SLAUGHTER AND MAY

What does a digital business look like?

12 July 2018

Tax authorities all over the world are behaving as if digital business is a tax golden goose, with proposals published by the UK, the EU and the OECD (see Taxing the Digital Economy, March 2018). But is it as simple as that?

It is important to remember that this issue is not about profit shifting or tax avoidance. It is about the problems with allocating 21st century profits using 19th century principles. Digitalisation is also potentially good from a tax compliance perspective, making it easier for tax authorities to monitor transactions that might previously been part of the cash economy.

Digital business is generally identified as being a business that creates value by user participation - usually data collection. Social media and on-line market places are the two most obvious examples. In what is akin to a barter transaction, users receive free social or economic interaction in return for providing valuable data to the digital service provider.

The premise behind these tax proposals is that there is a clear distinction between this business model and more conventional models. But is this correct? Is a free coffee for loyalty card participation a digital business? What about rewarding customers who submit online product reviews?

Perhaps unsurprisingly, given that eight of the ten largest tech companies are US multinationals, the US view is that there should be no special rules for digital business because there is no such thing as a separate digital economy.

There are also practical difficulties in identifying where the value-creating activity occurs. A user is not necessarily in the jurisdiction indicated by their IP address. A regime that operates on the basis of hard limits such as number of users may also impact behaviour and access to services. How do you define an active user? How might businesses go about losing less productive users?

There are good arguments that profit allocation methods, which are based around physical presence, need to be updated to reflect modern methods of doing businesses. Current proposals are not, however, just minor adjustments to the existing rules. The proposed EU long term solution, for example, involves a complicated profit split based on group, rather than individual corporate entity, profits. This is a fundamental change.

This is not going to be an easy or quick process, but surely it is worth seeking consensus on an international solution that goes back to square one? Is allocation of profit for corporate income tax purposes still the right method to tax business?

The rush to implement interim solutions is understandable but worrying, as the proposals are blunt instruments driven by the desire to “do something quickly”. The OECD is right not to support this, but instead to suggest focusing efforts on developing a long term solution. Interim solutions are likely to be complicated and unfair and potentially create double taxation. For example, how can a 3% revenue tax be an accurate method to tax value creation? Once implemented, interim regimes may be difficult to repeal, especially if they are raising material tax revenues.

This is not just an issue for tech companies - all businesses need to engage in the debate. What is required is a global approach that is economically justifiable and politically acceptable.