Budget 2018—the Digital Services Tax

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TMT analysis: Julia Cockroft (senior associate) and Miranda Cass (partner), from the tax team at Bristows LLP, discuss the 2018 Budget announcement on the Digital Services Tax. Julia and Miranda specialise in providing tax services to businesses operating in the technology and life sciences sector.

What has been proposed?

The Digital Services Tax (DST), nicknamed the 'tech tax' in the media, will introduce a 2% charge from April 2020 on the revenues (not profits) generated by certain digital businesses from UK user participation. DST brazenly targets the likes of Facebook, Google and other so-called tech giants.

The Budget announcement has sparked controversy given the UK's apparent disregard for international calls for a global, integrated approach to the digital tax issue. It has also generated widespread interest from the tax community as a consequence of the DST's novel approach to determining the UK tax base.

The DST proposals aim to introduce an entirely new regime, targeting the value users create for digital businesses. The traditional direct tax concepts of residence and permanent establishment are therefore irrelevant to the operation of DST. Any business that exceeds the turnover thresholds, generates revenue from three specific online business models, and has online users based in the UK, will be within scope, regardless of where the digital business is incorporated or operates from.

How will it work in practice and who does it target?

DST will apply to UK user revenue generated by three specifically targeted digital business models:

- search engines (taxing the advertising revenue linked to search terms entered by UK users)
- social media platforms (taxing the revenue generated by targeting adverts at UK users)
- online marketplaces (taxing the commission received for facilitating online sales to UK customers)

The new tax should not be confused with VAT or goods taxes—DST is not a tax on the online sale of goods. Where it applies to online marketplaces, the tax will only apply to 'revenues earned from intermediating such sales', not from direct sales revenues.

The proposal document describes the tax as 'narrowly-targeted', and the Chancellor made thinly veiled references to Facebook during his Budget speech. While a size threshold will be included, designed to ensure 'established tech giants—rather than our tech start-ups' pay DST, the proposed £500m global and £25m UK 'relevant revenue' tests have already been identified by the tech industry as being too low, bringing more businesses within its scope than the government has anticipated.

The proposal document acknowledges that a 2% tax on revenues could result in harsh outcomes for loss-making businesses or those with narrow profit margins. This is particularly the case given that DST will not be recognised under double tax treaties, and so will not entitle an overseas digital business to any relief against the tax payable in their home jurisdiction. One would assume overseas tax regimes will not readily offer unilateral relief or recognise the UK tax as a deductible expense, as this would reduce the tax take in the place where the digital business is based. Double taxation is, therefore, a very real concern.

To go some way towards acknowledging this issue and introducing a degree of proportionality, the proposal refers to a 'safe harbour' enabling a business to elect to pay DST on a different basis. This should result in no DST charges for loss-making businesses and a reduced rate of DST for those with a low profit margin. Details of exactly how this safe harbour will operate are currently unclear.

What are the key challenges?

Accurately defining the revenue streams underpinning DST and crafting legislation to capture entirely new tax concepts will be a significant challenge. It will also be interesting to see, when detailed proposals are published, how this new tax will be policed and what the collection mechanics will look like. Presumably, HMRC will need to be able to verify user participation data generated by digital businesses which could pose a wide range of legal and practical challenges.

What are the wider international implications?

The UK will face criticism for 'going it alone' rather than waiting for the Organisation for Economic Co-operation and Development (OECD) to develop international digital tax recommendations. Indeed, the US has already issued strong warnings against countries taking unilateral action on digital taxation. Clearly, the Chancellor feels the OECD is moving too slowly. This is not a wholly unreasonable view given that OECD members are split on the merits of each approach identified in the OECD's interim report on digital economy taxation published in March 2018, meaning it could take a long time to reach an international consensus.

It is not the first time the UK has taken unilateral action to address perceived tax unfairness while at the same time actively participating in efforts to find an international, OECD-led, solution. The introduction of the Diverted Profits Tax (DPT) in 2015 was controversial for cutting across efforts to address the same 'profit shifting' issue as part of the OECD BEPS project.

It will be interesting to see how the UK's announcement will be received by the EU in light of the proposed EU interim 3% digital revenue tax. EU members remain divided on the issue. Leaders of 16 large tech companies have recently written to the EU to voice their concerns over the EU proposals, and no doubt they will have similar comments to make about DST.

What are the next steps?

A consultation on the design of the DST will be issued in the coming weeks. The government aims to introduce legislation in the 2019/20 Finance Bill and apply DST from April 2020.

DST has been described as a temporary tax given the intention to remove it once an 'appropriate international solution' is in place. The proposal builds in a compulsory review in 2025, at which point DST will be critically analysed in view of international progress on the taxation of the digital economy. A sceptic might argue that the collection of significant tax revenues will make future governments reluctant to move to another taxation model.

Interviewed by Alex Heshmaty.

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