HM Treasury

Corporate tax and the digital economy:

position paper update

March 2018

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Executive summary

The government embraces the changes brought about by digitalisation. From innovative goods to revolutionary business processes, the adoption and spread of digital technology have contributed to significant increases in productivity, economic growth and consumer choice.

The government welcomes these positive trends and the important contribution made to the UK economy by its fast-growing digital tech sector, which employs more than 1.5 million people and accounted for £6.8 billion of investment in 2016, 50% higher than any other European country.[1]

It's for these reasons the government has set out a strategy for making the UK the best place to start and grow a digital business, and sees this as critical in ensuring the UK is a leader in emerging technologies and highly skilled jobs.

The speed and scale of the changes caused by digitalisation have naturally had implications for the UK tax system.

In some cases, there is scope to try and harness the benefits of technology to make the system more efficient for both taxpayers and tax administration. That's why the government is releasing further publications at Spring Statement on using split payments to combat online VAT fraud and the role of platforms in encouraging compliance by their users.

Yet unsurprisingly, the scale of change brought about by digitalisation has also posed challenges for tax policy. Nowhere is that truer than for corporation tax, where the development of certain business models has challenged our understanding of how and where companies create value.

At Autumn Budget, the government set out its initial position on this issue. While it continues to support the principle underpinning the international corporate tax system – that the profits of a business should be taxed in the countries in which it creates value – it believes that this principle is being challenged by business models for which value creation is in part reliant on the engagement and participation of users. The government's view is that the tax system has not kept pace with these changes and that action is needed.

The government has since benefitted from substantive feedback from a wide range of stakeholders, who have offered constructive challenge and insight into this issue. It is therefore publishing an updated position paper to reflect on some of the key

[1] Tech Nation Report, Tech City UK, 2017: https://technation.techcityuk.com/

questions that came out of that process, and provide an update on the government's thinking. The updated paper sets out the government's view that:

- **the participation and engagement of users is an important aspect of value creation for certain digital business models**, and is likely to be reflected through several channels, such as the provision of content or as a contribution to certain intangibles such as brand.
- **the preferred and most sustainable solution to this challenge is reform of the international corporate tax framework to reflect the value of user participation**. It is important that the members of the OECD's Inclusive Framework make progress in developing multilateral solutions, and to assist this process the paper sets out some of the government's initial considerations on what this could include.
- **as set out at Autumn Budget, in the absence of such reform, there is a need to consider interim measures such as revenue-based taxes**. The paper explores some of the important considerations regarding the scope and design of an interim measure, and the steps that could be taken to ensure that it is well-targeted and protects start-ups and growth companies. The government still thinks there are benefits to implementing an interim measure on a multilateral basis and it intends to work closely with the EU and international partners on this issue.

This paper does not look to set out the government's final position on these issues. It instead sets out the government's updated thinking, with a view to engaging further with businesses and other stakeholders to better understand and resolve some of the outstanding questions.

The government is nonetheless clear that there is a challenge that needs to be solved. The current misalignment between where digital businesses are taxed and where they create value threatens to undermine the fairness, sustainability and public acceptability of the corporate tax system.

The government hopes to find a multilateral solution to this challenge, and believes that the upcoming OECD report and G20 summit in Argentina will be important in setting out a programme of work for achieving that. The government thinks that this paper can help to inform that work, and help to achieve a coherent, proportionate and sustainable long-term solution.

Chapter 1
Introduction

The government's position

1.1 The international tax framework is based on a principle that the profits of a business should be taxed in the countries in which it creates value.

1.2 The UK continues to support that principle.

1.3 It believes that a country should be entitled to tax the profits of a business that result from activities, human enterprise and innovation that take place within its jurisdiction, irrespective of where the business's goods and services are ultimately sold.

1.4 The key question is the extent to which the international tax rules are delivering that principle for digital businesses, and whether there are features of how those businesses operate and generate value that mean the current international tax rules are failing in their objective.

1.5 The position paper published by the government in November sought to address that question, by assessing three possible challenges that have been put forward in this area.

Multinational avoidance

1.6 The paper first asked whether there are characteristics of digital businesses that increase the opportunities for cross-border avoidance and allow for arrangements that shift profits away from countries in which value is created.

1.7 The paper accepted that there remain weaknesses in the international tax rules, and emphasised the need to build on the notable reforms made through the G20-OECD Base Erosion and Profit Shifting (BEPS) project.

1.8 However, it concluded that those weaknesses (and the opportunities for cross-border avoidance they create) are relevant to all businesses, even if they might be put under particular stress by the characteristics of those in the digital sector.

1.9 It is for this reason that the paper placed less emphasis on the relevance of US tax reform and the continued implementation of BEPS recommendations in resolving the tax challenges posed by the digital economy.

1.10 While these developments will help to reduce the likelihood of business profits going untaxed, the government believes that countries' concerns about how the international tax rules apply to digital businesses are more fundamental.

Remote sales

1.11 The paper then considered whether the principle of the international tax system is being undermined by the ability of digital businesses to generate revenues from markets in which they have limited physical presence.

1.12 The paper accepted that the digitalisation of their core inputs, processes and outputs means that digital businesses may be better able to serve global customers from a remote location.

1.13 However, the paper challenged the idea that cross-border selling is unique to digital businesses, arguing that globalisation and technological improvement are increasing the ability of businesses in all sectors to centralise core economic functions and sell remotely into foreign markets.

1.14 It also challenged the idea that the increasing ability of a business to sell to customers in a market in which it has limited local presence somehow undermines the existing principle of the international tax system.

1.15 While business centralisation could impact on the level of taxable profits in customer jurisdictions, that doesn't undermine the principle of the international tax framework if there is no value being generated in markets into which goods and services are being remotely sold.

1.16 Some countries might argue that increased business centralisation, and the increase in artificial intelligence and robotics, threatens the foundations of the existing international tax regime by making the allocation of taxable profits increasingly sensitive to the location of a small number of decision-makers.

1.17 However, that is a question about the long-term sustainability of the principle underpinning the international tax rules, rather than the more pressing question of whether the existing principle is being realised for digital businesses.

Unrecognised user-created value

1.18 The paper finally considered whether the international tax rules were flexible enough to accommodate digital business models and take account of the way in which certain digital businesses generate value.

1.19 The paper took the view that some digital businesses appear to have important value drivers, that are not currently recognised in how the international tax rules allocate the profits of a business between the countries in which it operates.

1.20 Specifically, the paper identified the participation of users as an important driver of value for certain types of online platforms, contributing to the service-offering, supporting the strength of the brand and building a user network that underpins the success of many businesses in the digital sector.

1.21 The paper concluded that the failure of the international tax rules to take account of this user-created value is leading to outcomes that are inconsistent with the objectives of those rules, through the creation of a mismatch between the location in which business profits are taxed and the location in which business value is created.

1.22 The government therefore advocated reform of the international tax rules, as well as consideration of interim revenue-based taxes that could compensate countries for the unrecognised value being created in their jurisdictions pending multilateral reform.

Purpose of this paper

1.23 This paper seeks to build upon the paper published in November and responds to some of the questions that have been raised during a period of constructive engagement with businesses.

1.24 This includes setting out: a more detailed explanation of how user participation is considered to create value for certain digital businesses; a possible approach for incorporating user-created value into the international tax rules and some of the important questions regarding the detailed design of a revenue-based interim measure.

1.25 The government acknowledges the need, given the novel nature of these ideas and their important implications for the tax system, to continue refining its position in the coming months so it successfully meets its policy objectives.

1.26 Reflecting this, the paper aims to provide a basis for continued dialogue with businesses, and to inform the work being undertaken at the OECD, and in the EU, which the UK continues to actively support.

Chapter 2
User participation

Introduction

2.1 The government maintains its view that user participation is an important value driver for certain types of digital businesses, and one that deserves recognition in the rules for allocating taxing rights and taxable profits between countries.

2.2 Building on the paper published in November, this section looks to provide more detail of the channels through which user participation is considered to generate value for a business, and examples of the business models this concept applies to most strongly.

2.3 It also explains how the government believes that user participation can be distinguished from the role that customers serve in a business, and how user participation constitutes more than the collection of customer data, which is relevant to a broad range of digital and non-digital businesses.

What is meant by user participation?

2.4 The government understands user participation to be the process by which users can create value for certain types of digital businesses through their engagement and active contribution.

2.5 Based on an examination of digital business models, the government thinks there are at least four channels, set out in more detail below, through which this user-created value can arise.

2.6 The government thinks these are the channels that most clearly illustrate how businesses derive value from user participation, and how the role of the user has blurred traditional demand and supply side functions.

2.7 It is recognised however, that the relevance and materiality of these channels will differ between businesses. It is also recognised that these channels need to be considered alongside the important value-creating functions in these businesses that are recognised by the existing international tax framework, such as software development.

Generation of content

2.8 Some digital businesses operate online platforms that are substantially made up of user-generated content.

2.9 Consider a social media company that generates revenue from selling advertising on a platform populated by users' posts and photos. Equally, take a company that generates revenue from selling advertising on a platform that allows users to upload and promote self-created audio or video content.

2.10 The benefit that users derive from these platforms will in part be a function of the platform software and the overall user experience.

2.11 But the core business offering remains the content generated by users. It is the nature and quantity of that content that underpins the business's ability to attract users and generate revenues.

Depth of engagement with the platform

2.12 Users form strong relationships with certain online platforms with which they engage and participate.

2.13 That is partly a function of the significant duration of time that users spend engaging with such platforms. But it is also a function of how users spend that time, and their level of activity in contributing to content and interacting with other users.

2.14 This sustained engagement allows businesses to tailor their platforms and platform content to each user, with the aim of maximising user utility and delivering a more personalised experience.

2.15 It also allows businesses to generate valuable data on users' behaviours, interests and consumption habits through the intensive monitoring of their engagement with the platform.

Network effects and externalities

2.16 For some digital businesses, the value that a user derives from a platform is strongly correlated with the number of other active users on that platform.

2.17 Building large user networks can therefore be central to the success of these businesses, helping them to achieve economies of scale and allowing them to take advantage of the low marginal costs that there may be in making a platform available to new users.

2.18 Users are at the core of such networks, and help to develop those networks through their engagement and through actions which foster connections between users e.g. sharing content, rating content and creating internal networks.

2.19 This is relevant to platforms that rely on user-generated content, where the value of the platform to a potential user is directly linked to the actions of other users on the platform.

2.20 It is also relevant to platforms for which the quality of a service to a user is indirectly linked to the actions of other users. For example, the aggregate information and data provided by search engine users can affect and influence the searches made by other users and can improve how efficiently that engine can perform its functions for other users.

2.21 Finally, the development of a user network is highly relevant to platforms that provide a marketplace for third-party buyers and sellers, where user utility is a function of the number of users on the other side of the intermediated market and the choice/service those users are providing.

Contribution to brand

2.22 Some digital businesses are reliant on their users for platform content or for the goods and services that are provided on the platform.

2.23 To the extent that the value of those businesses reflects the content of platforms and the services offered through their platforms, users can be seen as key contributors to brand strength and reputation.

2.24 User participation in reviewing and rating content or services provided by third parties is also crucial in regulating what appears on the platform and establishing an important trust mechanism for other users.

2.25 That is crucial to the performance and value of collaborative platforms that generate revenue from bringing together large volumes of buyers and sellers, and might have very limited control of the parties that are participating on their platform and the quality of goods and services being provided.

How are customers different from users?

2.26 Customers are clearly of vital importance to a business.

2.27 They create the market for a business's product, can provide feedback that allows a business to improve that product and can play an indirect role in the marketing of the product and the enhancement of a business's brand.

2.28 However, the government believes that the users of certain digital platforms (which may or may not act as the businesses' customers) are distinguishable in terms of the value that they create and the channels through which that value is created.

2.29 For example:

a. the role of customers in creating demand for a product or service is different from the more complex role of users in co-contributing to a business's offering through the generation of content or the provision of services

b. the transactional relationship, limited to the purchase of goods or services, that many businesses have with their customers is different from the deep and interactive relationship that certain types of digital businesses have with their users

c. the limited ancillary role that customers might play in, say, improving or promoting a product is different from the integral role that users can play in building a network which will often determine the success or failure of a digital business

2.30 It follows that, for some types of digital businesses, users can be seen participating in a non-traditional value chain and performing supply-side functions that would historically have been undertaken by the business itself.

2.31 While digitalisation might allow traditional businesses to build stronger and more interactive relationships with their customers, the government does not expect the role of customers within those businesses to change to an extent that leads to the same blurring of production and consumption boundaries.

2.32 The principal role that customers serve to most businesses will continue to be paying for the goods or services that a business provides. Furthermore, while traditional multi-sided and intermediation business models do exist, the constraints to scale and remote operation mean that the value of customers/users will always be limited or substantially captured in the jurisdiction in which those customers/users are located.

Is user participation equivalent to the collection of data?

2.33 One of the ways in which user participation can translate into value for a digital business is through data.

2.34 Digital businesses can derive data from users' direct contributions on their platforms. Equally digital businesses can generate data from the intensive monitoring of users' activities and behaviours.

2.35 That data can be of significant value to a business whether it is sold, used to improve the targeting of adverts or monetised indirectly through the improvement of platform software and the personalisation of user experiences.

2.36 The collection of data can be a distinguishing feature of digital businesses in certain circumstances. For example, consider a business that does not charge for the provision of an online service, but monetises user engagement indirectly through the collection of large volumes of user data which then represents a central driver of the business's revenue.

2.37 However, the government does not generally think the mere collection of data from users/customers means that those users/customers can be said to be participating in the creation of value. For instance, there will often be businesses which collect data as part of product improvement, but for whom the collection and monetisation of data, whether direct or indirect, is not their primary revenue stream.

2.38 Consider a retailer which collects data through periodic customer reviews and loyalty cards, and uses that data to inform decisions on product selection and to develop more tailored marketing and pricing strategies.

2.39 Equally consider a business that collects real-time data from high-tech machinery that it has sold to a customer, allowing performance to be monitored and allowing the business to improve technologies and thus enhance future revenue growth.

2.40 The government does not believe that the sourcing of such operational and personal data from the UK, through what could be considered passive or transactional relationships with UK customers, should entitle the UK to a taxing right on business profit.

2.41 Instead, the government is focused on certain digital businesses for whom the collection of data from users results from a much broader and more active user relationship, which is central to how those businesses create value.

What businesses is user participation most relevant for?

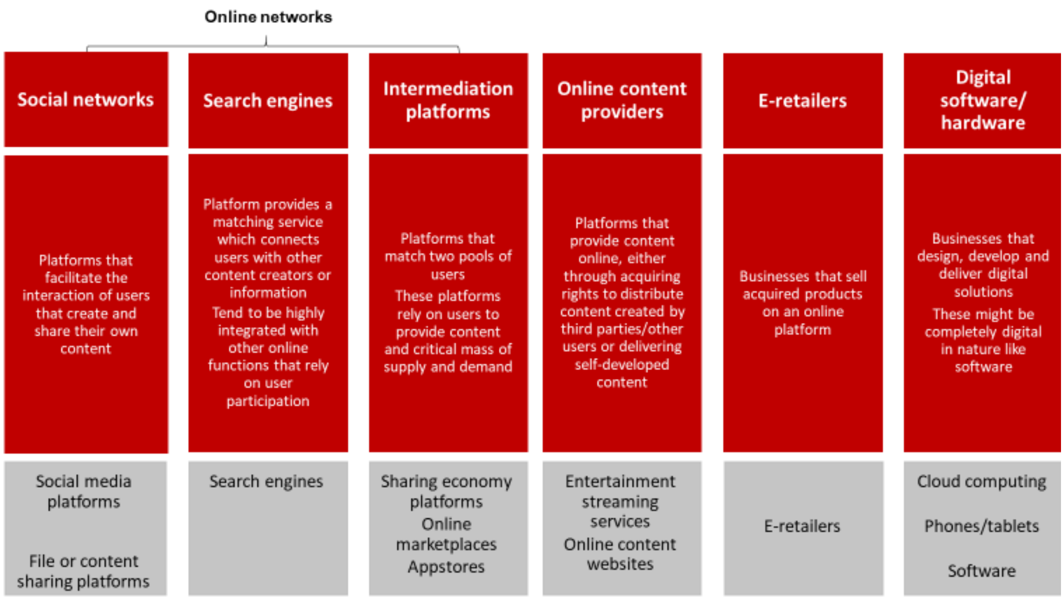
2.42 The table below sets out an illustrative and non-exhaustive categorisation of digitalised businesses.

2.43 These businesses share common characteristics including the digitalisation of business processes, and an ability to raise revenue from markets in the absence of local physical presence.

2.44 However, there is no commonality in the value that these businesses derive from user participation and thus the challenge that these businesses create for the international tax rules.

2.45 The channels by which user participation creates value for a business seem most relevant to online networks such as social media platforms, search engines, file-sharing platforms and online marketplaces (see Chart 2.A).

Chart 2.A: Illustrative examples of digital business models



2.46 These businesses will rely on these channels to different extents, but generally the functions performed or contributed to by users will be materially relevant to their success or failure. This includes the quality and quantity of content, the provision of highly specific data or the ability to capture consumption externalities.

2.47 The channels by which user participation creates value for a business seem least relevant to businesses that sell acquired goods on an online platform (e-retailers) or digital software/hardware providers.

2.48 For these businesses, user participation appears to be a less important source of value and less integral to the success of the business compared to more traditional functions such as the design, development and provision of a product or service.

Further business model considerations

2.49 There is a need to continue examining business models, to ensure any tax measure is targeted at businesses for whom user participation represents significant contribution to value creation and to consider how to deal with nuances between and within different business categories.

2.50 First there is a need to look in more detail at the relevance of user participation to digital content providers. Businesses providing access to acquired online content share similar characteristics to e-retailers, with a business model based on pricing, anticipating customer demand and taking risks with the acquisition of original material.

2.51 There is however a need to consider whether user participation could play a more important role in the value chain of a business acquiring and distributing online content rather than acquiring and selling physical goods online.

2.52 The fact that users access digital content through an online platform means that businesses might be able to develop more sustained relationships with their users; benefit from user-created networks such as user playlists; and adopt different models for raising revenue e.g. subscription fees, transactional pricing and/or online advertising.

2.53 Digital content is also non-rivalrous and so has the potential to blur the distinction between different business models. Take a business that acquires non-exclusive rights to a large volume of media content in return for paying the majority of revenues back to content owners. It could be argued that this business is, in substance, no different from an online marketplace, in bringing together content owners and content consumers in return for a small share of the transaction consideration.

2.54 Second there would be a need to consider the variation in businesses that fall into a given digital business category, and the variation in the value that those businesses derive from user participation.

2.55 For example, the importance of user participation to an intermediation platform business might depend on its sophistication, including the extent to which it regulates sellers and products; assumes effective product or service liability; and creates rather than facilitates transactions e.g. through aggregating multiple users in the matching of supply and demand.

2.56 Third there would be a need to consider the areas in which the distinction between different categories of business could become blurred.

2.57 Take an online marketplace that generates a commission from bringing together a third-party buyer and seller of a product. Then consider that the marketplace changes its model so that it momentarily acquires the product from the third-party seller prior to the transaction and re-sells the product to the third-party buyer i.e. it is now categorised as an e-retailer.

2.58 The question is whether that change in business model reflects a change in importance of user participation to the business, or whether it's just a change in legal form which introduces new risks to the business (e.g. product risk and credit risk) but risks that it might be possible to insure against at low cost.

2.59 Finally, given the rapid pace of innovation in the digital sector there is a need to consider the relevance of user participation for newer digital businesses models, such as those based on artificial intelligence or augmented reality.

Chapter 3
Long-term reform

Introduction

3.1 The international tax rules currently look to business functions and the control of assets and risks in determining the countries in which a business should be taxed, and the level of taxable profit or loss attributable to those countries.

3.2 The rules are reflected in the OECD Model Tax Convention:

- Article 9: The profits of a company within a group should be commensurate with the value it generates for the group through its activities, and commensurate with the reward that it would receive in undertaking those activities for an unrelated party at arm's length
- Article 5: In addition to their rights over resident companies, countries have a right to tax non-resident companies that have a permanent physical presence in their jurisdiction, termed a permanent establishment
- Article 7: Countries are entitled to tax non-resident companies on profits attributable to the activities undertaken through that local physical presence or permanent establishment

3.3 These rules, and the guidelines underpinning these rules, do not give recognition to the value created by user participation.

3.4 For example, the presence of an active user base in a jurisdiction is not of itself sufficient to evidence a permanent establishment in that jurisdiction, and does not therefore entitle the jurisdiction to tax the business's profits.

3.5 Equally, even if a business has a physical presence in a jurisdiction that gives rise to a permanent establishment, the jurisdiction will only have a right to tax profits attributable to the economic activities and assets of that permanent establishment. It will not be entitled to tax profits that are considered attributable to value creating activities of local users based on the channels set out above.

3.6 The government thinks that this is creating a mismatch between the location of value-creating activities and taxable profit for certain digital business models. This chapter therefore sets out possible options for reforming the international tax rules to take account of the value created by users.

Developing an approach for reform

1. Where is the value from user participation currently realised in a digital business group?

3.7 The government's position is that active user participation creates value for certain digital businesses, and that jurisdictions in which users are located should be entitled to tax a proportion of those businesses' profits.

3.8 In thinking about how that would be achieved, an important first question is where this user-created value is currently being substantially realised within those businesses i.e. in which group companies are the profits attributable to user-created value currently being taxed, and thus from where would profits taxable in user jurisdictions be reallocated.

3.9 The government's view is that it is very unlikely that profits attributable to user-created value are being realised in companies that are characterised as service providers for the group.

3.10 Those companies are undertaking activities to which users do not make a clear contribution, and are remunerated on a basis that is insensitive to the profits of the overall business and can be determined through an analysis of available market comparables.

3.11 The most likely position is that the value a business derives from user participation sits with the companies in the group that receive the residual profits of the business i.e. the profits of the business after the activities of service providers have been awarded an arm's length return. These companies are referred to as residual profit owners or principal companies for the purposes of this paper.

3.12 It is these companies that have control over the decisions and risks within the group - which will likely include those relevant to the solicitation, engagement and retention of users - and realise profits that are commensurate with the success or failure of those decisions and risks.

3.13 It is also these companies that are likely to own the group's brand, trademark and customer-related intangibles, and benefit from the contribution of users to the increase in those assets' value.

3.14 The government therefore thinks that some reallocation of the profits currently recorded by these companies to user jurisdictions is justified, and achievable in a way that minimises the impact on the current approach by respecting the arm's length reward for activities in the group where comparables are available.

2. How do you measure user-created value?

3.15 In thinking about a possible approach for reform, the second question is how much value these principal companies are deriving from user participation, and thus how much of their profit should be reallocated to jurisdictions in which users are located.

3.16 While the UK believes that users create value for certain digital businesses, there would be challenges in coming up with a suitable approach to measuring that value directly.

3.17 There may be indirect indicators of the value of a user base to a business, such as some or all of the cost that a business is willing to incur in running a free platform, and the costs of soliciting and retaining users on that platform. But it would be difficult to use those indicators to calculate an appropriate reward.

3.18 For that reason, the UK thinks that it might be necessary to reward user-created value through a percentage share of the residual profit realised by principal companies in the group i.e. a share of the profits of the principal companies after routine functions in the group have been remunerated with an arm's length return. That share would be designed to approximate the value that users generate for the business.

3.19 This approach wouldn't be indicative of the deemed value of user participation relative to other group activities. It would instead be recognition of the complexities in measuring the value generated by user participation.

3.20 Consideration would need to be given as to how that share could be tailored according to the different materiality of user participation within digital businesses. For example, user participation might be a more important value driver for a social media platform that relies on user contributions and extensive analysis of user activities than a platform populated by largely self-developed content with which users more passively engage.

3.21 It might be possible to include parameters for the share of residual profit that should be allocable to user participation for different categories of business in OECD guidance, and then to set out an approach for determining where a particular business should be placed within these parameters based on an assessment of business-specific criteria.

3. How can that user-created value be allocated to different user jurisdictions?

3.22 Once the business profit attributable to user participation has been identified, the next question in developing this approach is how that profit should be allocated between the different jurisdictions in which users giving rise to it are located.

3.23 There would be advantages in terms of certainty and administration in agreeing a mechanical approach for sharing user-created profits between user jurisdictions. One option would be an allocation key designed to approximate the value of users in Jurisdiction A versus the users in Jurisdictions B, C and D.

3.24 There would be limitations in relying purely on user numbers for this purpose, given the value created by individual users will differ markedly based on their level of activity on a platform, their ability to create networks, and the extent to which their engagement with a platform can be monetised based on their affluence and consumption habits.

3.25 The value that a digital platform generates from a given number of users in Jurisdiction A may therefore be different from the value that a digital platform generates from an equal number of users in Jurisdictions B, C and D.

3.26 It follows that an allocation key would need to account for those variations in individual user value, which might mean looking at active users (a definition that several digital businesses report) or looking at revenues attributable to users in a jurisdiction, which the UK thinks would be best suited to capture the variations above.

3.27 It would again be necessary to consider how such an allocation key could be tailored for a particular business, based on the characteristics of a user that are most important for value creation in that business.

4. How are user jurisdictions able to tax that profit?

Principal companies taxed in user jurisdictions

3.28 The questions above concern the identification of user-created profit within a digital business and the approach to breaking down that profit between the different countries in which users are located.

3.29 There is then the separate question of how the profit that has been attributed to a user jurisdiction would be taxed by that jurisdiction i.e. what legal person would the user jurisdiction have a right to tax.

3.30 The government considers that the simplest approach would be to give user jurisdictions the right to tax the companies in a digital business that are considered to be realising the value from participation of users (the principal companies).

3.31 User jurisdictions would then be entitled to tax the proportion of those principal companies' profits that are deemed to be attributable to the participation of their local users based on the methodologies outlined above.

3.32 This approach could lead to more than one company being taxed in user jurisdictions on user-created value, where there are multiple IP owners and several companies making valuable contributions to the generation of profit. The potential challenges with that are considered below.

Different company taxed in user jurisdictions

3.33 An alternative approach would be to give user jurisdictions the right to tax a company in the group, which may not be the principal company, with which users have some connection.

3.34 It may be difficult to link users to a single company within a digital business group given the number of companies that could be deemed to have a direct and indirect relationship with users.

3.35 Take a business that generates revenues from selling online advertising that is directed at users of a social media platform that it operates.

3.36 It could be said that the users have links with the companies that own the group's trademark, companies that develop the platform on which users engage, companies that offer support services to users and/or companies that monetise user engagement through the sale of advertising.

3.37 It may therefore be necessary to focus on a specific feature, such as the company with which users enter a legal agreement to use the platform or the company that generates third-party revenues from selling advertising on the platform that is targeted at local users.

3.38 User jurisdictions would still have a right to tax those companies on the profits of the business attributable to users in their jurisdiction, based on the aforementioned methods for determining those profits.

3.39 However, under this approach, user jurisdictions could be taxing a company that is different from the principal companies whose taxable profits currently reflect user-created value.

3.40 It would therefore be necessary to ensure that those profits are not doubly taxed, and that principal companies were not being subject to tax on profits attributable to user created value which could, under this approach, be taxed in a different company.

5. How could the taxing rights of user jurisdictions be appropriately constrained?

3.41 Under the model set out above, it would be important to ensure that user jurisdictions were subject to appropriate limitations on the amount of business profit that they would be entitled to tax e.g. through pre-determined parameters for the share of residual profit allocable to users.

3.42 That would be to ensure that this amount of profit was commensurate with the value created by local users and that there was sufficient recognition of the value that these businesses derive from other functions.

3.43 It would also be important to ensure that there was some threshold above which the presence of users in a jurisdiction entitled that jurisdiction a right to a share in user-generated profits i.e. a permanent establishment threshold set at a higher level than just the presence of local users.

3.44 That threshold could be based on a combination of metrics including number of active users and the revenues that the business is generating from those users.

3.45 The presence of such a threshold would be designed to avoid disproportionate administrative burdens. It would also be consistent with the policy objective, in only allocating profits to user jurisdictions where there is a material user base that is being monetised by the business.

Further considerations

Challenges with the proposed approach

3.46 Firstly, approaches that link users with a company different from the principal companies could lead to significant divergence between those entities’ tax and accounting profits. That could be the case, for example, if users were affiliated with a low-margin sales company that is then subject to tax on user-created value in multiple jurisdictions.

3.47 While differences between tax and accounting profits can arise for many reasons, there would need to be consideration of whether the potential scale of the difference under certain approaches could create challenges.

3.48 Secondly, the approaches above assume the existence of a principal company in the group that remunerates related service providers and then realises the residual profits of the business.

3.49 While that is considered a reasonable assumption, there would need to be consideration of the fact that:

- there could be multiple companies in the group taking a share of residual profit
- there could be a number of reasons for those companies taking a share in the results of the business e.g. the management of IP or the control of important risks
- there would be practical challenges in measuring residual profit for a specific business line within a group, and coping with currency differentials and differences between countries in the calculation of taxable profit
- there could be residual losses within a business, and/or significant variation between the contributions of different countries to a global residual profit figure

3.50 These challenges already exist to an extent under existing profit split methods, but there would be a need to consider whether the challenges could be exacerbated under this approach.

3.51 Thirdly, there could be administrative burdens if the approach taken resulted in multiple companies within a digital business being affiliated with users and having permanent establishments in a user jurisdiction. That could be the case if there were multiple owners of residual profit that users were affiliated with.

3.52 If this was considered a material issue, it might be possible to allow groups the option of electing for one of those companies to pay tax on their behalf. The tax liability would remain with the individual companies, but one company could be allowed to act as a collective payer on their behalf.

How can this approach be delivered through the Model Tax Convention?

3.53 To summarise the above, if user participation were to be recognised in the allocation of taxing rights and taxable profits between countries, the international tax framework would need to be amended in a way that:

a. recognised user participation as an important value driver for certain businesses

b. set out a method for determining that value

c. identified the companies within a business group that users should be linked to, and that should therefore be taxed on profits attributable to user created value as determined in the preceding step

d. give jurisdictions in which users are located the right to tax those companies, even if they are non-resident companies that do not have a permanent establishment under traditional definitions

e. set out a method for determining the proportion of those companies' user-created profits, as determined by Step B, that should be allocated to each user jurisdiction that has been awarded a taxing right under Step D

3.54 The government believes that this would require modifications to Articles 5, 7 and 9 of the OECD Model Tax Convention, as well as modifications to the OECD transfer pricing and profit attribution guidelines that underpin those articles.

3.55 For example:

- Article 9 and the corresponding transfer pricing guidelines would need to be revised to recognise the value that user participation can create for a business, provide a method for determining that value, and ensure that value is reflected in the taxable profits of the companies to which users are affiliated
- Article 5 would need to be revised to award jurisdictions in which users are located a right to tax those user-affiliated companies, in the absence of a traditional permanent establishment
- Article 7 would need to be revised so that user jurisdictions have a right to tax non-resident companies with a permanent establishment in their jurisdiction (under the modified Article 5) on profits attributable to value created by local users, and set out a method for determining that value which is consistent with the changes to Article 9

3.56 There would then need to be guidance on the definition of a user and an approach for identifying the companies with which users should be deemed to be affiliated.

Is the proposed approach consistent with the arm's length principle?

3.57 The government believes that the objective of long-term reform should be to better align taxable profits and value creation through the recognition of the important contribution of user participation to certain businesses.

3.58 The approach set out in this chapter would deliver that objective in a way that would minimise changes to the relevant Articles of the OECD Model and remain aligned with the existing arm's length principle.

3.59 That would be through: (a) awarding an arm's length return to companies undertaking activities for which comparables are available; and (b) allocating a share of residual profits to user jurisdictions to recognise the value created through user participation.

3.60 The government recognises that it's not likely to be possible to use the arm's length approach for measuring that share, or determining how that share then breaks down between specific user jurisdictions.

3.61 However, it believes that the profit split approaches suggested above could serve as a practical alternative for approximating the proportion of principal companies' profits – which have been calculated through the application of the arm's length principle – relevant to user participation rather than other functions performed by principal companies.

How would this work in practice?

3.62 The examples below consider how the approach set out above could work in practice, depending on where a taxing right was applied across a group

3.63 To begin with, consider a digital business that generates revenues from selling advertising on a social media platform with which there are active users in the UK.

3.64 Consider that the sales are booked into a company in Country A which, in this illustrative example, earns a small fixed margin to reflect its routine activities.

3.65 Finally, consider that the profits from those sales are realised by a principal company in Country B, after other group service providers have been remunerated on an arm's length basis.

Illustrative approach one

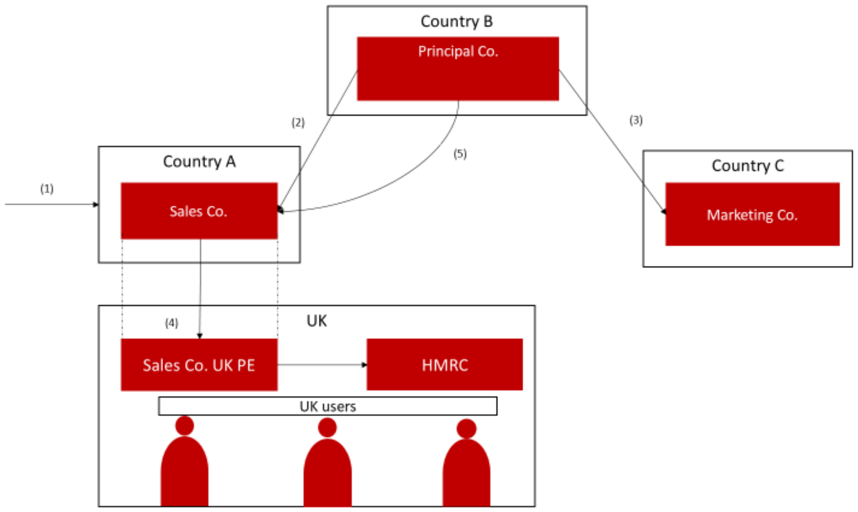
3.66 The UK users, in this approach, are deemed to be affiliated with the sales company in Country A. That sales company is determined to have a permanent establishment in the UK based on the scale of the UK user base and the revenues that the business generates from that UK user base.

3.67 The value that users create for the business is approximated by taking a Y% share of the residual profits of the business realised by the principal company

3.68 The value that UK users create for the business is then approximated by apportioning a share of that Y% (i.e. a share of total user-created value) to UK users based on a metric such as revenue from UK users as a share of total revenue. The UK taxes the sales company on the outcome of that, say X.

3.69 The taxable profits of the principal company in Country B decrease by X, to reflect those profits have been taxed in the sales company. That could be conceptualised as a deemed payment from the principal company to the sales company in recognition of the value it has realised from the sales company's users.

Chart 3.A: UK user routine-function based PE - single country example



Transactions:

(1) Sales Co books sales revenue

(2) Sales Co takes a small margin to reflect an arm's length return for its activities

(3) Marketing Co remunerated on an arm's length basis. Principal Co holds residual profit

(4) Nexus between UK users and Sales Co, creates a UK PE. There would be two steps in determining UK taxable profit (i) calculating what Y% of Principal Co residual profit relates to user-created value and (ii) apportioning that Y% between the UK and other user jurisdictions. The UK asserts a taxing right over an amount X equivalent to the UK user share of Y% of residual profit.

(5) Principal Co profits decrease by X. That could be conceptualised as a deemed payment of X from Principal Co to Sales Co

Illustrative approach two

3.70 The UK users, in this approach, are deemed to be affiliated with the principal company in Country B.

3.71 That principal company is determined to have a permanent establishment in the UK based on the scale of the UK user base and the revenues that the business generates from that UK user base.

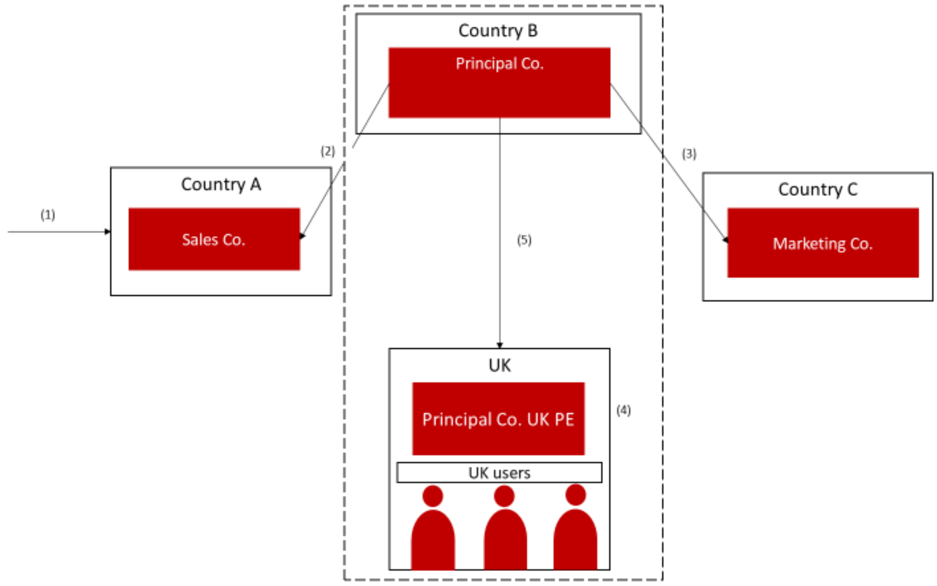
3.72 The value that users create for the business is approximated by taking a Y% share of the residual profits of the business realised by the principal company

3.73 The value that UK users create for the business is then approximated by apportioning a share of that Y% (i.e. a share of total user-created value) to UK users based on a metric such as revenue from UK users as a share of total revenue.

3.74 The UK taxes the principal company on the outcome of that, say X.

3.75 The taxable profits of the principal company are unchanged, but the allocation of those profits between countries is now different.

Chart 3.B: UK user principal company PE - single country example



Transactions:

(1) Sales Co books sales revenue

(2) Sale Sales Co takes a small margin to reflect an arm's length return for its activities

(3) Marketing Co remunerated on an arm's length basis. Principal Co holds residual profit

(4) Nexus between UK users and Principal Co, creates a UK PE

(5) Share of Principal Co residual profit - deemed to be Y% – is attributable to user participation. The UK asserts a taxing right over an amount X equivalent to the UK user share of Y% of residual profit.

Chapter 4
An interim measure

Introduction

4.1 At Autumn Budget, the government's original position paper set out its receptiveness, pending reform of the international tax framework, to work with other countries to explore short-term indirect measures for increasing the amount of UK tax paid by businesses deriving value from UK user participation.

4.2 This chapter explains the motivation for those measures and sets out some of the most important questions regarding their design and scope.

Principles and objectives

4.3 The government advocates reform of the international tax rules to take account of user-created value in how the taxable profits of digitalised businesses are allocated between countries, with Chapter 3 setting out an approach for how that reform could be achieved.

4.4 However, at the same time, the government acknowledges the difficulties in getting consensus for the necessary changes and translating them into a detailed set of proposals.

4.5 This poses a significant policy problem. Without reform, the disconnect in the digital economy between the location of value creation and taxable profit challenges the fair application of the UK corporate tax regime. This disconnect has implications for both market outcomes and the system's sustainability.

4.6 As set out at Autumn Budget, it is for that reason the government has outlined its receptiveness to an interim measure, preferably implemented on a multilateral basis, to compensate for unrecognised user-created value pending wider reform of the international corporate tax system.

4.7 It is envisaged that an interim measure would be a tax on the revenues of digital businesses deriving significant value from UK user participation.

4.8 It is then envisaged that the tax would apply to those businesses wherever they are located, and irrespective of the physical presence that they have in the UK.

4.9 The government would ensure that the tax was compatible with its double tax treaties and compliant with wider international obligations.

4.10 The government would also seek to minimise the acknowledged challenges with a tax on business revenues, including taking steps to ensure that the tax is appropriately targeted and does not inhibit start-ups and innovation in the UK tech sector.

4.11 The government believes that there would be value in multilateral coordination on the design of an interim measure and looks forward to engaging constructively with upcoming proposals from the European Commission. However, the UK equally stands prepared to act alongside a smaller number of like-minded countries, or unilaterally, in the absence of sufficient progress.

Businesses in scope

4.12 The first question with the design of a revenue-based tax would be the scope of that tax. This would in part flow from the underlying policy objective, which would be to raise revenue from digital businesses that are deriving material value from user participation.

4.13 To achieve this there would be a need to:

- draw an appropriate and sustainable boundary given the number of digital business categories and the differing importance of user participation to those categories
- ensure the tax could be applied effectively to groups that have multiple business lines which might fall either side of the boundary
- recognise that there might be various models for generating revenue within each business category

4.14 There are in theory three legislative approaches that the government thinks could be taken to determining the scope of a revenue-based tax.

4.15 The first approach would be to define the channels through which users create value for a business through their participation, and then impose a tax on the revenue streams of businesses for whom those channels are most relevant, based on a case by case assessment of their specific characteristics and value drivers.

4.16 The second approach would be to objectively define the categories of businesses that derive most value from user participation and then impose the tax on the revenue streams of businesses that fall into those categories. Based on the analysis in Chapter 2, that might for example involve defining social media platforms, search engines and online marketplaces.

4.17 The third approach would be to define the revenue streams that are commonly generated from those categories of business and then charge the tax on any business in relation to such revenues. Based on the categories of business identified in the preceding paragraph, that might mean a tax targeted at revenues from online advertising and/or revenues from facilitating third-party transactions on an online platform.

4.18 In practice, there are different merits and potential challenges with each approach and it might be that a combination of these approaches could be used to target the tax, supported by a meaningful de minimis threshold. This is an area the government intends to discuss further in future engagement with businesses and international partners.

Revenues in scope

4.19 In addition to defining the businesses in scope of the tax, there would be a need to identify the revenues of those businesses that should be subject to charge in the UK.

4.20 The government thinks that the logical approach would be to tax revenues that relate to users in the UK. That would align with the policy justification for the tax, and would represent a fair system for dividing taxing rights between the different countries that choose to implement such measures.

4.21 There is then a need to think about how that concept is applied to different business models and revenue streams.

4.22 In the case of online advertising the government envisages that the UK would have a right to tax revenues from online advertising targeted at UK users of an in-scope online platform.

4.23 Consider an online platform that generates revenues from selling advertising to a business in Country A that is to be targeted at users of the platform in the UK. The UK would have the right to tax those revenues under an interim measure, irrespective of the fact that the revenues relate to a business customer in country A.

4.24 There would be a need to think more carefully about how this concept would be applied in the case of an intermediation platform that is facilitating cross-border transactions.

4.25 Consider an online platform that takes a commission from bringing together a UK individual seeking to rent accommodation with a foreign individual seeking to lease accommodation. It could be argued that both individuals are users of the platform and both are generating value, in different ways, through their participation.

4.26 There are a number of possible options for determining where the taxing right resides in this case, such as splitting the revenue between the two jurisdictions, awarding the taxing right to the user that is providing the good/service, or awarding the taxing right to the jurisdiction where the commission is paid from.

4.27 There would be a need to consider which approach is most practical and provides the most consistent outcome across different businesses in a way that minimises the likelihood for distortion. There would also be value in consensus between countries on an approach to avoid multiple layers of taxation on cross-border transactions.

Wider considerations

Challenges in identifying user location

4.28 There would be a need to consider the potential challenges in establishing user location for the purposes of defining revenues in scope of the tax, some of which were noted by businesses in response to the November position paper.

4.29 Those challenges include the fact that some users could plausibly cross borders with relatively high frequency. This raises potential questions for the operation of the tax e.g. if a UK user clicks on an online advert while travelling abroad, does the right to tax the resulting revenue sit with the UK or the foreign jurisdiction in which the UK user is travelling.

4.30 It might also be that some businesses have only crude mechanisms for tracking actual user location, which make it difficult to accurately track users and break down revenues by user jurisdiction. The difficulty in tracking users could also be exacerbated, for example, where users access a platform through a virtual private network which disguises their location.

4.31 The government does not underestimate the technical challenges. However, it also considers that they are manageable given the importance that digital businesses place on understanding where users are located and the fact that some similar challenges, such as identifying the location of customers, have arisen and been addressed for VAT.

Start-ups, growth companies and loss-makers

4.32 The government recognises the need to minimise the distortions of any revenue-based tax and ensure that the tax does not undermine wider government objectives for growth and innovation in the UK digital sector, including through the protection of start-ups.

4.33 It believes that there are three ways in which that could be achieved through the design of the tax.

4.34 The first would be setting a high de minimis threshold, based on consolidated global revenues as well as revenues attributable to UK users, to ensure that a tax was focused on more developed digital businesses and did not directly affect digital start-ups.

4.35 This would reflect that it is larger businesses, with significant networks of users, for whom the benefit derived from user participation is greatest and thus the mismatch between value creation and location of taxable profit is most extreme.

4.36 The second would be setting the tax rate at an appropriate level that compensates the UK for unrecognised user-created value but recognises that the tax will be applied to businesses with different profit margins as well as to businesses that are making losses in trying to expand their market share.

4.37 A third way could be the possible inclusion of safe harbour mechanisms within the design of the revenue tax to protect businesses making losses and/or businesses with low profit margins. That may provide a way to acknowledge the potential for companies in the digital sector to have achieved meaningful market scale before translating that scale into profits.

4.38 For example, it might be possible to consider a cap on a company's liability under a revenue-based tax which is linked to an imputed measure of UK profit or balance sheet strength.

4.39 The question would be whether an effective mechanism could be introduced in a way that conforms with UK double tax treaties, given the importance to the UK of measures in this area being fully compatible with international obligations.

4.40 One further option that has been raised by business is the possibility of relief for corporation tax that has been paid on the revenues subject to charge.

4.41 The challenge with that approach would be in determining the profits that a business generates from UK revenues and then identifying the corporation tax that has been paid on those profits, which could be spread across multiple entities and in multiple different jurisdictions.

Conduits and revenue pass-through

4.42 By definition, a tax on revenues would not take into account costs that businesses incur in generating those revenues.

4.43 That said, reflecting feedback to the November paper, the government believes that there is a need to consider whether there might be certain situations in which revenues could be defined net of certain outflows, where a company is essentially acting as a conduit and passing on revenues received to a third party.

4.44 Take a business that generates revenue from selling advertising on its own platform as well as selling advertising placed on host websites accessed through its web browsing system.

4.45 Then consider that a proportion of the revenue from adverts placed on host websites goes to the host itself, but that the business's accounts recognise gross revenue and separately recognise reimbursement of the host (commonly referred to as traffic acquisition costs).

4.46 The question is whether there might be a case, in this instance, to tax the net revenues.

4.47 The answer to that question might be dependent on: (a) how the revenues are treated at the level of the host website; and (b) the extent to which these costs can be reasonably distinguished from other revenue costs. The government would like to continue exploring this question.

Tax administration and collection

4.48 Respondents to the position paper noted the potential challenges in collecting a revenue-based tax, to the extent that there are businesses in scope that have no physical presence in the UK.

4.49 The government would expect an implemented tax to be paid. It also has significant experience of collecting tax from businesses with no physical presence in the UK in areas such as VAT.

4.50 The government does not therefore see collection as a significant issue and has clearly expressed a preference to avoid alternative collection methods e.g. placing obligations on financial intermediaries to collect an interim tax.

4.51 The more important question is how to ensure that, for those businesses with minimal or no UK presence, compliance with the tax does not impose significant administrative burdens. That could include consideration of a registration regime similar to the one stop shop for VAT, to provide businesses with a simple way to pay the relevant tax.

4.52 Overall, collection and administration is a good example of an area where a tax would benefit from multilateral adoption, allowing countries to share relevant information and assist each other's collection efforts.

Chapter 5

Next steps

5.1 The government welcomes the submissions and business engagement it has received since the publication of the original position paper. This has been useful in drawing out further considerations that need to be explored as part of this work.

5.2 International discussions on this issue have now reached an important point, with both the EU and OECD due to shortly present the outputs of their work.

5.3 The government therefore intends to continue engaging with businesses, the Inclusive Framework and the EU, to discuss their reaction to these outputs and its own policy development, as it works towards developing a proportionate and effective policy solution.

5.4 If stakeholders would like to present written feedback on this updated paper they can do so by:

Email: digitalpaper@hmtreasury.gsi.gov.uk

Post: Corporate Tax Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Confidentiality

5.5 Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

5.6 If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals with, amongst other things, obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HM Treasury.

5.7 HM Treasury will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

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