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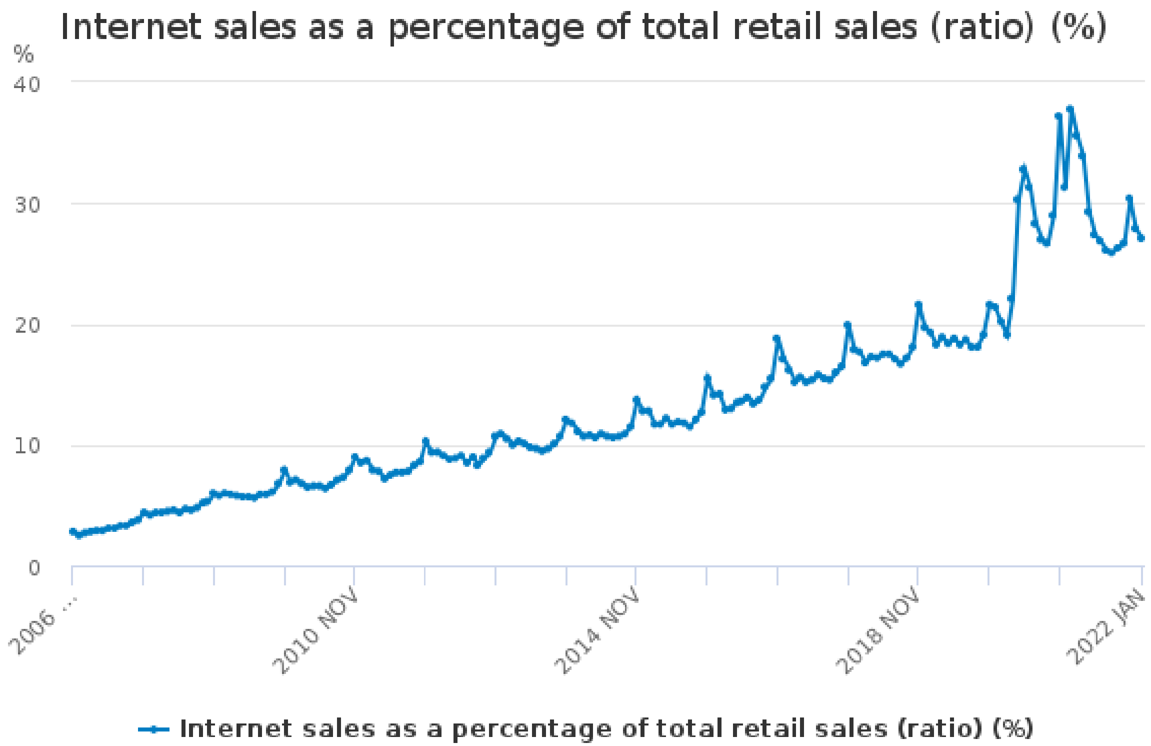
Is It Time for an Online Sales Tax in the UK?

Introduction

On 25 February 2022, HM Treasury published a policy consultation, "Online sales tax: Assessing an option to help rebalance taxation of the retail sector", to assess", the case for and against implementing … an online sales tax (OST) as a means to rebalance the taxation of the retail sector between online and in-store retail".

The consultation acknowledges that the evolution of retail patterns in recent years has brought about rapid technological "disruption", leading to modified consumer behaviours and expectations. As the chart immediately below illustrates, the share of internet sales of total retail sales has grown steadily from 2.8% (in November 2006) to 27.1% (in January 2022). The COVID-19 pandemic facilitated a period of accelerated change, which, although has fallen back slightly, leaves the online share well ahead of its pre-pandemic trend:



Source: ONS, Internet sales as a percentage of total retail sales (ratio) (%) (18 February 2022)

The rationale for implementing an OST is based on the perception that online retailers, with limited (or no) physical retail presence, are able to obtain an unfair advantage over tradition al, "bricks and mortar" competitors. That advantage, it is argued, arises from lower fixed costs, including, in particular business rates.

The aim, then, would be that an OST would form part of the government's wider effort to reform, improve and re-balance the current business rates system – see HM Treasury's Business Rates Review: Final Report, from October 2021. If introduced, the OST would not be used to raise revenue but, rather, to reduce business rates for "bricks and mortar" retailers.

It is important to emphasise that HM Treasury has not yet made any decision on whether to introduce an OST; the consultation is only an exploratory first step. An initial question that needs to be addressed is whether it is appropriate for the government to directly intervene in trends that develop in the retail economy.

Even if the government concludes that it does need to respond, there is a further fundamental question over whether using the tax regime is the appropriate policy tool to adopt. As the consultation clearly states:

"If change is being driven by other factors including technological development and consumer preferences, a new tax – even if coupled with additional relief for in-store retail – would be unlikely to reverse the shift to online [if, indeed, that is a desired outcome]. Meanwhile, there is concern that business rate reductions [funded from OST revenues] are likely to increase the rent expected for the property, limiting the long-term benefit to in-store retailers which are not the owners of the property they occupy."

An OST will need to meet several core principles that ought to underpin tax policy, namely:

- Long-term sustainability
- Efficient (incentivising growth with minimal distortion of the market)
- Fairness, simplicity and predictability

Unsurprisingly, therefore, the consultation does not make any firm proposals. The document is intentionally very broad in nature, seeking business input on a diverse range of issues, including:

- **Scope –** That is, the type of transactions taxed.
- **Design –** That is, the form of tax; the definition of an "online sale"; possible exemptions, thresholds and allowances; and territorial reach.
- **Practicalities –** That is, both administrative operation and interaction with other taxes (including, in particular, VAT).
- **Impacts –** That is, the effect on different types of business; innovation; and environmental considerations.

Scope

The government recognises that deciding on the "scope" (i.e. which sales are, and which are not, charged) is "challenging" because the dividing line between online and offline activity is increasingly blurred. In essence, the scope of the OST will come down to what constitutes a "taxable sale". Getting this definition right is fundamental, not only to the success of the OST but also to ensuring any unintended distortionary impact is minimised.

Some of the key issues in determining the definition of a "taxable sale", outlined and discussed in detail in the consultation, include:

- **Sales and services –** Does the OST apply to sales of goods only, or should it extend to include the provision of services? Is there any justification for particular types of goods (and/or services) to be exempt or subject to a reduced rate? In any event, rules will be needed to identify goods, services, suppliers and consumers.
- **Digital and physical goods –** Considering the aspiration to rebalance the business rates system, should the OST apply to the sale of digital goods (e.g. an eBook or streaming service)?
- **Online or remote –** Should the OST charge sales made purely "online" only or considering their lack of physical presence on the High Street, should the tax extend to any remote sales (e.g. via telephone, mobile apps and mail order)?
- **Alternative determination –** Is there a better determinative factor? For example, should the scope of the OST be decided according to the extent of personal interaction, or perhaps the timing of a sale?
- **Click and collect –** Should "click and collect" transactions, where a sale is concluded online but needs to be collected from a physical premises, be exempt from the OST?
- **Business-to-consumer (B2C) and business-to-business (B2B) –** With the focus on the retail sector, and the disadvantage experienced by those occupying High Street premises, is there any reason to extend the OST to B2B sales? If the OST was extended to B2B, there is a possibility of repeated OST charges throughout a supply-chain, resulting in excessive charges "cascading" and being passed to the ultimate consumer. In such cases, considering the additional compliance burden, would there be a justification for some sort of system of "input recovery", along the lines of VAT?
- **Avoidance and value-shifting –** As with all taxes, the OST regime will need stringent anti-avoidance rules to control abusive planning. Generally, the more complex the rules become, the more exemptions and exclusions are included, and the greater the potential incentive for avoidance and value-shifting activities.

Design

Much of the design of an OST comes down to the ease and efficiency of collection. Aligning the operational characteristics of an OST with business rates suggests that the appropriate entity to charge, collect and account for OST should be the "supplier" of taxable sales (i.e. the seller or vendor).

Even if this analysis is correct, questions quickly arise. The key design considerations addressed in detail in the consultation include:

- **Online marketplaces and intermediaries –** How does the involvement of online marketplaces and intermediaries, that facilitate a sale, affect the role and responsibility of the underlying supplier of a taxable sale? Does the contractual arrangements, or the allocation of functions, personnel and risks between the various parties, affect the analysis? Similar issues arise with respect to the collection of VAT, with more responsibility for data and tax collection being placed on the marketplaces; however, would that be an appropriate approach for the OST too? The issue is also relevant to working out when a seller is entitled to any allowance and when a business exceeds any thresholds.
- **Cross-border transactions –** One of the underlying assumptions for a UK OST is that it should only apply to taxable sales to UK customers. However, if that assumption is followed through, in order to avoid unfairly advantaging overseas sellers, the UK OST would need to be chargeable on (or at least collected by) UK *and* non-UK suppliers. With the digitalisation of the global economy making long-distance sales easier, the cross-border enforcement of a UK OST need consideration.

Another key consideration will be the form the OST takes. Two possibilities are considered in the consultation:

- **Revenue –** Under this approach, the amount of tax due would be a percentage of the value of the taxable sales made by the chargeable entity. Revenue-based turnover taxes are rarely desirable, primarily because turnover will not always reflect a business' profit and ability to pay; in economic terms, turnover taxes are considered to be "distortive" because they tax the product irrespective of the input. The consultation considers a suggested rate of 1-2%, although the precise rate will depend on a number of factors, including (obviously) the amount of revenue needed to re-balance the market, the complexity of OST rules, the number and level of exclusions and thresholds, and so on.
- **Flat-fee –** The "flat-fee" alternative would impose OST, of a set amount, based on the volume (as opposed to value) of sales made by the chargeable entity. The flat-fee option would be attractive from an administrative perspective. However, it would disproportionately impact suppliers of sales with a low value and could have severe "distortive" effects as businesses adjust behaviours to mitigate (or avoid) the tax through, for example, grouping numerous small orders into a smaller number of large orders.
- **Progressivity –** HM Treasury is interested in hearing views on making the OST more "progressive"; that is, making it more expensive (through rising rates or higher fees) as the value or number of orders passes (yet to be determined) thresholds. The idea is simply to ensure those that can afford to contribute do so. However, without additional complexity, the introduction of thresholds also encourages "distortive" behaviours around the thresholds, including, for example, bunching of transactions just below each threshold in order to avoid triggering higher rates.
- **Allowance –** One way of ensuring the smallest businesses do not attract an OST liability is that HM Treasury is considering the appropriateness of introducing an allowance. In simple terms, an allowance operates like a "safe-harbour"; a threshold of sales value or numbers below which the OST is set at zero. The existence of an allowance is a common feature of many tax regimes. The consultation considers a suggested (value) allowance of £1-2 million, although that could be complimented (or replaced) by a similar allowance based on the number of taxable sales in any period. Once sales exceed the allowance amount, the question arises whether the full amount of sales becomes liable to the OST, or whether only the excess is chargeable.

Practicalities

New taxes inevitably introduce new compliance and administration obligations on business. The more complex the new rules, the greater accuracy and targeting of the new tax can be achieved. However, in most cases, more complexity in the rules normally also means a greater compliance burden.

The consultation considers two main areas:

- **Reporting and payments** – The main consideration here is how the OST systems will (if at all) integrate with existing frameworks for other taxes (e.g. corporation tax and VAT). The closer the integration, the simpler the system requirements. The obvious problem is that other, pre-existing taxes may adopt reporting horizons and payment windows that are totally inappropriate for the OST. For example, it is possible that the particular design of the OST will require particular types of transactions to be extracted and analysed in a way that currently used and understood processes simply do not support. At the same time, the creation of a newly bespoke framework for the OST will inevitably impose a significant compliance burden businesses .
- **Data systems** – Many of the reporting and payment issues apply equally to (although could be solved by) businesses' data collection and processing systems. The question is how easy is it for businesses to develop (or re-wire) data systems to meet the demands of the new OST? The greater the need to adapt or create new processes, the greater the compliance, business and cost. The data challenge reflects the problems faced in identifying the parameters of the OST final design. The consultation concisely outlines five data challenges:
  - Identify sales of goods, as distinguished from sales of services (including those in mixed supplies)
  - Identify online sales, as distinguished from those made through other channels
  - Identify sales made by any remote means (online, over the phone, via email, over fax, by post), as distinguished from those made in person at a physical store premises
  - Identify sales made online, as distinguished (if at all) from "click and collect" transactions
  - IdentifyB2B sales, as distinguished from B2C sales

Impact

An OST is attempting to achieve a delicate balancing act. It is not intended to raise revenue, but nor is it intended to change business behaviour, or to hinder disruption, or innovation, in the retail market. Instead, the OST would attempt to "level the playing field" of that market by using the revenue raised to fundbusiness rate reductions for "brick and mortar" sellers. Accepting that much depends on its final design, the obvious question then is, how much revenue does the OST need to raise for the government to rebalance the market?

The consultation outlines one possible scenario: "estimates suggest that a revenue-based [UK wide] OST with a £2 million allowance, levied at a rate of 1% on online sales of goods from [B2C] and excluding services, could raise approximately £1 billion per year … if goods subject to a zero-rate of VAT were excluded from a revenue-based OST, this might reduce the yield by around 10% to 20%". To put that in context, HM Treasury estimates total business rates revenue from retail-only (excluding hospitality and leisure) properties in England alone is approximately £7.5 billion per year, meaning an OST built in this way would fund an estimated 13% reduction in business rates for those retail premises. Flexing any one of the design characteristics moves those figures up or down.

One of the major considerations in the design of any new tax is its incidence; that is, who actually bears the economic cost. Clearly, the intention is to ensure the online sellers incur the cost, in order to reduce the differential advantage they have in terms of operational costs. However, businesses will often simply maintain profit margins by passing increased costs down the chain to the ultimate consumer, or up the chain to suppliers by driving supply costs down further. In addition, it is far from clear that "bricks and mortar" sellers will benefit for the reduction in their business rates, with property owners potentially taking the opportunity to increase rents.

It is clear the apparent need for an OST has been occasioned by the continued prevalence of (and government reliance on) the archaic system of business rates. However, in the absence of a fundamental overhaul of business rates, the policy task for the OST is a delicate one. A false design choice will ensure the OST either does not achieve its aims, or is so distortive that it undermines the market altogether. It is hardly surprising HM Treasury is far from convinced introducing an OST is the right choice.

Is It Time for a UK OST?

The jury is still out. Reading between the lines of the consultation, HM Treasury will need to be persuaded. However, in the absence of fundamental business rates reform, it is keen to learn more from both those in favour, and those against, an OST. It recognises that the "design would not be straightforward" and, perhaps as a result, their consultation asks 40, detailed, questions.

As this alert has outlined, the design features of any OST, and, therefore, the consultation, focus on several key questions:

- **Scope** – What sales would be in scope of the tax?
- **Exemptions** – Are any exemptions appropriate?
- **Incidence** – Who is charged, collects and accounts for OST?
- **Territoriality** – How are cross-border sales dealt with?
- **Allowances** – Would an allowance or thresholds be appropriate?
- **Administration** – How is OST reported and paid?

The current consultation is open for comments until 10 a.m. on 20 May 2022.

Under the normal tax policy timetable, and in the absence of any acceleration, one might expect HM Treasury to consider its position over the summer, with a policy being made at the time of the Autumn Budget. Should the government decide to proceed, a further consultation (on the precise design parameters) would follow, with a final, technical, consultation on draft legislation likely during the summer of 2023. Adoption of the new tax could be expected to be confirmed at Budget 2023, legislation would be included in Finance Bill 2023/24, and would likely enter into force from April 2024.

All retail, hospitality and leisure businesses, whether likely in scope of an OST or not, are strongly encouraged to participate in HM Treasury's consultation. By doing so, fully and candidly, they will be able to inform UK government tax policy at an early stage in it development. The challenge arising from the digitalisation of the economy, and the disruption that online sales have brought to the operating business models of traditional retails sellers is real. The pandemic, national lockdowns, stressed supply-chains, and the sheer level of governmental intervention needed to support the High Street have all exposed imbalances, exacerbated difficulties and accelerated change.

We are collating comments from our retail clients in order to submit a response to the consultation on their behalf. We would welcome any comments, observations or ideas to help inform our response, and would be delighted to discuss any experiences or concerns at any time as we continue to track the progress of this potentially crucial development.

We have prepared an online survey (which will be open until 13 May 2022) to make the process as easy as possible.

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