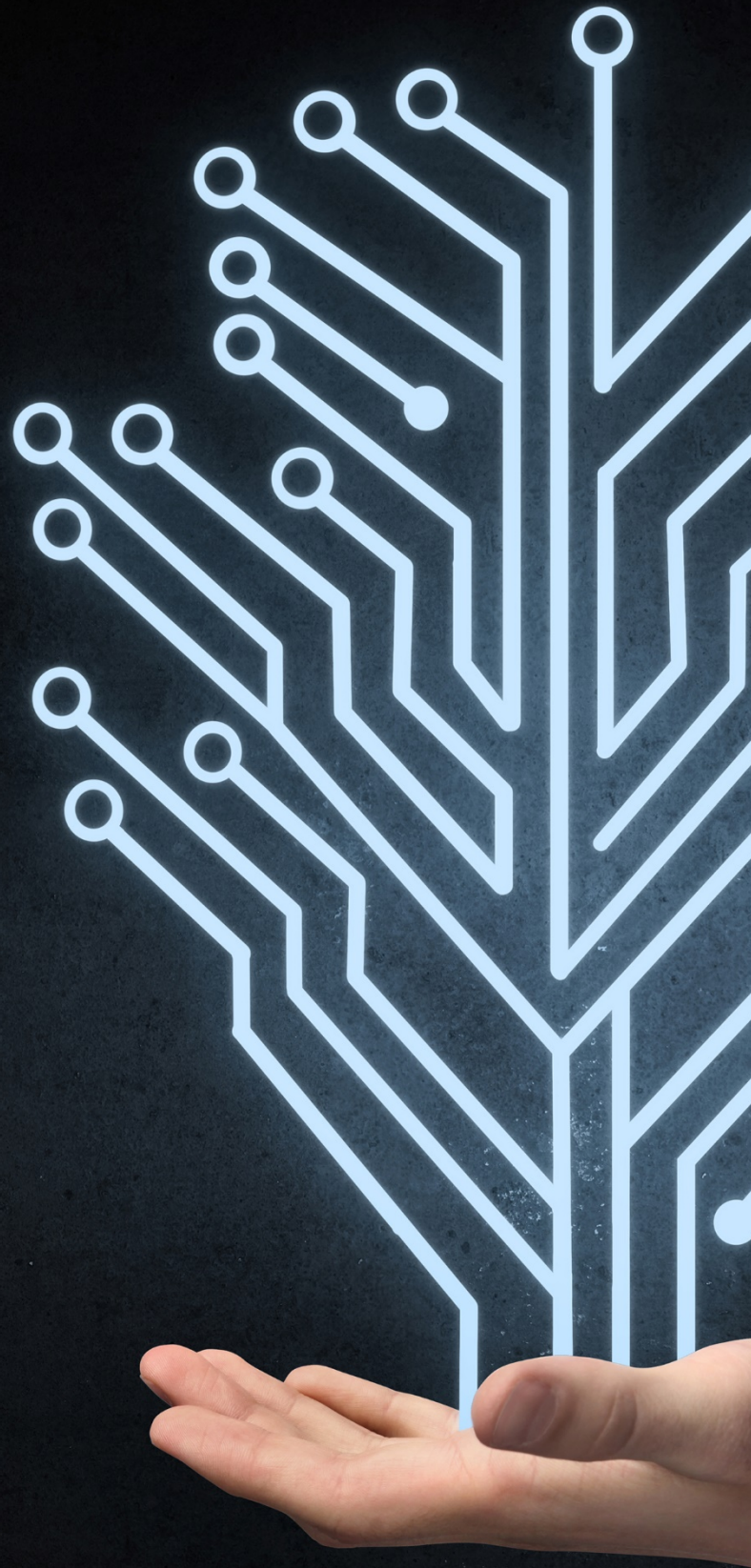




Options for taxing the digital economy – “work in progress” response

KPMG New Zealand



19 July 2019

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This commitment reflects our passion and belief that together New Zealand can maximise its potential, and that by helping inspire a market full of successful enterprises, we will in turn inspire a country of which we can be more proud.

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19 July 2019

Dear Ms Atkins

Options for taxing the digital economy – “work in progress” response

We are pleased to provide our response to the Government’s discussion document.

The tax question and caveat

The digital economy and global connectedness raise the question of the appropriate taxation of companies’ cross-border supplies. This does not necessarily mean that such suppliers are under taxed in market countries (to who they sell). It is possible that any under-taxation is:

- In their home country, because of political and tax policy decisions made for income tax.
- Of consumers, because the relevant indirect tax does not apply. GST/VAT regime rule changes for supplies of remote services and low-value goods and the United States *Wayfair* decision illustrate this and responses to it.

Assuming that market countries do not receive their “fair share” of income tax, as the discussion document implies, may not provide the right answer to the question.

The discussion document asks two broad questions in answering the question.

Digital Services Tax (DST) – is it an answer?

Our answer is relatively straightforward. We consider that the DST is a poor tax. Possible changes to its design are unlikely to improve it. More importantly, it has possible trade and tax retaliation risks for New Zealand, collateral damage as it will apply to New Zealand companies and compliance costs even for companies, which will pay no DST. Any incentive that a DST would have to reach a global consensus to an answer does not outweigh those fundamental problems. It should therefore not proceed as an interim solution.

OECD’s profit allocation work programme – is it an answer?

The answer here is not straightforward. It is sensible for New Zealand to contribute to the OECD profit allocation work programme as there appears to be no alternative. However, the answer is a work in progress and complex.

An OECD answer which more narrowly targets (some) cross-border supplies is more likely to be of fiscal benefit to New Zealand. It lessens the risk our company tax is paid to other countries. A wider answer appears better from a tax policy perspective – it is consistent with a broad base, low rate approach that encourages economic efficiency. (It appears that the OECD is moving to a wider answer so New Zealand may not be able to influence a narrow outcome.)



We consider that further urgent work is required to make a judgement call on what is best for New Zealand. The discussion document is a scoping exercise. There is little detail on the OECD options and little data and analysis of their fiscal and economic impact. The OECD is doing work on identifying the likely “winners and losers” but New Zealand should do its own analysis.

Further, although we do not want to overstate it as trade tends to find a way and tax alone is not a complete story, we are concerned that an OECD answer will reduce the value that New Zealand receives from its exports and will reduce imports of goods and services, which New Zealand needs.

The former concern is that net tax will be payable offshore if more of our exporters’ profits will be taxed in market countries and this outweighs the New Zealand tax paid by companies “selling to” New Zealand.

The latter concern is that some companies may cease or modify the way they do business with New Zealand. New Zealand is a small country. The size of our market means that New Zealand is often, at best, a rounding error. Global companies may simply restructure by closing or disposing of New Zealand operations as a result.

Approach

Our response applies a tax policy perspective. However, our conclusion is that this not just a tax issue. The issues raised are too important to rely on slogans. New Zealand’s response should involve a “NZ Inc” collaboration with a whole of government perspective, which is politically sustainable.

Accordingly, we have copied Ministers with relevant portfolios, the chair of the Finance and Expenditure Committee, the National Party spokesperson on Finance and the leader of the ACT NZ party. Copies of our letters to each are included.

We consider there is insufficient data, analysis and testing to make a judgement call on the OECD’s work programme. Our response is therefore a “work in progress”.

We have not named names or industries. That tends to generate more heat than light. From our own work, in this very complex area, ensuring the messages are understood is difficult. We are happy to provide more concrete examples if that is helpful.

We are ready to contribute to the further work on this important issue. Please do not hesitate to contact us, John Cantin on 04 816 4518 or Darshana Elwela on 09 367 5940, should you need any further information in relation to KPMG’s submission, or would like to engage further.

Yours sincerely

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Cc:

Hon Grant Robertson and Hon Stuart Nash, Ministers of Finance and Revenue
Rt. Hon Winston Peters, Deputy Prime Minister and Minister of Foreign Affairs
Hon David Parker, Minister for Trade and Export Growth
Hon James Shaw, Minister for Statistics
Dr Deborah Russell, Chair, Finance and Expenditure Committee
Hon Paul Goldsmith, National Party Spokesperson for Finance
David Seymour, Leader of the ACT Party
Mr Struan Little, Acting Chief Executive and Secretary of the Treasury

Our key messages

The challenges of taxing the digital economy are significant.

Technology is changing the world. Companies no longer require a physical presence to reach global markets. In this environment, it is clear that the traditional model for taxing multinational enterprises and cross border business requires closer examination.

This is a very complex tax challenge.

The OECD has been considering it for several years as part of its Base Erosion and Profit Shifting (BEPS) Action Plan. While the OECD has managed to make headway on many of the 15 BEPS Actions, Action 1: Addressing the Tax Challenges of the Digital Economy remains “work in progress”.

Introducing a Digital Services Tax (DST) is not the answer

The case for a DST is weak, both when analysed against the traditional tax policy framework and economically. It is not supported by the OECD process and is a unilateral measure that would put New Zealand “out on a limb” with only a handful of other countries.

The upside for New Zealand will be limited. The projected revenue is limited and it will not have the desired effect of taxing foreign multinational enterprises (MNEs), if they decide to leave our market or pass on the cost.

There is however a significant downside – our domestic businesses will be caught by the DST, which would be double tax, and it invites other countries to take steps to mitigate the impact on their businesses. The US, for example, has indicated that it will take trade action with countries that introduce a DST. Australia understands these risks and following a similar public consultation, it has deferred a DST, preferring to focus on working with the OECD for a consensus-based solution to the challenges of taxing the digital economy.

Staying with the OECD is a better course of action, at this stage

The OECD is working on several solutions to tax the digital economy – some more narrowly targeted at the taxation of so-called “digital companies” and some that apply more broadly as digitalisation and technology are impacting all companies. While the work is at a relatively early stage, support seems to be coalescing around a broader approach.

While this is likely to be better from a pure tax policy perspective, it does raise the question whether a broader approach is best from a “NZ Inc” perspective. There is a distinct possibility that NZ’s corporate tax base could move offshore (particularly if commodities are not excluded) under any broad OECD solution. New Zealand will also need to take care that de minimis thresholds aimed at reducing compliance costs for MNEs do not unduly eliminate New Zealand’s taxing rights.

In short, there is much work still to be done but New Zealand also needs to undertake its own economic and fiscal modelling of the OECD proposals to understand their impact, from a whole of government and NZ Inc perspective.

Our consideration of the proposed DST and the OECD options elaborates on these key messages and provides further detail.

We would welcome the opportunity to discuss these comments further with Officials.



1. Overview

The digitalisation of the economy raises fundamental questions on who, what and where to tax. The answers are not obvious.

Care is required

Although we understand the political concerns and perception that foreign MNEs are undertaxed, it would be a mistake to approach the question solely from the lens that the question and solutions are about taxing foreign MNEs.

This is because there is a potentially fundamental change to the taxation of cross-border transactions if NZ introduces a DST or adopts the OECD's "consensus" solution (if and when that arises) which:

...will impact NZ MNEs. As a trading nation we are heavily reliant on exports. NZ's MNEs will be affected by changes to the international tax system, which will affect our tax base. There is a tension between a broader approach, which is more efficient and potentially fairer from a tax policy perspective, and a narrower approach, which would likely better serve NZ exporters and our tax base.

... raises fundamental questions for NZ's tax system which may affect domestic only businesses. The DST and some of the OECD proposals, for trade reasons, necessarily affect domestic companies. Further, change to the international tax system will mean there is a dual tax system – for MNEs and for domestic only companies. This will mean there is an uneven playing field for domestic companies (instead of the current perceived position) and possibly a demand for consequential changes.

... raises risks for global trade as the responses to a change in the system are uncertain and unknown. It is difficult to predict both what will change (especially as there is no certainty about how the global tax rules will change) and the reaction to that (the US, for example, has signalled its dislike for proliferation of DSTs, which it considers disproportionately targets US MNEs).

However, any resulting double taxation, increased costs of compliance, and uncertainty may lead to changes in supply chains or to companies ceasing to provide goods and services to NZ consumers and businesses. (These are particular problems with a DST, which is economically equivalent to a tariff). Alternatively, other countries may

(as they have with others) consider steps to counter NZ's approach through tax or trade retaliatory measures.

Further, the OECD process itself creates risks because:

- **A consensus solution will require compromise, which is likely to be in the best interests of the major market economies, rather than NZ.** Unlike NZ, tax policy is not approached by most countries as a pure instrument dependent on what is the best tax policy, but is more often decided on political and trade (that is, broader "national interest") grounds;
- **Although countries may agree to an OECD consensus, this may not ultimately be implemented or implemented inconsistently.** We refer to the BEPS multi-lateral instrument as an example of slow implementation by countries having committed to it. Even where implemented, the scope and scale of adoption has been inconsistent. (We also note the various BEPS Actions, which provide choices leading to inconsistencies.) This is likely to lead to unexpected results, uncertainty and disputes.
- **The standard of "fairness" is undefined.** Although we make comments on fairness, there is no agreed standard, in a tax context. That makes it difficult to agree whether any proposal will increase fairness in the global tax system. This also increases the risk that any answer, which is labelled "fair", will not actually achieve the objective or may in fact decrease fairness. Given the lack of definition, it is also possible that current "unfairness" in the international tax system will be corrected to NZ's detriment. There is a need for an agreed framework if fairness is to be a tax objective.

We consider that further work, including detailed analysis of the fiscal and economic implications, is required to ensure that New Zealand's position under the different OECD options is well understood.

This will enable any decisions on the DST and OECD work programme options to take into account New Zealand's wider national interest, which should be protected as far as possible.

Background

The current global tax system is predicated on the difference between "trading with" and "trading in" a

country. “Trading in” is defined by physical presence. In a world dominated by trading in goods, physical presence, because of the need for physical delivery, was an appropriate standard. Without physical presence, the in country distribution margin is not available to a foreign supplier. Its absence is therefore a commercial rather than a tax decision.

The digital economy, and the broader digitalisation of the economy, changes that presumption for both goods and services. A physical retail presence, given modern logistics and delivery systems, is not required for goods to be supplied to a country. For services, it is easier still to deliver without a direct physical presence.

Broadly, although the digital economy allows disintermediation – for example, a motion picture can be made available consumer to consumer (i.e. “C2C” through a digital content sharing platform) rather than business to consumer (i.e. “B2C” through broadcasting by a television network) – a digital economy supplier will still monetise its services in the same way. This is through:

- Advertising revenue;
- Commissions on sales;
- Sale of customer information and data; and/or
- Sale of its own goods and services.

These are all familiar ways of doing business. However, the ability to do so is enhanced by technology.

These changes affect all sectors of the economy, not just digital companies.

This change raises fundamental questions on what is the appropriate basis of taxation in an increasingly digitalised and inter-connected world.

Perspectives

In considering our response we have considered multiple factors. Those factors are:

Tax policy in NZ is (largely) driven by good tax policy principles, which is not always the case in other countries.

The typical NZ starting point is to consider what a good tax policy would be. Political and, in the international context, specific perceptions of what is best for the particular country (from a trade, defence or other non-tax

perspective) tend to counter good tax policy objectives. (We do not mean there is never a political component to NZ’s tax policy as sustainability is one of the features of good tax policy.) In other countries, special interests can have greater sway, while local and geo-political political ramifications, government budget drivers and trade policy tend to rate more highly than pure tax policy considerations.

The ultimate outcome of the OECD process – a “compromise consensus” – is therefore likely to be weighted more closely to those drivers and countries’ broader national interests than good tax policy. (In previous submissions we have referenced the hybrids rules as an example where compromise does not necessarily result in good tax policy.)

Broad base, low rate.

We support NZ’s standard approach to designing taxes and tax systems, which, as far as possible, does not differentiate the imposition of tax based on industry or how a business operates. Equivalent profits should be taxed equivalently. This minimises distortions and increases efficiency by minimising any drag that tax may have on the economy. It also promotes “horizontal” equity. Departures from this approach should be clearly explainable and evidence based.

A change to the international tax system is more likely to reduce NZ’s tax base.

A narrow tax base solution, such as a DST, is not optimal from a pure tax policy perspective. A broad tax base solution (being considered under some of the OECD proposals) is more optimal from efficiency and fairness perspectives, but will mean that more profits of NZ MNEs will be taxed offshore. Although we acknowledge that NZ may tax more profits of foreign MNEs, under the OECD proposals, which will help counterbalance some of this revenue loss, New Zealand’s small market size suggests that it will be a net “loser” overall. This result can be inferred from the countries that are leading the OECD process (the G20 nations, which are populous countries with large markets).

This means that any weighting of profit allocation factors – such as sales, assets, employees, or users – will always favour those “market” countries over smaller economies such as NZ. (See our example in the discussion of the DST as an example.)

Double taxation needs to consider not only NZ tax but also foreign taxes.

A tax based on turnover or bases other than income, which is not a value added tax, will increase the overall tax paid as such taxes are not generally creditable against income tax payable. It is the overall tax position, and not whether NZ double taxes, which impacts a company and its response.

Double taxation of company profits is a feature of most tax systems but not of NZ's.

As a result it is easy for foreign observers (and, as a result, domestic observers who rely on foreign commentary and analysis) to assume that increasing company taxes increases the taxes borne by companies. The debate remains, but it ignores how much and to what extent the tax is economically borne by the company's customers, employees as well as its shareholders. (We assume that shareholders do bear some of the tax.) Ignoring who economically bears the tax hides the political and other impediments to change. For example, the shareholder's country of residence will be motivated to resist company taxes to the extent it affects their residents. (Simply, shareholders vote, the companies do not).

Successful companies do not simply appear.

Many have had a long lead-time to profitability. Others have disappeared. Focussing on successful companies only ignores their start-up phase and the unsuccessful companies. The fiscal costs of both will be borne by the tax policies of the country of residence. So, taking the economy as a whole, a country accepting a new international tax consensus will:

- have the costs of the start-up phase and of their unsuccessful companies in its tax base;
- while ceding the tax base of its successful (profitable) companies to other countries.

The result is that some countries will benefit from the profits of successful companies without bearing the cost of either their start-up phase or the losses attributable to unsuccessful companies. This would only be a fair result if all countries develop companies equally. As that is not the case, this does not appear to be a fair result for countries with high levels of entrepreneurship. (Our assumption is that such countries would likely have more

successful enterprises and an ecosystem which encourages their development.)

NZ's economic objective is for exports to move up the value chain.

Although it is debatable whether this has been achieved for NZ's exports, assuming it has not, means a narrower solution may be preferred from a fiscal perspective. However, if the objective is achieved and given our view that a broader base is better than a narrower one from a tax policy perspective, the current "win/loss" position for NZ from any changes to the international tax system would also change if one of the broader OECD solutions is adopted. A static assessment of NZ's position is unlikely to provide the true picture.

The behavioural responses are uncertain.

The Tax Working Group showed there is a distinct lack of good evidence on the impact of tax changes. There appears to have been little work done to date to assess the impact on the current state of the economy. This also means there has been even less work on the impact of the options on desirable or possible future states of the economy.

The tax outcome for MNEs are the result of domestic policy choices.

Their total tax rate will be influenced by domestic policy choices such as incentivising research and development or encouraging exports. This does not necessarily mean that there is additional income, which New Zealand can and should appropriately or validly tax.

Finally, for the foreseeable future, the world will remain interconnected.

Despite trends to nationalism and populism, goods, services and people will continue to cross borders. Tax systems need to be able to deal with that interconnectedness.

The above factors inform our view.

There are trade-offs which mean that no single factor should drive the decision. However, in our view, it is clear that caution is required as:

- NZ's national interest is unlikely to be a driver or concern for any of the major players at the OECD table; and

- Given other countries are promoting change which meets their national interests, there is a high risk that New Zealand will be a “net fiscal loser” (that is, it will collect less from foreign MNEs than New Zealand MNEs will pay to foreign governments).

This assumes any consensus solution will necessarily be shaped by what is acceptable to larger market economies, which may not align with the interests of small trading economies like New Zealand.

These risks suggest that pure tax policy principles should be given less weight than supporting an international solution that minimises any damage to New Zealand’s fiscal and economic position (i.e. a “NZ Inc” perspective needs to be taken when evaluating the options).

We would go as far as saying that NZ should be ready to take an alternative path. However, finding that path is not obvious given it is unlikely to be realistic to take a unique approach separate from any international consensus.

What is to be taxed?

The traditional drivers of profit (and allocation between countries) can broadly be grouped as:

- *Resources* – their extraction and delivery to...
- *Manufacture* – converting the resources into goods and services for...
- *Sale* – supplying the goods and services for consideration; and, in the modern context...
- *Intellectual Property and brand* – which is derived from the ability to develop and deliver goods and services, create a market for those products, and exclude competitors.

These elements are all viewed from the supplier’s perspective.

The digital economy raises questions of whether users (either directly or through supplying content) help drive profit so that a market perspective should be added to justify a change in the allocation of profits between countries. This is a market or user driver of profit.

We consider the question, in brief, is best put as:

Is the value to be taxed measured by the revenue from the activity or the data/information/use of the service?

We note, firstly, that not all profit can be attributed to user value. User value is dependent on the company’s product or service, so that user value is not the only driver.

We consider a tax base of user value has features of a wealth tax. It is uncontroversial that user data, engagement and information has some value. That value may not be recognised on a company balance sheet due to accounting rules. However, to the extent the value is recognised (via an asset recognised on a balance sheet or in the share value), it is justified by expectations of future sales. Taxing that value separately from sales is therefore a tax on wealth and not on income.

Accordingly, our answer is the actual revenue from the activity remains the appropriate tax base. This aligns with current profit measurement and is properly a tax on income (in the absence of New Zealand more formally adopting other tax bases).

Nexus

There remains an open question of whether user value is relevant to attributing profit to a location. To the extent that “user” is a substitute for the “market” or a “sale” the answer is more likely to be yes. This is consistent with our answer that revenue from the activity is more like to be the appropriate measure. However, the question is then what degree of connection to a country is required for profits to be attributed and taxed there. Finding a solution to that question will depend on the method being applied.

How should it be taxed? Summary conclusions

There are two parts to consider – the OECD Programme of Work and the implementation of a Digital Services Tax (DST). Both parts are “works in progress” with little detail and little analysis provided in the discussion document, or elsewhere.

Our analysis of the options is in the next part but, in short, based on our analysis and available information to date:

- **A DST should not proceed.** It is bad tax policy with too narrow a base and too uncertain an effect and with significant risks and costs. The DST is designed to be a proxy for income tax (because of DTA issues) but it does not actually tax the profit from the activity. We consider it unlikely that further analysis would change our conclusion.

- **For the OECD Pillar 1 profit allocation options, on pure tax policy grounds we prefer approaches which apply to all forms of business.** However, there are significant issues for NZ's tax base, particularly for the foreign taxation of our commodity profits, incentives for NZ businesses to move offshore, and consequences for the NZ tax system which must be addressed. This preference may change as further work is done on the fiscal and economic effects.
- **For the OECD Pillar 2 base protection measures, there is significant further work to be done on whether these measures can be integrated into NZ's tax system.** There are concerns for NZ's tax base as particular NZ tax regimes may be viewed as not fully taxing foreign income of NZ businesses. The Pillar 2 base protection measures, similar to the hybrid rules, would allow countries where deductions are taken to deny those deductions thereby taxing the profit offshore.

As there is significant work still to be done, our response can only be an interim answer until that work is completed.



2. OECD Programme of Work

The OECD Programme of Work is in two streams – Pillar 1 dealing with profit allocation and Pillar 2 with base protection.

Pillar 1 – Profit Allocation

The digital economy raises questions of how cross-border profits should be taxed. The discussion document

outlines four methods. The OECD’s Programme of Work outlines three. As they do not exactly overlap, we have summarised the methods as we understand them and provided high level comment. We then consider design issues that arise both for the options themselves and for New Zealand’s tax system.

Table 1: Discussion Document: Summary of profit allocation methods

Profit Method	Coverage	Allocation Method	KPMG Comment
<u>User value</u> “users also (compared to customers) generate value/profits”	Digital business that generate user data and content	Allocate residual profit to countries depending on the business model/simplified percentage	This method has a narrow base so that equivalent activities are not taxed in the same way. It is not a preferred method from a tax policy perspective. It may however provide net benefits from a fiscal perspective, if NZ can tax more than others can tax.
<u>Marketing Intangibles</u> “brands generate value and profits”	All businesses	Determine market intangibles’ share of residual profit and allocate on a sales basis to countries	As it applies to all businesses, it is preferable from a tax policy perspective, but NZ may cede more of its tax base to other countries. The extent to which NZ MNEs are high on the value chain is debateable. If not, this would suggest that there is more revenue to be gained under this option. However, this will depend on commodities being explicitly excluded and NZ MNEs not moving up the value chain in future. This option also has a “free-rider” problem. The costs of generating value through R&D and product development are not reflected in the base so that countries which do not bear that cost will benefit.
<u>Significant economic presence</u> “physical in country presence is not required to tax profits”	Technology businesses with “in country” presence due to: — users; — content; — local currency billings; or — local language website	Allocate group profit based on a weighing of sales, assets, employees, and other factors	This method has a narrow base so that equivalent activities are not taxed in the same way. It is not a preferred method from a tax policy perspective. It is unlikely to provide a net fiscal benefit, given the size of NZ’s user, asset and employee base, for these businesses.

Profit Method	Coverage	Allocation Method	KPMG Comment
<u>Johnson and Johnson</u> “global profit allocated based on benchmark”	All businesses	Allocate global profit based on the sales percentage relationship to group profit margin	<p>As it applies to all businesses, it is preferable from a tax policy perspective. It appears to give a fairer result as there is a relationship to the MNE’s profit, but it may be difficult to achieve a compromise on the detail required to implement the method.</p> <p>As with other broader approaches, NZ may cede more of its tax base to other countries which may outweigh the revenue gained. (See also our comments regarding the potential for supply chains to be restructured so that supplies to NZ are not made by affected MNEs.) Timeliness of calculation and attribution may be an issue for NZ (with its more real-time requirement for payment of taxes).</p>

Table 2: OECD Work Programme

Profit Method	Coverage	Allocation Method	KPMG Comment
<u>Modified Residual Profit Split</u> Allocate non-routine profits to markets	All businesses	Determine group profit; remove routine profit; use allocation keys to attribute residual to market countries	As it applies to all businesses, it is preferable from a tax policy perspective. However, determining non-routine profits is unlikely to be straightforward and is likely to cause uncertainty, unfairness and disputes.
<u>Fractional Apportionment</u> Allocate group profit	All businesses	Determine group profit; users are an allocation key to the market country	As it applies to all businesses, it is preferable from a tax policy perspective. However, determining the appropriate allocation key may be problematic with consequential effects on uncertainty and disputes.
<u>Distribution-based</u> Include non-routine and profit from “in country” marketing and distribution	All businesses	A baseline profit for marketing distribution and user-related activities, possibly adjusted for overall MNE profitability	Similar to the Johnson and Johnson method. The same comments above apply.

The modified residual profit split method is a combination of the user value and marketing intangibles proposals, the fractional apportionment method is a modification to the significant economic presence approach and the distribution method is effectively the Johnson and Johnson approach.

Importantly, all three will apply to all businesses. This may suggest that the consensus is developing contrary to the potentially narrower base that best works for NZ's fiscal position (in the short term at least).

Cross method issues

The OECD separately identifies four issues for its work programme:

- **Thresholds.** The assumption is that thresholds are required to justify the compliance and other costs for the revenue at stake. That is a logical concern. However, importantly, it may mean that NZ has no fiscal benefit (if there is a turnover and/or a profit threshold) given NZ's small market size. Further, thresholds raise questions for losses and fairness compared to domestic businesses.
- **Lines of business and regional segmentation.** This impacts the methods which have a wider application. A particular country may under/over tax transactions with its country if a group measure is used. Clearly, different industries have different profitability. A group measure will average the profitability. If a country has only some, not all, business lines/products, there will be over-taxation if the specific activity produces less profit than average and vice versa. However, segmentation is likely to increase compliance costs.
- **Losses.** In principle, losses should also be attributed and, at least, carried forward. However, there are transitional problems to resolve. If there are high turnover thresholds, pre-existing (or even used) tax losses may not be available to be carried forward to years in which taxable income arises. This means that the country where the tax losses have been incurred bears the full fiscal cost of the tax losses. This is an unfair result. Equally, the result may be double taxation as a foreign tax credit may not be available due to the use of the loss in the home country, which is not available in the market country. This requires careful consideration. This is especially the case if NZ's objective is to have more businesses

that add value to our exports (which will require NZ MNEs to take more risks).

- **Nexus.** We do not currently have a view on the required degree of connection with a country to justify the use of a new profit allocation method.

These separate issues and the methods themselves appear to assume a static world. If a tax change is material, MNEs will consider what changes are required to their structures and supply chains. The potential behavioural changes need to be factored into the analysis.

One reaction we often see to increase profitability is for MNEs to simply exit a jurisdiction. NZ as a small economy with typically small headcount, may mean a local operation is more readily closed or sold off. This is a potential response. The extent to which the activity would be stopped completely, or taken over by others is uncertain. However, even if carried on by others, it is not certain that equivalent profits will be made.

The methods appear to assume a consumer in the market country and/or a distributor in country. Given NZ's size, an MNE may be able to decide it will not trade with NZ but instead have another, unrelated, third party trade with NZ. (For example, a Hong Kong based distributor could acquire the goods to sell to NZ). The MNE would have no NZ sales although its brand may be in market.

We note that different MNEs and different industries will have different abilities to make such changes to their supply chains. For example, a regulated industry or one which relies heavily on trust in the supply chain to maintain quality may have less ability to change its commercial arrangements.

These possible changes to business models suggest that the expected fiscal benefits may not arise.

NZ tax system impact

In our view, a change to the international taxation system will have an impact on NZ's tax system and economy.

These are grouped as:

- ***Impact on calculating taxable income (accounting based for MNEs and tax legislation based for domestic only businesses and below threshold MNEs) and tax sovereignty concerns.***

Implementing Pillar 1 options will mean a dual tax system. This may cause particular problems as MNEs move in and out of the Pillar 1 method. For NZ

MNEs, their foreign tax base will not be the same as their NZ tax base. This is likely to cause double taxation and will add to compliance costs. By contrast, for domestic companies, their tax base will not be comparable to an MNE in the same business. Equivalent activity will not be taxed in the same way.

As a matter of tax policy, the solution would be to align the tax bases to an accounting method. This will fall unequally on taxpayers depending on whether additional (or earlier) deductions became available or whether earlier (and more) income was taxed. This would be a fundamental change to the business tax system. Further, a dual tax system may drive a global tax system. This would reduce NZ's ability to make local decisions for its benefit.

— ***Imputation regime.***

If the result is more tax is paid outside NZ, so there are fewer imputation credits, the benefits of NZ tax residency for an NZ MNE's shareholders will diminish. As, by definition, profits of NZ exporters will be derived from outside NZ, the incentive for NZ businesses to move from NZ will increase.

Pillar 1 conclusion

The issues and solutions to them are important for NZ's tax system. We consider there is insufficient detail and analysis to support any one of the Pillar 1 approaches.

Careful analysis and consideration is required.

Pillar 2 – Base Protection

Under Pillar 2, which is also covered by the discussion document, the OECD is considering an:

Income inclusion rule

This rule is aimed particularly at branch exemptions, which do not fully tax profits. The residence country would be entitled to tax income despite a branch exemption in certain circumstances.

In the active controlled foreign company (CFC) income exemption, NZ currently has a form of branch exemption.

The active CFC exemption was introduced to allow NZ companies to be more competitive with companies from other countries and to focus on types of income, which are more likely to be the subject of profit shifting. Removing NZ's active CFC income exemption (which would be the simplest way to give effect to this rule)

would be contrary to the reason for its introduction in the first place.

Otherwise, NZ does not generally operate a branch exemption regime – in fact it quarantines some branch losses. This aspect of Pillar 2 would therefore not apply.

However, the tax policy work programme includes consideration of a branch exemption to treat branches and CFCs the same (and for the same reasons that the CFC active income exemption applies). Implementing this rule may effectively prevent the benefits of a branch exemption being realised.

Denying deductions for under-taxed income rule

Under this rule, a prescribed level of foreign taxation would be required for a deduction to be allowed in NZ. This is similar to the hybrid rules (which deny a NZ deduction if there is a foreign deductible/non-taxable result, or vice versa) with the added requirement that the deduction must be taxed at a certain rate if the income is taxable.

For some deductions, there are existing rules which would overlap with this rule. For example, interest deductions are constrained by the transfer pricing and restricted interest rate rules. (These may also mean that there is no tax paid in a foreign jurisdiction.)

For some income received by NZ businesses from their offshore subsidiaries or branches, there may be no effective taxation due to deliberate policy decisions, which characterise amounts differently from how other countries may see the transaction. For example, a co-operative company rebate may be seen as a deductible dividend by another country. Requiring a specified level of taxation on an amount may mean that NZ allows another country to deny a deduction so that tax is paid in that country. Double taxation would impact the return.

Our experience with the hybrid rules is that rules of this nature are complex and have uncertain and unexpected outcomes. They are difficult to apply because the outcome of other countries' tax systems and settings are not well understood or clear.

The impact of incentive regimes, such as the R&D tax credit, may also impact the assessment of the effective tax rate. Taking such incentives into account would be inconsistent with the Government's innovation and growth policies.

The proposed rules and commitments made to implement them or to allow them to be applied (if there is no implementation of those rules) need to be carefully considered for their impact on the NZ tax base.

Pillar 2 conclusion

We consider that care is also required when assessing whether any Pillar 2 measures are suitable or required for NZ.

If Pillar 2 measures are detrimental to NZ, we may still be affected as other countries may implement measures which apply in the absence of Pillar 2 rules in those countries. (See the hybrid rules for provisions which only apply if the counter-party country does not itself have hybrid rules.) These types of measures should be resisted by NZ.



3. Digital Services Tax

This part of our response considers the application of a Digital Services Tax (DST) as an interim measure.

Description of the DST

We understand that the tax base for the proposed DST is:

$$\text{Digital Services Revenue} \times \text{NZ users/total users}$$

A user is someone who clicks on an advertisement or enters into a transaction using an intermediation platform. We understand that this base is preferred so that NZ based user value which is monetised through an offshore transaction (for example, advertising to NZ users, sold by a non-NZ company to a non-NZ business) is captured.

Digital services revenues would be revenue from:

- Facilitating the sale of goods and services using an online platform (i.e. commissions);
- Advertising on:
- Social media platforms;
- Content sharing sites;
- Search engines; and
- Sale of user data from the above platforms.

We understand that digital services revenue would not include:

- The actual sales of goods and services;
- The provision of online content;
- Services delivered through the internet (including software as a service);
- Information and communications supplies;
- Television and radio broadcasting; and
- Financial services such as electronic credit cards and EFTPOS services.

These services are undefined in the discussion document. Careful work is required to ensure they are appropriately defined to include “in scope” and exclude out of scope services.

The DST would also have global and local revenue thresholds and would not be an income tax (although it is targeted at profits) and apply to all businesses that are “in scope”. These design features are required to meet NZ’s DTA and World Trade Organisation and other free trade agreement obligations.

Our principal response

The DST is a poor tax, which does not fit well with NZ’s approach to tax policy development. Further, it creates geo-political risks, which are uncertain of resolution. It should not proceed as we consider that the problems with a DST cannot be readily or simply fixed.

Detailed comments

The problems with a DST are many:

It has too narrow a target.

This means that equivalent businesses, which compete, can face different outcomes. (For example, media companies competing for advertising revenue.) Businesses could, in theory, change their structures and business models so that the DST does not apply. We acknowledge that regulation and NZ market’s size may mean that does not always occur. However, that this is a potential commercial response means the DST is inconsistent with NZ’s tax policy settings, which is to tax equivalent economic activity the same.

Widening the target revenue is likely to bring more NZ businesses into the tax base.

This would help with ensuring the DST does not create WTO or trade concerns. However, New Zealand businesses would suffer double taxation as the DST is not creditable against their NZ income tax. NZ businesses already paying their “fair” share would be penalised.

Narrowing the target revenue (by increasing thresholds for application or excluding activities) will increase the problems with the DST.

The DST as outlined in the discussion document applies if revenue is made from “in scope” activities, even if those activities are not the business’s principal activity. This has the advantage of broadening the base but will bring more NZ businesses into the base and subject them to double tax, as their combined activity is likely to be over the suggested EUR750m gross revenue threshold. An approach which increases the revenue threshold or applies it to “in scope” digital services only will exclude more NZ businesses, but will further compromise the integrity of the DST (from both a trade and tax policy perspective).

By defining the base as users (rather than revenue) to capture out of country sales, the revenue collected from foreign MNEs may not be high.

The tax base is NZ users. NZ has a comparatively small population. The percentage of NZ users to total users in any year for most in scope businesses will be small. If NZ is of higher value to the business (because a premium or a higher price can be charged) that will not be captured in the calculation and included in the tax base.

A simple example, derived from publicly available information, illustrates our concern:

- A foreign MNE had \$16.9 billion of quarterly global advertising revenue and 1.52 billion daily average users.
- Its NZ revenue was estimated at \$41m (which is acknowledged as an underestimate).

So:

- NZ revenue to total revenue share is 0.24% (i.e. \$0.041 billion / \$16.9 billion).
- To achieve that percentage of NZ users, there would need to be approximately 3.6 million daily NZ users on average. (If the NZ revenue is higher, a correspondingly higher number of NZ users would be required.)

- We do not have information on the total daily NZ users but we suggest it is unlikely that the MNE had that many daily users on average.

- Accordingly, the amount attributed to NZ under the DST would be less than the estimated NZ revenue.

Businesses may be unable to identify residency of users given the reported use of bots and location masking to conduct activity.

We have not confirmed the significance of this issue, in practice, but note that the tax base relies on user location being able to be determined accurately. That is not always straight forward. (We acknowledge this is only a concern if NZ users are hidden. Any hidden non-NZ user is relevant only to total users. For example, if an Australian user is hidden, it makes no difference to the NZ user percentage.) There is also the question of how technologies such as advertising or content blocking software/applications will impact user value and base calculations. That is, if a particular country has a high proportion of users that use such technologies, then the user value attributable to such a country should be adjusted accordingly. However, this will be difficult to determine.

The DST’s impact is not transparent.

Determining the impact of a tax requires distinguishing who statutorily pays from who economically bears the tax. That a consumption tax, like GST, is generally borne by consumers is generally accepted. The DST however is not a consumption tax. It does not, because of the base, have a relationship to the consumption of a “for consideration” supply. It is more like a tariff as a result. However, because of the global user formula, it is not clearly a cost of the business for a specific transaction. Recovery of that cost therefore must come from revenue more generally. From an efficiency perspective, this may mean that more than the actual cost may be recovered, raising costs unnecessarily.

Further, this adds to doubts regarding the suitability of tax incidence analyses based on VAT increases to determine who ultimately bears the impact of a DST. VAT/GST are direct business to consumer costs. The consumer for

digital companies is generally the business, which pays for an advertisement or pays for a sale of user data. Digital businesses generally operate in “two-sided markets” which makes it difficult to determine the level of cross-subsidisation of users (if any), who drives value (depending on the product or service, it may be the consumer, not the user), and who ultimately bears the cost of taxation.

Implicit in our preceding comment is that we consider that some cost increases from a DST will be inevitable.

We have observed that businesses, which can be assumed to be fully profit maximising and therefore charging the maximum price they are able, still increase their prices for tax changes. An example in NZ is businesses whose products are subject to excise tax. NZ has automatically increased excise tax for Consumer Price Index increases. Those increases are passed on to customers. (These businesses can all be assumed to be profit maximising.) This suggests that businesses, which can provide an external rationale for price rises, will do so. This in turn suggests to us that there will be some price increases (to an unknown level) but the lack of transparency of the DST will mean that it may be difficult to observe or constrain.

The DST is unfair and may impact innovation.

The DST is intended to be a proxy for taxing profits. However, due to constraints, its design features mean that it is a turnover based tax. As a result, there is no relief from the DST for those “in scope” businesses which make losses or whose margins are less than the amount that will be captured by a DST. To the extent not all of the cost of a DST is able to be passed on, it will affect the cost of doing business in NZ and, at the margin, impact businesses looking to innovate or expand their goods or services offerings (if that innovation results in their business being “in scope” of the DST). This may, again at the margin, discourage the expansion of businesses to NZ and innovation by NZ businesses.

The beneficiary of digital services is the user. An alternative approach is to tax the user on that benefit but such a tax would not be transparent, easily calculated, or politically sustainable.

A user’s benefit from the use of digital services include:

- Access to information more quickly and easily than in a hard copy world (for search engines);
- Connection to others (for social media, although that may have both positive and negative effects);
- Access to goods and services (at all) or more quickly (for intermediation platforms).

These benefits are not explicitly priced. Determining a notional price to tax the user on that as income (as avoided expenditure, similar to the economic view that the benefit of an owner occupied home is untaxed) is unlikely to be a sustainable approach.

There may be a “cost” to the user, such as giving access to their data (e.g. email/contact details, browsing habits, etc) or having to view advertising, making the marginal benefit to tax even more difficult to identify. Further, there may be a direct costs as a user must incur charges (e.g. telecommunication and internet services) to access these benefits. Calculating the net user benefit to tax will therefore be difficult.

The unacceptability of the DST to the United States could have repercussions for NZ’s trade policy.

We note that the US Senate has written in opposition to the French equivalent of the DST. The US Trade Representative has commenced an inquiry into the fairness of the DST for US companies. Implicit in both actions is the potential, either from a tax or trade perspective, of retaliatory action.

Although NZ may be too small to warrant the same level of attention, there is no certainty that a similar focus will not be applied to NZ. (Particularly, if the US is required to take a consistent approach to all countries with DSTs, in justifying its opposition at the WTO or trade level.) There is a risk of collateral damage to our businesses and to NZ residents that any countervailing measures would

significantly outweigh the projected NZ\$30 to 80 million revenue from a 3% DST.

The potential support for an OECD consensus does not justify the DST.

Perversely, a proliferation of DST is said to be supportive of the OECD work programme as it will encourage a single consensus response. The problems with the DST do not justify its use to support working towards an OECD consensus. Further, as the OECD consensus has not been arrived at, lacks detail and may not be in NZ's interest, implementing a DST is risky if it in fact did support achieving an OECD consensus which is detrimental.

Compliance costs are likely to be greater than the revenue raised if it is possible to implement the DST at all.

Although rules such as GST on low-value goods and remote services suggest that identifying NZ residents is achievable, the systems required for these integrate with existing business processes. They follow the revenue streams and the delivery of goods and services. A user is disconnected from the revenue and service delivery process. New systems may be required to track them. These systems will be required even if no DST is payable as the attributable digital services revenue must be calculated to determine whether the NZ income threshold of NZ\$3.5 million applies.

Economic analyses

The economic and policy effects of DSTs are considered in two reports – one by Copenhagen Economics (available [here](#)) – the other by the United States Congressional Research Service (available [here](#)). Both reports raise questions about a DST as an appropriate or necessary tax.

We encourage Government and Officials to address the concerns raised in considering whether the DST should proceed.

DST conclusion

We consider that the key problems with the DST, including the potential adverse response and impact on NZ businesses and consumers, are not solvable. It should therefore not proceed.



4. Other matters

GST is not a tax on foreign MNEs

Appendix 2 of the discussion document characterises the GST remote services and low value goods changes as BEPS measures to tax foreign multi-nationals. This, in our view, is misleading. GST is a tax on consumption. The person who can be expected to economically bear the tax is the consumer, not business. As the rationale for those changes, which is to properly tax consumption in NZ, is misstated their effect is disguised and does not provide support for a DST. That should be acknowledged.

Response to specific discussion document questions

We have not specifically answered the detailed questions in the discussion document. We trust that our response does answer the questions more broadly. We emphasise our view that significant further work is required for NZ to be in a good position to decide on its approach.

We would be happy to discuss our response and to contribute to that further work.



5. Our team



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Hon Grant Robertson and Hon Stuart Nash
Minister of Finance and Minister of Revenue
Wellington

19 July 2019

Dear Ministers

Options for taxing the digital economy: A Government discussion document

We enclose KPMG's response to the Government discussion document.

We have not formally discussed this with you. Our work in responding to the issues raised in the discussion document has made clear that it is not simply a tax question to be answered and that a broader whole of economy "NZ Inc" consideration is required.

The broader reasons for copying you are contained in our cover letter to Officials. As the Ministers responsible for this policy consultation, we have taken the liberty of forwarding you a copy of our response.

As tax advisors, we have not done the analysis to confirm these wider issues but we believe there are questions to be answered. Our response is therefore necessarily a "work in progress".

We would be pleased to discuss our response with you. Please contact us if you would like to do so.

Yours sincerely

Darshana Elwela
Partner

John Cantin
Partner

Cc
Ms Cath Atkins, Deputy Commissioner, Policy and Strategy, Inland Revenue
Rt. Hon Winston Peters, Deputy Prime Minister and Minister of Foreign Affairs
Hon David Parker, Minister for Trade and Export Growth
Hon James Shaw, Minister for Statistics
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Rt. Hon Winston Peters
Deputy Prime Minister and Minister of Foreign
Affairs
Wellington

19 July 2019

Dear Deputy Prime Minister

Options for taxing the digital economy: A Government discussion document

We enclose KPMG's response to the Government discussion document.

We have not previously discussed this with you. Our work in responding to the issues raised in the discussion document has made clear that it is not simply a tax question to be answered and that a broader whole of economy "NZ Inc" consideration is required.

The reasons for copying you are contained in our cover letter to Officials. Specifically, we are concerned that there will be adverse impacts for New Zealand's relationships with other countries (in particular the United States) from the introduction of a unilateral Digital Services Tax. We have therefore taken the liberty of forwarding you a copy of our response.

As tax advisors, we have not done the analysis to confirm these wider issues but we believe there are questions to be answered. Our response is therefore necessarily a "work in progress".

We would be pleased to discuss our response with you. Please contact us if you would like to do so.

Yours sincerely

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John Cantin
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Hon David Parker
Minister for Trade and Export Growth and
Attorney General
Wellington

19 July 2019

Dear Minister

Options for taxing the digital economy: A Government discussion document

We enclose KPMG's response to the Government discussion document.

We have not previously discussed this with you. Our work in responding to the issues raised in the discussion document has made clear that it is not simply a tax question to be answered and that a broader whole of economy "NZ Inc" consideration is required.

The reasons for copying you are contained in our cover letter to Officials. Specifically, we are concerned that there will be adverse trade impacts from the introduction of a Digital Services Tax. The result may also constrain New Zealand's "tax sovereignty". We have therefore taken the liberty of forwarding you a copy of our response.

As tax advisors, we have not done the analysis to confirm these wider issues but we believe there are questions to be answered. Our response is therefore necessarily a "work in progress".

We would be pleased to discuss our response with you. Please contact us if you would like to do so.

Yours sincerely

Darshana Elwela
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Hon James Shaw
Minister for Statistics
Wellington

19 July 2019

Dear Minister

Options for taxing the digital economy: A Government discussion document

We enclose KPMG's response to the Government discussion document.

We have not previously discussed this with you. Our work in responding to the issues raised in the discussion document has made clear that it is not simply a tax question to be answered and that a broader whole of economy "NZ Inc" consideration is required.

The broader reason for copying you are contained in our cover letter to Officials. Specifically, we note that good information and appropriate tools to analyse it will be a key component of the further work that is required to evaluate the fiscal and economic impacts of these tax proposals. We believe that Statistics NZ can assist. We further note the Green Party's interest in a fair tax system. Our response may also be of interest to your colleagues.

We have therefore taken the liberty of forwarding you a copy of our response.

As tax advisors, we have not done the analysis to confirm these wider issues but we believe there are questions to be answered. Our response is therefore necessarily a "work in progress". We would be pleased to discuss our response with you. Please contact us if you would like to do so.

Yours sincerely

Darshana Elwela
Partner

John Cantin
Partner

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Dr Deborah Russell
Chair, Finance and Expenditure Committee
Wellington

19 July 2019

Dear Dr Russell

Options for taxing the digital economy: A Government discussion document

We enclose KPMG's response to the Government discussion document.

We have not previously discussed this with you. Our work in responding to the issues raised in the discussion document has made clear that it is not simply a tax question to be answered and that a broader whole of economy or "NZ Inc" consideration is required.

The broader reasons for copying you are contained in our cover letter to Officials. Specifically, any future legislation implementing Government decisions will need to be considered by the Finance and Expenditure Committee. We have therefore taken the liberty of forwarding you a copy of our response. We have no objections to our response being made to your Committee colleagues, if you consider it appropriate.

As tax advisors, we have not done the analysis to confirm these wider issues but we believe there are questions to be answered. Our response is therefore necessarily a "work in progress".

We would be pleased to discuss our response with you (and the Committee). Please contact us if you would like to do so.

Yours sincerely

Darshana Elwela
Partner

John Cantin
Partner

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Hon Paul Goldsmith
National Party Spokesperson for Finance
Wellington

19 July 2019

Dear Mr Goldsmith

Options for taxing the digital economy: A Government discussion document

We enclose KPMG's response to the Government discussion document.

We have not previously discussed this with you. Our work in responding to the issues raised in the discussion document has made clear that it is not simply a tax question to be answered and that a broader whole of economy "NZ Inc" consideration is required. This includes the need for any solution to be politically sustainable over time.

We have therefore taken the liberty of forwarding you a copy of our response on the Digital Services Tax and OECD proposals for taxing the digital economy.

As tax advisors, we have not done the analysis to confirm the wider issues but we believe there are questions to be answered. Our response is therefore necessarily a "work in progress".

We would be pleased to discuss our response with you. Please contact us if you would like to do so.

Yours sincerely

Darshana Elwela
Partner

John Cantin
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Mr David Seymour
Leader, ACT Party
Wellington

19 July 2019

Dear Mr Seymour

Options for taxing the digital economy: A Government discussion document

We enclose KPMG's response to the Government discussion document.

We have not previously discussed this with you. Our work in responding to the issues raised in the discussion document has made clear that it is not simply a tax question to be answered and that a broader whole of economy "NZ Inc" consideration is required. This includes the need for any solution to be politically sustainable over time.

We have therefore taken the liberty of forwarding you a copy of our response on the Digital Services Tax and OECD proposals for taxing the digital economy.

As tax advisors, we have not done the analysis to confirm the wider issues but we believe there are questions to be answered. Our response is therefore necessarily a "work in progress".

We would be pleased to discuss our response with you. Please contact us if you would like to do so.

Yours sincerely

Darshana Elwela
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Mr Struan Little
Acting Chief Executive and Secretary of the
Treasury
Wellington

19 July 2019

Dear Mr Little

Options for taxing the digital economy: A Government discussion document

We enclose KPMG's response to the Government discussion document.

We have not previously discussed this with you and we assume that The Treasury will receive our response, through its involvement with Inland Revenue in tax policy.

However, our work in responding to the discussion document has made clear that the issue is not simply a tax question to be answered and that a broader whole of economy "NZ Inc" consideration is required. The broader reasons for copying you are contained in our cover letter to Inland Revenue. As the Government's lead economic advisor, we believe the Treasury has a wider role to play.

We have therefore taken the liberty of forwarding you a copy of our response.

As tax advisors, we have not done the analysis to confirm these wider issues but we believe there are questions to be answered. Our response is therefore necessarily a "work in progress".

We would be pleased to discuss our comments with you. Please contact us if you would like to do so.

Yours sincerely

Darshana Elwela
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