



DIVERTED PROFITS TAX: CONSULTATION

Issued 28 February 2019

ICAEW welcomes the opportunity to respond to the Diverted Profits Tax consultation published by HMT and HMRC] on 7 November 2018.

This response of 28 February 2019 has been prepared by the ICAEW Tax Faculty. Internationally recognised as a source of expertise, the Tax Faculty is a leading authority on taxation and is the voice of tax for ICAEW. It is responsible for making all submissions to the tax authorities on behalf of ICAEW, drawing upon the knowledge and experience of ICAEW's membership. The Tax Faculty's work is directly supported by over 130 active members, many of them well-known names in the tax world, who work across the complete spectrum of tax, both in practice and in business. ICAEW Tax Faculty's Ten Tenets for a Better Tax System are summarised in Appendix 1.

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MAIN POINTS & GENERAL COMMENTS

1. We believe that there need to be clear principles that underpin the taxation of all, and in particular international business, which would otherwise be subject to multiple taxation and an increased level of disputes between the countries in which they operate as to the appropriate taxing rights.
2. The Treasury Select Committee in its 2011 report Principles of tax policy <https://publications.parliament.uk/pa/cm201011/cmselect/cmtreasy/753/753.pdf> set out the key basic principles that should underpin any tax, new or existing. The basic principles are fairness and economic welfare and any tax should support economic growth. There are then some more procedural principles which are certainty, stability and practicability. While a temporary tax, such as the proposed digital services tax, fails the stability principle, in the absence of international agreement on a longer term solution, we understand the government's concern that earlier action is needed. There are going to be clear problems in identifying business activities in scope and the geographical location of users to name just two of the more obvious issues that this new tax raises.
3. The Treasury Select Committee Principles of tax policy were derived, in part, from the ICAEW Tax Faculty's own Ten Tenets Towards a Better Tax System which are listed in Appendix 1.
4. We support the objective set out at the beginning of the consultation document in paragraphs 1.1 and 1.2 which is that:

“A multinational group should be taxed ...on the profits it derives from activities undertaken and value generated in the countries in which it operates ..”
5. The government is proposing to introduce a revenue based tax, the digital services tax (DST), on certain highly digitalised business models that derive value from the participation of their users.
6. DST will be a 2% tax on the UK revenues of digital businesses which derive significant value from users and within scope of the new tax will be the provision of social media platforms, search engines and online marketplaces.
7. DST will only apply to very large businesses defined as generating more than £500m in global annual revenue from in scope business activities of which more than £25m are linked to the participation of UK users.
8. It is intended that DST will be introduced from 2020 and will be dis-applied if an appropriate global solution is successfully agreed and implemented. It is suggested that a review would take place by 2025 at the latest. We think there should be a clear sunset clause so that the digital services tax, if introduced, will come to an end in 2025 unless there is a new statutory provision to allow the law to continue in place. We have set out our recommendation on this point below.
9. Since the publication of the UK consultation in November 2018 OECD has published, on 13 February 2019, a consultation document Addressing the tax challenges of the digitalisation of the economy for comment by 5 March 2019 to be followed by a public meeting in Paris on 13-14 March 2019.
10. It is anticipated that OECD will set out its views on a potential solution at the time of the G20 Summit meeting in Japan in June 2019.

11. OECD is currently working on the basis that it will have agreed final proposals, a solution, before the end of 2020 and these proposals will be put to the G20 at its 2020 summit in Saudi Arabia or at an appropriate time before the end of that year.
12. The current OECD position, as outlined in the February consultation document, has two main Pillars.
13. Pillar 1 contains three proposals one of which is a “user participation” proposal modelled on the UK DST. The second proposal is a “marketing intangibles” proposal which has the support of the United States and a number of developing countries and would be a more general proposal, not restricted to highly digitalised businesses. The third proposal is for a digitalised permanent establishment but this proposal has not been fully formulated in the most recent OECD consultation document.
14. Pillar 2 is a mixture of a minimum taxation of targeted businesses and a restriction on base eroding payments.

ANSWERS TO CONSULTATION QUESTIONS

15. We have not answered the questions individually but we have given our comments by reference to the group questions in each chapter in the consultation document.

Business activities in scope

Do you agree the proposed approach of defining scope by reference to business activities is preferable to alternative approaches?

Do you have any observations on the proposed features used to describe the business activities in scope of the DST?

Do you think the approach to scope negates the need for a list of exemptions from the DST?

Do you have any observations on the boundary issues the government has identified or others it has not identified?

16. We accept that the in scope business activities, to be subject to the DST, are best defined by reference to business activities (paragraph 3.2) rather than the other approaches by reference to channels (paragraph 3.1) or revenue streams (paragraph 3.3). Some of our members do favour the third approach as the value of the interaction of users with the social media platform, search engine or online market place is monetised at a later stage through for instance advertisements aimed at those users and the characteristics that they have “revealed” in their interaction with the social media platform etc. In other words value is often not created at the time of user participation with the digital business but at a later stage
17. We believe that it will be very difficult to provide very precise descriptions of the business activities which are in scope to capture the intended target activities and in such a fast changing business environment, even if DST is going to be disapplied within five years, there will be need for flexibility. We believe that the government ought to identify a list of exemptions and should have a statutory power to amend such a list via statutory instrument to make sure that the exemptions keep up with changes in business models.
18. The government has identified, at the end of paragraph 3.30, the challenge posed by online games and there will be other businesses which do not fit easily into whatever definitions are finally adopted so there will need to be flexibility.
19. The government has also identified boundary challenges, in paragraphs 3.34 to 3.50, and how it would deal with the challenges that it has identified and discussed in those

paragraphs. There will be currently identified challenges and new ones which will emerge over the next few years and there needs to be a transparent and robust means of dealing with these. We suggest that there should be online guidance in a designated DST part of the HMRC website to provide general details as to how specific boundary challenges have been dealt with, providing a generic description without identifying the individual businesses that form the basis for the particular conclusion.

Revenues in scope

Do you have any observations on the proposed approach for attributing revenues to business activities?

Do you think there is a need for mechanical rules to guide apportionment in certain circumstances?

20. The OECD consultation document, published on 13 February 2019, considered the mechanics of what is the UK approach in the context of other possible changes to the existing international taxation framework. These mechanics are set out in paragraphs 22 to 28 of the OECD consultation document and they are reproduced in Appendix 2.
21. There are clearly going to be practical issues in attributing revenues for a group of companies which has both in-scope and out of scope activities.

UK revenues

Do you have any observations on the proposed approach to defining a user?

Do you think the proposed approach for determining user location for the purpose of the DST is reasonable?

Do you think there is a need for mechanical rules to determine what is considered a UK user in certain circumstances?

Are there any other circumstances where the treatment of cross-border transactions needs to be clarified?

22. From a practical point of view there are going to be challenges in identifying a UK user from an objective point of view. If users operate through a VPN then it may be difficult to allocate a single country from which they interact with the particular business. But the businesses themselves, to the extent they need to delineate the user connection to direct advertising at specific users, will want their own delineations otherwise the targeting of the advertising will not be effective. So the way this is going to work in practice will need the active participation of businesses which are potentially affected to work out a modus operandi which achieves the government's objective while at the same time being practicable to the businesses and to reflect the underlying principles of the proposal.

Rates and de minimis thresholds

Do you have any comments on this chapter, and are there any other issues the government needs to consider in relation to the rate, thresholds or allowance?

23. Recent experience in relation to Diverted Profits Tax suggests that what is intended to apply to a very limited range of companies can end up becoming a compliance burden to a much large population of companies.

Safe harbour

Do you agree that the safe harbour should be based on a UK and business activity-specific profit margin?

What approach do you think the government should take in relation to the issues identified in determining a UK and business activity specific profit margin?

Are there other elements of how the safe harbour would operate that need to be clarified?

24. We are concerned that the current safe harbour proposals will give rise to a very high rate of tax on the UK allocated profits of low margin businesses.

25. If you take the example in paragraphs 7.12 to 7.15 the social media platform cited in the example has £100m of revenues linked to the participation of UK users, but with a profit margin of 1% that is an actual profit of £1m. The safe harbour DST liability is £0.6m but that is an effective tax rate of 60%. Paragraph 7.13 notes that “under the normal rules” the DST liability would have been £1.5m which is a tax rate on the profit of 150% which is clearly confiscatory and would definitely be unacceptable. But a tax rate of 60% is much higher than the currently accepted norm for profits taxes. The UK headline rate of corporation tax will be down to 17%
26. We urge the government to consider how the safe harbour provisions can be adapted to produce a more acceptable result.

Deductibility and crediting

Do you agree with the government’s characterisation on the circumstances of when the DST will be a deductible expense for UK corporate tax purposes? Are there other issues that require further clarification?

27. The businesses that will be within the digital services tax are likely to be amongst the most innovative companies and the government should consider whether there should be some interaction with the UK’s system of research and development tax credits.

Review clause and global reform

Do you have any observations on the proposed review clause?

28. Provisional tax revenues which raise a significant amount of revenue are very difficult for any government to give up.
29. As the French wisely say c’est du provisoire qui dure.
30. We recommend that the legislation should clearly state that at the end of the relevant period, 2025 is suggested in the consultation document, DST will be repealed.
31. It would then be necessary to bring separate action, through a Finance Bill, to maintain DST in place if at that time the government considered that to be appropriate.

Reporting

Do you foresee any difficulties for individual entities to calculate whether the worldwide group is in scope, and if so, how could they be overcome?

Do you agree that the DST should be reported annually?

Do you see any difficulties applying the CT rules for accounting periods for DST, and if so how could they be overcome?

Are there any other issues relating to reporting the government should consider?

32. We agree that DST should only be reported annually.
33. It is clear that it is not going to be simple and straightforward to identify the business activities and then the revenues in scope nor to identify UK users and attribute revenue to those users. This is likely to impose a considerable compliance burden on business and HMRC needs to operate the system in a way which recognises the difficulties that business will be facing and manages the system in a pragmatic way.

Payment and compliance

Do you agree that mirroring the CT framework is the correct approach to minimise the compliance burden? If not do you have a preference for an alternative framework and can you give details of why this is preferred.

Do you agree that allowing a Nominated Company to act on behalf of the group will reduce the compliance burden?

Do you foresee any difficulties with the Nominated Company calculating DST liability on behalf of the whole group?

Are there any practical issues around the Nominated Company accessing information from the rest of the group?

Would specific rules be needed for companies whose AP does not coincide with the Nominated Company's AP?

Do you have any observations on either of the proposed anti avoidance provisions, or other avoidance risks?

Do you think it will be necessary to introduce additional rules to ensure compliance with the tax?

34. We think it will be helpful for the administrative, reporting and compliance framework for DST to be aligned as far as possible with the corporation tax framework.
35. We can foresee problems enforcing the DST regime in relation to non-resident companies without a UK permanent establishment and we would want to look carefully at any proposed penalties to address potential non compliance by such businesses.

Assessment of impacts

Do you have any comments on the summary of impacts?

36. There seems to be a disconnect between the level of UK activity of the international businesses which are likely to be caught by DST and the relatively modest amount of revenue which the government expects to receive as a result of this measure. The annual revenue rises from £275m in 2020-21 to £440m in 2023-24, the last year for which a projection is published.
37. The government needs to explain in more detail the underlying assumptions which support the projections.

APPENDIX 1

ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. **Statutory:** tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.
2. **Certain:** in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.
3. **Simple:** the tax rules should aim to be simple, understandable and clear in their objectives.
4. **Easy to collect and to calculate:** a person's tax liability should be easy to calculate and straightforward and cheap to collect.
5. **Properly targeted:** when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.
6. **Constant:** Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.
7. **Subject to proper consultation:** other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.
8. **Regularly reviewed:** the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.
9. **Fair and reasonable:** the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.
10. **Competitive:** tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see <https://goo.gl/x6UjJ5>).

APPENDIX 2**Extract from OECD Consultation Document *Addressing the challenges of the digitalisation of the economy*****Chapter 2 – Revised profit allocation and nexus rules****The “user participation” proposal****Mechanics**

22. The proposal would modify current profit allocation rules to require that, for certain businesses, an amount of profit be allocated to jurisdictions in which those businesses’ active and participatory user bases are located, irrespective of whether those businesses have a local physical presence.
23. The proposal acknowledges the difficulties in using traditional transfer pricing methods for determining the amount of profit that should be allocated to a user jurisdiction. For example, it dismisses the idea that the value created by user activities can somehow be determined through the application of the arm’s length principle, e.g. through hypothesising the user base as a separate enterprise and asking what return it would receive at arm’s length in its dealings with other group entities.
24. It is instead proposed that the profit allocated to a user jurisdiction, in respect of the activities/participation of users, be calculated through a non-routine or residual profit split approach. This approach would, at a basic level, involve:
 1. Calculating the residual or non-routine profit of a business, i.e. the profits that remain after routine activities have been allocated an arm’s length return;
 2. Attributing a proportion of those profits to the value created by the activities of users, which could be determined through quantitative/qualitative information, or through a simple pre-agreed percentage;
 3. Allocating those profits between the jurisdictions in which the business has users, based on an agreed allocation metric (e.g. revenues); and
 4. Giving those jurisdictions a right to tax that profit, irrespective of whether the business has a taxable presence in their jurisdictions that meets the current nexus threshold.
25. Under this approach, the profit attributed to the routine activities of an MNE group would continue to be determined in accordance with current rules. The only effect of the proposal would be to reallocate a proportion of the non-routine profit of the business, from the entities that are currently realising that profit, to the jurisdictions in which users are located.
26. Significant challenges exist in calculating non-routine profit across an MNE group, and there would be additional difficulties in trying to calculate non-routine profit at the level of an individual business line, e.g. where user participation is considered a material driver of value for one business line within a multi-business line group.
27. To streamline its implementation, the proposal could rely on formulas that would approximate the value of users, and the users of each country, to a business. However, it is acknowledged that this would be a pragmatic approach for allocating profit to a novel driver of value, and one that helps to avoid disputes between countries based on their subjective view of value generated by user participation. The proposal could also be combined with a strong dispute resolution component to minimise additional controversy and double taxation.
28. It is proposed that this approach would be targeted at highly digitalised businesses for which user participation is seen to represent a significant contribution to value creation. That would include, and perhaps be limited to, social media businesses, search engines and online marketplaces. The proposal could also incorporate a range of additional restrictions based on the size of the business to further reduce the administrative burden for tax administrations and taxpayers.