# The Digital Services Tax: A New Tax Policy Tool for the Digital Age

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*Training session for the*

*Indian National Academy of Customs, Indirect Taxes & Narcotics*

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# Indirect taxes and international taxation (I)

- Cross-border transactions pose new challenges to traditional taxes—both the income tax and the VAT.
- Challenges in administration:
    - Increasing cross-border B2C trade in goods;
    - Increasing cross-border trade in services.

# Indirect taxes and international taxation (II)

- Tax policy challenges
  - Many goods and services are now produced with low (or zero) marginal cost, based on large fixed-cost investment in technology.
  - Technologies can be simultaneously deployed across many locations
  - Market power, including legal monopolies such as patent or trademark protection, or natural monopolies such as achieved through network effects, is necessary for profit making from such technologies.
  - Technology hubs are increasingly concentrated; technology-driven economic growth may be asymmetrical.

“[I]f most countries will not be able to tax ultra-profitable A.I. companies to subsidize their workers, what options will they have? I foresee only one: Unless they wish to plunge their people into poverty, they will be forced to negotiate with whichever country supplies most of their A.I. software — China or the United States — to essentially become that country’s economic dependent, taking in welfare subsidies in exchange for letting the ‘parent’ nation’s A.I. companies continue to profit from the dependent country’s users. Such economic arrangements would reshape today’s geopolitical alliances.”

— Kai-Fu Lee<br>
“The Real Threat of Artificial Intelligence”<br>
*The New York Times*<br>
June 24, 2017

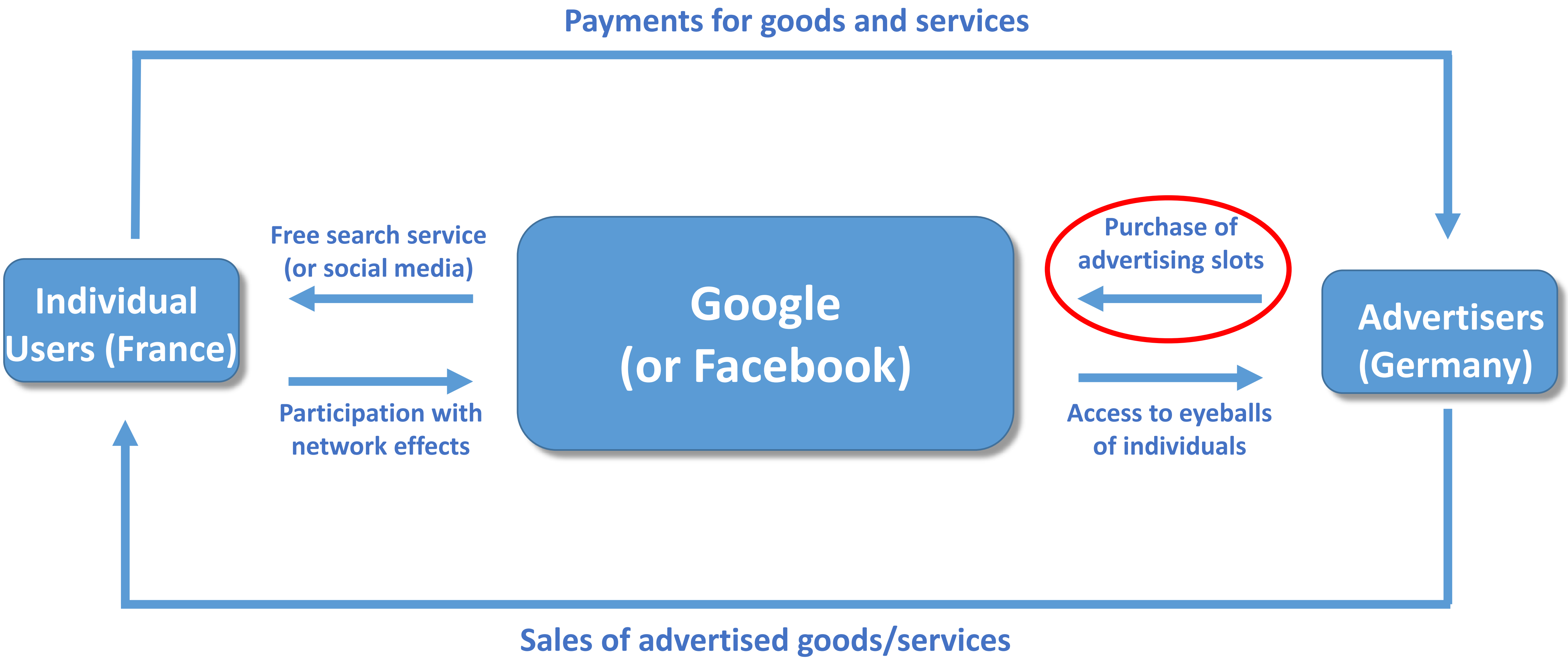
# The Digital Services Tax

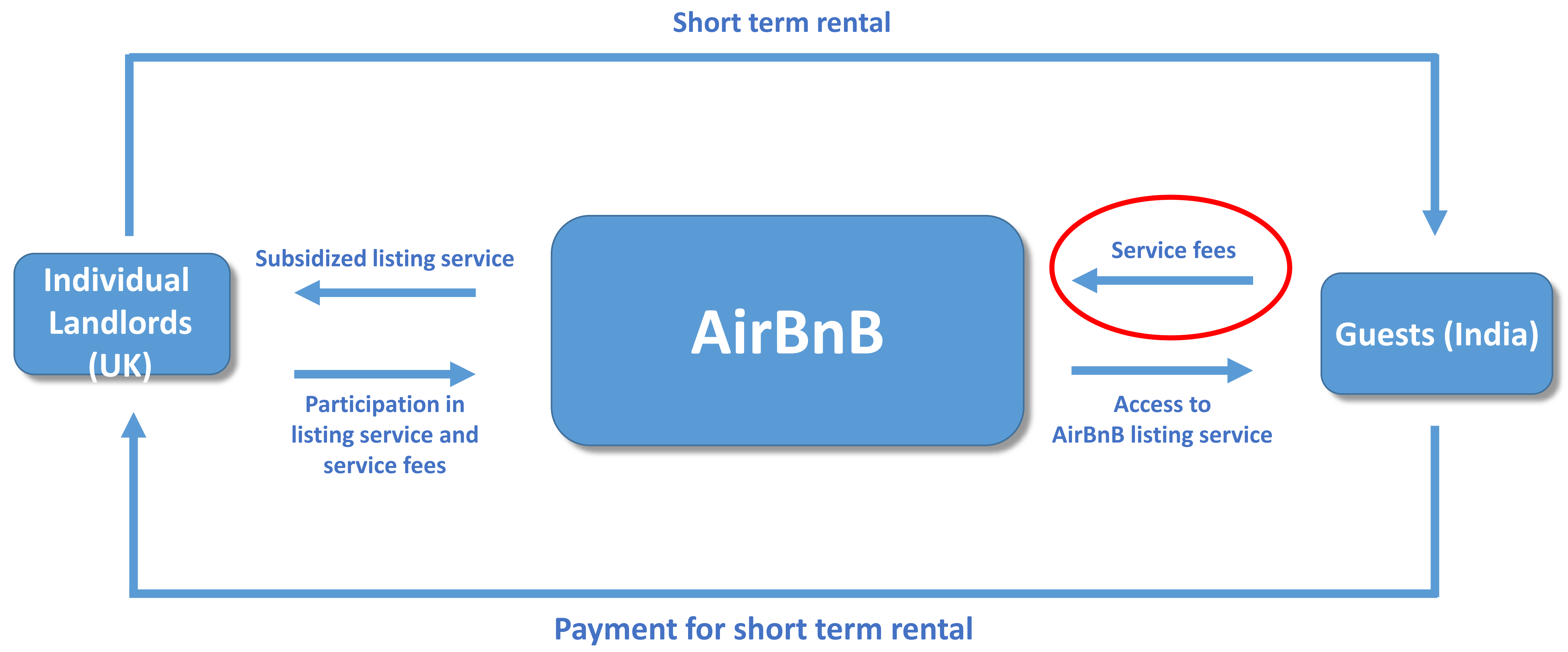
- What is it?
- How does it differ from the VAT and from traditional tariffs?
- A rationale based on taxing location-specific rent: analogy to resource royalties
- What is its relation to the traditional corporate income tax?
  - Contrast with Indian equalization levy

# The Digital Services Tax (DST)

- Announced in outline, separately, by UK HM Treasury and the European Council in March 2018
- Actual DSTs:
  - Enacted into law in France July 2019
  - Also in effect in Austria, France, Hungary, Italy, and Turkey.
- Proposed DSTs:
  - UK draft legislation and guidance released July 2019, adoption expected 2020.
  - Similar legislation pending in Belgium, the Czech Republic, Slovakia, and Spain.
  - In various stages of discussion in Canada, Latvia, Norway, and Slovenia.
  - On backburner in Australia, New Zealand, and Poland
- Strongly opposed by many multinationals and US politicians; initial negative reception among academic commentators on international taxation.

- The DST has been demonized. It purportedly:
  - Violates income tax treaties, WTO rules, and European Union principles
  - Resembles tariffs and erects barriers to cross-border trade
  - Creates unacceptable double taxation
  - Represents unilateral action and bad faith in international cooperation
  - Fails to achieve its intended purpose and hurts domestic constituencies in the countries enacting the tax.


Payments for goods and services
Free search service
(or social media)
Individual
Users (France)
Participation with
network effects
Google
(or Facebook)
Purchase of
advertising slots
Advertisers
(Germany)
Access to eyeballs
of individuals
Sales of advertised goods/services


Short term rental
Individual Landlords (UK)
Subsidized listing service
Participation in listing service and service fees
AirBnB
Service fees
Access to AirBnB listing service
Guests (India)
Payment for short term rental

# Contrast and similarities with VAT and traditional tariffs

- In many cases, no payment may originate from the taxing jurisdiction.
- Physical presence in taxing jurisdiction is even more unlikely.
- Can VAT or tariffs be imposed:
  - Without physical presence of taxpayer?
  - Without payment from the taxing country to the taxpayer?
- In other cases, there are paying platform users in the taxing country.

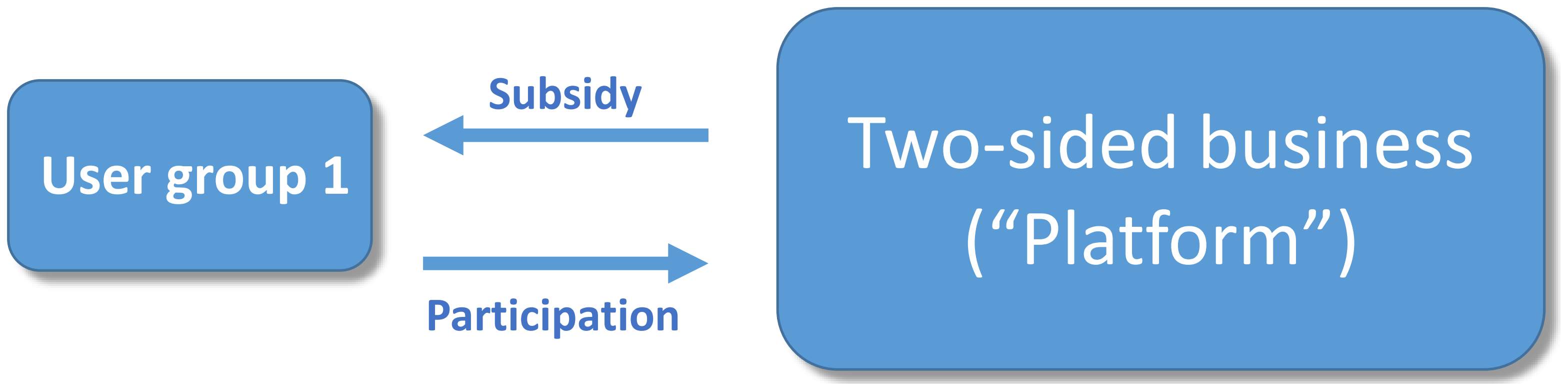
# A justification of the DST

# Basic structure of two-sided business model

Two-sided business
("Platform")

**By manipulating the structure of prices charged to the two groups of users, a two-sided business can increase transaction volume to maximize profit**

# Basic structure of two-sided business model

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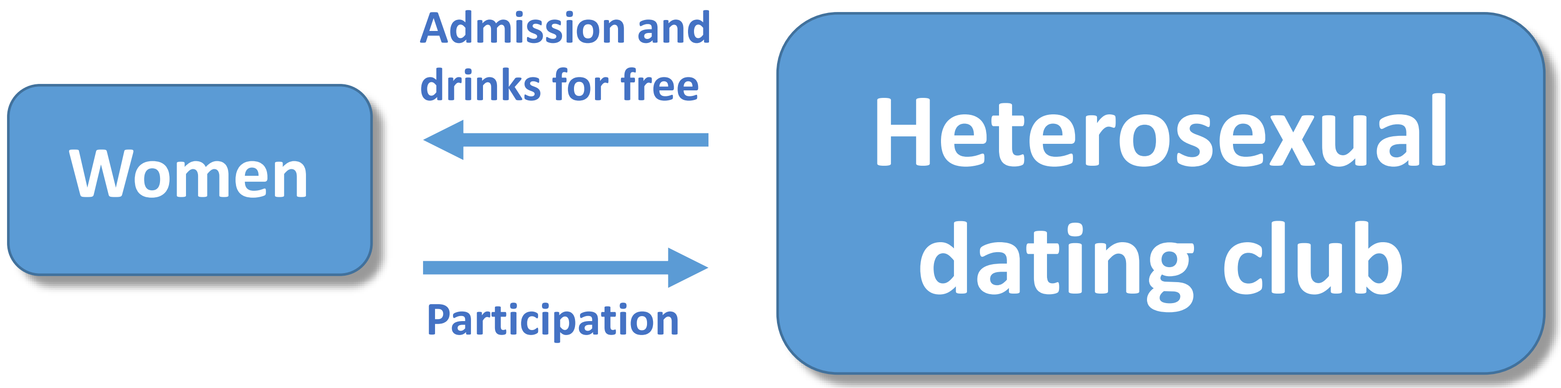
# Basic structure of two-sided business model


By manipulating the structure of prices charged to the two groups of users, a two-sided business can increase transaction volume to maximize profit

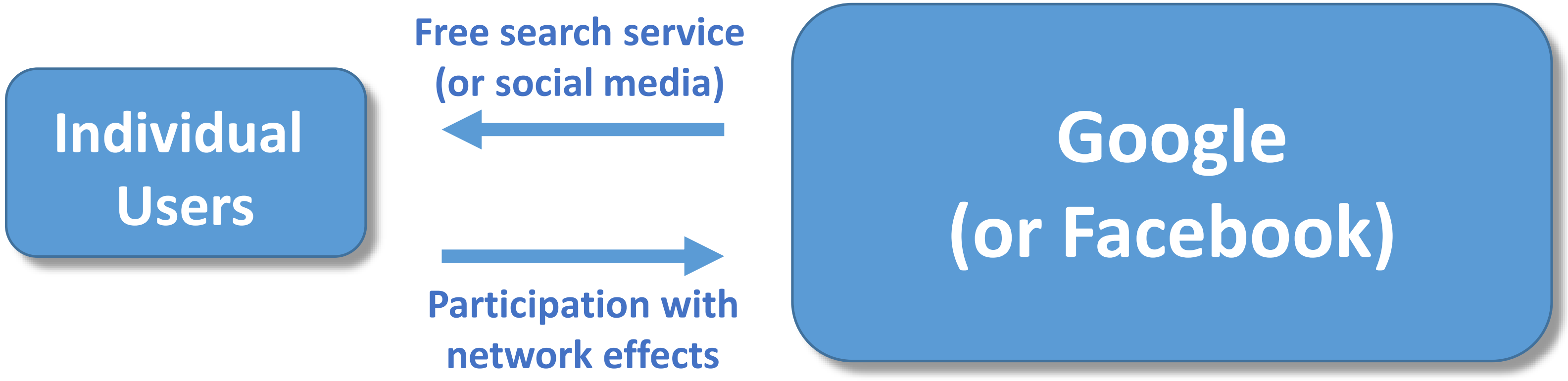
Heterosexual dating club

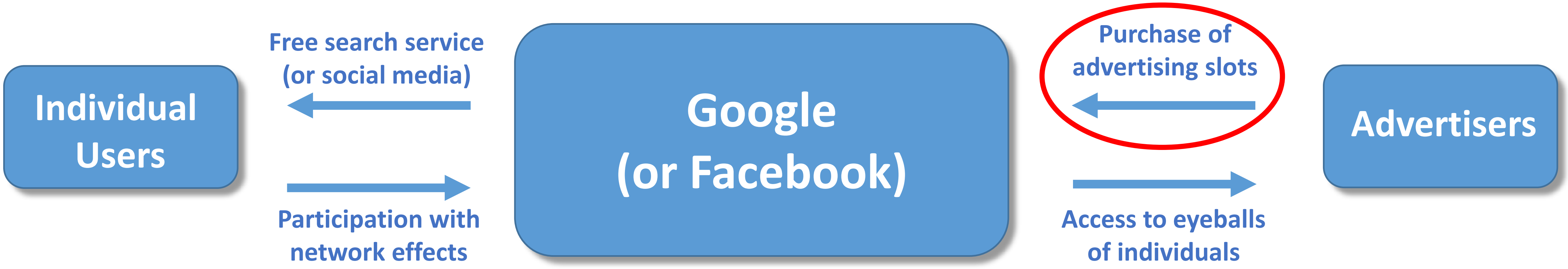

Women
Admission and
drinks for free
Participation
Heterosexual
dating club

Women
Admission and drinks for free
Participation
Heterosexual dating club
Admission fees
Access to women
Men


- Charging men $10 and letting women in free can attract 50 men and 50 women.
- Charging $5 to everyone puts women off, and without women attracts only 70 men.
- Same aggregate price, one price structure generates more profit than the other.

Google
(or Facebook)


Free search service
(or social media)
Individual Users
Google
(or Facebook)
Participation with
network effects


Individual Users
Free search service (or social media)
Participation with network effects
Google (or Facebook)
Purchase of advertising slots
Access to eyeballs of individuals
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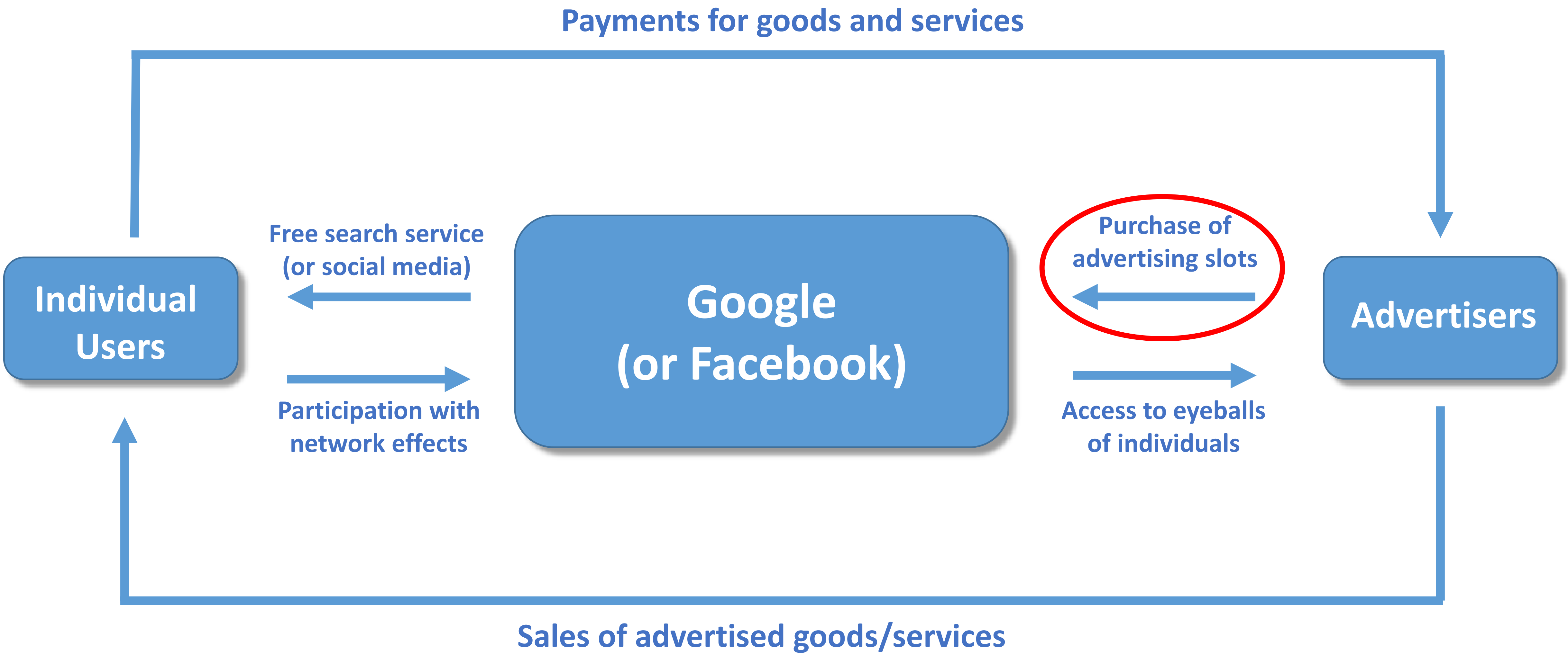
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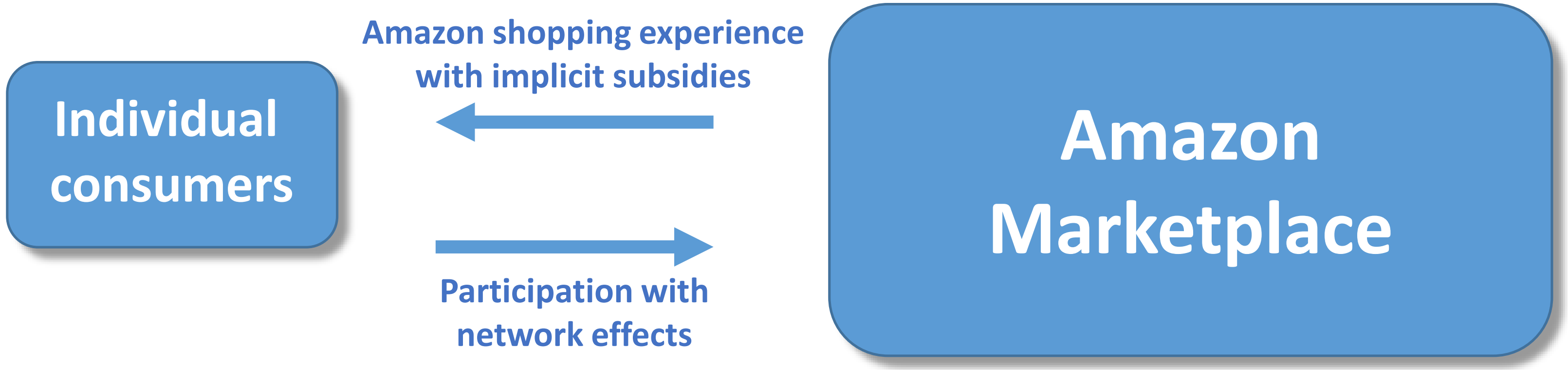
Amazon Marketplace


Individual consumers
Amazon shopping experience with implicit subsidies
Participation with network effects
Amazon Marketplace


Individual consumers
Amazon shopping experience with implicit subsidies
Participation with network effects
Amazon Marketplace
Commission on sales
Access to Amazon buyers
Third party online sellers


Individual consumers
Amazon shopping experience with implicit subsidies
Participation with network effects
Amazon Marketplace
Commission on sales
Access to Amazon buyers
Third party online sellers
Sales of goods and services


Payments for goods and services
Individual consumers
Amazon shopping experience with implicit subsidies
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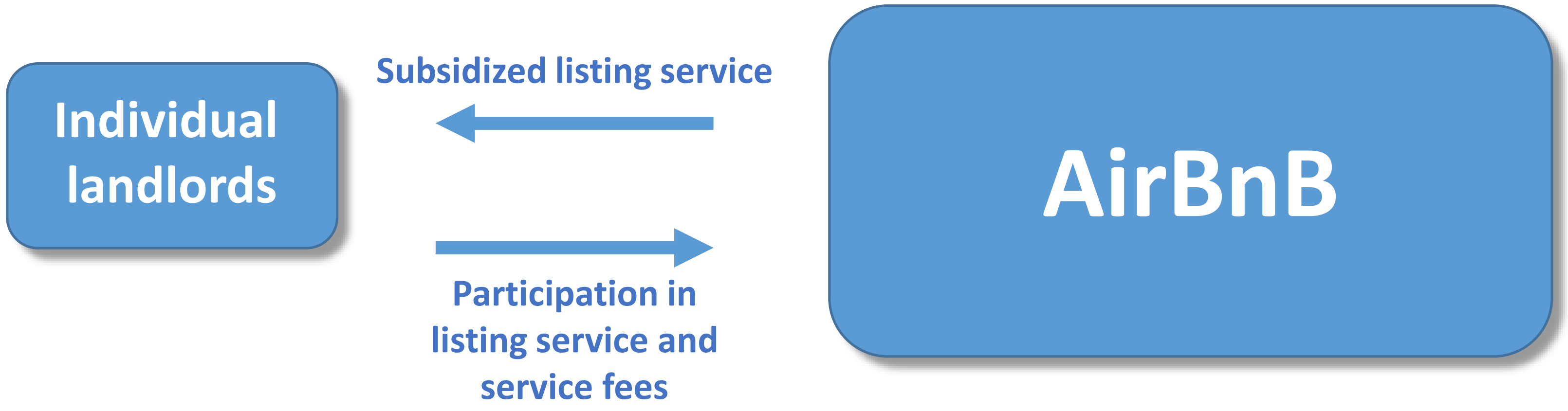
AirBnB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Subsidized listing service
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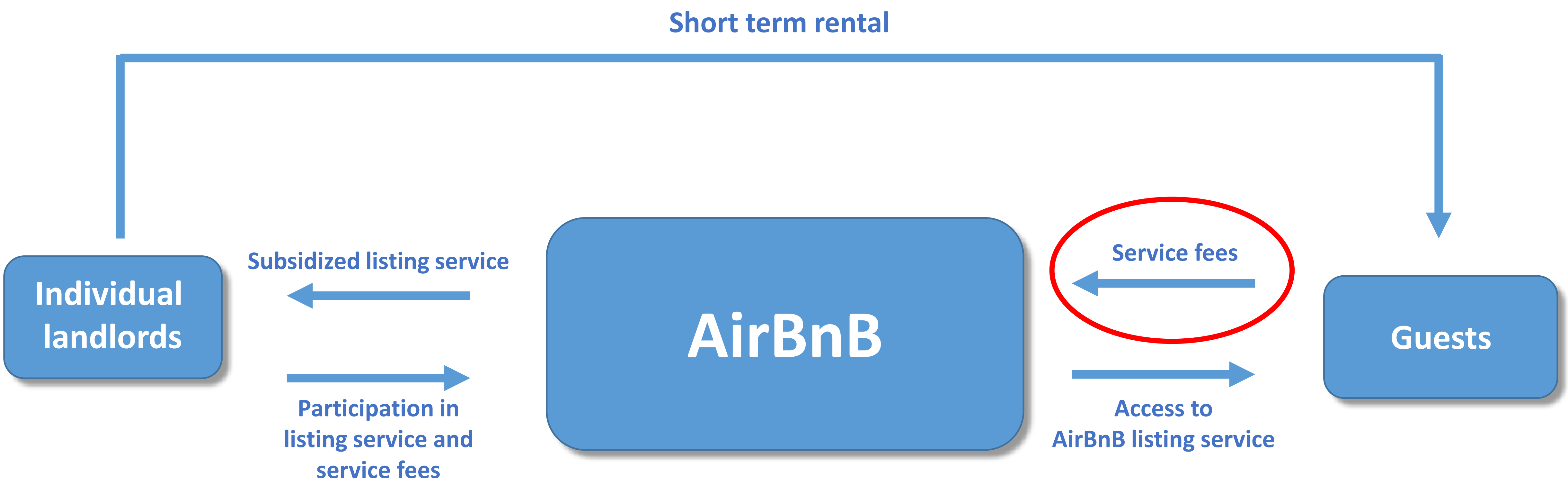
Access to AirBnB listing service
Guests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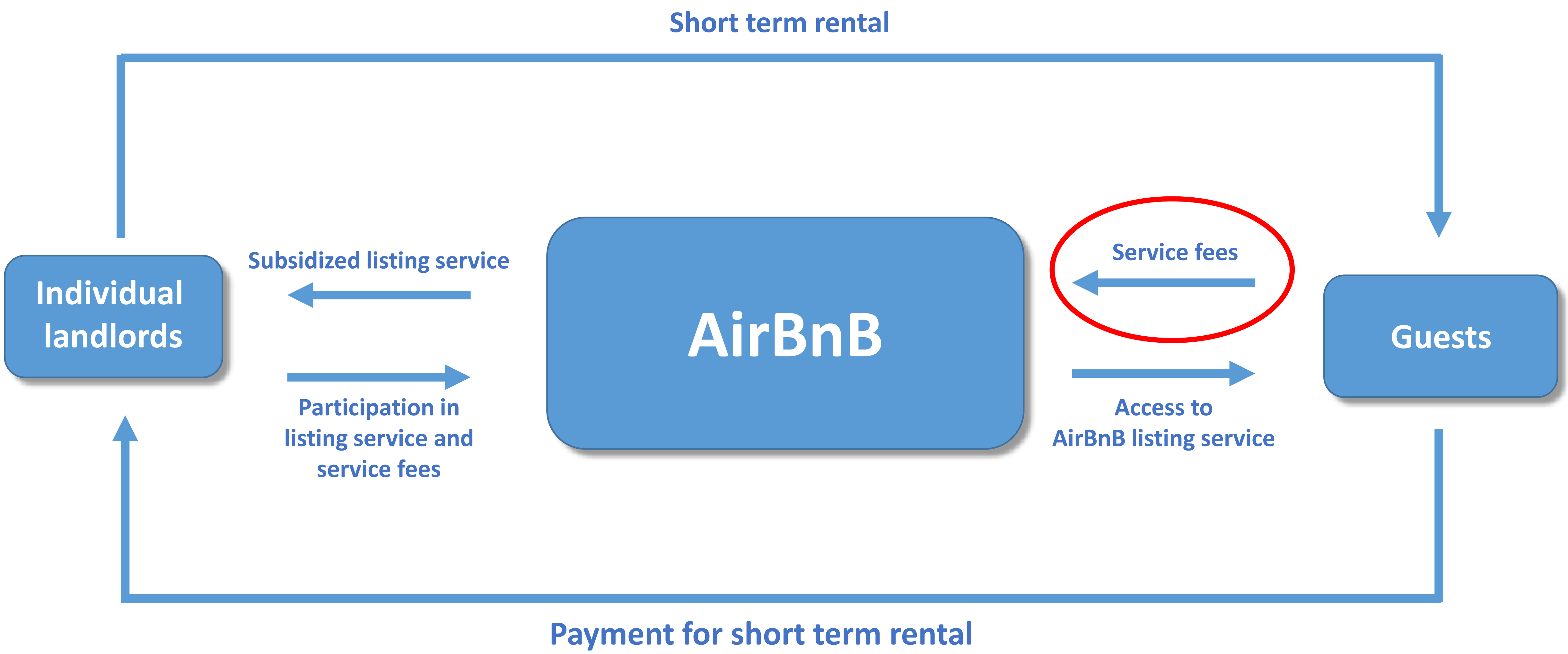
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- Platforms “bring to market” certain users valued by users on the other side. The rent thereby earned by the platform can be seen as specific to the side of the first user group, even though the rent is embodied in payments received from elsewhere.

- Non-rival deployment of technology
  - Operating in one country does not affect operation in another. Rent earned in one country can be earned only there.
  - Assigning the rent to that country is a less arbitrary assignment than to where IP is held.
  - It is, arguably, an equally compelling assignment as to the country of technology inventor.

# DST as a tax on location specific rent

- The DST is best analogized to resource royalties
- Countries (national and subnational governments) have long imposed royalties on the extraction of natural resources.
- Typical features of resource royalties:
  - No cost recovery. Low tax rate on revenue.
  - Generally not creditable against income taxes; only deductible against income.
  - Efficiently extract a public share of location specific rent.
  - Co-exists with many other tax and non-tax policy instruments with similar policy aims: public ownership; price control or public purchase; resource rent taxes.
- The DST is simply a new type of resource taxation—the resource being user activity and user data.

# Relationship to traditional corporate income tax

- Not related, simply a new tax
- The corporate income tax does not aim, and not surprisingly often fails, to tax location-specific rent.
- Compare with Indian equalization levy (EL):
  - EL harmonized with income tax imposed on profit attributable to permanent establishment
  - More importantly, EL is levied depending on where advertisers are located.
  - There may be no LSR in the location of advertisers. Consequently, advertising price may become more expensive for Indian advertisers.

# Are DSTs good for the world?

- Concern about discrimination and trade wars:
  - What is discrimination when trade in certain types of services is highly asymmetrical?
- Concern that it may hamper global technological progress:
  - Have price controls hampered pharmaceutical R&D?
  - Have resource royalties hampered natural resource extraction?
  - Perhaps yes, but these policies may still be justifiable.
- Concern that it undermines international consensus on income taxation:
  - The consensus may have long been eroded and rests on shaky foundations.
  - Can something be “unilateral” when 20 countries adopt it?
  - Does “unilateral” mean “without the consent of the United States”?

# Select references


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