Taxing the tech giants

Indirect Tax Large Corporate

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Peter Stevens explains the UK's interim position in relation to the digital services tax

Key Points

What is the issue?

Tech giants such as Google, Facebook and Amazon generate significant value from dealing with consumers in their countries but are able to organise their group structures in such a way that the profits resulting from those dealings are deemed to arise elsewhere.

What does it mean to me?

In his October 2018 budget speech, Philip Hammond announced that the UK would introduce its own digital services tax (DST), as it was not sustainable or fair that digital platform businesses can generate substantial value in the UK without paying tax here.

What can I take away?

DST will be charged on UK digital services revenues arising to a person in an accounting period, the amount and timing of revenues being determined by applicable accounting standards.

Many countries are concerned that the profits-based international tax system is ill-suited for the digital world, where tech giants such as Google, Facebook and Amazon generate significant value from dealing with consumers in their countries but are able to organise their group structures in such a way that the profits resulting from those dealings are deemed to arise elsewhere. The OECD and the EU have been working on solutions but, in his October 2018 budget speech, Philip Hammond announced that progress was 'painfully slow' and that the UK would introduce its own digital services tax (DST) in the meantime, as it was not sustainable or fair that digital platform businesses can generate substantial value in the UK without paying tax here.

Draft legislation was published on 11 July 2019. The final version will be published in the Finance Bill 2019, and will come into effect on 1 April 2020. The government will disapply DST as soon as an appropriate international solution is in place which leads to a greater allocation of profit of highly digitised businesses to the countries in which their users are located. The position will be reviewed in 2025.

DST will be charged at 2% of the revenues of large digital businesses providing social media platforms, internet search engines and online market places. Its stated purpose is to ensure the amount of tax paid in the UK is 'reflective of the value derived from UK users'. The Treasury forecasts it will raise £275m in 2019/20, rising to £370m in 2020/21, £400m in 2021/22 and £440m in 2022/23.

Digital services tax

DST is not a tax on online sales, or a general tax on businesses providing digital services, but is targeted on the revenues of specific digital businesses, which the UK government believes derive significant value from UK users. It will be charged on UK digital services revenues arising to a person in an accounting period, the amount and timing of revenues being determined by applicable accounting standards (UK GAAP, US GAAP or IAS).

Digital service revenue is assessed on a group basis, and is the total amount of revenues arising to members of the group in connection with any member of the group providing a social media platform, an internet search engine or an online market place, including any associated online advertising business.

Where revenues arise in connection with a digital services activity and anything else, there is a ‘just and reasonable’ apportionment.

Social media platform

A ‘social media platform’ is an online platform of which the main purpose, or one of the main purposes, is to promote interaction between users (including interaction between users and platform content provided by other groups) and which enables content to be shared with other users or groups of users. This is intended to catch social networking sites, micro-blogging platforms, video or image sharing platforms and online dating websites but not, for example, telecommunications networks or private communications platforms like email or messaging apps, which may indirectly facilitate interaction between users but where the promotion of such interaction is not a main purpose.

Internet search engine

‘Internet search engine’ is not defined in the draft legislation. The government believes it is already understood to mean a facility that allows users to search for websites or information on the internet. This is intended to catch activity which allows users to search the wider internet, not functions which operate only within the host website. Where the underlying search functionality is provided by a third party, the intention is to tax the party which provides the technology and benefits primarily from users using it, rather than the website owner.

Online marketplace

An ‘online marketplace’ is an online platform of which the main purpose, or one of the main purposes, is to facilitate the sale or hiring by users of particular goods, services or other property, and which enables users to sell, advertise or otherwise offer them for sale or hire to other users on the platform. DST is not intended to tax revenues derived from businesses selling their own goods online, either through their own websites or through a marketplace, as the number of users visiting the site or marketplace does not in itself generate value, but rather the revenues generated by the marketplace from acting as an intermediary in matching users and facilitating such sales.

The government decided against specific exemptions for businesses which stream, broadcast or publish online newspapers, films, music, video games or other works, which will not generally be caught. There may be difficult borderline cases where users play online games against other users but, in most cases, these will fall outside the scope of DST because the main purpose of growing the network is to increase users’ enjoyment from playing the games rather than encouraging social interaction as such.

The government believes that most financial services activity also falls outside the definition of ‘online marketplace’, but recognises that there could be some overlap. This is not intended, because the highly regulated nature of financial services means that maximising the number of users on the platform does not necessarily generate significant value but may significantly increase the risks and costs. There is therefore a specific exemption for online marketplaces provided by authorised persons and recognised investment exchanges (defined in the Financial Services and Markets Act 2000), payment services providers (defined in the Payment Services Regulations 2017), and those with corresponding activities outside the UK, where more than half the relevant revenues arise in connection with their facilitation of the trading or creation of financial assets (defined by applicable accounting standards) or contracts of insurance.

Associated online advertising business

‘Associated online advertising business’ is business operated on an online platform that facilitates the placing of online advertising and derives significant benefit from its connection with the relevant activity. The intention is to distinguish listings marketplaces, where a main purpose is to facilitate exchanges even though these cannot be effected directly on the website, from websites which display third party advertising, where the facilitation of sales of goods and services by users is not a main purpose.

Calculating the DST

A group’s ‘UK digital services revenue’ for a period is so much of that revenue for that period as is attributable to UK users.

Online marketplace revenues are always treated as attributable to UK users where they arise in connection with the sale of an interest in UK land or premises, the provision of accommodation in the UK, or the sale or hiring of any related services, goods or other property. Online advertising revenues are attributable to UK users insofar as the advertising is intended to be viewed by UK users, and other digital services revenue is attributable to UK users insofar as it arises in connection with UK users. Where the revenue is not exclusively attributable to UK users, there is a just and reasonable apportionment.

A ‘UK user’ is a person who it is reasonable to assume, in the case of an individual, is normally in the UK or, in any other case, is established in the UK. ‘In’ the UK simply means physically present, but it is unclear how long an individual must spend in the UK in any given period for this to be ‘normal’. What about someone who normally spends part of their time here and part elsewhere? The draft guidance states that if an individual provides a physical address in the UK, or UK payment details, it is likely to be reasonable to assume they are normally located in the UK.

The DST charge applies where a group’s total worldwide digital services revenue arising in any accounting period exceeds £500m, including at least £25m UK digital services revenue (reduced pro rata for accounting periods of less than a year). It does not matter where the companies receiving the digital services revenue are located.

The ‘group amount’ is 2% of the amount by which the group’s UK digital services revenue exceeds £25m, and each member of the group is liable pro rata to its share of the group total.

Safe harbour election

2% of revenue would exceed the corporation tax rate of 19% of profits (reducing to 17% in 2020) if the profit margin is less than 9.5% (8.5% in 2020), but groups can make ‘safe harbour’ elections where the UK operating margin is low. The digital services revenue and operating margin is calculated (separately for each of the three categories of activity); the £25m allowance is apportioned between them; and the DST is charged at 80% of the operating margin attributable to each category for which the election is made. This could be beneficial if the operating margin is less than 2½%.

In calculating the operating margin, expenses attributable to the earning of UK digital services revenue are deducted unless they are:

1. interest or of anything commercially equivalent to interest;
2. attributable to the acquisition of a business or part of a business;
3. incurred otherwise than in the normal course of business;
4. due to a change in the valuation of any tangible or intangible asset; or

5. tax (arising under the law of any territory).

In the case of a transaction on an online marketplace provided by a member of the group where a foreign user is a party to the transaction and all or any part of the group revenues in connection with the transaction are (or would be) subject to a foreign equivalent of the DST, half the UK digital services revenue and half of any relevant operating expenses are disregarded.

Administration and payment

The group must nominate a 'responsible member' to file group DST returns, comply with the group's DST payment and other obligations, and act as the point of contact between HMRC and the group. In default, the parent company will be responsible. The responsible member does not have to be UK resident, but HMRC may revoke the appointment if it has reason to believe the responsible member is not being provided with anything it needs to comply with its obligations, or is not complying.

The due date for payment of DST is nine months after the end of the relevant accounting period, and a DST return must be filed within 12 months from the end of the period. Unpaid DST carries interest at the applicable rate. Flat-rate penalties (varying with the delay and the number of previous defaults) apply if the DST return is not filed on time; and, if it is more than nine months late, there is an additional penalty of 10% of the unpaid tax, rising to 20% if it is more than 15 months late.

All members of the group in a period of account are liable for the whole group's DST for that period and, if the responsible member has not paid the DST within three months of the due date, HMRC can serve a payment notice anywhere in the world, on any other group member (whether or not UK resident) requiring it to pay all unpaid group DST liabilities, including interest and penalties, within 30 days. There is a right of appeal within 30 days, but only on the ground that the recipient of the notice was not a member of the group in the relevant accounting period. How HMRC enforces this obligation against non-resident companies outside the UK may be another question!

HMRC can make such adjustments as are just and reasonable to counteract any DST advantage that would otherwise arise from arrangements of which the main purpose, or one of the main purposes, is to enable a person to obtain such advantage. Because DST is not covered by any existing double tax treaty, it will not be creditable against UK corporate taxes.

Other developments

The OECD is concerned about countries taking unilateral measures, and is seeking to agree a solution by the end of 2020. On 9 October 2019, it published a consultation document on new nexus and profit allocation rules. This does not propose a final solution, but identifies areas of common ground among the competing proposals of its member countries, which are set out below:

- The new rules should focus on large (possibly over €750m revenue) businesses that generate revenue from supplying consumer products or providing digital services with a consumer facing element, but not extractive industries and commodities or, possibly, financial services.
- There should be a new nexus, based on sales over a specified threshold, to ensure that businesses with sustained and significant involvement in the economy of a market jurisdiction are taxable in that jurisdiction, irrespective of whether they have a permanent establishment or separate subsidiary there.
- The nexus should capture all forms of remote involvement, whether selling to consumers directly or through a connected or unconnected local distributor.

- The ‘routine’ profits should be calculated on the basis of an agreed level of profitability (possibly a fixed percentage industry by industry), taking into account existing transfer pricing rules; and a share of the remaining ‘non-routine’ profits should be allocated among the relevant market jurisdictions on the basis of a specified formula (using variables such as sales) and be taxable there. For certain ‘baseline’ marketing and distribution activities, in lieu of the current transfer pricing rules, a fixed rate of return (possibly varying by industry or region) would be taxable in the relevant jurisdiction.

A public meeting at the end of November will discuss the details.

The OECD expects to publish a consultation document on its proposals for a global anti-base profit erosion mechanism for discussion in December. Meanwhile, when the French Senate passed its own DST legislation on 11 July 2019, Donald Trump threatened retaliation for Emmanuel Macron’s ‘foolishness’, and the French had to backpedal, announcing that the French tax would cease to apply once an international solution was agreed, with any French tax in excess of what would have been paid under that solution being refunded. The US has also warned that there will be no UK-US trade deal post-Brexit unless the UK’s DST is abandoned. Given the importance which the UK attaches to its ability to do such trade deals, in particular with the US, further developments over the coming months will be awaited with interest.