

U.K. Proposes Draft DST Legislation Containing Double Tax Relief

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By Ryan Finley and Stephanie Soong Johnston

The United Kingdom has released draft legislation on its 2 percent digital services tax proposal, which allows a deduction for revenue subject to tax in multiple countries while offering some relief for unprofitable activities.

The [draft DST legislation](#), released July 11, would impose the controversial tax beginning April 1, 2020, on groups with consolidated worldwide digital services revenue exceeding £500 million and U.K. digital services revenue exceeding £25 million. Subject to a £25 million allowance, affected taxpayers would be subject to a 2 percent tax on revenue attributable to U.K. digital services revenue. Digital services revenue is defined in the draft legislation as revenue attributable to providing a social media platform, internet search engine, or online marketplace. The [U.K. DST proposal was first announced](#) by Chancellor of the Exchequer Philip Hammond in the [2018 budget](#).

Revenue attributable to both DST-relevant activities and other activities must be allocated on a “just and reasonable basis,” generally without regard for any complementary relationship between the activities, according to [draft guidance](#) released along with the legislation. ([Explanatory notes](#).)

“An online marketplace is a different business proposition than an online retail store, but there is potentially some complementarity when the two are offered alongside one another, such as helping to increase product offering, or helping to increase traffic. In cases such as these, HMRC does not generally expect indirect cross-subsidization to be factored into the calculation of taxable revenues,” the draft guidance says.

U.K. Users

Regarding the challenge of identifying the location of users, the draft guidance says a U.K. user is “a user who it is reasonable to assume is either an individual normally located in the U.K. or, for businesses, established in the U.K.,” adding that companies are not expected to account for users when the information reasonably necessary to determine location is unavailable.

“Businesses should determine whether a user is normally located or established in the U.K. based on the information available to them. The information a business collects from users will vary depending on its business model,” the draft guidance says. “The legislation consequently does not specify acceptable sources of evidence, use presumptions, or impose a prescriptive hierarchy of evidence. Instead, businesses should consider the information they hold and use the most appropriate evidence, or mix of evidence, to identify user location.”

From a technical standpoint, the DST relies on the definition of a U.K. user, but that definition will be challenging to determine accurately, according to Rhiannon Kinghall Were, head of tax policy at Macfarlanes LLP.

“Even if a business was to require users to confirm their place of normal residence, it is likely to be impossible in practice for such businesses to verify the accuracy of any given user’s confirmation,” Kinghall Were told *Tax Notes*. Information like payment details, delivery addresses, and other kinds of customer data that a user provides, along with IP address details, will be used, she noted.

However, although those details can help indicate a user’s location, “they are fundamentally different concepts,” Kinghall Were said. “And if a user’s location is not determinable due to a [virtual private network], then the business will have to use other sources of information to determine if it is a U.K. user,” she added.

All net revenue from an online marketplace transaction will generally be attributable to the United Kingdom if at least one party to the transaction is a U.K. user under the proposal. However, there is an exception for cross-border marketplace transactions in which one of the parties is a considered a user in another jurisdiction that imposes a DST. Under the draft legislation, taxable U.K. digital services revenue covered by the exception would be reduced by 50 percent.

According to Claire Hooper of EY UK’s London office, it was encouraging to see the government recognize that the same revenue may be subject to multiple DST charges and offer some relief. “The relief will not, however, be available in all circumstances,” Hooper told *Tax Notes*. “Furthermore, many groups will be subject to both U.K. corporation tax and DST on the same revenue.”

Alternative Charge

To account for cases in which the DST revenue base corresponds to unprofitable activities, the draft legislation also offers an alternative charge mechanism assessed on an operating margin basis. One of the persistent criticisms of turnover-based DSTs is that taxpayers could be subject to a tax that exceeds the profit earned on the transaction. Taxpayers that make an annual election to apply the alternative charge to any of the three relevant activities are subject to a tax equal to 80 percent of net revenue multiplied by the operating margin associated with that activity.

According to the draft guidance, the alternative charge formula provided in the legislation “ensures that the benefit of the non-standard rate is in proportion to the ability of the relevant activity to bear the additional cost of DST.” However, Kinghall Were expressed disappointment at the alternative charge safe harbor, which remained mostly unchanged after the consultation. “Whilst the safe harbor is designed as a relieving provision for low-margin businesses, accessing it is prohibitively complex and the economic burden for low-margin businesses is disproportionate,” she said.

Deductible operating expenses under the alternative charge would include cost of sales,

administrative expenses, and depreciation and amortization attributable to the activity, but would exclude interest expense, acquisition costs, and valuation changes. Costs that relate to both covered digital services and other activities must be allocated on a reasonable basis under the circumstances.

“Whether a basis is just and reasonable or not will depend on the particular facts and circumstances. The method should reflect the relative profitability of the activities and the markets to the business,” according to the draft guidance.

The draft guidance specifies that DST liability will not be creditable for corporate tax purposes. Although a deduction will generally be available for DST paid, the allocation of DST liability must be allocated among group members based on transfer pricing principles, the guidance says.

“Where there are controlled transactions between associated enterprises in the group, the companies should consider the treatment of the DST charge in arriving at the arm’s-length price. In particular, they should ask whether at arm’s length the company that paid and/or is liable to DST would have borne the cost of the DST expense, or whether it would have looked to recover some or all of the expense within the new transfer price,” the draft guidance says.

According to a [statement](#) by Financial Secretary to the Treasury Jesse Norman, the proposed DST is necessary as a short-term measure while [negotiations on a consensus solution continue at the OECD](#).

“The U.K. has always sought to lead in finding an international solution to taxing the digital economy. This targeted and proportionate digital services tax is designed to keep our tax system in this area both fair and competitive, pending a longer-term international settlement,” Norman said.

The government’s pledge to remove the DST once an international agreement on a solution to tax the digital economy is in place, and to review the tax by the end of 2025, should be welcome news, according to Hooper.

“However, even if the OECD inclusive framework is successful in its endeavors within its planned time frame, it will take time to implement any agreed solution, and so the DST is likely to be in place for a number of years,” Hooper said. “This is a particular concern given the government accepts that a revenue-based tax such as the DST is suboptimal.”

The draft legislation was released on the same day that [France approved its DST](#), while [U.S. lawmakers expressed their displeasure](#) with both countries’ DSTs, saying that they could threaten trade negotiations. On July 10, President Trump called on the office of U.S. Trade Representative Robert Lighthizer [to investigate whether the French DST legislation constitutes an unfair trade practice](#) by targeting U.S. companies.

“Given the narrow scope of application to social media platforms, internet search engines, and online marketplaces, it is quite obvious which companies” are being targeted by the U.K. DST legislation, Kinghall Were said. “The chances of the U.S. concluding that it unfairly targets American companies, just like it has done with the French proposals, seems high in the current environment,” she added.

