HM Treasury

Corporate tax and the digital economy: position paper

November 2017

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Chapter 1
Summary

1.1 The government believes in the principle that a multinational group's profits should be taxed in the countries in which it generates value.

1.2 And it has taken significant steps, at both a domestic and international level, to ensure that this principle is being delivered. It initiated the OECD-G20 Base Erosion and Profit Shifting (BEPS) project to tackle multinational tax avoidance, led the implementation of that project's outputs, and took bold unilateral action where needed, including the introduction of the Diverted Profits Tax in 2015 which is forecast to raise £1.35 billion by 2019.

1.3 However, there is still more to be done. Countries must continue to work together to identify areas where the international tax framework still leaves them exposed to multinational tax planning, and consider how that framework is being challenged by changes in how global businesses are managed and structured.

1.4 Moreover, there is a need to ensure that the international tax framework is responsive to the changing nature of our economies in the digital age, and able to accommodate new digital businesses that operate and create value in different ways.

1.5 The government recognises the benefits that these digital businesses provide in terms of enhancing consumer choice and supporting productivity, and is committed to supporting the continued growth and success of the UK tech sector. However, it is essential that the international corporate tax rules ensure that their UK corporation tax payments are commensurate with the value they generate from the UK market and specifically the participation of UK users.

1.6 This paper sets out how the government intends to achieve this:

a) The government will push for reforms to the international tax framework, to ensure that the value created by the participation of users in certain digital businesses is recognised in determining where those businesses' profits are subject to tax

b) Pending reform of the international framework, the government will explore interim options to raise revenue from digital businesses that generate value from UK users, such as a tax on revenues that these businesses derive from the UK market. The UK will work with other countries to consider how such a tax could be targeted, designed and co-ordinated to minimise business burdens and distortion. However, the government stands ready to take unilateral action in the absence of sufficient progress on multilateral solutions

c) The government will take more immediate action against multinational groups, primarily in the digital sector, who achieve low-tax outcomes by holding their valuable intangible assets such as intellectual property in low-tax countries where they have limited economic substance. This action, which is taken in accordance with the UK's international treaty obligations, will help to prevent groups achieving unfair competitive advantages in the UK market in which they operate. It will also help to ensure that the discussion on how value is created by the users of certain digital businesses starts from a more sustainable position

1.7 The government welcomes views on the challenges identified with the international tax framework in this paper and its proposed approach for dealing with them.

1.8 It hopes that the paper, and the debate it stimulates on this important issue, will inform the interim report being presented by the OECD Task Force on the Digital Economy to the G20 next spring. The government believes that the report needs to put forward bold multilateral solutions that build on the discussions taking place within the European Union, and help to ensure a more sustainable corporation tax framework for the future.

Contact

1.9 The position paper takes account of feedback provided as part of the recent OECD consultation, and invites additional comments on this specific UK position by 31 January 2018. Responses should be sent in writing or by email to:

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Chapter 2
The international tax framework

2.1 The important question when applying corporation tax to a multinational group is what amount of profit should be taxed in the UK compared with the other countries in which the group operates.

2.2 The answer to that question is currently determined by an international tax framework which was developed in the early 20th century, and is reflected in the OECD Model Tax Convention and in the double tax treaties that the UK has entered into with other countries.

2.3 That framework:

- through the transfer pricing rules (Article 9 of the OECD model), looks to ensure that a multinational group's profit is divided between its constituent companies in accordance with those companies' contributions to the generation of profit
- through the concept of a permanent establishment (Article 5 of the OECD model), awards taxing rights over the profits of a company to the countries in which that company has a permanent physical presence
- through the profit attribution rules (Article 7 of the OECD model), allocates the profits of that company between those countries based on the relative value of the activities it undertakes within each jurisdiction

2.4 The overall principle underpinning that framework is to tax a multinational group's profits in the countries in which it undertakes its value-generating activities, such as where major operating decisions are made and where important assets and risks are controlled.

2.5 That is a principle that the government continues to support. It does not, for example, believe that another country should have a general right to tax profits that a UK business generates from a product that is designed in the UK, manufactured in the UK, marketed in the UK and then sold remotely to that country's customers.

2.6 Equally it does not believe that the UK should have a general right to tax the profits that a foreign business generates from a product that is designed in another country, manufactured and marketed in that country and then sold remotely to a UK consumer.

2.7 Instead countries should have the right to tax business profits derived from productive activities, enterprise and human innovation in their jurisdiction, irrespective of where shareholders and customers are located.

2.8 However, while the government continues to support the principle of aligning profit with value creation, there is a clear need to consider the situations in which that principle is not being delivered by the existing international tax framework.

2.9 In particular, it is important to consider how the international tax framework is being stressed by digitalisation and whether it is flexible enough to take account of the differences in how certain digital business models operate and generate value.

Chapter 3
Challenges to the current framework

Continued risk of Base Erosion and Profit Shifting

3.1 The OECD-G20 BEPS project aimed to respond to identified weaknesses in the international tax framework which were frustrating the principle of aligning profits with value creation and creating opportunities for multinational groups to break that alignment through artificial structures.

3.2 The process produced a series of multilaterally agreed recommendations and best practice approaches. This included steps to protect the definition of a permanent establishment against avoidance, act against groups shifting taxable profits overseas through interest payments and revise the transfer pricing guidelines to put greater emphasis on real economic activities in determining how profits are allocated between countries.

3.3 The significance of the BEPS project should not be underestimated. There is clear evidence that its recommendations, along with the unilateral action undertaken by the UK through the Diverted Profits Tax, are having a discernible impact on multinational groups' behaviour and the viability of complex tax planning structures that unfairly reduce UK tax receipts.

3.4 However, as stated at the end of that project, the government believes that important weaknesses remain in the detailed application of the international tax framework which necessitate continued multilateral action. Specifically, there is a need to consider, and respond to, the challenges that remain with the transfer pricing rules.

3.5 That includes:

- the challenges for businesses and tax authorities in administering those rules. For example, the potential difficulties in applying the arm’s length concept to intra-group arrangements where no comparable arrangements exist between unrelated parties
- the extent to which the changes made to the transfer pricing guidelines as part of the BEPS project are being administered in a consistent manner by countries in a way that: (i) prevents residual profits being realised in low-tax entities that own assets and risks in the absence of true economic substance; and (ii) prevents groups from being able to transfer valuable assets into low-tax entities without triggering appropriate tax charges at the level of the transferee

- the extent to which tax authorities have the requisite information on a multinational group's global value chain, as opposed to just the group's local activities, in order to support transfer pricing judgements
- the situations in which the transfer pricing rules might leave countries exposed to risks of manufactured tax outcomes. For example, where the attribution of a large amount of profit is determined by the location of a small number of mobile and replaceable individuals taking decisions regarding the deployment of capital or the management of risk within a group

3.6 These are complex issues that need to be discussed multilaterally within the OECD and other international fora to ensure that the international tax framework continues to achieve sustainable results.

3.7 The government does not think these issues are specific to businesses operating in the digital economy, and does not therefore think they should be the focus of international discussions on digital business taxation. However, as part of more general discussions it will be important to consider how the digitalisation of businesses could exacerbate these issues, for example through changing businesses' revenue drivers or increasing the value of their intangible assets and the scale of cross-border royalty flows.

Increased business centralisation

3.8 The way in which businesses carry out their global activities has been fundamentally changed by digitalisation and technological advancement.

3.9 The speed at which information can be processed and analysed as well as the decision-making capabilities of newly developed software and algorithms have allowed for the automation of certain traditional business functions.

3.10 Equally, the ease with which people in different countries can be connected through an online platform has given businesses greater flexibility over where they locate their business activities and made it possible for them to access different geographic markets from a limited number of remote locations, without the need for a material local presence.

3.11 These changes do not undermine the principle that stands behind the international tax framework, even if they are affecting how the profits of a multinational group are allocated between countries for tax purposes.

3.12 Nor is business centralisation an issue specific to businesses in the digital economy, illustrated by the fact that some digital businesses operate with a large and geographically dispersed footprint and some non-digital businesses operate with a footprint that is comparatively concentrated.

3.13 However, it is necessary to consider how the increased integration of multinational groups, and the ability for groups to manage their global operations from a central location, could create challenges in the administration of transfer pricing rules (e.g. in determining where control is exercised) and how those challenges could be best dealt with. And as part of that, consideration should be given to how those challenges might be exacerbated in digital business models that are highly digitalised in terms of their inputs, processes and outputs.

User participation in digital businesses

3.14 In addition to these challenges there is a fundamental question as to whether the international tax framework is flexible enough to accommodate different business models within the digital economy and ensure fair outcomes that align profits with value creation.

3.15 The mere consumption of a good or service in a country should not, by itself, entitle that country to tax the profits of the business providing that good or service.

3.16 However, for many digital businesses that operate in markets through an online platform, the users of the platform (which may or may not be identical to a business's consumers) play a more integral role in the pursuit of revenue and create material value for a business through their sustained engagement and active participation.

3.17 Take, for example, a social media platform that generates revenue through directing adverts at UK users who use a free online platform. The success of that business is reliant on the development of a large user base, on the engagement of users and on users' contribution of content. It is also dependent on the collection of user data from intensive monitoring of that engagement and contribution, which can be sold to third parties or used to generate increased revenues through more precisely targeted adverts.

3.18 Equally, take an online marketplace that generates revenue through matching suppliers and purchasers of a good in return for a commission, or a collaborative platform that charges a commission for bringing together supply and demand for assets and possessions owned by individuals. The success of those businesses is reliant on the active involvement of users on either side of the intermediated market and the expansion of that user base to allow the business to benefit from network effects, economies of scale and market power.

3.19 The desire to maintain an engaged customer base and use information from that customer base to improve products and offerings is not new. However, the success of the businesses outlined above is much more reliant on the activities, decisions and participation of users with whom the business forms a more sophisticated and sustained relationship.

3.20 That participation, which is not under the control of the business, contributes to the creation of the brand, the generation of valuable data, and to the development of a critical mass of users which helps to establish market power and allows businesses to take advantage of the low marginal costs that are typically associated with running such a platform across multiple markets. It also explains why some of these businesses choose to, or are able to, provide innovative services to users for no charge.

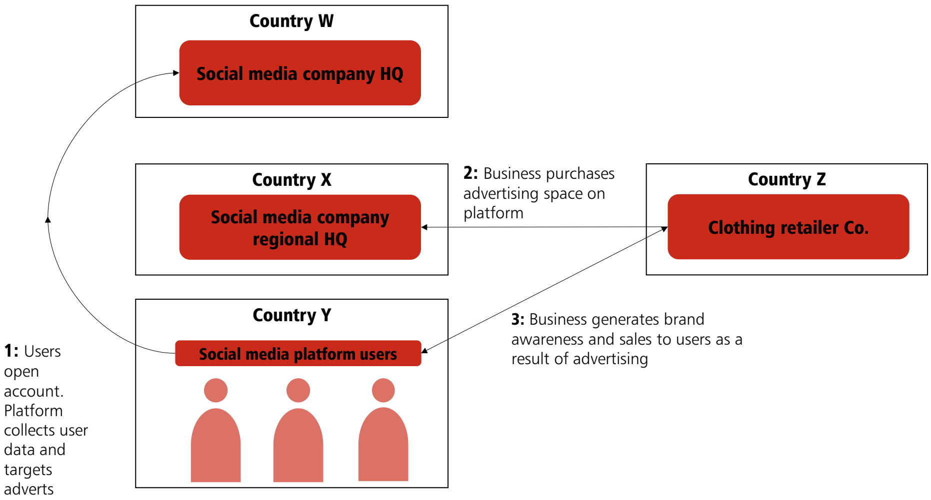
3.21 This user-generated value is not captured under the existing international tax framework, which focuses exclusively on the physical activities of a business itself in determining where profits should be allocated for corporate tax purposes. This means that the businesses outlined above can generate significant value from a market like the UK without the profits they derive from that value being subject to UK corporation tax.

3.22 This needs to be addressed. There is a need to consider the active participation of users, and the value that this participation creates, in determining how the taxable profits of certain digital businesses are allocated between countries for tax purposes – even where that business does not have a physical presence in a user jurisdiction.

3.23 There is also a case for reflecting on whether the activities associated with penetrating a market and sustaining a user base, which might be considered routine functions for many businesses, are more integral for certain types of digital platforms and should be given more weight in the allocation of profits between countries for tax purposes.

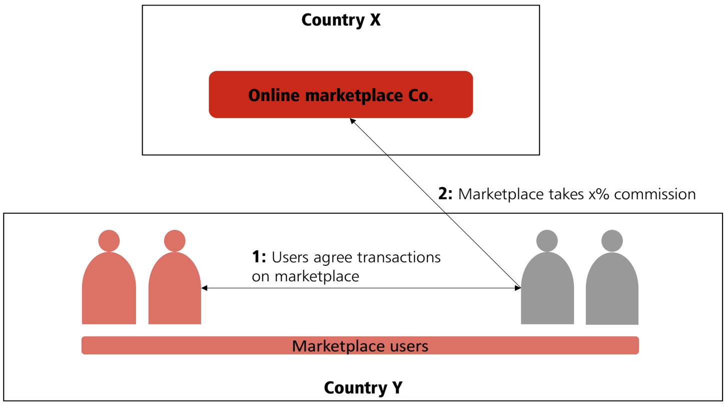
Box 3.A: User participation in digital business models – illustrations

Diagram 1: Social media business model



A social media business platform gives rise to a number of overlapping relationships. Overall in this model users have an important role in generating value for the social media company, by providing data and content which allows it to better target advertising and increase revenues.

Diagram 2: Online marketplace business model



In this example an online marketplace facilitates interactions between two different sets of consumers e.g. consumers looking to temporarily lease or rent property. There is no requirement for the marketplace to have a business entity or physical presence in the country where the transactions between consumers take place. However, the marketplace is reliant on having a large and engaged network of users in that country. It does not have a physical limit on its capacity to provide this marketplace function and may be able to intelligently monitor and respond to market outcomes by analysing aggregate trading activity and user data.

Chapter 4
The government's approach

Long-term reform

4.1 The challenges that digital businesses pose to the effectiveness of the international corporate tax rules can only be sustainably addressed in the long run through multilateral reforms.

4.2 There needs to be broad international acceptance of the need to address the challenges that digital businesses create for the tax system and agreement on a process and timetable for achieving meaningful reform of the international tax framework.

4.3 That reform would need to:

- ensure that the rules for determining the profits of companies within a group, or perhaps groups undertaking certain narrowly defined activities, reward the value that those companies might generate from user participation
- give countries a right to tax the profits of foreign companies that derive value from a material and active user base within their jurisdiction, even in the absence of those companies having a permanent establishment
- allocate an amount of profit of those foreign companies to the countries in which they have such a user base, based on a metric that approximates the value that the user base generates e.g. monthly active users

4.4 There will be difficulties in moving away from traditional and well-understood concepts, difficulties which help to explain the absence of agreed international action on this issue to date.

4.5 However, it will be important to consider how those difficulties could be overcome through targeting reform at specific business models, while acknowledging the practical challenges of defining those business models on a dynamic basis.

4.6 It will also be important to consider the merits of more pragmatic approaches for achieving the objectives of the corporate tax system in this area. That could include splitting a proportion of taxable income that a digital business group derives from online advertising and intermediation activity between market jurisdictions in accordance with some user or market based metric as a proxy for value created.

4.7 The government believes that the interim report of the OECD Task Force on the Digital Economy, due to be presented to G20 leaders next year, should consider these important points and outline a multilateral process by which they can be resolved.

Interim digital solutions

4.8 The issues identified in this paper with the international tax framework can be most sustainably and comprehensively addressed through multilateral reforms.

4.9 However, the government agrees with the European Commission and other EU Member States that, pending such international reform, there is a need to consider interim action in recognition of the growing public dissatisfaction that the corporation tax payments of digital businesses are not commensurate with the value that they derive from the UK market.

4.10 Of the options that have been put forward in this area, the government thinks the most attractive is a tax on the revenues that businesses generate from the provision of digital services to the UK market. There are a number of important design decisions however that need careful consideration:

- Scope: The government believes that the scope of such a tax should align with the specific concern raised above about user participation not being given sufficient recognition by the international tax framework. That concern seems relevant to businesses that generate revenues through intermediation and the provision of online advertising. The concern seems less relevant to businesses that generate revenue through selling self-developed goods to customers through an online platform, selling acquired goods on an online platform, charging customers for the provision of digital content, or charging customers for the provision of digital software and digital services

- Nexus: It would be important to consider what revenues the UK would have a right to tax given the lack of a typical consumer in these businesses models and the possibility of users being located in a different country from consumers (or the users of an intermediation platform being located in different countries). This was partly illustrated in Box 3.A. For example, a social media platform may generate revenue from a non-UK business in relation to adverts targeted at UK users

- Rate: The rate would need to be set at a level that raises material revenue in a way that is nonetheless fair, non-distortive and applicable to business models with different profit margins

- Collection mechanism: There are different ways such a tax could be collected. There are potential benefits to collecting the tax directly from the relevant companies, to ensure more efficient compliance and avoid placing new obligations on financial intermediaries, as may be the case under a withholding model

- Detailed design: It would need to be considered how the possible distortions with a revenue-based tax could be minimised, for example through the provision of double tax relief, de minimis thresholds and mitigating provisions for loss-making and early-stage businesses

4.11 While the UK stands ready to take unilateral action, there would be value in co-ordinated implementation of such a tax between countries. This would minimise administrative burdens for businesses operating in different jurisdictions and reduce some of the challenges associated with the collection of tax and the calculation of businesses' tax liabilities.

4.12 For that reason, the government believes that interim solutions of this nature should be actively considered in the OECD's interim report. Where relevant this report should also take into account analysis being undertaken by the European Commission.

Preventing under-taxation

4.13 The discussion on how to reflect user generated value within the corporate tax rules should start from the position that profits are taxed in the countries in which a business has genuine economic activities.

4.14 To maintain confidence in the international tax framework and avoid competitive distortion in local markets it is crucial that multinational groups are prevented from being able to realise profits in low-tax entities that are not justified by local economic substance.

4.15 That is partly about ensuring a robust international transfer pricing framework and pursuing multilateral reforms to address the limitations of that framework in aligning taxable profits with value creation.

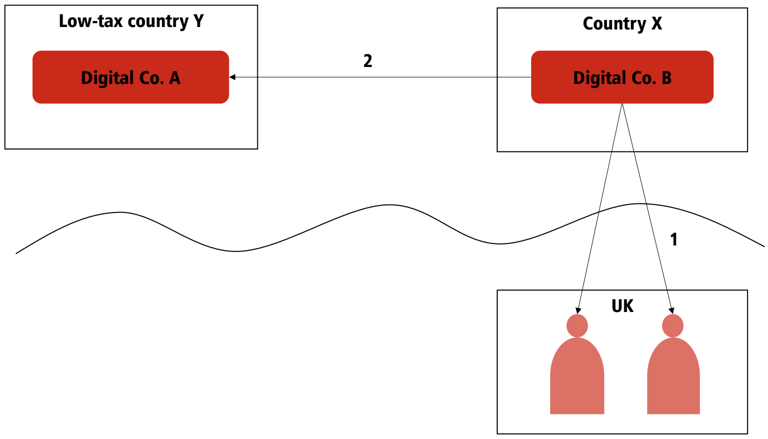
4.16 However, it is also about taking unilateral action where that framework is not being administered correctly and multinational groups are being allowed to realise significant profits in a jurisdiction through the mere holding of intangible assets.

4.17 Following consultation, the government will therefore introduce legislation seeking to tax profits that multinational groups make from selling products and services to UK customers, where those profits have been transferred to an entity in a low-tax country which has been awarded ownership of the group's intangible assets.

4.18 This will be implemented through an extension of UK withholding tax to cover royalties paid, in connection with sales to UK customers, to no or low-tax jurisdictions. The extension will be applied consistently with the UK's double tax treaties.

4.19 This is not a comprehensive response to all of the challenges posed by the digital economy, but it's one that maximises what can be done without overriding the UK's treaties, raises material revenue from businesses primarily in the digital sector, and demonstrates that the government is serious about achieving reform of the international tax system to ensure that it produces fairer and more sustainable outcomes.

Box 4.A: Extension of royalties withholding tax – illustration



Digital Co. A, resident in low-tax country Y with which the UK doesn't have a double tax agreement, owns the group's intellectual property rights to sell digital software to customers. It licences those rights to Digital Co. B.

Digital Co. B resident in country X then sells digital services to UK customers (transaction 1), and in return pays a royalty to Digital Co A in proportion to those sales (transaction 2). Digital Co. A is not subject to tax on that royalty income.

Digital Co. B has no UK taxable presence. Under existing rules the UK would not therefore impose a withholding tax on the royalty payment it makes to Digital Co. A.

The measure being announced at the Budget would lead to a withholding tax being imposed on the royalty payment, on the basis that it is paid in connection with UK sales to a company resident in a no or low-tax country with which the UK hasn't ceded its taxing rights under a double tax agreement.

Chapter 5
Important considerations

To what extent can digital businesses be ring-fenced?

5.1 The position paper acknowledges that the challenges that remain with the transfer pricing rules, and any challenges created by business centralisation, are not unique to businesses in the digital economy, even if those challenges might be exacerbated within highly dematerialised digital groups.

5.2 It does however identify a specific concern, which is the tax rules' failure to recognise the reliance that certain digital businesses place on a sustained relationship with an active user base.

5.3 It is not clear that the digitalisation of a manufacturing business or pharmaceutical business, for example, will ever lead to a relationship with customers that is of the same degree of importance in terms of generating value.

What businesses would fall in scope of an interim solution?

5.4 This is about businesses for whom the participation of, and relationship with, users is central to the success of the business model and has a direct link to the generation of revenue.

5.5 The government thinks that this feature is evident in:

- businesses that build a user base on an online service, and then generate revenues through directing adverts at that user base which are targeted more precisely through personal data derived from the systematic monitoring of users' activities e.g. a search engine
- businesses that build a user base on an online platform that allows for the sharing of content and user-generated contributions, and then generate revenues through directing adverts at that user base which are targeted more precisely through personal data derived from the systematic monitoring of users' activities e.g. a social media or file-sharing platform
- businesses that provide an online marketplace for buyers and sellers of goods/services and take a commission from the resulting transactions
- businesses that build up a user base on an online platform and then take a commission from matching users' common interests e.g. exchanging of goods, renting of assets, and forming of relationships

5.6 For these business models, the government believes that user participation provides a valuable and integral function in terms of providing data, building the brand and increasing the utility of other users, thus helping to build scale and market power.

5.7 The government believes that this is different from the role of customers within a more traditional business, where relationships are often more transactional and confined to the relationship between the customer and the business, rather than relationships between customers that give rise to consumption externalities.

5.8 Furthermore, while there are traditional equivalents of the business models outlined above, the value created by users in those business models is likely to be lower due to their inability to form such interactive relationships with users, and the constraints that physical intermediation imposes on scale. The user bases of those traditional equivalent businesses are also more likely to be aligned geographically with the businesses' wider activities, reducing the implications of their lack of recognition within the international tax framework for the geographic allocation of tax revenues.

5.9 As set out in the paper, the government does not believe that the concept of user/consumer created value is relevant to businesses that sell self-developed goods on a website or retailers that sell acquired goods on an online platform. It also questions the significance of user-generated value to businesses that generate revenues from selling acquired digital content on an online platform, or businesses that generate revenues through charging for the provision of digital software and digitally-provided services.

5.10 The government invites views on this position however, including where the distinctions between business models could be difficult, distortive and/or unjustified.

To what extent could restructuring in response to BEPS and possible US tax reform change the analysis?

5.11 The paper acknowledges the effect that the BEPS outputs have had on groups' international structures.

5.12 However, the government does not believe that such restructuring has eliminated the challenges that have been identified for the international tax framework, and in particular does not believe that such restructuring is an answer to the concerns that have been raised regarding the application of the framework to digital businesses.

5.13 For example, while there may be transparency benefits in large digital businesses booking revenues generated from the UK into a local company, that does not necessarily equate to an increase in UK tax revenues and does not address the fundamental question of whether the regime should be modified to place more emphasis on those businesses' user bases.

5.14 The government will continue to monitor the progress of US tax reform. However, while those reforms might help to address the concerns raised in this paper regarding non-taxed intellectual property-related income, they will not address the more fundamental concerns about the failure of the international tax regime to align profits with value creation in certain digital businesses.

5.15 That's why the current international work on digital taxation remains important and the government intends to actively support this process.

How does this interact with the role of the UK as a global digital hub?

5.16 The government wants the UK to be the best place to start and grow a digital business, and is committed to supporting the continued growth and success of the UK's world-class tech sector.

5.17 This is about ensuring businesses are taxed where they generate value and ensuring that technological developments do not undermine long-standing tax principles. In effect, we want to update the international tax system for the digital age.

5.18 It will ensure multinational digital businesses do not gain an unfair advantage from the international tax framework, ensuring a more level playing field that promotes competition and avoids entrenching incumbent positions.

5.19 An important consideration with the design of any interim measure would be ensuring that the UK remains a competitive place to do business. We would welcome feedback from stakeholders about how this can be best achieved.

What steps have been taken to address some of the challenges posed by digitalisation for the VAT system?

5.20 Significant changes have been made to the VAT treatment of cross-border digital services in recent years to better ensure that tax is paid where consumers are located. From 1 January 2015, changes to the VAT rules across the EU ensured that supplies of digital services to consumers are taxed on the basis of customer location (where the customer belongs) rather than supplier location. This change was estimated to bring in an additional £300 million per year for the UK.

5.21 The government is also taking further action to stop online VAT fraud in this Budget, which is estimated to cost the government around £1.2 billion per year. This builds on measures from Spring Budget 2017 and includes ensuring all online sellers, including those based in the UK, are in scope of joint and several liability rules which make the marketplaces responsible for losses as a result of VAT fraud on their sites. In addition, the UK is taking a leading role in international efforts to better collect VAT on sales via online marketplaces. To reduce online VAT fraud and improve how VAT is collected, the government is also looking at a split payment model. Following the call for evidence launched at Spring Budget 2017, the government will publish a response in December.

5.22 On a separate point, it has been observed that the provision of a free service such as a search engine in return for data constitutes a value-for-value barter transaction, to which it could be argued a VAT charge should be applied. The government remains focused on the corporate tax challenges with the digital economy, but believes that this observation - that users provide value that is recognised by a business through its provision of a free or discounted service – reinforces the justification for the potential interim solution outlined above.

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This document can be downloaded from www.gov.uk

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