Global Digital Taxation in the Era of Covid-19: An African Perspective

By:

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Introduction

The Covid-19 pandemic has further shone a spotlight on the evolution of digital business. The social distancing measures adopted globally have forced most businesses to close their physical locations and resort to digital commerce and online service delivery. While many businesses are experiencing unprecedented difficulties during the pandemic, the OECD reported that digitalized businesses might see profits rise. Some commentators have suggested that online business is fast becoming the new normal, and businesses are now amenable to online solutions more than ever before.

This rapid shift from physical to online operations has intensified the debate on the suitability of the present international tax rules, which traditionally ties taxing right to physical presence. The OECD flagged the weaknesses of the current international tax rules in light of digitalization in 2013. A more detailed report was later published in 2015, the OECD, however, fell short of

recommending any solutions. In January 2020, the OECD, under an Inclusive Framework that involves 137 developed and developing states (OECD-IF), outlined a unified approach that would be used as a basis for reaching a global solution on digital taxation. This blog article considers the OECD-IF proposed framework and its implication for African countries.

The problem

Normally, states establish their rights to cross-border tax income based on two connecting factors: residence and source. Residence taxation empowers a state to tax the worldwide income of its residents, regardless of where the income is sourced from. The definition of “residence” is typically determined in the domestic laws of the state, with the two main approaches being the place of incorporation and/or the place of effective management. Source taxation, on the other hand, empowers the state to tax the income of a non-resident sourced within its territory. Therefore, if a resident of state A makes profits from their business activity in state B, the profit might be taxed in state A and state B., This conflict of the two connecting factors, leads to what is known as juridical double taxation, which occurs when a taxpayer is taxed more than once on the same income by two or more states.

As a result, states enter into double tax treaties (DTTs) to prevent double taxation by allocating taxing rights to one another. This implies that one of the contracting states will have to forfeit part or all of its taxing right over a relevant income to the other state. The overwhelming majority of existing DTTs are based on either the OECD or the UN model tax treaty, which makes both organizations the de facto rule setters for international taxation.

The two model treaties use the concept of Permanent Establishment (PE) as a basis for allocating taxing rights on business profits. Essentially, the model treaties grant the residence state the exclusive right to tax cross-border business profits unless the source state can establish that the non-resident taxpayer has a PE in its jurisdiction (nexus) and that the profits are attributable to the PE. Different rules, however, apply to business incomes derived by way of dividends, interests, royalties, and capital gains. These categories of income are beyond the scope of this article.

The challenge is that Article 5 of the OECD and the UN model treaties requires a specified degree of physical presence of the non-resident company in the source state (either directly, or through the actions of its dependent agents or employees) for a PE to be constituted. As a result, source states are precluded from taxing digitalized businesses even ifthe businesses have a substantial economic presence in their various jurisdictions. The reason being that such businesses can function without physical presence and are, therefore, certain to fail the PE test as currently defined in the DTTs.

The OECD-IF proposed framework

The current effort of the OECD-IF to address the tax challenges of digitalization is part of the wider project on base erosion and profit shifting (BEPS 2.0). The BEPS 2.0 project is divided into two pillars. Pillar one considers proposals for new nexus and profit allocation rules that take digitalization into account. Pillar two seeks to set a global minimum tax rate in order to end the hazards of tax havens – this is a distinct problem and thus outside the scope of this article.

In January this year, a statement released by the OECD-IF outlined a preliminary framework that is intended to be used as a basis for reaching a global consensus on digital taxation. Essentially, the framework establishes a new taxing right that does not require physical presence. The new taxing right would only apply to automated digitalized businesses (i.e. businesses, such as social media platforms, online search engines and online intermediation platforms, that provide digital services to consumers or users remotely) and consumer-facing businesses (i.e. businesses that remotely market goods and services, whether directly or indirectly, to consumers), whose gross revenue meets a certain threshold.

The proposed nexus rule only requires the source state (or so-called market jurisdiction – i.e. the jurisdiction of thecustomer and/or user) to show that the non-resident MNE has a “significant and sustained engagement” in the market jurisdiction. The degree of engagement needed to constitute nexus would depend on whether the MNE is an automated digitalized business or a consumer-facing business. For automated digitalized businesses, the test would be measured by a minimum revenue threshold. For consumer-facing

businesses, the market jurisdiction would, in addition to meeting the minimum revenue threshold test, need to show a “plus factor” that indicates that the business has a sustained interaction with its jurisdiction.

In summary, for the new taxing right to be triggered: the multinational must be involved in automated digitalized businesses or consumer-facing businesses (subject to some sectoral carve-outs), its gross revenue must exceed a specified threshold (still to be determined), it must meet a specified nexus-revenue threshold (to be determined), and a “plus factor” must be satisfied in the case of consumer-facing businesses (which is still to be determined).

If the new taxing right is triggered, the profit allocable to it would be limited to a “portion” of the “residual profits” of the MNE. This envisages two types of taxable profits: the routine profits and the residual profits. The routine profits would continue to be governed by the existing nexus rule which is tied to “physical presence” and the existing profit allocation rule which is based on the separate entity and arm’s length principle. The residual profits would represent the remaining global profits that are not caught by the existing taxing right due to digitalization. In contrast to the existing separate entity and arm’s length principle, the allocable portion of the residual profits would be calculated based on the consolidated group account of the MNE and distributed through a formula. The final methodologies for the saidcalculation and distribution are still to be agreed. Still, there are indications that they would be complex and would not yield much returns for market jurisdictions.

Accordingly, the new profit allocation system would essentially involve four stages: the total profits of the multinational would have to be determined, the routine profits would then be removed from the total profits and allocated based on the existing arm’s length principle, a portion (which is still to be decided) of the residual profits allocable to the new taxing right would be set aside, and then the in-scope portion would be distributed to the different market jurisdictions using an “allocation key” that is still to be decided.

The African context

There is no doubt that these are radical and important changes to international tax rules, but what do they mean for African countries? It is important to note

that African countries, being primarily developing and capital-importing jurisdictions, predominantly source states in their DTTs with developed and capital-exporting countries. This disparityalready puts them at a disadvantaged position under the existing allocation rule, which gives residence states the exclusive taxing rights over business profits unless the source state meets a nexus test that is fundamentally tied to physical presence. This makes Africa's digital tax challenge a unique one, and any effort that seeks to expand source tax base should be welcome.

There are, however, signs that African countries may be left behind in the negotiations. The technical complexities involved in the ongoing negotiations and the speed with which the process is being driven in order to meet the 2020 deadline – a timeline the OECD itself admits to be "extremely ambitious" – may limit the ability of African countries to participate effectively, especially as the fallouts of Covid-19 already burden them.

Also, the concept of "residual profits" is a far cry from the global formulary apportionment solution initially proposed by developing countries. Although the preliminary framework agrees to the global formulary approach, the framework limits its application to a fraction of the MNE's residual profits whilst allowing a larger chunk of the MNE's profits (so-called routine profits) to remain subject to the problematic arm's length principle. This would enable MNEs to keep cheating the system by using transfer pricing rules to artificially shift most of their profits to affiliates located in low-tax jurisdictions. A global formulary approach would have prevented this by treating the group as a unified entity, calculating their profits based on a consolidated group account, and distributing profits to market jurisdictions based on objective factors (such as sales, employment, resources used, situation of fixed assets, etc.) that reflect economic activities.

African representatives also need to be wary of the political situation of the ongoing negotiations. The US has recently suspended talks, pointing to an "impasse" in negotiations and threatening to use tariffs to repel any efforts to levy digital taxes. This is no surprise, given that US tech companies were reported to have accounted for 75% of the $5.9 trillion combined worth of the world's 20 largest tech companies as at July 2018. African countries should be

prepared for a no-deal scenario, which looks very likely considering the US withdrawal and develop innovative solutions to the digital tax problem either unilaterally or at a regional level.

It is equally imperative that African representatives in the OECD-IF prepare ahead of the next negotiation phase that is due in July. This is because the negotiations are likely to have a lasting impact on the overall balance of taxing rights ifever concluded. A lot of issues remain to be determined. On the scope of the new taxing rights, African countries would want it to be defined as wide as possible, by ensuring, for example, that the gross revenue threshold required for in-scope businesses is low. The threshold of €750 million being suggested in the proposal would only catch the world's largest companies while leaving some active regional businesses out of scope. A way around this may be to set two thresholds, one for the global giants and a much lower threshold for regional businesses.

African countries would also need to ensure that the nexus-revenue threshold is as low as possible, in order to accommodate jurisdictions with a relatively small market. Other important issues that are still outstanding include i) the definition between routine and residual profits, ii) the required threshold for determining the portion of residual profits allocable, and iii) how the profits would be allocated to market jurisdictions. These are further areas that require detailed consideration and negotiation strategy.

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