



ATAF TECHNICAL NOTE

The tax challenges arising in Africa from the digitalisation of the economy

1. Background

- 1.1 Many African countries have reported concerns about the tax challenges they face as their economies become increasingly digitalised. That digitalisation enables multinational enterprises (MNEs) to carry out business in African countries with no or very limited physical presence in those countries. This makes it difficult for African countries to establish taxing rights over the profits the MNE is making from the business activities it carried out in the specific African country.
- 1.2 This is due to the current international tax rules only allocating taxing rights to a country where a non-resident enterprise creates sufficient physical presence in that country i.e. creating a “nexus” in that country. Business models that enable a MNE to carry out business in an African country with no or very limited physical presence in that country therefore represent a significant tax risk.
- 1.3 The examples cited by commentators of such business models are usually those such as social media platforms, search engines and online market places. However, digitalisation of the economy raises a number of tax challenges relating to the broader economy as digitalisation is increasingly impacting on the value chains of a wide range of businesses. These changes to value chains are therefore raising questions as to whether fundamental changes are needed to the two key underlying principles of the international tax rules. These are the above mentioned nexus rules and the profit allocation rules (which determine how the MNE’s global profits are allocated between jurisdictions, primarily using transfer pricing rules).

- 1.4 In particular digitalisation raises the question of how taxing rights on income generated from cross border transactions should be allocated between jurisdictions. The allocation of taxing rights between residence and source jurisdictions has been an issue of considerable concern for African countries for many years. African countries are generally source countries and tax on a source basis¹. ATAF members often report that they consider the current nexus and profits allocation rules are weighted too heavily in favour of the residence jurisdiction to the detriment of the source (African) jurisdiction.
- 1.5 African countries are also concerned that their tax bases are being eroded by Illicit Financial Flows due to MNEs artificially shifting profits to jurisdictions where the profit are subject it little or no tax. They consider that the outcomes of the OECD/G20 BEPS project do not adequately stem these Illicit Flows as they are too complex to effectively administer and are not comprehensive enough to address the artificial profit shifting seen in Africa.

2. The need for fundamental changes to the international tax rules

- 2.1 The global tax debate is now beginning to recognise these challenges. This debate is taking place in a number of fora including the OECD Inclusive Framework on BEPS which includes 21 African country members and the UN Tax Committee of Experts on International Cooperation in Tax Matters.
- 2.2 The Inclusive Framework is proposing to work towards reaching a consensus based solution to these challenges building on two pillars. One pillar focusses on the allocation of taxing rights and the second pillar aims to counter artificial profit shifting strategies used by MNEs that have not been addressed by the BEPS outcomes.
- 2.3 The first pillar will consider the need to revise the balance in allocating taxing rights between residence and source jurisdictions. The current profit allocation (transfer pricing) rules which in almost all countries, including African countries, are based on the arm's length principle will need to be reviewed. Importantly the pillar proposes revisions that will result in more profits being allocated to the market jurisdiction by recognising the value created by the brand perception in the minds of customers and by work done to build customer relationships etc.
- 2.4 The pillar also provides for an opportunity to consider simplification of the current transfer pricing rules which are extremely complex and fact intensive. African tax administrations

¹ Source taxation means that the income is taxed in the country in which it arises no matter where the recipient is tax resident

often report to ATAF that these complexities in the rules make it extremely challenging to stems such IFFs caused by abusive transfer pricing practices.

- 2.5 Revisiting the role of the arm's length principle and considering profit allocation rules that go beyond the arm's length principle both in the context of allocating taxing rights and addressing tax avoidance is therefore of great interest to African countries and is long overdue.
- 2.6 It will not however be sufficient to only revise the current profit allocation rules as digitalisation is leading to MNEs being able to carry out business in a country with no or little physical presence in that country and this may result in there being insufficient presence in market jurisdictions to give it taxing rights on the profits being made in that jurisdiction under the current nexus rules. These nexus rules therefore need to be broadened and revised to ensure an appropriate allocation of taxing rights to the market jurisdiction.
- 2.7 However, if these revised rules are to be effective for African countries they must be simpler for the tax administration to implement than the current highly complex rules. It is therefore crucial that revisions to these rules take account of the needs for the rules to be simpler and clearer enabling both taxpayers and tax administrations in African countries to apply the rules to both protect the tax base from artificial profit shifting and to create greater tax certainty.
- 2.8 The proposed second pillar of work notes that there are still BEPS challenges to be addressed. Those challenges have been reflected to some extent by recent tax changes by a number of countries, for example, the recent US tax reforms. African countries share those concerns and have reported that the BEPS outcomes will not address all of the BEPS risks they face of profits being artificially shifted to related entities in jurisdictions where the profits are subject to no or low tax.
- 2.9 This issue is interlinked to the allocation of taxing rights issue that is being proposed to be revisited in the first pillar of work. The proposals will explore providing secondary taxing rights to jurisdictions where the jurisdiction with primary taxing rights over those profits does not tax them or only taxes the profits to a limited extent.

3. ATAF current position on the tax challenges arising from the digitalisation of the economy

- 3.1 On 9th to 10th January 2019 the ATAF Cross Border Taxation Technical Committee convened in Pretoria, South Africa to discuss the Inclusive Framework proposals, the work being done by the UN Committee and other proposals and measures being made and taken by the European Union and individual countries.

- 3.2 The Technical Committee reached the following conclusion and recommendation for ATAF members:
- 3.3 In ATAF's opinion the current nexus and profit allocation rules are not ensuring appropriate taxing rights for source countries and in particular African countries.
- 3.4 This is partly due to the increasing digitalisation of the global economy and the African economy which enables non-residents and in particular multinational enterprises (MNEs) to increasingly carry out business in a country with no or very limited physical presence in that country and to create value from intangibles and other valuable and unique contributions.
- 3.5 The no or limited physical presence denies taxing rights under the current nexus rules. Where the nexus rule is met, the lack of recognition for the value of the market jurisdiction in the current profit allocation rules significantly limits the profits that can be taxed in the market jurisdiction.
- 3.6 The current profit allocation rules do not properly reflect the value created for the MNE by the brand perception in the minds of the customers in the market jurisdiction. In addition, other unique and valuable contributions to the profits of the MNE are not reflected in the profits allocated to the market jurisdiction. This leads to an under-allocation, and often significant under-allocation, of profits for tax purposes to the market jurisdiction.
- 3.7 The current rules provide an inappropriate balance between the taxing rights of residence and source jurisdictions and are inappropriately skewed in favour of residence jurisdictions. This is encouraging Illicit Financial Flows (IFFs) out of Africa through artificial profit shifting to no or low tax jurisdictions and the loss of taxes African countries need for vital development.
- 3.8 Significant changes are needed to the allocation of taxing rights between source and residence countries to help stem these IFFs out of Africa through such profit shifting.
- 3.9 ATAF considers that changes need to apply more broadly than to just highly digitalised businesses and therefore supports work being done to significantly change the nexus and profit allocation rules.
- 3.10 ATAF will emphasise to the Inclusive Framework the need for the revision of current rules to address the existing imbalance of allocation of taxing rights. In addition, the revisions must significantly reduce the complexity of the current nexus and profit allocation rules which hinder their effective implementation by tax administrations and impairs tax certainty for both African governments and businesses.

- 3.11 The drive for more effective administration needs to also consider simpler collection mechanisms including the use of withholding taxes which our members report is a very effective taxation mechanism in Africa.
- 3.12 It is the view of ATAF that the BEPS outcomes do not stem IFFs out of Africa because they do not adequately address the risks to African tax bases from artificial profit shifting. In ATAF's view this is due to the BEPS outcomes being largely specific and narrow revisions to the existing nexus and profit allocation rules instead of the fundamental overhaul needed to those rules. In addition, the BEPS outcomes lack strong anti-avoidance rules to address the situations where profits are shifted to jurisdictions where they are subject to little or no tax.
- 3.13 ATAF therefore considers work should be undertaken to address artificial profit shifting. That work should focus on addressing base eroding payments and related transactions that reduce the taxing rights of the source country. Such rules again need to be simpler than the current rules to ensure effective implementation by all tax administrations.
- 3.14 ATAF considers that the two proposed pillars of work should be carried out under these principles with a view to obtaining consensus to the principles at a policy level before work is carried out on designing the mechanics to achieve these principles.

4. Recommendations to ATAF members

- 4.1 Members should review the international [VAT/GST Guidelines](#) published under BEPS Action 1 to address the GST and VAT challenges arising from the digitalisation of the economy and implement the appropriate recommendations in their country.
- 4.2 Under the global anti-abuse pillar of work, a minimum effective tax rate test may lead to another jurisdiction taxing the income of taxpayers who benefit from a tax incentive regime in your country. Members should review their tax incentive regimes and policies to evaluate the impact that a minimum effective tax rate test might have on their effectiveness.
- 4.3 Effective administration of any new rules will require comprehensive exchange of information (EoI) mechanisms. Members should review their current EoI framework to ensure it is fit for purpose.
- 4.4 It is vital that African countries that are members of the BEPS Inclusive Framework or the United Nations actively participate in the Inclusive Framework and UN's work which may lead to fundamental changes to the international tax rules and the allocation of taxing rights. If Africa is to ensure these changes meet African needs countries must set out their positions in that debate.

- 4.5 Members should be aware that some jurisdictions have introduced a range of different interim unilateral measures to address some of the tax challenges arising from highly digitalised businesses [Report of Committee on Taxation of e-Commerce](#), [Proposal significant digital presence](#), [Digital Services Tax: Consultation](#).