

Adapting the corporate tax system for the digital economy

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Tax analysis: In November 2017 HM Treasury issued an open consultation on corporate tax and the digital economy. The consultation comprises a position paper setting out the government's view on the challenges posed by the digital economy for the corporate tax system, and its preferred solutions. Sarah Squires, barrister at Old Square Tax Chambers, comments on the paper.

What is the background to this paper?

Over recent years, tax administrations across the world have been grappling with how to tax digital businesses effectively. There has been increasing recognition that the international tax system reflects a way of doing business that bears little relation to the reality of today's global digital multi-nationals. In particular, in very simplistic terms, digital businesses can operate in a country without having to have a physical presence there—but under international tax rules (as reflected in Organisation for Economic Co-operation and Development (OECD)-based treaties), a company generally has to have an actual presence in a country (a permanent establishment) before that country can exercise taxing rights.

In 2013, the OECD began working on the base erosion and profit shifting (BEPS) project, with a view to recommending changes to the international tax framework to reflect changes in business practice. The focus was on countering tax planning of multi-national corporations (MNCs). This included a specific action on the challenges of the digital economy.

In its final report on this aspect of BEPS, the OECD acknowledged that, although it had identified several options for possible tax reform, it had not been able to get international agreement on any particular approach. As a result, the OECD's task force on the digital economy was asked to continue its work in this area. Its next report is due in April 2018.

While the OECD tries to build consensus on possible reforms, the EU is preparing for the possibility that the task force's next report will similarly fail to provide a way forward that counters tax planning by digital business. The EU announced in its own [investigation into the issues](#) in September 2017, and said that it would be working on possible EU solutions to guard against 'the absence of adequate global progress'.

The position paper shows that the UK shares the EU's concerns. The paper makes clear that the UK is concerned that the OECD may fail to come up with the type of bold reforms needed to ensure digital businesses are taxed appropriately. While the paper emphasises the need for multilateral reform, and reiterates the UK's commitment to the OECD BEPS programme, it also makes clear that the UK will go it alone if necessary—basically, by introducing what it calls 'interim measures' directed at securing the UK tax base. The paper then outlines what such unilateral action may involve.

What does the paper say about corporation tax and the digital economy?

The paper provides a useful summary of some of the challenges faced by tax authorities in dealing with digital businesses.

Chapter 2 is a high-level summary of the existing international tax framework, focusing on transfer pricing and profit attribution. Chapter 3 then discusses why the UK considers these rules are no longer fit for purpose in relation to the digital economy.

On transfer pricing, the paper focuses on practical issues—but this is basically going over old ground. What is clear is that—despite these difficulties—the UK remains committed to the arm's length principle, and so is looking for reform, not replacement.

But, on profit attribution, the paper argues for a new approach—one that allows account to be taken of 'user-generated value' when attributing profits between business entities. (In very simplistic terms, 'user-generated value' means the value generated for a business because of the ability to monetise the customer base.)

Currently, the UK is not able to tax the profits made by a non-UK business from its UK user base unless that business has a physical presence in the UK to which those profits can be attributed. The UK government says this has to change.

What types of digital business are affected?

The focus on 'user-generated value' as a possible basis for taxing digital businesses means that only certain types of digital business should be affected by the proposals.

These would, however, include businesses that provide social media platforms ‘free’ to consumers—here, the business model is one based on generating revenues by selling user data and/or access to advertisers (for example, Facebook). It would also include search engine providers like Google.

Businesses that provide online marketplaces could also be affected; this is because the success of the marketplace in attracting potential sellers (and therefore creating transaction volume) depends on the existence of an engaged user base.

How does the government propose the issues are dealt with?

The paper focuses on what it says is ‘the most attractive’ way of taxing user-generated value. The suggestion is that the UK would introduce new rules to allow it to tax revenues arising to a business that are generated from the provision of digital services to users in the UK. Again, simplistically, this means that if a social media platform sells data relating to its UK users to an advertiser, the UK would be able to tax those UK-user generated profits, regardless of where the company selling that data was based.

The paper acknowledges the difficulties in creating such a tax. There is limited detail on how such a tax would work. Instead the focus is explaining the complexity of the issues (both at policy and technical levels) involved—what it describes as ‘important design decisions’—and asking for ‘views’.

Section 4.10 summarises these design decisions—covering the ‘what to tax’ (both the scope of activity within the charge and what would constitute ‘UK’ revenues), the ‘how much’ tax (ie setting a rate that maximises tax receipts but can be said to be ‘fair’) and ‘how to collect’ (given that it would be chargeable even where a taxpayer had no other link to the UK).

Comments are invited on these design decisions; the consultation is open until 31 January 2018.

What other steps has the government taken to address the issues?

This is not the first time that the UK has been willing to ‘go it alone’ when it comes to digital businesses. In 2015, the UK introduced the diverted profits tax, which in part was aimed at digital businesses that structure their activities in the UK so as to avoid creating a permanent establishment.

There have also been recent changes to the VAT rules, adapting them to reflect how digital businesses operate. Since 2015, suppliers of digital services to consumers have been required to account for VAT in the jurisdiction of the consumer (not the supplier). This allows the UK to bring non-UK entities within the UK tax net. Concerns about VAT fraud on online marketplaces have resulted in the UK recently announcing plans to impose joint and several VAT liability on the marketplace itself.

In addition, the government has also looked at using withholding tax to protect the UK tax base from tax planning by MNCs (including digital businesses). The UK introduced a new royalty withholding tax in 2016. This was intended to counter the ability of groups to use royalty payments to shift profits from the UK to low-tax countries. However, this may not have been as successful a policy tool as first thought—at the November 2017 Budget, the Office of Budget Responsibility said that ‘HMRC has told us that ... very little of the £150m a year income tax yield in the original costing is now expected’.

The government has now said it intends to expand the measure—a [consultation has been launched](#). The paper references this proposal, confirming that it remains a key part of the government’s toolkit in tackling BEPS.

What are the potential further consequences of the proposals?

The UK is clearly committed to ensuring that digital businesses operating in the UK pay their ‘fair share’ of tax, whether or not the rest of the international community is in agreement. It looks likely that, regardless of what the OECD task force says in April, the UK is planning to develop the ideas set out in this paper in readiness for legislation.

Taxing a business by reference to its user base is a radical departure from existing rules—digital businesses (and their advisers) should look to engage now to try to ensure that any new tax is workable at least.

Interviewed by Anne Bruce.

The views expressed by our Legal Analysis interviewees are not necessarily those of the proprietor.