Taxing the Digital Economy: Options, Trade Considerations, and a Solution

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In this article, the authors consider four options for taxing the digital economy — tariffs on electronic commerce, VAT, the corporate income tax, and digital services taxes. They examine the potential effects of trade laws on each and propose a solution that would allow countries to select a tax that is suited to their needs.

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Efforts have been made to define and determine whether and how to tax the digital economy in the following areas: tariffs on electronic commerce, VAT, corporate income tax (CIT) imposed on the digital economy, and digital services taxes. While the CIT and DSTs are often discussed together, little effort has been made to align these taxing rights with the other two taxes. The impact of the trade agreements on taxes also has largely been overlooked.

This article focuses on two themes: how the knowledge gained in implementing any one of these taxes can be used to inform the development of the others, and how the application of trade agreements may affect the implementation of all four taxes. Recognizing that no one size fits all, we suggest a policy that permits countries to adhere to internationally agreed-upon frameworks and apply taxes that best suit their individual circumstances in the digital age with a particular focus on how the policy would affect developing countries. We hope that the international tax community can develop a consensus around this principle.

I. Introduction

What is the digital economy? It has almost as many definitions as it has authors writing about it. Since it is still evolving and developing, no one definition can capture it for all time. The WTO defines "electronic commerce," a term typically used interchangeably with the digital economy, as "the production, distribution, marketing, sale or delivery of goods and services by electronic means."[1] The IMF acknowledges the lack of a general definition of the term and for purposes of measuring economic activity has focused on the "digital sector" as "the core activities of digitalization, ICT [information and communication technology] goods and services, online platforms, and platform-enabled activities such as the sharing economy."[2] The U.N. Commission on Trade and Development (UNCTAD) breaks its definition into three broad components: (i) foundational aspects, including fundamental innovations such as semiconductors and computers; (ii) information technology sectors that produce key products and services such as digital platforms and mobile applications; and (iii) the "wider set of digitalizing sectors, which includes those where digital products and services are being increasingly used," such as finance and media.[3]

UNCTAD correctly notes that as digital technologies become ever more involved in transactions, "the digital economy is becoming increasingly inseparable from the functioning of the economy as a whole." While this article focuses on efforts to tax the digital economy, these discrete efforts are morphing into an examination of the some of the basic principles underlying international income taxation.

In Section II, we describe the four ways of taxing the digital economy. In Section III, we examine how trade rules affect tax laws. Section IV outlines four foundational issues underlying all of the taxes and the impact of the trade laws on each before suggesting a way forward in taxing the digital economy.

II. Four Ways to Tax the Digital World

The four taxes that we identified above all focus on taxing (or exempting from tax) the digital economy, but the terminology varies. In the case of tariffs, the tax focuses on "electronic transmissions"; in the case of VAT, it focuses on taxing services and intellectual property "where the supplier is not located in the jurisdiction of taxation"; and in the case of income taxes, the focus is on how to apply an income tax to e-commerce or the digital economy. Regardless of language, the goal is the same: They seek to come to grips with taxing (or deciding not to tax) newer forms of economic activity brought about by the internet and the digitalization of the global economy. This effort has been ongoing since at least 1998, when an OECD ministerial conference in Ottawa issued a report on taxing electronic commerce.[4]

While taxes are a critical source of revenue for all countries, the implementation of an effective tax system is a particularly important tool for developing countries.[5] Hence, the resolution of how to tax the digital economy is of particular importance to those countries, and they are a key concern of this article.

A. CITs Designed for the Digital Economy

We start our analysis with the OECD's effort to apply the CIT to the digital economy because this effort has received the most recent attention. In this endeavor, the OECD and more than 130 countries have formed the OECD/G-20 inclusive framework on base erosion and profit shifting. This group began as part of the OECD's overall work on curtailing tax avoidance.

1. The OECD's Proposed Unified Approach

Early in 2019, the OECD presented three alternatives for taxing the digital economy: attributing value to user participation, valuing market intangibles, or formulating a tax around the existence of a significant economic presence in a source country.[6] In October 2019 the OECD secretariat offered for comment a "unified approach" to taxing the digital economy that blends elements of these three alternatives and adds some new ones.[7] The unified approach calls for creating three baskets — amounts A, B, and C — for allocating profits. The starting point is a multinational enterprise's total profits for a line of business as determined by its financial accounts. Amount A is the element of profit left over, if any, after subtracting both amount B and the so-called routine profits (an amount deemed to constitute an adequate return on capital) from the total profits; it is somewhat akin to what economists refer to as rents.[8] Amount B, which is determined using a formula, covers routine functions such as marketing and distribution and may be refined to take into account different lines of business and geographic regions. Amount A is split among the market jurisdictions in which the MNE operates, with each jurisdiction's share determined using an allocation factor, such as relative amounts of sales. The proposal offers no guidance regarding the jurisdictions from which amount A is to be taken. Amount C is an indeterminate residual amount that can be divided among jurisdictions that believe they have not been allocated an adequate share of the MNE's profits via the other amounts.

Since the OECD secretariat first set out its unified approach, it has sought to refine its application. It announced that the tax would be applied to two business segments — automated digital services and consumer-facing businesses. The OECD is also interested in determining whether further granulation of the tax along particular lines of business and geographic regions is appropriate. The tax would apply only to large businesses, likely those with gross worldwide revenues exceeding €750 billion, and in jurisdictions where an MNE has generated a minimum amount of revenue through a sustained and substantial local presence, with consideration given to the size of the local economy.[9] The sustained and substantial local presence element needs to be further quantified in guidelines.

To be successful, the unified approach should be adopted by nearly all of the developed countries. Otherwise, MNEs will be subject to two different systems of international taxation — the historic arm's-length pricing concept and the new unified approach — which will lead to a never-ending series of disputes among jurisdictions over taxing rights. If it is universally accepted, the unified approach could be administered by the resident jurisdiction of a digital business's parent company or by a to-be-defined multilateral group of countries. The proposal appeared to be headed for some form of consensus agreement until U.S. Treasury Secretary Steven Mnuchin sent an unexpected letter to the OECD in December 2019 indicating that the United States would not agree to the proposal as written. Ángel Gurría, secretary-general of the OECD, replied the next day expressing concern that the U.S. position would delay the effort. The OECD continues to press forward with the implementation effort, but its fate is uncertain.

2. CITs in Developing Countries

The unified approach was developed largely based on input from developed countries, many of which thought the U.S. digital giants were not paying them an appropriate amount of taxes given the scale of the companies' business in the jurisdictions. Many developing countries have not voiced full support for the unified approach, although many have expressed that they like the simplicity of amount B standing alone and believe that it would increase their revenue without the need for involved tax audits.[10] The OECD has suggested that developing countries would realize a small revenue gain from the unified approach, but it has offered no explanation as to why.[11]

Before the formal introduction of the unified approach, a group of developing countries (the
G-24) proposed a fractional apportionment method (FAM) designed to give them greater taxing rights in the digital economy.[12] The FAM approaches the allocation of a digital business's profit to a jurisdiction by first establishing that the business has a sustained and significant economic presence there with sales exceeding a threshold amount. Revenue is attributed to the digital permanent establishment based on the local customers' digital usage of the business. The profit derived from this revenue is determined by multiplying the revenue by the operating profit margin of the business segment. Under this approach, profit is allocated among the market jurisdiction and jurisdictions that contribute factors of production to the business using an allocation formula that incorporates sales, assets, and employees. Many developing countries appear to favor this approach because it probably would allocate more revenues to them and because is easier to audit. India has taken the lead in this effort, offering a plan to impose a CIT based on a digital company's sustained and substantial presence in India and using a proposed FAM.[13]

B. DSTs: A Substitute for CITs

DSTs arose as an alternative to creating an effective CIT on the digital economy. When progress on a digital CIT appeared to lag, some countries began to enact DSTs. This effort has blossomed in recent months. While DSTs are viewed as an alternative to CITs, in practice they are transaction taxes and do not have the same attributes as income taxes.

DSTs are imposed on gross income in much the same way as tariffs are imposed on imported goods. They are based on a percentage of the revenue produced by specifically defined revenue streams. In particular, DSTs are directed at one or more of four possible revenue streams: (1) sales of data gathered by an internet provider; (2) the provision of an internet marketplace; (3) the creation of a market between internet users; and (4) specific services marketed to advertisers employing the internet. Some companies provide services in more than one category — Amazon, for example, provides services in categories 1, 2, and 4 — while others may be in only one category — for example, dating apps provide category 3 services. Some types of businesses are often excluded from the application of DSTs, most notably financial services. The taxes usually apply only to large MNEs — typically MNEs with €750 million or more in worldwide revenues and a designated minimum amount of in-country revenue, which is often based on the size of the local economy. Several EU states began implementing DSTs in 2017. In response, the European Commission set out to define an EU-wide method to apply an income tax to the digital economy and, in the interim, sought to outline a set of common rules for DSTs.[14] European politics and intervening proposals by the OECD and the inclusive framework caused the first goal to fail but left open the possibility that EU members might adopt DSTs as an interim measure — and many EU countries have done so.

France is the leading example. It intends to impose a tax of 3 percent on some services in which French users are deemed to play a major role in value creation, with the tax to take effect retroactively from January 1, 2019. The French DST is expected to apply to about 17 U.S. companies and 13 other entities worldwide. France and the United States entered into a pitched battle over this tax, which resulted in a U.S. unfair trade practice investigation[15] and U.S. threats to impose tariffs on many French goods. Recently, a truce in the resulting trade war was announced when France agreed to hold the tax in abeyance until the end of 2020 while the inclusive framework works on a worldwide CIT for the digital economy.

As for the rest of the world, more than 30 countries have enacted (or announced the intention to enact) DSTs.[16] Most follow the DST format described above.

Initially, countries adopted DSTs to serve as a bridge until a consensus agreement on a digital CIT could be reached. However, as more countries adopt DSTs, one wonders whether they will take on a more permanent character. Temporary taxes tend to have a life of their own once countries become accustomed to enjoying the revenue that they produce.[17]

C. VAT on IP and Services

1. VAT in the Digital Economy

VATs are a major source of tax revenue for both developed and developing countries. They are collected in a staged process with each intermediary business in a chain adding to the VAT charged based on the value added at that stage, until the product is consumed — and the tax paid — by the ultimate consumer.

In the digital economy, VATs have been used mostly to target remote service suppliers providing cross-border services and IP. No new rules are needed to apply VAT to goods exchanged digitally — the existing VAT rules work well in this area. For several years, the OECD worked to create internationally agreed-upon principles for applying VAT to suppliers of services and IP. This effort resulted in two sets of rules, both of which the OECD published in 2017. The first — the International VAT/GST Guidelines — explains how to enact VAT legislation and regulations, and the second — Mechanisms for the Effective Collection of VAT/GST — suggests mechanical rules that can be used to actually apply VAT in practice.[18] Both the guidelines and the mechanical rules have been embraced by countries around the world.

The collection of VAT on cross-border transactions can be divided into two categories: transactions between two businesses (B2B transactions) and transactions between a business and the ultimate consumer (B2C transactions). For B2C transactions, the guidelines suggest using a simplified registration process whereby the remote seller registers with the source country before transacting business there and then collects and remits the VAT due on these transactions. In the case of B2B transactions, the guidelines suggest using a reverse charge mechanism that requires the importing business to impose the VAT charge on itself. If these mechanisms did not prove effective, some form of withholding taxes might be imposed. When an intermediary is involved in a transaction, the guidelines suggest that the intermediary be made directly liable for the imposition of VAT or charged with its collection as the supplier's deemed agent.

In recent years, the OECD recognized the critical role that electronic platforms would play in the effective implementation of VAT for sales made over the internet. An OECD report issued in 2019 examines the potential legal liability of digital platforms for VAT, how they may be utilized to collect VAT, and how they may provide useful information and data even if they are not directly liable for the collection of VAT.[19] Early this year, the OECD published for comment proposed rules for platform operators involving the reporting of tax information about sellers in the sharing and gig economy.[20] In doing so, it sought to establish a set of common rules for taxpayers and jurisdictions to apply that call for intermediaries to play an important role in tax compliance. An annex to that report includes a proposed code of conduct for intermediaries. One example of the roles that intermediaries might play is that platform operators might freeze or close down the accounts of sellers that do not comply with their tax obligations. If platform operators consistently fail in their duties to assist in the collection of tax, they could be barred from engaging in business in the affected jurisdictions. A review akin to that used by the global forum for compliance with its tax information reporting regime could be used to ensure compliance by both platform operators and cooperating jurisdictions.

2. VAT in Developing Countries

Many developing countries have enacted VATs. In some cases, the VAT is largely focused on mobile phone transactions and high rates can disadvantage new and worthwhile business ventures. In other cases, the process of implementing a VAT has encountered significant problems because of the country's level of economic development or a lack of infrastructure and institutional resources. The result may be that only a few companies pay VAT and the total amount of revenue may be small. One option for reforming the VAT in developing countries would be to peg the level of tax to the value of transactions — eliminating it entirely for modest transactions.

Even with the implementation problems, the VAT is and will continue to become an increasingly important source of revenue for developing countries, especially as the digital economy expands in these regions.

D. Tariffs

1. Tariffs in General

Tariffs are taxes on imports. A type of transaction tax, tariffs are relatively easy to apply when physical goods are involved. Although — unlike a VAT — a tariff is not directly imposed on the consumer, in most cases, the consumer still bears the burden in the form of an increased price. A tariff is also unlike a VAT because it discriminates against imported products compared with competitive domestic products. Some critics believe tariffs provide opportunities for corruption involving government officials.[21] They may also result in cascading taxes because a tariff that generates an increase in the price of a good may be followed by the imposition of VAT on that increased price.

2. 1998 WTO Moratorium

On May 20, 1998, the WTO adopted the Declaration on Global Electronic Commerce (WT/MIN(98)/DEC/2) and imposed a moratorium on customs duties (tariffs) on electronic transmissions.[22] In the aftermath of the moratorium, however, WTO members have struggled to determine the scope of the term "electronic transmissions" — including whether it refers to goods, services, or something else — and how the transmissions should be governed under the WTO rules. Most developed countries want to make the moratorium permanent, an idea supported by a 2019 OECD economic analysis, but developing countries have resisted this effort.[23] In 2017 in furtherance of the effort to reduce trade barriers and acting together with 70 other countries under the auspices of the WTO, the United States issued a joint statement indicating that additional negotiations were going to take place on trade-related aspects of electronic commerce.[24] Since that time, several additional statements have been issued suggesting that the project is making progress. However, many developing countries still appear to be reluctant to join this effort.

If electronic transmissions are goods, then they are governed by the General Agreement on Tariffs and Trade; if they are services, the General Agreement on Trade in Services (GATS) applies. Some electronic transmissions do not fit neatly in either category. Historically, tariffs have not been applied to services.[25]

In the absence of a moratorium, no special rules would be needed to impose tariffs on the electronically enhanced trade in physical goods. Under GATT, countries agree to a maximum rate (the bound rate) for tariffs in each product import category. However, some countries choose to set their actual tariff rates below the bound rate, instead applying what is known as a most-favored-nation (MFN) applied rate. Countries generally rely on the Harmonized Commodity Description and Coding System (HS codes) to set their bound rates. The HS codes, however, do not have a category for nonphysical goods. One way to impose tariffs on goods that are transferred digitally (such as MP3 music content) is to apply the same tariff as would be applied to the relevant physical product (CDs). In that case, the digital goods would still be taxable, but the tariffs would have an upper boundary.

Another way to impose tariffs on digitalized goods would be to establish new goods classifications using their domestic classification system, as Indonesia did in 2018.[26] Even if digital trade in goods may be subject to tariffs, there is no framework within the WTO to apply tariffs to services transactions. Thus, even if the moratorium is lifted, countries that attempt to apply tariffs to international services and service suppliers may run afoul of their commitments under the GATS. As discussed in more detail below, the GATS does not allow countries to discriminate against foreign services and suppliers in sectors that they have bound under the agreement. If that framework changes in the future, the rules for applying VAT on IP and services may be useful for determining how to apply tariffs to services.

Traditional economic theory holds that tariffs interfere with the efficient production of goods and the allocation of capital.[27] Under the traditional view, the reduction in economic activity and resulting decrease in tax revenue as a result of the imposition of tariffs is of a larger amount than the revenues gained from the tariffs. Furthermore, traditional models assume that when countries liberalize trade the lost tariff revenue is replaced by other forms of tax revenue. However, recent studies dispute these conclusions in the context of developing countries. The authors of these studies argue that — for developing countries — additional tax revenue generated from the enhanced economic activity does not compensate for the loss of tariff revenue.[28]

3. Tariffs and Developing Countries

For developing countries in particular, tariffs remain an important source of revenue given their ease of application. While tariff levels in developed countries average between 2 and 6 percent, developing country tariffs range much higher — typically between 10 and 15 percent.[29] For this reason, many developing countries would prefer to see electronic transmissions treated as goods on which tariffs can be readily applied. However, for this desire to come fully into fruition, the WTO would need to lift its moratorium on tariffs on electronic transmissions.

III. Tax and Trade Agreements

The conflict between, on one hand, tax policies and the goals of tax administrations and, on the other, the objectives of trade and investment laws — namely, to encourage cross-border trade and investment — often simmers below the surface, with periodic public outbursts. The advance of the digital economy has exacerbated this conflict. While tax authorities are taking steps to achieve what they see as the equitable and effective application of tax law to the digital economy, trade authorities may see the same steps as protectionism that is in conflict with international rules on trade.

This section of the article provides an overview of the major trade agreements and examines their impact on the effort to tax the digital economy.

A. Background

The WTO was established in 1995, and this led to the creation of the modern trade rules. The general public began using the internet around 1999, which is also when the WTO adopted the moratorium on customs duties on electronic transmissions. Since then, led in large part by the United States, several developed countries have worked to expand the reach of the moratorium. By the time the BEPS project began in 2013, the issue of how to tax digital commerce was beginning to draw increasing attention. The BEPS project issued its initial reports in 2015, and the first action item addressed this issue. The report on this action item called for more research and stated that another report on the matter would be produced in 2020. As time moved on, many countries demanded an earlier resolution to the problems of taxing digital commerce; work on the issue accelerated with the hope that a consensus could be reached by the end of 2020.

While work in both the trade and tax arenas proceeded simultaneously, little interchange between the two worlds has taken place.

B. WTO Trade Agreements

For tax purposes, the most pertinent trade agreements are GATT, GATS, and the Agreement on Subsidies and Countervailing Measures (SCM). The various trade agreements affect tax issues in a variety of ways.[30]

1. GATT

GATT 1994, the version in effect today, adopted the original GATT 1947 by reference. It focuses on the reduction of tariffs on the cross-border trade of goods, and it has supplied the framework for many of the trade agreements that followed. The cornerstone of GATT — and the cornerstone of all WTO trade agreements — is nondiscrimination. This is embodied in the MFN and the national treatment articles (articles I and III, respectively). Under the MFN rule, a WTO member cannot treat products from another member less favorably than it treats products from any other country. This applies to tariff levels as well as other tax and regulatory matters. On their face, most tax laws do not attempt to distinguish between foreign products — or, as discussed in the following subsections, services or service suppliers — on the basis of origin. There are instances, however, when a tax will have a de facto inordinate impact on one trading partner over others, in which case the tax structure may violate the MFN standard. For example, a WTO panel decision from 1999 involved Indonesia's National Car Programme, which included several internal tax measures that indirectly favored South Korean auto imports over other those from other countries.[31] Although apparently neutral, the measures were found to violate the MFN standard of GATT.

The national treatment standard (examined in more detail in relation to GATS in the next subsection) requires WTO members to treat — in both taxation and regulation — foreign products no less favorably than like domestic products. Internal taxes are sometimes used to give preference to domestic products over foreign equivalents. This is especially the case for highly valued industries like alcohol and automobiles.[32] For our purposes, VATs, CITs, and DSTs vary in their discriminatory impact. Usually VATs, for example, will not run afoul of GATT because VATs generally do not contain provisions favoring local producers. The situation is more complicated for direct taxes, such as the CIT.

GATT does not apply to most direct tax provisions. However, some direct tax provisions operate like tariffs in that they favor local producers or discriminate against foreign firms.[33] When this is the case, as was the situation with some U.S. efforts to use favorable tax provisions to boost exports (see the discussion on subsidies below), nasty trade disputes can erupt. DSTs are even more controversial because they typically target foreign firms and, hence, are discriminatory. However, the tax writers in most jurisdictions have been careful to make them applicable to domestic firms as well, thus blunting any potential charge of discrimination charge. How effective this will be in deterring GATT cases remains to be seen.

2. GATS

The impact of the service provisions in GATS is potentially more worrisome for the new digital tax initiatives. Much of the economic activity in e-commerce exhibits some of the characteristics of a service, such as intangibility and inseparability, which would bring the GATS rules into play. As noted, the MFN standard requires that member countries treat services and service suppliers from other WTO member jurisdictions no less favorably than services or service suppliers from any other country.

The national treatment rule provides that a country may not treat foreign firms differently than it treats their domestic counterparts. This standard also shows up in article 24.1 of the OECD model tax convention and in most tax treaties that follow it. Tax treaties containing such a rule supplant the GATS national treatment provision.[34] Three conditions must be satisfied for the national treatment rule to apply: The service provider making a claim of discrimination must be "like" the national service provider, the treatment must relate to the national origin of the service provider seeking relief, and the treatment in question must be less favorable than the treatment of the local provider.[35] To illustrate, consider a DST that seeks to tax advertising revenue earned by an offshore service provider. If the tax does not apply to local firms or if it theoretically applies but there are no local competitors, the company subject to the tax might well argue that it violates the national treatment rule. In defense, the tax administrators might point to the GATS tax carveout.

The carveout protects laws "aimed at ensuring the equitable or effective imposition or collection of *direct* taxes" (emphasis added).[36] As direct taxes, income taxes are covered; the VAT and other transaction-based taxes (indirect taxes) are not.[37] DSTs, such as that posited above, present an interesting case. They fall somewhere between a direct and an indirect tax and therefore no firm conclusion can be reached regarding whether GATS would apply. Although probably less likely, other exemptions, like those examined in the discussion of free trade agreements in Section IV.B.1, may also serve to protect some tax provisions from the GATS rules.

While the GATS provisions have not often led to complications involving a sovereign's right

to tax, a recent case between Argentina and Panama illustrates how such issues may arise.[38] In 2012 Panama sought relief before the WTO from eight fiscal, tax, foreign exchange, and registration measures imposed on its service providers by Argentina. Panama claimed that the measures violated both the national treatment and MFN treatment standards. Argentina argued its action was lawful because Panama had not entered into an agreement with it for the effective exchange of tax information and, moreover, had not initiated talks with Argentina to do so. The tax elements of the dispute involved a withholding tax that Argentina planned to impose on interest and related elements of remuneration and also transfer pricing provisions. The agreement Argentina sought was in conformity with the standards imposed by the Global Forum on Transparency and Exchange of Information for Tax Purposes — a group dedicated to ensuring that jurisdictions comply with internationally agreed-upon transparency and exchange obligations — that have been adopted by about 160 member countries. After four years of litigation and appeals, the WTO's highest court reversed an earlier ruling by a WTO panel that found Argentina had violated several GATS provisions because it found that the panel had applied the incorrect legal test. The court, however, did not find that Argentina had not breached its obligations under the trade agreements — this issue was left unresolved.

3. Subsidy Controversies and the SCM

The tensions between tax and trade often come to the surface when one country or regional organization complains that the tax law of a foreign jurisdiction unfairly benefits a competitor as compared with companies headquartered in its jurisdiction or region. The regulation of subsidies in the SCM is one area that has generated significant conflicts between income tax laws and trade laws. Under the SCM, a subsidy exists when a government makes a financial contribution that confers a benefit that is not broadly available to other taxpayers in the jurisdiction in question. The financial contribution in the case of a tax subsidy is the relinquishment of government revenue.

In the case of the SCM ban on export subsidies, the EU and the United States have been embroiled in disputes for many years regarding some export subsidies incorporated in the U.S. income tax law. This started when the WTO reviewed provisions in the foreign sales corporation law and its successors (the domestic international sales corporation law and the Extraterritorial Income Exclusion Act) that reduced the tax rates on export income; the WTO held that they were all illegal subsidies.[39] The dispute between the EU and the United States regarding subsidies recently took on a new form with some EU officials arguing that the foreign-derived intangible income provision in the Tax Cuts and Jobs Act enacted in 2017 — another provision favoring exports — constitutes an illegal subsidy. Through the FDII provision, the U.S. government gives a tax break to income that comes from exporting products tied to intangible assets, such as patents.[40] Meanwhile, within the EU, several state aid cases involving favorable tax rulings given by Luxembourg, the Netherlands, and Ireland have been winding their way through the Court of Justice of the European Union with mixed results.[41] State aid is another form of subsidy that arises when a state provides (or is perceived as providing) an indirect subsidy through a beneficial tax law or ruling. The conflicts between the tax and trade laws are likely to continue with companies caught in the crossfire when one country thinks the tax laws of another country are favoring an individual or a group of companies unfairly.

D. Bilateral and Regional Trade Agreements

Compared with the nondiscrimination rules that apply under the WTO agreements, other free trade agreements (FTAs) often go further and they often overlap with tax laws in significant ways.[42] Two of the most notable examples are the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), which is the successor to the failed Trans-Pacific Partnership Agreement (TPP), and the United States-Mexico-Canada Agreement (USMCA), the renegotiated version of the North American Free Trade Agreement. These agreements fit the general pattern of regional economic integration agreements recognized by GATT and GATS.[43] They go beyond simple tariff rules, reaching into multiple policy domains that affect trade in goods and services, including investment and IP rights.

FTAs often provide for the unrestricted cross-border transfers of information, bar requirements to use local servers, and provide for the secrecy of source codes.[44] Some FTAs also state that cross-border service suppliers cannot be required to have a local presence — a rule that makes the lack of any extraterritorial reach in the proposals more important because this type of provision inhibits the ability of source states to enforce their own laws.[45] The United States appears to have adopted this agenda in FTAs on the use of data. On the surface, these data-focused provisions may seem unrelated to tax administration. However, this overlooks governments' need for access to data to properly administer taxes, especially in relation to some of the new digital taxes. For example, both the OECD unified approach and the DSTs rely on information regarding the location of the customers of digital businesses. This information is not found in financial statements, which tax authorities normally examine in auditing CITs; rather, the data are maintained on servers operated by the companies that are subject to these new taxes. There are good reasons for some of the restrictions imposed in FTAs: These include concern for the sanctity of trade secrets and other similar privileged information and the desire to protect the privacy rights of the individuals whose data are being maintained. That said, these restrictions need to be balanced against the access that governments need to administer the tax laws. The OECD and other multinational agencies should create a program to ensure that the data needed to enforce the new digital taxes are made available to all countries — especially developing countries.

Most of the FTAs have a carveout for taxation measures, typically along the lines of the GATS tax carveout, to ensure, *inter alia*, that data needed for tax purposes are available. Moreover, tax administrators may also rely on provisions that allow governments to adopt rules to achieve legitimate public policy, and most agreements allow governments to retain information "held or processed by or on behalf of the government." Unfortunately, in some cases, the tax carveout provisions can be numbingly complex and not very effective. This was true of the tax carveout in the proposed TPP that was carried over to the CPTPP.[46] The effectiveness of the tax carveouts in the CPTPP and USMCA has yet to be tested.

Some types of tax information are increasingly being made readily available to governments outside the parameters of FTAs. These include the U.S. Foreign Account Tax Compliance Act, the common reporting standards initiated by the OECD, country-by-country reporting rules under BEPS action 13, and rules on beneficial owner registries adopted by many countries. These are largely focused on corporate and individual income taxes. While they may provide some helpful data for the administration of DSTs, tariffs, and VATs, more information is needed for these reports to be maximally helpful in these areas.

IV. Taxing the Digital Economy: A Proposal

Drawing on the foregoing analysis, we now offer suggestions regarding how to use each of the four taxes to tax the digital economy, with a particular focus on how our suggestions may benefit developing countries. Keep in mind the two themes of this article: (i) the knowledge gained in implementing any one of the four taxes can be used to inform the development and implementation of the others; and (ii) trade agreements may affect the proper application of all four taxes. Before addressing the four taxes, we identify key foundational issues and discuss the impact of trade laws on the taxes. While the focus of this article is on taxing the digital economy, we recognize that many of our suggestions may have a wider impact on existing international tax rules.

A. Four Foundational Issues

1. Crystallize the Tax Base

Before any tax can be successfully deployed, the tax base must be clearly identified. The DSTs and FAMs focus on one or more of four identified revenue streams, which is a good start in this regard. If these taxes are going to be applied only to offshore taxpayers, the reason for doing so needs to be articulated better. The unified approach's shift from simply laying out a tax on all of e-commerce to a more granular approach targeting two business segments — digital enterprises and consumer-facing businesses — is helpful but more specificity is still needed. Assuming the moratorium on duties on electronic transmissions is eliminated, applying tariffs to e-commerce may still be problematic given the provision in many FTAs barring the application of tariffs. These restrictions should be rethought — at least in terms of the impact they have on developing countries. The tariff rules also need to be rewritten if they are to allow tariffs to be imposed on items that have a physical counterpart and also on the balance of e-commerce products that are likely to be treated as services under existing trade rules. The VAT's application to the value of goods, services, or IP does not need improvement.

2. Adopt a Digital Presence Standard

Each of the taxes already has eliminated or should eliminate any requirement that an offshore seller needs to have a physical presence in a jurisdiction before a tax can be imposed on its activities there. For the CIT and DST, a PE should be created when an offshore seller has a sustained and substantial digital presence in a jurisdiction. This will require a rewrite of article 5 in most double tax agreements to eliminate the need for a physical presence in a jurisdiction to create a PE. It will also require guidelines regarding the length of presence that will qualify as sustained and some measure of the amount of local business — a metric related to the size of the local economy — that will be deemed substantial. To the degree that this is not already the case, some minimal level of cross-border revenue should also be a requirement for applying a VAT and tariffs.

3. Impose and Enforce the Taxes

The OECD suggests that a VAT for B2C transactions should use a simple self-registration system and a VAT for B2B transactions should use some form of charge levied by the receiving business or the platform provider. With some adaptions, the other tax areas can follow this plan. Further, the OECD's recent focus on the key role that platform operators can play in imposing taxes on sellers in the sharing and gig economy is important. Ideas that have been put forth to minimize seller noncompliance by working with platform operators should be adopted. As noted, these rules could be enhanced using a form of the review process that the global forum uses for the collection and sharing of tax information, with the review applied to significant platform operators and also to jurisdictions looking for platform operators to play a role in tax compliance.

4. Emphasize Ease of Administration

No one wants a tax system that is overly complex to administer. Each of the taxes examined here has the potential to become complex. However, the advantage of the FAM and the DSTs over the unified approach is that they are likely to be much simpler to administer and more easily adopted, including by developing countries. Despite all of the issues created by the moratorium on tariffs on electronic transmissions, tariffs are a useful reminder that ease of administration is a useful characteristic for any tax. That said, the reach of tariffs on electronic transmissions should also be kept relatively simple by adopting a suitable base for the tax, which brings us back to the first foundational issue and serves as a reminder that all four of these points need to work in concert to create a solid digital tax.

B. Impact of Trade Agreements

1. Trade Agreements Generally

The key to the relationship between the tax and trade laws lies in the nondiscrimination clauses in the trade laws. These take two forms: the MFN standard and the national treatment standard. The latter is more important for the four taxes analyzed here. This article has focused on the impact of trade law on CITs and DSTs in particular because they seek primarily to tax offshore MNEs. When these laws are restricted in their application to foreign companies or when they are fashioned in such a way that the application is limited in practice, the argument will center on whether the taxes simply put the offshore provider in the same position as a local company that is already subject to income tax or treat it less favorably than local competitors. Even though the trade laws include a carveout for direct taxes, disputes are still likely to arise over the discriminatory impact of these two taxes. The moratorium on customs duties on electronic transmissions has superseded questions of discrimination in tariffs. Because VATs apply to foreign and domestic sellers equally, discrimination issues relating to their application are more limited.

2. E-Commerce Chapters in FTAs

Many of the newer FTAs include chapters addressing the governance of electronic commerce. Some may restrict access to key data that countries need to assess taxes. This lack of access to data may make it difficult — if not impossible — to determine sources of revenue by jurisdiction, an essential element in the unified approach, FAMs, and DSTs. VAT audits also need reliable data to support examinations regarding the actual price of goods and services to which VAT is being applied. While there are justifications for some of the FTA provisions, policymakers need to ensure that tax administrators have access to the data they will need to administer the new digital taxes. This issue receives far too little consideration and it must be considered when drafting international and domestic policy.

While the discussion here has focused on FTAs, many investment agreements also have similar data provisions. These must also be reexamined for any potential negative effects on the ability of countries to impose taxes on the digital economy.

C. Suggestions on the 4 Taxes

Drawing on the analysis in this article, we have the following suggestions for how to tax the digital economy, with a particular focus on ensuring these taxes can benefit developing countries.

1. Freedom to Choose

Different countries have different economic circumstances and different abilities to administer the tax law. One size cannot fit all. Accordingly, any set of rules to tax the digital economy must give countries the right to fashion and adopt the tax laws that best fit their circumstance. This freedom, however, should be constrained by consensually agreed-upon frameworks for each type of tax.

2. Applying a CIT to the Digital Economy

A PE resulting from a sustained and substantial digital presence in a country must be the starting point for any CIT directed at taxing the digital economy.

3. Unified Approach

The unified approach is only realistic if the great majority of countries agree to its adoption. This will call for an effort at the highest political level in major countries to get a critical mass of jurisdictions behind the endeavor, but even then, the unified approach seems to be an overly complex solution. The determination of the so-called routine return on capital will require, at a minimum, refinement along industry lines, and the reliance on financial accounts may have unfortunate side effects, including adjustments being made to reported statements to reduce taxes.[47] The adoption of the unified approach will also depend on the creation of new and effective dispute resolution rules. Smaller and less developed countries may feel that the tax gives them little benefit apart (possibly) from setting a predetermined return for specific services covered by amount B. If the unified approach is adopted in some form, it should carve out an exception for small and less-developed countries that do not wish to be governed by it or that simply wish to ignore the rules dealing with amount A and adopt another approach for taxing e-commerce profits instead.

4. Modified FAM

A solution to taxing the digital economy using a form of a FAM appears to constitute a better way forward. A modified FAM could be created using predetermined rates of taxation along the lines now being contemplated for the determination of amount B in the unified approach. The rates should reflect differences across businesses lines and geographic regions. For a given line of business, a typical rate of return on gross revenue or on cost of goods sold would be used to determine the amount of tax with an adjustment permitted for unusual circumstances. The rates of return should be adjusted periodically to reflect economic conditions. The tax also needs an allocation formula that takes into consideration three factors: sales, assets, and personnel. The data for its application could be taken from CbC reports if suitable modifications are made to the requirements for these reports. Disputes about taxing rights would largely be confined to disputes between source and resident countries — the same as disputes today. Hence, a new form of dispute resolution mechanism should not be necessary. The modified FAM, moreover, could be expanded to include a wider swath of MNEs than is contemplated under the unified approach. Even given these advantages, a modified FAM would still be a significant departure from existing international income tax rules, and it is likely to be greeted with considerable resistance.

5. Imposition of DSTs on E-Commerce

The DST is an imperfect solution for taxing the digital economy. It falls somewhere between a traditional income tax and a transaction tax. As a hybrid, it does not fit easily within existing rules for either category of taxes. However, despite its imperfection, it may be the only easy and effective way for some countries to tax the digital economy. If the OECD inclusive framework reaches a consensus on a CIT proposal that is satisfactory to the great majority of countries, DSTs can be eliminated apart from their application by small and developing countries that find implementing CITs too difficult. If, as seems more likely, a consensus cannot be reached, then DSTs should be recognized as a suitable substitute for more traditional CITs. In this event, the OECD should create guidelines for the taxing provisions in DSTs, including how they should be imposed and how DST-related disputes should be resolved. Under these guidelines, tax rates should be kept low, and the resident countries of MNEs should be encouraged to accept DSTs as credible taxes when a source company's income is also subject to tax in the resident country.

6. Moratorium on Customs Duties

The WTO community has been unable to reach a mutually agreeable definition of electronic transmissions. Thus, the moratorium on customs duties has become arbitrary, and its economic impact is the subject of lively debate. The best alternative is to drop the moratorium. Although commitments in some FTAs would remain and keep many countries from imposing tariffs on electronic commerce, ending the moratorium is an essential first step toward increasing tax revenue for many developing countries.

E-commerce involving online products that have physical counterparts could then be added to tariff schedules and subject to GATT. All other products would be subject to GATS, which has a substantially narrower scope. Further work should be undertaken to determine if there are transactions beyond those involving items with physical counterparts that should be subject to tariffs. Many developed countries are likely to resist this effort, and it will entail reworking provisions in many FTAs. Nevertheless, ideally, the tariff law should recognize the right of sovereign nations to impose tariffs if they so desire. Assuming tariffs can be imposed, steps should be taken to minimize cascading taxes that they might cause.

7. Imposition of VAT on E-Commerce

The OECD has created a set of well-recognized rules for applying a VAT to electronic commerce involving services and IP. These rules and the mechanisms to impose VAT have already been accepted by several countries and regional organizations, including the EU, with more expected to follow suit. While some developing countries struggle to impose VAT effectively, it is nonetheless a valuable tax and will become more so as developing countries grow and develop the expertise to employ it successfully. The OECD's effort in this area should be recognized and used as an example of the type of consensual change that may be possible in other areas.

D. Suggested Guidelines

Based on the foregoing, we propose a system that would give countries the freedom to choose a new system for taxing the digital economy from options based on clear guidelines such as the following:

- A CIT based on a PE that an MNE establishes by having a sustained and substantial digital presence in a jurisdiction. Income should be attributed to the PE either using the unified approach (if a broad consensus can be reached for its imposition) or a modified FAM along the lines detailed in the text above.
- A DST for small and developing countries that cannot effectively impose a CIT on e-commerce. The DST should be constrained by a framework that with reasonable specificity identifies the revenue streams to be taxed and sets tax rates that would result in offshore firms being responsible for roughly the same amount of tax as a taxable onshore firm.
- Tariffs subjecting e-commerce transactions that are comparable to transactions in physical goods to GATT rules and treating the balance of transactions as services subject to GATS. Further study is needed to identify those areas in e-commerce that may be suitable for the imposition of tariffs.
- A VAT based on the already accepted VAT guidelines established by the OECD for IP and services when the supplier is not located in the jurisdiction of taxation.

Once again, the key to our proposal is giving all countries the flexibility to exercise their sovereign right to tax the digital economy in the fashion that best suits their circumstances. This sovereign right, however, must be exercised within the boundaries of an appropriate framework for the imposition of the tax.

VI. Conclusion

The taxation of digital businesses involves four basic questions: how to define what is to be taxed; whether a set of transactions should be taxed at all in a separate category; if it is to be taxed, how to do so; and how any new tax will be affected by trade rules. The four taxes we have examined all address the first three questions, but their proponents often avoid a discussion of the fourth. Although the preliminary answers to the first three questions all differ, there is much to be learned by comparing and contrasting the taxes. By doing so, the proponents of each tax can incorporate useful insights learned from the application of one or more of the other taxes. Further, each of the proposals would benefit from a thorough review of the effects trade laws and agreements may have on the proposal. Our overarching conclusion is that we must give countries the flexibility to impose the tax (or combination of taxes) that is best suited to their individual circumstances within the bounds of an internationally agreed-upon framework for the tax in question. This is particularly true for developing countries because the ability to choose may be particularly important to their circumstances.

FOOTNOTES

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[9] OECD, "Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising From the Digitalisation of the Economy" (Jan. 2020).

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[34] GATS Article XXII:3.

[35] GATS Article XVII.

[36] GATS Article XIV(d). See also footnote 6 to Article XIV, which lays out six categories of measures that qualify for this exception.

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END FOOTNOTES

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This is the first article in Commentary & Analysis

Representing Sovereign Wealth Funds

Andrew Kreisberg examines the federal income tax treatment of sovereign wealth funds, with and without the benefit of section 892, and highlights practical strategies for structuring their investments.