Submission

By

THE NEW ZEALAND INITIATIVE

To the Minister of Finance, the Minister of Revenue, and the Inland Revenue Department

on the Government discussion document

Options for taxing the digital economy

15 June 2019

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1. INTRODUCTION AND SUMMARY

1.1 This submission on the government discussion document *Options for taxing the digital economy* is made by The New Zealand Initiative, a think tank supported primarily by chief executives of major New Zealand businesses. The purpose of the organisation is to undertake research to contribute to the development of sound public policies in New Zealand to help create a competitive, open and dynamic economy and a free, prosperous, fair, and cohesive society.

1.2 We support the government's overarching goal in ensuring that the tax system remains fair and that the tax base does not erode. Ensuring that multinational tax settings are appropriate is an important part of that goal. Not only must tax be fair, it must also be seen to be fair. The government's discussion document notes substantial international concern that multinationals may not be paying their fair share of tax; taxpayers more broadly should also be confident that the tax system is equitable and reliable.

1.3 International tax is inherently complex and is best addressed through multilateral negotiation through the OECD. New Zealand has prided itself on supporting a rules-based international order, from trade and security through to tax.

1.4 We suggest that a particularistic tax in New Zealand on the New Zealand-attributed gross revenues of certain multinationals works against New Zealand's broader interest in encouraging a rules-based international order. If there are holes in existing tax arrangements, those holes work to the detriment of many countries' tax systems, not just New Zealand's. Ensuring the international tax system works well requires leadership, international cooperation, and international commitment to sound, rules-based structures.

1.5 We worry that implementation here of a tax designed to differentially affect large foreign-based multinationals, and the contortions necessary to fit such a tax within our international obligations, will come to haunt us in other multilateral trade or tax negotiations where New Zealand's reputation as a fair dealer has otherwise provided us with some clout. There are all kinds of ways that countries can design provisions that look neutral but that are designed to give preference to domestic firms over foreign firms. It will be more difficult for New Zealand to argue against foreign measures that differentially target New Zealand firms if New Zealand has argued in favour of structures allowing it to target foreign firms.

1.6 Where New Zealand's reputation here is already being eroded, with the European Union now asking how New Zealand will provide WTO notification of the Provincial Growth Fund loan to Westland Dairy, the government should avoid further measures that would reinforce perceptions that New Zealand is abandoning its commitment to a multilateral, rules-based order.

1.7 We consequently strongly urge that New Zealand continue to show international leadership in the promotion of the rules-based order from which we greatly benefit, by working through and with the OECD to strengthen multinational tax arrangements rather than implementing New-Zealand-specific rules.

2. TAX NEUTRALITY AND DST DANGERS

2.1 The government suggests that a New Zealand Digital Services Tax could apply to firms meeting a double-threshold for inclusion. Taxed firms would be those 'whose value is dependent on the size and active contribution of their user base', including intermediation platforms 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. International agreements require that any such tax be neutral with respect to the company's country of origin; New Zealand firms would also need to be included.

2.2 Local firms meeting the first threshold would include TradeMe, but others could as well, depending on how their services develop. MyCare provides intermediation services in home-based care, interfacing between those in need of in-home care services and those wishing to provide such services. Xero's primary business is accounting software, but they may well leverage the data they oversee to provide business-facing services that rely on the depth of their users' data, which could bring them into the scope of the test. Many app-based services are able to provide low-cost or free services to users because of their ability to on-sell parts of their users' data; where that data is facilitated by active contributions of the user-base, the scope of this test may be broader than the government might currently believe.

2.3 The second part of the test is framed as a *de minimis* threshold designed to incorporate only firms large enough to make the game worth the candle, and neutral in the sense that it follows recommendations in the OECD Interim Report. But the effect of that rule here, and in any other country in which it is used, is to exclude from consideration almost all domestic firms. The OECD's double *de minimis* threshold first excludes all but the largest firms through a global annual turnover threshold of €750 million. Xero perhaps comes closest to that threshold, with annual operating revenue of close to $640 million NZD; it would hit the *de minimis* threshold were it to double its annual revenues. It is not inconceivable that Xero could enjoy that kind of growth, and that growth could be due to value provided by leveraging client data for B2B services. If any country following the proposed rule decided that Xero derives substantial value from B2B services leveraged off of its users' data, then foreign countries will start taxing Xero on activities already taxed in New Zealand. And there will be absolutely nothing New Zealand will be able to say about it, because we will have already conceded the point, other than to argue the toss about the proportion of revenues that are in-scope rather than out-of-scope.

2.4 Very similarly, if New Zealand passes general-in-appearance, but protectionist-in-effect tax rules based on gross revenues, what might New Zealand possibly raise as objection if some other country proposed taxing Fonterra on the proportion of its gross revenues derived from sales in that country? This may be considered somewhat daft and could easily lead to very substantial regret.

2.5 The second part of the *de minimis* test requires the company to have sufficient turnover in the taxing country to make the project worthwhile. While that seems eminently reasonable, there are obvious impracticabilities in effect, noted in the working paper. We may also worry that companies inching closer to the threshold may decide to prevent increased uptake among New Zealand users unless they expect a large expansion in the number of New Zealand users. The marginal tax rate on the user bringing a company past that second threshold would be near-infinite: the user whose subscription brings the company up to $3.5 million in New Zealand attributable earnings would cost the company $100,000 in tax. It would be a substantial and costly mistake for the firm to allow that user to subscribe to the service, unless the company expected that that user would be followed by sufficient numbers of additional users to make it worth that cost. And while this may have little effect for the current big players, it could have substantial effect on limiting access to new and emergent services.

2.6 The second part of the OECD *de minimis* test seems reasonable, despite issues in practicability and potential perverse consequences. But the first part smells of the kind of thing to which New Zealand traditionally objects. If some country across the Tasman claims that it does not have an (illegal) ban on apple imports from New Zealand, but only a neutral rule that happens

accidentally to have the effect of excluding New Zealand imports, can we credibly argue that those rules make a mockery of neutrality principles if we, in tax policy, adopt rules that are every bit as designed to pay lip service to neutrality while really working to ensure that the primary effect is to tax foreign firms? It simply does not pass the laugh test to claim that the rule is designed other than to tax foreign firms while not taxing domestic ones. Discussion at 3.55, noting that the DST would be designed to comply with our international obligations, feels like an effort to meet the letter of the rule while ignoring the spirit of them. We should not be advocates of underarm bowling, even if it meets the letter of the rule.

2.7 For all of these problems, what does New Zealand achieve? At 3.69, the paper notes the DST is likely to raise between $30m and $80m in tax. While the paper suggests, at 3.70, that that amount of tax could help assuage populist concerns around multinational taxation, the suggestion seems at best hopelessly optimistic. It seems rather more likely that those inclined to criticise multinational technology companies will simply reframe their arguments to highlight the small amount of tax paid relative to the harms they assert have obtained from those companies' activities. I note that those populist concerns are hardly abated when companies like Google provide evidence that their overall global tax rates are entirely in line with average statutory tax rates.[1] Conspiracy theories of global tax avoidance seem rather fixed.

2.8 At 3.76, the paper argues that a high *de minimis* threshold can help ensure that a tax on gross turnover does not wind up applying to firms enjoying net losses as larger firms are more profitable. But Uber's annual *losses* are higher than the threshold. Local taxi companies will applaud the neutral-but-protectionist move against the foreign-based company.

2.9 At 3.91, the paper notes risks to New Zealand's reputation for pursuing this out-of-OECD path to taxation of multinationals, but suggests those risks are reduced where other countries are also doing the same thing. This seems, again, completely inconsistent with New Zealand's advocacy of rules-based international orders where 'but lots of other places are doing it too' simply isn't a great excuse.

2.10 At 3.94 - 3.96, the paper notes administration and compliance costs. We suggest a potential additional one. If the tax officials who would be charged with designing and implementing a New Zealand DST are the same ones who would be advising New Zealand's OECD tax negotiators, then the opportunity cost of the New Zealand DST may be a reduction in New Zealand's capability to take on a leadership position in progressing efforts through the OECD.

3. The OECD proposals

3.1 We do not here offer advice or recommendations about the different options that New Zealand may advance through the OECD. We expect that IRD's tax experts are better placed than we are at present to weigh the relevant issues. We urge only that New Zealand focus its efforts on achieving a multilateral solution through the OECD rather than advance a DST in New Zealand. While the paper notes that an OECD solution may not be implemented until 2025, the relatively low levels of tax at stake here hardly justify New Zealand's rushing ahead with a local alternative.

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[1] Karan Bhatia, Vice President of Government Affairs & Public Policy at Google, notes that "Google's overall global tax rate has been over 23 percent for the past 10 years, in line with the 23.7 percent average statutory rate across the member countries of the Organisation for Economic Cooperation and Development (OECD)." https://www.blog.google/outreach-initiatives/public-policy/its-time-new-international-tax-deal/

4. RECOMMENDATIONS

4.1 We recommend that New Zealand redouble its efforts in pursuit of a multilateral solution through the OECD, consistent with New Zealand's long-standing bipartisan focus on promoting the kind of rules-based international order that is ultimately in the best interest of a small trading nation.

4.2 Eroding New Zealand's soft-power advantage, earned through decades of fair dealing, in pursuit of a relatively small amount of tax, in a quest that seems motivated more by a desire to punish large foreign firms than by any real current and pressing tax issues, seems a rather bad idea.

4.3 All of this would be a very bad idea even in the best of times. We are not in the best of times. America is undermining, whether deliberately or through sheer Executive incompetence, the decades-long consensus in favour of rules-based international order. New Zealand's continued leadership is needed now more than ever. It seems madness to pursue policy that would *correctly* be interpreted by the current American administration as a protectionist move by New Zealand targeting American companies. We *very strongly urge* that the Ministers take advice from New Zealand's diplomatic corps, trade negotiators, and MFAT about the likely consequences for New Zealand trade if New Zealand adopts a DST and Fox News chooses to highlight this particular protectionist policy.