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In this article, the author discusses the United Kingdom's proposed digital services tax in the context of OECD and EU efforts to address the perceived tax problems arising from digitalization.

The United Kingdom is working on its own digital services tax, which will be legislated for in the Finance Bill 2019-2020 and will apply from April 2020.

The U.K. government launched a consultation on the DST proposal and invited responses by February 28 on the plan's design, implementation, and administration. The DST is intended to be an interim measure until agreement is reached at an international level on how to best tax digital business profits.

This article summarizes international efforts led by the OECD and EU to address the perceived tax concerns arising from the digitalization of business. It also discusses other U.K. legislative tax measures meant to focus on some of the base erosion and profit-shifting problems the U.K. government hopes the DST will address.

OECD and EU Efforts

The OECD has been considering the tax questions arising from the digitalization of the economy as part of its BEPS project. The Task Force on the Digital Economy considered those questions and in 2015 published its action 1 report and in 2018 its action 1 interim report. On February 13 the OECD published a consultation document, which was followed by a public consultation meeting in Paris March 13 and 14, and on May 29 the OECD approved a work program on developing a consensus-based solution to the tax challenges arising from digitalization.

That program, which will revisit fundamental aspects of the international tax system, proposes a two-pillar approach to enable the OECD to issue by 2020 its final recommendations for a long-term global solution. The first pillar focuses on reconsidering and agreeing on an approach used to determine nexus for tax purposes and the appropriate allocation of profits. The second pillar focuses on designing a system to ensure multinational enterprises pay a minimum amount of tax. To meet its target, the OECD must agree to an outline of its solution by January 2020.

In March 2018 the European Commission published two proposals for the taxation of the digital economy. The first (COM(2018) 147 final) was based on a long-term solution that proposed to tax a digital permanent establishment, while the second (COM(2018) 148 final) was a short-term proposal that would apply to revenues created from specific digital activities. In March 2019 the EU Economic and Financial Affairs Council failed to reach consensus on a way forward.

It seems likely that there will not be an agreed approach in the EU until at least 2020. In the meantime, several EU states have introduced, or are considering introducing, unilateral measures, including the United Kingdom.

U.K. DST Details

The U.K. DST will take effect from April 2020; its precise legislation has yet to be published. However, the government's focus will likely be on user participation and how it creates value for specific digital businesses.

What Is the DST?

The DST will be a 2 percent tax on the U.K. revenues (not profits) of digital businesses that provide a social media platform, search engine, or online marketplace.

The category involving the provision of a social media platform is meant to capture revenue from companies that monetize users' engagement with the platform. It is intended to cover social or online networks, blogging or discussion platforms, content-sharing platforms, and dating platforms. The direct sale of online content (for example, TV or music subscription services) is not in scope. Merely facilitating user upload of content onto a website — for example, permitting users to comment on an article — does not fall in this category if those facilities are an incidental part of the platform.

The category involving the provision of a search engine is meant to capture platforms that generate revenue by monetizing users' engagement with the platform and with other closely integrated functions — for example, websites accessed through a web browser — that are delivered through a website or an alternative internet-based application (such as a mobile app). Other key elements of this platform are the ability to view webpages beyond those provided by the platform itself and the ability to search for and obtain information, services, and other matters of interest that result from or correspond to keywords, web addresses, or other information specified by the user.

The category involving the provision of an online marketplace covers companies that generate revenue through this platform by allowing users to advertise, list, or sell goods and services on the platform. Companies selling their own goods online will not be within the scope of this category. Companies providing financial or payment services are also excluded.

The U.K. government identified those three categories as digital companies operating through online platforms and for which users are integral in the pursuit of revenue and create material value for the company through their sustained engagement and active participation.

Thresholds

A company will be taxable under the new DST regime only if it:

- generates more than £500 million in global annual revenues from in-scope business activities; and
- generates more than £25 million in annual revenues from in-scope business activities linked to the participation of U.K. users.

Companies that meet those thresholds will not have to pay tax on the first £25 million of their U.K. revenues. When calculating the DST due, no deduction of costs incurred in generating revenue will be permitted.

Those thresholds are based on an expectation that the value derived from users will be more material for large digital companies that have established a large U.K. user base and generate substantial revenue therefrom. Consistent with the OECD's interim report, the thresholds also seek to ensure that the DST does not place unreasonable burdens on small businesses and scale-ups. They are meant to guarantee that the DST will apply only when the value derived from users is material to a company's business.

Scope, Revenue Allocation, and User Targeting

The main challenges in formulating the DST are identifying covered business activities and determining how to accurately allocate revenues to the relevant activities.

The U.K. government intends to define the business activities that derive most of their value from user participation (in-scope activities) and tax the revenue generated therefrom. It believes that is the best way to guarantee that the DST appropriately targets business models deriving value from user participation while ensuring that the regime's effect on in-scope activities is not conditional on how those activities are monetized. For example, if a social media platform derives its material value from user participation, it would still fall within scope, even if it generates revenue through online advertising rather than subscription fees.

Companies might derive revenue from both in- and out-of-scope activities, and while some business structures might make it easy to distinguish between those, it is likely that it will be difficult for many multifaceted enterprises to accurately do so. Any allocation will need to be on a just and reasonable basis.

Once companies have identified their in-scope DST business activities, the revenue generated from, or attributable to, those activities must be calculated. That revenue will be taxable when linked to the participation of a U.K. user. Because the attribution of profits for the DST will be difficult to calculate (and to legislate for, as the U.K. government noted in its consultation paper), it would be helpful for HM Revenue & Customs to publish guidance with specific examples.

Mechanical rules for apportionment would provide consistency, certainty, and a clear starting point for all in-scope taxpayers. However, creating rules that are broad enough to address the various business models that fall under the DST is challenging.

The U.K. government is likely to adopt a just and reasonable approach. While that clearly provides more flexibility and is not a novel concept, it adds another level of uncertainty to an already complex tax. It also places a burden on the taxpayer to adopt a just and reasonable approach to its business, as well as on the tax authority to analyze and decide whether the approach is in fact just and reasonable.

The U.K. government is targeting user participation, or the process by which users create value through their engagement and participation. The proposed definition of the term "user" is broad and includes an individual, company, or other legal person who participates in an in-scope business activity. Because the premise is to assess the DST based on users, it seems reasonable not to make specific references to the nature of a user or the capacity in which it operates.

Several challenges will arise in drafting legislation, such as defining in-scope business activities, assessing what revenue is generated from those activities, accurately identifying U.K. user participation, and accurately attributing revenue to that participation. It will also be difficult to identify how much residual profit derives from user participation, how to allocate that profit among jurisdictions, and which legal person should be liable for tax.

As digital transformation develops, the range of companies affected by the user participation concept can be expected to constantly expand. Therefore, if that concept is adopted into international tax norms, it is unlikely to be limited only to digital companies or to the business models highlighted in the DST proposal. One fundamental limitation of the user participation approach is that focusing on human interaction will not necessarily capture (or tax) the value created by machine interaction. That will need to be addressed by additional legislation or by adopting a broader international tax framework that is better equipped to handle the evolution of digital companies and the digital economy.

Safe Harbor

The U.K. government does not intend to capture companies that are either loss-making or have very low profit margins. There is a concern that in those circumstances, a DST becomes disproportionate relative to a company's ability to pay, or has other disproportionate effects on business sustainability.

To address those concerns, the government intends to include a safe harbor rule in the DST legislation. That rule would allow companies to make an alternative calculation of their tax liability under the DST to pay the lower of:

- 2 percent of in-scope revenue; or
- at least 80 percent of in-scope profits — that is, in-scope revenue * profit margin.

By way of example, consider an online marketplace that generates global revenues of £700 million, £200 million of which is linked to the participation of U.K. users. Under the usual rule, after deducting the £25 million allowance, the company would pay DST on £3.5 million (£175 million * 2 percent). Under the safe harbor provision, if the company has a profit margin of 1 percent, the amount to be paid (after the £25 million deduction allowance) would be £1.4 million (80 percent * £175 million * 1 percent).

According to the consultation, the 80 percent rate could be set even higher, and the profit margin will have a minimum level of 0 percent.

However, the precise design of the safe harbor legislative provisions remains to be seen.

Deductibility

No new rules are proposed for allowing or denying companies a deduction for DST liabilities against their profits for corporation tax purposes, so the DST is expected to be deductible from U.K. corporation tax. However, the government does not intend to make the DST creditable against that tax.

Market Access Levy and Treaty Compatibility

While the U.K. government has said the DST is not discriminatory against nonresident businesses, the tax is clearly targeted at U.S. companies and does create a transatlantic trade barrier. The DST is thus rightly described as a market access tax imposed on digital companies with sales in the United Kingdom that require limited (or no) U.K. infrastructure. There is strong political pressure to make sure that companies like that pay their fair share of tax for operating in the U.K. market. However, the downside of that approach is that absent an agreed international approach, it could harm U.K. competitiveness.

Another concern is that the DST is not coordinated through the renegotiation of tax treaties. The U.K. government maintains that the DST is not being introduced in lieu of corporate tax, so it remains unclear whether it will be creditable against non-U.K. taxes. That, along with increased compliance costs, means a higher cost of doing business in the United Kingdom with a potential knock-on effect to U.K. consumers.

State Aid

The DST structure as proposed is likely to trigger EU state aid concerns.[1] Under state aid rules, the reference framework for the DST — that is, the companies it targets — are companies falling in the three specified categories: social media platforms, search engines, and online marketplaces. The DST's high financial thresholds constitute a derogation from that reference framework that must be justified under state aid rules. Usually a justification exists only if the tax is somehow paid to the tax authorities in a different context. Because that is unlikely to be the case with the DST — that is, companies that do not meet the DST thresholds will not pay an amount corresponding to the DST in some other way to the U.K. tax authorities — it is unclear if the derogation can be justified.

Other Relevant Guidance and Legislation

The United Kingdom has recently introduced several unilateral legislative tax measures to address the tax and BEPS challenges arising from the digital economy. As more national and international regimes are introduced, it is important that a consistent approach is taken. Rather than having layers of tax regimes, it is preferable and more effective to implement systems that complement each other in achieving the same goals. By way of illustration, other initiatives in this area are summarized below.

OECD Transfer Pricing Guidance

The OECD has identified reliance on intangible assets (including intellectual property) as one of three factors frequently observed in some highly digitalized business models. It believes multinationals have used the transfer pricing of intangible assets to shift profits to low-tax jurisdictions, which led to the 2017 and 2018 updates to its transfer pricing guidelines.

The changes include clearly linking returns generated with the function of actually developing the value held in the intangible. That means that when there is a centralized legal owner of IP in a multinational group (a frequent feature of large multinational groups) that legal owner must have been economically responsible for the IP and must have exercised control over its development, enhancement, maintenance, protection, and exploitation. If the centralized legal owner has not been involved with the IP in that way, the economic rights associated with it will not necessarily rest with the legal owner of the IP for transfer pricing purposes.

Diverted Profits Tax

The diverted profits tax (DPT) was introduced under the Finance Act 2015 in response to the

[1] Although the United Kingdom is preparing to leave the EU, it is reasonable to assume that EU state aid rules will form part of any agreement regarding the relationship between the two.

BEPS project to prevent the erosion of the U.K. tax base. It was meant to counter aggressive tax planning by international companies that were diverting profits from the United Kingdom to reduce their U.K. corporation tax liability. The U.K. tax authority acknowledged that the DPT legislation had the secondary goal of providing information to HMRC to allow for a full and timely examination of high-risk transfer pricing transactions by providing strong incentives for full disclosure and early engagement by taxpayers in those cases.[2]

The DPT rate is 25 percent in most cases, although higher rates apply to specific industries, including the oil and gas sector. The tax operates through two main prongs. The first counteracts arrangements that exploit PE rules, broadly coming into effect when a person is carrying on activities in the United Kingdom in connection with the supply of goods and services by a non-U.K. resident company to U.K. customers. The second prong tries to prevent tax advantages obtained through the use of transactions or entities that lack economic substance. It counteracts arrangements that exploit tax differentials and applies when detailed conditions (including those on an effective tax mismatch outcome) are met.

Like the DPT, the DST is a U.K. government tax introduced to tax non-U.K. businesses that have U.K. end-users.

Withholding Tax and Offshore Receipts

In 2016 the United Kingdom widened the class of royalties subject to its 20 percent withholding tax to include royalty payments deemed to have a U.K. source. When royalty payments are made by a non-U.K. company and the royalty is connected to a trade being carried on through a U.K. PE, the royalty may be deemed to have a U.K. source. It is irrelevant whether the royalty would be deductible in calculating the profits of the U.K. PE.

In 2017 the U.K. government considered extending the withholding tax obligations to royalty payments made to low- or no-tax jurisdictions in connection with sales to U.K. customers, irrespective of the payer's location. However, following the HMRC consultation on that proposal, the government took a different approach and introduced rules in the Finance Act 2019 on the taxation of offshore receipts on intangibles. Those provisions are intended to counter U.K. base erosion and profit shifting by imposing U.K. tax on low-tax offshore entities that realize the income an international group received from U.K. sales stemming from intangible property. In practice, this means that from April 6, 2019, non-U.K. resident persons that are not resident in a jurisdiction with which the U.K. has a tax treaty that contains a nondiscrimination provision will be subject to a 20 percent U.K. tax on gross income generated from the enjoyment or exercise of intangible property rights that enables, facilitates, or promotes U.K. sales.

Profit Fragmentation Rules

The Finance Act 2019 also introduced rules that essentially extend the transfer pricing rules to address artificial profit-splitting arrangements entered into by individuals, partnerships, or companies to shield profits from U.K. tax by arranging for them to be attributed to offshore persons or entities. Generally, the rules apply when:

- as a result of a provision between a U.K. resident entity and an overseas entity, value derived from the profits of a U.K. trade is transferred from the U.K. resident entity to the overseas entity;
- the value transferred is greater than an arm's-length price;
- a related individual meets the enjoyment conditions; and
- there is a tax mismatch (broadly, the extra tax payable overseas is less than 80 percent of the reduction in U.K. tax).

Those rules came into effect for value transferred on or after April 1 for corporation tax and on or after April 6 for income tax.

Anti-Fragmentation Rules

In 2019 the U.K. implemented a BEPS recommendation into national law to address potential base erosion and profit shifting arising

[2] HM Revenue & Customs, "Diverted Profits Tax" (Jan. 8, 2015).

from the exploitation of PE rules. Nonresident companies are liable for U.K. corporation tax if they have a PE in the United Kingdom. Specific preparatory or auxiliary activities are categorized as exempt activities and do not create a PE for nonresident companies. From January 1, 2019, the United Kingdom amended the legislative definition of PE to prevent overseas companies from artificially splitting their operations to take advantage of the PE exemptions, thereby avoiding creating a PE. There is no exemption if the U.K. activities form part of a fragmented business.

Conclusion

The DST is the most recent U.K. legislative initiative to tackle the perceived tax challenges arising from the increased digitalization of the business world. The precise measures and definitions to be used in implementing those provisions remain to be seen.

A criticism of the U.K. approach is that the DST is a national measure that targets only three specific categories of digital companies. Given the pace of change and the evolution of digitization, the DST may become redundant in the very near future.

Further, the DST is being implemented while an increasing number of countries are introducing similar national legislation even though the OECD is trying to reach a consensus-based long-term solution by 2020. The only sustainable approach to addressing the tax challenges arising from the digital economy is to implement an appropriate international tax framework. In recognition of that, the U.K. government will provide a sunset clause requiring the DST to be reconsidered in 2025, in the hopes that a global solution will be achieved by then. ■