The Implications of Nigeria's Refusal to Endorse the OECD/G20 IF Digital Tax Deal.

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Introduction

Since the advent of internet, which has thrown up the possibility of income generation from jurisdictions miles away from where companies have physical presence, digital taxation has been a controversial subject giving rise to unilateral actions by different countries. Failure to appropriately tax digital earnings generated by Multinational Enterprises ("MNEs") or Non-resident companies ("NRCs") normally gives rise to base erosion in market jurisdictions. Also, an uncoordinated or unilateral imposition of tax on digital incomes by every country may lead to multiple taxation of the same stream of income and, in fact, impact negatively on the global earnings of MNEs. This in turn will stultify global economic growth. The resolution of the problem revolves round finding a balance between and/or amongst the competing ends. The reconciliation of the opposing or divergent views on the best way to tax the digital space is more pronounced between developed/rich countries on one hand and developing/poor countries on the other. This necessitated the long and tortuous negotiations that eventually gave birth to the October 2021 agreement reached by 136 members of the Organization for Economic Cooperation and Development/G20 Inclusive Framework ("OECD/G20 IF") on Base Erosion and Profit Shifting ("BEPS"). The multilateral agreement on digital taxation (the "Agreement") introduces a global minimum tax rate for MNES or NRCs. The Agreement recognizes the allocation of taxing right to market jurisdictions – instead of restricting tax jurisdiction to traditional principal place of business or permanent establishment. In particular, it adopts the two-pillar approach (ie Pillars 1 and 2) in addressing challenges arising from digital taxation.

Despite the acceptance of the Agreement by majority of OECD/G20 IF member countries, two African members of the group, ie Nigeria and Kenya, declined to sign up to the multilateral agreement on taxation of digital economy. The refusal to sign the multilateral agreement signifies there are unfavorable provisions in the agreement which Nigeria and her allies are not comfortable with. Regardless, the refusal to sign the agreement may have consequences too. This newsletter examines both sides of the argument and then draws conclusions on what is best for the country and businesses. To do this, we start off with the two-pillar approach and what it entails.

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Pillar 1

The traditional or uncontroverted international tax rules applicable to most countries allow the taxation of MNEs or NRCs in countries where they (corporate taxpayers) have physical nexus or connection with. Therefore, an absence of a physical nexus suggests an absence of taxing right. With the advent of internet and the subsequent integration of technology into the business operations of many businesses, the global reach of digital activities of companies, especially the MNEs, can only be imagined. This gives rise to the generation of incomes in market jurisdictions where there is no physical connection with the income earner.

Pillar 1 seeks to address the potential loss of tax revenues arising from the digitalization of the global economy. Simply, it does this by recognizing the taxing rights of market jurisdictions – ie where the goods and services are sold or where users are located. The recognition of this taxing right is not without conditions. Thus, under Pillar 1, MNEs with a global turnover of over 20 billion euros and 10% profitability will be subject to tax on a portion of their profits derived from market jurisdictions. The threshold of 20 billion euros is expected to reduce to 10 billion euros upon a successful implementation of the Agreement. The review for this reduction will however begin 7 years after the agreement comes into force and to be completed in no more than a year after the commencement of the review. The Agreement expressly excludes Extractives and Regulated Financial Services from the scope of Pillar 1.

In addition, market jurisdictions where MNEs derive at least 1 million euros in revenue or at least 250 thousand Euros, for small jurisdictions with a GDP of less than 40 billion euros would be entitled to tax such MNEs. The Agreement further provides that disputes arising from the implementation of Pillar 1 will be subject to a mandatory and binding dispute resolution mechanism.

In exchange for the taxing rights under Pillar 1, signatories to the Agreement are required to refrain from imposing Digital Services Tax (“DST”) and/or similar taxes. Thus, signatories to the Agreement that had earlier taken unilateral decision to impose a DST or DST-style tax are directed to repeal such DSTs laws.

Pillar 2

Pillar 2 deals with the new Global Anti-Base Erosion (GloBE) Tax Rules, which introduces a global minimum tax rate (“GMT”) of 15% applicable to MNEs with a revenue above 750 million euros. The GloBE Rules consist of the Income Inclusion Rule (“IIR”) and the Undertaxed Payment Rule (“UPTR”). The IIR requires a parent company (mostly the ultimate parent entity) to top-up its effective taxes paid in low-tax income jurisdiction to meet up to the 15 % minimum tax rate. On the other hand, the UTPR serves as a backstop to IIR. It reduces incentives for tax-driven inversions designed to financially erode a targeted jurisdiction through intra-group payments to low-taxed entities. Thus, it seeks to deny deductions, or take similar actions where low-taxed subsidiaries of an MNE are not subject to the IIR.

Pillar 2 also introduces a Subject to Tax Rule (STTR). The STTR is a treaty-based rule, which may disallow treaty benefits available in existing tax treaties where payments are not subject to a minimum tax rate available in a recipient country. Simply, this rule permits source jurisdictions to impose withholding tax at a minimum of 7.5% to 9% on interest, royalty and certain other payments between related entities where such payments are not subjected to a minimum tax rate. The OECD estimates that Pillar 2 will generate US$150 billion in additional global tax revenues yearly.

Nigeria's refusal to accede to the Agreement

The build up to the Two-Pillar solution saw different countries and blocs make proposals to the OECD with the aim of having a favorable agreement. On the African front, African Tax Administration Forum (ATAF) submitted its proposals to the IF including proposals for the exclusion of the extractive industries and for the reduction of the threshold of 1 million euros for small jurisdictions to 250 thousand euros. ATAF also made a proposal for inclusion of STTR in bilateral treaties with developing countries which was accepted by the IF[1].

The above concessions notwithstanding, two Africa countries – Nigeria and Kenya declined to endorse the Agreement. Nigeria does not see the contents of the Two-Pillar solution as beneficial as it should be. Interestingly, the Chairman of the FIRS noted in a statement that the Agreement is not beneficial to Nigeria because the threshold for taxing an MNE under Pillar 1 covers only MNEs that generate more than 20 billion euros in global revenue with a profitability threshold above 10% and which have generated at least 1 million euros in turnover from Nigeria within a year. The MNEs operating in Nigeria's digital economy do not generally meet the thresholds; therefore, Nigeria may not benefit much from the taxing right allocated to it under Pillar 1.

Further, the Chairman argues that the tax deal introduces a mandatory binding dispute resolution mechanism for Pillar 1 where issues relating to transfer pricing and business profits disputes will be resolved. This implies that most tax disputes involving MNEs may not be determined under Nigeria's legal framework, but through international arbitration – a very costly process for the country. These demonstrate that an endorsement and/or enforcement of the Agreement is likely to result in undesirable outcomes for the country.

Should Nigeria have signed the Agreement?

The past few years have seen Nigeria revamp its tax laws and introduce far-reaching changes with the aim of generating more tax revenues and strengthening tax enforcement measures in the country. In 2020, Nigeria introduced a Significant Economic Presence (SEP) regime as a nexus for taxing Non-resident Companies (NRCs) which have no physical presence in Nigeria. The SEP Regime creates a kind of DST that allows Nigeria tax MNEs offering digital, technical and professional services to Nigerian customers. The Federal Government of Nigeria stated, upon the commencement of the SEP Regime, that the new laws would allow Nigeria remove physical presence as a limitation on its tax collection and, also, widen the country's tax net.[2] Additionally, the 2021 Finance Act allows the imposition of tax on a fair and reasonable percentage of the turnover of companies that have SEP in Nigeria[3].

Under the Agreement, however, and, in exchange for the reallocation of taxing rights under Pillar 1, signatories to the Agreement will have to discontinue the imposition of DSTs and similar taxes. In Nigeria's case, it means that the SEP Regime would be cancelled. Obviously, this option is not attractive to Nigeria when it compares the possible benefits under both regimes. For emphasis, the Agreement states that only companies with a global turnover above 20 billion euros and a profitability above 10% that derive at least €1 million (250 thousand in the case of smaller jurisdictions with a GDP of lower than 40 billion euros) from market jurisdictions fall within the ambit of Pillar 1. On the other hand, the threshold established under the SEP Regime for taxing NRCs for the provision of digital services to Nigerian customers is a gross turnover or income of more than N25 million naira (circa $60,000).

[1] https://www.diacrongroup.com/en/tax-news/african-tax-administration-forum-comments-on-global-tax-agreement/
[2] https://www.vanguardngr.com/2021/09/well-tax-profits-made-by-global-giants-in-nigeria-osinbajo-3/
[3] Section 30 Companies Income Tax Act.

Therefore, from a Nigerian perspective, keeping the SEP Regime would mean that it can possibly tax more MNEs and generate more tax revenue than it would under the Agreement.

Regardless of the advantages derivable from Nigeria's unilateral approach, it appears there are benefits awaiting signatories of the OECD Global Tax Deal – such as:

Certainty of Administration & Compliance: Nigeria's unilateral approach (SEP Order) is fraught with administrative and implementation challenges such as (i) the difficulty in monitoring of MNEs' activities and ascertainment of taxable revenues thereto; (ii) lack of clarity on compliance regulations; as well as (iii) unclear interplay between national laws and tax treaties. This, coupled with the fact that 136 IF members acceded to the Two-Pillar solution may lead to significant non-compliance of the SEP Order which in turn is likely to affect the realization of projected tax revenues under the SEP Order regime. However, the international consensus demonstrated through the Agreement may likely lead to higher compliance rate since MNEs will be subject to the same rules and do not need to subject themselves to unilaterally imposed conditions by each country they operate.

Avoidance of potential trade & political tensions: Unilateral measures (such as Nigeria's) have often been met with threatened retaliatory trade sanctions from countries where those MNEs are headquartered. For instance, the United State Trade Representative (USTR) threatened significant tariffs in retaliation against France's Digital Services Tax[4]. This serves as a point of caution as U.S. goods and services trade with Nigeria totalled an estimated $10.4 billion in 2019.[5] Hence, if Nigeria seeks to enforce its unilateral measure, it may face the risk of increased tariffs and strained relationship with the United States and possibly other signatories to the Agreement. Recently, the United States terminated its tax treaty of 40 years with Hungary over the latter's resistance to implement the global minimum tax rate[6].

However, since the implementation of Pillar 1 demands the removal of DST and other unilateral measures, any possible trade tension will be avoided.

Summary and Conclusion

The Agreement offers benefits to developed and developing countries – such as promoting stability and certainty in global digital tax administration. Although Nigeria appears to have the potential to tax more MNEs and collect more tax revenues under the SEP Regime, implementation and enforcement bottlenecks militating against the regime appear to render it comatose despite the excitement accompanying its introduction into the country's fiscal regime. Unfortunately, there is no data showing growth in the generation of tax revenues through the DST. Lack of information and global non-cooperation awaiting dissident States that refuse to accede to the Agreement will further diminish the amount that could be generated through unilaterally enacted DST laws. Therefore, it appears that acceding to the Agreement may help Nigeria avoid being treated as a pariah State in global tax community. Indeed, it is better to fight within and negotiate for better terms along with countries of similar fate than being isolated. This is particularly more important now that the country is cooperating with the OECD in sharing of information – such as the automatic exchange of information – and other transparency projects championed by the OECD that will help Nigeria realize more tax revenues than it would if it goes it alone.

[4] Trump Administration Threatens Tariffs After France Digital Services Tax (taxfoundation.org)
[5] Nigeria | United States Trade Representative (ustr.gov)
[6] US to Terminate Treaty with Hungary Over Resistance to Global Tax. Retrieved from https://www.washingtonpost.com/us-policy/2022/07/09/hungary-treaty-yellen-tax/