Digital services tax: navigating a new landscape

International Tax | Large Corporate



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The approaching five-year anniversary of the UK's digital services tax presents an opportunity to reflect on the key learnings to date.

Key Points

What is the issue?

Digital services taxes have been controversial because, whilst seeking to address undertaxed profits, they deviate from the traditional framework of global corporate income taxation on profits and use a tax on revenue.

What does it mean for me?

The Inclusive Frameworks's already extended deadline of 30 June 2024 to reach agreement on Pillar One's Amount A has now passed. Even if agreement can be

reached, this would need to be executed by way of a Multilateral Convention.

What can I take away?

Although many remain optimistic about the broader Pillar One reforms, for now it is clear that digital services taxes are here to stay.

Since 2016, we have seen digital services taxes introduced around the world as a new instrument to tax digital activities. These digital activities, which include online marketplaces, social media platforms and search engines, have often been perceived by governments as highly profitable and insufficiently taxed under existing international tax rules.

Digital services taxes have been controversial because, whilst they are seeking to address undertaxed profits, they deviate from the traditional framework of global corporate income taxation (based on nexus and arm's length profit allocations) and use a tax on revenue. They are also hard to keep track of and comply with, given the unilateral nature of the measures in place or announced, following action by individual countries in the absence of global or even regional (e.g. EU) agreement on a common design.

The initiative from the OECD/G20 Inclusive Framework, managed by OECD officials, to tackle this proliferation of digital services tax is Amount A of BEPS Pillar One (see tinyurl.com/34pea49r). It is intended to remove unilateral measures and replace them with a globally consistent, profit-based system that applies to the world's largest and most profitable companies. However, those plans have so far neither been agreed nor implemented. As a result, some governments remain frustrated at the perception that data-dependent businesses can generate significant revenues from local users whilst not subject to material corporate income tax.

The already extended deadline of 30 June 2024 to reach agreement on Pillar One's Amount A has now passed. Even if agreement can be reached, this would need to be executed by way of an international treaty referred to as a Multilateral Convention.

For this to be effective, the Multilateral Convention needs to be ratified by at least 30 jurisdictions, including the US. The outcome of the US election may have a significant impact on the likelihood of material multinational progress any time soon – and the US has a long history of not signing up to Multilateral Conventions.

The next wave

The intended progression to a global solution saw countries initially hold off on the further introduction of unilateral measures. In October 2021, 138 members of the OECD/G20 Inclusive Framework agreed not to introduce new digital services taxes before the end of December 2023, provided the signature of the Multilateral Convention had made sufficient progress by this date.

Alongside this backdrop of continuing difficult negotiations and delayed progress, there is the potential for significant geopolitical change in 2024. By the end of the year, more than 64 countries, as well as the EU, will have held national elections. In addition, government finances continue to be stretched and the belief that digital activities represent a significant area of activity that is undertaxed locally persists. Therefore, it is perhaps no surprise that we are seeing a new wave of digital services taxes being introduced.

In 2024, new rules have been introduced in Canada and proposed in New Zealand, while other countries are also actively considering the introduction of a digital services tax. The Canadian rule has retroactive effect from 1 January 2022, which surprised many but effectively highlights the government’s sentiment that this is a deferred introduction of the rules.

As more countries implement these new taxes and build the revenues generated into their national budgets (for example, the Canadian authorities expect to raise $7.9 billion over the next five years), it may reduce the chances of agreement on Pillar One Amount A unless its local revenue impact is comparable with existing digital services taxes being removed. This may be unlikely in practice, given that Pillar One is based around a reallocation of profits, whereas digital services taxes are an incremental tax on revenues.

Navigating the global rules

With the lack of progress around the BEPS Pillar One proposals and with the increasing number of countries seeking to introduce unilateral measures, it is critical that impacted businesses have a clear process to monitor the frequent legislative developments. For many businesses, these processes will already be in place as part

of their routine monitoring of developments in the VAT on digital services space. However, there is also a subset of businesses that have historically adopted a ‘wait and see’ approach to global digital services tax monitoring, particularly after the October 2021 statement. In anticipation of increased tax authority activity in this area, businesses that have previously adopted this approach will need to rethink their digital services tax strategy.

At this stage, it is clear that businesses will not be able to adopt a common approach to assessing the impact of digital services taxes on their revenue streams across the current measures that exist, and will need to be agile as they respond to global digital tax service developments. The unilateral nature of the global digital services tax landscape means there are significant differences in how the rules have been implemented by legislators.

Countries have different views on the rates of tax, as well as on the nature of activity that should be within scope. Examples of variations in implemented rules include:

- **The scope of the impacted activities:** At one end of the spectrum, countries such as Turkey and Kenya apply a broad interpretation of the types of services that are in scope, whilst other countries such as Austria have narrowly focused their digital services tax on advertising activities only. The expected trend is that legislators will look to broaden the scope of the tax as more countries turn to them as a means to tax the digital economy and reduce fiscal deficits.
- **Applicable thresholds:** Countries such as the UK are applying far higher local thresholds than other European countries, such as Italy and Spain. For example, £25 million of local revenues are needed under UK rules, compared to €5.5 million and €3 million in Italy and Spain respectively.
- **The rate of tax:** The UK has one of the lowest rates at 2% compared to countries such as Turkey, where the digital services tax rate is 7.5%.
- **The impacted financial years:** Canada has recently issued an announcement making it the first country to apply the digital services tax regime on a retroactive basis, capturing revenues earned as far back as 2022.

The combination of these factors means it is critical that impacted businesses have a clear strategy in place to respond to developments, particularly against the backdrop of the increased awareness of shareholders, investors and auditors.

In the UK

The approaching five-year anniversary of the UK's introduction of its own digital services tax presents an opportunity to reflect on the key learnings and observations to date.

This also coincides with the anticipated HMRC review into UK digital services tax in 2025 – although no specific 'sunset clause' was included within the UK digital services tax legislation at the time of its introduction. However, the recent change in government presents a new interesting dynamic, and it remains to be seen whether this commitment will be upheld. One option would be for a consultation to be announced as part of the Autumn Budget.

The Labour Party manifesto was silent on the UK digital services tax. However, it was included in the Liberal Democrat manifesto, with a proposal to increase the rate of tax to 6%. In order to fund increased public spending, the new government will need to raise tax revenues to fund increased public spending and has committed to freezing VAT and corporate tax rates, opening the door to a possible increase in the UK digital services tax rate.

The government has also pledged to increase investment in HMRC to reduce the tax gap and it is reasonable to conclude that businesses that operate within the digital economy are likely to face increased scrutiny around compliance with UK digital services tax legislation.

Lessons learned so far…

- The scope of the 'marketplace' activity is broad and applies to a range of businesses. In addition to the clearly impacted businesses such as online platforms for used goods and travel, the digital services tax has also impacted price comparison sites and businesses that operate under a franchise model.
- The rules apply to non-resident businesses, as well as to UK-only businesses that derive all their revenue from UK users. This creates a 'cliff-edge', where businesses with revenues close to the £500 million global threshold are faced with the prospect of all their revenues being subject to UK digital services tax once the global threshold is exceeded, with the exception of the £25 million allowance.

- The trend of user-generated content and user-user interactions is continually increasing. We have seen businesses adopt different approaches as to who ultimately bears the cost of the digital services tax, with some choosing to pass the 2% cost onto their customers. This raises wider commercial implications regarding pricing structures, time to implement and communication with customers.
- HMRC has been open and collaborative with taxpayers and demonstrated a commitment to learning, as shown from the outset through the extensive consultation process, and has continued with HMRC publishing detailed guidance that is frequently updated.
- Digital services tax calculations are complicated. Whilst HMRC expects that businesses will use the data they already have, rather than build new processes, it can take time to work through and to correctly identify revenues and discounts, etc.
- Overall, the introduction of the UK digital services tax has been considered a success by HMRC. Many businesses that have registered have commented on the simplicity of the registration process and ongoing compliance. A 2022 National Audit Office review also highlighted the significant revenue raised by the digital services tax, which exceeded forecasts by 30% (£358 million in 2021, increasing to £567 million in 2023).

In summary

Should the 2025 review go ahead as originally planned, it is likely that taxpayers will want a range of considerations included, such as:

- a commitment to maintaining the existing alternative charge election for loss-making businesses and to not align the UK digital services tax with other countries where no similar provisions exist;
- continued clarity on what HMRC considers as ‘similar digital services taxes’ for the purposes of cross-border relief, including an explanation of why certain measures such as India’s equalisation levy are not considered similar;
- clarity around how the UK digital services tax applies to businesses involved in goods supply chains where flash title is exchanged; and
- a commitment to maintaining the existing 2% rate and existing scope.

Against the backdrop of increased controversy within the digital economy, such as the Italian VAT authorities challenge on social media businesses providing ‘free’ services to users, the introduction of new taxes such as digital services taxes only increases the pressures and demands on tax functions.

When digital services taxes were first introduced, they were considered by many as ‘temporary’ measures, pending a greater overhaul to the international tax system under BEPS Pillar One. What has become clear in recent years, however, is that the existing digital services taxes in force are viewed positively by legislators and tax authorities as solving the problem of how to tax those that operate in the digital economy.

Although many remain optimistic about the broader Pillar One reforms, for now it is clear that digital services taxes are here to stay. The longer they are in force, the harder it becomes politically to repeal these.

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