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MOBILE INTELLECTUAL PROPERTY AND THE SHIFT IN INTERNATIONAL TAX POLICY FROM DETERMINING THE SOURCE OF INCOME TO TAXING LOCATION-SPECIFIC RENTS: PART TWO

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In recent decades, a number of fantastically successful, mainly American, multinational entities ("MNEs")—led and epitomised by the 'Four Horsemen', Apple, Amazon, Facebook, and Google, but also extending beyond the tech sector—have earned huge profits, while paying very low global taxes, through their use of intellectual property ("IP"). Since IP, in contrast to tangible property, generally lacks a clear location, it empowers corporate tax avoidance at the expense of both the production countries where the MNEs' high-value owner-employees live, and the market countries where their customers live.

This two-part article assesses the challenges posed for countries' international tax systems by the rise of mobile IP, including but not limited to the case where it is embodied in a digital platform. Part One assessed the challenges posed for the traditional income tax concept of source, and for the Organisation for Economic Co-operation and Development ("OECD")'s proposed focus on the site of 'value creation'. In this issue, Part Two focuses on proposals to shift taxing rights towards market jurisdictions that may enjoy location-specific rents with regard to the MNEs' access to their consumers, including via the use of digital service taxes ("DSTs").

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

"Think globally, act locally," goes the saying. Multinational entities ("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

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their actions' spill over 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.[1] Non-residents' 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"[2] 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 foreign source income ("FSI") (including through an MNE) would generally seem to make one as well-off as earning domestic source income ("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 labour supply or investment) that often is otherwise associated with distribution-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 nonetheless treats United States ("US") MNEs as a category of interest to US policymakers is that many of them are substantially owned by US 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 US MNEs is a proxy for taxing US individuals, who are among 'us' in the United States, but elsewhere are among 'them'.

Even with respect to US 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,

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1 See, *eg*, Michael J Graetz, "Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies" (2001) 54:3 Tax L Rev 261.

2 Daniel Shaviro, "Taxing Potential Community Members' Foreign Source Income" (2016) 70:1 Tax L Rev 75 at 94.

rather than domestic, companies. Likewise, given that non-resident individuals generally are not taxable 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. *Non-Resident Individuals*

Generally excluding concern for non-resident 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. The second is that one may want to use tax and other policy instruments to transfer resources from 'them' to 'us', thereby increasing 'our' welfare. In this regard, however the crucial question is not whether 'they' are remitting tax payments in direct cash flow terms, but who bears the taxes economically.

Suppose for the moment that there were no limits to one's willingness to use tax instruments to extract resources from non-residents—not even those that, as I discuss below, might reflect strategic considerations or adherence to good conduct norms in tax policy. In this scenario, suppose we divided non-residents' 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 its lacking 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 non-residents' clear FSI, as distinct from their possible DSI. Addressing possible DSI seems likely to raise incidence issues, given the possibility that non-residents 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,[3] given that, by definition, it pertains to income that has no local connection.

We therefore have a seeming prediction, to the effect that countries should prefer Monty Python taxation to taxing non-residents' possible DSI. To be sure, the opportunity to do this is often limited by practical considerations, such as costly information-gathering. Such constraints, however, may be smaller with respect to MNEs that have substantial assets and business activities within a given country, and whose global business activities are to some extent discoverable through a conventional tax audit. Thus, the apparent falsity of the prediction that countries will aim to do as much Monty Python taxation as feasible suggests that, perhaps, the implicit behavioural model for governments in tax policy, as presented so far, is missing

[3] Daniel Shaviro, "Mobile Intellectual Property and the Shift in International Tax Policy From Determining the Source of Income to Taxing Location-Specific Rents: Part One" [2021] Sing JLS 681 at 685.

something important. Before turning to that, however, it is worth further exploring the incidence questions raised by attempting to tax foreigners with respect to possible DSI.

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

1. *Tariff incidence and optimal tariffs*

The incidence issues raised by the goal of imposing taxes that will be borne economically by non-residents 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 six 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 eight percent pre-tax 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.[4] On the other hand, if outside investors are earning location-specific rents ("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.[5] 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 US placed a $10 tariff on such wine, then, in the absence of US 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 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.[6] 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" (*ie*, has monopsony power).[7] Thus, if a sufficiently large portion of the overall market for the above French wine involved US consumers, the French wine sellers might end up accepting less than $80 per bottle, net of the tariff, causing them to bear at least some of the incidence. The upshot would be a wealth transfer from French to American individuals, albeit

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4 See, *eg*, Daniel N Shaviro, *Decoding the US Corporate Tax* (Washington, DC: The Urban Institute Press, 2009) at 67, 68.

5 See, *eg*, Joseph Bankman, Mitchell Kane & Alan Sykes, "Collecting the Rent: The Global Battle to Capture MNE Profits" 72 Stan Tax L Rev (forthcoming in 2020) (manuscript at 41) (on file with author).

6 See Bankman, Kane & Sykes, *supra* note 5 at 41.

7 *Ibid* at 40 (citing Harry G Johnson, "Optimum Tariffs and Retaliation" (1953) 21:2 Rev Economic Studies 142).

at the cost of both (1) reducing Americans' surplus from drinking the wine (if the US price still rose above $80), and (2) inducing French retaliation.

Likewise, suppose foreign sellers have market power that they use 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 retaliation.[8] Despite these downsides, however, optimal tariffs can increase domestic welfare on balance.

2. *Rents, quasi-rents, and location-specific rents*

As the above discussion makes clear, the relevance of the strategic trade literature to taxing MNEs is importantly affected by the fact that, at least *ex post* (*ie*, given their success), such firms earn global rents through sales in market countries around the world. They do this by deploying IP that was mainly created by high-value owner-employees in a production country (such as the US) 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. Before addressing how this might affect countries' behavioural incentives, and the contours of a global welfare analysis, it is important to address two aspects of these (at least *ex post*) rents. First, are they also rents *ex ante*, and does it matter? Secondly, to what extent does the existence of global rents, whether *ex ante* or *ex post*, suggest the existence of (and permit one to define) LSRs?

(a) *Rents, quasi-rents, and returns to labour or risk*: Do highly profitable firms actually earn rents? A company that, like Google, sees its value explode relative to the funds initially invested has certainly done so *ex post*. They are earning revenues in excess of short-term marginal costs, and thus (in standard microeconomic theory) will continue producing until such time as the price retained after-tax fails to cover such costs.[9]

However, even such highly successful firms *ex post* may face higher longer-term than current marginal costs, such as of updating IP and retaining brand value, that might conceivably yield a merely normal return. If they are only enjoying temporary quasi-rents, then taxing them as if they were earning true rents may eventually cause them to leave the market, or at least to reduce over time the scale of their operations.

There is also the question of whether seemingly clearly observed rents *ex post* were truly so *ex ante*. The founders' extraordinary returns on the funds that they invested may reflect that they also deployed labour effort towards the cause. Or they may in effect be lottery winners, who would not necessarily win every time if one could turn back the clock and rerun the 'tournament'. Accordingly, from an *ex ante* perspective, one may need to think about (potentially tax-deterrable) labour supply and the relevance of upside risk, before concluding that the winners enjoy rents.

The *ex ante* perspective may imply that taxing away the seeming rents enjoyed by today's winners will deter tomorrow's prospective winners from trying.[10] On

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8 See Bankman, Kane & Sykes, *supra* note 5 at 41.

9 See, *eg*, *ibid* at 7.

10 This, of course, is the classic economic problem of time consistency.

the other hand, today's prospective future equivalents of a Jeff Bezos or a Mark Zuckerberg might be so likely to succeed (at least in their own minds), or else so eager to supply the needed labour and embrace the upside risks, that their actual tax-sensitivity is low.

Successful MNEs may also enjoy *ex post* rents by reason of market power, economies of scale, and tax advantages (*eg*, profit-shifting opportunities) that are unavailable to purely domestic competitors.[11] Here, even if the *ex post* payoff looked more like a normal return *ex ante*, it is not of a sort that one should regret deterring. Thus, here an *ex ante* perspective may even enhance the policy conclusions that would follow from looking at rents just *ex post*.

On the various grounds noted above, I will assume in this paper that MNE rents, as observed *ex post* from the market posture of highly successful companies, are indeed reasonably treated as such. This still leaves open the question, however, of the relationship between overall global rents and the LSRs that particular countries might regard as within their respective purviews.

(b) *Locating LSRs*: Wei Cui and Nigar Hashimzade argue that DSTs are best analysed under a framework that is familiar from the literature concerning LSRs.[12] For example, a country with valuable oil in the ground may be able to attract the outside investment needed to extract it, without offering more than a normal return.[13] They urge thinking similarly about, say, the activities, directed towards a particular country, of an MNE such as Facebook.

After all, once a given MNE has relevant IP with global value, deploying the IP in a given country may involve only limited further marginal costs, be non-rivalrous with deploying it in other countries, and have no opportunity cost.[14] Facebook does not decide whether to be available in the UK or instead in France, like a winemaker shipping its fixed output to one place or another. It operates in both places, subject only to requiring a positive return in each country.

Moreover, one may think of an MNE's interactions with a given country's residents, or with people who are physically inside it while they interact with it, as geographically occurring or belonging there, no less than oil in the ground. This attribution of particular rents to a given country might be based on the actual reach of its government's power over its territory or residents, and/or on a normative view as to their being properly within its realm of authority.

Suppose that everyone in the world with whom the MNE might profitably interact is assignable to one specific country at the time of such interaction, and that the MNE's global profits consist entirely of rents derived from these interactions. Then its global rents must tautologically equal the sum of the LSRs earned in each country. If we define Monty Python taxation as taxing someone else's LSRs, then, in the absence of

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11 See Bankman, Kane & Sykes, *supra* note 5 at 7.

12 Wei Cui & Nigar Hashimzade, *The Digital Services Tax as a Tax on Location-Specific Rent*, CESifo Working Paper Series No. 7737 (2019) at 2.

13 This could be done by alternative means—for example, charging high royalties, and/or imposing special regimes for national resource taxation.

14 Wei Cui, "The Digital Services Tax: A Conceptual Defense" Tax L Rev (forthcoming in 2020) (manuscript at 13) (on file with author).

such taxation, there should be no overlap between the tax bases that countries reach if they tax their own LSRs.

To be sure, there is still a 'Coase problem' here. After all, the LSRs that are realised in particular market countries reflect IP that presumably was created by people's efforts (and/or good luck) in the other, production countries. Thus, in a production sense, rather than in a market sense, one would derive a very different, and completely overlapping, answer as to LSRs situs. So, one faces the same production country versus market country choice as with respect to determining the source of income—albeit, without being tied to semantic debates regarding the meaning of 'source'.

3. *Preliminary application to US (and other) MNEs*

In practice, MNEs often treat large swathes of their profits as arising in tax havens, rather than in either the true production or market countries. This reflects tax planning opportunities that may defeat the tax claims of both types of countries. Residence country taxation can too often be surmounted, even if the MNE's residence is in its main production country, not a tax haven. Some of the main tax policy issues that this poses for the production/residence countries and the market countries, are as follows.

(a) *Production/residence country*: The production/residence country, if it advances distributional goals through an income tax, has reason to impose current tax (or its equivalent) on resident employee-shareholders who own 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 unrealised stock appreciation. It also may not happen at the entity level insofar as the MNEs claim domestically non-taxable FSI.[15] Moreover, under US 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.[16]

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 for domestic welfare. For example, as noted above, the case for increasing residence-based corporate income taxation is weakened insofar as resident individuals can respond by earning FSI through non-resident MNEs. Likewise, the desirability of strengthening production-based source rules may be reduced by global tax competition with respect to actual production.

While the optimal resolution of these competing concerns is unclear, it is plausible that political economy biases cause home country MNEs to be undertaxed. Such companies may have high profiles as 'national champions', control vast economic

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[15] Note, however that Subpart F, GILTI, and the BEAT are possible vehicles for US taxability. See generally Jane G Gravelle & Donald J Marples, *Issues in International Corporate Taxation: The 2017 Revision (P.L. 115-97)* (Washington, DC: Congressional Research Services 2019), online: Congressional Research Services <https://fas.org/sgp/crs/misc/R45186.pdf>.

[16] See *Internal Revenue Code*, 26 USC § 1014 (1986).

resources, exert political influence, and have wealthy founders/controlling owners. Thus, both interest group politics[17] and the sway of the super-rich in a plutocratic era[18] may operate to their advantage.

Suppose 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 non-residents. 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 favour of national welfare benefit. 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[19] 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, the hostile US political response to recently proposed or enacted European Union ("EU") DSTs, as well as to earlier initiatives, such as the EU state aid cases, comes as no surprise.[20] Yet, as I discuss below, the question of whether EU-imposed taxes reduce US national welfare is distinct from that of whether, as a strategic matter, the US ought to respond aggressively to their imposition. Not all adverse effects on oneself of others' actions merit provocative retaliation.

(b) *Market countries*: For market countries, an initial issue to keep in mind is that nearly every country in the world, other than the US, has a value-added tax (("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 non-resident 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.[21]

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

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17 See, *eg*, Mancur Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups* (Cambridge, MA: Harvard University Press, 1965).

18 See, *eg*, Larry M Bartels, *Unequal Democracy: The Political Economy of the New Gilded Age* (Princeton: Princeton University Press, 2010).

19 See, *eg*, Daniel Shaviro, "The Mapmaker's Dilemma in Evaluating High-End Inequality" (2016) 71:1 U Miami L Rev 83 at 107.

20 When the US Treasury vigorously protested EU state aid rulings against particular US MNEs, I agreed that it was making a "good-faith [albeit, I argued, misguided] effort to advance the interests of the American people. . . " Daniel Shaviro, "Friends Without Benefits? The Treasury and EU State Aid" (2016) 83:12 Tax Notes Intl 1067 at 1067.

21 Singapore recently enacted a GST provision of this kind. See Mary Swire, "Singapore Updates Guidance on 2020 GST Reverse Charge Change" *Tax-News* (30 August 2019), online: Tax-News <https://www.tax-news.com/news/Singapore_Updates_Guidance_On_2020_GST_Reverse_Charge_Change_97290.html>.

seeking to impose tax burdens on outside MNEs that earn rents or quasi-rents through inbound activity. Under the suggested analogy between MNEs' market country LSRs and natural resource taxation, a digital platform's deployment in a given country is non-rival and free from opportunity cost may support the feasibility of taxing away the extra-normal portion of the return.[22]

The force of this argument is not limited to digital platform companies. For example, it holds with respect to Starbucks deploying the IP that lies behind the 'Starbucks Experience'. While Starbucks clearly incurs marginal costs in each country, its global IP and brand deployment are to a degree non-rival, free of opportunity cost, and associated with only limited rising marginal costs. Similar to Facebook, it may not be so much as choosing between United Kingdom ("UK") and French stores, as separately deciding how many stores each market profitably supports.

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 mainly emphasised unilateral national welfare, based on viewing national policymakers' normative concern as 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 non-residents' 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.

Secondly, 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 obligated to follow because of an internalised sense of duty, because of a fear of external non-legal sanctions, or both."[23] As I have discussed elsewhere, such norms-based behaviour can apply, through national policymakers, to countries' behaviour.[24]

Both pathways may be affected by the relationship between the gain that a particular country might realise and the 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,

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22 Cui, *supra* note 14 at 13.

23 Richard H McAdams, "The Origin, Development, and Regulation of Norms" (1997) 96:2 Mich L Rev 338 at 339.

24 See Daniel Shaviro, "Why Worldwide Welfare as a Normative Standard in US Tax Policy?" (2007) 60:3 Tax L Rev 155.

but can help build concord through the symbolic resonance of its gesturing towards mutual respect.

Norms may also steer self-interested behaviour into accepted channels. Consider individuals who unabashedly prefer paying less rather than more when bargaining with strangers, but who leave tips in restaurants to which they do not anticipate returning. Likewise, people whom John Roemer calls 'conditional Kantians' behave cooperatively, even when contrary to their direct material self-interest, when they believe that a sufficient proportion of other people are likewise doing so.[25]

Both strategic considerations and the norm of proportionality make relevant 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, distinguishing right and wrong channels for self-seeking behaviour may help in evaluating how countries might reasonably seek to impose tax burdens on non-residents. An example might be explaining reluctance to engage in Monty Python taxation.

2. *Global efficiency issues*

When 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.[26] For this reason, if each of two economically similar countries imposed comparably sized optimal tariffs on the other, each would likely lose on balance. Thus, the intelligent usually seek to avoid trade wars, even when one might have strategic trade rationales.

Such an analysis may not, however, apply when market countries seek to tax inbound LSRs generated by MNEs. Insofar as the MNE has market power, exercising offsetting monopsony power need not yield inefficient output reduction.[27] Moreover, even insofar as MNEs are merely earning normal returns, rather than efficiently taxed rents, their global tax planning opportunities suggest that they may at present be inefficiently undertaxed, compared to other businesses.

Insofar as MNEs are only earning quasi-rents, the efficiency analysis looks less favourable. Taxing quasi-rents is efficient *ex post* in the short run, but raises time consistency problems that can unduly discourage investment *ex ante*. These problems might be accentuated by individual countries' incentive to under-value adverse spill over effects on people in other countries. On the other hand, as Cui notes, if "competition in markets occupied by [digital] platforms [or other IP] is plagued by the problem of excessive search [for 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."[28]

There is also a political economy aspect to the analysis. Suppose that, as suggested above, production/residence countries (such as the US) are prone to under-taxing

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[25] See John E Roemer, *How We Cooperate: A Theory of Kantian Optimization* (New Haven, CT: Yale University Press, 2019).

[26] See, Bankman, Kane & Sykes, *supra* note 5 at 32.

[27] *Ibid* at 31, 32.

[28] Cui, *supra* note 14 at 30, 31.

powerful MNEs due to political choice problems. If such political constraints do not cross the border to market countries, the latter's taxation of MNEs may be better-suited to address collective global under-taxation of MNE profits, albeit potentially creating a 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 tax MNEs' LSRs. However, that is not the question being asked here. No global tax authority has the power to set global tax policy based on 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. Given the complex and offsetting character of the relevant efficiency issues, my own view is that such a claim of unreasonableness is wide of the mark.

3. *Equity issues and reasonableness*

The actual or perceived reasonableness of market country efforts to tax outside MNEs' LSRs may also be affected by issues of fairness or equity. As it happens, 'inter-nation equity' is a familiar concept in international tax policy debate.[29] While its meaning and relevance are disputed, it is sufficiently flexible to evoke 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 beneficence would suggest concern for the welfare of people in *all* countries, the focus of interest would still be individuals, not nations. Still, within such a framework, transfers from richer to poorer countries might tend to yield greater global progressivity as determined at the individual level—albeit, subject to the distributional playout within particular countries.

From such a standpoint, market country taxation of leading MNEs' LSRs might grade quite favourably. The US 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 suit if DSTs or similar instruments prove reasonably successful and become familiar. Even without such national-level differences, however, transfers from US MNE owners to peer countries' national treasuries might tend to improve global distribution.

There are also, however, common usages of inter-nation equity that treat countries as 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-centred view of both source and relevant benefit than has achieved consensus support in international tax policy debate.

In the current global political context, the high concentration of US MNEs among those that might face added taxation in market countries adds an inflammatory further dimension to the equity debate. As Cui and Hashimzade have noted, market countries' normative claims of entitlement to tax US companies' LSRs have "radical

[29] See, *eg*, Richard A Musgrave & Peggy B Musgrave, "Inter-nation Equity" in Richard M Bird & John G Head, eds, *Modern Fiscal Issues: Essays in Honor of Carl S. Shoup* (Toronto: University of Toronto Press, 2007) 63.

implications", as they imply that "the US need not be the primary claimant to the profits that result from the technologies its companies invent."[30]

The implicit underlying US' view might be further described as follows. Suppose one believes that US MNEs' global profits reflect the extraordinary talent and hard work of founders 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 their ability to pay. Analogously in the international realm, one might believe that only the US, as the home of all that innovation, is entitled to tax the resulting profits. Thus, even wholesale US *non*-taxation of MNE profits would fail to aid the market countries' claims. Only the US would be entitled to tax the fruits of US 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.[31] It also fails to track any existing global consensus about income's source, given its assuming of a production-based view. Even just as a predictive matter, neither its nationalistic chauvinism nor its market triumphalism is likely to wear well outside the US They might also cease to wear well inside the US if the direction of net global IP flow were to reverse, in keeping with its predominant direction at times in the past[32] 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,"[33] there is widespread concern that things will get out of hand. Thus, Lilian Faulhaber not only calls for a coordinated international solution, but urges the US 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."[34]

One set of concerns relates to the relationship between the production and market sides of the quest to tax rents. However, production/residence country reluctance to raise taxes on locally powerful businesses, or alternatively production country willingness to grant foreign tax credits as needed, could ease this problem, even if production/residence countries are unwilling to renounce expressly their taxation rights.

On the market country side, effective coordination may arise spontaneously if countries impose non-overlapping taxes on their own LSRs. Among the important

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30 Cui & Hashimzade, *supra* note 12 at 10, 11.

31 Moreover, even under an entitlement-based view, it requires rationalizing the distinction between redistributive taxation within the same country and more globally.

32 While the United States is now a leading global defender of IP rights, in the nineteenth century the United States was a notorious infringer of foreign copyrights. See, *eg*, 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 (2007), online: London School of Economics <https://core.ac.uk/download/pdf/93515.pdf>.

33 Bankman, Kane & Sykes, *supra* note 5 at 1.

34 Lilian V Faulhaber, "Beware. Other Nations Will Follow France With Their Own Digital Tax." *New York Times* (15 July 2019), online: New York Times <https://www.nytimes.com/2019/07/15/opinion/france-internet-tax.html>.

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 taxation.

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.[35] 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—and/or also to transactions around the world involving its residents. This might lead in practice to overlapping claims—if, say, both the US and the UK asserted tax jurisdiction over the same AirBnB stay, involving an American in London. However, the likely scope of this problem is unclear.

In sum, it is too early to say whether, taking account both of corporate income taxes and other tax instruments, systematic over-taxation is likely to become a problem. It is also possible that under-taxation will remain the norm, despite market countries' seeming incentive to be interested in taxing LSRs.

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 favouring one's own residents over 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 US should respond, although it does not eliminate the possibility of US benefit if [it] were to succeed in bluffing [other countries] into a retreat without creating too much residue of newly generated ill will."[36]

My own belief is that the US should focus more on restoring friendships with longstanding allies, and less on unilaterally picking fights. The claim that countries cannot reasonably tax large global profits, earned by US companies through market

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[35] For a parallel issue under existing tax instruments, consider VATs and retail sales taxes, which generally are supposed to apply based on where the consumption takes place. This reflects their being conceptualised primarily as internal distributional tools, rather than as devices for imposing tax burdens on non-residents.

[36] Shaviro, *supra* note 20 at 1078. On such grounds, I argued that the US, in deciding how aggressively to respond to the European Community's effort to impose tax burdens on particular US MNEs, should partly base its strategic choice on an assessment of the effort's reasonableness—not just its degree of adverse impact on US self-interest. See *ibid.*

interactions with their residents, and to a significant degree avoiding US taxation, is not one that has great resonance or could be expected to draw wide acceptance. This leaves 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-US MNEs, even when large and profitable, is a recipe for increasing, not just the likelihood of aggressive US retaliation, but internal US political consensus in favour of such a response. This would be no less unwise than it is unneighbourly.

II. 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."[37] 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 noted earlier, the emergence of DSTs is best rationalised in terms of their potential to be used in taxing market-side 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 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 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 to tax LSRs. Secondly, I examine the distinctive elements that DST proposals typically have, including considering the possible treatment of LSRs that lie clearly outside the scope of the DST model.

A. *Market Country Sourcing of MNE Profits*

The political resonance of taxing leading MNEs' LSRs is surely increased by their well-publicised success in minimizing global tax liability. Beyond just the optics, however, market countries would gain something from resolving source ambiguities in their favour with respect to the sourcing of MNE profits. Accordingly, it is worth

[37] Bankman, Kane & Sykes, *supra* note 5 at 46.

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 Part One of this article, arm's length transfer pricing ("ALTP") plays a major role in MNEs' profit-shifting from high-tax countries to low-tax countries and tax havens.[38] A broader aspect of the tax planning environment for MNEs is separate entity accounting for affiliated entities, such as GM's US, 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.[39]

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. Under US state income taxes, multistate companies' US profit long was apportioned between the states in proportion to shares of the companies' overall US property, payroll, and sales, each weighted equally in the formula. Over time, formulary apportionment has shifted towards allocating profits based only (or predominantly) on sales.[40]

In a widely noted 2008 proposal, Reuven Avi-Yonah, Kimberly Clausing, and Michael Durst proposed adopting sales-based formulary apportionment ("SBFA") internationally.[41] More recently, the Oxford International Tax Group has proposed what they call residual profit allocation by income ("RPAI"). This system, while formally distinct from SBFA, might be viewed as a more sophisticated (albeit, also more informationally demanding) version of it.[42]

RPAI'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. Secondly, it retains the use of ALTP to assign "routine profit to the country where function and activities take place."[43] Thus, in terms of the earlier example, GM-France and GM-Luxembourg would be

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38 Shaviro, *supra* note 3.

39 Various corporate income tax rules attempt to combat earnings-stripping, such as by denying deductions for certain payments to affiliates under a lower-rate alternative tax system. See, *eg*, Daniel Shaviro, "The New Non-Territorial US International Tax System: Part 1" (2018) 160:1 Tax Notes 57; Daniel Shaviro, "The New Non-Territorial US International Tax System: Part 2" (2018) 160:2 Tax Notes 171.

40 See, *eg*, Bankman, Kane & Sykes, *supra* note 5 at 24.

41 See Reuven S Avi-Yonah, Kimberly A Clausing & Michael C Durst, "Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split" (2009) 9:5 Fla Tax Rev 497 at 498.

42 See Michael P Devereux *et al*, *Residual Profit Allocation by Income*, Oxford Intl Tax Group Working Paper No 19/01 (2019), online: <https://www.sbs.ox.ac.uk/sites/default/files/2019-03/WP1901_1.pdf?>.

43 *Ibid* at 3.

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.[44] The use of ALTP for routine profit would leave whatever remained—that is, potentially large residual profit[45]—to be allocated based (approximately) on sales.[46] In this sense, it would generally be more similar to SBFA substantively than it is formally.

One of RPAI'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.[47] A second advantage is that its revised treatment of sales reduces certain tax planning opportunities that otherwise would arise.[48] 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.[49]

To the extent that existing source rules lean towards being production-based, both SBFA for all profits, and RPAI for residual profits, would "turn existing law on its head, and allow the import nation to capture rents."[50] So clear a concession of tax jurisdiction might be unappealing to policymakers in the production countries where the LSRs (as defined in a production sense) are being earned, even if in practice these countries tend to tax the global rents with a light hand. However, there are also questions regarding the degree to which market countries would actually succeed in taxing MNE rents. The three main concerns are as follows:

(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."[51] 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

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44 As Devereux *et al* explains: "In this outsourcing model the third party. . . does not share in the overall risk of the MNE, and earns no return based on the overall success. . . The routine profit for an affiliate would be based on the rate of profit earned by a comparable third party, applied to an appropriate cost base. . . " *Ibid* at 4.

45 See *ibid* at 22, 23 (comparing residual profits on the one hand, and economic rents on the other). This aspect of RPAI 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, residual profits can follow routine profits to a jurisdiction where only relatively trivial things happen.

46 More specifically, RPAI 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." *Ibid* at 6.

47 The fact that existing ALTP rules sometimes uses formulary elements further reduces the extent to which RPAI would fundamentally alter the existing legal landscape.

48 *Ibid* 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.

49 See *ibid* 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 [inter-country] fairness").

50 Bankman, Kane & Sykes, *supra* note 5 at 24.

51 See, *eg*, Devereux *et al*, *supra* note 42 at 63.

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.

Conceptually, this resembles one of the problems described in Part One with respect to PEs. Selling to the ultimate consumers directly—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"[52] that vary in their compatibility with the use of such distributors. Starbucks, for example, cannot offer the 'Starbucks experience' to UK consumers without actually having its own stores there.[53] Apple can do better than Starbucks in this dimension, but the popularity of Apple stores may impede migrating some of its sales.

A second tax planning problem pertains to profit lines that differ in profitability. If SBFA or RPAI applies at the overall MNE level, then combining the sales of highly profitable and less profitable items—the latter being proportionately sold more in low-tax countries—may cause a shift of overall tax base from high-tax to low-tax countries.[54] 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.[55] 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-favourable amalgamation is reasonable.

(b) *Integrated pricing of transactions between distinct parties under two-sided business models*: Due to their two-sided business models, digital platform companies like Facebook may find it profitable to subsidise users, such as by giving them free access to the platforms. 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 certain financial services. Suppose that my bank offers 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 interest rate my checking account. Here there are two offsetting non-arm's length prices—the subsidised 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 separately observed.

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52 Bankman, Kane & Sykes, *supra* note 5 at 26.

53 Starbucks does, however, sell packages of coffee beans for home use, the profits from which could be redirected to low-tax countries through independent distributors.

54 RPAI 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.

55 See Devereux *et al*, *supra* note 42 at 67, 68.

Under an income tax, bundling may yield implicit deductibility of the arm's length service fees (insofar as they would otherwise constitute non-deductible 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 mislabelling 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, what once again causes tax implications is the fact that overall liability does not depend just on the MNE's overall net cash flow. Under SBFA or RPAI, however, the market country in which users reside may not get to tax the LSRs that the two-sided MNEs 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 digitalised businesses are located."[56] However, such an approach has only been preliminarily discussed,[57] 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 users in each country but could only observe their 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.[58] Corporate rates may also be too low, with respect to LSRs earned by outsiders, insofar as they adjust for domestic shareholders' facing a second level of taxation as to corporate income.

2. *Destination-based cash flow tax ('DBCFT')*

During the DBCFT's "short but spectacular career"[59] in US tax policy debate, it often was misdescribed as a novel fiscal instrument, rather than as merely rejiggering familiar ones. Its US 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"[60] the cross-border analysis.[61] However,

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[56] *Ibid* at 52.

[57] See United Kingdom, Her Majesty's Treasury, *Corporate Tax and the Digital Economy: Position Paper Update* (London, The Stationery Office, 2018).

[58] Absent the special issues raised by LSRs, charging non-resident MNEs higher rates than purely domestic ones may involve local producers' creating non-optimal tariffs. In US state and local taxation, this concern (with federal supremacy) helps to explain the constitutional doctrine barring state and local discrimination against outside commerce.

[59] Daniel Shaviro, "Goodbye to All That? A Requiem for the Destination-Based Cash Flow Tax" (2018) 72:4/5 Bull Intl Taxation 248.

[60] Bankman, Kane & Sykes, *supra* note 5 at 27.

[61] See Shaviro, *supra* note 59 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

while the DBCFT has shown no recent signs of reviving politically, a lesser version of it—increasing VAT rates (or, in the US, 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 RPAI 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,[62] but rather in their happening to disallow any deductions or other cost recovery for amounts paid to foreigners for imports.[63] 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 RPAI. 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 VAT. . . would have to be accompanied by an equal increase in the VAT imposed on domestic firms. . . A VAT is simply not a well-targeted instrument for uniquely seeking out the returns to MNE activity."[64]

(c) *Currency adjustment issue*: VAT rate changes (or implementation) can affect a currency's exchange value as against other currencies. To illustrate, recall 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 the US adopts a (tax-exclusive) 25 percent VAT or DBCFT.[65]

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.[66] All else equal, therefore, a dollar would now trade at €1.25 on world currency markets,

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of David Bradford's X-tax," which would have added to it replacing the individual-level income tax with a graduated wage tax. *Ibid*.

62 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.

63 See Shaviro, *supra* note 59 at 3.

64 Bankman, Kane & Sykes, *supra* note 5 at 30.

65 A VAT of $20 on an $80 bottle, for example, provides a tax-exclusive rate of 25 percent or a tax-inclusive rate of 20 percent. In practice, VATs, unlike retail sales taxes ("RSTs") typically have their rates stated on a tax-inclusive basis.

66 See, *eg*, Bankman, Kane & Sykes, *supra* note 5 at 28.

changing the dollars to euros ratio to 4:5. Under this exchange rate, if US after-tax prices remained nominally the same as previously, and a US importer sent the French wine seller only the $64 that remained after paying the VAT,[67] 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 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.[68]

(d) *A new dimension to the two-sided markets issue?*: Under a VAT/DBCFT, just as under SBFA or RPAI, 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-penalise charging domestic users a part of the overall freight, relative to charging only the outside advertisers. 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 of consumer surplus, which arises whenever one's subjective valuation 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. *Conclusions regarding market country sourcing of MNE profits*

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, 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. 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

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[67] A one-time US 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. See Alan J Auerbach, *The Choice Between Income and Consumption Taxes: A Primer* NBER Working Paper No 12307 (2006), online: National Bureau of Economic Research <https://www.nber.org/papers/w12307>.

[68] An appreciated dollar would, however, lead to transition loss for US holders of foreign assets, and a transition gain for foreign holders of US assets. In 2017, it was estimated that enactment of a proposed DBCFT would lead to a net $3 trillion transition gain for foreigners, relative to US residents, reflecting extensive foreign ownership of US assets. See Shaviro, *supra* note 59 at 4.

taxes.[69] 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 has significant similarities to 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.[70] 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 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 is 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."[71]

(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 two 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

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[69] 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, *eg*, Daniel Shaviro, "Beyond the Pro-Consumption Tax Consensus" (2007) 60:3 Stan L Rev 745 at 747.

[70] See Paul Miller, Nicholas Gardner & Vicky Brown, "The UK's Proposed Digital Services Tax" in Paul Miller and Nicholas Gardner, eds, *Global Tax Insight* (London: Ashurst, 2019) 18, online: Ashurst <https://ashurstcde.azureedge.net/-/media/ashurst/documents/news-and-insights/insights/2019/nov/global-tax-insight-issue-5.pdf>.

[71] *Ibid*.

(including zero) in lieu of the two 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 two percent of the gross amount.[72]

(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,[73] 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-favoured 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 criticised as "arbitrary from a policy perspective"[74] and as hand-tailored to exclude domestic MNEs, even where the proposals' stated rationales seemingly would apply to them. 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

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72 *Ibid*.

73 See, *eg*, AB Atkinson & JE Stiglitz, "The Design of Tax Structure: Direct Versus Indirect Taxation" (1976) 6:1 J Pub Econ 55 (finding that all commodities should be taxed equally under specified circumstances, including that none are leisure substitutes or leisure complements).

74 Sean Lowry, *Digital Service Taxes (DSTs): Policy and Economic Analysis*, (Washington, DC: Congressional Research Service, February 2019), online: Congressional Research Service <https://fas.org/sgp/crs/misc/R45532.pdf>.

rests on three main claims. The first is that leading firms in these sectors, perhaps for broader structural reasons, have substantial market power,[75] allowing them to earn monopolistic or oligopolistic rents, and creating incentives for over-investment in pursuit of market power.[76] 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.[77] 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.[78]

(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 Google, rests on a confused version of production-based income sourcing.[79] 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 use 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 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 source—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'.[80] 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,[81] and when foreign visitors post hotel or restaurant reviews on Yelp or TripAdvisor.[82]

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75 Issues around market power in the digital economy have attracted a growing literature. See, *eg*, Kenneth A Bamberger & Orly Lobel, "Platform Market Power" (2017) 32:3 Berkeley Technology LJ 1051.

76 See, *eg*, Cui, *supra* note 14 at 25-30.

77 See, *eg*, Johannes Becker, Joachim Englisch, Deborah Schanz, *Re-Allocation of Taxing Rights for Big Business Data Models* (2019) SSRN Electronic Journal Working Paper, online: <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3433715>.

78 See Cui, *supra* note 14 at 25.

79 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 specialised regulators.

80 Johannes Becker & Joachim Englisch, "Taxing Where Value is Created: What's 'User Involvement' Got to Do With It?" (2019) 47:2 Intertax 161 at 169, 170.

81 *Cf*, Cui, *supra* note 14 at 12, 13 (describing nightclub owners' business model).

82 See Lowry, *supra* note 74 at 15.

But in any case the entire line of analysis seems unrelated to issues of actual normative interest, whether based on concern about efficiency or distribution. From the standpoint of taxing LSRs (without destabilizing Monty Python taxation), the Facebook-Google business model on the one hand, and that of Netflix or Spotify on the other, are not distinguished by the differences in how exactly users participate.

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 individualised 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.[83] This, however, might be easier to address without inventing new tax instruments than the use of two-sided business models to earn revenues from non-resident 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 avoidance by such MNEs.[84] 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 non-recoverable through the taxation of gross receipts or gross revenue. Thus, adapting the DST model to such a company would require limiting non-deductibility 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."[85] This consensus reflects VATs' European history as a replacement for turnover or gross receipts taxes that had serious economic drawbacks. One was their imposing cascading tax burdens on consumer goods produced by non-vertically integrated

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[83] See Mark Sweney, "Netflix Paid No UK Corporate Tax Last Year—and Got a £200K Rebate" *The Guardian* (21 June 2018), online: The Guardian <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. *Ibid*.

[84] As we saw earlier, Starbucks' business model happens to impede its avoiding both SBFA/RPAI and VATs/DBCFTs, but if it just sold beans (or relied less on the 'Starbucks Experience'), the former would lose effectiveness.

[85] George Kofler & Julia Sinnig, "Equalization Taxes and the EU's 'Digital Services Tax"' (2019) 47:2 Intertax 176 at 200.

businesses.[86] A second was their unduly discouraging business outlays that would yield tax liability based on the gross, rather than the net, return.[87]

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 consumers, rather than as business inputs, cascading may not significantly arise. 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."[88] 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 rationalised both as "exempting smaller businesses from potentially costly compliance burdens"[89] 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 enough to comply conveniently, but that happen to be politically favoured. The latter rationale might be less applicable when market power is being exercised in an oligopolistic manner by multiple firms, than when there is a single huge monopolist.

(g) *Biased against American MNEs?*: The whiff of anti-Americanism that US policymakers have discerned in European DSTs might be rationalised, 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 US responses to 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.

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86 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.

87 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.

88 Cui & Hashimzade, *supra* note 12 at 4.

89 *Ibid*.

That said, in my view neither the UK DST, nor the similar French DST,[90] displays suspicious tailoring to reach US but not EU firms, unless one can deduce this contextually from their size thresholds (and views such high thresholds as otherwise unjustified).[91] 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.[92] The affected firms' being so predominantly US-owned cannot reasonably be viewed as exempting them from market country policy responses that are themselves not unreasonable.

C. *DSTs With Versus Without RPAI*

The case for both DSTs and RPAI rests in part on the same point: Because ultimate consumers are presumed to be less mobile than producers (and perhaps also for political economy reasons), taxing both rents and normal profits is more feasible on the market side than the production country side. Key differences between them include the following:

(i) A DST targets particular firms, industries, or business models, rather than being designed to apply generally. It thus is not tied either to generally applicable tax rates, or to the identification of inbound sales transactions.
(ii) A DST addresses profit-shifting concerns through deduction disallowance, while RPAI instead uses the formulary allocation of global profits (presumed to be less manipulable than single-country profits).
(iii) A DST is best directed at extra-normal returns, while RPAI by design also reaches normal returns, albeit severing the link between where the underlying investments are made and how heavily they are taxed.

Despite these differences, a given country's adopting RPAI might reasonably reduce its degree of interest in considering the adoption of special tax instruments such as DSTs—at least, with respect to firms that this approach reaches fairly effectively. With respect to such firms, the main reason to go beyond RPAI would involve the view that the unusually high concentration of LSRs in specific sectors supported the imposition of higher tax rates.

Adopting RPAI would not, however, weaken the incentive to adopt special measures (whether or not these are DSTs) with regard to MNEs that it fails to tax effectively—for example, by reason of their using two-sided business models, or their being unusually able to exploit the use of independent distributors or conflation between differentially profitable lines of business.

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[90] 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. See James Ross, "The Rise of Digital Services Taxes" *McDermott Will & Emery* (13 November 2019), online: McDermott Will & Emery <https://www.mwe.com/insights/the-rise-of-digital-services-taxes> (comparing the French and UK DSTs).

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

[92] 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 minimise corporate income tax liability.

The recent spread of DSTs, in advance of any rush to adopt RPAI, appears to have multiple causes. One is the particular prominence of leading digital firms that have been combining high profits with low global tax liabilities—inducing close attention to issues of how best to tax the digital economy. A second is that tax treaties may be less of an impediment to adopting non-covered tax instruments than to dramatically changing transfer pricing doctrine and practice.

A third cause of this difference in willingness to innovate on the ground may be the apparent view, among many policymakers and commentators, that shifting towards anything like sales-based formulary apportionment (RPAI's cousin and precursor) inherently requires global consensus, or at least coordination. This not only would be difficult and time-consuming to arrange, but would seem to require MNE production countries, such as the US, expressly to renounce production-based sourcing, at least via entity-level corporate income taxation.[93] Such countries' policymakers may be reluctant to do this, even if in practice they are lax about pursuing it aggressively. In response, however, policymakers in market countries might reasonably ask themselves whether unilateral adoption of RPAI might be no less feasible and appealing than the unilateral enactment of DSTs.

III. 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 sufficiently well-designed novel tax instruments to expand their capacity to reach such LSRs are acting reasonably, as judged within existing norms for constraining and channelling countries' self-interested behaviour. 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 consumers' relative immobility and on locational rents, and less on decades-old doctrinal and semantic debates concerning the supposedly 'true' source of economic income and value creation.

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[93] In principle, a country that accepted SBFA or RPAI, thereby renouncing entity-level corporate income taxation of rents on a production basis, could still try to reach those same rents by moving towards Haig-Simons income taxation of the resident individuals who had been enriched by their ownership positions in highly profitable MNEs.