4-2020

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

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72 ALA. L. REV. (forthcoming)

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 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 DST 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 DST, especially with regard to the consumption tax aspect.

This Article is the first academic paper that highlights DST 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 DST's economic impact in multi-sided digital platforms. Second, it offers the advantages of DST over other types of consumption tax, such as value added tax and destination-based cash flow tax. Finally, it illustrates how the recent Supreme Court case of *South Dakota v. Wayfair, Inc.*, which discusses 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.

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[*] Associate Professor of Law, University of Utah SJ 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, 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 SJ 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.

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INTRODUCTION

As Google, Amazon, Facebook, YouTube, and other highly digitalized businesses become mainstream in the 21st 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 country.[1] The traditional rule and the resulting revenue allocation were considered reasonable in the 20th century's brick and mortar economy, where multinational enterprises access consumers in the market country by operating their business through a branch or a subsidiary. The branch or subsidiary establishes a physical presence, or tax nexus, in the market country by maintaining a physical connection in the country.[2] The profit allocation then rules mandate allocating certain profits to the market country first and the remaining profits to the home country of the multinational enterprises.[3] 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 United Kingdom, receives a bonus and would like to use it to purchase a new car. William is particularly interested in a mid-size 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 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 Mercedes-Benz E-Class, which he is now more likely to click on than before he began his preliminary car research.[4]

The above example shows the salient characteristics of highly digitalized

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

[2] CHARLES H. GUSTAFSON, ROBERT J. PERONI & RICHARD CRAWFORD PUGH, TAXATION OF INTERNATIONAL TRANSACTIONS: MATERIALS, TEXT, AND PROBLEMS 182 (4th ed. 2011); U.S. Model Income Tax Convention arts. 5 & 7, Feb. 17, 2016, https://www.treasury.gov/resource-center/tax-policy/treaties/Pages/treaties.aspx (hereinafter, U.S. Model).

[3] U.S. Model arts. 5 & 7; OECD, MODEL TAX CONVENTION ON INCOME AND ON CAPITAL: CONDENSED VERSION 2017, arts. 5 & 7, at 31–34 (2017) (hereinafter, OECD MODEL).

[4] The Google, German auto manufacturing company, and UK consumer example is inspired by a similar example in Wei Cui, *The Digital Services Tax: A Conceptual Defense*, TAX L. REV. __, 12–14 (forthcoming 2020).

business models and the resulting tax challenges. Google is the highly digitalized business model utilizing a multi-sided 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 United States, offers digital search engine service to the first group of users—user-buyers—located in various countries, including the United Kingdom, through which it collects a tremendous amount of valuable user data. Google has a proprietary algorithm that allows it to offer improved search results to the first group users in the UK who demonstrate similar interests to those of William, because the algorithm learns how to tailor experiences to individual user-buyers in the UK market. In addition, Google's algorithm offers customized advertising services to the second group of users—user-advertisers or user-sellers—such as Mercedes-Benz, that want to launch a targeted advertisement campaign to UK consumers "based on their demonstrated interests."[5] 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 20th century.[6] 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. 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 United States, can render the search engine and online advertisement services to consumers in the UK market without a physical presence in the UK. Thus, the United Kingdom cannot collect tax revenue from Google's profits, even though Google accessed, and gained a profit from, the UK market and consumers.

Furthermore, the features of multi-sided platforms[7] make collecting tax

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

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.[8] 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.[9] In the above example, Google does 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 UK. Technically, while Google's revenue in this example is relevant to the UK market because it collects and uses UK consumers' data, the profits are paid by German manufacturing companies. Thus, it is more challenging for the UK 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 United Kingdom, France, and Italy, have unilaterally introduced, or plan to introduce, a new tax, called the Digital Service Tax ("DST"), for certain highly digitalized businesses.[10] This has ignited heated debate across the globe. DST is 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 United States, 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.[11] Moreover, the U.S. government has even considered implementing tariffs of up to 100% on a range of French

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OF THE DIGITAL ECONOMY, ACTION 1 – 2015 FINAL REPORT (Oct. 5, 2015) [hereinafter OECD, BEPS ACTION 1]; OECD, TAX CHALLENGES ARISING FROM DIGITALISATION — INTERIM REPORT (2018) [hereinafter OECD, 2018 INTERIM REPORT].

[8] 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 it. CARL SHAPIRO AND HAL R. VARIAN, INFORMATION RULES: A STRATEGIC GUIDE TO THE NETWORK ECONOMY 13 (1999). Such effect exists 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.

[9] *See American Express*, 138 S. Ct. at 2281.

[10] See *infra* Part I.C.

[11] *Id.*

imports, including cheese, cosmetics, and champagne in order to discourage the adoption of France's DST.[12]

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 modifying current income tax rules and a prototype of DST.[13] All proposals attempt to give market countries greater taxing right, but none of these proposals have come to a consensus as to a solution.[14] In the meantime, DST is widespread, becoming the new status quo.[15]

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,"[16] 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.[17] Furthermore, both global and local revenue of digital businesses identified as in-scope businesses should exceed a specified threshold amount of revenue to trigger

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[12] Alex M. Parker, *US Proposes 100% Tariffs on French Imports Over Digital Tax*, LAW360 (Dec. 2, 2019), https://www.law360.com/technology/articles/1224350.

[13] The proposals will be discussed in *infra* Parts I.B. and C. in detail.

[14] Andrew D. Mitchell, *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 towards a regional DST structure).

[15] 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 UK have published proposals and other country's have shown intentions to implement DSTs in the future). *See infra* Part I.C.4.

[16] 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).

[17] *See Proposal for a Council Directive on the Common System of a Digital Services Tax on Revenues Resulting from The Provision Of Certain Digital Services*, COM 7–10 (2018) 148 final (Mar. 21, 2018) [hereinafter *EU Digital Services Tax Proposal 2018*]; HM TREASURY, BUDGET 2018 DIGITAL SERVICES TAX (2018), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752172/DST_web.pdf [hereinafter HM TREASURY, BUDGET 2018 DST].

DST application.[18]

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.[19] Second, they are blamed as discriminating against American tech giants, such as Google, Amazon, Facebook, YouTube, and Uber, because only those American tech giants can satisfy the revenue thresholds and be subject to a DST.[20] Third, they are also reprimanded as 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.[21] 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 such so as to eliminate double taxation.[22] 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

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[18] *EU Digital Services Tax Proposal 2018*, *supra* note 17, at 10 (providing an international revenue threshold of €750 million and a domestic threshold of €50 million); HM TREASURY, BUDGET 2018 DST (providing a "double threshold" of £500 million globally and £25 million of UK revenues).

[19] Daniel Bunn, *A Summary of Criticisms of the EU Digital Tax*, TAX FOUND. (Oct. 22, 2018), https://taxfoundation.org/eu-digital-tax-criticisms/#_ftn16; *see also* OECD, BEPS ACTION 1, *supra* note 7, at 149 (discussing neutrality as an important part of evaluating taxes on the digital economy).

[20] *See* Initiation of a Section 301 Investigation of France's Digital Services Tax, 84 Fed. Reg. 34042, 34042 (July 16, 2019); *see also* Jake Kanter, *Amazon, Facebook, and Google Come Out Swinging After Being Slammed With 'Unjustifiable' New Tax on Their Sales*, BUSINESS INSIDER (Aug. 14, 2019, 4:21 AM), https://www.businessinsider.com/amazon-facebook-and-google-lobby-french-digital-services-tax-2019-8.

[21] *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 17 (stating that the measure to target revenues of digital services based on user value creation underpins the Council intention to adapt corporate tax rules to new digital business models).

[22] Double taxation occurs in international tax when a market country (or source country in tax term) and home country (or residence country) levy tax on the same declared income. *See* Alvin Warren, *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 tax exemption or credit to foreign-source income. GUSTAFSON ET AL., *supra* note 2, at 63.

than considering DST theoretically. Furthermore, the criticism contains little discussion of the consumption tax aspect of the DST, although the positive law provides DST as a turnover tax and consumption tax. The third point of criticism argues that although DST is 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 DST should be interpreted as corporate income tax despite what positive law provides.[23]

As the first academic paper to highlight the consumption tax aspect of DST, this Article explores the origin of DST and analyzes the key common features of a DST that are distinct from conventional income tax. It offers the 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).[24] Consumption tax is considered more efficient and simpler, while income tax is considered normatively superior to achieve equity.[25] 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, DST is 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.[26] In conclusion, DST could offer a new path towards a consumption tax in international taxation for the digital economy.

However, to maximize the advantages offered by DST and for it to be a viable global solution for taxing the digital economy, further research and

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[23] 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, 4:06 PM), https://www.forbes.com/sites/realspin/2017/01/27/the-hungarian-experience-has-strengthened-the-case-for-flat-taxes/#5378c74cd477.

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

[25] *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 an Income Tax*, 58 STAN. L. REV. 1413, 1425 (2006).

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

improvement is required to overcome certain lingering issues. Moreover, the study of multi-sided markets is still an emerging topic, and thus there is not much tax scholarship analyzing these issues. This Article aims to fill the gap.

First, this Article explores the tax incidence of DST as a consumption tax in the case of multi-sided digital platforms. Current literature significantly lacks in-depth analysis on this issue. The early opponents of DST argued that a DST would be borne by consumers and would adversely affect the demand side of the digital economy.[27] However, such critique neglected the characteristics of multi-sided 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 who are also business enterprises. This is exactly what the recent enactment of the French DST proves to be the case.[28]

Second, this Article shows the advantages of DST over other types of consumption tax, such as Value Added Tax ("VAT") and Destination-Based Cash Flow Tax ("DBCFT"), to solve tax challenges in the digital economy. As to 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 UK. By contributing user data, user-buyers like William allow Google not only to offer the improved tailored experiences to future users, but also sell targeted advertising services to German auto manufacturing companies. This conundrum is analogous to the old debate on which country should exercise the primary taxing right over the income 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, the Article suspects that introducing VAT may repeat the same problem concerning value creation.

Another advantage that DST offers over other types of consumption tax is that DST can effectively reward market countries in a way that the

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[27] Julian Jessop, *Why the EU's Digital Turnover Tax is a Bad Idea*, EUR, POLICY INFO. CTR., 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 POLITICAL ECON. 4–6 (2018), https://ecipe.org/wp-content/uploads/2018/06/Five-Questions-about-the-Digital-Services-Tax-to-Pierre-Moscovici.pdf.

[28] 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 DST is the monopolistic position of digital tech giants, then in theory, digital firms ought to absorb the whole tax incidence, instead of passing part of the economic burden to the user-seller group. Still, there is no clear explanation on what ought to happen based on economic model analysis and what is happening based on empirical analysis. See *infra* Part III.A.

traditional cash flow tax, such as DBCFT, cannot. DBCFT gives taxing rights to the destination country of the sales of goods and services connected by the cash flow, because it posits that the destination of sales is the place where the consumption occurs.[29] However, in multi-sided platforms, market countries 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 United States or Germany,[30] and cannot be the United Kingdom, the market country all policy proposals aim to give more taxing rights. Hence, it is skeptical to recommend DBCFT to reward market countries.

Third, this Article proposes to improve the "ring-fencing" problem by overcoming the limited scope of DST. Only search engines, social media platforms, and online marketplaces are currently within the scope of DST and subject to pay the DST, whereas certain regulated financial and payment services and online content providers are excluded and thus exempted from DST.[31] So, Facebook, Twitter, YouTube, Google, Amazon, Kayak, Uber, and Airbnb are subject to DST, but PayPal, Netflix, Hulu, Spotify, and Ubisoft are exempted from DST liability. However, the current distinctions between in-scope and out-of-scope businesses are arbitrary and hard to justify theoretically. It is not fully convincing to include YouTube and exclude Spotify, because their business models share many common features.[32]

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 sales tax imposed on certain remote sellers,[33] and analyzes subsequent state legislation introducing the so-called "Netflix Tax" because both developments could shed light on possible solutions.[34] More than thirty

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

[30] 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.

[31] *See* Cui, *supra* note 4, at 5–6.

[32] 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.

[33] South Dakota v. Wayfair, Inc., 138 S. Ct. 2080 (2018).

[34] The "Netflix Tax" is a sales and use tax imposed on the digital streaming of shows,

state and local governments introduced the Netflix tax after *Wayfair* in order to impose sales tax—another type of consumption tax—on digital content providers, such as Netflix, Hulu, and Spotify.[35] 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 business within its scope confirms that the current line-drawing of DST is arbitrary. Thus, DST should overcome the ring-fencing problem by expanding its 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 DST, comparing DST with other types of consumption tax, and the ring-fencing problem concerning DST's limited scope. The Article then concludes with a brief statement concerning the importance of scholarly discussion to the anticipated and necessary resolution of digitalized business taxation in the 21st century.

I. DIGITAL ECONOMY AND THE ORIGIN OF DST

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

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movies, music, and games. The content providers, such as Netflix, Hulu, and Spotify, that are excluded from DST are subject to the Netflix Tax. Currently, the list of states and cities imposing the Netflix Tax is as follows: Alabama, Arizona, Arkansas, Chicago, Colorado, Connecticut, 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. Richard C. Auxier, Gail Cole, *Chicago's Streaming Tax Is A Bad Tax But It's Not A "Netflix Tax"*, TAX POLICY CENTER (Jun. 11, 2019), https://www.taxpolicycenter.org/taxvox/chicagos-streaming-tax-bad-tax-its-not-netflix-tax. However, the specific tax imposed by each state within the category vary widely.

[35] Jared Walczak & Janelle Cammenga, *State Sales Taxes in the Post-Wayfair Era* 1, 6, TAX FOUND. (Dec. 12, 2019), https://taxfoundation.org/state-remote-sales-tax-collection-wayfair/.

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 such highly digitalized business models as multi-sided platforms.[36] In tax literature, the multi-sided platforms are just referred to as "digitalization," "digital economy," or "certain highly digitalized businesses."[37] These digital platforms connect multiple distinct user groups, such as user-sellers and user-buyers, and provides them with certain network benefits. A network effect exists when the value of product or service provided by a business increases according to the number of other users it.[38] 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.[39]

However, the number of users participating in a digital platform is not the only factor determining the value of the highly digitalized businesses. The platforms must have proprietary technology that allows it 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 UK who demonstrate similar interests to those of William, because the algorithm learns how to tailor experiences to individual user-buyers in the UK market. In addition, Google's algorithm offers customized advertising services to another group of users—user-advertisers, such as Mercedes-Benz, that want to launch a targeted advertisement campaign to

[36] *See American Express*, 138 S. Ct. at 2280–81; *see* also Rochet & Tirole, *supra* note 7.

[37] *See e.g.*, OECD, BEPS ACTION 1, *supra* note 7; OECD, 2018 INTERIM REPORT, *supra* note 7.

[38] CARL SHAPIRO & HAL R. VARIAN, INFORMATION RULES: A STRATEGIC GUIDE TO THE NETWORK ECONOMY 13 (1999).

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

UK consumers "based on their demonstrated interests."[40]

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 of the success.[41] In this context, a recent report of the G20 and the OECD explains that the important features of digitalized business models include: i) cross jurisdictional scale without mass, ii) the heavy reliance on intangible assets, especially intellectual property, and iii) the importance of data, user participation and their synergies with intellectual property.[42]

Many multi-sided platforms offer their services across borders. They can do it without establishing physical presence in market countries where users are located thanks to the advanced technology in the 21st century. Also, in many multi-sided markets, users in one side of the market is charged little or nothing to participate, while all or majority of the profits come from the users in the other side.[43] In the William-Google example, Google can offer search engine services to William in the UK and online advertisement services to Mercedes-Benz in Germany, both remotely from the United States. 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.

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, no longer work effectively in the digitalized economy.[44] These businesses can generate profits in market countries

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[40] *Id*. at 10.

[41] This synergy is different from the so-called chicken and egg problem in multi-sided 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 and Bruno Jullien, *Chicken & Egg: Competition Among Intermediation Service Providers*, 34 RAND J. ECON. 309 (2003).

[42] OECD, 2018 INTERIM REPORT, *supra* note 7, at 51.

[43] *See American Express*, 138 S. Ct. at 2281 ("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.")

[44] In tax literature, market countries more often refer to the source countries where the income is produced, and home countries refer to the residence country where the taxpayers maintain residence or, for corporate taxpayers, are incorporated. David Eric Spencer, *BEPS and the Allocation of Taxing Rights (Part 4)*, 29 J. INT'L TAX'N 34, 36 (2018).

without 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.[45] 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.[46] A subsidiary or a branch in the market country generally establishes physical presence of a firm, but an agent can also create the firm's physical presence.[47] In tax term, this physical presence refers to a "trade or business" or a "permanent establishment" of the firm.[48] 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.[49]

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 in a traditional sense—user-buyer group in the William-Google example—but rather come from another type of users—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 20th century.[50] 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

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[45] I.R.C. § 862(b).

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

[47] *See* U.S. Model art. 5; OECD MODEL art. 5, *supra* note 3, at 31; GUSTAFSON ET AL., *supra* note 2, at 182; Christian Ehlermann & Marla Castelon, *When Does a Dependent Agent Act Habitually?*, 83 TAX NOTES INT'L 1141 (2016).

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

[49] *See* OECD MODEL, *supra* note 3, at 175–77.

[50] *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).

presence, and as such the service is not considered a substantial presence.[51] 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 multi-sided platforms, because firms' revenue relevant to the market country is not paid by the consumers in the market, not to mention the lack of physical presence in the country.

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 Subparts B and D, all of which aim to give market countries greater taxing right. Many proposals try to modify current income tax rules in various ways, while others attempt to introduce a new turnover tax similar to DST.[52] 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 for certain highly digitalized businesses. Subpart C offers a detailed survey of various DSTs.

B. European Developments: Modifying Income Tax v. 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.[53] Since September 2017, the European Commission ("EC") developed 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. This turnover tax, which is a subcategory of consumption tax as opposed to income tax, is called DST and has become a protype of various DSTs discussed in Subpart C.

The main concern for the EC was to ensure that the digital economy would be taxed fairly, and cited the growing market share of tech companies in the European economy and the relatively low effective tax rates for digital businesses.[54] The two main policy challenges noted by the EC were the

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[51] *See* OECD, 2018 INTERIM REPORT, *supra* note 7, at 51 (explaining the problem of remote technology allowing digital businesses to "have an economic presence in a jurisdiction without having a physical presence").

[52] All proposals will be discussed in *infra* Parts I.B. and I.D. in detail.

[53] *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).

[54] *Id*. at 2, 4, 6.

questions of where to tax—i.e., nexus— and what to tax—i.e., value creation.[55] In a Communication released on September 21, 2017, the EC advocated for a comprehensive solution, but also proposed three alternative, shorter-term, solutions.[56] 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.[57]

The 2017 Communication culminated in two proposals that the EC later released on March 21, 2018. The first proposal, called 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.[58] Thus, as long as a digital business enterprise has a significant digital presence in a market country, that market country may recognize the enterprises' taxable nexus to its jurisdiction even if there is no physical or traditional permanent establishment of such enterprise in that jurisdiction, and thus may exercise taxing right for the revenue of such enterprise. A business would be deemed to have such taxable nexus, or digital permanent establishment, for cross border digital business by fulfilling any of the following criteria: i) annual revenues from supplying digital services in a member state exceeding €7 million, ii) having more than 100,000 users in a member state in a taxable year, and iii) business contracts for digital services created between the company and business users exceeding 3,000 in a taxable year.[59] 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.[60]

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.[61] The in-scope digital business subject to the interim DST tax included (i) the placing of digital

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[55] *Id*. at 7.

[56] *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).

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

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

[59] *Id*. at 16.

[60] *Id*. at 17–18.

[61] *Id*. at 3.

advertising targeted at users in a member state, (ii) the transmission of user data generated from user activity, and (iii) intermediation services that allow users to find other users and interact with them.[62] On the other hand, provision of digital content, payment services, on-line sales goods or services, and certain regulated financial and crowd-funding services were excluded.[63] The interim DST proposal included two revenue thresholds necessary for entities to be taxed under the interim DST: i) worldwide revenues exceeding €750 million, and ii) taxable revenues within the EU exceeding €50 million.[64] 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."[65]

However, since the EU released the above two proposals in March 2018, members states of the EU disagreed on both the long-term and short-term proposals.[66] The European Council finally rejected both proposals in March 2019.[67] After the epic fail of the EU proposals, a number of member states have moved fast to implement their own unilateral measures for taxing the digital economy, discussed in the next Subpart.

C. DSTs as Popular Unilateral Measures

After the failure to either adopting a new DST or modifying 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.[68] Non-European countries, such as India, Mexico, and Canada, also have adopted or plan to introduce a DST. This

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[62] *Id*. at 24–25.

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

[64] *EU Digital Services Tax Proposal 2018*, *supra* note 17, at 25–26.

[65] *Id*. at 22.

[66] *See* SEAN LOWRY, CONG. RESEARCH SERV., R45532, DIGITAL SERVICES TAXES (DSTS): POLICY AND ECONOMIC ANALYSIS 6 (2019).

[67] *See* Robert Van der Jagt, *ECOFIN Discusses Digital Tax and Updates the EU Blacklist*, KPMG (last visited Feb. 16, 2020), https://home.kpmg/xx/en/home/insights/2019/05/etf-404-ecofin-discusses-eu-digital-services-tax1.html; *see also* Outcome of the Council Meeting Economic and Financial Affairs (EC) No. 7368/19 of 12 Mar. 2015 (PR CO 12) 6.

[68] As of January 30, 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, DEVELOPMENT SUMMARY 4 (Jan. 30, 2020), https://tax.kpmg.us/content/dam/tax/en/pdfs/2020/digitalized-economy-taxation-developments-summary.pdf.

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 the international tax policy and identify common key features of DSTs discussed in Part II.

1. United Kingdom

The United Kingdom is one of the early adopters of a unilateral DST, although it maintains its official position as waiting for the global solution for taxing the digital economy.[69]

As part of his 2018 budget, Chancellor Philip Hammond of the United Kingdom released a DST proposal that resembles the EC's March 2018 version apart from a reduced rate and the introduction of safe harbors for businesses with low profit margins or those taking losses.[70] The UK proposal would apply a 2% tax, instead of 3% tax suggested in the EC's version, on the revenues of specific digital business models where the revenues are linked to the participation of the UK users.[71] The first major change from the EC version is the implementation of an exemption to the tax for the first £25 million in taxable UK revenues and a 0% tax rate for companies making losses.[72]

The proposed tax would apply to business models that have revenues linked to the participation of UK users and is meant to apply specifically to (i) search engines, (ii) social media platforms, and (iii) online marketplaces.[73] Financial and payment services, the provision of online content, sales of software and hardware, and broadcasting services would not be within its scope.[74] The proposed tax would require businesses within its scope to earn

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

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

[71] HM TREASURY, BUDGET 2018 DIGITAL SERVICES TAX (2018), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752172/DST_web.pdf [hereinafter, HM TREASURY, BUDGET 2018 DST].

[72] 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, UK's chief financial minister, stated that the tax "will be carefully designed to ensure it is established tech giants – rather than our tech start-ups - that shoulder the burden of this new tax." https://www.gov.uk/government/speeches/budget-2018-philip-hammonds-speech.

[73] HM TREASURY, BUDGET 2018, *supra* note 70, at 44.

[74] *See* HM TREASURY, BUDGET 2018 DST, *supra* note 71.

annually at least £500 million globally to be taxable.[75] The proposal also includes a local revenue threshold for "relevant UK revenues" of £25 million, as a means to ensure small businesses remain outside the scope of the tax.[76]

In July, 2019, the UK introduced draft legislation for their DST that would take effect beginning April 1, 2020.[77] Uniquely, the draft legislation will provide a 50% reduction in the tax for instances where the tax would overlap with a user subject to a similar tax elsewhere.[78]

2. France

France is another country leading the unilateral change, following the EU's epic fail in March 2019. In the same month of March of 2019, the French Finance Minister, Bruno Le Maire, released a policy document detailing the country's unilateral approach to the DST.[79] French DST is keen to tax the American tech giants, such as GAFA, the acronym of Google, Apple, Facebook, and Amazon, because, as the French finance minister Bruno Le Maire said, the emergence of such tech giants are monopolistic and they "not only control the maximum amount of [user] data, but also escape fair taxes."[80]

The proposal would subject digital businesses to a 3% tax on income derived from: (i) the provision of a digital interface to enable users of platforms to interact with each other in order to exchange goods or service, (ii) advertising conducted on digital interface, and (iii) resale and management of personal data for advertising purposes.[81] To qualify for the above-listed income subject to DST, digital services must be made or supplied to French users located in France.[82] The user's location is determined based on, among others, French IP address used to connect to web

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[75] *Id.*

[76] *Id.*

[77] 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 70, at 43.

[78] *Id.*

[79] KPMG, FRANCE: DRAFT PROPOSAL FOR DIGITAL SERVICES TAX (Mar. 6, 2019), https://home.kpmg/xx/en/home/insights/2019/03/tnf-france-draft-proposal-for-digital-services-tax.html.

[80] 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.

[81] KPMG, *supra* note 68, at 8.

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

sites, which differs from the industry standard's user-click criteria.[83] 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.[84]

The discussion in the legislative body moved quickly.[85] After four months after the discussion began, President Emmanuel Macron signed the new tax bill into law on July 24, 2019.[86] It is expected to raise €500 million per year.[87]

Although France is the second country that introduced a DST, the new tax bill retroactively established the tax to tax revenues generated from January 1, 2019,[88] which chronologically makes France the first country to impose a DST. The retroactivity of the new digital tax sparkled strong resistance from American tech giants, such as Facebook and Amazon, arguing that "in order to comply, a company has to keep track of every user that observed an impression on a device while in France, and every user who observed an impression on a device everywhere in the world, back to Jan. 1, 2019."[89] Recognizing the severe pushback, President Macron assured that French DST is an interim measure and that "France will reimburse any tax paid under its digital services tax once there is an international deal on digital taxation."[90]

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 French DST targets American tech giants.[91]

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[83] *Id.*

[84] KPMG, *supra* note 68.

[85] On April 9, 2019, the National Assembly, France's lower house, passed a bill nearly mirroring the March 2019 proposal and the Senate, upper house, amended the bill with a number of important changes in May of 2019. KPMG, FRANCE: UPDATE ON DIGITAL SERVICES TAX; ENACTMENT ANTICIPATED (Jun. 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. (Jul. 11, 2019), https://taxfoundation.org/france-digital-services-tax-us-retaliatory-options/; Alderman, *supra* note 80.

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

[87] Alderman, *supra* note 80.

[88] *Id.*

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

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

[91] Parker, *supra* note 12.

France warned that it would retaliate with its own round of tariffs.[92] 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 plausible that France will not repeal the DST, regardless of the outcome of the global deal.[93]

3. Other EU Member States

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

On May 16, 2018, Italy began a public consultation in response to the EC's March 2019 DST proposals.[94] This public consultation eventually lead to the introduction of Italy's own DST, which is modelled directly off the EC's version on Dec. 31, 2018.[95] 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.[96] The Italian DST is effective from January 1, 2020.[97]

Very similar to the Italian DST, Spain released a preliminary draft bill for a DST on Oct. 23, 2018, that closely mirrors the EC version.[98] Spain's DST would apply the same 3% tax rate and €750 million global threshold.[99] Similarly, the tax would apply to online advertising services, online intermediation services, and data transfer services, but include several specific exceptions and does not include an exclusion for intra-group transactions.[100] The draft proposal also included a lower domestic threshold of €3 million.[101] However, since then, a new government has been formed, and it is unclear whether the new government would introduce a similar

[92] David Keohane, Chris Giles & James Politi, *France Warns US Against Digital Tax Retaliation*, FIN. TIMES (Jan. 5, 2020), https://www.ft.com/content/de451a5e-2fb6-11ea-9703-eea0cae3f0de.

[93] Alex M. Parker & Todd Buell, *US, France Fend Off Tariffs Over Digital Tax Issue*, LAW360 (Jan. 21, 2020), https://www.law360.com/articles/1236309.

[94] 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/.

[95] *See id.*, *see also* legge 30 dicembre 2018, n. 145, in Official Journal of the General Series Dec. 31, 2018, n. 302 (It.).

[96] Sledz, *supra* note 94.

[97] KPMG, *supra* note 68, at 11.

[98] EY, SPAIN RELEASES DRAFT BILL ON DIGITAL SERVICES TAX (Oct. 25, 2018), https://www.ey.com/gl/en/services/tax/international-tax/alert--spain-releases-draft-bill-on-digital-services-tax.

[99] *Id.*

[100] *Id.*

[101] *Id.*

budget bill that includes a DST.[102]

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 Apr. 4, 2019, that would expand its current advertising tax to apply to digital advertising.[103] This more confined version of the DST would implement a 5% turnover tax on revenue derived from advertising services in Austria and includes the same €750 million global threshold and a €25 million domestic threshold.[104] The Austrian DST is effective from January 1, 2020.[105]

Table 1 below summarizes and compares various DSTs that EU member states have enacted or proposed to implement.

TABLE 1. VARIOUS DSTS OF EU MEMBER STATES[106]

	Threshold[107]	Scope	Rate	Effective
EU DST	€750/50 million	Advertisement/ Digital interfaces, intermediation, online market place/ Data transfer, resale of private data	3%	(failed)
France	€750/25 million	Same above	3%	2019
Italy	€750/5.5 million	Same above	3%	2020
Spain	€750/3 million	Same above	3%	(unclear)
Czech Republic	€750/2 million	Same above	7%	2020 (expected)
UK	£500/25 million	Search engines/ Digital interfaces, intermediation, online market place/	2%	2020

[102] KPMG, *supra* note 68, at 15.

[103] KPMG, AUSTRIA: UPDATE ON PROPOSALS FOR DIGITAL SERVICES TAX (Jul. 12, 2019), https://home.kpmg/us/en/home/insights/2019/07/tnf-austria-update-proposals-digital-services-tax.html.

[104] *Id*.

[105] KPMG, *supra* note 68, at 5.

[106] Table 1 is created by the author based on the survey performed by KPMG. KPMG, *supra* note 68.

[107] The first amount refers to the global revenue threshold, and the second amount refers to the domestic revenue threshold.

		Social media		
Austria	€750/10 million	Advertisement	5%	2020
Hungary	HUF 100 million	Advertisement	7.5%	2017

4. Beyond Europe: DST as Status Quo

In addition to the EU member states, many countries, ranging from Canada[108] to other countries in all continents, have enacted, proposed, or publicly discussed DSTs. Chart 1 below shows the current status of the DST legislation in various countries as of January 2020.

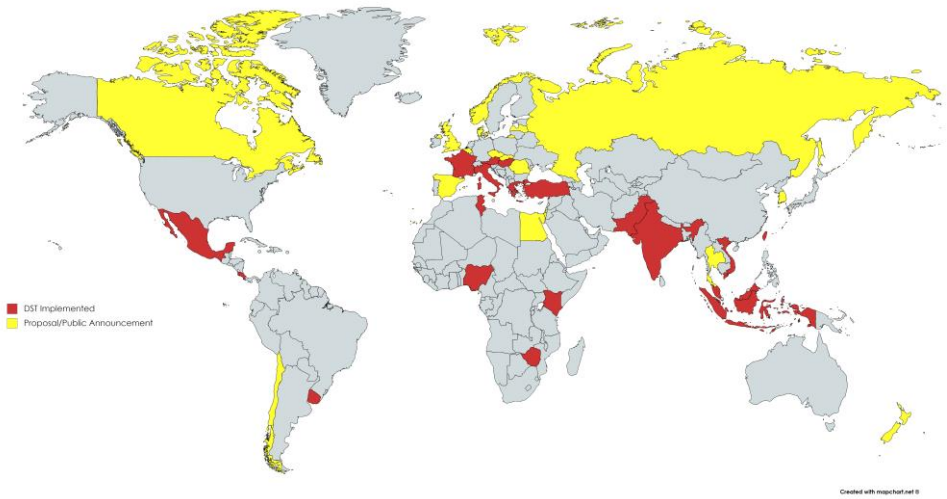
CHART 1. CURRENT STATUS OF DST LEGISLATION[109]

[108] 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 local revenue threshold is CAD 40 million. OFFICE OF THE PARLIAMENTARY BUDGET OFFICER, COST ESTIMATE OF ELECTION CAMPAIGN PROPOSAL (Sept. 29, 2019), https://www.pbo-dpb.gc.ca/web/default/files/Documents/ElectionProposalCosting/Results/32977970_EN.pdf?timestamp=1569835806287 (Can.).

[109] Chart 1 is created by the author based on the data released by KPMG. KPMG, *supra* note 68. Below is the list of countries in Chart 1.

Countries where DST has been implemented, colored in red: Austria, Costa Rica, France, Greece, Hungary, India, Indonesia, Italy, Kenya, Malaysia, Mexico, Nigeria, Pakistan, Taiwan, Tunisia, Turkey, Uruguay, Vietnam, Zimbabwe.

Countries that has proposed or publicly consider DST, colored in yellow: Belgium, Canada, Czech Republic, Denmark, Egypt, Israel, Latvia, New Zealand, Norway, Romania, Russia, Slovakia, South Korea, Spain, Thailand, United Kingdom.



About thirty-five 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.[110]

There are two countries whose DSTs show notable variations from the general features discussed in Part II.A. below: India and Turkey. 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,[111] the country introduced a turnover-based tax designated as a "equalisation levy,"[112] which is comparable to 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 its lack of physical

[110] Michael Graetz, Professor of Tax Law, Columbia Law School, Speech at the 2019 USCIB/OECD International Tax Conference (June 3, 2019).

[111] Finance Act, 2016, No. 2, Acts of Parliament, 2016 (India).

[112] Finance Act, 2016, No. 2 Sec. 165(1), Acts of Parliament, 2016 (India). The Finance Act followed from India reacting relatively quickly to the OECD's BEPS Action Report 1 that recommended an equalisation levy as one of three potential solutions to taxing the digital economy. OECD, BEPS ACTION 1, *supra* note 7, at 12. The act imposes 6% turnover tax on the gross revenues of foreign online advertising companies that do not have traditional PE in India. However, the levy is only applicable to those transactions that aggregates to more than INR 100,000 (approximately USD 1,500) in a financial year. The specified services subject to the equalization levy may be expanded in scope, and are defined as "an online advertisement, any provision for digital advertising space or any other facility or service for the purpose of online advertisement and includes any other services as notified by the Central Government." The levy came into effect as of June 1, 2016. Finance Act, 2016, No. 2 Secs. 164(i), 165(1), 163(2), Acts of Parliament, 2016 (India).

presence in India.[113] Hence, India has adopted both consumption tax-based solution and income tax-based solution.

Turkey will become the latest country to introduce a DST.[114] Turkey's newly enacted 7.5% DST will take effect on March 1, 2020. It is noteworthy that Turkey's DST is not only higher in tax rate than DST enacted by France and the UK, but also broader in scope because it applies to sales of digital content online as well.[115]

D. G20 and the OECD's Work

While many countries consider adopting a new DST unilaterally, the OECD and G20 has been working on a global deal to resolve the tax 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 modifies 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.[116]

Aggressive tax planning strategies by multinational enterprises have been the center of the fiscal agenda among many countries since the financial crisis in 2008.[117] For example, source countries, where investments occur and income is produced, suffer from tax base erosion by taxpayers, whereas

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[113] Finance Act, 2019, 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. Finance Act, 2019, No. 4 Secs. 4(2), 1(2), Acts of Parliament, 2019 (India). 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 ADVOCS. & SOLICS. (Mar. 21, 2018), https://tax.cyrilamarchandblogs.com/2018/03/taxing-digital-economy-rule-significant-economic-presence/.

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

[115] 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.

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

[117] *History of the G20 & BEPS*, OECD, https://www.oecd.org/tax/beps/about/#history (last visited Feb. 16, 2020).

residence countries, where investors reside, suffer from profit shifting to low-tax countries. In order to combat such base erosion and profit shifting ("BEPS") arising from multinational enterprises' clever use of gaps and mismatches in tax rules, the OECD and G20 initiated the BEPS project in 2013, which resulted in 15 final reports containing action plans for each topic in 2015.[118] 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.[119]

Among those 15 final reports and action plans, it is symbolic that Action 1 is "Addressing the Tax Challenges of the Digital Economy."[120] 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.[121] The limitations addressed in Action 1 indicate the tax challenges raised by digitalization go beyond the base erosion or profit shifting issues, because the remaining challenges relate to how taxing rights among countries should be allocated among relevant countries.

The G20/OECD 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 the Interim Report on Tax Challenges Arising from Digitalization in March 2018,[122] a policy note in January 2019,[123] the Public Consultation Document in February 2019,[124] and the Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalization of the Economy ("Programme of Work") in

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[118] *What is BEPS?*, OECD, https://www.oecd.org/tax/beps/about/ (last visited Feb. 16, 2020).

[119] *Id.*

[120] OECD, BEPS ACTION 1, *supra* note 7.

[121] *Id*. at 11.

[122] OECD, 2018 INTERIM REPORT, *supra* note 7, at 51.

[123] OECD, ADDRESSING THE TAX CHALLENGES OF THE DIGITALISATION OF THE ECONOMY – POLICY NOTE 1 (Jan. 23, 2019). 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. Pillar 2 seeks to further combat against the BEPS issue in the context of digitalization.123 See id. at 2. Pillar 1 is relevant to this Article, whereas Pillar 2 seeks to extent the policy that the US tax reform recently adopted, especially the global intangible low-income tax ("GILTI") minimum tax and the base erosion and anti-abuse tax ("BEAT").

[124] OECD, PUBLIC CONSULTATION DOCUMENT, *supra* note 39.

May 2019.[125] The proposals offered in these documents can be assorted into three categories. First 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").[126] Second 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").[127] Third 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").[128] The third proposal is the closest to DSTs with regard to emphasizing user participation, but is different from DSTs by sticking to the

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

[126] Many developing countries, such as G24, endorse this proposal. It aims to reward market countries by abandoning the traditional residency-based nexus rules in favor of economic nexus which would include digital presence. Furthermore, it adopts a formulary apportionment approach where the tax base is computed by applying the global profit rate of the multinational enterprise group to the revenue generated in a particular jurisdiction, and such tax base is allocated based on apportionment factors, such as sales, assets, employees, and importantly, users. It targets a wider scope than either of the User Participation or Marketing Intangibles proposals. OECD, PUBLIC CONSULTATION DOCUMENT, *supra* note 39, at 16–17.

[127] The second proposal is supported by the United States. This proposal is similar to the current residual profit split method in transfer pricing, which distinguishes the multinational enterprises' non-routine or residual profit from routine profit. But this proposal requires only a portion of the non-routine from in-scope activities or assets be allocated to the market jurisdiction. All other routine and non-routine 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 (Mar. 2019), for a distinction of residual profit from routine profit. Thus, it could reach a wider scope than the user participation proposal, going beyond highly digitalized businesses. However, it also departs from the traditional arm's-length principle, therefore making it difficult to satisfy the DST advocates. OECD, PUBLIC CONSULTATION DOCUMENT, *supra* note 39, at 11–16.

[128] The User Participation Proposal, supported by the UK and France, is premised on the idea that soliciting the sustained engagement and active participation of users is a critical component of value creation for certain highly digitalized businesses. The activities and participation of these users contribute to the creation of the brand, the generation of valuable data, and the development of a critical mass of users which helps to establish market power. Consequently, it targets certain highly digitalized businesses, such as social media platforms, search engines, and online marketplaces. For those businesses, non-routine or residual profit in excess of routine profit, which is generated from user participation, is required to be allocated to market countries where the relevant businesses' active and participatory user bases are located, irrespective of whether the businesses have a local physical presence. OECD, PUBLIC CONSULTATION DOCUMENT, *supra* note 39, at 9–11.

income tax framework and rejecting a new DST. All three proposals attempt to give market countries greater taxing right, but are different as to how and to what extent they modify the taxing rights.

After discussing the previous proposals, the OECD Secretariat proposed a "Unified Approach" in October 2019.[129] The proposal covers highly digitalized business models, but is increased in scope to include consumer-facing businesses.[130] It creates 1) a new nexus rule, not dependent on physical presence and instead largely based on sales, and 2) a new profit allocation rule using a formulaic approach to determine a share of residual, or non-routine, profit allocated to market countries.[131] Although it clings to the income tax framework, it goes beyond the existing norm, such as arms-length principle—income should be allocated among relevant countries at what independent parties would have paid—and physical presence requirements.[132] 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 not enough in reforming current international tax rules for the digital economy.[133] 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.[134] 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 that meet several thresholds.[135] If a firm does not have physical

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[129] OECD, UNIFIED APPROACH, *supra* note 116.

[130] *Id.* at 5.

[131] The Unified Approach creates a three-tier mechanism for apportioning a multinational enterprise's profits into various countries. First, Amount A is the deemed residual profit or deemed non-routine profit, which gets allocated among the various market countries even when an enterprise does not have a physical presence. Second, if the enterprise has a traditional tax nexus, such as physical presence, in a market country, additional amount—i.e., Amount B—attributed for baseline marketing and distribution functions may further be allocated to that country under current rules for transfer pricing and permanent establishment. Third, there might be a case where the market country argues that they may seek to tax an additional profit in excess of Amount B—i.e., Amount C—due to extra functions in that country. Then, the dispute over Amount C between the market country and the taxpayer should be subject to a legally binding and effective dispute prevention and resolution mechanism. *Id.* at 8–9.

[132] *Id.*; Alex M. Parker, *Mnuchin Has 'Serious Concerns' With OECD Digital Tax Plan*, LAW360 TAX AUTHORITY (Dec. 4, 2019), https://www.law360.com/tax/articles/1225261.

[133] Isabel Gottlieb, *OECD's Global Tax Overhaul Too Cautious, Trade Union Group Says*, BLOOMBERG LAW DAILY TAX REPORT (Feb. 5, 2020), https://bit.ly/2Hb0a3u.

[134] *Id*.

[135] *See e.g*., Jeroen Lammers, *OECD Unified Approach Leaves Market Jurisdictions Out in the Cold*, TAX NOTES INT'L (Jan. 13, 2020), https://bit.ly/2w3PS33.

presence, the new taxing rights are further limited.[136]

Furthermore, it becomes unclear whether a global deal can be reached on the Secretariat's proposal, because the United States recently withdrew its support.[137] U.S. Treasury Secretary Steven Mnuchin sent the OECD a latter in December 2019, expressing concerns that the proposal departs too far from the existing rules, and asked to add a safe harbor that would allow U.S. companies to choose between the new and old regimes.[138] The OECD have dismissed the idea of alternative safe harbor,[139] 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 the UK, French, and German government officials.[140] Also, Austria and Italy confirmed again in October 2019 that they intend to introduce a new DST from January 1, 2020.[141] 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 status quo. To better understand DSTs, Part II analyzes how positive law provides DSTs as common key features and critically evaluates merits and demerits of DSTs compared to conventional income-tax based approaches.

II. THE ANATOMY OF DST

This Part starts with how positive law provides DSTs by showing key design features that are common in various DSTs that have been enacted or proposed, explored in Part I.C. An important feature of DST is that it is designed as a turnover tax, which is a subcategory of consumption tax. Given the goal of 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 tax rules cannot. However, because of such departure from the conventional global norm of taxing profits of multinational enterprises in income tax framework, DSTs are subject to

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[136] *Supra* note 131.

[137] Parker, *supra* note 132; 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.

[138] *Id*.

[139] Parker & Buell, *supra* note 93.

[140] Natalie Olivo, *UK Digital Tax May Outlive Global Agreement*, LAW360 TAX AUTHORITY (July 25, 2019), https://www.law360.com/tax-authority/articles/1179756; Isabel Gottlieb, *More Unilateral Taxes Likely If OECD Talks Fail: German Official*, BLOOMBERG LAW DAILY TAX REPORT (Feb. 3, 2020), https://bit.ly/2UAWOyG; Parker & Buell, *supra* note 93.

[141] KMPG, *supra* note 68, at 5, 11; EY, *supra* note 98.

criticism discussed in Subpart B. Some opponents aggressively try to understand DST 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 the DST as a consumption tax, which has never been discussed seriously before. This Article seeks to do this which could bring a new life to the DST as a way of taxing the digital economy.

A. Key Features: A Positive Account of DST

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

1. Turnover Tax and Consumption Tax

DSTs are all designed as a turnover tax. In the most general sense, turnover taxes are defined as "a tax levied on the value of the sales revenue of a firm,"[142] rather than other commonly used tax bases such as corporate profits or sales price.[143] Likewise, DSTs are imposed on the "gross revenue" of specific digital business models where revenues are linked to the participation of its local users.[144] Some commentators interpret the DST as a

[142] *Turnover Tax*, ROUTLEDGE DICTIONARY OF ECONOMICS (3rd Ed. 2013). Turnover taxes may often be distortionary because when multiple firms touch in the development of a product, "the total tax paid will be higher for goods passing through several firms to their final sale than for those which do not." *Id*. This so-called "tax cascading" may result in further negative consequences to companies operating at a loss or with thin-margin. JOYCE BEEBE, RICE UNIVERSITY'S BAKER INSTITUTE FOR PUBLIC POLICY, RECENT DEVELOPMENTS ON THE E.U.'S DIGITAL TAX PROPOSAL 4 (Jan. 9, 2019).

[143] *See* SEAN LOWRY, *supra* note 66, at 9 (providing that DST is "not structured as [a tax] on corporate profits"). Feng Wei & Jean-François Wen, *The Optimal Turnover Threshold and Tax Rates for SMEs* 3, Int'l Monetary Fund, Working Paper 19/98 (2019). In accounting, turnover means the net sales amount by a business before deducting any expenses, whereas "profit is the residual earnings of a business after all expenses have been charged against net sales." *The Difference Between Turnover and Profit*, ACCOUNTING TOOLS (Jan. 4, 2018), https://www.accountingtools.com/articles/what-is-the-difference-between-turnover-and-profit.html.

[144] *See* SEAN LOWRY, *supra* note 66, at 9, 24; *see also* ACCOUNTING TOOLS, *supra* note 143. Turnover taxes are essentially one type of "indirect tax on private consumption expenditures." Robert F. Van Brederode, *A Normative Evaluation of Consumption Tax Design: The Treatment of the Sales of Goods Under VAT in the European Union and Sales Tax in the United States*, 62 TAX LAWYER 1055, 1056 (2009). If not explicitly a turnover tax, the DST may also be considered an excise tax, which consist of "narrowly based taxes on consumption, levied on specific goods, services, and activities." TAX POLICY CENTER BRIEFING BOOK, WHAT ARE THE MAJOR FEDERAL EXCISE TAXES, AND HOW MUCH MONEY DO THEY RAISE?, https://www.taxpolicycenter.org/briefing-book/what-are-major-federal-excise-taxes-and-how-much-money-do-they-raise (last visited Feb. 16, 2020).

disguised income tax,[145] but this Article observes what positive law provides and analyzes DST as a turnover tax.

A turnover tax is a subcategory of a consumption tax.[146] A consumption tax refers to a taxing system which taxpayers are taxed based on how much they consume rather than how much they earn income—income tax.[147] Consumption taxes can take the form of turnover taxes, tariffs, excise taxes, and other taxes on consumed goods and services.[148] The amount of consumption matches the sales revenue of a firm, so that a turnover tax that is levied on the sales revenue of a firm falls under the category of 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 a turnover tax.[149] 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."[150] Moreover, turnover taxes, in general, may be distortionary due to so-called "tax cascading"—that is, when multiple firms touch in the development of a product, "the total tax paid will be higher for goods passing through several firms to their final sale than for those which do not."[151] However, turnover taxes have broad tax base, and thus can bring a "large, stable source of revenue."[152] Furthermore, turnover taxes offer simplified compliance for taxpayers, because gross sales or

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[145] *Infra* Part II.B.2.

[146] HELLERSTEIN & HELLERSTEIN, *supra* note 16, 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).

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

[148] *See* HELLERSTEIN & HELLERSTEIN, *supra* note 16, at 649.

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

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

[151] *Turnover Tax*, *supra* note 142. This tax cascading may result in further negative consequences to companies operating at a loss or with thin margin. JOYCE BEEBE, *supra* note 142, at 4.

[152] 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/.

revenue are "relatively easier to measure, record, and verify than profit."[153] Thus, turnover taxes have traditionally been used in the taxation of small and medium sized enterprises in developing nations.[154] The pros and cons of using turnover tax for taxing the digital economy will be discussed further in Subpart C.2.

2. Tax Rates and Revenue Threshold

DSTs' tax rates are set in between 2~7%, and they offer revenue threshold requirements. In other words, a firm's global revenue from in-scope business models discussed in Subpart A.4. should exceed certain threshold amounts to trigger a DST. DSTs also offer a smaller local revenue threshold. The France DST requires €750 million of global revenue and €25 million of local revenue, and the UK DST requires £500 million of global revenue and £25 of local revenue for threshold amounts.

The rationales for revenue threshold requirements are to target tech giants that enjoy monopoly power and yet do not pay enough pay in the market countries.[155] Furthermore, the local revenue threshold is to recognize a firm's tax nexus to the market countries regardless of its physical presence, explained in Subpart A.3.[156] If a firm generates revenue more than the threshold amount in the market country, 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 sales tax on remote sellers, not a turnover tax.[157]

The revenue threshold requirements are criticized mainly for two reasons.

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[153] PwC, A New Turnover Tax Introduced from January 2013 (2013). Therefore, developing nations, such as South Africa and Armenia, introduced turnover taxes as an option to some small and medium sized enterprises. *Id.*

[154] *See* Wei & Wen, *supra* note 143, at 3.

[155] KPMG, France: Digital Services Tax (3%) Is Enacted (July 25, 2019), https://home.kpmg/us/en/home/insights/2019/07/tnf-france-digital-services-tax-enacted.html ("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 . . . ."), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/754975/Digital_Services_Tax_-_Consultation_Document_FINAL_PDF.pdf; *EU Digital Services Tax Proposal 2018*, *supra* note 17, 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 . . . .").

[156] *EU Digital Services Tax Proposal 2018*, *supra* note 17, at 10–11.

[157] *Wayfair*, 138 S. Ct. at 2099.

First, it does not offer safe harbors for businesses in losses.[158] Many digital firms would suffer from losses especially in their early stage of business, but those firms might be subject to DSTs as long as they generate large amount of gross revenue. To ameliorate this problem, for example, the UK DST proposal exempts for the first £25 million in taxable UK revenues and a 0% tax rate for companies making losses.[159] Second, it is suspected that only American tech giants might satisfy the revenue threshold requirements and be subject to DSTs. This critique will be discussed in Subpart B. in details.

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 the traditional requirement of physical presence and arm's length principle in income taxation. More precisely, it does not have to be bound by such requirements, because it is a turnover consumption tax.

In 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 as a related party of the firm and the global profits of the firm is allocated between Countries A and B based on the arm's length principle. That is, the amount charged by one related party to another for a given product or service must be the same as if the parties were not related. The so-determined amount of profits is allocated to Country B and subject to Country B's tax jurisdiction. The limitations of the traditional approach pertaining the digital economy is that there is no way for Country B to collect revenue from a firm's remote business if the firm does not establish a physical presence there.

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, revenue amount generated in market countries exceeds certain thresholds. The number of users or transactions occurred in the market country is also criteria to consider, which replaces the traditional physical presence in income tax. Second, once the tax nexus is recognized, an amount

[158] *See* Bunn, *supra* note 19 ("The tax would still apply even if those companies were not profitable, ignoring the costs associated with the revenues.").

[159] Bunn, *supra* note 72.

of profit should be allocated to market jurisdictions in which relevant business' active and participatory user bases are located, even if there is no local physical 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 the DSTs is their limited scope. A DST is designed to apply to the identified digital business models where tax challenges are primarily manifest with mobile IPs and significant user participation.[160] As a result, it "ring-fences," or segregates, such specified digital business models from the rest of the digital economy.[161] To illustrate, the scope of the UK DST is limited to search engines, social media platforms, and online marketplaces, but excludes certain regulated financial and payment services, the provision of online content, sales of software/hardware, and television or broadcasting services. Thus, Facebook, Twitter, YouTube, Google, Amazon Marketplace, Kayak, Priceline, Uber, and Airbnb are in scope, whereas PayPal, Netflix, Hulu, Spotify, and Ubisoft are excluded.[162]

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 a social media platform subject to a DST or a digital interface providing digital content and thus not subject to a DST. Also, Spotify and Netflix are currently not subject to a DST, but they raise another line-drawing question when they offer customized advertising services to their users. The scope of DSTs concerning the ring-fencing problem will be further discussed in Part III.C.3.

B. Criticisms on DST

While DSTs offer benefits, they cannot escape criticism from

[160] *EU Digital Services Tax Proposal 2018*, *supra* note 17, at 7–10 ("DST is a tax with a targeted scope, levied on the revenues resulting from the supply of certain digital services characterized by user value creation."); HM TREASURY & HM REVENUE & CUSTOMS, *supra* note 155, 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 recognize this important source of value creation").

[161] OECD, ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY: ACTION 1 2014 DELIVERABLE 12 (2014) (warning that the digital economy "would be difficult, if not impossible, to ring-fence the digital economy" by "[a]ttempting to isolate the digital economy as a separate sector").

[162] Cui, *supra* note 2, at 8–9.

stakeholders. Digital firms have bluntly expressed their unhappiness with this new tax.[163] The U.S. government also shares the same concerns held by many tech giants located in the United States.[164] On the other hand, academic literature is divided: some scholars take a critical stance towards DST, while others are more sympathetic.[165] Based on the key features discussed above, let us now examine the criticisms that DSTs are facing.

1. "Ring-Fencing" and Discrimination

First, because DST only applies to the specific digital business models, it has been criticized as ring-fencing, or segregating, the identified digital business models where tax challenges are primarily manifest with mobile IP and significant user participation. The proponents of other income tax-based proposals argue that DST is against the idea of a level playing field by penalizing the big or early players in the market.[166]

Second, various unilateral DSTs potentially discriminate businesses based on nationality.[167] It has been deeply suspected that the revenue threshold would only be satisfied by American tech giants. On this point of the challenge, the United States has been a major opponent to the DST general concept. In the letter of January 29, 2019, by Senators Grassley and Wyden to US Treasury Secretary Mnuchin, copying EC and European Council, they expressed concern about unilateral DSTs, because they are "designed to discriminate against US-based multinational companies."[168] In

[163] *See* Kanter, *supra* note 20 (including statements and actions from representatives from Amazon, Facebook, and Google decrying the French DST as unfair or harmful).

[164] Press Release, United States Trade Representative, USTR Announces Initiation of Section 301 Investigation into France's Digital Services Tax (July 10, 2019), https://ustr.gov/about-us/policy-offices/press-office/press-releases/2019/july/ustr-announces-initiation-section-301 ("The United States is very concerned that the digital services tax which is expected to pass the French Senate tomorrow unfairly targets American companies . . . .").

[165] For the former position, see Bauer, *supra* note 27; Jessop, *supra* note 27; Johaness Becker et al., *EU Digital Services Tax: A populist and Flawed Proposal*, KLUWER INT'L TAX BLOG (Mar. 16, 2018), kluwertaxblog.com/2018/03/16/eu-digital-services-tax-populist-flawed-proposal/?print=pdf. For the latter position, see e.g., Cui, *supra* note 4; Daniel Shaviro, *Digital Services Taxes and the Broader Shift from Determining the Source of Income to Taxing Location-Specific Rents* 5 (NYU Law and Economics, 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").

[166] Bunn, *supra* note 19.

[167] Ruth Mason & Leopoldo Parada, *Company Size Matters*, 2019 BRITISH TAX REV. 610, 646–49 (2019); Ruth Mason & Leopoldo Parada, *Digital Battlefront in the Tax Wars*, 92 TAX NOTES INT'L 1183, 1193–96 (2018).

[168] Letter from Sen. Charles E. Grassley & Sen. Ron Wyden, U.S. Senate Committee on

March 2019, Treasury Department Assistant Secretary for International Tax Affairs, Chip Harter, expressed concern that under the WTO, trade agreements, and treaties the French DST proposal could be challenged as discriminatory vis-à-vis US companies, and the US is opposed to any digital services tax proposals.[169] In December 2019, the U.S. Trade Representative proposed tariffs of up to 100% on French luxuries, such as wine, cosmetics, and handbags, to discourage French DST.[170] France warned that it would retaliate with its own round of tariffs.[171] For now, the two countries agreed to cool off while awaiting the global deal in the G20/OECD expected in late 2020,[172] but it is plausible that the DST debate would escalate to a trans-Atlantic trade war.

The above two criticisms raise fair concerns that need to be addressed. Implementing a tax that harms the growth of the new business and disproportionately impacts certain companies based on nationality is neither efficient nor fair.[173] However, it is eventually an empirical question that requires evidence on whether the majority of the companies subject to DST are foreign multinationals from market jurisdictions, and 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 DST as a disguised direct tax, or corporate income tax, resulting in double taxation problem in international tax.[174] The first two criticisms above contain little discussion of the consumption tax aspect of the DST, although the positive

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Finance, to Sec'y Mnuchin, Sec'y of the U.S. Treasury (Jan. 29, 2019), https://www.finance.senate.gov/imo/media/doc/2019-01-29%20CEG,%20Wyden%20to%20Treasury%20(Foreign%20Digital%20Services%20Taxes-OECD).pdf.

[169] *U.S. Sees Unilateral Taxes on Web Giants As 'Discriminatory': Treasury Official*, REUTERS (Mar. 12, 2019, 5:09 AM), https://reuters.com/article/us-usa-tax-harter-idUSKBN1QT1CT.

[170] Parker, *supra* note 12.

[171] Keohane, Giles & Politi, *supra* note 92.

[172] Parker & Buell, *supra* note 93.

[173] Bunn, *supra* note 19; Mason & Parada, *Digital Battlefront in the Tax Wars*, *supra* note 167, 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.").

[174] *See e.g.*, Ismer & Jescheck, *supra* note 21, at 577; *EU Digital Services Tax Proposal 2018*, *supra* note 17.

law clearly provides DST as a turnover tax and consumption tax.[175] In this regard, the third criticism offers important doctrinal implications.

The attempt to interpret DST as income tax is largely based on the idea that current design of DST "departs from traditional income tax or turnover taxes."[176] The critiques argue that, if the goal of such unconventional DST is to make up the foregone revenue from traditional income tax system, the legislative intent may infer that DST relates to "profits" of tech giants,[177] which is the tax base of income tax.[178] 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.[179] The taxable period of DST is also a yearly basis, rather than per transaction basis, which is more similar to direct taxation than indirect taxation.

Interpreting DST as income tax may result in double taxation problem in international tax.[180] 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 double

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[175] 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. Article 401 of Directive 2006/112/EC ("the VAT Directive"). 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 17, at 10. However, such EU policy for single consumption tax cannot prevent the scholars from constructing DST as a consumption tax, both doctrinally and normatively.

[176] Ismer & Jescheck, *supra* note 21, at 577.

[177] *Id.* at 575.

[178] 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 United States Contrasted*, 7 FLA. TAX REV. 259, 267–68 (2006).

[179] 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 periodic" 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).

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

taxation problem.[181] 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 a foreign tax credit or an exemption from tax.[182]

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.[183]

However, the double taxation problem does not occur if two taxes are imposed on different tax bases. For example, many countries impose VAT on a business's consumption, or gross margin, and at the same time they impose corporate income tax on the business's net income.[184] Although the tax base of VAT and that of corporate income tax are not exactly the same, they may significantly overlap. However, this is not double taxation, because VAT is imposed on taxpayer's consumption whereas corporate income tax is imposed on the taxpayer's net income. The same explanation upholds for DST. The positive law clearly states that the tax base of DST 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 the DST of creating a double taxation problem is not likely a legitimate concern as long as DST is interpreted as a turnover tax.[185]

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[181] *See e.g.*, U.S. Model pmbl. ("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 . . . .").

[182] Rebecca M. Kysar, *Interpreting Tax Treaties*, IOWA L. REV. 1378, 1393–94 (2016).

[183] Ismer & Jescheck, *supra* note 21, at 574.

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

[185] Ismer & Jescheck, *supra* note 21, 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).

Furthermore, interpreting DST as income tax may not always promote the national interest of the United States. 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 DST is 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 to foreign tax credit for such DST paid to market countries, or source countries.[186] 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 DST as income tax might decrease American tech giants' worldwide tax liability, but it may open a possibility to reduce the U.S. tax revenue.[187]

The issue of doctrinal interpretation of DST 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).[188] The detailed analysis of the

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[186] The UK DST proposal recognizes this potential foreign tax credit issue and provides that DST will not be within the scope of the UK's double tax treaties, it will not be creditable against UK Corporate Tax. HM TREASURY & HM REVENUE & CUSTOMS, *supra* note 155, at 29, 32.

[187] 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 Advocate General regarding Hungarian DSTs consistently holds that Hungarian DST constitutes a turnover-based special income tax in order to bypass the single consumption tax policy of the EU, discussed in *supra* note 175. Fővárosi Közigazgatási és munkaügyi bíróság [Budapest Administrative and Labor Court] July 4, 2019, C-323/18 (Hung.); Fővárosi Közigazgatási és munkaügyi bíróság [Budapest Administrative and Labor Court] June 13, 2019, C-75/18 (Hung.); Fővárosi Közigazgatási és munkaügyi bíróság [Budapest Administrative and Labor Court] Sept. 12, 2019, C-482/12 (Hung.). 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. PAUL CRAIG AND GRÁINNE DE BÚRCA, EU LAW, TEXT, CASES AND MATERIALS 70 (5th ed., 2011). If that is the case, it would be wise for the U.S. government to consider the foreign tax credit issue more seriously.

[188] General Agreement on Trade and Services art. XIV(d), Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1B, 1869 U.N.T.S. 183 (1994) [hereinafter GATS]; Mitchel 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), https://thesuite.pwc.com/media/10060/dst-

GATS' direct tax exception is beyond the scope of this Article; but some might find it more beneficial to interpret DST 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 DST as income tax is arguably based on its unconventionality. However, it is not fully convincing why as a result DST should be interpreted as income tax notwithstanding that positive law clearly provides it as a turnover tax. What is unconventional is the new digital economy that gives birth to DSTs; but the design of DST itself is a conventional turnover-based consumption tax. The tax base of DST 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 DST 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 DST as income tax? Put it more generally, is income tax-based solution better than consumption tax-based solution? If the answer would be the negative, what are the benefits of constructing DST as a consumption tax? The next Subpart deals with such normative discussion that has been neglected in the DST debate.

C. Should We Stick To Income-Tax Based Solution?

DST has been gaining more political impetus in many countries as a solution for the tax challenges in the digital economy, becoming the new status quo.[189] It is designed as a turnover tax imposed on gross revenue, and therefore, by definition, it is a subcategory of consumption tax. On the other hand, there are still ongoing efforts to propose a global solution based on traditional income tax framework, either by modifying current income tax rules or interpreting DST as income tax.[190] Such DST debate reminds of 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

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under-wto-law.pdf. 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 art. XXVIII(o).

[189] *Supra* Part I.C.

[190] *Supra* Parts I.D. and II.B.2.

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 v. Income Tax

A consumption tax is a tax on the purchase of goods or services.[191] 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.[192] 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.[193]

Consumption taxes are generally born by consumers because vendors charge a higher price for the good or service to account for the amount of consumption tax.[194] The vendor then remits the tax to the appropriate federal, state, or local government.

Proponents of a consumption tax argue that it encourages saving and investment, which makes the economy more efficient, whereas an income tax penalizes savers and rewards spenders.[195] Thus, they argue that it is fairer to tax those who take out of the limited resource pool through consumption, rather than what they contribute to the pool using their income. On the other hand, opponents argue that a consumption tax adversely affects the poor who, by necessity, spend a higher percentage of their income.[196] Since

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

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

[193] HELLERSTEIN & HELLERSTEIN, *supra* note 16, 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).

[194] This concept is called "tax incidence." *See infra* Part III.C.1. *See also* TAX POLICY CENTER BRIEFING BOOK, WHO BEARS THE BURDEN OF A NATIONAL RETAIL SALES TAX?, https://www.taxpolicycenter.org/briefing-book/who-bears-burden-national-retail-sales-tax (last visited Feb. 16, 2020).

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

[196] *Id.*

consumption tax is a form of regressive tax, the wealthy population consumes a smaller fraction of their income than poorer households do.[197] On the other hand, the income tax is justified as more progressive due to ability to pay being determined through levels of income.[198]

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.[199] 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."[200] 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.[201] 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.[202]

In international tax, scholars have greater focus on efficiency and administrability over equity or fairness.[203] International tax literature has been described as having a "narrow normative focus" which is "guided by worldwide economic efficiency [] concerned with increasing economic output and reducing deadweight loss, wherever it occurs."[204] In contrast, domestic tax, especially personal income tax, tend to focus more heavily on concerns over equity and fairness.[205] 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

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[197] *Id.*

[198] *See* Daniel S. Goldberg, *The U.S. Consumption Tax: Evolution, Not Revolution*, 57 TAX LAWYER 1 (2003); *see also* Warren, *supra* note 192, at 1092–93.

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

[200] Goldberg, *supra* note 198, at 21.

[201] *See* Chris R. Edwards, *Simplifying Federal Taxes: The Advantages of Consumption-Based Taxation*, CATO INST. (Oct. 17, 2001), https://object.cato.org/sites/cato.org/files/pubs/pdf/pa416.pdf (providing a detailed list of income tax complexities that could be eliminated in implementing a consumption tax).

[202] Andrews, *supra* note 199, at 1115.

[203] *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) ("equity has more recently been considered as 'irrelevant' to contemporary international tax policy, and the more recent literature primarily focuses on economic principles.") (footnote omitted).

[204] Graetz, *supra* note 50, at 280.

[205] *See Id.* at 276.

addressing efficient deployment of global capital of multinational enterprises. This insight may apply to the new debate on DST, discussed below.

2. New Debate: DST 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. Efficiency and administrability are more emphasized than equity in international tax and business tax. Thus, applying this weighted policy criteria may be appropriate for analyzing international taxation responses to digitalization. Considering that the strength of consumption tax is efficiency and administrability and that of income tax is equity, consumption tax-driven proposals may be normatively superior, at least for cross-border digitalization of the economy.

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

First, there is no need to make efforts to undertake the fundamental overhaul of nexus and allocation rules to reward more taxing rights 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 relying 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.[206]

Second, a solid construction of DST as a consumption tax may easily eliminate the double taxation concern in international tax addressed in Subpart B.2. Interpreting a DST as an income tax and inviting tax treaty to deal with potential double taxation is not wise, considering that tax treaty is not a good tool to deal with the tax challenges in digital economy.[207]

Third, a DST, as a consumption tax, may be more efficient and

[206] *EU Digital Services Tax Proposal 2018*, *supra* note 17.

[207] 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 the restriction on the treaty framework may have on international cooperation).

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. DST, as a turnover tax, also provides broad tax base as a large, stable source of revenue and simplicity to administer.[208] More interestingly, a DST designed as a turnover tax may overcome the general criticism on turnover taxes: that is, such taxes are imposed on gross revenue and thus, creates economic distortion due to tax cascading.[209] This tax cascading problem occurs when multiple firms are involved in the development of a product or supply chain.[210] However, highly digitalized business models subject to DST involve a single firm or short supply chain functioning as platforms. Those digital firms implicate almost zero or negligible marginal cost when they generate revenue.[211] The new features of the digital economy may mitigate the potential tax cascading problem associated with turnover taxes.[212]

Fourth, as compared to income tax-based proposals, a consumption tax-based approach might not serve equity or fairness well. However, DST may overcome the fairness or regressive problem with respect to individual taxpayers, considering that many highly digitalized businesses subject to DST adopt multi-sided platform models. In a multi-sided 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. 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, *Wayfair* Court overturned the physical presence rule in favor of an economic presence rule. 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 to 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. Furthermore, the Netflix Tax adopting

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[208] Watson, *supra* note 152.
[209] *Supra* Part II.A.1.
[210] *Turnover Tax*, *supra* note 142.
[211] Cui, *supra* note 4, at 25–27.
[212] *See infra* Part III.A.

an economic nexus rule following *Wayfair* resemble 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.

III. HOW TO IMPROVE DST AS A CONSUMPTION TAX

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

A. Tax Incidence of DST

The first issue that is prominently understudied in 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 DST debate, critics argued that the tax incidence of the DST will be borne by consumers because of the turnover tax design, and subsequently negatively affect the demand side of the digital economy.[213] However, such criticism is not convincing, considering that many digital business models are multi-sided. In a multi-sided business model, there are two types of users—user-buyer and user-seller—and the fees imposed by a service provider is on the user-seller side. Thus, it is not conceptually impossible to pass the tax incidence to user-sellers, rather than user-buyers.[214]

In fact, since the adoption of the new French DST, Amazon announced that it considers the French DST a consumption tax and will "pass the tax's cost to [user-sellers] on its website in France through a 3% referral fee increase starting Oct. 1[, 2019]."[215] Thus, despite attempts of interpreting DST as disguised income tax, DST is applied as a consumption tax in the real

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[213] Bauer, *supra* note 27; Kanter, *supra* note 20; Elizabeth Schulze, *France's Digital Tax Could Hurt Consumers More Than Tech Companies*, CNBC (July 12, 2019, 9:00 AM), https://www.cnbc.com/2019/07/12/france-digital-tax-could-hurt-consumers-more-than-tech-companies.html.

[214] Cui, *supra* note 4, at 3.

[215] 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.

world.[216]

Nevertheless, although the French anecdote on tax incidence proves that market players perceive DST as a consumption tax, and accordingly pass the tax incidence to one type of users—the user-sellers, whether such tax incidence is normatively desirable is another question. Should a DST, constructed as a turnover tax or consumption tax, logically and conceptually pass the economic burden of the tax to one side of users? Or, from a policy perspective, can we design a DST as consumption tax where 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 multi-sided business models and subject to DST, are largely monopolistic, and thus may result in a different policy analysis of tax incidence. This Subpart further explores this issue in relation to traditional and recent studies on the tax incidence of multi-sided business models.

1. Tax Incidence and Fairness

Consideration of the incidence of a tax is important as it represents which part of the economy bears the ultimate burden of the tax, and can help policy makers determine the overall progressivity and efficiency of any tax proposal.[217] 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."[218] In the case of the DST, the statutory incidence has been placed on those digital businesses with high enough gross revenues that offer the digital goods and services targeted by the tax.[219] On the other hand, economic incidence "measures the changes in economic welfare in society arising from a tax."[220] In other words, the economic incidence means who will ultimately bear the economic burden of the tax.[221]

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[216] *Supra* Part II.B.2.

[217] *See* WILLIAM M. GENTRY, U.S. TREAS. DEPT., OTA PAPER 101, A REVIEW OF THE EVIDENCE ON THE INCIDENCE OF THE CORPORATE INCOME TAX 3 (2007), https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/WP-101.pdf; Don Fullerton & Gilbert E. Metcalf, *Tax Incidence*, NBER Working Paper 8829, 1 (2002), https://www.nber.org/papers/w8829.pdf.

[218] Fullerton & Metcalf, *supra* note 217, at 1.

[219] For examples of digital services placing the statutory incidence on targeted digital industries, see HM TREASURY, BUDGET 2018 DST, *supra* note 71; KPMG, *supra* note 68, at 9; Sledz, *supra* note 94; and EY, *supra* note 98.

[220] Fullerton & Metcalf, *supra* note 217, at 1.

[221] 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.

This Article discusses the economic incidence of DST, focusing on the extent, if any, that the economic burden of DST is borne by the end-consumers of taxed digital platforms.

Consumption taxes are usually assumed to be borne entirely by the final consumer.[222] Many articles follow the accepted view that consumption taxes are regressive and thus not good at promoting equity or fairness.[223] 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.[224] Moreover, the OECD analyzed the distributional impact of consumption taxes, including VATs and excise taxes, in 20 OECD countries and found that the consumption taxes would be "roughly proportional or even slightly progressive" if analyzed for expenditure rather than income.[225]

The DST has similarly been criticized in that the tax will simply be born in large part, if not entirely, by consumers, and thus regressive and unfair.[226] 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."[227] It appears then that the implementation of

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[222] *Id*.

[223] *See generally* ROBERT E. HALL & ALVIN RABUSHKA, THE FLAT TAX (2nd 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, *Shifting Taxes from Labor to Consumption: More Employment and More Inequality* 16–17, Discussion Paper No. 15-042 (2015), http://ftp.zew.de/pub/zew-docs/dp/dp15042.pdf (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).

[224] 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 theoretical offset of the reduction in tax burden apportioned to high-income earners following the transition to a consumption tax.

[225] OECD, THE DISTRIBUTIONAL EFFECTS OF CONSUMPTION TAXES IN OECD COUNTRIES 25–40 (2014). This study found that in the case of income, the consumption taxes followed the basic assumption and were regressive. However, under an expenditure perspective, the taxes were found to be roughly proportional or even slightly progressive. It argued that "an expenditure-based 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."

[226] *Supra* note 213 and accompanying text.

[227] Julien Pellefigue, *The French Digital Service Tax: An Economic Impact Assessment*, DELOITTE TAJ (2019), https://taj-strategie.fr/content/uploads/2020/03/dst-impact-

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,[228] or at least function like them, and are affected differently by taxes as well as potentially being able or more willing to absorb the cost of the DST.[229] Lastly, proponents of the DST may be able to adopt the supportive contentions that have arisen for consumption tax incidence, as the DST essentially functions as a consumption tax. At the least, the DST may benefit from the same arguments against the regressive aspect of consumption tax.

2. Multi-Sided Platforms

Multi-sided markets can be defined as "markets in which one or several platforms enable interactions between end-users and try to get the two (or multiple) sides 'on board' by appropriately charging each side."[230] The firms at the center of multi-sided markets, or the multi-sided platform firms, are essentially intermediaries between the user-buyers (consumers) and user-sellers (advertisers, merchants, etc.) of the market, and their main function is to internalize various externalities generated by the interaction between the two groups.[231] In order to optimally facilitate interactions, and thus maximize profits, the two-sided platform firms must adapt their pricing strategies to the demands of the different customer groups.[232] Examples of two-sided platform firms include hardware & software systems like Mac OS, digital exchanges like Amazon, peer-to-peer marketplaces such as Airbnb and Uber, as well as digital media firms like YouTube, Facebook, and Google.[233]

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assessment-march-2019.pdf (determining the pass-through rate of the French DST on merchants and consumers).

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

[229] *See infra* Part III.A.3.

[230] Rochet & Tirole, *supra* note 7, at 645.

[231] 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 7, at 657.

[232] Hans Jarle Kind et al., *Tax Responses in Platform Industries*, 62 Oxford Econ. Papers 764, 765–766 (2010).

[233] Bellaflamme & Toulemond, *supra* note 231, at 2.

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 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."[234]

The large digital firms that appear to be the main target of the DST fit comfortably within the definition and dominating capability of multi-sided platform firms.[235] These digital platforms have established their powerful economic presence through the internalization of cross-group externalities. Because these firms rely on externalities in order to determine prices and price structure, the typical incidence analysis attributed to one-sided markets does not cleanly apply. Most importantly, "two-sided platform firms may find it profitable to charge prices that are below marginal cost or even negative for one of its products (customer group). This is in contrast to conventional markets (one-sided) where marginal cost equal to marginal revenue pricing is well established as guidance."[236]

Recent literature on tax incidence of multi-sided 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,[237] 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.[238] Similar findings occurred under analysis focused on the hypothetical increase of an ad valorem tax rate on the user-buyer side, finding that the price charged on the user-buyer's side fell following an increase in the ad valorem tax rate.[239]

In contrast, Bellaflamme & Toulemonde found that an increased ad valorem tax imposed on one side of a two-sided market is born by the side the tax is levied on—that is, the platform itself—and any competing platforms, but that agents on the other side of the market are unaffected.[240] Additionally, empirical analysis by Eleanor Wilking found an increase in after-tax prices paid by consumers of Airbnb—user-buyers—following the

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[234] *Id*. at 2.

[235] *Id.* at 2, n.1.

[236] Kind et al., *supra* note 232, at 767. *See also American Express*, 138 S. Ct. at 2281.

[237] Kind et al., *supra* note 232, at 787. Ad valorem tax refers to a tax based on the value of the property or transaction subject to tax.

[238] *Id.* at 774–76.

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

[240] Bellaflamme and Toulemond, *supra* note 231, at 9.

new obligation of the individual hosts—user-sellers—to remit the relevant tax to the digital firm.[241]

Such mixed conclusions of recent studies suggest that multi-sided platforms may nonetheless follow typical assumptions of tax incidence for one-sided markets, but that conclusion may not hold true for all digital multi-sided platforms.[242]

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 that a newly introduced tax will not pass on to users.[243] In other words, firms will absorb the tax incidence and will not raise prices. Applying this analysis to DST, if digital firms will absorb the incidence of DST, then introducing DST is actually 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.[244] Taxing the good or service would usually only result in an increase in price, effectively shifting the burden onto the consumers.[245] However, monopolies that produce goods or services with relatively elastic demands may instead decide to reduce price, absorbing the cost of the tax.[246] This decision results from the monopoly power that the firm exerts in the market. Because the monopoly firm is able to set a lower price than equilibrium level, the firm extracts supernormal profits derived from consumer surplus.[247] Taxation of the firm's profits results in a reduction of excess profits similar to the imposition of additional fixed costs.[248]

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

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[241] Wilking, *supra* note 7, at 21.

[242] *See generally id.*

[243] Rikita Muley, *Effect of Taxes on Monopoly Equilibrium (With Diagram)*, ECONOMICS DISCUSSION, http://www.economicsdiscussion.net/monopoly/effect-of-taxes-on-monopoly-equilibrium-with-diagram/17081 (last visited Feb. 16, 2020).

[244] *Id*.

[245] *Id*.

[246] *Id*.

[247] *Id*.

[248] *Id*.

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

First, as to the VAT, it is worth noting that there is a huge debate on the notion of "value creation" in digital taxation discourse.[249] 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 contributor 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 contributor 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

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

revenue under traditional tax rules. The DBCFT was proposed during the US tax reform debate in 2017, but was ultimately rejected by both the EU and the US because they considered it too aggressive and contentious.[250] 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.

In the William-Google example, cash flow exists between the service provider (Google in the US) and the user-seller (Mercedes-Benz in Germany), and not between the service provider and the user-buyer (William in the UK). 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 UK where user-buyers are located. Given that there is no cash flow between the service provider (Google in the US) and user-buyer (William in the UK), 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.[251]

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.[252] 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 promoting DST as a turnover tax.

C. Overcoming the Ring-Fencing Problem

The next issue to explore is how to overcome the limited scope of DST.

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[250] *See* Daniel Shaviro, *Goodbye to All That?: A Requiem for the Destination-Based Cash Flow Tax* 10, 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, 1:19 PM), https://www.forbes.com/sites/janetnovack/2017/03/29/eu-wrong-to-challenge-destination-based-cash-flow-tax/.

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

[252] Joseph Bankman, Mitchell Kane & Alan Sykes, *Collecting the Rent: The Global Battle to Capture MNE Profits*, TAX L. REV. 47 (forthcoming 2020).

The limited scope of DST 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 DST.[253] However, given that the revenue threshold requirements are necessary to sort the digital firms with monopoly power and subject them to DST,[254] it could be immature to expand the scope of DST by lowering the revenue threshold. Instead, this Subpart proposes to expand the scope of DST in order to overcome the ring-fencing problem.

In the UK DST, search engines, social media platforms, and online marketplaces are within the scope of DST, but certain regulated financial and payment services, the provision of online content, sales of software/hardware, and television or broadcasting services are excluded. Thus, Facebook, Twitter, YouTube, Google, Amazon Marketplace, Kayak, Priceline, Uber, and Airbnb are in scope, whereas PayPal, Netflix, Hulu, Spotify, and Ubisoft are excluded.[255]

The rationale of the current line drawn between the two groups is that the policymakers envision a fundamental difference between the two business models.[256] 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.[257] However, it is still unclear whether YouTube or LinkedIn are considered a social media platform that is subject to DST or a digital interface 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-

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[253] *See e.g.*, Mason & Parada, *Company Size Matters*, *supra* note 167; Mason & Parada, *Digital Battlefront in the Tax Wars*, *supra* note 167.

[254] *Supra* Part III.A.3.

[255] Cui, *supra* note 2, at 8–9.

[256] *See* HM TREASURY, BUDGET 2018 DST, *supra* note 71; *see also* HM TREASURY, CORPORATE TAX AND THE DIGITAL ECONOMY: POSITION PAPER 15–16 (2017), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/661458/corporate_tax_and_the_digital_economy_position_paper.pdf; HM TREASURY, DST, *supra* note 69, at 9–19, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/816389/DST_response_document_web.pdf

[257] Bankman et al., *supra* note 252, at 14–18.

fencing distinctions.

In order 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 advertisement.[258] While YouTube primarily derives revenues from the use of engagement advertisements,[259] it generates some non-advertising revenue through the means of YouTube subscriptions, such as YouTube Premium, YouTube TV, and Channel Membership.[260]

In contrast, Netflix is solely a content provider. Netflix is the largest internet entertainment service with over 167 million paid memberships, as of January 2020, throughout 190 countries.[261] Netflix offers digital content, such as feature films, television shows, and documentaries, which are either originally created by Netflix or licensed to Netflix from other studios.[262] Unlike other streaming services, Netflix does not offer any commercials and derives no revenue from paid advertisers.[263] 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,[264] whereas Netflix is solely a content provider.

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

[259] 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 28. YouTube's cost-per-click is lower than other Google platforms. *Id.*

[260] *Id*. at 32.

[261] Netflix, Inc., Annual Report (Form 10-K), at 1 (Jan. 29, 2020).

[262] *Id*.

[263] *Id*.

[264] YouTube Premium is one small section of YouTube's service. Also, YouTube intends to make its original content free to all users beginning in September 2019. Non-subscribers will be subject to advertisements.

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.[265] 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.[266] The Ad-Supported segment allows users similar access to content but is subject to advertisements.[267] In 2019, Spotify's Premium Service comprised 90% of its total gross revenue, earning approximately €6,086 million.[268] Spotify's Ad-Supported segment generated €678 million.[269]

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.[270] Additionally, both services pay content providers based on the success of the content on the platform.[271]

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

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

[266] *Id*. at 46.

[267] *Id*. at 47.

[268] *Id*. at 50.

[269] *Id*.

[270] Spotify, Spotify for Artists Terms and Conditions, Sec. 6 (Sep. 26, 2017), https://www.spotify.com/us/legal/spotify-for-artists-terms-and-conditions/; YouTube, Terms of Service (Dec. 10, 2019), https://www.youtube.com/static?template=terms.

[271] 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." Spotify Technology S.A., Annual Report (Form 20-F), *supra* note 265, at 55. Similarly, YouTube content owners can be compensated based on the number of views of their video. YouTube, YouTube Partner Earnings Overview, https://support.google.com/youtube/answer/72902?hl=en&ref_topic=9257988 ("Earnings are generated based on a share of advertising revenue generated when people view your video. More views may lead to more revenue") (last visited Feb. 16, 2020). Therefore, content owners both receive compensation from Spotify or YouTube, and thus have a financial interest in the content doing well on the service.

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 DST, 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 DST to reward market countries and the merits of DST for accomplishing such need, the ring-fencing problems should be addressed by eventually broadening the scope of businesses subject to DST. This may address the discrimination problem as well by subjecting many non-US digital firms, such as Spotify, to DST. Perhaps *Wayfair* would offer insight on this issue. The sales tax issue discussed in *Wayfair* also targets the digital economy, but the case has not involved 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.[272] The fact that one type of consumption tax, or DST, 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 DST is arbitrary and needs to be addressed.

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 DST a solution. However, DST is already widespread and considered the new status quo for taxing the digital economy. While the critiques of DST 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 the DST 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 21st century economy, which is different from the brick and mortar economy of the 20th century.

[272] *Supra* note 34.

Furthermore, the agenda also gives an opportunity to consider an updated debate on consumption tax versus income tax in the 21st century economy. This requires serious academic research for an extended period that this Article aims to start.