THE 100 GROUP

Taxation Committee

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Dear Sirs

Digital Services Tax Consultation

We welcome the opportunity to respond to the consultation on the Digital Services Tax proposals. We have not responded to the specific questions raised in the consultation document as this is best left to individual companies who may have specific issues, however we have set out below some broader comments on the proposals together with some areas where we think further work would be beneficial.

General Principles

There are political and public concerns around how increasingly digitalised businesses are taxed. We believe that the increasing digitalisation of operating models does pose new challenges for existing tax frameworks. We therefore think that the matter of taxation of digital activity needs to be addressed comprehensively to ensure that the tax system operates fairly across all business models but also to ensure there is a public trust in the tax system.

Our strong preference would be for an international consensus solution as we believe this is the best way to ensure coherence of the international tax system and prevent both double taxation and double non-taxation.

International discussions are continuing but in the meantime jurisdictions are looking to unilateral measures. We are aware of the stated reasons for the approach adopted by the UK but we do not consider unilateral action to be a sustainable solution. For the reasons set out in more detail below, we are not convinced that the proposals in their current state will necessarily achieve the policy intent.

Competitiveness

We are concerned about the proposals in terms of both our international competitiveness and our international relations. As we head towards Brexit and the accompanying uncertainty we consider that it is important that the UK is as competitive as possible and complexity in the tax code is minimised. We do not think introducing a unilateral measure at the present time helps in this respect. Proceeding with

unilateral measures may risks a loss of goodwill afforded by the UK's international partners, notably the US who have already expressed concern at the proposals.

It is important that the UK maintains its position as an attractive place to do business. The tax system is a core component of the domestic investment environment. This measure risks creating complexity in terms of (a) application of the rules, which employ a series of 'judgement calls'; (b) the significant global compliance burden that will be created by the proposals which we think the document underestimates; and (c) the double taxation that this measure will inevitably cause.

Our preferred approach

We set out below in more detail some of the specific aspects of the consultation document which we think should be addressed as the consultation progresses. Overall, however, we consider that the introduction of the DST should be deferred with the following objectives:

- That the OECD work can be progressed further such that if a viable international solution appears in the meantime this would obviate the need for a unilateral tax;
- To allow more work to be done on the scoping of the rules to ensure they are appropriately targeted and defined to aid ease of application and compliance at a business level; and
- To allow taxpayers more time to understand the implications of the proposals on their businesses and implement the necessary systems changes to ensure they can comply with the rules.

Scoping issues

Chapter 3 of the document sets out three potential approaches for identifying the business activities in scope. The Government has chosen the second approach of defining the relevant 'business activities' as it believes this will best ensure the DST is appropriately targeted.

There are broadly four steps that would need to be undertaken for a business to calculate any DST liability based on the current proposals:

1. Identify what business activities might be in scope;
2. Establish what the revenues from those activities are by either capturing specific information (if available) or by determining a reasonable basis for allocating revenues between in scope and out of scope activities;
3. Analyse the users of those activities to further allocate the revenues to UK users; and
4. Test the output against the thresholds and allowances in para 6.4.

We have identified a number of practical challenges with this process:

1. *Identification of activities:* The consultation is clearly written with certain well-known business models in mind. However, most businesses will have some user participation but will not operate within the parameters set out in the document. They will likely touch some of the definitions and will be neither clearly in nor out of scope. In the absence of clear parameters, judgement will be required in identifying the relevant activities, and it is likely that in practice the definition of in-scope activities will involve lengthy discussions with HMRC. It is questionable whether HMRC have the necessary coverage at present to engage in these discussions.

2. *Identification of revenues:* The consultation states that the DST will apply to revenues attributable to in-scope activities, 'whatever the character' and however they are monetised.

   While this may be straightforward for a minority of well-known businesses, for most UK businesses that are in-scope to any degree, there will be considerable uncertainty as to which revenues should be attributed to those activities. The consultation requires that where revenue streams are not easy to allocate to in-scope activities they should be allocated on a just and reasonable basis. This is no easy task and, again, will require significant judgement. In many cases it seems unlikely that swift agreement can be reached with HMRC on what would be a reasonable allocation of revenues. The lengthy time required for such discussions will have a knock-on impact on the ability of businesses to set up the necessary systems to capture those revenues in time to comply with this new tax.

   This can perhaps be demonstrated using IFRS15 which came into effect on 1 January 2018 and deals with revenue recognition in financial statements. The document itself extends to some 50 or 60 pages and the guidance produced by some of the professional services firms extends to hundreds of pages. This underlines the complexity that can be involved in attributing and calculating revenue. There is no reason to assume that calculating revenue streams for tax purposes would be any easier, particularly where that revenue is not clearly attributable to any specific activity.

3. *Identification of users:* For certain businesses the location of the user may also not be easy to identify. This is very likely to be the case where the location of the user currently has no particular relevance to the business model. For example, academic publishers offer on-line publications or other resources (eg workflow solutions etc). Increasingly users will interact via on-line communities – access to these communities may be closely related to other mainstream on-line resources. It may be that user location is of no relevance to providing this community.

   In principle, if the location of a user drives value in any particular business model, it would be reasonable to assume that user location data is already actively monitored and used directly in the process of monetising that data. However, it is unlikely that any taxpayer would gain sufficient comfort from this assumption in isolation to be able to eliminate themselves from the scope of these proposals. It would therefore be necessary for businesses to go through a detailed data collection and analysis process in order to confirm this.

   Collecting and analysing the information (even if only to prove that they can be excluded) will raise complex data capture issues as well as legal issues in relation to sourcing and maintaining the data (eg GDPR restrictions).

   Furthermore, in some situations the user location may not be readily 'visible'. For example, users may well access content via corporate or personal VPNs. The consultation does acknowledge this as a potential issue but we think that the challenge (ie the number of users accessing via VPNs) is far greater than the document assumes.

The underlying themes are as follows:

- The current proposals are not sufficiently narrowly defined and targeted for businesses to be able to apply them with any certainty. The vast majority of businesses will not fall easily within or outside the parameters set out.

- Business models change all the time, particularly in the digitalised space. The current broad scope means that businesses will need to constantly revisit their activities and data to comply. This is not a calculation that can be easily 'rolled forward' from one year to the next.
- The proposals require global analysis of activities, revenues etc. This significantly increases the compliance burdens for business.
- The current approach includes an over-reliance on judgements in relation to what business activities or revenue streams may fall in scope and how to allocate revenue streams (on a just and reasonable basis) to in-scope activities.
- The proposal is not intended to apply to ancillary activities but does not define what this means other than by imposing a de-minimis in the threshold calculation. To a certain extent if the data is not already collected in some form this indicates that the activity is unlikely to be a significant value driver. However, under the current proposals, even businesses who do not believe themselves to be within the policy intent of the proposals, will need to do significant work to satisfy themselves of this.

Many business systems will not currently collect or analyse the data necessary to test the points above. Adapting any existing system to collect this data will involve costly and time consuming system upgrades (all for what is intended to be a short term 'blunt instrument' measure). However, unless businesses can confidently identity with clarity the models and revenue streams that are in scope then they cannot implement the systems changes necessary to capture and analyse the relevant data.

In our view, the proposals need to be developed further as follows:

- The proposals need to be drafted with a narrower and more clearly defined target, perhaps one that is based on a combination of both approaches 2 and 3, i.e. defined revenues streams from defined business models, with some clear guiding principles;
- Whilst we recognise the concern that a rule that is too narrowly scoped may allow taxpayers to side-step their obligations we think that to ease the burden for the vast majority of compliant businesses, it would be better to have a narrower and clearer scope that is easy to apply and use anti-avoidance legislation to manage any boundary issues;
- The scope should be adequately described in law so that reliance on guidance is minimal. The implementation of the Diverted Profits Tax relied heavily on (potentially subjective) interpretation through guidance[1] rather than reliance on legislation and this significantly increased the uncertainty for businesses. Bearing in mind the potential for increased levels of data capture and analysis on a global basis, together with the judgements involved in applying the DST as currently envisioned, clarity in the law rather than guidance will be key to delivering equity for taxpayers and ensuring that they can collect the relevant data with confidence; and
- Rather than forcing a significant compliance burden on businesses at the margins, there may be some benefit in introducing an exclusion or safe harbour based on a readily quantifiable measure (eg a minimum percentage of revenue). Falling within the safe harbour would mean the DST does not apply. Where the business does not fall within the safe harbour then further work would be necessary to assess whether the business was excluded under other tests (for example, by demonstrating that the activity/revenues are ancillary). This would only work, of course, if the safe harbour is a readily quantifiable measure in the first place which circles back to our first point on bringing more clarity to the scoping of the proposals.

[1] We recognise, however, that guidance is very helpful in providing further detail and examples

Other Policy Design Issues

Temporary nature

We think it is important that the DST is a temporary measure only. Our strong preference is for an international consensus solution.

We think that a delay in the start date would not only give time to work through some of the scoping issues we identify above, but it would also give an opportunity for the OECD to develop a solution. As currently intended, the start date of April 2020 will likely predate when the OECD is intending to issue its final report. We would like to see these measures adopt an approach similar to that suggested at the ECOFIN meeting on the EU Digital tax proposals in December by ensuring they are introduced only if the OECD fails to produce an international consensus by a certain date (a formal sunrise clause).

We think a similar approach should be taken to these measures falling away. The current proposed review date of 2025 seems to be long after the OECD expects to have published its final report. We would recommend therefore that the review is brought forward and that there is a formal 'sunset clause' linked to the timing of any OECD recommendations but also with a formal backstop date.

Profit vs revenue

Taxing revenues is a relatively blunt instrument but does have the benefit of removing the need to allocate taxing rights and reduces international disputes and multl-jurisdictional profit splits, which can be very costly for businesses and add significantly to business uncertainty.

However, taxing revenues increases other issues such as how you cater for loss-makers or low margin businesses. It also increases the risk of unrelieved double taxation as transactions may fall into two taxing regimes with no treaty relief.

The downsides that both routes can produce underlines the need for the DST to be carefully and narrowly targeted.

Double taxation

As stated above the proposals provide no real relief against double taxation.

The proposals provide for a tax deduction where the DST is incurred 'wholly and exclusively' for the purposes of the trade. This will offer only partial relief against double taxation and only in the context of transactions already subject to UK corporation tax.

We consider that purely domestic transactions should either be:

a) Fully excluded from the DST as in these situations the proposals represents no more than a supplemental tax on businesses that operate in the UK using in-scope business models with UK users; or
b) Allow full credit relief for the DST against UK corporation tax.

The consultation acknowledges that transactions involving UK and non-UK users may result in double taxation where another country has introduced a similar DST (para 5.29). In these cases the consultation says that an appropriate division of taxing rights will be negotiated. We would prefer to see a greater commitment to avoiding double taxation by, for example, setting out certain principles that HMRC will adopt. This might be providing full credit relief from the DST or a pro-rata statutory reduction in the

revenues subject to UK DST (ie, if two countries are involved, only subjecting 50% of the relevant revenues to the UK DST).

Safe harbours

The consultation recognises the potential for unfair results for loss-making and low margin businesses and includes a solution of adopting the actual profit margin and a multiplier of at least 0.8.

Whilst this approach will exclude loss makers (because the profit margin floor will be zero) we do not believe it will offer practical relief to low margin businesses. In order for the safe harbour to provide relief for a low margin business, the relevant profit margin would need to be 1/40th of a business that pays the 2% DST.

In addition, the compliance burden for a business that wishes to use the safe harbour is greater than for a business that does not. The calculation of the safe harbour involves calculation of a profit margin based on 'a UK and business-activity-specific profit margin' (para 7.17). The documents states that this is to help ensure that the profit margin reflects the performance of the business within the UK and hence more accurately the value created by UK users. In contrast, to apply the full DST does not require a profit calculation.

Therefore in order to assess whether to elect for the safe harbour a business would have to calculate all of the data to assess the full DST liability in the normal way but then also do additional data collection and profit margin calculations to assess the liability under the safe harbour rules and therefore whether to make the election. It seems counterintuitive that a safe harbour designed to provide relief involves a greater compliance burden.

We would suggest that the safe harbour needs more testing and a revised approach to ensure that the relevant businesses obtain reasonable relief without increasing compliance burdens.

Concluding comments

We trust the above comments are of use as you consider the proposals further. Please feel free to contact me at chris.oshea@the100group.co.uk should you wish to discuss our comments further.

Yours faithfully

Chris O'Shea
Chairman
Taxation Committee

Who we are:
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