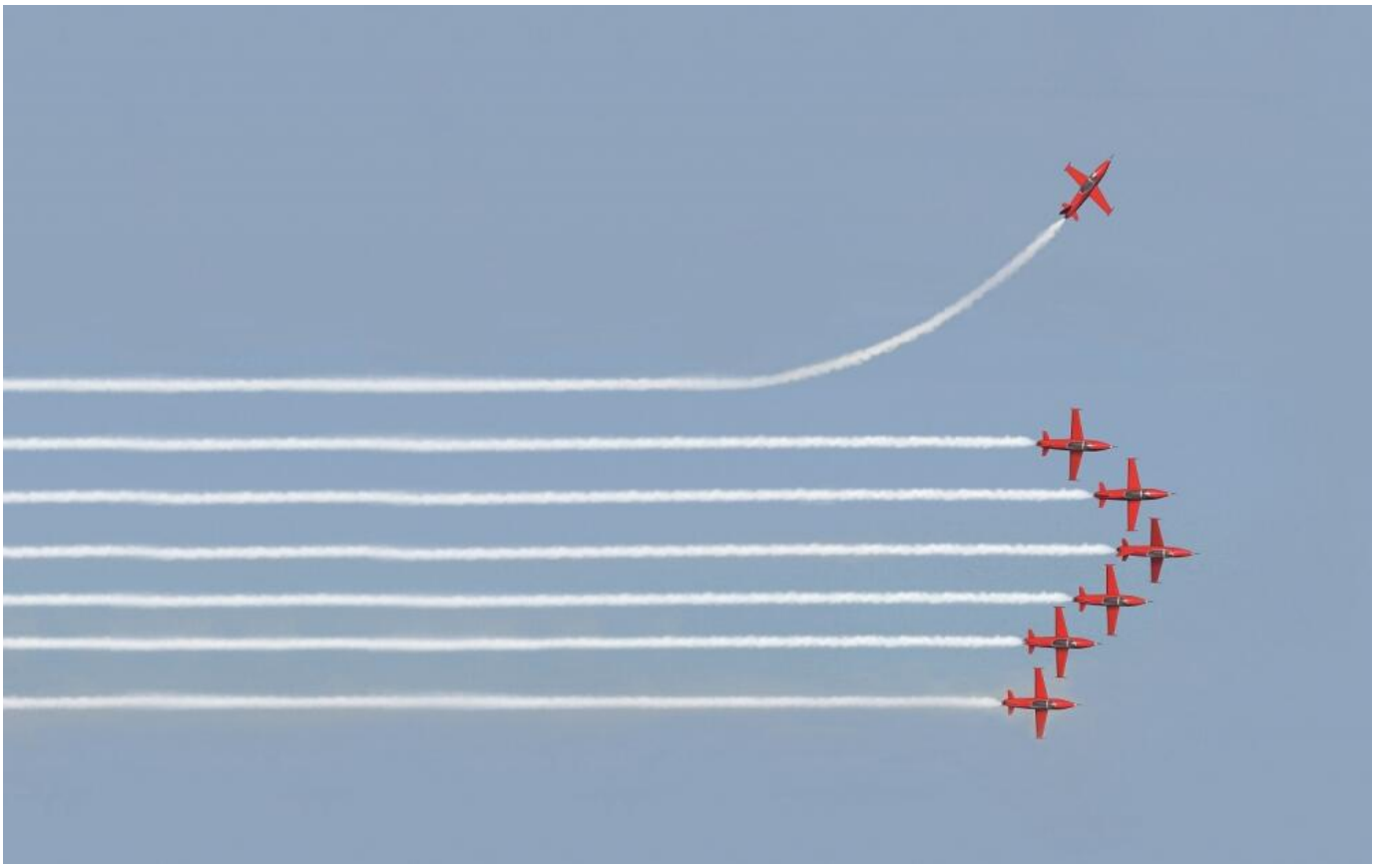
A radical departure

International Tax | Large Corporate



01 December 2018

Matt Stringer and *Amanda Collinson* consider the implications of the new Digital Services Tax

Key Points

What is the issue?

The UK is to introduce a 2% Digital Services Tax from 1 April 2020 on gross revenues generated from certain activities in the UK.

What does it mean to me?

Businesses which derive value from their UK user base will need to carefully consider the new provisions as details become available. DST is a radical departure from traditional taxation methods and usual international tax methodology for determining the tax base may not apply.

What can I take away?

Background to the ‘digital issue’, an overview of how DST is expected to operate, and a taster of some of the complexities that introducing this new tax will bring.

On Budget day, 29 October 2018, Chancellor Phillip Hammond announced the arrival of a new UK tax: the Digital Services Tax, or ‘DST’ as it is likely to be commonly referred to by the time we go to print!

DST is a radical divergence from several well-established international tax principles. It is a tax on gross revenues (rather than profits). This completely disregards the overarching principle that tax follows profits, and that profits should be split on an arm’s length basis between jurisdictions, based on the activities carried out by the employees of the multinational enterprise. DST could apply where, under traditional methods, no profits should be allocated to the UK and where businesses have no UK taxable presence.

But before we get too excited, let’s rewind and think about where this idea has developed from.

Back in time…

Over five years ago, the G20 and OECD identified the challenges of the digital economy as a key part of the action plan for the Base Erosion & Profit Shifting (‘BEPS’) project. So key, in fact, that it was labelled as Action 1. The issue was clear: our global tax system was designed with the ‘bricks and mortar’ business in mind. In today’s world, many business models can operate with very little physical presence, and exponential growth in technology has left the traditional system of taxing profits according to jurisdictional splits of functions at best running to catch up (and, at worst, no longer fit for purpose).

When the initial BEPS recommendations were published in October 2015, there was no specific policy recommended to deal with this ‘digital’ problem. At the time, the G20/OECD suggested that changes to other action areas should be implemented first and to then revisit the issue in 2020.

The BEPS Inclusive Framework has continued to discuss possible solutions to the tax challenges arising from digitalisation and the Task Force on the Digital Economy published an interim report earlier in the year. In essence, they are focused on trying to achieve international agreement in certain areas – including whether digital nexus should trigger taxable presence in-country, and how to attribute value to the growing importance of data and user base. The Inclusive Framework remains committed to a consensus-based response that addresses the challenges of the digital economy as opposed to implementing new taxes that act as sticking plasters whilst agreement is reached. They have committed to issue their final report in 2020 and are targeting the G20 Finance Ministers meeting in June 2019.

The European Commission (EC) has also been considering this area and published its findings in the same week as the OECD earlier this year. The EC proposed a long-term measure of a new taxable presence threshold of a Significant Digital Presence (SDP). The SDP would act as a new permanent establishment concept and allocate profits according to traditional functional analysis techniques. However, the EC also noted the need for an interim measure – a DST. The EC recommended a 3% revenue based DST, levied on the gross revenues of certain large digital businesses. The recommendations included thresholds to ensure that only large businesses were impacted and carved out a number of business models (e-tailers, communication or payment services, crowd funders) from their scope.

As with all tax matters at EC level, the proposals would require unanimous support to be implemented. As the proposals face opposition from several Member States (including, publicly, Ireland and the Nordics), it seems unlikely that an EC-led DST will be implemented in the near future. Progress is not fast enough for some Member States, with Italy and Spain already having introduced draft legislative provisions for a DST.

Budget 2018

The UK Government echoes the view that progress at both G20/OECD and EC level has not been fast enough. As a result, unless international consensus can be

reached before implementation date, the UK will introduce DST from 1 April 2020. At the time of writing, very little detail is known as to exactly how the tax will operate. HM Treasury is due to publish a detailed consultation document in the coming weeks.

We do, however, have an outline of how DST is intended to apply. It closely follows the EC proposals in many ways, although appears to be narrower in scope:

- DST will be levied at 2% on gross revenues of specific digital activities, where these revenues are linked to the participation of UK users
- The three business models that will be 'in scope' are: search engines, social media platforms and online marketplaces. This seems to be purposefully narrower than EC proposals.
- DST is not intended to penalise the UK user, or be a tax on online business. The tax will apply to revenues earned from the intermediation of sales where UK users have driven the value allowing for those sales to take place
- A number of other digital business models will be specifically 'out of scope': financial and payment services, providing online content, software / hardware sales, television and broadcasting services.
- A 'double' threshold will be in place to ensure DST only impacts the largest digital businesses. Only groups with global revenues from in-scope business models of >£500 million will fall within scope, and the first £25 million of relevant UK revenues will always be exempt
- Safe harbours will be in place so that loss making businesses do not suffer DST and low profit margin businesses will be charged at a reduced rate
- DST is intended to be temporary, until international consensus is reached; and there is a commitment to review its necessity in 2025

The challenges of DST

It is good news that the UK will now launch a detailed consultation process prior to implementation of the rules or drafting the legislation. Before seeing that, there a number of challenges which seem immediately apparent that will need dealing with:

1. Defining the 'in scope' businesses

The UK Government is clearly intending for certain large US technology companies to be within the proposed provisions – the world's largest search engine and most

popular social networking platform are sure to be signing a cheque. Online marketplaces are harder to define. The conceptual idea is to tax the commissions earned by facilitating transactions between UK users (whether or not they are also customers). Businesses that link drivers with passengers, homes with renters, buyers with sellers, app developer with their customer base (and the list goes on) will need to pay careful attention to the consultation proposals and the drafting of the definitions.

2. Calculating the tax due

Some businesses may already capture and report their revenue streams from UK users whereas for others, this will be an entirely new requirement to identify when UK users are contributing to their platform. There are also questions around when an in-scope business falls to have in-scope revenues (e.g. a website facilitates a transaction between a UK individual renting out his French home to a Zambian renter). Tracking and calculating the DST will necessarily involve new technology solutions and greater information needed regarding users and their location. The privacy impact of this additional tracking and data storage will need to be considered.

3. Enforcing collection of the tax due

DST is extra-territorial, meaning it can apply in the absence of any UK taxable presence. While many multinationals impacted will also have UK group companies and therefore be both more informed about their obligations and more easily targeted by HMRC, others may not. I will let the lawyers decide whether there is credible basis for the UK to collect tax revenues which falls out of their usual remit to tax under a profit allocation method.

4. US retaliation

Finally, considerations need to be made around how other countries may respond, namely the US.

Kevin Brady, Chairman of the US Ways and Means committee has already issued a statement calling out the UK DST as ‘troubling, inconsistent with international norms and ‘a blatant revenue grab’. He has also said that changes in the UK and other jurisdictions would prompt a review of the US tax and regulatory approach in a bid to

determine the appropriate actions in ensuring a level playing field across global markets.

Aside from the practical challenges, there is a wider, more philosophical question around whether a tax on gross revenues of certain digital businesses achieves the aim of shifting the international tax framework to better align the digital world with tax collection? It is not clear that it does. For some business models, revenue generated from UK user interaction is not reflective of the contribution of UK users to the value chain. There is good reason that the traditional international tax framework has considered profits as a primary driver for relevant ‘success’ in country – the size of in-country revenues may not correlate to ‘success’ at all. Whilst there are proposed limits in place such that only large businesses are impacted, after the cliff edge of those tests, it is not yet clear if there will be sufficient distinction between an ‘adequate’ profit margin business with marginal user contribution to its relative success, and a business wholly dependent on user interaction with super-profits in the UK.

DST could be said to undermine the broader international tax system in this regard, a view that is certainly held at US and OECD level. A harsh critic might go so far as to call it a crude attempt at taxing a small number of US technology companies without due consideration of the global tax system and the need for international cooperation.

We can hope that a useful consultation period can mean that challenges regarding business models and revenue streams that should be in or out of scope can be well defined and that due thought can be given to tax collection and logistics. We know now that UK DST is coming (with or without international agreement) and only time will tell whether it takes helpful steps toward tackling the challenges of the digital economy, or distorts the tax system in an uncooperative way.