



**Tax policy report: Options for taxing the digital economy**

<b>Date:</b>	13 December 2018	<b>Priority:</b>	Medium
<b>Security level:</b>	In Confidence	<b>Report number:</b>	T2018/3710 IR2018/801

**Action sought**

	<b>Action sought</b>	<b>Deadline</b>
Minister of Finance	<b>Agree</b> to recommendations <b>Note</b> the contents of this report	18 December 2018
Minister of Revenue	<b>Agree</b> to recommendations <b>Note</b> the contents of this report	18 December 2018

**Contact for telephone discussion (if required)**

<b>Name</b>	<b>Position</b>	<b>Telephone</b>
Carmel Peters	Policy Manager, Inland Revenue	Withheld under section 9(2)(a) of the Official Information Act 1982
Sam Rowe	Senior Policy Advisor, Inland Revenue	
Matthew Gan	Tax Specialist, The Treasury	

13 December 2018

Minister of Finance  
Minister of Revenue

## **Options for taxing the digital economy**

---

### **Executive summary**

---

1. The purpose of this report is to advise Ministers on options for taxing the digital economy, and in particular, whether New Zealand should adopt a digital services tax (DST).
2. There has been significant international concern over the ability of highly digitalised companies to derive significant income from a country without being liable for income tax there. This is mostly caused by deficiencies in the current international tax framework, which has not kept up with digitalisation and other modern business developments. This under-taxation of the digital economy threatens the sustainability of Government revenues and public perceptions of the fairness of the tax system. It also provides a competitive advantage to overseas digital companies compared to local businesses, which are subject to full income tax.
3. We currently consider that changing the international tax framework is the best option for taxing the digital economy in the long-term. Accordingly, New Zealand should continue to participate in the OECD discussions on this, with a view to supporting an agreed solution (bearing in mind its effect on our exporters). There are 3 proposals being considered at the OECD:
  - A limited proposal for digital services only, focussing on social media, digital advertising, multi-sided platforms and data. This is the European Union (EU) and the United Kingdom (UK) proposal.
  - A broader proposal, which would allow greater taxing rights to market countries (such as New Zealand) based on certain "market intangibles" created there by multinationals (including brands and trade names used in the country, customer data and customer relationships). This is the United States proposal and would apply beyond the digital economy.
  - A minimum tax proposal suggested by France and Germany. This proposal would apply beyond the digital economy and would be targeted at a multinational's transactions with related parties in low tax jurisdictions.
4. The OECD is aiming to get G20 approval of its preferred proposals in June 2019 (we attach an article which has a good description of the OECD's approach). We consider it more likely than not that the OECD will be successful in achieving an international solution, but there is no guarantee of this. Accordingly, we recommend the Government also consider whether a digital services tax (DST) might be appropriate as an interim measure. This DST would be like the one proposed by the UK and would apply to online advertising, social media, intermediation platforms (like Uber, eBay and Airbnb) and the sale of data. We note a DST does have significant downsides, which would need to be carefully assessed and explored.
5. To commence, we recommend the Government publishes a discussion document in the first half of 2019 to get public feedback on the options for taxing the digital economy (being the international solution discussed at the OECD and a DST). We recommend the discussion document make it clear that:

- the Government has not yet decided whether it wants to introduce a DST, but is considering this as an option;
  - any DST would only be introduced if the OECD is unable to arrive at an international solution in a reasonable time-frame and a critical mass of other countries also adopt DSTs; and
  - the DST would be an interim measure that would cease to apply once an international solution was fully implemented.
6. The Australian Government has also issued a discussion document on options for taxing the digital economy, which takes a similar approach.
7. If you agree with this approach, we would aim to release a discussion document to seek public feedback in the first half of 2019 (following approval by Cabinet). We would report back to you on this feedback in the second half of 2019, together with final policy recommendations. At that stage we will be in a better position to provide a timeline for further steps, including legislation if the decision is made to proceed with a DST.
8. The current problem with taxing the digital economy only relates to income tax. The Government has already acted to ensure that the digital economy will be fully subject to New Zealand GST. GST has been applied to 'remote' services since 2016 (including digital services), and the Government has announced its intention to charge GST on low-value imported goods from 1 October 2019.

### Recommended action

---

9. We recommend that you:
- (a) **Agree** that New Zealand should continue to participate in the OECD discussions, with a view to supporting a long-term solution to the taxation of the digital economy (bearing in mind its effect on our exporters).
- Agreed/Not agreed Agreed/Not agreed
- (b) **Agree** that the Government should also start considering a possible DST as an option for taxing the digital economy, in case the OECD are unable to achieve an international solution in a reasonable timeframe.
- Agreed/Not agreed Agreed/Not agreed
- (c) **Direct** officials to draft a discussion document for release in the first half of 2019 to get public feedback on these options for taxing the digital economy (the international solution and the DST). In relation to the DST, the discussion document should state that:
- the DST would be like the one proposed by the UK;
  - the Government has not yet decided whether it wants to introduce a DST but is considering it as an option;

- any DST would only be introduced if the OECD is unable to arrive at an international solution in a reasonable timeframe and a critical mass of other countries also adopt DSTs; and
- the DST would be an interim measure that would cease to apply if an international solution was fully implemented.

Agreed/Not agreed

Agreed/Not agreed

**Matt Cowan**

Team Leader, Tax Strategy Team  
The Treasury

**Carmel Peters**

Manager, Policy and Strategy  
Inland Revenue

**Hon Grant Robertson**

Minister of Finance  
/ /2018

**Hon Stuart Nash**

Minister of Revenue  
/ /2018

## Background

---

10. There has been significant international concern recently over the ability of highly digitalised companies to derive significant income from a country without being liable for income tax there. This is also an issue for New Zealand.
11. The value of cross border digital services provided to New Zealand consumers is estimated to be approximately \$2.7 billion in 2018, and this market is expected to continue growing. For online advertising, the New Zealand market for 2017 was \$923 million, which was 36% of New Zealand's advertising market. The total size of New Zealand's e-commerce market is hard to ascertain, but a rough estimate is \$26 billion in total, with supplies from offshore worth \$11.5 billion.
12. The current problem with taxing the digital economy relates to income tax, rather than GST. GST has been applied to 'remote' services since 2016 (including digital services), and the Government has announced its intention to charge GST on low-value imported goods from 1 October 2019.
13. We previously reported on the digital economy in IR2017/657 and IR 2018/200.

## The problem

---

14. The main problem is that the current international tax framework has not kept up with modern business practices, particularly digitalisation. In particular:
  - Digital companies can transact with customers over the internet without having the physical presence required by double tax agreements (DTAs) for income tax to be charged in the country.
  - Even if a digital company does have a taxable presence in a country, the profit allocation rules do not recognise the new kinds of value that are generated by digital companies in that country.
  - Much of the value of digital companies is attributable to intangible assets. These intangibles are hard to value. They are also mobile, meaning the income attributable to them can be easily moved to low tax jurisdictions. We note this is also an issue for the taxation of some non-digital companies.
15. The result of this is that digital companies can participate significantly in the economic life of a country, without being liable for any income tax there.
16. This under-taxation of the digital economy threatens the sustainability of Government revenues and public perceptions of the fairness of the tax system. It also provides a competitive advantage to overseas digital companies compared to local businesses, which are subject to full income tax.

## Options for solving the problem

---

17. There are two options for solving the problem. One is to change the current international income tax framework. The other is to apply a separate tax (usually called an equalisation tax, or a digital services tax) to digital transactions.

## Changing the international framework

18. Changing the international framework is generally agreed by countries to be the best long-term solution to the taxation of the digital economy. However, it requires changes to existing DTAs and international standards. Accordingly, New Zealand cannot change this framework by itself - it requires multilateral agreement.

19. Countries are currently discussing possible changes to address the problems with the international framework at the OECD. There are 3 proposals being considered:
- A limited proposal for digital services only, focussing on social media, digital advertising, multi-sided platforms and data. This is consistent with how the European Union (EU) and the United Kingdom (UK) have proposed addressing the issue.
  - A broader proposal, which would allow greater taxing rights to market countries (such as, New Zealand) based on certain “market intangibles” created there by multinationals. These are intangibles that relate to marketing activities in the country, or which aid in the commercial exploitation of a product or service or have an important promotional value (such as brands and trade names used in a country, customer data, customer relationships and customer lists). This is how the United States (US) has proposed addressing the issue. This approach would apply beyond the digital economy, but we expect it to be targeted at large companies with significant intangible value in market jurisdictions. [REDACTED]  
Withheld under section 6(a) of the Official Information Act 1982
  - A minimum tax proposal suggested by France and Germany. This proposal would apply beyond the digital economy and would be targeted at a multinational’s transactions with related parties in low tax jurisdictions. This proposal addresses some remaining base erosion and profit shifting (BEPS) issues and is not specifically directed at the digital economy (although it would also apply to digital companies). This proposal is independent of the first two, and so could apply in addition to one of them
20. Neither of the first two proposals would require a digital company to have a physical presence in a market country. Accordingly, both proposals should allow New Zealand to tax highly digitalised companies on their sales income here (with the second proposal also allowing us to tax other multinationals with significant local marketing intangibles). The OECD is also discussing whether the first two proposals could be combined.
21. The OECD’s proposals would potentially apply to the 124 countries forming part of its wider Inclusive Framework (which includes China and India), plus any other countries which elected to adopt them.
22. There is still disagreement at the OECD on what should be done. However, countries have committed to reaching consensus on an international solution by 2020 and the OECD is putting a significant amount of effort into achieving this. Progress is being made and there is a real possibility that the OECD will be successful, [REDACTED] s 6(a) [REDACTED]. But it is still too early to tell.
23. The OECD is aiming for G20 approval of its preferred proposals in June 2019 [REDACTED] [REDACTED] s 6(a) [REDACTED]. If this occurs, it is likely that an international solution can be achieved in 2020. Accordingly, we should have a better idea of the likelihood of an international solution after the June G20 meeting. Even if an international solution is achieved in 2020, it could still take 3-4 years for the solution to be designed in detail at the OECD and implemented.

### A digital services tax

24. The other option for taxing the digital economy is to introduce a special tax, called a “digital services tax”, or DST. A DST is targeted at certain digital companies and is not an “income tax” for DTA purposes. This means a DST is not subject to the current international tax framework, and so it can be charged to digital companies regardless of whether they have a physical presence in a country. Consequently,

- countries can introduce a DST unilaterally, without the need for international agreement.
25. The UK recently announced it would introduce a separate 2% DST on the profits of certain digital companies that would apply from April 2020. Spain, Italy and India have also enacted or announced DSTs (although India's has a much narrower scope than the others). The EU Commission has proposed a 3% DST for Europe, however it has not been able to achieve the support of all EU members. The EU's original proposal has recently been replaced with a narrower DST only targeting online advertising, which EU members will consider early in 2019. This narrower DST is proposed to apply only in the event that an international solution cannot be achieved at the OECD.
  26. The DST is quite controversial (it was not recommended by the OECD due to a lack of consensus), but we expect at least some additional EU countries to enact one even if the EU as a whole does not. In addition, Australia issued a consultation paper on taxing the digital economy in October 2018, which included discussion of a possible DST (among other options for taxing the digital economy).
  27. The DSTs proposed so far (other than India's, which was introduced before the recent international interest in taxing the digital economy) share a set of common features. They are flat taxes charged at a low rate (2%-3%) on gross revenues from certain digital platforms. These are digital platforms whose value is dependent on the size and active contribution of their user base – for example, intermediation platforms like Uber and eBay; social media platforms like Facebook; and content sharing sites like YouTube or Instagram (although the EU's latest proposal only targets online advertising).
  28. This means a DST is narrowly targeted at certain highly digitalised business models. It would not apply to sales of goods or services (other than advertising or data) over the internet. So, it would not apply to Netflix for example, or to goods sold online by Apple or Amazon. It also would not apply to the kinds of digital services typically exported by New Zealand (such as accountancy services).
  29. A DST is levied by reference to where the users of the digital platform are located rather than where payments are made. To achieve this, an affected digital company's consolidated global gross revenues are apportioned between the relevant country and the rest of the world by reference to the proportion of global users in that country. The revenue attributable to that country is then subject to the DST.
  30. For example, suppose a digital company had \$10 billion of total gross global revenue and 5% of its total global users in State A. The revenue attributable to State A would be \$10 billion x 5% = \$500 million. State A would then charge 3% tax on its allocated \$500 million of revenues, for total tax of \$15 million. In calculating this tax, it is only the location of the users that is relevant, not the location of the customers paying the digital company for its services. Therefore the \$15 million DST would still be charged even if no actual payments were made to the digital company from State A.
  31. For New Zealand, a DST would be a way of collecting some tax from some digital companies (but not all of them) that have been paying little tax either here or overseas. As a rough estimate, we expect a 3% DST would raise between \$30m and \$80m of tax<sup>1</sup>, depending in part on its scope and design. A DST would also significantly improve public confidence in the fairness of the tax system, which is an important factor underlying voluntary compliance. In addition, the size of the

---

<sup>1</sup> This is based on a rough bottom-up estimate of what we think a DST would raise in New Zealand, combined with top down estimates based on what the EU and UK have forecast their DSTs to raise, adjusted for differences in GDP and exchange rates.

digital economy is growing as a proportion of the total economy. Consequently, it will become increasingly important for New Zealand to tax it appropriately.

32. However, there are issues with a DST. These include:

- The consistency of the tax with other tax settings. The DST may not mesh well with other elements of our tax system. This might result in some double taxation of compliant firms (including possibly some domestic firms) and taxation of businesses with losses.

Withheld under section 9(2)(h) of the Official Information Act 1982

- The economic incidence of the tax. The issue here is whether the tax would be passed along by the non-resident suppliers to New Zealand customers. We expect around half of the cost of the tax could be passed on to customers, based on the limited evidence available.
- The effect on New Zealand's reputation as a good place to do business. New Zealand is a small open economy and we compete for capital with the rest of the world. That means we want New Zealand to be an attractive place for non-residents to do business.
- The potential effect on our export sector. The implications of adopting a DST for our export sector would need to be considered. Some trading partners, s 6(a), might raise concerns should New Zealand introduce a DST. Members of the US Congress and US technology industry have previously claimed DST proposals by the UK and the European Commission would lead to double taxation, and that proposed turnover thresholds would amount to discrimination against US companies in breach of World Trade Organization national treatment provisions.

Withheld under section 6(a) of the Official Information Act 1982

- The period of time for which a DST would be applicable. The OECD expects that any DSTs would be repealed once a multilateral solution is achieved. Other countries that have recently proposed DSTs have also agreed with this. Accordingly, if agreement was reached quickly at the OECD, then it may not be worth designing a DST that would only apply for a short period of time.
- The administration and compliance costs of introducing a new tax. This is particularly an issue given that a DST is not expected to raise significant revenue. In addition, given a DST would be expected to (at least predominantly) apply to companies outside of New Zealand, there are fewer tools available to Inland Revenue to enforce the tax.



## What should New Zealand do?

---

### Continue participating in the OECD discussions

33. We currently consider that changing the international tax framework, if possible, would be the best option for taxing the digital economy in the long term. It would integrate the taxation of these companies into the income tax system, and so avoid the need for a separate DST with all its attendant issues (as discussed above). At this stage, we also expect this option to benefit New Zealand overall. This is because New Zealand imports more highly digitalised services than it exports. [Redacted]   
 [Redacted]   
 [Redacted] However, we will need to wait until the proposals are developed in more detail before we can come to any firm conclusions about this.
34. Therefore, we recommend New Zealand continue to participate in the OECD discussions, with a view to supporting an international solution (bearing in mind its effect on our export sector).

### Commence formal consideration of a DST in the interim

35. There may be benefits in adopting a DST in the following circumstances:
- the OECD cannot achieve an international solution in a reasonable timeframe (as any DST would need to be repealed once that solution was achieved);
  - a critical mass of other countries also adopts a DST, particularly Australia (to reduce the reputational risks of adopting a DST);
  - New Zealand companies are not unduly affected by the DST; and
  - the DST will not just be passed on to New Zealand consumers.
36. This evaluation is also consistent with the Tax Working Group's recommendations on a DST in their interim report.
37. We recommend that the Government start considering a DST as another option for taxing the digital economy. To commence, we recommend publishing a discussion document. This will also help to identify some of the advantages and disadvantages of a DST, and so will put the Government in a better position to subsequently decide whether it should introduce one.

### Contents of the discussion document

---

38. The discussion document should broadly outline the two options for taxing the digital economy – namely an OECD led international solution, and a unilateral DST. The DST proposed should include the common features discussed above. In addition, we understand that the OECD is planning to publicly consult on its proposed international solutions in February 2019. Accordingly, the discussion document can also describe the OECD's proposed options in detail and invite feedback to the Government on them. We suggest the discussion document be framed as exploring the options (as with the Australian discussion document on the digital economy), rather than consulting on a preferred approach.
39. We also recommend that the discussion document make it clear that:
- the Government has not yet decided to whether to introduce a DST, but is considering it as an option;

- the DST would only be introduced in the event the OCED is unable to reach an international solution in a reasonable timeframe and a critical mass of other countries also adopt DSTs; and
- The tax would be repealed when an international solution was fully implemented.

## Consultation

---

40. We consulted with the Ministry of Foreign Affairs and Trade on this report.

41. Withheld under section 9(2)(h) of the Official Information Act 1982

42.

## Next steps

---

43. If you agree, we would aim to publish a discussion document for public consultation in the first half of 2019 (following Cabinet approval). We would report back to you on the consultation, together with final policy recommendations, in the second half of 2019.
44. The subsequent steps will depend in part on developments at the OECD (particularly whether the G20 endorse the OECD's preferred proposals in June 2019), and on the work programme adopted by the Government following the Tax Working Group's final report. We will be in a better position to provide you with a timeline for these subsequent steps when we report back in the second half of 2019.

**Annex – article from Tax Notes International**

OECD

---

**G-20 Leader Unity Key to Digital Taxation Agreement, OECD Says**

by Stephanie Soong Johnston

Tax Notes International - 10 December 2018 - available at <https://www.taxnotes.com/tax-notes-international/information-exchange/g-20-leader-unity-key-digital-taxation-agreement-oecd-says/2018/12/10/28n61>, Withheld under section 18(d) of the Official Information Act 1982

