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The Digital Services Tax: A Conceptual Defense

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Abstract: As 2018 nears its end, a digital service tax (DST) seems imminent in Europe, yet elaborations of the DST's motivations have so far come primarily from the European Commission and the UK Treasury: academic and practitioner commentators remain largely skeptical. This paper offers a new conceptual defense of the DST that is independent of the existing government positions. I argue that a clear case can be made for the DST as a way of taxing location-specific rent earned by digital platforms. While the DST may also be partially motivated by other, potentially conflicting visions for reforming international taxation, such as destination-based apportionment or greater protection of the "source-based" taxing rights, the justification in terms of taxing location-specific rent both is distinct from and arguably offers a more compelling fit with the current policy focus of European governments than these other visions.

Conceiving of the DST as a tax on location-specific rent allows principled replies to its critics. Two of the most prominent critiques point to the DST's character as a turnover tax, and the fact it is not coordinated through the renegotiation of income tax treaties. With respect to the first critique, it can be countered that digital platforms enjoy low marginal costs of production, implying that the difference between taxing revenue and taxing profit is small. The fact that many platform companies potentially subject to the DST are in fact loss-making does not make the DST inefficient; indeed, the DST may enhance efficiency by deterring excessive entry and market fragmentation in natural monopoly contexts. With respect to the second critique, it can be argued that a tax on location specific rent requires less coordination through tax treaties since a deduction for DST paid would leave an appropriate corporate tax base for other countries. Moreover, it is unlikely that traditional profit attribution methods under tax treaties would help with the identification of location specific rent (and the consequent allocation of taxing rights). Therefore it is unclear that treaty-based coordination would improve the efficiency of the tax.

A conception of the DST as a tax on location-specific rent, however, is in tension with certain specific features of the EC's DST proposal, as well as the EC view that a "long-term solution" that relies on the concept of significant digital presence (SDP) is superior. The conceptual defense of the DST offered in this paper thus casts a new light on both sides of the debate.

Keywords: digital services tax, international taxation, significant digital presence, location-specific rent, digital platforms.

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Introduction

Do digital platforms, operated by multinational companies (MNCs), give rise to new profit tax bases? Do they support new claims to, or new desirable international allocations of, taxing rights with respect to MNC profits? Within the last year, these questions have been forcefully raised by bold proposals advanced by the European Commission (EC)¹ and the UK government.² Both the EC and the UK's HM Treasury called for the international community to explore a "long-term solution" to reforming international taxation, such that taxing right over MNC profits would be reallocated to reflect the value contributed by users of digital platform. They also both announced the intention to adopt "interim solutions" that do not require international consensus and that allow the current framework of tax treaties to stay in place. These interim solutions deploy taxes imposed on revenues from digital services and are meant to prod nations into multilateral action. The proposed interim taxes bear resemblances to turnover taxes already levied on cross-border advertising and digital revenues in France, Hungary and a number of other countries,³ and therefore the threat of their imposition is highly credible. As of October 2018, the EU appears fiercely divided, even as a large number of Member States push for the adoption of the interim solution by the end of 2018.

Reactions among both practitioners and academics to the EC and UK proposals have been predominantly negative.⁴ The proposals are often branded as populist,⁵ financially expedient,⁶ or worse,⁷ as though no sound policy justification could possibly be offered for them. In addition to Ireland and Malta (low-tax jurisdictions that aspire to attract MNCs), Denmark, Sweden, and Finland have expressed explicit opposition to the EC proposal, and did so remarkably in the name of the existing

¹ *Proposal for a Council Directive Laying down Rules relating to the Corporate Taxation of a Significant Digital Presence*, EUR COMM'N COM (2018) 147 final (Mar. 21, 2018) (hereinafter "EC Long-Term Proposal"); *Proposal for a Council Directive on the Common System of a Digital Services Tax on Revenues Resulting from the Provision of Certain Digital Services*, EUR COMM'N COM(2018) 148 final (Mar. 21, 2018) (hereinafter "EC DST Proposal")

² HM TREASURY, CORPORATE TAX AND THE DIGITAL ECONOMY: POSITION PAPER, Nov. 2017 (UK) (hereinafter "UK 2017 Paper"); HM TREASURY, CORPORATE TAX AND THE DIGITAL ECONOMY: POSITION PAPER UPDATE, Mar. 2018 (UK) (hereinafter "UK 2018 Paper")

³ EC DST Proposal, at 3 (unilateral measures for digital service taxation "are in place or are concretely planned in 10 Member States"); Joe Kirwin, *EU Races to Solve Issues Hampering Digital Tax Proposal*, BLOOMBERG INT'L TAX (Sept 10, 2018) (eleven EU Member states already are planning or have adopted their own version of DST); Freshfields: Tax Reform in the Digital Economy: Recent OECD and Commission Activity.

⁴ See, e.g. CLIFFORD CHANCE, *Missing the Target? The Surprising Scope of the Proposed New EU Digital Services Tax*, Mar. 2018; Helge Sigurd Næss-Schmidt et al, *The Proposed EU Digital Services Tax: Effects on Welfare, Growth and Revenues*, COPENHAGEN ECONOMICS (Sept. 2018); CFE TAX ADVISERS EUROPE, *Opinion Statement FC 1/2018 on the European Commission Proposal of 21 March 2018 for a Council Directive on the Common System of a Digital Services Tax on Revenues Resulting from the Provision of Certain Digital Services* (May 2018).

⁵ Johannes Becker & Joachim Englisch, *EU Digital Services Tax: A Populist and Flawed Proposal*, KLUWER INT'L TAX BLOG (Mar. 16, 2018), <http://kluwertaxblog.com/2018/03/16/eu-digital-services-tax-populist-flawed-propos-al/>.

⁶ Gary Clyde Hufbauer & Zhiyao (Lucy) Lu, *The European Union's Proposed Digital Services Tax: A De Facto Tariff*, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS (Jun. 2018).

⁷ Bloomberg Editorial Board, *Europe's Digital Tax is a Bad Idea*, BLOOMBERG (Apr. 10, 2018), <https://www.bloomberg.com/view/articles/2018-04-11/europe-s-digital-tax-is-a-bad-idea> ("Doing nothing would be better than this").

international tax paradigm, which the EU and UK directly criticize as inadequate.⁸ In light of this opposition, the OECD has taken a neutral view, advocating for greater time for deliberation and consensus building, without immediately rejecting the soundness of the EC and UK's approach.⁹

There is, however, growing public recognition that digital platforms display distinctive economic characteristics. These include, at the minimum, (i) network effects that generate market power, (ii) two- or multi-sided business models that involve complex pricing choices in profit maximization, (iii) negligible marginal cost, and (iv) geographic mobility in the location of service delivery and profit recognition. The core intellectual question about digital service taxation is whether these economic characteristics of digital platforms give rise to new profit tax bases and new ways of allocating such tax bases among countries that have normative appeal. If the answer is yes, and especially if there are good reasons to believe that businesses demonstrating such characteristics will become even more important to the global economy in the future, the new digital service taxation proposals would possess ample policy motivation. That they may be politically or fiscally expedient is beside the point from the perspective of tax policy design.

In this paper, I abstract from the EC and the UK's particular policy formulations and canvas broader economic efficiency arguments that may be constructed to support a digital service tax (DST). I show that there is a variety of plausible arguments in favor of a DST: dismissive criticisms directed against it miss some of its most basic and obvious rationales. Rather than whether such a tax has *any* adequate justification, a topic worthier of discussion is what might be the best design of such a tax—which depends on how its expected welfare effects vary according to its design and to the presence or absence of international coordination. In short, there are reasons to think that the statement of Pierre Moscovici, the EU Taxation Commissioner, that “digital taxation is no longer a question of ‘if’ – this ship has sailed”¹⁰ is apt not only politically, but also intellectually.

Interestingly, although both the EC and the UK proposals suggest that a multilateral agreement on taxing profits from digital platforms is superior to unilateral taxes imposed on turnover, the reason of such presumed superiority is not obvious. For example, if digital platforms generate revenue at zero or negligible marginal cost, then there is little difference between taxing marginal profits and taxing revenue. The latter may therefore not distort pricing or production decisions. Whether it distorts investment decisions in a way that reduces welfare is also open to debate. Moreover, while some forms of international tax design may best be implemented on a multi-lateral basis, this is not always the case. Therefore, while there is much that we still do not know, theoretically or empirically, about the optimal design of taxes on digital platforms, there is also little, I will argue, that should lead one to dismiss even the short-term solutions contemplated by the EC and the UK.

There is one distinction between the long-term and the short-term solutions currently under discussion, however, that has little to do with optimal tax design: the long-term solution aims to revise the tax treaty framework to accommodate profit taxes on digital platform companies, whereas the

⁸ MINISTRIES OF FINANCE, GLOBAL COOPERATION IS KEY TO ADDRESS TAX CHALLENGES FROM DIGITALIZATION, June 1, 2018 (Sweden, Denmark, Finland) <https://www.government.se/statements/2018/06/global-cooperation-is-key-to-address-tax-challenges-from-digitalization/>

⁹ OECD, *Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, OECD PUBLISHING, 2018 (hereinafter OECD 2018 Report).

¹⁰ *Keynote Speech by Commissioner Moscovici at the ‘Masters of Digital 2018’ Event*, EUR COMM’N SPEECH/18/981 (Feb. 20, 2018). Desmond to find cite

short-term solution designs the DST to be compatible with the current tax treaty framework. This issue of treaty compatibility is purely legal, and its policy importance is ambiguous, but it plays a surprisingly prominent role in the politics of international tax reform. With respect to this aspect of the current debate, this paper will argue that two irrational pieces of treaty ideology need to be jettisoned. The first is a blind, indeed perverse, instinct to broaden the coverage of tax treaties (through the interpretation of Article 2), which constrains the space within which countries can unilaterally design optimal taxes. The second is a fixation on modifying the “permanent establishment” concept, which masks the fact that this concept has at most an administrative purpose and has little intrinsic meaning. A change to using the concept of “significant digital presence”, or “virtual permanent establishment”, involves little more than the flip of a set of legal and administrative switches. The much more important issues of efficiency and fair allocation of corporate profit taxation cannot be addressed by that concept at all.

Overall, this article lays out three types of arguments in defense of the DST. The first is that it possesses ample motivation (which is not the same as saying that any particular version of the tax is well designed). The second is that while the optimal design of taxes that reflect user value creation is unclear, it is also unclear that the unilateral, turnover versions of the tax is inferior to the traditional treaty approach of attributing corporate profits based on the arm’s length principle (ALP). The third is that, more generally, the merits of the new tax should not be judged relative to the existing treaty framework. That framework unjustifiably limits the adoption of optimal taxes, and its focus on allocation issues through arbitrary legal devices provides poor guidance on how to improve tax design in the global digital age.

The rest of the paper is organized as follows. Part I briefly describes the EC’s DST proposal, the related proposal for adopting the concept of “significant digital presence”, as well as the UK’s own version of these proposals. Part II outlines four different types of rationales that might motivate the DST. They are that location specific rent is created by digital platforms’ (1) direct network effects, (2) their indirect network effects; that (3) the taxation of advertising revenue serves as an effective form of destination-based formulary apportionment; and that (4) the collection of data through digital platforms should itself be deemed to generate a tax base.

Part III then examines the optimal design of taxes that recognize location-specific rent from platform usage. It shows that neither the inferiority of unilateral turnover taxes, nor the superiority of traditional corporate profit accounting combined with the arm’s length principle, is obvious. Part IV finally argues that just as the optimal design of the DST needs to be further investigated, the irrationality of much treaty ideology standing in the way of reform needs to be exposed. A brief Conclusion follows.

I. EC and UK Proposals for Taxing Digital Platforms

1. The EC Digital Services Tax Proposal

The March 2018 EC DST Proposal contains specific proposed language for a Directive to be adopted by the European Council, in addition to an Explanatory Memorandum as well as extensive recitals that elaborate the policy objectives of the proposed Directive. For our purposes, the most important aspects of the proposed Directive are the provisions on taxable revenue, and on how taxable revenue is to be allocated among EU member states.¹¹

¹¹ The proposed Directive also contains extensive provisions regarding the DST’s administrative aspects (Articles 9-23).

a. Taxable revenue

“Taxable revenue” in the DST Proposal consists of revenues from three types of services:¹²

- (a) the placing on a digital interface of advertising targeted at users of that interface;
- (b) the making available to users of a multi-sided digital interface which allows users to find other users and to interact with them, and which may also facilitate the provision of underlying supplies of goods or services directly between users; and
- (c) the transmission of data collected about users and generated from users' activities on digital interfaces.

A number of carve-outs are made from these provisions, the most important of which are to service type (b): such service does not include “the making available of a digital interface where the sole or main purpose of making the interface available is for the entity making it available to supply digital content to users or to supply communication services to users or to supply payment services to users”.¹³

The interpretation of these provisions depends on the definitions of several key terms. First, “digital interface” is defined broadly to mean “any software, including a website or a part thereof and applications, including mobile applications, accessible by users.” Second, “user” “means any individual or business”. These two definitions not only potentially render the scope of business revenue covered by the DST very broad, but also affect the ways in which the ensuing DST revenue is allocated among EU countries. Third, the definition of “digital content”, as “data supplied in digital form, such as computer programmes, applications, music, videos, texts, games and any other software, other than the data represented by a digital interface”, counteracts the effects of the previous two definitions. Since revenue from the provision of digital content is exempted from the scope of the DST, an expansive reading of this term shrinks the scope of the DST.

With these definitions, the broad intent behind the EC’s delineation of taxable revenue seems discernible, even though much ambiguity remains. Type (a) service, for example, broadly captures online advertising. Type (b) service seems to encompass a whole range of digital business models selling connections among different users, such as Uber, AirBnB, Amazon Marketplace, Match/Tinder, the various platforms within the Booking Holding group,¹⁴ and so on. At the same time, credit card companies and payment settlement services such as PayPal seem excluded from the DST, although they operate classic two- or multi-sided business models.¹⁵ Equally importantly, online retailers (e.g. Amazon) and content and solution providers (e.g. Netflix, Spotify, Ubisoft, AWS, ADP) also appear to be excluded. The EC’s rationale for this is that although online retail, digital content provision, and online services might also allow some degree of user interaction, such interaction is ancillary to the main purpose of the delivery of goods, content and services.¹⁶ The “value creation” in such cases lies mainly with the production of the goods, content, and services sold online, whereas the user’s role in value

¹² EC DST Proposal, Article 3(1).

¹³ Id, Article 3(4). Further exemptions from type (b) services are made for trading venues, “systematic internalizers”, and crowdfunding providers regulated by a 2014 European Directive (2014/65/EU) on financial instruments, and for facilitators of the grant of loans.

¹⁴ Booking.com’s owner, Booking Holdings, also owns familiar platforms such as OpenTable, Kayak, Priceline, Agoda, and RentalCars.

¹⁵ However, payment services are not included in the exemptions from type (c) services. This would seem to leave them taxable as if such services involve “transmission of data collected about users and generated from users’ activities on digital interfaces”.

¹⁶ EC DST Proposal, at 8.

creation is less central.¹⁷ Since many digital platforms engage both in online retail and content and service provision, on the one hand, and user intermediation, on the other, the DST appears to require them to separate revenue from taxable and non-taxable services.¹⁸

The precise application of the proposed Directives language is far from clear, even in some seemingly central cases of digital platforms. Is Microsoft, the provider of operating systems (clearly a software accessible by users), a business that makes available a digital interface that facilitates the supplies of goods or services directly between users (e.g. between end users and app developers)? If LinkedIn provides information about other LinkedIn users in exchange for subscription fees, is this the provision of digital content, user intermediation, or the transmission of data? The proposed Directive's language leaves very large room for further determination on a case-by-case basis. So far, commentaries on the proposed Directive also mainly focus on its broad policy appeal (or lack thereof), instead of the precise delineation of its scope.

b. Attribution of revenue to EU Member States

Taxable revenue will generate DST liability under the proposed Directive—through a EU-wide, uniform 3% tax rate¹⁹—only when earned by “taxable persons”, which are firms or corporate groups that earn (on a consolidated basis) worldwide revenue in excess of €750 million and taxable revenue “obtained...within the Union” in excess of €50 million in a financial year. Both for determining whether this basic threshold of taxability is met, and for understanding which countries can claim taxing rights and DST revenue, the proposed Directive provides that revenue is “treated...as obtained in a Member State in [a] tax period if users with respect to the taxable service are located in that Member State in that tax period.”²⁰ Different rules for determining user location are in turn offered for different types of services.²¹ In the case of advertising revenue, it is clear that what matters is the location of the users (at which advertisements are targeted), not the locations of ad purchasers.²² Similarly, in the case of data transmission, what matters is the location of the users the data regarding whom is transmitted.²³ In the case of digital intermediation, however, since there are “users” on both sides of a platform, the determination of the source of revenue is less clear. It is apparently either (i) the location of a device that is used to conclude an underlying transaction on the interface, or, (ii) in cases other than the supplies of goods or services directly between users, the location of the device where the user accesses the account. Presumably, it takes two sides to “conclude” a transaction. Thus it appears that revenue from digital intermediation can be attributed to different jurisdictions even in connection with the same transaction.

These rules have provoked extensive discussion about the implementability of user geolocation and its compatibility with user privacy law.²⁴ For purposes of this paper, however, the more important

¹⁷ Id, recital paragraphs (13)-(15).

¹⁸ Freshfields.

¹⁹ EC DST Proposal, Article 8.

²⁰ EC DST Proposal, Article 5(1)

²¹ Id, Article 5(2).

²² Specifically, the location where a device (on which the advertising in question appears) is used to access a digital interface.

²³ Specifically, the location where the user's use of a device generated the data.

²⁴ CLIFFORD CHANCE, *supra* note 4; SULLIVAN & CROMWELL LLP, *Digital Economy Taxation: OECD Publishes Report on Taxation of the Digital Economy; European Commission Publishes Draft Directives*, Mar. 27, 2018.

issue is how user location determines the allocation of tax revenue, because it goes to the nature of the justification for imposing the DST in the first place. This aspect of the proposed Directive has hardly received any commentary, yet important questions remain unanswered. For example, even if the location of viewers of advertisements can be determined, there is a question about whether allocation should be made on a per entity or per ad basis. Even for the same digital platform, some ads may be sold on a pay-per-view basis while others on a pay-per-click basis.²⁵ Different advertising slots also attract different prices based on auctions. Therefore, it seems that apportionment should be made on a per advertisement basis.²⁶ Similarly, with data transmission, it may be that data about different users may generate different quantities of revenues, and inaccuracies may arise if user numbers are deployed to apportion total revenue from data transmission.²⁷

Perhaps most importantly, the proposed Directive allocates revenue from digital intermediation without distinguishing between types of users: “if the service involves a multi-sided digital interface that facilitates the provision of underlying supplies of goods or services directly between users,” allocation is “in proportion to the number of users having concluded underlying transactions on the digital interface in that tax period.”²⁸ Thus if there are always more user-buyers than user-sellers, revenue from intermediation would always be allocated to a greater extent to the buyer jurisdiction. As we will see in Part II, this can be the wrong result, even from a user-value-creation perspective, if it is the seller-users that contribute the most value (as in the case of AirBnB).

2. The EC Significant Digital Presence Proposal

Although published at the same time (March 21, 2018) as the DST Proposal, the EC’s proposed Directive “relating to the corporate taxation of a significant digital presence” is not imminent, in that agreement on it within the EU is expected to take a longer time. The most important differences between this “long-term” proposal and the EC DST Proposal lie in the following formal and substantive respects. Formally, the “long-term” proposal is one for amending the income tax conventions among Member states and between Member states and non-EU countries. Substantively, the long-term proposal contemplates changing treaty-based corporate income taxation rules for a much wider range of digital services than are touched by the DST. Moreover, instead of taxing revenue from digital services at a low rate, the long-term proposal would allow corporate income from digital services (allocated to countries in the manner described below) to be taxed at the same rate and otherwise in the same way as other forms of corporate income.

²⁵ <https://www.pwc.com/gx/en/about/assets/reponse-ec-proposals-digital-tax-package.pdf>.

²⁶ In Martti Nieminen, *The Scope of the Commission’s Digital Tax Proposals*, 72 *Bulletin for International Taxation* ___ (2018), the author suggests that for targeted advertising, the apportionment would be done on a per advertisement basis. The more times an advertisement has been displayed through a device in a jurisdiction, the more DST it can claim. The number of users in a jurisdiction does not matter.

²⁷ Nieminen, *id*, suggests that for selling of user data, intermediation with underlying transactions, or intermediation without underlying transactions, the apportionment would be done on a per user basis. The more users there are in a jurisdiction, the more DST it can claim. The amount of data the users contribute or the magnitude of the transactions facilitated does not matter.

²⁸ EC DST Proposal, at 21: “Taxing rights over the revenues of the business making available the interface are allocated to Member States where the users concluding underlying transactions are located, irrespective of whether the users are the sellers of the underlying goods or services or the buyers.”

The way the EC long-term proposal expects to achieve this is by extending the treaty concept of “permanent establishment” to include a “significant digital presence”.²⁹ A business will have a “significant digital presence” in a Member state if, in a given tax period, (a) the revenues from providing digital services to users in that Member State exceed €7 million; (b) the number of users of one or more of those digital services located in the Member State exceeds 100,000; or (c) the number of contracts for supplying digital services concluded by business users located in the Member State exceeds 3,000.³⁰ A range of activities occurring on a digital interface that constitutes a “significant digital presence” will be regarded as “economically significant activities” of the latter,³¹ which would then justify profit attribution to the latter. The exact way in which such profit attribution is to be carried out is left unspecified, but the EC proposal (i) insists that it would still be based on the ALP,³² while at the same time (ii) extensively rely on the profit split method used in current transfer pricing rules.³³ Overall, profit attribution to a “significant digital presence” aims “to reflect the way value is created in digital activities.”³⁴

Both the EC DST proposal and its long-term proposal aim to correct the discrepancy between where value is purportedly created (especially the locations of the values contributed by user participation) and what countries currently have the right to tax under the existing treaty framework. The DST is purportedly targeted at the most egregious discrepancies, while the long-term solution aims to address all discrepancies. Neither explains how to measure the extent of the discrepancies: the long term’s solution merely claims that it will try to do so within a given legal framework (i.e. arm’s length plus profit split). By all appearances, therefore, the differences between the two proposals are predominantly legal. This fact will be the focus of our discussion in Parts III and IV.

3. UK Government Proposals

In a separate policy development, the UK HM Treasury released a position paper in November 2017 that anticipated the outlines of the EC DST Proposal. The paper announced the intention, “[p]ending reform of the international framework,...[to] explore interim options to raise revenue from digital businesses that generate value from UK users, such as a tax on revenues that these businesses derive from the UK market.” Specifically, the scope of the tax would focus on revenue earned from intermediation and online advertising, while leaving out online retail and online content and service provision.³⁵

In an updated position paper released in March 2018, the HM Treasury reiterated the intention to enact “an interim measure...a tax on the revenues of digital businesses deriving significant value from UK user participation. It is...envisaged that the tax would apply to those businesses wherever they are located, and irrespective of the physical presence that they have in the UK. The government would ensure that the tax was compatible with its double tax treaties and compliant with wider international obligations.”³⁶ The updated position paper went to greater length than the 2017 paper in elaborating

²⁹ EC Long-Term Proposal, Article 4.

³⁰ Id., Article 4(3).

³¹ Id., Article 5(5).

³² Id., Article 5(2).

³³ Id., Article 5(6).

³⁴ Id., at 8 (detailed explanation of Article 5).

³⁵ UK 2017 Paper, Paragraph 4.10.

³⁶ UK 2018 Paper, paragraphs 4.7-4.9.

which business models, in the opinion of the UK government, rely to a significant extent for their value on user participation.³⁷ Nevertheless, it ended essentially with the same policy conclusions as the 2017 paper and the EC DST proposal: social networks, search engines, and intermediation platforms raise more serious problems of misalignment between value creation and taxation than online content providers, e-retailers, and digital service providers do.³⁸ While the 2018 paper explicitly raised the question of how user contributed value can be measured, it provided no substantive answer to that question.

II. Principles Motivating the Digital Services Tax

This Part considers what economic characteristics of digital platforms might motivate the DST and similar taxes. The most important arguments in support of such taxes identify significant sources of location-specific rent, the taxing rights over which fail to be allocated to the jurisdiction where the rent arises under the traditional international tax regime. Interestingly, digital platforms can give rise to new sources of location-specific rent in both producer and consumer countries, so giving greater taxing right to the jurisdictions of “user value creation” need not always mean expanding the taxing rights of consumer jurisdictions. In this and other respects, the case for reallocating taxing rights based on location-specific rent must be distinguished from a case based on “destination-based” apportionment. Accordingly, this Part has two goals. The first is to articulate the structure of arguments in favor of the DST based on location-specific rents. Some such arguments point to network effects, both direct and indirect, displayed by digital platforms; others may apply even in the absence of network effects. Second, I distinguish these arguments from other arguments that have been advanced in support of the DST—and in support of taxes on advertising in particular.

Even if the arguments from location-specific rents have some force, whether an acceptable form of such tax is feasible is a different question. The examination of that question begins in Part III.

1. Location-specific, direct network effects
 - a. Direct network effects among users

“Direct network effects” refer to externalities among users of the same type.³⁹ Examples are the activities of individual users of Facebook, LinkedIn, YouTube, and Amazon who share content on these platforms, and the positive effect such activities have on other users’ participation. Network effects may provide strong incentives to users to remain or join a platform, potentially creating incumbent advantages.⁴⁰ A platform provider can then potentially exploit such effect to earn profits, even without

³⁷ In particular, user generated content, deep engagement, and contribution to brand were identified, in addition to network effects and externalities. *Id.*, Chapter 2.

³⁸ *Id.*, paragraphs 2.42-2.48.

³⁹ Paul Klemperer, *Network Goods (Theory)*, in *THE NEW PALGRAVE DICTIONARY OF ECONOMICS* (Steven N. Durlauf & Lawrence E. Blume eds., 2008).

⁴⁰ Nothing in the discussion that follows, however, assumes naively that network effects necessarily create “winner takes all” dynamics, or that platform competition is more likely to lead to undesirable monopolies than to sub-optimal market fragmentation. For nuanced discussions of these issues, see E. Glen Weyl & Alexander White, *Let the Best ‘One’ Win: Policy Lessons from the New Economics of Platforms* (Coase-Sandor Institute for Law and Economics Working Paper No. 709, Dec. 2014); David S. Evans & Richard Schmalensee, *The Antitrust Analysis of Multi-Sided Platform Business*, in *OXFORD HANDBOOK ON INTERNATIONAL ANTITRUST ECONOMICS* (Roger Blair & Daniel Sokol eds., 2015).

operating a two- or multi-sided platform (which involves indirect network effects discussed below). One example is Amazon. Purchasers on Amazon offer (without compensation) user reviews. The quantity and quality of user reviews affect the chances that future users will make purchases on Amazon.⁴¹ Amazon's profitability, as a seller of goods or services, may thus be partially attributed to consumer reviewers, the network effect among whom provides Amazon, as an online retailer, with an observable advantage in marketing.⁴² In this sense, "user-created value" contributes to the profitability of Amazon.

Of course, many other things, particularly supply chain management, web design, and technological innovation (including running a giant computing division) contribute to Amazon's advantage over traditional retailers. In comparison, the impact of user reviews may be relatively small. It also seems hard to determine how much network effects contribute to a company's revenue and profits. This suggests that it was wise for the EC *not* to include online retailers in the scope of the DST.⁴³ However, what is important at this preliminary stage of our discussion is not the measurability or magnitude of the contribution of user network effects to platform companies' profits. A more basic point is how such effects, supposing that they can be measured, might justify new claims of taxing rights.

Such claims seem to arise because—or when—the network effects are location-specific. If the online activities of users residing in country A increase the demand of country A consumers for product X, then it seems that additional economic (consumer and producer) surplus is created independently of what the producers and distributors of X do. The cause of this outward shift in the demand curve is location-specific, and the government of A may wish to tax any resulting rent⁴⁴ just as it would want to tax other forms of location-specific rent.

Of course, Amazon's technology and business innovations seem to have been a precondition for the emergence and magnitude of such user-side network effects. Amazon's technology, aimed at creating network effects among country A users, can be divided into two components. One is the general set of technological tools that can be applied to all Amazon interfaces; the other is the investment that Amazon needs to make to render such tools usable for residents of country A, e.g. creating an Amazon interface in country A's language. Both components of Amazon's technology may be created outside of country A. Does this detract from the claim that network effect from country A users' participation on Amazon is location-specific to country A?

The growing attention paid to the taxation of location-specific rent in recent years has, I believe, given us greater confidence that the answer is No. Not only is it the case that Amazon's investment in the country-A-language interface able to earn a return only in Country A: because Amazon's operation of a country-A interface need not interfere with its operation of other interfaces elsewhere, all rent that arises from country A users can be attributed to country A. As long as Amazon does not face a choice between deploying its technology in country A *or* country B, the rent arising from A is not a form of mobile rent.

⁴¹ For empirical studies on the effect of user reviews on consumer and producer surplus, see Chunhua Wu *et al.*, *The Economic Value of Online Reviews*, 34 MARK. SCI. 739 (2015); Alan T. Sorensen, *Bestseller Lists and the Economics of Product Discovery*, 9 ANNU. REV. ECON. 87 (2017).

⁴² Amazon, as an online retailer, also benefits from the network effects on Amazon Marketplace's two-sided platform. We will return to this in the discussion of indirect network effects below.

⁴³ *Supra* note 12.

⁴⁴ Under a corporate regime, it is the additional producer surplus that may be taxed.

Contrast this reasoning with a recent argument made by Professor Wolfgang Schön.⁴⁵ Schön suggests that country A might be able to tax Amazon, even when Amazon does not have a physical presence there, on the basis that Amazon has made a country-specific “digital investment” in A, such as an interface in country A’s language. Such investment can be measured by the cost of developing such an interface, and Schön suggests that it is conceivable for A to tax an imputed return to this investment. The logic of this claim is that Country A has a taxing claim because Amazon has a country-A specific asset. This, however, need not be the logic of location specific rents. The idea of the latter is that the rent is attributed to country A because they arise from users residing there, and not because Amazon’s cost of investment is partially attributable to A.

The desirability of a Country A tax on location specific rent of course hinges on the possibility of measuring such rent. We return to this issue in Part III below. For now, note that so far the justification for digital taxation is independent of the two- or multi-sidedness of platforms. A one-sided market can still give rise to location specific rent through network effects. Also, note that the argument for a new type of tax claim given here is compatible with recognizing that Amazon’s online sales may be subject to general consumption taxation (i.e. through a value added tax) in country A already. A general consumption tax applies to all products and services provided by all sellers, regardless of what they earn location-specific rent. What is at issue in the DST debate is whether an additional tax should be applied to digital platforms, both on account of location-specific rent and in an attempt to capture such rent.

b. Comparison with personalized remote services

It seems easy to distinguish between two frequently mentioned features of digital platforms on the user side. The first is the network effect discussed above. The other is personalization: users’ activities on a platform may reveal a lot of personal characteristics—with geolocation being the most obvious example—which may help both the platform provider and third parties to find profitable transactions with users. Advertisers care about both network effects and personalization: advertisements should be targeted as much as possible, but they should also reach as many relevant users as possible. For online goods and services, however, personalization itself increases demand: it is the revelation of personal information (e.g. geolocation), not how many users there are, that is key to the generation of new profitable transactions.

In justifying its DST-like interim proposal, the UK government has argued that information-generating user activities that allow the personal customization of services give rise to a new form of user-created value, thereby justifying a new type of user jurisdiction’s claim to taxing profits from the remote delivery of goods and services.⁴⁶ Under the current international tax regime, such profits are taxed only in the producer jurisdiction. It is almost as though in the UK’s vision, user participation amounts to a novel channel of product distribution and marketing. Prior to the advent of the digital economy, distribution and marketing functions would have been carried out by dedicated subsidiaries or permanent establishment. In those circumstances, it has been recognized that a business presence in

⁴⁵ Wolfgang Schön, *Ten Questions about Why and How to Tax the Digitalized Economy*, IBFD BULL. FOR INT’L TAX. (Apr./May 2018), at ___. See also Johannes Becker & Joachim Englisch, *Taxing Where Value is Created: What’s “User Involvement” Got to Do With It?* (October 2018)

⁴⁶ UK 2018 Paper, paragraphs 2.12-2.15.

the consumer country (e.g. an Apple Store) can generate its own location-specific rent.⁴⁷ In the future, however, more and more such functions might be implemented virtually, where consumer participation and the consequent revelation of personal information would enable personalization. Just as a dedicated sales or distribution subsidiary (or PE) can generate additional producer surplus—with a portion of such surplus attributed to the consumer country by virtue of the physical location of the subsidiary (or PE)—producer surplus generated by consumer participation and personalization should arguably be attributed to the location of the consumer.

Whereas the argument from network effects relies on the location of groups of users, the argument from personalization relies on the location of single users. However, the logic of the two arguments is identical. In both cases, a technology (the intellectual property ownership of which can be located anywhere in the world) is deployed in a consumer country to shift consumer demand there for various products. Such a shift occurs independently of any changes in producers' supply curves. It leads to additional transactions and thus increased consumer and producer surplus, a portion of which the technology owner extracts. Country A then claims a portion of that surplus extracted, on the ground that it can arise without changes to the behavior of producers and consumers elsewhere. This logic, we will see, also applies in the context of indirect network effects.

2. Location-specific, indirect network effects

“Indirect network effects” refer to externalities among different types of users—the phenomenon where users on at least one side care about what users on the other side do (including how many such users there are). Such effects are crucial to the operation of two- or multi-sided platforms.⁴⁸ A basic insight from the economic analysis of multi-sided business models is that a two-sided business can price below marginal cost on one side (i.e. providing a subsidy to that side) while making up for that loss on the other side.⁴⁹ It is not hard to see the relevance of this for international taxation. A two-sided platform may provide services entirely for free to users on one side (e.g. individual consumers) in a given country, while charging users on another side (e.g. sellers of products and services) in a different country for access to the first set of users. The platform company may thus profit from “user value creation” in Country A without receiving any payment from Country A, in contrast to one-sided business models.

The most prominent examples of this business model that hold relevance for international taxation are companies, like Google and Facebook, that profit heavily from advertising. However, we will see that advertising may give rise to new taxing claims independently of indirect network effects. Thus, it is best to begin with non-advertising examples.

a. Non-advertising examples

⁴⁷ See Joseph Bankman, Mitchell Kane & Alan O. Sykes, *Collecting the Rent: The Global Battle to Capture MNE Profits* (Forthcoming).

⁴⁸ See Alexander White, *Online Platforms, Economics of*, in THE NEW PALGRAVE DICTIONARY OF ECONOMICS (Online Ed., 2012); Jonathan D. Levin, *The Economics of Internet Markets*, (NBER Working Paper No. 16852, Mar. 2011); Marc Rysman, *The Economics of Two-Sided Markets*, 23 J. ECON. PERSP. 125 (2009).

⁴⁹ The users receiving the subsidy (e.g. the non-charging or waiver of subscription or transaction fees) effectively receive in-kind income.

Many multi-sided businesses sell connections between consumers and non-advertisers, e.g. AirBnB, Uber, Booking.com, Amazon Marketplace, etc. Take Amazon Marketplace, which generated 17% (\$23 billion) of Amazon's total net revenue in 2016. Buyers on Amazon Marketplace do not pay any fee. Only sellers pay per transaction charges (plus subscription fees for professional sellers). For a large subpopulation of the third-party sellers, it is plausible to assume that their business activities are of substantially the same kind as they would be without participating in online sales (i.e. these sellers have the same production functions online and offline). What Amazon Marketplace offers is a substantial boost in demand from indirect network effects online. Such effects are the joint product of buyers on Amazon and Amazon's own technology and business model (with important spillovers between its different lines of business). By the argument from the previous sub-section, some portion of these effects may be regarded as location specific to the buyers. Yet under the current international tax regime, the buyer jurisdiction may be able to tax very little of the additional aggregate surplus created by such effects—especially the portion extracted by Amazon from sellers located in other jurisdictions. The buyer jurisdiction may therefore wish to claim a greater taxing right over such surplus, by taxing Amazon's revenue from third-party sellers from other countries.

Importantly, in some cases—especially digital platforms that support the sharing economy—the jurisdiction that is interested in claiming greater taxing right may be the producer/supplier country. For example, AirBnB allows many property owners to rent out rooms who would not do so otherwise. The property owners are subsidized to an extent and AirBnB earns a profit mainly from service fees charged to renters. The renters come from all over the world, and contribute to the profitability of AirBnB, but it is arguably the participation of the property owners that enable the success of AirBnB's business. That is, the additional economic surplus comes from the rightward shift of the supply curve.

Yet this increase in supply is clearly location specific: the deployment of AirBnB's technology is not sufficient in itself and requires the participation of property owners; and the deployment of AirBnB's technology in one country does not interfere with such deployment elsewhere. Thus, it is the jurisdiction of the property owner (service supplier) that may wish to claim a greater portion of AirBnB's profits—on top of the income and consumption taxes already levied on the property owners.

The AirBnB example illustrates an important point: the new claims to taxation generated by two-sided platforms, arising from the divergence between the jurisdiction of location-specific rent and the jurisdiction of payment/income recognition, do not necessarily allocate taxing rights from source or producer countries to destination or consumer countries. The aim is to enable the taxation of location specific rent, which can arise either in a producer or a consumer jurisdiction. This is one crucial respect in which a DST need not be "destination-based". As will be further elaborated below, tax design referencing location specific rents is fundamentally different from tax design appealing to final-sales-based formulary apportionment, which do not aim to locate country-specific producer surplus.

The AirBnB example also serves to show that not all "users" are of the same value in a platform business. The location-specific rent, according to the argument just given, is attributable to the jurisdiction where AirBnB hosts' properties are located. However, there are clearly a lot more renters than hosts among AirBnB "users". If a tax on AirBnB's profit (or revenue) is allocated to different countries according to how many "users" are located in each, the countries generating the location-specific rent will hardly get to tax any of the platform's profit. This is an important critique of the EC's

current “user-based” proposal for allocating taxable revenue under the DST imposed on intermediation services.⁵⁰

Of course, an important reality of the sharing economy—and of the digital platforms that support it—is that both demands and supplies are altered by platform technology. In such cases, it may be hard to say which side receives the subsidy, or from which side additional aggregate surplus arises. Where the two sides are located in different countries,⁵¹ a re-allocation of taxing rights may be harder to support. In such situations, the main international tax policy in contention may be whether all user countries should claim greater taxing right vis-à-vis a third country (e.g. European Union member states v. the United States). While this economic and political reality may be acknowledged, it is nonetheless possible to point to examples where the location of the economic rent clearly diverges from the location of a platform business’ source of revenue, which may justify a reallocation of taxing rights.

As in the case of direct network effects,⁵² how to measure location specific rent arising from indirect network effects is an important question that we have not yet considered. But nothing we have said suggests that one must adopt the kind of hypothetical approach embodied by the arm’s length principle (ALP) under traditional transfer pricing. The counterpart to ALP for two-sided businesses would be to counterfactually imagine that the platform abandons a two-sided model, charges a fee based on marginal cost (without subsidies) to the consumers, and on that basis impose a tax in the consumer jurisdiction. Such an approach would involve basically imagining away the source of platform rent, and with that the possibility of arguing that the rent is to some extent location specific. We will return to the likely futility of measuring location specific rent through ALP in Part III. Instead, proponents of taxing user value creation must come up with a way of measuring user value creation within the multi-sided business paradigm.

b. Advertising as an example of two-sided businesses

Thanks to the fabulous profitability of Facebook and Google, advertising revenue is a central focus of current DST proposals. Advertising on Facebook and Google offers clear illustrations of the operation of a two-sided platform: individual users benefit from the platforms without charge, while the platforms bill advertisers and incur negligible marginal cost. Although the extent of the effectiveness of online advertising is still unclear,⁵³ apparently advertisers find it a more effective means—or at least offering a much larger extensive margin for investing in advertising without diminishing returns—than existing alternatives. This business model vividly illustrates a case where the network effect is present in one country—the user country—while the other side of the two-sided market, advertisers, may be located in another country. The platform company earns economic rent charging advertisers in the

⁵⁰ *Supra* note 28.

⁵¹ Uber is an example of a technology that changes both demand and supply. But given the nature of the service, both sides—the drivers and the ride-hailers—are located in the same jurisdiction, and payments also arise from that jurisdiction.

⁵² Note that it is possible to have indirect network effects without direct network effects. Credit card networks are a classic example: consumers may not care what credit card other consumers are using, nor do merchants care about credit card usage by other merchants. Each cares only about what the other side does. Therefore, it is theoretically possible for new international taxation claims to arise for each type of effect separately.

⁵³ Jasmine Gasrd, *Does Facebook Really Work? People Question the Effectiveness of Ads*, NPR (Sept. 12, 2018), available at: <https://www.npr.org/2018/09/12/647040758/advertising-on-facebook-is-it-worth-it>; Anja Lambrecht et al., *How do Firms Make Money Selling Digital Goods Online?*, 25 MARK. LETT. 331 (2014).

latter country, but it is the users in the former country that make this possible. By the argument of the previous subsections that should be familiar by now, it is Facebook, Google and their users that brought a new set of demand curves to the advertisers, whose production functions remain largely unchanged. Therefore, what Google and Facebook can extract from the additional producer surplus should be allocated to the user jurisdictions.

3. Taxing advertising: destination-based apportionment v. protection of source-based taxation

Because the norms guiding international taxation are in such a state of flux, a novel tax instrument may hold appeal for distinct and sometimes even mutually conflicting reasons. Turnover taxes on advertising revenue recently adopted and proposed by various countries offer an important example of this phenomenon. Consider a scenario where (i) country A is the jurisdiction of individual consumers, (ii) country B is the jurisdiction of producers of goods and services who purchase advertising targeted at country A consumers, and (iii) country C is the (tax haven) jurisdiction of the platform company that places ads on digital interfaces. In the argument from indirect network effects given in the preceding subsection, the participation of individuals in country A in the digital platform enables the platform company (in country C) to extract some producer surplus from firms in country B. Country A claims that the platform company earns country-A-specific rent, which it should therefore be able to tax.

There is also a second, completely different kind of claim that country A may make, which is that the producer surplus arising from sales made to consumers in country A should be taxable in country A, even if there is no location specific rent in country A. This kind of argument has recently been brought to public attention by proponents of final-sales-based formulary apportionment (FA).⁵⁴ We will see below that a tax on advertising revenue can be a way of implementing such apportionment. Yet a third kind of taxing claim may be asserted by country B: it may want to tax advertising revenue paid by country B producers to the country C platform company, simply as a way of protecting country B's own revenue.

This subsection discusses the latter two kinds of arguments for deploying a tax on advertising revenue for international taxation purposes, which are independent of the two-sidedness of advertising.

a. Taxing advertising as apportionment

Advertising expenses are necessarily paid out of expected producer surplus. Specifically, advertising directed at users in country A almost invariably will be paid out of expected producer surplus from sales made to consumers in country A. Advertising revenue, in other words, is a form of cost of sales (for the purchasers of advertising service) that can be reliably allocated to a consumer jurisdiction.

Under the current international tax regime, producer surplus is generally taxed in the jurisdiction where the producer is located (although such taxation is vulnerable to base erosion and profit shifting). Suppose, however, there is a desire to apportion taxing right over producer surplus to

⁵⁴ See Reuven S. Avi-Yonah, Kimberly A. Clausing, & Michael C. Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 FLA. TAX REV. 497 (2009) for a proposal for a "destination-based" FA of an income tax base; see Michael P. Devereux & Rita de la Feria, *Designing and Implementing a Destination-Based Corporate Tax* (Oxford University Centre for Business Taxation WP 14/07, May 2014) for a proposal for a "destination-based" FA of a cash flow tax base.

the consumer jurisdiction. Suppose, that is, one is interested in adopting final-sales-based FA. Then taxing advertising revenue may be deployed as a way of taxing at least a portion of such producer surplus, albeit the surplus is (i) taxed in the hands of the seller of advertising space, and (ii) in the form of such seller's revenue instead of a producer's expenditure.⁵⁵ Although it is clear that taxing advertising aimed at consumers in country A falls far short of apportioning all corporate profit according to final sales to country A, final sales apportionment might still contribute to wider acceptance of taxes on advertising revenue to the extent that it is one of the new principles of international corporate income/profit taxation being discussed nowadays. Indeed, a recent report by the European Committee on Economic and Monetary Affairs on the EC's DST proposal explicitly linked the DST to "a destination-based tax system for digital services".⁵⁶ Numerous practitioners have also drawn a connection between the DST and the Zeitgeist of destination-based taxation.⁵⁷

However, arguments appealing to location-specific rent are quite distinct from arguments appealing to consumer location. The primary argument for final-sales-based FA made by its proponents is that it helps to reduce the distortionary incentives created by traditional corporate taxation.⁵⁸ If, the argument goes, corporate profits can be taxed by reference to a relatively immobile factor, namely, final consumers, MNCs would stop engaging in tax planning that locate either production or accounting profits in low-tax jurisdictions, and would cease to make investment decisions depending on marginal tax rates offered by different source countries. The argument for final-sales-based FA, in other words, is fundamentally efficiency-based, and distinct from arguments about what constitute fair allocations. By contrast, arguments for taxing rents by their locations comprise both an efficiency and a fairness aspect.⁵⁹ Moreover, final-sales-based FA can be meaningful even in a rent-free world (or a world in which no rent is location-specific), whereas allocation of taxing right according to location-specific rent necessarily assumes the existence of such rent.

Be that as it may, taxing advertising may hold appeal precisely because of the efficiency focus of proposals for final-sales-based apportionment. This is because taxing advertising both (a) partially implements final-sales-based FA and also (b) potentially improves the overall efficiency of the latter. To see point (a), consider that if final-sales-based FA were to be applied to multinationals, the profit from advertising earned by digital platforms stands out in terms of the ease with which apportionment can be made. Even though advertising is a type of intermediate input purchased by producers, the fact that such advertising is targeted at final consumers in country A makes it easy to associate such input with final sales made to country A. The intermediate good of advertising has a clear final destination.

Point (b) is more convoluted. There are two ways of thinking about final-sales-based FA. The first is that a multinational firm makes an overall computation of profits (and losses), which is then apportioned to different countries according to final sales (including indirect final sales). The second is that the same firm specifically allocate production costs to sales to each country, so that if a firm makes final sales to five different countries, it would be treated as having five distinct production units, and

⁵⁵ As we will discuss in the next Part, where the seller of advertising faces zero-marginal cost, the tax on its revenue is equivalent to a tax on its profits, and the incidence of the tax may be entirely on the seller, i.e. there may be no change to the decisions of the producer (i.e. purchaser of advertising).

⁵⁶ *Draft Report on the proposal for a Council directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services*, COMM. ECONOMIC AND MONETARY AFFAIRS, 2018/0073(CNS) (Sept. 21, 2018), at 8 (Amendment 5).

⁵⁷ See CLIFFORD CHANCE, *supra* note 4, at 3.

⁵⁸ Wei Cui, *Destination-Based Cash-Flow Taxation: A Critical Appraisal*, 67 U. TORONTO L. J. 301 (2017).

⁵⁹ Mitchell Kane, *A Defense of Source Rules in International Taxation*, 32 YALE J. REG. 311 (2015).

profit and losses are computed for each. Proposals for final-sales-based FA have generally not been sufficiently detailed to identify which of these two approaches would be adopted. But it is likely that only the first approach is feasible. The reason is that apportionment can aspire to be non-distortionary only if only final sales, not intermediate sales, are considered in apportionment: apportionment according to intermediate sales is likely to result in the allocation of multinational profits according to the highly mobile choice of where to locate intermediary firms.⁶⁰ Apportionment according to final sales, on the other hand, requires sellers of intermediate goods to make rough estimates about the “ultimate destination” of one’s goods when incorporated in the downstream producers’ products. Many may view this as infeasible,⁶¹ but even if it were, it is not clear what it would mean to allocate one’s own cost of production to the sales revenue realized by other producers.

In other words, there are reasons to think that final-sales-based apportionment would require a multinational firm to compute overall profit and losses and allocate a single pool of profit (or loss) to different countries according to sales. But this could create distortionary incentives for the firm to expand sales in a low tax country, even if such sales generate no additional profit or even lead to losses. This is because by making additional sales to the low tax jurisdiction, the firm can channel the profit made in the high tax country to the low tax country, and this may be worthwhile as long as the loss incurred from additional sales to the low tax country is sufficiently small.⁶² From a social point of view, however, such tax planning can be welfare reducing.

Against this background, one can see that because advertising directed at consumers in country A is a form of cost that can be reliably allocated to sales made to country A, taxing advertising, as a way of taxing producer surplus arising from final sales made to country A, can mitigate the distortions associated with final-sales-based FA.

b. Taxes on advertising imposed by source countries

The argument from final-sales-based FA supports the imposition of a tax on advertising depending on the location of the targeted audience of the advertisement, not the location of the purchaser of advertising. Several countries, however, currently impose turnover taxes on advertising depending on where the buyer of advertising, or the source of advertising revenue, is located. This is clearly the case with the Indian equalization levy,⁶³ and it appears to be the case with Italy’s Levy on Digital Transactions as well.⁶⁴ The justification for such taxes would clearly need to rest on something other than final-sales-based FA. And, unless there are reasons to believe that purchasers of advertising generate rent for digital platforms that is specific to the country of the purchasers,⁶⁵ such justification seems not to appeal to location specific rent, either.

⁶⁰ Harry Grubert, *Destination Based Income Taxes: A Mismatch Made in Heaven?*, 69 TAX L. REV. 43 (2015).

⁶¹ See Cui, *supra* note 58, at 34-326, 342-44.

⁶² Suppose that, at the start, a firm produces and sells a total X number of widgets to high-tax country H and low-tax country L, generating a total profit of π , with non-negative profit associated with each sale. Suppose the rate differential between H and L is $\Delta\tau$. Making one more unit of sale to L (while keeping sales to H constant) would reduce the total tax liability by $\pi * \Delta\tau / (1+X)$. There theoretically exists a small loss l associated with the production and sale of an extra unit to L, such that $l < (\pi - l) * \Delta\tau / (1+X)$.

⁶³ OECD 2018 Report, at 142.

⁶⁴ *Id.*, at 143. In contrast, Hungary’s and France’s taxes on advertising make the presence of targeted consumers in Hungary and France (respectively) a crucial element in determining what revenue is taxable. *Id.*, at 145 and 146.

⁶⁵ Insofar as placing the ads of producers from one country reduces the scope for placing ads of producers from another country—for example because users are ad-averse and the placement of additional ads may have the

Instead, countries have advanced arguments to the effect that digital companies “artificially” avoid permanent establishments, or that, even if there is no artificial tax planning, taxing platform profit is still necessary to create an equal footing between multinational companies and domestic firms (hence the term “equalization” levy). These arguments appear implicitly to embrace the traditional norm of source-based taxation. Assessing their merits lies beyond the scope of this paper; what deserve emphasis here are instead two points. First, clearly, source-based claims for taxing advertising are incompatible with destination-based claims. Because final-sales-based FA has been proposed to *replace* source-based taxation,⁶⁶ we currently have little idea how the two principles of taxation can co-exist (unlike the co-existence of source and residence based taxation under the traditional paradigm). There may thus be a genuine concern when the same revenue of a digital platform might be subject to new tax claims made by both source and destination countries (in addition to claims by residence countries).

Second, proposals for new taxes on digital platforms based on the identification of location-specific rent do not embrace allocation of taxing rights to either destination or source countries. Instead, the idea is to allow the country where the rent is located to tax the rent. This can be the destination country of final consumers—which we can imagine to be the case for Amazon Marketplace (though the reality may be more complex)—or the source country of suppliers of goods and services—which we can imagine to be the case for AirBnB (though, again, the reality may be more complex). There may even be scenarios where the location specific rent arises in a residence country. The taxation of location-specific rent is already a feature of many source-based taxing claims. What the analysis of platform business models shows is that such rent may not be exclusive to source countries, and, moreover, traditional source-based taxing rights may not even be adequate for taxing rent arising from the source country (as in the AirBnB case).

To further illustrate the distinctions among different rationales for taxing advertising, consider a recent empirical study of the effect of taxes on digital platforms. Such studies are, not surprisingly, still rare: most new taxes on digital platforms are still merely proposed and not implemented. In one existing study, Cuevas et al examine the impact of the implementation of the UK’s diverted profit tax (DPT)—which is not specifically targeted at digital platforms—on Facebook’s advertising prices.⁶⁷ Apparently, before the implementation of the DPT, Facebook booked most of its advertising revenue received from UK producers in Ireland, a low-tax jurisdiction. When the DPT was adopted, Facebook began booking its revenue from UK advertisers in the UK, a high-tax jurisdiction. Cuevas et al observe that prices for advertising space directed at users in the UK, as well as at users in countries where imports from the U.K. represent a large share of total imports, experienced a significant rise. In other words, advertisements purchased by UK producers became more expensive.

Cuevas et al explain this by a theoretical model in which the digital platform decides to place ads from producers from two different countries, one with high tax and one with low tax. When profit from selling advertising to the high tax country becomes less profitable (due to a higher profit tax), the platform may try to increase advertising revenue from the other country instead. This way, the total number of ads placed on the platform does not increase, which helps the platform avoid alienating its

effect of reducing users—any rent earned by the digital platform from local producers is arguably not “location specific”.

⁶⁶ Avi-Yonah, Clausing, and Durst, *supra* note 54.

⁶⁷ A. Cuevas et al, *The Taxman Calls. How Does Facebook Answer? Global Effects of Taxation on Online Advertising* (NET INSTITUTE, Working Paper # 17-09, Sept. 2017).

users with excessive advertising. Cuevas et al conclude that if countries are generally interested in imposing taxes like the DPT on digital platforms, they are better off coordinating, since governments unilaterally adopting source-based taxes are likely to set tax rates too low.

The DPT, of course, implements source-based corporate taxation. The conclusion of Cuevas et al is also familiar from previous studies of source-based taxation. It is important to emphasize, however, that what Cuevas et al have studied is precisely not the type of taxes that the EU is envisioning under the DST in connection with advertising. Such a new tax would be imposed by the UK on Facebook's advertising revenue from ads targeted at UK users, regardless of where the advertising revenue is earned. Under such a tax, Facebook would not have the choice, as in the model of Cuevas et al, of maximizing profit by choosing among advertisers from different countries: the UK tax would be imposed regardless of the location of the ad purchasers. Not only would the revenue allocation be different under the DST than under the UK DPT, the DST's incidence is also likely to be different.⁶⁸

4. Data as Location Specific Rent

So far, we have not discussed the component of the EC DST Proposal that imposes the tax on data transmission. It is clear how the monetization of user data might represent a form of location specific rent, if such monetization produces profits: after all, the data is about users in particular locations. However, the collection of data is of course not free: the users generate such data in most cases by engaging in online activities that the platform company either offers for free or subsidizes. Just as importantly, the sale of personal data will likely be subject to increasingly stringent privacy regulations across the globe. But perhaps most importantly, it is very unclear that the sale of data (even if not further regulated) can be a sustainable source of profit for platform companies. Of all the data that Google collects, *Google* is most likely to be able to make the most valuable use of the data. A platform company that does not know what use to make of the data it collects (and must sell the data to third parties) seems unlikely to remain competitive and stay in business.

This suggests that the portion of the EC DST imposed on the sale of data may serve purposes other than expropriating corporate rent. Maybe it would discourage data collection and sale. Implementing such an objective, however, may have unintended consequences.⁶⁹ Interestingly, the UK 2018 Paper explicitly claims that data collection should not be analogized to user participation and in itself does not create new taxing rights for the country from which user data is collected.⁷⁰

The EC DST Proposal has provoked some interesting discussion about the barter exchange, between users and digital platforms, of data for online services. Some argue that if such exchange is to be recognized, it is the users, not the platform, that should be subject to taxation.⁷¹ While this is intended merely as a polemic against the DST, it actually relates to broader discussions about future platform models. Posner and Weyl, for example, argue that data is nowadays free mostly because of the

⁶⁸ As we will see in Part III below, it is not at all clear whether a DST would have any effect on advertising prices. The incidence of the DST may even fall entirely on the platform company.

⁶⁹ Francis Bloch & Gabrielle Demange, *Taxation and Privacy Protection on Internet Platforms*, 20 J. PUB. ECON. THEORY 52 (2018).

⁷⁰ UK 2018 Paper, Paragraphs 2.33-2.41.

⁷¹ Becker & English, *supra* note 5, at ___; Schön, *supra* note 45, at ___.

monopsony power of digital platforms.⁷² They suggest that social welfare can be improved if platform companies actually compensate users for the data they provide (especially if the users can play crucial roles in assisting the application of Machine Learning to the data). In any case, it is quite possible that platform companies' use of data can become highly profitable (aside from advertising and intermediation), and some of profit needs to be allocated to the user jurisdiction.⁷³

III. Optimal DST Design: Is the Short-Term Solution Necessarily Inferior?

Part II aimed to show that location-specific rent generated by digital platforms may justify new claims of taxing rights over corporate profits: the country of consumer residence, for example, may intelligibly assert entitlement to taxing the platform company's profit from sales of advertising space to producers in other countries.⁷⁴ If a DST can be designed to implement such claims, then declarations that DST proposals are completely devoid of coherent motivation are exaggerated and mis-informed. Whether the DST is the *best* tax design for implementing such claims, however, is a separate issue.

Both the EC and the UK government seem to embrace two premises that bear on this issue. First, the new taxing rights based on "user value creation" should be implemented through the corporate income tax. Therefore, international income tax norms that fail to acknowledge such rights should be modified. Second, the new taxing rights should be implemented while keeping traditional norms intact for segments of the economy not (significantly) affected by user created value.⁷⁵ Both premises point to the modification of existing tax treaties as the direction for reform. On the one hand, tax treaties represent the most important sources of international legal norms governing corporate income taxation. On the other hand, since treaties already embody norms that function (supposedly) tolerably well aside from considerations of user value creation, they should be maintained where possible.

It also seems to follow from these premises that DST is an inferior measure, at best an interim, stand-in solution, before a multilateral, treaty-based solution can be agreed on. For the EU and the UK government, this inferior policy instrument is nonetheless necessary because it is the only one available for them to adopt without violating treaty-based obligations. For many opponents of the DST, however, regardless of whether the choice of the DST is forced by ongoing compliance with treaty obligations, the fact that the DST is a tax on revenue and not on profit renders it inherently senseless and without merit.

It is well-known, the argument goes, that many platform companies incur substantial losses for many years before turning a profit. Therefore it is evident that a tax on revenue would either be a confiscatory tax on such companies' profits (except in the case of a few extraordinarily profitable firms), or in the case of loss-making companies, not a tax on profits at all. A tax on revenue is poorly designed to serve the function of mitigating the under-taxation of profitable companies, or to put traditional and platform companies on an even playing field.

⁷² Eric Posner & E. Glen Weyl, *RADICAL MARKETS: UPROOTING CAPITALISM AND DEMOCRACY FOR A JUST SOCIETY* chapter 5 (2018); Imanol Arrieta-Ibarra et al, *Should We Treat Data as Labor? Moving Beyond "Free"*, 1 AM. ECON. ASS. PAPERS AND PROCEEDINGS 1 (May 2018).

⁷³ Kai-Fu Lee, *The Real Threat of Artificial Intelligence*, THE N.Y. TIMES (June 24, 2017).

⁷⁴ Or, again, the country of producer residence may reasonably assert the right to tax a platform company's profit from intermediation services sold to consumers in other countries.

⁷⁵ Many have criticized or expressed skepticism about this second premise, questioning whether the "digital" economy can be "ring-fenced" from traditional ones. None, to my knowledge, has questioned the first premise.

The logic of this argument may appear so simple and compelling, indeed, that the fact that the DST is still even considered seems only to offer evidence of the irrationality and desperation of European politicians. However, the substantive merit of DST design is much more complex, and some basic reflection suggests that the argument is largely rhetorical.

1. Substantive justifications for a tax on turnover

An important feature of digital firms is that they operate with very low, often negligible, marginal costs: the placement of each ad, the facilitation of each online transaction, indeed the provision of digital content and much digital service to an additional customer, are largely automated with little additional labor and other input from the platform company, once the platform is running. This means that the marginal revenue of a platform company from each transaction is essentially identical to its marginal profit from the transaction. A tax on revenue, therefore, is approximately a tax on marginal profits. It follows that the platform company's pricing and production decisions aimed at profit maximization should be the same under a revenue tax or a profit tax.⁷⁶

In the presence of marginal cost and especially of two-sided pricing, revenue taxation may affect a platform company's business model. For example, if a tax on one side of the platform reduces profit earned from that side, the company may aim to shift its profit generation to the other side. Nonetheless, some theoretical models have shown that the platform firm may not try to shift the tax through price increases. One earlier study,⁷⁷ for instance, demonstrates that when newspaper subscriptions are subject to taxation, the newspaper may lower (rather than raise) the price of subscription, because doing so would (i) increase newspaper circulation, (ii) thereby attract additional advertisers and increase profit on the advertising side, and (iii) at the same time compensate readers for the increase in advertisement with the lower subscription price. More recent studies have demonstrated similar possibilities for platform firms that charge both users (through subscription fees) and advertisers and are subject to taxes on revenue on both sides.⁷⁸ In these scenarios, one can say that the platform firm fully bears the burden of the tax.⁷⁹

The reason why platform companies often incur years of substantial losses is due not to their marginal costs, but to fixed costs. Business incur such fixed costs in the expectation of eventually making a profit. Indeed, the standard story about platform companies is that investors in them burn money through a (sometimes long) initial stretch in a gambit to build market power and eventually earn monopoly or oligopolistic rent. An ad valorem tax on revenue would erode such rent, and even sometimes discourage investment by rendering an undertaking otherwise profitable in expectation

⁷⁶ This point has been emphasized in most recent theoretical analyses of the taxation of digital platforms. See Marc Bourreau et al, *Taxation of A Digital Monopoly Platform*, 20 J. PUB. ECON. THEORY 40 (2018), at 45-6; Jacques Cremer, *Taxing Network Externalities*, in FRANCE STRATÉGIE, *Taxation and the Digital Economy: A Survey of Theoretical Models*, Feb. 26, 2015 (France); Hans Jarle Kind & Marko Koethenbuerger, *Taxation in Digital Media Markets*, 20 J. PUB. ECON. THEORY 22 (2018), at 25, 34.

⁷⁷ Hans Jarle Kind et al, *Tax Responses in Platform Industries*, 62 OXFORD ECON. PAPERS 764 (2010).

⁷⁸ Bourreau et al, *supra* note 76, at 47-50; Kind & Koethenbuerger, *supra* note 76 at 33.

⁷⁹ Although these scenarios are presented mostly as theoretical possibilities—there is as yet insufficient empirical information about key theoretical parameters for us to know whether these possibilities apply to the real world—numerical examples have been offered to illustrate their plausibility.

unprofitable. But an income tax that does not subsidize losses (i.e. compensate taxpayers when they suffer losses) also has a similar effect.

Further, an important strand of current research on the economics of digital platforms suggest that many of the markets platform companies occupy are characterized by ease of entry, with many viable strategies for entrants to undermine incumbents.⁸⁰ These markets are therefore more likely to be characterized by excessive fragmentation than by quick lock-ins for (potentially inefficient) first movers. In such markets, a major source of inefficiency is excessive investment in the competition to capture monopoly rent. A tax on investment, in the form of either of tax on revenue or a tax on income without compensation for losses, can therefore improve social welfare by deterring such over-investment.⁸¹

Overall, although the existing theoretical literature has identified important differences between specific and ad valorem taxes on digital platforms, no major results pointing to differences between revenue and profit taxes have emerged (thanks to the fact that platform firms have negligible marginal costs). It is true that the theoretical analysis of the likely incidence, revenue and welfare effects of taxes on digital platforms, as well as the effect of such taxes on competition between platform firms, is still very preliminary.⁸² Nonetheless, we can ask the question: why does the traditional corporate income taxation set a relevant normative benchmark? In particular, why is it important not to impose tax liabilities on firms that show current period accounting losses?

Arguably, the design of the DST should aim to achieve two fundamental objectives. The first is to minimize economic distortions and consequent reductions in social welfare. This is the objective theoretical economists have so far focused on. In the context of negligible marginal costs, imperfect competition, and possible excessive market entry, however, there is little relation between this objective and the precept of not taxing loss-making companies. A second objective for DST design is to identify the magnitude of location specific rent, so as to allocate taxing right to jurisdictions only to the extent of rent that is location-specific to them. So far, we have little knowledge as to how to attribute platform rent reliably to locations. According to the arguments in Part II, this would involve identifying the magnitude of shifts in demand or supply curves induced by user participation and the contribution of such shifts to producer or consumer surplus. But we also have no reason to think that this task will be helped in any way by looking at the accounting profits (or losses) of platform firms.

2. Unilateralism v. coordination

Another supposed source of inferiority of the DST is that its imposition would not be coordinated with taxing rights currently recognized under income tax treaties. Here, it is useful to distinguish between two types of coordination. First, suppose that countries design and implement the DST to capture rent specifically located in them. The need for coordination may seem to arise because under the existing international regime, taxing rights over such rent is also allocated to what traditionally are regarded as either residence or source countries. Second, countries may also enact DSTs to achieve other objectives that potentially conflict with the allocation of taxing rights over rent to

⁸⁰ Weyl and White, *supra* note 40.

⁸¹ Cremer, *supra* note 76, at 11-13 (the larger is the value of users to platform companies when compared to the value of quality (which requires costly investment) for the consumers, the more incentives firms will have to overinvest, in which case a profit tax without compensation for losses can be welfare-improving).

⁸² In addition, empirical information about important theoretical parameters is largely missing, and therefore it is difficult to anchor the theoretical possibilities to the real world.

countries where the rent is located: some might use the DST to implement final-sales-based formulary apportionment, while others use it to protect the source-based corporate tax base. In this case, conflicting designs of the DST need to be coordinated, in addition to coordination with taxing rights already enshrined in treaties. The EC DST Proposal can be seen as aiming to achieve this latter kind of coordination among EU Member States. By contrast, only the EC Long-Term Proposal, relying on the introduction of the concept of Significant Digital Presence, would help make advances on the first type of coordination.

In assessing the inferiority of the DST in comparison with the long-term solution, therefore, it is the first type of coordination that is more relevant. Here the key question is what would happen if there were no coordination. Income tax treaties enable coordination between source and residence countries through two types of mechanisms. First, the residence country offers the foreign tax credit (FTC) or exemption treatment with respect to income—either business profit in connection with a PE or certain other types of income in the absence of PE—subject to tax in a source country. Second, the source country cedes taxing right to residence country in other cases. Suppose that certain platform rent can be shown to be locatable in country X, but X is not regarded as the “source” of the platform firm’s income under traditional rules. Then the possibility arises that the residence country would not grant FTC for the DST charged, or would not treat the platform firm’s income (including X-specific rent) as exempt foreign income.⁸³ Alternatively, yet another country may claim that it is the source of income that X subjects to the DST.⁸⁴ In that case, that source country may provide neither credit nor exemption for the revenue subject to tax in X.

How bad is this kind of non-coordination? Despite perennial (and often mindless) rhetoric against international double taxation,⁸⁵ a reasonable reply is: it is unclear. Without FTC or exemption, the default treatment in most residence countries for foreign taxes paid is to grant a deduction. If the DST is successfully designed as a tax on economic rent, however, a deduction of the DST from the income tax base would still leave room for an income tax to be imposed without causing distortions. Indeed, regular corporate income taxation has always left ample room for the imposition of additional taxes on supra normal returns (e.g. “excess profits”). Historically, many such taxes on economic rent (typically imposed by “source” countries that also represent the locations of the rent) have been left out of treaty-based coordination.⁸⁶ It would seem, then, that no additional issues are raised by such unilateral taxes imposed by other countries, even if they would not be traditionally regarded as countries of source.

In other words, the non-coordination between the DST—as a way of implementing the taxation of location-specific rent—and regular corporate income taxation raises merely a secondary concern.⁸⁷ If

⁸³ For instance, Facebook’s advertising revenue from non-UK advertisers targeted as UK consumers would not normally be regarded as giving rise to UK source income. Therefore, the residence country of the Facebook advertising entity may not grant credit for the UK DST or regard Facebook’s income from advertising as from an exempt UK source.

⁸⁴ For instance, Facebook’s advertising revenue targeted as UK consumers may be booked to a permanent establishment in a third country.

⁸⁵ For a thorough critique, see Daniel Shaviro, *Fixing U.S. International Taxation* (2014)

⁸⁶ [US readers may recall that in the PPL dispute, the IRS rejected the argument that the UK Windfall Tax was covered by the UK-US treaty. The Supreme Court in *PPL Corp & Subsidiaries v. Commissioner* 569 U.S. 329 (2013) did not reach this issue.] See, generally, Wei Cui, Article 2: Taxes Covered, *IBFD’s Global Tax Treaty Commentaries*.

⁸⁷ If countries exercising traditionally recognized taxing right do not allow deductions for DST paid by platform companies (for example if they subject revenue received by platform companies to gross-basis withholding tax),

this is correct, then the emphasis given it in the EC's Long-Term Proposal (and the UK's position papers) seems misplaced. What should be of greater concern is the imposition of DST that does not aim to capture location specific rent at all. As anticipated in Part II.3.b, if the same advertising revenue that Facebook receives from Italian manufacturers targeted at UK consumers are subject both the Italy's Levy on Digital Transactions (as a source-base protection measure) and the UK's Digital Services Tax (as a tax on location specific rent), then it is plausible that Facebook may be over-burdened.⁸⁸ Similarly, taxes designed as instruments for destination-based apportionment may be in conflict with both traditional, source- or residence-based taxes and new taxes targeted at location specific rent.

In short, it is new taxes on digital platform companies that do not target location-specific rent that raise issues of coordination—*both* in the short-term and in the long-term. One objection to the EC DST proposal, implied by our previous discussion, is that it tolerates potentially mutually incompatible claims of user-value creation as motivations of the DST. This would be a distinct objection from ones based on incompatibility with traditional treaty claims.

3. User value creation: the irrelevance of arm's length

Of course, if a DST purportedly targeted at location-specific rent is or cannot be designed to do so, then the foregoing defense of its non-coordination under income tax treaties would not work. The possibility of measuring user value creation lies as the core of countries' aspiration to realign taxations with value creation. At least in theory, such measurement is not hard to describe. Suppose that data is available to allow the estimation of the demand curves for a broad range of imported products and services in a given country. Suppose, further, that there are opportunities for empirically identifying changes in such demand curves upon the introduction of online advertising, online reviews, and/or online customization. One might then be able to calculate the increase in producer surplus that results from such changes. If it is plausible that such changes occurred independently of any change in the supplies of the products, the increase in producer surplus will be an instance of rent arising from the consumer jurisdiction. Similar exercises might also measure rent arising from changes to supply curves brought about by digital platforms.

This type of empirical information may be hard to come by. However, the need for such information will presumably arise not only from tax law, but also from competition and other areas of regulatory law. In all of these areas, new doctrines may need to evolve to do rough justice to the idea of user value creation, in the absence of precise measurement. The likely directions of such future developments are beyond the scope of this paper. But it would seem that the current approaches to profit allocation under tax treaties might be entirely uninformative. This is because profit allocation under tax treaties is solely about transfer pricing, which deals with situations in which the pricing of inter-company transactions might be determined "artificially"—the pricing does not matter to the overall profit of the MNC group. Pricing decisions on different sides of a digital platform, however, are central to the platform's profit maximization strategy.

then the risk of distortionary taxation increases. However, such scenarios are likely to be uncommon, and the distortion arguably arises not from the DST but from the gross-basis withholding tax.

⁸⁸ Even here, though, one should be mindful that it is not how many times one's revenue or profit is subject to taxation, but the aggregate magnitude of the tax burden, that determines the extent of economic distortions. Shaviro, *supra* note 85.

Consider the arm's length principle (ALP), for example. Once rent is earned from a digital platform, it may be shuffled among different entities in an MNC group, and ALP may be useful for preventing this traditional type of profit shifting. But the inquiry into user value creation is primarily one about who, among parties already at arm's length (e.g. the platform and the different sides it intermediates), is responsible for corporate rent earned. It would be very odd to be told that the answer to this question is: "We will first pretend that the third-party users are not third parties but a part of the digital platform's business operations (e.g. an SDP carrying out "significant economic activities"); we will then attribute profits to this fictional business unit by further pretending that it is dealing with the platform company at arm's length." Similarly, it seems unclear what would even be meant, let alone what would be gained, by conducting a "functional analysis" of users as though they form business units of the digital platform.⁸⁹

This argument concerning the irrelevance of the ALP is particularly decisive if one accepts the premise articulated in Part II: once a platform technology is applied to country X to generate profit, and assuming that the deployment of that technology for country X users does not exclude the deployment of the same technology elsewhere, the entire economic rent generated by the technology in respect of X should be attributed to X. It is possible that current transfer pricing doctrines resist this type of profit attribution, and insist that managerial decisions, legal ownership of intellectual property rights, and the bearing of financial risks should entitle a company to residual (and extraordinary) profits outside the user jurisdiction. This would be a disagreement about the fundamental definition of user created value, not about its measurement. If, however, the conception of location specific rent in Part II is accepted, then traditional profit attribution rules will be relevant only for attributing normal returns to various business functions.

IV. Must the DST Be Given a Basis in Tax Treaties?

Part III argued that, in terms of optimal DST design: turnover tax may not be unacceptable (though it is possible that profit taxes are superior); international coordination may not be necessary if DST is aimed at taxing location-specific rent; and identifying such rent should be the sole measure of the tax's success and legitimacy, and therefore the main issue that the debate about taxing digital platforms should focus on. Another way of casting these arguments is that while the EU and the UK cast their DST proposals as ways of prodding other nations into long-term action, one might not see a "there" there in the long-term direction suggested. If one is interested in taxing location-specific rent generated by digital platforms, both coordination with existing taxes and finding a treaty-compatible formula for profit attribution are secondary issues. In this Part, I reinforce these points by showing that reaching international agreement on "significant digital presence" (SDP) as the jurisdictional basis for taxing corporate profits is also a secondary issue with little policy content. But, first and more generally, one should question the aim of fitting new taxes on digital platforms into the tax treaty framework.

1. The Ideology of Broad Treaty Coverage

The EC designed its DST as a tax on revenue, specifically so that the latter cannot be viewed as a tax governed by income tax treaties. There are no doubt legal and political reasons for this. For example, in many European countries, treaty overrides may be harder to carry out as a matter of domestic law than they are in the United States or U.K.. Some countries may also see it as being strongly in their self-

⁸⁹ Becker and Englisch, *supra* note 45, expresses similar skepticism about the ability to incorporate "user value creation" into the "authorized OECD approach" to transfer pricing.

interest to maintain the appearance of strict adherence to treaties. Even so, there is a narrower legal question that bears examination: What should the scope of income tax treaties be interpreted to be? This question is largely governed by the treaty counterparts to Article 2 (Taxes Covered) of the OECD Model Convention. Specifically, the question is whether any tax that appears to be designed as a tax on profit would be presumed to be a tax on income, and therefore within the scope of Article 2 (and its counterparts in actual treaties).

It is my view that there are plenty of persuasive arguments—supported by many examples from real-world treaties—that the answer is No.⁹⁰ A general consideration is that, treaties being contractual agreements between states, the contracting states can choose the scope of the agreements to be as narrow or as broad as they like.⁹¹ Thus, for example, just as there is nothing odd about including payroll taxes in the scope of an income tax convention, there is nothing remarkable about leaving them out either. There exist both sufficient similarities and sufficient differences between payroll taxes and income taxes for either to be acceptable. By the same token, some practitioners have suggested that a DST can be designed as a tax on net profits but (i) allocated according to some unusual formula based on user participation and (ii) imposed alongside the standard corporate income tax, and that it should as a result not be viewed as sufficiently similar to treaty-covered taxes and therefore can be adopted without breaching tax treaties. Indeed, this is very much the type of argument that has been made to suggest that the UK Diverted Profit Tax falls outside the scope of tax treaties.⁹²

However, there is what one might call a “treaty ideology” (which seems especially popular in Europe) that the scope of income tax treaties should be given the broadest reading possible. The justification for this (sometimes called “contextualist”) approach is that only so would taxpayers be afforded the broadest protection against double taxation, however that may arise. The invocation of “double taxation” as an absolute evil, of course, should never be taken seriously. Even supposing that avoiding double taxation is an important goal,⁹³ it needs to be remembered that tax treaties coordinate countries to achieve that goal by agreeing on the allocation of taxing rights: tax treaties cannot be said to succeed if they mitigate double taxation but only at the cost of generating allocations that go against countries’ wishes. There is no reason to think that countries put such great value on the avoidance of double taxation that they are willing to broaden the scope of tax treaties at all costs.

In the context of the controversy surrounding taxing digital platforms, the ideology of giving existing treaties the broadest coverage seems even more capricious. The possibility of significant user value creation points to some fundamental alterations of the distribution of taxing rights. While countries prepare to assert their new claims, they are also interested in honoring their obligations under existing treaty law. To include all profit taxes (and indeed even taxes on turnover aimed to bear on profits) within the scope of such obligations, however, potentially leaves countries with fewer and worse policy instruments to pursue their objectives. This means that from the world’s perspective (and not just from the perspective of individual country preferences), an over-broad reading of the scope of treaty

⁹⁰ Cui, *supra* note 86.

⁹¹ A further argument is that because the purported normative objective (the prevention of juridical double non-taxation) of tax treaties is so formalistic, it is difficult to offer “contextual” arguments for broadly interpreting treaty terms such as “taxes on income”. *Id.*

⁹² See P. Wagman, *The U.K. Diverted Profits Tax: Selected U.S. Tax Considerations*, 147 *Tax Notes* 1413 (22 June 2015);

⁹³ There are many reasons to be skeptical of the crude formulations of this goal that are usually relied on. See Shaviro, *supra* note 85; Wei Cui, *Minimalism about Source and Residence*, 38 *Mich. J. Int’l L.* 245 (2017) (arguing traditional claims about double taxation systematically ignore the economic incidence of taxes).

obligations can be welfare diminishing. Indeed, the perverse effect of an over-broad reading of the scope of treaty obligations is quite extreme, if the argument from Part III.3 is correct: incorporation into tax treaties may do *nothing* to advance the goal of allocating rights to tax location-specific rents, since traditional treaty norms offer no guidance on such allocation. If treaties do not significantly enhance the taxation of platform rent, precluding the possibility of such taxation unless it is implemented through treaties is nothing but irrational.

2. SDP

The last contention of this paper should now come as no surprise: the international adoption of the concept of “significant digital presence” (SDP) arguably has little policy content and therefore cannot be used to mark any policy achievement.

The arguments for this contention are simple. SDP expands the concept of permanent establishment (PE), but the latter concept serves only a very limited purpose: it gives a country the right to tax the business profit of a non-resident enterprise under a treaty-covered tax. Notably, PE is far from the only basis for asserting taxing jurisdiction under international law. Indeed, tax jurisdictional claims have become quite fluid and flexible in the field of international taxation in the post-BEPS world.⁹⁴ It is thus important to remember that PE is only a jurisdictional threshold for treaty-covered taxes (and only for net-income based taxation within treaty-covered taxes, for that matter). Suppose, then, that a DST designed to tax location-specific rent earned by digital platforms can be distinguished from existing treaty-covered taxes (indeed suppose even that such a tax is designed as a tax on profits and not turnover). Then further introducing the concept of SDP gives countries no greater jurisdictional claim than they could already make.

Suppose, to the contrary, that no well-designed DST can be sufficiently distinguished from existing treaty-covered corporate income taxes, and therefore can be implemented only through the modification of tax treaties. Presumably, this will be because the DST allocates taxing rights very differently from existing income taxes. We will then want to know what this difference consists in. This, however, depends on how profit is attributed to SDPs under the new treaties. The notion of SDP will not itself tell us that.

Conclusion

In the coming months, either if the EC adopts the proposed DST, or if individual European countries (and the UK) adopt their own DSTs in the aftermath of the EC’s failure of action, the topic of taxing digital platforms will likely provoke worldwide public debate and voluminous commentary. In the discourse surrounding the DST that has emerged so far, however, there is little clear articulation of the fundamental objectives of the DST. The most important articulation so far, in fact, is to be found in the EC’s and the UK Treasury’s own publications. Scholars and other commentators have been at best agnostic, and indeed have much more frequently been outright dismissive, of the possibility that the DST could have coherent objectives. With no clear view as to what the enactment of the DST is for, reactions to the DST proposals understandably have tended to emphasize stability and the political process of international coordination. This has led to an almost uniform acceptance of the idea a long-

⁹⁴ One is tempted to say: “nexus” claims are now cheap.

term treaty-based solution is superior, and any interim action is only of strategic value in bringing about the long-term solution.

This paper has tried to upend this discourse, by articulating more clearly than others have done the fundamental purposes of a DST. Moreover, in light of at least one such fundamental purpose, namely taxing location-specific rent earned by digital platforms, I have argued that the widely-discussed “long-term solution” may have little to offer by way of policy substance. Even if the arguments in this paper are not entirely successful, it is hoped that they can help inoculate at least some readers against mindless invectives against the DST, and lead to better discussions of how that fundamental policy objective can be better served.