Nigeria’s Finance Act 2021 and the Digital Tax Framework: Another Attempt to Boil the Ocean?

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Both Nigeria’s Finance Act 2019 (‘2019 Act’) and Finance Act 2021 (‘2021 Act’) address the tax consequences of the digital economy. The 2019 Act addresses the key issues of nexus and allocation of profit, which are global tax consequences of the digital economy. The 2019 Act adopts a ‘Significant Economic Presence’ (SEP) test to determine nexus of non-resident digital companies operating in Nigeria. The SEP approach is not substantially different from the recommended options in the OECD’s 2015 Final Report on the same subject, and this idea of SEP might have been borrowed from the OECD. The OECD’s work itself is an assemblage of previous works on providing alternative definition to the traditional permanent establishment, which has been eroded by the wave of the digital revolution. The 2019 Act was enacted at the time the OECD’s consensus-based framework for the digital tax problems was at an advanced stage, and even gaining public acceptance in non-OECD states. Nigeria’s unilateral approach might, thus, appear contrary to the OECD’s appeal to international consensus and cooperation. It is interesting that at this time, Nigeria had a relatively key role in the OECD's Steering Group that is working on the same subject matter.

The 2019 Act generally treats digital platforms as non-resident companies and deems their profit to be derived in Nigeria if they meet the SEP requirements. The 2019 Act only amends S. 13(2) Companies Income Tax Act (CITA), which applies to non-resident companies. The 2019 Act's approach to specifically target foreign digital platforms is of great utility and interest, as these entities are equipped by intricacies of the digital economy to operate and earn income in Nigeria without having a physical nexus. By the 2019 Act and the subsequent Ministerial Order, a digital platform has SEP where it derives N25,000,000 (approximately $60,000) annual gross turnover; uses a Nigerian domain name (i.e., .ng) or registers a website address in Nigeria; or has a purposeful and sustained interaction with persons in Nigeria by customizing its digital page or platform to target persons in Nigeria.

One of the principles of international taxation is that a state should only impose taxes it can administer. The 2019 Act's approach has significant administrative challenges. While ascertaining SEP using any of the criteria stated above may relatively be straight forward and achievable, attribution of profit to the in-country significant economic activity may be a tall order. The concern here is related to non-resident digital platforms with no offices and agents in Nigeria. It will be a weak position to assume or canvass an argument that the financial institutions through which payments may be made to extremely virtual businesses should be held as agents of the digital platforms. It is possible to by-pass intervention of the financial institutions in Nigeria – a developing country with little resources to monitor and capture digital transactions. We may need to consider the possibility of making payment for such services through a cryptocurrency – a decentralized ecosystem that is difficult for a developing country to trace to a particular person or an entity. Even, where the payments are made through local and traditional financial institutions, the issue of whether these institutions have competencies and resources to determine the threshold of economic activities will arise. Also important to this is whether there are incentives to motivate and discourage the staff of the financial institutions from colluding with these platforms; or a system that enables a third party to oversee and monitor internal activities of the financial institutions. The incentives need not be monetary, and they do not suggest that the staff should be bribed to discharge the expected obligations. Incentives, in this context, are policies that intrinsically encourage and promote honesty, selflessness, commitment, diligence and heroism.

Allocation of profit is very fundamental in this circumstance, because without it a foreign digital platform will not be correctly taxed or not taxable at all even if it is proved to be virtually and economically present. It is a huge task to really attribute profit to the digital platforms which business model is unique and fluid, and their activities can arise simultaneously in different jurisdictions. Even where the digital platforms file tax returns, the accounting process of ascertaining taxable profit may be difficult because the tax authorities will not have materials to confirm the operating expenses reported by the digital platforms. The possibility that the digital platforms might transfer some of the costs incurred in other jurisdictions to the tax returns cannot be ruled out. The uncertainty around allocation of taxable profit is unhealthy for both the tax administration and the digital platforms.

Has the 2021 Act resolved the problem?

It appears that the conundrum in the 2019 Act was noted by the tax authority, and the subsequent amendment was used to correct it. The 2021 Act introduces a turnover-assessment instead of the problematic profit attribution of the 2019 Act. Foreign digital platforms are now assessable and taxable on ‘such fair and reasonable percentage of that part of the turnover attributable to that presence’. What constitutes fair and reasonable percentage is neither defined nor explicitly stated in the law – not in the 2021 Act or any other tax law. Nigeria’s Minister of Finance has, however, confirmed that the fair and reasonable percentage is 6%. The principle of fair and reasonable percentage is not novel in the Nigerian taxation regime. The origin of this doctrine is traced to the Nigeria’s budget press briefing in 1996, which stated the government’s position to tax non-resident companies on their turnover at 6% rate. Since then, the Nigerian tax authority has been using the 6% tax rate for turnover assessment. This principle assumes that 20% of revenue of a taxable entity is profit while the remaining 80% is operating costs. The 20% deemed profit is taxed by the standard corporate tax rate of 30% to get the 6% effective tax rate. Rather than waiting for the company to assess and ascertain profit that will be taxed at 30%, the tax authority will simply apply 6% tax rate on the turnover. The standard corporate tax rate of 30% is used in both instances; the difference is only in the procedure to ascertain the underlying tax base – the regular approach uses adjusted/total profit as the base while the ‘fair and reasonable percentage’ approach uses turnover.

The principle of ‘fair and reasonable percentage’ was introduced at the time when the corporate income tax rate of 30% applied to all companies irrespective of their annual profits. The proportional tax regime of applying a single tax rate to all taxable companies was substituted in 2019 for a progressive tax rate that applies different tax rates for different categories of companies. It will be contrary to the assumption of the ‘fair and reasonable percentage’ to apply 6% to a medium-sized company that should be taxed at a lower rate.

The principle of ‘fair and reasonable percentage’ has been criticized for its general application to all businesses without considering their unique features and economies. The criticism is of much relevance to the digital sector of the economy. The digital sector requires constant review and understudy to understand the economics and revenue patterns before a reasonable and fair percentage can be ascertained. The assumption of 20% operating profit may be inapplicable and unfair to the foreign digital platforms. This assumption may also result into revenue loss for tax authorities in the event that the digital platform’s operating profits exceed the assumed rate of 20%. A rushed attempt to fix a ‘fair and reasonable percentage’ without undertaking the huge task of reviewing its business uniqueness may be inappropriate.

It is important to review intra-conflict between Sections 13(2) and 30(b)(ii) CITA. By 13(2), a foreign digital tax platform is taxable if profit can be attributed to its in-country economic activities, but under 30(b)(ii), an eligible digital platform is taxed on its turnover. There is no need to retain the ‘profit’ requirement in 13(2), since digital platforms are now taxable on their turnover and not profit.

Conclusion

Nigeria is being careful with its approach in its quest to tax the digital economy. Rather than enacting a stand-alone digital service tax law, Nigeria is amending key parts of its corporate income tax law to accommodate effects of the digital economy. These amendments, particularly the latest amendment on turnover assessment, are not substantially different from an average digital service tax. Both taxes are levied on turnover of digital platforms. The 6% tax rate on turnover is likely to be a major concern for non-resident companies as it is much higher than the digital service taxes in other jurisdictions. France and UK impose 3% and 2% digital service tax respectively; while Kenya, a comparable developing country in the same region, has 1.5% digital service tax. Canada is in advanced stage of launching its 3% digital service tax on all in-country revenues earned on digital activities.

Administration of the turnover assessment on non-resident digital platforms may be problematic, and voluntary compliance with this new regime is uncertain. Nigeria should rather enact a stand-alone digital service tax law at a relatively modest rate as a stop-gap pending conclusion of the global solution to the digital tax problems. France, UK and Canada have enacted or proposed digital service tax despite their influential roles in the OECD/G20 works on having a multilateral approach to the digital tax. An attempt by another country to do same should not be regarded as unnecessary but as an interim measure.