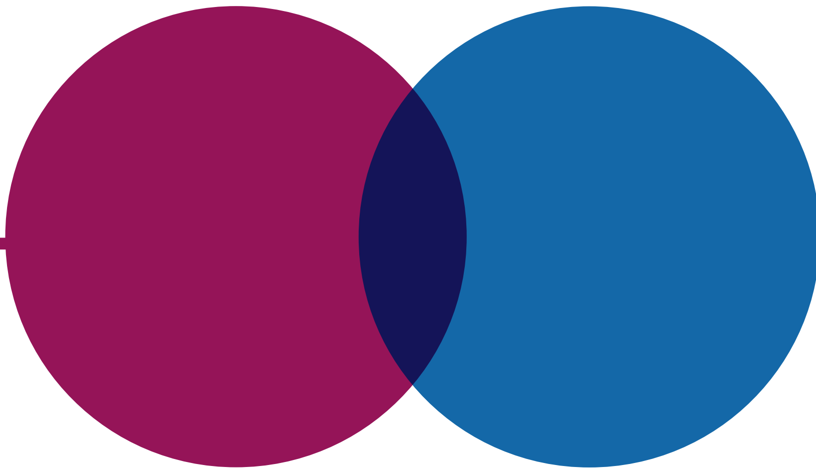
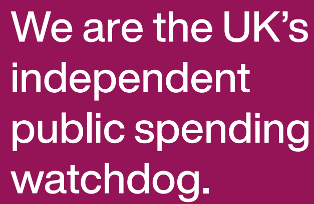


REPORT

Investigation into the Digital Services Tax

HM Revenue & Customs

SESSION 2022-23
23 NOVEMBER 2022
HC 905



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Investigation into the Digital Services Tax

HM Revenue & Customs

Report by the Comptroller and Auditor General

Ordered by the House of Commons
to be printed on 21 November 2022

This report has been prepared under Section 6 of the National Audit Act 1983 for presentation to the House of Commons in accordance with Section 9 of the Act

Gareth Davies
Comptroller and Auditor General
National Audit Office

17 November 2022

HC 905 | £10.00

Investigations

We conduct investigations to establish the underlying facts in circumstances where concerns have been raised with us, or in response to intelligence that we have gathered through our wider work.

We undertook this investigation to report on how HMRC implemented, and is administering, the Digital Services Tax following its introduction in April 2020.

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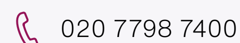
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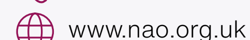
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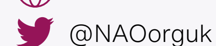
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What this investigation is about

1 This investigation examines HM Revenue & Customs' (HMRC's) implementation of the Digital Services Tax (DST). The government introduced DST in April 2020 because it was concerned that the existing international tax system did not recognise the value being generated for digital companies through UK online users. DST is designed to tax business groups that derive large revenues from UK users of search engines, social media platforms and online marketplaces. It taxes the revenues (rather than profits) derived from these activities at a rate of 2%. The DST is levied on business groups (groups of companies with the same controlling interest) rather than each individual company. Groups are liable to pay DST if their worldwide revenues from in-scope activities are more than £500 million and more than £25 million are derived from UK users. A group's first £25 million of UK revenues are exempt from DST.

2 Historically taxes on corporations have been levied based on the location of the profit-making activity of a company, but the internet enables companies to generate revenues without being physically located in the UK. The UK is among many other countries seeking a multilateral solution to concerns about how the international tax system operates for multinational companies. The Organisation for Economic Co-operation and Development (OECD) and G20 are leading work with around 140 countries and tax jurisdictions under an 'Inclusive Framework on Base Erosion and Profit Shifting' project to reform international tax rules.

3 The UK government intends to retire DST once 'Pillar One' of the OECD reforms is introduced in the UK. Pillar One is expected to re-allocate some taxing rights over the largest and most profitable multinational business groups from their home countries to the tax jurisdictions where their customers and users are located. In July 2022 the OECD announced that the multilateral convention which will implement Pillar One globally will be open for jurisdictions to sign in mid-2023, with the aim of the Pillar One reforms coming into force in 2024. Separately, 'Pillar Two' will introduce a global minimum corporate tax rate.

4 This investigation reports on how DST is operating following the first year of its implementation. This report sets out:

- what are DST and the OECD reforms and why they are happening;
- the impact of DST in its first year; and
- how HMRC has managed the risks of non-compliance with the tax by companies within its scope, and what lessons it has learned.

5 The report does not provide details about the tax paid by individual business groups, since this would violate taxpayer confidentiality. The report does not seek to examine and report on the value for money of HMRC's administration of DST at this early stage in its operation, but it does make recommendations to support its implementation.

Summary

Key findings

Revenues generated by Digital Services Tax (DST)

6 **HM Revenue & Customs (HMRC) received £358 million in DST receipts for the 2020-21 tax year, which was 30% more than forecast. HMRC's initial forecast, in July 2019, expected DST receipts of £275 million for 2020-21.** HMRC and the Office for Budget Responsibility forecast in March 2022 that cumulative revenue from DST will exceed £3 billion by 2024-25. HMRC told us there were two main reasons for the higher-than-expected receipts:

- The initial forecast assumed that business groups would seek to minimise their DST liability, but it had not observed such behaviour.
- Fourteen of the 18 groups that paid DST paid more than expected. One group paid almost five times the amount initially forecast. HMRC had not identified six of the payers in its initial assessment (paragraphs 2.2 to 2.4 and 2.11, and Figure 6).

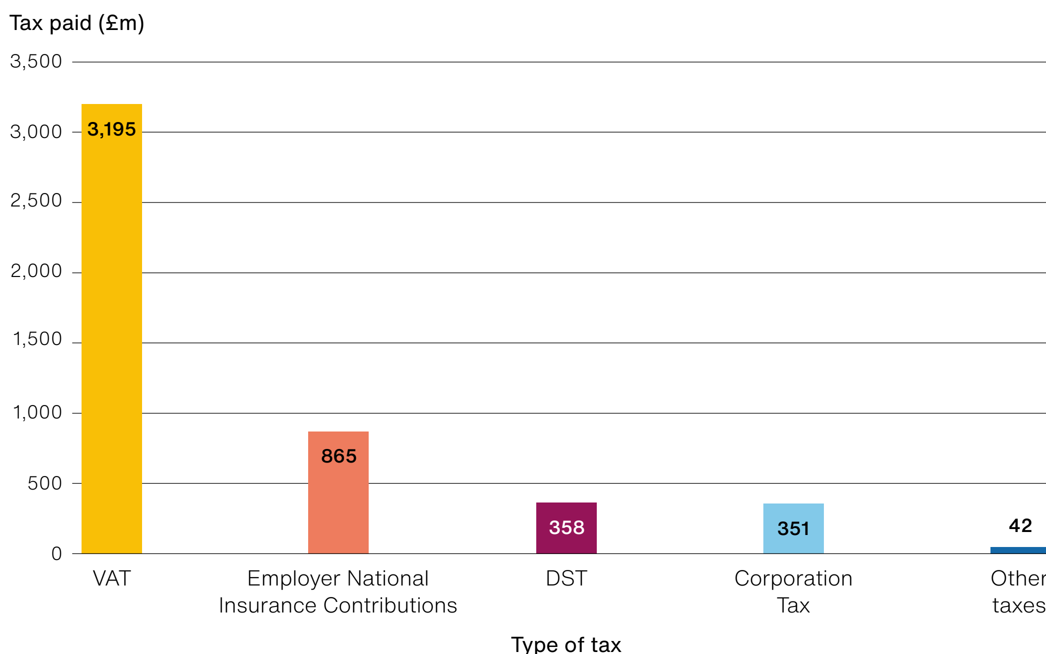
7 **Around 90% of DST revenues for 2020-21 were provided by five business groups.** In total 18 business groups paid DST. Of the £358 million in DST receipts, £324 million (90%) was paid by five groups. Eleven of the 20 business groups that HMRC initially expected to make a payment determined they did not owe any DST (paragraphs 2.2 to 2.4 and Figure 5 and Figure 6).

8 **DST accounted for 7% of tax paid by in-scope business groups in 2021-22.** The 18 business groups that paid DST for the 2020-21 tax year paid around £4.8 billion across all taxes in 2021-22 (excluding employee income tax and national insurance). This included £358 million in DST for the 2020-21 tax year, representing 7% of the UK tax take from those business groups (see **Figure 1**). These groups have paid considerably more tax in total since the beginning of the COVID-19 pandemic as revenues have increased. Their total tax paid increased by 36% between 2019-20 and 2020-21 and by 34% between 2020-21 and 2021-22 (excluding DST). Around two-thirds of tax paid was VAT and around one-fifth was employer contributions to National Insurance. Their taxable profits increased by 16% during the pandemic, while VAT revenues doubled. It is unclear how much of this was due to increased sales or new VAT rules on imported goods (paragraphs 2.8 and 2.9 and Figure 8).

Figure 1

Tax paid broken down by tax type for the 18 business groups that paid Digital Services Tax (DST) in 2021-22

The DST was roughly equal to the amount of Corporation Tax paid by business groups liable for DST



Notes

1 VAT includes both VAT and Import VAT.

2 Other taxes are Import Duty and Stamp Duty Land Tax.

3 This Figure does not include Employee National Insurance Contributions and Employee Income Tax. These taxes were collectively worth £2,466 million in 2021-22.

4 Business groups paid DST incurred in 2020-21 during 2021-22.

Source: National Audit Office analysis of HM Revenue & Customs data

9 **Most digital business groups who are paying the tax now pay more in DST than they do in Corporation Tax.** The introduction of the Digital Services Tax has meant that most groups affected are paying significantly more tax as a result. Of the 18 groups paying DST, 13 paid more DST than Corporation Tax in 2020-21. Of these, nine paid more than twice as much DST as Corporation Tax. A further three groups paid no Corporation Tax. At the other end of the spectrum, three groups paid mostly Corporation Tax, with DST representing less than 10% of their Corporation Tax bill (paragraph 2.10 and Figure 9).

The implementation of DST

10 HMRC implemented DST for £6.3 million, around £1.5 million under budget. HMRC's review of its implementation of DST concluded that it had successfully delivered its key criteria. It recorded underspends against both staff costs (spending £3.5 million of a £4.1 million budget) and Information Technology (IT) costs (£2.8 million of a £3.7 million budget), which it attributed to setting a conservative budget (paragraphs 3.2 and 3.3).

11 Digital services taxpayers and their representatives were broadly positive about HMRC's implementation of Digital Services Tax. They appreciated being able to return a single submission for the whole business group (rather than separate submissions for each company) and only needing to submit a return annually. Most noted that HMRC tended to be helpful when contacted, provided clear guidance and took a flexible and proportionate approach regarding how groups calculated their DST liability in order to reduce the administrative burden (paragraph 3.6).

Managing the risk that business groups do not meet their DST obligations

12 HMRC's compliance work for DST in the 2020-21 tax year is ongoing and it has not yet identified any tax losses. HMRC has identified eight categories of behaviour that could lead to non-payment of tax, ranging from tax evasion (deliberate illegal activity) to errors in completing tax returns. HMRC has not yet identified any tax losses in any category (although its compliance work is ongoing). HMRC considers the risk of evasion as low because the reputational risk to companies would likely outweigh any financial gains. HMRC also told us it had not observed business groups attempting to avoid the tax by reducing or removing their requirement to pay DST within the law, as originally expected. HMRC worked with groups to understand how they calculated their DST liability. HMRC told us it has not audited the data underlying DST returns for any group so far, but that it has the resource to do so if needed. Its current focus is on supporting groups to calculate their liability accurately (paragraphs 3.9 and 3.10).

13 HMRC has identified more groups potentially in scope for DST than it initially expected. In July 2019, HMRC initially identified 31 business groups as being potentially in scope for DST. In September 2022 it had reviewed, or was assessing, 101 groups, and had undertaken, or was undertaking, a more detailed risk assessment of 30 of these groups following their submission of a return. HMRC told us that any group identified as being potentially liable for DST in the 2021-22 tax year will also be retrospectively assessed for the 2020-21 tax year (paragraphs 3.8 and 3.11 and Figure 13).

14 Future compliance work may be more challenging, as HMRC identifies more business groups potentially liable for DST. New groups may have different characteristics and attitudes to paying DST. The challenges HMRC may face include:

- managing groups that misunderstand, or seek to misrepresent, whether their revenues are in scope for DST. Relatively subtle distinctions in the business model used by a group can move revenues in or out of scope for DST;
- communicating with groups that do not have a physical presence in the UK, but may be liable to pay DST; and
- taking enforcement action against groups that do not have a physical presence in the UK and refuse to pay DST they owe. HMRC has not yet faced this situation, so the enforcement options available to it are untested (paragraphs 3.11 to 3.17 and Figure 14).

Preparing for the OECD reforms

15 Uncertainty over the details of the Organisation for Economic Co-operation and Development (OECD) 'Pillar One' reforms means that HMRC has not yet estimated the impact on total tax receipts. DST is intended to be a temporary tax, until it is replaced by the OECD's Pillar One reforms to international corporate tax rules. HMRC told us it is not yet able to estimate how much tax revenue it might collect, as key elements of the Pillar One rules have yet to be finalised. These reforms will affect future tax receipts in three ways:

- DST will no longer apply, so revenues from it will cease.
- Corporation Tax payments from some groups will change under Pillar One rules.
- Some groups will be able to reduce their Corporation Tax payments by the amount that their DST payments exceeded what they would have paid under Pillar One during the 'transition' years of 2022 and 2023.

Although the Pillar One reforms will effectively replace DST, HMRC considers that differences mean that there is little in the design, legislation and administration of DST that can be meaningfully applied to its future work. Decisions relating to legislation, implementation and the compliance regime will need to be agreed between all participating nations (paragraphs 1.12 to 1.14 and 3.19 to 3.21).

Concluding remarks

16 Big digital companies are paying more UK tax, and the Digital Services Tax (DST) is part of this. HMRC collected 30% more revenue through DST than originally forecast for its first year, around 90% of which was paid by five business groups. DST accounted for 7% of the total amount of tax paid by business groups within scope for the tax. Other taxes paid by these business groups grew by 34% between 2020-21 and 2021-22, due to increased sales during the COVID-19 pandemic and new VAT rules on imported goods.

17 HMRC has yet to identify any non-compliance and it is not yet clear if HMRC has captured all groups that should be within scope for the tax. HMRC could still face challenges ahead with enforcing compliance, especially among groups without a physical presence in the UK. It will need to manage a larger population of business groups across a wider range of business activities than it initially expected. HMRC will need to ensure good levels of compliance to maintain DST as a credible alternative until the OECD Pillar One reforms come into effect.

Recommendations

18 To help it prepare for the potentially larger population of business groups liable for the Digital Services Tax, HMRC should:

a **set out criteria to ensure its teams are able to consistently identify all business groups, companies and sources of revenue that are in scope for the Digital Services Tax.** This could include updating guidance to DST Compliance teams to specify when, or in what circumstances, they should:

- escalate a case to additional levels of scrutiny; and
- triangulate data supporting an individual group's tax return with other information, including the group's contracts with other companies, management information and (where necessary) the group's data on UK internet traffic to help understand completeness, and potentially identify additional revenue streams within groups;

b **estimate the potential tax gap for DST (the difference between total theoretical tax liabilities and the amount that has been paid) separate from any HMRC calculation of the overall tax gap.** For example, by comparing total revenue with macro-economic data since the COVID-19 pandemic began and data on business sectors not initially expected to be in scope for DST;

c **develop and implement a plan to identify, and raise awareness among, business groups that are unaware they may be liable for the UK DST,** particularly those without a physical presence in the UK; and

d **develop a contingency plan for enforcement against business groups that do not have a physical presence in the UK and fail to engage with HMRC,** after exploring the available options. This could include discussions with tax authorities in other countries that operate a digital services tax and have similar interests, to ensure there is a clear pathway for enforcement.