AFRICAN TAX ADMINISTRATION FORUM
FORUM SUR L'ADMINISTRATION FISCALE AFRICAINE

ATAF TECHNICAL NOTE

Inclusive Framework proposals to address the tax challenges arising in Africa from the digitalisation of the economy

1. Introduction

1.1 Today the Inclusive Framework released a Public Consultation Document (PCD) titled "Addressing the Tax Challenges of the Digitalisation of the Economy". The PCD sets out several proposals that the Inclusive Framework members consider might form part of a long-term solution to the broader tax challenges arising from the digitalisation of the economy and the remaining BEPS issues.

1.2 The PCD describes the proposals that were discussed at the Inclusive Framework meeting in January 2019. It seeks comments from the public on a number of policy issues and technical aspects. The comments provided will assist members of the Inclusive Framework (of which 22 are African countries) in the development of a solution to these challenges and will be followed by a public consultation meeting in March 2019 at the OECD.

2. Proposals to change the fundamental of the international tax rules

2.1 As set out in the ATAF Technical Note CBT/TN/01/19 [add link], some of the proposals focus on the allocation of taxing rights by proposing changes to the key tax rules on profit allocation and nexus based on the concepts of user contribution and marketing intangibles. During the January 2019 Inclusive Framework meeting a further proposal on this issue based on the concept of significant economic presence was discussed and is included in the PCD. The final proposal focuses on unresolved BEPS issues. It should be noted that the proposals are all at the policy design phase and therefore their description is at a high level.

2.2 The PCD sets out the policy rationale and the basic design features for each proposal. In the case of the proposal relating to remaining BEPS issues it sets out two sets of interlocking rules designed to give tax jurisdictions a remedy in cases where income is subject to no or only very low taxation. The rules would give such jurisdictions the right to tax profits that have only been taxed at low effective tax rates.

2.3 The ATAF Technical Note CBT/TN/01/19 sets out why changes are needed to the international tax rules if they are to be fit for purpose and effectively stem Illicit Financial Flows from Africa. It also sets out ATAF's current position on the tax challenges arising from the digitalisation of the economy. That position was conveyed by the ATAF delegation to the Inclusive Framework meeting in January.

2.4 This Technical Note CBT/TN/02/19 provides further detail on i) the proposed revisions to the profit allocation and nexus rules and ii) the proposals to address remaining BEPs issues. It then sets out details of how ATAF will work with members to ensure Africa helps to steer the development of these proposals to ensure the revisions to the international tax rules address the tax challenges in Africa and stem Illicit Financial Flows that occur from artificial profit shifting by multinational enterprises (MNEs).

3. Revised profit allocation and nexus rules

3.1 The proposals set out in the consultation document would require fundamental changes to both the profit allocation and nexus rules[1] and would expand the taxing rights of market jurisdictions by recognising the value created by a business's activity or participation in user/market jurisdictions that is not recognised in the current framework for allocating profits.

3.2 The proposals all aim to address the challenge to the current rules from businesses being increasingly able to carry out business activities in a country and create value for their business through these activities without needing to establish a taxable physical presence (nexus) in the country.

3.3 Changes will be needed to both the profit allocation (primarily transfer pricing) rules in addition to the nexus rules. Without those changes the business activities may create a taxable presence through revised nexus rules but little if any income will be allocated to that taxable presence.

[1] These rules are explained in ATAF Technical Note CBT/TN/02/19

3.4 The Inclusive Framework is currently examining three proposals for revising the profit allocation and nexus rules in response to these challenges. All three seek to expand the taxing rights of the user or market jurisdiction. Below is a summary of each proposal

The User Participation proposal

3.5 This proposal is based on the concept that obtaining the sustained engagement and active participation of users is a critical component of value creation for certain highly digitalised businesses. The activities and participation of these users contribute to the creation of the brand, the generation of valuable data, and the development of a critical mass of users which helps to establish market power[2]. The proposal considers that this source of value is most significant for the business models of social media platforms, search engines and online marketplaces

3.6 The value generated by user participation is not captured in the tax jurisdictions of the users under the existing international tax framework, due to these rules requiring a physical presence to create a taxable presence

3.7 The proposal looks to revise the current profit allocation rules to accommodate the value creating activities of user participation and to revise the nexus rules so that the user jurisdictions would have the right to tax the additional profit allocable to them. It should be noted that this proposed change in the rules would be limited to those business models which benefit from this type of user base i.e. social media platforms etc. For businesses that have more traditional relationships with customers, there would be no change in the profit allocation or nexus rules.

3.8 The proposal would modify current profit allocation rules to require that, for certain businesses, an amount of profit be allocated to jurisdictions in which those businesses' active and participatory user bases are located, irrespective of whether those businesses have a local physical presence.

3.9 The proposal is that profit allocated to a user jurisdiction, in respect of the activities/participation of users, would be calculated through a non-routine or residual profit split approach. This approach would, at a basic level, involve:

[2] Market power refers to a company's relative ability to manipulate the price of an item in the marketplace by manipulating the level of supply, demand or both.

i. Calculating the residual or non-routine profit of a business, i.e. the profits that remain after routine activities have been allocated an arm's length return;
ii. Attributing a proportion of those profits to the value created by the activities of users, which could be determined through quantitative/qualitative information, or through a simple pre-agreed percentage;
iii. Allocating those profits between the jurisdictions in which the business has users, based on an agreed allocation metric (e.g. revenues); and
iv. Giving those jurisdictions a right to tax that profit, irrespective of whether the business has a taxable presence in their jurisdictions that meets the current nexus threshold.

3.10 Under this approach, the profit attributed to the routine activities of an MNE group would continue to be determined in accordance with current transfer pricing rules. The only effect of the proposal would be to reallocate a proportion of the non-routine profit of the business, from the entities that are currently realising that profit, to the jurisdictions in which users are located.

3.11 To streamline its implementation, the proposal could rely on formulas that would approximate the value of users, and the users of each country, to a business. The approach would be targeted at highly digitalised businesses for which user participation is seen to represent a significant contribution to value creation.

The marketing intangibles approach

3.12 The marketing intangible proposal aims to address a situation where an MNE group can remotely or through a limited local presence (such as a limited risk distributor), carry out activities to develop a user/customer base and other marketing intangibles. It sees an intrinsic functional link between marketing intangibles and the market jurisdiction.

3.13 It is based on the concept that marketing intangibles such as brands are reflected in the positive attitude in the mind of customers and therefore have been created in the market jurisdiction. Other marketing intangibles such as building customer relationships are also derived from activities targeted at customers and users in the market jurisdiction, and this supports the treatment of such intangibles as being created in the market jurisdiction.

3.14 The proposal would modify current transfer pricing and treaty rules to require marketing intangibles and risks associated with such intangibles to be allocated to the market