Taxation and the digital economy—Update

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Tax analysis: The government's Spring Statement in March 2018 included an updated position paper on corporate tax and the digital economy, to address feedback provided during public consultation. Sarah Squires, barrister at Old Square Tax Chambers, comments on the updated position paper.

What is the background to this updated position paper?

The publication of some form of response to November's position paper at the Spring Statement was not surprising—this was after all the first fiscal event following the 31 January 2018 deadline for comments.

Timing of publication of the updated paper may however have also been influenced by what has been going on at both EU and OECD level in this area.

Within a week or so of HM Treasury releasing its update, the OECD published its interim report on the challenges to international tax norms arising from digitalisation and the EU went even further, setting out specific proposals (in the form of two draft Council Directives) for taxing digital activity.

By virtue of being published first, the UK could comment generically on international discussions without addressing specific proposals. This is even though it should have known what was in the OECD and EU reports.

In some ways, the UK appears to be positioning itself neatly between the OECD and EU. The UK says its paper is intended to 'inform the work being undertaken at the OECD, and in the EU'. So, like the OECD report, the UK paper explains and comments on the technical challenges in taxing digital businesses effectively, highlighting its own current thinking and the questions that still need to be answered.

But then, like the EU, the UK re-affirms its willingness to 'go it alone' with measures to tax revenues derived from (UK) user-participation—but, in contrast to the EU, the paper falls short of providing specifics. The design of any new digital tax is presented as a work-in-progress with the executive summary making clear that the paper is not intended to set out the government's final position.

What further details are provided on how user participation creates value for online digital businesses?

Chapter 2 explains why the UK considers that user participation is a value-driver for certain digital businesses.

It starts by describing what is meant by 'user participation'—distinguishing a 'user' from a customer (with the key differential said to be the nature and level of engagement of the user with a business).

It contrasts the use of an online platform in a conventional business structure—where the relationship is primarily transactional, for example, to buy or sell, with the value of the 'user' to the business mainly deriving from that transaction-with the type of (user-)engagement seen in those digital businesses that rely on user-generated content, user-networks or user-data to drive revenues (with the paper helpfully outlining what each of these examples of user-participation mean in practice).

To better illustrate the distinction and to provide context to what is in essence a discussion of business economics the paper identifies those businesses where it considers user-participation as core to business success: namely, social networks, file-sharing platforms, online marketplaces and search engine providers.

The government acknowledges that for each of these businesses user participation works in a different way, meaning there can be no simple 'one size fits all' tax solution.

However, at no point does the paper engage with the counter-argument, for example user-participation is not value-creating—even though it is clear from the OECD report that the UK's view is not universally shared.

What does the government believe is the best way to capture 'user-created value'?

The UK wants the international tax rules changed so that countries can tax 'user-created value' deriving from users based in their jurisdiction.

In simple terms, the government's view is that the value digital businesses derive from user-participation should be taken into account when allocating profits between jurisdictions for tax purposes. So, for example, if a US business has UK users, the UK would be entitled to tax profits deriving from the engagement of those users, regardless of where the business itself is based

The government acknowledges that such an approach, while conceptually simple, raises several challenges, not least how to calculate user-created value-i.e. the profits attributable to user-participation. Rather than try to work out the actual value arising from users, which is firmly placed in the 'too hard' pile, the government focuses instead on an approach intended to 'approximate' user-value.

This approach involves working out a group's residual profit from its activities, such as profits after meeting all 'routine' expenses, whether intra-group or third party. A specified percentage is applied to that residual profit—with that percentage providing the approximation of user-related value.

The paper acknowledges that, because of the different ways digital businesses profit from user-value, there may need to be different percentages for particular business models.

As that percentage represents aggregate user-created value across all jurisdictions, it must then be allocated between all those jurisdictions that assert user-linked taxing rights (save those excluded through some form of de minimis threshold by reference to user numbers). This, the government states, means there has to be an allocation key, whether based either on 'active' user numbers, or by comparing user-related revenues (the UK prefers the latter).

What amendments is the government suggesting to the international corporate tax framework?

New rules are needed to define user-related value and any allocation methodology, with the government suggesting that this is best dealt with through amendments to Article 9 (associated enterprises) of the OECD Model Tax Convention and related OECD transfer-pricing guidance.

As the proposals are directed at allowing countries to tax non-residents based on user location, rather than physical presence, changes are also needed to Article 7 (business profits) of the OECD Model Tax Convention (given it currently limits taxing non-residents to profits attributable to a permanent establishment). The government also suggests amending Article 5 (permanent establishment), so that a business with users, but no physical presence, in a jurisdiction can be deemed to have the appropriate nexus with a jurisdiction for the purposes of Article 7 (which would also need tweaking to give a taxing right based on that nexus).

The paper explains these specific changes in paragraphs 3.53 to 3.61, but more usefully contains illustrative examples of what this suggested approach could mean in practice (paragraphs 3.66 to 3.75)—though these tend to make a rather complex process look (unrealistically) simple.

Are the suggestions made in this respect workable and are there any outstanding issues or concerns?

The paper acknowledges the challenges involved in updating the current international tax framework along the lines proposed—in some ways the paper is more about floating ideas as to how to deal with some of these issues than proposing a solution. It's clear however that a lot of detailed technical work is needed to get close to substantive proposals and that this will take time. The OECD itself, having committed to 2020 for its next report, says that the timetable is challenging.

In any event, there is a more fundamental issue—perhaps even a roadblock—to changing the international tax framework. This is the lack of international consensus as to whether there is even an issue that needs solving.

This is very starkly set out in the brief published alongside the OECD interim report and is referenced throughout the report itself. Some countries see no need to change anything. This is why the OECD is working towards a consensus-based solution, rather than promising delivery of one.

What interim measures are being suggested and how will they work?

The updated UK paper gives some new information about how the UK would approach an interim measure.

First, while its favoured long-term solution is focused on user-created profits, any interim measure would instead be targeted at revenues generated from UK users.

The paper deals with who to tax, what to tax and how to collect—but unlike the EU, makes no reference to specifics. It is apparent that there is still further thinking to be done.

In terms of 'who to tax', three different legislative approaches are set out, all potentially subject to a de minimis (to ensure the measure is appropriately targeted) and a safe harbour for start-ups (so as not to discourage the UK's own digital sector).

The first is based on defining how revenues are generated from users, which the paper calls channels. Any businesses deriving revenues through those channels would be within the scope of the new tax.

The second relies on defining the types of business within scope, for example 'social media platform'. Defining digital business models however will not be simple.

The third works by defining the nature of the revenues within scope, such as advertising and taxing any business earning those revenues.

On the 'what to tax', the paper shows that the government recognises that saying that you will tax revenues generated from UK users is one thing but working out what those revenues are is another altogether. The paper highlights issues linked to locating users—including when a UK citizen 'engages' as a user while traveling abroad or where access is through a VPN.

Further, for some business models, the government seems to accept that a tax based on gross revenues—as proposed—is unfair, meaning certain costs may need to be netted off.

There is no discussion of the likely rate.

But, when it comes to collection, the government is bullish, simply stating that it 'would expect an implemented tax to be paid'. It also sees recent experience on VAT one-stop shops as offering a helpful precedent for administration. The government is equally confident that it will not breach treaty obligations if it imposes such a tax.

What are the potential further consequences of the proposals?

As the OECD and EU reports highlight, the UK is not alone in considering an interim measure. The OECD report devotes an entire chapter to interim taxes—it sets out design considerations, while taking pains to emphasise that it is not recommending such measures.

Given that the UK states several times in Chapter 4 that it is willing to work with other countries on designing an effective interim tax, it may be that the updated paper is as much designed to encourage engagement with those tax authorities that also see merit in an interim solution designed to ensure digital businesses pay their fair share as it is to engage with business.

What are the next steps?

The government expressly invites further engagement from stakeholders as it formulates its policy in this area—and interestingly sets no end date for comments.

Given the approach of the paper—airing the issues, rather than making a specific proposal—and taking account of the ongoing discussions within the EU and OECD in which the UK is actively participating, it's not surprising that the consultation is continuing.

Businesses potentially affected by the proposals should continue to engage with the UK government. Plus, given the UK's stated willingness to go it alone with interim measures (or with selected 'friends') if international progress is too slow, potentially affected businesses should also closely monitor and if possible engage with what is happening within both the EU and OECD.

It is worth noting the UK's comment that it 'looks forward to engaging constructively with upcoming proposals from the European Commission' on interim measures. Those proposals are now set out in a draft directive which details the framework for a new digital tax on user revenues (including rate and thresholds), with the Commission calculating it could provide Member States with €5bn by 2020. That in itself is a good incentive for engagement.

Interviewed by Anne Bruce.

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