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The Superiority of the Digital Service Tax over Significant Digital Presence Proposals

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Responding to calls for reallocating taxing rights over multinationals' profits to reflect the place of user value creation, the OECD recently announced a Program of Work to implement international tax reform. I use the European Commission's 2018 proposal to introduce the "significant digital presence" concept into income tax treaties as an example of the type of approach the OECD favors, and argue that it is inferior to recently proposed digital services taxes (DSTs). DSTs directly address the question of where profits should be allocated and taxed, while SDP proposals subordinate this vital question to superfluous treaty conventions. Global tax coordination deserves better focal points.

Key words: digital services tax, significant digital presence, international taxation, tax treaties, profit attribution.

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I. INTRODUCTION

In 2018, the UK government, the European Commission (EC), and several European national governments separately announced bold legislative proposals for enacting a new tax policy instrument, the "digital services tax" (DST).[1] These governments demanded the international community to explore long-term strategies to reforming international business income taxation so that taxing right over the profits of multinational digital platform companies (e.g. such as Google, Facebook and Amazon) could be reallocated to reflect the value contributed by platform users. DST proposals are unilateral, "interim solutions" meant to prod nations into multilateral action: DSTs would be enacted *unless* countries come to agree on reforming international income taxation in satisfactory manners.

The bid by DST-proposing countries to set the agenda for international tax reform has been remarkably successful. In May 2019, the Organization for Economic Development and Cooperation (OECD) announced a "Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy" (OECD 2019b). The document explicitly considers, among several other reform proposals, methods that refer to "user participation" for revising the profit allocation rules under international income taxation (see also

[1]See HM Treasury 2018a and 2018b (UK policy statements); [EC 2018a]; European Commission 2018a and 2018b (proposed Directives on SDP and DST, respectively); KPMG 2019 (Spain); Sprackland 2019 (France).

OECD 2019a). Notably, the OECD's new Programme of Work not only is endorsed by the G20 but also commands a mandate, from the outset, from the OECD/G20 Inclusive Framework, which boasts of 116 member countries.[2] This represents both the highest-level and the broadest multi-governmental endorsement that efforts at international coordination in the realm of business taxation have ever achieved.

What might serve as worthy focal points for such unprecedented global coordination? Some prominent intellectuals have recently offered new articulations (or re-statements) of their visions for why the international tax system must change (see, e.g. Summers 2019, Zucman 2019, Devereux and Freedman 2019). But most recent commentaries by academics and practitioners continue to give more emphasis to certain narrowly-conceived means, rather than the goals, of global coordination. Two themes are perhaps repeated most often. First, international coordination should be organized within the longstanding framework of income tax treaties. Second, under such a framework, countries' claim of taxing rights over corporate profits are to be given recognition through the legal concepts of "nexus" and "profit attribution" to nexus. Moreover, countries should design mechanisms for avoiding "double taxation" and for efficient dispute resolution. From these starting points, the "work" of reforming international taxation quickly turns to technicalities. In fact, most of the OECD "programme of work" is outlined by reference to these technicalities. The programme's position seems to be that whatever reallocation of taxing rights is agreed upon, they must be formulated and comprehensible through the concepts of nexus, attribution of income to nexus (or "source of income"), the alleviation of double taxation, and adequate dispute resolution. Although certain

[2] By contrast, the OECD's Base Erosion and Profit Shifting (BEPS) project, launched in 2013, initially did not proceed under the Inclusive Framework, which was set up only in 2016.

new profit allocation rules are also suggested,[3] their descriptions are similarly couched in traditional treaty (especially transfer pricing) jargon, with more references to the technicalities of administration than to what international tax reform is supposed to accomplish.

In this article, I argue that global coordination on business tax reform probably requires, and certainly deserves, better ideas as focal points. The obvious advantage of steering such coordination through the traditional tax treaty framework is the latter's familiarity to businesses and tax professionals. But this has to be weighed against two important disadvantages. First, the concepts defining the treaty framework often stand for superfluous conventions. Clinging to these conventions will likely impede discussions of reform by rendering reform objectives obscure. Second, imposing the treaty boilerplate on the global debate about international tax reform also restricts our view about what counts as international cooperation. Ultimately, this may restrict the scope of such cooperation.

I illustrate these arguments through the comparison of two tax policy proposals. The first is the EC's 2018 proposal to introduce the concept of "significant digital presence"(SDP) into the treaty framework. The second is the DST, which the EC (and other governments) presented as the short-term policy substitute, pending an international consensus on the SDP proposal or other tax-treaty-based reform proposals. I argue that the SDP concept exposes the near-emptiness of the treaty convention of allocating business profit through a two-step procedure: finding nexus, and attributing profit to nexus. This lack of substance stems from two fallacies embodied in that convention. The first is conflating criteria for determining the existence of an obligation to compute taxable profits and the criteria for properly determining the extent of such profit. The

[3] In OECD 2019a, three proposals were identified: (1) user participation, (2) marketing intangibles, (3) significant economic presence. In OECD 2019b, a re-labelling of approaches was adopted. Two "methods", the modified residual profit split method and the fractional apportionment method, and an "approach" (which is supposed to be simpler than a "method"), the distribution-based approach, were briefly described.

second is the pretention that the “arm’s length principle” provides a relevant guide to the allocation of profits, even when no actual transaction among related parties occurs. Fitting proposals for reallocating tax rights within this conventional two-step procedure perpetuates these fallacies without advancing discussions of desirable reallocation.

By contrast, DST proposals embody the idea that countries should be entitled to tax location-specific rent (LSR) associated with them. Within the realm of tax policy, taxing LSR is widely supported by governments, scholars and businesses and is implemented through a wide variety of taxes. It is not tied to and can be understood and evaluated independently of any particular legal convention. The goal of giving countries the ability to claim a public share of the economic rent that arises in them is pursued in a large variety of government policies, tax or non-tax. Countries have an understanding about what it is to coordinate in the mutual pursuit of this goal that is also not tied to any particular treaty framework, and have evidently achieved such coordination with frequent success. Insofar as proposed DSTs adequately implement the objective of taxing LSR, it is easy to state what international coordination around them requires without reference to the tax treaty framework. This raises the question: Why should we, in the global debate on reforming international taxation, (i) privilege the treaty framework for coordination (ii) at the expense of obscuring the goals of coordination?

I have analyzed the design of the DST as a tax on LSR elsewhere (Cui 2019, Cui and Hashimzade, 2019) and will only briefly summarize the analysis in Section III. This article focuses on three sets of new arguments. First (Section II), I highlight the fallacies underlying the conventional two-step procedure for allocating profits to countries. I am not aware of previous commentaries explicitly criticizing the convention this way.[4] Second, I defend (Section III) the

[4] This set of arguments in this Article complements arguments developed in Cui 2017a against other aspects of treaty concepts and doctrines (namely that (1) the concepts of residence and source under international taxation

DST against several common objections (specifically that (i) the DST inappropriately ring-fences the digital economy, and (ii) the DST targets certain two-sided business models while excluding others without any intelligible justification). Third, I explain what international coordination around DST implementation requires (Section IV). Overall, I make the case that in structuring the international community's current effort to acknowledge and coordinate new claims of taxing rights, coordination through the income tax treaty framework is far from being the only or the most appropriate option.

II. SDP AND THE SUPERFLUOUSNESS OF THE TWO-STEP PROFIT ATTRIBUTION CONVENTION

The OECD's May 2019 Programme of Work asserts that all the new profit allocation rules it considers and that may give shape to international tax reform "contemplate the existence of a nexus in the absence of physical presence." Therefore, the Programme "will explore the development of a concept of remote taxable presence…and a new set of standards for identifying when such a remote taxable presence exists"(OECD, 2019b, p.11). In this respect, the Programme takes for granted a convention that no country can claim a taxing right over the business profit of a foreign person without a presence or "nexus". The concept of "nexus" is either a pre-requisite to the allocation of taxing rights or at least an indispensable concept for making statements about profit attribution. This convention is so ingrained in the tax treaty framework that it seems hard to imagine international income taxation without it.[5]

possess minimal content, and (2) the prevention of "double taxation" cannot be relied on as a coherent goal for international coordination.)

[5] European legal scholars, even in proposals intended to boldly reimagine international taxation, invariably adheres to this convention. See, e.g., Schön, 2018, Becker and Englisch, 2019.

A. The EC SDP Proposal

Instead of waiting for the Programme of Work to be filled out, one can already find a good illustration of how a new nexus concept might be elaborated in the EC's March 2018 proposal for amending tax treaties among the E.U. Member States. This proposal would allocate taxing rights over the profits of digital platforms according to the Significant Digital Presence concept (EC 2018a). The EC SDP Proposal contains specific 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. The proposal would extend the treaty concept of "permanent establishment" (PE) to include a "significant digital presence" (Article 4 of the proposed Directive). A business will have an SDP 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 (Article 4(3)).

In addition, a range of activities pursued by an enterprise in connection with an SDP would be regarded as "economically significant activities" of the enterprise.[6] These activities are conceived as constituting the "development, enhancement, maintenance, protection and exploitation of intangible assets" in the SDP jurisdiction, and therefore justify profit attribution to the jurisdiction (even though the activities are physically carried outside the jurisdiction). Finally, "profit attribution" to an SDP would follow two principles. First, it would be consistent with the

[6] The definition of "economically significant activities" is broad and encompasses, inter alia, "(a) the collection, storage, processing, analysis, deployment and sale of user-level data; (b) the collection, storage, processing and display of user-generated content; (c) the sale of online advertising space; (d) the making available of third-party created content on a digital marketplace; and (e) the supply of any digital service not listed in points (a) to (d)." Article 5(5)

arm's length principle (ALP).[7] Second, it would extensively rely on the profit split method used in current transfer pricing rules but would consider factors beyond expenses incurred for research, development and marketing to include "the number of users and data collected per Member State" (Article 5(6)). This way, profit attribution to an SDP aims "to reflect the way value is created in digital activities."[8]

The language of the EC proposed Directive for attributing profits to an SDP adopts very similar formulations to the general principles of profit attribution to a PE under the OECD model tax convention. Even though the proposed Directive has received little commentary—because the political feasibility within the EC of its adoption was always doubtful—it would not be surprising if the OECD's Programme of Work ends up with recommendations very much like it. What, though, does this set of legal language accomplish?

It is useful to paraphrase the EC's proposed profit attribution procedure. Once a digital company has enough dealings with a country (defined as revenue from, the number of users located within, or the number of contracts concluded with users so located), it has an SDP there. The revenue sources, contracts, or users are then conceived as intangible assets to which certain activities of the company (i.e. those that are "economically significant") are attributed. This is the first step in profit attribution, and it comprises two conceptual maneuvers: (1) customers/users are treated as assets of the digital company, and (2) activities associated with tangible assets (e.g. servers) and activities (employees) of digital company outside the SDP jurisdiction are attributed to the intangible assets conceptualized in (1). In the second step of profit attribution, profits are

[7] "The profits attributable to or in respect of the SDP shall be those that the digital presence would have earned if it had been a separate and independent enterprise performing the same or similar activities under the same or similar conditions, in particular in its dealings with other parts of the enterprise, taking into account the functions performed, assets used and risks assumed, through a digital interface" (Article 5(2))

[8] EC, 2018a, p.8 (detailed explanation of Article 5).

determined for the activities conceptualized in the first step, as though those activities are carried out by a third-party business independent of the rest of the enterprise.

How is this different from simply identifying a sufficient volume of transactions with (or user participation from) a jurisdiction, and asking how much profit is generated from such transactions or participation, and how much should be allocated to the user jurisdiction for potential taxation? Besides stating a threshold of taxing right, the insertion of a "nexus" concept (i.e. SDP) appears to do the work of bringing into fictional existence a non-physical and internal component of the digital company (i.e. assets and activities in the SDP jurisdiction)—*just so that* it can be undone by a further fiction, that of arm's length transactions among internal divisions. This is paradoxical, in more than one way. When the arm's length relationship between digital platforms and their users are already in plain daylight, why does one need to create a fictional arm's length relation among them? Moreover, in the case of two-sided business models—which many of the digital companies embroiled in the international tax reform debate implement—one set of users (e.g. individual users of Google or Facebook) may be located in a different country from other users (e.g. advertisers) that the platforms bring together. According to the SDP concept, the SDPs thus found in different countries should be treated as transacting with the platform, and with one another, as independent enterprises. Yet the very concept of two-sided business models is that *one* business brings two sets of users together that would not otherwise be able to interact with one another, and profit from such ability to intermediate (see Section III for further discussion).

The most important point to note about the SDP concept, though, is not its paradoxical nature. It is that it does nothing to speak to the questions: how much profit is generated from user participation, and how much of the profit should be allocated to the user jurisdiction for potential taxation? The work of answering these questions seems to be left to the profit attribution rules. The SDP concept itself is silent on them. Why, then, is the concept necessary?

B. Two-Step Profit Attribution Convention in General

The above argument may be read as picking the easy target of an already unpopular policy proposal. That is not my intention in making it here. The point is instead that the same argument can be made against the thoroughly familiar and widely accepted profit attribution convention under the income tax treaty framework. Under this convention, a country can claim taxing rights on a non-residents business profits only when a PE (the archetypical nexus concept) is found, and the extent of the consequently-taxable profit is determined as what is "attributable" to the PE. I would argue that this two-step convention is itself as empty and as paradoxical as the SDP concept, and roughly for the same reasons.

The problem of the treaty profit-attribution convention can be described in terms of two fallacies. The first is a conflation between an obligation to compute taxable profit and how such profit should be computed. The second is a confusion about the utility of the ALP when no actual related party transactions or pricing is involved.

1. The obligation to compute taxable profit v. the extent of the taxable profit

Under income tax treaties, the PE concept is used to ground the right of a country to tax non-residents' business profits.[9] This does not mean that the country in which a PE is found will necessarily have anything to tax: it is possible that no net profit is attributed to a PE. A PE merely stands for a status that requires the non-resident enterprise with a PE to calculate its net profit arising from the country in which the PE is located. There are thus two (logically exhaustive) ways

[9] PE is not the only ground for the exercise of taxing rights under the income tax over non-residents. Countries can levy withholding taxes (or even taxes on net income, in the case of capital gain) on non-residents in the absence of a PE.

of interpreting the PE concept. One is that it is purely an administrative threshold, meeting which leads to an obligation, on the part of a non-resident, to compute taxable business profit from the PE jurisdiction. The other is that PE stands not only for a compliance obligation, but also implies a judgment that there is *enough* taxable profit attributable to the PE country that an explicit determination of the extent of such profit (through the filing of income tax returns that allocate income and expenses) is in order.

Yet these two possibilities create a dilemma for explaining the concept of PE. On the one hand, if PE is purely an administrative concept, there is no such thing as an amount of profit properly attributable to a PE. *No* amount of taxable profit is naturally or inherently attributable to a mere obligation to compute taxable profit. This implies that the exercise of determining the profit attributable to a PE is literally nonsensical. Whatever profit is determined to be taxable in the PE jurisdiction must be so determined by virtue of something other than the existence of a PE (*qua* obligation to compute net income).

On the other hand, if the application of the PE concept carries some implicit judgment that enough taxable profit is likely attributable to the PE jurisdiction, then the attribution of profit is already being done by the finding of a PE in the first place. One should be able to make such implicit judgments explicit without even referring to the concept of PE or nexus. This possibility also raises the question of whether there can be judgments about the appropriate attribution of business profits to a jurisdiction independently of the judgments implicit in any PE concept. If the answer is yes, profit attribution again is independent of the PE concept, and the latter cannot be presented as a pre-requisite for making statements about profit attribution.

The challenge this dilemma poses for the two-step profit attribution convention is severe. Each horn of the dilemma implies that the PE concept is irrelevant for specifying how profit should be attributed to a jurisdiction. And neither horn is easy to escape. For instance, few probably would deny that the PE concept is heavily coloured by administrative concerns, making the first horn of the dilemma a serious threat. The history of inbound taxation In the United States offers an especially vivid illustration of how “nexus” often functions purely as a compliance requirement. As documented in Sicular and Sobol, 2003, between 1913 and 1936, *all* foreign persons were subject to net-income-basis taxation on income from sources within the U.S.. There was no PE-like threshold on the United States’ power to tax foreigners’ net income. In 1936, a version of this threshold was introduced: only foreign persons engaged in a U.S. trade or business or who had an office or place of business needed to report their U.S. source income on annual tax returns and pay tax on such income on a net basis. While the “trade or business” or “office or place of business” concepts seem to instantiate the notion of nexus, they, in fact, sustained no profit attribution exercise: once a foreigner triggers a return-filing obligation, all U.S.-source incomes are taxed in the same fashion. This “force of attraction” regime displayed no concern to *attribute* net profit to a particular U.S. “trade or business” or “office or place of business”.

Before 1966, the force of attraction regime was modified only to deal with tax avoidance and offered a competing paradigm to the European approach of profit attribution to PEs.[10] It was not until 1966, facing a balance of payment crisis, that the U.S. abandoned the force of attraction regime for FDAP income and capital gains, and introduced the concept of “income effectively connected” to a U.S. trade or business. Even so, a “residual force of attraction” regime is retained under I.R.C. Sec. 864(c)(3) and Sec. 897: the obligation to file full U.S. income tax returns remains somewhat independent of the nature and extent of income reportable on such return.

[10] The force of attraction regime had parallels in other parts of the world and, even today, is an acknowledged practice in the United Nation’s Commentaries on its model tax convention.

The second horn of the dilemma is similarly pressed by real-world examples. A number of governments have in recent years enacted taxes on the business profit of non-residents in the absence of PEs, arguing that taxing rights over profits arising from their jurisdictions should not be defeated by the successful avoidance of PE status. These taxes—including the U.K.'s diverted profit tax (DPT) and Australia's Multinational Anti-Avoidance Law (MAAL)—have been subject to vicious criticism, on the ground that they violate the enacting governments' treaty obligations (which makes PEs a prerequisite for the taxation of non-resident's business profits). Such criticisms, however, are immediately undermined by the legal argument that PE is a relevant concept only for treaty-covered taxes. Taxes that do not tie taxing right to PEs may simply not be covered by tax treaties (Wagman, 2015).

The fundamental reason for the weakness of treaty-based objections to the DPT or MAAL is that those who make them fail to state a persuasive, independent case that the profits that the U.K. or Australian governments aim to tax through these novel tax instruments are not properly allocable to these countries. The objection is only that, legally, a PE is absent. But this simply reinforces the governments' claims that the traditional PE criteria fail to capture intuitions about where business profits are allocable, and that these intuitions can be sensibly stated without the PE concept.[11]

2. The irrelevance of ALP

The main principle guiding the second step of the conventional profit attribution approach, the ALP, is also superfluous. This can be explained more briefly. The ALP originates from Article 9 (related enterprises) in income tax treaties. The idea is that while the pricing of related party

[11] The failure of the PE concept to capture many intuitions about profit attribution explains why tax jurisdictional claims have become quite fluid in the post-BEPS world. Again, it is important to remember that PE is a jurisdictional threshold only for net-income-based taxation, even within treaty-covered taxes. It is far from the only basis for asserting taxing jurisdiction under international law.

transactions may alter the profits computed for the related parties, it does not alter the aggregate profit of the related parties. Therefore, the actual pricing of related party transactions may not be reliable in determining the parties' respective profits. Consequently, arm's length pricing needs to be consulted. That is, in the related party context, ALP is used to correct the impact of actual pricing of actual related party transactions on the determination of profits. The extension of ALP to Article 7 (profit attribution to a PE), however, faces an immediate objection. The PE and the non-resident company it forms a part of are not distinct legal entities. Often, they do not engage in actual transactions. Unless, for non-tax reasons, the PE and the rest of the enterprise to which the PE belongs record nominal transactions and corresponding prices, the existence of separate persons and transactions is itself fictional. The threat of mispricing in such transactions is therefore also fictional. The ALP is simply irrelevant.

The takeaway is that the two-step profit attribution approach adopted by income tax treaties is not only a very oblique convention for allocating taxing rights over multinational profits, it often does not provide guidance over such allocation *at all*. The irony is that when an upheaval in international taxation is fueled by countries' insistence to reallocate taxing rights, the OECD, EC and many others in the international tax community seem to insist that the best long-term solution can only be found by sticking to this oblique convention.

To some readers, it may seem surprising that the critiques of the superfluousness of two-step profit attribution convention stated in this Section are not already widely understood. I believe that the reason why they have not aroused much prior interest is that, relative to transfer pricing among related parties, profit attribution to PEs is a small portion of international tax planning and also generates negligible revenue for governments. Most multi-national corporations operate their foreign operations through subsidiaries rather than unincorporated business presences that give rise to PEs. The amount of tax at stake in Article 7 profit attribution, therefore, has been relatively small. But when the OECD, EC, and other governments look to the nexus concept to reform international taxation in the age of digitization, they are precisely looking to this relatively obscure corner of international taxation for principles to ground the future of international taxation. The conventions in this area, however, simply cannot bear that weight.

III. THE DST

Arguably, the most important contrast between the SDP proposal (and other similar treaty-based proposals) and proposals for enacting a digital services tax is that the latter speak directly to the question: where is profit located? The basic rationale that the EC, U.K., and other governments gave for the DST is that there is a misalignment between where value is created for certain digital platform companies and where the current international tax regime allocates taxing rights. The concept of the place of user created value is front and center.

A. A Direct Approach to Identifying Profit Location

The "user value creation" concept has a natural and compelling interpretation when applied to certain digital platforms (Cui, 2019). Many such platforms—Google, Facebook, Amazon Marketplace, Uber, Airbnb, to name a few prominent examples—operate two-sided (or multi-sided) businesses. That is, they simultaneously provide different types of services to different sets of users, and do so because of externalities among these different sets of users: at least one type of user (on one "side") cares about what the other type of users (on "the other side") do, including how many such latter users there are. Such "indirect network effects" create the possibility for two-sided businesses to manipulate the structure of the prices charged to each side, and rely on variations in price structure (even when the aggregate price charged to the two sides for a given transaction is fixed) to maximize transaction volume and profit (Rochet and Tirole, 2006). For example, a two-sided business can price below marginal cost on one side (i.e. providing a subsidy to that side), thereby increasing the number of users on that side, and make up for the loss on the other side, because users on the second side value the larger number of users on the first side and are willing to pay for it.

Two-sided business models are not new: newspapers, credit card networks, and broadcasting supported by advertising revenue are examples of earlier incarnations. What is new is that some of the largest multinational companies in the world today operate such models, with users participating from different jurisdictions. This has direct implications for international taxation. A platform may provide services at prices below cost to users on one side in a given country while charging users on another side in a different country for access to the first set of users. Users on the first side are crucial for the platform company's ability to profit from users on the second side, yet such "user value creation" in the country of the first side may be accompanied by little or no payment *from* that country.

Consider, for example, a stylized depiction of Facebook's business model (Figure 1). Facebook offers free social media service to users from all over the world while offering advertising services to advertisers for a price. Suppose American companies purchase advertising slots on Facebook targeted at French consumers, in the hope that the latter would purchase their goods or services.[12] Facebook earns a profit from such American producers and receives payments from them in the United States. Even if Facebook has a PE in France, there may be no reason to attribute the profit Facebook earns from American advertisers to the French PE: such profit may simply have no connection with the activities of the PE. However, there is a clear and distinct

[12] When the American companies make sales of goods or services to French consumers, the sales may be subject to the French VAT or other taxes on sales (whether they are subject to French income tax depends on whether they have a PE in France).

sense in which Facebook's profit earned from the ads targeted at the French are based on value creation in France. The American companies are willing to pay Facebook only because they expect the ads would boost sales in France. And there is no boosting of sales in France unless French consumers use Facebook's social media platform. In this sense, the French users' participation makes Facebook a profitable seller of advertising. Moreover, although the use of Facebook is enabled by Facebook's technology and services, often delivered away from the user jurisdiction, Facebook's placement of ads targeted at French users has no opportunity cost in terms of ads targeted at users elsewhere. Therefore, Facebook's profits from French-targeted ads can be earned only from French users. This leads to the conclusion: French users created value for Facebook.

In this interpretation, the "user value creation" concept identifies, in the foregoing example, a location of profit that is distinct from both the source of payment to Facebook (i.e. the United States) and the locations of Facebook's physical assets and personnel. It does not identify such location by analogy to the PE concept (e.g. by asserting that French users represent intangible assets of Facebook's) or any other concept of "nexus". Instead, the concept plausibly connects Facebook's profit to France, and thereby supports a potential claim by France to tax Facebook's profit, independently of any existing convention of international income tax law. An important question, therefore, is why one must bend such a concept (and the reasoning it supports) into the mold of the conventions of income taxation to be considered and to attain legitimacy.

The DST is a way of implementing the "user value creation" concept outside the income tax framework. In the above example, France would impose a 3% DST on Facebook's revenue from ads targeted at French users, thus claiming a share of Facebook's profit that it could not claim under the existing international income tax regime. The DST can be analogized to a variety of taxes that are distinct from the regular corporate income tax and that are also imposed on location-specific business profits, such as royalties and resource rent taxes on natural resource extraction (Cui and Hashimzade, 2019). Like these other taxes, the DST takes a view about where profit is located and is specifically tailored to taxing such profit.

B. “Ring-Fencing” and Other Objections

The most dismissive objections against the DST have been premised on the assumption that the “user value creation” concept is incoherent, ad hoc, or hopelessly vague. Once that concept is interpreted in terms of location-specific platform rent, however, many of these objections quickly fall away.

Take, for example, the popular slogan that one cannot “ring-fence” the digital economy and change international tax rules just for a few sectors (especially not just for a few big American companies). What, however, is the principle against “ring-fencing” exactly? If it is that a uniform set of international tax rules must apply to the taxation of all businesses, then the principle has no subscribers. Even within the utterly conventional world of tax treaties, differential treatments abound. Special provisions are made for the taxation of the labour income of artists, athletes, educators, and diplomats in contrast to the general provisions for taxing cross-border labour income. International transportation income and sometimes income from technical services are treated differently from other types of business profit. Income from real properties can also be taxed differently from other types of investment income. The domestic law provisions of each country governing the income taxation of cross-border transactions usually offer an even greater variety of differential treatments. If a special set of income tax rules can be designed and agreed upon for taxing online advertising, would a provision setting out such rules even *look* out of place in tax treaties?

The principle against ring-fencing, therefore, must reflect simply the notion that no *arbitrary* distinction should be drawn among different business models and sectors in re-designing income taxation in the digital age. This notion is quite weak, however, and has bite only when one assumes that new taxes like the DST serve no purpose.[13] The concept of location-specific rent is not arbitrary, nor is the notion of "user value creation" when interpreted in terms of LSR. Suggestions that the distinctions drawn by the DST are arbitrary must be backed by more specific arguments. Consider, for instance, the question[14]: "There are so many two-sided businesses, old and new, why shouldn't the DST be imposed on all of them?" The answer is clear. The DST is designed to deal with problems in international taxation created by two-sided businesses—specifically, the misalignment between value creation (a la rent location) and the source of payment. Many two-sided businesses do not generate such misalignment (or at least not to a substantial degree).[15] The business models initially selected to be the target of the DST clearly instantiate such mis-alignment. Governments proposing the DST are well aware of other two-sided digital businesses. Such businesses are explicitly outside the scope of the DST, based on an implicit judgment that there is no (substantial) misalignment in those cases.

Another type of objection that has been made against the DST is that as currently proposed, it is not applied to all cases of location-specific platform rent. This is quite likely true: the DST has faced such vehement opposition that governments that propose it may well hesitate before expanding the scope of the tax. However, this also clearly does not lead to the conclusion that the DST should not be enacted. Countries try to tax LSR from the extraction of certain natural

[13] Many early critics of the DST assumed that the notion of "user value creation" merely reflects platitudes such as "all producer surplus depends on there being consumers", or "all consumer surplus from market goods depends on there being producers." The idea that specific instances of platform rent can be traced to particular consumer or producer location is clearly distinct from such platitudes.
[14] This question is implied by Grinberg, 2018 in his discussion of the Lloyd's insurance marketplace.
[15] When foreign merchants pay domestic newspapers or owners of ad boards to advertise to domestic consumers, for instance, the country of the consumers has no trouble taxing the newspapers or ad board owner.

resources such as oil and gas, but probably fail to tax other forms of LSR. This is not an argument against the levying of resource rent taxes or royalties!

It is also important to note here that there is a variety of ways for governments to claim a public share of location-specific rent. Consider the observation in Grinberg 2018 that patients participating in clinical trials represent an important form of "user participation" generating value for pharmaceutical companies. Should the profit of pharmaceutical companies, therefore, be taxable in the countries where the patients undertake clinical trials? This seems at least initially not implausible. Indeed, arguably, governments already do it, by regulating drug prices, adopting policies of public procurement for certain drugs, or imposing import tariffs (Bankman, Kane and Sykes, 2018). The variety of policy instruments available to capture location specific rent may explain why governments do not always take special measures under the corporate income tax. But if they do so, it could appeal to similar justifications as the deployment of these other policy instruments.

A more positive way for DST proponents to state their argument is this. The DST does not ring-fence the digital economy. There is indeed nothing special about the digital *per se*. Location-specific rents earned by digital platforms are just like location-specific rent earned by companies extracting oil, mineral, timber, and other tangible natural resources. The principles for taxing digital platforms are fundamentally the same as for taxing these other sectors. Indeed, taxes separate from the income tax can be imposed on both, and both tax and non-tax policy instruments might be deployed.

IV. WHAT IS HARMFUL ABOUT UNILATERALISM?

An alleged 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 problems. 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 objectives other than the exercise of taxing rights over rents located in them. Some countries, for example, may impose new taxes on advertising on digital platforms to put digital companies on an equal footing with traditional companies that have physical presences in them ("equalization" taxes). In this case, conflicting designs of the DST need to be coordinated, in addition to coordination with taxing rights already enshrined in income treaties.

In assessing the relative merits of the DST and the SDP proposal, it is the first type of coordination that is more relevant. Here, the key question is what would happen in the absence of 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 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.[16] Then it is likely that the residence country would not grant FTC for the DST charged (even putting aside the fact that the DST is not an income tax), or would not treat the platform firm's income (including X-specific rent) as exempt foreign income. Alternatively, yet another country may claim that it is the source of income that

[16] For instance, in the Facebook example given in Section III, Facebook's income would not be treated as French-source, but as U.S.-source, since the income is earned from U.S. advertisers.

X subjects to the DST.[17] 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 rhetoric against international double taxation, 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, i.e. they are not treated as treaty-covered taxes (Cui 2017b). Under domestic law, such taxes that do not qualify as income taxes (e.g. resources royalties) would also not be eligible for foreign tax credits. In other words, it is not clear why one should adopt the presumption that the DST should be creditable against income taxes, instead of being deductible from taxable income. But in the absence of such a presumption, the non-coordination between the DST and regular corporate income taxation also raises no special concern.

What should be of greater concern is the imposition of DSTs that do not aim to capture location specific platform rent, or that take conflict views about where such rent is located. For example, some recent proposed taxes on online advertising that have been lumped together with the DST include India's Equalization Levy and Italy's Levy on Digital Transactions, both of which are imposed by the jurisdictions of the advertisers. If the advertising revenue that

[17] For instance, Facebook's advertising revenue targeted as French consumers may be booked to a permanent establishment in a third country.

Facebook receives from Italian or Indian manufacturers targeted at French consumers are subject to such revenue-based taxes in addition to the French DST, then it is plausible that Facebook may be over-burdened. But the reason for such mis-coordination is that these new taxes on digital services take conflicting views about where profit from such services should be attributed. It is not that they are not coordinated under the income tax system.

Notably, the EC DST proposal from 2018 already contemplates coordination among such new taxes. The EC proposed to levy a single 3% tax on all revenue from digital services earned within the EU, and would apportion the revenue to EU Member States according to the number of users in them. For online intermediation, "users" from Member States may be from different sides of digital platforms. This apportionment approach ensures that online intermediation services are not subject to tax in both the buyer and seller jurisdictions. While the approach does not adhere to the purity of the rationale for the DST as a tax on location-specific rent, it would represent a pragmatic compromise to alleviate concerns about over-taxation.

V. CONCLUSION

When the EC and the UK government proposed their DSTs in 2018, both cast the DST as an interim measure that is compatible with the current tax treaty framework and does not require a revision of the latter. Such revision would be a long-term objective, embodied in the EC SDP proposal and now taken on by the OECD. The arguments of the preceding sections, however, suggests that there might be no "there" there in the contemplated long-term. If the momentum for international tax reform comes from a need to reallocate taxing rights, then one must take note of the fact that the DST addresses this need directly and explicitly, whereas how the SDP proposal (and treaty-based proposals generally) may address such need is far from clear.

Ultimately, it's problematic to equate international tax coordination with the traditional income tax treaty framework. The problem can be described as follows. The treaty framework is characterized by three fundamental limitations. First, it is focused on the income tax. Countries have always had the option to, but for the most part chose not to, coordinate their tax bases under other taxes through the tax treaty framework. Second, tax treaties do not have a lot to say about how to allocate business profit to different countries. As Section II argued, the ALP and attribution of business profits to PEs are fairly shallow conventions that guide profit allocation only in limited circumstances. Much of profit attribution relies instead on domestic laws, as well as pure personal jurisdiction (e.g. corporate residence in the case of corporate profits). Third, the goal of treaty-based coordination is explicitly stated as the avoidance of double taxation. Treaty mechanisms for mitigating double taxation, however, largely assume profit allocations made independently of treaty guidance. In other words, once we know how profit is allocated to different jurisdictions, we know how double taxation can be avoided.

Insofar as the current international tax debate arises because countries have come to disagree on how taxing rights over corporate profit should be allocated (and because new allocations are advocated), recognizing these limitations of the tax treaty framework has enormous implications. First, it implies that it would be irrational to subordinate the goal of acknowledging new allocations of taxing rights to the goal of avoiding double taxation. Tax treaties cannot be said to succeed if they mitigate double taxation but only at the cost of preserving allocations that go against countries' wishes. Second, previous treaty formulae for profit attribution may altogether lack relevance. Third, the question must be asked: is international coordination the goal, or is coordination through the income tax the goal? To assume that the answer is the latter is to assume a lot. Instead, international coordination around new claims of taxing rights may take the form of agreements to resolve problems in the joint imposition of new taxes—much in the spirit of the EC DST proposal (binding on all EU Member States). Such agreements can take the form of binding treaties, as exemplified by long-standing bilateral treaties regarding social security taxes, taxes on international transportation, or estate, inheritance, or other taxes on capital. Or they can take the form of customary practice as instantiated by the wide adoption of the destination-based VAT. Alternatively, such coordination may simply be done through an acknowledgement that new taxes imposed are not in conflict with existing international obligations, much as the imposition of resource royalties, resource rent taxes, taxes on extraordinary profits, and similar taxes by different governments—all of which, in some sense, stake out new claims of taxing rights over multinationals' profits—have been accepted by the international community.

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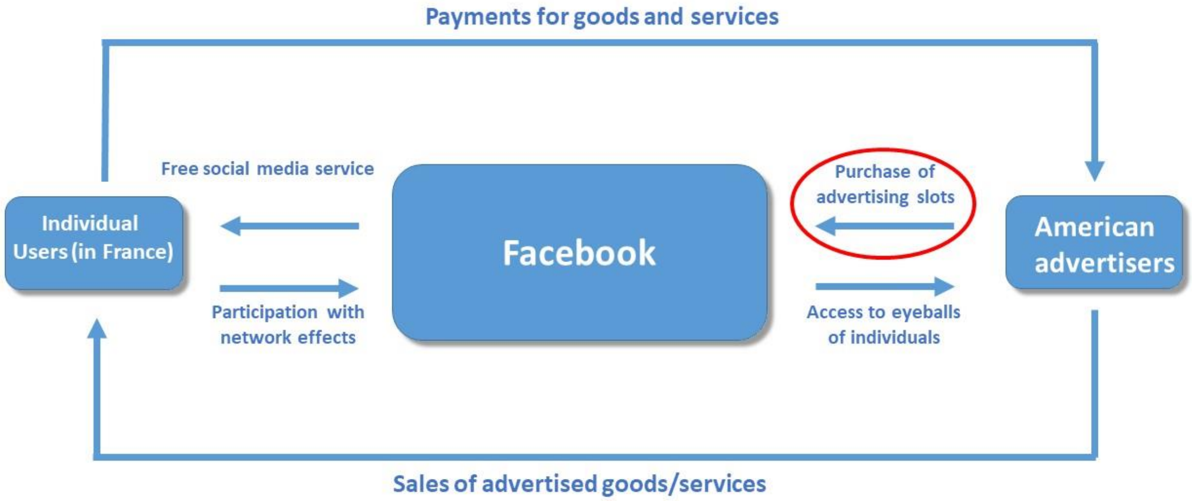
Figure 1


Payments for goods and services
Free social media service
Individual Users (in France)
Facebook
Purchase of advertising slots
American advertisers
Participation with network effects
Access to eyeballs of individuals
Sales of advertised goods/services