In Confidence

Office of the Minister of Finance

Office of the Minister of Revenue

Chair, Cabinet

OPTIONS FOR TAXING THE DIGITAL ECONOMY

Proposal

1. This paper seeks Cabinet agreement to prepare a Government discussion document on options for taxing the digital economy, including a digital services tax (DST). This discussion document could be released together with the Government's response to the Tax Working Group's final report, s 9(2)(f)(iv) [redacted]. Feedback from the discussion document will be used to help formulate the best policy for taxing the digital economy.

Executive Summary

2. The Government will consider several measures recommended by the Tax Working Group (TWG) to improve the structure, fairness, and sustainability of the tax system. This includes a broad extension of capital income taxation, which will primarily affect New Zealand businesses and investments. However, it is important to also ensure that multinational companies pay their fair share of tax in New Zealand.

3. A major issue with the taxation of multinationals is the ability of highly digitalised companies to derive significant income from a country without being liable for income tax there. This is an issue both globally and in New Zealand. This issue is mostly caused by deficiencies in the current international tax rules, which have not kept up with digitalisation and other modern business developments. This under-taxation of the digital economy threatens the sustainability of Government revenues and the fairness of the tax system. It also provides a competitive advantage to overseas digital multinationals compared to local businesses, which are subject to full income tax.

4. We currently consider that changing the international income tax rules is the best option for taxing the digital economy in the long-term. These rules are contained in New Zealand's double tax agreements and in various internationally agreed standards. This means New Zealand cannot change the international tax rules on its own – it requires international agreement. 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 two broad measures being considered at the OECD:

   - A measure to allocate greater taxing rights over a multinational's profits to market countries. The measure would not require the multinational to have a

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physical presence in the country. There are 3 proposals being considered for this purpose (only one of which would be adopted):

- 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 "marketing intangibles" created there by multinationals. This is the United States proposal and would apply beyond the digital economy. s 6(a)
- A proposal which seems to provide for apportionment of a multinational's profit to market countries under an agreed formula, which would be based on certain factors such as sales and user participation. This proposal could extend beyond the digital economy Withheld under section 6(a) of the Official Information Act 1982

- A minimum tax measure suggested by France and Germany. This proposal would apply beyond the digital economy and would ensure that multinationals pay a minimum level of tax on profits earned in low tax jurisdictions.

5. The OECD is aiming to obtain G20 approval of its preferred measures in June 2019. 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 actively consider introducing a DST as an interim measure. This DST should initially be designed to be like the one proposed by the UK (as the UK's proposed DST is the most advanced and is likely to influence other countries' DSTs, s 6(a)) 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. We also see real benefits to aligning New Zealand's position on a DST with Australia's.

6. To commence, we recommend the Government publishes a discussion document to obtain 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 is determined to ensure that multinational companies pay their fair share of tax in New Zealand.
- The Government is actively considering introducing a DST in advance of an international solution. While New Zealand is committed to finding a solution at the OECD, if sufficient progress is not made this year, a DST is a credible option.
- The DST would be an interim measure that would cease to apply once an international solution was adopted.
- We would aim to design the DST so it is fully consistent with New Zealand's international obligations (which we expect to be possible).

- The Government sees real benefits in aligning New Zealand's position on a DST with Australia's.

7. The Australian Government has also issued a discussion document on options for taxing the digital economy, which takes a similar approach. Consultation closed for this on 30 November 2018.

8. We consider that measures to address this issue should be combined with the TWG measures adopted by the Government, so that the Government can present a comprehensive package of reforms to improve the New Zealand tax system. To this end, the digital economy discussion document could be released together with the Government's response to the Tax Working Group's final report, s 9(2)(f)(iv) [redacted]. We would report back to Cabinet 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.

Background

9. The Government commissioned the TWG to recommend measures to improve the structure, fairness, balance and sustainability of the tax system. The TWG provided its final report in January 2019. We are also reporting to Cabinet on the TWG report contemporaneously with this paper.

10. The concrete measures recommended by the TWG report are mostly focussed on the taxation of New Zealanders. However, the Government must also ensure that multinationals pay a fair share of tax in New Zealand. The Taxation (Neutralising Base Erosion and Profit Shifting) Act (BEPS Act) we enacted in 2018 prevented multinationals from using various strategies to avoid paying their fair share of tax in New Zealand. However, a significant outstanding issue is the taxation of digital multinationals operating in New Zealand.

11. The digital economy in New Zealand is significant and growing, with non-residents making up a large portion. The value of cross border digital services provided to New Zealand consumers was 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. It is not clear exactly what proportion of online advertising is supplied by non-residents, but it is likely to be between 60% - 75%. The total size of New Zealand's e-commerce market is hard to ascertain, but a rough estimate for 2018 is $26 billion in total, with supplies from offshore worth $11.5 billion.

Analysis

The problem

12. 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 deal 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.

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- Even if a digital company does have a taxable presence in a country, the current internationally agreed rules for attributing the digital company's profit to the country 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 non-physical, intangible assets, like patents and trademarks. These assets are hard to value. They are also mobile, meaning they can be used to shift income to low tax jurisdictions. This is also an issue for the taxation of some non-digital companies.

13. 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.

14. This under-taxation of the digital economy is a significant problem. It 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.

15. 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.

16. A diverted profits tax, of the kind adopted by Australia and the UK, would not solve the current problems with taxing the digital economy. This is because a diverted profits tax (like our recent BEPS Act) basically prevents multinationals from avoiding a country's existing income tax rules. However, taxing the digital economy requires a fundamental change to those rules.

Options for solving the problem

17. There are two options for solving the problem. One is to change the current international income tax rules, which have been agreed to by countries. The other is to apply a separate DST to digital transactions.

Changing the internationally agreed income tax rules

18. Changing the internationally agreed income tax rules 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 income tax rules at the OECD. There are two measures being considered:

    - A measure to allocate greater taxing rights over a multinational's profits to market countries. The measure would not require the multinational to have a physical presence in the country. There are 3 proposals being considered for this purpose (only one of which would be adopted):

- 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 multilaterally.

- A broader proposal, which would allow greater taxing rights to market countries (such as, New Zealand) based on certain "marketing intangibles" created there by multinationals. These are non-physical intangible assets 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 assets in market jurisdictions. Withheld under section 6(a) of the Official Information Act 1982

- A proposal which seems to provide for apportionment of a multinational's profit to market countries, based on a formula that would take into account factors like sales and user participation. The measure would require the multinational to have a significant economic presence in the country (which need not be physical) and could involve withholding taxes. This proposal could apply beyond the digital economy s 6(a)

- A minimum tax proposal suggested by France and Germany. This proposal would apply beyond the digital economy and would ensure that multinationals pay a minimum level of tax on profits earned 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).

20. These measures should address the current problems with taxing the digital economy.

21. 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, especially now that the US supports a solution. But it is still too early to tell.

22. The OECD is aiming for G20 approval of its preferred measures in June 2019 Withheld under section 6(a) of the Official Information Act 1982 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. If an international solution is achieved in 2020, it could take 3-4 years for the solution to be designed in detail at the OECD and implemented.

A digital services tax

23. The other option for taxing the digital economy is to introduce a separate DST. A DST is targeted at certain highly digitalised companies and is not an "income tax" for DTA purposes. This means countries can introduce a DST unilaterally, without the need for international agreement. A DST applies even if the digital company does not have a physical presence in the country.

24. The UK recently announced it would introduce a 2% DST from April 2020. Spain, Italy, France, Austria, and India have also enacted or announced DSTs (although India's has a 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. 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).

25. The DSTs proposed so far generally share a set of common features. They are flat taxes charged at a low rate (2%-3%) on gross revenues from certain digital platforms that are attributable to the users in the relevant country. The DSTs apply to 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).

26. 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).

27. For New Zealand, a DST would be a way of collecting some tax from some digital multinationals (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, depending in part on its scope and design. The small size of this figure compared to the size of New Zealand's digital economy as a whole (as discussed in paragraph 11) reflects the narrow scope of a DST – it is targeted at certain highly digitalised business models, and so does not apply to a large portion of the digital economy.

28. A DST may also improve public confidence in the fairness of the tax system, which is an important factor supporting voluntary compliance. In addition, the size of the digital economy is growing as a proportion of the total economy. Consequently, it will become increasingly important for New Zealand to tax it appropriately. Therefore, we consider a DST to be a credible option for taxing the digital economy. We also see real benefits in aligning New Zealand's position on a DST with Australia's.

29. However, there are issues with a DST that would need to be carefully worked through in deciding whether to adopt one, including consideration of consistency with New Zealand's international trade obligations and double tax agreements as well as the potential reactions of trading partners, including with respect to treatment of New Zealand exporters under their domestic tax and other laws.

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The Tax Working Group

30. The TWG also considered the taxation of the digital economy. In its final report, the TWG concluded that New Zealand should continue to participate in the OECD discussions on changing the internationally agreed income tax rules, but should also stand ready to implement a DST if a critical mass of other countries move in that direction, and it is reasonably certain the New Zealand's export industries will not be materially impacted by any retaliatory measures.

What should New Zealand do?

Continue participating in the OECD discussions

31. We currently consider that changing the internationally agreed income tax rules, 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. We also expect this option to benefit New Zealand overall, however, we will need to wait until the OECD's proposals are developed in more detail before we can come to any firm conclusions about this. 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). This was also the recommendation of the TWG in its interim report.

Commence formal consideration of a DST in the interim

32. We need to ensure that multinationals are fairly-taxed in New Zealand. Therefore, while we prefer an international solution, we need to consider a DST as an option in case this cannot be achieved in a reasonable time frame. In this regard, there may be benefits in adopting a DST as an interim measure in advance of an OECD solution if:

    - the OECD cannot make sufficient progress on an international solution this year;
    - 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.

33. This is broadly consistent with the TWG's analysis of a DST.

34. We recommend that the Government publish a discussion document to commence its formal consideration of a DST (as Australia has done). 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.

35. The discussion document could be released together with the Government's response to the TWG's final report later in 2019.

Contents of the discussion document

36. 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, the OECD issued a public consultation document on its proposed international solutions on 13 February 2019. Accordingly, the discussion document can also describe the OECD's proposed options in detail and invite feedback to the Government on them.

37. Although the OECD is consulting on its proposals, we recommend that the discussion document also seek feedback from stakeholders on them. This is so that the Government can understand the effect of the OECD's proposals on New Zealand in particular (which is unlikely to be apparent from the OECD's worldwide consultation). This understanding can be used to develop New Zealand's own position on the OECD proposals, which we can then advance at subsequent OECD discussions, and on any potential unilateral options the Government might want to pursue in the face of insufficient progress on a multilateral solution.

38. The discussion document should be presented as part of a package of comprehensive tax reforms that includes any TWG recommendations adopted by the Government.

39. We also recommend that the discussion document make it clear that:

    - The Government is determined to ensure that multinational companies pay their fair share of tax in New Zealand.
    - The Government is actively considering introducing a DST in advance of an international solution. While New Zealand is committed to finding a solution at the OECD, if sufficient progress is not made this year, a DST is a credible option.
    - The DST would be an interim measure that would cease to apply once an international solution was adopted.
    - We would aim to design the DST so it was consistent with New Zealand's international obligations (which we expect to be possible).
    - The Government sees real benefits in aligning New Zealand's position on a DST with Australia's.

Consultation

40. Inland Revenue, the Treasury and the Ministry of Foreign Affairs and Trade were consulted on the Cabinet paper and support the preparation of the discussion document. The discussion document will be used as a basis for consultation with the public. Inland Revenue and the Treasury will consult with other interested Government agencies in preparing the discussion document, such as the Ministry of Foreign Affairs and Trade. We will report back to Cabinet with a draft of the proposed discussion document prior to its release.

Financial Implications

41. There are no financial implications for the release of the discussion document. The introduction of new measures to tax the digital economy would be fiscally positive, although by how much depends on what options are selected and how they are designed (whether by New Zealand or the OECD). Advice on financial implications will be provided when approval on the finalised package is sought.

Administrative impacts

42. Officials will consider administrative impacts when they draft the discussion document. Advice on administrative impacts will be provided when approval on the finalised package is sought.

Legislative Implications

43. The publication of the discussion document does not have any legislative implications. However legislative change will be necessary if Cabinet subsequently decides to implement the policy recommendations developed out of the discussion document.

Impact Analysis

44. Elements of the regulatory impact analysis will be included in the discussion document at a level that is appropriate given the stage of policy development. A full regulatory impact analysis will be carried out later in the policy process, once officials have finalised their policy recommendations.

Human Rights

45. There are no human rights implications associated with the release of the discussion document.

Publicity

46. We will arrange the appropriate publicity for the release of the discussion document. This publicity could be combined with the publicity for the Government's response to the TWG's final report, so that together they form a comprehensive package to improve the New Zealand tax system.

Proactive Release

47. We propose to proactively release this Cabinet paper in part, together with the associated Ministerial reports. These could be released at the same time as the papers for the Government's response to the TWG's final report.

48. Some parts of the Cabinet paper and associated Ministers' reports will be redacted under the grounds contained in the Official Information Act, for example where it is necessary to prevent prejudice to New Zealand's international relations.

Recommendations

The Minister of Finance and the Minister of Revenue recommend that Cabinet:

1. **Note** that the Government is considering measures recommended by the Tax Working Group to improve the New Zealand tax system.

2. **Note** that there is a problem with the current taxation of the digital economy, both in New Zealand and internationally.

3. **Note** that a number of countries, including Australia, are investigating or implementing digital services taxes (DSTs).

4. **Agree** that New Zealand should continue to participate in the OECD discussions on the taxation of the digital economy, with a view to supporting a long-term solution (bearing in mind its effect on our exporters).

5. **Agree** that the Government should also actively consider a possible DST as an option for taxing the digital economy, in case the OECD are unable to achieve sufficient progress this year.

6. **Direct** officials to draft a discussion document to get public feedback on the options for taxing the digital economy (being the international solution and the DST). In relation to the DST, the discussion document should state that:

   - The Government is determined to ensure that multinational companies pay their fair share of tax in New Zealand.
   - The Government is actively considering introducing a DST in advance of an international solution. While New Zealand is committed to finding a solution at the OECD, if sufficient progress is not made this year, a DST is a credible option.
   - The Government sees real benefits in aligning New Zealand's position on a DST with Australia's.
   - The DST initially proposed would be like the one proposed by the UK.
   - The DST would be an interim measure that would cease to apply once an international solution was adopted.
   - We would aim to design the DST so it was consistent with New Zealand's international obligations (which we expect to be possible).

7. **Delegate** authority to the Minister of Finance and the Minister of Revenue to decide when the discussion document will be released.

8. **Note** that we will report back to Cabinet with a draft of the discussion document prior to its release.

9. **Note** that this Cabinet paper, the associated Cabinet minute, and key advice papers will be proactively released on Inland Revenue's website.

Authorised for lodgement

Hon Grant Robertson
Minister of Finance

Hon Stuart Nash
Minister of Revenue

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