

## ANALYSING NEW ZEALAND'S DIGITAL SERVICES TAX PROPOSAL

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### ABSTRACT

The allocation of taxing rights for cross-border digital profits is a critical issue for the 21<sup>st</sup> century. The New Zealand government has responded with a discussion document proposing a digital services tax as an interim measure. Given the lack of global consensus on solutions for the issue, a digital services tax is a serious possibility. This article examines the government's proposal.

The proposal's rationale is based on active contribution, which is conceptually weak and contains several interpretative issues. The proposal fails to distinguish between traditional businesses and highly digitalised businesses ('HDBs') and, as a result, business activities of traditional businesses are, theoretically, in scope. However, high *de minimis* thresholds ensure that only large HDBs are liable.

Fundamentally, there is a lack of evidence that HDBs are paying tax at a lower effective rate than other businesses. Given this, it is strange that an international effort has been made to tackle HDBs. Furthermore, this unilateral approach could dangerously reduce multilateral cooperation in tax matters.

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## I INTRODUCTION

On average, New Zealanders spend nearly two hours per day on social media.<sup>1</sup> Non-resident social media companies derive income from selling our attention to advertisers. They operate multi-sided platforms that connect users and advertisers. New Zealand, along with nearly all other jurisdictions, currently treats the income earned by social media companies and non-resident digital platforms as non-taxable in New Zealand. However, there is global unease as prominent businesses, such as Facebook and Google, derive large revenue from market jurisdictions. New Zealand is participating in talks at the Organisation for Economic Co-operation and Development ('OECD'), where jurisdictions are attempting to ascertain a multilateral approach to tackle the 'digital economy'.<sup>2</sup> However, New Zealand's government, along with those of other jurisdictions,<sup>3</sup> has proposed a digital services tax ('DST') as an interim or final solution if there is no multilateral consensus. Inland Revenue ('IR') has produced a discussion document, *Options for Taxing the Digital Economy: A Government Discussion Document*, outlining the government's proposal.<sup>4</sup>

The DST represents a new unilateral approach to international tax issues. It applies a flat 3 per cent tax rate to large businesses on gross turnover of certain in-scope activities. This article analyses the government's proposal. Section II examines the DST. There are several interpretative issues in the government's proposal, and, furthermore, there are several negative consequences. Section III tests whether highly digitalised businesses ('HDBs') are paying their fair share of tax. Furthermore, it explores the rationale of active contribution as a justification for taxing rights, and questions the path of unilateralism. Section IV concludes with closing remarks.

## II DST PROPOSAL: INTERPRETATION AND ANALYSIS

### *A Interpretation*

The DST proposal outlines a systematic process to determine liability:

6. Determine if the group's business includes any of the activities defined to be in scope.
7. Assess whether the group exceeds two *de minimis* thresholds.
8. Determine the group's annual gross revenue attributable to its in-scope business activities.

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<sup>1</sup> Hootsuite and we are social, 'Digital in 2018: In Oceania — Part 2: East' (SlideShare, 29 January 2018) <<https://www.slideshare.net/wearesocial/digital-in-2018-in-oceania-part-2-east>>.

<sup>2</sup> OECD, *Addressing the Tax Challenges of the Digitalisation of the Economy: Public Consultation Document* (OECD Publishing, 6 March 2019).

<sup>3</sup> Austria, Belgium, the Czech Republic, Italy, Poland, Slovenia, Spain and the UK.

<sup>4</sup> Inland Revenue, New Zealand Government, *Options for Taxing the Digital Economy: A Government Discussion Document* (June 2019) <<https://taxpolicy.ird.govt.nz/sites/default/files/2019-dd-digital-economy.pdf>>.

9. Determine the group's proportion of that revenue attributable to New Zealand.
10. Calculate the group's DST payable on that attributable revenue at 3 per cent.
11. Return and pay the DST to IR by the due date.

### B Calculation of DST

#### 1 Step 1: Are the Group's Activities within Scope?

As a general principle, the DST would 'apply to the services provided by business activities whose value is dependent on the size and active contribution of their user base'.<sup>5</sup> Therefore, the two requirements are that:

- the service must consist of a business activity
- the business activity's value depends on the size and active contribution of the user base.

This principle assesses the relationship between the business and users. The Macmillan Dictionary defines 'user base' as 'the number of people who use a particular product or service, especially one available on the Internet'.<sup>6</sup> Hence, the DST is restricted to internet users — it cannot apply to a farmer's market, for example.

The first requirement is straightforward: business activities. The *Income Tax Act 2007* (NZ) defines 'business' as including an 'undertaking carried on for profit'.<sup>7</sup> Many online services are not carried on for a profit, hence these services are excluded.

The second requirement is more complex. The reference to size suggests that the DST only applies to business activities that have network effects — that is, where a service gains additional value the more people use it. Network effects are evident across many industries (insurance, telecommunications, etc). The active contribution of users is the key underlying pillar of the DST. Users in New Zealand must actively contribute to the value of the HDB through personalised content, such as posting, uploading photos, commenting, creating groups

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<sup>5</sup> Ibid 3.20. Several exceptions apply, at 3.21:

- The sales of ordinary goods or services (other than advertising or data) over the internet. It would not apply to goods sold online (for example, by Amazon itself).
- The provision of online content, such as music, games, TV shows and newspapers. This means it would not apply to Netflix for example. The DST would apply to a platform which facilitated the sale of goods, services or content between buyers and sellers, such as Apple music. In this case, the DST would apply to the platform owner, but not to the people who made or supplied the good, services or content over the platform.
- Services delivered directly through the internet, such as accounting services delivered via the cloud.
- Information and communications technology (ICT) providers, such as telecommunication companies and internet service providers.
- Standard financial services, such as credit cards and EFTPOS providers.
- Television and radio broadcasting.

<sup>6</sup> *Macmillan Dictionary* (online at 13 November 2019) 'user base' <<https://www.macmillandictionary.com/dictionary/british/user-base>>.

<sup>7</sup> *Income Tax Act 2007* (NZ) s YA 1; *Grieve v Commissioner of Inland Revenue* [1984] 1 NZLR 101 (CA); *Case 2/2012* [2012] NZTRA 02/(2012) 25 NZTC 1-014.

and tracking devices. It is contentious whether tracking users would constitute active contribution. Many applications (for example, Google Maps) track the location or browser history of users. The users are contributing data, but not to such an extent as on Facebook. Furthermore, it is also arguable whether users subjected to targeted online advertising (with some clicking on the advertisements), without providing personalised content, constitutes active contribution. The general principle is unlikely to be included in any legislative proposal; however, it gives a clue about the purpose of the DST proposal.

The below list provides a more concise test:<sup>8</sup>

Specifically, the DST would apply to supplies made through:

- intermediation platforms, which facilitate the sale of goods or services between people (like Uber and eBay);
- social media platforms like Facebook;
- content sharing sites like YouTube and Instagram; and
- search engines and the sale of user data.

The above test applies to ‘supplies made through’ various platforms. It is debatable whether ‘supplies’ refers to the supply of services by the platform owner to the user (for example, Facebook offering a free platform to users), or the supply of services by the platform owner to the advertiser (for example, Facebook offering advertising space to a café). The general principle would support reference to the supplies provided to the user. Step 4 refers to the proportion of New Zealand users when attributing an amount to New Zealand. The example in IR’s discussion document refers to the activity of fictional multinational group SocMed, but does not explain the nature of the activity.<sup>9</sup> None of the exclusions at s 3.21 provide any indication. Further clarification from IR is necessary.

The first category, an ‘intermediation platform’, is an intermediary that brings different types of users together (for example, Uber and eBay). Other prominent intermediaries include Airbnb, Booking.com, Expedia, Groupon, TripAdvisor and Trade Me. The second category, a ‘social media platform’, ‘is a web-based technology that enables the development, deployment and management of social media solutions and services’.<sup>10</sup> Facebook, YouTube, Instagram, Pinterest, Tumblr and Reddit are examples of social media platforms. The third category, ‘content sharing sites’, is very broad. All websites share content. The listed companies, such as YouTube and Instagram, suggest that the category only applies to sites where users can upload their own content.

The fourth category includes two parts: ‘search engines’ and the ‘sale of user data’. Google dominates the search engine market in New Zealand with a 96.32 per cent share.<sup>11</sup> Bing is the only other company with more than 1 per cent (2.18 per cent). Hence, it is highly likely that

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<sup>8</sup> Inland Revenue (n 4) 3.20.

<sup>9</sup> Ibid 19.

<sup>10</sup> ‘Social Platform’, *Technopedia* (Web Page, 2019) <<https://www.techopedia.com/definition/23759/social-platform>>.

<sup>11</sup> ‘Search Engine Market Share New Zealand July 2019’, *statcounter: GlobalStats* (Web Page, 2019) <<http://gs.statcounter.com/search-engine-market-share/all/new-zealand>>.

only Google would be in scope. The ‘sale of user data’ is a unique sub-category: it does not involve a multi-sided platform but the pure selling of user data. There are hundreds of companies that access data by various methods (public records, browser cookies and trackers, club lists, loyalty programmes, etc), which sell this data to other companies. The sub-category, however, only applies to the ‘sale of user data’. This suggests only data collected digitally is applicable. As mentioned earlier, it is debatable whether the general principle of active contribution covers collection of user data by businesses (that is, passive contribution). The ‘sale of user data’ sub-category indirectly includes passive contribution only where a company later sells data. It is most likely an anti-avoidance provision to prevent HDBs from collecting data and selling it to different entities.

There are several important exclusions to the DST.<sup>12</sup> The first exclusion is the ‘sale of ordinary goods or services (other than advertising or data) over the internet’. The DST is targeting the platform owners rather than the user or the advertiser (for example, Amazon itself). This is a buyer–seller relationship, rather than a multi-sided platform.

The second exclusion is the ‘provision of online content, such as music, games, TV shows and newspapers’. Netflix is explicitly excluded, as there is only a transaction between users and Netflix. Netflix offers a subscription service (without advertising) directly to the user. On the other hand, Apple music provides online music, but it is explicitly included as it facilitates the sale of music owned by another party to users. It acts as a platform to bring interested parties together.

Several newspapers and online media websites provide online content. In addition, many traditional television and radio broadcasters provide online content. Nearly all major newspapers, online media websites, traditional television and radio broadcasters use online advertising on their websites. These activities are arguably in scope, as their advertisements facilitate the sale of goods or services between users and advertisers. Furthermore, the sale of advertising is explicitly removed in the second exclusion. Newspapers, television and radio broadcasting are excluded; however, this refers only to non-digital activities, rather than the entities themselves. The active contribution rationale is difficult to ascertain in these cases. These businesses’ primary activity is to provide information to users, rather than connect advertisers to users. The advertisements are similar to traditional non-digital advertising — as these businesses have limited information about users, they have limited ability to target advertisements to particular users. Therefore, it is difficult to justify including the sale of advertising within the scope of the DST.

These examples illustrate how traditional businesses are digitalising their products to enhance value. The automobile industry is a subtle illustration. Olbert and Spengel showed how BMW gathers revenue from its Connected Drive application.<sup>13</sup> The application offers BMW customers digital services on demand, which has a unique value. BMW allows third-party commercial users to connect with BMW customers accessing the application. The revenue directly from customers would likely fall outside of the DST. However, the revenue from allowing commercial users access to customers would likely fall within the DST. BMW would need to identify the relevant revenue stream that would apply to the DST.

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<sup>12</sup> For all exclusions, see Inland Revenue (n 4) 3.21.

<sup>13</sup> Marcel Olbert and Christoph Spengel, ‘Taxation in the Digital Economy — Recent Policy Developments and the Question of Value Creation’ (2019) 2(3) *International Tax Studies* 1, 8.

Furthermore, the revenue mix will likely change over time as business models develop more digital revenues. Online grocery platforms are another example. Customers can now shop online for their groceries or even order packaged meals. Platform owners often take a fee for providing the platform for advertisers to sell to users. Hence, they are facilitating the sale of goods between persons. These activities are likely to fall within the scope of the DST. It is again difficult to justify the rationale of active contribution. The DST proposal fails to distinguish between businesses using digital technology to support their activities and businesses with digital platforms as their core activities.

The saving grace for the DST is its high *de minimis* thresholds. The global revenue for in-scope activities by traditional businesses is unlikely to exceed the thresholds. Hence, traditional businesses will not pay the DST. However, distinguishing between in-scope activities constitutes a compliance burden for many businesses.

## 2 *Step 2: Are Both de minimis Thresholds Exceeded?*

Two *de minimis* thresholds are applicable.<sup>14</sup> First, the group's global revenue must exceed EUR750 million. Second, the amount of the group's global revenue that is attributable to New Zealand users must exceed NZD3.5 million. Step 4 explains how to attribute revenue to New Zealand users. Both thresholds ensure that the DST only applies to large businesses. The EUR750 million threshold, taken from the country-by-country reporting requirement of the OECD, is a positive step in reducing the compliance burden for small- and medium-sized businesses.

## 3 *Step 3: Determine the In-Scope Global Revenue*

The DST 'would apply to any revenue from in-scope business activities',<sup>15</sup> as defined in Step 1. The group would be required to exclude out-of-scope business activities.<sup>16</sup> Given the increased role of digital platforms for traditional businesses, this will become difficult. The discussion document indicates that registration with IR is required where a DST liability is applicable.<sup>17</sup> Therefore, it appears that businesses have no obligation to notify IR of in-scope activities where they fall below the threshold.

## 4 *Step 4: Determine the Amount Attributable to New Zealand*

Unlike the calculation method for global in-scope activities, the amount attributable to New Zealand is the proportion of global users in New Zealand.<sup>18</sup> As mentioned in Step 2, the group's global revenue that is attributable to New Zealand users must exceed NZD3.5 million. The discussion document identifies the possibility of using the actual contribution of users in a country, but cites difficulties for certain companies.<sup>19</sup>

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<sup>14</sup> Inland Revenue (n 4) 3.24.

<sup>15</sup> *Ibid* 3.29.

<sup>16</sup> *Ibid* 3.30.

<sup>17</sup> *Ibid* 3.48.

<sup>18</sup> *Ibid* 3.33.

<sup>19</sup> *Ibid* 3.37.

The discussion document defines a user as ‘anyone who used the platform or service; however the exact definition would vary depending on the type of platform and revenue’.<sup>20</sup> This ignores that digital platforms offer myriad different interaction options, and users themselves often differ significantly in their use of digital platforms. One user may spend more than three hours a day on digital platforms, while another user may spend one hour a month. Revenue derived from different jurisdictions is also likely to vary significantly depending on the wealth of the nations. The average American consumer creates greater value for a digital platform than the average New Zealand consumer. However, the global users test treats them equally. The discussion document acknowledges this issue.<sup>21</sup>

A second issue is locating a user. The majority of citizens will live in one country for a significant period of the year; however, a significant number of New Zealanders will travel outside New Zealand for holidays. Under the discussion document, a user is in New Zealand if they are located there. New Zealand has experience in dealing with this issue from a goods and services tax (‘GST’) perspective.<sup>22</sup> For example, the person’s billing address or the mobile country code is often used.

Overall, there is no easy solution for identifying a user. However, experience with the GST system should at least guide IR.

#### 5 *Step 5: Calculate the DST Payable*

The group must apply a 3 per cent tax to the amount attributable to New Zealand. The government chose not to include a safe harbour test, which would reduce the burden on HDBs with losses or low profit margins.<sup>23</sup> Since some HDBs are currently incurring losses (for example, Uber), it is unfair to burden them with further costs when the target of the DST is large, profitable HDBs.

#### 6 *Step 6: Return and Pay the DST*

The group must nominate a member to return and pay DST. All group members are jointly and severally liable.<sup>24</sup> There is a concern that New Zealand will be unable to enforce the DST, as there are few enforcement mechanisms available if groups ignore it. However, the author is confident that IR could enforce the DST, if it utilised available mechanisms like an online supplier registration model (similar to GST on remote sales).<sup>25</sup> Recent experiences with registration for GST purposes suggests that businesses will comply.

Various questions arise. For example, if IR has identified a firm that could potentially fall within the DST, how could IR gather information and what are the rights of the firm? If a firm is cooperative with the tax administration, what are the boundaries to the tax audit? HDBs have highly valuable algorithms, developed over years, and would be reluctant to share any

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<sup>20</sup> Ibid 3.40.

<sup>21</sup> Ibid 3.36.

<sup>22</sup> *Goods and Services Act 1985* (NZ) s 8B(2).

<sup>23</sup> Inland Revenue (n 4) 3.46.

<sup>24</sup> Ibid 3.53.

<sup>25</sup> Ibid 3.48.

commercially sensitive information. Guidance from IR could reduce compliance burdens and uncertainty.

Overall, each step creates several compliance and administrative costs. The DST is predicted to only raise between NZD30 million and NZD80 million.<sup>26</sup> Companies will require guidance from IR. Given the small amount of tax, it is difficult to justify the administrative and compliance hurdles.

### *C Unique Issues*

The discussion document discusses several issues with the DST. This section briefly explores three key issues.

#### *1 Conflict with Double Tax Agreements*

There is concern that the DST is an income tax under New Zealand's double tax agreements ('DTAs'). According to the government, '[t]he current problem with taxing the digital economy only relates to income tax'.<sup>27</sup> An income tax, however, would violate New Zealand DTAs where the HDBs have no permanent establishment ('PE') in New Zealand. Under nearly all PE articles, without a physical presence of the firm, the market country has no taxing rights to income.<sup>28</sup> Hence, the DST is designed to fall outside the DTAs.

The European Commission ('Commission') stated that their proposed DST is an indirect tax,<sup>29</sup> although their target is large technology giants.<sup>30</sup> The Commission has taken the opposite view in another matter involving a social solidarity tax, introduced by France, based on the total annual turnover of the taxpayer.<sup>31</sup> The Commission has taken the position that the tax is a direct tax.<sup>32</sup> Hence, the Commission's own position on the DST is questionable.

Recourse to the OECD Model Commentaries provides some guidance.<sup>33</sup> Article 2(2) includes taxes on 'elements of income'. Article 2(4) expressly covers 'identical' taxes that replace or supplement existing taxes: 'The Convention shall apply also to any identical or substantially similar taxes that are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes'.

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<sup>26</sup> Ibid 3.69.

<sup>27</sup> Inland Revenue and Treasury, *Options for Taxing the Digital Economy* (Tax Policy Report Nos T2018/3710 and IR2018/801, 13 December 2018) 2.

<sup>28</sup> India is an exception.

<sup>29</sup> European Commission, 'Digital Taxation: Commission Proposes New Measures to Ensure That All Companies Pay Fair Tax in the EU' (Press Release IP/18/2041, 21 March 2018) Proposal 2.

<sup>30</sup> Fred van Horzen and Andy van Esdonk, 'Proposed 3% Digital Services Tax' (2018) 25(4) *International Transfer Pricing Journal* 267, 270.

<sup>31</sup> Cour de cassation [French Court of Cassation], C-39/17, ECLI:EU:C:2018:49, 14 June 2018.

<sup>32</sup> van Horzen and van Esdonk (n 30) 270.

<sup>33</sup> Michael Lang and Florian Brugger, 'The Role of the OECD Commentary in Tax Treaty Interpretation' (2008) 23 *Australian Tax Forum* 95; Klaus Vogel, 'The Influence of the OECD Commentaries on Treaty Interpretation' (2000) 54(12) *Bulletin for International Fiscal Documentation* 612.



The contentious issue is whether the DST is ‘identical or substantially similar’ to an income tax. On the one hand, the DST applies only to large HDBs deriving more than NZD3.5 million revenue from New Zealand, which suggests an income tax. On the other hand, the DST applies to the supply of in-scope activities and ignores the net accretion of economic power. This suggests that the DST is closer to an indirect tax. The DST appears as a hybrid between an income tax and an indirect tax. On the balance of probabilities, it is more likely that the DST would not violate the DTAs. Recent experience with the UK’s diverted profit tax indicates that businesses will not challenge the DST from a DTA perspective.

## 2 *Burden of Tax*

The discussion document acknowledges that New Zealand residents will incur a tax burden.<sup>34</sup> It is important to distinguish between who pays a tax and who bears the burden of the tax. The actual burden of a DST depends ultimately on the elasticity of demand and supply. Given the dominant position of prominent technology businesses, the incidence of tax could likely fall on the consumer,<sup>35</sup> hence the tax burden would fall to New Zealand residents. New Zealand residents will face higher prices for the services consumed. Businesses that are not monopolistic would suffer a greater incidence of tax than the consumer, hence a DST would burden businesses in competitive markets.

## 3 *Distortion of Competition*

The arbitrary nature of the DST would favour out-of-scope activities and possibly distort consumer decisions.<sup>36</sup> Schön notes that taxes are usually only created on goods if there is a market failure — for example, tobacco — but HDBs are not seen as a market failure.<sup>37</sup> All major political organisations proclaim the benefits of digitalisation.<sup>38</sup> However, our narrow concept of its value could be undermined in the future, once we understand the impact of digitalisation on society.

Categorising certain types of income or taxpayers for tax purposes under domestic and international tax law is standard practice — for example, artists, entertainers and athletes. However, a different treatment is only appropriate where the ‘the underlying concepts of taxing rights do not contradict those applied for the more generic cases’.<sup>39</sup> Hence, different treatment should align with allocation of taxing rights and principle-orientated solutions. Targeting certain HDBs that derive revenues from extracting certain value to the exclusion of others lacks a serious principled approach.

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<sup>34</sup> Inland Revenue (n 4) 3.81.

<sup>35</sup> Wolfgang Schön, ‘Ten Questions about Why and How to Tax the Digitalized Economy’ (2018) 72(4/5) *Bulletin for International Taxation* 278, 284.

<sup>36</sup> *Ibid*; van Horzen and van Esdonk (n 30) 271.

<sup>37</sup> Schön (n 35) 285.

<sup>38</sup> G20 Research Group, ‘Communiqué’ (G20 Finance Ministers and Central Bank Governors Meeting, 17–18 March 2017) para 6.

<sup>39</sup> Schön (n 35) 281.

### III THE CONCEPTUAL ARGUMENT FOR A DST

The rationale for a DST based on active contribution is premised on three key arguments. First, non-resident HDBs do not pay their fair share of tax. Second, active contribution is unique to HDBs. Third, a unilateral approach is the only alternative where a multilateral approach fails. A closer analysis shines doubt on these arguments.

#### *A Paying a Fair Share of Tax*

The fear that HDBs are paying less tax than businesses in other industries is a key driver of the DST. The discussion document states: ‘There has been significant international concern over the under-taxation of the digital economy, and digital multinationals in particular.’<sup>40</sup>

This accurately encapsulates the concerns of governments and other organisations. However, are HDBs under-taxed?

There is no clear answer. Ascertaining the average tax rates for HDBs is extremely difficult. The discussion document quotes a Commission report, which claims that the average tax rates for a digital company and a traditional business are 9.5 per cent and 23.2 per cent, respectively,<sup>41</sup> based on another report by the Centre for European Economic Research (‘ZEW’).<sup>42</sup> However, it is unclear how the Commission derived these numbers, as the ZEW report does not state these percentages. The ZEW report adopts the Devereux and Griffith model for calculating effective tax rates,<sup>43</sup> which considers a hypothetical incremental investment with several theoretical assumptions, including statutory tax rates.<sup>44</sup> Hence, it is inappropriate to use their model as an indicator of assessing average tax rates between businesses and across industries.<sup>45</sup>

Bauer claims that HDBs are paying effective corporate tax rates (‘ECTRs’) similar to traditional businesses.<sup>46</sup> Bauer’s report compared the ECTRs between less-digital corporations, non-digital corporations (Euro Stoxx 50 index) and digital corporations, using actual financial statements. Taking data from a five-year period, the digital corporations had a higher ECTR

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<sup>40</sup> Inland Revenue (n 4) 1.

<sup>41</sup> Ibid 2.12; European Commission, ‘Impact Assessment’ (Staff Working Document No SWD(2018) 81 final/2, 21 March 2018) 18.

<sup>42</sup> Christoph Spengel et al, *Effective Tax Levels: Using the Devereux/Griffith Methodology — Final Report 2016* (Centre for European Economic Research, October 2016) <[https://ec.europa.eu/taxation\\_customs/sites/taxation/files/final\\_report\\_2016\\_taxud.pdf](https://ec.europa.eu/taxation_customs/sites/taxation/files/final_report_2016_taxud.pdf)>.

<sup>43</sup> MP Devereux and R Griffith, ‘The Taxation of Discrete Investment Choices’ (Working Paper No 98/16, Institute for Fiscal Studies, 1999).

<sup>44</sup> Christoph Spengel et al, ‘The Impact of Tax Planning on Forward-Looking Effective Tax Rates’ (Taxation Paper No 64, Centre for European Economic Research, 31 August 2016) 10 <[https://ec.europa.eu/taxation\\_customs/sites/taxation/files/taxation\\_paper\\_64.pdf](https://ec.europa.eu/taxation_customs/sites/taxation/files/taxation_paper_64.pdf)>.

<sup>45</sup> Institute for Economic Research, *Die Besteuerung Der Digitalwirtschaft (Taxing the Digital Economy)* (August 2018) 4 <<https://www.ifo.de/DocDL/Studie-Digitalsteuer-2018.pdf>>.

<sup>46</sup> Matthias Bauer, ‘Digital Companies and Their Fair Share of Taxes: Myths and Misconceptions’ (Occasional Paper No 03/2018, European Centre for International Political Economy, 2018) <[https://ecipe.org/wp-content/uploads/2018/02/ECI\\_18\\_OccasionalPaper\\_Taxing\\_3\\_2018\\_LY08.pdf](https://ecipe.org/wp-content/uploads/2018/02/ECI_18_OccasionalPaper_Taxing_3_2018_LY08.pdf)>.

(29.1 per cent) compared to traditional corporations (27.1 per cent).<sup>47</sup> Furthermore, profitability levels and tax expenses of digital corporations varied in a similar manner to non-digital corporations.<sup>48</sup> A report from the Institute for Economic Research found that digital corporations had an average tax rate of 20.9 per cent compared to 26.7 per cent for non-digital corporations.<sup>49</sup> Both reports used the income tax expense calculated under accounting standards. However, this is misleading as actual taxes paid will be different to the accounting income tax expense. This mainly arises through different treatment of depreciation. Furthermore, businesses may take ‘uncertain tax positions’, where favourable tax positions are less than certain.

Without any disclosure by the Commission, it is impossible to verify their claims for under-taxation of HDBs. Media illuminates high-profile examples of tech giants paying low rates of taxation based on total revenue. However, media reports cannot justify new tax rules.<sup>50</sup> Spengel et al illustrated that the main drivers for lower effective tax rates of digital businesses (based on a theoretical model) are: immediate expensing of investment costs for digital business; more generous depreciation rates for fixed assets; and special provisions that favour digital business models.<sup>51</sup> Countries compete for digital businesses to stimulate their economies.<sup>52</sup> However, a theoretical model is not clear evidence.

Overall, there is a lack of substantial evidence to suggest that HDBs are paying less tax than other businesses. This insight seriously questions the efforts to target HDBs. Ultimately, a lack of evidence did not stop the OECD from pursuing the Base Erosion and Profit Shifting (‘BEPS’) project, and thus, it is unlikely to stop countries targeting HDBs.

### *B Active Contribution*

There is a major conceptual flaw with active contribution. A key rationale for the DST is that active contribution by users creates network effects — that is, a service gains additional value the more people who use it. However, as mentioned earlier, the network effects created by HDBs are evident in many industries. For example, consider an old technology, such as fax machines.<sup>53</sup> The more users participating by sending messages via fax machines, the more valuable fax machines become. Telecommunication networks operate in the same manner. Based on the same logic, the users are creating value that justifies taxation of that value where the users are located. Another example is clinical trials.<sup>54</sup> New medicines often require a rigorous clinical trial that involved users providing personal information in exchange for

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<sup>47</sup> Ibid 10.

<sup>48</sup> Ibid 7.

<sup>49</sup> Institute for Economic Research (n 45) 6.

<sup>50</sup> Olbert and Spengel (n 13) 4.

<sup>51</sup> Marcel Olbert and Christoph Spengel, ‘Measuring and Interpreting Countries’ Tax Attractiveness for Investments in Digital Business Models’ (2019) 47(2) *Intertax* 148.

<sup>52</sup> Italy, Austria and Ireland all have provisions to reduce the tax burden of digital businesses.

<sup>53</sup> OECD, ‘Public Comments Received on the Possible Solutions to the Tax Challenges of Digitalisation’ (13 February–6 March 2019) 5 <<https://www.oecd.org/tax/beps/public-comments-received-on-the-possible-solutions-to-the-tax-challenges-of-digitalisation.htm>>.

<sup>54</sup> Ibid.

compensation. The resulting data leads eventually to new medicines whereby the pharmaceutical company derives profits. Even a basic loyalty scheme for a local supermarket involves participants receiving targeted advertisements. Other examples include newspapers, broadcast television, video game consoles, financial exchanges, and farmer's markets.<sup>55</sup> Therefore, it is arbitrary to focus only on value created by users on digital platforms. Several value factors within a market jurisdiction could justify taxation — for example, infrastructure, rule of law, reliable payment systems, welfare payments, and so on. Focusing on active contribution by users of particular digital platforms appears confusing and incoherent. The OECD has acknowledged the difficulty of attempting to isolate the digital economy.<sup>56</sup> Efforts to demarcate the digital economy from the rest of the economy are likely to face these issues.

### *C Unilateral Approach*

The DST is advocated as the only alternative to a multilateral approach. The DST represents a unilateral approach that could set a dangerous precedent to the multilateral approach to international tax issues. The integrity of DTAs will erode if jurisdictions take actions that are essentially targeting income, but designing them in such a manner as to avoid DTAs. The key principle of *pacta sunt servanda* — that is, parties to a treaty must adhere to a treaty in good faith — would be seriously undermined.<sup>57</sup> Perhaps a movement against the ideology of globalisation and free markets is the driving force behind the proposals.<sup>58</sup>

The DST could ignite a cascade of unilateral approaches by governments to common and complex tax issues that could damage the international tax system. The positive aspects of our international tax system cannot be ignored: global institutes that provide a platform for common ground (such as the OECD and United Nations); the rule-based system of DTAs; and exchange of information and cooperative relationships between tax administrations. It is far easier to damage a system than improve it. The New Zealand government should carefully consider this important truth.

## IV CONCLUSION

There are no easy solutions for jurisdictions attempting to confront the new economic digital reality. The article has identified several interpretative issues regarding the DST proposal. The DST scope is very broad. The proposal fails to distinguish between HDBs and traditional businesses that are digitalising. The reference to 'supplies' should be clarified. The third

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<sup>55</sup> Ibid 6.

<sup>56</sup> OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 — 2015 Final Report* (OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, October 2015) 118 <<https://dx.doi.org/10.1787/9789264241046-en>>. '[B]ecause the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy. Attempting to isolate the digital economy as a separate sector would inevitably require arbitrary lines to be drawn': at 54.

<sup>57</sup> *Vienna Convention on the Law of Treaties*, opened for signature 23 May 1969, 1155 UNTS 340 (entered into force 27 January 1980) art 31(1).

<sup>58</sup> See BIAC comment in OECD, *Tax Challenges of Digitalisation: Comments Received on the Request for Input — Part I* (25 October 2017) 32 <<https://www.oecd.org/tax/beps/tax-challenges-digitalisation-part-1-comments-on-request-for-input-2017.pdf>>.

category, ‘content sharing sites’, would include many traditional businesses and, therefore, IR should consider removing this category. This would remove from scope businesses that are using digital platforms to support their business, rather than as a business model itself. Furthermore, the explicit inclusion of advertising should also be removed. Advertising will often take place where users are not actively contributing data, for example, users on newspaper websites. Ultimately, the general principle of active contribution does not adhere to the concise test provided in the proposal. However, the high *de minimis* thresholds ensure only large HDBs will be liable to pay the DST.

There is anecdotal evidence of BEPS behaviour from prominent HDBs, however, there is no clear evidence that HDBs are under-taxed. The tax incentives offered by jurisdictions to HDBs suggests lower effective tax rates, but it also provides a possible explanation. The rationale of active contribution is conceptually weak, as network effects are evident across industries. Lastly, a unilateral approach is a dangerous course for a small country such as New Zealand to pursue.