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 publish the attached tax policy Government discussion document *Options for taxing the digital economy*. This discussion document will be released as part of Budget 2019. Feedback from the discussion document will be used to help formulate the best policy for taxing the digital economy.

Executive Summary

2. 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.

3. 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. This option is currently being discussed at the OECD. The other option is to apply a separate digital services tax (DST) to certain revenues earned by highly digitalised multinationals in New Zealand.

4. The Government supports an internationally agreed solution at the OECD, but it will seriously consider a DST if the OECD cannot make sufficient progress this year.

5. On 18 February 2019 Cabinet agreed to issue a discussion document to consult on options for taxing the digital economy (Cabinet Minute CAB-19-MIN-0041 refers). The 18 February Cabinet paper noted that we would report back to Cabinet with a draft of the discussion document prior to its release.

6. We attach a draft of this discussion document (Discussion Document) to this paper for approval by Cabinet.

Background

7. 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 also an issue for New Zealand. The 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 impacts 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.

8. On 18 February 2019 Cabinet agreed to issue a discussion document to consult on options for taxing the digital economy (Cabinet Minute CAB-19-MIN-0041 refers).

Analysis

Content of the discussion document

9. We have drafted the Discussion Document as outlined in the February Cabinet paper. The Discussion Document explains the problems with taxing the digital economy. It then outlines the two options for taxing the digital economy – imposing a DST or changing the internationally agreed tax rules at the OECD – and invites public feedback on those options. Some information about the size of the digital economy in New Zealand and globally is included as well.

Option 1 – imposing a DST

10. The Discussion Document states that:

- The Government is determined to ensure that multinational companies pay their fair share of tax in New Zealand.
- While the Government supports an internationally agreed solution at the OECD, it will seriously consider a DST if the OECD cannot make sufficient progress this year
- 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.

11. The DST proposed in the Discussion Document is based on the DST announced by the UK, and shares a set of common features with other DSTs. It is a flat tax charged at a low rate (3%) on gross revenues that are attributable to the users in the relevant country. The DST would 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.

12. This means the proposed 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 accountancy services delivered via the cloud.

13. Countries which have introduced or announced DSTs so far are Austria, the Czech Republic, France, India, Italy, Spain and the UK. The European Commission proposed a 3% DST for the EU but it could not achieve the support of all EU members.

14. The Discussion Document explains the benefits of a DST and its issues. These issues include the 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. The Discussion Document also considers how much of a DST may be passed on to New Zealand consumers, amongst other things.

Option 2 - Changing the internationally agreed income tax rules

15. The Discussion Document describes two measures being considered at the OECD for changing the internationally agreed income tax rules. These are:

- A measure to allocate greater taxing rights over a multinational's profits to market countries (such as New Zealand). The measure would not require the multinational to have a physical presence in the country. There are three 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 based on certain "marketing intangibles" created there by multinationals. This is the United States proposal and it would apply beyond the digital economy. s 6(a) [redacted]

    - A proposal which provides 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 and is supported by a group of 24 developing countries (the G24).

  It is possible that the OECD may adopt an option that incorporates elements of more than one of the three proposals, or an alternate proposal not yet considered.

- 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.

16. The OECD is aiming to obtain G20 approval of its preferred measures in June 2019 and countries have committed to working towards a consensus solution in 2020.

Conclusion

17. The Discussion Document concludes that the Government supports an internationally agreed solution at the OECD, but it will seriously consider a DST if the OECD cannot make sufficient progress this year. Factors to be considered in making this decision are:

- whether the OECD can make sufficient progress on an international solution this year;
- whether a critical mass of other countries also adopts DSTs (to reduce the reputational risks of adopting a DST);
- whether New Zealand companies would be unduly affected by a DST; and
- whether the cost of a DST would all be passed on to New Zealand consumers.

18. This is broadly consistent with the Tax Working Group's analysis of a DST.

Australia's announcement that it would not proceed with a DST at this time

19. Australia announced on 20 March 2019 that it would not adopt a DST at this time. Instead it will focus on achieving a multilateral solution at the OECD. The announcement follows Australia's recent consultation on options for taxing the digital economy (which included a DST). The announcement noted that:

    - the Australian Government firmly believes that digital firms, like all firms, must pay their fair share of tax;
    - the submitters overwhelming supported Australia continuing to engage in the ongoing multilateral process at the OECD; and
    - many submitters raised significant concerns about the potential impact of an Australian DST across a wide range of Australian businesses and consumers.

20. Australia's announcement should not affect New Zealand's decision to consult on a DST. The Government was clear when it announced the Discussion Document in February that it prefers a multilateral solution, but wants to consider a DST now in case the OECD does not make sufficient progress. So the Government shares Australia's preference for an OECD-led multilateral solution, but wants to be ready to implement a DST in case this cannot be achieved in a reasonable time-frame.

Next steps

21. If Cabinet approves the Discussion Document, then we would release it as part of Budget 2019. We would report back to Cabinet on the feedback from the Discussion Document 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.

22. Some minor editorial and technical changes may need to be made to the Discussion Document following its approval by Cabinet including changes to reflect any updates to the OECD proposals prior to the release of the Discussion Document. This is because there is a possibility that the OECD will update its proposals before the Discussion Document is released. If this occurs, we will update the description of those proposals in the Discussion Document.

Consultation

23. We consulted with the following on this Discussion Document: Inland Revenue, The Treasury, The Ministry of Foreign Affairs and Trade, The Ministry of Business, Innovation and Enterprise, The Ministry for Culture and Heritage, and The New Zealand Customs Service. We have incorporated their feedback into the Discussion Document and they support the preparation of the Discussion Document.

24. The Discussion Document will be used as a basis for consultation with the public.

Financial Implications

25. There are no financial implications for the release of the Discussion Document. We expect the introduction of new measures to tax the digital economy to 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). As a rough estimate, we expect a 3% DST would raise between $30m and $80m of tax, depending in part on how it is designed. Advice on financial implications will be provided when approval for our final policy recommendations is sought.

Administrative impacts

26. There are no administrative impacts from the publication of the Discussion Document. A DST and an OECD solution would have administrative impacts. We have designed the proposed DST in the Discussion Document to minimise these. Advice on administrative impacts will be provided when approval for our final policy recommendations is sought.

Legislative Implications

27. 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

28. Elements of the regulatory impact analysis have been 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

29. There are no human rights implications associated with the publication of the Discussion Document.

Publicity

30. We will arrange the appropriate publicity for the release of the Discussion Document. The release of the Discussion Document will also be included in the publicity for the 2019 Budget.

Proactive Release

31. We propose to proactively release this Cabinet paper in part, together with the associated Ministerial reports.

32. 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 there is a problem with the current taxation of the digital economy, both in New Zealand and internationally.

2. **Note** that a number of countries are investigating or implementing digital services taxes (DSTs).

3. **Agree** that the Ministers of Finance and Revenue may make minor editorial and technical changes to the Discussion Document before its release.

4. **Note** that if the OECD proposals change before the release date, we will update the description of those proposals in the Discussion Document under recommendation three above.

5. **Agree** to publicly release the attached Government discussion document *Options for taxing the digital economy*, subject to any changes made pursuant to recommendation three above.

6. **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