in double taxation. Given that we are not talking about anti-avoidance measures, they should not undermine the purpose of double taxation agreements.

1.8 Any unilateral measure would likely cause a reaction from trade partners, and this needs to be factored in to Australia's decision-making. A unilateral measure could set a precedent that is then applied in a way that is relatively detrimental to Australia's exporting industries, and could even be incorporated into any multilateral solution.

1.9 Maximum effort should be made to ensure that the international consensus-based measures provide taxpayers with certainty. This means we may need to move away from a principles-based approach towards bright-line criteria for elements of the solution.

1.10 New measures should align with industry's capacity to identify and self-assess the data on which the measures would be predicated.

The drawbacks of a unilateral interim measure

1.11 We are concerned that any unilateral interim measure would have the following adverse fiscal and economic consequences:

a) In a number of cases, it could be the digital business customers and/or users who bear the ultimate burden of a digital services tax (DST). This is more likely to be the case in respect of the larger businesses who are perceived as the primary "targets" of a DST, because they may have the market power to pass on the cost to their customers. There is no economic rationale for wanting customers to pay more for these services.

b) It is unlikely that a DST could be designed in a manner so as to exclude domestic digital services businesses whose profits are already fully subject to Australian tax. It would therefore be a competitive burden on these innovative businesses.

c) A proliferation of unilateral taxes on the lines of a DST would inhibit economic growth in the digital economy sector. Technology companies would face increased risks and difficulties in business planning and expenditure on product development.

d) A DST would either be a blunt, excise-type tax on certain gross revenues or a more balanced tax that made allowances for lower profitability and the offset of losses. The former approach would lead to effective double taxation of profits. The latter

approach would leave the DST more open to having its legitimacy challenged under bilateral tax agreements due to it being more like a "tax on income".

e) A DST would be an explicit shift towards "demand side" taxation, a principle which could in turn be applied by the international community to Australia's highest value exports. Therefore Australia needs to consider very carefully any unilateral move that would be seen as endorsement of this principle.

f) Some countries and academics have sought to justify the imposition of a DST by advocating the idea that users of a business's digital platform are creators of value for that business. We are not convinced by this analysis and are concerned that it opens up the risk of greater complexity and uncertainty in the international tax system. In any event, the value derived from the digital enterprise's intangible assets, such as algorithms and databases, would be much more significant.

g) We prefer the proposition that users and the platform-provider are undertaking a barter transaction, with the user exchanging their data and content material in return for use of the platform.

h) We recognise that the announcement of a DST could be used as a lever to try and accelerate the process of achieving multilateral consensus, and that the prospect of this may be more useful than the imposition. However there is a high level of risk in this approach, particularly when the burden of the tax may ultimately fall on local business or consumers.

1.12 Australia should therefore take a long-term view of digital economy taxation, and consider the means by which the global tax system should be updated to better accommodate the digital economy. Australia should continue to participate in multilateral initiatives looking at adapting the existing principles of nexus and profit allocation such that they produce acceptable outcomes, based on consensus, in respect of the digital economy.

2. KPMG responses to discussion questions

Question 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?

2.1 The current international corporate tax system does not recognise user participation. Instead it relies on concepts of value creation within an enterprise, and of taxable nexus, which are well understood although not always simple to apply.

2.2 We are not convinced by the arguments put forward in support of "user created value" being recognised by the international tax system. We prefer the analysis that the user and the platform-provider are engaged in a (tax neutral) barter transaction, where user-provided data and content are traded in return for access to the platform and to other users' content.

2.3 At the same time, the existence of a cohort of users and/or customers in a particular country creates a connection between the foreign digital business and the jurisdiction in which those users and customers reside. The concept of the "digital permanent establishment" (an example of which is contained in the European Commission's proposal for a long-term multilateral solution) could be a reasonable basis for identifying the jurisdictions in which a digital business has a taxable presence.

2.4 The allocation of taxable profits to those jurisdictions where the business has a nexus represents an even more complex problem. In order to be fair and sustainable, any allocation methodology must factor in an appropriate return on tangible and intangible assets, and not be limited to "demand-side" factors such as the number or value of user and customer relationships.

Question 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?

2.5 Currently the value contributed by marketing intangibles such as brand names is attributed principally to jurisdictions where those intangibles are maintained and protected. Again this is a well understood principle, although determining an arm's length value for the use of such assets is becoming increasingly difficult and controversial as their international usage spreads.

2.6 The question arises as to whether that value should be attributed to a greater extent to the markets where the marketing intangible is exploited, on the basis that without the consumers in those jurisdictions, the brand name would generate less revenue. We would see this approach as having more justification in relation to something like a brand name, than in the case of an invention, patent or recipe for example.

2.7 A difficulty in establishing the amount of a fair return on the marketing intangible for the country where it is maintained and protected is that internally generated assets of this kind may not be attributed any value in the enterprise's balance sheet.

2.8 In relation to other intangibles, it would be important for any revision to the international corporate tax system to include provision for a relatively high return (compared to marketing intangibles) on those assets to be treated as taxable profit in the jurisdiction where the asset is maintained. The importance of this aspect is that otherwise jurisdictions would have less incentive to create an environment where innovation and research are encouraged, because they would not get a fair share of the tax revenues once the new technology or equipment generated a profit. This situation would be to the detriment of the global economy as a whole.

2.9 The United States' introduction of rules attributing the "global intangible low-taxed income" or "GILTI" of a foreign subsidiary to its US parent effectively creates a precedent for applying a minimum tax rate to intangible assets held in low- or no-tax jurisdictions. At a rate of 10.5%, this precedent moves the minimum much closer to the level that headline corporate income tax rates are trending towards in many developed countries.

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

2.10 A strength of the current profit attribution rules is that they allow the value created from assets maintained in a jurisdiction to be recognised and taxed in that jurisdiction. However with the expected increasing diversity of internally generated intangible assets that will emerge, it will become more difficult to place an arm's length value on the contribution of these assets, using current methods based on external market comparable data. It will become ever more difficult to identify truly comparable arm's length situations.

2.11 Therefore a global consensus-based solution might instead provide for a "taxable return" on different classes of asset, calculated as a percentage of the revenue derived from the deployment of that asset. The balance of the multinational enterprise's profits might be attributed across jurisdictions based on a matrix of factors including users, customers, sales and employees for example.

2.12 We recognise that there would be difficulty in identifying reasonable returns for separate classes of asset, and obtaining international consensus on these. However if this could be agreed at an international level it would lead to significantly less ongoing complexity and administration cost for both enterprises and revenue authorities.

Question 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?

2.13 Any alternative approach would need to ensure that there was minimal risk of double taxation through overlap in the allocation method. Ideally it would be aligned to data that the enterprise can readily identify and provide.

2.14 Further, in order to be both fair and sustainable, the profit allocation must allow for a reasonable return on assets (both tangible and intangible) maintained in a jurisdiction to be taxed in that jurisdiction.

2.15 In this regard, it may be reasonable that a marketing intangible attracts a lower return than an invention such as an algorithm.

2.16 However taxing rights should only be allocated to jurisdictions in which the enterprise is deemed to have a taxable presence, under whatever rules for determining taxable presence are adopted by international consensus.

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

2.17 The phenomenon of "scale without mass" means that it is now possible for an enterprise to have a significant role in the commercial activity carried out by residents

of a jurisdiction, without the enterprise needing to have a commensurate physical presence in that jurisdiction.

2.18 Expanding the concept of the permanent establishment to include digital nexus would be a step towards addressing this apparent gap.

2.19 It is vital that any change to the nexus rules is carried out in a coordinated manner on the foundation of international consensus. In order to manage administrative costs for both enterprises and revenue authorities, any new approach should include a requirement that a taxable presence can only arise once a threshold level of digital nexus has been achieved.

Question 6: From a tax perspective, do you consider that the digitalised economy is distinguishable from the 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?

2.20 Currently, the distinction between highly digitalised business and traditional business may appear easy to identify in many cases. However it is inevitable that over time there will be fewer businesses at the extremely traditional end of the spectrum, and many more where the question of whether they meet the highly digitalised description will be harder to answer.

2.21 In future the key differentiator between enterprises will really about the relative size of the role that intangible assets play in the enterprises' business model. Therefore the focus should be on coming to a consensus approach on how profit will be attributed to the jurisdictions where intangibles are maintained.

Question 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?

2.22 For the reasons outlined in the answer to Question 6, we do not believe that the international community should attempt to 'ring-fence' the digital economy vis-a-vis a special set of additional rules on nexus and profit attribution.

2.23 It may be possible to draw a more straightforward distinction in the taxation of a business that supplies goods versus one that supplies services. Enterprises supplying

services are likely to have a greater reliance on intangibles, and would be more capable of achieving "scale without mass" and benefitting from network effects.

2.24 As a country with significant exports of tangible commodities, it may benefit Australia for the international system to retain a "traditional' approach to taxing profits from the sale of goods, while moving to a new approach for the taxation of services.

Question 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?

2.25 Over several years KPMG has consistently supported proposals for a comprehensive review of Australia's tax system.

2.26 In 2017 KPMG collaborated with Treasury in a study of corporate tax rates and collections across a range of countries, and found that Australia has one of the highest levels of reliance on corporate income tax.

Reform areas that Australia should consider include:

- A reduction in the company income tax rate
- A broadening of the GST base and an increase in the rate
- Federal administration of state-based taxes such as payroll tax and land tax in order to increase efficiency of collection and oversight
- Continued targeting of the black economy
- Tightening the rules on work-related expense deductions

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

2.27 Those unilateral interim measures which have been implemented or are being contemplated all diverge from the principles that we have stated as underpinning a sound and sustainable policy response. That is:

- They are not based on broad international consensus and therefore are likely to lead to double taxation for multinational enterprises.
- They could lead to a disincentive to adopt new technology and a distortion of economic behaviour within the local economy. In order to comply with international trade agreement obligations, the likelihood is that local digital services businesses operating wholly in the domestic market would also have to pay the interim tax.
- They are principally revenue-based, rather than profit-based, and therefore would impact lower-margin and unprofitable operators disproportionately.
- They cause international trade partners to consider some form of countermeasure which may outweigh the expected revenue benefit from the interim measure.
- Over time, the burden of the tax could be expected to effectively shift to consumers.

2.28 The US Senate Committee on Finance has written a letter to the European Commission in regards to its proposal for a Digital Services Tax, strongly urging the European Union against implementing the measure:

> *The EU DST Proposal violates the long-held principle that taxes on multinationals should be profit-based, not revenue-based. The EU already has a revenue tax based on the location of the customer – the VAT. Consequently the DST will undoubtedly lead to double taxation of multinational companies.*
>
> …
>
> *The turnover thresholds … are discriminatory, putting in-scope companies at a competitive disadvantage without objective justification. This raises concerns about the EU DST Proposal's compliance with the EU's national treaty commitments under the World Trade Organization General Agreement on Trade in Services.*

The very fact that they create such a range of uncertain and potentially problematic outcomes is itself key to the experience of announcing or implementing interim measures.

Question 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?

2.29 No. Earlier in this submission we have set out the in-principle drawbacks of a unilateral interim solution. As a trade-dependent, capital-importing economy, Australia would in practice be heavily exposed to each of these drawbacks. In addition, all of the interim measures currently in operation or under consideration have a "demand-side" bias which carries an extreme risk in Australia's case of setting an unfavourable precedent in relation to our own export industries.

Question 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?

2.30 KPMG does not support any unilateral interim measure, even if limited to certain business models. In our view the concept of user-created value has not been shown to be a compelling vehicle for arriving at a consensus solution.

There is a wide and increasing variety of user relationships which exists across the digital economy, including:

(1) A person who uses a social networking platform,

(2) A driver who uses a ride-sharing platform to provide ride-sharing services to customers with their car,

(3) A paying customer of the same ride-sharing platform who uses the platform to arrange lifts with drivers,

(4) A user of an online shopping platform (either buying or selling),

(5) An individual who uses an online search engine.

These examples demonstrate the different ways in which users interact with a multinational businesses and therefore the extent to which assessing user-created value would be a highly complicated matter.

2.31 The common element to each of these examples is that the digital enterprise's intellectual property is key to the generation of value for the enterprise. We see the contribution of the user as being a barter transaction, where the user freely provides data in return for access to the platform. In some cases (such as social media) the user is actively providing the data, whereas in many others (such as ride-share or online purchase) the data is a by-product of the service the user is receiving.

2.32 Given the role of users in the digital business's environment we would instead see it as reasonable for the international corporate tax system to acknowledge 'usership' as a relevant factor in establishing a taxable nexus with a jurisdiction in which the users reside.

Question 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?

2.33 Our comments relate to the choice of nexus criteria for a longer-term consensus-based multilateral approach. An interim unilateral measure should not be pursued.

2.34 Regarding the issue of balancing ease of administration with avoidance concerns, if the choice of nexus criteria is one that is based on international consensus, then the risk of avoidance should be very low. In this regard, the adoption of minimum tax regimes such as the US "global intangible low-taxed income (GILTI)" provisions, in conjunction with the BEPS measures already adopted internationally, means that enterprises already have less opportunity to "play the system".

2.35 Any criteria for a revised or expanded nexus rule should ideally be based on data that the impacted enterprises can readily provide from their existing systems.

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

2.36 Any threshold based on revenue could be interpreted as having a bias against major overseas-headquartered digital businesses, and could consequently conflict with Australia's international trade obligations.

2.37 If a profitability threshold were applied to adjust for the limited capacity of lower-margin and start-up businesses to pay an additional levy under an interim measure, this would cause the tax to have greater similarity to a tax on income, meaning that it would be more likely to be challenged under existing bilateral tax treaty rules.

2.38 Consequently there is little prospect of being able to introduce a unilateral interim measure, compliant with Australia's international trade obligations, that does not apply to Australian digital businesses that are already paying tax on all of their profits in Australia.