

Clients & Friends Memo

The UK Government's Spring Statement

14 March 2018

The Chancellor of the Exchequer delivered his first Spring Statement on 13 March 2018. As much of the United Kingdom Government's substantive taxation measures will, as announced last year, be introduced in an Autumn budget, the Spring Statement contained very few substantive taxation measures.

However, a number of public consultations, "calls for evidence" and other documents were published by the Government. These publications included a "position paper update" on the public document published by the Government in November 2017 entitled "*Corporate Tax and the Digital Economy*", an important framework document outlining a series of ambitious Government proposals for taxing the United Kingdom's rapidly growing digital economy.

Corporation Tax and the Digital Economy

The November 2017 document, "*Corporate Tax and the Digital Economy*", addressed ambitiously the question of the extent to which international tax rules (and the United Kingdom's tax legislation) were effectively taxing the profits of digital businesses in countries where such businesses create value.

In particular, the position paper focused on several challenges:

- that the United States' current programme of tax reform and the continued implementation of the OECD's base erosion and profit shifting report are unlikely, by themselves, to resolve the taxation challenges posed by the digital economy. Opportunities for cross-border tax avoidance in the digital economy are most likely to be addressed by further fundamental reform of international tax rules;
- the importance of user-generated value to digital businesses, and the lack of current recognition or capture of that value in the existing international tax framework; and
- the identification of the participation of "users" of the digital economy as a key feature of value creation in certain digital businesses. Once the importance of user-created value is ascertained, the challenge would then move to the practicalities of income being subject to taxation where that income derives from online advertising or intermediation activity, split between jurisdictions in accordance with a user- or market-based metric.

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The Government's position paper on the digital economy was published against a backdrop of other reports into the same sector by international policy-makers, including the European Commission and the OECD Task Force on the Digital Economy (due to present a report later this month at the G20 meeting in Argentina). Unilateral action has already been taken by a number of jurisdictions such as India, and is being considered actively by other jurisdictions, including The Netherlands and New Zealand, which have proposed taxation measures focused on, or particularly applicable to, digital businesses.

The Spring Statement Updated Position Paper

The Government's updated position paper on "*Corporate Tax and the Digital Economy*", published on 13 March 2018, provides additional details on possible international and United Kingdom tax changes which would address risks which have been identified relating to the taxation of the digital economy. While the Government is careful to state that the updated position paper does not articulate the Government's final position, a number of themes in the Government's approach can clearly be discerned.

- The updated position paper provides a greater explanation regarding the Government's understanding of "user-participation" and how user engagement and active contribution enhances the value of certain digital businesses. In the paper, the spotlight of the Government is placed on a variety of circumstances contributing to business value, including the depth of user engagement with digital platforms, correlation of user activity across online platforms, the inter-relationship of user contribution and brand development, and the differences between participating users of digital businesses and traditional customers.

Social networks, e-retailers, intermediation platforms and search engines are compared in the paper in the context of user-participation, with the aim to ensure any tax measure is targeted at businesses for whom user-participation represents a significant contribution to value creation.

- One of the long-term aspirations of the Government in the updated position paper is to facilitate a reform of the international tax rules relating to the digital economy in double taxation treaties. Ultimately, the ideal situation for the Government would appear to be to tax value-creating activities of digital businesses based on user location. Currently, the provisions of Articles 5, 7 and 9 of the OECD Model Tax Convention (the framework for the United Kingdom's tax treaties) do not allow this, being focused on business (permanent) establishments, as opposed to imposing taxation based on value which is created and driven by user-participation.

Changing current international taxation approaches is likely to prove very difficult and time-consuming, as the Government admits in its updated position paper. Even before the mechanics of taxation on user-participation can be considered, additional work would be required on value creation by user-participation. Where, geographically, is value from user-participation in a digital business actually created? How should user-created value be measured? Once measured and evaluated, how should user-created value be allocated

across different jurisdictions? How would double taxation be avoided once such user-participation value is assessed to tax?

Any practical measures to tax the digital economy and user-participation will need to overcome these challenges. At the heart of the Government's proposals to tax user-participation is the need to recognise user-participation as a value-driver for certain digital businesses, and develop a methodology for profit attribution relating to user-participation. The Government has proposed that any change of international tax law to refocus on user-participation in digital businesses should then be possible through amendments to the OECD Model Tax Convention. While these challenges may not be insurmountable where a broad consensus is achieved across many governments and policy-makers, as the OECD's remarkable BEPS project has shown, it remains the case that such challenges are unlikely to be overcome quickly.

- Accordingly, and perhaps unsurprisingly, the Government has suggested an interim approach involving short-term indirect taxation measures to increase the amount of United Kingdom tax paid by businesses deriving value from user-participation. Such a tax would apply to a digital business irrespective of the geographical location of the business and regardless of any physical presence or taxable permanent establishment in the United Kingdom. The update to the position paper sets out a framework for consideration of such an interim taxation regime.

The methodology for creating an interim tax on digital value created through user-participation looks similar to the United Kingdom's diverted profits tax (introduced, controversially, in 2015). The Government's proposal would be to determine the scope of the tax, defining the channels through which users create value through their participation and impose taxation on revenue streams of businesses for which those channels are most important. Taxation might be applied in different ways to particular business models and revenue streams. The example of online advertising is given in the updated position paper, with the Government suggesting that a right to taxation may arise from online advertising targeted at United Kingdom users of an in-scope online platform.

The difficulties in effectively framing the scope for taxation in such a malleable and rapidly developing marketplace are likely to be substantial. Opportunities for double taxation, non-taxation or discriminatory taxation between businesses will exist, and the Government states that it does not underestimate the technical challenges. Somewhat optimistically, the updated position paper cites similar hurdles having been overcome in VAT legislation. However, the comparison between what the Government is considering in the context of taxing the digital economy on the one hand, and VAT legislation on the other, is slightly misleading. The comparison does not expressly recognise the time taken to refine and streamline VAT legislation over an extended period, nor the multi-national intra-EU nature of VAT generally.

The concern is likely to remain, pending the finalisation of the Government's proposals, that the expedience of revenue raising through a unilateral "short-term" measure is likely to

develop its own impetus in favour of a quick legislative fix, regardless of the technical challenges which may exist.

Conclusion

The Government clearly states in the updated position paper that its final position has not yet been determined, noting that both the EU Commission and the OECD are due to shortly present updated versions of their own reports and workstreams in the area of the digital economy. Further comments are invited by the Government from stakeholders, and no doubt the Government will have a careful eye open during the remaining months of 2018 towards any unilateral developments in respect of digital economy taxation among its trading partners, and in particular the United States.

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If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

Adam Blakemore

+44 (0) 20 7170 8697

adam.blakemore@cwt.com

Catherine Richardson

+44 (0) 20 7170 8677

catherine.richardson@cwt.com