

DIGITAL SERVICES TAX:
A CROSS-BORDER VARIATION OF CONSUMPTION TAX DEBATE[†]

Young Ran (Christine) Kim^{*}

As highly digitalized business models, such as Google, Amazon, and Facebook, have been mainstreamed in the economy, the traditional profit allocation and nexus rules of taxation are further strained. Traditionally, profit is allocated to market countries when the business has physical presence there. However, highly digitalized business models can generate profits in market countries without physical presence. Thus, market countries, especially the EU, have started imposing a digital services tax (“DST”) on the gross revenue generated in jurisdictions with highly digital business models, which has ignited heated debate across the globe.

DST is criticized as “ring-fencing,” or segregating, certain digital business models, because it arguably imposes a disguised corporate income tax on the profits of only certain digital firms, which discriminates against American tech giants. However, while DST is politically driven, the criticism is largely based on practical concerns and focused on the imminent impact, such as who is the winner and loser in the short term, rather than considering DST theoretically. More importantly, there is little discussion of the consumption tax aspect of the DST. DST is a turnover tax, which is a subcategory of consumption tax levied on the gross revenue of a firm. However, strangely, there is little discussion of the theoretical value of DST as a consumption tax.

This article examines the policy debate on the recent legislative movement in the EU to adopt a DST, and then discusses whether it would be a new path towards a consumption tax in international taxation. The article further analyzes the tax incidence of DST as a consumption tax in the case of multi-sided digital platforms where a digital service provider, such as Amazon, interacts with multiple distinct user groups, such as user-buyers and user-sellers, that provide

[†] Apologies for the many missing citations. Comments and suggestions very welcome and appreciated.

^{*} Associate Professor of Law, University of Utah SJ Quinney College of Law. For helpful comments, I am grateful to Jordan Barry, Jorge Contreras, Miranda Fleischer, Ariel Jurow Kleiman, Nancy McLaughlin, Daniel Shaviro, the participants in the Annual Meeting of the Law and Society Association, Junior Tax Scholars Workshop, SEALS Annual Conference, UC Irvine Law School Trans-Pacific Business Law Dialogue, University of Utah SJ Quinney College of Law Faculty Scholarship Lunch, University of San Diego School of Law Tax Law Speakers Series, Loyola Law School Tax Policy Colloquium, LatCrit 2019 Biennial Conference, BYU Law School Faculty Workshop, University of Vienna Tax Conference, National Tax Association Annual Conference, AALS Annual Meeting New Voices in Tax Law & Policy, and BYU Winter Deals Conference. Special thanks to the University of Utah's Albert and Elaine Borchard Fund for Faculty Excellence for its generous support. Bryan Call, Shad Edwards, Nathan Holtman, and Eli LeCates provided excellent research assistance.

each other with network benefits. It then compares DST with other types of consumption tax, such as value added tax and destination-based cash flow tax. The article also considers whether the recent Supreme Court case of *South Dakota v. Wayfair*, discussing sales tax imposed on remote sellers, and subsequent state legislation on Netflix Tax may shed light on ways to overcome certain challenges DST faces.

Contents

INTRODUCTION	3
I. THE ORIGIN OF DST	11
A. G20 and the OECD’s Work	11
B. European Developments	14
C. Unilateral Measures of Countries: DSTs	17
1. United Kingdom	17
2. France	18
3. Italy, Austria, and Spain	20
4. India.....	21
II. THE ANATOMY OF DST	22
A. Key Features	22
1. Turnover Tax	22
2. Revenue Threshold.....	24
3. New Rules for Tax Nexus and Profit Allocation.....	24
4. Limited Scope (“Ring-Fencing”)	25
B. Challenges of DSTs	25
C. Revisiting Challenges Based on the Status Quo	27
III. DST AS A CONSUMPTION TAX	30
A. An Old Debate: Consumption Tax v. Income Tax.....	30
B. A Possible New Debate: DST vs. Other Proposals	32
C. Remaining Issues Toward a Consumption Tax	34
1. Tax Incidence of DST	34
2. Why Not Other Types of Consumption Tax?.....	45
3. Overcoming the Ring-Fencing Problem.....	48
4. Barter Transactions in Consumption Tax	52
CONCLUSION	52
APPENDIX: OECD PROPOSALS.....	53
A. Current Rules	54
B. February-March 2019 Proposals	54
1. User Participation Proposal.....	54
2. Marketing Intangibles Proposal.....	56
3. Significant Economic Presence	57
C. May 2019 Proposals.....	58
1. Modified Residual Split Method	59
2. Fractional Apportionment Method	59

3. Destination Based Methods.....	60
D. October 2019: Unified Approach.....	60

INTRODUCTION

When emerging digital technology companies, such as Google, started providing free email accounts or search engine services in the 1990s, many people anticipated that such highly digitalized businesses would begin charging fees for their services. Nevertheless, Google and other highly digitalized business models, such as Amazon, YouTube, and Facebook, have not yet charged fees to retail users for significant parts of their services. Instead, they operate other business lines, such as online advertising technologies, cloud computing, and other online platforms that connect different types of user groups, such as user-sellers and user-buyers. Most of their profits do not come from the retail user-buyer group, but rather from the user-seller group or user-advertiser group. The term multi-sided platform refers to highly digitalized business models that connect multiple distinct user groups, such as user-sellers and user-buyers, and provides them with certain network benefits.¹

To illustrate the concept of a highly digitalized business model utilizing a multi-sided platform, let us consider the example of William. William, who lives in the United Kingdom, receives a bonus and would like to use it to purchase a new car. William is particularly interested in a mid-size luxurious German sedan, but he begins the car buying process by performing some preliminary research. He begins his research by “googling” key words like “20 best sedans for 2019.” William skips search results relating to Toyota, Hyundai, Chrysler, and similar sedans, and only focuses on sedans such as

¹ Multi-sided markets or multi-sided platforms are often used by case law and literature on economics, antitrust, and administrative regulations. *See e.g.*, *Ohio v. American Express Co.*, 138 S.Ct. 2274 (2018); Jean-Charles Rochet & Jean Tirole, *Two-Sided Markets: A Progress Report*, 37 RAND J. OF ECONOMICS 645 (2006); Erik Hovenkamp, *Platform Antitrust*, J. CORP. L. (forthcoming 2019); Eleanor Wilking, *Hotel Tax Incidence with Heterogenous Firm Evasion: Evidence from Airbnb Remittance Agreements* (Working Paper, 2016), <https://www.austaxpolicy.com/wp-content/uploads/2016/09/Wilking.pdf>. In tax literature, the multi-sided platforms are just referred to as “digitalization,” “digital economy,” or “certain highly digitalized businesses.” *See e.g.*, OECD, ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY, ACTION 1 – 2015 FINAL REPORT (Oct. 5, 2015) [hereinafter OECD, BEPS ACTION 1]; OECD, TAX CHALLENGES ARISING FROM DIGITALISATION — INTERIM REPORT (2018) [hereinafter OECD, 2018 INTERIM REPORT].

Mercedes-Benz E-Class, Audi A7, and BMW 5 Series. After virtually touring some German sedans, Williams remembers to check the results of his favorite football club's recent match and visits ESPN's website. Next to the results he was looking for, William finds an advertisement of Mercedes-Benz E-Class, which he is now more likely to click on than before he began his preliminary car research.²

In the above example, Google is the highly digitalized business model utilizing a multi-sided platform. Google is a digital search engine service provider, located in the United States. It offers search engine service to users located in various countries, including the United Kingdom, through which it collects a tremendous amount of valuable user data. Recent tax policy literature describes this user data collection as "user participation," because "soliciting the sustained engagement and active participation of users is a critical component" of highly digitalized businesses.³ Google has a proprietary algorithm that allows it to offer improved search results to users in the UK who demonstrate similar interests to those of William, because the algorithm learns how to tailor experiences to individual user-buyers in the UK market. In addition, Google's algorithm offers customized advertising services to another group of users—user-advertisers, such as Mercedes-Benz, that want to launch a targeted advertisement campaign to UK consumers "based on their demonstrated interests."⁴ Additionally, most of Google's profits come from user-sellers or user-advertisers, rather than user-buyers in the market country.

Although the above example is only a fragmentary sketch of highly digitalized business models and digitalization of the economy more broadly, it shows their salient characteristics. A recent report of the G20 and the Organisation for Economic Co-operation and Development ("OECD") explains that the important features of digitalized business models include: i) cross jurisdictional scale without mass, ii) the heavy reliance on intangible assets, especially intellectual property, and iii) the importance of data, user participation and their synergies with intellectual property.⁵

As highly digitalized businesses become mainstreamed in the 21st century economy, they pose new global taxation challenges. More specifically, the traditional international tax nexus and profit allocation rules, which allocate tax revenue among relevant countries, no longer work effectively in the

² The Google, German auto manufacturing company, and UK consumer example is inspired by a similar example in Wei Cui, *The Digital Services Tax: A Conceptual Defense*, TAX L. REV. ___, 12–14 (forthcoming 2019) [hereinafter Cui, *Conceptual Defense*].

³ OECD, BASE EROSION AND PROFIT SHIFTING PROJECT, PUBLIC CONSULTATION DOCUMENT, ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY 9 (Feb. 13 – Mar. 6, 2019) [hereinafter, OECD, PUBLIC CONSULTATION DOCUMENT].

⁴ *Id.* at 10.

⁵ OECD, 2018 INTERIM REPORT, *supra* note 1, at 51.

digitalized economy. Traditionally, global profits of multinational enterprises are partly allocated to market countries where consumers are located only if the business has physical presence in the market country. In other words, service providers must be physically present in the subject market country for a substantial amount of time and render services there.⁶ This physical presence constitutes a tax nexus, and then the profit allocation rules mandate allocating certain profits attributable to such tax nexus to the market country and the remaining profits to the home country of the multinational enterprises.

On the other hand, if the business does not have physical presence, or tax nexus, in a market country, the market country cannot exercise tax jurisdiction over the firm's profits. This is where the traditional tax nexus and profit allocation rules are constrained in the highly digitalized business models, because those businesses can generate profits in market countries without physical presence. In the Google example, Google, located in the United States, can render the search engine and online advertisement services to the consumers in the UK market without physical presence in the UK. Moreover, the profits do not come from the consumers in the UK. Technically, while Google's revenue is relevant to the UK market because it collects and uses UK consumers' data, the profits are paid by German manufacturing companies. Thus, market countries can no longer collect tax revenue from those businesses.

The traditional physical presence requirement for a market country to exercise tax jurisdiction was considered reasonable when the rule was developed in the early 20th century.⁷ When a business renders services to foreign customers, somebody must go to that market country and be present there. If it suffices to render the service remotely, it is not considered enough to constitute a tax nexus in that market country. However, such rationale has become inadequate as many businesses offer remote services. It is further difficult to justify the rationale for the highly digitalized businesses with multi-sided platforms, where firms' revenue relevant to the market country is

⁶ For the Internal Revenue Code ("I.R.C.", or the "Code")'s term, this physical presence refers to a U.S. Trade or Business, to which income of foreign service providers is allocated and subject to the U.S. tax jurisdiction. 26 U.S.C. [hereinafter, I.R.C.] § 862(b). A *de minimis* level of services rendered in the U.S. does not constitute a U.S. Trade or Business if, for example, the services are performed while the foreign service provider is present in the U.S. temporarily or no more than 90 days during the year. I.R.C. § 864(b)(1) (2012).

⁷ See e.g., Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 DUKE L.J. 1021, 1088–89 (1997); Michael J. Graetz, *The David R. Tillinghast Lecture Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261, 319 (2001).

not paid by the consumers in the market, not to mention the lack of physical presence there.

In brief, in the highly digitalized economy, market countries lose tax revenue that could have been available to them from traditional business models, and currently are unable to collect under traditional tax rules. Realizing the need to address the tax challenges of the digital economy, the European Union (“EU”), the G20, and the OECD, which are important voices in international taxation, have discussed this issue as their top priority and offered three proposals to address the issue. First is expanding the tax nexus rules to include significant digital presence and introducing new profit allocation rules based on formulae (“Significant Economic Presence Proposal”). Second is modifying both tax nexus and profit allocation rules and reallocating an amount of income deriving from specific intellectual properties, called marketing intangibles, to market countries (“Marketing Intangibles Proposal”). Third is modifying only profit allocation rules to require an amount of profit be allocated to market countries where user participation is active, irrespective of whether the businesses have a local physical presence, or tax nexus (“User Participation Proposal”). This proposal is later embodied more aggressively in supporting countries, such as the United Kingdom and France, by introducing a new tax, called Digital Services Tax (“DST”). All three proposals attempt to give market countries greater taxing right, but are different as to how and to what extent they modify the taxing rights.⁸

Unfortunately, the global community failed to reach a consensus on any of the above proposals in March 2019. In response, market countries, especially in Europe, have unilaterally introduced, or plan to introduce, a DST for certain highly digitalized businesses, which has ignited heated debate across the globe. For example, France has started imposing a 3% DST on the gross revenue of certain highly digitalized firms generated in France from July 2019, retroactively in effect on January 1, 2019. United Kingdom will also introduce a 2% DST in 2020.

DSTs are designed as a turnover tax, defined as a tax levied on the gross revenue of a firm, which is an example of consumption tax.⁹ DSTs apply only to a limited scope of digital businesses where tax challenges primarily manifest, such as social media platforms, search engines, and online marketplaces. In addition, both global and local revenue of those identified digital businesses from in-scope businesses should exceed a specified threshold amount of revenue to trigger a DST. All requirements being met,

⁸ All three proposals will be discussed in *infra* Part I.A. in detail.

⁹ JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE AND LOCAL TAXATION 649 (6th ed. 1997) (including the turnover tax as part of a list of consumption taxes including retail sales tax, use tax, excise tax, and gross income tax).

an amount of profit should be allocated to the market country where relevant businesses' activity and participatory user base are located, irrespective of whether the businesses have a local physical presence.

Due to such background, the DST is criticized as “ring-fencing,” or segregating, certain digital business models from the rest of the economy for tax purposes. It is also reprimanded as arguably imposing a disguised corporate income tax on the profits of certain digital firms to compensate the forgone corporate tax revenue. Furthermore, it is blamed as discriminating against American tech giants, such as Google, Amazon, Facebook, YouTube, and Uber, because only those American tech giants can satisfy the revenue thresholds and thus subject to a DST.

However, while the DST is politically driven, the criticism is largely based on practical concerns and focused on the imminent impact, such as who is the winner and loser in the short term, rather than considering DST theoretically. More importantly, there is little discussion of the consumption tax aspect of the DST, in contrast to the other proposals based on income taxation.

DST is a turnover tax, which is a subcategory of consumption tax levied on the gross revenue of a firm.¹⁰ When it comes to a tax proposal based on consumption tax, there has been considerable intriguing theoretical discourse comparing the pros and cons of consumption tax and income tax with regard to three criteria of tax policy: efficiency, equity, and administrability (or simplicity).¹¹ Generally speaking, consumption tax is considered more efficient and simpler, while income tax is considered normatively superior to achieve equity. However, strangely, there is little discussion of the theoretical value of DST as a consumption tax—such as (i) how and to what extent the DST is simpler and more efficient than the other proposals based on income tax, (ii) whether the DST is untenable due to its weakness in equity or whether there is any way to make up for such weakness by analyzing tax incidence—that is, who bears the economic burden of such tax,¹² and (iii) whether there are other types of consumption tax, such as value added tax (“VAT”) and destination-based cash flow tax (“DBCFT”), that can address the tax challenges of the digital economy in a better way.¹³

Lack of analysis on the consumption tax aspect of a DST is largely due

¹⁰ *Id.*

¹¹ Some tax scholars call the third criterion of administrability as simplicity. See MICHAEL J. GRAETZ ET AL, FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES 28–31 (8th ed. 2018).

¹² This concept is called “tax incidence.” See *infra* Part III.C.1.

¹³ See *infra* Part III.C.2.

to the EU's single consumption tax policy, where only one type of consumption tax—i.e., VAT—may exist in the EU.¹⁴ However, such policy cannot prevent the scholars from constructing the normative interpretation of DST as a consumption tax. In fact, some European scholars also interpret the DST as at least a hybrid of income tax and consumption tax.

As the first academic paper that highlights the consumption tax aspect of DST, this Article argues that DST is a suitable tax policy to solve tax challenges of the digital economy. Opponents of DST may argue that DST is a practically compromised, second-best, policy sought by politicians over the adoption of other proposals, such as the Marketing Intangibles Proposal or the Significant Digital Presence Proposal. However, this Article provides support that DST is a normatively good tax policy, because it is largely relevant to business taxation and international taxation, where efficiency and administrability are more emphasized than equity. Therefore, the consumption tax-based DST can present its merits. Also, there is no need to undertake the fundamental overhaul of tax nexus and profit allocation rules to reward market countries, because those rules effect income taxation while DST is a consumption tax. Furthermore, DST is particularly efficient because although the tax base is a digital firm's gross revenue, not net income, such firm incurs almost zero marginal cost, reducing the additional concerns of economic distortion commonly found in turnover taxes. In conclusion, DST could offer a new path towards a consumption tax in international taxation for the digital economy.

Nevertheless, because discussing DST as a consumption tax is new in scholarly discourse, there are several issues that require further research to better construct DST as a consumption tax. First, this Article analyzes the tax incidence of DST as a consumption tax in the case of multi-sided digital platforms where a digital service provider, such as Amazon, interacts with multiple distinct user groups, such as user-buyers and user-sellers, that provide each other with network benefits. When the DST was just introduced, the early opponents of DST argued that DST would be borne by consumers and thus would adversely affect the demand side of the digital economy. However, such critique neglected the characteristics of multi-sided platform, where the service providers do not charge fees on consumers, or user-buyers. It would be more plausible to pass the tax burden onto user-sellers who are also business enterprises, which the recent enactment of the French DST exactly proves to be the case. However, whether such tax incidence on the user-seller side is normatively desirable is another question. If one of the

¹⁴ Thus, many policy papers in the EU explain that a DST is a lumpsum tax to compensate a loss of corporate tax revenue. See *Proposal for a Council Directive on the Common System of A Digital Services Tax on Revenues Resulting From The Provision of Certain Digital Services*, COM 25–26 (2018) 148 final (Mar. 21, 2018); [more cites?]

policy rationales of market countries to justify DST is the monopolistic position of digital tech giants, then in theory, digital firms ought to absorb the whole tax incidence, instead of passing part of the economic burden to the user-seller group. Still, there is no clear explanation on what ought to happen based on economic model analysis and what is happening based on empirical analysis.

Second, this Article compares DST with other types of consumption tax, such as VAT and DBCFT, as alternative consumption taxes to solve tax challenges in the digital economy. As to VAT, it would be difficult to define the “value added” by a digital firm. There has been a huge debate on the notion of “value creation” in the digital economy. In our William and Google example, it is difficult to answer whether, and to what extent, Google’s value is created by either engineers writing computer codes of algorithm in California or various user-buyers in the UK. User-buyers contribute their data to allow Google to monitor the user data, and thus not only offer the improved tailored experiences to future users, but also sell targeted advertising services to German auto manufacturing companies. This conundrum is analogous to the old debate on which country should exercise the primary taxing right over the income deriving from natural resource extraction—is it the home country of multinational oil companies with extraction technology, or the source country with natural resources on its soil? Considering that the natural resource problem has not been fully resolved, the Article suspects that introducing VAT may repeat the same problem concerning value creation.

Furthermore, this Article doubts that DBCFT would be able to reward market countries as well as DST does. Intuitively speaking, as the name stands for, the DBCFT gives tax jurisdiction to the destination country of the sales of goods and services connected by the cash flow, because it posits that such destination of sales is the place where the consumption occurs.¹⁵ Importantly, however, market countries, where digital businesses are active and user-buyers are located, may not fall under the definition of destination under the DBCFT. That is because the cash flow exists only between the digital businesses providing services and user-sellers—in other words, in the William-Google example, cash flow exists only between Google in the U.S. and Mercedes-Benz in Germany. Thus, destination of cash flow is either the United States or Germany,¹⁶ and cannot be the United Kingdom, the market

¹⁵ So, for domestic tax purposes, receipts from exports are not included in taxable revenues and imports are included in taxable revenue. For detailed explanation on DBCFT, see e.g., Alan Auerbach et al., *Destination-Based Cash Flow Taxation*, Said Business School Research Paper 2017-09 (2017).

¹⁶ More precisely, the destination is Germany in this example, because sales of services

country all policy proposals mentioned above aim to give more taxing right. Hence, it is skeptical to recommend DBCFT as a means to reward market countries.

Another issue to polish is the ring-fencing problem due to the limited scope of DST. As explained, only search engines, social media platforms, and online marketplaces are currently within the scope of DST and subject to pay DST, whereas certain regulated financial and payment services and online content providers are excluded and thus exempted from DST. So, Facebook, Twitter, YouTube, Google, Amazon, Kayak, Uber, and Airbnb are subject to DST, but Paypal, Netflix, Hulu, Spotify, and Ubisoft are exempted from DST liability. However, the current distinctions between in-scope and out-of-scope businesses are arbitrary and hard to justify theoretically. It is not fully convincing to include YouTube and exclude online content providers, such as Hulu, and Spotify, because their business models share many relevant common features. For example, both YouTube and Spotify offer premium services as well as ad-based free services, and the only difference is how much revenue derives from ad-based services—85% for YouTube and 10% for Spotify. However, the ratio between paid service and ad-based free service itself is not likely to be a good criterion to draw the line between the two groups. The line is more problematic when a user can watch an episode of a TV series, such as *Modern Family*, on both YouTube and Hulu.

To find a way to overcome the ring-fencing problem, the Article considers whether the recent Supreme Court case of *South Dakota v. Wayfair*, discussing sales tax imposed on remote sellers,¹⁷ and subsequent state legislation may help shed light on the issue. *Wayfair* can be inferred as case that discusses another type of consumption tax—here, sales tax—and can be used for taxing the digital economy. Furthermore, it is worth noting the so-called Netflix tax which more than thirty state and local governments introduced after *Wayfair* in order to impose sales tax on digital content providers, such as Netflix, Hulu, and Spotify. The fact that one type of consumption tax, or DST, excludes online content providers from its scope and another type of consumption tax, or sales tax, includes the same business within its scope confirms that the current line-drawing of DST is arbitrary. Thus, the Article argues that DST should overcome the ring-fencing problem by expanding its scope to other digital businesses based upon closely analyzing the nature of those business models, rather than practical or political concerns.

This Article proceeds as follows. Part I unravels the origin of the DST by

occur in Germany, and thus Google cannot include such receipts, or cash inflow, from this transaction in its taxable revenue. On the other hand, the cash outflow, or expenses, is taxed in the origin country where such expenses are incurred. *Id.* at 16.

¹⁷ *South Dakota v. Wayfair, Inc.*, 138 S.Ct. 2080 (2018).

going over the discussions in the G20, the OECD, and the EU, and explains the User Participation Proposal, the Marketing Intangibles Proposal, and the Significant Economic Presence Proposal. It further overviews varied versions of DSTs that countries unilaterally adopted, or plan to adopt. Part II examines the key features of DSTs, including the use of a turnover tax, revenue thresholds, new rules for tax nexus and profit allocation in DSTs, and their limited scope. It then critically analyzes the three important challenges by which DSTs are particularly judged, and proposes to evaluate DSTs as a cross-border consumption tax. Part III explores the tax policy discourse on comparing consumption tax and income tax and offers a possible new debate between DSTs as a consumption tax and the other proposals based on income tax. It also explores the remaining issues to better construct DST as a cross-border consumption tax, such as understanding tax incidence of DST, comparing DST with other types of consumption tax, such as VAT and DBCFT, and ring-fencing problem concerning DST's limited scope. The Article then concludes with a brief statement concerning the importance of scholarly discussion to the anticipated and necessary resolution of digitalized business taxation in the 21st century.

I. THE ORIGIN OF DST

A. *G20 and the OECD's Work*

Aggressive tax planning strategies by multinational enterprises have been the center of the fiscal agenda among many countries since the financial crisis in 2008.¹⁸ For example, source countries, where investments occur and income is produced, suffer from tax base erosion by taxpayers, whereas residence countries, where investors reside, suffer from profit shifting to low-tax countries. In order to combat such base erosion and profit shifting (“BEPS”) arising from multinational enterprises’ clever use of gaps and mismatches in tax rules, the OECD and G20 initiated the BEPS project in 2013, which resulted in 15 final reports containing action plans for each topic in 2015.¹⁹ Furthermore, the working parties realized the need to collaborate with more countries beyond the OECD and G20 to implement the goal of the BEPS project, so they created the OECD/G20 Inclusive Framework on BEPS, within which over 130 countries and jurisdictions are working

¹⁸ *History of the G20 & BEPS*, OECD, <https://www.oecd.org/tax/beps/about/#history> (last visited Sept. 8, 2019).

¹⁹ *What is BEPS?*, OECD, <https://www.oecd.org/tax/beps/about/> (last visited Sept. 8, 2019).

together to tackle tax avoidance globally.²⁰

Among those 15 final reports and action plans, it is symbolic that Action 1 is “Addressing the Tax Challenges of the Digital Economy.”²¹ The report not only recognized the tax challenges arising from the digitalization of the economy but also noted that it would be “difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes” because of the increasingly pervasive nature of digitalization.²² The limitations addressed in Action 1 indicate the tax challenges raised by digitalization go beyond the base erosion or profit shifting issues, because the remaining challenges relate to how taxing rights among countries should be allocated among relevant countries.

Therefore, the G20/OECD Inclusive Framework continued to analyze the challenges and released an Interim Report on Tax Challenges Arising from Digitalization in March 2018. The Interim Report describes the main features of digital markets as follows: i) cross jurisdictional scale without mass, ii) the heavy reliance on intangible assets, especially intellectual property, and iii) the importance of data, user participation and their synergies with intellectual property.²³

Subsequently, in January 2019, the OECD released a policy note explaining that it will examine the tax challenges under two separate pillars, while hoping to form the basis for consensus by 2020.²⁴ Pillar 1, the focus of this paper, examines how to modify the traditional nexus and allocation rules to give market jurisdictions greater rights to assert tax nexus and be entitled to a share of multinational enterprises’ taxable income. Pillar 2 seeks to further combat against the BEPS issue in the context of digitalization.²⁵

In February 2019, the OECD released the Public Consultation Document with three proposals on the taxation of the digital economy: 1) the User Participation Proposal; 2) the Marketing Intangibles Proposal; and 3) the Significant Economic Presence Proposal.²⁶ Subsequently in May 2019, the OECD working group released the Programme of Work to Develop a

²⁰ *Id.*

²¹ OECD, BEPS ACTION 1, *supra* note 1.

²² *Id.* at 11.

²³ OECD, 2018 INTERIM REPORT, *supra* note 1, at 51.

²⁴ OECD, ADDRESSING THE TAX CHALLENGES OF THE DIGITALISATION OF THE ECONOMY – POLICY NOTE 1 (Jan. 23, 2019) [hereinafter OECD, 2019 POLICY NOTE].

²⁵ *See id.* at 2 (recognizing the importance of exploring taxing solutions “that would strengthen the ability of jurisdictions to tax profits where the other jurisdiction with taxing rights applies a low effective rate of tax to those profits.”). Examples of solutions include the extension of the policy that the US tax reform recently adopted, especially the global intangible low-income tax (“GILTI”) minimum tax and the base erosion and anti-abuse tax (“BEAT”).

²⁶ OECD, PUBLIC CONSULTATION DOCUMENT, *supra* note 3, at __.

Consensus Solution to the Tax Challenges Arising from the Digitalization of the Economy (“Programme of Work”),²⁷ which again introduces the three proposals under different names: 1) the Distribution-Based Approaches, 2) Modified Residual Profit Split Method, and 3) Fractional Apportionment Method, respectively. After discussing the previous proposals, the OECD released the Secretariat Proposal for a “Unified Approach” in October 2019.²⁸ The proposal covers highly digitalized business models, but is increased in scope to include consumer-facing businesses. The Unified Approach creates 1) a new nexus rule, not dependent on physical presence and instead largely based on sales, and 2) a new profit allocation rule using a formulaic approach to determine a share of residual, or non-routine, profit allocated to market countries. This proposal offers a possible consensus-based solution to be agreed to by the end of 2020.

The details of the seven proposals and the comparison of the tax consequences under each proposal are explained in Appendix. For purposes of understanding the origin of DST, it is worth understanding the first three proposals in the February document briefly here.

First, the User Participation Proposal, supported by the UK and France, is premised on the idea that soliciting the sustained engagement and active participation of users is a critical component of value creation for certain highly digitalized businesses. The activities and participation of these users contribute to the creation of the brand, the generation of valuable data, and the development of a critical mass of users which helps to establish market power. Consequently, it targets certain highly digitalized businesses, such as social media platforms, search engines, and online marketplaces. For those businesses, non-routine or residual profit in excess of routine profit, which is generated from user participation, is required to be allocated to market countries where the relevant businesses’ active and participatory user bases are located, irrespective of whether the businesses have a local physical presence.

Second is the Marketing Intangibles Proposal supported by the United States. This proposal is similar to the current residual profit split method in transfer pricing, which distinguishes the multinational enterprises’ non-routine or residual profit from routine profit. But this proposal requires only the non-routine or residual income attributable to *marketing intangibles* be

²⁷ OECD, PROGRAMME OF WORK TO DEVELOP A CONSENSUS SOLUTION TO THE TAX CHALLENGES ARISING FROM THE DIGITALISATION OF THE ECONOMY (May 29, 2019) [hereinafter OECD, 2019 PROGRAMME OF WORK].

²⁸ OECD, SECRETARIAT PROPOSAL FOR A “UNIFIED APPROACH” UNDER PILLAR ONE (Oct. 9, 2019) [hereinafter, OECD, UNIFIED APPROACH].

allocated to the market jurisdiction. All other routine and non-routine profit would continue to be allocated based on existing profit allocation principles.²⁹ Thus, it could reach a wider scope than the user participation proposal, going beyond highly digitalized businesses. However, it also departs from the traditional arm's-length principle, therefore making it difficult to satisfy the DST advocates. Furthermore, the definition of marketing intangibles is obscure and the formula of allocating residual income is very complicated.

Third is the Significant Economic Presence Proposal. Many developing countries, such as G24, endorse this proposal. It aims to reward market countries by abandoning the traditional residency-based nexus rules in favor of economic nexus which would include digital presence. Furthermore, it adopts a formulary apportionment approach where the tax base is computed by applying the global profit rate of the multinational enterprise group to the revenue generated in a particular jurisdiction, and such tax base is allocated based on apportionment factors, such as sales, assets, employees, and importantly, users. It targets a wider scope than either of the User Participation or Marketing Intangibles proposals.

Despite the differences across the seven proposals, all proposals allocate more taxing rights to market jurisdictions where users and customers are located. Nevertheless, while the G20/OECD has worked on a globally coordinated solution, a number of market countries, such as the UK and France, have adopted or plan to adopt the Digital Services Tax ("DST") in order to collect more revenues from Multinational Enterprises ("MNE"). The UK and France mentioned that the DST is an interim measure or stated that the DST will be reconsidered once there is an international deal on digital taxation. But will we reach a consensus by the end of 2020? And will market countries drop the DST already in place despite the domestic political pressure for additional revenue? We have to wait and see what will happen, but it is possible that DST will still remain after an international deal.

B. European Developments

While the OECD/G20 Inclusive Framework worked on developing a consensus-based proposal for taxation of digital economy, the EU developed its own long-term and short-term policy proposals for taxing the digital economy.

On September 21, 2017, the European Commission ("EC") released a Communication advocating for the EU to adopt a new tax framework to deal

²⁹ See Itai Grinberg, *International Taxation in an Era of Digital Disruption: Analyzing the Current Debate*, 97 TAXES 111–12 (2019), for a distinction of residual profit from routine profit.

with the growing digital economy.³⁰ The main concern for the commission was to ensure that the digital economy would be taxed fairly, and cited the growing market share of tech companies in the European economy and the relatively low effective tax rates for digital businesses.³¹ The two main policy challenges noted by the EC were the questions of where to tax—i.e., nexus—and what to tax—i.e., value creation.³² While advocating for a comprehensive solution, the EC also proposed three alternative, shorter-term, solutions.³³ One of which is a levy on revenues generated from the provision of digital services or advertising activity, matching very closely to the eventual final proposal of the EC.³⁴ The European Council adopted the conclusions of the EC on October 19, 2017.³⁵

The 2017 Communication culminated in two proposals from the EC released on March 21, 2018. The first proposal, called digital permanent establishment (“PE”) proposal, was intended as a long-term solution, and sought to establish corporate tax rules for taxing the digital economy by extending the current physical permanent establishment rules to those businesses with a significant digital presence.³⁶ Thus, as long as a digital business enterprise has a significant digital presence in a market country, that market country may recognize the enterprises’ taxable nexus to its jurisdiction even if there is no physical or traditional permanent establishment of such enterprise in that jurisdiction, and thus may exercise taxing right for the revenue of such enterprise. A business would be deemed to have such taxable nexus, or digital PE, for cross border digital business by fulfilling any of the following criteria: i) annual revenues from supplying digital services in a member state exceeding €7 million, ii) having more than 100,000 users in a member state in a taxable year, and iii) business contracts for digital services created between the company and business users exceeding 3,000 in

³⁰ *Communication from the Commission to the European Parliament and the Council: A Fair and Efficient Tax System in the European Union for the Digital Single Market*, COM (2017) 547 final (Sept. 21, 2017).

³¹ *Id.* at 2, 4, 6.

³² *Id.* at 7.

³³ *Id.* at 10 (proposing three short-term solutions that include an equalization tax on turnover of digitalized companies, a withholding tax on digital transactions, and a levy on revenues generated from the provision of digital services or advertising activity).

³⁴ *Id.*

³⁵ *See generally* Presidency Conclusions, Brussels European Council (Oct. 19, 2017).

³⁶ *See generally* *Proposal for a Council Directive Laying Down Rules Relating to the Corporate Taxation of a Significant Digital Presence*, COM (2018) 147 final (Mar. 21, 2018).

a taxable year.³⁷ The proposal also included rules detailing how member states may attribute profits to or in respect of a significant digital presence, presented a non-exhaustive list of economically significant digital activities, and was intended to amend member states' tax treaties with non-EU jurisdictions.³⁸

The second proposal is the origin of the DST, originally intended as a short-term solution establishing a common tax system targeting revenues stemming from the supply of certain digital services.³⁹ The in-scope digital business subject to the interim DST tax was set out in Art. 3(1) of the proposal, which included (i) the placing of digital advertising targeted at users in a member state, (ii) the transmission of user data generated from user activity, and (iii) intermediation services that allow users to find other users and interact with them.⁴⁰ On the other hand, provision of digital content, payment services, on-line sales goods or services, and certain regulated financial and crowd-funding services were excluded.⁴¹ The proposal included two revenue thresholds necessary for entities to be taxed under the interim DST: i) worldwide revenues exceeding €750 million, and ii) taxable revenues within the EU exceeding €50 million.⁴² Lastly, the proposal set a 3% tax rate deemed to be “an appropriate balance between revenues generated by the tax and accounting for the differential DST impact for businesses with different profit margins.”⁴³

However, since the EU released the above two proposals in March 2018, members states of the EU disagreed on both the long-term and short-term proposals.⁴⁴ The European Council finally rejected both proposals in March 2019.⁴⁵ After the so-called “epic fail” of the EU proposals,⁴⁶ a number of member states have moved fast to implement their own unilateral measures for taxing the digital economy, discussed in the next Subpart.

³⁷ *Id.* at 16.

³⁸ *Id.* at 17–18.

³⁹ *Id.* at 3.

⁴⁰ *Id.* at 24–25.

⁴¹ *See Id.* at 25; *see also* Council Directive 2014/65, Annex 5, 2014 O.J. (L 173) 349 (EC).

⁴² *Proposal for a Council Directive on the Common System of a Digital Services Tax on Revenues Resulting From The Provision Of Certain Digital Services*, COM 25–26 (2018) 148 final (Mar. 21, 2018).

⁴³ *Id.* at 22.

⁴⁴ *See* SEAN LOWRY, CONG. RESEARCH SERV., R45532, DIGITAL SERVICES TAXES (DSTs): POLICY AND ECONOMIC ANALYSIS 6 (2019).

⁴⁵ *See* Robert Van der Jagt, *ECOFIN discusses digital tax and updates the EU backlog*, KPMG (last visited Sept. 9, 2019), <https://home.kpmg/xx/en/home/insights/2019/05/etf-404-ecofin-discusses-eu-digital-services-tax1.html>; *see also* Outcome of the Council Meeting Economic and Financial Affairs (EC) No. 7368/19 of 12 Mar. 2015 (PR CO 12) 6.

⁴⁶ [Cite]

C. Unilateral Measures of Countries: DSTs

Despite the failure to adopt either DST or digital PE at the level of the European Union, several supporting member states have taken various levels of unilateral action, which are largely skewed towards multiple distinct versions of a DST. This Subpart explores the most noteworthy cases in Europe [and other countries] to understand the implications on the international tax policy and identify common key features of DSTs.

1. United Kingdom

The United Kingdom is driving the user participation proposal in the G20/OECD discussion. Although the United Kingdom maintains its official position as presenting the most sustainable solution for taxing the digital economy, as it was agreed to at the OECD, the UK became one of the early adopters of a unilateral DST.⁴⁷

As part of his 2018 budget, Chancellor Philip Hammond of the United Kingdom released a DST proposal that resembles the EC's March 2018 version apart from a reduced rate and the introduction of safe harbors for businesses with low profit margins or those taking losses.⁴⁸ The UK proposal would apply a 2% tax, instead of 3% tax suggested in the EC's version, on the revenues of specific digital business models where the revenues are linked to the participation of the UK users.⁴⁹ The first major change from the EC version is the implementation of an exemption to the tax for the first £25 million in taxable UK revenues and a 0% tax rate for companies making losses.⁵⁰ [However, it is criticized that the safe harbors are available to almost no businesses.⁵¹]

⁴⁷ United Kingdom still states that its legislating for DST is an interim measure. See HM TREASURY, DIGITAL SERVICES TAX: RESPONSE TO THE CONSULTATION 7–8 (2019), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/816389/DST_response_document_web.pdf [hereinafter, HM TREASURY, DST].

⁴⁸ See HM TREASURY, BUDGET 2018 44 (2018), <https://www.gov.uk/government/publications/budget-2018-documents/budget-2018> [hereinafter, HM TREASURY, BUDGET 2018].

⁴⁹ HM TREASURY, BUDGET 2018 DIGITAL SERVICES TAX (2018), <https://www.gov.uk/government/publications/digital-services-tax-budget-2018-brief> [hereinafter, HM TREASURY, BUDGET 2018 DST].

⁵⁰ Daniel Bunn, *Revenue Estimates for Digital Services Tax*, TAX FOUND. (Apr. 26, 2019), <https://taxfoundation.org/digital-services-tax-revenue-estimates/>.

⁵¹ Philip Hammond, UK's chief financial minister, stated that the tax “will be carefully designed to ensure it is established tech giants – rather than our tech start-ups - that shoulder

The proposed tax would apply to business models that have revenues linked to the participation of UK users and is meant to apply specifically to (i) search engines, (ii) social media platforms, and (iii) online marketplaces.⁵² Financial and payment services, the provision of online content, sales of software and hardware, and broadcasting services would not be within its scope.⁵³ The proposed tax would require businesses within its scope to earn annually at least £500 million globally to be taxable.⁵⁴ The proposal also includes a local revenue threshold for “relevant UK revenues” of £25 million, as a means to ensure small businesses remain outside the scope of the tax.⁵⁵

As of July 11, 2019, the UK has introduced draft legislation for their DST that is intended to apply beginning April 1, 2020.⁵⁶ Uniquely, the draft legislation will provide a 50% reduction in the tax for instances where the tax would overlap with a user subject to a similar tax elsewhere.⁵⁷

2. France

France is another country leading the unilateral change, following the EU’s epic fail in March 2019. In the same month of March of 2019, the French Finance Minister, Bruno Le Maire, released a policy document detailing the country’s unilateral approach to the DST.⁵⁸ French DST is keen to tax the American tech giants, such as GAFAs, the acronym of Google, Apple, Facebook, and Amazon, because, as the French finance minister Bruno Le Maire said, the emergence of such tech giants are monopolistic and they “not only control the maximum amount of [user] data, but also escape fair taxes.”⁵⁹

The proposal would subject digital businesses to a 3% tax on income derived from: (i) the provision of a digital interface to enable users of

the burden of this new tax.” <https://www.gov.uk/government/speeches/budget-2018-philip-hammonds-speech>.

⁵² HM TREASURY, BUDGET 2018, *supra* note 47, at 44.

⁵³ See HM TREASURY, BUDGET 2018 DST, *supra* note 48.

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ HM Revenue & Customs, *Introduction of the New Digital Services Tax*, GOV.UK (July 11, 2019), <https://www.gov.uk/government/publications/introduction-of-the-new-digital-services-tax/introduction-of-the-new-digital-services-tax>; HM TREASURY, BUDGET 2018, *supra* note **Error! Bookmark not defined.**7, at 43.

⁵⁷ *Id.*

⁵⁸ *France: Draft Proposal for Digital Services Tax*, KPMG (Mar. 6, 2019), <https://home.kpmg/xx/en/home/insights/2019/03/tnf-france-draft-proposal-for-digital-services-tax.html>.

⁵⁹ Liz Alderman, *France Moves to Tax Tech Giants, Stoking Fight With White House*, N.Y. TIMES (July 11, 2019), <https://www.nytimes.com/2019/07/11/business/france-digital-tax-tech-giants.html>.

platforms to interact with each other in order to exchange goods or service, (ii) advertising conducted on digital interface, and (iii) resale and management of personal data for advertising purposes.⁶⁰ To qualify for the above-listed digital businesses' income subject to DST, digital services should be made or supplied to French users located in France.⁶¹ The user's location is determined based on, among others, French IP address used to connect to web sites, which differs from industry's user-click criteria.⁶² The French DST includes its own criteria in applying the tax only to companies earning at least €750 million in worldwide revenue and €25 million in domestic revenue.⁶³

On April 9, 2019, the National Assembly, France's lower house, passed a bill nearly mirroring the March 2019 proposal and the Senate, upper house, amended the bill with a number of important changes in May of 2019.⁶⁴ The French Senate approved the new tax on July 11, 2019,⁶⁵ and the new tax bill was signed into law by President Macron on July 24, 2019.⁶⁶ It is expected to raise €500 million per year.⁶⁷

Although France is the second country that introduced a DST, the new tax bill retroactively established the tax to tax revenues generated from January 1, 2019,⁶⁸ which chronologically makes France the first country to impose a DST. The retroactivity of the new digital tax sparked strong resistance from American tech giants, such as Facebook and Amazon, arguing that "in order to comply, a company has to keep track of every user that observed an impression on a device while in France, and every user who

⁶⁰ KPMG, *TAXATION OF THE DIGITALIZED ECONOMY DEVELOPMENTS SUMMARY* 8 (Sept. 4, 2019), <https://tax.kpmg.us/content/dam/tax/en/pdfs/2019/digitalized-economy-taxation-developments-summary.pdf>.

⁶¹ Jessie Gaston, *Tax Alert: French Digital Services Tax ("DST")*, DENTONS (July 15, 2019), <https://www.dentons.com/en/insights/articles/2019/july/15/french-digital-services-tax-dst>.

⁶² *Id.*

⁶³ KPMG, *supra* note 59.

⁶⁴ *France: Update on Digital Services Tax; Enactment Anticipated*, KPMG (June 27, 2019), <https://home.kpmg/us/en/home/insights/2019/06/tnf-france-update-on-digital-services-tax-enactment-anticipated.html>.

⁶⁵ Daniel Bunn, *France Approves Digital Services Tax; U.S. Explores Retaliatory Options*, TAX FOUND. (July 11, 2019), <https://taxfoundation.org/france-digital-services-tax-us-retaliatory-options/>; Alderman, *supra* note **Error! Bookmark not defined.8**.

⁶⁶ Hamza Ali, *France's Macron Signs Digital Services Tax Into Law*, BLOOMBERG TAX (Jul. 25, 2019, 4:52 AM), <https://news.bloombergtax.com/daily-tax-report-international/frances-macron-signs-digital-services-tax-into-law>.

⁶⁷ Alderman, *supra* note 58.

⁶⁸ *Id.*

observed an impression on a device everywhere in the world, back to Jan. 1, 2019.”⁶⁹ Recognizing the severe pushback, President Macron assured that French DST is an interim measure and that “France will reimburse any tax paid under its digital services tax once there is an international deal on digital taxation.”⁷⁰

3. Italy, Austria, and Spain

There are a number of other European countries that also plan to adopt DSTs mimicking the original EU DST proposals.

On May 16, 2018, Italy began a public consultation in response to the EC’s March 2019 DST proposals.⁷¹ This public consultation eventually led to the introduction of Italy’s own DST, which is modelled directly off the EC’s version on Dec. 31, 2018.⁷² Italy’s DST is included in Articles 35-49 of Law No. 145 of 2018 and includes the same 3% rate, applicable digital businesses, and worldwide revenue threshold but also provides for a domestic threshold of €5.5 million in Italian revenues.⁷³ The Italian DST was set to be implemented June 30, 2019, but has since been amended and the effective application date moved to Jan. 1, 2021.⁷⁴

The Austrian Finance Ministry published its own digital tax draft legislation on Apr. 4, 2019, that would expand its current advertising tax to apply to digital advertising.⁷⁵ This more confined version of the DST would implement a 5% turnover tax on revenue derived from advertising services in Austria and includes the same €750 million global threshold and a €25 million domestic threshold.⁷⁶ However, in May of 2019 a change in the Austrian government has further implementation of its DST on hold as an interim government is now in control with development of the DST awaiting the outcome of elections come Sept. 2019.⁷⁷ In the event of its

⁶⁹ Alex M. Parker, *Facebook, Amazon Blast French Digital Tax in USTR Hearing*, LAW360 (Aug. 19, 2019), <https://www.law360.com/tax/articles/1188541>.

⁷⁰ Matt Thomson, *French Digital Tax To Be Repaid After Int'l Deal, Macron Says*, LAW360 (Aug. 26, 2019), <https://www.law360.com/tax/articles/1192446>.

⁷¹ Robert Sledz, *Italy Enacts Budget Law 2019, Laying Groundwork for Digital Services Tax*, THOMSON REUTERS (Jan. 10, 2019), <https://tax.thomsonreuters.com/blog/italy-enacts-budget-law-2019-laying-groundwork-for-digital-services-tax/>.

⁷² *See id.*, *see also* legge di bilancio 30 December 2018, n. 145, in Official Journal of the General Series Dec. 31, 2018, n. 302 (It.).

⁷³ Sledz, *supra* note 70.

⁷⁴ KPMG, *supra* note **Error! Bookmark not defined.**9, at 10.

⁷⁵ *Austria: Update on Proposals for Digital Services Tax*, KPMG (July 12, 2019), <https://home.kpmg/us/en/home/insights/2019/07/tnf-austria-update-proposals-digital-services-tax.html>.

⁷⁶ *Id.*

⁷⁷ *Id.*

implementation, the Austrian DST is scheduled to be introduced on January 1, 2020.⁷⁸

Very similar to the Italian DST, Spain released a preliminary draft bill for a DST on Oct. 23, 2018, that closely mirrors the EC version.⁷⁹ Spain's DST would apply the same 3% tax rate and €750 million global threshold.⁸⁰ Similarly, the tax would apply to online advertising services, online intermediation services, and data transfer services, but include several specific exceptions and does not include an exclusion for intra-group transactions.⁸¹ The draft proposal also included a lower domestic threshold of €3 million.⁸² However, as of April 30, 2019, the Spanish Parliament rejected the proposed budget bill that included the DST.⁸³

4. India

India has undertaken two significant unilateral actions in taxing the digital economy since 2016. As part of the Indian Government's Finance Act of 2016,⁸⁴ the country introduced a turnover-based tax designated as a "equalisation levy,"⁸⁵ which is comparable to DST. In 2018, following India's participation and review of the OECD's BEPS continuing research, the country also expanded the definition of PE in its income tax statute to include digital companies that would otherwise not be taxed due to its lack of physical presence in India.⁸⁶ The discussion below explains the major elements of the two taxes introduced by India.

First, India's equalisation levy was introduced as part of its 2016 Finance Act. The act followed from India reacting relatively quickly to the OECD's BEPS Action Report 1 that recommended an equalisation levy as one of three potential solutions to taxing the digital economy.⁸⁷ The act imposes 6%

⁷⁸ Clemens Grassinger, *Austria: Digital Services Tax Proposed*, SCHOENHERR (July 15, 2019), <https://www.lexology.com/library/detail.aspx?g=3624e1a9-90b9-4aa5-bb34-28ce647045d6>.

⁷⁹ *Spain releases draft bill on Digital Services Tax*, EY (Oct. 25, 2018), <https://www.ey.com/gl/en/services/tax/international-tax/alert--spain-releases-draft-bill-on-digital-services-tax>.

⁸⁰ *Id.*

⁸¹ *Id.*

⁸² *Id.*

⁸³ KPMG, *supra* note **Error! Bookmark not defined.**9, at 13.

⁸⁴ Finance Act, 2016, No. 2, Acts of Parliament, 2016 (India).

⁸⁵ Finance Act, 2016, No. 2 Sec. 165(1), Acts of Parliament, 2016 (India).

⁸⁶ Finance Act, 2019, No. 4, Acts of Parliament, 2019 (India).

⁸⁷ OECD, BEPS ACTION 1, *supra* note 1, at 12.

turnover tax on the gross revenues of foreign online advertising companies that do not have traditional PE in India.⁸⁸ However, the levy is only applicable to those transactions that aggregates to more than INR 100,000 (approximately USD 1,500) in a financial year.⁸⁹ The levy came into effect as of June 1, 2016.⁹⁰

Second, India expanded the definition of PE by introducing the significant economic presence (“SEP”) concept in the amendment of the Income-tax Act.⁹¹ The purpose of the amendment was to establish SEP of foreign digital companies and tax those entities and other foreign companies with traditional PE alike.⁹² The SEP amendments were set to come into force April 1, 2018.⁹³ In sum, the SEP changes made by the Indian government seek to make income attributable to any significant economic presence to be considered as taxable income in India.⁹⁴

II. THE ANATOMY OF DST

A. Key Features

Let us examine the key design features of DSTs that have been enacted or proposed.

1. Turnover Tax

First, DSTs operate as a turnover tax. In the most general sense, turnover taxes are defined as “a tax levied on the value of the sales revenue of a firm,”⁹⁵

⁸⁸ Finance Act, 2016, No. 2 Sec. 165(1), Acts of Parliament, 2016 (India). The specified services subject to the equalization levy may be expanded in scope, and are defined as “an online advertisement, any provision for digital advertising space or any other facility or service for the purpose of online advertisement and includes any other services as notified by the Central Government.” Finance Act, 2016, No. 2 Sec. 164(i), Acts of Parliament, 2016 (India).

⁸⁹ Finance Act, 2016, No. 2 Sec. 165(1), Acts of Parliament, 2016 (India).

⁹⁰ Finance Act, 2016, No. 2 Sec. 163(2), Acts of Parliament, 2016 (India).

⁹¹ Finance Act, 2019, No. 4, Acts of Parliament, 2019 (India).

⁹² Finance Act, 2019, No. 4 Sec. 4(2), Acts of Parliament, 2019 (India).

⁹³ Finance Act, 2019, No. 4 Sec. 1(2), Acts of Parliament, 2019 (India).

⁹⁴ S.R. Patnaik, *Taxing the Digital Economy: The Rule of ‘Significant Economic Presence’*, CYRIL AMARCHAND MANGALDAS ADVOC. & SOLICS. (Mar. 21, 2018), <https://tax.cyrilamarchandblogs.com/2018/03/taxing-digital-economy-rule-significant-economic-presence/>.

⁹⁵ *Turnover Tax*, ROUTLEDGE DICTIONARY OF ECONOMICS (3rd Ed. 2013). Turnover taxes may often be distortionary because when multiple firms touch in the development of a product, “the total tax paid will be higher for goods passing through several firms to their final sale than for those which do not.” *Id.* This so-called “tax cascading” may result in further negative consequences to companies operating at a loss or with thin-margin. JOYCE

rather than other commonly used tax bases such as profit or sales price.⁹⁶ Likewise, DSTs are imposed on the gross revenue of specific digital business models where revenues are linked to the participation of its local users. Some commentators interpret the DST as a quasi-withholding tax,⁹⁷ but this paper takes the form as is and analyzes it as a turnover tax.

Turnover taxes have existed for over a century, but they have recently become a topic of tax policy scholarship as a “few countries have enacted or proposed a turnover tax on digital services as an interim measure to address” current international tax issues.⁹⁸ Turnover taxes have been criticized in part simply because they “are not based on profits, measures of income, or any other indicator of consumption power that is targeted by most other tax instruments in modern developed economies.”⁹⁹ Moreover, turnover taxes, in general, may be distortionary due to so-called “tax cascading”—that is, when multiple firms touch in the development of a product, “the total tax paid will be higher for goods passing through several firms to their final sale than for those which do not.”¹⁰⁰ However, turnover taxes offer simplified compliance for taxpayers, because gross sales or revenue are “relatively easier to measure, record, and verify than profit.”¹⁰¹ Thus, turnover taxes have traditionally been used in the taxation of small and medium sized enterprises

BEEBE, RICE UNIVERSITY’S BAKER INSTITUTE FOR PUBLIC POLICY, RECENT DEVELOPMENTS ON THE E.U.’S DIGITAL TAX PROPOSAL 4 (Jan. 9, 2019).

⁹⁶ Feng Wei & Jean-François Wen, *The Optimal Turnover Threshold and Tax Rates for SMEs* 3, Int’l Monetary Fund, Working Paper 19/98 (2019). In accounting, turnover means the net sales amount by a business before deducting any expenses, whereas “profit is the residual earnings of a business after all expenses have been charged against net sales.” *The Difference Between Turnover and Profit*, ACCOUNTING TOOLS (Jan. 4, 2018), <https://www.accountingtools.com/articles/what-is-the-difference-between-turnover-and-profit.html>.

⁹⁷ [Cite]

⁹⁸ ECONOMIC AND POLICY ASPECTS OF DIGITAL SERVICES TURNOVER TAXES: A LITERATURE REVIEW, PWC (2018); see Meyer D. Rothschild, *The Gross Sales, or Turnover Tax*, 13 NAT’L TAX ASS’N 180, 196–204 (1920) (discussing, in part, the place of a one percent turnover tax within the United States’ taxation scheme around 1920); JOHN F. DUE, *INDIRECT TAXATION IN DEVELOPING ECONOMIES* 118 (1970) (describing the modern use of the turnover tax as beginning in the Philippines with a low-rate tax on all transactions).

⁹⁹ Justin Ross, *Gross Receipts Taxes: Theory and Recent Evidence*, TAX FOUND. (Oct. 6, 2016), <https://taxfoundation.org/gross-receipts-taxes-theory-and-recent-evidence/>.

¹⁰⁰ *Turnover Tax*, *supra* note 94. This tax cascading may result in further negative consequences to companies operating at a loss or with thin margin. JOYCE BEEBE, *supra* note 94, at 4.

¹⁰¹ PWC, *A NEW TURNOVER TAX INTRODUCED FROM JANUARY 2013* (2013). Therefore, developing nations, such as South Africa and Armenia, introduced turnover taxes as an option to some small and medium sized enterprises. *Id.*

in developing nations.¹⁰² The pros and cons of using turnover tax for taxing the digital economy will be discussed further in Part III.C.2.

2. Revenue Threshold

Second, DSTs' tax rates are set in between 2~3%, and they offer revenue threshold. In other words, global revenue from in-scope business models should exceed certain threshold amounts to trigger a DST. DSTs also offer a smaller local revenue threshold.

3. New Rules for Tax Nexus and Profit Allocation

Third, as to the mechanics of recognizing tax nexus and allocating profits of digital firms, DSTs reject the traditional requirement of physical presence and arm's length principle. Traditionally, when a firm located in Country A sells goods or services in Country B (market country), profits of the firm may be allocated to, and subject to income tax in, Country B only if the firm has tax nexus in Country B. The most notable form of the tax nexus is the firm's physical presence, such as a subsidiary and a permanent establishment, in Country B. Once the tax nexus is recognized, the physical presence is considered as a related party of the firm and the global profits of the firm is allocated between Countries A and B based on the arm's length principle. That is, the amount charged by one related party to another for a given product or service must be the same as if the parties were not related. The so-determined amount of profits is allocated to Country B and subject to Country B's tax jurisdiction. The limitations of the traditional approach pertaining the digital economy is that there is no way for Country B to collect revenue from a firm's remote business if the firm does not establish a physical presence there.

On the other hand, DSTs would modify current tax nexus and profit allocation rules and require allocating profit to market jurisdictions where users are located, irrespective of whether the businesses have a local physical presence. First, DSTs do not require a physical presence to recognize a tax nexus in market jurisdictions. Instead, they recognize a tax nexus if, for example, revenue amount generated in market countries exceeds certain thresholds. The number of users or transactions occurred in the market country is also criteria to consider, which replaces the traditional physical presence. Second, once the tax nexus is recognized, an amount of profit should be allocated to market jurisdictions in which relevant business' active and participatory user bases are located, even if there is no local physical

¹⁰² See Wei & Wen, *supra* note 95, at 3. In fact, “[i]n several OECD countries . . . turnover taxes are also applied to sole proprietorships.” *Id.* at 25.

presence. As a result, market countries would be able to collect revenue from the digital economy, which was not possible under the traditional rules.

4. Limited Scope (“Ring-Fencing”)

Finally, one of the most important features of the DSTs is their limited scope. A DST is designed to apply to the identified digital business models where tax challenges are primarily manifest with mobile IPs and significant user participation. As a result, it ring-fences such specified digital business models. To illustrate, the scope of the UK DST is limited to search engines, social media platforms, and online marketplaces, but excludes certain regulated financial and payment services, the provision of online content, sales of software/hardware, and television or broadcasting services. Thus, Facebook, Twitter, YouTube, Google, Amazon Marketplace, Kayak, Priceline, Uber, and Airbnb are in scope, whereas PayPal, Netflix, Hulu, Spotify, and Ubisoft are excluded.¹⁰³

However, there are certain platforms that need further clarification on whether they should be within the scope of DSTs. For example, it is still puzzling whether LinkedIn or YouTube are considered a social media platform subject to a DST or a digital interface providing digital content and thus not subject to a DST, especially when it relates to the premium service. Also, Spotify and Netflix are currently not subject to a DST, but they raise another line-drawing question when they offer customized advertising services to their users who do not use a premium service and thus are required to be exposed to those advertisements. The scope of DSTs concerning the ring-fencing problem will be further discussed in Part III.C.3.

B. Challenges of DSTs

Based on the key features discussed above, let us now examine the challenges that DSTs are facing.

First, because DST only applies to the specific digital business models, it has been criticized as ring-fencing, or segregating, the identified digital business models where tax challenges are primarily manifest with mobile IP and significant user participation. The proponents of the Marketing Intangibles and Significant Digital Presence proposals argue that DST is against the idea of a level playing field by penalizing the big or early players in the market.

¹⁰³ Cui, *Conceptual Defense*, *supra* note 2, at 8–9.

Second, DST has been criticized as a disguised direct tax, or corporate income tax, which may result in double taxation in income tax treaties. The majority of countries have income tax systems and enter into income tax treaties with their major trading partners to eliminate double taxation on certain income when two or more countries concurrently contribute to that income. One country might contribute to the income as a residence country of a taxpayer, and another country might contribute to the same income as a source country where the taxpayer deploys investment. However, if the two countries claim to collect tax on the same income, double taxation occurs. Thus, when a state exercises primary tax jurisdiction on certain income based on the rule set by an income tax treaty, the other contracting state should concede to the first state's tax jurisdiction and exercise residual tax jurisdiction or offer measures to eliminate double taxation on the same income, such as a foreign tax credit or an exemption from tax.

Putting the double taxation problem in the digital economy, a digital firm's profits, including those generated from market countries, have been subject to corporate income tax in the firm's residence country. Now, however, market countries are introducing a DST on the firm's gross revenue generated from the market country. From the firm's perspective, it now faces two different taxes to two different countries, respectively.

In theory, the double taxation problem does not occur if two taxes are imposed on different tax bases. For example, many countries impose VAT on a business's consumption, or gross margin, and at the same time they impose corporate income tax on the business's net income.¹⁰⁴ Although the tax base of VAT and that of corporate income tax are not exactly the same, they may significantly overlap. However, this is not double taxation, because VAT is imposed on taxpayer's consumption whereas corporate income tax is imposed on the taxpayer's net income. The same explanation upholds for DST. The tax base of DST is gross revenue of certain digital firms and that of income tax is net profit, or net income after deducting expenses from gross revenue, of the digital firms, and thus accusing the DST of creating a double

¹⁰⁴ For example, a toy manufacturer located in a country having a 10% VAT and 20% corporate income tax. The toy manufacturer buys the raw materials for \$4.00, plus a VAT of \$0.40—payable to the government—for a total price of \$4.40. The manufacturer then sells the toy to a retailer for \$10.00 plus a VAT of \$1.00 for a total of \$11.00. However, the manufacturer renders only 60 cents to the government, which is the total VAT at this point, minus the prior VAT charged by the raw material supplier. Note that the 60 cents also equals 10% of the manufacturer's gross margin of \$6.00. In addition, the toy manufacturer should pay corporate income tax on its net income of \$6.00, which is the gross revenue of \$10.00 minus deductible expenses for the raw materials of \$4.00, at 20% corporate income tax rate, which is a total of \$12.00 corporate income tax. This example shows that tax base of VAT and corporate income tax may significantly overlap, but it is still not considered as double taxation.

taxation problem is not likely a legitimate concern.

However, the opponents of DST argue that DST should be considered as a disguised corporate income tax. If the object of the DST is to tax profits where value is created, then the object itself admits that it relates to “profits,” which is the tax base of direct tax, or corporate income tax. The fact that the tax base is gross revenues does not necessarily negate the suspicion of direct taxation because other direct taxes, such as withholding tax as a collection mechanism of income tax, are also levied on gross profits. The taxable period of DST is also a yearly basis, rather than per transaction basis, which is more similar to direct taxation than indirect taxation.

If the DST is a direct tax, then there is a risk that a DST is within the scope of “Taxes Covered” in Article 2 of the OECD Model Tax Convention on Income and on Capital. Such risk leads to the treaty-level concern of double taxation.

Third, various unilateral DSTs potentially discriminate businesses based on nationality. Although it is eventually an empirical question that requires evidence on whether the majority of the companies subject to DST are foreign multinationals from market jurisdictions, it has been deeply suspected that the revenue threshold would only be satisfied by American tech giants.

On the third point of the challenge, the United States has been a major opponent to the DST general concept. In the letter of January 29, 2019, by Senators Grassley and Wyden to US Treasury Secretary Mnuchin, copying EC and European Council, they expressed concern about unilateral DSTs, because they are "designed to discriminate against US-based multinational companies."¹⁰⁵ On March 12, 2019, Treasury Department Assistant Secretary for International Tax Affairs, Chip Harter, expressed concern that under the WTO, trade agreements, and treaties the French DST proposal could be challenged as discriminatory vis-à-vis US companies, and "the US is opposed to any digital services tax proposals . . . [U]ser participation is just not a sound basis for taxing companies . . . [U]sers are unrelated parties and . . . their input is purchased on barter basis [for] a free service."¹⁰⁶

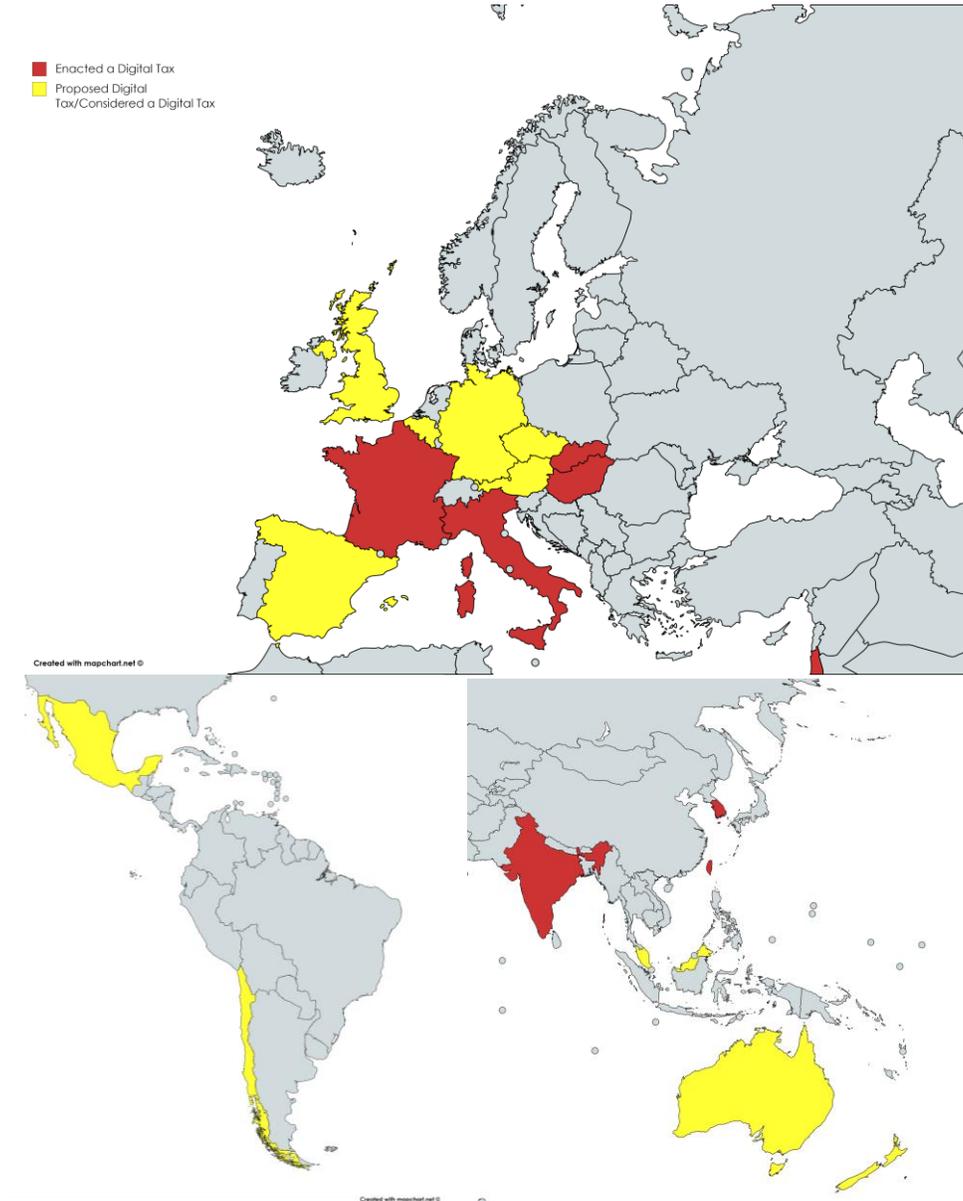
C. Revisiting Challenges Based on the Status Quo

Although commentators and policy makers are sympathetic to the US’ hostility towards a DST, many countries have already adopted DST models. For example, India, who endorses the significant digital presence proposal, enacted a DST in 2016. As shown below, many other countries have followed

¹⁰⁵ [Cite]

¹⁰⁶ [Cite]

suit and either enacted, proposed, or considered a DST. Therefore, Michael Graetz commented at a recent conference that the current nexus and profit allocation rules are no longer status quo; status quo has become each country unilaterally adopting its own DST without coordination.¹⁰⁷



Furthermore, the OECD has pledged in the Interim Report that it will

¹⁰⁷ 2019 USCIB/OECD International Tax Conference (June 3-4, 2019, Washington, D.C.).

review each of the three proposals without prejudice. Part II.B. probed the challenges of the DST and the underlying user participation concept based on the User Participation Proposal, but to be fair, the discussion should fully consider the merits of the User Participation Proposal along with demerits of the other two proposals for an unbiased review. Although the OECD has not completed its own review yet, this paper offers the following observation on the three proposals in the reverse order.

First, the Significant Economic Presence proposal would be the most comprehensive reform proposal, which requires a fundamental overhaul of international taxation on nexus and profit allocation rules. However, it is doubtful that whether the global community is ready to give up the traditional residence-based nexus rule. Also, the significant economic presence proposal adopts a formulaic approach; however, there is no consensus between the traditional arm's length principle and the formulary apportionment with respect to the profit allocation rules.

Second, the Marketing Intangibles Proposal is strongly endorsed by the United States. It is more moderate than the significant economic presence proposal in terms that it modifies the current profit allocation and nexus rules based on the residual profit split method. However, it is not clear whether the US will successfully persuade DST advocates towards its Marketing Intangibles Proposal because it too has significant flaws. Because it departs from the traditional arm's-length principle, it will be challenging to satisfy the DST advocates with this model. Furthermore, as discussed, the definition of marketing intangibles is obscure and the formula for allocating residual income is very complicated. The US government officials and some commentators rebut such criticism, arguing that multinationals may reasonably calculate the worldwide profit and routine profit, and that the residual profit may be calculated simply by subtracting the routine profit from worldwide profit.¹⁰⁸ However, other US multinationals, such as Johnson & Johnson and P&G, criticize the proposal based on the residual profit split method, expressing their difficulty in determining the routine profit itself and many complications associated with the profit split method.

Third, the User Participation Proposal, which is later embodied as DST in a more aggressive way, at least deserves an unbiased analysis. Among the flawed addressed in the II.B. above, the ring-fencing problem and the discrimination problem raise valid points. However, at the same time, they are practical problems that can be improved in the stage of implementation or design. In other words, those two problems are not highly theoretical.

¹⁰⁸ E.g., Microsoft.

On the other hand, the disguised direct income tax and the potential double taxation problem are truly theoretical issues and difficult to overcome as long as DST is genuinely considered as a direct tax. Nevertheless, it is not fully convincing to claim DST as a direct tax. The most notable rationale for constructing DST as a direct income tax is the claim by taxpayers, who merely complain of the increased tax burden due to DSTs for market countries on top of corporate tax for their residence country. However, the tax base of DST is clearly different from that of corporate income tax, and it is well established that significant overlap of tax base between consumption tax, such as VAT, and income tax is not considered double taxation. On the contrary, envisaging DST as a turnover tax offers an important, yet neglected, avenue to analyze the DST as a consumption tax as opposed to the other proposals based on income tax.

In brief, the DST has been gaining more political impetus in many countries. In an effort to evaluate DST from an unbiased perspective, this paper offers a novel idea based on the key features of the DST. It is designed as a turnover tax imposed on gross revenue, and therefore, by definition, it is a subcategory of consumption tax. The above challenges made against the DST are hard to overcome if it is considered a direct tax or income tax. Therefore, in an effort to overcome some of these challenges, this paper views the DST as a variation of a cross-border consumption tax. The next Part will develop this new perspective.

III. DST AS A CONSUMPTION TAX

A. *An Old Debate: Consumption Tax v. Income Tax*

A consumption tax is a tax on the purchase of goods or services.¹⁰⁹ In a broader sense, consumption tax refers to a taxing system where people are taxed based on how much they consume rather than how much they add to the economy, such as under an income tax.¹¹⁰ Examples of a consumption tax include retail sales taxes, excise taxes, value added taxes, use taxes, import duties, and most importantly for this paper, turnover taxes or taxes on gross business receipts.¹¹¹

¹⁰⁹ Anne L. Alstott, *The Uneasy Liberal Case Against Income and Wealth Transfer Taxation: A Response to Professor McCaffery*, 51 TAX L. REV. 363 (1996) (“A consumption tax, by definition, taxes only income spent on current, personal consumption (for example, on cars, food and travel).”).

¹¹⁰ See Alvin Warren, *Would A Consumption Tax Be Fairer Than An Income Tax?*, 89 YALE L.J. 1081, 1083–84 (1980) (citing generally H. SIMONS, PERSONAL INCOME TAXATION 59-102 (1983)).

¹¹¹ HELLERSTEIN & HELLERSTEIN, *supra* note 9, at 649. (including the turnover tax as part of a list of consumption taxes including retail sales tax, use tax, excise tax, and gross

Consumption taxes are generally born by consumers because vendors charge a higher price for the good or service to account for the amount of consumption tax.¹¹² The vendor then remits the tax to the appropriate federal, state, or local government.

Proponents of a consumption tax argue that it encourages saving and investment, which makes the economy more efficient, whereas an income tax penalizes savers and rewards spenders.¹¹³ Thus, they argue that it is fairer to tax those who take out of the limited resource pool through consumption, rather than what they contribute to the pool using their income. On the other hand, opponents argue that a consumption tax adversely affects the poor who, by necessity, spend a higher percentage of their income.¹¹⁴ Since consumption tax is a form of regressive tax, the wealthy population consumes a smaller fraction of their income than poorer households do.¹¹⁵ On the other hand, the income tax is justified as more progressive due to ability to pay being determined through levels of income.¹¹⁶

Overall, consumption tax has strength in efficiency and administrability, whereas income tax has merits in equity. In terms of efficiency, an income tax effectively reduces the value of future consumption relative to present consumption by discriminating against savings, creating a deadweight loss.¹¹⁷ On the other hand, a consumption tax improves efficiency by treating savings at a more neutral standpoint, allowing for “greater individual savings and investment, capital formation, and ultimately greater economic productivity.”¹¹⁸ As for administrability, the strength of the consumption tax in modern tax dialogue can be more readily seen from the reduced complexity that would occur in replacing an income tax with a consumption tax.¹¹⁹

income tax).

¹¹² See TAX POLICY CENTER, *Who bears the burden of a national retail sales tax?*, Subheading to *Tax Policy Center Briefing Book How Could We Improve the Federal tax System?*, <https://www.taxpolicycenter.org/briefing-book/who-bears-burden-national-retail-sales-tax> (last visited Sept. 9, 2019).

¹¹³ Martin A. Sullivan, *Introduction: Getting Acquainted With VAT*, in THE VAT READER WHAT A FEDERAL CONSUMPTION TAX WOULD MEAN FOR AMERICA 12 (2011), [http://www.taxhistory.org/www/frefiles.nsf/Files/VATReader.pdf/\\$file/VATReader.pdf](http://www.taxhistory.org/www/frefiles.nsf/Files/VATReader.pdf/$file/VATReader.pdf).

¹¹⁴ *Id.*

¹¹⁵ *Id.*

¹¹⁶ See Daniel S. Goldberg, *The U.S. Consumption Tax: Evolution, Not Revolution*, 57 TAX LAWYER 1 (2003); see also Warren, *supra* note 109, at 1092–93.

¹¹⁷ William D. Andrews, *A Consumption Or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1113–14 (1974).

¹¹⁸ Goldberg, *supra* note 115, at 21.

¹¹⁹ See Chris R. Edwards, *Simplifying Federal Taxes: The Advantages of Consumption-Based Taxation*, CATO INSTITUTE (Oct. 17, 2001),

Proponents of the consumption tax point to the complexity of income taxes in inconsistently treating certain categories of income, such as the different tax treatment between savings from ordinary income and increases in wealth through appreciation.¹²⁰

In international tax, scholars have greater focus on efficiency and administrability over equity or fairness.¹²¹ International tax literature has been described as having a “narrow normative focus” which is “guided by worldwide economic efficiency [] concerned with increasing economic output and reducing deadweight loss, wherever it occurs.”¹²² In contrast, domestic tax, especially personal income tax, tend to focus more heavily on concerns over equity and fairness.¹²³ Relying on international concerns of taxation focused more heavily on economic principles, especially efficiency, the consumption tax is likely to have an advantage over income tax in addressing efficient deployment of global capital of multinational enterprises.

B. A Possible New Debate: DST vs. Other Proposals

The DST discussion largely occurs in cross-border business transactions. In international tax and business tax, the three traditional policy prongs—namely, efficiency, equity, and administrability—are not equally important. Efficiency and administrability are more emphasized than equity in international tax and business tax. Thus, applying this weighted policy criteria may be appropriate for analyzing international taxation responses to digitalization. Considering that the strength of consumption tax is efficiency and administrability and that of income tax is equity, consumption tax-driven proposals may be normatively superior, at least for cross-border digitalization of the economy.

Noticing the possible advantage of consumption tax in cross-border business transaction, this paper proposes an alternative approach to validate DST by envisaging it as a cross-border consumption tax, which offers the following merits.

First, there is no need to make efforts to undertake the fundamental overhaul of nexus and allocation rules to reward more taxing rights to market jurisdictions. A consumption tax is by nature imposed in the place where the

<https://object.cato.org/sites/cato.org/files/pubs/pdf/pa416.pdf> (providing a detailed list of income tax complexities that could be eliminated in implementing a consumption tax).

¹²⁰ Andrews, *supra* note 116, at 1115.

¹²¹ David L. Forst, *The U.S. International Tax Treatment of Partnerships: A Policy-Based Approach*, 14 BERKELEY J. INT’L L. 239, 250 (1996) (“equity has more recently been considered as ‘irrelevant’ to contemporary international tax policy, and the more recent literature primarily focuses on economic principles.”) (footnote omitted).

¹²² Graetz, *supra* note 7, at 1375.

¹²³ *See Id.* at 1370–71.

consumption occurs; in the highly digitalized business model, it is the market jurisdictions where users are located.

Second, the tax base of a consumption tax is the gross proceeds rather than the net income amount, which conceptually matches the current DST characteristics. A solid construction of DST as a consumption tax may easily eliminate the double taxation concern in international tax addressed in Part II.B. Furthermore, interpreting a DST as an income tax and inviting tax treaty to deal with potential double taxation is not wise, considering that tax treaty is not a good tool to deal with the tax challenges in digital economy.¹²⁴

Third, a DST, as a consumption tax, may be more efficient than other proposals based on an income tax approach, because consumption tax is superior in terms of efficiency. The tax challenges of the digitalization of the economy are inevitably related to cross-border transactions or business taxation, where efficiency is more important. More interestingly, a DST may overcome a general criticism on turnover tax that is imposed on gross revenue and thus creates economic distortion due to tax cascading explained in Part II.A.1, because digital economy subject to DST implicates almost zero marginal cost.¹²⁵

Fourth, a DST may overcome the fairness or regressive problem with respect to its implication on individual taxpayers, considering that many highly digitalized business models subject to DST adopt multi-sided platform model. As discussed more in Part III.C.1. below, in multi-sided platform model, fees charged by digital firms are paid by another business, such as user-sellers or advertisers, not the retail users, and thus the tax incidence would be on the user-sellers or advertisers, not the retail users.

It is also worth noting that *Wayfair* examines the economic nexus rule in connection with a “sales tax,” which is an example of a consumption tax. The policy rationale in *Wayfair* is consistent with the OECD’s discussion on the new tax nexus rule, which is moving away from strict physical presence rules. However, the decision itself is not necessarily supportive to a specific proposal on a new profit allocation rule introduced by the OECD. Many commentators interpret *Wayfair* as a parallel to the Significant Digital Presence, or digital PE, proposal. However, the more contextualized economic nexus could be viewed as a parallel to various proposals, including the Marketing Intangibles or User Participation proposals. Despite the

¹²⁴ Wei Cui, *The Superiority of the Digital Services Tax over Significant Digital Presence Proposals*, NAT’L. TAX J. at 3–4 (forthcoming 2019) (weighing the familiarity in using the treaty approach against the disadvantages of clinging to “superfluous conventions” and the restriction on the treaty framework may have on international cooperation”).

¹²⁵ Cui, *Conceptual Defense*, *supra* note 2, at 25–27.

contradicting interpretation of *Wayfair*, it is obvious that *Wayfair* is a sales tax case. The South Dakota's sales tax rules at issue were quite similar to the current design of the DST, besides the applicable tax rate. Furthermore, other similar state sales tax models adopting an economic nexus rule after *Wayfair* resemble DSTs. As observed in *Wayfair*, the discussion on the modern taxation of digitalized business models could occur with respect to a consumption tax, such as a DST.

C. Remaining Issues Toward a Consumption Tax

There are a couple of issues that requires further exploration when DST is construed as a consumption tax.

1. Tax Incidence of DST

The first remaining issue is who bears the economic burden of DST. In tax term, the question refers to the tax incidence of a DST. There is little literature criticizing DSTs with respect to tax incidence. The arguments state that because a DST is designed as a turnover tax, it will be borne by consumers, and subsequently it will negatively affect the demand side of the digital economy.¹²⁶ However, such criticism is not fully convincing, considering that many digital business models are multi-sided. In a multi-sided business model, there are two types of users—user-buyer and user-seller—and the fees imposed by a service provider is on the user-seller side. Then it is not conceptually impossible to pass the tax incidence to user-sellers, rather than user-buyer.

In fact, since the adoption of the new French DST, Amazon announced that it will consider the French DST a consumption tax and “pass the tax's cost to [user-sellers] on its website in France through a 3% referral fee

¹²⁶ Dr. Matthias Bauer, *Five Questions about the Digital Services Tax to Pierre Moscovici*, (ECIPE Occasional Paper, 2018), <https://ecipe.org/wp-content/uploads/2018/06/Five-Questions-about-the-Digital-Services-Tax-to-Pierre-Moscovici.pdf>; Jake Kanter, *Amazon, Facebook, and Google come out swinging after being slammed with an 'unjustifiable new tax on their sales*, BUSINESS INSIDER (Aug. 14, 2019, 6:21 AM), <https://www.businessinsider.com/amazon-facebook-and-google-lobby-french-digital-services-tax-2019-8>; Elizabeth Schulze, *France's Digital Tax Could Hurt Consumers More Than Tech Companies*, CNBC (July 12, 2019, 9:00 AM), <https://www.cnn.com/2019/07/12/france-digital-tax-could-hurt-consumers-more-than-tech-companies.html>.

increase starting Oct. 1[, 2019].”¹²⁷ Thus, despite the attempts of the EU¹²⁸ and separate countries like France¹²⁹ to construe DST as a corporate income tax on corporate profits, DST is taken as a consumption tax in the real world.¹³⁰

Nevertheless, although the French anecdote on tax incidence proves that market players perceives DST as a consumption tax, and accordingly pass the economic burden, or tax incidence, to one type of users—the user-sellers, whether such tax incidence is normatively desirable is another question. Should a DST constructed as a turnover tax or a consumption tax logically and conceptually pass the economic burden of the tax to one side of users? Or from a policy perspective, can we design a DST as consumption tax, of which tax incidence is absorbed by digital platform firms? This question is particularly important because the digital economy where DST operates is no longer the same as the simple one-sided market where traditional tax incidence model has assumed. Furthermore, the digital firms providing the multi-sided business model and subject to DST are largely monopolistic, and thus may result in a different policy analysis of tax incidence. This Subpart further explores this issue in relation to traditional and recent studies on the tax incidence of multi-sided business model.

a. Tax Incidence in General

Consideration of the incidence of a tax is important as it represents which part of the economy bears the ultimate burden of the tax, and can help policy makers determine the overall progressivity and efficiency of any tax proposal.¹³¹ The incidence of a tax can refer to either the statutory incidence

¹²⁷ Todd Buell, *Amazon Raising Fees on French Sellers After Digital Tax*, LAW360 (Aug. 1, 2019), <https://www.law360.com/articles/1184355/amazon-raising-fees-on-french-sellers-after-digital-tax>. The referral fee is the fee that the company charges vendors for using Amazon to sell products.

¹²⁸ *Proposal for a Council Directive on the Common System of A Digital Services Tax on Revenues Resulting From The Provision Of Certain Digital Services*, COM 16 (2018) 148 final (Mar. 21, 2018) (stating that the measure to target revenues of digital services based on user value creation underpins the Council intention to adapt corporate tax rules to new digital business models).

¹²⁹ KPMG, *supra* note 59 (“[T]he draft legislation mentions a flat tax of 3% of the taxable income. . . . The amount of tax paid would be deductible from the accounting result of the taxpayer (hence the corporate income tax basis)”).

¹³⁰ *See supra* text accompanying notes 9–14.

¹³¹ *See* WILLIAM M. GENTRY, U.S. TREAS. DEPT., OTA PAPER 101, A REVIEW OF THE EVIDENCE ON THE INCIDENCE OF THE CORPORATE INCOME TAX 3 (2007), <https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/WP-101.pdf>;

or the economic incidence. The statutory incidence of a tax is placed on the individuals, entities, or sectors of the economy that have “the legal obligation to remit taxes to the government.”¹³² In the case of the DST, the statutory incidence has been placed on those digital businesses with high enough gross revenues that offer the digital goods and services targeted by the tax.¹³³ The other type of incidence is economic incidence, which “measures the changes in economic welfare in society arising from a tax.”¹³⁴ Another useful term to understand economic incidence is “ultimate economic burden,” which is the measurement of overall change in “after-tax incomes after all the economic adjustments to the tax have occurred across all affected markets”¹³⁵ Additionally, tax incidence analyzes how much of the tax burden may be passed upstream, or backward, to the consumers, and how much is passed downstream, or forward, onto consumers.¹³⁶ The mentioned terms are not used consistently throughout incidence literature, and this paper discusses incidence more generally with economic incidence and “burden” being used interchangeably.

Analysis of economic incidence relies on the interaction of a number of factors including, but not limited to, consumer behavior, output prices, wages, and the pass-through rate of a tax.¹³⁷ A simple analysis of tax incidence could follow the steps of an increase in the price of a good due to taxation resulting in consumers buying less of the taxed good, further resulting in lowered production of the good, incidentally causing a reduction

Don Fullerton & Gilbert E. Metcalf, *Tax Incidence*, NBER Working Paper 8829, 1 (2002), <https://www.nber.org/papers/w8829.pdf>.

¹³² Fullerton & Metcalf, *supra* note 130, at 1.

¹³³ For examples of digital services placing the statutory incidence on targeted digital industries, see HM TREASURY, BUDGET 2018 DST, *supra* note 48; KPMG, *supra* note **Error! Bookmark not defined.**9, at 8; Sledz, *supra* note 70; and EY, *supra* note 78.

¹³⁴ Fullerton & Metcalf, *supra* note 130, at 1.

¹³⁵ Stephen Entin, *Tax Incidence, Tax Burden, and Tax Shifting: Who Really Pays the Tax?*, HERITAGE FOUNDATION (Nov. 5, 2004), <https://www.heritage.org/taxes/report/tax-incidence-tax-burden-and-tax-shifting-who-really-pays-the-tax>.

¹³⁶ Cf. Julien Pellefigue, *The French Digital Service Tax: An Economic Impact Assessment*, DELOITTE TAJ (2019), <https://taj-strategie.fr/content/uploads/2020/03/dst-impact-assessment-march-2019.pdf> (determining the pass-through rate of the French DST on merchants and consumers) with Fullerton & Metcalf, *supra* note 130, at 2.

¹³⁷ See Fullerton & Metcalf, *supra* note 130, at 1 (discussing changes in behavior due to taxation resulting in changing equilibrium prices); GENTRY, *supra* note 130, at 1 (discussing tax incidence in relation to wages and output prices). See generally E. Glen Weyl & Michal Fabinger, *Pass-Through as an Economic Tool: Principles of Incidence under Imperfect Competition*, 121 J. OF POL. ECON. 528 (2013) (using pass-through rate of tax to determine tax incidence under imperfect competition); Pellefigue, *supra* note 135 (determining the pass-through rate of the French DST on merchants and consumers), <https://taj-strategie.fr/content/uploads/2020/03/dst-impact-assessment-march-2019.pdf>.

in the purchase of the inputs that go into the goods creation.¹³⁸ The incidence of a tax can be used to determine many different aspects and changes resulting from a tax's implementation, but in this paper the focus is on the extent, if any, that the incidence of the DST is borne by the end-consumers of the taxed digital platforms.

Tax incidence has also been used to determine the more specific incidence analysis of both the corporate income tax¹³⁹ and consumption taxation.¹⁴⁰ First, for income taxation, Arnold Harberger released his popular study in 1962¹⁴¹ which used a “general equilibrium model” that has since been expanded upon alongside the use of direct empirical analysis.¹⁴² The general equilibrium analysis focuses on a “theoretical two-sector closed economy” that first identified the burden of the corporate income tax being borne by capital and labor, with no shift towards consumers.¹⁴³ This first analysis identified a number of important conclusions, but most importantly that “the majority of the tax burden fell on capital.”¹⁴⁴

The original equilibrium model has since been expanded upon to include analysis of an “open economy,” which better suits the realities of international taxation where more mobile capital could shift more of the burden to the relatively immobile labor.¹⁴⁵ A number of studies following this open economy approach have resulted in findings that contradict the original Harberger conclusions that capital would bear the majority of the burden under corporate income taxation.¹⁴⁶ Using two “central estimate” approaches

¹³⁸ See Fullerton & Metcalf, *supra* note 130, at 1 (providing a similar analysis tax incidence focused on changes in behavior and resulting changes in equilibrium prices).

¹³⁹ See generally Arnold C. Harberger, *The Incidence of the Corporation Income Tax*, 70 J. OF POL. ECON. 215 (1962) (providing analysis for the “probable incidence of [the corporate income tax] in the United States.”).

¹⁴⁰ See generally Paul L. Menchik & Martin David, *The Incidence of a Lifetime Consumption Tax*, 35 NAT. TAX. J. 189 (1982) (analyzing the welfare distribution of a consumption tax using data from bequests and *inter vivos* transfers).

¹⁴¹ See Harberger, *supra* note 138, at 215.

¹⁴² Jennifer C. Gravelle, *Corporate Tax Incidence: A Review of Empirical Estimates and Analysis* 1, CBO Working Paper 2011-01 (2011), <https://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/122xx/doc12239/06-14-2011-corporatetaxincidence.pdf>.

¹⁴³ See Jennifer Gravelle, *Corporate Tax Incidence: Review of General Equilibrium Estimates and Analysis*, 66 NAT. TAX. J. 185, 187 (2013).

¹⁴⁴ *Id.*

¹⁴⁵ *Id.*

¹⁴⁶ The studies relied heavily on the assumption that the tax would be imposed by a large country, and analysis focused on several factors including: factor substitution elasticities, capital mobility elasticity, substitution elasticities between domestically produced and imported products, and relative factor intensities. *Id.* at 197–200.

garnered from analysis of four separate studies on general equilibrium research, Jennifer Gravelle has found that open-economy studies result in similar estimates as to the allocation of the corporate tax burden between capital and labor.¹⁴⁷ Gravelle's analysis suggests that roughly "40 percent of the corporate tax burden falls on labor and 60 percent falls on capital . . ." ¹⁴⁸

It is important to note that the open economy models following Harberger, and the general equilibrium model in general, are not without drawbacks.¹⁴⁹ Among various critiques, Harberger himself pointed out in his own study, 56 years following his original, that the new internationally focused, open-economy models rely on stylized scenarios of the corporate tax and the assumption that only the United States changes its tax rate.¹⁵⁰ In addition, efforts in the field of empirical analysis for corporate income taxation has resulted in findings that conflict with the general equilibrium models. Specifically, the empirical tests suggest that labor may bear a substantial portion of the corporate income tax burden,¹⁵¹ and thus "the corporate tax may not as progressive as many politicians assume."¹⁵²

It is important to note here that the open-economy models, including those relying on empirical analysis, rely on concerns over international factors, such as international capital mobility, that may coincide better with the potential tax incidence of the internationally focused DST.¹⁵³

¹⁴⁷ See *Id.* at 204–05.

¹⁴⁸ *Id.* at 205.

¹⁴⁹ For example, Alan Auerbach has pointed out that the general equilibrium models do not account for potentially important factors such as investment incentives, corporate financial choice on using debt or equity to finance investment, risk, imperfect competition, organizational form of the corporate entity, and management incentives. Alan J. Auerbach, *Who Bears the Corporate Tax? A Review of What We Know*, 20 TAX POLICY & ECON. 1, 3 (2006).

¹⁵⁰ Arnold C. Harberger, *Corporate Tax Incidence: Reflections on What is Known, Unknown, and Unknowable*, in *Fundamental Tax Reform: Issues, Choices, and Implications* 301–02 (John W. Diamond & George R. Zodrow eds., 2008) [hereinafter Harberger 2008].

¹⁵¹ GENTRY, *supra* note 130, at 2. One empirical analysis from R. Alison Felix suggested that "the marginal burden of the corporate tax falls between 2.35 and 6.2 times the tax revenue collected" from the corporate income tax. R. Alison Felix, *Passing the Burden: Corporate Tax Incidence in Open Economies* 20–21, Federal Reserve Bank of Kansas City RRWP 07-01 (2007), <https://www.kansascityfed.org/Publicat/RegionalRWP/RRWP07-01.pdf>. Additionally, Felix found that the "burden of the corporate tax on wages is shared equally across-skill level, suggesting that the corporate tax may not be as progressive as many politicians assume." *Id.* at 22.

¹⁵² *Id.* at 22. Even Harberger's own studies have resulted in similar contradicting findings, with his 2008 paper suggesting that domestic labor's burden of the corporate income tax in the country imposing the tax was 96 percent with imperfect product substitution and a burden of 130 percent under perfect product substitution. See Harberger 2008, *supra* note 149, at 36.

¹⁵³ See generally Harberger 2008, *supra* note 149 (discussing international capital mobility and international product substitution); Felix, *supra* note 150, at 1–2 (describing

Second, the analysis of tax incidence for consumption taxes follows similar lines as to corporate income tax in determining ultimate economic burden and progressivity.¹⁵⁴ However, the analysis differs sharply in that much of the study on consumption tax incidence is usually required to analyze multiple types of consumption taxes, such as VATs or excise taxes,¹⁵⁵ taxes that rely on a general current consumption—that is, income less saving—model,¹⁵⁶ and usually must address incidence in terms of the distributional effects in transitioning from income taxation to consumption-based taxation.¹⁵⁷ Another difference that sometimes results in contrasting findings is that a study on consumption tax incidence may present results in two ways, either measuring incidence as a percentage of income or as a percentage of expenditure.¹⁵⁸ Lastly, unlike income taxation analysis, consumption taxes are usually assumed to be initially borne entirely by the final consumer.¹⁵⁹

In general, many articles follow the accepted view that consumption taxes are regressive. For example, a study on the incidence of the Flat Tax first described by Hall and Rabushka¹⁶⁰ found that the tax “would increase the tax burdens of a majority of taxpayers, and it would significantly redistribute tax burdens, mainly from the top decile to other taxpayers.”¹⁶¹ Another paper

openness as a concept dealing with international capital mobility).

¹⁵⁴ See Alan J. Auerbach, *The Choice Between Income and Consumption Taxes: A Primer* 35–37, NBER Working Paper 12307 (2006), <https://www.nber.org/papers/w12307.pdf> (explaining the analysis of consumption tax incidence mainly from the perspective of burden and measures of progressivity).

¹⁵⁵ OECD, *The Distributional Effects of Consumption Taxes in OECD Countries* 28 (2014), https://read.oecd-ilibrary.org/taxation/the-distributional-effects-of-consumption-taxes-in-oecd-countries_9789264224520-en#.XXakzChKjZs [hereinafter OECD, *Distributional Effects of Consumption Taxes*].

¹⁵⁶ See John Sabelhaus, *What is the Distributional Burden of Taxing Consumption?*, 46 NAT'L. TAX J. 331, 331 (1993).

¹⁵⁷ See generally William M. Gentry & R. Glenn Hubbard, *Distributional Implications of Introducing a Broad-Based Consumption Tax*, 11 TAX POLICY & ECON. 1 (1997). Additionally, analyzing the incidence of consumption taxes addresses the “life-time” amount that individuals save disproportionately when compared to similar research of the income taxation. [cite]

¹⁵⁸ OECD, *Distributional Effects of Consumption Taxes*, *supra* note 154, at 30–31.

¹⁵⁹ *Id.* at 28.

¹⁶⁰ See generally ROBERT E. HALL & ALVIN RABUSHKA, *THE FLAT TAX* (2nd ed. 2007).

¹⁶¹ Amy Dunbar & Thomas Pogue, *Estimating Flat Tax Incidence and Yield: A Sensitivity Analysis*, 51 NAT. TAX. J. 303, 321 (1998). This article on flat tax incidence was based on actual tax parameters from previous years in the United States, and addressed situations in which the flat tax was modified in order to allow for deduction of payroll taxes and for employers to deduce all fringe benefit expenses. *Id.*

addressed a more insulated case of the “partial shift of taxation from labor income to consumption in Germany.”¹⁶² Using information on household budgets and simulations of labor market reactions, the authors found that “a shift from personal income tax to VAT has a regressive impact on household budgets[, with] . . . budget loss amounts [] up to 4% of equivalized income.”¹⁶³

However, there has been contention over how the incidence of consumption taxes should be addressed. For example, one article suggested that “[i]t is reasonable to infer that existing studies using the residual method to compute saving are biased toward determining that consumption taxes are more regressive than what is probably the case.”¹⁶⁴ Perhaps following from this contention, findings from both scholarly authors and the OECD have presented findings that run contrary to some of the assumptions underlying the analysis of consumption tax incidence. In studying the distributional impact of introducing a broad-based consumption tax, one article suggested that “a consumption tax is less regressive than would be suggested by assuming a consumption tax exempts all parts of capital income,” because both income and consumption taxes treat the capital income of wealthier households similarly.¹⁶⁵

Most surprisingly, however, are findings from a recent study on the distributional impact of consumption taxes by the OECD. In their analysis, the OECD studied the effect on distribution in 20 OECD countries.¹⁶⁶ Similar to the expanded, open-economy studies, referenced in the income tax discussion, the OECD research used a cross-country comparison.¹⁶⁷ Additionally, the study covered both VATs and excise taxes, and measured the incidence of the two taxes as both a percentage of income and a percentage of expenditure.¹⁶⁸ The study found that in the case of income, the consumption taxes followed the basic assumption and were regressive.¹⁶⁹ However, under an expenditure perspective, the taxes were found to be

¹⁶² Nico Pestel & Eric Sommer, *Shifting Taxes from Labor to Consumption: More Employment and more Inequality* 16, Discussion Paper No. 15-042 (2015), <http://ftp.zew.de/pub/zew-docs/dp/dp15042.pdf>.

¹⁶³ *Id.* at 17.

¹⁶⁴ Sabelhaus, *supra* note 155, at 343.

¹⁶⁵ *Id.* The authors suggest this reasoning counters the common assumption that consumption taxes do not tax capital income, resulting in theoretical offset of the reduction in tax burden apportioned to high-income earners following the transition to a consumption tax. OECD, *Distributional Effects of Consumption Taxes*, *supra* note 154, at 25.

¹⁶⁶ *Id.* at 26.

¹⁶⁷ *Id.* (“The models follow a consistent methodology enabling cross-country comparison of results.”).

¹⁶⁸ *Id.* at 33–40.

¹⁶⁹ *Id.* at 31.

“roughly proportional or even slightly progressive”¹⁷⁰ The OECD also argued that “an expenditure-base approach provides a more reliable measure of the lifetime distributional effects of a consumption tax, challenging the general public perception that consumption taxes are regressive.”¹⁷¹

The DST has similarly been criticized in that the tax will simply be born in large part, if not entirely, by consumers.¹⁷² An impact assessment on the French DST by a consulting firm found that “[a]pproximately 55% of the total tax burden will be borne by consumers, 40% by businesses that use digital platforms, and only 5% by the large internet companies targeted.”¹⁷³ It appears then that the implementation of the DST goes against normative concerns as to the progressivity and incidence of new taxes. However, these normative concerns may be misplaced due to a number of underlying misconceptions over taxation of the digital economies targeted by the DST. The first example would be the two-sided platform quality of the digital firms which may require completely different analysis as to incidence. Second, these large digital firms are generally considered monopolies,¹⁷⁴ or at least function like them, and are affected differently by taxes as well as potentially being able or more willing to absorb the cost of the DST.¹⁷⁵ Lastly, proponents of the DST may be able to adopt the same contentions that have arisen for consumption tax incidence, as the DST essentially functions as a consumption tax. At the least, the DST may benefit from the same international efficiency arguments as consumption taxes in general.

b. Two-Sided Platforms: Tax Incidence and Other Considerations

Two-sided markets, or more broadly multi-sided markets, can be defined as “markets in which one or several platforms enable interactions between end-users and try to get the two (or multiple) sides ‘on board’ by appropriately charging each side.”¹⁷⁶ The firms at the center of two-sided markets, or the two-sided platform firms, are essentially intermediaries

¹⁷⁰ *Id.* at 36.

¹⁷¹ *Id.* at 26.

¹⁷² *Supra* note 125 and accompanying text.

¹⁷³ *See* Executive Summary of Pellefigue, *supra* note 135.

¹⁷⁴ *See e.g.*, HM TREASURY, UNLOCKING DIGITAL COMPETITION, REPORT OF THE DIGITAL COMPETITION EXPERT PANEL (Mar. 13, 2019), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/785547/unlocking_digital_competition_furman_review_web.pdf (providing analysis of major tech companies as monopolies).

¹⁷⁵ *See infra* Part III.C.1.c.

¹⁷⁶ Rochet & Tirole, *supra* note 1, at 645.

between the user-buyers (consumers) and user-sellers (advertisers, merchants, etc.) of the market, and their main function is “to internalize the various external effects that the interaction between the two groups generate.”¹⁷⁷ Examples of two-sided platform firms include hardware & software systems like Mac OS, digital exchanges like Amazon, peer-to-peer marketplaces such as Airbnb and Uber, as well as digital media firms like YouTube, Facebook, and Google.¹⁷⁸ The interaction between the two sides of the market create cross-group externalities that rely on the effectiveness of the two-sided platform in facilitating the two groups interactions.¹⁷⁹

Essentially, two-sided platforms derive their success by maximizing profit through the facilitation of inter-group interactions that create externalities mainly derived from a quantity spillover from one side or group.¹⁸⁰ In order to optimally facilitate interactions, and thus maximize profits, the two-sided platform firms must adapt their pricing strategies to the demands of the different customer groups.¹⁸¹

The concept of two-sided markets is incredibly relevant to the implementation of the DST and the overall discussion over the tax avoidance of large digital multinational enterprises. The reason is that “[s]ome of these ‘digital platforms’ have exploited the self-reinforcing nature of network effects, together with global reach of the internet, to become dominant players in many countries. . . . These countries are well-known to generate very large profits but to pay, comparatively, very low effective corporate taxes.”¹⁸²

The large digital firms that appear to be the main target of the DST fit comfortably within the definition and dominating capability of two-sided

¹⁷⁷ Paul Bellaflamme & Eric Toulemonde, *Tax Incidence on Competing Two-Sided Platforms*, 20 J. OF PUB. ECON. THEORY 1, 2 (2017).

¹⁷⁸ *Id.*

¹⁷⁹ Rochet & Tirole, *supra* note 1, at 657; Mark Armstrong, *Competition in Two-Sided Markets*, 37 RAND J. ECON. 668, 668–69. Rochet & Tirole provide another, more explicit, definition of a two-sided market:

“We define a two-sided market as one in which the volume of transactions between end-users depends on the structure and not only on the overall level of the fees charged by the platform. A platform’s usage or variable charges impact the two sides’ willingness to trade once on the platform and, thereby, their net surpluses from potential interactions; the platforms’ membership or fixed charges in turn condition the end-users presence on the platform. The platforms’ fine design of the structure of variable and fixed charges is relevant only if the two sides do not negotiate away the corresponding usage and membership externalities.” Rochet & Tirole, *supra* note 1, at 646.

¹⁸⁰ Hans Jarle Kind et al., *Tax Responses in Platform Industries*, 62 Oxford Economic Papers 764, 765–766 (2010).

¹⁸¹ *Id.*

¹⁸² Bellaflamme & Toulemond, *supra* note 176, at 2.

platform firms.¹⁸³ These digital platforms have established their powerful economic presence through the internalization of cross-group externalities. Because these firms rely on externalities in order to determine prices and price structure, the typical incidence analysis attributed to one-sided markets does not cleanly apply. Most importantly, “two-sided platform firms may find it profitable to charge prices that are below marginal cost or even negative for one of its products (customer group). This is in contrast to conventional markets (one-sided) where marginal cost equal to marginal revenue pricing is well established as guidance.”¹⁸⁴

Recent literature on tax incidence of two-sided markets in the digital economy also shows mixed analyses. For example, Kind et al. used a digital media firm to discuss externalities in two-sided markets,¹⁸⁵ and found that an increase in an ad valorem tax, like the DST,¹⁸⁶ may possibly increase sales and reduce price with increased likelihood if the user-buyers consider the interaction with the user-sellers (such as advertisements) as a negative externality.¹⁸⁷ Similar findings resulted in an analysis focused on the hypothetical increase of an ad valorem tax rate on the user-buyer side, finding that the price charged on the user-buyer’s side fell following an increase in ad valorem tax rate.¹⁸⁸ The focus on a tax placed on the user-buyer side of a two-sided market may conceptually fits with the implementation of the DST, as the tax targets user participation, or user-buyer transactions in digital markets.¹⁸⁹

In contrast to these findings, Bellaflamme & Toulemonde found that an increased ad valorem tax imposed on one side of a two-sided market is born by the side the tax is levied on—that is, the platform itself—and any competing platforms, but that agents on the other side of the market are unaffected.¹⁹⁰ Additionally, empirical analysis by Eleanor Wilking found an increase in after-tax prices paid by consumers of Airbnb following the new obligation [of the user-sellers (individual hosts)] to remit the relevant tax to the digital firm.¹⁹¹ Wilking’s study provides real world analysis on the tax

¹⁸³ *Id.* at 2, n.1.

¹⁸⁴ Kind et al., *supra* note 179, at 767.

¹⁸⁵ *Id.* at 766.

¹⁸⁶ *Id.* at 787.

¹⁸⁷ *Id.* at 774–76.

¹⁸⁸ Sovik Mukherjee & Vivekananda Mukherjee, *Tax Incidence of Two Sided Monopoly Platforms* 25 (2017), <https://www.isid.ac.in/~epu/acegd2017/papers/SovikMukherjee.docx>.

¹⁸⁹ cite DST tax. (parenthetical speaking to user participation being user-buyer interaction on two sided markets)

¹⁹⁰ Bellaflamme and Toulemond, *supra* note 176, at 9.

¹⁹¹ Wilking, *supra* note 1, at 21.

incidence of two-sided markets and contends that the result is “consistent with low levels of voluntary compliance among individual hosts prior to implementation of mandatory withholding”¹⁹²

Such mixed conclusions of recent studies suggest that two-sided platforms may nonetheless follow the typical assumptions of tax incidence for one-sided markets, but may not hold true for all digital two-sided platforms as Airbnb’s pricing structure is not shared across the board.¹⁹³

c. Monopoly Power and Possible Cost Absorption

Another point worth to mull over is the monopolistic position of the digital platform firms, such as Google and Amazon. In a monopoly, firms are already extracting maximum profits in current supply-demand, so that the newly introduced tax will not pass on to the users.¹⁹⁴ In other words, the firms will absorb the tax incidence and will not raise the price. Applying this analysis to DST, if digital firms, such as Google and Amazon, will absorb the incidence of DST, then introducing DST is actually a good policy to exploit rent of multinational enterprises.

To simply explain, for taxes like the DST, which vary with the output, or in this case user participation, the incidence of the tax partially relies on the elasticity of the good or service.¹⁹⁵ Taxing the good or service would usually only result in an increase in price, effectively shifting the burden of the tax onto the consumers.¹⁹⁶ However, monopolies that produce goods or services with relatively elastic demands may instead decide to reduce price, absorbing the cost of the tax.¹⁹⁷ This decision results from the monopoly power that the firm exerts in the market. Because the monopoly firm is able to set a lower price than equilibrium level, the firm extracts supernormal profits derived from the consumer surplus.¹⁹⁸ Taxation of the firm’s profits results in a reduction of excess profits similar to the imposition of additional fixed costs.¹⁹⁹

However, analyzing the extent of the digital firms’ monopoly power and its possible implications on tax incidence is not easy. It requires extensive empirical research until policy makers find reasonable results. If, however,

¹⁹² *Id.*

¹⁹³ *See generally id.*

¹⁹⁴ *Effect of Taxes on Monopoly Equilibrium (With Diagram)*, ECONOMICS DISCUSSION, <http://www.economicdiscussion.net/monopoly/effect-of-taxes-on-monopoly-equilibrium-with-diagram/17081> (last visited Sept. 8, 2019).

¹⁹⁵ *Id.*

¹⁹⁶ *Id.*

¹⁹⁷ *Id.*

¹⁹⁸ *Id.*

¹⁹⁹ *Id.*

the digital economy subject to DST is indeed monopolistic, it is fair to ask whether the current French anecdote of tax incidence passing the economic burden to user-sellers is acceptable. It further raises questions, such as whether regulatory agencies should and could invoke a measure to adjust economic burden of DST, which is beyond the scope of this paper.

d. DST as a Consumption tax

Counter-intuitive to the description of the DST by the EU,²⁰⁰ the DST is “not structured as [a tax] on corporate profits.”²⁰¹ Corporate profits are equal to total revenue minus total cost, whereas the DST applies to revenue generated from user participation with the digital firms regardless of the cost similar to a turnover or excise tax.²⁰² Additionally, commentators expect that the distribution of the French DST’s tax burden is “similar to what would have been obtained with a consumption tax.”²⁰³

Still, the refined policy analysis on how to design a DST and what its tax incidence should be like is still at the early stage. The discussion above invites tax, economics, and public finance scholars to further study the tax incidence of DST. Above all things, one thing that has been clear by the discussion above is that, regardless of the normative discussions on the tax incidence of the DST, the function and form of the DST is essentially a consumption tax, and thus benefits from the same arguments of efficiency on the international stage already overviewed.

2. Why Not Other Types of Consumption Tax?

Another difficult question to design and implement DST as a

²⁰⁰ See *supra* notes 38–42 and accompanying text.

²⁰¹ Sean LOWRY, *supra* note 43, at 9.

²⁰² See *id.* at 9, 24; see also ACCOUNTING TOOLS, *supra* note 95. Turnover taxes are essentially one type of “indirect tax on private consumption expenditures.” Robert F. Van Brederode, *A Normative Evaluation of Consumption Tax Design: The Treatment of the Sales of Goods Under VAT in the European Union and Sales Tax in the United States*, 62 TAX LAWYER 1055, 1056 (2009). If not explicitly a turnover tax, the DST may also be considered an excise tax, which consist of “narrowly based taxes on consumption, levied on specific goods, services, and activities.” TAX POLICY CENTER, *What are the major federal excise taxes, and how much money do they raise?* <https://www.taxpolicycenter.org/briefing-book/what-are-major-federal-excise-taxes-and-how-much-money-do-they-raise> (last visited Aug. 31, 2019).

²⁰³ Pellefigue, *supra* note 135, at 27. *Cf.* However, the same report further expects that the cost of DST will be borne by all households equally, which has regressive features. *Id.*

consumption tax is whether there is a better type of consumption tax to pursue, such as DBCFT or VAT.

First, as to the VAT, it is worth noting that there is a huge debate on the notion of “value creation” in the digital taxation discourse.²⁰⁴ Where is the value created in the digital economy? In an example of Google, what factors of the digital economy contribute to Google’s value creation the most? Is it California where engineers have developed and are operating Google’s proprietary algorithm? Or is it the market countries where users fuel their data to the algorithm? The debate of value creation resembles the old debate on allocating tax revenue relating to extracting natural resources. Are the western multinationals with proprietary technology for extraction along with their residence countries the major contributor to the production of natural resources and thus deserve more share of tax revenue? Or are the source countries with natural resources on their soil the major contributor to the production and deserve more share of tax revenue? The discussion has been far from being fully resolved. In principle, source countries are entitled to primary tax jurisdiction on the rent from natural resources. In effect, however, they offer various tax breaks to attract foreign capital. International taxation could not solve the puzzle of value creation with respect to natural resources in the past. And it is likely that replacing a DST with a VAT may repeat the same problem as to measuring the tax base, or the value addition.

[It is also questionable whether the credit-invoice method would work well with the taxation on the digital economy with multi-sided platforms.]

Second, the DBCFT proposal offers a different set of problem. It was proposed during the US tax reform debate in 2017, but was ultimately rejected both by the EU and the US because they consider it too aggressive and contentious.²⁰⁵ Unlike VAT where exports are untaxed while imports are taxed, a DBCFT is conceptually easier to apply to cross-border business taxation. However, the DBCFT proposal would allow immediate expensing of costs, especially R&D expenditure, whereas the tax base of DST is gross

²⁰⁴ See Michael Devereux & John Vella, *Value Creation as the Fundamental Principle of the International Corporate Tax System*, EUROPEAN TAX POLICY FORUM (2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3275759; Johanna Hey, “*Taxation Where Value is Created*” and the OECD/G20 Base Erosion and Profit-Shifting Initiative, 72 BULLETIN INT’L TAXATION (2018); Susan Morse, *Value Creation: A Standard in Search of a Process*, 72 BULLETIN INT’L TAXATION (2018); Wolfgang Schön, *One Answer to Why and How to Tax the Digital Economy*, Max Planck Institute Working paper 2019-10 (2019).

²⁰⁵ See Daniel Shaviro, *Goodbye to All That?: A Requiem for the Destination-Based Cash Flow Tax* 10, NYU Law and Economics Research Paper No. 18-05 (2018); see also Janet Novack, *EU Wrong To Challenge Destination Based Cash Flow Tax*, FORBES (Mar. 29, 2017, 1:19 PM), <https://www.forbes.com/sites/janetnovack/2017/03/29/eu-wrong-to-challenge-destination-based-cash-flow-tax/>.

revenue without deducting any expenses.²⁰⁶ As a result, the DBCFT proposal would have significantly less reward the market jurisdiction than the DST proposal does. It is against the policy need to introduce DST to fully reward market countries.

Third and more fundamentally, neither VAT nor DBCFT would be a good policy to accomplish what the OECD’s three proposals aim to accomplish—that is, rewarding market jurisdictions that are likely get less than a fair share of tax revenue under the traditional nexus and profit allocation rules. That is because, tax consequences of both VAT and DBCFT follow the cash flow of the economy, but there is no cash flow between digital firms providing digital services and user-buyers located in market countries. Thus, the concept of “destination” in the DBCFT or VAT may not refer to the market jurisdiction where user-buyers are located. For example, assume that a German auto-manufacturing company offers a targeted online advertisement to the UK consumers through Google. The cash flow exists between the service provider (Google) and the user-seller (German auto-manufacturing company), and not between the service provider and the user-buyer (UK consumer). Thus, the destination jurisdiction in cash flow tax is where user-sellers are located—here, Germany. Then, the cash flow tax or DBCFT will allocate revenue to the destination jurisdiction (Germany), although the market jurisdiction, which all three OECD proposals aim to reward, is the UK where user-buyers are located. Given that there is no cash flow between service provider (Google in the US) and user-buyer (UK), how can we reward the market jurisdiction under the cash flow taxation? Thus, a pure cash flow taxation and VAT might not be a great means to reward the market jurisdiction after all.²⁰⁷

Also, a recent article by Bankman, Sykes, and Kane implies that a well-designed excise tax, which is another type of consumption tax, would be the best tool to extract rent of multinational enterprises.²⁰⁸ Considering excise tax being another type of consumption tax, Bankman et al.’s work is likely to be in line with this article’s attempt to construct a DST as a turnover tax.

²⁰⁶ [Discuss the zero marginal cost of the digital economy, and the implication of such zero marginal cost in consumption tax, not income tax.]

²⁰⁷ See Alan Auerbach et al, *Destination-Based Cash Flow Taxation* 9–13, Oxford University Centre for Business Taxation Working Paper 17/01 (2017), <https://eml.berkeley.edu/~auerbach/CBTWP1701.pdf>.

²⁰⁸ Joseph Bankman, Mitchell Kane & Alan Sykes, *Collecting the Rent: The Global Battle to Capture MNE Profits*, TAX L. REV. (forthcoming 2019).

3. Overcoming the Ring-Fencing Problem

The next issue to explore is how to overcome the problem created by the ring-fencing, or segregating, of certain digital business models [and the discrimination problem]. In the UK DST example, search engines, social media platforms, and online marketplaces are within the scope of DST, but certain regulated financial and payment services, the provision of online content, sales of software/hardware, and television or broadcasting services are excluded. Thus, Facebook, Twitter, YouTube, Google, Amazon Marketplace, Kayak, Priceline, Uber, and Airbnb are in scope, whereas PayPal, Netflix, Hulu, Spotify, and Ubisoft are excluded.²⁰⁹

The rationale of the current line drawn between the two groups is that the policymakers envision a fundamental difference between the two business models.²¹⁰ Lifting the ring-fence may inadvertently and unexpectedly distort the market, especially when the ring-fencing occurs due to the specific need to distinguish one market from another.²¹¹ However, it is still unclear whether YouTube or LinkedIn are considered a social media platform subject to a DST or a digital interface providing digital content, which is not subject to a DST, especially when considering YouTube and LinkedIn's premium service. Also, Spotify and Hulu are currently not subject to a DST, because they are classified as content providers, but they raise another line-drawing question when they offer free or discounted services to users who do not subscribe to their respective premium services but are then exposed to advertisements. These line-drawing questions, which questionably subject one company, such as YouTube, to a DST and exempts another similar company, such as Spotify, illustrate the need to thoroughly review and question this distinction.

In order to reasonably consider these line-drawing questions, it is important to examine whether there are fundamental differences between the in-scope and out-of-scope business models. To do this, let us compare companies that are in-scope, such as YouTube, with companies that are out-of-scope, such as Netflix and Spotify, noticing that all three platforms offer online content.

According to Alphabet Inc.'s annual report, Google and its subsidiary

²⁰⁹ Cui, *Conceptual Defense*, *supra* note 2, at 8–9.

²¹⁰ See HM TREASURY, BUDGET 2018 DST, *supra* note 48; see also HM TREASURY, CORPORATE TAX AND THE DIGITAL ECONOMY: POSITION PAPER 15–16 (2017), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/661458/corporate_tax_and_the_digital_economy_position_paper.pdf; HM TREASURY, DST, *supra* note 46, at 9–19, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/816389/DST_response_document_web.pdf

²¹¹ Bankman et al., *supra* note 207, at 14–18.

YouTube derive the majority of their revenue—i.e., 85% of their revenue in 2018—from advertisement.²¹² While YouTube primarily derives revenues from the use of engagement advertisements,²¹³ it generates some non-advertising revenue through the means of YouTube subscriptions, such as YouTube Premium, YouTube TV, and Channel Membership.²¹⁴

In contrast, Netflix is solely a content provider. Netflix is the largest internet entertainment service with over 139 million paid memberships, as of January 2019, located throughout 190 countries.²¹⁵ Netflix offers digital content, such as feature films, television shows, and documentaries, which are either originally created by Netflix or licensed to Netflix from other studios.²¹⁶ Unlike other streaming services, Netflix does not offer any commercials and derives no revenue from paid advertisers.²¹⁷ And most importantly, it does not provide users the ability to share content and does not anticipate making its original content available for free to all users who choose to watch advertisements.

With respect to the categories of contents provided through YouTube, one may discover three different types of contents: (1) contents posted by professionals attempting to reach a wide audience, (2) contents posted by amateurs for a small audience, and (3) YouTube’s original contents offered only to the subscribers of YouTube Premium or other subscription-based services. This third category of YouTube’s original contents is analytically difficult to distinguish from the business model of Netflix as a “content provider.” However, while YouTube Premium is one small section of YouTube’s service, YouTube intends to make its original content free to all users beginning in September 2019. Non-subscribers will be subject to advertisements. Therefore, while YouTube is in part a content provider, its

²¹² Alphabet, Inc., Annual Report (Form 10-K) 4, 7 (Feb. 4, 2019).

²¹³ Specifically, YouTube generally generates revenue through the use of “engagement ads.” *Id.* at 27. Advertisers pay YouTube when a user clicks on the advertisement. *Id.* This is referred to as “cost-per-click,” because it is a click driven revenue. *Id.* However, YouTube’s engagement ads “monetize at a lower rate than traditional desktop search ads.” *Id.* at 5. YouTube’s cost-per-click is lower than other Google platforms. *Id.* YouTube’s advertising comes in the form of (1) embedded advertisements, (2) home page advertisements, and (3) sponsored videos. First, embedded advertisements are advertisements that are shown immediately before, immediately after, and sometimes during videos played on the service. Second, home page advertisements are advertisements that are shown on YouTube’s home page. Third, sponsored videos are videos that advertisers pay to YouTube to have their video appear higher in the results page of a user’s search. [cite]

²¹⁴ *Id.* at 25.

²¹⁵ Netflix, Inc., Annual Report (Form 10-K), at 1 (Jan. 29, 2019).

²¹⁶ *Id.*

²¹⁷ *Id.*

main or sole purpose is monetizing *user* content through the use of advertisements, whereas Netflix is solely a content provider.

Although one may find the above differences between YouTube and Netflix substantial enough to justify the current line between the two business models, it would be hasty to push ahead with such conclusion without comparing YouTube and Spotify, another out-of-scope content provider.

Spotify Technology S.A. (“Spotify”) is the largest global music streaming service with 207 million monthly-active-users and 96 million users paying for the Premium Service as of December 31, 2018.²¹⁸ Spotify makes up approximately 38% of the global streaming market share, with 34% of the streaming market share in the United States.²¹⁹ Spotify has two business segments: (1) Ad-Supported Service, a segment focused on monetizing the user base through paid advertising; and (2) Premium Service, which is a user paid, commercial-free, subscription service “with unlimited online and offline high-quality streaming access” to its catalog.²²⁰ The Ad-Supported segment allows users similar content but are subject to advertisements.²²¹ In 2018, Spotify’s Premium Service comprised 89.69% of its total gross revenue, earning approximately 4,717 million Euros.²²² Spotify’s Ad-Supported segment generated 542 million Euros.²²³

YouTube and Spotify have extremely similar business models and offer very similar products to their users. First, both of them offer a commercial-free premium service coupled with an ad-based service. Moreover, both services mainly license content from third-party providers that the service then distributes to the users.²²⁴ Additionally, both services pay their content providers based on the success of the content on the website.²²⁵

²¹⁸ Spotify Technology S.A., Annual Report (Form 20-K) 39 (Feb. 12, 2019).

²¹⁹ *Id.*

²²⁰ *Id.* at 7.

²²¹ *Id.* at 45.

²²² *Id.* at 48.

²²³ *Id.*

²²⁴ Spotify licenses most or all of its content from third parties. YouTube licenses most of its content from third parties. In YouTube’s Terms and Conditions, when a user uploads his/her own video, he/she “license[s] to YouTube all patent, trademark, trade secret, copyright or other proprietary rights in and to such Content for publication on the Service pursuant to these Terms of Service.” [cite] Therefore, YouTube is technically licensing content from third parties.

²²⁵ The content owner for both YouTube and Spotify have a financial interest in his/her content that is licensed to YouTube or Spotify. For example, Spotify pays a royalty fee to the content owner. The royalty fee is calculated on numerous factors, including “Premium and Ad-Supported revenue earned or user/usage measures.” Spotify Technology S.A., Annual Report (Form 20-K), at 54. Therefore, the licensor has a financial interest in the content doing well on the service. Similarly, third-parties licensing content to YouTube can be compensated based on the number of clicks their content generates. This is very similar to Spotify’s royalty fee to third parties. Therefore, third parties both receive compensation

A key difference between YouTube and Spotify is whether the majority of revenue derives from advertisements. Alphabet, Inc. generates 85% of its revenue from advertisements, whereas Spotify generates only 10% of its revenue from advertisements. However, given that both companies offer similar digital services, Premium Service and Ad-Based Service, it is implausible to argue that only Spotify qualifies as a content provider, which is exempt from DST, based only on the fact that most users choose to subscribe to the Premium Service, whereas YouTube users do not.

Another argument to justify the distinction is that YouTube allows users to upload their own content, whereas Spotify is more selective and only contracts with select parties to stream their content. Therefore, YouTube becomes more like a social media platform because multiple users can upload to the service. However, Spotify is involved in a new beta tool called “Spotify for Artists.” This is a feature that allows individual artists to upload their own original content. This is not currently available to the public yet, but if this feature is available to the public, it will make Spotify’s business model more difficult to distinguish from that of YouTube.

Part II.C. noted the practical problems with ring-fencing [and discrimination], but those problems will still need to be addressed and overcome eventually. A DST should not be used against big players. It is against the spirit of a level playing field. However, considering the policy need to adopt DST to reward market countries and the merits of DST for accomplishing such need, the ring-fencing problems should be addressed by eventually broadening the scope of specified types of businesses subject to DST [and lowering the threshold amount of revenue.] Perhaps, *Wayfair* and subsequent state legislations will offer insight on this issue, because state sales tax discussed in *Wayfair* also targets the digital economy, but these cases have done little to further the discussion on the ring-fencing or discrimination issues. However, it is noteworthy that more than 30 states have recently broadened their sales tax base by introducing a so-called “Netflix Tax” on digital content providers.²²⁶ The fact that one type of consumption

from Spotify or YouTube. [what about location?]

²²⁶ The “Netflix Tax” is a sales and use tax imposed on the digital streaming of shows, movies, music, and games. The content providers, such as Netflix, Hulu, and Spotify, that are excluded from DST are subject to the Netflix Tax. Currently, the list of states and cities imposing the Netflix Tax is as follows: Alabama, Arizona, Arkansas, Chicago, Colorado, Connecticut, Florida, Hawaii, Indiana, Iowa, Louisiana, Maine, Minnesota, Mississippi, Nebraska, New Jersey, New Mexico, Ohio, Pennsylvania, Rhode Island, South Dakota, Tennessee, Texas, Utah, Vermont, Washington, Wisconsin, Wyoming, and Washington D.C. Gail Cole, *State-by-State Guide to the Taxability of Digital Products*, AVALARA (Feb. 20, 2019), <https://www.avalara.com/us/en/blog/2019/02/state-by-state-guide-to-digital->

tax, or DST, excludes digital contents providers from its scope, whereas another type of consumption tax, state sales tax, includes the same business within its scope, only confirms that current line-drawing of DST is arbitrary and needs to be improved.

4. Barter Transactions in Consumption Tax

Final issue that requires deeper exploration is the tax consequences of barter transactions in the context of consumption tax. As Chip Harter commented in his recent statement, some commentators interpret that user-buyers are unrelated parties whose input is purchased on barter basis for a free service. Such explanation makes sense if we focus on the relationship between service-providers and user-buyer side, and it will become more important given that those data would contribute to the development of artificial intelligence and machine learning technology. Thus, it is critical to explore whether constructing the multi-sided digital transaction as a combination of physical cash flow and barter transaction would result in a new chapter of digital tax discourse. [To discuss the EU discussion on the tax consequences of barter transactions in the consumption tax context.]

CONCLUSION

There will be a multilateral taxing approach at the end of 2020. Correctly allocating taxation is an important issue that many countries have been anticipating. Thus, once it is on the table, they are not going to walk away. But the timeline is too tight, considering that the issue on the table will result in the fundamental overhaul of the international tax rule that has been procrastinated for about one hundred years. The agenda on the table is not just about digitalization, but rather the 21st century economy as a whole, which is different from the brick and mortar economy in the 20th century. Furthermore, the agenda also gives an opportunity to consider an updated debate on consumption tax versus income tax in the 21st century economy. This requires serious academic research for extended period of time that this paper aims to initiate.

products-and-sales-tax.html. However, the specific tax imposed by each state within the category vary widely.

APPENDIX: OECD PROPOSALS

In order to further understand the various proposals discussed by the OECD arising from the BEPS project, it is helpful to consider how each of the proposals would apply to a certain hypothetical business, Group X.²²⁷

Hypothetical 1

Group X is a multinational corporation that provides digital content streaming through a service called StreamFlix. StreamFlix offers customers TV shows, movies, documentaries, and other forms of digital streaming. Group X's customers pay a monthly subscription for access to StreamFlix. Group X is highly profitable, earning substantial non-routine profits.

P Co is the parent company of Group X, residing in Country 1. P Co generates routine profits. Furthermore, it owns all the intangible assets used for StreamFlix and is entitled to all Group X's non-routine profits.

H Co is a subsidiary of P Co, located solely in Country 2, and is responsible for marketing, facilitating, and distributing StreamFlix in Country 2. H Co sells StreamFlix directly to customers in Country 2. H Co generates only routine profits.

Additionally, H Co has begun to sell StreamFlix remotely to residents in Country 3, where neither H Co nor Group X has any physical presence.

[Table 1]

	Country 1	Country 2	Country 3
P Co	Physical Presence	N/A	N/A
H Co	N/A	Physical Presence	N/A

Hypothetical 2

All facts are the same as Hypothetical 1, except that Group X owns and operates a web-based search engine service, rather than operating a streaming service.

²²⁷ The hypothetical examples in this Appendix are almost identical to an illustration in the OECD, UNIFIED APPROACH, *supra* note __, at 11 (2019), which only offers the tax consequences under the unified approach. The author analyzes the tax consequences under the various other proposals suggested by the OECD during 2019.

The tax consequences under the various proposals will be discussed below. The result is summarized in Table 2.

A. Current Rules

Current nexus rules require that a business have a physical presence in a country for that country to assert a taxing right over any profit of the business. Then, cross border transactions between two affiliated entities will be treated under the arm's length standard. The arm's length standard requires an objective look at other relevant entities within the industry to determine the cost of these transactions and allocate the profits appropriately to each country. Therefore, here is how Group X's profits would be taxed in each country in both hypotheticals:

- Country 1: All of P Co's profits.
- Country 2: All of H Co's Profits.
- Country 3: Nothing. Group X has no physical presence in Country 3.

This scenario highlights the problems with the current nexus and profit allocations rules when taxing the digital economy, because Country 3 is not able to assert any taxing right over Group X, although there is a large customer base of StreamFlix (Hypo 1) or search engine service (Hypo 2) located there. As such, the OECD has proposed the following proposals that would potentially improve the outcomes.

B. February-March 2019 Proposals

The Public Consultation Document released in February-March 2019 offers three proposals as follows.

1. User Participation Proposal

This model is premised on the idea that soliciting the sustained engagement and active participation of users is a critical component of value creation for certain highly digitalized businesses. The activities and participation of these users contribute to the creation of the brand, the generation of valuable data, and the development of a critical mass of users which helps to establish market power. Consequently, it targets certain highly digitalized businesses, such as social media platforms, search engines, and online marketplaces, whose success is largely dependent on the participation of users.

This proposal seeks to modify the current arm's-length principle in favor of a non-routine or residual profit split approach and allocate profit based on the location of the businesses' active and engaged user base, regardless of

physical presence. The proposal argues that a residual or non-routine profit split would better capture value created by users in market jurisdictions.

The proposal would generally consist of four steps: (1) determine the residual or non-routine profit of the business; (2) determine the portion of those profits that are produced from the value created by user activities; (3) allocate those profits among the different jurisdictions in which the business has users; and (4) allowing those jurisdictions the taxing right over those profits, regardless of physical presence.²²⁸ To streamline the implementation, many of these determinations would rely on formulas for determining appropriate amounts, including non-routine profits and percentages determined to be user created value.²²⁹ Finally, “routine profit” is allocated under the current transfer pricing guidelines.²³⁰ However, certain challenges may arise with this proposal largely based on the difficulties of calculating routine and non-routine profits, and its heavy reliance on formulas to approximate the value of users.

Hypothetical 1:

Group X’s tax liability is the same as the one under current rules. The User Participation Proposal only targets (1) social media platforms, (2) search engines, and (3) online marketplaces. This is because these highly digitalized business models depend heavily on their user bases to add value to the business. In contrast, Group X offers a streaming service, StreamFlix. Although it is highly digitalized, its *value* is not dependent on its users. Rather, its *revenue*, like most other businesses, is dependent on its users. Therefore, Group X is outside the scope of the User Participation Proposal. As such, there is no change in Group X’s tax liability.

Hypothetical 2:

Under the User Participation Model, unlike a streaming service, a web-based search engine service is one of the types of highly digitalized business models that this proposal targets. Therefore, Group X must bifurcate its profits into routine and non-routine. It then must determine the portion of its non-routine profits are created by user activities in Countries 1, 2, and 3. This amount will then be allocated among the different countries.

²²⁸ 10-11

²²⁹ 11.

²³⁰

- Country 1: Retains P Co's routine profits and a portion of P Co's non-routine profits based on the value contributed by Group X's users located in Country 1.
- Country 2: Retains H Co's routine profits and receives a portion of P Co's non-routine profits based on the value contributed by Group X's users located in Country 2.
- Country 3: Receives a portion of P Co's non-routine profits based on the value contributed by Group X's users located in Country 3.

NOTE: The User Participation Proposal is the only proposal that offers different consequences in Hypotheticals 1 and 2. The tax consequences under the other proposals remain the same in Hypotheticals 1 and 2.

2. Marketing Intangibles Proposal

Second is the Marketing Intangibles Proposal supported by the United States. Similar to the User Participation Proposal, this proposal distinguishes between multinational enterprises' non-routine or residual profit from routine profit, and would modify current profit allocation and nexus rules to allow market jurisdictions the taxing right over certain non-routine profits, regardless of physical presence. However, this proposal further requires the division of non-routine profit into that attributable to market intangibles²³¹ and that of trade intangibles.²³² Moreover, this proposal broadens the scope from the User Participation Proposal to apply to more multinational enterprises than certain highly digitalized businesses.

This proposal also includes a number of steps to determine the amount to be taxed under this new proposal, which includes: (1) determining the relevant profit; (2) determining routine functions and their compensation, which can be done by either full transfer pricing or a mechanical approach using a mark-up on costs or on tangible assets; (3) deducting routine profit from total profit, this can be done through cost based methods or a formulaic approach; and (4) dividing the remaining "residual" profit among the market jurisdictions, this would likely be done through an agreed upon metric such

²³¹ The OECD defines the term Marketing Intangible as "*an intangible . . . that relates to marketing activities, aids in the commercial exploitation of a product or service and/or has an important promotional value for the product concerned. Depending on the context, marketing intangibles may include, for example, trademarks, trade names, customer lists, customer relationships, and proprietary market and customer data that is used or aids in marketing and selling goods or services to customers.*" OECD TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS 27 (2017)

²³² Trade Intangibles generally arise from substantial, observable activities arising in a specific location. Pg. 13.

as sales or revenues. All other routine and non-routine profit (e.g., attributable to tech-related intangibles generated by R&D, or to routine functions such as distribution) would continue to be allocated based on existing profit allocation principles.²³³ This proposal also presents significant challenges, including the obscure definition of a Marketing Intangible making it difficult for multinationals to calculate taxable profits attributable to any given market jurisdiction, and it also departs from the traditional arm's-length principle, therefore making it difficult to satisfy the DST advocates.

In both Hypotheticals 1 and 2, Group X would have increased tax liability in Countries 2 and 3. The Marketing Intangibles Proposal requires Group X to divide its routine and non-routine profits. It then further requires Group X to determine which non-routine profits are attributable to its marketing intangibles and their attendant risks. This profit is then allocated to relevant market countries.

- Country 1 – Retains right to tax routine profits and non-routine profits related to trade intangibles from P Co.
- Country 2 – Increased taxing right because it will be treated as a market country for P Co, and therefore, will be attributed certain non-profits generated from P Co / Group X's marketing intangibles. Will also retain profits to H Co for its routine activities conducted in Country 2.
- Country 3 – Increased taxing right because it will also be treated as a market country for Group X. It will be attributed a certain pre-determined percentage of the non-routine marketing intangibles profit of Group X.

3. Significant Economic Presence

Third is the Significant Economic Presence Proposal. Many developing countries, such as G24, endorse this proposal. It aims to reward market jurisdictions by abandoning the traditional residency-based nexus rules in favor of an economic nexus rule, which includes digital presence. In other words, it adopts a formulary apportionment approach where the tax base is computed by applying the global profit rate of the multinational enterprise group to the revenue generated in a particular jurisdiction, and such tax base is allocated based on apportionment factors, such as sales, assets, employees, and importantly, users. It targets a wider scope than either of the User

²³³ See Itai Grinberg, *International Taxation in an Era of Digital Disruption: Analyzing the Current Debate*, 97 TAXES 111–12 (2019), for a distinction of residual profit from routine profit.

Participation or Marketing Intangibles proposals.

In this case, under this new Significant Economic Presence, Group X and P Co may be deemed to have a “significant economic presence” in Countries 2 and 3. Assuming that Group X is deemed to have a significant economic presence in Countries 2 and 3, a certain percentage of Group X’s profits would be attributed to Countries 2 and 3, depending on a certain agreed upon formula, based mostly on various allocation keys, such as the volume of digital content derived from the jurisdiction, billing and collection in local currency, sustained marketing and sales promotion activities, etc.

- Country 1 – Retains profits for P Co, but taxing right will likely be decreased because it will be allocated based on the allocation keys.
- Country 2 – Retains profits from H Co and gains certain profits from P Co based on the allocation keys.
- Country 3 – Gains profits from P Co determined by the allocation keys.

NOTE: This scenario assumes that Group X and P Co are deemed to have a significant economic presence in Countries 2 and 3. The criteria for finding a significant economic presence has yet to be determined. Moreover, the allocation keys dividing profit among various countries where the multinational enterprise has a significant economic presence is also yet to be determined.

C. May 2019 Proposals

Despite the differences across the above three proposals in February/March 2019 document, all proposals allocate more taxing rights to market jurisdictions where users and customers are located. They also contemplate the existence of a new nexus of such market jurisdictions even if the enterprises have no physical presence. Thus, in May 2019, the OECD/G20 working group released the Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalization of the Economy (“Programme of Work”).²³⁴ The primary goal of this document, as the title suggests, is to develop a consensus-based solution to the taxation of the digital economy. It further clarifies that the three proposals under Pillar 1 should distinguish the solution for new nexus rules that determine which country has jurisdiction to tax non-resident enterprises, from the new rules allocating taxing rights that determine the relevant share of the profits that will be subject to taxation of a country that has nexus.

²³⁴ OECD, PROGRAMME OF WORK TO DEVELOP A CONSENSUS SOLUTION TO THE TAX CHALLENGES ARISING FROM THE DIGITALISATION OF THE ECONOMY (May 29, 2019) [hereinafter OECD, 2019 PROGRAMME OF WORK].

On nexus rules, market jurisdictions will have the right to tax even in the absence of nexus. On the new profit allocation rules, the Programme of Work introduces the same three proposals under different names: the distribution-based approaches, modified residual profit split method, and fractional apportionment method, respectively. They are slightly different from the February-March proposals, as explained below.

1. Modified Residual Split Method

The Modified Residual Profit Split Method allocates portions of a multinational enterprise's non-routine profits to a market jurisdiction. It is similar to the Marketing Intangibles Proposal, but it eliminates the distinction of a Marketing Intangible entirely. It generally involves four steps: (1) determine the total profit that must be split; (2) extract routine profits from non-routine profits; (3) determine the certain in-scope non-routine profit that should be allocated; and (4) allocate such in-scope non-routine profits to the relevant market jurisdictions, which is determined by an allocation key. Steps two and three will be determined either by using current transfer pricing guidelines or other simplifying conventions.

In both hypotheticals, this method will require Group X to bifurcate total profit into routine and non-routine. Certain non-routine profit will then be attributed to relevant market jurisdictions based upon possible allocation keys.

- Country 1 – Retains routine profits and certain out of scope non-routine profits from P Co.
- Country 2 – Will increase tax revenue because it will be treated a market country for P Co, and therefore, will be attributed certain non-profits generated from P Co / Group X's in scope non-routine profits. Country 2 will also retain profits to H Co for its routine activities conducted in Country 2.
- Country 3 – Will increase tax revenue because it will also be treated as a market country for Group X. It will be attributed a certain pre-determined percentage of the in scope non-routine profit of Group X.

2. Fractional Apportionment Method

The Fractional Apportionment Method does not distinguish between routine and non-routine profit. Rather, this method contemplates an agreed upon metric to determine the total amount of profit to be divided, and then certain

formulas / allocation keys that will divvy the profit to the relevant market jurisdictions. This method is similar to the Significant Economic Presence Proposal, but it carves out the tax nexus discussion from its proposal and only focuses on the profit allocation rules. This method would generally consist of three steps: (1) determine the profit to be allocated; (2) select an allocation key; and (3) apply the formula to determine the profit allocated to the market jurisdiction. The factors in the formula may include employees, assets, sales, and importantly, users.

- Country 1 – Retains profits for P Co but the allocation will be determined based on the allocation keys.
- Country 2 – Retains profits from H Co, and may gain certain profits from P Co based on allocation keys if determined that P Co has a nexus in Country 2.
- Country 3 – May gain profits from P Co if determined to have nexus, and profit allocated will be based on allocation keys.

3. Destination Based Methods

The Programme of Work also considered various Distribution-Based Approaches to serve the demand for simplicity and administrability for determining nexus and profit allocation. However, it is not clear how this approach would be developed. One approach could have been to specify a baseline profit in the market jurisdiction or marketing, distribution, and user-related activities, which then could be modified by other variables, such as industry and market differences. In contrast to the Modified Residual Profit Split method, this mechanism would effectively allocate some routine profits associated with marketing and distribution activities in addition to non-routine profits to market jurisdictions.

- Country 1 – Retains P Co's total profit *less* baseline profit allocated to Countries 2 and 3 below.
- Country 2 – Retains profits from H Co and may gain baseline profit from P Co (including both routine and non-routine profit) in Country 2 for marketing, distribution, and user-related activities.
- Country 3 – May gain baseline profit from P Co (including both routine and non-routine profit) in Country 3 for marketing, distribution, and user-related activities.

D. October 2019: Unified Approach

After discussing the previous proposals, the OECD released the Secretariat Proposal for a "Unified Approach" for the new tax nexus and profit allocation rules to address the tax challenges of the increasingly

digitalized economy in October 2019. The proposal covers highly digitalized business models, but is increased in scope to include consumer-facing businesses. The Unified Approach creates 1) a new nexus rule, not dependent on physical presence and instead largely based on sales, and 2) a new profit allocation rule using a formulaic approach to determine a share of residual, or non-routine, profit allocated to market countries.

To be specific, the Unified Approach creates a three-tier mechanism for apportioning a multinational's profits into various countries. First, Amount A is the deemed residual profit or deemed non-routine profit, which gets allocated among the various market countries even when an enterprise does not have a physical presence. Second, if the enterprise has a traditional tax nexus, such as physical presence, in a market country, additional amount—i.e., Amount B—attributed for baseline marketing and distribution functions may further be allocated to that country under current rules for transfer pricing and permanent establishment. Third, there might be a case where the market country argues that they may seek to tax an additional profit in excess of Amount B—i.e., Amount C—due to extra functions in that country. Then, the dispute over Amount C between the market country and the taxpayer should be subject to a legally binding and effective dispute prevention and resolution mechanism.

In both hypotheticals, Group X would have increased tax liability in Countries 2 and 3, each of which will have the gained taxing right over non-routine residual profits (Amount A) from Group X and P Co. Amount A will be distributed among the various marketing countries in which Group X has a taxing nexus. Amount B will continue to be taxed in the country in which those physical activities take place. Then, if any country believes they are entitled to more tax, they may undertake a dispute which may entitle them to Amount C.

- Country 1 – Retains right to tax a portion of P Co's non-routine or residual profits (Amount A) and will also retain the right to tax P Co's traditional marketing and distribution activities (Amount B).
- Country 2 – Will receive the right to tax a portion of P Co's non-routine or residual profits (Amount A) and will also retain the right to tax H Co's traditional marketing and distribution activities (Amount B).
- Country 3 – Will receive the right to tax a portion of P Co's non-routine or residual profits (Amount A).

	(i.e., all profits)								(Amount B)
Country 3	<u>P Co:</u> <ul style="list-style-type: none"> • None 	<u>P Co:</u> <ul style="list-style-type: none"> • None 	<u>P Co:</u> <ul style="list-style-type: none"> • Part of non-routine profits based on value of Country 3's users 	<u>P Co:</u> <ul style="list-style-type: none"> • Percentage of non-routine of marketing intangibles 	<u>P Co:</u> <ul style="list-style-type: none"> • Amount (w/o distinction b/w routine and non-routine profits) allocable to Country 3 determined by formulaic allocation keys (Note: user is a factor of the formula) 	<u>P Co:</u> <ul style="list-style-type: none"> • Percentage of non-routine profits from in-scope activities in Country 3 	<u>P Co:</u> <ul style="list-style-type: none"> • Amount (w/o distinction b/w routine and non-routine profits) allocable to Country 3 determined by formulaic allocation keys (Note: user is a factor of the formula) 	<u>P Co:</u> <ul style="list-style-type: none"> • Baseline profit (including both routine and non-routine profit) in Country 3 for marketing, distribution, and user-related activities (Note: Rules providing a baseline amount of profit to be developed later) 	<u>P Co:</u> <ul style="list-style-type: none"> • Percentage of non-routine profits (Amount A)
	<u>H Co:</u> <ul style="list-style-type: none"> • None 	<u>H Co:</u> <ul style="list-style-type: none"> • None 	<u>H Co:</u> <ul style="list-style-type: none"> • None 	<u>H Co:</u> <ul style="list-style-type: none"> • None 	<u>H Co:</u> <ul style="list-style-type: none"> • None 	<u>H Co:</u> <ul style="list-style-type: none"> • None 	<u>H Co:</u> <ul style="list-style-type: none"> • None 	<u>H Co:</u> <ul style="list-style-type: none"> • None 	<u>H Co:</u> <ul style="list-style-type: none"> • None