TAXATION OF THE DIGITAL ECONOMY: EVALUATING THE NIGERIAN AND GLOBAL APPROACH

By Uche Val Obi SAN, Joshua Akhator, Lynda Ugo Ezike and Omoerere Erhuen[1]

Introduction

The digital economy is growing at a rapid rate. As of 2016, the digital economy was worth an estimated 11.5 trillion dollars worldwide, equivalent to 15.5 per cent of the global GDP.[2] According to McKinsey, the African digital economy is expected to grow to about $300bn by 2025.[3] The major players in the digital economy are multinational enterprises (MNEs), otherwise known as "tech giants" that deploy technologically advanced tools and adopt sophisticated operational models that enable them to operate across several jurisdictions with limited or no physical presence. Limited or no physical presence means their business activities will not create any form of permanent establishment or fixed base. This has greatly inhibited the taxing rights of countries in which they operate. According to the Organization for Economic Co-operation and Development (OECD), the effective cost or losses occasioned by tax avoidance mechanisms deployed by MNEs ranges from US$ 100 billion to US$240 billion as of the year 2015.[4] The need to avert economic inequalities, unfair competitive environment and tax revenue losses brought about the necessity for a legal framework for taxing businesses operating in the digital economy. This has intensified the need for international taxation rules that fairly allocate taxing rights amongst states for cross-border transactions that generate income from different jurisdictions, while also eliminating double taxation and non-taxation. This piece evaluates the current global approach towards allocating taxing rights to the income generated in the digital economy and the unilateral approach to taxation of the digital economy adopted by the Nigerian government.

---

[1] [1] Uche Val Obi SAN, Joshua Akhator, Lynda Ugo Ezike and Omoerere Erhuen are Managing Partner, Director, Executive Associate and Associate respectively at Alliance Law Firm, Lagos.

[2] World Bank Group eLibrary - https://elibrary.worldbank.org/doi/abs/10.1596/34366

[3] See https://www.mckinsey.com/featured-insights/diversity-and-inclusion/a-300-billion-dollar-opportunity-serving-the-emerging-black-american-consumer

[4] https://www.oecd.org/tax/beps/beps-actions/action11/

The Two Pillars Approach of the OECD Inclusive Framework

The OECD's Base Erosion & Profit Shifting (BEPS) initiative is made up of 15 Action Points. Action Point 1 of the BEPS initiative is centred on addressing the tax challenges associated with the digital economy. Following the specific mandate of the G20 countries, the OECD championed the initiative to reform the international taxation rules along the lines of developing a multilateral consensus on the vexed issue of taxation of digitalised economic activities. After many years of detailed and intensive work, deliberations and negotiations, members of the OECD/G20 Inclusive Framework on BEPS agreed on a solution to address the tax challenges associated with the digital economy[5](the "OECD Inclusive Framework" or the "Framework"). According to the OECD Secretary-General's statement earlier in 2021[6] "*After years of intense work and negotiations, this historic package will ensure that large multinational companies pay their fair share of tax everywhere…This package does not eliminate tax competition, as it should not, but it does set multilaterally agreed limitations on it. It also accommodates the various interests across the negotiating table, including those of small economies and developing jurisdictions.*".

The OECD Inclusive Framework proposes a two-pillar approach to taxing income or profit generated from the digital economy by MNEs.

Pillar One

[5] OECD/G20 Base Erosion and Profit Shifting Project "Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy" October 2021; see also https://www.oecd.org/tax/beps/brochure-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf

[6] See OECD SECRETARY-GENERAL TAX REPORT TO G20 FINANCE MINISTERS AND CENTRAL BANK GOVERNORS dated July 2021; see also https://www.oecd.org/tax/oecd-secretary-general-tax-report-g20-finance-ministers-july-2021.pdf

The provisions of Pillar One are highlighted in bullet points below for ease of comprehension. Pillar One:

- is centred on the allocation of taxing rights and inhibiting base erosion or profit shifting;
- is applicable in respect of MNEs with an annual group turnover of over €20 billion and profits above 10% of revenue;
- allocates 25% of profits in excess of 10% of revenue to the jurisdiction from which such revenue is derived, using a revenue-based allocation key. I.e. the market jurisdictions in which the consumers of the product or services are resident. This is irrespective of the creation of a fixed base, permanent establishment or any form of physical presence by the MNE in such market jurisdictions. However, only jurisdictions that are allocated at least 1 million euros in revenue (250,000 euros if the jurisdiction has a gross domestic product of less than 40 billion euros) would receive an allocation.

Pillar Two

Pillar Two is centred on inhibiting global anti-base erosion strategies for shifting profits from high-tax jurisdictions to tax heaven or jurisdictions with lower tax rates. This feat is sought to be achieved under Pillar Two through the introduction of a global minimum tax of 15% for MNEs with consolidated group revenue over €750m on income generated from tax jurisdictions subject to certain criteria and rules.

Nigeria's Unilateral Approach to Taxation of the Digital Economy

Nigeria's unilateral approach to developing taxation rules for the digital economy saw the emergence of the concept of "Significant Economic Presence" ("SEP"). This concept was introduced into Nigerian taxation law under the Finance Act 2019. On May 29, 2020, in the exercise of the delegated authority conferred under the Finance Act 2019, the Nigerian Finance Ministry issued the Companies Income Tax (Significant Economic Presence)

Order, 2020 (the SEP Order) specifying the criteria for identifying non-resident entities with SEP in Nigeria. Based on the SEP Order, a non-resident entity will be deemed to have a SEP in Nigeria if it:

i. derives gross turnover or income of more than NGN 25 million or equivalent in other currencies from Nigeria in a year from any of the following activities:
   - Streaming or downloading of digital content.
   - Transmission of data collected about users in Nigeria.
   - Provision of goods or services directly or through a digital platform.
   - Intermediation services that link suppliers and customers in Nigeria.

   Activities carried out by connected persons shall be aggregated to determine the NGN 25 million threshold.

ii. uses a Nigerian domain name (.ng) or registers a website address in Nigeria, or

iii. has purposeful and sustained interactions with persons in Nigeria by customising its digital platform to target persons in Nigeria (e.g. by stating the prices of its products or services in naira).

To aid the seamless administration and implementation of the SEP Order, the Finance Act 2021 introduced further amendments to the provisions of section 30 of the Companies Income Tax Act (CITA) by empowering the Federal Inland Revenue Service (FIRS) to access MNEs operating in the digital economy to tax on a fair and reasonable percentage of the part of their turnover attributable to their presence in Nigeria where such MNE has a SEP in Nigeria. This is the deemed profit basis of tax assessment and in practice, the FIRS usually impose deemed profit tax at the rate of 6% of turnover.

The SEP Order is not applicable to companies covered under any multilateral agreement to which Nigeria is a party. Such companies will be treated in accordance with the relevant multilateral agreement.

The SEP Order also specifies that non-resident entities that provide technical, professional, management, or consultancy services would be deemed to have created a SEP in Nigeria

in any accounting year if it earns any income or receives any payment from a person resident in Nigeria or a fixed base or agent of a foreign entity in Nigeria. The income of such entities will be subject to tax at the rate of 10% which will be final tax on such income. However, a non-resident company will not be deemed to have created a SEP in Nigeria in relation to any payment made:

- to its employees under an employment contract
- for teaching in an educational institution or for teaching by an educational institution
- by a foreign fixed base of a Nigerian company.

Rejection of the Two Pillars Approach of the OECD Inclusive Framework

The Federal Government of Nigeria refused to endorse the Two Pillars Approach of the OECD Inclusive Framework.[7] Upon further engagement and consultation with stakeholders, the FIRS opined that the framework does not serve the overall interest of the country.[8] The FIRS also issued a Public Notice dated 23 May 2022 explaining that the cautious approach to the endorsement of the OECD Inclusive Framework is in the best interest of the country, and to ensure that Nigeria does not lose out on potential revenue from the digital economy. The specific reasons proffered by the FIRS are highlighted below:

- The Framework could compound the issues in the tax system by effectively reducing the number of eligible taxpayers and narrowing the tax net. Pillar One of the Framework applies to MNEs that have an annual global turnover of €20 billion and a global profitability of 10%. Most MNEs that operate in Nigeria do not meet this threshold and will no longer be taxable in Nigeria.

---

[7] See Guardian News Paper of 24 May 2022 - https://guardian.ng/business-services/firs-explains-nigerias-rejection-of-oecd-tax agreement/#:~:text=The%20Federal%20Inland%20Revenue%20Service,overall%20interest%20of%20the%20country.

[8] Ibid

- The stipulated threshold of €20 billion global annual turnover and global profitability of 10% is not just for one accounting year, but it is that the MNE must make €20 billion in revenue and 10% profitability on average for four consecutive years for such an entity to be taxable in Nigeria. This will further reduce the number of MNEs taxable in Nigeria.
- Under the framework, only MNEs that have generated at least €1 million turnover from Nigeria within a year will be taxable in Nigeria. This will create an unfair competitive environment for companies that are resident in Nigeria. This is because such domestic companies with turnover as low as NGN25 million (circa €57,000) are subject to income tax.
- The dispute resolution mechanism prescribed under the Framework will subject Nigeria to the jurisdiction of an international arbitration panel in the event of a tax dispute with any MNE. The international arbitration panel will still be seised of jurisdiction, to the exclusion of Nigerian courts, even where the income is directly related to a Nigerian member of an MNE group. Additionally, such a dispute resolution process in an international arbitration panel will be associated with heavy expenses on legal services, travelling and other incidental costs.
- The Nigerian government has adopted the following tools and strategies for addressing the challenges associated with taxation of the digital economy:

  i. *Regular amendment of tax laws to reflect current global realities:*
  In the Public Notice, the FIRS indicated that the challenges associated with taxation of the digital economy will be mitigated through regular amendment to applicable tax laws citing the SEP rule as a veritable product and a glaring example of such efforts.

  ii. *Deployment of Technology:*
  Another strategy is to deploy technology to bring digital transactions to the tax net. According to the FIRS, companies like Facebook, LinkedIn, X (formerly Twitter), Netflix, and others that have no physical presence in

Nigeria and did not pay taxes have now registered with the FIRS for the purpose of paying taxes.

iii. *Data-4-Tax Initiative:*

The Public Notice indicates that the FIRS is jointly developing blockchain technology with the Internal Revenue Service of the 36 States of the Federation and the FCT, under the auspices of the Joint Tax Board. This initiative is to enable the FIRS to seamlessly obtain information on digital transactions and economic activities of all individuals and corporate bodies in Nigeria.

iv. *Setting up a Specialized Tax Office:*

The FIRS has set up the Non-Resident Persons Tax Office to specifically manage the taxation of non-resident persons and cross-border transactions.

The OECD Inclusive Framework is comprised of 141 member countries. The three other countries that have rejected the Framework are Kenya, Pakistan and Sri Lanka.

The Good and Improvable Features of the OECD Inclusive Framework

Considering the specifications and criteria for the allocation of taxing rights in Pillar 1 and Pillar 2 of the OECD Inclusive Framework, it could be said that the interests of developing countries is not adequately protected or considered under the Framework. On this issue, the African Tax Administration Forum (ATAF) had argued that the profit allocation rules under the Framework "maintained an unfair playing field" and demanded that the OECD simplify its pillar one proposal.[9] The ATAF has continued to engage the OECD in terms of drawing attention to the specific needs of African economies and to some extent, some level of success has been recorded on some of the relevant issues. There is clearly a need for further modification of the Framework to make it attractive to developing economies.

[9] https://www.ataftax.org/itr-global-tax-50-2021-22-logan-wort

Again, the need to submit tax disputes to an international arbitral panel is inconsistent with the practice and ground norm of many developing countries. In Nigeria for example, tax disputes are not arbitrable. Section 251 (1) (b) of the 1999 Constitution of the Federal Republic of Nigeria confers the Federal High Court with the exclusive jurisdiction to adjudicate matters relating to the taxation of companies. This was reiterated in the cases of *Esso Petroleum and Production Nigeria Ltd & SNEPCO V. NNPC*[10] *(Suit No. FHC/ABJ/CS/923/2011)* and *Shell Nigeria Exploration and Production & 3 others v. Federal Inland Revenue Service and another (Appeal No. CA/A/208/2012)*. Thus assenting to the OECD Inclusive Framework would have raised serious constitutional issues in Nigeria. The dispute resolution mechanism prescribed under the Framework has also been viewed by stakeholders as an infringement on Nigeria's sovereignty.[11]

On a closer look, the OECD Inclusive Framework creates an avenue for the possibility of tax disputes among sovereign states. Aside from tax disputes between sovereign states and taxpayers, states that are signatories to the Framework may be in dispute *inter se* over the implementation of certain provisions of the Framework. Countries that have rejected the Framework, such as Nigeria, will not dread the possibility of such disputes.

On the other hand, the refusal to endorse the OECD Inclusive Framework could adversely impact investment decisions of MNEs or foreign investors that would rather opt for the definitive rules that are stipulated under the OECD Inclusive Framework as opposed to the unpredictability and uncertainties associated with the unilateral approach adopted by countries like Nigeria.

Conversely, an inherent advantage of endorsing the OECD Inclusive Framework is the ease of enforcement of taxing rights, especially with respect to MNEs with complex operational

[10] Appeal No. CA/A/507/2012; delivered on 22nd July 2016
[11] https://leadership.ng/ifa-backs-firs-rejection-of-oecd-digital-economy-tax-agreement/

models. The Framework is expected to foster mutual collaborative assistance among signatory states in terms of enforcement of taxing rights.

Conclusion

It is now common knowledge that the digital economy is continuously evolving with MNEs deploying innovative technologies to enhance revenue yield and investment returns. It may be difficult to conceptualize a flawless approach to the taxation of income generated from the digital economy. It is therefore essential to track the economic impact of every framework, tool, policy, legislation, subsidiary legislation or treaty pertaining to the taxation of the digital economy in other to purposefully ascertain required adjustments or reforms. It is important to be mindful of the fact that whatever approach is adopted impacts investment decisions, economic growth and international relations. There are also concerns that the global minimum tax rule (of 15% ETR)[12] prescribed under Pillar 2 could impact Nigeria's tax base once fully implemented. This is irrespective of Nigeria's status as a signatory or non-signatory state to the Framework. It is comforting to know that the FIRS and relevant policymakers are still in discussion with the OECD on this very important issue. For instance, a delegation from the OECD met with the FIRS and representatives of the Nigerian government on the 4th and 5th of April 2023, at a workshop partly organised by the OECD in collaboration with the FIRS, to discuss the maximisation of the benefits of the Framework for Nigeria. Thus, it could be concluded that the window is still open for further deliberations on the provisions of the Framework, and probably, key into its benefits.

---

[12] Effective tax rate