Taxation of the digital economy: where are we and where are we going?

International Tax | Large Corporate

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The CIOT has engaged with the government in the ongoing debate about taxation of the digital economy following the publication of a position paper on the digital economy and an autumn Budget proposal for a new royalty withholding tax.

The digital economy has been the subject of much debate in recent years and in November 2017 the government published a position paper on *Corporate tax and the digital economy*. The government also announced a new royalty withholding tax at the Autumn Budget and subsequently published a consultation document on the detail of this proposal.

The CIOT welcomes this update of the government's thinking, the opportunity it provides to respond and continue to contribute to the ongoing debate in this difficult area. The CIOT has been involved in this debate since the digital economy was identified as an action point of the G20/OECD Base Erosion and Profit Shifting (BEPS) project in 2013 and has engaged with the OECD and the European Commission, as well as with the UK government since then. Most recently, the OECD Digital Taskforce issued a public consultation in autumn last year, to which the CIOT responded, and is expected to produce some recommendations this spring. The European Union has also looked at the area and held discussions under the Estonian Presidency last autumn, again with a public consultation which concluded in January and to which the CIOT responded.

Following the announcements by the UK government at the Autumn Budget and publication of the position paper, the CIOT has met with HMT and HMRC to discuss the position paper on the digital economy and the proposed royalty withholding tax.

We have also submitted a written response to the position paper and will respond on the royalty withholding tax proposals in due course.

The CIOT welcomes the clarity in the government's position paper around the issues and the problem that is to be addressed, as well as the explanations of what is not intended to be within the scope. It is clear that the increasing and pervasive nature of digitalisation across the majority of businesses and, therefore, the economy presents unique and new challenges for tax policy makers in seeking to address the perceived imbalances that arise.

However, in particular, we also welcomed the commitment in the position paper to the existing principles of the international tax framework and, specifically, the principle that a multinational group's profits should be taxed in the countries in which it undertakes its value-generating activities.

The approach in the position paper is around the identification of activities – user participation – as being a new key identifier of the value creation that is to be targeted. We said that conceptually, we can see the case that in certain and limited circumstances, new value indicators, may have been created by digital innovation, and user participation on platforms where such participation is central to the business model could be such a circumstance. However, we also set out our view that even in these cases, the overwhelming bulk of value creation would be represented by the long term investment in the platforms themselves, and this is where the vast majority of profit and taxing rights should be allocated; the attribution of profit to user participation will always be small, and once divided between all jurisdictions where users participate, it will not represent a major source of income for governments in those territories.

At our meeting and in our response, we also emphasised the importance of arriving at a long term multilateral solution to this issue. We said that the challenges should not be underestimated, and many of these challenges are identified in the position paper – particularly around identifying the businesses which are to be within the scope of any changes.

We suggested that time should be taken now to investigate and consider the difficult and complex questions to help ensure that unintended consequences are avoided. In our view it is unfortunate that a number of countries have already introduced unilateral and uncoordinated domestic measures aimed at tackling the digitalised

economy. We continue to strongly encourage the UK government to seek greater and early consensus at an international level that the problem to which a solution is sought is along the lines of that set out in the position paper and to seek a commitment that these issues will be tackled globally. We have previously similarly emphasised to both the OECD and the European Commission in our responses to the work in this area by those bodies the importance of multilateral action across the globe.

As noted above, the position paper introduces the concept of user participation – as being a new key identifier of the value creation that is being targeted. In our response we said that conceptually, we understand this argument, and can see that it can be distinguished from factors such as ‘size of market’ which are not seen as value indicators requiring profit attribution. However, we also said that given the range of different business models and the changing economy we think it will be extremely difficult (if not impossible) to design the rules so that they capture the intended targets without also drawing in businesses that are not intended to be effected.

It is clear that valuing any user input is going to be very difficult and result in considerable controversy. The position paper suggests that it might be possible to use a simple proxy for value generation such as monthly active users. We do not think that this would result in a fair assessment of value because the value of each user’s contribution is going to vary considerably between businesses and even within the same business over time.

We also reiterated the point made in previous responses to the UK government, the OECD and the European Commission that it is important to recognise that digitalisation is a main driver of innovation and growth and this should be encouraged. Changes to taxation should seek to ensure that this innovation and growth is not discouraged or inhibited by double taxation, or the fear of double taxation, and seeking to prevent double taxation should continue to be a fundamental aim of work in this area.

The government’s position paper also raised questions about possible interim measures and we responded that we are very sceptical about the wisdom of these. We would be concerned that any such measures, although intended to be for the short term would, in the end, stay for the longer term. In this regard we noted that a short term measure is likely to be a blunter tool than a fully developed long term

solution and therefore would probably catch more than it should. Unfortunately, it is likely that countries would not want to give up these interim measures, even when a better targeted longer term solution is agreed. Therefore we strongly encouraged the UK government to focus its efforts on a longer term solution.

With regard to interim measures, we also discussed with HMT and HMRC the proposed royalties withholding tax measure which was announced at the Autumn Budget and is the subject of a separate consultation document. We will be responding more fully to that consultation document in due course. At this stage, however, we have pointed out to HMT and HMRC that, following the US tax reforms which occurred after this measure was announced, it is not clear that the proposals are necessary or worthwhile. Following the US tax reforms, it seems to us unlikely that these measures will raise any significant revenue for the Exchequer, but will result in significant costs for HMRC (as well as taxpayers) in terms of compliance, in addition to the significant Parliamentary drafting time that will be required. We have suggested to HMT and HMRC that the expected revenue that may be raised should be weighed against the negative impact on the UK competitiveness at this sensitive economic time.

Our full response to the position paper on Corporate tax and the digital economy can be viewed on the CIOT website.