It's a digital world

David Klass considers the background and main features of the digital services tax which was introduced in April 2020.

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After many months in the planning, the UK digital services tax (DST) came into force on 1 April 2020. It is a new 2% tax on specified revenues of search engines, social media services and online marketplaces which derive value from UK users.

Background

The context of the genesis of the DST was the attempt to agree, at an international level, how to tax multinationals operating in the 'digital' economy more effectively than the existing – somewhat arcane – principles of international taxation would allow.

Those principles include the requirement that a business has some form of taxable presence based on traditional concepts of international taxation – typically that of the 'permanent establishment' – in the country concerned to entitle that jurisdiction to subject its profits to taxation there.

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So if, by means of careful structuring, a multinational was able to avoid creating such a permanent establishment in a particular jurisdiction, that multinational could avoid being subject to tax there even if it generated significant profits by virtue of operating there digitally.

The argument is that the current international corporate tax rules are not fit for the purpose of effectively taxing businesses which operate in the digital economy.

Key points

- Current international corporate tax rules are not fit for purpose for the digital economy.
- Several countries have introduced a digital services tax to ensure multinationals pay tax where they generate profits.
- The UK digital services tax came into force in April 2020 at a rate of 2%.
- It is a turnover tax and applies to digital service revenues rather than profits.
- Some businesses have passed on the cost further down the chain.

The Organisation for Economic Co-operation and Development has been campaigning hard for the need to reach a global consensus on how to address the digital services taxation issue. But in the absence of meaningful progress, some governments have decided to introduce digital services taxes unilaterally.

Among the first governments to do so was France, which introduced a digital services tax – with a broadly similar scope to that of the UK's – in 2019. The French digital services tax had something of a rocky ride on its introduction, because the US raised significant objections, claiming that it discriminated against American multinationals in part due to its exemption of businesses with annual worldwide digital services revenues of less than €750m.

The US launched an internal legal review of the French digital services tax and, having found that it infringed some principles of international law, informed France that it would introduce what were, in effect, retaliatory measures if France insisted on implementing the new tax as planned. In the face of those threats, France elected to modify its regime, including an agreement to postpone the collection of any tax until 2021.

On 6 June of this year, the Office of the US Trade Representative (USTR) announced that it was opening an investigation into several existing and proposed digital services taxes, including the UK's. Among other things, it alleged de facto discrimination against US companies in light of the large thresholds for liability which resulted in smaller, and therefore likely non-US headquartered digital services providers not being caught by the new rules.

There was in fact some doubt as to whether the UK government would introduce the DST in the light of the stance adopted by the US but, ultimately, the decision was taken to press ahead – and one imagines the UK government is glad that it did so, bearing in mind the impact of the Covid-19 pandemic on the public finances.

The DST represents part of a longstanding international process, but it is also significant that it has come into force just when the impact of Covid-19 means that the UK government's tax take is under greater pressure than perhaps at any point in recent memory.

As is often the case in situations such as the present one, there are winners as well as losers. Providers of digital services are among the former and are likely to remain in robust economic health. If the UK government had wanted to single out an area of the economy for additional taxation, it is likely this would have been the one; the DST represents a new form of targeted taxation that it has considered, consulted on and designed already.

Outline of the operation of the DST

The DST regime is set out in FA 2020, having been announced at Budget 2018, and consulted on since late that year. To apply, the following two annual revenue thresholds must be met:

- £500m of worldwide revenue from the digital services activities; and
- £25m of those revenues being attributable to UK users.

If those are met, the first £25m of worldwide in-scope revenues (so-called 'UK digital services revenues') are exempt, with the excess subject to tax at a rate of 2%.

One of its key, distinctive features is that it is a turnover tax, which distinguishes it significantly from corporation tax. So it is applied to revenue rather than profit.

Digital services activities

Digital services revenues arise in connection with digital services activity. These comprise the provision of:

- a social media platform, such as Facebook;
- an internet search engine, such as Google; or
- an online marketplace, such as Amazon.

In connection with an online marketplace, in-scope revenue would typically be commission on a successful transaction, but could cover numerous other types of fees as well. Although there have been calls for a tax on the sales of companies such as Amazon (and these have become increasingly audible as the consequences of the Covid-19 pandemic continue to unfurl), the government has always been clear that this was not its aim in introducing the digital services tax.

In connection with a social media platform, subscription fees payable by members are an example of fees that would be in-scope. HMRC's guidance contains examples of typical revenue for each of the three in-scope digital services activities.

In the guidance, HMRC states that the following types of website will typically be covered in the social media category:

- social networking;
- professional networking;
- micro-blogging;
- video sharing platforms;
- online dating; and
- platforms that exist primarily to share user reviews.

Notwithstanding this elaboration, the social media platform is arguably the activity whose precise scope remains difficult to define, particularly when a website does not easily fall into or outside the categories referred to above.

The legislation provides that the following two factors should be considered to help determine whether the activity of a website constitutes a social media activity:

- the main purpose, or one of the main purposes, of the service is to promote interaction between users, including interaction between users and user-generated content; and
- making content generated by users available to other users is a significant feature of the service.

There will still occasionally be areas of uncertainty, where detailed further consideration will be required – with the assistance of HMRC guidance – to determine whether a particular scenario could constitute a social media platform.

By way of example, one such area is that of video games which facilitate online interaction with other gamers. There is no 'one size fits all' answer – the nature of video game, and the importance of the multi-player feature will be significant considerations, there being a difference between games which merely have a multiplayer functionality and those which are considered 'massively multiplayer online' (MMO) games.

Attribution of UK digital services revenues

Of a group's worldwide revenues arising from in-scope activities, only those attributable to UK users (the UK digital services revenues) are within the scope of DST.

The rules determine the extent to which digital services are attributable to UK users by setting out five cases, the first four being specific to types of scenario and the fifth being a 'catch all' provision.

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- Cases 1 to 3 concern attributing digital services to UK users in the context of online marketplaces. They provide that when either there is a transaction to which a UK user is party (case 1), the subject matter is land or accommodation located in the UK (case 2) or the revenues relate to advertising which is paid for by a UK user (case 3), the relevant revenues will be considered attributable to UK users. So, in the context of an online marketplace transaction where a user is a UK user, all the revenue from that transaction will be UK digital services revenues, regardless of whether the UK user is providing or consuming the goods or services in question.
- Case 2 ensures that online marketplace revenues will be UK digital services revenue if connected with accommodation or land in the UK, regardless of both the owner and the user's residence position.
- Case 3 applies to the listing or advertising of specific property on online marketplaces and is aimed at listing fees, regardless of whether a successful transaction arises.

Planning point

The rate of the digital services tax for UK digital services revenues arising from online marketplace transactions is reduced by 50% when the foreign user is in a jurisdiction that applies an equivalent charge.

- Case 4 concerns revenue which is online advertising revenue, and the advertising is viewed ('or otherwise consumed') by UK users.
- Case 5 – the catch-all provision – states that when none of cases 1 to 4 applies but the digital revenues 'arise in connection with UK users', they will be attributable to UK users. In its guidance, HMRC expresses the view that revenues typically falling within case 5 will be subscription fees and other fees paid to access specific content such as premium content.

A UK user, if an individual, is a person who is normally in the UK and, if a non-individual, they will be a UK user if they are established in the UK. In each scenario, the test is whether it is 'reasonable to assume' that such is the case.

The DST applicable to UK digital services revenues arising from online marketplace transactions is reduced by 50% in the case of a cross-border transaction when the foreign user is in a jurisdiction which has a similar DST regime – a form of double taxation relief.

Pass on the cost

The recent decisions by Amazon and Google – arguably two of the prime targets of the DST – to pass on the cost of the UK DST to some of their fee-paying customers (in Amazon's case, sellers and in Google's case, advertisers), may not have come as a great surprise to the UK government.

It should not materially affect the level of revenue arising from the UK DST. One would have thought the additional charge is unlikely significantly to deter such users from benefiting from those digital platforms. The decision does mean however that the profits of those companies are likely to remain unaffected by the introduction of the DST. So if one of the aims of the introduction of the tax was to try to ensure particular multinationals paid something closer to an amount of tax representing their 'fair share', the decision to deflect most if not all of the cost of the DST to other parties in the online ecosystem may initially raise some eyebrows.

Ultimately, however, it seems likely to be accepted as a cost of doing business on these platforms which are – perhaps more than even before – a fundamental part of modern commercial life.

Author details

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