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ALERT MEMORANDUM

Proposed UK Digital Services Tax: Why, Who, How, and What Next

April 15, 2019

In the Autumn Budget 2018, the UK Government announced that an interim digital services tax ("**DST**") will take effect from April 2020, and issued a consultation (the "**Consultation**") setting out further details. If enacted as proposed in the Consultation, the tax will be applied at 2% on revenues derived from social media platforms, search engines or online marketplaces. To fall within scope, the revenue must be linked to the participation of UK users.

The Consultation is now closed for responses, and the Government reaction is awaited. If the Government decides to move ahead and apply the DST from April 2020, the relevant legislation will be introduced in Finance Bill 2019/20.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors:

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This memorandum summarises the significance of the DST, the reasons it has been proposed, and the main concerns for businesses. A more detailed summary of the proposal is set out on the final page.

Businesses should continue to monitor the progress of the DST and of global developments generally on the taxation of the digital economy. If you would like to discuss this topic in more detail, please reach out to your regular firm contact or the authors of this memorandum.

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What is the significance of the DST?

The DST is an entirely new tax, focused on specific income streams of certain businesses. It is a unilateral measure, proposed in the context of ongoing global discussions on digital taxation.

It marks a shift away from the UK's traditionally profits-based system of taxation, prescribing a new revenue-based model. It also does not use the familiar concepts of residence or permanent establishment, but rather targets certain revenues which are linked to 'UK user' participation.

Why is the tax being introduced?

The question of how to tax digital businesses has been a topic of discussion at the OECD and EU level for some time, with the UK taking an active role in negotiations. As yet, there has been no internationally agreed solution. The OECD consulted publicly in February and March 2019, and is due to provide a progress update in June 2019, aiming to propose a consensus-based long term solution in 2020. EU discussions also continue, although a preference to follow an OECD-coordinated approach has been voiced by many member states (including France and Germany), provided that such approach can be agreed by 2020.

The UK Government's ultimate objective remains to address the challenges of digital business taxation through reform of the international corporate tax framework. The DST proposal includes a sunset clause, which will allow disapplication if a global agreement is implemented. A review date is set for 2025.

What are the main concerns for businesses?

— Uncertainty. In practice, it is unclear how a number of the definitions (for example, the definitions of the affected business activities, and the concept of 'UK user') will be applied. Greater certainty could be obtained if HMRC were to introduce an advance clearance mechanism for businesses to use, but no such mechanism is suggested in the Consultation.

— Evolution. As noted in the above bullet point, the current DST proposal results in uncertainty of scope and definition. Without clarity of guiding principles and application, it may be unworkable to apply the proposed tax to new and evolving business models.

— Double taxation. The DST will not be recognised under double tax treaties. This means that overseas digital businesses will not be entitled to offsetting relief against corporate income taxes payable in their home jurisdiction. There is also a risk that the DST may overlap with other UK and non-UK taxes.

— Collection and enforcement mechanisms. The proposal leaves a number of operational questions unanswered. It is unclear, for example, how HMRC will effectively enforce the tax for businesses that have a limited physical presence in the UK. The handling and verification of extensive user data by HMRC will also need to be carefully considered.

— Profit margins. As discussed on the next page, an alternative form of calculation is to be available for businesses with low profit margins, in order to lower their effective DST rate. However, the details of the final proposal will be important in enabling businesses to make an estimation of liability. Some of those details are likely to be subject to debate.

DST: The details

Which businesses, and types of revenue, are within scope?

The proposal identifies three categories of business that may fall within scope, and specifies which revenues of those businesses are intended to be taxable.

1. Social media platforms (covering social / online networks, blogging / discussion platforms, content sharing platforms, review platforms and dating platforms). In each case, the proposal would tax revenues generated by advertising targeted at UK users, or which involves a UK user action (e.g. a click), and other forms of revenue involving UK users (e.g. subscription fees paid by UK users).
2. Search engine provision. In this case, the proposal to target revenues generated by UK user participation is expected to principally capture advertising revenues where the advertising was targeted at UK users or involved a UK user action (e.g. a click).
3. Online marketplaces (which allow users to advertise, list or sell goods or services to other users, regardless of whether the sales actually take place on that platform). In this case, the proposal is expected to capture both revenue resulting from a transaction involving a UK user (e.g. a commission fee, consideration share or delivery fee), and revenues from advertising targeted at UK users or which involve a UK user action.

The question of who qualifies as a 'UK user' is to be determined using concepts of 'normal residence' and 'primary location'.

When will the tax apply, and are there any exemptions, allowances or safe-harbours?

A business will only be taxable if it generates more than:

— £500m in global annual revenues from in-scope business activities; and

— £25m in annual revenues from in-scope business activities linked to UK user participation.

Businesses with mixed activities will need to identify revenue that falls within the scope of the tax and revenue that falls out of scope.

There will be an allowance for the first £25m of UK taxable revenues. There will also be a "safe harbour", which will permit businesses with very low profit margins (or loss-making businesses) to elect an alternative form of calculation in order to lower their effective DST rate.

The tax may be deductible against UK corporation tax under the normal rules, but will not give rise to a tax credit either under the UK domestic regime, or pursuant to any double tax treaties.

Are there any specific anti-avoidance rules?

Two targeted anti-avoidance rules are considered in the proposal:

1. An anti-forestalling rule, which deals with the risk of taxpayers accelerating recognition of revenue before 1 April 2020; and
2. A rule to prevent taxpayers artificially recharacterising revenue streams to fall outside a taxable business activity.

How will the tax operate in practice?

The proposal indicates that, as with corporation tax, companies would be required to notify HMRC if they are liable to pay the DST. Companies would also be required to self-assess on an annual basis, and pay in quarterly instalments if found to be within scope.

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