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Addressing the Challenges of Taxation of the Digital Economy: Lessons for African Countries

Summary of ICTD Working Paper 105 by Solomon Rukundo

The rapid growth of the digital economy in many African countries poses serious challenges to traditional tax regimes. Revenue authorities must protect their revenue base without hindering the development and use of new technologies or the business community's involvement in the e-marketplace.

Two international taxation rules pose a challenge to taxing the global digital economy. The permanent establishment (PE) rule allocates taxing rights to a country where a digital multinational enterprise (MNE) creates a sufficient physical presence, and the profit allocation rule, based on the arm's length principle (ALP), allocates profits based on value created. Both envisage a bricks-and-mortar business environment aligning taxing rights with the location of economic activities. Digital MNEs, however, can operate with only a web presence and use multisided business models to gain value from externalities generated by free products, challenging notions of where and how value is created.

Multilateral approaches

In 2015, the OECD identified three options for unilateral action: (1) a new nexus based on non-physical significant economic presence; (2) a withholding tax on digital transactions; (3) an equalisation levy. However, none was recommended for adoption.

In 2016, the OECD/G20 Inclusive Framework on BEPS (OECD-IF) was established to develop standards on BEPS-related issues. 134 countries, 24 of them African, are members.

In October 2019, the OECD Secretariat released a proposal (Pillar One) focusing on consumer-facing highly digital businesses. It seeks: reallocation of taxing rights in favour of the market jurisdiction; a new nexus rule independent of physical presence; to go beyond the ALP and depart from the separate entity principle; simplicity, stabilisation of the tax system, and increased tax certainty in implementation.

> “Current efforts to tax the digital economy have limited application to Africa's unique situation.”

Pillar Two (November 2019) focuses on the creation of co-ordinated rules addressing current risks from structures that allow MNEs to engage in profit shifting to low-tax jurisdictions. It proposes an effective minimum tax rate.

Unilateral approaches

A significant economic presence (SEP) threshold based on purposeful, sustained interaction with a country's economy using technology, e.g. the internet, would be sufficient to subject an entity to taxation. India amended its tax laws in 2018 to cater for this concept.

Withholding of tax on digital transactions, either by businesses or third parties. The former was adopted in India in 2016 as a 6 per cent levy on online advertisement valued at over Rs. 100,000 (USD 1500) per year.

An equalisation levy, or digital service tax (DST) has been proposed by the EC. In 2019, France introduced a 3 per cent levy on sales of digital companies with revenue of over EUR 750 million and over EUR 25 million generated in France.

A bit tax based on the volume of bandwidth used by MNEs' websites was originally considered by the OECD in 2014 but abandoned. Hungary's bit tax of 150 forints (USD 0.60) per gigabyte of data traffic, introduced in 2014, attracted massive protests and was repealed.

Profit shifting tax (PST) or diverted profit tax: the UK Finance Act 2015 contains provisions to limit tax avoidance by digital MNEs making profits in the UK while paying taxes elsewhere. It targets two main approaches: first, MNEs using PE rules to divert profits accrued in the UK; second, where tax advantages are created through transactions using foreign entities lacking economic substance.

Taxes targeting social media and mobile application users have been introduced in several African countries. In 2018, a daily excise duty charge of UGX 200 (USD 0.05) for using social media sites was introduced in Uganda.

VAT on supplies made by digital MNEs requires collection by suppliers, customers or intermediaries. Several African countries apply this tax to the supply of electronic services by digital MNEs. South Africa, Kenya and Uganda require registration by non-resident digital service suppliers. Nigeria is using withhold by financial intermediaries.

Lessons for Africa

Africa's digital taxation challenge is unique. The growing digital economy poses a greater risk for the tax base of developing countries than of developed countries. CIT and VAT, the mechanisms most threatened by the digital economy, form a much larger portion of total tax revenues in developing countries than in developed countries.

Administrative challenges should be considered. African revenue administrations are resource-constrained and face frequent political interference. They also face challenges accessing data and enforcing legal obligations on non-residents. Some African countries have previously announced requirements for MNEs to register for taxation and been ignored.

Tax should not hinder growth of the global digital economy. African countries should ensure that the measures adopted do not hinder the growth of the digital economy: internet services provided by digital MNEs are cost-saving tools for many micro, small and medium enterprises (MSMEs).

Tax should not unduly burden home-grown digital MNEs or MSMEs. Home-grown platforms are rising to challenge the dominance of global online platforms, but could face financial difficulties in complying with measures targeted at larger digital MNEs.

Multilateral action is preferable. Uncoordinated proliferation of digital taxation will likely result in unnecessary complexity and jeopardise global cooperation. As the digital economy poses a global tax challenge, final solutions will be global. African countries should participate in global debates through regional and international organisations, pushing for reform and for the development of international tax rules that consider their interests as source or market jurisdictions.

If unilateral action is taken, compatibility with existing laws is necessary. Any unilateral measures must be compatible with existing domestic laws and DTA obligations and international rules.

An evolutionary approach is preferable to the introduction of a radically different tax regime.

Conclusion

While African countries should participate in multilateral discussions, their challenges are different from those of developing countries, which remain at an advantage and can take some unilateral steps. Africa may have to develop its own multilateral approach, considering the limited but growing digital market, the benefits that MSMEs gain from digital platforms, and the administrative challenges of African tax administrations.

Further reading

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Credits

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