Think Ahead ACCA

Corporate tax and the digital economy: position paper

A position paper issued by HM Treasury

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SUMMARY

The UK government's position, that in principle a multinational group's profits should be taxed in the countries in which it generates value, appears uncontroversial. However there is a fine but important distinction between that principle and the practice of what currently happens. A multinational group's profits are taxed in those companies in which they are accounted for, subject to limited adjustment (including cross-border transfer pricing adjustments) for tax purposes. Reconciling the general policy statement with existing reporting and assessment tools in a fashion which would not create significant uncertainty for business would be a significant accounting and legal drafting challenge.

There is a clear preference among the general population, in the UK and across the whole of the G20, for taxes to be rooted in legislation, rather than based upon notions of morality or fairness[1]. The greatest challenge facing tax authorities the world over will be to bridge the gap between political rhetoric and legal reality, creating enforceable frameworks of statutory regulation which offer the clarity, certainty and coherence essential to long term economic growth and stability.

Similarly, there is a clear preference for cooperation and coordinated action, rather than unilateral actions[2]. The economic environment within which those regulations must seek to operate is dynamic, and the rate of change and diversity of situations are greater than they have ever been. The challenge is significant, and should not be underestimated. Given the risks associated with unilateral short term responses, and the effort which would be required to attempt to frame a proportionate and effective response, there is a question as to whether it would make more sense over all to concentrate on the international efforts to find a sustainable long term solution.

While inaction would lead to continued exchequer impacts (and public dissatisfaction) it is vital to take a step back and reflect on the government's intended aim, and how that outcome can be achieved without at the same time driving other less desirable outcomes. Steps already taken to deal with concerns about the wider international tax environment should also be given time to bed in and properly take effect. As the government acknowledges, many of the concerns discussed in the position paper are not unique to digital business, and are covered by existing Action points of the OECD BEPS programme. Introducing additional measures which may overlap or even conflict with the implementation of that programme risks hampering the assessment of impacts, and diluting the overall impact of both.

[1] http://www.accaglobal.com/uk/en/technical-activities/technical-resources-search/2017/march/g20-public-trust-in-tax.html Key finding 6
[2] Ibid, Key finding 5

AREAS FOR SPECIFIC COMMENT:

The current framework

At present, the reporting boundary for accounts (on which most tax computations are based) is the entity, or the consolidated group. This means that accounting is not currently designed to recognise ‘consumption externalities,’ much less to measure them. There are attempts in various sectors to capture such external outcomes notably by businesses and proponents International <IR> framework, and through the Embankment Project being led by EY and the Coalition for Inclusive Capitalism[3]. However, these developments are in their infancy. HMRC and other tax administrations should follow these developments closely, in order to gain a better understanding of the drivers of value.

The paper talks about untaxed intangible assets. Most intangible assets are not within charge to tax partly because they are not recognised in the accounts – and this is because their future cash impacts are too uncertain, and too difficult to quantify. More alignment between taxation and accounting would be particularly helpful in attempting to capture and describe the value of intangible assets. It would be undesirable for the tax base to shift too far away from accounting, however, as that introduces significant complexity and uncertainty for businesses.

Until what ‘value’ means can be defined more consistently, it is perhaps inadvisable to move away from a tax system which taxes profits to a system which taxes ‘value,’ whatever that may mean. Wider value creation (be it in terms of technological innovation, society, or the environment) should surely be encouraged; taxing ‘value’ could have the undesirable effect of discouraging value creation unless clear mechanisms exist to ensure that only returns in excess of costs are to be targeted.

There are a number of concepts relevant to the discussion which would benefit from precise definition before moving into detailed policy design. It is not always apparent whether the paper is referring to “corporate tax” as simply the contribution made by incorporated businesses to society, or “corporation tax” as defined in the UK taxes acts, as a charge on specified business profits. Similarly the paper refers to the interrelated concepts of value and profit generation without clearly articulating the precise basis of assessment for the proposed charge. The measures suggested in the paper could range in characteristics form something more akin to a revenue based VAT style charge to a pure direct profits tax, and while some degree of flexibility in debate is useful at this

[3] https://www.inc-cap.com/embankment-project/

early stage it is essential before going further that the precise nature of the charge is clarified.

Design Considerations

When constructing a legal arrangement with a view to capturing a specific set of transactions within the charge to tax, it will be important to ensure that those businesses who are not caught by the charge or do not have an exposure to it are able to effectively ignore it. This imposes a number of design constraints on the operation of the tax. The identifying features must be positive, and easy to understand. The tax itself should be assessed and paid by the entity responsible for judging whether the identifying features are present for a liability to arise. Enforcement of the charge must be practicable and properly resourced.

One of the difficulties for legislators attempting to prepare tax law to deal with avoidance issues is that the Jacobellis formulation of “I know it when I see it” is not reasonably compatible with taxpayer self-assessment. It can function hand in hand with the exercise of discretionary power by the tax authority, but this in return relies upon several other conditions holding true – in particular, the full and proper resourcing of the tax authority to effectively manage the risk to the Exchequer. When setting the conditions for the charge to apply, designers must ensure that the obligations to account for the charge are aligned with liability for creating and paying the charge.

There are probably some lessons which can be learnt from looking at the structure of other anti-avoidance charges. A useful comparator is the IR35 intermediaries’ legislation, which currently exists in two distinct formats with radically different impacts on the businesses exposed to it. The IR35 charge is aimed at individuals who avoid the employment taxes properly due on an employment type relationship by imposing an intermediary which is not an employee into the chain of contractual relations. The policy was originally aimed overtly at “Friday to Monday” contractors, and it remains the case that the charge should apply only to those who can control the form in which the rewards for their labour are returned to them.

The legislation requires two conditions to be met for the charge to apply: paraphrased, a relationship which looks like employment, and the ability to control the flow of the payment for that relationship. If either is absent, the charge will not apply.

In the private sector, the compliance burden falls almost exclusively upon the contractors, and investigation work is entirely at the discretion of HMRC. If the conditions for the charge to arise are not fulfilled there is no need for any party to do anything to confirm that position. Only those businesses or individuals who are the target of the original policy should need to turn their minds, and resources, to dealing with it. However, for such a design to be effective the enforcement and compliance effort needs to be properly resourced.

In the public sector, a third party is involved in the assessment and collection of the charge, and is on risk if a relationship is incorrectly assessed to be outside the scope of the charge. The transfer of risk has had a significant impact on all parties, with the parties along the contractual chain needing to transmit information and assessments in order for the potentially “on risk” party to satisfy itself that it is not exposed to enforcement action.

The characteristics which made the application of the charge so powerful a weapon when operated at the discretion of the investigating authority make the definitive disapplication of the charge that much harder to demonstrate, and that much more important to consider. Similarly, any attempt to design a closely targeted digital tax where definition of the target population relies on comparatively broad criteria must ensure that the nature of the assessment process does not impose unnecessary burdens on businesses which are not the target of the charge.

In developing a clear legal basis for a charge along the lines proposed in the paper, there are two key design issues to be settled, one of which has already been encountered in digital taxes already implemented elsewhere (subject matter of the tax) and the other of which is peculiar to the novel extraterritorial aspects of the UK proposal – namely how to identify and, more importantly, recover the funds from, the relevant overseas entities.

The formulation of the Italian “web tax”, which specifically targets supplies of online advertising, incorporates tests around the automated nature of the activities in order to restrict its application to “digitalised” businesses. Depending upon the detailed intention of the UK government a similar test could be appropriate in order to limit the impact on “non-digitalised” business models.

However, as the position paper clearly acknowledges, there is no clear line between digitalised businesses and “conventional” businesses. Likewise, there are not two discrete sets of structures and mechanisms operated by two distinct sets of businesses; rather, the existing structures targeted by the BEPS programme intermingle with the novel issues brought up by digitalisation. There are obvious risks in attempting to apply new “digital taxes” to cover aspects of the tax system which are already covered by the BEPS proposals. Accordingly, some filter to distinguish those issues which can only arise in digitalised situations from those which can equally arise in more conventional businesses would be appropriate.

The main design issue here will be what metrics are used to define the transactions which are to be taxed, and then how to accurately assess the level of taxable activity. It is here that the difficulties of reconciling fine rhetoric with fine legal detail become painfully apparent. Policy makers need to be clear on the ends they wish to achieve, and then to calmly appraise the tools they have available at their disposal to pursue those ends. If the tools do not currently exist that they could be created, but if that is the case then design must be approached with care to avoid the creation of powers beyond what is needed, or that are open to misuse or misunderstanding with potentially harmful effects. The limitations on available valuation data to support the enumeration of the charge would need to be addressed. The difficulty of such an exercise should not be underestimated, especially against the backdrop of developing technologies and applications thereof.

There is also a fundamental issue around the reporting of the transactions giving rise to the “value” which is identified in these cases. While it is intuitively obvious that some link exists between the size of the customer base and the value of the information extracted from it, identifying and quantifying that link in a fashion sufficiently precise to fit into existing models of corporate taxation will be an entirely novel challenge.

Previous attempts to deal with externalities have focused on identification of alternative metrics which are then translated into monetary charges – for example, carbon consumption, measured in terms of physical outputs, which is then taxed. The carbon values are independent of the business’s other economic metrics, ie the monetary values accounted for in the financial statements of the companies involved. Conceptually, a tax on the value created off the back of a large user base has more in common with the tax on carbon consumption than it does with a traditional profits tax. This will have a number of impacts upon the design of the charge and will make development of the assessment process a non-trivial exercise.

Interim digital solutions

The position paper is clear that additional work will be needed in the long run to ensure that the tax system remains sustainable and fair. Whatever the shape of any measures aimed at ensuring profits derived from digital activities are brought within the charge to tax, whether short term or long term, it seems inevitable that they will rely absolutely upon a level of intergovernmental cooperation not yet seen in relation to taxation. While it is clear from the ACCA/IFAC/CAANZ survey that there is popular support for such cooperation, there are other calls upon the resources of governments, and other pressures on their policy making, which might restrict the ability of governments to commit to such measures to the extent required.

There are considerable technical and legal hurdles to overcome in any digital economy tax mechanisms, and if government is to create a sustainable long term model then cooperation and coordination with all those directly involved is essential. Public opinion may guide policy, but practical considerations and informed expert advice must drive the implementation. Business and government in the UK currently face a unique and unparalleled set of challenges in the wider political and economic environment demanding instant and detailed attention. In deciding whether to pursue interim tax measures alongside long term sustainable solutions policy makers should weigh carefully the opportunity cost of diverting resource into temporary structures, and take particular account of the risks should those temporary structures have unintended side-effects. Prudent allocation of resource may indicate a focus exclusively on the greater prize of long term solutions.