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UK TAX QUARTERLY UPDATE – THE UK DIGITAL SERVICES TAX

To Our Clients and Friends:

The government has introduced, with effect from 1 April 2020, a new 2% digital services tax ("**DST**") levied on the revenues of search engines, social media services and online marketplaces which derive value from UK users. There was some speculation prior to the Budget delivered on 11 March that the measure would be withdrawn or postponed pending international agreement on long-term reform of the international corporate tax rules in respect of digital businesses. With the Finance Bill 2019-21 due for its second reading in the House of Commons on 22 April, there remains a remote possibility that the effective date of the DST may yet be delayed before the Bill receives Royal Assent.

This Alert details some of the factors that have influenced the introduction of DST and its wider implications for multinational enterprises. It follows our previous Alert "*Taxing the Digital Economy*" published 18 December 2019 (which can be accessed here).

For our client alert on broader tax measures in respect of the 2020 Budget, please click here.

We hope that you find this alert useful. Please do not hesitate to contact us with any questions or requests for further information.

International context

The measure comes following wider negotiations at the OECD level with over 130 countries that aim to address the tax challenges of the digitalisation of the economy. In particular, it was perceived that the OECD Model Tax Convention on Income and Capital as currently drafted does not recognise the value created by user participation. This may create a mismatch between the location of value-generating activities and taxable profits of certain digital business models. The current proposal at the OECD level is that despite minimal physical presence, multinational businesses would pay some of their corporate income taxes where their consumers or users are located – a departure from established international tax norms.

The European Commission proposed in March 2018 its own turnover tax on digital businesses, pending reform of its common corporate tax rules for digital activities. Such proposals have however been laid aside due to opposition from several EU member states. Despite ongoing negotiations, a growing list of countries (including the UK, France, Austria, Hungary, Italy and Turkey) have decided to move ahead with unilateral measures to tax the digital economy.

Despite the political challenges of replacing a revenue-generating measure such as the DST (for example to conform with a future multilateral solution at the OECD level), the UK government has committed to reviewing the position by the end of 2025 in order to better align UK tax policy with the international consensus. Any repeal of the DST at that time however, would be conditional on that consensus properly addressing the core mismatch issues outlined in the OECD Interim Report on Taxation Challenges in the Digital Economy (March 2018). The OECD is currently working towards reaching a political decision at the OECD/G20 meeting scheduled for 1-2 July 2020 in Berlin on the key components of a multilateral solution.

Scope of DST

The UK's DST applies to business groups whose worldwide revenue from search engines, social media services and online marketplaces exceeds £500 million, with more than £25 million of these revenues deriving from UK users. There is an allowance of £25 million, which means a group's first £25 million of revenues derived from UK users will not be subject to DST. Further, where revenues arise in connection with both a digital services activity and anything else, the revenues attributable to the digital services activity is to be determined by the taxpayer on a just and reasonable basis.

Taxable UK digital services revenues will include any revenue earned by the group which is connected to the social media service, search engine or online marketplace, irrespective of how the business monetises the service, and provided such revenues are attributable to UK users. Revenues may be attributable to UK users if the revenue arises by virtue of a UK user using or paying for the service, subject to certain exceptions. Advertising revenues however are derived from UK users when the advertisement is intended to be viewed or consumed by a UK user.

The rules are also helpful in detailing what should not fall within the scope of DST. For example, large businesses that have a search facility on their website should not be considered to be carrying out an internet search engine activity for DST purposes. The UK government has noted that it is not clear how the rules apply to marketplace delivery fees, but has committed to considering this further in line with the policy rationale of the DST.

A UK user is an individual that is normally located in the UK, or a business that is established in the UK. These concepts are not further defined in the legislation, with the intention presumably being that it would not be practical for taxpayers to determine where its third-party users are resident for broader tax purposes. HM Revenue & Customs ("**HMRC**") guidance clarifies that a UK user does not include a UK employee of a business, confirming that an activity can only be a service for DST purposes if it is provided to third party users. For example, internal company social media platforms or message boards for employee use should fall outside the scope of DST.

Associated advertising

The scope of the new tax is broad, so that the provision of a search engine, social media platform or online marketplace services include the carrying on of any associated online advertising service. An associated online advertising service is one that is operated on an online platform that facilitates the placing of online advertising, and derives significant benefit from its association with the social media

platform, search engine or online marketplace. HMRC guidance on the concept explains that the definition is broad and intended to cover online services at all stages in the online advertising process or value chain. It also includes supporting technologies which facilitate the display of online advertising, such as ad exchanges and analytic programmes.

Financial services exemptions

There is a notable exemption from the online marketplace definition for financial and payment services providers with more than half their relevant revenues arising from the trading of financial instruments. This should make administrative sense given a UK regulatory environment that predominantly requires such services to be booked in the jurisdiction where the consumer resides. Notably however, the concept of financial instruments takes its meaning from relevant accounting standards, and not by reference to the provider's regulatory approvals (whether UK, EU or elsewhere). A narrowing of the exclusion to providers that are regulated may be seen in later iterations of the DST.

Alternate method of calculation

Interestingly, groups will be able to elect to calculate their DST liability under an alternative method that considers a proportion of relevant operating expenses attributable to UK digital services revenues applicable to the group. The election is intended to ensure that the new tax does not have a disproportionate effect on business sustainability in cases where a business has a low operating margin from providing in-scope activities to UK users.

If a taxpayer group has two in-scope activities (such as an online marketplace and an internet search engine), it could choose to apply the alternative method to one, both or neither of these activities. The calculation then includes:

a. determining a UK group profit (or "operating") margin for each type of activity for that accounting period after including a just and reasonable share of relevant operating expenses, but which excludes:
    i. interest,
    ii. the acquisition of a business,
    iii. events outside the normal course of business,
    iv. a change in the valuation of any asset, and
    v. any tax (irrespective of territory);
b. apportioning the £25 million allowance pro-rata to each type of activity;
c. for any elected activity, the taxable amount is 0.8 x the operating margin x the net revenues (for any non-elected activities, the taxable amount is 2% of the net revenues as normal);
d. the aggregate result or "group amount" is then apportioned to individual group companies according to their respective contributions to UK digital services revenues.

By way of example, a business operates both an online marketplace and a social media platform, generating £1 billion of UK relevant revenues and incurring £800 million of relevant operating expenses. Intuitively, this may imply a 20% operating margin, however a just and reasonable allocation of revenues and operating expenses between the activities (e.g. following a review of management accounts) provides:

a. Marketplace: 75% of revenues, 93% of operating expenses; and

b. Social media: 25% of revenues, 7% of operating expenses.

UK relevant revenues (£1 billion)	***Less* £25 million, allocated by revenue proportion**	**Allocate operating expenses to determine operating margin**	**DST method**
Marketplace 75% (£750 million)	£750 million, *less* £18.75 million (=£731.25 million)	Marketplace 93% (£744 million) (= 0.8% operating margin)	***Normal method*: 2%** x 731.25 million = £14.625 million *Alternative method*: 0.8 x 0.8% x £731.25 million = £4.68 million
Social media 25% (£250 million	£250 million *less* £6.25 million (=£243.75 million)	Social media 7% (£56 million) (= 78% operating margin)	***Normal method*:** 2% x £243.75 million = £4.875 million *Alternative method*: 0.8 x 78% x £243.75 million = £152.1 million
Search engine 0% (£nil)	£nil *less* £nil (=£nil)	Search engine 0% (= nil% operating margin)	£nil

In the above example, due to the very low operating margin, it is only beneficial for the taxpayer to elect for the alternative method in relation to online marketplace revenues. This results in total DST due of £4.68 million, rather than the £14.625 million that would have been due under the normal method of calculation subject to the full 2% rate.

Cross border relief

Transactions concluded on a marketplace may often be cross-border in nature, so that the revenues may be linked to both a UK user and a foreign user. Normally, all the revenues from the transaction will be UK digital services revenues, however subject to a valid claim being made, UK digital services revenues from qualifying cross-border transactions may be reduced by 50%. In order to qualify, the cross-border transactions should be:

a. a marketplace transaction where a foreign user is a party, and

b. where all or part of the revenues arising in connection with the transaction are, or would be, subject to a foreign digital services tax charge.

To prevent distortion of the relevant operating margin where an election for the alternative method of calculation is made, the group must also disregard a corresponding 50% of any relevant operating expenses incurred in respect of qualifying cross-border transactions.

Taxpayers may be concerned as to what constitutes a foreign DST. Importantly, a foreign DST need not be identical to the UK DST, but should be "similar". As there is no further legislative interpretation, HMRC guidance on the matter will be important in practice. HMRC has not as yet published a list of countries it views as having a similar tax, but has provided that it will look objectively as to whether the foreign DST is similar in nature and character to the UK DST. In particular, whether the tax:

a. is levied on gross revenues;

b. is calculated on the revenues that are derived from users in that territory; and

c. applies to broadly similar services based on a similar policy rationale.

HMRC acknowledges in its guidance that some foreign DSTs apply a different approach to the UK DST in identifying taxable revenues. For example, the calculation of certain foreign DSTs involve the multiplication of total taxable revenues by the proportion of total users in that territory (i.e. not requiring identification of individual transactions). Consequently there can be difficulties for taxpayers in proving the same revenues have been subject to a foreign DST charge. It is welcome therefore, that HMRC's interpretation of the words: "or would be," in limb (b) applies where the relevant transaction is included in the tax base of the foreign DST in a way that increases the charge of the business. As long as the business demonstrates a relevant transaction has been subject to a foreign DST, it is not necessary to demonstrate how much foreign DST has been paid in respect of individual transactions.

Taxpayers may wish to take a pragmatic view in respect of applying for cross border relief claims and should note that due to differences in thresholds and calculation methods (for example the French DST targets certain revenue streams rather than activities), there may be some businesses that are in scope of only one DST. Businesses that are in scope of multiple DSTs may also come to appreciate that the allocation of revenues to each country may not be seamless – for example the UK seeks to tax revenues connected to users *normally located* in the UK, whereas the French DST taxes revenues attributable to users' interaction with the platform *whilst they are physically located in France*.

As taxpayers are unlikely to benefit from double tax treaty relief in respect of DST paid, and different jurisdictions may have different policies on the deductibility of DST for corporate income tax purposes (see *Interaction with UK tax treaty obligations, EU state aid rules and other taxes* section below), it is important to note that businesses deriving in-scope revenues in more than one jurisdiction may be subject to multiple DST charges on the same global revenues, that are not otherwise creditable under a double tax treaty.

DST liability

DST is calculated at the group level, but the tax liability falls on the individual entities in the group that realise the revenues that contribute to the total. The charge is then allocated to the individual entities that recognise the UK digital services revenues, in the proportion of their contribution to the group's total digital services revenues. DST uses group and revenue recognition principles from applicable accounting standards to determine the total.

A single entity in the group will be responsible for reporting the tax to HMRC. Groups can nominate an entity to fulfil these responsibilities, otherwise, the ultimate parent of the group will be responsible. Although the tax starts from 1 April this year, no DST is expected to be collected before 2021 as the tax is charged on an annual basis with DST for existing businesses due following the end of 9 months from the end of the accounting period (following 1 April) of the group for which the relevant provider is a member.

Interaction with UK tax treaty obligations, EU state aid rules and other taxes

As DST applies to all in-scope digital revenues irrespective of the residence of the entity recognising the revenue stream, the UK government does not expect it to discriminate against non-resident businesses or to fall foul of non-discrimination provisions that form part of the UK's existing tax treaty obligations. In addition, the tax is thought by the UK government to maintain the essential character of a revenue tax (this is not the first time the UK has implemented such a tax, for example the petroleum revenue tax introduced in 1975). That is, a tax separate from corporation or income tax, and therefore not subject to the same tax treaty limitations applicable to taxes on income of non-resident companies. This may be an overly simplistic characterisation however, as businesses that pay DST under the alternative method of calculation (see above) which permits certain operating expenses may be paying a tax that is closer to profit, than revenue, in nature.

The European Commission has been particularly proactive in the implementation of EU state aid rules in recent years. It is unlikely the progressive nature of the DST should entail a selective advantage in favour of lower-turnover undertakings to constitute a breach of EU state aid rules. Support for this can be found in the legal opinion by Advocat General Kokott in case C-75/18 (*Vodafone Magyarország Mobil Távközlési Zrt*) which concluded that a special progressive telecommunications tax imposed between 2010 and 2012 in Hungary did not constitute a selective advantage (and therefore did not constitute state aid). The DST may otherwise represent a derogation that is justified by reference to the nature or general scheme of the underlying system.

The government has however concluded that the DST should not be creditable against any UK corporate tax liability, as such a credit may be seen as discriminatory under EU law. Absent a UK-EU trade deal following Brexit, World Trade Organisation rules would then become relevant which may achieve broadly the same result.

HMRC guidance indicates that DST, being an expense directly related to the earning of a business and a legal obligation, should in the normal course be deductible for UK corporation tax purposes, however deductibility should be assessed on the particular facts of the business. Under normal “wholly and exclusive” rules on the deductibility of expenses, were DST to be deductible for UK corporation tax purposes, we may expect the same principle to apply to digital services tax liabilities enacted in other jurisdictions.

Although DST is assessed at the group level, DST liability falls on those companies in the group that recognise the UK DST revenues. Consequently, taxpayers may wish to review their group structure arrangements to determine the extent to which DST may be deductible for UK corporation tax purposes. Similarly, where there are controlled transactions between associated enterprises in the group, the companies may wish to consider the treatment of the DST charge in arriving at the arm’s length price for transfer pricing purposes.

Concluding thoughts

DST seems likely to affect a relatively small number of groups, many of which are headquartered in the US. Given the interactions between France and the US in the case of France’s equivalent digital tax and threatened retaliatory tariffs by the US, the introduction of the UK DST at a time when the UK is seeking to agree a UK/US trade deal will be an interesting position to monitor going forward.

Although publicised to be temporary in nature, taxpayers should be prepared for the measures to last until at least the end of 2025. Government published costings in March 2020 reveals expected tax receipts from DST in 2024/25 to be c.£515 million. This may be indicative of UK government expectations as to when a multilateral solution may actually come to fruition.

Gibson Dunn’s lawyers are available to assist with any questions you may have regarding these developments. For further information, please contact the Gibson Dunn lawyer with whom you usually work, any member of the Tax Practice Group or the authors:

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