The **BEPS** Monitoring Group

These comments have been prepared by the BEPS Monitoring Group (BMG). The BMG is a network of experts on various aspects of international tax, set up by a number of civil society organisations which research and campaign for tax justice, including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. These comments have not been approved in advance by these organisations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives. They have been drafted by Sol Picciotto, with contributions and comments from Tommaso Faccio.

We appreciate the opportunity to provide these comments, and we are happy for them to be published.

Comments on the

UK TREASURY CONSULTATION ON A PROPOSED DIGITAL SERVICES TAX

OUTLINE OF THE PROPOSAL

This proposal is for a 2% tax on the gross revenues (net of VAT) derived from the provision of a social media platform, search engine or online marketplace linked to the participation of a UK user base. The taxable revenues are not defined by the nature of the online transactions (e.g. online sales of goods, services or advertising), or by whether the transactions are cross-border, but depend on whether the revenues derive from a UK user base. Revenue from these 'in scope' activities may come in any form, e.g. from online advertising, subscriptions, commission fees, or sales of data, and would be taxable whether realised in an entity resident in the UK or abroad.

It would affect only a few very large multinational corporations (MNCs). A business would be taxable only if the corporate group's in-scope activities generate (i) more than £500 million in global annual revenues and (ii) more than £25 million in annual revenues linked to the participation of UK users, though the first £25 million of UK taxable revenues would be exempt. There would be an optional 'safe harbour' for loss-making or low-profit businesses, based on a complex method for calculating the profit margin for in-scope business, or alternatively by applying some measure of the group's consolidated profit margin. The tax would then apply to this profit, in excess of the £25m allowance, at a rate proposed to be at least 80%.

The tax would be deductible from, but not creditable against, corporation tax. It is to be introduced in the 2019-20 budget for 2020, dis-applied 'if an appropriate global solution is successfully agreed and implemented', and reviewed in 2025. It is expected to produce net tax revenue of £270m in its first full year (2020-21), rising to £440m in 2023-4.

Justification and scope

The proposal argues that user participation generates value by (i) generation of content, (ii) depth of engagement resulting in data-collection, (iii) network effects and externalities, and (iv) contribution to a brand. So, it focuses on 'those business models for which the participation of a user base can reasonably be considered a central value driver, critical to the success or failure of the business'. The businesses in its scope are those which generate revenue or monetise user engagement by the provision of:

> (a) **a social media platform**, including for professional/social communities, blogging/discussion, sharing content e.g. media, publishing aggregated user input e.g. reviews, dating;
>
> (b) **a search engine**, enabling search for and access to websites and webpages beyond the platform itself; and
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> (c) **an online marketplace** facilitating the exchange of goods or services between users.

It would **exclude** activities that do not have 'active users'. These include:

> (a) the provision of financial or payment services;
>
> (b) the sale of own goods online, either through a seller's own website or through a marketplace (though the revenues from the marketplace would be included), and the provision of hardware, software and cloud computing;
>
> (c) the provision of online content e.g. subscription services for TV, music, news etc, to which the business has the communications rights, and radio and TV broadcasting services; online games may also be excluded, although since these often create an online community, it accepts that further reflection is needed on this.

The proposal discusses 'boundary issues' in distinguishing between

> (a) **a marketplace v. selling of own goods**: would depend on ownership of the goods, but rules on substance over form may be needed to deal with artificial transfers of title;
>
> (b) **a search engine v. a website**: would depend on whether any search function extended outside the website;
>
> (c) **a social media platform v. a website with comments functionality**: would depend on whether contributions such as comments are merely ancillary or incidental;

Enforcement

The proposal would require corporate groups to decide for themselves which of their business activities fall within the defined scope. It accepts that, while this would be easy for those which have only one major activity that falls within scope, it would pose problems for integrated businesses. Unless a business already segregates in its accounts the activities defined as in scope, it would be required to do so.

The proposal accepts that it may be difficult to determine which revenues derive from in-scope activities where activities are integrated, e.g. advertising across a common platform, or revenues from a website providing both a marketplace and own-sales platform. It suggests that these could be apportioned on a 'reasonable' basis, perhaps using a mechanical rule for certainty and simplicity.

Revenue from online advertising would be taxable if the adverts are displayed at UK users (people or legal entities) or involve a UK user action (e.g. a click). Revenue from other sources (e.g. subscription, commission etc.) would be taxable if the payment comes from a UK user, or relates to a transaction that involves a UK user. A UK user would be a person normally resident in the UK and hence 'primarily located in the UK when participating with the relevant business activity'. However, businesses will be allowed to decide how to identify UK users, e.g. by the country to which the advertising is targeted, or the IP address, or by customer address for revenues linked to sales of goods. It is recognised that there will be hard cases, e.g. mobile users, or where there is contradictory evidence of user location. In all cases the method for attribution must be 'just and reasonable'. Cross-border transactions would be taxable if one of the users is a UK user; this would include e.g. a UK business selling to a foreign customer through a digital marketplace, or vice versa. If other countries introduce a similar tax, double taxation would be dealt with by negotiating an appropriate division of taxing rights. (The EU proposal includes a mechanism for allocation among member states).

A corporate group would be required to determine whether its in-scope revenues exceed the thresholds, in which case any member entity with in-scope revenues would be liable to pay the tax, wherever it is resident. However, there would be joint and several liability for all members of the group, which means that if there is a member in the UK, the tax liabilities of all group members could be enforced against it. Groups which include several entities liable to the tax may be allowed or required to nominate one affiliate to make a single return. A business liable to the tax which is in a group with no UK-resident entity or permanent establishment will be expected to comply voluntarily, but new penalties are also being considered.

International alignment

The tax is considered to be compatible with tax treaties because (i) it does not discriminate against non-resident persons or their permanent establishments, and (ii) it is not a tax on income or a similar tax. (For that reason, however, tax paid would not be creditable against tax due in another country, though it would normally be deductible.)

It is considered to be in line with the OECD's interim report on tax and digitalisation because it is temporary, targeted, and minimises the impact on small or unprofitable businesses, hence it is considered a proportionate interim solution. It should be noted however that the UK's diverted profits tax enacted in 2015 is a special tax on income and is aimed at arrangements by non-resident companies, but it was argued to be justifiable as an anti-avoidance measure.

A similar proposal for a DST was put forward in March 2018 by the European Commission, though it proposed a 3% rate. However, that proposal aimed at revenues from (i) placing advertising on a digital interface, (ii) making available a multi-sided digital interface, and (iii) transmission of data collected about users of digital interfaces, so it avoids some of the problems of segregating user-related activities and revenues. It has been reported that the Commission proposal has been amended during discussions in the Council to refocus only on advertising, due to German government concerns about its application to the collection of data from vehicle in-board computers.

India introduced an 'equalisation levy' in 2016 as a 6% charge on payments made to non-resident entities, initially for advertising. Though the liability is on the non-resident payee, it is collected by the person making the payment, and is essentially a B2B (business-to-business) tax.

COMMENTS

There is much to be said for taking immediate action to deal with some of the glaring deficiencies of existing international tax rules. This seems necessary in view of the lack of progress towards a multilateral solution, although the issue was designated Action 1 in the BEPS project launched in 2013. This proposal has been designed comply with the UK's international obligations, and to be in line with the OECD recommendations for interim measures.

However, such measures should be also aim to (i) make a constructive contribution to a multilateral solution, and (ii) be relatively easy to administer. In our view, this proposal has some significant defects in both these respects.

Flaws in the conceptual basis

This DST would have a relatively narrow scope, being aimed only at 'those business models for which the participation of a user base can reasonably be considered a central value driver, critical to the success or failure of the business'. Thus, it would be aimed only at some digitalised business models and exclude others. The major finding of the reports in 2015 and 2018 from Action 1 of the G20/OECD project on base erosion and profit shifting (BEPS) was that the 'digital economy' is not a separate sector, the whole economy has become digitalised. Hence, any remedial measure should be general and should not discriminate between sectors or business models. Singling out business models deriving revenue from user involvement is clearly a ring-fenced measure. Taking due account of the importance of user contributions in some digitalised business models is important but should be part of a more general approach dealing with the tax consequences of digitalisation. The UK has already introduced other unilateral measures, notably the Diverted Profits Tax of 2014, while engaging with the BEPS process. We should place greater priority on supporting reforms that would benefit all states, especially poor countries, and that can improve simplicity and certainty for business.

Furthermore, the DST targets only one aspect of digitalisation: the participation of users. The argument for targeting user involvement is flawed, because user contributions do not directly add commercial value, and are less significant than other digitalised activities such as large-scale data collection. The content that users share on social media platforms cannot be monetised by the provider of the platform. The provision of the platform may produce revenue from subscriptions for access (usually to an enhanced version), but it results especially from advertising targeted at the users. Targeted advertising depends on large-scale data collection and analysis, usually by combining different sources of data. The data collected from social or professional interactions on the platform do not have significant monetary value until they can be related to data about purchasing history or habits that must be acquired from other sources.

Indeed, the provider of a sales website derives as much or more value from customer reviews as a social media platform does from user contributions. Such customer inputs create network effects just as do contributions to social media platforms, and in addition they contribute to product marketing. Yet the DST as presently formulated would not apply to a website selling own-goods even if it is greatly enhanced by customer reviews, unless they are more than merely 'ancillary'.

Digital technologies transform the scale and intensity of communication and interaction. From the economic perspective this enables businesses to have much closer relationships with their customers, without needing a significant physical presence in the market

Box: The Example of Amazon

Amazon derives its revenues from cloud computing, video streaming, sales of kindles and e-books and own-goods sales, as well as its 'marketplace' for third-parties. As was revealed in August 2018, Amazon's UK subsidiaries in 2017 paid under £5m in tax, although according to its US filings it had some £8.6b in UK sales. This is because the UK subsidiaries are treated as providing contractual services to the group, and the sales revenues are attributed to its Luxembourg entity. Although Amazon in 2015 agreed to treat its UK sales as booked in the UK by accepting that the Luxembourg company has a UK taxable presence (a 'permanent establishment'), this entity is also likely to be treated as providing sales support services and hence pay little UK tax. (Since it is a branch, its accounts are not published.)

This clearly indicates the fundamental flaws of the arm's length principle, which requires each affiliate of a multinational corporation (MNC) to be treated as if it were independent. This ignores the integrated nature of MNCs, which produces additional profits due to synergy, as the whole is much greater than the sum of its parts. This is clearly shown by Amazon, whose website provides access to a wide range of content and services, which reinforce each other. The company itself clearly recognizes this, since the top executives of its UK affiliates were rewarded with shares in the parent company, which allowed them to participate in its global success. These payouts are deductible, and further reduced the tax payable in the UK: in 2017 for Amazon UK Services the deduction was £17.5m on profits of £72m, and for Web Services a whopping £12m on profits of only £5m, several multiples of the tax collected by HMRC. Yet the DST would apply to only a small part of the revenues from Amazon's integrated activities.

jurisdiction. Suppliers of products such as computers, mobile phones and automobiles now have a continuous relationship with their purchasers, who have become more like clients than customers. Thus, manufacturing is increasingly resembling the provision of services. Digital technologies make it possible for these closer interactions to take place on a much wider scale, even globally, as well as deepening them. A notable example is cloud computing, in which clients make a minimal outlay on hardware purchase but pay subscription fees to a remote provider for access to sophisticated computing services. Similarly, a search engine and an online marketplace can bring together producers and consumers who may be geographically separated, while creating trust through feedback and other quality assurance mechanisms.

Thus, attempting to target only revenues derived from significant user contributions would address only one aspect of digitalisation, and indeed an aspect which is not central to the generation of profits. The need to isolate user-related revenues would make the DST difficult to apply, as well as ineffective in dealing with most of the international tax consequences of digitalisation. A notable example is Amazon, which has grown into a global giant, partly by exploiting the opportunities for international tax avoidance created by the dysfunctional nature of current international tax rules (see Box). Its ability to avoid tax has given it an unfair competitive advantage against national high-street businesses. Yet the DST would seem to apply to only part of Amazon's activities, Amazon Marketplace. This would hurt the many small businesses that take advantage of Amazon's advanced software to sell their products, while not applying to Amazon's own direct sales.

The proposed narrow scope is in our view therefore not sufficient to capture the way digital businesses create value and should therefore be reconsidered. It would be possible, and desirable, to take account of user contributions within a wider long-term proposal, perhaps by treating them as unremunerated labour. It also creates significant practical problems, discussed below.

It has become clear that a long-term solution should treat MNCs in accordance with the economic reality that they operate as integrated firms, and it should allocate their total consolidated profits according to factors which reflect their real activities in each country. These should be people and capital (production factors), and sales (consumption factor), since without sales profits cannot be realised. Such a solution is now in sight especially since the US tax reform of December 2017, which brought the US system more in line with others, with a corporate tax rate on US profits of 21%, and minimum effective tax provisions on both inbound and outbound investment. The US now supports some allocation of taxing rights to market jurisdictions, although based on 'marketing intangibles', whereas the UK proposes 'user contributions'. Another significant development is the proposal tabled by the G24 group of developing countries, formulated by India, Ghana and Colombia. This points out that 'both production and sales are essential for generation of profits'. It argues for 'a simple method for apportionment of business profit', and it suggests that users should be treated as either a labour factor or as capital assets. A multilateral solution would need to take a broader approach and should not target only once aspect such as user contributions.

The practical problems

The conceptual flaws of the proposed DST will create serious practical problems in applying it, as will be seen from the answers that we are sure will be given by business to the specific questions posed in the consultation document. We will respond here to the questions which in our view are fundamental.

Question: Do you agree the proposed approach of defining scope by reference to business activities is preferable to alternative approaches?

A short-term measure in the form of an indirect tax such as this one should focus on the characteristics of the payment on which the tax is levied, and not by reference to the nature of the business activities giving rise to the payment. The design of the measure is conceptually flawed, for the reasons outlined above, and will give rise to complexity and unnecessary compliance costs.

Question: Do you have any observations on the proposed features used to describe the business activities in scope of the DST?

The proposal does not cover revenues from cross-border digital delivery of services, or payments to a non-resident entity from online sales of goods. This means that it would have no impact on the competitive inequalities caused by low taxation of non-resident entities with often high sales volumes in the UK, unless their revenues can be said to result from user contributions.

For example, sales websites derive considerable value from customer reviews, but these would not be considered user contributions in the current proposal. Many platforms and applications derive value from the systematic collection of data from users, but this also is not regarded as contributing value. On the other hand, the user contributions that are targeted in this proposal do not directly generate substantial value for the provider of the platform or application unless they can be combined with other data.

Question: Do you have any observations on the boundary issues the government has identified or others it has not identified?

Defining scope by reference to business activities will clearly create major boundary problems and require firms to attempt to segregate revenue streams artificially. They stem from the conceptual flaws discussed above, which make it hard to define what kinds of 'contribution' would justify an allocation of taxing rights. Some of these boundary problems are already mentioned in the proposal, notably a gaming application or a games website. The proposal suggests that online marketplaces would be included because they enable users to play a role in regulating the quality of goods and services provided on the platform, such as by offering public reviews or providing feedback directly to the platform. These arguments apply also to sales websites selling products or services directly, yet these do not seem to be included in the proposal.