SQUIRE PATTON BOGGS

Before The DST Settles

United Kingdom Pushes Ahead With Digital Services Tax

On Thursday 11 July 2019, the UK government confirmed that it will bring forward legislation for a new Digital Services Tax (DST) to take effect from April 2020.

The announcement itself did not come as a surprise and the detailed design of the new tax is, broadly speaking, consistent with what was widely expected. In short, the UK DST will be a 2% tax on the revenues of search engines, social media platforms and online marketplaces, which derive value from UK users.

The government insists that it remains committed to finding an international response to the tax challenges arising from the digitalisation of the economy. Therefore, the UK government presented the UK DST as an interim measure, pending a comprehensive consensus-based solution from the OECD/G20 Inclusive Framework on BEPS (the Inclusive Framework) – for the latest on which see Digitalisation of the Global Economy: Navigating the Tax Challenges. By introducing detailed legislation for what it considers to be "a targeted, proportionate, and temporary tax", the UK will hope to keep the pressure on the Inclusive Framework.

The draft legislation and guidance is the subject of consultation, which will run until 5 September 2019. The provisions will then be included in the Finance Bill 2019-20, which will become Finance Act 2020 in due course.

Targeted

The specific design of the UK DST ensures only the *largest* digital businesses will be in scope. In reality, it will likely apply to just 30 or so of the world's established multinational technology companies. Intentionally, it will not apply to small businesses or those making losses in the UK. The government states that this will help protect start-ups, but it is no coincidence that part of the UK's Industrial Strategy is the promotion of UK-based digital unicorns.

What Types of Businesses Are Subject to the DST?

The UK DST will apply to businesses providing a DST activity (i.e. digital service) to UK users, comprising one of the following:

- A social media platform
- An internet search engine
- An online marketplace (except financial and payment services providers)

Online advertising provided via a social media platform, internet search engine or online marketplace is also caught.

When Will the UK DST Apply?

An affected group will be within the scope of the UK DST where its annual:

- Global, group wide, digital services revenues (from providing those services) exceed £500 million
- UK user-derived digital services revenues (from providing those services) exceed £25 million (the first £25 million of UK digital services revenues will be exempt)

A global group is comprised of all entities included in the group's consolidated financial accounts (or would be if such accounts were prepared in accordance with generally acceptable accounting principles).

It is important to emphasise that the focus is on digital *revenues*, not the entity or jurisdiction in which such revenues are recognised. The point is that UK user-derived revenues will trigger a potential UK DST liability irrespective of whether the entity recognising them has a taxable nexus (in the traditional sense) in the UK. The departure from taxing profits – in favour of targeting revenues – and from territoriality and residence – in favour of extraterritorial taxation – are the two most radical, and heavily criticised, design characteristics of the UK DST.

What Are Revenues?

Revenues for the purposes of the UK DST include *any* revenue connected to the provision of in-scope digital services, irrespective of how the business monetises the platform. To the extent revenues arise from the provision of these services and other activities, businesses will need to apportion their revenue on a just and reasonable basis.

In the case of online marketplaces, *all* revenues from a transaction will be UK user-derived if either of the following applies:

- One of the parties to a transaction is a UK user
- The transaction involves land or buildings in the UK

However, in circumstances where the other party to the transaction is normally located in a country that operates a similar DST (including, for example, France), the UK user-derived revenues will be reduced by half.

What Are UK Users and UK User-derived Revenues?

A UK user is a user that is normally located in the UK.

UK user-derived revenues are revenues arising from a UK user using the platform. In the case of advertising revenues, UK user-derived revenues arise from advertisements intended to be viewed by a UK user.

What Will the UK DST Rate Be?

A business subject to the UK DST will be taxed at a rate of 2% on its UK user-derived digital services revenues (in excess of £25 million).

Proportionate

How Is Liability to the UK DST to Be Calculated?

In a minor change of policy, the total liability of a group will now be calculated (and reported) at the level of the global group. The government hopes this will reduce the administrative and compliance burden associated with the new tax. However, once calculated, each member of the group recognising UK DST revenues will be liable to UK DST (irrespective of tax residence or UK presence) in proportion to the amount it contributes to the group's total UK DST revenues. Transfer pricing on transactions between associated entities will still apply.

What Is the Alternative Charge "Safe-harbour" Provision All About?

The legislation allows a group to elect to adopt an alternative, "safe harbour", mechanism for calculating their DST liability. In essence, the safe harbour should ensure:

- Where a UK digital activity is loss making, no UK DST arises in respect of the revenues attributable to that activity
- A UK DST liability cannot create a loss

The alternative mechanism produces a reduced effective UK DST rate. This (non-standard) rate is calculated by:

- Identifying the group's operating margin rate (from providing a digital activity to UK users) in an accounting period
- Multiplying that operating margin by a factor of 0.8
- Applying the result to its UK digital services revenues (in excess of £25 million)

The total group liability is then allocated between group members in the normal way. Each digital activity must be treated separately. Elections must be made annually and apply to the accounting period in question only. A maximum of three elections (one for each type of activity) can be made in any given accounting period.

Due to the way the calculation works, the government expects only groups with low DST UK operating margins will make the safe-harbour election. This election is voluntary and is applied against business activities. So, for example, if a business has two in-scope business activities (e.g. an internet search engine and an online marketplace) it could choose to apply the alternative basis of charge to one, both or neither of these activities.

What Is the Tax Treatment of UK DST Payments?

The UK DST is deductible as a normal expense of business (provided it is incurred wholly and exclusively for the purposes of a trade) but, crucially, is not creditable against any liability to UK corporation tax. As a result, the UK government recognises that the DST has the potential to result in double taxation. It also acknowledges this "may create challenging outcomes for businesses which already recognise significant taxable profit in the UK". However, it has declined to introduce a credit system on the basis that to do so would not be "simple" and could jeopardise the (government asserted) "non-discriminatory" design of the tax.

In a slightly surprising but stark admission, the government concedes that these challenging outcomes are "an example of why the DST should ideally be a temporary measure" to be replaced by "appropriate changes to international corporate tax rules" in due course. However, there is nothing in the legislation committing or obliging the UK government to withdraw the UK DST in such circumstances.

How Much Will the UK DST Raise?

The forecast tax yield from the UK DST is just £275 million in the tax year 2019-20, rising to £370 million for 2020-21 and reaching £440 million by 2022-23. To put this in context, the latest fiscal forecast[1] from the UK Office for Budget Responsibility (OBR) predicts receipts from (onshore) corporation tax in the same years will be £55.3 billion, £54.9 billion and £57.1 billion, respectively. Whatever else it might be, the UK DST is not a revenue raising measure.

Temporary

Why Does the Government Describe the UK DST as Temporary?

There is no "sunset" clause in the legislation introducing the UK DST. Therefore, there is no prescribed date by which the UK DST will cease to apply.

However, the *current* government is clear that it:

- Intends the UK DST to be an interim measure, pending a long-term global solution to the tax challenges arising from digitalisation
- Is committed to dis-applying the DST once an appropriate international solution is in place

The UK government says that intention and commitment "achieves the same objectives as a sunset clause". Some might feel differently. However, the UK has changed its tax code in response to international developments in the past. For example, in 2017, the UK modified its worldwide debt cap regime as part of the introduction of new corporate interest restriction legislation to bring the UK's rules for denying excessive relief for financing costs into line with the recommendations of Action 4 of the OECD/G20 BEPS Project.

1 Office for Budget Responsibility: Tax by tax, spend by spend – Onshore corporation tax (27 March 2018).

The legislation does impose an obligation on HM Treasury to "conduct a review of digital services tax and prepare a report of the review" before the end of 2025. There are no details on the purpose of, or parameters and metrics for, such a review other than "whether it is meeting its policy objectives". It is not at all clear that the review will necessarily precipitate the withdrawal of the UK DST. Given the ambitious timeline being followed by the Inclusive Framework (they intend to outline a consensus solution by the end of 2019 with implementation commencing before the end of 2020), there is no clear logic for adopting 2025 as the review date in any event.

The government's response to the November 2018 consultation also sets out its demand that "an international solution addresses the concerns the UK has raised about the way highly digitalised businesses create value" (i.e. through "user participation"). It is far from clear that the international solution will address those concerns in such a specific way. The question then must be whether the UK decides, at some future date, to retain the UK DST alongside a global consensus-based solution on the basis that it meets a particular concern of the UK.

Timing Is Everything

Although the announcement was not a surprise, the timing was most unfortunate. The draft provisions for the Finance Bill 2019-20 had been scheduled for publication on 11 July 2019 for some time. Unfortunately, this fell:

- One day after the US Trade Representative (USTR) announced it was initiating an investigation under Section 301 (of the Trade Act of 1974) into the discriminatory nature of French proposals to introduce its own DST. Despite this, the French Senate approved the French DST (broadly, a 3% tax on revenues generated from sales of user data, digital advertisements and online platforms) on 11 July. President Macron has 15 days to sign the provision into law.
- Two days after the unseemly diplomatic spat between London and Washington DC following a leak of sensitive diplomatic telegrams sent by Sir Kim Darroch, the UK ambassador to the US, which ultimately resulted in the Ambassador's resignation.

Remarkably, for tax law, the wider context is crucially important. London's decision to push ahead with its own DST proposals, despite Washington DC's strengthening objection to and increasing resolve to retaliate against, similar developments in Paris, is likely to only increase the sense of irritation in the US administration with what it perceives to be taxes that "unfairly target … certain U.S.-based technology companies".

There are some differences between the UK and French proposals. Most important is timing. The French DST will apply retrospectively from 1 January 2019, once approved by President Macron, although it is also designed to expire in 2021 (on the basis that a global solution will have presented itself by then). The UK DST, by contrast, still has a number of hurdles to clear before becoming UK law.

The draft legislation:

- Is the subject of technical consultation
- Must be confirmed at the next Budget (due in the autumn)
- Must undergo Parliamentary scrutiny (as part of the Finance Bill 2019-20) before obtaining Royal Assent and becoming law next April

In normal times, the next seven or eight months would pass without incident and the UK DST would become law in April 2020. However, in the UK, these are far from normal times for UK politics (and, therefore, UK policy).

Next week alone in Westminster will see the appointment of a new Prime Minister, and with him a new Cabinet, with new priorities. Whoever the new Prime Minister is, his first priority will be to bring Brexit to some sort of resolution. That could see the UK:

- Leave the European Union on 31 October 2019, without a withdrawal agreement
- Leave the European Union with a withdrawal agreement (probably after 31 October 2019, but probably before the end of the year)
- Hold a general election (to return a new Parliament and, possibly, a new party of government)

The direction in which the UK heads next will significantly influence UK policy in the immediate future. The next seven or eight months are also likely to see significant developments and advances in the Inclusive Framework's Programme of Work addressing the tax challenges of digitalisation that could change the calculus in London.

When the DST Settles

There are many moving parts. However, in any scenario, a new Chancellor of the Exchequer will deliver the Autumn Budget (and any emergency Brexit Budget) and will need to confirm the introduction of the UK DST. One of the main upsides of Brexit has always been the possibility of a Free Trade Agreement (FTA) between the UK and the US. Therefore, it is no coincidence that Senate Finance Committee ranking member Ron Wyden (D-Ore.) has threatened the feasibility of any such FTA in a direct response to the UK's current plans.

On one hand, in the face of US hostility (and possible retaliatory action) and the presentation of a consensus-based solution by the Inclusive Framework, the question will be whether the new UK regime will choose to implement its "interim" proposal for what might only need to be a very short period. On the other hand, if the Inclusive Framework's consensus solution satisfies its concerns, the UK might equally feel that its DST proposal (and willingness to act unilaterally) has exerted the pressure intended, achieved its purpose and is no longer necessary.

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