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UK GOVERNMENT ANNOUNCES RADICAL NEW DIGITAL SERVICES TAX

– THOUGHT LEADERSHIP

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In his October 2018 Budget speech, the UK Chancellor announced a radical new Digital Services Tax (DST) on digital platforms that derive their economic value from the participation of UK users. The DST significantly departs from the traditional allocation of international taxation rights between states. It does so by imposing UK tax on internet companies, even where they lack a UK taxable presence, on the basis of revenues deriving from UK users. This represents a crude proxy for the value generated by UK users on those sites. Many features of the DST are likely to be distortive, arbitrary and may be susceptible to legal challenge

What is the DST?

The UK Government have announced that the DST will be introduced from April 2020 with the aim of ensuring that digital businesses pay UK tax which reflects the value they derive from UK users. The companies within scope will be those operating an "in-scope business model" – which is set to include social media platforms, search engines and online marketplaces – with global revenues of at least £500m globally. The DST will be charged at a rate of 2% of the revenues of those businesses which derive from the participation of their UK users. This will mean different businesses will have a different taxable base – for example, search engines may be charged 2% of their advertising revenues for adverts displayed against UK users' search requests; whereas online marketplaces may be charged 2% of the commissions they generate for facilitating transactions between UK users. The first £25m of relevant UK revenues will not be taxable and protection for very low-margin businesses will be introduced. Exemptions for financial and payment services, the provision of online content and television/ broadcasting services are expected.

Why introduce a DST?

The UK Government is under political pressure to ensure that major internet companies pay their "fair share" of tax. Some consider it unfair that some US headquartered digital businesses operate globally but operate minimal taxable presences in the UK and other target jurisdictions. Such businesses are also accused of exploiting the mobile nature of intangibles to allocate profits outside target markets, while extracting valuable user contributions and data in such markets without making a proportionate tax contribution in return. Dealing with the challenges which digital businesses present is difficult and requires broad international consensus at OECD level as to how international taxing rights should be allocated. This seems unlikely to be reached in the short term – especially while most of the relevant digital businesses are headquartered in the US. The European Commission has previously proposed to introduce a digital services tax in the European Union on certain types of digital services, including online advertising, intermediation and transmission of user data. The proposal faces opposition from a number of Member States (including Sweden, Finland, Ireland and the Czech Republic) and the Council Legal Service has issued a legal opinion that the Commission brought its proposal on an improper legal basis. As such, it is doubtful that the proposal will be implemented any time soon. For these reasons, the UK Government is introducing what it terms an "interim measure" – the DST – which unilaterally taxes digital businesses on the basis of their UK-user derived revenues, as a very rough proxy for the contribution that UK users make to digital value creation. Other EU Member States are rumoured to be following suit.

The UK DST proposal is in many respects more intelligent than the EU proposal – care has clearly been taken in defining the

in-scope businesses and realistic consideration has been given to how best to calculate their taxable base. Contrast this with the EU's proposal, which would have taxed news sites serving advertisements to EU users and suffered from a number of anomalies – on its face taxing revenues from the advertisement-based free Spotify service, but not Spotify Premium, for example.

What is radical about the DST?

The traditional view is broadly that companies operating in multiple states should be taxed on their profits in the jurisdiction(s) in which they add the value generating the profits. This profit allocation method is the approach found in most double tax treaties around the world – which generally grant taxing rights to the state in which a company is resident, except to the extent the profits are generated by a permanent establishment of that company in another state through the application of people, assets or the assumption of risks in that other state. The DST departs from this consensus by seeking to tax companies' profits in the UK even where the profits were not generated through value added by the company in the UK. The DST could even apply where the company has no UK permanent establishment. In this respect it shares some similarity with the UK's Diverted Profits Tax, although for the DST to apply there is no requirement for any tax avoidance or artificial diversion of profits to be alleged. The Government's stated reason for this new approach is that some digital businesses operate online platforms whose value substantially derives from user-generated content, such as social media sites, video upload and streaming sites and review/rating sites; while others operate platforms whose value substantially derives from the network effects of having a large and active userbase, such as online marketplaces and search engines. The Government is of the view that users (whether or not they are also customers) of these types of websites can be seen as participating in non-traditional value chains in which they perform supply-side functions which would historically be undertaken by the business itself. Absent new measures, this creation of value in the business by users would remain untaxed.

What are the problems with the DST?

While there is some force behind the Government's argument that international tax rules do not adequately permit the UK to tax on the basis of where the relevant value is added in the case of digital businesses, the DST is not narrowly tailored to this problem and suffers from a range of defects.

UK derived revenues are a poor proxy for UK users' added value

Instead of calculating the tax charge by reference to the actual value created by UK users, which would be difficult to quantify, the DST instead adopts a more simplistic approach by taxing by reference to the amount of revenues that relate to users in the UK. Even if there is a correlation between UK user contribution and the revenues generated by them (which seems unlikely for some websites), the DST taxes on the basis of a very crude proxy for UK users' added value. It is impossible to compute the amount of revenues relating to UK users without arbitrariness, and the DST therefore seems inapt to meeting the Government's objective of properly taxing the added value.

Taxing revenues instead of profits is distortive

By taxing on the basis of revenue, the DST ignores the fact that many digital businesses are substantially loss-making until they have gained significant market share, and even many mature digital businesses operate on negative or low margins. The DST is only expected to take costs into account in a limited way, e.g. by permitting certain outflows to be taken into account only where the digital company is fulfilling a conduit role and passing on revenues to a third party. This leads to distortive effects. For example, a tax of 2% on a business with a 5% margin would have a substantial impact on that business; whereas a 2% tax on a business with a 40% margin would not have so dramatic an effect. Small and medium sized digital

enterprises are likely to operate with lower profit margins, and so the DST may entrench the market position of mature digital businesses and constrain innovation. The Government would surely meet this argument by referring to the £500m global revenues de minimis threshold, which ensures that the DST is only imposed on sizable market participants; the exemption for the first £25m of UK-derived revenues; and the ability for low-margin businesses to elect for a different taxable basis to reduce their DST liability. However, excluding small and medium-sized competitors from the tax, and applying different bases of taxation for different digital businesses, creates an unlevel playing field, as well as a distortive cliff-edge effect at the tipping point between a business falling within or outside the DST. A legal challenge to the DST under the State aid rules therefore seems likely, if it is introduced as announced.

Incidence

Crucial to the success of the stated objectives of the DST is that the digital businesses within scope economically bear the additional tax. However, as a tax on revenues, the DST is likely to have a cascading effect across value chains. A likely response by companies within the scope of the DST to an extra 2% charge on UK-user derived revenues is to pass the cost on to their UK customers. UK advertisers, traders and contributors on digital businesses may well find themselves paying higher fees and charges. This would place UK customers of digital businesses at a disadvantage to other customers in the global marketplace, and hardly meets the Government's objective of online businesses paying their "fair share".

Technology needed for compliance

To comply with the UK DST, taxpayers will need to calculate the proportion of their revenues which is attributable to UK users. This is likely to entail different computations for different types of online businesses. It seems likely that such businesses will at a minimum need to track their number of UK users, which is not itself straight-forward given that users are internationally mobile. Is a Frenchman visiting the UK a UK user; and is an Englishman visiting France not a UK user? Moreover, how should businesses treat visitors accessing their site through a VPN or an encrypted browser, even if they had the technology to recognise this? Especially difficult issues arise in the context of individual users accessing digital websites through multiple devices. If the same person accesses their Facebook account on their home laptop, their work PC and their personal mobile phone, should that count as one user or three? The problem is even more acute for web services which do not require a log in to be used. The risk for double counting of users is plain. Technological solutions may be formed to deal with this, but many of these are controversial from a privacy perspective and may be prohibited under GDPR without express user consent.

In responding to o these technological quandaries, the Government may well end up tipping the balance against legitimate privacy-based concerns of users. An increase in the amount of personal data tracked and retained for tax compliance purposes will likely increase cybersecurity risks that businesses – and the Government – will need to anticipate. Appropriate data safeguarding mechanisms will need to be deployed, resulting in increased compliance costs.

Enforcement

Enforcement issues will also arise in seeking to tax on an extraterritorial basis. The UK Government claims that the DST is consistent with its network of double tax treaties, as the DST falls outside their scope. The UK's tax treaty partners, and taxpayers benefitting from those treaties, may disagree with this and legal challenges could well result. Moreover, it is difficult to see how the UK intends to enforce the DST practically against all of the digital businesses within the scope of the tax. While most US multinationals have at least some UK presence and are therefore likely to comply with the UK DST; other businesses, such as Chinese digital businesses with UK users but no other UK presence, will have little incentive to do so. The UK Government may struggle to enforce the tax against such companies in practice Another possibility is that non-UK sites may simply

ban UK users, rather than dealing with the additional compliance burden and cost of allowing UK users to access their services. The prospect of this is not fanciful – indeed, when the GDPR took effect across the EU, the US LA Times and Chicago Tribune (among others) reacted by simply banning EU users from their websites.

Unclear basis for distinguishing internet businesses

It is also questionable in principle how much of the value of digital businesses should be attributed to user participation, as much of the value of a digital business will still be derived from employee know-how and the application of unique algorithms. To the extent value of digital businesses is created by users, it is difficult to see how this distinguishes internet businesses from many other types of business which also benefit from more traditional network effects, such as telephone manufacturers and producers of offline computer software. Any network effect by definition increases the value of the product or service, so it is difficult to see what makes web-based network effects sufficiently different to warrant different tax treatment. It seems clear that the digital businesses within the crosshairs of the UK Government are US digital multinationals. This risks being seen as opportunistic – why should the UK (or the EU) apply the normal rules of international taxation to traditional businesses, but apply a new extra-territorial tax specifically for areas where it has failed to create world-leading companies?

Potential US retaliatory measures

At the extreme, the DST could cause discussion as to whether s891 of the US Internal Revenue Code should be exercised. This provides that where a foreign country imposes a discriminatory or extraterritorial tax on US corporations or citizens, the President may decide to double the US tax rate applied to UK corporations and citizens. To date the power has never been used, but the prospect of President Trump exercising his power to impose retaliatory taxes of some kind cannot be entirely ruled out. In any event, a new UK tax perceived to apply exclusively (or almost exclusively) to digital US businesses seems ill-timed given the desire to strike a post-Brexit trade deal with the US.

CONTACTS

Dan Neidle
Partner
London
T: +44 207006 8811
E: dan.neidle@
cliffordchance.com

Nick Mace
Partner
London
T: +44 207006 4679
E: nicholas.mace@
cliffordchance.com

Chris Davies
Global Practice Area Leader for TPE
London
T: +44 207006 8942
E: chris.davies@
cliffordchance.com

Jonathan Kewley
Partner
London
T: +44 207006 3629
E: jonathan.kewley@
cliffordchance.com

Melissa Fogarty
Join Head of Corporate
London
T: +44 207006 4699
E: melissa.fogarty@
cliffordchance.com

Andre Duminy
Partner
London
T: +44 207006 8121
E: andre.duminy@
cliffordchance.com

NOTES

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