

## UK releases draft clauses and guidance on Digital Services Tax

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### Executive summary

At Budget 2018, the United Kingdom (UK) confirmed that it would introduce a Digital Services Tax (DST), notwithstanding the international reform project being undertaken by the Organisation for Economic Co-operation and Development (OECD). Accordingly, the UK has now published draft legislation as part of the draft Finance Bill 2019-20 confirming its intention for the tax to be in place for revenues arising from 1 April 2020. At the same time, it has published draft guidance which, like the draft legislation, is subject to consultation until 5 September 2019.

As a reminder, the UK's 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. 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 legislation is very broad in scope and may apply to groups that had not thought they would be within it. It applies to revenues linked to UK users and not just to UK companies or permanent establishments. There are provisions for collecting the tax due from companies outside the UK which are chargeable to the tax.

The UK has reiterated its desire for discussions on a coordinated international measure to succeed, with a commitment to dis-applying the DST once an appropriate international solution to the perceived issue is in place and in any case reviewing the tax by the end of 2025.

## Detailed discussion

### Details of the proposal

The DST will be a 2% tax on the revenues earned from 1 April 2020 that a group derives from providing a social media platform, search engine or an online marketplace to UK users. A group will be liable to DST when it provides a relevant business activity, the worldwide revenues attributable to relevant business activities exceed £500m and more than £25m of these revenues are attributable to UK users. There is an allowance of £25m, which means a group's first £25m of revenues derived from UK users will not be subject to DST.

The revenues from the business activity will include any revenue earned by the group which is connected to the business activity. If revenues are attributable to the business activity and another activity, the business will need to apportion the revenue to each activity on a just and reasonable basis.

A UK user is a user that is normally located in the UK. Revenues are derived from UK users if the revenue arises by virtue of a UK user using the platform. However, advertising revenues are derived from UK users when the advertisement is intended to be viewed by a UK user.

Where one of the parties to a transaction on an online marketplace is a UK user, all the revenues from that transaction will be treated as derived from UK users. This will also be the case when the transaction involves land or buildings in the UK. However, in the case of a transaction on an online marketplace, the revenue charged will be reduced to 50% of the revenues from the transaction when the other user in respect of the transaction is normally located in a country that operates a similar tax to the UK DST (this has changed following consultation).

### Safe harbor election

There remains the option to use an alternative "safe harbor" calculation which must be made against a specific category of revenue. As the draft guidance points out this means that

if a business has two in-scope business activities (e.g., an internet search engine and an online marketplace) it could choose to apply the alternative basis of charge to one, both or neither of these activities.

Under the "safe harbor" election, the DST tax rate is calculated by reference to the UK operating margin of the in-scope activity. It provides a mechanism so that where the UK activity is loss making no DST needs to be paid on revenues attributable to that activity. Effectively, due to the way the alternative calculation works, the election is only valuable where the operating margin is less than 2.5%.

### Financial services

The draft legislation provides a carve out for financial services activities that is likely to be welcomed by some in the sector. The Government's position is that it believes that most financial services activity would be outside of the scope of UK DST in the first place. However, it does recognize the concern that some financial services potentially overlap with the online marketplace head of charge. It has therefore proposed a financial services exemption such that a regulated activity which primarily involves facilitation of the trading or creation of financial assets will not be considered an online marketplace. This means that, in practice, banking activity will be outside of the scope of UK DST in most situations (given that typically their business involves dealing in financial assets). What is less immediately clear is whether the carve out will be fully effective in other areas of financial services like insurance or for Fintech businesses which may carry out different activities than their traditional counterparts.

### Anti-avoidance

The draft legislation contains anti-avoidance provisions allowing for a tax advantage arising from relevant avoidance arrangements to be counteracted by the making of such adjustments as are just and reasonable.

Arrangements are "relevant avoidance arrangements" if their main purpose, or one of their main purposes, is to enable a person to obtain a tax advantage. However, arrangements are not "relevant avoidance arrangements" if the obtaining of any tax advantage that would arise can reasonably be regarded as consistent with any expressed or implied principles of the legislation or the policy objectives of the legislation. This seems to be a new approach to the "main purpose" test.

## Administration of the tax

The total DST liability will be calculated at the group level but the tax will be charged on the individual entities in the group that realize the revenues that contribute to this total. The group consists of all entities which are included in the group consolidated accounts, provided these are prepared under an acceptable accounting standard.

A single entity in the group will be responsible for reporting the DST to HM Revenue & Customs (HMRC). Groups can nominate an entity to fulfil these responsibilities. Otherwise, the ultimate parent of the group will be responsible.

DST will now be payable annually rather than in quarterly installments as previously proposed and will be due nine months after the end of the period concerned. Where any DST liability relating to a group for an accounting period is unpaid at the end of the period of three months after the relevant date, a payment notice may be given to any person who was a member of the group in the relevant accounting period. The payment notice can require that person, within 30 days of the giving of the notice, to pay all unpaid DST liabilities relating to the group for the accounting period.

## Guidance and next steps

The Government has also published draft guidance for the DST which is subject to consultation until 5 September 2019. HMRC will publish updated guidance later in 2019, reflecting comments received on the guidance and also reflecting the legislation at the time of publishing in the Finance Bill.

The release of draft guidance is very helpful and will help alleviate concerns of some taxpayers. However, there remain unanswered questions that will need to be worked through.

The Government has reiterated its commitment to dis-apply the DST once an appropriate international solution is in place. Furthermore, the draft legislation provides that the Treasury must conduct a review of the DST before the end of 2025.

## How should businesses respond?

With the release of both the draft legislation and the draft guidance, businesses should now be looking at the DST proposals in detail with a view to determining whether their business activities are in the scope of the DST and if so, start to assess the potential impact. This will require engagement within the business to assess the impact on both current and planned business models and whether restructuring steps or other actions may be desirable. This may include

consideration as to whether the tax can be passed on in the supply chain through third party contractual arrangements.

Businesses will also need to consider the compliance obligations that come with the DST. Although the first return and payment will not be due until 2021 at the earliest, businesses should consider the IT and systems work needed around the identification of in-scope revenues and calculation of DST liability.

Businesses should also be prepared to respond to questions from investors who are likely to show a renewed interest in this area.

The impact of the proposals can only really be tested now that there is draft legislation and the design features are clearer. Businesses that are affected by the DST should consider responding on both the draft legislation and the accompanying draft guidance by 5 September.

Furthermore, 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 whether other actions may be desirable. There are likely to be differences between the proposals in different countries.

## Next steps

EY has had regular meetings with HM Treasury throughout the development of the proposals and has been monitoring proposals not just at the UK level but in other territories and at the EU and OECD supra-national level. EY has the experience to assist groups in preparing for these changes in many ways including through:

- ▶ Analysis of revenue streams to confirm whether and to what extent business activities are within the charge to UK DST
- ▶ Analysis of the group's revenue profile to determine the interaction of its possible UK DST exposure with exposure to other DST charges
- ▶ Assistance and input into a group's response as part of the consultation on the legislation including support in discussions with HM Treasury on the scope of the legislation
- ▶ Support in determining any apportionment methodologies and calculations the business may wish to consider using
- ▶ Input into possible changes to the existing business model the group may wish to make as a result of the DST
- ▶ Where appropriate, assistance in preparing for the necessary compliance obligations (possibly in multiple territories) that may follow

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