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by Ken Brewer

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Pillar 1 for Dummies: Digital Turf Wars

by Ken Brewer

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In this article, the author provides his perspective on a developing area of international law concerning governmental rights to impose tax and compliance obligations on remote providers of digital services.

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In 1931, to put an end to its protracted turf wars, the New York mob came to a consensus on the specific territories that would belong to each of its five crime families. Historically, the five New York mob families were overseen by "the Commission," which included bosses from the families and the heads of the Buffalo and Chicago mobs.[1] Each boss would also be accompanied at the Commission by a *consigliere*.

In many respects, governments operate much like organized crime families, each one governing the people and things within its turf. Like the mob, governments sometimes try to expand their turf, either by invading territory controlled by other countries, or by claiming unclaimed turf.

However, unlike organized crime families, governments and their *consiglieri* conduct relations with each other under civilized and sophisticated international laws. As a result, they don't use the word "turf." They use a much fancier, legal term: "jurisdiction." But if you pay any attention at all to the way that countries actually relate to one another, it becomes apparent that public international law is little more than a code of conduct (much of which is unwritten) among organized crime families.

Recent efforts (both unilateral and multilateral) to expand source-based tax jurisdiction over the digital profits of nonresident enterprises provide a new vantage point from which to observe governments attempting to grab new turf, while at the same time appealing to their version of the Commission — here, the OECD — to reach a consensus.

The multilateral aspect of that turf war, known as "pillar 1,"[2] is the first of the OECD's two-pillar approach to arriving at consensus for taxing the digital economy.[3]

What Pillar 1 Proponents Want and Why

As the story goes, after his capture (the last of many) in February 1952, legendary bank robber Slick Willie Sutton was asked by newspaper reporters why he robbed banks. Sutton's candid answer: "Because that's where the money is."

Governments use that same logic to identify potential revenue sources. And it is no secret that there is plenty of untaxed money in the tech sector. Perhaps the first to point that out were Trey Parker and Matt Stone, the creators of *South Park*, who dubbed that potential pot of fiscal gold "the

[1] Robert Anglen, "The Five Families of New York: How the Mafia Divides the City," *Arizona Republic*, Oct. 31, 2017.

[2] OECD, "Secretariat Proposal for a 'Unified Approach' Under Pillar One — Public Consultation Document" (Oct. 2019).

[3] In contrast, pillar 2 is not about turf wars. It is about arriving at consensus on another aspect of taxing the digital economy — that is, the minimum level of tax that a home country should impose on its own resident enterprises. In organized crime circles, that would be known as price fixing, but that is for another article.

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internet money."[4] Perhaps some of the pillar 1 proponents saw that episode.

But there is more to the fiscal process than just identifying where the money is. Lawmakers must determine which potential sources of money can be extracted from their rightful owners in the most politically safe way. And finally, a government must be able to establish that it has jurisdiction over those owners or their money.

As for political safety, there is an old adage in fiscal circles: "Don't tax you, don't tax me, tax that fellow behind the tree." For most governments (at least those that operate as democracies), the "you" and "me" are the voters — the people who actually live in a jurisdiction and work for enterprises that have a presence there. Lawmakers know that if they raise taxes on "you" and "me," they do so at their own political peril.

For governments that support pillar 1, that fellow behind the tree is Google, Apple, Facebook, Amazon, and similar enterprises that have little or no physical presence in their countries and, therefore, little or no direct effect on elections there. But they have a lot of internet money. The holy grail for the pillar 1 proponents is the secret formula that gives them legitimate access to the internet money of those fellows behind the tree. That formula appears to involve one part technically plausible legal theory and two parts consensus.

The Plausible Legal Theory in a Nutshell

The thinking by those governments that have enacted, or are considering, a digital services tax is that the internet money is ripe for the taxing if it bears any connection, however tenuous, to any country that can artfully define itself as the market jurisdiction where that money was earned and can find a way around traditional notions of tax jurisdiction under international law.

Perhaps the best example of how tenuous that connection could be is Hungary's turnover-based tax on internet advertising revenues earned by anyone, anywhere, if the advertisement (or the website on which it appears) is primarily worded in Hungarian.[5] And if that's not incredible enough, Advocate General Juliane Kokott issued a formal opinion concluding that the use of Hungarian by a nonresident enterprise was in and of itself sufficient nexus for Hungary to tax the nonresident taxpayer involved in that case.[6]

At the heart of the legal reasoning supporting the extraterritorial assertion of tax jurisdiction over the internet money is the argument that the fellow behind the tree is making huge amounts of money because of a connection he has to people in a jurisdiction through the internet. That fellow behind the tree directs its commercial activities from somewhere outside a country through the internet toward people that are in the country to derive revenue from them. That provides sufficient nexus to permit that country to take some of that fellow's internet money.[7]

After all, jurisdiction to tax is (at least arguably) like any other aspect of jurisdiction under international law. There is little doubt that if a foreign enterprise with no local physical presence was selling illegal drugs to a country's residents via the internet, the country would have jurisdiction to impose criminal sanctions on the company. It could probably also rely on the assistance of other governments to enforce that exercise of jurisdiction. Well then, that country must also have jurisdiction to tax a foreign enterprise if it is selling legal products or services to local residents over the internet.

One potential problem with the theory described above, at least in the context of income taxation, is that virtually all tax treaties prohibit treaty partners from asserting tax jurisdiction over nonresident companies that have no local physical presence. But most of the unilateral DSTs

[4] "Canada on Strike" (originally broadcast Apr. 2, 2008).

[5] *See* Ryan Finley, "Language Can Create Nexus for Hungary's Advertising Tax, AG Says," *Tax Notes Int'l*, Sept. 16, 2019, p. 1178.

[6] Kokott's opinion in *Google Ireland Ltd. v. Hungary*, C-482/18, ruled against the tax on a different technicality — that is, that it violates EU law by limiting nonresidents' appeal rights, which constitutes an unjustified restriction on the freedom to provide services. On the jurisdictional point, Kokott's legal reasoning was in essence that everyone knows that nobody speaks Hungarian except Hungarians, and that most of them are in Hungary. But in a major blow to U.K. Prime Minister Boris Johnson, Kokott was quick to point out that the United Kingdom might not be able to rely on her opinion to support its jurisdiction over revenue from all English-language advertisements.

[7] *Id.*

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that have been introduced thus far are (at least arguably) not income taxes. They tend to be imposed on gross receipts, more like a sales tax. So theoretically, they are beyond the protections afforded by tax treaties.

Sympathy for the Devil (the Pillar 1 Deniers)

There would seem to be little doubt that a sovereign nation has jurisdiction, unimpeded by income tax treaties, to tax payments made by persons or consumers in its jurisdiction. But maybe the real question is whether that sovereign nation has jurisdiction to impose the related accounting, reporting, and tax remittance obligations on a remote digital services provider — that is, the fellow behind the tree.[8]

That question becomes even more complicated, given the seemingly infinite contractual variations on the chain of digital commerce. In some — maybe even most — cases, the out-of-country person on whom DST compliance obligations are imposed is not the recipient of the payment by the in-country consumer. For example, an in-country consumer might have clicked on an advertisement by a nonresident manufacturer that resulted in the consumer purchasing a product from and making a payment to a local retailer. The local retailer made a different payment to the nonresident manufacturer, which made a different payment to the online advertising company, which made a different payment to the ISP.

In a December 3, 2019, press conference, President Trump articulated the technical legal position of the pillar 1 deniers in his response to a question from a reporter on what he had to say to President Macron about France's DST. His response — equally candid as that of Willie Sutton — in relevant part, was:

> The tech companies that you're talking about. They're not my favorite people because they're not exactly for me, but that's okay. I don't care. They're American companies. And we [the United States] want to tax . . . them. That's not for somebody else to tax them. And, as the President [Emmanuel Macron] knows, we taxed wine and we have other taxes scheduled. But we'd rather not do that.

Some might think that message is a bit cryptic. If Rep. Adam Schiff, D-Calif., were to clarify Trump's statement, it might sound something like this:

> You know those tech companies you're talking about? I don't like them, and they don't like me. But you can tell Macron that they live on my turf. And that's all that matters here. If they're gonna pay protection money to anyone, it's gonna be to me. And you know those pretty French wine and fashion companies? You can tell Macron that it would be a shame if something bad happened to them.

Clearly this version is more articulate; but, like him or not, Trump nailed it — "it" being the relevant guiding principles of jurisdiction under international law. Under traditional international notions of jurisdiction, France and the other countries that are unilaterally imposing, or attempting to impose, DSTs on U.S. companies that have no in-country physical presence are arguably violating the United States' exclusive tax jurisdiction (or invading its turf). And while there might not be any international court to hear the U.S. case, there might be other remedies that are perfectly — or at least arguably — legal under international and domestic U.S. tax law.

Shortly after Trump articulated the technical legal basis for his position, France temporarily paused its DST.

The Commission to the Rescue

Unlike the enforcement of criminal sanctions, there may be a question whether a government that unilaterally imposes a DST will be able to rely on assistance from other governments (for example, the United States) in extracting perfectly legal internet money from their residents. Perhaps because of that, there seems to be recognition by all the *consiglieri* that the unilateral imposition of DSTs by multiple countries will inevitably lead to

[8] This has traditionally been an issue in the United States, in the state and local sales tax context. Pillar 1 proponents may find some reason for optimism in recent developments in the United States favoring the rights of states to impose sales taxes and related compliance obligations on remote sellers. *See, e.g.*, *South Dakota v. Wayfair Inc.*,138 S. Ct. 2080 (2018).

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"human sacrifice, dogs and cats living together — mass hysteria!"[9]

In addition to avoiding the chaos that might be caused by multiple unilateral measures, a consensus achieved through the OECD could remove the treaty-based impediment to the imposition of net income taxes on the internet money of those fellows behind the tree. In that regard, perhaps another multilateral instrument may be in the offing.

Conclusion

The real hope of pillar 1 proponents is that enough of the governments that want a piece of the internet money action can come to a consensus that will involve the dramatic change they want in the code of conduct accepted among governments. Maybe then the United States and any other powerful pillar 1 deniers will have little choice but to get in line.

Just to be clear, there's nothing inherently wrong with governments working together to change their code of conduct in a way that benefits their people. For its part, the OECD is reportedly making remarkable progress on pillar 1.[10] The plan is to have consensus by the end of 2020. But for now, it seems hard to believe that Trump (with the advice of his *consigliere*, Treasury Secretary Steven Mnuchin) will agree to surrender so much of his country's turf . . . at least not without some kind of major quid pro quo. What that might be may have nothing at all to do with taxes. If the OECD ends up pulling off pillar 1 on schedule, don't be surprised if the United States ends up owning Greenland (maybe even before the November elections). ■

[9] Bill Murray as Dr. Peter Venkman in *Ghostbusters* (1984).

[10] *See, e.g.*, Stephanie Soong Johnston, "Unified Approach Adopted as Basis for OECD Tax Overhaul Talks," *Tax Notes Int'l*, Feb. 3, 2020, p. 467.

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