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THE TAXATION OF THE DIGITAL ECONOMY: THE OECD BEPS POLICY RESPONSE VERSUS THE UN FACTI PANEL'S PRINCIPLE RESPONSE

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Summary

The residence/source tax rules that have been in place for over a decade have become redundant in the modern-day digitalised economy. Concepts that created tax certainty such as the concept of permanent establishment have become redundant as the value chains and business models have changed. Although a work in progress, the OECD has been working towards developing a new tax nexus and allocation of taxing rights under BEPS 2.0. The UN FACTI Panel has meanwhile adopted a principle-based approach that attempts to guide countries towards a fairer more transparent way of taxing the digital economy. The question this paper seeks to answer is whether implementing the UN FACTI Panel's principle-based approach as part of the formulation of taxing and profit allocation rules under the OECD BEPS' policy driven approach give these rules the legitimacy needed for equitable and fair enforcement? It concludes by adopting the position that the OECD rules at present leave little for developing counties and that an African position that better safeguards her interests should be adopted.

Key Words: Africa, Digital Taxation, OECD BEPS, Pillar 1, Pillar 2, UN FACTI

Introduction

Unilateral measures have been taken by states aimed at taxing the digital economy. At the same time, the OECD seeks to build international political consensus to implement its radical new proposal that will reallocate and perhaps enlarge the tax pie between nations – or among specific nations. Pillar 1 of the OECD's proposal looks to transform the tax pie by applying a formula based on routine and residual profit. Pillar 2 looks to introduce some form of a controlled foreign company rule to stop profit diversion and a race to the bottom dropping of tax rates by local tax authorities. Pillars 1 and 2 do not just involve digital companies, rather, they involve all Multinational Enterprises (MNEs) that face consumers (OECD, 2021).

This brief focuses only on the envisaged approach to taxing the digital economy and whether African countries will be able to reign in taxes from global profits drawn in from the digitised economy. The policy response under BEPS has come under criticism by specific countries, advocacy groups and institutions

as presenting an asymmetry of forms in identifying, mobilising and attributing taxes to domestic states sourced from the global operations of digital companies (Chowdhary, 2021; Mosiaoma, Nacpil & Moreno, 2022). Whether this presumed inequality resulting from the asymmetrical policy response can be mitigated by implementing the recommendations made by the UN FACTI Panel's 2020 report is evaluated here.

The UN FACTI Panel report (UN FACTI Panel Report 2020) proposes a principle response to taxing the digital economy. It advocates for an integrated institutional approach through which international financial data can be collected, processed, shared and attributed to its source to establish a clear tax nexus. To what extent can the FACTI report complement the work already done under BEPS, or influence moving the global discussions on taxing the digital economy to the auspices of the United Nations? This brief discusses this policy versus principle nuances in the taxation of the digital economy to secure the digital tax net for African countries and propose a common position for African countries to support future political discussions on taxing the digital economy.

The Policy Response under BEPS

The OECD BEPS project seeks to develop a long-term solution to the broader tax challenges arising from the digitalisation of the economy. Since 2015, the OECD has been analysing the potential tax policy alternatives to address broader direct tax challenges raised by the digitalisation of the economy. However, the OECD has not presented any concrete solutions approved through international consensus. Concrete proposals on taxing the digital economy have been framed within two complementary pillars. Under Pillar 1, new rules on the allocation of taxing rights based on nexus and profit allocation are developed. Under Pillar 2, the remaining BEPS issues are focused on.

Many discussions have gone into addressing Pillar 1 – the blueprint for taxing the digitalisation of the economy. Through these discussions, three policy proposals (user participation, marketing intangibles and significant economic presence) were made on Pillar 1.

The United Kingdom suggested user participation to focus on highly digitalised businesses. Under this policy approach, parts of the profits derived from such businesses would be attributed to jurisdictions where an active and engaged user base is located, regardless of whether these businesses have a local physical presence (OECD, 2019).

The United States proposed marketing intangibles. It required that the residual or the non-routine income of a multinational enterprise group be attributed to marketing intangibles and their corresponding risks to the market jurisdiction (OECD, 2019).

The G-24 group proposed the third policy proposal under Pillar 1 for developing economies. This was related to establishing a taxable presence in a jurisdiction when a non-resident enterprise has a purposeful and sustained interaction through digital technology and other automated means of significant economic presence. The G-24 group suggested using

the fractional apportionment method to allocate profits to such a significant economic presence (OECD, 2019).

These three policy proposals under Pillar 1 needed to be reduced. This was worked out in the OECD' Programme of Work'. The OECD attempted to develop a consensus solution to the tax challenges arising from the digitalisation of the economy (OECD, 2019). The OECD Secretariat published a public consultation document proposing a Unified Approach under Pillar 1 to reach an international consensus based on this report. The Unified Approach combines the significant commonalities of the three policy proposals (user participation, marketing intangibles and significant economic presence). Therefore, the current OECD BEPS discussion on taxing the digitalisation of the economy focuses on four issues.

First, to reallocate taxing rights in favour of the market jurisdiction, which is, for some business models, the jurisdiction where the users are allocated. Second, consider a new nexus rule that does not depend on physical presence in the market jurisdiction. Third, to go beyond the arm's length principle and fourth, to find ways to stabilise the tax system making it simple and to increase tax certainty in implementation (OECD, 2019).

These policy moves under BEPS to develop taxing rules for the digitalisation of the economy represent a shift from levying taxes by reference to the country of residence towards the market country in its role as a destination country, that is, the country of the consumer location or the relevant market. This policy approach means that the onus, therefore, is on the destination country to search for the new source of tax revenue that may arise from the digitalisation of the economy. The danger here is that the discussion on finding a consensus solution may not entirely be possible since it would be led by the interests of the individual members seeking to receive a higher share of the overall tax revenue than on sound economic principles. This would knock out African countries whose ICT sectors are yet in the nascent stages of identifying such online data with which to tax profits made by digital business models.

An international framework on financial accountability, transparency and integrity towards tax data sharing as recommended by the UN FACTI Panel 2021 Report is therefore necessary if Pillar 1 is to achieve its intended aims towards enabling a fair share of taxing profits from the digitalisation of the economy. However, whether such exchange of information is made available under Pillar 1 proposals on Amount A and Amount B, removing the FACTI (UN, 2021) recommendation requires some assessment.

The OECD proposes levying taxing rights that are not dependent on the actual physical presence of an enterprise in the market jurisdiction (Amount A) and proffers a new profit allocation mechanism (Amount A and Amount B). While both types of taxable profits described by Amount A and Amount B encompass new and revised profit allocation rules, only Amount A aspires to introduce a new taxing right. Amount A shall reflect profits associated with qualified businesses' active and sustained engagement in the market jurisdiction. A share of the residual profit shall be attributed to the market jurisdiction

using a formulaic approach to meet this objective.

In this sense, Amount A constitutes the main response of Pillar 1 to the tax challenges arising from the digitalisation of the economy. Amount B provides a fixed return for baseline marketing and distribution functions carried out in the market jurisdiction. This fixed return shall be based on the arm's length principle and seeks to simplify the remuneration for such baseline activities and reduce uncertainty and disputes regarding the pricing for baseline marketing and distribution activities, thereby enhancing tax certainty (OECD,2021).

In so far as digitalisation of the economy is concerned, arguably, the policy response under BEPS Pillar 1 seeks to ensure a more equitable distribution of profits for market jurisdictions by re-allocating taxing rights out of revenue generated from Automated Digital Services (ADS) and Consumer-Facing Businesses (CFB). To what extent African states will benefit from implementing these taxing rights remains to be seen.

The allocation of Amount A to a market jurisdiction is pegged at where in-scope MNEs earn at least Euros 1 million in that jurisdiction, generally wealthy states. For smaller jurisdictions with a GDP lower than Euros 40 billion, such as the African nations, the nexus will be set at Euros 250,000 – this seems fair. Amount A is also pegged on residual profits. These profits as a source of taxation for African market jurisdictions may not necessarily result in adequate revenue generation.

Difficulties will arise in how market jurisdictions, particularly African states, and with access to what financial data will calculate the portion of the residual profits they can subject to tax. The OECD policy approach seems to leave Africa behind on the technicalities of levying its taxation rights. Perhaps this difficulty can be resolved through another policy measure: the minimum tax proposal under Pillar 2, as articulated most recently in the Pillar 2 Model Rules requiring governments to create 'Qualified Domestic Minimum Top-Up Tax' (QDMTT) (OECD, 2021).

This is a positive policy approach at the OECD level that allows a minimum tax to be incorporated into the domestic law of jurisdiction. However, it must compute profits and calculate any top-up tax due in the same way as Pillar 2 rules. A QDMTT, if enacted by a country, would eliminate the application of the income inclusion rules by the parent resident jurisdiction, which can help calculate the residual profit under Pillar 1 for the benefit of African market jurisdictions. This could be helpful to African countries willing to adopt a minimum tax. This is a bit of a minor point in the broader discussion of international tax standards and who should be applying them.

While the OECD has not articulated standards, the UN FACTI Panel has made some recommendations. The obligation lies with the OECD to develop processes to help government and tax authorities assess whether a proposed minimum tax will constitute a QDMTT. Multinational enterprise groups with less than Euro 250,000 of consolidated global revenue would not be caught by African domestic

minimum tax based on the nexus and profit allocation rules.

A QDMTT, for Africa, poses tax loss risks since such a policy move may lead to countries increasing incentives to offer low corporate income tax rates to all corporate entities. This poses serious considerations for African states if they are to secure their taxing rights. This OECD policy approach seems complex. To get priority taxing rights, QDMTTs must first be based on determining Amount A and Amount B. This poses administrative challenges. Perhaps the UN FACTI recommendations of a **Centre for Monitoring Taxing Rights** through which global coordination of tax data is to be achieved offers a solution.

The UN FACTI Panel report (UN, 2021) proposes a principle response to taxing the digital economy. It advocates for an integrated institutional approach through which international financial data can be collected, processed, shared and attributed to its source to establish a clear tax nexus.

The FACTI report complements the work already done under BEPS by requiring states to globally agree on integrating a set of criteria within the OECD policy-based approach that ensures inclusive and fair taxing rights based on access to financial data.

The next section discusses this principle approach to the taxation of the digital economy. The objective is to secure the digital tax net for African countries and to propose a common position for African countries to support future political discussions on taxing the digital economy.

The Principle Response under FACTI

The UN FACTI Panel supports an international tax architecture based on accountability, legitimacy, transparency, and fairness. It sees these principles as key determinants to fostering financial integrity. Since principles cannot operate in isolation, FACTI Panel recommends setting up specific institutions to secure the implementation and enforcement of these financial principles. It proposes an independent agreement towards establishing a Global Pact for Financial Integrity for Sustainable Development to support stronger laws and institutions needed to facilitate greater transparency and stronger international cooperation for imposing a minimum corporate tax and taxing digital giants.

The OECD BEPS Action 1 on Pillar 1 and Pillar 2 can be moved within this Global Pact so that every UN Member State can actively participate in framing the nexus and profit allocation rules openly at the UN General Assembly through debate and discussion rather than lobbying and consensus-building. Being principle-led, such discussions will also promote related discussions on financial information sharing through a coordinated system facilitating the open financial exchange of data between states and multinational digital enterprises. While the Global Forum on Transparency and Exchange of Information already provides such a platform, it is limited in membership. It does not consider the different needs and capacities of African states. This undermines legitimacy in the international tax system, which can be secured through the UN.

Based on a principled approach to taxing the digitalisation of the economy, there are several strategic alternatives to resolve difficulties under the OECD BEPS Pillar 1 and 2 approaches.[1] The OECD has led efforts through its BEPS project on the kind of tax reforms needed to mobilise revenue streams resulting from digitalisation.

However, to ensure that the tax reform process will be accountable, transparent, and of integrity, the FACTI Panel has published several important recommendations to evaluate considering their potential to solve problems envisaged in Pillar 1 and Pillar 2 of the BEPS project. These pillars address international tax norms and reforms required to tap the taxation of revenue streams sourced out of digitalisation.

This section inquires into whether the FACTI recommendations contribute to aiding action towards consensus building on digital taxation, which under BEPS is disputed. Six recommendations from the FACTI report have been identified that can impact or contribute to the BEPS project. The section starts by drawing attention to the problems underpinning Pillar 1 and Pillar 2. The new taxing right under Pillar 1 and the global minimum tax under Pillar 2 in the context of digitalisation do not entirely replace the existing international tax system but overlay it. The permanent establishment threshold and the separate entity arm's length principle live on in various ways despite the move under Pillar 1 to treat MNEs as a group to tax their global profit and imposing under Pillar 2 a global minimum corporate tax on the group's profit as a whole.

So, under BEPS, the solution is to impose the new digital taxing rights based on a new set of sourcing rules applied to an MNE as a group – the difficulty here is that some of these MNEs operate as part of separately negotiated bilateral agreements. Therefore, assessing an MNE group's global profit will require consensus under BEPS to rework any double taxation agreements that default to the separate entity regime, which ousts digital financial flows from the tax net.

A formula still needs to be agreed upon to tax Big Tech corporations like Google, Amazon, and Facebook. We dare add Jumia as a group following the BEPS ideology. The existing rules demand that tax assessment be disaggregated when dealing with subsidiaries – of a physical nature, but what of corporates of a digital nature? This is problematic because when assessing a group whose entities are incorporated under multiple jurisdictions that are also part of secrecy jurisdictions re-introduces the challenge of information asymmetries.

These information asymmetries in the context of the digitised economy would relate to complexities in establishing user participation, value creation and which data was monetised by which affiliate or subsidiary in which jurisdiction (Latif, 2020). There are problems in imposing a digital tax under Pillars 1 and 2.

[1] Some of the arguments in this section have been drawn out of a previous discussion under Latif, L., 'UN FACTI Panel Report 2020 Recommendations Supplementing BEPS 2.0', *Tax Prism*, Issue 009 (KESRA, 2022).

FACTI proposed solutions appear under recommendations 4A and 4C which suggest a similar treatment to taxing profits of a digital business model as a group under Pillars 1 and 2. 4A - concerns equitably taxing digital services on the profit assessment of an MNE as a group.

4C – requires the creation of fairer rules on a global minimum corporate tax. These recommendations allow each country to tax profits of the MNE based on the evolution of the concept of permanent establishment into a digital or virtual or remote, or cloud establishment, thus deriving a portion in tax out of the global minimum corporate tax. But this can only be made possible when the MNE shares financial information showing user participation, value creation, and monetised data on which these fairer rules would apply to delineate taxing allocation rights.

FACTI speaks of fairer rules without formulating them, except to direct that these rules must be embedded within the principles of financial accountability, transparency and integrity. Would the 'Anti Global Base Erosion or GloBE Rules' be what FACTI intends as part of the fairer rules normative framework? Are GloBE rules in tandem with FACTI principles applied to the digital economy's taxation?

The Pillar 2 Model Rules are designed to ensure large MNEs pay a minimum level of tax on the income arising in each jurisdiction where they operate. The rules run to about 45 pages with another 15 pages of definitions. They are drafted as model rules that provide a template that jurisdictions can translate into domestic law, which should assist them in implementing Pillar 2 within the agreed timeframe and in a co-ordinated manner. Could these Pillar 2 rules be seen as creating fairer rules on the global minimum corporate tax recommended by FACTI? Could the idea of fairness in the development of rules presuppose the creation of an intergovernmental entity that uniformly and collectively decides on the fair formulation of the digital tax allocation rights? How would the problem of information asymmetries be dealt with at the intergovernmental level in the absence of effective automatic exchange of tax and financial information?

Going back to recommendations 4A and 4C these can be properly enforced if they are read alongside the recommendations made under 3B and 8A, which solves the problem of information asymmetries in relation to obtaining tax and financial data (generated out of user participation, value creation and monetised data).

3B requires that there be improvements in tax transparency by having all MNE publish accounting and financial information on a country-by-country basis – this enables a transparent exchange of information between revenue authorities. Under Pillar 2 Model Rules, is it envisaged the exchange of information on consolidated revenue below the EUR 750 million threshold?

Recommendation 8A requires an end to information asymmetries in relation to information shared for tax purposes so that all countries can receive information. This will be helpful under Pillar 2 as it will allow countries to access financial accounts of MNEs to determine income earned from a taxing jurisdiction and access financial

information adjusting intragroup payments, and it will be easy to pick out under or over-invoicing and the methods for arriving at the arm's length principle that does not reflect market value. For digital business models, it will help pick out data on user participation, value creation and monetised data based on which the business earned its digitally enabled income.

But for these recommendations under 3B and 8A to be implemented and enforced, the FACTI report suggests that countries sign onto a Global Pact that would aim for international consensus building. This is envisaged through a UN Tax Convention and not the OECD. So, in looking at tax reform to capture digital financial flows, this would require an intergovernmental body on tax matters responsible for assisting states in imposing the digital tax.

This would require:

a. Global coordination of tax data. This can be facilitated by implementing recommendation 11A that requires establishing a Centre for Monitoring Taxing Rights to collect and disseminate national aggregate and detailed data about taxation and tax cooperation on a global basis. This approach can aid in understanding how to conceptualise user participation as a tax liability.
b. Creation of international rules and standards to promote financial integrity. This can be supported by implementing recommendation 14A that suggests establishing a global coordination mechanism at UN ECOSOC to address financial integrity on a systemic level. This approach, in my view, can support imposing tax on online data mined and sold to third party.
c. The Centre and ECOSOC can facilitate global exchange of financial information to strengthen enforcement when it comes to collecting tax on digital financial flows and support the call toward the intergovernmental body on tax matters drafting the UN Tax Convention that will embed the digital tax as part of the evolving tax architecture.

Conclusion: Towards an African Coordinated response

Implementing BEPS will require capacity building for African tax authorities in tracking financial data to establish what profits were made by a digital multinational corporate and how much of it is subject to tax, and by whom. The application of Amount A and Amount B is subject to transparent and clear financial information provided under the rubric of accountability through institutions of integrity. The OECD does not provide such a resource platform. The OECD only issues policy consensus building. This resource platform must be coordinated through the United Nations. A new intergovernmental body on tax matters is therefore overdue.

If African states are to secure taxing rights based on new nexus and profit allocation rules relating to the taxation of the digitalisation of the economy, these rules should be negotiated as part of a UN Tax Convention. This can potentially prevent any race to the bottom that may result from the application of the QDMTT. To give effect to the OECD BEPS rules, African states might introduce measures that may jeopardise their taxing rights by

providing tax incentives in the hope of attracting business by digital giants. Whereas African companies have large extractive and financial service enterprises, their exclusion from the 'scope' of MNEs in the BEPS rule constitutes an opportunity to lose huge tax revenue. Therefore, there remains a tendency to overtax these firms using unilateral measures. Hence, African countries would have to make a case for a certain size of large firms, either in financial services or extractive industry, to be captured for tax purposes under BEPS.

On the possibility of tracking financial and transactions details, the large informal sector, black and parallel markets in Africa might constitute a bottleneck in one way or another. Critical attention must be given to digital data infrastructure, management, and utilisation, especially by tax authorities. Except for a few countries such as South Africa, Senegal, Rwanda, Tanzania and Uganda, tax data facilities and data management capacity are still low in Africa.

The implementation of the BEPS rule when it is finally legislated at domestic levels may result in tax revenue losses. To prevent this, improvements relating to financial integrity are required. It is impossible to effectively assess progress and make informed decisions regarding global tax data without data. The FACTI proposed Centre for Monitoring Taxing Rights offers data gathering to support governments in their aggregate analysis. This centre offers a solution to the current fragmented financial data sharing approaches in Africa that are poorly coordinated through their regional economic communities (RECs).

In conclusion, further OECD BEPS consensus building must be approached from a FACTI inspired set of principles. In informing a common African position taking into consideration the current BEPS rules and FACTI recommendations, the following set of questions will need to be further interrogated and continentally agreed upon:

◊ How to overcome the challenge of tax allocation rights to different jurisdictions from where value is generated for entities such as AirBnB? What can the African continent do collectively to reign in the digital tax from global conglomerates? There is the current threshold of 750 million euros under Pillar 2 Model Rules- would a formula apportionment be the way forward for this that would be deemed inclusive and just for developing countries, especially Africa?

◊ How can WATAF, ATAF, the Committee on Fiscal Studies in their policy advising roles coordinate on supporting a common African position to taxing the digitised economy? Should these institutions support the development of unilateral measures in taxing the digital economy? So far unilateral measures look feasible, but it comes with the problem of placing the tax burden on the consumer if not properly regulated and also enabling tax leakages from the lack of consolidated revenue information from group digital empires.

◊ How broad should the tax net be for capturing the digital tax? Unilateral

measures have a variegated response - in Kenya it is the imposition of the digital service tax and VAT, in Nigeria 7.5% VAT is imposed on the provision of digital services - of course, these taxes will be passed on to the consumer – do unilateral measures then create a tax design built on the consumer base instead of the producer/creator base? Can African countries agree on a common rate for imposing the digital tax, can they agree on a central data monitoring centre responsible for collecting and publishing financial information necessary for revenue authorities to establish their tax claims? Is the idea of a central continental data monitoring centre feasible? What will technical capacity be needed?

◊ Who should capture 'digital intelligence' from BigTech to share with state revenue authorities to guide tax allocation? Should it be the UN body as proposed under FACTI? Or a Data Monitoring centre? Can we trust MNEs to provide this data without distorting information as they do by using professionals (lawyers, auditors) to design tax avoidance schemes?

◊ Pillar 2 Model Rules do not apply to entities that meet the definition of an investment fund – this is to preserve the widely shared tax policy of not wishing to add layer of taxation between the investment and the investor. Where a digital company chooses to invest in the fintech industry of an African country, is it reasonable to remove this company from the tax bracket of claiming digital tax on its return of investments?

Implementing the FACTI principle-based approach as part of the formulation of rules under the BEPS' policy driven approach will give these rules the legitimacy needed for equitable and fair enforcement.

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