Which way forward?

International Tax | Large Corporate

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Bill Dodwell considers the taxation of the digital economy

One of the hottest topics in tax policy is the taxation of the digital economy. The G20 asked the OECD to re-establish its Digital Taskforce and produce some recommendations by April 2018. The European Union also thought it essential to look at the area and held discussions under the Estonian Presidency last autumn.

Into the mix stepped the UK at the Autumn Budget, with a position paper and the announcement of a new withholding tax.

The withholding tax will apply from April 2019 – and levy UK tax on payments made by non-UK companies to related parties based in territories without a UK double tax treaty with a non-discrimination clause. The objective is to ensure that ‘payments for the exploitation of certain property or rights in the UK that are made to connected parties in low or no tax jurisdictions will be subject to appropriate taxation.’ The measure might be seen as a further ‘encouragement’ to ensure that royalties are no longer paid to zero-tax locations, typically without the people-based functions necessary to attract profits under the new transfer pricing approach. The challenges with this measure undoubtedly come from reporting and collecting tax from a legal entity outside the UK.

The UK’s position paper on the digital economy is much more wide-ranging and interesting. It gives a wider perspective than anything so far from the EU or the OECD. The measures being considered go beyond the parameters of the Base Erosion and Profit Shifting (BEPS) project. BEPS has something to say about the digital economy, but it deliberately left open any question of specific tax measures, noting ‘Because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes.’

It turns out that this was not the last word on the digital economy. The 22 November paper says ‘…there is a need to ensure that the international tax framework is responsive to the changing nature of our economies in the digital age, and able to accommodate new digital businesses that operate and create value in different ways.’

The paper notes that ‘the challenges that digital businesses pose to the effectiveness of the international corporate tax rules can only be sustainably addressed in the long run through multilateral reforms.’ The distinctive feature that supports a different approach to certain digital businesses is that some derive value from a material and active user base –which is central to the success of the business model and has a direct link to the generation of revenue. In such cases, the paper argues that jurisdictions where the users are based should be able to tax a company even though it may not have a fixed place of business in that location. It suggests that a metric for such a profit allocation needs to be worked out – based on something like average monthly users. It may be relatively easy to measure usage – but there are no clear economic theories of calculating value. This theory is sometimes known as virtual permanent establishment. Adopting this would require global agreement and a major change to double tax treaties.

Reassuringly, the paper affirms that ‘countries should have the right to tax business profits derived from productive activities, enterprise and human innovation in their jurisdiction, irrespective of where shareholders and customers are located.’ This is of course the long-standing basis of international taxation, reaffirmed during the BEPS project. it is also important to find a means of distinguishing general businesses from digital businesses deriving value from their user base. If this distinction cannot be drawn clearly, then it could open up the prospect of a much more major change to international tax – by allocating some profit to the customer location.

The paper does discuss an interim measure that a group of countries – such as the EU – could adopt, in the form of a turnover-based tax. Such a tax would be levied on businesses that derive value from their user base – but it would not apply to digital businesses selling self-developed or acquired goods to customers through an online platform, or charging customers for the provision of digital content, digital software and digital services.

Examples of the type of business in scope are:

- businesses that build a user base on an online service, including those that allow for the sharing of content and user-generated contributions, and then generate revenues through directing targeted adverts at that user base using personal data, e.g. a search engine, a social media or file-sharing platform
- businesses that provide an online marketplace for buyers and sellers of goods/services and take a commission from sales, or those which take a commission from matching users’ common interests, e.g. exchanging of goods, renting of assets, and forming of relationships.

The paper acknowledges the challenges of a turnover tax and suggests the provision of double tax relief, de minimis thresholds and mitigating provisions for loss-making and early-stage businesses.

It remains to be seen whether the international community will manage to reach agreement on the way forward in this challenging area.