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U.K. Announces Draft Legislation for Digital Services Tax

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The U.K. government has recently published draft legislation for a new Digital Services Tax (the "U.K. DST"). From April 2020, the U.K. DST will be charged at a rate of 2 per cent. on enterprises which derive revenue from the provision of social media platforms, search engines, or online marketplaces to U.K. users. The U.K. DST is expected to raise at least £275 million in the 2020-2021 tax year. The draft legislation was subject to technical consultation until 5 September 2019.

The rationale provided for the new legislation is that the current U.K. corporation tax provisions have led to a misalignment between the place where profits are taxed and the place where value is created. The U.K. DST is a reaction to large multi-national enterprises who have been accused of paying relatively small amounts of tax in the U.K. by funneling business through low-tax jurisdictions such as Luxembourg.

This is relevant in particular where businesses derive value from their interactions, engagement, and participation with a user base (which has, to date, not been taken into account in allocating the profits of multinational business across jurisdictions).

Who Will Be Affected by the DST?

The U.K. DST will not apply to individual users but to enterprises that are engaged in both the provision of certain digital businesses (the "DST Activity Condition") and fulfill a de minimis revenue requirement (the "Revenue Condition").

The Activity Condition

Broadly, enterprises that are involved in the provision of any of the following may be liable to U.K. DST:

- social media platforms;
- internet search engines; or
- online marketplaces (together "DST Activities").

The U.K. DST will also capture an "associated online advertising business"—defined as a business operated on an online platform that facilitates the placing of online advertising and derives significant benefit from its connection to the social media platform, online search engine, or online marketplace.



The Revenue Condition

The Revenue Condition will be met when certain minimum thresholds are met, as follows:

- the worldwide revenue attributable to the DST Activities exceeds **£500 million** in the accounting period; and
- the revenue attributable to the DST Activities which are attributable to U.K. users exceeds **£25 million** in the accounting period.

Revenue from the business activity will include any revenue earned by the group that is connected to the business activity, irrespective of how they monetise the platform. A social media platform's revenue will include displaying advertising to users, charging users to access specific content, and the sale and licensing of user data. In the case of a search engine, the revenue will include revenue from advertising on search results and third-party websites and the sale or licensing of data. An online marketplace's revenue will include certain fees, such as those received for commission, delivery, access, subscriptions, and advertising.

"U.K. User"

A U.K. user is defined as a user that it is reasonable to assume is normally located or established in the U.K. and includes both individuals and legal persons. The legislation does not specify when a user is a "U.K. user". The burden will therefore fall on businesses to take reasonable steps to identify U.K. users and allocate appropriate revenue. Indicators of a U.K. location or establishment may be the delivery address, payment address, IP address, intended destination of advertising or the address of property, or location of goods to be rented out. In the case of marketplace transactions, where one of the users is a U.K. user or revenues that arise in connection with the sale of U.K. land or premises or provision of accommodation in the U.K. (including the sale of goods or services in relation to any such land), all the revenue from that transaction will be treated as attributable to U.K. users.

Calculation and Formalities

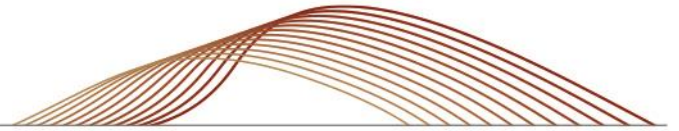
Where the Revenue Condition is met, the U.K. DST will not be payable on the first £25 million of relevant U.K. DST revenues, but will be levied at a rate of 2 per cent. on all relevant revenue above this de minimis threshold.

In order to ensure that the U.K. DST does not negatively impact businesses that have a low operating margin, there may be cases where such businesses can elect to have a lower rate of DST applied to revenues caught by the legislation.

The U.K. DST is a self-assessment tax, payable and reportable annually. U.K. DST will be deductible against corporation tax under the normal principles.

The U.K. DST will be calculated at a group level, but each entity in a group will be liable to the U.K. DST. A group can nominate a group entity to be the group's reporting entity for U.K. DST purposes; otherwise, the reporting entity will be the ultimate parent. If U.K. DST is not paid within three months, HMRC can serve notice for payment on any member of the group and a penalty may also be due. Once a group has registered for the U.K. DST, it must continue to report annually.

It is expected that HMRC will publish further guidance on the U.K. DST before April 2020.



Next Steps

Businesses should carefully consider whether they might be, or become, within the scope of the DST. Businesses should note that even where their business is not specifically aimed towards the U.K., the U.K. user concept embedded in the legislation may still mean that their business is (or becomes) within the scope of the U.K. DST legislation.

Commentary

The implementation of the U.K. DST has been subject to criticism. One of the main concerns from industry is that the £500 million revenue threshold is, in fact, low and poses the risk that smaller companies (and not just the multi-national enterprises the legislation is aimed at) will be within the scope of the U.K. DST. This may have the effect of suppressing innovation in the U.K. on a larger scale by undermining the U.K.'s reputation as an attractive jurisdiction for tech investment and start-ups.

In the context of Brexit, the implementation of the U.K. DST also comes at a critical time. Given the dominance of U.S. tech giants, it comes as no surprise that the U.K. DST has not been welcomed by the U.S., with Trump sending clear warnings that the U.K. will not get a free trade deal unless the DST is dropped. Indeed, the U.K.'s introduction of the U.K. DST follows shortly after the implementation of the French DST. The U.S. has reacted to the new French tax by opening an investigation into whether it is discriminatory towards U.S. taxpayers. The U.S. and France are said to have now reached an agreement until an international proposal on a DST is implemented.

Despite U.S. noise in reaction to the new tax, with two-member states already implementing a DST, the EU may step forward and implement an EU-wide directive to reduce the risk that EU member states will continue to implement a DST outside of the commissioner's ambit.

The need for streamlined implementation of a DST, however, is a global one and it is likely that more countries will follow in the U.K.'s footsteps. The U.K. government has stated that the long-term, sustainable solution is reform of the international corporate tax rules such as through G7 and G20, including OECD Base Erosion and Profit Shifting ("BEPS") efforts. The OECD BEPS initiative is making steady progress towards a consensus on Action 1 ("tax challenges arising from digitalisation"). However, the U.K. legislation makes no provision for the repeal of the U.K. DST following any global implementation of a similar tax, only a promise to review the legislation in five years' time. As such, unless mounting pressure from the U.S. succeeds, it looks like the U.K. DST is here to stay.



If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings London lawyers:

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