5 November 2018

Indirect Tax Alert

UK proposes Digital Services Tax: unilateral measure announced in Budget 2018

NEW! EY Tax News Update: Global Edition

EY's new Tax News Update: Global Edition is a free, personalized email subscription service that allows you to receive EY Global Tax Alerts, newsletters, events, and thought leadership published across all areas of tax. Access more information about the tool and registration here.

Also available is our EY Global Tax Alert Library on ey.com.

Executive summary

The United Kingdom (UK) is one of a number of countries that is considering the need for reform of corporate tax rules to ensure the tax system addresses digital businesses. Building on position papers released in Autumn Budget 2017 and Spring Statement 2018, the UK has now confirmed that it will introduce a Digital Services Tax (DST) while international reform is pending.

The UK's announced measure is targeted at capturing value generated by certain digital business models (being search engines, social media platforms and online marketplaces) from their UK user-base.

Following input from stakeholders, the Government confirmed that safe harbor mechanisms will be included to mitigate the impact on small businesses, loss makers and very low profit margin businesses.

For businesses undertaking the in-scope activities, the revenues linked to UK users will be subject to the DST at 2%. This tax can be claimed as an allowable expense against UK corporation tax, but is not creditable.

The UK is clearly keen for discussions on a coordinated international measure to progress at a faster pace. The UK's announcement follows similar developments in other countries, e.g., Spain, India and Italy where unilateral measures are also recommended and Australia where a review of digital taxation measures is

Building a better working world

underway. Accordingly, this pressure for coordinated action is being made by multiple countries. However, until that's achieved, the differences between each unilateral measure will need to be carefully monitored.

More detail on the UK's announcement will be available in a few weeks when a consultation on detailed design considerations is published. It is proposed that the DST will be legislated for in Finance Bill 2019/20, and apply from April 2020.

Detailed discussion

Targeting user generated value

Building on the UK's two previous position papers, the Government has announced that it will introduce a DST aimed at reforming the corporate tax system to capture value generated by certain digital business models from their user-base. The Government considers that users can create value for a company through their engagement and active contribution (for example, by providing content or enhancing the brand) in a way distinct from the role that a customer serves in a traditional business.

The UK measure is intended to be narrowly targeted at social media platforms, search engines and online marketplaces as these business models are considered to derive significant value from participation of their users. The measure is not intended to apply to financial and payment services, the provision of online content, sales of software/hardware and television/broadcasting services.

This is at the narrower end of options being considered and is narrower than the current draft European Union (EU) directive that was released in March 2018, which includes broader instances of revenue generation from on-line advertising and data collection. This said, while the announced measure is relatively narrow, we could see the scope broadened in the future.

In addition, there has been recent discussion around whether the UK would include e-retailers in the scope of the DST, given the impact that the increasing move to on-line retail is having on the high-street. This included the Financial Secretary to the Treasury, Mel Stride, recently stating that he thought an online retail tax was required in addition to the DST. However, on Budget day, the Chancellor was clear on this point stating that the DST is not an online sales tax.

Other Budget measures that could have addressed the disparity between online retailers and high-street stores, e.g., business rates reform, were limited. Accordingly, the potential for further developments in this area should be carefully monitored.

Safe harbor mechanisms

Following the consultation with business on the position papers released over the last year, the UK has now provided some more detail on their intention to protect small, loss-making and very low profit margin businesses from the new rules.

Businesses with global revenues from in-scope activities below £500m will be excluded and the first £25m of UK revenues is also not taxable.

This double threshold is set by reference to the in-scope revenues linked to UK users, being:

- A social media platform generating revenues from targeting advertisements at UK users
- A marketplace generating commission by facilitating a transaction between UK users
- A search engine generating revenues from displaying advertising against the result of key search terms inputted by UK users

Limiting the threshold to in-scope activities in this way will help businesses that might carry on these activities alongside other out-of-scope activities.

A safe harbor mechanism for loss-making and very low profit margin businesses is also intended and will be designed further as part of the upcoming consultation. It is stated that businesses will be able to elect to calculate their liability on an alternative basis, the outcome of which will exclude loss-making businesses and enable very low profit margin businesses to pay a reduced rate of tax.

Detailed design considerations

The Government will be issuing a consultation on the design of the DST in coming weeks, intended to explore the key questions and challenges concerning the application of the DST. As well as setting out further thinking on safe harbor mechanisms, it may cover practical matters such as how UK users are to be identified and the administrative procedures for collection and remittance of the tax.

Path to a globally consistent approach

The Government has reiterated its commitment to developing an international solution that will ultimately replace the UK DST if such a solution can be agreed. It is therefore proposed that the DST will be subject to a formal review in 2025 to ensure it is still required and the DST will be dis-applied if a global solution is in place prior to that review.

This said, the UK proposal clearly differs from other country positions, e.g., the recently announced Spanish unilateral measure and the current EU draft directive. For example:

- Revenues generated that are linked to UK users will be subject to the DST at 2%. This rate is lower than that proposed by the European Commission.
- The measure is limited to social media platforms, search engines and market places, which is narrower than the European Commission proposal.

These differences increase the compliance burden for businesses, who need to determine whether they are in the scope of each different measure, and suggests that the scope of the UK proposals may increase over-time as EU-wide or broader international consensus is achieved.

Implications

The UK measure announced on Budget day is clearly intended to narrowly target certain digital business models and the UK revenues they generate. The exact boundaries of the proposals will become clearer in the coming weeks when the consultation is released.

As more countries introduce unilateral measures, it will be important to carefully monitor developments in each territory in which users are located, consider the impact on business models and restructuring steps or other actions that may be required as a result of the proposals. This may include consideration of whether the tax will be passed on in the supply chain through third-party contractual arrangements. Compliance with the new tax, especially as there is likely to be subtle differences between the proposals in different countries, should also be carefully considered.

Meanwhile companies might like to actively engage in the consultation to reduce unintended consequences and minimize likely compliance burdens and re-engage with internal and external stakeholders to determine and communicate the effect of the rules.

For additional information with respect to this Alert, please contact the following:

Ernst & Young LLP (United Kingdom), London

- Claire Hooper chooper@uk.ey.com
- Charlotte Fox cfox2@uk.ey.com

Ernst & Young LLP, UK Tax Desk, New York

- Graham Shaw graham.shaw@ey.com
- Matthew Williams matthew.williams1@ey.com

EY | Assurance | Tax | Transactions | Advisory

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

Indirect Tax

© 2018 EYGM Limited.
All Rights Reserved.

EYG no. 011668-18Gbl

1508-1600216 NY
ED None

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

ey.com