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"Digital Services Taxes and the Broader Shift from Determining the Source of Income to Taxing Location-Specific Rents"

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Week 5

SCHEDULE FOR FALL 2019 NYU TAX POLICY COLLOQUIUM
(All sessions meet from 4:00-5:50 pm in Vanderbilt 202, NYU Law School)

1. Tuesday, September 3 – Lily Batchelder, NYU Law School.
2. Tuesday, September 10 – Eric Zwick, University of Chicago Booth School of Business.
3. Tuesday, September 17 – Diane Schanzenbach, Northwestern University School of Education and Social Policy.
4. Tuesday, September 24 – Li Liu, International Monetary Fund.
5. Tuesday, October 1 – Daniel Shaviro, NYU Law School.
6. Tuesday, October 8 – Katherine Pratt, Loyola Law School Los Angeles.
7. Tuesday, October 15 – Zachary Liscow, Yale Law School.
8. Tuesday, October 22 – Diane Ring, Boston College Law School.
9. Tuesday, October 29 – John Friedman, Brown University Economics Department.
10. Tuesday, November 5 – Marc Fleurbaey, Princeton University, Woodrow Wilson School.
11. Tuesday, November 12 – Stacie LaPlante, University of Wisconsin School of Business.
12. Tuesday, November 19 – Joseph Bankman, Stanford Law School.
13. Tuesday, November 26 – Deborah Paul, Wachtell, Lipton, Rosen, and Katz.
14. Tuesday, December 3 – Joshua Blank, University of California at Irvine Law School.

DIGITAL SERVICES TAXES AND THE BROADER SHIFT FROM DETERMINING THE SOURCE OF INCOME TO TAXING LOCATION-SPECIFIC RENTS

Daniel Shaviro*

Preliminary Draft

Please don't quote or cite!

September 3, 2019

I. INTRODUCTION

In recent decades, a number of fantastically successful, mainly American, multinational entities (MNEs) – led and epitomized by the "Four Horsemen," Apple, Amazon, Facebook, and Google[1] – have risen to global economic hyper-prominence. While their market capitalizations and profits are high, reflecting that they earn substantial rents or quasi-rents,[2] their aggregate global taxes are generally quite low, reflecting their ability to create stateless income.[3]

Often, these MNEs are technology companies, like the Four Horsemen – but not always. Starbucks, for example, enjoys high global profits and low taxes despite its following a "classic brick-and-mortar retail business model."[4] This reflects that, like its more obviously high-tech peers, it relies on valuable intellectual property (IP), pertaining here in particular to its

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[1] See, e.g., Scott Galloway, THE FOUR: THE HIDDEN DNA OF APPLE, AMAZON, FACEBOOK, AND GOOGLE (2017). Other prominent examples of U.S. companies, often with digital platforms or other online presence, include Microsoft, AirBnb, Uber, Netflix, PayPal, Spotify, EBay, Expedia, Youtube, and Starbucks. [ETC]. [And can note that 8 of the top 10 companies in the world by market capitalization are American.

[2] Joseph Bankman, Mitchell Kane, and Alan Sykes, *Collecting the Rent: The Global Battle to Capture MNE Profits* 2 (2018) (footnote omitted). The authors note that quasi-rents differ ex ante from rents in that they require investment under what may be at least somewhat competitive market conditions.

[3] See, .e.g., Edward D. Kleinbard, *The Lessons of Stateless Income*, 65 Tax L. Rev. 99 (2011).

[4] Edward D. Kleinbard, *Through a Latte, Darkly: Starbucks's Stateless Income Planning*, Tax Notes, June 24, 2013,

"trademark and expertise and synergies in its worldwide operations."[5] Such assets are invaluable with respect to creating both global pretax profitability and stateless income.

While leading MNEs' success in either of these two realms might have sufficed to draw them widespread and not wholly favorable attention, the combination was bound to yield calls for pushback. Purely as a matter of instrumental rationality, "[g]overnments have an interest in capturing … rents for their citizens or national treasuries."[6] However, the rise of globally untaxed MNE rents also has strong symbolic valence, especially coming after the 2008 financial crisis, subsequent fiscal austerity, other controversies surrounding some of these firms,[7] and the rise of high-end inequality.

Pushback by tax authorities has focused more directly on stateless income than on rents – reflecting their subject matter jurisdiction and expertise, rather than any considered social judgment as to which is the more important issue. Leading efforts and proposals to date can conveniently be divided into three main categories. First, the OECD, both in its 2013-2016 Base Erosion and Profit-Shifting (BEPS) project[8] and subsequently,[9] has aimed to organize coordinated global action towards requiring that MNEs report their profits where "value creation" occurred.[10] Second, a number of leading tax policy experts have advocated assigning the right to tax MNE profits to market countries where gross revenues arise, rather than to production countries such as those where IP was developed – based on claims about good policy,

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[5] Bankman, Kane, and Sykes, supra, at 17.
[6] Id. at 2.
[7] E.g., note antitrust and misuse of information controversies re. Facebook etc.
[8] See, e.g., OECD/G20 Base Erosion and Profit-Shifting Project, *Addressing the Tax Challenges of the Digital Economy, Action 1: 2015 Final Report* (2015).
[9] See, e.g., OECD, *Public Consultation Document: Addressing the Tax Challenges of the Digitalisation of the Economy*, 13 February – 6 March 2019.
[10] OECD, etc. cites.

not semantic parsing of the term "value creation."[11] Third, a number of market countries have adopted, or are considering, novel tax instruments, such as digital services taxes (DSTs) and diverted profits taxes (DPTs) that aim to raise revenue from large MNEs with particular business models.

DSTs to date[12] have generally been gross receipts taxes, targeting large companies (such as Facebook and Google) that (1) use digital platforms, (2) have two-sided business models, such as by reason of their offering advertisers targeted, data-rich access to users / consumers, and (3) feature relatively active user participation (e.g., posting on Facebook, rather than merely viewing content on Netflix).[13] So far as the enterprise of taxing LSRs is concerned, however, the third of these factors lacks policy relevance, and the first two are only indirectly relevant, in particular to the choice of tax instrument. This suggests the possibility that the rationale for seeking to tax LSRs, via instruments that are tailored to particular industries, may potentially extend more broadly – both within the digital sector and beyond it.

One of this paper's main arguments is that DSTs, despite their mainly bad press,[14] have promise, not just in themselves, but as a model for broader rethinking of international tax policy. They clearly raise dangers of chaotic collective over-taxation, but it is not clear that these dangers outweigh those of sub-optimally low global taxation of MNE rents. So countries that rationally pursue their fiscal self-interest with regard to taxing LSRs – possibly in the face of

[11] See, e.g., Reuven S. Avi-Yonah, Kimberly A. Clausing, and Michael C. Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, U. Mich. Law School, Public Law and Legal Theory Working Paper Series, No. 138 (2008); See Michael P. Devereux et al, *Residual Profit Allocation by Income*, Oxford International Tax Group Working Paper 19/01 (2019).

[12] In section IV.B, infra, I discuss in particular the recently announced UK DST, which is scheduled for enactment in the Finance Bill 2019-20 (subject, presumably, to the broader short-term uncertainties in UK politics).

[13] See section IV infra for further discussion of what these criteria mean.

[14] See Wei Cui and Nigar Hashimzade, *The Digital Services Tax as a Tax on Location-Specific Rent* 2 (2019). Cui's work is a key exception that deserves broad attention.

strategic and political economy pressures not to do so – should not be viewed as harmful outlaws or norm-breakers.

More broadly, this paper's main conclusions include the following:

1) The OECD-led push for placing greater emphasis on "value creation" – As many have recognized, value creation is an ambiguous term,[15] in particular as between production countries (including those where valuable IP was developed), and market or consumption countries from which the MNEs derive gross revenues. To illustrate this key distinction in an extremely simple fact setting, suppose that I never leave New York City, but write novels in Tagalog that I sell directly to people in the Philippines (and no place else). Here the United States is the production country, and the Philippines is the market country. Both countries can reasonably claim tax nexus – whereas, say, Brazil and Germany cannot – if source requires only an adequate degree of connection between the taxing country and the taxed activity.[16] But if countries are only taxing domestic source *income*, then only the United States has a proper claim under what I call a production-based view of the source of income, and only the Philippines has a proper claim under what I call a consumption or market-based view.[17]

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[15] Critics of the value creation standard who note its ambiguity include, for example. Allison Christians, *Taxing According to Value Creation*, 90 Int'l Tax Notes 1379 (2018); Michael Devereux and John Vella, *Are We Heading towards a Corporate Tax System Fit for the 21st Century?*, 35 Fiscal Studies 449, 452 (2014; Devereux and Vella, *Value Creation as the Fundamental Principle of the International Corporate Tax System* (2018); Itai Grinberg, *International Taxation in an Era of Digital Disruption: Analyzing the Current Debate* (2018); Mindy Herzfeld, *The Case Against BEPS: Lessons for Tax Coordination*, 21 Fla. Tax Rev. 1 (2017); Johanna Hey *"Taxation Where Value is Created" and the OECD/G20 Base Erosion and Profit-Shifting Initiative*, 72 Bulletin for International Taxation (2018); Susan Morse, *Value Creation: A Standard in Search of a Process*, 72 Bulletin for International Taxation (2018); and Wolfgang Schön, *One Answer to Why and How to Tax the Digital Economy*, Max Planck Institute Working Paper 2019-10 (2019).

[16] See, e.g., 1 RESTATEMENT OF THE LAW (Fourth) FOREIGN RELATIONS LAW OF THE UNITED STATES § 402(1) (AM. LAW INST. 2018), asserting that United States jurisdiction to prescribe law with respect, inter alia, to (a) persons, property and conduct within its territory, (b) conduct that has a substantial effect within its territory, and (c) its citizens and residents when outside its territory.

[17] I am abstracting here from such operative concepts in existing international income tax law as the requirement of a permanent establishment

In effect, the OECD's aim in this scenario is to ensure that only the United States or the Philippines could tax the income from my book sales, without necessarily specifying which one should get to do so. Much of its discussion of value creation has a production-based flavor[18] – along, perhaps, with an implication that the location of productive "brains" may matter more than that of mere "hands."[19] However, OECD publications have also stated, for example, that "value creation in the *user/market jurisdiction* … is not [properly] recognised in the current framework for allocating taxing rights and taxable profits."[20] So the OECD has certainly not foreclosed taking an at least partly market-based view of value creation, although the degree to which its framework might support doing so is unclear.

Such ambiguity may aid in the creation of short-term consensus with respect to addressing stateless income.[21] As an organizing approach (or at least a battle cry), value creation has the distinct, if limited, advantage of providing a "negative source rule."[22] Thus, with respect to taxpayers, it can be invoked to rebut claims that profits arose in tax havens,[23] impeding the creation of stateless income. With respect to governments, it might help to prevent the rise of what I call "Monty Python taxation," exemplified by the bowler-hatted man who, in an episode of the famous British TV show's episodes, states: "To boost the British economy I'd tax all foreigners living abroad."[24]

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[18] See, e.g., Hey, supra, at 203 ("It is likely that, in a location where ... [an MNE] exercises real economic activity, some value is created"); Morse, supra, at 2 ("Value creation …. is roughly in line with the idea of benefit taxation …. [and p]resumably a corporation receives public spending benefits in jurisdictions where its employees are located").

[19] See Schön, supra, at 7; Christians, supra, at 1381.

[20] OECD, *Public Consultation Document*, supra, at 9 (emphasis added).

[21] See, e.g., Christians, supra, at 1383; Schön, supra, at 6.

[22] Adolfo Martín Jiménez, *BEPS, the Digital(ized) Economy, and the Taxation of Services and Royalties*, University of Cadiz Tax Working Papers 2018/1 at 5 n. 6 (2018).

[23] See Schön, *supra*, at 6.

[24] Daniel Shaviro, *Taxing Potential Community Members' Foreign Source Income*, 69 Tax L. Rev. 1, _ (2015).

Monty Python taxation – or that lacking a requisite connection to the taxing jurisdiction, and thus making possible a global free-for-all – has not to date been a significant international tax policy problem. It might conceivably become more so in the future, as countries respond unilaterally to stateless income and/or the tax-elusiveness of MNE rents and quasi-rents. However, the notion of taxing only one's own LSRs offers a potential (if imperfect) coordinating device that is independent of value creation. Moreover, we do not yet know whether global over-taxation or under-taxation of such items is likely to prove the more serious problem.

Despite value creation's possible short-term advantages, it bodes ill over a longer timeframe for resolving hard and contentious tax base choices. It revivifies, without making resolvable, longstanding disputes regarding what the geographical "source of income" means[25] – in particular, as between the production and market countries for particular MNE profits. In addition, the semantic debates that it encourages are ill-suited for focusing attention on issues of genuine normative interest, such as that of identifying LSRs.

2) Assigning MNE tax base to market countries – As noted above, a number of leading tax policy experts have advocated assigning the right to tax MNE profits to market countries, rather than to production countries. This would be the result, for example, of adopting either sales-based formulary apportionment for the profits of global MNE groups,[26] or largely sales-based residual profit allocation as between their affiliates.[27] Sales to consumers would also govern the allocation of tax base if value-added taxes (VATs) replaced origin-based corporate income taxes, as would happen under the so-called destination-based cash flow tax (DBCFT).[28]

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[25] See, e.g., Hugh J. Ault and David F. Bradford, *Taxing International Income: An Analysis of the U.S. System and Its Economic Premises*, in Assaf Razin and Joel Slemrod (eds.), TAXATION IN THE GLOBAL ECONOMY (1992); Mitchell Kane, *A Defense of Source Rules in International Taxation*, 32 Yale J. Reg. 311 (2015).
[26] See, e.g., Reuven S. Avi-Yonah, Kimberly A. Clausing, and Michael C. Durst, supra.
[27] See Michael P. Devereux et al, *Residual Profit Allocation by Income*, supra.
[28] For a discussion of DBCFT proposals, see Daniel Shaviro, *Goodbye to All That? A Requiem for the Destination-Based Cash Flow Tax*, 72 Bulletin for Int'l Taxation No. 4/5 (2018).

All of these proposals aim to increase efficiency and reduce the efficacy of MNE tax planning, rather than to favor market countries as an end in itself, but their distributional effects as between differently situated countries are unlikely to escape notice by interested policymakers.

We will see that, while such proposals have significant advantages, their efficacy might anomalously vary with the particular business model of an MNE or industry. Starbucks, for example, ineluctably has consumer sales in high-tax countries, both because it offers coffee rather than free access to a digital platform (like Facebook or Google), and because it happens to prefer operating its own stores to licensing third party franchisees. Accordingly, under sales-based formulary apportionment or residual profit allocation, Starbucks might face higher taxes in consumer jurisdictions than either digital companies or (in the income tax versions) a hypothetical peer company that was similar except for making greater use of franchisees and third party intermediaries.[29]

While this problem would not arise under VATs / DBCFTs,[30] those taxes may also apply unequally across business models. For example, Facebook and Google do not charge users for access to their digital platforms. This reflects that, under their two-sided business model, they can price below marginal cost on one side and make up the difference on the other side.[31] Accordingly, the revenues that Facebook and Google derive by reason of offering their digital platforms within a given jurisdiction may escape a conventionally structured VAT / DBCFT.[32]

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[29] See Devereux et al, supra, at 65-69 (describing the problem, and noting that it would not arise if third party sales could be traced through to the ultimate consumers).

[30] Under a DBCFT / VAT, source country tax liability depends purely on the price to the consumer (minus domestically incurred business outlays), without regard to the MNE's worldwide profits or the amount paid to import the consumer good. See infra.

[31] See, e.g., Wei Cui, *The Digital Services Tax: A Conceptual Defense* 3-4 (2019).

[32] Another well-known problem with respect to imposing uniform tax burdens across industries relates to taxing the financial sector. VATs typically exclude financial flows, thereby missing the embedded service fee that intermediaries such as banks earn – for example, by paying depositors lower interest rates than those charged to borrowers. [Cite, e.g., Bradford, Toder-Viard, and Weisbach re. this issue under the X-tax.]

But even when this is not an issue, a standard VAT / DBCFT does not permit taxing inbound LSRs at a higher tax rate than that which it applies to domestic consumption generally – potentially an important and undesirable constraint.[33]

In sum, while sales-based proposals have clear virtues, they are limited in their capacity both to achieve comparable effectiveness across MNE business models and to reach MNE rents to the extent that the governments in market countries might prefer. Meanwhile, general adoption of this approach would require production countries, along with MNE residence countries, to accede potential tax base to sales jurisdictions right off the bat, possibly contrary to their preferences and interests. Thus, even if one prefers one or more of the sales-based approaches both to present law and to the OECD's value creation initiatives, one might still want to consider adopting additional tax or other instruments that are aimed at MNE rents and stateless income.

3) More ad hoc and targeted approaches – This brings us to the third category of approaches – generally the most controversial among both tax experts and American policymakers. Their common theme is identifying particular types of MNEs to face novel tax instruments, such as DSTs and DPTs, that either expressly or in practice do not apply to businesses generally.[34]

DSTs' (and similar instruments') tailoring raises the concern that they will "create inequitable treatment between firms,"[35] along with seemingly inefficient tax bias. Criticism also

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[33] See Bankman, Kane, and Sykes, *supra* at 30.

[34] One might also view this category as including the recent EU state aid cases, in which the European Commission (EC) used a novel legal theory to challenge favorable transfer pricing and other agreements that member countries had offered to the likes of Amazon, Apple, Fiat, and Starbucks. See Daniel Shaviro, *Friends Without Benefits? The Treasury and EU State Aid*, 83 Int'l Tax Notes 1067 (2016). The analogy between these cases and the likes of newly enacted DSTs is admittedly imperfect, as the former (1) on their face merely applied generally applicable existing law, and (2) were viewed by critics as unduly ex post, given the claimed difficulty of anticipating that the EC would thus act.

[35] Congressional Research Service, *Digital Service Taxes (DSTs): Policy and Economic Analysis*, Summary (2019).

reflects such particular features of DSTs as their typically being gross receipts or turnover taxes[36] – typically a poor tax design.[37] However, I will argue – drawing on recent work by Wei Cui,[38] and by Joseph Bankman, Mitchell Kane, and Alan Sykes[39] – that there are special reasons why using properly designed DSTs and similar instruments is reasonable.

For example, as Cui notes,[40] the standard criticism of gross receipts or turnover taxes loses force with respect to DSTs insofar as a given MNE has low (or even zero) marginal costs of operating – say, through a generally available digital platform – in the taxing jurisdiction. Indeed, under such circumstances, a gross receipts tax might even come closer than a highly manipulable net income tax to identifying the true net revenue increase that an MNE anticipated by reason of its deciding to target a particular jurisdiction.[41]

Moreover, as Bankman, Kane, and Sykes note, whereas broadly applicable VATs are in some respects ill-suited to pursue MNE rents, a sales jurisdiction may benefit from "us[ing] excise taxes selectively in industries where … it suspects the presence of substantial MNE rents, and where it has sufficient leverage to extract rents.[42] They rely on the modern "strategic trade" literature, which shows that, in imperfectly competitive markets, market countries can use tax and other instruments, such as "optimal tariffs," to capture rents for themselves.[43]

[36] But note the UK DST, section 10(2) and (4), specifying certain "relevant operating expenses" that are allowable in group calculations under section 9.
[37] See id. (stating that, by reason of their being turnover taxes, "DSTs are likely to have the economic effect of an excise tax on intermediate services," and to be more regressive than corporate profits taxes).
[38] Cui, supra.
[39] Bankman, Kane, and Sykes, supra.
[40] See Cui, supra, at 26-27.
[41] Obviously, extending the DST concept to non-digital firms, such as a Starbucks, would require allowing deductions for such clear marginal costs, at least when paid to third parties, as rent, electricity, local advertising, employee salaries, and the cost of the beans used to make coffee. See section IV, infra.
[42] See Bankman, Kane, and Sykes, supra, at 46. The full quotation also suggests targeting sectors where import penetration is high. However, rents enjoyed by domestic individuals may likewise be worth taxing, albeit for somewhat distinct reasons, as I discuss in part III, infra.
[43] Id. at 41. As Bankman, Kane, and Sykes also note, the best-suited tools for addressing LSRs are not always tax instruments.

DSTs can function, albeit imperfectly, as optimal tariffs. Moreover, while classic optimal tariffs exploit the market jurisdiction's monopsony power to impose global welfare losses that exceed the local distributional gain – as well as inviting retaliation in kind – both the global efficiency analysis and that concerning strategic retaliation have the potential to be relatively benign in the case of MNEs' LSRs.

While I will treat DSTs as a prime example of the third type of approach, I will not here closely examine their varying details in particular versions, or rate them against rival instruments (such as withholding taxes) that have been proposed.[44] Instead, after offering some context by describing the recently emergent UK DST (which generally follows a model proposed by the European Commission), I will step back and examine the big picture regarding the shift that DSTs may betoken – including by reason of their basing tax nexus, not on the claimed existence of domestic source income (DSI), but rather on that of "significant economic presence,"[45] treated as a nexus requirement that can be met whenever a foreign taxpayer "participate[s] in the economic life of a country in a regular [or "purposeful"] and sustained manner"[46] – for example, via high-volume remote sales.

This article's main takeaways, for readers with distinct perspectives, include the following:

1) Non-U.S. policymakers and commentators – I will argue that there is nothing greatly objectionable going on when market countries prioritize their own residents' welfare by taxing LSRs that U.S. MNEs are earning with respect to their residents – often without facing significant U.S. taxation. However, it is important from a global welfare standpoint that such

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[44] Cite for withholding tax proposals?
[45] OECD/G20 Base Erosion and Profit-Shifting Project, *Addressing the Tax Challenges of the Digital Economy, Action 1*, supra, at 102.
[46] *Id.* at 107.

countries seek to reach only their own (reasonably defined) LSRs, rather than engaging in Monty Python taxation of those arising in other countries. The limits to tax nexus ought in principle to address this concern, but in practice it is too soon to tell how well this will work out.

Two further important points that non-U.S. policymakers should keep in mind are as follows. First, there is no need to focus on irrelevant issues such as whether their own residents are ostensibly "creating value" – such as by writing Facebook posts (for which Facebook does not pay them), as distinct from merely screening Netflix movies or buying Starbucks Frappuccinos. The national and global welfare issues raised by DSTs and other efforts to reach LSRs are little if at all affected by such distinctions.[47]

Second, it would be prudent, as well as benign, for market countries to avoid unduly fostering the perception that they are targeting U.S. MNEs. Perhaps no one can truly ignore the elephant in the room – i.e., the fact that, at present, so many of the world's leading MNEs are U.S. companies – and no one should really expect this not to affect countries' calculations. But demonstrating a reasonable degree of good faith could greatly ease the path to general acceptance of a regime in which MNE profits are less globally tax-favored than they were at the peak of the stateless income era.

2) U.S. policymakers and commentators – Even without suspected targeting of U.S. MNEs in particular, Americans may reasonably prefer that other countries *not* tax the rents that these companies (owned primarily by American individuals) are earning through sales in foreign markets. All else equal, the United States is better off if its people retain a greater, rather than a lesser, pre-U.S. tax share of total global wealth.

[47] Hence, e.g., in the March 2019 OECD release on digitalization of the economy, the user participation and marketing intangible proposals are too narrow.

But there is a difference between preferring that peer countries not impose taxes that one's own residents might bear, and viewing this as sufficiently offensive to call for retaliation. As I noted with regard to the recent EU state aid cases, "the extent to which the other side is acting reasonably and in good faith (even if self-interestedly) … may affect one's own choice of strategic stance."[48] Surely Americans might likewise want to tax rents that foreign-owned MNEs earn in the domestic market, if that were the main direction of such activity. Indeed, given that the day may come when the roster of enormously successful MNEs is not so U.S.-centric, Americans might at some point benefit from a functioning international regime in which inbound rents can regularly be reached.[49] All this argues in favor of a circumspect American response to DSTs and similar instruments that would predominantly reach U.S. companies – especially in an era of generally rising global discord, and in which American leaders appear to have set about systematically weakening important alliances and alienating non-authoritarian peer countries.

3) The global welfare perspective – The state of play in which highly profitable MNEs were generating substantial globally untaxed stateless income was both undesirable and unlikely to be politically stable. MNEs were being inefficiently tax-favored relative to other businesses – whereas, to the extent that they had greater rents, they ought, from both an efficiency and a distributional standpoint,[50] to have been *more* highly taxed. Nor, even without the red flag of anti-Americanism, were people in countries around the world, facing anxiety and austerity in the aftermath of the 2008 financial crisis, likely to deem it just fine that foreign MNEs' creative destruction was being so little accompanied by significant taxpaying.

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[48] Shaviro, *Friends Without Benefits?*, supra, at 1075.

[49] Cf. patent and copyright protection, as to which Americans were notorious pirates in the nineteenth century but now are global champions.

[50] MNE founders as billionaires, etc.

The optimal response to the rise of stateless income and MNE rents would surely be globally coordinated. However, such coordination is costly, and it may be slow to emerge, if it does at all. Neither leading MNEs nor the United States government can be counted on to help accelerate agreement to a coordinated global solution. In the interim, the use of novel tax instruments by market countries, in lieu of their patiently waiting for something to happen at the global level, is both understandable and reasonable.

The rest of this paper proceeds as follows. Section II discusses value creation, section III discusses taxing LSRs, section IV discusses DSTs and possible extensions thereof, and section V offers a brief conclusion.

II. VALUE CREATION: WHAT IS IT, IS IT THE ANSWER, AND IF SO THEN WHAT IS THE QUESTION?

A. A New Concept, or an Old One?

The OECD's value creation principle holds that "corporate profits are [and should be] taxed where value is created."[51] Its promulgation reflected the view that "[n]o or low taxation" of MNEs' cross-border activity becomes "a cause of concern … when it is associated with practices that artificially segregate taxable income from the activities that generate it."[52] Imposing tax where value actually was created would, almost by definition, prevent such separation. It also would be expected to increase taxation of MNEs' profits, if countries where significant income-generating activities can readily occur – unlike those that are more suited to hosting shell companies and incorporated cash boxes – tend not to be tax havens.

Such a focus on value creation involves making three closely linked claims. The first is that a geographical source concept with respect to income or profits is economically meaningful. The second is that existing source rules sufficiently implement this concept to suggest that it lies at their core aspirationally, even if they do not always fulfill it. The third is that source rules can and should be revised to match the site of value creation more accurately than they do at present.

While OECD BEPS publications treat value creation as a generally accepted approach to international tax law and policy,[53] critics call it a "brand new standard,"[54] albeit only in the sense

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[51] Michael Devereux and John Vella, *Value Creation as the Fundamental Principle of the International Corporate Tax System* 1 (2018). Devereux and Vella note that it was "articulated and put center stage in the Base Erosion and Profit Shifting (BEPS) project led by the G20/OECD between 2013 and 2015," *id.*, lying at the heart of Phase One.
[52] OECD, *Action Plan on Base Erosion and Profit Shifting* 10 (2013). For an example of the value creation principle's also being cited by the OECD in response to what I call Phase Two developments, *see, e.g.,* OECD/G20 Base Erosion and Profit Shifting Project, *Addressing the Tax Challenges of the Digitalisation of the Economy, Public Consultation Document* 6-8 (13 February-6 March 2019).
[53] See, e.g., [OECD BEPS cites].
[54] Herzfeld, supra, at 42. See also *Schön, supra, at 5.*

of adding the "overlay of a new 'substance' requirement over the existing system."[55] In disputing whether value creation is a familiar approach or a novel one, both sides have a point. Its relative familiarity versus novelty depends on which of the above three claims one emphasizes.

The first two claims, concerning existing source rules' relationship to the true economic source of income, are long-familiar, albeit controversial. They simply restate a well-known set of premises regarding the putative underpinnings of the generally accepted principle which holds that, when a country purports to be taxing "income," only nonresidents' DSI from that country's standpoint, not their foreign source income (FSI), is properly reachable.[56] This inherently relies on a notion of geographic source, especially if rationalized on a view that the benefits provided locally to or on behalf of the taxpayer help to justify the source-based tax.[57] And while the third claim is on its face a call for legal change, value creation's critics often agree with its proponents that the rise of stateless income calls for significant change of *some* kind.

Source-based taxation was bound to become more challenging in recent decades, as both real activities and financial flows became ever more mobile, and with the rise of intangible assets as sources of economic value. Why, then, double down on it? The OECD's answer would appear to be twofold. First, it makes sense to work as best one can with the regime that is already in place, and the existing regime relies on source rules. Second, unforced and fixable errors in the particulars of prevailing source rules caused their deterioration to be greater than it needed to be. Thus, addressing those errors might yield significant improvement with respect to addressing the rise of stateless income.

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[55] *Id.* at 42 n. 135, citing Michael Devereux and John Vella, *Are We Heading towards a Corporate Tax System Fit for the 21st Century?*, supra, at 452.
[56] See, e.g., Reuven Avi-Yonah, ADVANCED INTRODUCTION TO INTERNATIONAL TAX LAW (2nd edition) 3 (2019).
[57] See, e.g., Robert **A.** Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 Cornell L. Rev. 18 (1993); Mitchell Kane, *A Defense of Source Rules in International Taxation*, 32 Yale J. Reg. 311, 314-15 (2015).

These arguments rely in particular on two key doctrinal aspects of the longstanding international tax regime: (1) the principle of arm's length transfer pricing (ALTP) as between related entities in affiliated corporate groups, and (2) bilateral tax treaties' permanent establishment (PE) requirement for taxing nonresident companies on a source basis. Each of these two doctrines had conceptual problems from the start, but rising mobility and intangibles magnified their difficulties more than just those of "source" writ large. We can start, however, with the question of what the source of income, or site of value creation, means to begin with.

B. The Meaning of Source: Is There a There There?

In the Tagalog book example, my income from writing and selling the books had only two possible sources: the United States under a production-based view, and the Philippines under a market-based view. One could easily alter the example to leave just one possible source. For example, if I grow vegetables in a New York City rooftop garden and sell them for cash to my neighbor, who cooks them for dinner, the income is U.S. source under either view.

The existence of such clear-cut cases is in tension with Hugh Ault's and David Bradford's well-known argument that "the source of income is not a well-defined economic idea."[58] In their view, if income, by definition, "attaches to someone or something that consumes and that owns assets," then it "does not come from some place, even … [if we] keep track[] of payments that have identifiable and perhaps locatable sources and destinations."[59] Thus, *my* economic income under the Haig-Simons definition[60] accrues to *me*,[61] rather than to any

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[58] Ault and Bradford, supra, at 30.
[59] Id. at 31.
[60] See Henry Simons, PERSONAL INCOME TAXATION 50 (1938), defining economic or Haig-Simons income as the sum of the market values of the taxpayer's consumption and change in net worth during the relevant accounting period.
[61] Ault and Bradford accept applying the Haig-Simons definition to corporations, even though legal entities cannot themselves experience utility, on the view that the analog of personal consumption **is** distributions to shareholders. See Ault and Bradford, supra, at 32.

locations where particular transactions occurred, and thinking about income in source terms would appear to involve a "category mistake."[62]

Yet why is it non-economic to think of income as arising where the relevant people, assets, or activities were when it arose? Calling my hypothetical vegetable garden income U.S. source seems less a category mistake than the product of invoking a classification metric that is orthogonal to, but not in tension with, the Haig-Simons definition of economic income.

The problems that Ault and Bradford have in mind are real enough, but somewhat narrower. They fall into two categories. The first is that of choosing between production-based and market-based views of source. The second is that of applying either view in circumstances where its logical implications are not so clear.

<u>Production-based or market-based?</u> – When a seller in Country A finds a buyer in Country B, can we say where the seller's income – that is, the excess of the sale price over its cost – actually arose? We have at this point a semantic question, not necessarily one about good policy. That is, we are asking what a term in common usage logically means. This is not equivalent to asking how it might best be taxed from either a global welfare standpoint, or that of a particular country.

A first approach might be to ask where the income actually arose in a causal sense. Unfortunately, however, in a standard price theory framework, the realization of any profit depends on both supply and demand. The point of intersection between the supply and demand curves presumably determines the market price, and therefore any participant's surplus given its

[62] Kane, supra, at 316. Kane in effect demurs to the Ault-Bradford argument, responding that the source of income is a legal concept, not an economic one, serving to aid countries in deciding how to allocate the global tax base among themselves.

cost or disutility on the supply side, or its subjective utility on the demand side.[63] Thus, both sides were necessary for transactional surplus to arise. If production occurred in one country and consumption in another, then asking which side gave rise to the profit is akin to asking, in Ronald Coase's famous torts hypothetical, whether a train spark's burning a wheat field was the railway's fault or the farmer's.[64] The two together generated the outcome.

Now suppose that, in keeping with the view that benefit principles underlie source-based taxation, we ask ourselves which government played a critical role in permitting the producer's share of the joint surplus (i.e., its profit) to arise: that in the production country, or in the source country. Unfortunately, however, we are still in Coase territory. When a seller in Country A finds a buyer in Country B, both countries' governments may have helped to create the preconditions for transactional surplus. For example, government-funded roads and education may have helped both to reduce production costs in Country A, and to increase consumer demand in Country B.

Another approach might be to try to derive the answer from the character of the tax base. Arguably, the fact that we are sourcing income, under fiscal instruments called income taxes, supports a production-based view. After all, the producer is the party that takes actions directed at realizing the profits that are then taxable to it. By this logic, however, if we converted existing income taxes into consumption taxes, as has frequently been proposed,[65] then, all of a sudden, properly determined "source" would shift to the consumption jurisdiction.[66]

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[63] See, e.g., Johannes Becker and Joachim Englisch, *Taxing Where Value is Created: What's "User Involvement" Got to Do With It?*, 47 Intertax 161 (2019).
[64] See Ronald H. Coase, *The Problem of Social Cost*, 3 J. Law & Econ. 1 (1960).
[65] See, e.g., Shaviro 2004 and 2018b.
[66] Note, however, that, while consumption taxes are typically done on the destination basis, they can also be done on the origin basis. E.g., Bradford's X-tax and Carroll-Viard

There are reasons for doubting that tax instruments' labels should so dictate the result. For example, existing "income" taxes frequently have significant consumption tax-type features – such as allowing expensing for capital outlays, and deferral of returns to saving under multiple circumstances. In addition, the central question in the vast literature debating the relative merits of income and consumption taxation – how to treat savings that imply deferred consumption – has little, if any, discernible relationship to the inter-nation tax base allocation question. Why, for example, should the question of how particular U.S. or Philippine tax instruments treat savings for deferred consumption, relative to immediate consumption, be thought to predetermine the question of which country can claim source jurisdiction with respect to the profits from my cross-border book sales?

Another approach would proceed from the view that source rules are simply a device for achieving consensus between countries regarding allocation of the global tax base,[67] such that (under the "single tax principle") each dollar of a given MNE's profits is taxed exactly once.[68] Hence, perhaps the right question to ask is not which view stands on stronger logical ground, but which can better fulfill this underlying purpose. Unfortunately, however consensus may be hard to generate under either view, given countries' disparate interests.

Throughout the history of the corporate income tax, there has been a divide between countries that are primarily exporters, and those that are primarily importers, of MNEs' products. This is distinct from their status as net exporters or importers overall. The United States, for example, although in today's global economy a huge net importer of both capital and consumer goods, is the home base for a disproportionate share of the world's leading MNEs. The Four Horsemen and many of their American peers are not just U.S. residents for corporate income tax

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[67] See, e.g., Kane, supra, at 361.
[68] See Avi-Yonah, supra, at 5-6.

purposes, but firms whose high-value, often stock-compensated, employees work mainly in the United States on creating and maintaining the IP that underlies the firms' global profitability.[69]

Accordingly, when market countries seek to tax the rents that these MNEs earn from sales to their own residents, they are going after income that is largely U.S. source under a production-based view – even if not so treated for U.S. federal income tax purposes[70] – but rightfully within their reach under a market-based view. This elephant in the room makes it difficult for policymakers from different countries disinterestedly to agree about whether income should be defined in such a way say, the Four Horseman should pay tax predominantly in the United States (if at all), or in market countries where they generate substantial revenues.

Divergent national interests thus impede finding consensus semantic paths out of the value creation maze. The term appears not to offer grounds based either on internal logic, common usage, or ready agreement for determining whether the income from cross-border commerce should be attributed to production countries or market countries. Further interpretive problems arise, however, even if one definitively chooses either view.

<u>Lack of clear answers under a production-based view</u> – Even if one settles on adopting a purely production-based view of value creation, the source concept often fails to offer helpful guidance. Consider the difficulty of sourcing passive income, such as interest earned on debt and dividends paid on portfolio stock. In practice, such income is typically sourced based on the payor's tax residence, but this is widely recognized as formalistic.[71] Likewise, when an MNE earns economic returns in multiple jurisdictions, it can be hard or impossible to specify the

[69] See, e.g., discussion infra of the "Starbucks Experience."
[70] E.g., could note cost-sharing rules and the EU state aid cases.
[71] See, e.g, Devereux and Vella, *supra*, at 4. A more substantively oriented approach might focus on where the underlying funds earned (or were expected to earn) the return that permitted the payment of interest or dividends. This, however, would be challenging inquiry given the fungibility of money.

"correct" geographical treatment of costs that support its operations more broadly (such as headquarters expense) or that involve fungible inputs (such as the interest paid on loan capital).[72] In all such cases, formalism necessarily prevails, often with the consequence of giving MNEs tax planning opportunities to the detriment of both production and market countries.

Another set of problems concerns cross-border synergies. Suppose that a particular MNE combines a pair of affiliates in different countries, each bringing unique attributes to the table. For example, say that Acme's U.S. and French affiliates would each have earned $75 if operating separately, but that they actually earned $250 in total, by reason of the unique synergies made possible by their joint ownership. In this scenario, where did the $100 of synergy profits arise?

Suppose we think of this as an ALTP issue, given that the owners of Acme-US and Acme-France (if unrelated) would each want as large a share of the synergy profits for themselves as possible. Then one needs to determine how they would have agreed to split the bilateral monopoly profit that they can only realize by cooperating. Unfortunately, bilateral monopoly negotiating problems generally lack clear answers. Their outcomes can depend on the parties' relative bargaining power, strategic judgments, and other idiosyncratic factors that are hard to specify in a generalized hypothetical.[73]

<u>Lack of clear answers under a market-based view</u> – Market-based sourcing rules often give clearer answers than those that are production-based. Thus, suppose a given consumer good is produced in stages across five countries, and then is consumed by an individual in a sixth country. A production-based view requires untangling the value added in each country during the

[72] For interest expense, if one wants to be more sophisticated than simply tracing the use of particular funds, one might consider allocating interest expense pro rata to something – for example, assets or gross income. U.S. income tax rules for interest allocation or apportionment often use such approaches. Such an approach does not, however, accurately track the marginal use of funds, in a case where extra loan capital would fund particular operations, not the MNE's cash needs in general.
[73] Cite.

production process. A market-based view faces no such difficulties. It may, however, depending on its structure, face such problems as (1) distinguishing between personal consumption and the use of items as business inputs, (2) determining whether an intermediate sale breaks the chain between a producer and the ultimate consumer, (3) distinguishing between product lines, if relevant to a given rule's application,[74] and (4) evaluating physical presence or other (such as "significant economic presence") grounds for asserting tax nexus, if treated as a prerequisite to taxing the nonresident producer.

C. Arm's Length Transfer Pricing (ALTP) and Permanent Establishment (PE) Requirements

The difficulties both of choosing between production-based and market-based approaches to the source of income, and of applying the former approach in particular, are not new to international taxation. They have been muddled through for decades, and only the rise of global production and capital mobility, and of the relative importance of IP, have created the sense of urgency that underlies OECD efforts. Given the OECD view that muddling's adequacy might be restored by suitably modernizing the rules around ALTP and the PE requirement, I turn next to those rules' main aspects, and to how recent decades' economic changes have undermined them.

1. ALTP

Suppose that, in 1958, General Motors' U.S. parent company had spent $1,500 with respect to the manufacture and sale of a Cadillac that it then shipped to Paris, where (after undertaking storage and promotion) its wholly-owned subsidiary, GM-France, had sold the car to an independent French dealership for $4,000. How would prevailing legal doctrines have

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[74] See, e.g., Devereux et al at 67-68.

suggested dividing the GM group's $2,500 global profit,[75] as between the parent's U.S. source income and the subsidiary's FSI?

Both in theory and as a matter of widespread statutory and treaty law, the answer was thought to depend on the hypothetical transfer price that GM-U.S. would have charged GM-France had they been dealing with each other at arm's length, as if they were unrelated parties, each trying to maximize its own share of the profit. So there was in principle a right answer – assuming a single correct transfer price – as to the true U.S. and French source income (as well as that of each affiliate) arising by reason of this transaction.

Suppose the real value here lay in GM-U.S.'s design and manufacture of cars that consumers around the world highly valued, whether for their quality or their association with a famous global brand. And suppose further that there was nothing special about GM-France's marketing and sales activities – i.e., that it was merely performing routine functions that others could have performed just as well. Then a true arm's length negotiation between the U.S. and French affiliates would have allowed the latter to capture but little of GM's profits from selling cars in France. The U.S. parent would have had no reason to over-pay a third party for performing routine functions, and thereby to give away value that (taken as given the consumer side of the market) its actions had created.

This helps to show that ALTP is in principle a production-based concept. It posits hypothetical arm's length transactions within an integrated productive process. In that setting, one presumably must provide good value in order to be paid well. In practice, however, ALTP uses a range of methodologies that may not well track relative value provision at all. For example, it has long relied heavily on the notion of applying observed prices from true arm's

[75] This calculation of the GM group's global profit leaves out any expenses incurred by GM-France (for example, for sales and promotion) that are treated as pertaining to the sale of this particular car.

length transactions that may actually have little in common with those at issue within a globally integrated MNE – allowing the use of misleading comparisons that cause substantial profit shares to be assigned to tax haven affiliates that do little if anything to add value.[76]

Suppose, for example, that – in keeping with tax planning technology that dates back at least to the 1950s – GM had inserted an affiliate in low-tax Luxembourg to buy the car from GM-U.S., hold it briefly, and then on-sell it, at a generous markup, to GM-France. GM might claim that the mark-up created Luxembourg-source income, reducing its worldwide tax liability if both the U.S. and France had higher tax rates. In principle, this maneuver could be challenged by asking whether the intermediate prices were arm's-length. This might have involved examining what, if anything, GM-Luxembourg did to earn its spread. Yet properly applying the transfer pricing rules proved so hard in practice that, in 1962, the United States enacted, as an apparent back-up, a rule (still in force today) that was designed specifically to make U.S. parents currently taxable on the tax haven FSI created through such transactions.[77] This rule seemingly would have been unnecessary if the transfer pricing rules were working properly.

One reason for the enforcement difficulties may have been taxpayers' informational advantages over government auditors regarding their own operations. However, consider as well GM-France-type cases, in which the local affiliate is not a tax haven conduit but actually handles local consumer sales. If the MNE as a whole is earning extra-normal profits, one would be wholly unsurprised to see the local tax authorities seeking to claim more than a routine share thereof – indeed, perhaps with the MNE's blessing if the market country's tax rate lies below that of the marginal alternative source claimant (such as the production country).

[76] Note also transfer pricing methods in the U.S. section 482 regulations that can allow pro rata types of splits where value is not necessarily pro rata.
[77] See Internal Revenue Code section 954 (base company sales rules).

In such a case, extra-normal returns that reflected rents created in the production country might in effect be treated as if they were instead bilateral monopoly profits (and hence subject, in an arm's length negotiation, to being split up "fairly"). However, we need not posit that auditors or others were actually thinking in exactly these terms. Rather, given the large profits to be allocated, and the lack of a strong underlying consensus in favor of production-based sourcing, transfer pricing (in the absence of true comparable sales) could be a sufficiently flexible and underspecified instrument to allow for its partly implementing a market-based view in practice.

To illustrate transfer pricing's two-way flexibility (i.e., either to the market country's benefit or detriment) through a modern example, consider Starbucks, which "claimed [tax] losses in 14 of the first 15 years of its existence in the United Kingdom and as a result paid virtually no U.K. company tax, despite a 31 percent market share and shareholder reports indicating solid profitability."[78] Transfer pricing was among the key elements in its claiming U.K. tax losses.[79] Unfortunately for Starbucks, however, public outrage, including consumer boycott threats, induced it to agree to pay £10 million in corporate taxes for each of the next two years, even if it continued reporting tax losses.[80]

Obvious though it was that Starbucks generated large profits by reason of having U.K. stores, it was not so obvious that much profit was actually generated there, if we define the term in a production sense. The company has elsewhere stated that its "fundamental corporate strategy is to deliver the Starbucks Experience to each customer, store by store," requiring "tightly integrated" operations that cause it to prefer company-owned stores to the use of franchisees.

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[78] Kleinbard, *Through a Latte Darkly*, supra, at 1519.
[79] See id. at 1526-27. Outbound royalties and interest payments may have played an even larger role than transfer pricing in creating the U.K. losses.
[80] Id. at 1519.

And "the brain center of the Starbucks Experience is its support center in Seattle; foreign operations appear to be reduced to the localization of that centrally conceived experience."[81]

This suggests that true arm's length negotiations between Starbucks' central headquarters and third parties (such as franchisees), compensating the latter for what they did in the U.K., would have yielded the latter only a routine return. Hence, in the scenario where franchisees could be trusted to behave the same as store employees, presumably they would have captured only a modest share of the overall marginal profits to be reaped by reason of deploying the preexisting "Starbucks Experience" in the U.K. There is no reason to think that such U.K. actors would have been bringing sufficiently unique skills to the table to turn the hypothetical negotiation into one concerning the division of bilateral monopoly profits. Nonetheless, the fact that Starbucks' U.S.-developed business model induced it to prefer direct ownership of its U.K. retail stores meant that there was room for the U.K. tax authorities – however little they initially did about it – to use transfer pricing, among other tools, in order to claim that more than a routine share of the profits resulting from Starbucks' sales to U.K. consumers was actually U.K. source.

2. PE Rules

Bilateral tax treaties have long committed the signatories to forgoing source-based taxation of each other's resident companies absent a physical permanent establishment (PE) through which the companies were locally conducting business. It is easy to see how this fits with a production-based source of income concept. From such a perspective, it may seem obvious that a company cannot earn income in a given country unless it has employees or property physically located there. Otherwise, surely all the production activity must be taking place somewhere else.

[81] Id. at 1525.

Yet, had it been sufficiently obvious that one cannot earn income in a given country without a physical presence there, specific PE rules would seemingly have been unnecessary. Under a production-based view, merely requiring DSI, as a prerequisite for one signatory's taxing the other's residents, seemingly would have offered protection enough. What made PE rules relevant and potentially important, rather than superfluous, was the possibility that countries would employ market-based views of source. After all, under such a view, having sales in a jurisdiction, especially if one is deliberately targeting it, may mean that one is truly earning income there. Thus, the existence of PE rules indirectly testifies to the source concept's underlying ambiguity as between production-based and market-based understandings.

Once an MNE has a PE in a given market country, the PE's presence can serve as a ratchet that empowers the country to exploit the source concept's ambiguity as between production-based and market-based definitions. Consider *Taisei Fire & Marine Ins. Co. v. Commissioner*,[82] a prominent U.S. case holding that the taxpayers, a group of Japanese property and casualty insurance companies that engaged in reinsurance in the U.S. market, did not have PEs in the United States, and hence were exempt from U.S. tax under the U.S.-Japan tax treaty. The taxpayers' victory followed from the court's conclusion that their only representatives in the United States with authority to conclude contracts on their behalf were independent, rather than dependent, agents.

Whether dependent or independent, the agents themselves were taxable in the United States on whatever amount the Japanese insurance companies paid them. But only if they were deemed dependent agents could the companies be taxed on some measure of *their* own profits from participating in the U.S. reinsurance market. An obvious takeaway was that foreign MNEs

[82] 104 T.C. 535 (1995).

should plan, if possible, to use only independent, not dependent, agents under such circumstances. A further corollary was that those whose business models made this feasible could avoid U.S. source-based U.S. tax that those with different models might have to pay. For example, banks, which, unlike insurance companies, may need on-site dependent agents to meet with customers, may therefore be exposed to greater source-based taxation, despite the increasing interchangeability of their respective business models in other respects.[83]

The difference was not that U.S. production was necessarily greater when dependent, rather than independent, agents were being used. Either way, individual agents' pay presumably reflected the value of what they were doing. Rather, the difference was that attributing their activities to the foreign MNEs would permit the United States to tax income that was derived from U.S. source in a market sense, but less plausibly so in a production sense. So the U.S. tax consequences of having a U.S. PE might exceed the choice's effect on pretax global profits, via its offering a ratchet for the imposition of market-based income sourcing on an outside MNE.

3. The Decline of ALTP and PE as Instruments for Enabling Effective (Albeit Ambiguously Defined) Source-Based Taxation

In recent decades, an effectively shrinking globe and the rise of intangibles have reduced the efficacy of both ALTP and PE rules. As to the former, MNEs' integrated productive processes, involving multiple sites around the world, bring synergies to the fore, while also raising the number and complexity of imputed intra-group transactions. Consider the iPhone, often assembled in China but using components that were manufactured in dozens of different countries around the world (Costello 2019), and using valuable IP that Apple took great care to ensure was largely sited in tax havens. It comes as little surprise, therefore, that neither

[83] See Edward D. Kleinbard, *Competitive Convergence in the Financial Services Markets*, 81 Taxes 225 (2003).

production nor market jurisdictions – including the United States, as the country where much of Apple's (at least partly stock-compensated) owner-employee brainpower was located – have blocked Apple from using conventional transfer pricing doctrine to place a large share of its global profits in tax havens.[84]

Likewise, with the rise of the digital economy (and of cheaper communications and transport generally), MNEs far less frequently need to use in-country PEs to perform, say, local distribution and marketing functions. If the PE were truly what mattered for its own sake, then, as Wei Cui notes, it would be "bizarre to claim that countries remain entitled to impose a tax based on the old business model because the new model replaces it."[85] But insofar as PEs are merely a prerequisite for allowing consumption jurisdictions to stake a larger claim on cross-border income than would be available to them otherwise – reflecting the lack of any definite consensus that only the place of production should count – this may logically be viewed as undermining the previously prevailing international tax regime.

D. <u>Going Beyond Value Creation</u>

The OECD's effort to revivify the existing international tax regime, through a focus on value creation that includes paying particular attention to existing ALTP and PE rules, has virtues. Those rules need updating insofar as their use continues (i.e., leaving aside more dramatic changes), and the "negative source rule" aspect of value creation can strengthen both production-based and market-based approaches to income sourcing. Yet value creation's ambiguities are dismayingly unhelpful, and the effort to shore up old approaches should not crowd out also looking for new ones, whether to complement or replace them.

[84] [But this is not to say that Apple couldn't have been reined in more on transfer pricing. See Permanent Subcommittee on Investigations Apple report from 5/21/13.

[85] Cui, supra, at 19.

In considering possible next steps, it is important to adjust the analytical perspective. The OECD, quite logically given its character as an international intergovernmental organization, offered proposals for multilateral adoption, based on claims of collective benefit. Given, however, that individual countries are the prime actors in the international tax policy realm, it is important to look at their motivations with regard to taxing MNEs. I discuss this next in section III.

III. FROM SOURCE TO LOCATION-SPECIFIC RENTS: NATIONAL POLICY AIMS IN TAXING MULTINATIONAL ENTITIES

"Think globally, act locally," goes the saying. MNEs can actually do this. Their flexibility regarding where to locate both actual productive activities, and the formal or legal arrangements that affect where they will report profits, means that they can think about their opportunities globally, before putting down any markers locally. Governments, however, may be more inclined to the reverse: thinking locally, where they sit and exercise sovereignty, while acting globally, given their actions' spillover effects. Thus, it is useful to start by examining governments' national policy aims, before returning to the global framework.

A. Resident Individuals and Corporations

Governments commonly view themselves as particularly charged with promoting their own citizens' or residents' welfare.[86] Nonresidents' welfare, by contrast, generally is excluded from the calculus (at least, leaving aside human rights concerns about extreme deprivation or mistreatment). Thus, the "distin[ction] between 'us' and 'them' – that is, between people whom we classify as members of the home community, and those whom we classify as outsiders"[87] is of central, at least descriptive, importance to international tax policy, even if its underlying normative foundations can be questioned.

Counting resident individuals' welfare positively may support applying ability-to-pay-based taxation to them, so that people with higher incomes (or whatever is being used as a metric) pay suitably more tax than those with lower incomes. In thus evaluating ability to pay, a dollar of income's particular source seems unlikely to have much relevance. Earning FSI

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[86] See, e.g., Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 Tax L. Rev. 261 (2001).
[87] Daniel Shaviro, *Taxing Potential Community Members' Foreign Source Income*, 69 Tax L. Rev. 1 (2015).

(including through an MNE) would generally seem to make one as well-off as earning DSI. Hence, governments have reason to treat both types of income as taxable. Suppose, moreover, that a given individual's income includes rents. Without regard to whether they constitute DSI or FSI, rents can generally be taxed without incurring the efficiency cost (such as from discouraging labor supply or investment) that often is otherwise associated with distributionally minded taxation.

However, the taxation of FSI is complicated by its often being earned through MNEs, causing it, in the first instance, to be taxable only at the entity level. A corporation's conceded FSI cannot be taxed unless it is classified as a domestic resident. Yet corporations' residence status, however determined, does not directly raise "us versus them" issues. A corporation, not being sentient, has no greater capacity than a rock or a meme to itself be among either "us" or "them" in a normatively interesting sense.

The reason this article has nonetheless treated U.S. MNEs as a category of interest is that many of the companies so classified are substantially owned by U.S. individuals, including both founders (or their heirs) who still possess large stakes, and stock-compensated owner-employees. This increases the extent to which, despite cross-border stock ownership, taxing U.S. MNEs is a proxy for taxing U.S. individuals, who are among "us" in the United States, but elsewhere are among "them."

Even with respect to U.S. MNEs, however, one must keep in mind entity-level residence's imperfection as a proxy for owner-level residence. For example, given cross-border shareholding, taxing resident companies' FSI has the defect of being avoidable insofar as resident individuals respond by earning FSI through foreign, rather than domestic, companies. Likewise, given that nonresident individuals generally are not taxable (Monty Python-style) on

FSI, taxing them indirectly at the entity level, when they own stock in resident companies, may deter them from holding such stock. This may reduce or even eliminate the taxing country's capacity to cause any of the incidence of the entity-level tax to fall on them, unless it has market power with respect to corporate residence. For these reasons, under an entity-level corporate income tax, the case for taxing FSI the same as DSI is much weaker than it would be if corporate income were flowed through to the shareholders for tax purposes.

B. Nonresident Individuals

Generally excluding concern for nonresident individuals' welfare from the domestic policy calculus has two main tax implications. The first is that one lacks the motivation to apply ability-to-pay taxation to them, as that would typically be a byproduct of normative concern about how well-off particular individuals are. The second is that one may want to use tax and other policy instruments to transfer resources from "them" to "us," thereby increasing the welfare of those who *do* count positively. In this regard, however the crucial question is not whether "they" are remitting tax payments in direct cash flow terms, but whether they are bearing the taxes economically.

Let us suppose for the moment that there were no limits to one's willingness to use tax instruments to extract resources from nonresidents – not even any limits that, as I discuss below, might be derived from strategic considerations and/or adherence to norms of good conduct in tax policy. In this scenario, suppose we divided nonresidents' worldwide income into (a) that which might conceivably be DSI, as it is connected somehow (whether on the production or consumption side) with the taxing jurisdiction, and (b) that which is definitely FSI, due to the lack of any such connection.

The goal of transferring resources from "them" to "us" would imply paying no direct heed to the distinction between possible DSI and clear FSI. Either way, a dollar transferred to "us" would leave "us" a dollar richer. Yet there might be practical reasons for concentrating tax effort on nonresidents' clear *FSI*, as distinct from their possible DSI. Addressing possible DSI seems likely to raise incidence issues, given the possibility that nonresidents would respond by curtailing the domestic connections that may give rise to liability. By contrast, they might not be able thus to respond to Monty Python taxation, given that, by definition, it pertains to income that has no local connection.

We therefore have a seeming prediction, to the effect that (all else equal) countries ought to prefer Monty Python taxation to taxing nonresidents' possible DSI. This prediction's apparent falsity suggests that perhaps the implicit behavioral model for governments in tax policy, as presented so far, is missing something important. Before turning to that, however, it is worth further exploring the incidence questions raised by attempting to tax foreigners with respect to income or activity that has a domestic connection.

C. Rents or Quasi-Rents and the Optimal Tariff Literature

1. General considerations

The incidence issues raised by the goal of imposing taxes that will be borne economically by nonresidents have been extensively explored in the international trade literature. For example, it is well understood that, while countries with small open economies can nominally tax inbound capital flows, they lack the market power to impose tax burdens on outside investors if the latter are merely earning normal returns that could equally be earned elsewhere. Thus, if 6 percent is the globally available after-tax rate, and Country X imposes a 25 percent income tax on inbound investment, this should cause investors to demand an 8 percent pretax return. In such a case, while "[t]he furnishers of the capital … are actually sending tax payment checks to the treasury of Country X … [they] bear none of the incidence of the tax.[88] On the other hand, if outside investors are earning LSRs in Country X that they cannot shift elsewhere, X may be able to tax those rents.

Likewise, consider the standard economic analysis of tariffs.[89] In a perfectly competitive market, tariffs imposed on imports are wholly borne by residents. Thus, suppose that French wine of a given type and quality sells for $80 per bottle on world markets. If the United States placed a $10 tariff on such wine, then, in the absence of U.S. market power, the French wine sellers would still demand $80 per bottle. Accordingly, they would now require $90 per bottle if they were nominally paying the tariff. Americans would therefore not only bear the tariff's entire incidence, but lose any surplus that they would have enjoyed from drinking bottles that they valued subjectively at between the pre-tariff and post-tariff prices.

Even short of perfect competition, this analysis often sufficiently holds to support widespread agreement among economists that import tariffs tend to be bad national policy, even leaving aside the risk that they will trigger retaliation. There are exceptions, however, explored in the modern "strategic trade" literature.[90] Among these is the case of the optimal tariff, which potentially is available "if the importing nation is 'large' in the parlance of international economics – that is, if the quantity that it purchases affects the price that it pays …. conferring a degree of monopsony power on its consumers collectively."[91] Thus, if a sufficiently large portion of the overall market for the above French wine involved U.S. consumers, the French wine

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[88] See, e.g., Daniel N. Shaviro, DECODING THE U.S. CORPORATE TAX 67-68 (2009).
[89] See, e.g., Bankman, Kane, and Sykes, supra, at 41; Paul Krugman, Maurice Obstfeld & Marc Melitz, INTERNATIONAL ECONOMICS: THEORY AND POLICY __ (11th ed. 2017).
[90] See Bankman, Kane, and Sykes, supra, at 41.
[91] Id. at 40 (citing Harry Johnson, Optimum Tariffs and Retaliation, 21 Rev. Econ. Stud. 142 (1953).

sellers might end up accepting less than $80 per bottle, net of the tariff, in the aftermath of its imposition, causing them to bear at least some of the incidence. The upshot would be a wealth transfer from French to American individuals, albeit at the cost of both (1) reducing Americans' surplus from drinking the wine (if the U.S. price still rose above $80), and (2) potentially triggering French retaliation, whether through French optimal tariffs on particular U.S. exports or otherwise.

Likewise, suppose foreign sellers have market power that they are using to extract rents from domestic consumers. Now they may bear some of the incidence of an import tariff, although once again this may be accompanied by increased domestic deadweight loss and the risk of inviting retaliation.[92] Despite these downsides, however, optimal tariffs can increase domestic welfare on balance – given, for example, that purely domestic taxes likewise may impose deadweight loss, but without the wealth transfer.

2. Preliminary application to U.S. (and other) MNEs

How might such considerations apply to taxing MNEs such as the Four Horsemen and Starbucks? These firms, and many like them, earn global rents or quasi-rents through sales in market countries around the world, based on IP that was mainly created by high-value owner-employees in a production country (such as the United States) that often is also the corporate residence country. Their profits therefore largely arise in the production / residence country under a rigorously applied production-based view, and in market countries under a market-based view. In practice, however, MNEs often treat large swathes of their profits as arising in tax havens.

[92] See Bankman, Kane, and Sykes, supra, at 41.

<u>Production / residence country</u> – In these circumstances, the production/residence country, if it advances distributional goals through an income tax, has reason to impose current tax (or its present value equivalent) on resident employee-owners who are being enriched by the MNEs' global profits. With entity-level corporate income taxation, however, this does not happen at the owner level insofar as these individuals get tax-deferred compensation and/or benefit from unrealized stock appreciation. It also may not happen at the entity level insofar as the MNEs report their global profits as domestically non-taxable FSI.[93] Moreover, under U.S. income tax rules, the owner-level tax on stock appreciation, rather than merely being deferred until realization, may permanently disappear via the tax-free basis step-up at death for inherited property.[94]

This domestic policy failure might be partly offset by increasing entity level corporate income taxes, based either on worldwide residence-based taxation or the more rigorous application of production-based source rules. Yet such responses are not unambiguously desirable, from a domestic national welfare standpoint. For example, as was noted above, the case for increasing residence-based corporate income taxation is weakened insofar as resident individuals can respond by earning FSI (as labeled by the tax system) through nonresident MNEs. Likewise, the desirability of strengthening production-based source rules may be reduced by global tax competition with respect to where actual production activity occurs.

While the optimal resolution of these competing concerns is unclear, it is plausible that political economy biases would cause home country MNEs to be undertaxed. Such companies may have high profiles as "national champions," they control vast economic resources that they can use to exert political influence, and they often have extremely wealthy founders / controlling

[93] Note subpart F, GILTI, and the BEAT as possible vehicles for U.S. taxability.
[94] See IRC section 1014.

owners. Thus, both interest group politics[95] and the sway of the super-rich in a plutocratic era[96] may operate to their advantage.

Suppose, at least for argument's sake, that home country MNEs are indeed under-taxed from a national welfare standpoint. Would this suggest that home countries should welcome, at least as a fallback, market country taxation of their MNEs' otherwise untaxed rents from overseas sales? Under a standard economic framework, the answer is clearly no. The problem is that, unlike in the case of the MNEs' paying higher domestic taxes, the revenues go to the benefit of nonresidents. Accordingly, market country taxes (assuming the requisite incidence) make MNE owners in production countries poorer, without making any of their fellow residents richer.

A broader perspective might allow for arguments in favor of there being a national welfare benefit. For example, market country taxation (in lieu of global non-taxation) may reduce MNEs' incentives to engage in excessive profit-shifting from the domestic standpoint. Moreover, negative externalities from high-end inequality[97] might cause the wealth loss to MNE owners to improve domestic welfare even if no resident individual had an offsetting wealth gain.

Despite such arguments, however, the hostile U.S. political response to recently proposed or enacted EU digital services taxes (DSTs), as well as to earlier initiatives, such as the EU state aid cases, that were similarly aimed at tax-avoiding U.S. MNEs, comes as no surprise.[98] Yet, as I discuss below, the question of whether EU-imposed taxes reduce U.S. national welfare is distinct

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[95] See, e.g., Mancur Olson, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS (1965).
[96] See, e.g., Larry M. Bartels: UNEQUAL DEMOCRACY: THE POLITICAL ECONOMY OF THE NEW GILDED AGE (2010); Martin Gilens, AFFLUENCE AND INFLUENCE: ECONOMIC INEQUALITY AND POLITICAL POWER IN AMERICA (2012).
[97] See, e.g., Daniel Shaviro, *The Mapmaker's Dilemma in Evaluating High-End Inequality*, 71 U. Miami L. Rev. 83, 107 (2016).
[98] When the U.S. Treasury vigorously protested EU state aid rulings against particular U.S. MNEs, I agreed that it was making a "good-faith [albeit, I argued, misguided] effort to advance the interests of the American people, which, after all, is Treasury's job in the international arena." Shaviro, Friends Without Benefits, supra, at 1067.

from that of whether, as a strategic matter, the U.S. ought to respond aggressively to their threatened or actual imposition.

Market countries – For market countries, an initial issue to keep in mind is that nearly every country in the world, other than the United States, has a VAT (sometimes called a goods and services tax, or GST). These national consumption taxes, like income taxes, serve distributional goals as between residents, by causing the amount one spends on market consumption to determine how much tax one pays. Purely in service of this aim, and even without regard to the wealth consequences for nonresident individuals, countries may want to ensure that MNEs' inbound sales do not escape such administrative features of VATs / GSTs as tax collection and remission by the remote seller.[99]

While such VAT / GST inclusion and reporting requirements are merely an aspect of treating domestic consumption neutrally, there is also an optimal tariff-style case for seeking to impose tax burdens on outside MNEs that earn rents or quasi-rents through inbound activity. Wei Cui has noted that the purveyors of digital platforms, such as Facebook, Google, and AirBnb, earn LSRs by deploying their platforms in particular countries. At least to a large extent, such platforms' "deployment [in a given country] is non-rival and free from opportunity cost."[100] For example, Facebook does not decide whether to be available in the U.K. or instead in France, like a winemaker shipping its finite output to one place or another. It operates in both places, subject only to having a positive expected return in each country in the face of what (given the platform) are presumably fairly limited per-jurisdiction marginal operating costs.

The force of this argument is not limited to digital platform companies. For example, with respect to Starbucks, it holds with respect to deploying the IP that lies behind the

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[99] Singapore recently enacted a GST provision of this kind. Cite.
[100] Cui, supra, at 13.

"Starbucks Experience." While Starbucks clearly has marginal costs for its operations in each country – such as for store rent, coffee beans, and employee salaries[101] – its global IP deployment is to a degree non-rival, free of opportunity cost, and associated with only limited rising marginal costs. Similarly to Facebook, it may not be so much choosing between U.K. and French stores, as separately deciding in each country how many stores the market will profitably support.

D. Shifting Back (Partway) Towards a Global Perspective

1. The Relevance of Strategic Considerations and Cooperative Norms

So far, the discussion in this section has emphasized unilateral national welfare, based on the assumption that national policymakers' normative concern is mainly limited to their own countries' residents. However, a full analysis requires also considering the global aspect, reflecting everyone's wellbeing. This not only matters normatively, but may affect what countries actually do, for at least two reasons apart from any direct concern that policymakers may have for nonresidents' wellbeing.

The first is the potential for strategic interaction. For example, countries may cooperate for mutual gain. Or, if a self-interested Country A policy would impose losses on Countries B, C, and D that exceeded the gains to itself, they in principle could either compensate it for agreeing to forgo the policy, or credibly threaten tit-for-tat retaliation that would leave A (even if also themselves) worse off overall.

Second, countries may at times act cooperatively in particular realms, even when defecting might yield at least short-term gains. With respect to individuals, a large literature discusses the importance of social norms, or "informal social regularities that [people] feel

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[101] In addition, the Seattle "brain center" that monitors global deployment of the "Starbucks Experience" may have marginal costs of monitoring Starbucks' operations in each country.

obligated to follow because of an internalized sense of duty, because of a fear of external non-legal sanctions, or both."[102] As I have discussed elsewhere, such norms-based behavior can apply, through national policymakers, to countries' behavior.[103]

Both pathways may be affected by the relationship between the extent of the gain that a particular country might realize and the net harm, if any, that it would thereby inflict outside its borders. Strategic cooperation has a larger net payoff than otherwise when the global welfare loss would be especially great. Likewise, a social norm of proportionality may suggest forgoing the imposition of hardship on others substantially in excess of the benefit to oneself. Such a norm not only may yield pragmatic benefits over time, but can help build concord through the symbolic resonance of its gesturing towards mutual respect.

Norms may also involve steering self-seeking behavior into accepted channels. Consider, by analogy, individuals who unabashedly prefer paying less rather than more when they are bargaining with strangers, but who leave tips for the waiters in restaurants to which they do not anticipate returning. Likewise, people whom John Roemer calls "conditional Kantians" behave cooperatively, even when this is contrary to their direct material self-interest, so long as they believe that a sufficient proportion of other people are likewise doing so.[104]

Both strategic considerations and the norm of proportionality give relevance to the global efficiency effects of countries' international tax rules. What would otherwise be zero-sum transfers become increasingly negative-sum as deadweight loss increases. Likewise, the view that there are right and wrong channels for self-seeking behavior may help one in evaluating how

[102] Richard H. McAdams, "The Origin, Development, and Regulation of Norms," 96 Mich. L. Rev. 338, 339 (1997). Norms may either consciously or unconsciously reflect long-term strategic considerations, including a need to rein in one's own inclinations towards short-termism that may prove self-defeating over time.
[103] See Daniel Shaviro, Why Worldwide Welfare as a Normative Standard in U.S. Tax Policy?, 60 Tax L. Rev. 155 (2007).
[104] See John E. Roemer, HOW WE COOPERATE: A THEORY OF KANTIAN OPTIMIZATION (2019).

countries might reasonably (or not) seek to impose tax burdens on nonresidents. Such beliefs may, for example, help to explain general reluctance to engage in Monty Python taxation. One also sees it at work in OECD efforts to distinguish between "fair" and "unfair" tax competition, and to foster a global consensus to the affect that the former, but not the latter, is acceptable.[105]

2. Global Efficiency Issues

In the classic case where a country uses its monopsony power to impose optimal tariffs, global welfare declines, because the pure transfer from producer countries to the market country is accompanied by deadweight loss from reducing output, thereby eliminating transactions that would have yielded surplus.[106] For this reason, if each of two economically similar countries imposed comparably sized optimal tariffs on the other, it seems likely that each would be worse-off on balance. The still (and perhaps increasingly) well-understood undesirability of trade wars, involving optimal as well as regular tariffs, may have contributed to the existence (until recently) of a degree of global consensus that was averse to tariffs, even when they could be rationalized as an instrument of strategic trade policy.

Such an analysis may not, however, apply when market countries seek to tax the inbound LSRs being generated by leading MNEs. Insofar as an MNE itself has market power, the exercise of offsetting monopsony power need not yield inefficient output reduction.[107] Moreover, taxing rents is generally efficient as compared to using alternative revenue sources. And even insofar as MNEs are merely earning normal returns, their global tax planning opportunities suggest that they may at present be inefficiently undertaxed, compared to other businesses.

[105] Cite.
[106] See, e.g., Bankman, Kane, and Sykes, supra, at 32.
[107] Id. at 31-32.

Insofar as MNEs are only earning quasi-rents that are the fruits of investment under uncertainty with only a normal expected return, the efficiency analysis looks less favorable. Taxing quasi-rents is efficient ex post, but it raises time consistency problems that can unduly discourage investment ex ante. These problems might be accentuated by individual countries' incentive to under-value the adverse spillover effects on people in other countries that their taxes would have if they discourage global innovation. On the other hand, as Cui notes, if "competition in markets occupied by [digital] platforms [or other valuable MNE IP] is plagued by the problem of excessive search [founded on the hope of garnering monopoly profits, then] … the private value of search efforts exceeds its social value. A tax on firm revenue in such contexts would diminish such socially inefficient incentives."[108]

There is also a political economy aspect to the analysis. Suppose that, as suggested above, production / residence countries (such as the United States) are prone to under-taxing powerful MNEs (and their owners), due to political choice problems such as interest group politics and the rise of plutocracy. Such episodes as the threatened UK Starbucks boycott suggest that leading U.S. MNEs swim in icier political waters across the Atlantic Ocean than they do at home. Market country taxation of MNEs may therefore be better-suited than that in production countries to address collective global under-taxation of MNE profits, albeit potentially increasing the risk of collective over-taxation.

Clearly, it is hard to draw confident conclusions regarding the likely net global efficiency effects of market countries' efforts to capture the LSRs (be they actual rents or only quasi-rents) that are being enjoyed by leading MNEs. However, that is not the question being asked here. There is no global tax authority with the power to set global tax policy based on a rigorous

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[108] Cui, supra, at 30-31.

analysis of all relevant global welfare considerations. Rather, the question raised by recent and ongoing market country efforts to tax LSRs is whether this would sufficiently reduce global efficiency – creating outside losses in excess of inside gains – to suggest that the market countries are acting unreasonably, even by the perhaps somewhat lax standards of contemporary international behavior. Given the complex and offsetting character of the relevant efficiency issues, my own view is that such a claim of unreasonableness would be wide of the mark.

3. Equity Issues and Reasonableness

The actual or perceived reasonableness of market country efforts to tax outside MNE's LSRs may also be affected by issues that fall under the heading of fairness or equity. As it happens, "inter-nation equity" is a familiar concept in international tax policy debate.[109] While its meaning and relevance are disputed, it is a sufficiently flexible term to stand in for multiple lines of argument.

In a standard welfare economics framework, inter-nation equity is not an issue as such, since only people matter. Hence, while a global framework would suggest applying distributional goals (such as those associated with ability to pay) to the people in all countries, not just one's own country, the focus of interest would still be individuals, not nations. Still, within such a framework, transfers from richer to poorer countries might generally be likely to yield greater global progressivity as determined at the individual level – albeit, subject to the full distributional playout within particular countries.

From such a standpoint, market country taxation of leading MNEs' LSRs might grade quite favorably. The United States has high per capita GDP, even compared to such early movers in the DST realm as France and the UK. Moreover, poorer countries might be likely to follow

[109] See, e.g., Peggy Musgrave and Richard Musgrave, Inter-nation equity (1972), reprinted in R. Bird, and J. Head (eds), MODERN FISCAL ISSUES: ESSAYS IN HONOR OF CARL S. SHOUP (2007).

suit if DSTs or similar instruments prove reasonably successful and become familiar. Even without such national-level differences, however, transfers from U.S. MNE owners to peer countries' general revenues might be likely to increase global tax progressivity – just as, within the United States, they might increase national progressivity.

There are also, however, common usages of inter-nation equity that treat countries as the morally relevant units. For example, proponents of source-based taxation based on benefit principles might ask whether such principles can reasonably support market country taxation of LSRs. Here the answer is clearly yes, unless one takes a more exclusively production country-centered view both of source and of relevant benefit than has achieved consensus support in international tax policy debate.

In the current global political context, the high concentration of U.S. MNEs among those that might face added taxation in market countries adds an inflammatory further dimension to the equity debate. As Wei Cui and Nigar Hashimzade have rightly noted, market countries' normative claims of entitlement to tax U.S. companies' LSRs have "radical implications," as they imply that "the U.S. need not be the primary claimant to the profits that result from the technologies its companies invent."[110]

The implicit underlying U.S. view might be further described as follows. Suppose one believes that U.S. MNEs' global profits reflect the extraordinary talent and hard work of founders and their colleagues who created the underlying business models and IP. In the domestic tax policy realm, some who take this view believe that such "wealth creators" are wholly entitled to the fruits of their success, notwithstanding any ability-to-pay based arguments to the contrary. Analogously in the international realm, one might believe that only the United

[110] Cui and Hashimzade, supra, at 10-11.

States, as the home of all that innovation, is entitled to tax the resulting profits. Thus, even wholesale U.S. *non*-taxation of MNE profits would fail to aid the market countries' claims. Only the United States, under this view, would be entitled to tax the fruits of U.S. individuals' efforts.

To anyone whose policy views are grounded on concern about human welfare, rather than on accepting a priori entitlement claims, this line of argument should be unpersuasive.[111] It also fails to track any existing global consensus about the source of income, given its assuming a production-based view. Even just as a predictive matter, I believe that neither its nationalistic chauvinism nor its market triumphalism are likely to wear well outside the United States. They might also cease to wear well inside the U.S. if the direction of net global IP flow were to reverse, in keeping with its predominant direction at times in the past[112] and perhaps also in the future.

4. Ease of Cooperating

As proposals directed at taxing LSRs rapidly emerge, amid the "global battle to capture MNE profits,"[113] there is widespread concern that things will get out of hand. Lilian Faulhaber, for example, not only calls for the adoption of a coordinated international solution, but urges the United States to cooperate in this process, lest "American companies [instead] … face a cascade of different taxes from dozens of nations that will prove onerous and costly."[114] Even leading DST proponents, such as the European Commission, state that these are merely "interim

[111] Moreover, even under an entitlement-based view, it requires rationalizing the distinction between redistributive taxation within the same country and more globally.
[112] For example, while the United States is now perhaps the leading global defender of IP rights against countries, such as China, that are accused of infringing these rights, in the nineteenth century the United States was a notorious infringer of foreign copyrights. See, e.g., Bingchun Meng, Property Right or Development Strategy? Protection of Foreign Copyright in 19th Century America and Contemporary China, Media@LSE Electronic Working Papers No. 11, available online at https://core.ac.uk/download/pdf/93515.pdf .
[113] Bankman, Kane, and Sykes, supra (article title).
[114] Lilian V. Faulhaber, Beware. Other Nations Will Follow France With Their Own Digital Tax. New York Times, July 15, 2019.

measures to address the tax challenges arising from digitalization," potentially to be replaced once corporate income tax rules have more generally been suitably updated.[115]

Unilateral responses should be less of a concern, however, insofar as countries simply impose non-overlapping taxes on their own particular LSRs. This would in effect satisfy the global single tax principle, so far as DSTs are concerned, and prevent overlap from leading to collective over-taxation. While there might still be a need to coordinate the claims of production (or residence) and market countries, this is a familiar sort of problem under existing corporate income taxes. It also is too early to say whether, taking account both of corporate income taxes and other tax instruments, systematic over-taxation or under-taxation of MNEs is more likely to prove more of a long-term political economy problem.

Among the important questions here are (1) how consistently LSRs can be defined and measured in practice, and (2) to what extent countries are likely refrain from venturing out into the world of Monty Python taxation. As to (2), this may depend in part on how inter-nation comity and cooperation are faring more broadly.

Assessing (1) is difficult before one gets to observe the process of rule development, administrative practice, and tax planning responses. It is worth keeping in mind, however, that MNEs' tax planning and reporting flexibility may enable them to push towards the LSR equivalent of double non-taxation, even if governments are simultaneously pushing towards double (or more) taxation.

[115] European Commission, Proposal for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services 2 (2018), available online at https://ec.europa.eu/taxation_customs/sites/taxation/files/proposal_common_system_digital_services_tax_21032018_en.pdf . The recently enacted French DST goes so far as to devote its entire Article 1 to setting forth the path for its replacement.

However, one theoretical ambiguity to keep in mind is the following. The relevant LSRs might be defined either in terms of a particular country's residents, or its geographical territory, since it may have monopsony power with respect to each.[116] While often these two tax bases substantially overlap, consider AirBnB or Uber. Assuming tax administrators' access to the needed information for enforcement, a country that was interested in exercising its monopsony power with respect to rents that these companies earn could look to all lodging or rides provided within its borders – the main approach considered under DSTs to date[117] – and/or also to transactions around the world involving its residents. This might lead in practice to overlapping claims. However, the likely scope of this problem is unclear.

E. United States Pushback?

The preceding analysis suggests that it is well within the bounds of ordinary reasonableness for market countries to tax MNEs' inbound LSRs, even if this reflects the goal (hardly a surprising one) of favoring one's own residents relative to foreigners. In a world where concord and cooperation between countries can be of great benefit to all, and have been under rising threat in recent years, this surely affects "how aggressively the U.S. should respond, although it does not eliminate the possibility of U.S. benefit if [it] were to succeed in bluffing [other countries] into a retreat without creating too much residue of newly generated ill will."[118]

[116] For a parallel issue under existing tax insturments, consider VATs and retail sales taxes, which generally are supposed to apply based on where the consumption takes place, not on where the purchaser sits. This reflects their being conceptualized primarily as internal distributional tools, rather than as devices for imposing tax burdens on nonresidents. However, any American tourist who has pondered the difficulty of obtaining VAT rebates at the airport knows that this rule may fail to apply to her detriment. And anyone who has avoided VAT or retail sales tax on, say, digital purchases from remote vendors that do not remit the tax legally due may experience it not applying to her benefit.

[117] Cite.

[118] Shaviro, Friends Without Benefits, supra, at 1078. On such grounds, I argued that the United States, in deciding how aggressively to respond to the European Community's effort to impose tax burdens on particular U.S. MNEs in the EU state aid, should partly base its strategic choice on an assessment of the effort's reasonableness – not just its degree of adverse impact on U.S. self-interest. See id.

My own belief is that the United States should focus these days more on restoring friendships with longstanding allies, and less on picking fights in which it is likely to stand alone. The claim that countries cannot reasonably tax large global profits, earned by U.S. companies through market interactions with their residents, and to a significant degree avoiding U.S. taxation, is not one that has great resonance or could be expected to draw wide acceptance. This leaves just the bullying option, whose limits when attempted in other areas grow clearer by the day.

The fractious global political environment of recent years should also, however, be kept in mind by market countries that are considering DSTs or similar instruments. For example, tailoring such instruments so that they seemingly (or actually) arbitrarily exempt home country or other non-U.S. MNEs, even when large and profitable, is a recipe for increasing, not just the likelihood of aggressive U.S. retaliation, but internal U.S. political consensus in favor of such a. This would be no less unwise than it is unneighborly.

IV. MEANS OF TAXING LOCATION-SPECIFIC RENTS

The previous section concluded that a market country might both advance its own self-interest, and be acting reasonably from a global standpoint, if it taxed LSRs that MNEs earn from market interactions with its residents, or within its territory. Conceived most broadly, this would involve designing particular tax instruments to apply "selectively in industries … where [the country] suspects the presence of substantial MNE rents, and where it has sufficient leverage to extract rents."[119] This suggests a need for case-by-case analysis (beyond this article's scope) of where such taxes should be levied. The conclusions of such an analysis might vary both between countries, and within a given country across time.

As Wei Cui has argued, the emergence of DSTs is best rationalized in terms of their potential to be used in taxing LSRs. Although there is no canonical DST model, they might broadly be defined as gross receipts taxes, targeting large companies in specified industries that use digital platforms and have two-sided business models, and perhaps also mainly or wholly directed at MNEs that rely on active user participation in creating online content. Each of these features requires distinct assessment, as does the question of whether *any* special tax instruments, targeting particular industries, are desirable on balance from a market country standpoint.

The discussion in this section proceeds in two stages. First, I examine whether simply assigning MNE tax base to market countries, under generally applicable income or consumption taxation, would be sufficient with respect to taxing LSRs. Second, I examine the distinctive elements that DST proposals typically have. This includes considering the possible treatment of LSRs that lie clearly outside the scope of the DST model.

A. <u>Market Country Sourcing of MNE Profits</u>

[119] Bankman, Kane, and Sykes, supra, at 46.

The political resonance of taxing leading MNEs' LSRs is surely increased by their well-publicized success in minimizing global tax liability altogether. Beyond just the optics, however, market countries would gain something from resolving source ambiguities in their favor with respect to the sourcing of MNE profits. Accordingly, it is worth asking whether the likes of formulary apportionment or residual profit allocation under the corporate income tax, or the replacement of one's corporate income tax by a DBCFT, would obviate, or at least greatly reduce, the need to identify and tax LSRs more particularly. The assessment requires distinguishing between the income tax and consumption tax variants of proposals to adopt market country sourcing.

1. Formulary apportionment and residual profit allocation

As was discussed in section II, ALTP plays a major role in MNEs' profit-shifting from high-tax countries to low-tax countries and tax havens. A broader aspect of the tax planning environment for MNEs is separate entity accounting for affiliated entities, such as GM's U.S., French, and Luxembourg affiliates in the earlier example. This further aids tax avoidance by allowing for earnings-stripping from high-tax to low-tax affiliates via the structuring of deductible interest and royalty payments from the former to the latter.[120]

An alternative approach to taxing MNEs would involve taxing affiliated entities, at least insofar as they are conducting a unitary business, on a consolidated basis. Under such a model, in lieu of using transfer pricing and the deduction / inclusion of cash flows between affiliates, the group's global net income would first be computed, and then apportioned geographically based

[120] Various corporate income tax rules attempt to combat earnings-stripping, such as by limiting interest deductions, or, in the case of the U.S.'s recently enacted base erosion anti-avoidance tax (BEAT), wholly denying deductions for certain payments to affiliates under a lower-rate alternative system that functions like a minimum tax. On the BEAT generally, see, e.g., Daniel Shaviro, The New Non-Territorial U.S. International Tax System: Parts 1 and 2. 160 Tax Notes 57-72 and 171-194 (2018).

on specific factors. Under U.S. state income taxes, multistate companies' U.S. profit long was apportioned between the states in proportion to shares of the companies' overall U.S. property, payroll, and sales, each weighted equally in the formula. Over time, formulary apportionment has shifted towards allocating profits based only (or at least mainly) on sales.[121]

In a widely noted 2008 proposal, Reuven Avi-Yonah, Kimberly Clausing, and Michael Durst proposed adopting sales-based formulary apportionment (SBFA) internationally.[122] More recently, the Oxford International Tax Group, a team of leading experts chaired by Michael Devereux, has proposed what they call residual profit allocation by income ("RPA-I"). This system, while formally distinct from SBFA, might be viewed as a more sophisticated (albeit, also more informationally demanding) version of it.[123]

RPA-I's main two differences from SBFA are as follows. First, it formally retains separate entity accounting, although the extent to which this matters (compared to under present law) is greatly reduced by its generally ignoring such inter-group cash flows as interest and royalty payments. Second, it retains the use of ALTP to assign "routine profit to the country where function and activities take place."[124] Thus, in terms of the earlier example, GM-France and GM-Luxembourg would be attributed the likely modest returns that third party service providers typically get, on an outsourcing basis, for doing the things they actually did. The assessment would be made by assuming that they are compensated only for bearing the risks associated with those functions, as distinct from sharing in those of the MNE's overall business.[125] The use of ALTP for routine profit would leave whatever remained – that is, residual

[121] See, e.g., Bankman, Kane, and Sykes, supra, at 24.
[122] See Avi-Yonah, Clausing, and Durst, supra.
[123] See Devereux et al, supra.
[124] Id. at 3.
[125] As Devereux et al further explain: "In this outsourcing model the third party functions essentially as a service provider; it does not share in the overall risk of the MNE, and earns no return based on the overall success or failure of the product or business to which its activities relate. The routine profit for an affiliate would be based on the rate

profit, likely to be the lion's share when an MNE is earning significant economic rents[126] – to be allocated based (approximately) on sales.[127] In this sense, it would generally be more similar to SBFA substantively than it is formally.

One of RPA-I's advantages, relative to SBFA, is its greater consistency with the existing international tax regime, since it formally retains the shell of separate entity accounting and ALTP for routine profits.[128] A second advantage is that its revised treatment of sales reduces certain tax planning opportunities that otherwise would arise.[129] It also might placate production countries to a degree, relative to SBFA, by throwing them a bone in the form of their still getting to tax routine profits on a production basis.[130]

To the extent that existing source rules lean towards being production-based, both SBFA for all profits, and RPA-I for residual profits, would "turn existing law on its head, and allow the import nation to capture rents."[131] At least, this would be so in the absence of effective tax planning responses.[132] However, three main concerns might affect such approaches' capacity to allow market countries duly to tax the LSRs that MNEs earn through inbound market interactions with their residents, or within their territories.

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of profit earned by a comparable third party, applied to an appropriate cost base, although other transfer pricing approaches could also be used." Id. at 4.

126 See id. at 22-23, comparing and contrasting residual profits on the one hand, and economic rents on the other. This aspect of RPA-I means that routine profits can indeed be shifted to tax havens – subject to the functions and activities that attract it actually being performed there. However, there would no longer be the effective discontinuity under present law whereby (if only due to gaming of the ALTP rules), residual profits can follow routine profits to a jurisdiction where only relatively trivial things are happening.

127 More specifically, RPA-I would "us[e] as an apportionment formula not sales but 'residual gross income' (RGI), defined as sales to third parties less costs attributable to those sales." Id. at 6.

128 [Note also that existing ALTP can use formulary elements, so even the treatment of residual profits might be viewed as formally less than a sharp break from it.]

129 As Devereux et al, supra at 5, note, using RGI instead of sales has "advantages in terms of both economic efficiency and robustness to avoidance." Id. at 5. For example, sales that cost as much to execute as they grossed from the buyer would not end up altering where residual profits were taxed.

130 See Devereux et al, supra, at 71 (production-based sourcing of routine profit "may arguably make the RPA-I more clearly aligned than pure destination systems with a traditional understanding of fairness in the international allocation of taxing rights between countries").

131 Bankman, Kane, and Sykes, supra, at 24.

132 Id.

a) Tax planning – The proponents' main rationale for allocating profits to market countries, rather than to production countries, is that "individual consumers are relatively immobile; they are unlikely to move their location to save tax on the profit of the business supplying them with a good or service."[133] This, however, is a point about ultimate consumers, who may in some cases be hard to observe. If an MNE can break the chain between itself and consumers in high-tax countries, by selling directly to independent distributors in low-tax countries, who then separately on-sell the items to the consumers, it not only lowers its worldwide tax liabilities, but frustrates market countries' aim of taxing its LSRs with respect to such consumers.

Conceptually, this resembles one of the problems described in section II with respect to PEs. Selling to the ultimate consumers directly rather than indirectly – like having dependent rather than independent agents in a given country – has, on the one hand, some sort of net benefit or cost that the MNE would be expected to evaluate neutrally in the absence of tax consequences, and on the other hand a strong tax thumb on the scales for choosing one approach rather than the other. The likely consequences include not only an inefficient incentive to sell to independent distributors in low-tax countries, but "differential effects across sectors"[134] that vary in their compatibility with the use of such distributors. Starbucks, for example, cannot offer the "Starbucks experience" to U.K. consumers without actually having its own stores there.[135] Apple can do better than this, although the popularity of Apple stores may impede migrating some of its

[133] See, e.g., Devereux et al, supra, at 63.
[134] Bankman, Kane, and Sykes, supra, at 26.
[135] Starbucks does, however, sell packages of coffee beans for home use, including through separate retailers. The profits from this part of its business model perhaps could be redirected to low-tax countries through the use of independent distributors.

sales. Microsoft does better still, from a tax standpoint, insofar as its stores sufficiently lack cachet to make remote sale through independent distributors more generally the best option.

A second tax planning problem pertains to profit lines that differ in their profitability – for example, because one but not another allows for earning rents. If SBFA or RPA-I applies at the overall MNE level, then combining, within a single MNE, the sales of highly profitable and less profitable items – with the latter being proportionately sold more by the MNE in low-tax countries – may cause a shift of overall tax base from high-tax to low-tax countries.[136] An example might be operating run-of-the-mill grocery stores in low-tax countries, in addition to earning rents everywhere. High-tax market countries might respond by requiring MNEs to do the relevant computations separately for distinct products or product lines.[137] However, this not only may work imperfectly in practice, but might apply differentially across industries, if some are more compatible than others with claiming that tax-favorable amalgamation is reasonable.

b) <u>Lack of separate arm's length consumer prices under two-sided business models</u> – Due to their two-sided business models, such digital platform companies as Facebook and Google may find it profitable to subsidize users, such as by giving them access to the platforms for free. These prices are in a sense non-arm's length, even though the parties are unrelated. What allows this to happen is the MNE's capacity to charge advertisers for access to the users and user data.

For a partially analogous problem, consider the longstanding difficulty, under both income and consumption taxes, of suitably taxing the value of certain financial services. Suppose, for example, that my bank offers me free checking and ATM use, even though these services are costly to provide and valuable to use, because it is also paying me a below market

[136] RPA-I might do better than formulary apportionment in limiting the tax payoff to this approach, however, since RGI is reduced by the costs attributable to third party sales.
[137] See Devereux et al, supra, at 67-68.

interest rate on the funds in my checking account. Here there are two offsetting non-arm's length prices – the subsidized free services and the interest rate – that presumably add up together to an arm's length economic relationship. Tax consequences may arise, however, if the two bundled transactions would be treated differently if they could be separately observed.

Under an income tax, bundling may yield implicit deductibility of the arm's length service fees (insofar as they would otherwise constitute nondeductible consumption expenses) that I bear in the form of forgone interest that would otherwise have been taxable. Under a VAT or GST that excludes financial flows from the tax base, bundling may lead to mislabeling of the bank's spread between (i) the high interest it earns on loans, and (ii) the low interest that it pays on checking accounts, as merely an exempt net-positive financial flow, when in fact it reflects bundled-in service fees.

Returning to the two-sided business model, where the linked transactions involve distinct third parties (from the MNE's standpoint) rather than the same one, what once again causes tax implications is the fact that overall liability does not depend just on the MNE's overall net cash flow. In a one-country example, use of the two-sided business model might make no difference. With SBFA or RPA-I, however, the market country in which users reside may not get to tax the LSRs that the MNEs using these two-sided models reap by reason of their drawing local users to their digital platforms.

A possible response is "allocating … residual profit to countries where users of services offered by certain highly digitalized businesses are located."[138] However, such an approach has only been very preliminarily discussed,[139] and would raise questions of how exactly it should be done. Suppose, for example, that one wanted to base the formula on the value associated with

[138] Devereux et al, supra, at 52.
[139] See HM Treasury, Corporate tax and the digital economy: position paper update (2018).

users in each country but could only observe their absolute numbers, screen time, or clicks. Moreover, even if user-based allocation proved feasible, its adoption would involve departing from one-size-fits-all, facially uniform corporate income taxation of all industries (testifying to the need for diverse instruments).

c) Tax rate constraint – If sales are used to allocate MNE profits under a corporate income tax, then presumably the next step is to apply the general corporate rate. If LSRs truly are involved, however, then requiring that they face the same tax rate as that for normal returns earned by local businesses may be undesirably constraining from a unilateral national welfare standpoint.[140] Corporate rates may also be too low, with respect to LSRs earned by outsiders, insofar as they adjust for the expectation that domestic shareholders may face a second level of taxation with respect to corporate income.

2) Destination-based cash flow tax (DBCFT)

During the DBCFT's "short but spectacular career … in United States tax policy debate"[141] – in early 2017, it briefly appeared to be a serious candidate for enactment – it often was misperceived as a novel fiscal instrument, rather than being correctly understood as a package rejiggering familiar ones. Its U.S. enactment would have amounted to a combination of (a) enacting a VAT, (b) repealing the existing corporate income tax, and (c) adding a wage subsidy that would not "meaningfully affect"[142] the cross-border analysis that I focus on in this paper.[143] However, while the DBCFT has shown no recent signs of coming back to life

[140] Absent the special issues raised by LSRs, charging nonresident MNEs higher rates than purely domestic ones may involve local producers' creating non-optimal tariffs to favor their interests against those of local consumers. In U.S. state and local taxation, this concern (along with national government supremacy over the states) helps to explain the constitutional doctrine barring state and local discrimination against outside commerce.
[141] Shaviro, Goodbye to All That, supra, at 1,
[142] Bankman, Kane, and Sykes, supra, at 27.
[143] See Shaviro, Goodbye to All That, supra, regarding this three-part decomposition of the DBCFT. Even the combination of elements was familiar, insofar as the DBCFT was "essentially just a scaled- down or 'skinny' version of David Bradford's X-tax," id., which would have added to it replacing the individual-level income tax

politically, a lesser version of it – increasing VAT rates (or, in the U.S., newly enacting a VAT) while reducing corporate income tax rates – generally is among the plausible options. Hence, it is worth asking here how the VAT component fares with respect to taxing LSRs in market jurisdictions.

The main respects in which this requires changing or expanding on the preceding analysis of the income-tax-based SBFA and RPA-I proposals include the following:

a) No intermediate sellers problem – VATs / DBCFTs do not face the problem of MNE tax avoidance via the use of intermediate sellers in low-tax countries. Here the difference lies not in their being consumption taxes that treat the present versus future consumption choice neutrally[144] - in contrast to an income tax that discourages saving – but rather in their happening to disallow any deductions or other cost recovery for amounts paid to foreigners for imports.[145] Thus, the in-country retail sales price determines liability on the consumer sale, whether the MNE sells directly or inserts an unrelated foreign intermediary as the importer.

Likewise, VATs / DBCFTs do not face the line of business issue that might arise under SBFA and RPA-I. Given that the gross, rather than the net, domestic sales price is being taxed, they do not rely on determining (and then apportioning) global net income.

b) Different tax rate constraint – Since the VAT and DBCFT taxes goods imported by MNEs as part of a broader domestic consumption tax, rather than a broader domestic income tax, the tax rate constraint depends on the consumption tax, not the income tax, rate. Absent special rules addressing MNE items in particular, "[a]ny effort to extract more MNE rents through a

with a graduated wage tax. Even in the skinny DBCFT version, the wage subsidy would merely have partly offset the wage tax component of the individual income tax, without causing the fiscal system to offer a net wage subsidy.

[144] In practice, a consumption tax may discourage saving, despite its well-known theoretical aim of being neutral between present and future consumption, if the expected future consumption tax rate exceeds the current one.

[145] See Shaviro, Goodbye to All That, supra, at 3.

VAT … would have to be accompanied by an equal increase in the VAT imposed on domestic firms (and borne in large measure by domestic consumers of all products). A VAT is simply not a well-targeted instrument for uniquely seeking out the returns to MNE activity."[146]

c) Currency adjustment issue – VAT rate changes (including the rise from zero percent rate when they are first enacted) can affect a currency's exchange value as against other currencies. To illustrate, suppose we return to the example of the French bottle of wine that sells for $80 per bottle on world markets. Moreover, suppose (for computational simplicity) that dollars and Euros initially trade at exactly 1:1 on world currency markets, and that the same bottle therefore also sells for €80. Finally, however, suppose that the United States adopts a (tax-exclusive) 25 percent VAT or DBCFT.[147]

A strong economic argument suggests that this would cause the dollar to appreciate, relative to other currencies, by the full amount of the tax rate increase.[148] All else equal, therefore, a dollar would now trade at €1.25 on world currency markets, changing the dollars to Euros ratio to 4:5. Under this exchange rate, if U.S. after-tax prices remained nominally the same as previously, and a U.S. importer sent the French wine seller only the $64 that remained after paying the VAT,[149] that amount would still, at the new exchange rate, yield the wine seller the same €80 that it had been clearing previously. This helps to show that, to the extent currency

[146] Bankman, Kane, and Sykes, supra, at 30.
[147] A tax-exclusive rate of 25 percent equals a tax-inclusive rate of 20 percent. For example, suppose that an $80 bottle of wine (taxes aside) generates $20 of VAT liability. This amount is 25 percent of the tax-inclusive $80 pre-tax price, and 20 percent of its with-tax $100 price. In practice, VATs, unlike retail sales taxes (RSTs) typically have their rates stated on a tax-inclusive basis.
[148] See, e.g., id. at 28.
[149] A one-time U.S. price level increase by reason of the VAT's or DBCFT's enactment would be expected to have an opposite effect, all else equal, lowering the dollar's currency value. Cite.

adjustments match the long-term (or general equilibrium) predictions of economic theory, foreign sellers into the domestic market would not bear the incidence of the new tax.[150]

d) <u>A new dimension to the two-sided markets issue?</u> – Under a VAT / DBCFT, just as under SBFA or RPA-I, no domestic tax liability would arise when MNEs offered users free access to their digital platforms. Given, however, that a VAT / DBCFT aims to tax domestic consumption – wholly apart from any impact on LSRs – a question arises as to whether that function is undermined by the way two-sided markets operate here.

If one thinks of neutrality between consumption choices, there arguably is an issue. The VAT / DBCFT does indeed tax-penalize charging domestic users a part of the overall freight, relative to charging only the outside advertisers (however immaterial this might be if the business model indicates charging only the latter in any event). Yet, in terms of equitably measuring ability to pay via the consumption costs that people incur, the existence of a significant problem is debatable. Excluding the subjective value to domestic users of free digital platform access is merely another example, among many, of consumer surplus, which arises whenever one's subjective valuation of a consumption benefit exceeds its market price. It is unclear whether addressing this particular instance, while presumably leaving others untouched, would improve a VAT / DBCFT's overall domestic equity and efficiency effects.

3) <u>Conclusions Regarding Market Country Sourcing of MNE Profits</u>

Nothing in this section rebuts claims that adopting SBFA or RPA-1 within the corporate income tax, or else shifting away from corporate income taxation and towards the use of VATs,

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150 An appreciated dollar would, however, lead to transition loss for U.S. holders of foreign assets, and a transition gain for foreign holders of U.S. assets (including dollars). In 2017, it was estimated that enactment of the DBCFT that was being proposed by the Republican Congressional leadership would lead on balance to a net $3 billion transition gain for foreigners, relative to U.S. residents, reflecting extensive foreign ownership of U.S. assets. See Shaviro, Goodbye to All That, supra, at 4.

would improve countries' tax systems. The main arguments in support of such claims rest on grounds distinct from increasing market country taxation of outside MNEs' LSRs. However, even if such changes are adopted, and even if they reduce MNEs' current ability to locate tax jurisdiction over their profits in tax havens, market countries would still have reason to consider addressing LSRs more particularly. I therefore next turn to DSTs, as a currently prominent means of trying to do this.

B. Evaluating Key Features of Existing and Proposed DSTs

There is no canonical form of "ideal DST," discernible in parallel to such familiar constructs of the academic literature as ideal income and consumption taxes.[151] Rather, the term is a label that has been used to describe a growing set of similar actual or proposed tax instruments that both vary in their details, and could perhaps take new directions, without there being clear guidelines to tell us at exactly what point the label might cease to be apt. To ground the analysis, however, this section briefly describes the recently promulgated UK DST, which generally follows the model proposed by the European Community, before turning to a more general consideration of DSTs' main features, and possible alternative features.

1. The Proposed UK DST

On July 21, 2019, HM Revenues and Customs published the text of a DST that is scheduled to be part of the 2019-20 UK Finance Bill. Its main provisions include the following:

(a) Digital service activities – The tax would apply to revenues from digital services activities, which include providing a social media platform, an internet search engine, or an online marketplace. Relevant revenues include those arising in connection with online

[151] The term "ideal" income or consumption tax refers to its expressing a pure abstract form of the instrument in question, rather than suggesting that its adoption in that form would be ideal in a normative sense. See, e.g., Daniel Shaviro, Beyond the Pro-Consumption Tax Consensus, 60 Stan. L. Rev. 745, 747 (2007).

advertising and the provision of goods, services, or accommodation in the UK. Online financial marketplaces are expressly excluded, and digital platforms that provide content, rather than hosting that provided by the users themselves, are outside the definitional scope.

(b) UK share of global digital services revenues – Only the UK's share of global digital services revenues are subject to the tax. These generally are revenues attributable to UK users, and from advertising intended to be viewed by UK users. Where revenues relate to both UK and non-UK users, or to digital and other activities, they are to be attributed to UK users "to such extent as is just and reasonable."

(c) Minimum threshold and tax rate – The UK DST only reaches companies that, for the year, have digital service revenues of at least £500 million globally, and at least £25 million in the UK. Companies above both thresholds face a 2 percent DST rate on their UK digital service revenues in excess of £25 million.

(d) Not purely a gross revenues tax – An alternative computation provides relief to taxpayers that faced large costs of generating UK digital service revenues. Under it, the taxpayer reduces such revenues by an "appropriate portion" of "relevant operating expenses." It can then elect to pay 80 percent of the amount thus computed (including zero) in lieu of the 2 percent tax on (gross) UK digital service revenues. Taxpayers presumably will choose this option only when 80 percent of the net amount thus determined is less than 2 percent of the gross amount.

(e) Companies that might be subject to the UK DST (assuming they meet the thresholds) – Under the above criteria, the likes of AirBnB, Amazon Marketplace, eBay, Expedia, Facebook, Google, Twitter, Uber, and YouTube would appear to be taxpayers, subject to their meeting the revenue thresholds. However, content providers such as Netflix and Spotify appear likely to be outside the DST's scope, despite their having some user participation (such as through the posting of customer reviews or playlists).

2. Assessing DSTs' Main Features

(a) Selective application – Whatever criteria one uses for DST applicability, the instrument inherently is not meant to apply to all firms, as distinct from a subset of them that are in the digital sector. DSTs thus are in tension with tax neutrality – a hallowed principle that not only promotes efficiency under wide-ranging circumstances,[152] but may improve political outcomes even when well-chosen non-neutralities would be optimal.

The efficiency case for departing from tax neutrality through enactment of a well-designed DST is nonetheless clear. Applying a tax on LSRs selectively takes heed of variations in rents and the national government's market power. In addition, facially neutral treatment does not necessarily yield substantive tax neutrality. For example, taxing all DSI (as defined by domestic law) at the same rate, but allowing MNEs distinctively to avoid having DSI, may cause them to be tax-favored relative to purely domestic firms. A DST might therefore actually increase tax neutrality as between industries and firms even if, on its face, it applied selectively.

However, the political economy issues raised by DSTs' selectivity are potentially more troubling. Encouraging policymakers to pick and choose between prospective taxpayers, even using nominally general criteria, can have bad consequences. The particular eligibility rules in proposals similar to the UK DST have been criticized as "arbitrary from a policy perspective"[153] and as hand-tailored to exclude domestic MNCs, even where the proposals' stated rationales

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[152] See, e.g., Anthony Atkinson and Joseph Stiglitz, The Design of Tax Structure: Direct Versus Indirect Taxation, 6 J. Pub. Econ. 55 (1976) (finding that all commodities should be taxed equally under specified circumstances, including that none are leisure substitutes or leisure complements).
[153] Congressional Research Service, Digital Service Taxes, supra, at 19.

seemingly would apply to them.[154] This, however, raises the question, discussed next, of whether DSTs' particular criteria, which are indeed mainly set at a broad level of generality, are reasonably defensible.

(b) Why tax social media platforms, internet search engines, and online marketplaces? – The case for applying a special tax instrument to these types of companies – whether or not also to other types of companies – rests on three main claims. The first is that leading firms in these sectors, perhaps for broader structural reasons, have substantial market power,[155] allowing them to earn monopolistic or oligopolistic rents, and creating incentives for over-investment in pursuit of market power.[156] The second is that such firms are generally undertaxed under existing law, for reasons that reflect corporate income taxation's weaknesses as an instrument. These include its susceptibility to MNE profit-shifting, its reliance on physical presence, and two-sided business models' effect on market-based income sourcing.[157] The third is that such firms' low marginal cost both for entering a given country, and accommodating particular transactions, reasonably allows the use of design features, such as taxing gross revenue rather than net income, that would not otherwise be appropriate.[158]

(c) Why exclude online content providers? – A common rationale for excluding, say, Netflix and Spotify from DSTs, while applying them to companies such as Facebook and

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[154] While taxing domestically owned firms presumably would not transfer resources from foreigners to resident individuals, it still might be efficient and serve domestic distributional goals.
[155] Issues around market power in the digital economy have attracted a growing literature. See, e.g., Kenneth A. Bamberger and Orly Lobel, Platform Market Power (2017), available online at https://scholarship.law.berkeley.edu/btlj/vol32/iss3/2/.
[156] See, e.g., Cui, supra, at 25-30.
[157] See, e.g., Johannes Becker, Joachim Englisch, and Deborah Schanz, *Re-Allocation of Taxing Rights for Big Business Data Models* (2019), available online at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3433715 .
[158] See Cui, supra, at 25.

Google, rests on a confused version of production-based income sourcing.[159] Ostensibly, a market country's exercise of tax jurisdiction is more reasonable if resident users generate value through their contributions to a digital website than if they are merely passive participants.

This view's greatest weakness is its relying on unpersuasive and normatively irrelevant income sourcing notions. The very fact that a given country's residents are using a particular digital platform, whether actively or passively, and that the MNE is thereby profiting, should suffice to make claims of tax nexus reasonable. Yet the claim that active user participation matters as such may also be challenged within the logic (such as it is) of production-based income sourcing. As Johannes Becker and Joachim Englisch have noted, the claim here is not just that the users' content creates value – subject to the usual Coase problem of where it was created – but that it "amounts to a co-production of value that accrues to the business." This in turn ostensibly gives market countries' claims greater legitimacy, based on a production-side theory.

Even insofar as one is willing to play the empty semantic game here, it might be noted that users post content for reasons of their own that are often non-pecuniary, and that the firm generally does not monitor the quality and quantity of their "work."[160] If positive externalities to the firm amount to co-production that is relevant to taxability, then the same presumably holds when singles bars draw appealing foreign guests,[161] and when foreign visitors post hotel or restaurant reviews on Yelp or TripAdvisor.[162] But in any case the entire line of analysis seems

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[159] A further question might be why online financial marketplaces are excluded. This may reflect a view that this market sector is highly competitive, rather than featuring significant LSRs, and/or that its tax and regulatory treatment are best left in the hands of specialized regulators.
[160] Becker and Englisch, supra, at [18].
[161] Cf. Cui, supra, at 12-13 (describing nightclub owners' business model).
[162] See Congressional Research Service, supra, at 15, noting that it is not commonly claimed, "with regard to everything from dog walkers to dry cleaners to …. [that] the act of providing a review" conveys taxing rights to the countries in which the users reside.

unrelated to issues of actual normative interest, whether based on concern about efficiency or distribution. From the standpoint of taxing LSRs without resort to globally destabilizing Monty Python taxation, it is hard to see any normatively meaningful difference between the Facebook-Google business model on the one hand, and that of Netflix or Spotify on the other.

This is not, however, to prejudge how a more suitably directed analysis of particular content-providing digital platforms would come out. For example, insofar as the case for a special tax instrument rests on the difficulty of applying recognizable corporate income models, it may matter that content providers often charge individualized subscription or downloading fees. As it happens, Netflix apparently treats its UK subscribers' fees as income that arose in the Netherlands, thereby contributing to its paying very little UK income tax.[163] This, however, might be easier to address without inventing new tax instruments than the use of two-sided business models to earn revenues from nonresident advertisers.

(d) What about other types of firms with LSRs? – As noted earlier, even an MNE that, like Starbucks, sells actual physical products in brick-and-mortar stores may (1) reap LSRs, (2) have the opportunity to make non-rival use of its valuable IP in multiple jurisdictions, and (3) be very successful at tax avoidance under present law. Does this imply deploying new tax instruments, perhaps similar to DSTS but reaching entirely beyond the digital sector?

Two main issues should drive the analysis. The first is how successfully general purpose tax instruments, such as the existing corporate income tax, can limit market country tax

[163] See Mark Sweney, Netflix Paid No UK corporate tax last year – and got a £200K rebate, The Guardian, June 21, 2018, available online at https://www.theguardian.com/media/2018/jun/21/netflix-paid-no-uk-corporate-tax-last-year-and-got-a-200k-rebate. In 2017, Netflix earned roughly £500 million from UK subscribers' fees.

avoidance by such MNEs.[164] The second is how well one could devise special instruments to target their LSRs.

A company that sells physical products through brick-and-mortar stores inevitably has non-trivial marginal operating costs, which could not reasonably be made nonrecoverable through the taxation of gross receipts or gross revenue. Thus, adapting the DST model to such a company would require limiting nondeductibility to items, such as royalties for the use of IP, that, even if recoverable in a standard income tax model, are no less subject to a zero-marginal-cost line of argument than the IP used by purveyors of digital platforms.

(e) Why tax gross rather than net revenues? – One of DSTs' most controversial features is that, as gross receipts taxes, they "deviate from the historical consensus that taxation of multinationals should be based on profits rather than turnover."[165] This consensus reflects VATs' European history as a replacement for turnover or gross receipts taxes that, as it came to be understood, had serious economic drawbacks. One was their imposing cascading tax burdens on consumer goods that, during the production process, were sold from one non-vertically integrated business to another as productive inputs.[166] A second was their unduly discouraging business outlays that would yield tax liability based on the gross, rather than the net, return.[167]

For instruments such as the UK DST, the former of these two problems may not be especially important. Insofar as the goods and services that are being taxed are used by

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[164] As we saw earlier, Starbucks' business model happens to impede its avoiding both SBFA / RPA-I and VATs / DBCFTs, but if it just sold beans (or relied less on the "Starbucks Experience") the former would lose effectiveness.
[165] George Kofler and Julia Sinnig, Equalization Taxes and the EU's 'Digital Services Tax,' 47 Intertax 176, 200 (2019).
[166] Business-to-business sales are exempt under a well-designed retail sales tax, but not under a gross receipts tax on each separate business. Under the latter, however, vertical integration between companies linked on the production chain eliminates taxable sales transactions between them.
[167] Thus, under the UK DST in the absence of its net revenue provision, suppose that a taxpayer could gross an additional £100 by spending an additional £99. The pre-DST £1 profit would turn into a £1 loss after considering the DST implications.

consumers, rather than as business inputs, cascading may not significantly arise.[168] So the issue of prime interest is disregarding the marginal costs of realizing gross returns, in circumstances where such marginal costs may often be fairly low.

Even where the disallowed marginal costs are positive, it is possible for disallowance to yield a more accurate measure of net profits than would result from allowing deductibility. As Cui and Hashimzade have noted, natural resource taxes often depend on gross revenue, rather than net profit, based on the recognition that "revenue-based taxes are easier to implement and more robust against tax planning and profit-shifting."[169] The same rationale could apply to LSRs that are subject to the DST, although this depends both on the level of true marginal costs from local deployment (including from the existence of quasi-rents rather than true rents), and on the degree of taxpayer manipulability.

Suppose that, in practice, the problem of taxpayer overstatement of deductible marginal costs goes more to where deductions are claimed than to their overall global amount. That might support using a formulary approach – just for deductions or, indeed, for all net revenue in lieu of taxing gross revenue – if one could devise a formula that worked sufficiently well with respect to digital platform use.

(f) How high should revenue thresholds be? – Minimum size thresholds for DSTs and other such instruments may be rationalized both as "exempting smaller businesses from potentially costly compliance burdens"[170] and as using size as a proxy for suspected market power. However, the former rationale can be misused to the benefit of firms that are large

[168] Uber rides and AirBnB lodging are examples of items subject to the UK DST that might be used in a business setting. But existing income taxes, VATs, and retail sales taxes likewise struggle with the business versus consumption distinction in such settings.
[169] Cui and Hashimzade, supra, at 4.
[170] Id.

enough to comply conveniently, but that happen to be politically favored – for example, in the case of European DSTs, because they are local rather than American firms. The latter rationale might be less applicable when market power is being exercised oligopolistically by multiple firms (some of which might be relatively small), than when there is a single huge monopolist.

(g) Biased against American MNEs? – The whiff of anti-Americanism that U.S. policymakers have discerned in European DSTs might (if verified) be rationalized, from an EU perspective, either as an authentic voter / consumer preference regarding whose LSRs to target, and/or as helping, albeit selectively, to overcome undue pro-company bias in the policymaking process. Yet the potential impact on U.S. responses of even mistakenly perceived bias makes it strategically important for proponents of LSR taxation to choose their eligibility filters carefully, reasonably, and with an eye towards simplicity and generality.

That said, in my view neither the UK DST, nor the similar French DST,[171] displays suspicious tailoring to reach U.S. but not EU firms, unless one can deduce this contextually from their size thresholds (and views such high thresholds as otherwise unjustified).[172] The provisions address, in general terms, digital firms of particular kinds that do in fact raise distinctive (even if not wholly unique) tax policy issues.[173] The affected firms' being so predominantly U.S.-owned cannot reasonably be viewed as exempting them from market country policy responses that are themselves not unreasonable.

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[171] The French DST appears generally to resemble the UK DST in substance, and thus likely would apply to a similar set of firms, although the inclusions and exclusions are structured somewhat differently. It applies, with a 3 percent rate, to MNEs with digital interfaces that allow users to contact and interact with other users, including for delivery of goods and services. It also similarly excludes the provision of digital content and regulated financial services. Its global revenue threshold is higher (€750 million instead of £500 million), and its national revenue threshold is similar at current exchange rates (€25 million versus £25 million).

[172] For a forceful argument to the effect that the size thresholds do indeed constitute "covert nationality discrimination," see Ruth Mason and Leopoldo Parada, Digital Battlefront in the Tax Wars, 92 Tax Notes 1183 (2018).

[173] For example, large digital firms may be especially likely to earn rents, have low marginal costs of operating in particular markets, and be well-situated to avoid or minimize corporate income tax liability.

V. CONCLUSION

The rise of highly profitable MNEs that both earn substantial global rents (or quasi-rents) and are adept at locating their profits in tax havens places pressure on existing corporate income tax models. While such models' capacity to combat MNE tax planning might perhaps be significantly improved, this would still leave market countries well short of being able to tax, as fully as they might like, the LSRs that these companies earn by interacting with their residents, or within their geographical territories.

Market countries that use reasonably well-designed novel tax instruments to expand their capacity to reach such LSRs are acting reasonably, as judged within existing norms for constraining and channeling countries' self-interested behavior. Their efforts also have the potential to improve, rather than worsen, global efficiency and distribution. DSTs in particular, whether they prove permanent or merely transitional, look like harbingers of a new era in which entity-level corporate taxation rightly focuses more on locational rents, and less on decades-old doctrinal and semantic debates concerning the supposedly "true" source of economic income and value creation.