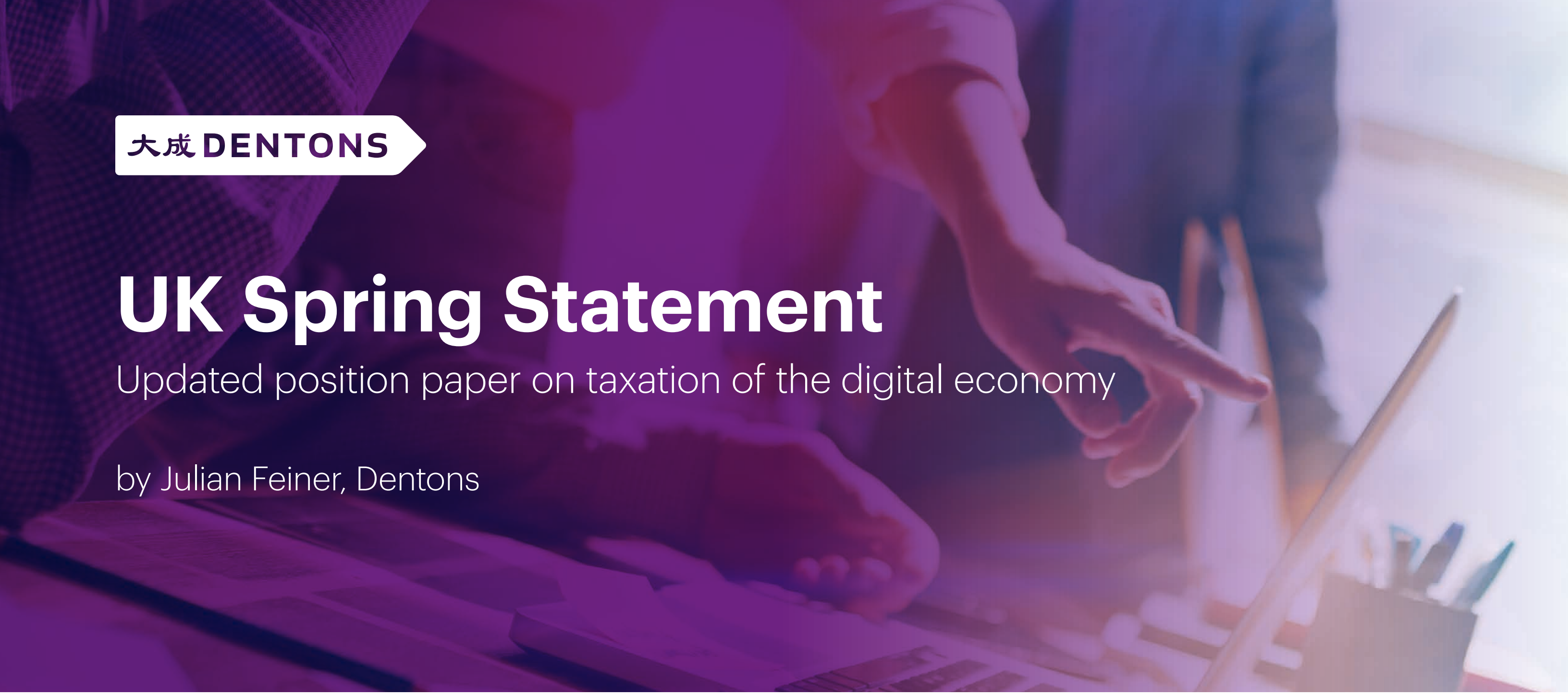

UK Spring Statement

Updated position paper on taxation of the digital economy

by Julian Feiner, Dentons

Julian Feiner of Dentons, London, discusses the UK government's updated position on corporate tax and the digital economy, published March 13, 2018 as part of the government's Spring Statement

The UK government's Spring Statement, delivered March 13, 2018, includes an updated position paper on corporate tax and the digital economy, to address feedback provided during public consultation.

The paper addresses one of the fundamental objects of the OECD BEPS Project: to develop a fair and effective option to reform the corporate tax framework for certain digital business models.

The principle driving the reform is that profits should be taxed in the country in which value is created. The UK, and other European governments, perceive that the current framework enables certain digital businesses to avoid tax in the countries in which value is created, in particular the "user-created value" of certain social networks, search engines and online intermediation platforms.

The challenge is to find a solution acceptable to OECD and G20 countries, including the US, where many digital businesses are formed. Failing a multilateral solution, the UK has indicated that it is prepared to enact an interim measure together with other EC countries, or unilaterally if necessary.

Long-term reform proposal

The UK's long-term proposal is to tax the profits of a non-resident digital business to the extent that its profits are attributable to the value created by UK users. It would achieve this by reforming Articles 5, 7 and 9 of the OECD Model Tax Convention, so that a permanent establishment is created in the UK if user participation in the UK creates significant value for the non-resident digital business.

The key questions are who would be taxed, to what extent, and on what technical basis:

- Who would be taxed? The UK would likely seek to tax the companies in the group that receive the residual profits of the business, after the activities of group service providers have been awarded an arm's-length return. These are the companies that have control over the decisions and risks within the group and are likely to own the group's brand, trade mark and customer-related intangibles. If there are multiple companies, to avoid administrative complexity the UK might allow the group to nominate one representative taxpayer.

- How much would they be taxed? This is entirely unclear at the moment. First, the user-created value has to be measured. This will be difficult and highly contentious. The position paper merely acknowledges the difficulty and suggests that the OECD could specify relevant parameters. Second, once the user-created value is measured, it must be allocated between the countries where the users are based. The UK recognises the limitations of an allocation key based on user numbers, and instead appears to favour an allocation key based on the revenues that the business generates from those users. This would need to be tailored to the particular business types. The amount allocated to the UK would then be subject to tax at the current corporation tax rate. At the moment we have no sense of the anticipated UK tax revenue. It could be low if, for example, user-created value is only 1 per cent of the residual profit and that 1 per cent is shared among 30 countries. Or it could be extremely high, if user-created value exceeds 50 per cent of the profits and is shared among a small number of countries. Until we have a better sense of the expected impact, it is hard to predict how other countries will respond to the proposal. A country that has relatively high user numbers, but few of its own digital businesses, could obtain increased tax revenues under the proposal (and vice versa).

- On what technical basis? The tax treaties would be amended so that a digital business has a permanent establishment in the country where user value is created. The UK considers that this should only arise where there is a "material user base that is being monetised by the business". The threshold for a permanent establishment might be based on a combination of metrics, including the number of active users and the revenues generated from those users.

Other practical challenges include the measurement of residual profit for the group, coping with currency differentials and the differences between countries in the calculation of taxable profit.

Overall, even if the technical issues are resolved, in practice it is hard to see how multilateral agreement will be obtained from countries which stand to lose significant tax revenue. The UK may need to consider in more detail its options to implement the proposal unilaterally.

Interim measure proposal

Recognising the difficulty in securing the long-term reform, the UK proposes an alternative interim measure, in the form of a revenue-based tax, to compensate for unrecognised user-created value.

This would be in the form of either a tax on the revenue streams of digital businesses on a case-by-case assessment, a tax on the revenue of objectively defined categories of businesses (e.g. social networks, search engines and online marketplaces), or a tax on defined categories of revenue streams of digital businesses (e.g. online advertising and/or revenues from facilitating third-party transactions on an online platform). Or it could perhaps be a combination of those approaches, supported by a de minimis threshold or safe harbour, to protect start-ups, growth companies and loss-makers.

There are various challenges with this approach. In particular, how to allocate the revenue for online marketplace platforms between the users in different jurisdictions, how to track the location of users who travel frequently, and how to set the tax rate at an appropriate level that compensates the UK for user-created value, but recognises that the tax will be applied to businesses with different profit margins as well as to businesses that are making losses in trying to expand their market share.

Moreover, the rationale for having a revenue-based tax, rather than a profits tax, is not clear. It accords with the initial draft of the European Commission's proposal, which was leaked to the press in late February. However, recent reports suggest that the EC may instead propose a profit-based tax, following further consultation. We will wait to see the final EC proposal, expected on 21 March.

Formal OECD proposals are also expected shortly. This is now a hot issue, with momentum building for change, particularly in Europe, but there are many technical and practical obstacles to overcome.

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