BOOK REVIEW

Taxing the Digital Economy: Theory, Policy and Practice

Craig Elliffe

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I INTRODUCTION

With the G20's recent endorsement of a global minimum corporate tax rate and mounting fiscal concerns of the COVID-19 pandemic, there is growing pressure to tax highly digitised businesses. In the serendipitously timed *Taxing the Digital Economy: Theory, Policy and Practice,* Craig Elliffe delivers a comprehensive and methodical account of the challenges digitalisation poses to the international tax system, as well as a review of the current proposals. This text is a must-read for policymakers as concerns grow over the short-term political demands influencing methods of reform.

Taxing the Digital Economy is divided into two parts. In Part I, Elliffe sets out the background and framework of the international tax regime. He explains fundamental concepts in the context of cross-border transactions, the rise of digitalisation and challenges posed by these developments. Part II looks at the OECD/G20 Inclusive Framework's response to these challenges. Elliffe outlines the current proposals and measures their effectiveness in targeting the challenges described in Part I. He considers the implementation of these proposals and the policy strategies that preceded them. The text concludes with an endorsement of a long-term unified multilateral approach to reform and emphasises the need for urgent action.

II CHAPTER REVIEW

Part I: Challenges to the International Tax Law System

In Chapter One, Elliffe lays the foundation for his discussion by explaining fundamental concepts and the history of the international

tax law system. He begins with addressing residence-based taxation, which allows states to collect tax if the subject is a tax resident in their jurisdiction,[1] and source-based taxation, which allows collection if the income itself is earned within the state's territory.[2] He explains that the uncoordinated use of both approaches resulted in double-taxation. This prompted an international response that created the basis of the modern international tax system.[3]

The international solution was preceded by several reports in the 1920s. In surveying these reports, Elliffe draws the reader's attention to a 1923 report commissioned by the League of Nations, which was described by some to be the foundation of the current regime.[4] Although this report advocated for a purely residence-based approach, history shows that it was a hybrid between residential and source-based taxation, with the most influential dependent on the category of income.[5] What Elliffe tries to convey in this section is the arbitrary nature of this compromise that was subsequently accepted by the international community. The author adopts Graetz and O'Hear's terminology of the "1920s Compromise" to describe this system.[6]

The chapter then turns to examine the justification for taxation. After briefly surveying the "ability to pay" theory, Elliffe provides a deeper exploration of the benefit theory. A modern interpretation of this theory states that tax is justified because it enables the state to provide an environment where individuals can create economic value.[7] With reference to the Wayfair decision from the United States Supreme Court, Elliffe highlights that the benefit theory has justified non-resident tax in the analogous context of interstate taxation.[8] The author then connects this discussion to the increasingly influential, yet undefined, concept of value creation. This concept may provide justification to tax without a physical presence, offering a challenge to the 1920s Compromise.[9] When viewed as a development of the

1 Craig Elliffe *Taxing the Digital Economy: Theory, Policy and Practice* (Cambridge University Press, Cambridge, 2021) at 6.

2 At 6.

3 At 9.

4 At 11.

5 At 13.

6 Michael J Graetz and Michael M O'Hear "The 'Original Intent' of US International Taxation" (1997) 46 Duke L J 1021 at 1026.

7 At 24.

8 At 31.

9 At 37–40.

benefit theory, Elliffe claims that value creation may provide theoretical justification for a 2020s Compromise.[10]

After reviewing the issues associated with residence-based taxation, Elliffe concludes that source-based taxation will likely continue as the preferred method for business profits in line with the 1920s Compromise.[11] In support of this conclusion, Elliffe highlights the following points: that countries are practically committed to the 1920s Compromise; source-based taxation has a stronger theoretical foundation; states have a desire to tax the demand side of the market; and the political importance of the amount of tax multinational enterprises (MNEs) pay.[12] Elliffe continues this thought by suggesting the 1920s Compromise can be modified to expand taxing rights to MNEs in the digital age. However, given limited constraints on domestic source taxation, he hints that a long-term multilateral solution establishing a new framework is most appropriate.[13]

In Chapter Two, Elliffe undergoes the descriptive task of outlining the key characteristics of digital businesses. After briefly reviewing the benefits and difficulties of digitalisation, he looks to describe the digital market. Elliffe summarises its features as including direct and indirect network effects; economies of scale and mobility; high switching costs and lock-in effects; the importance of data; and the complementary nature of the relevant goods and services.[14] These factors have afforded some firms a significant competitive advantage.[15]

Next, Elliffe turns to the new business models that have emerged from the digital economy, describing the variety of models as "bewildering".[16] He refers to the OECD's classifications, including multi-sided platforms, which allow two or more types of participants to interact (e.g. Uber with drivers and passengers); resellers, who acquire goods and services to sell to consumers (e.g. Amazon); vertically integrated firms, who have integrated their supplier within their company (e.g. Netflix); and input suppliers, who supply intermediary inputs to other firms.[17]

10 At 41.

11 At 41–44.

12 At 45–46.

13 At 55.

14 At 64–65.

15 At 66.

16 At 66–67.

17 At 67–68.

Finally, Elliffe makes observations on the key characteristics of these business models in relation to digitalisation. He notes that all models benefit from intangible assets.[18] All models, except input suppliers, benefit from the growing importance of network effects and the ability to operate across borders without a physical presence.[19] Multi-sided platforms are the most likely to benefit from non-neutral pricing and end-user control on key terms.[20] All models benefit from efficiencies, economies of scale and the low marginal costs of digitising.[21] User participation in the form of data collection, interactions, comments and reviews and the expansion of networks will benefit multi-sided platforms and, to a lesser extent, resellers and vertically integrated firms.[22]

Chapter Three naturally progresses to the challenges posed by the digital economy. Elliffe highlights that international tax rules are no longer "fit for purpose"[23] as he introduces seven major areas of challenges to the tax system. First, is the "vanishing ability to tax business profits".[24] Countries have agreed not to tax business profits unless the entity has a "permanent establishment" (PE) in their territory.[25] However, digitalisation has made it easier for firms to carry on business activities without a physical presence in the market jurisdiction.[26] Secondly, the system is not equipped to assess the value of data and user contribution. Data collection has become a key success factor[27] and consumers contribute to the brand and the critical mass of users.[28] Thirdly, digital businesses are often reliant on intangible assets. These assets are easily transferable between jurisdictions and difficult to value for transfer pricing purposes.[29] Fourthly, it is difficult to fit new digital products and services into traditional categories of business profits, technical services or

18 At 78.

19 At 79.

20 At 80.

21 At 80.

22 At 80–83.

23 European Commission *Proposal for a Council Directive Laying Down Rules Relating to the Corporate Taxation of a Significant Digital Presence* (European Commission, COM (2018) 147 final 2018/0072 (CNS), March 2018) at 1 as cited in Elliffe, above n 1, at 87.

24 At 89.

25 At 90.

26 At 94–95.

27 At 97.

28 At 98–99.

29 At 103.

royalties.[30] For example, cloud computing can be classified as any of the three categories depending on the jurisdiction.[31]

The final three challenges are more general, though exacerbated by the effects of digitalisation. The fifth challenge relates to the insufficiencies of the current transfer pricing regime. The arm's length approach is not adequate in attributing the effects of integration and synergy within MNEs.[32] The sixth challenge highlights how the failures of source-based taxation are compounded by the inadequacies of residence-based taxation.[33] Problems arise with the mobility and ease of establishing corporate residency and the ability to separate shareholder and corporate taxation.[34] The final challenge concerns competition by states.[35] Countries compete to attract economic activity and support domestic business, sometimes tolerating aggressive tax planning.[36] Elliffe highlights competition to be the "first and most difficult challenge".[37] It is closely tied to international cooperation, which is likely the linchpin to this issue more broadly as a stable long-run solution requires consensus. In outlining these seven challenges, Elliffe creates a framework later employed to assess proposals.

Chapter Four considers two broad options for reform with a focus on existing legal constraints. Elliffe believes that the international system is at a crossroads between a consensus-driven multilateral solution and unilateral domestic taxes. He first looks at the proposal by members of the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting Project ("Inclusive Framework") who advocate for a multilateral solution.[38] In a section titled "The Brave New World", Elliffe briefly introduces their two-pillar proposal, saving a deeper exploration for Chapter Five. However, he flags their radical nature by describing Pillar One as "the most far-reaching international tax [reform] for a hundred years" due to its revision of the allocation of taxing rights, taxable nexus and arm's length principle.[39]

30 At 104.

31 At 105.

32 At 106.

33 At 108.

34 At 109.

35 At 110.

36 At 110.

37 At 110.

38 At 113–114.

39 At 117–118.

Elliffe recognises the politically and intellectually challenging nature of tax reform. He warns that if countries are unable to agree on a long-term solution, there is a risk of widespread unilateral action due to growing domestic political pressures.[40] In support of a multilateral solution, Elliffe highlights the disadvantages of such an approach, including economic concerns on investment, innovation, adverse growth and economic incidence. Further, if an interim tax was imposed, it must take the form of an excise tax risking overpayment, double taxation and inefficiencies.[41]

The second section of Chapter Four looks at existing legal constraints on interim taxes. He first examines Double Tax Agreements (DTA), which operate to prevent taxation of a non-resident enterprise where there is no PE. Although each tax must be analysed in light of individual DTAs,[42] Elliffe concludes that it is possible that DTAs would not apply to the characteristics of some interim taxes generally.[43] If they did apply, the DTA would likely restrict the imposition of the tax.[44] In examining the relevant obligations under the General Agreement on Trade in Services, Elliffe finds that they would not apply. This is partially due to broad policy grounds, the intention to "take tax off the table" and the difficulty in raising tax disputes due to sovereignty concerns.[45]

Part II: Proposals for Reform

Having equipped the reader with an understanding of the international tax landscape, Elliffe dedicates Part II to possible responses. Turning back to the pillars introduced in Chapter Four, Chapter Five outlines the key elements of these proposals, the policy behind these developments and the broad direction of these changes. Elliffe begins this chapter with a review of the proposals that preceded Pillar One. In doing so, he highlights the difficulties in achieving consensus while providing necessary context to understanding the first pillar.

Pillar One consists of a three-tier combination system of Amounts A, B and C. The author flags Amount A as the most controversial for providing taxing rights without a physical presence.[46]

40 At 119.

41 At 120–121.

42 At 139.

43 At 138–139.

44 At 142.

45 At 159–161.

46 At 177.

Instead, a nexus is established through significant and sustained engagement with the market jurisdiction.[47] Although the exact scope of Amount A has yet to be finalised, it aims to restrict application to the deemed residual profits of large highly digitised and consumer-facing businesses.[48] A further departure from the status quo is illustrated through how Amount A is calculated. MNEs' consolidated profits have replaced individual entities as the starting point for calculations and the use of formulas and agreed proportions take the place of traditional individual arm's length computations.[49] Elliffe illustrates these principles through a four-step process and a summary of the key points.[50]

Elliffe then turns to Amount B, which proposes fixed remuneration for baseline marketing and distribution functions.[51] Described as "simple pragmatism", it is a formulaic approach broadly consistent with the arm's length principle.[52] Although Amount B requires a physical presence, it has been viewed as a backstop to Amount A for situations where companies allocate modest returns to limited risk distributors.[53] As a result, the scope of Amount B is broader than Amount A.[54] Amount C then acts to "correct" the Amount B outcome where it is considered arbitrary or unacceptable from an arm's length perspective.[55] It ensures there is no under-taxation of MNEs by bridging any discrepancy between Amount B and the arm's length calculation. Elliffe highlights that Amount C is a return to the status quo as it was rationalised to adhere to the traditional principle. In doing so, he critiques that it "unwinds" the certainty of Amount B.[56]

The chapter then considers the importance of dispute prevention and binding resolution mechanisms as well as the requirements and considerations that inform these processes. Elliffe ends this section by elaborating on the tensions between the objectives of Amount B and Amount C. Arguably, greater use of Amount B will lead to fewer disputes as adjustments under Amount C may result in

47 At 187.

48 At 181.

49 At 192.

50 At 188–193.

51 At 193.

52 At 195.

53 At 177.

54 At 194.

55 At 198.

56 At 199.

uncertainty and double taxation. However, Elliffe highlights that an ideal solution protects certainty and administrative convenience while also preventing abuse of the system.[57]

The chapter then moves to consider Pillar Two. Pillar Two addresses base erosion and profit shifting (BEPS) issues, colloquially known as the "race to the bottom".[58] These are tax planning strategies that shift profits from a high-tax jurisdiction to a lower-tax jurisdiction resulting in an erosion of the tax base of the high-tax jurisdiction. This proposal looks broader than the digital economy and contemplates a minimum level of tax paid on all internationally operating businesses.[59]

Pillar Two consists of two rules. The income inclusion rule effectively acts as a minimum tax rate by extending residence-based taxing rights where the effective tax rate in the source jurisdiction is below the minimum rate.[60] The tax base eroding payment rule denies a benefit or imposes source-based taxation where payment from a company in one jurisdiction to a related party in another jurisdiction is not taxed at the minimum rate.[61] Elliffe highlights that these pillars will have a significant impact with an estimated global net revenue gain of 4 per cent of global corporate income tax, or US$100 billion.[62] He terms the Inclusive Framework's proposals to be the "2020s Compromise".

In Chapter Six, Elliffe assesses the pillars against the seven challenges outlined in Chapter Three. The pillars successfully address the vanishing ability to tax business profits by creating a new taxing nexus that does not require a physical presence. The sub-issue of allocating profits is addressed through a combination of Amounts A and B.[63] The challenge concerning the inadequacy of residence-based taxation is addressed by Pillar Two. With respect to some challenges, Elliffe highlights that the proposals go significantly further than what is necessary. This is the case for the use, creation and valuation of data[64] and more general issues concerning transfer pricing.[65]

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57 At 202–203.

58 OECD *Public Consultation Document: Secretariat Proposal for a "Unified Approach" under Pillar One* (OECD Publishing, October 2019) at [54] on 25 as cited in Elliffe, above n 1, at 168.

59 At 206.

60 At 207.

61 At 210.

62 At 212.

63 At 221–222.

64 At 225.

65 At 231.

The pillars fail to fully address other challenges, such as the valuation and transferability of intellectual property. Although Pillar Two is best placed to address this issue, it does not apply where the property is located in a high-tax jurisdiction as it was not tailored for this issue.[66] Similarly, the challenge of characterising digital transactions and income was not targeted. Although the pillars will have an incidental effect, Elliffe highlights that the 2020s Compromise requires further work on these issues.[67]

Regarding competition by states, Pillar Two addresses the challenge by eliminating the advantages of incorporation in a low-tax jurisdiction.[68] Although Elliffe has generally provided a comprehensive account for each issue, this section leaves the reader questioning how realistic it is for states who benefit from the current system to support substantial change. Elliffe provides partial insight into this issue by stating that Pillar One addresses the imbalance between developed and less developed jurisdictions.[69] He is clearly conscious of the difficulties in reaching international consensus as he reminds the reader that the proposals may need to be revisited to achieve political acceptance.[70] However, if Elliffe were to provide speculation on what is necessary to achieve this, this may satiate the reader's curiosity on this point.

In Chapter Seven, Elliffe navigates how the 2020s Compromise could be implemented. Regarding Amount A, the approach to create a new nexus and taxing right was confirmed in January 2020.[71] Existing profit allocation rules must be amended and double taxation will need to be addressed largely through tax treaties. In respect of changing domestic law concerning source income, Elliffe considers that the "most obvious way" is for countries to collectively adopt a reasonably consistent new sourcing rule.[72] As Amounts B and C do not warrant a fundamental change, only minor adjustments to the existing framework are required. Additions such as a method to calculate Amount B and an acknowledgment that Amount B is subject to Amount C would suffice.[73]

66 At 227.

67 At 228.

68 At 234–235.

69 At 234.

70 At 236.

71 At 242.

72 At 247.

73 At 252–253.

The chapter then moves to consider the implementation of Pillar Two. The income inclusion rule is likely to take the form of a domestic piece of legislation coordinated for consistency between jurisdictions.[74] Reducing conflict with existing treaties is best ensured through an express statement in the instrument.[75] The undertaxed payments and subject to tax rules would require domestic and treaty amendments.[76] Elliffe highlights the coordination and ordering of rules as a key issue to prevent double taxation.[77] In implementing both pillars, he considers a multilateral instrument to be the most suitable method. Simultaneous implementation is an important factor to ensure a level playing field.[78] Elliffe again raises the need for a clear dispute resolution process; however, there remains no consensus on the nature of this mechanism.[79]

To better understand the foundation of the 2020s Compromise, Elliffe dedicates Chapter Eight to examining the radical policy alternatives that influenced them. The first is destination-based cash flow taxation (DBCFT). Similar to consumption taxes, it is a tax on cash flow ultimately received by the location of the final consumer.[80] The most important element of DBCFT adopted into the proposals was destination-based taxation in respect of remote sales.[81] Elliffe believes that if there is a lack of consensus for the 2020s Compromise, we may see an emergence of some or even all of the elements of DBCFT.[82]

The chapter then turns to residual profit allocation by income (RPAI), which utilises existing transfer pricing techniques to identify routine profits and allocate residual profits to jurisdictions based broadly on sales to the ultimate third-party customer.[83] RPAI made a significant contribution to Pillar One in the allocation of residual profit to the market jurisdiction.[84] If Pillar One does not achieve international consensus, it has been suggested that features of RPAI

74 At 255.

75 At 259.

76 At 260.

77 At 260.

78 At 261.

79 At 261–262.

80 At 268.

81 At 271.

82 At 272.

83 At 276–277.

84 At 279.

may be adopted in future international tax reform.[85] However, Elliffe takes the position that sharing taxing rights is more desirable.[86]

The third alternative is formulary apportionment, which is the allocation of total net profit to the states where the profits were created according to allocation keys such as sales or number of employees.[87] Formulary apportionment contributed two features to the 2020s Compromise, namely basing the allocation of profits to the market on worldwide profitability and the allocation of profit to the destination jurisdiction.[88]

Finally, Elliffe looks at expanding the concept of PE away from the requirement of a physical presence towards a "significant economic presence" combined with sustained revenue.[89] As it utilises a familiar concept, change could be viewed as incremental but still responding to the challenge. Adopted features from this method include destination-based taxation, although differences are apparent as the pillar's nexus is established through the presence of "in-scope" revenue.[90] A key conclusion of this section is that these alternatives contributed to the idea that any proposal must move the allocation of taxing rights to a destination basis.[91]

The chapter then moves to consider two approaches taken by states. The first involves states interpreting the existing framework broadly to enable the taxation of the digital economy.[92] Elliffe surveys Israel and India as examples of countries who have established PEs on the basis of a significant digital or economic presence in their territory. The second approach uses domestic legislation to target MNEs who have set up schemes to avoid tax liability. The author illustrates this approach with examples from the United Kingdom, Australia and New Zealand. Elliffe warns that these approaches carry significant political and economic risk as well as possible double taxation and uncertainty. He critiques that they are the result of a "determined and somewhat desperate approach" to respond to political pressure to ensure MNEs pay their "'fair share' of tax – whatever that is."[93]

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85 At 279–280.

86 At 280.

87 At 281.

88 At 284.

89 At 286.

90 At 289.

91 At 265.

92 At 290.

93 At 304.

In the final chapter, Elliffe calls for a consensus-driven multilateral solution. He commits the first part of this chapter to outlining key generic design issues with unilateral domestic taxes and endorses the two pillars as the preferred option.[94] He highlights three "big picture" benefits in the multilateral approach. These include the coherence of a long-term agreement; tax credits against any tax arising under the existing framework; and a unified tax system that would reduce double taxation, disputes and opportunities for tax avoidance and profit shifting.[95]

Elliffe then reflects on the major areas of change proposed in the 2020s Compromise. He reiterates that the most significant of which is the move towards destination taxation.[96] Elliffe highlights tax competition as the most controversial change. He leaves the reader with words of warning that self-interest poses the risk of undermining the international consensus necessary to implement these changes.[97]

III CONCLUSION

Taxing the Digital Economy provides a comprehensive guide to one of modern society's most pressing issues. Elliffe demonstrates his natural teaching ability by bringing accessibility to a highly technical area. Equipped with the use of examples, bullet points and detailed background, *Taxing the Digital Economy* breaks down the barriers to understanding international tax law. Although flow is, at times, sacrificed for clarity, this trade-off is fair considering the accessibility achieved. This is especially important considering this issue has captured the publics' attention and attracted significant political influence.

Although Elliffe is cautious in keeping the text largely descriptive, his perspective simmers in the background of his writing, peeking through in its final chapters where he highlights the necessity and urgency in pursuing a long-term multilateral solution. Although the COVID-19 pandemic has resulted in growing pressures to pursue reform, Elliffe hopes the pressure may result in a coherent and consensus-driven approach. Although this reviewer remains sceptical, recent G20 announcements appear to support Elliffe's position.

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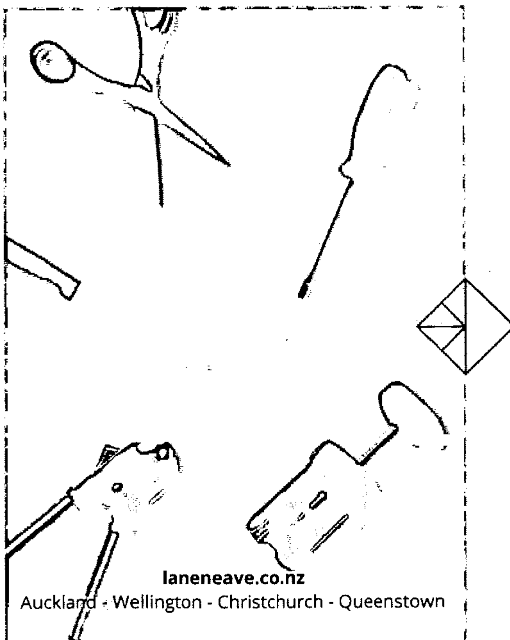
94 At 313.

95 At 313.

96 At 316.

97 At 320–321.

Taxing the Digital Economy has left this reviewer with a renewed frustration over the shortcomings of the international tax system. Although once in support of the populist impositions of taxation, frustrations are tempered by Elliffe's principled arguments for a multilateral solution. As the Inclusive Framework's pillars remain a proposal, only time will tell the direction the international community will take on this issue. Elliffe is correct in concluding that a 2020s Compromise is needed now more than ever.



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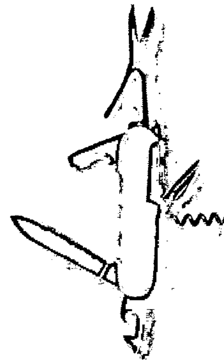

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