Analysis

Is the DST compatible with the UK's international obligations?

Speed read

The OECD has warned against unilateral measures leading to taxation of the digitalised economy outside the international tax framework. The UK is one country that has proposed such measures: UK digital services tax. Unlike the normal charge to corporation tax on income, this proposed tax could be levied on entities with no taxable UK presence. The UK government's stated view is that the tax is consistent with the UK's international obligations. However, it may well breach both double tax treaties and international trade law. Given the OECD's warning, affected groups should refresh their engagement with HM Treasury and HMRC, raising these concerns in particular.

Rupert Shiers
Hogan Lovells
Partner Rupert Shiers has specialised in contentious UK tax issues since 2001. His current practice has a close focus on the tech sector. He has first-class honours in law from Oxford and Cambridge Universities. He has been top-ranked by legal directories for more than ten years. He is a long-serving member of the CIOT Management of Taxes Sub-Committee. Email: rupert.shiers@hoganlovells.com; tel: +44 20 7296 2966.

Jonathan T. Stoel
Hogan Lovells
For two decades, Jonathan Stoel has focused on international trade and investment law. As a partner based in Washington DC, his practice includes resolving disputes before World Trade Organisation (WTO) panels and the U.S. courts. Email: jonathan.stoel@hoganlovells.com; tel: +1 202 637 6634.

On 9 October, the OECD published a proposal aimed at reaching a consensus-based approach under which affected multinationals would pay additional tax where they have significant customer-facing activities and generate their profits. As part of this, the OECD warns of the negative consequences of countries acting unilaterally in the interim.

The UK is one of the countries that has published unilateral proposals: draft legislation was published in July 2019 for a new UK tax to be known as the digital services tax (UK DST).

Unlike the normal charge to corporation tax on income, the UK DST can apply to a taxpayer that is neither UK tax resident nor has a UK permanent establishment. For entities without such a UK taxable presence, would the UK DST, in the form published, be compatible with the UK's international obligations under double taxation treaties and international trade law? In our view, there are good grounds for concluding that the answer in each case is no.

The UK DST appears to not only risk the negative consequences that the OECD warn of, but to also run contrary to the UK's track record of sound, principles-based tax policy. It may even be potentially detrimental to the UK's international standing and ability to conclude new treaties post-Brexit.

The allocation of taxing rights on business profits

The UK has a wide network of bilateral double tax treaties. They (broadly) allocate taxing rights related to cross-border activities between two states. Many of the UK's treaties are based on the model published by the OECD ('OECD Model').

An exception is the UK's treaty with the US (UK/US Treaty). Given the number of digital services groups based in the US, and that the US is likely to be particularly robust in its stance on the UK DST, this treaty is likely to be significant. The UK/US Treaty is based on a model published by the US Internal Revenue Service ('US Model'). It is, however, structurally very similar to the OECD Model (and, as explained below, the key provisions are also similar).

The OECD also publishes commentary on the OECD Model ('OECD commentary'), as the IRS does for the US Model.

Most of the UK's treaties include a 'business profits' article based on article 7 of the OECD Model. This broadly prohibits the UK from charging taxes covered by the treaty on the business profits of an entity resident in the other state unless it has a UK permanent establishment to which the profits are attributable. Article 7 of the UK/US Treaty is similar.

So if, as will often be the case, an entity subject to the UK DST is resident in the US or another treaty state and has no UK permanent establishment, does the business profits article prevent the UK from charging the UK DST? This depends on whether the UK DST is a tax to which the relevant treaty, and its business profits article in particular, applies.

A tax on revenue

The default position under clause 8 of the draft UK DST is that, where a group meets threshold conditions for an accounting period, each group member is liable to the UK DST in respect of its proportion of the group's UK digital services revenues. Clause 9 provides an elective alternative basis of charge which, broadly, imposes the UK DST at a rate of 80% of the particular revenue stream's revenues net of certain expenses. Being calculated by reference to revenue, rather than profits, is the UK DST a covered tax for treaty purposes?

Taxes covered by the OECD Model

Article 2 of the OECD Model provides:

- that the treaty is to apply to 'taxes on income and capital' (para 1);
- that this includes 'all taxes imposed on total income … or on elements of income' (para 2);
- for a list of existing taxes to which the treaty applies 'in particular' (para 3); and
- for the treaty also to apply to any 'identical or substantially similar' taxes introduced after the signature of the treaty (para 4).

The OECD Commentary on article 2 states that the article is to 'widen as much as possible the field of application of the [treaty]' (para 1). It also makes clear that the list of taxes in para 3 'is not exhaustive. It serves to illustrate the preceding paragraphs of the Article' (para 6).

Revenues clearly appear to be an element of income. This analysis is supported by a leading academic and practitioners' work, *Klaus Vogel on Double Taxation Conventions* (2015). This states (at para 36 of its discussion of article 2): 'Articles 10 and 11 [of the OECD Model] further illustrate that gross receipts can also constitute income.'

Together, these points indicate a clear argument that despite being primarily a tax on gross revenues, the UK DST is a tax covered by treaties based on the OECD Model. As such, a UK DST charge appears to be prohibited for entities with no UK taxable presence. Article 7 of the OECD Model restricts taxes on 'profits' rather than 'income' per se. However, para 71 of the OECD commentary on article 7(4) makes clear that 'profits' should be understood to have a broad meaning, including all income derived from carrying on an enterprise.

Position under the UK/US Treaty

Article 2 of the UK/US Treaty defines the taxes it covers in a way that is essentially consistent with the OECD Model. As with the OECD Model, the UK/US Treaty will generally apply to the UK DST if the UK DST is a tax on income, or on the elements of income, 'irrespective of the manner in which … levied' (articles 2(1) and 2(2)).

Article 2(3) of the UK/US Treaty lists taxes to which the treaty applies at the date it was signed. Unlike the OECD Model, the list in article 2(3) is not expressed as being 'in particular' and as such appears to be an exhaustive list of the relevant taxes as the date of signature. Like the OECD Model, article 2(4) also extends the application of the treaty to 'any identical or substantially similar taxes that are imposed … after the date of signature'.

As explained in relation to the OECD Model, it is at least arguable that the UK DST is a tax on income or elements of income. The UK/US Treaty would therefore apply to the UK DST if it is such a tax even if it is not 'identical or substantially similar to' the article 2(3) taxes. The absence of the words 'in particular' in article 2(3) makes the position slightly less clear but in our view does not materially change the analysis. Article 7 of the UK/US Treaty therefore appears to prohibit the UK DST from being charged on a US entity with no UK permanent establishment.

The UK government's view

The UK government states that it is 'confident' that the UK DST 'is consistent' with its international obligations, including, by implication, those under double tax treaties (see paras 10.1 and 10.2 of the DST consultation document, and para 7.15 of the response to the consultation document).

In particular, it has sought to address whether the UK DST is an income tax and thus subject to the constraints that treaties impose on taxes on non-residents (DST condoc, para 10.6). The government's published view is that the UK DST will not be a covered tax to which relevant treaty provisions apply. In particular, it says that the UK DST won't qualify as a tax on 'income', as (broadly speaking) 'income' refers to net income. It states that this is the case even though the UK DST is being justified based on concerns regarding the existing corporate tax system (DST condoc, paras 10.12–10.25).

However, as explained above, both the UK/US Treaty and the OECD Model apply not only to taxes on net income but to taxes on total income or elements thereof. Further, HMRC's draft guidance on the UK DST acknowledges that the alternative basis of charge in clause 9 is specifically intended to reflect the underlying *operating profitability* of the business. The UK government has not publicly addressed either of these points.

Challenging taxation levied in breach of a treaty

Article 25 of the OECD Model and article 26 of the UK/US Treaty each set out a mutual agreement procedure (MAP) which a taxpayer can instigate if it considers that the UK DST will result in taxation not in accordance with the provisions of the treaty. This applies irrespective of domestic law remedies.

Under the OECD Model, a taxpayer can present its case to the competent authority of either state. Under article 26(1) of the UK/US Treaty, a US-incorporated entity must present its case to the IRS. The states must then engage. If no agreement has been reached within two years of the start date, the OECD Model (in article 25(5)) provides for the taxpayer to be able to request binding arbitration. There is no provision for treaty arbitration in the UK/US Treaty.

It is generally accepted (and see HMRC's *International Tax Manual* at INTM423040) that a case may be presented before tax is charged, i.e. as soon as a taxpayer can show that it will be subject to the tax. In the case of the UK DST (if not delayed), this is likely to be from royal assent to FA 2020 in Q1 2020. The UK took an average of 16 months to resolve MAP cases in 2016 and 2017, although this varied between different types of dispute (figure C.6. of the 2019 MAP peer review report for the UK). For a company with calendar year accounting periods, a MAP started as early as possible *might* reach a conclusion before the first UK DST payment date on 1 October 2021. But this is far from clear and the UK is likely to resist arguments that the UK DST is a covered tax. It may require a determined counterparty such as the US to persuade the UK.

> If the government proceeds with the UK DST in its current form ... there are credible arguments that it will breach the UK's obligations under double tax treaties, international trade law, or both

We note that no legislation has been proposed to implement tax treaties into UK law in respect of the UK DST. However, we are not aware of the UK ever resisting implementation of the outcome of a MAP.

The UK's obligations under international trade law

Double tax treaties are not the only basis on which the UK DST could breach the UK's treaty commitments. International trade law in the form of World Trade Organisation (WTO) rules is another. A threshold issue there is whether the affected digital services are (or will be) covered by a general agreement on trade in services (GATS) commitment made by the EU or, post-Brexit, the UK.

Are digital services covered?

The current GATS commitments made by the EU entered into force in 1995 when the digital economy was (at best) nascent. As a consequence, none of the services the revenues from which are subject to the UK DST are directly mentioned.

Nevertheless, there is consensus that digital services are covered by various GATS sectors. In particular, the provision of social media services, search engines, and online marketplaces appears to fall under certain enumerated GATS sectors, including, *inter alia*, data processing services, data base services, advertising, market research, retailing services/mail order and computer services. Digital services may also be covered by the EU commitments regarding telecommunication services, which cover 'the transport of electro-magnetic signals – sound, data image, and any combination thereof, excluding broadcasting' (*European Community and their member states schedule of specific commitments*, GATS/SC/31, 15 April 1994 and GATS/SC/31/Supppl.3, 11 April 1997).

If the UK leaves the EU, the UK's GATS commitments are currently expected to be largely identical to those of the EU and an effort to reduce them would be subject to close scrutiny by trading partners, including in particular the US. Accordingly, this analysis should continue to be relevant.

What do the GATS commitments require?

The EU commitments include national treatment and most-favoured nation treatment (GATS articles XVII, II). Regardless of which specific subsector (or which 'mode of supply', not discussed here) digital services fall under, the commitment is the same. This is because those EU commitments – and the public commitments proposed by the UK – are the same for all of the sectors discussed above and include no relevant reservations. They include providing market access and national treatment, without limitations. As such, the UK is prima facie prohibited from providing less favourable treatment to, or discriminating against, service providers from other WTO members.

Exceptions to GATS obligations

GATS provides an exception for prima facie violations of a GATS obligation in article XIV(d) for measures 'aimed at ensuring the equitable or effective imposition or collection of direct taxes'. The definition of direct taxes for these purposes is very similar to that of taxes on income in the OECD Model. This makes it unlikely that the UK DST is a direct tax for WTO purposes but not an income tax for tax treaty purposes.

A footnote to article XIV(d) provides guidance on when a measure related to the imposition or collection of a direct tax is considered equitable. The UK government is likely to rely on this in contending that the UK DST is only ensuring 'the equitable or effective imposition or collection of direct taxes' that would otherwise be circumvented by large foreign companies providing digital services to UK users.

Notwithstanding, the scope of the exception is constrained by the chapeau to article XIV. The chapeau limits application of the article XIV(d) exception to measures 'not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where like provisions prevail.' The legislation's current form raises red flags as to whether the UK DST fails this test.

Arbitrary discrimination

There appear to be clear arguments that the threshold conditions for the UK DST in clause 7(1) of the draft legislation are *de facto* discriminatory. The revenue thresholds of at least £500m in global gross revenue and at least £25m in UK revenue appear targeted at US technology companies. Few UK or EU groups are thus likely to be caught. Indeed, the then chancellor, Philip Hammond, was widely quoted as saying when announcing the UK DST: 'It is only right that these global giants, with profitable businesses in the UK, pay their fair share towards supporting our public services.' This statement shows discriminatory intent against non-UK firms.

The UK digital services revenues within scope, by virtue of clauses 2 to 4 of the draft legislation, also appear defined to capture the business models of US digital firms but not UK or EU digital firms. Taxable revenues include those from digital advertising, internet search engines, social media platforms and internet marketplaces (where a number of players in the market are US-based), but not subscription fees for access to music where the platform is acting as principal (the main revenue of Spotify, based in Sweden) nor in-app purchases (the main revenue of Supercell, based in Finland).

Practical implications of possible WTO violations

As noted above, post-Brexit the UK must negotiate a new set of UK-specific commitments as an individual WTO member. This process is currently underway. Assuming important digital services will remain covered by the UK-specific commitments, the UK DST could breach these, subject to whether it satisfies the chapeau to article XIV.

The WTO provides a legal mechanism for challenging the UK DST. This state-to-state mechanism is unlikely, however, to provide an effective remedy here due to the considerable time required to undertake a formal legal challenge. WTO dispute resolution takes three to five years under the best of circumstances and can be much longer in a complicated or contentious case (for example, the Boeing-Airbus WTO litigation is still going strong after more than a decade). In addition, the US is currently blocking new appointments to the WTO appellate body, meaning that the WTO dispute settlement mechanism could be substantially impaired as soon as this December.

These timelines demonstrate that formal WTO dispute resolution is unlikely to provide concerned WTO members with effective relief, as the UK government aims for a voluntary repeal of the UK DST in the mid-2020s (once an OECD multilateral approach is adopted). WTO members' strong concerns about a UK breach of its WTO obligations would likely be an important issue in post-Brexit trade negotiations, especially with the US. This, coupled with the OECD's concerns over countries acting unilaterally in this area, will inevitably create uncertainty and political pressure that could lead to the repeal or modification of the UK DST. France is already considering what is, in effect, a retrospective partial repeal of its DST following strong US action.

Other issues

Our view is also that the UK DST is likely to be incompatible with the EU Treaties: both in respect of fundamental freedoms, under an analysis based on *Eurowings* (Case C-294/97) and *Hervis Sport* (Case C-385/12), and, potentially, state aid rules. The impact of that will depend on the terms and timing of the UK's departure from the EU.

Conclusion

The OECD has warned against unilateral action in this area. If the government proceeds with the UK DST in its current form, not only could it generate the problems the OECD highlights, but there are credible arguments that it will breach the UK's obligations under double tax treaties, international trade law, or both.

It would seem wholly legitimate for groups apparently subject to a tax that the OECD has warned against to test whether it is legally appropriate. However, if the UK DST is adopted, reaching clarity under double tax treaties and, even more challengingly, a WTO dispute settlement is likely to take some time – potentially a significant proportion of the intended temporary duration of the UK DST. Given the uncertainty this will cause, continued engagement with the UK government on these issues before the UK DST comes into force seems imperative. If the government doesn't take account of concerns, commencing MAP promptly post-enactment may become necessary. ■

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- The UK digital services tax: ashes to ashes, DST to dust? (Robert O'Hare & Jefferson VanderWolk, 21.8.19)
- Unify and conquer: the OECD's 'unified approach' to pillar one (Brin Rajathurai & Murray Clayson, 16.10.19)