THE U.K. DIGITAL SALES TAX – IT COULD BE YOU

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INTRODUCTION

On November 7, 2018, the U.K. government confirmed that it will proceed with the introduction of a digital services tax ("D.S.T.") on large businesses from April 2020. The government concluded that certain business models derive huge value from the participation of U.K. users, which is largely untaxed.

A digital service or product provider outside the U.K. might think that it would not be covered by the tax. Unfortunately, this view would not be correct as – like the G.D.P.R. – the tax is based on the user's jurisdiction and has a global reach.

D.S.T. will charge 2% tax on any revenues that can be "linked" to U.K. users, regardless of where the provider is located and irrespective of whether the business has a physical presence in the U.K.

Note that this is a tax on revenue, not profit, which means the U.K. government takes the view that it can ignore obligations under income tax treaties.

To fall within the D.S.T., a large non-U.K. digital service or product provider need only have U.K. user-related revenues from business activities in one or more key areas: search engines, social media platforms, and online marketplaces.

Unknown at this time is how H.M.R.C. will define the revenues to which the tax will apply. Notwithstanding a 53-page consultation document, H.M.R.C. has not identified the actual hallmarks of tax jurisdiction. The overarching message of the consultation is that, although it is all very difficult, businesses will know if they are supposed to be within the scope of the tax or not and will self-assess their liability accordingly. If a business does not reach the conclusion that H.M.R.C. wants, it can expect a "just and reasonable" recalculation of the tax due.

Regarding the tricky matter of how revenue is linked to user participation, no clear guidance has been given in the consultation document, and many in the market have questioned how a decent definition can even be formulated. The tax is chargeable on revenues generated from defined activities that are linked to the participation of a U.K. user. But, what does that mean?

It is clear that the proposed approach to defining the participation of a U.K. user is incredibly broad – it covers not just advertising revenue from advertisements aimed at U.K. users but pretty much anything involving a U.K. user, even a click on a page by accident.

It comes as a surprise that H.M.R.C. expects large businesses to simply know the accurate location of people clicking on their pages. The task should not be underestimated. There are entire companies dedicated to writing software that determines

and tracks where users are located. Moreover, in a world where data protection and data misuse are hot topics, these practices have come under public scrutiny.

DETERMINING COVERAGE UNDER THE THREE TARGETED AREAS

Consultation is ongoing, and in terms of scope, there is no proper sense yet of where the boundaries will lie.

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The definition of activities relating to online marketplaces and search engines are relatively narrow and more or less as expected.

However, the definition of a social media platform is much wider. It covers anything from typical social networks to blogging, review, and discussion platforms. It may even extend to online gaming.

D.S.T. is explicitly not a tax on

- online sales of own goods,
- online advertising,
- data collection,
- financial and payment services,
- the provision of online content,
- sales of software or hardware, or
- television or broadcasting services.

Additional exemptions may emerge as the public consultation continues on the proposals.

£500 MILLION THRESHOLD

To fall within the ambit of the tax, a business must generate revenues from the three key areas of at least £500 million globally. Smaller players will not be caught until they start to play in the big leagues. This is problematic since rapidly growing businesses are caught as soon as they pass the threshold, and while the first £25 million of relevant U.K. revenues are exempt, imposing the tax is anti-competitive towards smaller players trying to compete with the global giants.

Particularly problematic is how a business is supposed to isolate in-scope activities when various activities are undertaken. A tax compliance nightmare can be expected even if a company is not, in the end, within the rules. Especially troubled will be those businesses that only have a small proportion of revenue generated from the activities in question but have to spend significant time and fees working out whether D.S.T. should be charged, at all.

There is a proposed safe harbor, but it will entail a costly compliance exercise. The idea is sensible. A company runs an alternative D.S.T. calculation if it has a very low profit margin or is loss making. However, the formula will be difficult to apply in

practice, as it first relies on a capability to identify the U.K. profit margin within an international business and then forces the company to apply a whole subset of tax assumptions – varying that margin around what costs are allowed and how overheads are split and excluding exceptional items.

The tax is meant to be temporary, and the U.K. government has promised a formal review in 2025 that would repeal the D.S.T. if an "appropriate international solution" is in place. However, a comprehensive global solution does not look likely to happen anytime soon – the O.E.C.D. must get its Member States to agree. The O.E.C.D. is not making any headway at reaching a consensus and looks unlikely to do so by 2020.

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The U.K. is the first European country to introduce unilateral measures, but it probably will not be the last – France and Italy are also pushing for action. At the same time, the European Commission is proposing its own version for the E.U. While adoption of the E.U. approach has been stalled by E.U. politics, with Member States arguing about its terms, an E.U.-wide digital tax is on the horizon, and no one would be surprised to see it adopted in the near term.

CONCLUSION

A digital tax with global reach has been announced in the U.K. It is one of many such taxes proposed in Europe. How the U.K. tax will work in practice is anyone's guess. One certainty at this time is that the cost of demonstrating whether a company is or is not covered will be expensive. If covered, the cost of demonstrating the boundaries of U.K. user-related revenue may be even more costly.

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