THE ALP REVIEW

Tax Challenges Facing Digital Enterprises

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1.0 Introduction

The global economy is in the midst of a digital transformation, and tax authorities are struggling to keep up. The rise of digital enterprises has created new challenges for tax authorities around the world. Major corporations are increasingly conducting their business online, and many are using sophisticated tax avoidance strategies. In response, governments are beefing up their tax enforcement efforts. But they face an uphill battle because the tax rules are complex and outdated, and the global tax system is fragmented. The tax challenges facing digitized enterprises are significant, and it is clear that the taxation system was not designed with digitized enterprises in mind, and as a result, these businesses face unique tax challenges. These challenges posed by digital enterprises are likely to intensify in the years ahead, as more businesses move online, and the use of artificial intelligence and other digital technologies grows. The emergence of digital enterprises has defied the international principles of taxation and it is challenging to juggle the traits of these new digital business models with the tenets of the established global tax system.

2.0 What Are Digital Enterprises?

All businesses that conduct economic transactions over the internet are considered digital enterprises. The digital economy is made up of digital enterprises. The Organization for Economic Cooperation and Development defined digital economy as "all economic activities that are dependent on or specifically enhanced by the use of digital inputs, including digital technologies, digital infrastructure, digital services, and data." It refers to all producers and consumers, including governments, who use digital inputs in their economic activities[2]

2.1. Taxation Of Digital Enterprises.

Taxes are imposed in practically every country in the world, mostly to fund government expenditures and other functions of the government. In Nigeria, there are different types of taxes imposed on persons or organizations. For instance, Netflix has been available in Nigeria since 2016 and according to report, experienced a global increase of about 16,000,000 during the pandemic[3]. It can be assumed that the number of Nigerian subscribers presently, should be well above 50,000 as reported in 2019 . This is one example of an enterprise getting revenue from Nigeria without the need to be physically present.

[2] O. Isiadinso & E. Omoju – "Taxation Of Nigeria's Digital Economy: Challenges And Prospects" – https://www.mondaq.com/nigeria/tax-authorities/810276/taxation-of-nigeria39s-digital-economy-challenges-and-prospects/ <> accessed on 26-09-2022

[3] Steven Zeitchick "Netflix adds a whopping 16 million subscribers worldwide as coronavirus keeps people home" – https://www.washingtonpost.com/business/2020/04/21/netflix-adds-whopping-16-million-subscribers-worldwide-coronavirus-keeps-people-home <> accessed on 26-09-2022

[4] Frank Eleanya et al. "Nigeria's 123 Million Internet Users Missing on Netflix Top 50" – https://businessday.ng/technology/article/nigerias-123-million-internet-users-missing-on-netflix-top-50 <> accessed on 26-09-2022

3.0.Tax Challenges Faced by Digital Enterprises

It is accurate to say that the digital economy has presented tax officials with new obstacles. Compared to traditional physical commercial interactions, the e-commerce regime contains more complicated challenges. This places a heavy burden on tax authorities to safeguard their revenue base without impeding the advancement of new technology or the participation of the business community in the ever-changing and expanding market. A discussion regarding the appropriate taxation system has arisen as a result of the rapid expansion of digital firms through the selling of goods and services online. While the evolution of e-commerce by digital enterprises raises issues in the application of the traditional consumption tax rules in each of these areas, all these issues are compounded by the potential for different implementing legislation in different countries.[5] Due to the lack of a physical presence, the heavy reliance on intangible assets, the complexity of the transactions carried out in the digital economy, and the difficulty of defining assets, activities, and types of income, the implementation of inconsistent laws could result in double taxation or unintentional non-taxation of digital enterprises in addition to increased compliance costs for governments and suppliers.

Multinational enterprises (MNEs) such as Amazon, eBay, Twitter, Uber, Facebook, YouTube, Google, Netflix, Spotify, Alibaba, PayPal, etc., have over time leveraged the digital space to expand their cross-border reach without establishing a physical presence in all the countries where they earn their revenues. For instance, about 2.14 billion people globally purchased consumer goods via e-commerce in 2021[6], representing about $5.2 trillion in sales worldwide and up to an 18% growth rate.[7] While the U.S. and the U.K. account for the largest share of e-commerce activities for consumer goods, there is still a significantly large untapped digital market, especially among developing countries.[8] The rising profile of digital businesses with huge capitalization, accelerated expansion, revenues and profits, without corresponding tax payments in the countries where they generate their revenues, has stimulated various questions like: should digital enterprises be taxed, or should they be exempt from being taxed? How would exemption from tax or taxing e-commerce businesses affect small business units as well as MNEs, if digital enterprises are to be taxed, how should it be done? What simplifications of tax laws and administration are required for the taxation of digital enterprises? Etc.

The major challenge for policymakers in tax is the potential risk for MNEs to shift profit away from jurisdictions where the underlying economic activity took place, thereby eroding the value created in such jurisdictions[9]. The omnipresent operating model of digital businesses also tends to bring up the thorny issue of cross-border trade and how taxation should be allocated among participating jurisdictions to address under or over-taxation which is one of the major challenges facing international taxation and business practices. For example, while a non-resident company has always been unable to sell into a jurisdiction without a physical presence there, advances in Information and Communication Technology (ICT) have dramatically expanded the scale at which such activity is now possible. In addition, traditionally for companies to expand opportunities in a market jurisdiction, a local physical presence in the form of manufacturing, marketing, and distribution was very often required. These in-country operations would have engaged in potential high-value operations such as procurement, inventory management, local marketing, branding and other activities that earned a local return subject to tax in the market country. The fact that less physical presence is required for digital enterprises in market economies in typical business structures today, therefore, raises challenges for taxation.

[5] Topical Issues on Nigerian Tax Laws and Related Matters (Vol 2): Prof. J.A.M Agbonika: Josephine A.A. Agbonika (PhD); Ololkooba Saka Muhammed (Ph.D).

[6] "Number of digital buyers worldwide from 2014 to 2022" – https://www.statista.com/statistics/251666/number-of-digital-buyers-worldwide <> accessed on 29-09-2022

[7] Daniela Coppola "E-commerce worldwide - statistics & facts" – https://www.statista.com/topics/871/online-shopping/#dossierContents__outerWrapper <> accessed on 29-09-2022

[8] Wole Obayomi et al. "INSIGHT: Taxation of the Digital Economy in Nigeria and the 2019 Finance Bill" – https://news.bloombergtax.com/daily-tax-report-international/insight-taxation-of-the-digital-economy-in-nigeria-and-the-2019-finance-bill <> accessed on 29-09-2022

[9] Ibid.

The digital economy also creates challenges for Value Added Tax (VAT) systems, particularly where goods, services and intangibles are acquired by private consumers from suppliers over the internet. Cross-border trade in goods, services and intangibles creates challenges for VAT systems, where such products are acquired by private consumers from suppliers abroad[10]. The digital economy magnifies these challenges, as the evolution of technology has dramatically increased the capability of private consumers to shop online and the capability of businesses to sell to consumers around the world without the need to be present physically or otherwise in the consumer's country. This often results in no VAT being levied at all on these flows, with adverse effects on countries' VAT revenues and on the level playing field between resident and non-resident vendors. The main tax challenges related to VAT in the digital economy relate to: (i) imports of low-value parcels from online sales which are treated as VAT-exempt in many jurisdictions, and (ii) the strong growth in the trade of services and intangibles, particularly sales to private consumers, on which often no or an inappropriately low amount of VAT is levied due to the complexity of enforcing VAT-payment on such supplies.[11]

3.1. Import of Low-value Goods

Many VAT jurisdictions, of which Nigeria is one of such country[12] apply an exemption from VAT for imports of low-value goods as the administrative costs associated with collecting the VAT on the goods is likely to outweigh the VAT that would be paid on those goods. The exemptions for low-value imports have therefore become increasingly controversial in the context of the growing digital economy. The difficulty lies in finding the balance between the need for appropriate revenue protection and avoidance of distortions of competition, which tend to favour a lower threshold and the need to keep the cost of collection proportionate to the relatively small level of VAT collected, which favours a higher threshold.[13] At the time when most current low-value import reliefs were introduced, internet shopping did not exist and the level of imports benefitting from the relief was relatively small[14]. Over recent years, many VAT countries have seen significant and rapid growth in the volume of low-value imports of physical goods on which VAT is not collected resulting in decreased VAT revenues and potentially unfair competitive pressures on domestic retailers who are required to charge VAT on their sales to domestic consumers.

3.2. Remote Digital Supplies to Consumers:

The second challenge regarding the collection of VAT arises from the strong growth in cross-border B2B (Business to Business) and B2C (Business to Consumer) supplies of remotely delivered services and intangibles. The digital economy has increasingly allowed the delivery of such products by businesses from remote locations to consumers around the world without any direct or indirect physical presence of the supplier in the consumer's jurisdiction.[15] Such distant provision of services and intangibles poses problems for VAT systems since it frequently leads to little or insufficient VAT collection and may put domestic providers under competitive pressure. An online retailer of streaming media, such as movies and TV series, for instance, sells primarily to customers who can access the media through their Internet-connected computers, mobile devices, and televisions. It would be necessary for the provider to collect and remit that jurisdiction's VAT on the supplies if it shares the same jurisdiction as its clients. Problems might materialize, though, if the provider resides outside the consumer's country of residence.

10 ibid
11 Ibid
12 First Schedule, Value Added Tax (Modification) Order, 2021
13 OECD (2014), "Broader tax challenges raised by the digital economy", in Addressing the Tax Challenges of the Digital Economy, OECD Publishing, Paris.
14 Ibid.
15 Ibid.

In addition to these policy challenges, a number of administrative issues are raised by the digital economy. The borderless nature of the digital economy produces specific administrative issues around the identification of businesses, determination of the extent of activities, information collection and verification, and identification of customers . While classic identification hurdles are present in the digital economy's global company structures, these problems are exacerbated by the difficulty of identifying remote sellers, which may make tax collection difficult at the end of the process. Even if the identities and roles of the parties involved can be established, it may be impossible to determine the scope of sales or other activities without information from the offshore seller, as it's possible that no sales or other accounting records are kept in the local jurisdiction or are otherwise available to the local revenue authority. The ability to access this data from third parties, such as consumers or payment intermediaries, may be possible, but it may be restricted by privacy or financial regulation rules.

4.0.Recommendation

To address the tax challenges of the digital economy, the Organisation for Economic Co-operation and Development (OECD) Inclusive Framework proposes different approaches for allocating taxing rights among jurisdictions. These proposals include:

- User contribution—this allocates taxing rights based on value created by an entity in a jurisdiction by focusing on user base, data and content generation in a highly digitized business. The U.K. has adopted this principle for taxing the digital economy .

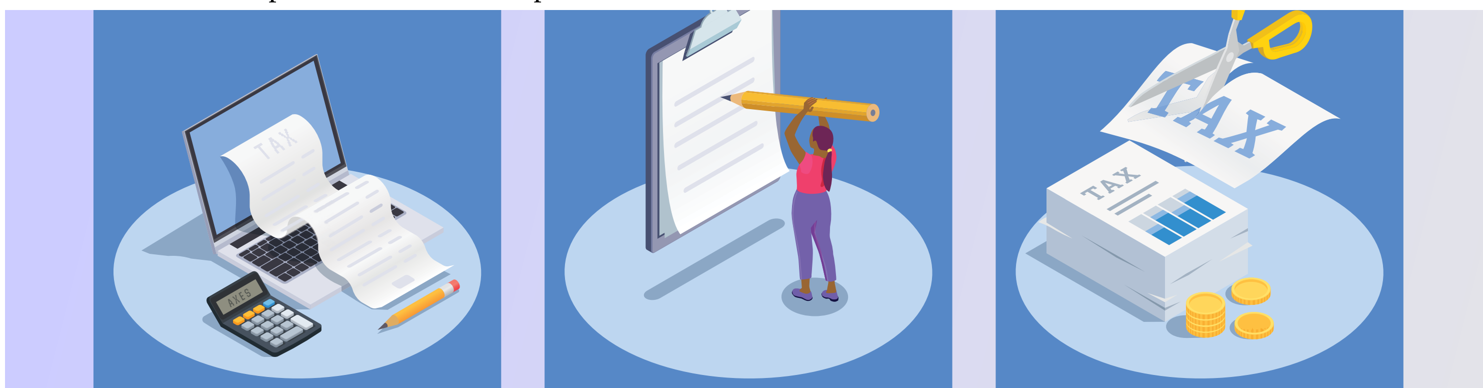
- Marketing intangibles—this has a broader application by focusing on aspects of commercial exploitation of a product or service, and includes trademarks, customer list, proprietary market, etc. This principle is favored by the U.S .

- Global minimum tax—this represents a prescriptive approach to allocating taxing right by which jurisdictions impose a minimum tax threshold to revenue derived therein by foreign companies. This has been adopted by both Germany and France .

- Significant Economic Presence (SEP)—this allocates taxing rights based on evidence of a combination of factors that create purposeful and sustained interaction with the economic life of a jurisdiction via digital means. India and Israel have adopted SEP .

According to a recent report by the world bank, the digital economy is equivalent to 15.5% of global GDP, growing two and a half times faster than global GDP over the past 15 years. Research shows that a 10% increase in mobile broadband penetration in Africa would result in an increase of 2.5% of GDP per capita[21]

Nigeria as Africa's largest economy with one of the world's largest youth populations is well-positioned to derive benefits from the digital economy. Nigeria has therefore taken certain steps in recognising the digital economy in its tax regime, so as to track and trap resources from this pool.



16 Ibid.
17 Wole Obayomi et al. "INSIGHT: Taxation of the Digital Economy in Nigeria and the 2019 Finance Bill" – https://news.bloombergtax.com/daily-tax-report-international/insight-taxation-of-the-digital-economy-in-nigeria-and-the-2019-finance-bill <> accessed on 29-09-2022
18 Ibid.
19 Ibid.
20 Ibid.

4.1. Federal Inland Revenue Service

The Federal Inland Revenue Service (FIRS) stated a four-plan action that the Federal Government of Nigeria has put into place to solve the ongoing challenge of the digital economy, and they are:

1.The tax law will be amended globally to reflect current global economic realities

2.Technology to help track digital transactions will be deployed. This coupled with the significant economic presence rule will record positive impacts. According to the FIRS, companies like Twitter, Facebook, and Netflix who have no physical presence in Nigeria and hereto not paying tax have now registered for tax purposes and are now paying tax accordingly.

3.Data-4-Tax initiative – a blockchain technology which the FIRS is currently developing with the internal revenue authority of the 36 states in Nigeria and the FCT under the supervision of the joint tax board. When completed, the project will enable the seamless viewing and assessment of all economic activities of individual and corporate bodies in Nigeria, including digital commerce.

4.A specialised office – The Non-Resident Persons Tax Office will be set up to manage the taxation of non-resident persons and cross-border transactions, including all tax treaty operational issues and income derived from Nigeria by non-resident individuals and companies.

4.2. Companies Income Tax (Significant Economic Presence) Order, 2020[22]

Before the Companies Income Tax (Significant Economic Presence) Order, 2020 (SEP Order), there was no threshold of what significant economic presence meant. Therefore, this meant that Nigeria was not properly positioned to tax the activities and profits of Digital enterprises. However, with the introduction of SEP Order a threshold and qualification criteria have been provided.

According to Section 1(1) of the Order, a foreign company will be subject to tax under section 13 of the Companies Income Tax Act if it has a significant economic presence in Nigeria. For a company to be said to have a significant economic presence and thus liable to tax it must:

1. Derive a gross turnover or income of more than N25,000,000 (twenty-five million naira) or its equivalent in other currencies, in that year from any or in combination of any of the following.

a. Streaming or downloading services of digital content, including but not limited to movies, videos, music, applications, games, and e-books to any person in Nigeria.

b.Transmission of data collected about Nigerian users which has been generated from such users' activities on a digital interface including websites and mobile applications.

c. Provision of goods and services directly of indirectly through a digital platform in Nigeria.

d. Provision of intermediation services through a digital platform, website or other online applications that link suppliers and customers in Nigeria.

[22] **Order, 2020 (SEP Order) made pursuant to the finance act 2020**

e. Uses a Nigerian domain name (.ng) or registers a website address in Nigeria.

f. Has a purposeful and sustained interaction with persons in Nigeria by customizing its digital page or platform to target persons in Nigeria, including reflecting the prices of its products or services in Nigerian currency or providing options for billings or payment of Nigerian currency.

Section 2(1) of the Order provides that for a company to be subject to taxation under section 13(2)e of the Companies Income Tax Act, A non-Nigerian company carrying on services of specialized nature (including advertising) shall have a significant economic presence in Nigeria in any accounting year, where it earns any income or receives payment from:

a. A person resident in Nigeria

b. A fixed base or Agent of a company other than a Nigeria company.

4.3. Companies Income Tax Act

The Finance Act[23]also sets the tone for the taxing of non-Nigerian companies with a significant economic presence (SEP) in Nigeria. Section 4(2)(c)(of the Finance Act, 2021 amended the Companies Income Tax Act (CITA)[24] by including digital enterprises.
Accordingly in Section 13 of CITA:
The profits of a company other than a Nigerian company from any trade or business shall be deemed to be derived from or taxable in Nigeria if—

> ***c.it transmits, emits or receives signals, sounds, messages, images or data of any kind by cable, radio, electromagnetic systems or any other electronic or wireless apparatus to Nigeria in respect of any activity, including electronic commerce, application store, high frequency trading, electronic data storage, online adverts, participative network platform, online payments and so on, to the extent that the***
>
> ***company has significant economic presence in Nigeria and profit can be attributable to such activity; e. the trade or business comprises the furnishing of technical, management, consultancy or professional services outside of Nigeria to a person resident in Nigeria to the extent that the company has significant economic presence in Nigeria.***

With this strategy, the basis for taxation profits received in Nigeria from digital services offered by Non-Resident Companies (NRCs) has been increased by stipulating those earnings of a company, other than a Nigerian company, from any trade or business, should be regarded to be derived from Nigeria. Thus, the NRCs which have customers resident in Nigeria but previously had no tax obligations in the country may be deemed to have a fixed base on the basis of SEP and may be required to register for taxes and file income tax returns with the Federal Inland Revenue Service (FIRS)[25]. It also allows the tax payable on the activities stated above to be limited to the withholding tax deducted by the Nigerian recipient of the services[26].

4.4. Value Added Tax Act

Similar to the CITA, the Finance Act[27] has also set the tone for the taxing of non-resident persons that makes a taxable supply to Nigeria. Section 30 of the Act[28]amended the Value Added Tax Act.

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[23] **Finance Act, 2021**
[24] **Companies Income Tax (Amendment) Act, 2007**
[25] **Wole Obayomi et al. "INSIGHT: Taxation of the Digital Economy in Nigeria and the 2019 Finance Bill" – https://news.bloombergtax.com/daily-tax-report-international/insight-taxation-of-the-digital-economy-in-nigeria-and-the-2019-finance-bill <> accessed on 29-09-2022**
[26] **Ibid.**
[27] **Finance Act, 2021**
[28] **Ibid.**

Accordingly in Section 10 of the Value Added Tax Act:

> ***1.…a non-resident person that makes a taxable supply to Nigeria, shall register for tax with the Service and obtain a Tax Identification Number.***
>
> ***2. A non-resident person shall include the tax on its invoice for all taxable supplies.***
>
> ***3. The taxable person to whom a taxable supply is made in Nigeria, or such other person as may be appointed by the Service shall withhold or collect the tax, as the case may be, and remit same to the Service.***

This new clause is a positive move that will put an end to the ongoing debates about how to tax the digital economy. Regardless of whether the services were physically performed inside or outside of Nigeria, Nigerian VAT will now apply to any services obtained by a person in Nigeria. Even if the NRC neglects to include VAT on its invoice, the Nigerian recipient of the services will still be required to deduct the VAT at source and return it directly to the Federal Inland Revenue Service (FIRS).

5.0.Conclusion

In conclusion, the article provides a detailed overview of the tax challenges facing digital enterprises. It highlights the difficulties of taxing digital goods and services, as well as the challenges of dealing with double taxation and cross-border transactions. These challenges can be divided into three main categories: tax compliance, tax planning, and tax administration. As digital enterprises continue to grow, they will face new tax challenges. These challenges include issues related to capital income tax, value-added tax, and withholding tax. While there are no easy solutions to these problems, digital enterprises can stay compliant by working closely with their tax advisors. Furthermore, by understanding the issues and engaging with tax authorities, digital enterprises can develop strategies to mitigate their tax risks.

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