



## **ATAF TECHNICAL NOTE**

**The changes needed to the global tax rules if Africa is to address the tax challenges arising from the digitalisation of the economy**

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## 1. Introduction

- 1.1 This is the fourth in ATAF's series of Technical Notes on the tax challenges arising in Africa from the digitalisation of the economy. The third Technical Note CBT/TN/03/2019 titled *"Inclusive Framework proposals to address the tax challenges from the digitalisation of the economy"* [add link] provided an overview of the proposals set out in the OECD Inclusive Framework publication titled *"Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy"* and a summary of the discussions held between ATAF and the OECD to discuss how a global consensus based proposal might be reached that meets the needs of African countries through i) new nexus rules, ii) new profit allocation rules and iii) a new global anti-base erosion rule.
- 1.2 On 30<sup>th</sup> September and 1<sup>st</sup> October 2019 the ATAF Cross Border Taxation Technical Committee (CBT) met to discuss in-depth the current Inclusive Framework proposals and to identify the key policy issues for Africa and the key recommendations that ATAF will make to the Inclusive Framework on the changes that are needed to the current global tax rules.

## 2. New Nexus rules

- 2.1 The CBT agreed that new nexus rules<sup>1</sup> are required to enable a jurisdiction to tax a foreign entity on the profits it generates in that jurisdiction whether or not it has a physical presence in that jurisdiction provided the entity's sales in that jurisdiction meet a predetermined sales threshold. That threshold should also take into account the value created by digital users in highly digitalised businesses. **The CBT concluded that the threshold must be country-specific and adjusted to the relative size of the country's economy to ensure that jurisdictions with smaller economies are not excluded from the new nexus rules.**
- 2.2 This will ensure that smaller economies receive their appropriate allocation of taxing rights as

market jurisdictions. It will also reduce the risk of double taxation that might occur where a high threshold leads to excluded jurisdictions taxing under the arm's length principle profits that have already been allocated to another jurisdiction under the new profit allocation rules outlined in section 3 below.

## 3. New profit allocation rules

- 3.1 The CBT discussed in detail the proposals set out in the Programme of Work (PoW) to allocate more profits to market jurisdictions. As set out in CBT/TN/03/2019 the CBT strongly supports the policy objective of allocating more taxing rights to market jurisdictions.
- 3.2 **The CBT concluded that a distribution-based approach, whereby the new profit allocation rules would allocate a minimum guaranteed fixed return for tax purposes to routine marketing and distribution activities taking place in a market jurisdiction, must be one element of the new rule.** This will address many of the current transfer pricing disputes taking place in Africa over the appropriate level of returns to such market and distribution activities under the arm's length principle. A fixed minimum return rule will reduce transfer pricing disputes and increase tax certainty for both tax administrations and taxpayers in Africa. However, a clear definition of what constitutes routine marketing and distribution activities will be needed if this rule is to be effective in achieving these objectives. **The CBT considers the inclusion of a fixed minimum return rule for such activities in the new profit allocation rules a high priority for African countries.**
- 3.3 **The CBT also strongly supports the proposal to develop rules that allocate to market jurisdictions a portion of an MNE's non-routine profits to reflect the value created in the market that is not recognised in the existing profit allocation rules.** The starting point for calculating the non-routine profits should be the profits of the MNE group, possibly derived from its consolidated Financial Statements, taking into account different accounting standards as appropriate. The non-routine profit element of the overall MNE profit

<sup>1</sup> These rules are explained in ATAF Technical Note CBT/TN/01/19

would be calculated by designating a deemed routine return on the activities of the group or business line and the remaining profit would be deemed to be the non-routine profit. **The CBT concluded that if this rule is to result in a fairer allocation of profits and taxing rights to market jurisdictions the calculation of the deemed routine return must be set at a level that fairly reflects the value of such routine functions. If the calculation attributes an excessive return to such routine activities the integrity of the new profit allocation rules will be seriously undermined.**

3.4 Having calculated the non-routine profit, the proposed new rule will then need to determine the portion of the deemed non-routine profits that is attributable to the market jurisdiction and the portion that is attributable to other factors such as trade intangibles, capital and risk, etc. **The CBT concluded that this determination must ensure that a fair proportion of the non-routine return is allocated to marketing intangibles as in the CBT's view the current transfer pricing rules often result in a substantial undervaluation of the contribution of the market jurisdiction to the MNE's profits.**

3.5 The final step of the proposed approach would be to allocate the relevant portion of the deemed non-routine profit among the market jurisdictions. This allocation will need to be based on agreed allocation keys, using variables such as sales and, in the case of some highly digitalised businesses, user participation. The CBT noted that careful consideration will need to be given to how the allocation keys are weighted.

#### 4. Global anti-base erosion (GloBE) proposal

4.1 A summary of the key elements of the proposed GloBE rule is set out in the ATAF Technical Note CBT/TN/03/2019. Broadly, the policy rationale for the GloBE proposal is to ensure that all the income of a MNE is subject to tax on at least a minimum effective rate of tax. The new rules aim to achieve that objective by changes to domestic law and tax treaties to provide jurisdictions with the right to tax income of an entity tax resident in

another jurisdiction if that income was subject to tax at an effective rate in the resident jurisdiction that is below a minimum rate.

4.2 As set out in Technical Note CBT/TN/03/2019, these changes will be through two inter-related rules:

- i. **an income inclusion rule** that would tax the income of a foreign branch or a controlled entity if that income was subject to tax at an effective rate that is below a minimum rate; and
- ii. **a tax on base eroding payments rule** that will include two elements: an undertaxed payments rule that would deny a deduction or impose source-based taxation (including withholding tax) for a payment to a related party if that payment was not subject to tax at a minimum rate; and a subject to tax rule in tax treaties that would only grant certain treaty benefits if the item of income was subject to tax at a minimum rate.

The above rules will incorporate a co-ordination or ordering rule to avoid the risk of economic double taxation.

4.3 The CBT discussed the proposal that the extent of the taxing rights under both the income inclusion rule and the tax on base eroding payments rule would be limited to a top up to the minimum effective rate. **The CBT concluded that for the GloBE rule to be effective in stemming artificial profit shifting through excessive base eroding payments by African taxpayers to related parties in no or low tax jurisdictions, the minimum effective tax rate must be set at a high enough rate to remove the incentive for such profit shifting.** Statutory corporate income tax rates vary across African countries, but most African countries have rates between 25% and 35%. If the minimum effective rate is substantially below these rates it is unlikely to lead to a change in taxpayer behaviour in respect of such profit shifting.

4.4 As set out in Technical Note CBT/TN/03/2019 the proposals for the GloBE rule include different

options of blending<sup>2</sup>. As stated in that Technical Note, the CBT is of the view that there should be no or only limited blending to limit tax planning opportunities. **The CBT concluded that the greater the level of blending allowed under the GloBE rule the greater the rationale for a higher level minimum effective tax rate to limit these tax planning opportunities.**

- 4.5 The CBT discussed the issue of the ordering of the Income Inclusion Rule and Tax on Base Eroding Payments Rule. **The CBT concluded that the Subject to Tax Rule must be applied first through revised domestic legislation and tax treaty provisions as this should be more straightforward to implement through the already effective withholding tax mechanisms. This will also help to address the current imbalance in allocating taxing rights between residence and source jurisdictions as it will grant rights to the source jurisdiction to tax payments made from that jurisdiction which have been taxed in the recipient jurisdiction at a rate below the minimum effective rate.**

## **5. Developing an African position on the new global tax rules**

- 5.1 As stated in Technical Note CBT/TN/03/2019, ATAF will continue its proactive participation in both the work of the Inclusive Framework and the United Nations on the development of new global tax rules to address the challenges from the digitalisation of the economy.
- 5.2 **The priority issues for African countries identified above need to be addressed in order to tackle the current imbalance in the allocation of taxing rights as well as artificial profit shifting to help stem illicit financial flows in Africa. We will work to ensure that these issues are appropriately reflected in the development of the new rules.**

- 5.3 We will continue to provide technical updates to members through this series of Technical Notes and will increase our consultations with ATAF members on our current view of the priority issues for African countries. We will ensure the Inclusive Framework and United Nations are aware of and take into account these African consultations in the revised global tax rules.
- 5.4 On 9 October 2019 the OECD published proposals for a unified approach on the Pillar One work described in sections 2 and 3 above. The unified approach proposals will be discussed at a public consultation meeting held on 21 and 22 November 2019 at the OECD Conference Centre in Paris. ATAF will participate in that meeting. The Inclusive Framework's aim is to have the outline of a unified approach agreed upon by January 2020 to facilitate the development of a final solution by December 2020.
- 5.5 ATAF has issued a media release on the proposed unified approach and our technical response to the proposals [add link].
- 5.6 If you have any comments or questions on this Technical Note or the development of the new global rules please feel free to contact the ATAF team using the contact details below.

**Telephone: +27 12 451 8800**

**E-Mail: [info@ataftax.org](mailto:info@ataftax.org)**

<sup>2</sup> Blending refers to the ability of taxpayers to mix high-tax and low-tax income to arrive at a blended rate of tax on income that is above the minimum rate.