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### Digital Services Tax: A Cross-Border Variation of the Consumption Tax Debate

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# DIGITAL SERVICES TAX: A CROSS-BORDER VARIATION OF THE CONSUMPTION TAX DEBATE

*Young Ran (Christine) Kim*

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## DIGITAL SERVICES TAX: A CROSS-BORDER VARIATION OF THE CONSUMPTION TAX DEBATE

*Young Ran (Christine) Kim* \*

*The rise of highly digitalized businesses, such as Google and Amazon, has strained the traditional income tax rules on nexus and profit allocation. Traditionally, profit is allocated to market countries where consumers are located only if the business has a physical presence. However, in the digital economy, profits can be easily generated in market countries without a physical presence, resulting in tax revenue loss for market countries. In response, market countries have started imposing a new tax, called the digital services tax (DST), on certain digital business models, which has ignited heated debate across the globe. Supporters defend the DST, designed as a turnover style consumption tax, as an effective measure to make up the foregone revenue in the digital economy because it is not bound by the traditional rules of income taxation. Opponents criticize DSTs as “ring-fencing” or segregating certain digital business models, discriminating against American tech giants, and arguably imposing a disguised income tax. The debate has been focused on the imminent impact, such as who is the immediate winner and loser, but the discussion lacks efforts to understand the fundamentals of DSTs, especially with regard to the consumption tax aspect.*

*This Article is the first academic paper that highlights DSTs as a consumption tax and provides normative implications for policy makers deliberating a DST. It argues that a DST, with certain modifications, can be a good solution for the tax challenges of the digital economy. First, the Article offers an in-depth analysis of DSTs’ economic impact in multisided digital platforms. Second, it offers the advantages of DSTs over other types of consumption tax, such as value added tax and cash-flow tax. Finally, it illustrates how the recent Supreme Court case of *South Dakota v. Wayfair, Inc.*, which discusses a sales tax imposed on certain remote sellers, and the subsequent *Netflix Tax* may shed light on ways to overcome the ring-fencing problem of the DST.*

### INTRODUCTION

As Google, Amazon, Facebook, YouTube, and other highly digitalized businesses become mainstream in the twenty-first century economy, they pose new global tax challenges. The traditional income tax rules on nexus and profit allocation, which allocate tax revenue among relevant countries, no longer work effectively in the digitalized economy. Under the current rule, global profits of multinational enterprises are partly allocated to market countries where consumers are located only if the business has a physical presence in the market

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\* Associate Professor of Law, University of Utah S.J. Quinney College of Law. For helpful comments, I am grateful to Ellen Aprill, Jordan Barry, Joshua Blank, Jorge Contreras, Heather Field, Miranda Fleischer, Victor Fleischer, Ariel Jurow Kleiman, Omri Marian, Ruth Mason, Nancy McLaughlin, Diane Ring, Theodore Seto, Daniel Shaviro, Stephen Shay, the participants in the Annual Meeting of the Law and Society Association, Junior Tax Scholars Workshop, SEALS Annual Conference, UC Irvine School of Law Trans-Pacific Business Law Dialogue, University of Utah S.J. Quinney College of Law Faculty Scholarship Lunch, University of San Diego School of Law Tax Law Speaker Series, Loyola Law School Tax Policy Colloquium, LatCrit 2019 Biennial Conference, BYU Law School Faculty Workshop, University of Vienna Tax Conference, National Tax Association Annual Conference, AALS Annual Meeting New Voices in Tax Law & Policy, and UC Irvine School of Law Tax Policy Colloquium. Special thanks to the University of Utah’s Albert and Elaine Borchard Fund for Faculty Excellence for its generous support. Bryan Call, Shad Edwards, Nathan Holtman, and Eli LeCates provided excellent research assistance.

country.<sup>1</sup> The traditional rule and the resulting revenue allocation were considered reasonable in the twentieth century's brick-and-mortar economy, where multinational enterprises accessed consumers in the market country by operating their business through a branch or a subsidiary. The branch or subsidiary established a physical presence, or tax nexus, in the market country by maintaining a physical connection in the country.<sup>2</sup> The profit allocation rules then mandated allocating certain profits to the market country first and the remaining profits to the home country of the multinational enterprises.<sup>3</sup> However, such conventional rules do not work effectively in the new digital economy, where digital firms operate in market countries without a physical presence and connect multiple groups of customers via online platforms.

To illustrate the concept of a highly digitalized business model, let us consider the hypothetical example of William. William, who lives in the U.K., receives a bonus and would like to use it to purchase a new car. William is particularly interested in a midsize luxury German sedan, and he begins the car buying process by performing some preliminary research. He begins his research by googling key words like "10 best sedans for 2019." William skips search results relating to Toyota, Hyundai, and similar sedans, and only focuses on sedans such as the Mercedes-Benz E-Class, Audi A7, and BMW 5 Series. After virtually touring some German luxury sedans, William remembers to check the results of his favorite football club's recent match and visits ESPN's website. Next to the results he was looking for, William finds an advertisement of a Mercedes-Benz E-Class, which he is now more likely to click on than before he began his preliminary car research.<sup>4</sup>

The above example shows the salient characteristics of highly digitalized business models and the resulting tax challenges. Google is the highly digitalized business model utilizing a multisided platform. William is part of a group of users—user-buyers—and Mercedes-Benz is part of another group of users—user-sellers or user-advertisers. Google, located in the U.S., offers digital search engine services to the first group of users—user-buyers—located in various countries, including the U.K., through which it collects a tremendous amount of valuable user data. Google has a proprietary algorithm that allows it to offer

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1. For the Internal Revenue Code's (I.R.C. or the Code) term, this physical presence refers to a U.S. trade or business, to which income of foreign service providers is allocated and subject to the U.S. tax jurisdiction. 26 U.S.C. [hereinafter I.R.C.] § 862(b) (1986). A *de minimis* level of services rendered in the U.S. does not constitute a U.S. trade or business if, for example, the services are performed while the foreign service provider is present in the U.S. temporarily or no more than ninety days during the year. *Id.* § 864(b)(1).

2. CHARLES H. GUSTAFSON ET AL., *TAXATION OF INTERNATIONAL TRANSACTIONS* 182 (4th ed. 2011); U.S. MODEL INCOME TAX CONVENTION art. 5, 7 (U.S. DEP'T TREASURY 2016) [hereinafter U.S. MODEL].

3. U.S. MODEL, *supra* note 2, art. 5, 7; MODEL TAX CONVENTION ON INCOME AND ON CAPITAL: CONDENSED VERSION 2017 art. 5, 7 (OECD 2017) [hereinafter OECD MODEL].

4. The Google, German auto manufacturing company, and U.K. consumer example is inspired by a similar example in Wei Cui, *The Digital Services Tax: A Conceptual Defense*, 73 *TAX L. REV.* (forthcoming 2020) (available at [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3273641](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3273641)).

improved search results to the first group, users in the U.K. who demonstrate similar interests to those of William, because the algorithm learns how to tailor experiences to individual user-buyers in the U.K. market. In addition, Google's algorithm offers customized advertising services to the second group of users—user-advertisers or user-sellers—such as Mercedes-Benz, that want to launch a targeted advertisement campaign to U.K. consumers based on their demonstrated interests.<sup>5</sup> Most of Google's profits come from user-sellers or user-advertisers rather than user-buyers in the market country.

Such highly digitalized business models did not exist when the traditional income tax rules on nexus and profit allocation were formed in the early twentieth century.<sup>6</sup> Market countries, or source countries in tax terms, are entitled to exercise primary taxing rights on a multinational enterprise's profits generated from the market if the enterprise has a physical presence in the market country.<sup>7</sup> However, the newly emerged, highly digitalized businesses can access consumers and generate profits in market countries without an actual physical presence in the country. In the above example, Google, located in the U.S., can render the search engine and online advertisement services to consumers in the U.K. market without a physical presence in the U.K. Thus, the U.K. cannot collect tax revenue from Google's profits even though Google accessed and gained a profit from the U.K. market and consumers.

Furthermore, the features of multisided platforms<sup>8</sup> make collecting tax revenue by market countries from such businesses even more difficult. Multisided platforms serve two or more distinct groups of customers or users who value each other's participation.<sup>9</sup> Users on one side of the market are charged little to nothing to participate, while the users on the other side are charged all or the majority of the profits.<sup>10</sup> In the above example, Google does

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5. *Id.* at 10.

6. Lilian V. Faulhaber, *Taxing Tech: The Future of Digital Taxation*, 39 VA. TAX REV. 145, 150 (2019).

7. OECD MODEL, *supra* note 3, art. 7.

8. Multisided platforms or multisided markets are often used by case law and literature on economics, antitrust, and administrative regulations. *See, e.g.*, *Ohio v. Am. Express Co.*, 138 S. Ct. 2274 (2018); Jean-Charles Rochet & Jean Tirole, *Two-Sided Markets: A Progress Report*, 37 RAND J. ECON. 645 (2006); Erik Hovenkamp, *Platform Antitrust*, 44 J. CORP. L. 713, 725–26 (2019); Eleanor Wilking, *Why Does it Matter Who Remits? Evidence from a Natural Experiment Involving Airbnb and Hotel Taxes* (Apr. 25, 2020) (unpublished paper) (available at [http://www-personal.umich.edu/~ewilking/airbnb\\_current.pdf](http://www-personal.umich.edu/~ewilking/airbnb_current.pdf)). In tax literature, the multisided platforms are just referred to as “digitalization,” “digital economy,” or “certain highly digitalised businesses.” *See, e.g.*, OECD, ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY, ACTION 1 - 2015 FINAL REPORT (2015) [hereinafter OECD, BEPS ACTION 1]; OECD, TAX CHALLENGES ARISING FROM DIGITALISATION – INTERIM REPORT 2018 (2018) [hereinafter OECD, 2018 INTERIM REPORT].

9. This refers to network effects. A network effect exists when the value of product or service provided by a business increases according to the number of other users. CARL SHAPIRO & HAL R. VARIAN, INFORMATION RULES: A STRATEGIC GUIDE TO THE NETWORK ECONOMY 13 (1999). Such effects exist in the highly digitalized businesses, such as Twitter, Facebook, Google, and Amazon, because the value of their services to users increases as more users join the platform.

10. *See Am. Express*, 138 S. Ct. at 2281.

not charge fees to retail users. Instead, it operates other business lines, such as online advertising services, that connect different types of user groups—user-sellers and user-buyers. Most of the profits do not come from the consumers in the U.K. Technically, while Google’s revenue in this example is relevant to the U.K. market because it collects and uses U.K. consumers’ data, the profits are paid by German manufacturing companies. Thus, it is more challenging for the U.K. to exercise tax jurisdiction if the business is located in a different country and the group paying for the services—user-advertisers or user-sellers—is located in a third country.

The preceding example illustrates the archaic nature of the traditional nexus and profit allocation rules. As described above, under traditional tax rules, market countries lose tax revenue simply because of the unique nature of highly digitalized business models and their ability to infiltrate market countries through their digital platforms without the need of a physical presence. In response, and in an effort to recoup some of the lost tax revenue, market countries, such as the U.K., France, and Italy, have unilaterally introduced, or plan to introduce, a new tax called the Digital Service Tax (DST) for certain highly digitalized businesses.<sup>11</sup> This has ignited heated debate across the globe. DSTs are designed as a turnover tax, which is a subcategory of consumption tax, because policy makers think introducing a new tax rather than modifying conventional income tax rules would be more effective to address the tax challenges in the digital economy. However, the U.S., which is home to many global tech giants, continues to oppose European DSTs because it believes these proposals are discriminatory against U.S. tech giants.<sup>12</sup> Moreover, the U.S. government has announced that it would impose additional tariffs up to 25% on a range of French imports, including handbags, soap, and cosmetics, starting in January 2021 in order to retaliate against the adoption of France’s DST.<sup>13</sup>

Realizing the need to offer a global solution for the tax challenges of the digital economy, the European Union (EU), the G20, and the Organisation for Economic Co-operation and Development (OECD), which are important voices in international taxation, have offered a couple of proposals, including a

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11. See *infra* Part I.C.

12. See, e.g., Ruth Mason, *The Transformation of International Tax*, 114 AM. J. INT’L L. 353, 397–98 (2020) (implying that such discrimination could be a political strategy, such as bringing the U.S. to the bargaining table and pleasing their voters); Ruth Mason & Leopoldo Parada, *The Legality of Digital Taxes in Europe*, 40 VA. TAX REV. (forthcoming 2020) (arguing that DSTs may be discriminatory in intent, but the Court of Justice of the European Union would uphold such taxes).

13. Notice of Action in the Section 301 Investigation of France’s Digital Services Tax, 85 Fed. Reg. 43,292, 43,292–97 (July 10, 2020); ROBERT E. LIGHTHIZER, OFF. U.S. TRADE REPRESENTATIVE, REPORT ON FRANCE’S DIGITAL SERVICES TAX (Dec. 2, 2019); Alex M. Parker, *US Moves Ahead on French Tariffs over Digital Taxes*, LAW360 (July 10, 2020), <https://www.law360.com/articles/1291187/print?section=internationaltrade>; Alex M. Parker, *US Proposes 100% Tariffs on French Imports over Digital Tax*, LAW360 (Dec. 2, 2019), <https://www.law360.com/technology/articles/1224350/print?section=technology>.

proposal to modify current income tax rules and a proposal for a prototype DST.<sup>14</sup> All proposals attempt to give market countries greater taxing rights, but none of these proposals have come to a consensus as to a solution.<sup>15</sup> In the meantime, DSTs are widespread, becoming the new status quo.<sup>16</sup>

DSTs are levied on the gross revenue of a firm. In tax terms, this is a tax on gross receipts called a “turnover tax” and is considered a subcategory of “consumption tax,”<sup>17</sup> as opposed to income tax. An important reason to design the DST as a consumption tax is to reward market countries without being restricted by the traditional international tax rules that require physical presence. Market countries are where the relevant business activity and participatory user base are located, and thus, a consumption-tax-based DST can allocate an amount of profit to the relevant market country, irrespective of whether the business has a local physical presence, so long as all other requirements are met. In addition, DSTs apply only to a limited scope of digital businesses where tax challenges primarily manifest, such as social media platforms, search engines, and online marketplaces.<sup>18</sup> Furthermore, both global and local revenue of digital businesses identified as in-scope businesses should exceed a specified threshold amount of revenue to trigger DST application.<sup>19</sup>

However, current design of DSTs is not without criticism. First, DSTs are criticized as ring-fencing, or segregating, certain digital business models from the rest of the economy for tax purposes.<sup>20</sup> Second, they are blamed for discriminating against American tech giants, such as Google, Amazon, Facebook, YouTube, and Uber, because only those American tech giants can

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14. The proposals will be discussed *infra* Parts I.B and I.C in detail.

15. Andrew D. Mitchell et al., *Taxing Tech: Risks of an Australian Digital Services Tax Under International Economic Law*, 20 MELB. J. INT'L L. 88, 90–91 (2019) (citing various interim DST proposals and enactments and the abandonment by the EU toward a regional DST structure).

16. Elke Asen, *FAQ on Digital Services Taxes and the OECD's BEPS Project*, TAX FOUND. (Jan. 30, 2020), <https://taxfoundation.org/oecd-beps-digital-tax> (showing that Austria, France, Hungary, Italy, and Turkey have implemented a DST while Belgium, the Czech Republic, Slovakia, Spain, and the U.K. have published proposals, and other countries have shown intentions to implement DSTs in the future); see *infra* Part I.C.4.

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

18. See *Commission Proposal for a Council Directive on the Common System of a Digital Services Tax on Revenues Resulting from the Provision of Certain Digital Services*, at 7–10, COM (2018) 148 final (Mar. 21, 2018) [hereinafter *EU Digital Services Tax Proposal 2018*]; HM TREASURY, *BUDGET 2018 DIGITAL SERVICES TAX* (2018) [hereinafter *HM TREASURY, BUDGET 2018 DST*].

19. *EU Digital Services Tax Proposal 2018*, *supra* note 18, at 10 (providing an international revenue threshold of €750 million and a domestic threshold of €50 million); *HM TREASURY, BUDGET 2018 DST*, *supra* note 18, at 2 (providing a “double threshold” of £500 million globally and £25 million of U.K. revenues).

20. Daniel Bunn, *A Summary of Criticisms of the EU Digital Tax*, TAX FOUND. (Oct. 22, 2018), [https://taxfoundation.org/eu-digital-tax-criticisms/#\\_ftn16](https://taxfoundation.org/eu-digital-tax-criticisms/#_ftn16); see also OECD, *BEPS ACTION 1*, *supra* note 8, at 149 (discussing neutrality as an important part of evaluating taxes on the digital economy); OECD, *ADDRESSING THE TAX CHALLENGES OF THE DIGITALISATION OF THE ECONOMY – POLICY NOTE* (Jan. 23, 2019) [hereinafter *OECD, POLICY NOTE*].

satisfy the revenue thresholds and be subject to a DST.<sup>21</sup> Third, they are also reprimanded for arguably imposing a disguised corporate income tax, rather than a consumption tax, on the profits of certain digital firms to compensate for forgone corporate tax revenue.<sup>22</sup> If a DST is taken as a corporate income tax, only home countries of digital firms could collect tax revenue from relevant profits generated in market countries because traditional international tax rules on tax nexus and profit allocation provide this to eliminate double taxation.<sup>23</sup> One of the reasons that DSTs are designed as a consumption tax is to reward market countries without being bound by the traditional international tax rules, but critics attack the design of DSTs, interpret DSTs as disguised income tax, and revert the issue back to the traditional rules setting where we cannot reward market countries.

The criticism is largely based on practical concerns and focused on the imminent impact, such as who is the winner and loser in the short term, rather than considering DSTs theoretically. Furthermore, the criticism contains little discussion of the consumption tax aspect of the DST, although the positive law provides DSTs as a turnover tax and consumption tax. The third point of criticism argues that although DSTs are designed as a consumption tax, it is introduced to compensate for forgone corporate tax revenue, but it is not fully convincing why, as a result, DSTs should be interpreted as corporate income tax despite what positive law provides.<sup>24</sup>

As the first academic paper to highlight the consumption tax aspect of DSTs, this Article explores the origin of DSTs and analyzes the key common features of a DST that are distinct from conventional income tax. It offers the

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21. See Initiation of a Section 301 Investigation of France's Digital Services Tax, 84 Fed. Reg. 34,042, 34,042 (July 16, 2019); see also Ruth Mason & Leopoldo Parada, *Company Size Matters*, 2019 BRIT. TAX REV. 610, 646–49 (2019); Ruth Mason & Leopoldo Parada, *Digital Battlefield in the Tax Wars*, 92 TAX NOTES INT'L 1183, 1193–96 (2018); Jake Kanter, *Amazon, Facebook, and Google Come Out Swinging After Being Slammed with an 'Unjustifiable' New Tax on Their Sales*, BUS. INSIDER (Aug. 14, 2019), <https://www.businessinsider.com/amazon-facebook-and-google-lobby-french-digital-services-tax-2019-8>.

22. See, e.g., Roland Ismer & Christoph Jescheck, *Taxes on Digital Services and the Substantive Scope of Application of Tax Treaties: Pushing the Boundaries of Article 2 of the OECD Model?*, 46 INTERTAX 573, 577 (2018); *EU Digital Services Tax Proposal 2018*, *supra* note 18, at 1 (stating that the measure to target revenues of digital services based on user value creation underpins the Council's intention to adapt corporate tax rules to new digital business models).

23. Double taxation occurs in international tax when a market country (or source country in tax terms) and home country (or residence country) levy taxes on the same declared income. See Alvin C. Warren, Jr., *Income Tax Discrimination Against International Commerce*, 54 TAX L. REV. 131, 133 (2001). Many countries enter into income tax treaties to avoid such double taxation. Under the tax treaties, source countries offer the reduced withholding tax rates for aliens' income from domestic sources, whereas residence countries offer a tax exemption or credit to foreign-source income. GUSTAFSON ET AL., *supra* note 2, at 63.

24. Countries may introduce consumption tax in addition to income tax or increase one tax rate to compensate revenue loss resulting from the rate cut from another tax. See, e.g., Eimi Yamamitsu et al., *Japan Raises Taxes on Its Spenders Despite Growth Worries*, N.Y. TIMES (Sept. 30, 2019), <https://www.nytimes.com/2019/30/business/japan-abe-consumption-tax.html>; Fahim Mostafa, *The Hungarian Experience Has Strengthened the Case for Flat Taxes*, FORBES (Jan. 27, 2017), <https://www.forbes.com/sites/realspin/2017/01/27/the-hungarian-experience-has-strengthened-the-case-for-flat-taxes/#5378c74cd477>.



normative proposal that a consumption-tax-based DST can be a suitable tax policy to solve the tax challenges of the digital economy if the existing design concerns are mitigated. When it comes to a tax proposal based on consumption tax, there has been considerable theoretical discourse comparing the pros and cons of consumption tax and income tax with regard to three criteria of tax policy: efficiency, equity, and administrability (or simplicity).<sup>25</sup> Consumption tax is considered more efficient and simpler, while income tax is considered normatively superior to achieve equity.<sup>26</sup> Under the above criteria, the consumption-tax-based DST can present its merits as being largely relevant to business taxation and international taxation where efficiency and administrability are more emphasized than equity. Furthermore, DSTs are particularly efficient because, although the tax base is a digital firm's gross revenue, not net income, such a firm incurs almost zero marginal cost, reducing the additional concerns of economic distortion commonly found in turnover taxes.<sup>27</sup> In conclusion, DSTs could offer a new path toward a consumption tax in international taxation for the digital economy.

However, to maximize the advantages offered by DSTs and for them to be a viable global solution for taxing the digital economy, further research and improvement is required to overcome certain lingering issues. Moreover, the study of multisided markets is still an emerging topic, and thus there is not much tax scholarship analyzing these issues. This Article aims to fill the gap. It also provides the following normative implications for policy makers deliberating a DST or considering digital advertising taxes that benchmark DSTs to raise more revenue during the COVID-19 pandemic.<sup>28</sup>

First, this Article explores the tax incidence of DSTs as a consumption tax in the case of multisided digital platforms. Current literature significantly lacks in-depth analysis on this issue. The early opponents of DSTs argued that a DST would be borne by consumers and would adversely affect the demand side of the digital economy.<sup>29</sup> However, such critique neglected the characteristics of multisided platforms, where service providers do not charge fees on consumers or user-buyers. It would be more plausible to pass the tax burden onto user-sellers or user-advertisers, who are also business enterprises, rather than

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25. Some tax scholars label the third criterion of administrability as simplicity. See MICHAEL J. GRAETZ ET AL., *FEDERAL INCOME TAXATION* 28–31 (8th ed. 2018).

26. See Reuven S. Avi-Yonah, *The Three Goals of Taxation*, 60 *TAX L. REV.* 1, 11 (2006); see also Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Consumption Tax over an Ideal Income Tax*, 58 *STAN. L. REV.* 1413, 1425 (2006).

27. See Cui, *supra* note 4, at 25–27.

28. See, e.g., Ruth Mason & Darien Shanske, *Insight: The Time Has Come for State Digital Taxes*, *BLOOMBERG TAX* (May 29, 2020), <https://news.bloombergtax.com/daily-tax-report-state/insight-the-time-has-come-for-state-digital-taxes-55>.

29. Julian Jessop, *Why the EU's Digital Turnover Tax Is a Bad Idea*, *EUR. POL'Y INFO. CTR.* (Sept. 5, 2018), [www.epicenternetwork.eu/wp-content/uploads/2018/09/Why-the-EU's-digital-turnover-tax-is-a-bad-idea-1.pdf](http://www.epicenternetwork.eu/wp-content/uploads/2018/09/Why-the-EU's-digital-turnover-tax-is-a-bad-idea-1.pdf); Matthias Bauer, *Five Questions About the Digital Services Tax to Pierre Moscovici*, *EUR. CTR. INT'L POL. ECON.* 4–6 (2018).

user-buyers, who are consumers. This is the reaction of Amazon and Google in response to the recent enactment of the French and the U.K. DSTs.<sup>30</sup> More interestingly, Facebook and eBay announced that they would not pass the DST's costs to its user-sellers or user-advertisers.<sup>31</sup> A majority of the tech firms subject to DSTs still remain silent. The divided market reaction proves the importance of understanding the tax incidence of DSTs.

Second, this Article shows the advantages of DSTs over other types of consumption taxes, such as a Value Added Tax (VAT) and a Destination-Based Cash Flow Tax (DBCFT), to solve tax challenges in the digital economy. As to a VAT, it would be difficult to define the “value addition” or “value creation” by a digital firm. In the William-Google example, it is difficult to answer whether and to what extent Google's value is created by either engineers writing computer codes of algorithm in California or by various user-buyers in the U.K. By contributing user data, user-buyers like William allow Google not only to offer the improved tailored experiences to future users but also to sell targeted advertising services to German auto manufacturing companies. This conundrum is analogous to the old debate regarding which country should exercise the primary taxing right over the income derived from natural resource extraction—is it the home country of multinational oil companies with extraction technology or the source country with natural resources on its soil? Considering that the natural resource problem has not been fully resolved, this Article suspects that introducing a VAT may repeat the same problem concerning value creation.

Another advantage that DSTs offer over other types of consumption taxes is that DSTs can effectively reward market countries in a way that the traditional cash flow taxes, such as a DBCFT, cannot. DBCFT's gives taxing rights to the destination country of the sales of goods and services connected by the cash flow because they posit that the destination of sales is the place where the consumption occurs.<sup>32</sup> However, in multisided platforms, market countries

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30. See *infra* note 232. However, whether such tax incidence on the user-seller side is normatively desirable is another question. If one of the policy rationales of market countries to justify DSTs is the monopolistic position of digital tech giants, then, in theory, digital firms ought to absorb the whole tax incidence instead of passing part of the economic burden to the user-seller group. Still, there is no clear explanation on what ought to happen based on economic model analysis and what is happening based on empirical analysis. See *infra* Part III.A.

31. Announcement, eBay U.K., Protecting Your Business from Digital Services Tax Costs (Aug. 10, 2020) (available at <https://community.ebay.co.uk/t5/Announcements/Protecting-your-business-from-Digital-Services-Tax-costs/ba-p/6701162>); Stephanie Soong Johnston, *EBay Won't Pass U.K. Digital Services Tax on to Sellers*, TAX NOTES TODAY INT'L (Aug. 12, 2020), <https://www.taxnotes.com/tax-notes-today-international/digital-economy/ebay-wont-pass-uk-digital-services-tax-sellers/2020/08/12/2cts2>; Hamza Ali, *Facebook Not Passing U.K. Digital Tax Costs on to Advertisers*, BLOOMBERG TAX (Sep. 3, 2020), <https://news.bloombergtax.com/daily-tax-report-international/facebook-not-passing-u-k-digital-tax-costs-on-to-advertisers>.

32. So, for domestic tax purposes, receipts from exports are not included in taxable revenues and imports are included in taxable revenue. For detailed explanation on DBCFT, see, for example, Alan Auerbach et al., *Destination-Based Cash Flow Taxation* 9 (Said Bus. Sch., Working Paper 17/01, 2017).

may not fall under the definition of destination under the DBCFT because the cash flow exists only between the digital businesses providing services and user-sellers. In the William-Google example, cash flow exists only between Google in the U.S. and Mercedes-Benz in Germany. Thus, the destination of cash flow is either the U.S. or Germany<sup>33</sup> and cannot be the U.K.—the market country to which all policy proposals aim to give more taxing rights. Hence, it is inappropriate to recommend DBCFTs to reward-market countries.

Third, this Article proposes to improve the ring-fencing problem by overcoming the limited scope of DSTs. Only search engines, social media platforms, and online marketplaces are currently within the scope of DSTs and subject to pay the DST, whereas certain regulated financial and payment services and online content providers are excluded and thus exempted from DSTs.<sup>34</sup> So, Facebook, Twitter, YouTube, Google, Amazon, eBay, Kayak, Uber, and Airbnb are subject to DSTs, but PayPal, Netflix, Hulu, Spotify, and Ubisoft are exempted from DST liability. However, the current distinctions between in-scope and out-of-scope businesses are arbitrary and hard to justify theoretically. It is not fully convincing to include YouTube and exclude Spotify because their business models share many common features.<sup>35</sup>

To find a way to overcome the ring-fencing problem, this Article both introduces the recent Supreme Court case of *South Dakota v. Wayfair, Inc.*, which discusses the remote sellers' obligation to collect sales tax from the remote buyers<sup>36</sup> and analyzes subsequent state legislation introducing the so-called "Netflix Tax" because both developments could shed light on possible solutions.<sup>37</sup> More than thirty state and local governments introduced the Netflix Tax after the *Wayfair* ruling in order to require remote sellers to collect sales tax—another type of consumption tax—from digital content providers,

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

34. See Cui, *supra* note 4, at 5–6.

35. The only difference is how much revenue derives from ad-based services—83% for YouTube and 10% for Spotify—and from premium services. However, the ratio between the two types of services itself is not likely to be a good criterion to draw the line between the two groups of digital firms. See *infra* Part III.C.

36. *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080, 2088 (2018).

37. The Netflix Tax is a sales and use tax imposed on the digital streaming of shows, movies, music, and games. See Richard C. Auxier, *Chicago's Streaming Tax: Is a Bad Tax but It's Not a "Netflix Tax"*, TAX POL'Y. CTR. (June 11, 2019), <https://www.taxpolicycenter.org/taxvox/chicagos-streaming-tax-bad-tax-its-not-netflix-tax>. The content providers, such as Netflix, Hulu, and Spotify, that are excluded from DST are subject to the Netflix Tax. Currently, the list of states and cities imposing the Netflix Tax is as follows: Alabama, Arizona, Arkansas, Chicago, Colorado, Connecticut, Delaware, Florida, Hawaii, Idaho, Indiana, Iowa, Kentucky, Louisiana, Maine, Massachusetts, Maryland, Minnesota, Mississippi, Nebraska, New Jersey, New Mexico, North Carolina, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, Washington, West Virginia, Wisconsin, Wyoming, and Washington D.C. *Id.* However, the specific tax imposed by each state within the category varies widely.

such as Netflix, Hulu, and Spotify.<sup>38</sup> The fact that one type of consumption tax, a DST, excludes online content providers from its scope and another type of consumption tax, a sales tax, includes the same businesses within its scope confirms that the current line-drawing of DSTs is arbitrary. Thus, DSTs should overcome the ring-fencing problem by expanding their scope to other digital businesses based upon close analysis of the nature of those business models, rather than practical or political concerns.

This Article proceeds as follows. Part I unravels the tax challenges in the digital economy and the origin of the DST by exploring the discussions in the G20, the OECD, and the EU. It further overviews varied versions of DSTs that countries unilaterally adopted, or plan to adopt. Part II examines the key features of DSTs, including the use of a turnover tax, revenue thresholds, and their limited scope. It then critically analyzes the three important challenges by which DSTs are particularly judged. Part III proposes that a consumption-tax-based DST could be a normatively sound solution for the tax challenges in the digital economy if current shortcomings are improved, such as understanding tax incidence of DSTs, comparing DSTs with other types of consumption taxes, and the ring-fencing problem concerning DSTs' limited scope. The Article then concludes with a brief statement concerning the importance of scholarly discussion to the anticipated and necessary resolution of digitalized business taxation in the twenty-first century.

## I. DIGITAL ECONOMY AND THE ORIGIN OF DSTS

### A. *Digital Economy and Global Tax Challenges*

When emerging digital technology companies, such as Google, started providing free email accounts or search engine services in the 1990s, many people anticipated that such highly digitalized businesses would begin charging fees for their services. Nevertheless, Google and other highly digitalized business models, such as Amazon, YouTube, and Facebook, have not yet charged fees to retail users for significant parts of their services. Instead, they operate other business lines, such as online advertising technologies, cloud computing, and other online platforms that connect different types of user groups, such as user-sellers and user-buyers.

Case law and literature refers to such highly digitalized business models as multisided platforms.<sup>39</sup> In tax literature, the multisided platforms are just referred to as “digitalization,” “digital economy,” or “certain highly digitalised

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38. Jared Walczak & Janelle Cammenga, *State Sales Taxes in the Post-Wayfair Era*, TAX FOUND. (Dec. 12, 2019), <https://taxfoundation.org/state-remote-sales-tax-collection-wayfair>.

39. See *Ohio v. Am. Express Co.*, 138 S. Ct. 2274, 2280–81 (2018); see also Rochet & Tirole, *supra* note 8.

businesses.”<sup>40</sup> These digital platforms connect multiple distinct user groups, such as user-sellers and user-buyers, and provide them with certain network benefits. A network effect exists when the value of a product or service provided by a business increases according to the number of others using it.<sup>41</sup> This so-called network effect is present in the highly digitalized business models, such as Amazon, Twitter, and Google, because the value of their services to users increases as more users use the platform. In the William-Google example, Google collects a tremendous amount of valuable user data by offering search engine services, and it can offer improved search results to users as more users use the services. Recent tax-policy literature describes this user data collection as “user participation,” because “soliciting the sustained engagement and active participation of users is a critical component” of highly digitalized businesses.<sup>42</sup>

However, the number of users participating in a digital platform is not the only factor determining the value of highly digitalized businesses. The platforms must have proprietary technology that allows them to offer improved services as more users participate. In the William-Google example, Google has a proprietary algorithm that allows it to offer improved search results to users in the U.K. who demonstrate similar interests to those of William, because the algorithm learns how to tailor experiences to individual user-buyers in the U.K. market. In addition, Google’s algorithm offers customized advertising services to another group of users—user-advertisers, such as Mercedes-Benz—that want to launch a targeted advertisement campaign to U.K. consumers “based on their demonstrated interests.”<sup>43</sup>

Thus, without sufficient technology developed for a platform, the highly digitalized businesses cannot attract users. Without a solid user base, the technology cannot realize its potential value. The synergies between the intellectual property of the businesses and user participation is the key to their success.<sup>44</sup> In this context, a recent report of the G20 and the OECD explains that the important features of digitalized business models include: (1) a cross-jurisdictional scale without mass; (2) the heavy reliance on intangible

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40. See, e.g., OECD, BEPS ACTION 1, *supra* note 8; OECD, 2018 INTERIM REPORT, *supra* note 8.

41. SHAPIRO & VARIAN, *supra* note 9, at 13.

42. OECD, ADDRESSING THE TAX CHALLENGES OF THE DIGITALISATION OF THE ECONOMY 9 (Mar. 6, 2019) [hereinafter OECD, PUBLIC CONSULTATION DOCUMENT].

43. *Id.* at 10.

44. This synergy is different from the so-called chicken and egg problem in multisided platforms in that the former occurs between the platform and the overall users and the latter exists between different groups of users. The chicken-and-egg problem refers to the causality dilemma where each group of users relies on the presence of the other groups in order to derive value of the network. A platform wants to get both the buyers and the sellers onto the network but sellers will not come on board until the buyers do and vice versa. See, e.g., Bernard Caillaud & Bruno Jullien, *Chicken & Egg: Competition Among Intermediation Service Providers*, 34 RAND J. ECON. 309 (2003).

assets, especially intellectual property; and (3) the importance of data, user participation, and their synergies with intellectual property.<sup>45</sup>

Many multisided platforms offer their services across borders. They can do it without establishing a physical presence in market countries where users are located, thanks to advanced technology in the twenty-first century. Also, in many multisided markets, users on one side of the market are charged little or nothing to participate, while all or a majority of the profits come from the users on the other side.<sup>46</sup> In the William-Google example, Google can offer search engine services to William in the U.K. and online advertisement services to Mercedes-Benz in Germany, both remotely from the U.S. Most of Google's profits do not come from the retail user-buyer group, where William belongs, but rather from the user-seller group or user-advertiser group, where Mercedes-Benz belongs.<sup>47</sup>

These new features of the highly digitalized business models have led to global tax challenges. The traditional international income tax rules on tax nexus and profit allocation, which allocate tax revenue between market countries and home countries,<sup>48</sup> no longer work effectively in the digitalized economy. These businesses can generate profits in market countries without a physical presence, and firms' revenue relevant to the market country is not technically paid by the consumers in the market. As a result, market countries cannot collect tax revenue from digital firms that access the consumers and generate profits in the market.

To be specific, in traditional cross-border transactions, global profits of multinational enterprises are partly allocated to market countries where consumers are located only if the business has physical presence in the market country and only to the extent that profit can be allocated to that physical presence.<sup>49</sup> In other words, product sellers or service providers must be physically present in the subject market country for a substantial amount of time and render sales or services there.<sup>50</sup> A subsidiary or a branch in the market country generally establishes physical presence of a firm, but a dependent agent can also create the firm's physical presence.<sup>51</sup> In tax terms, this physical

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45. OECD, 2018 INTERIM REPORT, *supra* note 8, at 51–54.

46. *See* *Ohio v. Am. Express Co.*, 138 S. Ct. 2274, 2281 (2018) (“Sometimes indirect network effects require two-sided platforms to charge one side much more than the other . . . [and t]he optimal price might require charging the side with more elastic demand a below-cost (or even negative) price.”).

47. *See infra* note 280 and accompanying text.

48. In tax literature, market countries more often refer to the source countries where the income is produced, and home countries refer to the residence countries where the taxpayers maintain residence or, for corporate taxpayers, are incorporated. David Eric Spencer, *BEPS and the Allocation of Taxing Rights*, 29 J. INT'L TAX'N 142, 144 (2018).

49. I.R.C. § 862(b); U.S. MODEL, *supra* note 2, art. 7; OECD MODEL, *supra* note 3, art. 7, at 33–34.

50. *See, e.g.*, I.R.C. § 864(b)(1) (2012).

51. *See* U.S. MODEL, *supra* note 2, art. 5; OECD MODEL, *supra* note 3, art. 5; GUSTAFSON ET AL., *supra* note 2, at 182; Christian Ehlermann & Marta Castelon, *When Does a Dependent Agent Act Habitually?*, 83 TAX NOTES INT'L 1141 (2016).

presence refers to a “trade or business” or a “permanent establishment” of the firm.<sup>52</sup> This physical presence constitutes a tax nexus, and then the profit allocation rules mandate allocating certain profits attributable to such tax nexus to the market country and the remaining profits to the home country of the multinational enterprises.<sup>53</sup>

On the other hand, if the business does not have physical presence, or tax nexus, in a market country, the market country cannot exercise tax jurisdiction over the firm’s profits. This is where the traditional tax nexus and profit allocation rules are constrained in the highly digitalized business models. Those businesses can generate profits in market countries without physical presence. Furthermore, most of the firm’s profits do not come from the consumer—the user-buyer group in the William-Google example—in a traditional sense; rather, most of the profits come from the user-seller or user-advertiser group.

The traditional physical presence requirement for a market country to exercise tax jurisdiction was considered reasonable when the rule was developed in the early twentieth century.<sup>54</sup> When a business renders services to foreign customers, somebody must go to that market country and be present there. If the business can render a service remotely, it is not enough to constitute a tax nexus in that market country because there is no physical presence, and as such the service is not considered a substantial presence.<sup>55</sup> However, such rationale has become inadequate as more businesses offer remote services. It is also difficult to justify the rationale behind this physical presence requirement for highly digitalized businesses with multisided platforms because firms’ revenue relevant to the market country is not paid by the consumers in the market.

As a result, in the highly digitalized economy, market countries lose tax revenue that could have been available to them from traditional business models, and currently are unable to collect under traditional tax rules. Realizing the need to address the tax challenges of the digital economy, the EU, the G20, and the OECD, which lead international tax rules, have offered a few proposals to address the issue, discussed in Parts I.B and I.D, all of which aim to give market countries greater taxing rights. Many proposals try to modify current income tax rules in various ways, while others attempt to introduce a new turnover tax similar to a DST.<sup>56</sup> However, these proposals have yet to reach a consensus in the global community. In the meantime, market countries, especially in Europe, have unilaterally introduced, or plan to introduce, a DST

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52. See I.R.C. § 882; U.S. MODEL, *supra* note 2, art. 5; GUSTAFSON ET AL., *supra* note 2, at 181–82.

53. See OECD MODEL, *supra* note 3, at 175–77.

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

55. See OECD, 2018 INTERIM REPORT, *supra* note 8, at 51 (explaining the problem of remote technology allowing digital businesses to “have an economic presence in a jurisdiction without having a physical presence”).

56. All proposals will be discussed *infra* Parts I.B and I.D in detail.

for certain highly digitalized businesses. Part I.C offers a detailed survey of various DSTs.

*B. European Developments: Modifying Income Tax vs. a New Turnover Tax*

Having suffered prominently from the global tax challenges in the digital economy, Europe emerged the front-runner of advocating a new tax framework to deal with the growing digital economy.<sup>57</sup> In September 2017, the European Commission (EC) began developing a proposal for a long-term solution that extends the concept of permanent establishment in income tax and a short-term solution that introduces a new turnover tax.<sup>58</sup> This turnover tax, which is a subcategory of consumption tax as opposed to income tax, is called a DST and has become a prototype of various DSTs discussed in Part I.C.

The EC stated that its main concern was to ensure that the digital economy would be taxed fairly, citing the growing market share of tech companies in the European economy and the relatively low effective tax rates for digital businesses.<sup>59</sup> The two main policy challenges noted by the EC were the questions of where to tax—i.e., nexus—and what to tax—i.e., value creation.<sup>60</sup> In the Communication released on September 21, 2017, the EC advocated for a comprehensive solution, but also proposed three alternative, shorter-term, solutions,<sup>61</sup> one of which is a levy on revenues generated from the provision of digital services or advertising activity, matching very closely to the eventual final proposal of the EC.<sup>62</sup>

The 2017 Communication culminated in two proposals that the EC later released on March 21, 2018. The first proposal, called the digital permanent establishment proposal, was intended as a long-term solution and sought to establish corporate tax rules for taxing the digital economy by extending the current physical permanent establishment rules to those businesses with a significant digital presence.<sup>63</sup> Thus, as long as a digital business enterprise has a significant digital presence in a market country, that market country may recognize the enterprise's taxable nexus to its jurisdiction even if there is no physical or traditional permanent establishment of such enterprise in that

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

58. *Id.* at 8–10.

59. *Id.* at 2, 4, 6.

60. *Id.* at 7.

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

62. *Id.* The European Council adopted the conclusions of the EC on October 19, 2017. *See generally* Presidency Conclusions, Brussels European Council (Oct. 19, 2017).

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



jurisdiction. Thus, the market country may exercise its taxing right for the revenue of such an enterprise. A business would be deemed to have such a taxable nexus, or digital permanent establishment, for cross-border digital business by fulfilling any of the following criteria: (1) annual revenues from supplying digital services in a member state exceeding €7 million; (2) having more than 100,000 users in a member state in a taxable year; and (3) business contracts for digital services created between the company and business users exceeding 3,000 in a taxable year.<sup>64</sup> The proposal also included rules detailing how member states may attribute profits to or in respect of a significant digital presence, presented a non-exhaustive list of economically significant digital activities, and was intended to amend member states' tax treaties with non-EU jurisdictions.<sup>65</sup>

The second proposal is the origin of the DST, originally intended as a short-term solution establishing a common tax system targeting revenues stemming from the supply of certain digital services.<sup>66</sup> The in-scope digital businesses subject to the interim DST included: (1) the placing of digital advertising targeted at users in a member state; (2) the transmission of user data generated from user activity; and (3) intermediation services that allow users to find other users and interact with them.<sup>67</sup> On the other hand, provision of digital content, payment services, online sales of goods or services, and certain regulated financial and crowdfunding services were excluded.<sup>68</sup> The interim DST proposal included two revenue thresholds necessary for entities to be taxed under the interim DST: (1) worldwide revenues exceeding €750 million; and (2) taxable revenues within the EU exceeding €50 million.<sup>69</sup> Lastly, the proposal set a 3% tax rate deemed to be “an appropriate balance between revenues generated by the tax and accounting for the differential DST impact for businesses with different profit margins.”<sup>70</sup>

However, since the EU released the above proposals in March 2018, member states of the EU disagreed on both the long-term and short-term proposals.<sup>71</sup> The European Council finally rejected both proposals in March 2019.<sup>72</sup> After the epic fail of the EU proposals, a number of member states

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64. *Id.* at 16.

65. *Id.* at 17–18.

66. *EU Digital Services Tax Proposal 2018*, *supra* note 18, at 3.

67. *Id.* at 24–25.

68. *See id.* at 25; *see also* Council Directive 2014/65, 2014 O.J. (L 173) 349 (EU).

69. *EU Digital Services Tax Proposal 2018*, *supra* note 18, at 25–26.

70. *Id.* at 22.

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

72. *See* Robert Van der Jagt, *ECOFIN Discusses Digital Tax and Updates the EU Blacklist*, KPMG, <https://home.kpmg/xx/en/home/insights/2019/05/etf-404-ecofin-discusses-eu-digital-services-tax1.html> (last visited Sept. 16, 2020); *see also* Outcome of the Council Meeting (EC) No. 7368/19 of 12 Mar. 2019 (PR CO 12) 6.

have moved fast to implement their own unilateral measures for taxing the digital economy, discussed in the Part I.C.

### C. DSTs as Popular Unilateral Measures

After the failure to either adopt a new DST or modify income tax by expanding the definition of “permanent establishment,” several EU member states have taken various levels of unilateral action. The unilateral measures are surprisingly skewed towards introducing a new DST rather than modifying income tax rules.<sup>73</sup> Non-European countries, such as India, Mexico, and Canada, have also adopted or plan to introduce a DST. This Subpart explores the most noteworthy DSTs in Europe and other countries, which can serve as a preliminary exercise to understand the implications of DSTs on international tax policy and to identify common key features of DSTs that will be discussed in Part II.

#### 1. United Kingdom

The U.K. was one of the early proponents of a unilateral DST. Although it maintained its official position as waiting for the global solution for taxing the digital economy, it eventually enacted a DST in 2020.<sup>74</sup>

As part of his 2018 budget, Chancellor Philip Hammond of the U.K. released a DST proposal that resembles the EC’s March 2018 version apart from a reduced rate and the introduction of safe harbors for businesses with low profit margins or those taking losses.<sup>75</sup> The U.K. proposal would apply a 2% tax, instead of the 3% tax suggested in the EC’s version, on the revenues of specific digital business models where the revenues are linked to the participation of U.K. users.<sup>76</sup> The first major change from the EC version is

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73. As of August 11, 2020, only four countries—Belgium, India, Israel, and Slovakia—have introduced, or plan to introduce, a concept of “digital permanent establishment.” KPMG, TAXATION OF THE DIGITALIZED ECONOMY 5 (Aug. 11, 2020). Ruth Mason commented that the conflict resulting from DSTs is a proxy war for allocating tax revenue from cross-border transactions among countries. Ruth Mason, *The Digital-Tax Proxy War*, MEDIUM (Dec. 2, 2018), <https://medium.com/@ProfRuthMason/the-digital-tax-proxy-war-1f618a0f8d43>.

74. The U.K. still states that the legislation for a DST is an interim measure. See HM TREASURY, DIGITAL SERVICES TAX: RESPONSE TO THE CONSULTATION 7–8 (2019) [hereinafter HM TREASURY, DST]. It became law in July 2020, retroactively effective from April 2020. Finance Act 2020, c. 39–72 (U.K.); Stephanie Soong Johnston, *U.K. Digital Services Tax Becomes Law, Stoking Trade Tensions*, TAX NOTES TODAY INT’L (July 23, 2020), <https://www.taxnotes.com/tax-notes-today-international/digital-economy/uk-digital-services-tax-becomes-law-stoking-trade-tensions/2020/07/23/2cr9q>.

75. See HM TREASURY, BUDGET 2018 44 (2018) [hereinafter HM TREASURY, BUDGET 2018].

76. HM TREASURY, BUDGET 2018 DST, *supra* note 18.

the implementation of an exemption to the tax for the first £25 million in taxable U.K. revenues and a 0% tax rate for companies sustaining losses.<sup>77</sup>

The proposed tax would apply to business models that have revenues linked to the participation of U.K. users and is meant to apply specifically to search engines, social media platforms, and online marketplaces.<sup>78</sup> Financial and payment services, the provision of online content, sales of software and hardware, and broadcasting services would not be within its scope.<sup>79</sup> The proposed tax would require businesses within its scope to earn annually at least £500 million globally to be taxable.<sup>80</sup> The proposal also includes a local revenue threshold for “relevant U.K. revenues” of £25 million as a means to ensure small businesses remain outside the scope of the tax.<sup>81</sup>

In July 2019, the U.K. introduced a bill for its DST, with an effective date of April 1, 2020.<sup>82</sup> Uniquely, the U.K. DST bill provides a 50% reduction in the tax for instances where the tax would overlap with a user subject to a similar tax elsewhere.<sup>83</sup> The bill received royal assent and became law on July 22, 2020, retroactively effective from April 1, 2020.<sup>84</sup>

## 2. France

France is another country leading the unilateral change following the EU’s epic fail in March 2019. In the same month of 2019, the French Finance Minister, Bruno Le Maire, released a policy document detailing the country’s unilateral approach to the DST.<sup>85</sup> The French DST is keen to tax the American tech giants, such as GAFA, the acronym of Google, Apple, Facebook, and Amazon, because, as Le Maire said, the emergence of such tech giants are

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77. Daniel Bunn, *Revenue Estimates for Digital Services Tax*, TAX FOUND. (Apr. 26, 2019), <https://taxfoundation.org/digital-services-tax-revenue-estimates>. However, it is criticized that the safe harbors are available to almost no businesses. Philip Hammond, the U.K.’s chief financial minister, stated that the tax “will be carefully designed to ensure it is established tech giants—rather than our tech start-ups—that shoulder the burden of this new tax.” Philip Hammond, Chancellor of the Exchequer, HM Treasury, Budget 2018: Philip Hammond’s Speech (Oct. 29, 2018) (transcript available at <https://www.gov.uk/government/speeches/budget-2018-philip-hammonds-speech>).

78. HM TREASURY, BUDGET 2018, *supra* note 75.

79. HM TREASURY, BUDGET 2018 DST, *supra* note 18.

80. *Id.*

81. *Id.*

82. HM Revenue & Customs, *Introduction of the New Digital Services Tax*, GOV.UK (July 11, 2019), <https://www.gov.uk/government/publications/introduction-of-the-new-digital-services-tax/introduction-of-the-new-digital-services-tax>; HM TREASURY, BUDGET 2018, *supra* note 75.

83. HM Revenue & Customs, *supra* note 82.

84. Finance Act 2020, c. 39–72 (U.K.); Johnston, *supra* note 74.

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

monopolistic and they “not only want to control the maximum amount of [user] data, but also escape fair taxes.”<sup>86</sup>

The proposal would subject digital businesses to a 3% tax on income derived from: (1) the provision of a digital interface to enable users of platforms to interact with each other in order to exchange goods or service; and (2) advertising conducted on digital interface.<sup>87</sup> To qualify for the above-listed income, subject to a DST, digital services must be made or supplied to French users located in France.<sup>88</sup> The user’s location is determined based on, among others, the French IP address used to connect to websites, which differs from the industry standard’s user-click criteria.<sup>89</sup> The French DST includes its own criteria in applying the tax only to companies earning at least €750 million in worldwide revenue and €25 million in domestic revenue.<sup>90</sup>

The discussion in the legislative body moved quickly.<sup>91</sup> Four months after the discussion began, President Emmanuel Macron signed the new tax bill into law on July 24, 2019.<sup>92</sup> It is expected to raise €500 million per year.<sup>93</sup>

Although France is the second country that introduced a DST, the new tax bill retroactively established the tax to collect tax revenues generated from January 1, 2019,<sup>94</sup> which chronologically makes France the first country to impose a DST. The retroactivity of the new digital tax sparked strong resistance from American tech giants, such as Facebook and Amazon, arguing that “[i]n order to comply, a company has to keep track of every user that observed an impression on a device while in France, and every user who observed an impression on a device everywhere in the world, back to Jan. 1, 2019.”<sup>95</sup> Recognizing the severe pushback, President Macron assured that the French DST is an interim measure and that “France will reimburse any tax paid under

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

87. KPMG, *supra* note 73, at 8; LIGHTHIZER, *supra* note 13, at 12.

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

89. *Id.*

90. KPMG, *supra* note 73, at 21.

91. On April 9, 2019, the National Assembly, France’s lower house, passed a bill nearly mirroring the March 2019 proposal and the Senate, the upper house, amended the bill with a number of important changes in May of 2019. *France: Update on Digital Services Tax; Enactment Anticipated*, KPMG (June 27, 2019), <https://home.kpmg/us/en/home/insights/2019/06/tnf-france-update-on-digital-services-tax-enactment-anticipated.html>. The French Senate approved the new tax on July 11, 2019. Daniel Bunn, *France Approves Digital Services Tax; U.S. Explores Retaliatory Options*, TAX FOUND. (July 11, 2019), <https://taxfoundation.org/france-digital-services-tax-us-retaliatory-options>; Alderman, *supra* note 86.

92. Hamza Ali, *France’s Macron Signs Digital Services Tax into Law*, BLOOMBERG TAX (July 25, 2019), <https://news.bloombergtax.com/daily-tax-report-international/frances-macron-signs-digital-services-tax-into-law>.

93. Alderman, *supra* note 86.

94. Ali, *supra* note 92.

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

its digital services tax once there is an international deal on digital taxation.<sup>96</sup> Also, the collection of DSTs has been delayed to the end of 2020.<sup>97</sup>

Despite the French conciliatory gesture, it is possible that this new tax will escalate to a trans-Atlantic trade war. The U.S. Trade Representative proposed tariffs of up to 100% on French luxuries, such as wine, cosmetics, and handbags, claiming that the French DST targets American tech giants.<sup>98</sup> France warned that the EU would retaliate with its own round of tariffs.<sup>99</sup> For now, the two countries agreed to cool off while awaiting the global deal in the G20/OECD expected in late 2020, but it is possible that France will not repeal the DST regardless of the outcome of the global deal.<sup>100</sup> Recently, the U.S. government announced that it would impose additional duties of 25% on French products, such as handbags and cosmetics, starting January 2021.<sup>101</sup>

### 3. Other EU Member States

There are a number of other European countries that have already implemented, or plan to adopt, DSTs, mimicking the original EU DST proposals.

On May 16, 2018, Italy began a public consultation in response to the EC's March 2019 DST proposals.<sup>102</sup> This public consultation eventually led to the introduction of Italy's own DST version on December 31, 2018, which is modelled directly off the EC's version.<sup>103</sup> Italy's DST includes the same 3% rate, applicable digital businesses, and worldwide revenue threshold, but modifies a domestic threshold into €5.5 million in Italian revenues.<sup>104</sup> The Italian DST is effective from January 1, 2020.<sup>105</sup>

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

97. *France Agrees to Delay New Tax on Tech Giants*, BBC (Jan. 21, 2020), <https://www.bbc.com/news/business-51192369>.

98. Parker, *US Moves Ahead on French Tariffs over Digital Taxes*, *supra* note 13; Parker, *US Proposes 100% Tariffs on French Imports over Digital Tax*, *supra* note 13; see also Ruth Mason, *France-US Skirmish over Amazon Digital Tax Shows Why the Century-Old International Tax System Is Broken*, CONVERSATION (Jan. 31, 2020, 12:13 PM), <https://theconversation.com/france-us-skirmish-over-amazon-digital-tax-shows-why-the-century-old-international-tax-system-is-broken-130835>.

99. David Keohane et al., *France Warns US Against Digital Tax Retaliation*, FIN. TIMES (Jan. 5, 2020), <https://www.ft.com/content/de451a5e-2fb6-11ea-9703-eea0cae3f0de>.

100. Alex M. Parker & Todd Buell, *US, France Fend Off Tariffs over Digital Tax Issue*, LAW360 (Jan. 21, 2020), <https://www.law360.com/articles/1236309>.

101. Notice of Action in the Section 301 Investigation of France's Digital Services Tax, 85 Fed. Reg. 43,292, 43,292–97 (July 10, 2020).

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

103. See *id.*; see also legge 30 dicembre 2018, n.145, in G.U. Dec. 31, 2018, n.302 (It.).

104. Sledz, *supra* note 102.

105. KPMG, *supra* note 73, at 10.

Very similar to the Italian DST, Spain released a preliminary draft bill for a DST on October 23, 2018, that closely mirrors the EC version.<sup>106</sup> Spain's DST would apply the same 3% tax rate and €750 million global threshold.<sup>107</sup> Similarly, the tax would apply to online advertising services, online intermediation services, and data transfer services, but include several specific exceptions and does not include an exclusion for intragroup transactions.<sup>108</sup> The draft proposal also included a lower domestic threshold of €3 million.<sup>109</sup> The bill is pending in Parliament.<sup>110</sup>

The Austrian DST has a narrower scope than the other DST proposals because it limits the scope to digital advertisement services. The Austrian Finance Ministry published its own digital tax draft legislation on April 4, 2019, that would expand its current advertising tax to apply to digital advertising.<sup>111</sup> This more confined version of the DST would implement a 5% turnover tax on revenue derived from advertising services in Austria and would include the same €750 million global threshold and a €25 million domestic threshold.<sup>112</sup> The Austrian DST is effective from January 1, 2020.<sup>113</sup>

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106. *Spain Releases Draft Bill on Digital Services Tax*, EY (Oct. 25, 2018), [https://www.ey.com/en\\_gl/tax-alerts/spain-releases-draft-bill-on-digital-services-tax](https://www.ey.com/en_gl/tax-alerts/spain-releases-draft-bill-on-digital-services-tax).

107. *Id.*

108. *Id.*

109. *Id.*

110. KPMG, *supra* note 73, at 11.

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

112. *Id.*

113. KPMG, *supra* note 73, at 6.

Table 1 below summarizes and compares various DSTs that European countries have enacted or proposed to implement.

TABLE 1. VARIOUS DSTs IN EUROPE<sup>114</sup>

	Threshold <sup>115</sup>	Scope	Rate	Effective
EU Proposal	€750/50 million	Advertisement/ Digital interfaces, intermediation, online marketplace/ Data transfer, resale of private data	3%	(failed)
France	€750/25 million	Same as above	3%	2019 (collection postponed until Dec. 2020)
Italy	€750/5.5 million	Same as above	3%	2020
Spain	€750/3 million	Same as above	3%	2020 (expected)
Czech Republic	€750/CZK 100 million	Same as above	5%	2021 (expected)
Belgium	€750/5 million	Selling of user data	3%	n/a (proposed)
U.K.	£500/25 million	Search engines/ Digital interfaces, intermediation, online marketplace/ Social media	2%	2020
Austria	€750/10 million	Advertisement	5%	2020
Hungary	HUF 100 million (no local threshold)	Advertisement	7.5%, temporarily 0% (July 2019 – Dec. 2022)	2017
Poland	n/a	Audio-visual media service and audio-visual commercial communication	1.5%	2020

114. Table 1 is created by the author based on the survey performed by KPMG. *Id.*

115. The first amount refers to the global revenue threshold, and the second amount refers to the domestic revenue threshold.

#### 4. *Beyond Europe: DSTs as Status Quo*

In addition to the EU member states, many countries, ranging from Canada<sup>116</sup> to South Africa, have enacted, proposed, or publicly discussed DSTs. Chart 1 below shows the current status of the DST legislation in various countries as of August 2020.

CHART 1. CURRENT STATUS OF DST LEGISLATION<sup>117</sup>



About thirty countries have followed suit and either enacted, proposed, or considered a DST. Michael Graetz commented at a recent conference that the current nexus and profit allocation rules are no longer status quo; status quo has become each country unilaterally adopting its own DST without coordination.<sup>118</sup>

116. After the election in late 2019, Canada has expressed its intent to introduce a 3% DST for certain digital industries, which mimics the French DST. The global revenue threshold amount is CAD 1 billion and the local revenue threshold is CAD 40 million. OFF. PARLIAMENTARY BUDGET OFFICER, COST ESTIMATE OF ELECTION CAMPAIGN PROPOSAL (Sept. 19, 2019).

117. Chart 1 is created by the author based on the data released by KPMG. KPMG, *supra* note 73. Below is the list of countries in Chart 1.

Countries where a DST has been implemented are colored in black: Austria, France, Hungary, India (Equalisation Levy), Indonesia (Electronic Transaction Tax), Italy, Kenya, Paraguay, Poland, Tunisia, Turkey, and the United Kingdom.

Countries that have proposed or publicly considered a DST are colored in gray: Belgium, Brazil, Canada, Czech Republic, Denmark, Egypt, Israel, Latvia, New Zealand, Norway, Romania, Russia, Slovakia, Slovenia, South Africa, South Korea, and Spain.

Countries that have enacted or are considering income-tax-based approaches, including Costa Rica, Greece, Malaysia, Mexico, Nigeria, Taiwan, Uruguay, Vietnam, and Zimbabwe, are not included in Chart 1.

118. Michael Graetz, Professor of Tax Law, Columbia Law Sch., Speech at the 2019 USCIB/OECD International Tax Conference (June 3, 2019).



There are two countries, India and Turkey, whose DSTs show notable variations from the general features discussed in Part II.A below. India has undertaken two significant unilateral actions in taxing the digital economy since 2016. First, as part of the Indian Government's Finance Act of 2016,<sup>119</sup> the country introduced a turnover-based tax designated as an "equalisation levy,"<sup>120</sup> which is comparable to a DST. Second, in 2018, following India's participation and review of the OECD's BEPS continuing research, the country also expanded the definition of PE in its income tax statute to include digital companies that would otherwise not be taxed due to their lack of physical presence in India.<sup>121</sup> Hence, India has adopted both a consumption-tax-based solution and an income-tax-based solution.

Turkey became one of the latest countries to introduce a DST.<sup>122</sup> Turkey's newly enacted 7.5% DST is effective on March 1, 2020.<sup>123</sup> It is noteworthy that Turkey's DST is not only higher in tax rate than the DST enacted by France and the U.K. but also broader in scope because it applies to sales of digital content online as well.<sup>124</sup>

#### D. G20 and the OECD's Work

While many countries consider adopting a new DST unilaterally, the OECD and G20 have been working on a global deal to resolve the tax

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119. Finance Act, 2016, No. 28, Acts of Parliament, 2016 (India).

120. *Id.* § 165(1). The Finance Act followed from India reacting relatively quickly to the OECD's BEPS Action Report 1 that recommended an equalization levy as one of three potential solutions to taxing the digital economy. OECD, BEPS ACTION 1, *supra* note 8, at 115–16. The act imposes a 6% turnover tax on the gross revenues of foreign online advertising companies that do not have traditional PE in India. *Id.* § 165(1). However, the levy is only applicable to those transactions that aggregate to more than INR 100,000 (approximately USD 1,500) in a financial year. *Id.* § 165(2)(b). The specified services subject to the equalization levy may be expanded in scope and are defined as an "online advertisement, any provision for digital advertising space or any other facility or service for the purpose of online advertisement and include[] other service[s] as may be notified by the Central Government." *Id.* § 164(i). The levy came into effect as of June 1, 2016. KPMG, *supra* note 73, at 25.

121. Finance Bill, 2018, No. 4, Acts of Parliament, 2019 (India). India expanded the definition of PE by introducing the significant economic presence (SEP) concept in the amendment of the Income-tax Act. The purpose of the amendment was to establish SEP of foreign digital companies and tax those entities and other foreign companies with traditional PE alike. The SEP amendments were set to come into force April 1, 2018. *Id.* §§ 1(2), 4(2). In sum, the SEP changes seek to make income attributable to any significant economic presence to be considered as taxable income in India. S.R. Patnaik, *Taxing the Digital Economy: The Rule of 'Significant Economic Presence'*, CYRIL AMARCHAND MANGALDAS BLOGS (Mar. 21, 2018), <https://tax.cyrilamarchandblogs.com/2018/03/taxing-digital-economy-rule-significant-economic-presence>.

122. KPMG, TURKEY: DIGITAL SERVICES TAX ENACTED, EFFECTIVE DATE OF MARCH 2020 (Dec. 11, 2019), <https://home.kpmg/us/en/home/insights/2019/12/tmf-digital-services-tax-enacted-effective-march-2020.html>.

123. KPMG, *supra* note 73, at 12.

124. It applies to sales of digital content, which France's law excludes, and also eliminates other exemptions in the French legislation such as revenue from information gathered by sensors. Alex M. Parker, *Turkey Enacts 7.5% Digital Services Tax*, LAW360 (Dec. 12, 2019), <https://www.law360.com/tax/articles/1227913>.

challenges in the digital economy. The OECD/G20 proposals, first released in early 2019 and updated in October 2019, reject the DST-based approach and rather modify the traditional income tax rules. It would allocate a digital firm's income between the market countries and the firm's home country based on a new formula according to sales and some online activities, regardless of whether the firm has physical presence in the market countries.<sup>125</sup>

Aggressive tax planning strategies by multinational enterprises have been the center of the fiscal agenda among many countries since the financial crisis in 2008.<sup>126</sup> For example, source countries, where investments occur and income is produced, suffer from tax base erosion by taxpayers, whereas residence countries, where investors reside, suffer from profit shifting to low-tax countries. In order to combat such base erosion and profit shifting (BEPS) arising from multinational enterprises' clever use of gaps and mismatches in tax rules, the OECD and G20 initiated the BEPS project in 2013, which resulted in fifteen final reports containing action plans for each topic in 2015.<sup>127</sup> Furthermore, the working parties realized the need to collaborate with more countries beyond the OECD and G20 to implement the goal of the BEPS project, so they created the OECD/G20 Inclusive Framework on BEPS, within which over 130 countries and jurisdictions are working together to tackle tax avoidance globally.<sup>128</sup>

Among those fifteen final reports and action plans, it is symbolic that Action 1 is "Addressing the Tax Challenges of the Digital Economy."<sup>129</sup> The report not only recognized the tax challenges arising from the digitalization of the economy but also noted that it would be "difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes" because of the increasingly pervasive nature of digitalization.<sup>130</sup> The limitations addressed in Action 1 indicate that the tax challenges raised by digitalization go beyond the base erosion or profit shifting issues because the remaining challenges relate to how taxing rights among relevant countries should be allocated.

The OECD/G20 continued to analyze the tax challenges in the digital economy and produced several reports, with a hope to form the basis for consensus by 2020. The reports include *Tax Challenges Arising from Digitalisation—*

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125. See, e.g., OECD, SECRETARIAT PROPOSAL FOR A "UNIFIED APPROACH" UNDER PILLAR ONE 8–9 (Nov. 2, 2019) [hereinafter OECD, UNIFIED APPROACH].

126. *History of the G20 & BEPS*, OECD, <https://www.oecd.org/tax/beps/about/#history> (last visited Sept. 17, 2020).

127. *What is BEPS?*, OECD, <https://www.oecd.org/tax/beps/about/> (last visited Sept. 17, 2020).

128. *Id.*

129. OECD, BEPS ACTION 1, *supra* note 8.

130. *Id.* at 11.

*Interim Report* in March 2018,<sup>131</sup> a policy note in January 2019,<sup>132</sup> the *Public Consultation Document* in February 2019,<sup>133</sup> and the *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy* (Programme of Work) in May 2019.<sup>134</sup> The proposals offered in these documents can be sorted into three categories. The first category is expanding the tax nexus rules to include significant digital presence and introducing new profit allocation rules based on formulae according to sales and some online activities (Significant Economic Presence Proposal or Fractional Apportionment Method).<sup>135</sup> The second category is modifying profit allocation rules to reallocate an amount of income deriving from specific intellectual properties, called residual profit, to market countries (Marketing Intangibles Proposal or Modified Residual Profit Split Method).<sup>136</sup> The third category is modifying profit allocation rules to require an amount of profit be allocated to market countries where user participation is active, irrespective of whether the businesses have a local physical presence or tax nexus (User Participation Proposal or Distribution-Based Approaches).<sup>137</sup> The third proposal is the

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131. OECD, 2018 INTERIM REPORT, *supra* note 8.

132. OECD, POLICY NOTE, *supra* note 20. This 2019 policy note explains that the OECD will examine the tax challenges under two separate pillars while hoping to form the basis for consensus by 2020. Pillar 1, which is relevant to this Article, examines how to modify the traditional nexus and allocation rules to give market jurisdictions greater rights to assert tax nexus and be entitled to a share of multinational enterprises' taxable income. *Id.* at 2. Pillar 2 seeks to further combat against the BEPS issue in the context of digitalization. *See id.* Pillar 1 is relevant to this Article, whereas Pillar 2 seeks to extend the policies that the U.S. tax reform recently adopted, especially the global intangible low-income tax (GILTI) minimum tax and the base erosion and antiabuse tax (BEAT).

133. OECD, PUBLIC CONSULTATION DOCUMENT, *supra* note 42.

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

135. Many developing countries, such as those in the G24, endorse this proposal. It aims to reward market countries by abandoning the traditional residency-based nexus rules in favor of economic nexus which would include digital presence. Furthermore, it adopts a formulary apportionment approach where the tax base is computed by applying the global profit rate of the multinational enterprise group to the revenue generated in a particular jurisdiction. Such a tax base is allocated based on apportionment factors, such as sales, assets, employees, and importantly, users. It targets a wider scope than either of the User Participation or Marketing Intangibles proposals. OECD, PUBLIC CONSULTATION DOCUMENT, *supra* note 42, at 16–17.

136. The second proposal is supported by the U.S. This proposal is similar to the current residual profit split method in transfer pricing which distinguishes the multinational enterprises' non-routine or residual profit from routine profit. But this proposal requires only a portion of the nonroutine from in-scope activities or assets to be allocated to the market jurisdiction. All other routine and nonroutine profit would continue to be allocated based on existing profit allocation principles. See Itai Grinberg, *International Taxation in an Era of Digital Disruption: Analyzing the Current Debate*, TAXES 85, 98–101 (2019), for a distinction of residual profit from routine profit. Thus, going beyond highly digitalized businesses, it could reach a wider scope than the User Participation Proposal. However, it also departs from the traditional arm's length principle, therefore making it difficult to satisfy the DST advocates. OECD, PUBLIC CONSULTATION DOCUMENT, *supra* note 42, at 11–16.

137. The User Participation Proposal, supported by the U.K. and France, is premised on the idea that soliciting the sustained engagement and active participation of users is a critical component of value creation for certain highly digitalized businesses. The activities and participation of these users contribute to the creation of the brand, the generation of valuable data, and the development of a critical mass of users, which helps to establish market power. Consequently, it targets certain highly digitalized businesses, such as social

closest to a DST because it emphasizes user participation; but it is different from a DST because it maintains the income tax framework and rejects a new DST. All three proposals attempt to give market countries greater taxing rights but are different as to how and to what extent they modify the taxing rights.

After discussing the previous proposals, the OECD Secretariat proposed a “Unified Approach” in October 2019.<sup>138</sup> The proposal covers highly digitalized business models but is increased in scope to include consumer-facing businesses.<sup>139</sup> It creates two new rules: (1) a new nexus rule, not dependent on physical presence and instead largely based on sales; and (2) a new profit allocation rule using a formulaic approach to determine the share of residual, or non-routine, profit allocated to market countries.<sup>140</sup> Although it clings to the income tax framework, it goes beyond the existing norms, such as the arm’s length principle—income should be allocated among relevant countries at what independent parties would have paid—and physical presence requirements.<sup>141</sup> It aims to offer a possible consensus-based solution to be agreed to by the end of 2020.

Yet, the Secretariat’s proposal is seen as “excessively cautious” and insufficient in reforming current international tax rules for the digital economy.<sup>142</sup> It is a nice combination of all of the previous proposals, but at the same time it introduces another layer of complexity to the already-complex international tax rules.<sup>143</sup> Also, it is not enough to reward the market countries: most corporate profits would still be taxed under current rules, and market countries may exercise new taxing rights only on a very small portion of profits

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media platforms, search engines, and online marketplaces. For those businesses, nonroutine or residual profit in excess of routine profit, which is generated from user participation, is required to be allocated to market countries where the relevant businesses’ active and participatory user bases are located, irrespective of whether the businesses have a local physical presence. OECD, PUBLIC CONSULTATION DOCUMENT, *supra* note 42, at 9–11.

138. OECD, UNIFIED APPROACH, *supra* note 125.

139. *Id.* at 5.

140. The Unified Approach creates a three-tier mechanism for apportioning a multinational enterprise’s profits to various countries. First, Amount A is the deemed residual profit or deemed nonroutine profit, which gets allocated among the various market countries even when an enterprise does not have a physical presence. Second, if the enterprise has a traditional tax nexus, such as physical presence in a market country, an additional amount—i.e., Amount B—attributed for baseline marketing and distribution functions may further be allocated to that country under current rules for transfer pricing and permanent establishment. Third, there might be a case where the market country argues that it may seek to tax an additional profit in excess of Amount B—i.e., Amount C—due to extra functions in that country. Then, the dispute over Amount C between the market country and the taxpayer should be subject to a legally binding and effective dispute prevention and resolution mechanism. *Id.* at 9.

141. *Id.*; Alex M. Parker, *Mnuchin Has ‘Serious Concerns’ with OECD Digital Tax Plan*, LAW360 (Dec. 4, 2019), <https://www.law360.com/tax/articles/1225261>.

142. Isabel Gottlieb, *OECD’s Global Tax Overhaul Too Cautious, Trade Union Group Says*, BLOOMBERG TAX (Feb. 5, 2020), [https://www.bloomberglaw.com/product/tax/document/X8EF01GS000000?bna\\_news\\_filter=daily-tax-report-international&jcsearch=BNA%252000000170167ddcd9a5f3b67df0a00001#jcite](https://www.bloomberglaw.com/product/tax/document/X8EF01GS000000?bna_news_filter=daily-tax-report-international&jcsearch=BNA%252000000170167ddcd9a5f3b67df0a00001#jcite).

143. *Id.*

that meet several thresholds.<sup>144</sup> If a firm does not have physical presence, the new taxing rights are further limited.<sup>145</sup>

Furthermore, it becomes unclear whether a global deal can be reached on the Secretariat's proposal because the U.S. wants to pause the negotiation on the digital tax reform.<sup>146</sup> U.S. Treasury Secretary Steven Mnuchin sent the OECD a letter in December 2019, expressing concerns that the proposal departs too far from the existing rules and asking to add a safe harbor that would allow U.S. companies to choose between the new and old regimes.<sup>147</sup> The OECD has dismissed the idea of an alternative safe harbor,<sup>148</sup> and there is no sign of a compromise.

Thus, many countries are more likely to maintain DSTs even after 2020, which has been implied by U.K., French, and German government officials.<sup>149</sup> Also, Austria, France, Italy, Poland, Turkey, and the U.K., among others, have implemented DSTs during the year 2020.<sup>150</sup> The current status confirms an earlier observation of Michael Graetz that the existing global tax norms in income taxation, such as nexus and profit allocation, are outdated and that DSTs are the status quo. To better understand DSTs, Part II analyzes how positive law provides DSTs and critically evaluates the merits and demerits of DSTs compared to conventional income-tax-based approaches.

## II. THE ANATOMY OF DSTS

This Part explains how positive law provides DSTs by showing key design features that are common in various DSTs that have been enacted or proposed. An important feature of a DST is that it is designed as a turnover tax, which is a subcategory of a consumption tax. Given that the goal of a DST is to reward market countries' tax revenue, a consumption-tax-based approach is considered effective because it taxes digital platforms in a way that the traditional income

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144. See, e.g., Jeroen Lammers, *OECD Unified Approach Leaves Market Jurisdictions Out in the Cold*, TAX NOTES INT'L (Jan. 13, 2020), <https://www.taxnotes.com/tax-notes-international/base-erosion-and-profit-shifting-beps/oece-unified-approach-leaves-market-jurisdictions-out-cold/2020/01/13/2bqdn>.

145. OECD, UNIFIED APPROACH, *supra* note 125, at 8.

146. Parker, *supra* note 141; Elodie Lamer & Sarah Paez, *U.S. Withdrawal from Digital Talks Marks 'Collective Failure'*, TAX NOTES TODAY FED. (June 19, 2020), <https://www.taxnotes.com/tax-notes-today-federal/digital-economy/us-withdrawal-digital-talks-marks-collective-failure/2020/06/19/2cmwb>; Rochelle Toplensky, *How Trump's Tariff Threats Are Hustling Global Tax Reform*, WALL ST. J. (Feb. 3, 2020), <https://www.wsj.com/articles/how-trumps-tariff-threats-are-hustling-global-tax-reform-11580726125>.

147. See Maximilian Frank, *OECD Digital Tax Negotiations Thread the Sovereignty Needle*, COUNCIL ON FOREIGN REL. (May 20, 2020), <https://www.cfr.org/blog/oece-digital-tax-negotiations-thread-sovereignty-needle>.

148. Parker & Buell, *supra* note 100.

149. Natalie Olivo, *UK Digital Tax May Outlive Global Agreement*, LAW360 (July 25, 2019), <https://www.law360.com/tax-authority/articles/1179756>; Isabel Gottlieb, *More Unilateral Taxes Likely if OECD Talks Fail: German Official*, BLOOMBERG TAX (Feb. 3, 2020), <https://news.bloombergtax.com/daily-tax-report-international/more-unilateral-taxes-likely-if-oece-talks-fail-german-official>; Parker & Buell, *supra* note 100.

150. KPMG, *supra* note 73, at 6–12.

tax rules cannot. However, because of such departure from the conventional global norm of taxing profits of multinational enterprises in the income tax framework, DSTs are subject to criticism discussed in Part II.B. Some opponents aggressively try to understand DSTs as a disguised income tax despite what positive law provides as a consumption turnover tax. While these critiques contain merit and need to be addressed, the DST debate could be viewed differently when viewing DSTs as a consumption tax, which has never been discussed seriously before. This Article seeks to do so, which could bring a new life to the DST as a way of taxing the digital economy.

### A. Key Features of DSTs in Positive Law

This Subpart observes how positive law offers DSTs. The doctrinal analysis of such design, as well as criticisms of DSTs, continues to Part II.B.

#### 1. Turnover Tax and Consumption Tax

DSTs are all designed as turnover taxes. In the most general sense, a turnover tax is defined as “a tax levied on the value of the sales revenue of a firm”<sup>151</sup> rather than other commonly used tax bases such as corporate profits or sales price.<sup>152</sup> Likewise, DSTs are imposed on the “gross revenue” of specific digital business models where revenues are linked to the participation of the business’s local users.<sup>153</sup> Some commentators interpret DSTs as a disguised income tax,<sup>154</sup> but this Article observes what positive law provides and analyzes DSTs as a turnover tax.

A turnover tax is a subcategory of a consumption tax.<sup>155</sup> A consumption tax refers to a taxing system where taxpayers are taxed based on how much they

151. *Turnover Tax*, ROUTLEDGE DICTIONARY OF ECONOMICS (3d ed. 2013).

152. See LOWRY, *supra* note 71, at 9 (providing that DSTs are “not structured as [a tax] on corporate profits”); Feng Wei & Jean-François Wen, *The Optimal Turnover Threshold and Tax Rate for SMEs 3* (Int’l Monetary Fund, Working Paper No. 19/98, 2019). In accounting, turnover means the net sales amount by a business before deducting any expenses, whereas “profit is the residual earnings of a business after all expenses have been charged against net sales.” Steven Bragg, *The Difference Between Turnover and Profit*, ACCOUNTINGTOOLS (Nov. 10, 2019), <https://www.accountingtools.com/articles/what-is-the-difference-between-turnover-and-profit.html>.

153. See LOWRY, *supra* note 71, at 9, 24; see also Bragg, *supra* note 152. Turnover taxes are essentially one type of “indirect tax on private consumptive expenditures.” Robert F. Van Brederode, *A Normative Evaluation of Consumption Tax Design: The Treatment of the Sales of Goods Under VAT in the European Union and Sales Tax in the U.S.*, 62 TAX LAW. 1055, 1056 (2009). If not explicitly a turnover tax, DSTs may also be considered an excise tax, which consists of “narrowly based taxes on consumption, levied on specific goods, services, and activities.” Brookings Inst., *Briefing Book*, TAX POLY CTR., <https://www.taxpolicycenter.org/briefing-book/what-are-major-federal-excise-taxes-and-how-much-money-do-they-raise> (last visited Feb. 16, 2020).

154. See *infra* Part II.B.2.

155. HELLERSTEIN & HELLERSTEIN, *supra* note 17, at 649 (including the turnover tax as part of a list of consumption taxes including retail sales tax, use tax, excise tax, and gross income tax).

consume rather than how much they earn—income tax.<sup>156</sup> Consumption taxes can take the form of turnover taxes, tariffs, excise taxes, and other taxes on consumed goods and services.<sup>157</sup> The amount of consumption matches the sales revenue of a firm, so a turnover tax that is levied on the sales revenue of a firm falls under the category of a consumption tax.

Turnover taxes have existed for over a century, but they have recently become a topic of tax policy scholarship as countries have enacted or proposed DSTs as turnover taxes.<sup>158</sup> Turnover taxes have been criticized in part simply because they “are not based on profits, measures of income, or any other indicator of consumption power that is targeted by most other tax instruments in modern developed economies.”<sup>159</sup> Moreover, turnover taxes, in general, may be distortionary due to so-called “tax cascading”—that is, when multiple firms touch in the development of a product, “the total tax paid will be higher for goods which pass through several firms to their final sale than for those which do not.”<sup>160</sup> However, turnover taxes have a broad tax base and thus can bring a “large, stable source of revenue.”<sup>161</sup> Furthermore, turnover taxes offer simplified compliance for taxpayers because gross sales or revenue are “relatively easier to measure, record, and verify than profit.”<sup>162</sup> Thus, turnover taxes have traditionally been used in the taxation of small and medium-sized enterprises in developing nations.<sup>163</sup> The pros and cons of using turnover tax for taxing the digital economy will be discussed further in Part II.C.2.

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156. Jane L. Seigendall, *A Framework on Consumption Taxes and Their Impact on International Trade*, 18 DICK. J. INT'L L. 575, 576 (2000).

157. See HELLERSTEIN & HELLERSTEIN, *supra* note 17, at 649.

158. PwC, ECONOMIC AND POLICY ASPECTS OF DIGITAL SERVICES TURNOVER TAXES: A LITERATURE REVIEW 1 (2018); see Meyer D. Rothschild, *The Gross Sales, or Turnover Tax*, 13 NAT'L TAX ASS'N 180, 196–204 (1920) (discussing, in part, the place of a one percent turnover tax within the U.S.'s taxation scheme around 1920); see JOHN F. DUE, *INDIRECT TAXATION IN DEVELOPING ECONOMIES* 105–06 (rev. ed. 1988) (describing the modern use of the turnover tax as beginning in the Philippines with a low-rate tax on all transactions).

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

160. *Turnover Tax*, *supra* note 151. This tax cascading may result in further negative consequences to companies operating at a loss or with a thin margin. JOYCE BEEBE, BAKER INST., RECENT DEVELOPMENTS ON THE E.U.'S DIGITAL TAX PROPOSAL 4 (Jan. 9, 2019).

161. Garrett Watson, *Resisting the Allure of Gross Receipts Taxes: An Assessment of Their Costs and Consequences*, TAX FOUND. (Feb. 6, 2019), <https://taxfoundation.org/gross-receipts-tax>.

162. See Wei & Wen, *supra* note 152, at 3.

163. PwC, NEW TURNOVER TAX INTRODUCED FROM JANUARY 2013 1 (2013). Therefore, developing nations, such as Armenia, introduced turnover taxes as an option to some small- and medium-sized enterprises. *Id.* at 2.

## 2. Tax Rates and Revenue Threshold

DSTs' tax rates are set around 2%–7.5%, and they offer revenue threshold requirements.<sup>164</sup> In other words, a firm's global revenue from in-scope business models discussed in Part II.A.4 should exceed certain threshold amounts to trigger a DST. DSTs also offer a smaller local revenue threshold. The French DST requires €750 million of global revenue and €25 million of local revenue, and the U.K. DST requires £500 million of global revenue and £25 million of local revenue for threshold amounts.<sup>165</sup>

Countries explain that the rationale for revenue threshold requirements is to target tech giants that enjoy monopoly power and yet do not pay enough tax in the market countries.<sup>166</sup> Furthermore, the local revenue threshold is to recognize a firm's tax nexus to the market countries regardless of its physical presence—explained in Part II.A.3.<sup>167</sup> If a firm generates revenue more than the threshold amount in the market country where users are located, it is enough to recognize the tax nexus to the market countries, and thus, market countries should be able to exercise taxing rights on the firm. These requirements are also upheld in *Wayfair*, although the tax at issue in the case is the sales tax collection obligation of remote sellers, not a turnover tax liability imposed on the platforms.<sup>168</sup>

The revenue threshold requirements are criticized mainly for two reasons. First, they do not offer safe harbors for businesses in losses.<sup>169</sup> Many digital firms would suffer from losses, especially in their early stage of business, but they might be subject to DSTs as long as they generate large amounts of gross revenue. To ameliorate this problem, for example, the U.K. DST proposal exempts the first £25 million in taxable U.K. revenues and provides a 0% tax rate for companies making losses.<sup>170</sup> Second, critics suspect that only American tech giants might satisfy the revenue threshold requirements and be subject to DSTs. This critique will be discussed in Part II.B in detail.

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164. See Initiation of Section 301 Investigations of Digital Services Taxes, 85 Fed. Reg. 34,709, 34,709–10 (June 5, 2020).

165. *France: Digital Services Tax (3%) is Enacted*, KPMG (July 25, 2019), <https://home.kpmg/us/en/home/insights/2019/07/tnf-france-digital-services-tax-enacted.html>.

166. *Id.* (“Tech companies allegedly have realized benefits from an undue advantage . . . .”); HM TREASURY & HM REVENUE & CUSTOMS, DIGITAL SERVICES TAX: CONSULTATION 22 (2018) (“The thresholds are also based on an expectation that the value derived from users will be more material for large digital businesses . . . .”); *EU Digital Services Tax Proposal 2018*, *supra* note 18, at 10 (supporting a global revenue threshold to limit application of tax to “companies of a certain scale, which are those which have established strong market positions that allow them to benefit relatively more from network effects and exploitation of big data”).

167. *EU Digital Services Tax Proposal 2018*, *supra* note 18, at 10–11.

168. *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080, 2099 (2018).

169. See Bunn, *supra* note 20 (“The tax would still apply even if those companies were not profitable, ignoring the costs associated with the revenues.”).

170. Bunn, *supra* note 77.



### 3. *New Rules for Tax Nexus and Profit Allocation*

As to the mechanics of recognizing tax nexus and allocating profits of digital firms, DSTs reject both the traditional requirement of physical presence and arm's length principle in income taxation. More precisely, they do not have to be bound by such requirements because they are turnover consumption taxes.

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

DSTs would, in effect, modify such tax nexus and profit allocation rules in income tax because they require allocating profits to market countries where users are located, irrespective of whether the businesses have a local physical presence. First, DSTs do not require a physical presence to recognize a tax nexus in market jurisdictions. Instead, they recognize a tax nexus if, for example, the revenue amount generated in market countries exceeds certain thresholds. The number of users or transactions occurring in the market country is also a criterion to consider, which replaces the traditional physical presence in income tax. Second, once the tax nexus is recognized, an amount of profit should be allocated to market jurisdictions in which relevant businesses' active and participatory user bases are located, even if there is no local physical presence. As a result, market countries would be able to collect revenue from the digital economy, which was not possible under the traditional rules.

### 4. *Limited Scope*

One of the most notable features of DSTs is their limited scope. A DST is designed to apply to the identified digital business models where tax challenges

are primarily manifest with mobile IPs and significant user participation.<sup>171</sup> As a result, it “ring-fences,” or segregates, such specified digital business models from the rest of the digital economy.<sup>172</sup> To illustrate, the scope of the U.K. DST is limited to search engines, social media platforms, and online marketplaces but excludes certain regulated financial and payment services, the provision of online content, sales of software/hardware, and television or broadcasting services. Thus, Facebook, Twitter, YouTube, Google, Amazon Marketplace, Kayak, Priceline, Uber, and Airbnb are in scope, whereas PayPal, Netflix, Hulu, Spotify, and Ubisoft are excluded.<sup>173</sup>

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

### B. Criticisms of DSTs

While DSTs offer benefits, they cannot escape criticism from stakeholders. Digital firms have bluntly expressed their unhappiness with this new tax.<sup>174</sup> The U.S. government also shares the same concerns held by many tech giants located in the U.S.<sup>175</sup> On the other hand, academic literature is divided: some scholars take a critical stance towards DSTs, while others are more sympathetic.<sup>176</sup> Based on the key features discussed above, let us now examine the criticisms facing DSTs.

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171. *EU Digital Services Tax Proposal 2018*, *supra* note 18, at 7–12 (“DST is a tax with a targeted scope, levied on the revenues resulting from the supply of certain digital services characterised by user value creation.”); HM TREASURY & HM REVENUE & CUSTOMS, *supra* note 166, at 6 (explaining that the DST is “designed to ensure digital businesses pay tax reflecting the value they derive from the participation of UK users” and simultaneously dealing with “the international tax framework’s failure to recognise this important source of value creation”).

172. OECD, ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY 12 (2014) (warning that the digital economy “would be difficult, if not impossible, to ring-fence” by “[a]ttempting to isolate [it] as a separate sector”).

173. Cui, *supra* note 4, at 6.

174. *See* Kanter, *supra* note 21 (including statements and actions from representatives from Amazon, Facebook, and Google decrying the French DST as unfair or harmful).

175. Press Release, USTR Announces Initiation of Section 301 Investigation into France’s Digital Services Tax, OFF. U.S. TRADE REPRESENTATIVE (July 10, 2019) (available at <https://ustr.gov/about-us/policy-offices/press-office/press-releases/2019/july/ustr-announces-initiation-section-301>) (“The U.S. is very concerned that the digital services tax which is expected to pass the French Senate tomorrow unfairly targets American companies . . .”).

176. For the former position, see Bauer, *supra* note 29; Jessop, *supra* note 29; Johannes Becker & Joachim Englisch, *EU Digital Services Tax: A Populist and Flawed Proposal*, KLUWER INT’L TAX BLOG (Mar. 16,

### 1. *Ring-Fencing and Discrimination*

First, because DSTs only apply to the specific digital business models, it has been criticized as ring-fencing, or segregating, the identified digital business models where tax challenges are primarily manifest with mobile IP and significant user participation. The proponents of other income-tax-based proposals argue that DSTs go against the idea of a level playing field by penalizing the big or early players in the market.<sup>177</sup>

Second, various unilateral DSTs potentially discriminate against businesses based on nationality.<sup>178</sup> It has been deeply suspected that the revenue threshold would only be satisfied by American tech giants. On this point of the challenge, the U.S. has been a major opponent to the general concept of a DST. In a letter dated January 29, 2019, from Senators Grassley and Wyden to U.S. Treasury Secretary Mnuchin, copying EC and European Council, the Senators expressed concern about unilateral DSTs because they are “designed to discriminate against U.S.-based multinational companies.”<sup>179</sup> In March 2019, Treasury Department Assistant Secretary for International Tax Affairs, Chip Harter, expressed concerns that under the WTO, trade agreements, and treaties, the French DST proposal could be challenged as discriminatory vis-à-vis U.S. companies and stated that the U.S. is opposed to any digital services tax proposals.<sup>180</sup> In December 2019, after a study in which it concluded that the French DST violated section 301 of the Trade Act of 1974 as a discriminatory tax, the U.S. Trade Representative proposed tariffs of up to 100% on certain French imports to discourage the French DST.<sup>181</sup> In response, France, in concert with the EU, contemplated the counteractive trade sanctions against the U.S.<sup>182</sup> The tension seemed to be relaxed while the G20/OECD countries agreed to wait for the global deal by the end of 2020,<sup>183</sup> but in July 2020, the U.S. government declared that it would impose additional duties of 25% on

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2018), [kluwertaxblog.com/2018/03/16/eu-digital-services-tax-populist-flawed-proposal/?print=pdf](https://kluwertaxblog.com/2018/03/16/eu-digital-services-tax-populist-flawed-proposal/?print=pdf). For the latter position, see, for example, Cui, *supra* note 4; Daniel Shavero, *Digital Services Taxes and the Broader Shift from Determining the Source of Income to Taxing Location-Specific Rents* 5 (N.Y.U L. & Econ., Research Paper No. 19-36, 2019) (stating that DSTs “have promise, not just in themselves, but as a model for broader rethinking of international tax policy”).

177. See Bunn, *supra* note 20.

178. See *supra* note 21 accompanying text.

179. Letter from Charles E. Grassley & Ron Wyden, U.S. Senators, U.S. Senate Comm. on Fin., to Steven T. Mnuchin, Sec’y, Dep’t U.S. Treasury (Jan. 29, 2019) (available at [https://www.finance.senate.gov/imo/media/doc/2019-01-29%20CEG,%20Wyden%20to%20Treasury%20\(Foreign%20Digital%20Services%20Taxes-OECD\).pdf](https://www.finance.senate.gov/imo/media/doc/2019-01-29%20CEG,%20Wyden%20to%20Treasury%20(Foreign%20Digital%20Services%20Taxes-OECD).pdf)).

180. Leigh Thomas & Francesco Guarascio, *U.S. Sees Unilateral Taxes on Web Giants as ‘Discriminatory’*: *Treasury Official*, REUTERS (Mar. 12, 2019), <https://reuters.com/article/us-usa-tax-harter-idUSKBN1QT1CT>.

181. Parker, *supra* note 13.

182. Keohane et al., *supra* note 99.

183. Parker & Buell, *supra* note 100.

French luxuries.<sup>184</sup> In addition, the U.S. government announced investigations of several other governments that have adopted or are considering DSTs, including the EU, U.K., Italy, Spain, Indonesia, Brazil, Turkey, and India.<sup>185</sup> So, it is plausible that the DST debate would escalate to a trans-Atlantic, and even global, trade war.

The two criticisms above raise fair concerns that need to be addressed. Implementing a tax that harms the growth of new business and disproportionately impacts certain companies based on nationality is neither efficient nor fair.<sup>186</sup> However, it is essentially an empirical question that requires evidence on whether the majority of the companies subject to a DST are foreign multinationals from market jurisdictions; yet, no such data is available. Furthermore, the criticism is largely based on practical concerns and focused on the imminent impact, such as who is the winner and loser in the short term, that can be improved in the implementation stage. Part III proposes possible alternatives to improve DSTs on these points.

## 2. *Disguised Income Tax*

Third, some commentators argue that it is possible to interpret DSTs as a disguised direct tax, or corporate income tax. Such interpretation may result in a double taxation problem and violations of tax treaties in international tax.<sup>187</sup> The first two criticisms above contain little discussion of the consumption tax aspect of DSTs, although the positive law clearly provides DSTs as a turnover tax and a consumption tax.<sup>188</sup> In this regard, the third criticism offers important doctrinal implications.

The attempt to interpret DSTs as income tax is largely based on the idea that the current design of DSTs “depart[s] from traditional income or turnover taxes.”<sup>189</sup> The critics argue that, if the goal of such unconventional DSTs is to make up the foregone revenue from traditional income tax system, the

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184. Notice of Action in the Section 301 Investigations of France’s Digital Services Tax, 85 Fed. Reg. 43,292, 43,292-97 (July 16, 2020).

185. Initiation of Section 301 Investigations of Digital Services Taxes, 85 Fed. Reg. 34,709, 34,711–14 (June 5, 2020).

186. Bunn, *supra* note 20; Mason & Parada, *supra* note 21, at 1197 (“[W]e argue[] that revenue thresholds in current digital tax proposals are vulnerable to nationality discrimination claims because they are intended to – and as applied by individual member states, likely would – burden mostly nonresident companies.”).

187. *See, e.g.*, Ismer & Jescheck, *supra* note 22, at 577; *EU Digital Services Tax Proposal 2018*, *supra* note 18.

188. Lack of analysis on the consumption tax aspect of a DST is largely due to the EU’s single consumption tax policy, where only one type of consumption tax—i.e., VAT—may exist in the EU. Council Directive 347/65, art. 401, 2006 O.J. (L 347) (EC). Thus, policy papers in the EU often explain that a DST is a lumpsum tax to compensate a loss of corporate tax revenue. *See, e.g.*, *EU Digital Services Tax Proposal 2018*, *supra* note 18, at 10. However, such EU policy for single consumption tax cannot prevent the scholars from constructing DSTs as a consumption tax, both doctrinally and normatively.

189. Ismer & Jescheck, *supra* note 22, at 577. Furthermore, the U.K. DST is effectively exempted for companies making losses. *See supra* text accompanying note 77.

legislature may infer that DSTs relate to “profits” of tech giants,<sup>190</sup> which are the tax base of income tax.<sup>191</sup> The fact that the technical tax base is gross revenues does not necessarily negate the suspicion of income taxation because other direct taxes, such as withholding tax as a collection mechanism of income tax, are also levied on gross profits.<sup>192</sup> The taxable period of DSTs is also on a yearly basis, rather than on a per-transaction basis, which is more similar to direct taxation than indirect taxation.

Interpreting DSTs as income tax has important implications in international tax, because it may cause double taxation and violations of tax treaties.<sup>193</sup> Double taxation on certain income may occur when two or more countries concurrently contribute to that income. One country might contribute to the income as a residence country of a taxpayer, and another country might contribute to the same income as a source country where the taxpayer deploys investment. However, if the two countries claim to collect tax on the same income, double taxation occurs. Thus, countries enter into income tax treaties with their major trading partners to eliminate such a double taxation problem.<sup>194</sup> When a state exercises primary taxing rights on certain income based on the rule set by an income tax treaty, the other contracting state should concede to the first state’s taxing rights and exercise residual taxing rights or offer measures to eliminate double taxation on the same income, such as foreign tax credits or exemptions from taxes.<sup>195</sup>

Putting the double taxation problem in the DST debate, a digital firm’s profits, including those generated from market countries, have been subject to corporate income tax in the firm’s residence country. Now, however, market countries are introducing a DST on the firm’s gross revenue generated from the market country. From the firm’s perspective, it now faces two different taxes to two different countries respectively.<sup>196</sup>

However, the double taxation problem does not occur if two taxes are imposed on different tax bases. For example, many countries impose VAT on

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190. Ismer & Jescheck, *supra* note 22, at 575.

191. Income tax is classified as a direct tax, whereas a turnover tax is classified as an indirect tax. See Henry Ordower, *Horizontal and Vertical Equity in Taxation as Constitutional Principles: Germany and the U.S. Contrasted*, 7 FLA. TAX REV. 259, 267–68 (2006).

192. Withholding tax is a tax levied on income, such as wages and certain income of nonresident aliens, that a payor withholds from the payment and pays directly to the government. See, e.g., I.R.C. §§ 1441, 3402. For example, “fixed or determinable annual or periodical” income of nonresident aliens is usually subject to a 30% withholding tax on the gross amount paid. Harvey P. Dale, *Withholding Tax on Payments to Foreign Persons*, 36 TAX L. REV. 49, 59 (1980).

193. If a DST is a direct tax, there is a risk that the DST is within the scope of “Taxes Covered” in Article 2 of the OECD Model Tax Convention on Income and on Capital. Such risk leads to the treaty-level concern of double taxation. OECD MODEL, *supra* note 3, at 28.

194. See, e.g., U.S. MODEL, *supra* note 2, at 1 (“The Government of the United States of America and the Government of \_\_\_, intending to conclude a Convention for the elimination of double taxation with respect to taxes on income . . .”).

195. Rebecca M. Kysar, *Interpreting Tax Treaties*, 101 IOWA L. REV. 1387, 1393–94 (2016).

196. Ismer & Jescheck, *supra* note 22, at 574.

a business's consumption, or gross margin, and at the same time they impose corporate income tax on the business's net income.<sup>197</sup> Although the tax base of VAT and that of corporate income tax are not exactly the same, they may significantly overlap. However, this approach is not double taxation, because VAT is imposed on taxpayer's consumption whereas corporate income tax is imposed on the taxpayer's net income. The same explanation should hold for DSTs. The positive law clearly states that the tax base of DSTs is gross revenue of certain digital firms. This is different from the tax base of income tax, which is net income after deducting expenses from gross revenue. Thus, accusing DSTs of creating a double taxation problem should not be a legitimate concern as long as DSTs are interpreted as a turnover tax.<sup>198</sup>

Furthermore, interpreting DSTs as income tax may not always promote the national interest of the U.S. American tech giants have complained about their increased overall tax liability due to new DSTs because both market countries and home countries of tech giants can impose tax on such tech giants by bypassing the double tax issues—the former imposes a turnover tax, and the latter imposes income tax. On the other hand, if DSTs are interpreted as disguised income tax, it results in double taxation, which must be avoided as per the mandate by income tax treaties. A plausible solution would be for home countries, or residence countries, of the firms to allow a foreign tax credit for such DSTs paid to market countries, or source countries.<sup>199</sup> In the DST debate, the American digital firms would claim foreign tax credit against the corporate tax liability payable to the U.S. government. In other words, interpreting DSTs as income tax might decrease American tech giants' worldwide tax liability, but it may open a possibility to reduce the U.S. tax revenue.<sup>200</sup>

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197. *Id.* at 576. For example, a toy manufacturer is located in a country having a 10% VAT and 20% corporate income tax. The toy manufacturer buys the raw materials for \$4.00, plus a VAT of \$0.40—payable to the government—for a total price of \$4.40. The manufacturer then sells the toy to a retailer for \$10.00 plus a VAT of \$1.00 for a total of \$11.00. However, the manufacturer renders only sixty cents to the government, which is the total VAT at this point, minus the prior VAT charged by the raw material supplier. Note that the sixty cents also equals 10% of the manufacturer's gross margin of \$6.00. In addition, the toy manufacturer should pay corporate income tax on its net income of \$6.00, which is the gross revenue of \$10.00 minus deductible expenses for the raw materials of \$4.00, at 20% corporate income tax rate, which is a total of \$12.00 corporate income tax. This example shows that the tax base of VAT and corporate income tax may significantly overlap, but it is still not considered double taxation.

198. Ismer & Jescheck, *supra* note 22, at 575, 577 (conceding that the DST enacted as either a Member State tax or "a real 'EU tax'" would bring the DST outside the scope of taxes covered by income tax treaties while still maintaining that it is unclear how the court would classify DSTs).

199. The U.K. DST proposal recognizes this potential foreign tax credit issue and provides that if the DST will not be within the scope of the U.K.'s double tax treaties, it will not be creditable against the U.K. Corporation Tax. HM TREASURY & HM REVENUE & CUSTOMS, *supra* note 166, at 29, 32.

200. Even if DSTs are interpreted as income tax, it might be challenging for tech giants to successfully claim foreign tax credit for DSTs due to complicated requirements for foreign tax credit. However, it is noteworthy that recent opinions of the Advocates General regarding Hungarian DSTs consistently hold that the Hungarian DST constitutes a turnover-based special income tax in order to bypass the single consumption tax policy of the EU, discussed *supra* note 188. *See* Case C-323/18, Tesco-Global Áruházak Zrt. v. Nemzeti Adó- és Vámhivatal Fellebbviteli Igazgatósága, 2019 E.C.R. 567; Case C-75/18, Vodafone

The issue of doctrinal interpretation of DSTs as income tax or consumption tax might have implications on the potential trade war. If a DST is considered as income tax rather than a turnover-based consumption tax, it could fall under the Direct Tax Exception in art. XIV of the General Agreement on Tariffs in Services (GATS).<sup>201</sup> The detailed analysis of the GATS' direct tax exception is beyond the scope of this Article, but some might find it more beneficial to interpret DSTs as a consumption tax if they would like to hold the cards that could be used in a potential trade law dispute.

As discussed above, the attempt to doctrinally interpret DSTs as income tax is arguably based on its unconventionality. However, it is not fully convincing why DSTs should be interpreted as income tax simply because it is unconventional, notwithstanding that positive law clearly designs it as a turnover tax. What is unconventional is the new digital economy that gives birth to DSTs; the design of DSTs themselves is a conventional turnover-based consumption tax. The tax base of DSTs is clearly different from that of income tax, and it is well-established that significant overlap of tax base between consumption tax and income tax is not considered double taxation. Perhaps a blunt motivation for this doctrinal analysis would be the global revenue competition by states who cannot easily ignore the complaint of tech giants for the increased tax burden. However, the above discussion infers that interpreting DSTs as income tax might not serve the best interest of the home countries of such tech giants that are arguably losing in the revenue competition.

Then, the discussion develops into the next phase: normatively, should we construct DSTs as income tax? Put more generally, is an income-tax-based solution better than a consumption-tax-based solution? If the answer would be negative, what are the benefits of constructing DSTs as a consumption tax? Part II.C deals with such normative discussion that has been neglected in the DST debate.

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Magyarország Mobil Távközlési Zrt. v. Nemzeti Adó- és Vámhivatal Fellebbviteli Igazgatósága, 2020 E.C.R. 139; Case-C482/18, Google Ir. Ltd. v. Nemzeti Adó- és Vámhivatal Fellebbviteli Igazgatósága, 2019 E.C.R. 728. The opinions of the Advocates General are advisory and do not bind the court, but they are nonetheless very influential and are followed in the majority of cases, as shown in the *Tesco-Global* case and the *Vodafone* case. For detailed analysis of these cases, see Mason & Parada, *supra* note 12, at 24–36. If that is the case, it would be wise for the U.S. government to consider the foreign tax credit issue more seriously.

201. General Agreement on Trade in Services art. XIV(d), Apr. 15, 1994, 1869 U.N.T.S. 194–96 [hereinafter GATS]; Andrew D Mitchell et al., *Taxing Tech: Risks of an Australian Digital Services Tax Under International Economic Law*, 20 MELB. J. INT'L L. 88, 105 (2019); PwC, A WHITE PAPER ANALYZING THE EU'S 2018 PROPOSED DIGITAL SERVICES TAX (INTERIM MEASURE) UNDER WTO LAW 14–15 (2019). The definition of direct taxes under the GATS encompasses “all taxes on total income, on total capital or on elements of income or of capital, including taxes on gains from the alienation of property, taxes on estates, inheritances and gifts, and taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.” GATS, *supra* at 201.

### C. *Should We Stick to Income-Tax-Based Solutions?*

DSTs have been gaining more political impetus in many countries as a solution for the tax challenges in the digital economy, becoming the new status quo.<sup>202</sup> They are designed as turnover taxes imposed on gross revenue, and therefore, by definition, they are subcategories of consumption tax. On the other hand, there are still ongoing efforts to propose a global solution based on the traditional income tax framework, either by modifying current income tax rules or by interpreting DSTs as income tax.<sup>203</sup> Such DST debate recalls the traditional debate on the normative superiority between consumption tax and income tax. But the DST debate shows variation from the old debate between consumption tax and income tax as it relates to a cross-border taxation in the digital era, while the old debate largely focuses on domestic taxation. This Subpart gives an overview of the old debate between consumption tax and income tax and offers a new perspective on the DST debate: a consumption-tax-based DST can be a suitable tax policy to solve tax challenges of the digital economy if the concerns in the existing design are mitigated.

#### 1. *Old Debate: Consumption Tax vs. Income Tax*

A consumption tax is a tax on the purchase of goods or services.<sup>204</sup> In a broader sense, consumption tax refers to a taxing system where people are taxed based on how much they consume rather than how much they add to the economy, such as under an income tax.<sup>205</sup> Examples of a consumption tax include retail sales taxes, excise taxes, value added taxes, use taxes, import duties, and most importantly for this paper, turnover taxes or taxes on gross business receipts.<sup>206</sup>

Consumption taxes are generally borne by consumers because vendors charge a higher price for the good or service to account for the amount of consumption tax.<sup>207</sup> The vendor then remits the tax to the appropriate federal, state, or local government.

202. See *supra* Part I.C.

203. See *supra* Parts I.D and II.B.2.

204. Anne L. Alstott, *The Uneasy Liberal Case Against Income and Wealth Transfer Taxation: A Response to Professor McCaffery*, 51 TAX L. REV. 363, 364 (1996) (“A consumption tax, by definition, taxes only income spent on current, personal consumption (for example, on cars, food and travel).”).

205. See Alvin Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?*, 89 YALE L.J. 1081, 1083–84 (1980) (citing generally HENRY C. SIMONS, PERSONAL INCOME TAXATION 59–102 (1938)).

206. HELLERSTEIN & HELLERSTEIN, *supra* note 17, at 649 (including the turnover tax as part of a list of consumption taxes including retail sales tax, use tax, excise tax, and gross income tax).

207. This concept is called “tax incidence.” See *infra* Part III.A.1; see also *Who Bears the Burden of a National Retail Sales Tax?*, TAX POL’Y CTR., <https://www.taxpolicycenter.org/briefing-book/who-bears-burden-national-retail-sales-tax> (last updated May 2020).



Proponents of a consumption tax argue that it encourages saving and investment, which makes the economy more efficient, whereas an income tax penalizes savers and rewards spenders.<sup>208</sup> Thus, they argue that it is fairer to tax those who take out of the limited resource pool through consumption, rather than to tax what they contribute to the pool using their income. On the other hand, opponents argue that a consumption tax adversely affects the poor who, by necessity, spend a higher percentage of their income.<sup>209</sup> Because consumption tax is a form of regressive tax, wealthy households consume a smaller fraction of their income than poorer households do.<sup>210</sup> On the other hand, the income tax is justified as more progressive due to the ability to pay being determined through levels of income.<sup>211</sup>

Overall, consumption tax has strength in efficiency and administrability, whereas income tax has merits in equity. In terms of efficiency, an income tax effectively reduces the value of future consumption relative to present consumption by discriminating against savings, creating a deadweight loss.<sup>212</sup> On the other hand, a consumption tax improves efficiency by treating savings at a more neutral standpoint, allowing for “greater individual savings and investment, capital formation, and ultimately greater economic productivity.”<sup>213</sup> As for administrability, the strength of the consumption tax in modern tax dialogue can be more readily seen from the reduced complexity that would occur in replacing an income tax with a consumption tax.<sup>214</sup> Proponents of the consumption tax point to the complexity of income taxes in inconsistently treating certain categories of income, such as the different tax treatment between savings from ordinary income and increases in wealth through appreciation.<sup>215</sup>

In international tax, scholars place greater focus on efficiency and administrability than on equity or fairness.<sup>216</sup> International tax literature has been described as having a “narrow normative focus,” which is “guided by worldwide economic efficiency . . . concerned with increasing economic output

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208. Martin A. Sullivan, *Introduction: Getting Acquainted with VAT*, in *THE VAT READER* 12 (2011).

209. *Id.*

210. *Id.*

211. See Daniel S. Goldberg, *The U.S. Consumption Tax: Evolution, Not Revolution*, 57 *TAX LAW.* 1 (2003); see also Warren, *supra* note 205, at 1092–93.

212. William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 *HARV. L. REV.* 1113, 1113–14 (1974).

213. Goldberg, *supra* note 211, at 21.

214. See CHRIS R. EDWARDS, *CATO INST., SIMPLIFYING FEDERAL TAXES: THE ADVANTAGES OF CONSUMPTION-BASED TAXATION* 16 (2001) (providing a detailed list of income tax complexities that could be eliminated in implementing a consumption tax).

215. Andrews, *supra* note 212, at 1115.

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

and reducing deadweight loss, wherever it occurs.”<sup>217</sup> In contrast, domestic tax, especially personal income tax, tends to focus more heavily on concerns over equity and fairness.<sup>218</sup> Relying on international concerns of taxation focused more heavily on economic principles, especially efficiency, the consumption tax is likely to have an advantage over income tax in addressing efficient deployment of global capital of multinational enterprises. This insight may apply to the new debate on DSTs discussed below.

## 2. *New Debate: DSTs vs. Income-Tax-Based Proposals*

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

Noticing the possible advantage of consumption tax in cross-border business transactions, this Article proposes an alternative approach to validate DSTs by envisaging them as a cross-border consumption tax, which offers the following merits.

First, there is no need to make efforts to undertake the fundamental overhaul of nexus and allocation rules to reward more taxing rights if the goal of the DST debate is to reward market jurisdictions. A consumption tax is by nature imposed in the place where the consumption occurs; in the highly digitalized business model, it is the market jurisdictions where users are located. Thus, a consumption-tax-based DST can be successful in rewarding market countries. Furthermore, the DST as a turnover tax is meant to make up for the inapplicability of traditional income tax rules that were mainly created for brick-and-mortar businesses and relied on physical presence. This is a very important justification for the EU using the turnover tax to deal with aggressive tax planning from digital companies by subjecting them to tax that can be implemented without following traditional tax laws.<sup>219</sup>

Second, a solid construction of a DST as a consumption tax may easily eliminate the double taxation concern in international tax addressed in Part II.B.2. Interpreting a DST as an income tax and inviting a tax treaty to deal with

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217. Graetz, *supra* note 54, at 276, 280.

218. *See id.* at 276.

219. EU *Digital Services Tax Proposal 2018*, *supra* note 18.

potential double taxation is not wise, considering that tax treaty is not a good tool to deal with the tax challenges in the digital economy.<sup>220</sup>

Third, a DST, as a consumption tax, may be more efficient and administrable than income-tax-based proposals because a consumption tax is superior in efficiency and administrability. The tax challenges of the digitalization of the economy are inevitably related to cross-border transactions or business taxation, where efficiency and administrability are more important. DSTs, as a turnover tax, also provide a broad tax base as a “stable source of revenue” and is simple to administer.<sup>221</sup> More interestingly, a DST designed as a turnover tax may overcome the general criticism on turnover taxes: such taxes are imposed on gross revenue and thus create economic distortion due to tax cascading.<sup>222</sup> This tax cascading problem occurs when multiple firms are involved in the development of a product or supply chain.<sup>223</sup> However, highly digitalized business models subject to a DST involve a single firm or short supply chain functioning as a platform. Those digital firms implicate almost zero or negligible marginal cost when they generate revenue.<sup>224</sup> The new features of the digital economy may mitigate the potential tax cascading problem associated with turnover taxes.<sup>225</sup>

Fourth, although a consumption-tax-based approach might not serve equity or fairness well as compared to income-tax-based proposals, a DST may overcome the fairness or regressive problem with respect to individual taxpayers considering that many highly digitalized businesses subject to DSTs adopt multisided platform models. In a multisided platform model, fees charged by digital firms are paid by another business, such as user-sellers or advertisers, and thus, the tax incidence would be on the user-sellers or advertisers, not retail users.

It is also worth noting that *South Dakota v. Wayfair, Inc.* examines the economic nexus rule in connection with a “sales tax,” which is an example of a consumption tax.<sup>226</sup> Until the summer of 2018, because of the traditional physical presence requirement, remote online sellers did not collect sales tax from customers located in states where they did not have a physical presence. However, the *Wayfair* Court overturned the physical presence rule in favor of

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220. Wei Cui, *The Superiority of the Digital Services Tax over Significant Digital Presence Proposals*, 72 NAT'L. TAX J. 839, 840–41 (2019) (weighing the familiarity in using the treaty approach against the disadvantages of clinging to “superfluous conventions” and discussing the impact the restriction on the treaty framework may have on international cooperation).

221. Watson, *supra* note 161.

222. *See supra* Part II.A.1.

223. *Turnover Tax*, *supra* note 151.

224. Cui, *supra* note 4, at 25–27.

225. *See infra* Part III.A.

226. *See generally* Ruth Mason, *Implications of Wayfair*, 46 INTERTAX 810, 814–19 (2018) (providing the implications of *Wayfair* in international tax, with a preference to the general solution over a temporary solution, such as DSTs).

an economic presence rule.<sup>227</sup> The policy rationale in *Wayfair* is consistent with the G20/OECD's discussion on the new tax nexus rule, which is moving away from strict physical presence rules. However, the decision itself is not strictly supportive of income-tax-based proposals because the new tax nexus rule can be applied in the context of a consumption tax. South Dakota's sales tax rules upheld in *Wayfair* were quite similar to the current design of the DST, besides the applicable tax rate and the detailed obligation of the remote sellers.<sup>228</sup> Furthermore, the Netflix Tax, adopting an economic nexus rule following *Wayfair*, resembles DSTs. As observed in *Wayfair*, the discussion on the modern taxation of digitalized business models could apply to a consumption tax, such as a DST.<sup>229</sup>

### III. HOW TO IMPROVE DSTs AS A CONSUMPTION TAX

Part II critically reviewed the critiques against a DST and argued that constructing a DST as a consumption tax could bring new life to the DST and taxation of the digital economy. In order to do so, certain issues need to be further explored and improved. This Part, among other topics, discusses the tax incidence of the DST, compares the DST with consumption taxes, and suggests expanding the scope of businesses subject to the DST to overcome the limited scope. These novel discussions inspired by DSTs may also offer a new path toward a consumption tax in international taxation of the digital economy.

#### A. Tax Incidence of DSTs

The first issue that is prominently understudied in the DST debate is who bears the economic burden. In tax terms, the question refers to the tax incidence of a DST. At the early stages of the DST debate, critics argued that the tax incidence of DSTs would be borne by consumers because of the turnover tax design and therefore would negatively affect the demand side of the digital economy.<sup>230</sup> However, such criticism is not convincing considering that many digital business models are multisided. In a multisided business model, there are two types of users—user-buyers and user-sellers—and the fees imposed by a service provider are on the user-seller side. Thus, it is not

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227. *Id.* at 814–15.

228. To be precise, remote sellers in *Wayfair* had the obligation to “collect” sales tax from remote buyers, whereas digital platforms in DSTs have the obligation to “pay” DSTs as their own tax liability.

229. *Id.* at 818–19.

230. Bauer, *supra* note 29; Elizabeth Schulze, *France's Digital Tax Could Hurt Consumers More Than Tech Companies*, CNBC (July 12, 2019), <https://www.cnbc.com/2019/07/12/france-digital-tax-could-hurt-consumers-more-than-tech-companies.html>.

conceptually impossible to pass the tax incidence to user-sellers, rather than user-buyers.<sup>231</sup>

In fact, since the adoption of the new DST in France and the U.K., Amazon and Google announced that they consider the DST a consumption tax and will pass the tax's cost to user-sellers or user-advertisers in those countries by increasing various fees.<sup>232</sup> Thus, despite attempts at interpreting DSTs as disguised income tax, DSTs are applied as a consumption tax in the real world.<sup>233</sup> On the other hand, Facebook and eBay announced that they would not pass on the new U.K. DST's cost to user-sellers or user-advertisers in the U.K.<sup>234</sup>

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

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231. Cui, *supra* note 4, at 3.

232. Kanter, *supra* note 21. Amazon increased a referral fee on French user-sellers by 3% starting October 1, 2019, to reflect the cost of the French DST. Todd Buell, *Amazon Raising Fees on French Sellers After Digital Tax*, LAW360 (Aug. 1, 2019), <https://www.law360.com/articles/1184355/amazon-raising-fees-on-french-sellers-after-digital-tax>. The referral fee is the fee that the company charges vendors for using Amazon to sell products. Similarly, Amazon will increase user-sellers' fees on its U.K. site by 2% starting September 1, 2020, although the U.K. DST became law in July 2020, effective on April 1, 2020. Hamza Ali, *Amazon Passes Cost of U.K. Digital Services Tax to Sellers (1)*, BLOOMBERG TAX (Aug. 4, 2020), <https://news.bloomberglaw.com/daily-tax-report-international/amazon-passes-cost-of-u-k-digital-services-tax-to-sellers?context=search&index=39>. Google follows Amazon's suit and plans to raise user-advertisers' fees on its platform. Alex Barker, *Google to Pass Cost of Digital Services Taxes on to Advertisers*, FIN. TIMES (Sep. 1, 2020), <https://www.ft.com/content/fda648aa-bb52-4ab2-aa18-46b5023cb893>.

233. See *supra* Part II.B.2.

234. Joseph Boris, *eBay Says It Won't Shift UK Digital Tax Burden to Sellers*, LAW360 (Aug. 12, 2020), <https://www.law360.com/articles/1300712/ebay-says-it-won-t-shift-uk-digital-tax-burden-to-sellers>; Ali, *supra* note 31.

### 1. Tax Incidence and Fairness

Consideration of the incidence of a tax is important because it represents which part of the economy bears the ultimate burden of the tax and can help policy makers determine the overall progressivity and efficiency of any tax proposal.<sup>235</sup> The incidence of a tax can refer to either the statutory incidence or the economic incidence. The statutory incidence of a tax is placed on the individuals, entities, or sectors of the economy that have “the legal obligation to remit taxes to the government.”<sup>236</sup> In the case of DSTs, the statutory incidence has been placed on those digital businesses with high enough gross revenues that offer the digital goods and services targeted by the tax.<sup>237</sup> On the other hand, economic incidence “measures the changes in economic welfare in society arising from a tax.”<sup>238</sup> In other words, the economic incidence refers to who will ultimately bear the economic burden of the tax.<sup>239</sup> This Article discusses the economic incidence of DSTs, focusing on the extent, if any, that the economic burden of DSTs is borne by the end consumers of taxed digital platforms.

Consumption taxes are usually assumed to be borne entirely by the final consumer.<sup>240</sup> Many articles follow the accepted view that consumption taxes are regressive and thus not good at promoting equity or fairness.<sup>241</sup> However, there has been contention over how the incidence of consumption taxes should be addressed. In studying the distributional impact of introducing a broad-based consumption tax, one article suggested that a consumption tax is less regressive than would be suggested because both income and consumption taxes treat the capital income of wealthier households similarly.<sup>242</sup> Moreover,

235. See WILLIAM M. GENTRY, U.S. DEP'T TREASURY, A REVIEW OF THE EVIDENCE ON THE INCIDENCE OF THE CORPORATE INCOME TAX 3 (2007); Don Fullerton & Gilbert E. Metcalf, *Tax Incidence* 1 (Nat'l Bureau of Econ. Rsch., Working Paper No. 8,829, 2002), <https://www.nber.org/papers/w8829.pdf>.

236. Fullerton & Metcalf, *supra* note 235.

237. For examples of digital services placing the statutory incidence on targeted digital industries, see HM TREASURY, BUDGET 2018 DST, *supra* note 18; KPMG, *supra* note 73, at 9; Sledz, *supra* note 102; and *Spain Releases Draft Bill on Digital Services Tax*, *supra* note 106.

238. Fullerton & Metcalf, *supra* note 235.

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

240. *Id.*

241. See generally ROBERT E. HALL & ALVIN RABUSHKA, THE FLAT TAX (2d ed. 2007); Amy Dunbar & Thomas Pogue, *Estimating Flat Tax Incidence and Yield: A Sensitivity Analysis*, 51 NAT'L TAX J. 303, 321 (1998); NICO PESTEL & ERIC SOMMER, CTR. FOR EUR. RSCH., SHIFTING TAXES FROM LABOR TO CONSUMPTION: MORE EMPLOYMENT AND MORE INEQUALITY 16–17 (2015) (arguing that a shift from personal income tax to VAT in Germany has a regressive impact on household budgets with budget loss amounts up to 4% of equivalized income).

242. John Sabelhaus, *What is the Distributional Burden of Taxing Consumption?*, 46 NAT'L TAX J. 331, 343 (1993). The authors suggest this reasoning counters the common assumption that consumption taxes do not tax capital income, resulting in a theoretical offset of the reduction in tax burden apportioned to high-income earners following the transition to a consumption tax. *Id.*

the OECD analyzed the distributional impact of consumption taxes, including VATs and excise taxes, in twenty OECD countries and found that the consumption taxes would be “roughly proportional or slightly progressive” if analyzed for expenditure rather than income.<sup>243</sup>

The DST has similarly been criticized in that the tax will simply be borne in large part, if not entirely, by consumers and thus will be regressive and unfair.<sup>244</sup> An impact assessment on the French DST by a consulting firm found that “[a]pproximately 55% of the total tax burden will be borne by consumers, 40% by businesses that use digital platforms, and only 5% by the large internet companies targeted.”<sup>245</sup> It appears then that the implementation of the DST goes against normative concerns as to the progressivity and incidence of new taxes.

However, these normative concerns may be misplaced due to several underlying misconceptions over taxation of the digital economies targeted by the DST. The first example is the two-sided platform quality of the digital firms, which may require completely different analysis as to incidence. Second, these large digital firms are generally considered monopolies,<sup>246</sup> or at least function like them, and are affected differently by taxes and may potentially be able or more willing to absorb the cost of the DST.<sup>247</sup> Lastly, proponents of the DST may be able to adopt the supportive contentions that have arisen for consumption tax incidence because the DST essentially functions as a consumption tax. At the least, the DST may benefit from the same arguments against the regressive aspect of consumption tax.

## 2. *Multisided Platforms*

Multisided markets can be defined as “markets in which one or several platforms enable interactions between end-users, and try to get the two (or multiple) sides ‘on board’ by appropriately charging each side.”<sup>248</sup> The firms at the center of multisided markets, or the multisided platform firms, are essentially intermediaries between the user-buyers (consumers) and user-sellers

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243. OECD, THE DISTRIBUTIONAL EFFECTS OF CONSUMPTION TAXES IN OECD COUNTRIES 38 (2014). This study found that in the case of income, the consumption taxes followed the basic assumption and were regressive. *Id.* at 25. However, under an expenditure perspective, the taxes were found to be roughly proportional or even slightly progressive. It argued that “an expenditure-base[d] approach provides a more reliable measure of the lifetime distributional effects of a consumption tax, challenging the general public perception that consumption taxes are regressive.” *Id.* at 26.

244. *Supra* note 230 and accompanying text.

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

246. *See, e.g.*, JASON FURMAN ET AL., UNLOCKING DIGITAL COMPETITION, REPORT OF THE DIGITAL COMPETITION EXPERT PANEL (Mar. 13, 2019) (providing analysis of major tech companies as monopolies).

247. *See infra* Part III.A.3.

248. Rochet & Tirole, *supra* note 8, at 645.

(advertisers, merchants, etc.) of the market, and their main function is to internalize various externalities generated by the interaction between the two groups.<sup>249</sup> To optimally facilitate interactions, and thus maximize profits, the two-sided platform firms must adapt their pricing strategies to the demands of the different customer groups.<sup>250</sup> Examples of two-sided platform firms include hardware and software systems like Mac OS, digital exchanges like Amazon, peer-to-peer marketplaces such as Airbnb and Uber, as well as digital media firms like YouTube, Facebook, and Google.<sup>251</sup>

The concept of two-sided markets is incredibly relevant to the implementation of the DST and the overall discussion over the tax avoidance of large digital multinational enterprises, the reasons being that “[s]ome of these ‘digital platforms’ have exploited the self-reinforcing nature of network effects, together with the global reach of the Internet, to become dominant players in many countries . . . . These companies are well-known to generate very large profits but to pay, comparatively, very low effective corporate taxes.”<sup>252</sup>

The large digital firms that appear to be the main target of the DST fit comfortably within the definition and dominating capability of multisided platform firms.<sup>253</sup> These digital platforms have established their powerful economic presence through the internalization of cross-group externalities. Because these firms rely on externalities to determine prices and price structure, the typical incidence analysis attributed to one-sided markets does not cleanly apply. Most importantly, “two-sided platform firms may find it profitable to charge prices that are below marginal cost or even negative for one of its product[s] (customer group). This is in contrast to conventional markets (one-sided) where marginal cost equal to marginal revenue pricing is well established as a guidance.”<sup>254</sup>

Recent literature on tax incidence of multisided markets in the digital economy also shows mixed results. For example, Kind et al. found that an increase in an ad valorem tax, like the DST,<sup>255</sup> imposed on a digital media firm may increase sales and reduce price if user-buyers consider the interaction with the user-sellers (such as advertisements) as a negative externality.<sup>256</sup> Similar findings occurred under analysis focused on the hypothetical increase of an ad

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249. Paul Bellaflamme & Eric Toulemonde, *Tax Incidence on Competing Two-Sided Platforms*, 20 J. PUB. ECON. THEORY 1, 2 (2017); Mark Armstrong, *Competition in Two-Sided Markets*, 37 RAND J. ECON. 668, 668–69; Rochet & Tirole, *supra* note 8, at 657.

250. Hans Jarle Kind et al., *Tax Responses in Platform Industries*, 62 OXFORD ECON. PAPERS 764, 765–66 (2010).

251. Bellaflamme & Toulemonde, *supra* note 249.

252. *Id.*

253. *Id.* at 2 n.1.

254. Kind et al., *supra* note 250, at 766; *see also* Ohio v. Am. Express Co., 138 S. Ct. 2274, 2281 (2018).

255. Ad valorem tax refers to a tax based on the value of the property or transaction subject to tax.

256. Kind et al., *supra* note 250, at 774–76.



valorem tax rate on the user-buyer side, finding that the price charged on the user-buyer's side fell following an increase in the ad valorem tax rate.<sup>257</sup>

In contrast, Bellaflamme and Toulemonde found that an increased ad valorem tax imposed on one side of a two-sided market is borne by the side the tax is levied on—that is, the platform itself—and any competing platforms, but that agents on the other side of the market are unaffected.<sup>258</sup> Additionally, empirical analysis by Eleanor Wilking found an increase in after-tax prices paid by consumers of Airbnb—user-buyers—following the new obligation of the individual hosts—user-sellers—to remit the relevant tax to the digital firm.<sup>259</sup>

The market reaction in the early stage of a DST's implementation is also divided. Amazon and Google will pass on the DST's cost to its user-sellers or user-advertisers by increasing various fees imposed on them, whereas Facebook and eBay will not.<sup>260</sup>

Such mixed conclusions of recent studies and market reaction suggest that multisided platforms may nonetheless follow typical assumptions of tax incidence for one-sided markets, but that conclusion may not hold true for all digital multisided platforms.<sup>261</sup>

### 3. *Monopoly Power and Possible Cost Absorption*

Another worthy point to mull over is the monopolistic position of digital platform firms, such as Google and Amazon. In a monopoly, firms are already extracting maximum profits in current supply-demand, so a newly introduced tax will not be passed on to users.<sup>262</sup> In other words, firms will absorb the tax incidence and will not raise prices. Applying this analysis to DSTs, if digital firms will absorb the incidence of DSTs, then introducing DSTs is a good policy to exploit the rent of multinational enterprises.

To explain simply, the incidence of a tax partially relies on the elasticity of the good or service.<sup>263</sup> Taxing the good or service would usually only result in an increase in price, effectively shifting the burden onto the consumers.<sup>264</sup> However, monopolies that produce goods or services with relatively elastic

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257. Sovik Mukherjee & Vivekananda Mukherjee, Tax Incidence of Two Sided Monopoly Platforms 25–27 (2017) (unpublished manuscript) (available at <https://www.isid.ac.in/~epu/acegd2017/papers/SovikMukherjee.docx>).

258. Bellaflamme & Toulemonde, *supra* note 249, at 9.

259. Wilking, *supra* note 8, at 21.

260. *See supra* text accompanying notes 232 and 234.

261. *See generally* Wilking, *supra* note 8.

262. Rikita Muley, *Effect of Taxes on Monopoly Equilibrium (with Diagram)*, ECON. DISCUSSION, <http://www.economicdiscussion.net/monopoly/effect-of-taxes-on-monopoly-equilibrium-with-diagram/17081> (last visited Oct. 2, 2020).

263. *See id.*

264. *Id.*

demands may instead decide to reduce prices, absorbing the cost of the tax.<sup>265</sup> This decision results from the monopoly power that the firm exerts in the market. Because the monopoly firm can set a lower price than equilibrium level, the firm extracts supernormal profits derived from consumer surplus.<sup>266</sup> Taxation of the firm's profits results in a reduction of excess profits similar to the imposition of additional fixed costs.<sup>267</sup>

However, analyzing the extent of the digital firm's monopoly power and its possible implications on tax incidence is not easy. It requires extensive empirical research until policy makers find reasonable results. If, however, the digital economy subject to DSTs is indeed monopolistic, it is fair to ask whether Amazon's and Google's current anecdote of passing the economic burden to user-sellers or user-advertisers is acceptable. It further raises questions, such as whether regulatory agencies should and could invoke a measure to adjust the economic burden of DSTs, which are beyond the scope of this paper.

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

#### B. *Why Not Other Types of Consumption Tax?*

Another difficult question in the design and subsequent implementation of DSTs as a consumption tax is whether there is a better type of consumption tax to pursue, such as DBCFT (cash-flow tax) or VAT.<sup>268</sup> In fact, DBCFT or VAT, as indirect consumption taxes, have been considered superior forms of taxation to turnover-based gross receipts taxes; VAT avoids taxes on business inputs and thus produces efficiency gains and avoids tax cascading.<sup>269</sup> However, highly digitalized business models subject to DSTs involve a single firm or short supply chain functioning as platforms and thus may mitigate the potential tax cascading problem associated with turnover taxes.<sup>270</sup> Moreover, the traditional argument supporting a cash-flow tax or VAT may not hold true

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265. *See id.*

266. *Id.*

267. *Id.*

268. William G. Gale, *Understanding the Republicans' Corporate Tax Reform*, BROOKINGS (Jan. 10, 2017), <https://www.brookings.edu/opinions/understanding-the-republicans-corporate-tax-reform>. DBCFT is very similar to a VAT, but it can deduct wages from its base whereas VAT's cannot. *Id.*

269. *See, e.g.*, Karl Russo, *Superiority of the VAT to Turnover Tax as an Indirect Tax on Digital Services*, 72 NAT'L TAX J. 857, 857 (2019).

270. *See infra* Part II.C.2.

when it comes to multisided digital platforms operating in multiple jurisdictions for the following reasons.

First, as to the VAT, it is worth noting that there is a huge debate on the notion of “value creation” in digital taxation discourse.<sup>271</sup> Where is the value created in the digital economy? In the example of Google, what factors of the digital economy contribute to Google’s value creation the most? Is it California where engineers have developed and are operating Google’s proprietary algorithm? Or is it the market countries where users feed their data to the algorithm? The debate of value creation in the digital economy resembles the old debate on allocating tax revenue relative to extracting natural resources. Are Western multinationals with proprietary technology for extraction and their home countries the major contributors to the production of natural resources and thus deserving of a greater share of tax revenue? Or are the source countries with natural resources on their soil the major contributors to production and deserve a larger share of tax revenue? The discussion has been far from fully resolved. In principle, source countries are entitled to primary taxing rights on the rent from natural resources. In effect, however, they offer various tax breaks to attract foreign capital. International taxation could not solve the puzzle of value creation with respect to natural resources in the past. And it is likely that replacing a DST with a VAT may repeat the same problem as to measuring the tax base, or the value addition.

Second and more fundamentally, neither VAT nor DBCFT would be a good policy to accomplish what the DST debate aims to accomplish—rewarding market countries that likely receive less than their fair share of tax revenue under traditional tax rules. The DBCFT was proposed during the U.S. tax reform debate in 2017 but was ultimately rejected by both the EU and the U.S. because they considered it too aggressive and contentious.<sup>272</sup> Unlike VAT where exports are untaxed while imports are taxed, a DBCFT is conceptually easier to apply to cross-border business taxation. Tax consequences of both VAT and DBCFT follow the cash flow of the economy, but there is no cash flow between digital firms providing digital services and user-buyers located in market countries. Thus, the concept of “destination” in the DBCFT or VAT may not refer to the market jurisdiction where user-buyers are located, and thus neither would be effective in rewarding market countries.

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271. See Michael Devereux & John Vella, *Value Creation as the Fundamental Principle of the International Corporate Tax System*, EUR. TAX POLY FORUM (2018); Johanna Hey, “Taxation Where Value is Created” and the OECD/G20 Base Erosion and Profit-Shifting Initiative, 72 BULL. INT’L TAX’N 203 (2018); Susan C. Morse, *Value Creation: A Standard in Search of a Process*, 72 BULL. INT’L TAX’N 196 (2018); Wolfgang Schön, *One Answer to Why and How to Tax the Digital Economy* (Max Planck Inst. For Tax L. & Pub. Fin., Working Paper 2019–10, 2019).

272. See Daniel Shaviro, *Goodbye to All That?: A Requiem for the Destination-Based Cash Flow Tax*, 72 BULL. INT’L TAX’N 10 (2018); see also Janet Novack, *EU Wrong To Challenge Destination Based Cash Flow Tax*, FORBES (Mar. 29, 2017), <https://www.forbes.com/sites/janetnovack/2017/03/29/eu-wrong-to-challenge-destination-based-cash-flow-tax>.

In the William-Google example, cash flow exists between the service provider (Google in the U.S.) and the user-seller (Mercedes-Benz in Germany) and not between the service provider and the user-buyer (William in the U.K.). The destination country in a cash flow tax is where user-sellers are located—here, Germany. The cash flow tax or DBCFT will allocate revenue to the destination country (Germany), although the market country, which all proposals in the DST debate aim to reward, is the U.K. where user-buyers are located. Given that there is no cash flow between the service provider (Google in the U.S.) and user-buyer (William in the U.K.), how can we reward the market countries under cash flow taxation? Thus, a pure cash flow tax and VAT might not be the best means to reward the market jurisdiction after all.<sup>273</sup>

Also, a recent article by Bankman, Kane, and Sykes implies that a well-designed excise tax, another type of consumption tax, would be a better tool to extract the profits of multinational enterprises than conventional income tax and DBCFT.<sup>274</sup> Considering the excise tax is another type of consumption tax, Bankman et al.'s work is likely to be in line with this Article's promotion of DSTs as a turnover tax.

### C. *Overcoming the Ring-Fencing Problem*

The next issue to explore is how to overcome the limited scope of DSTs. The limited scope of DSTs is created both by the ring-fencing, or segregating, of certain digital business models and by the revenue threshold requirements. Some commentators attack the revenue threshold and the resulting discriminatory trait in support of expanding the scope of DSTs.<sup>275</sup> However, given that the revenue threshold requirements are necessary to sort the digital firms with monopoly power and subject them to DSTs,<sup>276</sup> it could be premature to expand the scope of DSTs by lowering the revenue threshold. Instead, this Subpart proposes to expand the scope of DSTs to overcome the ring-fencing problem.

Under the U.K. DST, search engines, social media platforms, and online marketplaces are within the scope of the DST, but certain regulated financial and payment services, the provision of online content, sales of software/hardware, and television or broadcasting services are excluded. Thus, Facebook, Twitter, YouTube, Google, Amazon Marketplace, Kayak, Priceline, Uber, and

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273. See Alan Auerbach et al., *Destination-Based Cash Flow Taxation* 9–13 (Oxford Univ. Ctr. for Bus. Tax'n, Working Paper 17/01, 2017).

274. Joseph Bankman et al., *Collecting the Rent: The Global Battle to Capture MNE Profits*, 72 TAX L. REV. (forthcoming 2020) (available at [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3273112#](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3273112#)).

275. See, e.g., Mason & Parada, *Company Size Matters*, *supra* note 21; Mason & Parada, *Digital Battlefield in the Tax Wars*, *supra* note 21.

276. *Supra* Part III.A.3.

Airbnb are in scope, whereas PayPal, Netflix, Hulu, Spotify, and Ubisoft are excluded.<sup>277</sup>

The rationale of the current line drawn between the two groups is that the policy makers envision a fundamental difference between the two business models.<sup>278</sup> Lifting the ring-fence may inadvertently and unexpectedly distort the market, especially when the ring-fencing occurs due to the specific need to distinguish one market from another.<sup>279</sup> However, it is still unclear whether YouTube and LinkedIn are considered social media platforms that are subject to a DST or digital interfaces providing digital content that is not subject to a DST, especially when considering YouTube Premium and LinkedIn Premium services. Also, Spotify and Hulu are currently not subject to the DST because they are classified as content providers, but they raise another line-drawing question when they offer free or discounted services to users who do not subscribe to their respective premium services but are then exposed to advertisements. These line-drawing questions, which questionably subject one company to a DST and exempt another similar company, illustrate the need to thoroughly review and question the ring-fencing distinctions.

To examine whether there are fundamental differences between the in-scope and out-of-scope business models, let us compare an in-scope company (YouTube) with out-of-scope companies (Netflix and Spotify) noticing that all three platforms offer online content.

According to Alphabet Inc.'s annual report, Google and its subsidiary YouTube derive the majority of their revenue—i.e., 83% of their revenue in 2019—from advertisements.<sup>280</sup> While YouTube primarily derives revenues from the use of engagement advertisements,<sup>281</sup> it generates some nonadvertising revenue through the means of YouTube subscriptions, such as YouTube Premium, YouTube TV, and Channel Membership.<sup>282</sup>

In contrast, Netflix is solely a content provider. As of January 2020, Netflix was the largest internet entertainment service with over 167 million paid memberships throughout 190 countries.<sup>283</sup> Netflix offers digital content, such as feature films, television shows, and documentaries, which are either originally

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277. See Cui, *supra* note 4, at 8–9.

278. See HM TREASURY, BUDGET 2018 DST, *supra* note 18; see also HM TREASURY, CORPORATE TAX AND THE DIGITAL ECONOMY 15–16 (2017); HM TREASURY, DST, *supra* note 74, at 9–19.

279. Bankman et al., *supra* note 274, at 14–18.

280. Alphabet, Inc., Annual Report (Form 10-K) 9 (Feb. 4, 2020).

281. Specifically, YouTube generally generates revenue through the use of “engagement ads.” *Id.* at 30. Advertisers pay YouTube when a user clicks on the advertisement. *Id.* This is referred to as “cost-per-click” because it is a click-driven revenue. *Id.* However, YouTube’s engagement ads “monetize at a lower rate than traditional [desktop] search ads.” *Id.* at 27. YouTube’s cost-per-click is lower than other Google platforms. *Id.*

282. *Id.* at 32.

283. Netflix, Inc., Annual Report (Form 10-K) 1 (Jan. 29, 2020).

created by Netflix or licensed to Netflix from other studios.<sup>284</sup> Unlike other streaming services, Netflix does not offer any commercials and derives no revenue from paid advertisers.<sup>285</sup> Most importantly, it does not provide users the ability to share content and does not make its original content available for free to all users who choose to watch advertisements.

With respect to the categories of content provided through YouTube, one may discover three different types: (1) content posted by professionals attempting to reach a wide audience, (2) content posted by amateurs for a small audience, and (3) YouTube's original content offered only to subscribers of YouTube Premium or other subscription-based services. This third category of YouTube's original content is analytically difficult to distinguish from the "content provider" business model of Netflix. However, while YouTube is in part a content provider, its main purpose is monetizing user content through the use of advertisements,<sup>286</sup> whereas Netflix is solely a content provider.

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

Spotify Technology S.A. is the largest global music streaming service with 271 million monthly active users and 124 million users paying for Premium Service as of December 31, 2019.<sup>287</sup> Spotify has two business segments: (1) Ad-Supported Service, a segment focused on monetizing the user base through paid advertising; and (2) Premium Service, which is a user paid, commercial-free, subscription service "with unlimited online and offline high-quality streaming access" to its catalog.<sup>288</sup> The Ad-Supported segment allows users similar access to content but is subject to advertisements.<sup>289</sup> In 2019, Spotify's Premium Service comprised 90% of its total gross revenue, earning approximately €6,086 million.<sup>290</sup> Spotify's Ad-Supported segment generated €678 million.<sup>291</sup>

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284. *Id.*

285. *Id.*

286. Alphabet, Inc., Annual Report (Form 10-K) 31–32 (Feb. 4, 2020). YouTube Premium is one small section of YouTube's service. Also, YouTube has begun to offer its original content free to all users since September 2019. Sarah Perez, *YouTube Originals Become Ad-Supported and Free After September 24th*, TECHCRUNCH (Aug. 19, 2019), [https://techcrunch.com/2019/08/19/youtube-originals-become-ad-supported-and-free-after-september-24th/#:~:text=YouTube%20Originals%20become%20ad%2Dsupported%20and%20free%20after%20September%2024th,-Sarah%20Perez%40sarahintampa&text=In%20an%20email%20distributed%20to,customer%20after%20September%2024th%2C%202019](https://techcrunch.com/2019/08/19/youtube-originals-become-ad-supported-and-free-after-september-24th/#:~:text=YouTube%20Originals%20become%20ad%2Dsupported%20and%20free%20after%20September%2024th,-Sarah%20Perez%40sarahintampa&text=In%20an%20email%20distributed%20to,customer%20after%20September%2024th%2C%202019.). Premium subscribers can watch the content ad-free, whereas non-subscribers are subject to advertisements. *Id.*

287. Spotify Technology S.A., Annual Report (Form 20-F) 40 (Feb. 12, 2020).

288. *Id.* at 46.

289. *Id.* at 47.

290. *Id.* at 50.

291. *Id.*

YouTube and Spotify have extremely similar business models and offer very similar products to users. First, both offer a commercial-free premium service coupled with an ad-based service. Moreover, both services mainly license content from third-party providers that the service then distributes to users.<sup>292</sup> Additionally, both services pay content providers based on the success of the content on the platform.<sup>293</sup>

A key difference between YouTube and Spotify is whether the majority of revenue is derived from advertisements. Alphabet, Inc. generates 83% of its revenue from advertisements, whereas Spotify generates only 10% of its revenue from advertisements. Given that both companies offer similar digital services—Premium Service and Ad-Based Service—it is implausible to argue that only Spotify qualifies as a content provider that is exempt from DSTs, based only on the fact that most users choose to subscribe to the Premium Service, whereas YouTube users do not.

Part II.B.1 noted the problems with ring-fencing and discrimination, which need to be addressed and overcome eventually. A DST should not be used against big players. It is against the spirit of a level playing field. However, considering the policy need to adopt DSTs to reward market countries and the merits of DSTs for accomplishing such need, the ring-fencing problems should be addressed by eventually broadening the scope of businesses subject to DSTs. This may address the discrimination problem as well by subjecting many non-U.S. digital firms, such as Spotify, to DSTs. Perhaps *Wayfair* would offer insight on this issue. The sales tax issue discussed in *Wayfair* also targets the digital economy, but the case did not involve ring-fencing or discrimination. After *Wayfair*, more than thirty state and local governments have recently broadened their sales tax base by introducing a so-called Netflix Tax on digital content providers.<sup>294</sup> The fact that one type of consumption tax—DSTs—excludes digital content providers from its scope, whereas another type of consumption tax—state sales tax—includes the same business within its scope, only confirms that the current line-drawing of DSTs is arbitrary and needs to be addressed.

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292. *Spotify for Artists Terms and Conditions*, SPOTIFY, Sec. 6 (Sep. 26, 2017), <https://www.spotify.com/us/legal/spotify-for-artists-terms-and-conditions>; *Terms of Service*, YOUTUBE (Dec. 10, 2019), <https://www.youtube.com/static?template=terms>.

293. Spotify Technology S.A., Annual Report (Form 20-F) 55 (Feb. 12, 2020). The content owner for both YouTube and Spotify have a financial interest in the content that is licensed to YouTube or Spotify. For example, Spotify pays a royalty fee to the content owner. The royalty fee is calculated on numerous factors, including “Premium and Ad-Supported revenue earned or user/usage measures.” *Id.* Similarly, YouTube content owners can be compensated based on the number of views of their video. *YouTube Partner Earnings Overview*, YOUTUBE [https://support.google.com/youtube/answer/72902?hl=en&ref\\_topic=9257988](https://support.google.com/youtube/answer/72902?hl=en&ref_topic=9257988) (last visited Oct. 2, 2020) (“Earnings are generated based on a share of advertising revenue generated when people view your video. More views may lead to more revenue.”). Therefore, content owners receive compensation from Spotify or YouTube, and thus have a financial interest in the content doing well on the service.

294. *Supra* note 37.

## CONCLUSION

G20 and the OECD expect to offer a multilateral, long-term solution for taxing the digital economy for a global deal by the end of 2020. However, the discourse is largely focused on various income-tax-based proposals and does not sincerely consider DSTs a solution. Yet, DSTs are already widespread and considered the new status quo for taxing the digital economy. While the critiques of DSTs contain merit and need to be addressed, the DST debate could be viewed differently when viewing the DST as a consumption tax, which has never been seriously discussed. This Article seeks to bring this consumption tax perspective to the forefront, which could bring a new life to DSTs as a solution to taxing the digital economy.

Furthermore, the timeline of the OECD's global deal is too tight, considering that the issue on the table will result in the fundamental overhaul of the international tax rules that has been procrastinated for about one hundred years. The agenda on the table is not just about taxing the digital economy but rather taxing the entire twenty-first century economy, which is different from the brick-and-mortar economy of the twentieth century. Furthermore, the agenda also gives an opportunity to consider an updated debate on consumption tax versus income tax in the twenty-first century economy. This requires serious academic research for an extended period that this Article aims to start.