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Tax issues for online platforms

Online platforms don't comfortably fit within the international tax framework. This briefing considers the challenges and expected new measures.

Online platforms throw up some interesting tax problems. In part this is because they don't comfortably fit the mould of a traditional multinational in terms of how their profit is generated and where value sits. In part, it is because they facilitate the gig and sharing economy and other forms of e-commerce, which are more difficult for tax authorities to police than traditional models.

We've highlighted below some of the tricky areas for online platforms and how these are being addressed, both in the UK and internationally. We've focused on common themes for online platforms facilitating transactions between individuals, in particular those bringing together buyers and sellers of goods or services rather than social media platforms, for example. Of course, over-generalisations are always dangerous: the issues vary according to the type of platform and the lack of consistency (and clarity) is part of the problem. We're seeing more signs of joined up thinking in setting tax policy for online platforms but it's long overdue. In the meantime online platforms face real uncertainty about what the future holds.

What is being supplied, and by whom?

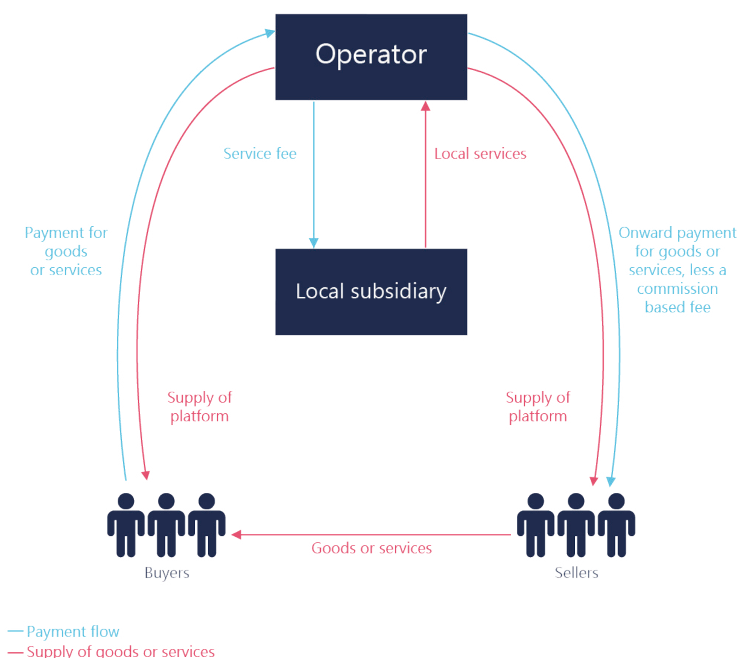
The principal / agent model

Is there a 'standard' business structure for an online platform? The principal / agent model – in one form or another - perhaps comes close. The intended analysis for the taxpayer here is that:

Is there a 'standard' business structure for an online platform? The principal / agent model – in one form or another - perhaps comes close.

- An entity (possibly offshore, elsewhere in the EU) (the ***Operator***) owns and operates the online platform that connects buyers and sellers of goods or services. The Operator supplies digital services (i.e. the use of the platform) as principal to users, for which the Operator charges a service fee (typically to the sellers). Buyers and sellers on the platform contract with one another as principals through the agency of the Operator, with the Operator intermediating payments.
- The tax position flows from this network of relationships:
  - The digital service is in principle subject to VAT where the (paying) recipient is located, regardless of whether it is business to business (***B2B***) or business to consumer (***B2C***). If it is an international B2B supply, then the reverse charge will apply, and (if the recipient is below a registration threshold) no VAT will in fact be chargeable. The supplies by sellers to buyers will in principle be subject to VAT if the seller is a taxable person. But if sellers are below a registration threshold, again no VAT will in fact be chargeable.
  - Individual sellers supplying labour via a platform are treated as self-employed for tax, NICs and employment law purposes; they act as principals on their own behalf, independent from the Operator.
  - Only the digital service fee is included in the Operator's taxable profits.
- An Operator may also supply goods or services through its platform as principal, alongside the intermediated transactions. The tax treatment for those transactions then follows that construct, but without interfering with the treatment of the intermediated transactions.

See the diagram overleaf for a simplified overview of the intended model for intermediated transactions.



Why are the authorities interested in challenging this?

The model dictates the incidence, jurisdiction and quantum of tax. The results the model produces – the taxable profits of the Operator in the relevant jurisdiction or the amount of VAT accounted for by the Operator in that jurisdiction – may play well into a political narrative about certain technology firms not contributing enough to the public purse. Cue interest from tax authorities querying the Operator's true role as an agent.

If the agency relationship is rebutted, the nature of what is being supplied morphs. Rather than digital services, the Operator will be supplying all of the relevant goods or services to buyers itself, and VAT and direct tax will follow. While that might be the right analysis in certain scenarios, in others the simplistic narrative glosses over the substance of what is taking place: individual transactions between multifarious buyers and sellers, facilitated by a digital interface. The mere fact of aggregation on a single platform should not *on its own* change the nature of what is happening for tax purposes.

The model also dictates the employment and competition law treatment of the relationships constituted via the platform. The model described above is general; it could relate to transport, tourist accommodation, tickets or takeaways. The authorities' interest in challenging the basic tenet of the model has, however, tended to focus on those platforms forming part of the 'gig economy'; i.e. platforms allowing users to sell their labour on an ad hoc basis, rather than enabling the exploitation of underused assets (via the sharing economy) or the simple sale of goods (via online marketplaces).

This seems to have been born of concerns about employment rights, which don't arise in relation to sharing economy or online marketplace platforms. The employment rights debate – about the extent to which Operators and their users should be permitted to trade traditional employment rights for flexibility and independence by using this model – is an important one. However, it should not be conflated with the question of what is being supplied, and by whom, for tax purposes.

(Of course, if it is right that the individuals providing services through a platform do actually have a contract of employment with the Operator, that will in itself dictate the rest of the tax analysis. The Operator will by definition be supplying the relevant services as principal, through the agency of its employees.)

What does a robust model look like?

Both VAT and employment law start with an analysis of the relevant contracts. They also require a court to look at all the circumstances and consider the commercial reality of the transactions and relationships concerned. If a principal / agent model is to stand up to scrutiny, it will be important for the contracts to be robust and consistent with an agency relationship. That is a necessary, not a sufficient, condition. It is also crucial that what happens in practice is consistent with the overall tenet of the model.

The following points are likely to be relevant to the analysis:

- ***Does the Operator determine the quantity of work that sellers are required to undertake, and do they guarantee a certain level of work?*** Mutuality of obligation is a fundamental facet of an employment relationship.
- ***Are sellers entitled to (and do they in practice) develop their business by providing similar services on other platforms, or directly to buyers?*** A principal should not be restricted from transacting outside the confines of the platform.
- ***To what extent does the Operator control prices?*** A seller being able to negotiate (and in fact negotiating) their own price is consistent with their acting as principal.
- ***Do sellers provide their own 'tools of the trade' required to provide the relevant services to buyers?*** Principals do not generally rely on their agents for their equipment.
- ***Do sellers bear the financial risk of transactions on the platform?*** The Operator guaranteeing a minimum level of income for sellers, or taking financial responsibility where buyers seek redress for poor service, may be an indicator against sellers acting as principal.

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While it has been a point of focus in some recent employment rights cases, the mere fact that an Operator seeks to impose quality standards should not (in our view) be decisive. Quality controls and the ongoing vetting of sellers are consistent with the principal / agent model. The Operator has a strong commercial interest in ensuring that a minimum standard of service (or goods) is offered on its platform. Indeed, the integrity of the platform is the essence of the Operator's business. The organiser of a food market does not become the seller of the food by virtue of their imposing conditions on their proprietors.

Arguably, the principal / agent model is inherent in the very nature of what it means to offer an online 'platform'. If the platform is not allowed to function as a mechanism through which users are able to transact freely as principals, is it really a 'platform' at all?

Looked at through that lens, the fundamental question here should perhaps be summarised thus: is this a genuine third party platform through which users operate independently (albeit subject to certain justifiable stipulations imposed by the Operator to protect its commercial interests), or is the 'platform' in reality an interface by which the Operator provides an (essentially homogenous) service to buyers, through its 'sellers'?

The dividing line is blurry, but Operators should be able to protect the integrity of their platform and still fall on the right side of it.

Tax status of sellers

Even if there's no question of individual sellers being employees of the platform, there remain questions as to whether those sellers are trading (for income tax purposes) or taxable persons (for VAT purposes). These can be difficult questions to answer, as they are highly sensitive to the particular facts.

On the income tax side, the distinction between a trade and a hobby (at least in the UK) depends on the badges of trade. These include whether there is a profit seeking motive, the regularity of transactions, the way in which the transactions are carried out and the nature of the goods or services being provided – and they are notoriously difficult to apply.

On the VAT side, the issue of whether an individual is a taxable person usually turns on whether they're carrying out an economic activity. This is a broader concept than trade – it generally requires remunerated activity with some degree of regularity, although some argue that *any* business transacted on an online platform is an economic activity, even if only occasional. Where the platform allows buyers and sellers to exchange rather than sell goods and services, either directly (e.g. a flat swap) or via a common pool (e.g. a community sharing platform), the water becomes murkier. On exchange platforms, even regular sellers may not be taxable persons if there is insufficient link between the supply and the consideration.

Tax-free allowances and VAT registration thresholds also need to be factored in, although they generally affect liability to tax rather than tax status. These can vary by activity and by jurisdiction. For example, in the UK rent-a-room relief lets you earn up to a threshold of £7,500 per year tax-free from letting out furnished accommodation in your home, and there are

two new annual tax allowances for individuals of £1,000 each, one for trading and one for property income. These are separate from the allowances and exemptions for capital gains. Different rules apply in other jurisdictions and VAT registration thresholds also vary by Member State. The UK's VAT registration threshold is pretty high at £85,000 but thresholds are far lower in other Member States, while some do not apply them at all. Together these make for a messy compliance picture, bearing in mind that many online platforms operate internationally.

Tax compliance issues

Assessing seller tax status

Assessing the tax status of sellers is a headache for tax administrations but also for Operators, who need to do this to work out where VAT is payable and by whom in relation to the fees charged for using the platform.

The VAT regulations provide some assistance here, allowing suppliers of "electronically supplied services" to treat an EU-based seller as non-taxable as long as the customer has not communicated an individual VAT registration number. Where the Operator is not strictly (or not only) providing electronically supplied services (e.g. where it is treated as providing intermediation services), it can generally still treat the seller as non-taxable unless it has information to the contrary.

Normally for B2C transactions (i.e. where an Operator is dealing with non-taxable persons) the VAT liability sits with the Operator and the supplies take place where the Operator is established. However, there is a special rule for "electronically supplied services" which treats a B2C supply as made where the recipient is established. This means Operators may need to register for VAT in every jurisdiction where they operate, unless they make use of the VAT mini one-stop shop (***MOSS***). MOSS broadly permits a single point of registration for all EU-based B2C supplies, with VAT collected and distributed to other Member States by the Operator's home jurisdiction.

Tax reporting

Tax reporting is another headache for both tax authorities and Operators. Tax authorities need access to information to test the tax status and tax liability of individuals conducting business on the platform. Operators need to be sure that in providing this information they are not breaching confidentiality obligations under contract or data protection legislation. These concerns have been made more acute by the introduction of the General Data Protection Regulation (***GDPR***) and the recent furore about use of data by certain technology firms. There is also a compliance burden for Operators so it's important the legislation offers a level playing field, across jurisdictions and against competitors.

Where the MOSS regime applies, information relevant to the VAT treatment of supplies made by the Operator must be made available to the home tax authority, which must make this available to other EU tax authorities on request. Outside MOSS, tax authorities need to direct requests to the Operator and most tax authorities have broad powers (both under direct tax and VAT legislation) to access the information they need, including under double tax treaties where required. However, this is time consuming and can throw up difficult issues around possession and power and data protection.

From 2021, a broader range of reporting obligations takes effect. All platform Operators will have to report all B2C transactions taking place on their platform (not just their own supplies) on request by any EU tax authority. As this becomes the norm, the onus will be on Operators to make sure they have the systems in place to report smoothly. Almost as important is to make sure their communication strategies anticipate a broader raft of tax disclosure so that their sellers are not caught unaware.

Tax collection

Against this background, it's hardly surprising that HMRC published a call for evidence in March this year about the role of online platforms in ensuring tax compliance by their users. Of course, the inherent unreliability of self-assessment when left in the hands of individuals isn't a new problem: it rears its head whenever individuals earn income outside the traditional employment model. The IR35 rules (including recent and proposed changes to these rules), construction industry scheme and common reporting standards are all examples of measures introduced to tackle these basic tax compliance issues.

A key question that is currently vexing tax authorities is the extent to which the Operator should be made responsible for collecting tax from (or educating) its sellers. There are a number of different approaches open to tax authorities. For example, the UK has already made online marketplaces jointly and severally liability for unpaid VAT of recalcitrant sellers,

where the marketplace fails to take remedial action following receipt of a notice from HMRC. Other jurisdictions require (or permit) online platforms to withhold tax at a flat rate from payments made to their sellers.

These sorts of measures can operate unfairly and may be subject to challenge in domestic or European courts. Clearly, any solution to the tax collection problem needs to work across borders and cannot favour some enterprises over others in a way that would distort competition or amount to state aid. This is an area where joined up thinking is needed.

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In the end, most individuals want to get their tax right so greater transparency, automatic information exchange and better information on the tax rules that apply are likely to prove more effective tools than withholding tax or joint and several liability. This models the approach landed upon by the offshore banking sector after decades of struggles with tax compliance issues.

France may be leading the way here by requiring platforms to provide sellers with detailed tax statements which will be automatically reported to the French tax authorities from 2019. In their call for evidence, HMRC ask whether a similar approach might be adopted in the UK. Respondents note that Operators typically only have limited information about their sellers and will not want to be liable for bad advice. They would prefer to provide basic information about a seller's transactions on the platform and point to user-friendly advice produced by HMRC on the tax consequences.

HMRC also notes that some jurisdictions have introduced voluntary measures to facilitate reporting of income from online platforms. This suggestion has received cautious support but some query whether the take-up would justify the compliance cost. Ultimately, it may be better for HMRC to develop its own online tool which Operators can pre-populate on request from sellers.

Tax on the profits of the Operators

The status quo

Things aren't necessarily any easier when it comes to the Operators' own corporate income tax position.

There are usually two key questions of concern to Operators. First, do they have a permanent establishment (***PE***) in states where the platform is used (***User Jurisdictions***)? Secondly, if they do have a PE, are any material profits attributable to it?

1. Is there a PE?

Under current international tax rules, a PE typically arises when a company has a fixed place of business or a dependent agent in a jurisdiction. Both of these require the company to have some physical presence there.

Generally speaking, the Operator won't need to have a physical presence itself in the User Jurisdiction to carry out its core activities. Under the principal / agent model, the Operator can supply digital services to the users of its platform without stepping foot in that market – so-called "scale without mass".

In some cases, that might not be the full picture. Some online platforms may need people on the ground: for example, to deal with customer complaints or regulatory issues or to make sure the app is fit for purpose in the local market. However, this can often be achieved through the use of a subsidiary. That means the Operator still has no PE and, if the services supplied by the subsidiary are routine, OECD transfer pricing principles may only require that the subsidiary earns a small margin on its costs.

Nor will Operators necessarily be caught by recent changes to the PE rules resulting from BEPS Action 7 or the UK's diverted profits tax (***DPT***). Those rules focus on cases where activity in the local market has been designed to fall short of the PE threshold (e.g. where contracts are negotiated in the local market but not concluded there). With an online platform, all users have to do is tick a box affirming the Operator's terms and conditions when they sign up to the app. There's no negotiation or other activity of the Operator in the local market to give rise to a PE (under the revised OECD definition) or an avoided PE (under the UK's DPT rules).

In many cases, an Operator will be able to conclude that it does not have a PE in its User Jurisdictions.

2. Is any material profit attributable to any PE?

Even if the Operator concludes that it has a PE, it could well conclude that no material profit is attributable to that PE.

That's in part because of the significance of intangibles for online platforms. Post-BEPS Actions 8-10, returns on intangibles for profit attribution purposes have to be calculated by reference to the so-called 'DEMPE' functions. (These are the functions performed, assets used, and risks assumed in the development, enhancement, maintenance, protection and exploitation of those intangibles.)

For an online platform, these functions will often sit with the Operator (or perhaps another – usually offshore – group company), that develops the technology and own the brand, trademark and other customer related intangibles. It's also the Operator that agrees to provide users with access to its platform in exchange for a fee. In other words, the Operator often owns the assets, performs many if not all of the DEMPE functions and assumes the risks of them underperforming. This will suggest profits should be attributed to head office.

It's also in part because of how value driven by user participation features (or does not feature) in profit attribution. Some argue that user participation is a key generator of value for online businesses, so that some profit should be attributed to jurisdictions where users are based. However, the focus of existing transfer pricing principles on where functions are performed, assets used and risks assumed doesn't readily lend itself to an attribution of profit based on user participation value.

Changes on the horizon

The level of corporate income taxes paid by many digital businesses isn't popular politically in many User Jurisdictions. Unsurprisingly, that has prompted calls to change the system. To date, however, there's been a lack of international consensus about whether, and what, changes may be required. In 2015, the OECD's final report on taxation of the digital economy (BEPS Action 1) recognised significant differences of opinion on the subject. The OECD concluded that the other BEPS actions should be allowed to 'bed in' before further work was undertaken.

That bedding in process isn't complete, but pressure has built for further action. The OECD is therefore working with stakeholders to develop a consensus-based solution by 2020. In the meantime, though, some countries are pushing ahead with their own (uncoordinated and unilateral) measures to fix (what they say are) the unique problems arising from the digital economy.

Some of the proposals are ambitious, aiming to fundamentally change how the international tax system operates. The European Commission's proposals are among the more advanced of these; their stated aim is to fix a "misalignment" between the place profits are taxed and the place where value is created. They proposed to achieve that via:

- a new category of PE for a "significant digital presence" (*SDP*) (see Box 1); and
- new attribution methods to recognise profits in the SDP PE.

Box 1: EU long-term proposals – key concepts

Significant digital presence: This requires supply of digital services through a digital interface (e.g. a website or app) and one or more of the following thresholds to be met in the relevant EU Member State in a tax period:

- Revenues from supplying **digital services** exceeding €7m;
- Number of users of **digital services** exceeding 100,000; and
- Number of online business contracts for **digital services** exceeding 3,000.

Activities of associated enterprises are aggregated in applying the thresholds.

Digital services: This is a service delivered over the internet or an electronic network and the nature of which renders the supply essentially automated and involving minimal human intervention from the supplier. The definition is very broad covering, for example, online platforms, search engines, website hosting, electronic downloads of books, games, music or other electronic content and cloud storage.

Location of users: Users are generally deemed to be located in a Member State in a tax period if a user uses a device in that Member State during that tax period to access the digital interface through which the digital services are supplied. Location is determined by IP address unless a more accurate geolocation method is available.

So how do these proposals affect Operators? The starting point is that Operators are clearly intended to be within scope and will often have an SDP PE. However, Operators face a trickier task in determining how this affects their corporate tax bill.

A key rationale for the changes seems to be to tax the value of user participation in User Jurisdictions. However it's not easy to pin down that value for an online platform, even at a conceptual level. Online platforms don't typically rely on user-generated content to attract other users (and advertisers). Nor is user data from online platforms typically sold. Instead, the most commonly cited user participation value for online platforms is a "network effect" (i.e. that having more users makes the platform more attractive generally) and a possible boost to brand reputation and trust from user reviews and ratings. These aren't easy things to value.

The Commission's answer is based on the authorised OECD approach (***AOA***). That means Operators will need to work out on a case by case basis what profits the SDP would have earned had it been a separate and independent enterprise, taking into account the functions performed, assets used and risks assumed; however they are to do so with some modifications. Quite how those modifications will work remains unclear but arguably involves overriding (at least aspects of) a traditional significant people functions (***SPFs***) analysis and simply deeming some risks or assets to be attributable to the SDP PE. That is to be combined with a recommended profit split method, potentially based on users or data collected in the jurisdiction, for example.

The Commission has suggested that more specific guidelines could be developed in future. In the meantime, Operators would have a difficult task on their hands. How should they allocate based on the SDP PE's deemed activities as compared with actual SPFs in the head office? Does the profit split require them to ignore head office functions? It's not hard to see a risk of international disagreement and double taxation for Operators, especially given various other unilateral actions (as well as the UK's position paper (in March 2018), Argentina, Israel, Italy, Slovakia and Taiwan have all introduced measures in this area).

By contrast, the route HM Treasury has mooted to deal with practical difficulties in valuing user participation is just to agree a fixed percentage of residual profits attributable to user participation for each of the different categories of digital business. That's a relatively simple approach, but is quite a blunt instrument – it could leave similar businesses in quite different positions. It also leaves unanswered the thorny question of how those fixed percentages would be determined.

Interim measures

Box 2: EU interim solution – key concepts

Taxable revenues: Subject to limited exceptions, this would capture revenues from:

- **selling advertising** on a digital interface (e.g. a website or app);
- **selling user data** generated from users' activities on the digital interface; and
- **digital intermediary activities** allowing users to interact with other users and which can facilitate the sale of goods and services between them.

Taxable persons: Companies are only taxable persons where they (or their consolidated group) have:

- total annual worldwide revenues of at least €750m; and
- total annual EU taxable revenues of €50m.

Whatever your view on the rationale behind them, the proposals to change the PE and profit attribution rules generally seek to achieve a coherent update to international tax rules. The problem is that, without international buy-in (not seen to date), there are limits to what can be achieved on that front. Existing double tax treaties will prevent states from applying the proposed changes in many cases.

The Commission has said it hopes its proposals can shape the OECD's work, and also recommends that Member States seek to amend their double tax treaties to accommodate them. However, the potential difficulties have prompted some, including the EU and UK, to consider other unilateral interim measures.

Among these is the Commission's proposed digital services tax (***DST***). This tax would have effect from the start of 2020. It would be a 3% tax, applicable to "taxable revenues" earned by "taxable persons" (see Box 2). Its scope would be more narrowly focused than the longer term proposals described above, but it could be at least as onerous for online platforms. A significant additional tax take is expected (the DST is expected to raise €5bn per year in aggregate), without any relief for unprofitable or loss-making companies. There's also a substantial compliance burden – platforms will need to maintain records of when and from where users have accessed the platform to determine what tax is due.

Whether the EU measures will make it into law isn't clear. Unofficial reports have suggested progress is being made, but a number of Member States have expressed concerns about them and the US has urged the EU to abandon the proposals. In the meantime, others are pressing ahead with their own versions of unilateral measures. It was confirmed at the UK Budget 2018 that the UK is to introduce its own DST with effect from April 2020. Like the EU DST, this is proposed to be an interim measure until international consensus on a permanent solution is reached. A consultation has been published on the detailed design of the new DST, and it is proposed to apply to UK revenues from search engines, social media platforms and online marketplaces at a rate of 2%. Other jurisdictions are also taking similar steps, from India's equalisation levy to the recent launch of a consultation by Australia on its own reforms.

All of this means online platforms face an unpredictable and incoherent international tax regime, with the risk of double taxation.

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What should online platforms be doing?

With proposals still developing, online platforms could be forgiven for taking a "wait and see" approach. The risk though is that they're caught flat-footed.

To put themselves in the best position, we think Operators should be thinking ahead and participating in the debate. That includes:

- testing their business model and tax structure against emerging thinking;
- considering how data about sellers is stored and accessed, and potential risks or challenges relating to data requests;
- thinking about how they can support sellers in their tax compliance (e.g. by providing tax information or helping sellers access tax advice); and
- engaging constructively with international discussions on taxation of digital platforms (especially on profit attribution).

Ultimately, Operators need to be part of solution, not part of problem.

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