Submission to the Inland Revenue Discussion Paper on Options for Taxing the Digital Economy

July 2019

Interactive Games & Entertainment Association

1. Introduction

IGEA is pleased to provide this submission in response to Inland Revenue's discussion paper on options for taxing the digital economy. We appreciate the New Zealand Government's decision to consult early and openly on this issue through a practical, detailed and well-drafted discussion paper and we welcome the opportunity to contribute to this dialogue and any further consultations.

We are the peak industry association representing the business and public policy interests of New Zealand and Australian companies in the interactive games industry. Our members publish, market, develop and distribute interactive games and entertainment content and related hardware. While the video games market locally is increasingly becoming digital, we are still at our core very much a traditional industry – focused on the sale and distribution of physical consoles and games in retail stores in cities and towns throughout New Zealand.

We note that the Government is currently consulting on two potential options for taxing the digital economy. The first option is to apply a separate digital services tax (DST) to certain digital activities, such as on intermediation platforms (like Uber), social media platforms (like Facebook), content sharing sites (like Instagram) and search engines and the sale of user data. The second option is to change the current international income tax rules, which would need to be agreed to by countries.

Our submission provides our views on these two options and we hope Inland Revenue finds it useful and compelling. Our appreciation again for the opportunity to participate in this consultation process.

2. IGEA's position and key perspectives

At the outset, we are strongly of the view that the second option – changes to international tax arrangements – is the only approach that will provide an effective and sustainable solution, while the first option – a DST – will be difficult to implement and can fairly and respectfully be characterised as a 'high risk / low reward' gamble.

We do not consider that a justifiable case has been made for New Zealand to implement an interim DST at this time and in a highly uncertain global trade environment, especially when momentum appears to be building within the OECD and other multilateral fora for countries to come together to develop a truly effective international solution to reform international tax rules more broadly. While it is true to some countries are exploring DSTs, many others are not, with Australia having come to a recent decision to focus on multilateral efforts without an interim

DST, having acknowledged its risks and concerns from not only the business sector but financial commentators and economists.

As an initial threshold issue, one issue that the discussion paper does not address in sufficient detail is the fact that questions about the fairness of the tax system are not limited to digital platforms, with many of the 'unique' advantages of how digital businesses operate are now common across more traditional businesses. For example, the 'scale without mass' argument raised in the paper is not unique to just digital businesses but is a trait of many businesses across much older industries. There are many significant risks with taking interim measures and its costs could well outweigh its uncertain and, as the discussion paper already concedes, modest benefits. The risks of an interim DST include a stifling of innovation and competition across New Zealand's broader digital environment, even if many smaller businesses would be unlikely to reach the size threshold.

Also, as the discussion paper also concedes, the implementation of a tax based on revenue rather than profit strays from well-accepted international practice and could lead to double taxation (in spirit and practicality if not in strict legality). We believe the paper also underestimates both the complexity of implementing a DST (which is still a very new concept and one where there are few precedents) as well as the compliance and administrative burden of affected businesses who may decide to pull out of a small market like New Zealand given the relatively low domestic $3.5 million threshold. This would affect not only consumers but all the workers, contractors and small businesses who may rely on their innovative platforms.

We believe that while there may well be a need for reform, modernisation of the international tax system through multilateral arrangements is the only approach that will be effective and sustainable. Rather than New Zealand going down the path of still untested interim measures, we would rather support New Zealand as a global leader in progressing dialogue on a consensus-based approach that will provide equity and lasting certainty for both countries and businesses. We also believe the discussion paper underplays the risks of retaliatory measures – not only in the shape of challenges to the validity of a DST in New Zealand – but retaliatory trade measures at exactly a time when the threat of escalating trade wars seem increasingly real.

Nevertheless, should a DST be seriously considered in New Zealand, we think many further details still need to be clarified and consulted broadly upon. We appreciate that the discussion paper clarifies that the sale of goods and services, such as video games which are already subject to GST in New Zealand, would not be within the scope of any DST. We also think platforms like digital marketplaces for games should also be kept outside the scope of any DST. It is expanded on later in this submission, but for many reasons they are not 'intermediation services' as described in the paper and, given the principle articulated in the paper that a DST should be highly focussed on a small number of activities, the definition of such services should be precise and limited in its scope in any potential DST in the future. To summarise these reasons, digital game storefronts are not intermediation services but are generally just digital extensions of physical game stores, with the added difference that they also invest heavily into developing and selling their own hardware and software.

Finally, we also consider that it is premature to implement interim measures against online advertising and user contributions outside of internationally agreed-upon approaches on how they should be dealt with. While we acknowledge that the model of the proposed DST will have global and domestic revenue thresholds that would exclude most businesses, there are still questions that have not been answered with clarity which creates uncertainty for industries like ours. These include how the revenue threshold will be fairly assessed (what if DST-attracting activities only form a minuscule portion of the multi-national's revenue base?), how 'user contributions' will be measured given the diverse and ever-changing shape and activities of innovative digital businesses, and what other safeguards need to be implemented. If the DST idea progresses, the next step must be further scoping and consultation.

The rest of this submission expands on these points to argue why the New Zealand Government should exercise high caution around the idea of an interim DST and our recommendation that it focus on working with global partners on a long-lasting solution through the international tax rules.

3. Flawed rationale for singling out the digital sector

We do not believe that the discussion paper clearly articulates why the local and global digital economy should be subject to an immediate, drastic, non-futureproofed and transitory interim tax reform ahead of other broad tax reforms. While the discussion of the benefits of New Zealand's digital economy are consigned to Appendix 1, the paper identifies three problems with digital businesses – scale without mass, user value creation and intangible assets. Our argument here is not that these issues shouldn't be subject to further discussion at a global level, but that they are issues that are not constrained to digital businesses but are increasingly relevant to the business models of traditional businesses more broadly. Targeting just 'pure' digital business model in isolation of fundamental global tax reform may lead to unfair and perverse outcomes and will be generally difficult to implement.

There is discussion in the paper around concerns with digital businesses that operate in New Zealand but with a limited physical presence or profit-generating assets onshore. However, we feel that the discussion paper underplays the reality that cross-jurisdictional scale without mass and intangible assets are not unique to companies with digital business models, with the paper simply noting in passing that "many nondigital companies [also] have valuable intangible assets". In fact, there are ample examples of these qualities applying to businesses across a whole range of industries, with the Australian Treasury's 2018 discussion paper specifically highlighting the automobile sector.

Other examples also exist in the manufacturing, defence, retail and services industries as globalisation make firms nimbler and more reliant on assets based on knowledge, technology, customer reach, data and reputation. Specifically, many overseas-based businesses in a range of sectors in the traditional economy have business models that operate in New Zealand's market but hold the majority of profit-generating assets and labour offshore. Many export-orientated goods and services share this characteristic, with offshore call centres just one example. One of the many economic benefits of globalisation is the ability to reach into foreign markets without significant scale and this benefit is not unique to digital businesses and are characteristics of both foreign businesses in New Zealand as well as ambitious and outward-looking New Zealand businesses operating abroad. We question whether there is a specific and urgent need to target digital businesses.

Similarly, in terms of intangible assets, while it is clear that many digital businesses have flexibility over where they develop their intellectual property, host their services and base their regional or global headquarters, this also applies to many traditional industries too. One economic reality not discussed in significant detail in the paper is that many businesses that have not relied on digital business models still rely heavily on intangible assets. Examples include the many multinationals that supply pharmaceuticals, whose profits stem from their patents, and creative industries that rely on their intellectual property. Despite this, the discussion paper does not articulate why only the intangible assets used by digital businesses should be the focus of tax reform attention. The discussion paper suggests that the traditional challenges of intangible assets are exacerbated by digitalisation, while problems with the international tax framework are particularly acute for digital companies. We do not find this a compelling enough reason for such bold reform. If that is the case, then that is even more reason to prioritise international tax reform, which may help address broader issues beyond those perceived as endemic to the current digital landscape and better bolster the agility of New Zealand's tax system as future business models evolve in the coming years and decades.

Finally, the use of 'user contribution' is no longer the sole domain of digital businesses but is vital to organisations right across traditional industries and the community and government sectors who leverage the information of its users. Big data is helping businesses to better serve their customers, and governments to develop more informed policies. While there may be an argument that the leveraging of user contribution may be more prevalent among digitalised businesses than traditional businesses, we argue this is divide is rapidly losing relevance. One example is newspapers, including some of the oldest and most traditional businesses in New Zealand and the world, most of which have digitalised parts of their businesses and are exploiting overseas audiences through online advertising – leveraging both user contributions and scale without mass. Once again, it is also not entirely clear why only the newer, innovative digital businesses need to be targeted. These concerns have been echoed by the OECD, which warned in its Action 1: 2015 Final Report that the digital economy was rapidly becoming the economy itself and increasingly difficult to be 'ring-fenced' from the broader economy for tax purposes.

4. Complexities and challenges of implementing a DST

We believe that the paper underplays the difficulties and challenges that would be encountered in implementing a DST and that a 2020-21 timeframe is ambitious. A new revenue-based tax would be a particularly unorthodox and challenging approach with few precedents to provide any guidance or best practices to model upon. We consider that even if the Government were to determine that a DST should be progressed, the implementation path remains long and treacherous. The discussion paper, while very helpful for this consultation process, lacked some important details on the exact scope and operation of the DST and we think further consultation is needed to ensure all outstanding questions are addressed. It is also still not clear how the DST would be administered and how it would be enforced. There is also a risk of resources being diverted to implementing the DST within the Government at the expense of supporting New Zealand's role in OECD negotiations on broader reform, which will occur no matter what and remain the highest priority.

A DST would stray from both conventional practices and international tax principles and New Zealand would need to join the small number of countries testing the waters on a highly divisive and untested issue. There is a reason why revenue-based taxes are not the norm – they are not based on agreed and proven tax principles and cause discomfort among many respected economists and policymakers. For companies that are not yet profitable because all capital is being invested into growth and servicing debt, a DST that accentuates existing financial pressures may significantly hamper the company's research, innovation, growth and ability to invest or operate in New Zealand.

The discussion paper acknowledges that the question still remains open whether revenue-based taxes like the DST avoid double taxation and infringe on double taxation agreements. With the OECD's Interim Report only providing limited and circumspect guidance on the matter, there is still real uncertainty around the legality of the DST model that has not yet been tested. The discussion paper notes that the United States (US) has criticised the DSTs proposed by the United Kingdom (UK) and the European Union but not yet alleged that the DSTs would contravene double taxation agreements. This does not necessarily mean that the US and other countries will not challenge them in the future, nor that they will not consider it easier to retaliate in other, more practical, ways.

Compliance costs for New Zealand businesses that fall within the scope of the DST - and even those businesses that are excluded but still need to prepare for it - would be high. Businesses would need to implement complex and expensive new compliance systems, particularly if they need to accommodate a new revenue-based tax. More broadly, these new rules and costs could have a stifling effect on economic growth, innovation and risk-taking at exactly the wrong time as New Zealand urgently focusses on diversifying and modernising its economy and works towards building up digital exports to maintain its international competitiveness in the Asia-Pacific region and beyond. Currently, there is insufficient detail available in the discussion paper around the precise scope and operation of a DST to determine the extent of the compliance burden.

The OECD’s Interim Report has itself recognised similar risks and, as outlined in the discussion paper, has warned that interim measures could result in over-taxation, may have an adverse impact on investment and innovation and have high compliance and administrative costs. The OECD has also warned that interim measures may increase the cost to consumers of goods and services impacted by such measures and may distort the choices of businesses and consumers. Perhaps most worryingly, the OECD warned that interim measures may add artificialities to the market, distort how businesses and consumers make choices and change the landscape of digital goods and services available in New Zealand to one that does not efficiently match the market.

Finally, one has to ask the question whether the implementation effort and cost to the Government, as well as the compliance burden on industry and effect on the market and consumers, will be worth the likely limited benefit gained (especially given that the DST would need to be eventually repealed). As noted in the discussion paper, the OECD in its Interim Report warned that there would likely to be a negative impact on the overall welfare of an economy and on its output. The Government therefore needs to decide whether all of these risks outlined in this section are worth the tax revenue that it has acknowledged in its discussion paper is “unlikely to be a significant revenue earner”.

5. Reforming international tax rules the only genuine solution

Most countries and industry groups recognise that tax laws around the world may need to be modernised given their age and in light of the continued globalisation and digitalisation that has occurred this century. However, these issues can only be solved through multilateral cooperation and partnership to reform the international tax system, such as those being led by the OECD and the G20. While they may take time, genuine solutions that are sustainable can only be reached through multilateral agreement and a consensus-based approach.

Countries pursuing their own paths with unilateral reforms will only hinder their ability to achieve an effective and sustainable global solution. Our concern is that the more countries consider interim measures, albeit noting that the number of countries and regions doing so remains low, the less incentivised and invested they will be to try to find a permanent solution. If the Government believes that multilateral agreement is the only viable and sustainable solution, unilateral actions will only disrupt and slow down progress.

Undertaking interim measures like a DST could also have more direct and troubling impacts on New Zealand's trade relationships too. The international trade environment is currently in a fragile state and New Zealand is delicately negotiating five free trade, including with the European Union and India and an upgrade being negotiated with China. Noting that a DST would likely apply to companies from all three of these regions, any interim measures could delay or hinder these negotiations and the implementation of future agreements.

As already raised, interventions like a DST would also run the very real risk of being treated as protectionism and could lead to retaliatory tariffs on New Zealand's relatively vulnerable export sectors, including in meat, dairy, fruits, wood and manufacturing. Specifically, a DST may be taken as a proxy tax largely targeting US and Chinese companies at a particularly volatile time and there is a real risk of retaliatory measures by these countries. Such retaliatory measures could have a significantly wider and deeper impact on the New Zealand economy than any modest increases in receipts that could be expected to be gained from a new DST.

6. Digital game content should remain out of scope

Video games businesses in New Zealand can broadly be placed into three categories: publishers, distributors and developers. Publishers generally market and distribute games that they or other parts of their broader organisation develop. Distributors market and distribute third party games, after having acquired the legal rights to sell those games in New Zealand. Developers create their own games which they publish themselves or through a publisher or distributor. Our members include most of the major game publishers and distributors operating in New Zealand and we are strong supporters of local game development studios.

While many interactive games are sold digitally, most of New Zealand's games market is still heavily focused on the sale of games through physical 'boxed' products or games that are sold in both digital and physical form. According to our research, over a quarter of New Zealand's consumer spending on video games still takes the form of physical games sold in bricks and mortar stores. Many of the digital products that our members sell are simply digital versions of physical products that are sold in stores, giving customers the flexibility to purchase the versions they prefer. Clearly, games are far from being pure digital goods.

We note that the discussion paper clarifies that the sale of goods and services, such as video games, would not be within the scope of any DST, which we support as an easy and sensible decision and one that is in line with other DSTs being considered abroad. Crucially, GST applies to sales of digital goods and services to New Zealand consumers including from overseas - including digital games - just like it does to physical goods and services. We consider that New Zealand's GST system has comprehensively dealt with the issue of the taxation of digital game content.

One of the concerns with the digital economy identified in the discussion paper is that some digital businesses carry out activities in New Zealand with a minimal physical presence or locate most of their profit-making assets outside New Zealand. Many of our members are local New Zealand companies that have physical offices and even infrastructure like warehouses. Our New Zealand members pay all relevant taxes, contribute millions of dollars each year to the economy through their businesses and contribute back to their communities. Together, our members employ many, many New Zealanders and indirectly support the hundreds if not thousands of New Zealanders who are employed in businesses around the country that develop, sell, market, support, exhibit, compete in and write about video games.

We also urge the Government, should a DST be progressed, to be precise in its language so that video games are not caught by the tax even where games by their very nature are enhanced by 'user participation'. Games differ greatly from services that rely primarily on user-created value. The vast majority of the revenue of games businesses are transaction-based and therefore already attracting taxation. Furthermore, the primary economic value of games comes from the production, design, innovation, artistry, story, mechanics and playability of games – all of which is highly expensive and labour-intensive to create. The economic value of games derives less from 'user participation' than user value derives from their enjoyment of the games that they play.

While the UK's DST consultation paper initially noted the need to further reflect on the treatment of "online games that share similar features to social media and online marketplace business models" - a very vague and confusing reference to us - it subsequently moved away from that thought in its most recent draft legislation. While no such references were repeated in the New Zealand discussion paper, we will still provide our views on it for the sake of clarity. Many if not most kinds of games allow players to interact with their friends and other players as part of gameplay and it is not clear why or how these games are different to the multiplayer games that the UK paper has explicitly excluded from the DST. We are also not aware of any games that rely on "online marketplace business models" and there are very few (if any) games that allow players to buy and sell game content from one another in any legitimate way.

7. Digital game storefronts are not intermediation services

Video games are often sold digitally through storefronts or marketplaces like the Sony PlayStation Store, Nintendo Game Store, Microsoft Xbox Store and the Google Play Store. Again, while there is nothing in this discussion paper that suggests that these kinds of platforms would necessarily fall within the scope of a DST, the paper's discussion of "intermediation services" which match buyers and sellers is vague and it is not entirely clear which activities would be covered and which would not.

Games storefronts and marketplaces are not "intermediation services" and are not analogous to digital platforms that facilitate interaction between users like eBay and Uber (the examples used in the discussion paper), or aggregator platforms like travel and hotel booking websites that connect users with third parties. Rather, games platforms are substantially and uniquely different from intermediation services in several important ways. First, they are not simply matching services between buyers and sellers. Game storefronts and marketplaces are far more like digital extensions of physical game stores that enable game developers and publishers to sell games, game content and related services to players of their games.

Second, rather than being a matching service that depends on user volume like some of the businesses that are considered intermediation services in the discussion paper, game storefronts and marketplaces are highly evolved products and services in their own right that develop and support complex relationships with both game publishers and players. Unlike intermediation services, the businesses that build these storefronts and marketplaces also generally need to develop the underlying hardware, software and infrastructure to enable games to be built, sold and played on the platform. These include multiple generations of gaming consoles, peripherals, operating systems and firmware. These businesses do not simplistically leverage value from their user base but instead, have literally created and continue to support an ecosystem of game developers and game players through investments of billions of dollars.

Third, unlike intermediation services, games companies are often deeply involved and have invested themselves in the marketplaces and storefronts that they run. One major console manufacturer, for example, currently owns 15 game development studios. Games console manufacturers often play a hands-on role with the games distributed on their well-curated platforms, often publish their own games (first party games) on their platform and need to work closely or in partnerships with other game developers and publishers to bring content to their platforms, including via equity investments, licensing or profit-sharing arrangements. In this way, many games storefronts are more akin to a Netflix model of bringing content to the consumer (especially so as games subscription services become increasingly popular) which the discussion paper clarifies would be outside the scope of a DST.

Fourth, and perhaps most importantly, these companies already pay significant amounts of GST and taxes in New Zealand on the underlying digital and physical goods and services that underpin the sector, including the games, consoles and devices sold instore and online throughout New Zealand. Earlier in this paper, we have already spoken about the difficulties in ring-fencing digital and non-digital businesses, and video games companies are prime examples of this. Given that the discussion paper repeatedly states that a DST would be narrowly targeted towards certain highly digitalised supplies, we hope this means games platforms and storefronts would be excluded.

Finally, to conclude this section, we note that the European Commission shares the view that digital storefronts and marketplaces should not fall within the scope of any digital tax, explaining in its Explanatory Memorandum to COM(2018)148 that:

> *"services by an entity to users through a digital interface consisting in the supply of digital content such as video, audio or text, either owned by that entity or which that entity has acquired the rights to distribute, **are not to be regarded as intermediation services** and should therefore be excluded from the scope of the tax, **given that it is less certain the extent to which user participation plays a central role in the creation of value for the company**" (emphasis added).*

8. Premature to tax online advertising and user contribution

This paper urges caution generally against New Zealand going down the path of a DST. However, it remains a possibility that following this discussion paper consultation process the Government will still consider that a DST targeting online advertising and user contribution are worth further consideration. If this occurs, we think that there is significantly more analysis, scoping and consultation that is needed before any such measure can be progressed and introduced into Parliament.

There are real questions about how a tax on online advertising (as well as user contributions) would work, how it would be valued, how it would be implemented, how compliance would be monitored and how it would be enforced. There is also a danger that if the taxation of online advertising is normalised around the world, there will be serious consequences for New Zealand’s mobile game developers. Our local developers, many of whom rely on online advertising within their games, are among the most innovative and successful in the industry. They inject millions of dollars into the economy and form the backbone of one of the country’s most important and forward-looking digital creative industries. Even if most local developers would be unlikely to reach the global revenue threshold necessary to trigger the DST, it would likely stoke fear of the broader business model and, most importantly, discourage global publishers from investing into local New Zealand studios lest their broader company then fall within the DST’s remit.

As already discussed, there are just as many questions and uncertainties about how a tax on user contributions would work and how the value of user contributions can even be calculated. What kinds of user contributions are covered and how are they valued? For the purposes of calculating the local portion of a company’s global revenue-generating activities, is a New Zealand user worth the same as a user in an economy with a vastly different level of development? If yes, why, and if not, how will the difference be calculated? And how will the DST deal with companies with blended traditional and digital business models – noting the challenges with ring-fencing already discussed? As far as we are aware, no country or organisation has been able to develop any kind of effective formula that is not an indiscriminate tax and the DST that is the subject of this consultation is no different. Unfortunately, there is little agreement or cooperation even between the few countries that are seriously discussing interim taxes on user contributions and we are worried about the impact on the global economy of this fragmentation of national approaches to an international tax issue.