The government is reportedly considering a new tax on the digital economy. While no details of the tax are available yet, the digital services tax recently proposed by the European Commission may give us an idea what the tax might look like.

In essence, the proposal will impose a 3% tax on the turnover of large digital economy companies in the European Union. Similar ideas have been suggested in the UK and France .

The current international tax system was designed before internet was invented, so this new tax is a response to this problem. Under the current system, a foreign company will not be subject to income tax in Australia unless it has a significant physical presence in the country. The key word here is "physical".

It is well known that modern multinationals such as Google can derive substantial revenue and profits from Australia without significant physical presence here. It is no surprise that this 20th-century tax principle struggles to deal with the 21st-century economy.

This problem is well known but the solution is far more elusive.

Attempts to tax digital companies

The best solution in response to the rise of the digital economy is to reword the laws to take more into account than the "physical" presence of a company in the international tax regime. However, this reform would require international consensus on a new set of rules to allocate the taxing rights on the profits of multinationals among different countries.

In particular, it would mean more taxing rights for source countries where the revenue is generated. The formidable political resistance is not difficult to imagine.

The OECD has attempted to address this fundamental issue, but in vain so far. Its report on the taxation of digital economy in the Base Erosion Profit Shifting project did not provide any recommendation to improve the system at all. The recent report on its continuing work on the digital economy again shows little progress.

While the EU also recognises that the long-term solution should be a major reform of the international tax regime, the slow progress of the OECD’s effort is seriously testing the patience of many countries. Therefore, the EU has proposed the digital services tax as an “interim” measure.

Google as an example

The Senate enquiry into corporate tax avoidance revealed that Google is deriving billions of dollars of revenue every year from Australia but has been paying very little tax. In particular, the revenue reported to the Australian Securities and Investments Commission in Australia in 2015 was less than A$500 million, with net profits of A$47 million.

The government responded by introducing the Multinational Anti-Avoidance Law in 2016, targeting the particular tax structures used by multinational enterprises such as Google.

Google Australia’s 2016 annual report states that the company has restructured its business. Though not stated explicitly, the restructure was most likely undertaken in response to the introduction of this law.

As a result of the restructure, both revenue and net profits of Google Australia increased by 2.2 times.

However, here is the bad news. Though Google has reported significantly more profits in Australia, the profit margins of the local company remain very low compared to its worldwide group. For example, the net profit margin of Google Australia was 9% while that of the group was 22%.

Of course, a business may have different profit margins in different countries for genuine commercial reasons. However, based on our understanding of the tax structures of these multinationals, it's likely that significant amounts of profits are booked in low-tax or even zero-tax jurisdictions.

This example suggests that while the Multinational Anti-Avoidance Law is achieving its objectives, it alone is unlikely to be enough.

A digital services tax in Australia

The digital services tax is a turnover tax, not an income tax. This circumvents the restrictions imposed by the current international income tax regime.

The targets of this tax include income of large multinationals from providing advertising space (for example, Google), trading platforms (for example, eBay) and the transmission of data collected about users (for example, Facebook).

If Australia follows the model of the digital services tax, the new tax may generate substantial amount of revenue. For example, Google Australia's revenue reported in its 2016 annual report was A$1.1 billion. A 3% tax on that amount would be A$33 million.

Along with the digital services tax proposal, the EU proposed the concept of "significant digital presence" as the long-term solution for the international tax system. The exact details are subject to further consultation. However, the relevant factors may include a company's annual revenue from digital services, the number of users of such services, and the number of online contracts concluded on the platform.

The destiny of this proposal is unclear, but it's likely to be subject to fierce debate among countries. In any case, the proposals of the digital services tax and the digital presence concept suggest there may be a paradigm shift in the thinking of tax policymakers in response to the challenges imposed by the digital economy that would be difficult, if not impossible, to resist.

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