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Corporate tax and the digital economy

Lots of questions – but no simple solutions.

Heather Self
Blick Rothenberg
Heather Self is a partner at Blick Rothenberg. She has over 30 years' experience, most recently as a partner at Pinsent Masons and prior to that as the head of tax at a FTSE 100 company, an anti-avoidance adviser at HMRC and a partner at a Big 4 accounting firm. She is recognised for her work in setting up the 'Women in Tax' network and regularly speaks and writes on tax matters. Email: heather.self@blickrothenberg.com; tel: 020 7544 8752.

The concept of a permanent establishment worked well in the days when a physical presence was needed in order to sell goods. With the increasing growth of digital business transactions, the role of the 'sales rep' has almost disappeared, and governments across the world struggle with how to extract their 'fair share' of taxation.

This paper updates the one published at November 2017, and continues to explore the concept of 'user value'. There is a recognition that simply taxing businesses by reference to sales would have unforeseen consequences, particularly as more and more sales are made over the internet. Hence it is agreed that mere sales do not create value, but that in some cases the users themselves contribute significantly to the enterprise's value chain. The challenge is how to recognise, and then tax, that value.

User-created value is considered to arise in a number of situations. Four channels are identified:

- User-generated content, for example an online platform which generates revenue from selling advertising on a platform populated by users' posts and photos;
- Users who form strong relationships with an online platform, so that the business can generate valuable data through monitoring of users' engagement;
- Building a large user network, so that the value a user derives is enhanced by the number of other active users; and
- Contributing to brand strength and reputation, for example through user participation in reviewing and rating services.

The long term solution is far from simple, and the paper recognises that achieving consensus will be difficult (for which, read impossible in the next few years?). For many years, OECD transfer pricing principles have allocated value by reference to functions, assets and risks: the proposal is that a new element should be added, in respect of user value. This would mean updating the OECD model convention in respect of articles 5 (permanent establishment), 7 (taxing business profits attributable to a permanent establishment) and 9 (profits should be commensurate with value generated). Crucially, the end result would be that some of the profit currently considered to be entrepreneurial profit would be reallocated to the location of users. It is recognised that any long term solution would need international agreement, probably via the OECD. The obvious difficulty with this is that the US, in particular, is likely to object strongly to its taxing rights being reduced.

The paper therefore also outlines a potential interim solution, which is aligned with the EU's proposals for a tax on revenues. The government would prefer a multilateral solution, but makes clear that it will press ahead with a sub-group of like-minded countries, or alone if necessary.

The aim of a revenue-based tax would be to 'raise revenue from digital businesses that are deriving material value from user participation'. This poses a number of challenges, in identifying the appropriate businesses, ensuring the tax can be applied effectively (particularly where groups have multiple business lines) and recognising that groups will have varying levels of profitability. In determining the scope of the tax, three legislative approaches have been identified:

- Define the channels through which users create value, and then impose a tax on revenue streams of businesses for whom those channels are 'most relevant';
- Objectively define the categories of businesses that derive most value from user participation, and then impose a tax on those businesses. For example, this might involve defining social media platforms, search engines and online marketplaces; or
- Define the revenue streams that are commonly generated from those businesses, and then charge the business in relation to such revenues. This might mean a tax on revenues from online advertising or revenues from facilitating third-party transactions on an online platform.

None of these approaches is likely to be simple, and a key risk will be that as soon as a definition is agreed, business models will change so that new businesses will no longer be within scope. The sheer speed of development in this area makes it unlikely that a stable tax base could be identified. Whichever approach is used, there is likely to be a high *de minimis* threshold, in order to protect start-ups and smaller businesses.

It will also be necessary to identify which revenues should be subject to charge in the UK, and this will involve identifying UK users. Whilst there are some practical difficulties (such as users who are travelling, or using a virtual private network), the document notes that similar challenges have been overcome for VAT. This does, however, beg the question of why a revenue-based corporate tax, rather than VAT, is considered to be the best way to tax these digital businesses? The EU Group of Experts on the Digital Economy, which reported in 2014, addressed similar issues and recommended a greater focus on VAT, or possibly a destination-based corporate tax.

Finally, it should be noted that the updated paper does not address the proposed withholding tax on royalties. This was the subject of a separate consultation which closed on 23 February 2018, and it appears it will be introduced as planned in April 2019.

The position paper invites comments, but without setting a specific deadline. Whatever the ultimate answer, it seems likely that it will do nothing to reduce the complexity of the UK tax system, and perhaps the main aim of this paper is for the chancellor to be seen to be at least thinking about 'doing something' in relation to the taxation of digital businesses. ■

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- Taxation of the digital economy: unilateral measures (B Jones, S Seabrook, S Sciliberto & G Jones, 1.3.18)
- The royalties withholding tax consultation: non-UK UK source (J Cape & B Gilbey, 17.1.18)