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Analysis – The UK's digital services tax: what's new

Insight and analysis

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Speed read: With effect from 1 April 2020, the UK now has a digital services tax (DST), joining France and Italy which already have in place broadly similar taxes. The UK DST is charged at 2% on revenues made by large businesses that provide a social media service, search engine or online marketplace to UK-based users. While the legislation has not changed significantly since the draft issued in July 2019, the guidance has been comprehensively re-worked and expanded, offering significantly more examples on how, in HMRC's view, the DST should be applied by businesses.

As we are all forced into confinement by the coronavirus pandemic, the ability of digital businesses to keep us connected, entertained and provisioned has seen a sharp spike in their usage. The government's implementation of its digital services tax (DST) could therefore perhaps be considered fortuitous timing. Commentators in the early part of the year queried whether the government might postpone the DST to see what progress the OECD makes on reaching an international consensus. It did not hold off though, and the DST is now to come into force on royal assent of the Finance Bill

2019/20 and with effect from 1 April 2020. Accordingly, businesses with online revenues must assess the changes made in the revised legislation and HMRC's guidance in its *Digital Services Tax Manual*, as well as their obligations and exposure under the new tax.

The basics

The DST is a 2% tax on the VAT-exclusive revenues derived from UK users and is to be imposed on large businesses that provide a social media service, search engine or online marketplace. For this purpose, a business is large if (judged on a consolidated group-wide basis) it has in-scope annual global revenues of more than £500m and more than £25m of those are attributable to UK sales. The first £25m of revenue derived from UK sales is excluded from the tax.

For low margin or loss making businesses, there is an alternative basis of calculation, whereby the DST rate will be based on the UK operating margin of the group's relevant activities. This means that where the group's UK operating margin is nil or negative, no UK DST liability should arise.

The tax has to be paid within nine months of the end of the relevant accounting period, and the DST return submitted within one year. The first tax payments could be due in early 2021.

An 'online service'

The key question for businesses is whether their revenues are in-scope. In this respect, the tax only applies to 'online services'. What constitutes an 'online service' is not defined, but the revised guidance contains some detailed discussions on whether activities are sufficiently separate to be considered a 'service' in their own right or if they are part of or ancillary to a wider business function (which may lead to discussions reminiscent of some VAT cases). This is an important gateway test for businesses: are their online activities sufficiently distinct to be considered an 'online service'? If so, are the 'online services' within the three in-scope categories.

1. Social media service

The definition of 'social media service' has changed from that in the draft legislation published last July. The first limb (main purpose of promoting user interactions) remains, but the second limb (sharing of user-generated content) has been narrowed. The sharing of user-generated content must now be 'a significant feature of the service'. This additional condition is welcome, as it means businesses will not be in-scope just because users share content on their platform even if, for example, that content is not significant because it merely relates to commenting on content provided by the business.

One concern which was raised with respect to the DST was whether online games would be in-scope, given the significant growth in e-sports and the revenue generated from such activities. The revised guidance provides a lengthy discussion on this but does not provide the sweeping exemption the industry was perhaps looking for. Rather, the guidance notes that a case by case approach will be needed to determine whether user-generated content is a significant part of the game. Any in-game messaging and user-generated items would be considered user-generated content, although playing the game itself will not be.

2. Internet search engines

There remains no statutory definition of an 'internet search engine', meaning that it will take its ordinary understanding if a court ever has to construe it. The legislation does, however, now exclude search engines which search a single (or closely related) website. The search engines that are in-scope are those where their core business involves the operation of a search engine. The guidance notes that these engines will in principle search the whole of the internet. The guidance also notes that where a website has a 'search box' that uses third party technology to display results from external websites, the third party technology provider typically would be considered to be performing an in-scope activity, rather than the website owner.

3. Online marketplaces

An online marketplace is in-scope where the marketplace has a main purpose to facilitate the sale (or hire) of goods or services offered by users, and the marketplace enables users to sell or advertise. (The use of the 'main purpose' test may lead to some debate, given the difficulty that there has been historically in the use of this test.)

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The legislative test has been amended to make it clearer that it includes marketplaces which bring users together, even if the sale occurs away from the platform. Another of the concerns with the draft legislation and guidance was particular uncertainty around the scope of 'online marketplace'. In response to this, HMRC's guidance on the definition has been substantially expanded and now sets out a list of factors that it considers to be relevant in determining whether there is an online marketplace. These include competition between sellers, the existence of a recognisable place or portal, and features that allow customers to search for products or services. This guidance, along with the plethora of new examples, is a big step forward in giving online businesses comfort around how they will be treated under this aspect of the regime.

Financial marketplaces

The government's response to the 2018 consultation on the DST acknowledged that there were a number of reasons for excluding financial platforms, including that there are strict rules and limitations on how these platforms interact with users, they often bear significant costs and risks, and they are often very localised. In dealing with these concerns, the draft legislation sought to define the exclusion very narrowly. Following further consultation, the legislation in the Finance Bill has now been significantly expanded, as follows:

- The requirement that the provider of an online marketplace must be a regulated entity has been removed.
- The exclusion now expressly includes the trading of commodities and forex, as well as financial instruments.
- 'Trading' has now been expanded to include the creation of assets which means that peer to peer lenders (which facilitate the origination of new financial instruments for users of the platform) should be within the exemption.

The expanded exemption will therefore come as a huge relief to the financial sector. It is worth flagging though that while the DSTs in France, Italy and the draft DST in Spain also contain exclusions for financial marketplaces, these are substantially narrower in scope. This then is an area where international businesses will need to be wary, and it highlights the difficulties with jurisdictions imposing unilateral solutions to the taxation of digital businesses.

Which revenues are in-scope?

Revenues in-scope for DST are third party revenues generated from the three in-scope 'online service' activities listed above. Revenues are taxable under the DST if attributable to an in-scope business activity and linked to UK user participation.

In addition, revenues from an activity that is ancillary to any in-scope business activity will be included as digital service revenues (so, for example, where an online marketplace charges payment handling fees, these would be in-scope where they relate to sales on the marketplace). Businesses with in-scope activities will also need to consider whether they have an associated online advertising service as this will also be in-scope to the extent the advertising service obtains a significant benefit from the digital service.

The amount of digital services revenues are determined from the consolidated financial statements of the business prepared in accordance with the appropriate accounting framework. This had led to concern for some businesses (such as investment funds) which are not required to prepare consolidated accounts. To address this, the legislation has been amended to provide that digital services revenues are those revenues which would have been recognised in the consolidated group accounts if no exemption from the requirement to prepare consolidated accounts had applied.

What are UK revenues?

Revenues from in-scope services will be subject to UK DST if they are attributable to UK users. As with the original draft legislation, a user will be a UK user if it is reasonable to assume he is normally located or established in the UK.

Businesses have consistently raised concerns over the difficulty in establishing whether a user is normally located or established in the UK. While the revised guidance on this is relatively unchanged from the draft guidance, the message remains that HMRC considers that this is a pragmatic test based on available information and businesses are not expected to obtain additional information about their customers. In practice, businesses will have to consider how to assess which users are UK based — and how to deal with the situation where the information collected provides conflicting evidence regarding user location.

Businesses will be concerned that the approach they take to determine user location in one jurisdiction will not be acceptable in another jurisdiction imposing a DST. While the guidance indicates that HMRC appears relatively relaxed about the method used, unfortunately there is no indication of what measure of advance comfort will be obtainable from HMRC as to the approach that should be taken.

The future for the UK DST

The government remains committed to developing a multilateral solution to the challenges that digitalisation has created. The revised guidance expressly states that the UK DST will be disapplied once an appropriate global solution is in place. In this respect, the legislation contains a requirement that the UK DST be reviewed before the end of 2025, albeit the hope and expectation is that the OECD's work on reaching a multinational solution will bear fruit long before then.

The OECD has announced that it is 'working full steam' and that this will continue on schedule despite the Covid-19 pandemic — the stated aim being to reach a political consensus by July 2020, with an agreed solution by the end of 2020.

If the OECD is unable to keep to this timeframe, and accordingly DST becomes chargeable, the UK can expect to encounter strong resistance from the US. When France introduced its digital services tax in 2019, this led to a trade dispute with the US; a dispute which is currently observing a truce as France has deferred collection of the tax for 2020. The Italian DST is similarly in abeyance for this year.

Since the 2020 Budget announcement, the US government has not made any public comment on the introduction of UK DST, but it is to be noted that the UK and US will soon be engaged in trade negotiations and it is perhaps inevitable that the DST will be on the table.

Notwithstanding this uncertainty, affected businesses should consider whether they are likely to be subject to this tax — and, if they are, what systems should be in place to deal with calculating the correct amount due.

Like many countries, the UK is likely going to need to raise taxes to meet the costs of the Covid-19 pandemic. Given that need to raise cash and the fact that some digital businesses have thrived as a result of the current lockdown, the UK may look to the DST to plug some of the gap.

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- Digital taxation: a bluffer's guide (Eloise Walker, 3.2.20)
- The UK digital services tax: ashes to ashes, DST to dust? (Robert O'Hare & Jefferson VanderWolk, 21.8.19)

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