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United Kingdom: Next steps in taxing digital business – will the sleeping giant be awoken?

Jonathan Schwarz (Temple Tax Chambers; King's College London) · Friday, November 24th, 2017

Taxation of the digital economy featured in discussion on the implementation of the OECD/G20 BEPS action items at the annual conference of the Canadian Tax Foundation in Toronto on 21 November 2017. Several speakers note that no generally accepted solution had been found to address the impact of the digitalisation of the global economy on taxation. Unilateral measures adopted by a number of countries such as the diverted profits tax in the UK and Australia (and soon to be New Zealand) and the Indian Equalisation Levy to tax digital economy transactions were discussed. The view was expressed that while the OECD was seeking a longer term solution to the challenges posed by the digital economy, unilateral measures by states would be acceptable short term solutions, pending the development of a consensus.

Withholding tax on digital economy royalties

This view is echoed in the UK Budget announcement on 23 November 2017 of plans to introduce a withholding tax on royalties paid by a non-UK resident company to another non-resident company in a no or low-tax jurisdiction if the royalty is "in connection with" sales of products and services to UK customers. The proposal is advanced as a short term response to multinational groups selling to UK customers, where the group's intangible assets are in such a jurisdiction. In the longer term, international consensus though the OECD BEPS project is seen as the solution.

A position paper entitled *Corporate tax and the digital economy* published by HM Treasury agrees that challenges to international tax rules by the digital economy can only be sustainably addressed in the long run through multilateral reforms. However, the government is of the view that, pending such international reform, interim action is needed. This they say is in recognition of public dissatisfaction digital businesses tax contributions are not commensurate with the value that they derive from the UK market.

Target businesses

The kind of businesses that are identified as potential payers of the new withholding tax are exemplified by some of the major tech companies whose international operating models have come under scrutiny during the BEPS project including those that

"build a user base on an online service, and then generate revenues through directing adverts at that user base which are targeted more precisely through personal data derived from the systematic

monitoring of users' activities e.g. a search engine" (i.e. Google)

"build a user base on an online platform that allows for the sharing of content and user-generated contributions, and then generate revenues through directing adverts at that user base which are targeted more precisely through personal data derived from the systematic monitoring of users' activities e.g. a social media or file-sharing platform" (i.e. Facebook)

"provide an online marketplace for buyers and sellers of goods/services and take a commission from the resulting transactions" (i.e. Amazon)

"build up a user base on an online platform and then take a commission from matching users' common interests e.g. exchanging of goods, renting of assets, and forming of relationships" (i.e. AirBNB)

Connecting factors

The withholding tax will apply royalties "in connection with" sales of products and services to UK customers. While the consultation document states that the mere consumption of goods or services in a country should not, itself, give that state taxing rights, the thrust of the proposal makes such consumption a core connecting factor. Thus non-resident online businesses selling goods, digital content, software or services to customers in the UK are likely to be within the scope of the proposed measures. The exact nature of any other factors that connect the royalty with the UK territory are as yet unknown. Withholding will be required if royalties are paid by a non-UK resident company to another non-resident company in a no or low-tax jurisdiction. This is a common feature of the business models adopted by major United States-based technology companies who frequently have their core intangible assets owned in non-or-low tax paying entities. There is some overlap with the existing UK Diverted Profits Tax which also applies to such business models.

Treaty application

The stated intention is that the measure will be consistent with UK treaties. That is an improvement on other unilateral responses to digital economy issues such as the UK Diverted Profits Tax and the Indian Equalisation Levy which operates outside treaties. It has long been UK tax treaty policy to seek to eliminate withholding taxes on royalties and around a third of UK treaties have a zero rate on such payments.

Territorial basis of taxation

This proposal signals UK concurrence with the move to a more territorial basis of corporate taxation. That concurrence has been present in the UK corporate tax system for some time in the form of dividend exemptions, the foreign permanent establishment exemption and the substantial shareholder exemption. What is radically different is the determination of the location of the source of business profits by reference to the place where customers are present or where goods and services are consumed.

Where is value added and by what?

Novel theories of taxing jurisdiction will awake one of the sleeping giants of international taxation. The position paper commences with the proposition that "The government believes in the principle

that a multinational group's profits should be taxed in the countries in which it generates value." Once market countries also have taxing jurisdiction, the question will then arise which intangibles generate the value (or more value) – marketing intangibles in the market state, or trade intangibles in the state of their creation and development?

If you thought that you lived in interesting times during the BEPS project, the times are about to get even more interesting.

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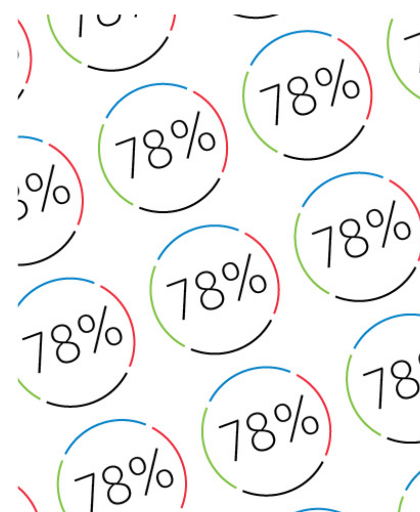

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