The Digital Services Tax: A Principled Proposal for the Future of International Taxation

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Main Claims

• Digital services tax (DST) proposals identify genuinely new problems in international taxation, and provide attractive solutions to these problems from both efficiency and fairness perspectives.

• All policy proposals are politically motivated. Unlike many other current proposals, the DST actually embodies a good idea.

• DST proposals should not be equated with “unilateral actions”. They incorporate a rich notion of “location specific rent”, which should become a focal point for international cooperation in reallocating taxing rights.
New problems in international taxation

1. Two-sided business models operating at a global scale create misalignments between sources of value creation and origins of payment.

2. Non-rival use and remote deployment of digital technology generate a significant new class of location specific rent (LSR)
By manipulating the structure of prices charged to the two groups of users, a two-sided business can increase transaction volume to maximize profit.
Basic structure of two-sided business model

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Heterosexual dating club
Heterosexual dating club

Participation

Admission and drinks for free

Women
Heterosexual dating club

- Women: Admission and drinks for free
- Men: Admission fees
- Participation: Access to women
- Charging men $10 and letting women in free can attract 50 men and 50 women.
- Charging $5 to everyone puts women off, and without women attracts only 70 men.
- Same aggregate price, one price structure generates more profit than the other.
Google
(or Facebook)
Individual Users

Free search service (or social media)

Participation with network effects

Google (or Facebook)
Individual Users

Free search service (or social media)
Participation with network effects

Google (or Facebook)

Purchase of advertising slots
Access to eyeballs of individuals

Advertisers
Google (or Facebook) Participation with network effects

Free search service (or social media)

Individual Users

Purchase of advertising slots

Access to eyeballs of individuals

Advertisers

Sales of advertised goods/services
Google (or Facebook)

Participation with network effects

Free search service (or social media)

Purchase of advertising slots

Access to eyeballs of individuals

Individual Users

Payments for goods and services

Sales of advertised goods/services

Advertisers

Payments for goods and services

Sales of advertised goods/services
Amazon Marketplace Participation with network effects

Amazon shopping experience with implicit subsidies

Individual consumers
Amazon Marketplace Participation with network effects

Amazon shopping experience with implicit subsidies

Commission on sales

Access to Amazon buyers

Individual consumers

Third party online sellers
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Sales of goods and services
Individual landlords

Subsidized listing service

Participation in listing service and service fees

AirBnB
AirBnB

Participation in listing service and service fees

Subsidized listing service

Individual landlords

Service fees

Access to AirBnB listing service

Guests
AirBnB Participation in listing service and service fees

Subsidized listing service

Individual landlords

AirBnB

Short term rental

Service fees

Access to AirBnB listing service

Guests
AirBnB

Participation in listing service and service fees

Subsidized listing service

Individual landlords

Payment for short term rental

Short term rental

AirBnB

Access to AirBnB listing service

Guests

Service fees
Summary

- Platforms “bring to market” certain users valued by users on the other side. The rent thereby earned by the platform can be seen as specific to the side of the first user group, even though the rent is embodied in payments received from elsewhere.
  - The first group of users may be in countries of consumption (“destination”), production (“origin”), or even investment (“residence”). Location specific rent is not exclusively source- or destination-based.

- Operating in one country does not affect operation in another. Rent earned in one country can be earned only there.
  - Assigning the rent to that country is a less arbitrary assignment than to where IP is held.
  - It is equally compelling an assignment as to the country of technology inventor.
Fundamental inadequacies of the traditional international tax regime

• Recall the two new problems of international taxation:
  1. Two-sided business models operating at a global scale create misalignments between sources of value creation and origins of payment.
  2. Non-rival use and remote deployment of digital technology generate a significant new class of location specific rent (LSR)
• Profit attribution based, in a completely ad hoc manner, on physical presence and source of payment. Stumbles in dealing with problem 1.
• Arm’s length principle completely silent on proper allocation of rent (arising from market power) among unrelated parties. Stumbles in dealing with problems 1 and 2.
• Residual profit allocation lacks guiding principles of fairness and ignores market structure. Stumbles in dealing with problems 1 and 2.
Is the DST as currently designed acceptable?

• All business models covered are likely to have near-zero marginal cost.

• Much of the losses faced by the platform companies are due to expenditures to capture market share, which has little social value in platform contexts characterized by natural monopoly.

• Low-rate tax on revenue is likely to under-tax rent, just like low-rate resource royalties.

• In its application to advertising and data, very unlikely to create double taxation.

• Intra-community coordination part of the EC proposal.

Wei Cui and Nigar Hashimzade, The Digital Services Tax as a Tax on Location-Specific Rent (2019)

Thank you and comments are welcome!
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