International Tax Poker

The United Kingdom's Digital Services Tax Proposal

The Chancellor of the Exchequer, Philip Hammond, announced during the Autumn Budget Statement on October 29, 2018 that the UK would introduce a new Digital Services Tax (DST) in April 2020. The government will shortly issue a consultation setting out the proposal in more detail. The government intends the DST to be an interim measure. DST will be withdrawn and replaced when an international solution for the taxation of digital businesses is agreed among relevant states.

The UK government has already published two position papers (the first alongside the Autumn Budget 2017 and the second alongside the Spring Statement 2018) setting out its initial thinking on corporate tax and the digital economy. However, despite pre-Budget rumours that the UK was considering the possibility of acting alone, announcement of a UK DST still came as a mild surprise to some.

Recognizing (or at least reacting to) the economically disruptive effect digital businesses have had, the official justifications for introducing a DST in the UK are familiar: to ensure "the corporate tax system is sustainable and fair across different types of businesses" and "large multinational businesses make a fair contribution to supporting vital public services".

However, the UK DST is not simply a new tool for raising UK revenue. There is more at issue here – the UK is playing international tax poker and the stakes are high. Apparently no longer willing to wait for a global consensus on reform of the international corporate income tax framework, the UK's determination to move ahead, to be a "first-adopter", on the unilateral implementation of a DST, is illustrative of a wider, and more politicized, set of issues in the domestic and international context.

A Blind-raise: The UK DST

The broad framework for the new UK tax is straightforward. The UK will charge the relevant *revenues* of certain digital businesses to the UK DST. The rate applicable will be 2%. The scope of the UK DST will be relatively narrow. It will only apply to the revenues attributable to a specified digital business, where such revenues relate to UK "user participation".

The affected businesses are:

- **Search engines** – generating revenue from advertising relating to the result of search terms inputted by UK users
- **Social media platforms** – generating revenue from adverts targeted at UK users
- **Online marketplaces** – generating revenue from commission by facilitating transactions between UK users of that marketplace

Many digital businesses will not be part of the UK DST tax base. The examples provided by the government include online financial and payment services, businesses providing data content online (e.g. music streaming and cloud data storage services) and telecommunications. The exclusions do not make logical sense. It is not obvious, for example, that the excluded businesses do not also involve the facilitation of transactions between UK users generating revenue from the payment of a commission.

In addition, the Chancellor was keen to emphasize that the UK DST will not affect businesses selling goods online. "This is not", he said, "an online sales tax on goods ordered over the internet; such a tax would fall on consumers of those goods". The government has stated that, as part of its consultation process, it will consider whether further exemptions should be available to minimize the potential for regressive impacts but the precise nature, extent and operation of all exemptions will clearly require careful drafting in the legislation.

The UK DST will be deductible as an allowable expense for the purposes of corporation tax, but, crucially, because it is not a tax on profits, it does not purport to be within the scope of the UK's double tax treaties and so neither treaty relief nor local country creditability is likely to be available. In the absence of unilateral domestic relief, double taxation is, therefore, almost certain to result for affected businesses.

A number of exceptions will further restrict the UK DST tax base. These include:

- **A double threshold** – Businesses generating less than £500 million a year of relevant revenues *globally* will not be liable to UK DST. In addition, the first £25 million a year of relevant revenues generated in the *UK* will be exempt.
- **A safe harbour** – Businesses will be able to make an election to calculate their DST liability using an (unspecified) "alternative basis". In effect, the alternative calculation should ensure that only profitable businesses are liable to UK DST at the full 2% rate while those businesses with (as yet undefined) "very low profit margins" will be able to elect to be liable at a reduced rate.
- **A five-year review clause** – The government has committed formally to review the DST in 2025.

The UK government claims this commitment to review DST as part of a pledge to "continue to lead" efforts (in the G20, OECD and even, despite Brexit, the EU) to facilitate global agreement on reforming the international corporate tax framework, but the fact is the UK is breaking away from those efforts. The UK will, it says, abolish UK DST if the international community adopts an "appropriate" solution that makes it obsolete.

The government expects the new tax will raise £1.5 billion over the four-year period 2020-24. Although the government's intention to consult on the design of the UK DST over the next year is welcome, the consultation will not extend to the existence of a UK DST and it is probable that the UK will legislate for the new tax to take effect from April 2020.

All-in: Will Others Follow?

It is noteworthy that the UK has chosen to act now and act alone. Ironically, HM Treasury was never a particular fan of the European Commission's proposals for an interim DST, notwithstanding that proposal shares similar design principles with the UK DST, albeit having a broader base and a higher 3% rate. Bogged down by the need to secure the unanimous support of all EU member states, the European plan is struggling to make progress irrespective of positive pronouncements, however unfounded (mainly originating in France), of the possibility of adopting the plan by the end of 2018. Italy, Hungary and, more recently, Spain have already tired of the lack of progress and either adopted, or announced an intention to adopt, rules to tax digital businesses.

In addition, while the UK has published its thinking on digital disruption, the digitalization of the global economy, and the challenges it presents for the international corporate tax framework, the UK has, to date, always been a firm supporter of multilateral efforts to address them. The UK has generally worked from a position of influence within the G20 and OECD to facilitate change. India has already implemented a form of digital tax (an equalization levy charged on online advertising revenues since 2016) while Australia published a Treasury Discussion Paper in October (following much of the UK's own logic) considering whether it should "pursue interim options ahead of an OECD-led, consensus-based solution". It is possible the UK's action will precipitate a number of other countries choosing to act sooner rather than later.

Keep Them Honest: Is the UK Bluffing?

The question, then, is what really lies behind the UK announcement?

It is possible that the UK wants to make, in the words House Ways and Means Committee Chairman Kevin Brady (R-TX) has used to describe it, "a blatant revenue grab", taking advantage of being a "first mover" in the area (alongside Spain, Italy and India). However, given the expected annual revenue take from the UK DST is likely to be just £440 million per annum by 2024 (it could actually be significantly greater if the targeted tax base has been miscalculated), the "grab" could easily have been much, much bigger simply by imposing a higher rate. If this was solely what UK DST is about, the UK has undoubtedly missed an opportunity.

The more likely explanation for the UK's action is political. Domestically, the government can present UK DST as an exercise in "fair taxation"; increasing the UK tax bill of multinational enterprises, widely perceived to be avoiding contributing their fair share, is going to be popular with the public. Internationally, it is possible the UK feels the need (or simply wants) to exert some political pressure to hurry along the OECD's work; in the Chancellor's own words, "progress is painfully slow. We cannot simply talk forever". By pre-empting the OECD and EU, the UK is perhaps attempting to position itself in the vanguard of efforts to remould the international tax framework. Global, post-Brexit, Britain indeed.

A Royal Flush: Does the UK Hold the Best Hand?

If that is true, it will be disappointing for three main reasons:

First, as a tax on revenue, a DST is, at best, a crude and poorly targeted tool to tax multinational enterprises. It ignores long-established principles of international taxation and, by its unilateral nature, does so outside the accepted forum for changing those principles.

Second, it incentivizes and justifies other countries taking similar, but not identical, actions.

Third, it focuses solely on particular types of digital businesses and ignores the much bigger, more pressing, challenge presented by the digitalization of the global economy as a whole.

In those three respects, the swift condemnation from the president of the US Chamber of Commerce, Tom Donohue, that the UK DST sets "a dangerous precedent" is justified.

In addition, there are several design problems inherent in the current UK proposal. These include:

- **Extra-territoriality** – The extra-territorial extension of the UK tax-base. By focusing on "UK user participation", the point of taxation shifts from "source" to "consumption", decoupling a jurisdiction's taxing right from the requirement a taxpayer has a taxable presence (or nexus) in that that jurisdiction. Perhaps this should not come as much of a surprise because the UK has already dabbled in extending its tax base beyond its borders; see, for example, both the Diverted Profits Tax and the new regime for taxing offshore receipts in respect of intangible property (previously known as the Royalties Withholding Tax) coming into effect from April 2019.
- **Basis** – Assuming it is accepted that taxation should align with the location of value creation, and one can define what "value creation" means, that shift in tax point is only justifiable if the central assumption underpinning UK DST, namely that "user participation" can be equated with "value creation" (or economic activity), is accepted. It is an easy and convenient assumption to make, but not one that is universally accepted nor one that is immediately obviously correct.
- **Diplomatic** – Not only does the UK DST focus solely on digital businesses, but the exceptions also restrict its scope to a relatively small number of global businesses. The restriction is undoubtedly intentional and could be interpreted as being discriminatory. There is no desire on the part of the UK government to damage UK businesses. As the Chancellor himself pointed out, it has been "carefully designed to ensure it is established tech giants, rather than [UK] tech start-ups, that shoulder the burden of this new tax". The backlash in the US has been both swift and predictable.

Perhaps UK DST is an elaborate bluff. Possibly, but it will be interesting, in light of Brexit and the UK's desire to negotiate new Free Trade Agreements in the coming years, to see whether, and how, other countries call it. The UK is playing for high stakes now. It is clear that a global patchwork of national responses to digitalization is starting to emerge. For that reason alone, the reaction within the OECD's Centre for Tax Policy and Administration to the UK's announcement is undoubtedly one of deep irritation and frustration.

Taxation of the digitalized global economy is a local and global phenomenon. It is an area of fluid evolution.

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