

Analysis

Digitalisation: where are we headed?

Speed read

The UK digital services tax is in full force and effect. The original policy rationale is unchanged, and the technical design is almost identical to that in the draft legislation. However, the UK DST emerges into a radically different world. The OECD/G20 project on the tax challenges of economic digitalisation has struggled to make substantive progress. The US has been particularly unenthusiastic. It is equally unimpressed by the proliferation of DSTs. In the UK, Brexit now looms large while the economic harm of the pandemic is starting to emerge. Certainly no one would choose to start from here, but the question remains: where are we headed on digitalisation?



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The UK's DST

Chancellor of the Exchequer, Rishi Sunak, did not mention the UK's digital services tax (DST) in his Budget on 11 March 2020 (nor, indeed, during his summer economic update on 8 July), but the Budget report confirmed that the UK would introduce a DST with effect from 1 April 2020. The legislation was incorporated into part two of Finance Bill 2019/21, which is now FA 2020 following royal assent on 22 July 2020. The UK DST is now in full force and effect.

The official policy rationale for introducing a DST is familiar, and unchanged: digitalisation of the economy has allowed businesses access to the UK market without creating a taxable presence here. As a result, under the existing principles of international taxation, the place where profits are taxed and the place where value is created – in this context, value deemed by the UK to be derived from 'UK user participation' – is thought to be misaligned.

The UK remains committed to efforts to find a long-term global consensus on reform of the international tax framework, but it has also remained equally resolute in its commitment to introducing a UK DST on revenues (not profits) that it asserts

are generated in the UK from specific digital platform business models. This, it argues, will ensure that 'large multi-national businesses pay their fair share [whatever that might mean] towards the public services' in the UK.

As outlined below, despite the repeated affirmation of determination to facilitate agreement by the end this year, the OECD's two 'pillar' project has struggled to make substantive progress. The difficulties encountered at the international level, and the introduction of similar DSTs in multiple other jurisdictions, have eased the passage of the UK DST. There has been little, if any, political opposition. The government has restated that the UK DST will be removed 'once an appropriate long-term solution is in place', but it still has not legislated to that effect, nor outlined what 'an appropriate' solution is. Instead, FA 2020 merely commits HM Treasury to 'conduct a review of [DST] and prepare a report' before the end of 2025. Opposition amendments calling for an annual review, tabled during consideration of the Finance Bill in the House of Commons, all failed.

Little has changed in the technical design of the UK DST. In very broad outline, the UK DST is charged on the revenues of corporate groups providing digital services. Three types of digital services activities are within its scope: social media services; internet search engines; and online marketplaces (excluding any online financial marketplace). Any online advertising business deriving a significant benefit from its connection with a digital services activity is also caught.

A group has a potential UK DST liability where in a 12 month accounting period: worldwide digital services revenues exceed £500m; and UK digital services revenues exceed £25m. The main UK DST rate is 2%. It is charged on the group's total UK digital services revenues in excess of an annual allowance of £25m. Subject to making an election, a group can choose to calculate its liability, in respect of any of its digital services activities, using an alternative basis (a so-called 'safe harbour'). The alternative basis will most likely benefit loss-making groups or those operating at a low profit margin in the UK.

To mitigate (but not eliminate) any double taxation, a group can, subject to making a claim, halve the level of in-scope UK revenues from an online marketplace activity involving cross-border transactions where the group is subject to a foreign DST charge (i.e. a charge similar to the UK DST) in respect of the same revenues.

Although originally designed to be aligned with UK corporation tax, and so payable in quarterly instalments, the UK DST is now due and payable annually, nine months after the end of the relevant accounting period. UK DST liability arises to the entities that generate the relevant revenues; a nominated responsible member (or the parent entity) will though be able to administer a group's compliance obligations.

The OECD/G20 project

In the meantime, the OECD's Inclusive Framework on BEPS, which now includes 137 countries, has continued its efforts to find consensus on proposals to address the tax challenges of the digitalisation of the economy. The programme of work that was approved by the G20 in this regard in mid-2019 would involve changes, in certain circumstances, to well-established principles underlying the taxation of multinational business income.

Specifically, the first set of proposals, known as 'pillar one', would address tax nexus and profit allocation issues by departing from established principles of physical presence and arm's-length pricing, while the second set, known as pillar two, would establish a global minimum tax regime that could be implemented by all of the Inclusive Framework's member countries. The pillar one proposals include not only new rules

for tax nexus and formulaic allocation of global profit among the countries where a multinational group has customers, but also new rules establishing fixed profit margins for baseline distribution and marketing activities in a country, and new rules relating to the prevention and resolution of tax disputes involving two or more countries.

The United States has been a reluctant participant in the process from the outset. This became clear when, in early December 2019, US Treasury Secretary Stephen Mnuchin sent a letter to the OECD secretary-general expressing misgivings about the pillar one proposals' mandatory departures from established international tax principles and stating that the US would prefer a 'safe-harbour approach' (meaning an elective approach) to new nexus and profit allocation rules. At the same time, the US Trade Representative (USTR) announced that he was considering imposing tariffs on French goods in retaliation for France's imposition of its DST, which disproportionately affects US multinationals.

At the meeting of the World Economic Forum in Davos in January 2020, Secretary Mnuchin and French Finance Minister Bruno Le Maire reached agreement on a one-year ceasefire agreement under which the US agreed not to impose tariffs on French imports and France agreed not to collect its DST from US companies. Both parties expressed renewed commitment to finding consensus on a new approach to the taxation of multinational business income through the OECD's Inclusive Framework process.

The Inclusive Framework met in Paris in late January and approved a slightly revised program of work that included new scope limitations on the profit reallocation rules under pillar one. Specifically, the rules would apply only to income from automated digital services businesses and consumer-facing businesses. The US's proposal of a safe-harbour approach was acknowledged as worthy of discussion, but the discussion was postponed until after further elaboration of the details of pillars one and two.

Then came the coronavirus (Covid-19) pandemic, which affected the work on the project in a number of ways. First, tax policy officials around the world had to focus on responses to the effects of lockdown, which drastically reduced their capacity to spend time on the Inclusive Framework's project. Second, meetings of the relevant working groups at the OECD had to be held via video-conferencing, which is far less effective than face to face meetings. Third, the prospect of widespread losses, rather than profits, among multinational businesses in the wake of the pandemic called into question the need for urgent resolution of the policy questions regarding profit allocation. Finally, the shift to remote working demonstrated the economic importance of automated digital services, leading some politicians to call for increased taxation of multinationals in that sector.

In these new and difficult circumstances, the OECD and the Inclusive Framework have soldiered on with the work. The OECD is expected to submit a 'blueprint' – but not a long-term consensus solution – for new global tax rules at the G20's meeting in October 2020.

The US's call for a 'pause'

On 2 June 2020, the USTR signalled continuing US opposition to DSTs and announced new investigations under s 301 of the Trade Act of 1974 regarding DSTs that have been enacted or proposed in Austria, Brazil, the Czech Republic, the European Union, India, Indonesia, Italy, Spain, Turkey, and the UK. Section 301 authorises the USTR to recommend retaliatory measures, such as tariffs, if a foreign law is found to be 'unreasonable or discriminatory and burdens or restricts US commerce.'

Shortly thereafter, on 12 June 2020, US Treasury Secretary Mnuchin wrote to the finance ministers of France, Italy, Spain, and the UK, stating that negotiations on pillar one were 'at an impasse' and calling for a pause in the discussion of pillar one issues. Mnuchin was responding to the four finance ministers' 'joint proposal for a phased implementation of pillar one' rules. Although the details of that proposal have not been made public, observers understand that the proposal involved a first-phase set of rules that would have applied only to large multinationals that provide automated digital services – most of which are headquartered in the US.

Given that the US is the most economically significant single country in the G20 and the OECD, Mnuchin's letter delivered a body blow to the Inclusive Framework's project. However, the multilateral talks are continuing, with the US at the table, but it seems safe to say that pillar one will not be on the agenda for at least the next few months, unless the Europeans come up with a new proposal that does not target digital services. However, pillar two, also known as the global anti-base erosion (GloBE) proposal, will now move up to the top of the agenda in the short-term. Mnuchin's letter noted that the US 'fully supports' the goal of reaching agreement on pillar two before the end of this year.

The Inclusive Framework's discussions on these issues will most likely continue into 2021 and perhaps beyond. Even if agreement is reached on the US's proposal for the pillar one rules to be elective rather than mandatory, a host of other important design issues must be dealt with. These still include:

- the scope of the new nexus and allocation rules;
- the determination of the profits to be re-allocated to market jurisdictions;
- the method of identifying the jurisdictions from which those profits will be taken; and (perhaps most importantly)
- the mandatory binding dispute resolution processes that will be agreed to.

In addition, many developing countries are insisting that the pillar one regime include new rules requiring local reporting of a significant fixed taxable return on routine distribution activities ('amount B', in the proposed unified approach).

With respect to pillar two, the Inclusive Framework is grappling not only with agreeing on a minimum effective rate of tax on multinational business income, but also with differences of opinion on how proposed income-inclusion and undertaxed-payments rules should interact. Developing countries generally want source countries to have the first bite of the apple, whereas developed countries favour primacy for the income-inclusion rule, under which tax is paid to the country in which the parent company is resident. This fundamental question will need to be resolved if the pillar two work is to mean anything other than an exploration of the different types of anti-base erosion measures that countries are free to adopt if they wish.

It is clear that DSTs are not acceptable to the current US administration, which appears to be willing to engage in any number of trade wars globally. The USTR announced in July that tariffs of up to 25% would be imposed on \$1.3bn worth of French goods imported into the US, starting in January 2021. Barring changes in the DSTs of the other countries named in the USTR's s 301 investigation, it appears likely that the US will impose tariffs on imports from those countries as well—unless, of course, the US election in November results in a new administration and a new trade policy. If it hasn't already, the UK would do well to take note.

If an agreement could be reached among the Inclusive Framework countries on pillars one and two, the countries with DSTs would be obliged, as part of that agreement, to repeal them. This possibility is what keeps the US engaged in

the Inclusive Framework's discussions. The crucial questions is: what sort of a deal *would* be acceptable to the US?

First and foremost, ring-fencing of automated digital services would be a deal breaker from the US perspective. Note that in this regard that the G20/OECD member countries were in agreement from the outset of the BEPS project in 2013 that the 'digital economy' could not be ring-fenced, due to the fact that digital technologies are being used in new and innovative ways throughout the entire global economy.

Second, the US is unlikely to look with favour upon any agreement that would give part of the US corporate income tax base to other countries. In the US tax reform of 2017, a global minimum tax regime was enacted, with the provocative name GILTI (global intangible low-tax income) rules. The Trump Administration has spent two years writing implementing regulations for the GILTI regime, aimed at ensuring that low-taxed foreign earnings of US-owned companies will be taxed in the US at a certain rate. The presumed Democratic nominee for president, Joe Biden, is proposing to make the GILTI rules tougher still. Therefore, it should be assumed that any agreement on multinational corporate tax policy will need to leave the US corporate income tax base effectively untouched.

Ultimately, this all means that the OECD's proposed unified approach will probably have to be revised, unless the result of the reallocation of profits under pillar one is neutral, or positive, for the US. In that case, the US might well support an agreement that provides greater certainty of tax results to all countries in which a multinational enterprise does business – especially if the US business community expresses its support with a unified voice.

A new political and economic reality

As developments at the OECD and around the world illustrate, the UK DST was only ever a part of a much bigger picture. It was never intended to be a significant revenue raiser for HM Treasury. Originally, it was most probably a political play, intended to apply creative pressure on the OECD and protect the UK's position (and tax revenues) in the short-term as other jurisdictions (most notably, and aggressively, France) pushed ahead with their own DST plans.

Of course, the UK has never been shy in asserting taxing rights beyond its territorial borders if it identifies a suitable source of revenue to tap. The diverted profits tax (DPT) and, in the digital space, the withholding tax for offshore receipts in respect of intangible property (ORIP) both illustrate UK policy innovation. In that tradition, and in the absence of global agreement, the UK DST is a predictable next step.

However, the world is now changing. Inertia at the OECD, Brexit and, above all, Covid-19 have transformed the UK's political and economic reality. The inability of the OECD to find a path towards a global consensus means that, in the short-term at least, we will probably see a proliferation of unilateral digital tax measures. That, in turn, heralds double (or worse) taxation for affected businesses and the likelihood of growing numbers of international tax disputes.

The UK's departure from the EU finally 'got done' after Boris Johnson's victory at the general election in December 2019. Although a 'hard Brexit' was avoided on 31 January 2020, fraught negotiations between London and Brussels over the future relationship have made little progress. The UK passed up the opportunity to request an extension for Transition meaning that, whatever further progress is made beforehand, the UK will leave the EU single market and customs union on 31 December 2020.

Economically, Brexit was always going to be challenging simply because the UK is *creating* barriers with its largest, and closest, market. The UK economy is not self-sufficient.

It cannot thrive without international trade. Unsurprisingly, therefore, 1 January 2021 is presented as a 'new start'. The government is keen to 'get going', to take control of its trade policy by (rapidly) striking new free trade agreements (FTAs) with multiple jurisdictions around the world and establish the UK as truly 'Global Britain'. As well as discussions with the EU, the UK hopes to join the CPTPP (Comprehensive and Progressive Agreement for Trans-Pacific Partnership) and is currently prioritising FTA negotiations with Japan, Australia, New Zealand and, of course, the US.

To complicate matters further, Covid-19 has overturned a decade of prevailing UK fiscal policy in less than six months. Covid-19 has hit the UK hard. The total cost of the government's policy response to the crisis since the end of March stands at around £193bn. According to the Bank of England, government borrowing in 2020/21 could top £350bn and, at the end of June 2020, government debt totalled £1,983.8bn (around 100% of GDP (gross domestic product)).

Where are we headed?

As the Office for Budgetary Responsibility puts it, 'at some point, given the structural fiscal damage..., the longer-term pressures on spending and the range of fiscal risks..., it seems likely that there will be a need to raise tax revenues and/or reduce spending (as a share of national income) to put the public finances on a sustainable path'.

However, the government has 'doubled-down' on its commitment to spend big on infrastructure, science and innovation, public services, and tackling climate change, to 'build the foundations now for future prosperity'. It remains equally adamant that tax promises in the Conservative Party manifesto – not to raise the rates of income tax, VAT or national insurance – will be honoured.

Covid-19 has undoubtedly scarred the economy, but it has also revealed the pervasiveness of digitalisation. There is a perception that global digital businesses have survived the crisis better than most others and are best able to contribute to the rebuild. Their revenues are now an even more attractive source of potential tax revenue for increasingly indebted governments, including in the UK. With little prospect of an imminent OECD solution, there is a simple logic in retaining, possibly even expanding (or increasing the rate of), the UK DST.

The obvious problem is that the UK's renewed enthusiasm for globalisation, free trade and the diversification of its supply chains beyond Europe is that geopolitical relations are currently defined by protectionism, tariffs and trade wars. The French experience suggests that if it perseveres with its DST, the UK can expect punitive tariffs on its most valuable exports to the US (including, for example, chemicals, automotive and aeronautical parts, and Scotch whisky). Outside of the EU, without collective backing from Brussels, London should expect to encounter significant obstacles when trying to secure a comprehensive FTA with Washington; one of the main prizes Brexit promised.

As the UK economy is reshaped so, inevitably, must UK tax policy adapt. The UK could be on the threshold of a critical programme of tax reform. There is much that is in a state of flux, and whether the UK can make a success of post-Covid, post-Brexit, global Britain remains to be seen, but one thing is certain: no one would choose to start from here. ■

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