TAXATION OF THE DIGITAL ECONOMY FOR DEBT SERVICE: Operational Issues

Will 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 firstly, for equitable and fair enforcement and then, secondly, ***to earmark such tax for foreign debt service?***

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

1. Introduction

Unilateral measures have been taken by states aimed at taxing the digital economy while 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 the application of a formula based on routine and residual profit; whereas 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 corporations (MNCs) that face consumers.[1]

This observation seeks to focus 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, and **whether political consensus can be made to utilise such gains towards foreign debt service**. The policy response under OECD BEPS project 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.[2] 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 should be evaluated if tax gains can be secured with which to reduce debt obligations.

[1] OECD, BEPS Action 1: Statement on the Two-Pillar Approach 2020; OECD, 'Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two)' (OECD, 2021).

[2] A M Chowdhary, Developing Country Demands for an Equitable Digital Tax Solution, Tax Cooperation Policy Brief (South Centre, October 2021); A Mosioma, L Nacpil, L Moreno et al., Time for developing countries to go beyond the OECD led tax reform, Global Alliance for Tax Justice (02 December 2020).

The UN FACTI Panel report[3] 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 in order to establish a clear tax nexus. To what extent can the FACTI report complement the work already done under the OECD BEPS project, or influence moving the global discussions on taxing the digital economy to the auspices of the United Nations? **This observation discusses this policy versus principle nuances in the taxation of the digital economy so as 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 on the strength of securing this tax base for foreign debt service.**

2. The Policy Response under BEPS

The OECD BEPS project seeks to develop a long-term solution to the broader tax challenges arising from the digitalization of the economy. Since 2015, the OECD has been analysing the potential tax policy alternatives to address broader direct tax challenges raised by the digitalization of the economy. However, to date 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 the Pillar 1, new rules on the allocation of taxing rights based on nexus and on profit allocation are developed. Under the Pillar 2, the remaining BEPS issues are focused on.

A lot of discussion has gone into addressing Pillar 1 – the blueprint for taxing the digitalisation of the economy. Through these discussion three policy proposals (user participation, marketing intangibles and significant economic presence) were made on Pillar 1. '*User participation'* was suggested by the United Kingdom 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 in that jurisdiction.[4] *'Marketing intangibles'* was proposed by the United States. It required that the residual or the non-routine income of MNCs to be attributed to marketing intangibles and their corresponding risks to the market jurisdiction.[5] The third policy proposal under Pillar 1; *'significant economic presence',* was proposed by the G-24 group of developing and emerging economies. It related to establishing a taxable presence in a jurisdiction when a non-resident enterprise has a purposeful and sustained interaction in the jurisdiction through digital technology and other

[3] UN FACTI Panel Report 2020.
[4] OECD, BEPS Action 1: Public Consultation Document 2019, para 21. Ibid, para 43.
[5] Ibid, para 43.

automated means. The G-24 group suggested the use of the fractional apportionment method to allocate profits to such a significant economic presence.[6]

These three policy proposals under Pillar 1 needed to be reduced and this was worked out in the OECD 'Programme of Work' through which the OECD attempted to develop a consensus based solution to the tax challenges arising from the digitalization of the economy.[7] Based on this report, the OECD Secretariat further published a public consultation document proposing a Unified Approach under Pillar 1 to reach international consensus. 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, to 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.[8] **We propose a fifth issue for consideration at the OECD and UN level, this being, the digital tax so generated to be earmarked by the taxing state for debt service.**

These policy moves under the BEPS project to develop taxing rules for the digitalisation of the economy represents 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 digitalization of the economy. The danger here is that the discussion on finding a consensus solution may then not entirely be possible since it would be led by the interests of the individual members who would be 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 nascent stages from 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. If this can be achieved, then the next fundamental question on whether such tax gains can be utilised for debt service can be canvassed.** However, whether such exchange of information is made available under Pillar 1 proposals on Amount A and Amount B requires some assessment before the FACTI[9] recommendation can be incorporated.

[6] Ibid, para 51.
[7] OECD, BEPS Action 1: Programme of Work 2019.
[8] OECD, BEPS Action 1: Secretariat Proposal for a Unified Approach 2019, para 10.
[9] UN FACTI Panel Report 2021.

The OECD BEPS project proposes on levying taxing rights which are not dependent on actual physical presence of an enterprise in the market jurisdiction (Amount A) and proffer a new profit allocation mechanism (Amount A and Amount B). While both types of taxable profits described by Amount A and Amount B encompasses new and revised profit allocation rules, only Amount A aspires to introduce a new taxing right. Amount A shall reflect profits associated with the active and sustained engagement of qualified businesses in the market jurisdiction. To meet this objective a share of the residual profit shall be attributed to the market jurisdiction by means of a formulaic approach. 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 for a fixed return for baseline marketing and distribution functions that are 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 and thereby enhance tax certainty.[10] So let's delve a little deeper into understanding Amount A and Amount B as the tax policy approaches to taxing the digitally sourced generation of profits.

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). **The concern is on how to secure tax. For Pillar 1 to generate legitimacy and acceptability a political consensus is needed to align Amount A towards payments to reduce foreign debt globally.** 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 MNCs earn at least Euros 1 million in that jurisdiction, generally wealthy states. For smaller jurisdictions with 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. Those countries taking a significant portion of the pie should, therefore, have the obligation to support African nations with their foreign debt service.

Difficulties will arise in how market jurisdictions, in particular African states, and with access to what financial data, will calculate the portion of the residual profits that 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 – that is, 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).[11] This is a positive policy approach at OECD level that allows a minimum tax to

[10] OECD, BEPS Action 1: Report on Pillar One Blueprint 2020, para 11.

[11] OECD, *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS*, OECD, Paris (2021).

be incorporated into the domestic law of a 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 potentially help in the calculation of 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. That said, this is a bit of a minor point in the broader discussion of international tax standards and who should be applying them and towards what ends.

While standards have not been articulated by the OECD, the UN FACTI Panel has made some recommendations (discussed later in the observation). 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 global consolidated 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. **Any tax losses in securing the digital tax base would mean limited revenue mobilization towards foreign debt service**. This OECD BEPS 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 a global coordination of tax data is to be achieved offers a solution.

The UN FACTI Panel report[12] 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 in order to establish a clear tax nexus. The 2021 FACTI report complements the work already done under the BEPS project by requiring states to globally agree on integrating within the OECD policy-based approach a set of criteria 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 and **on the strength of securing this tax base for foreign debt service.**

3. The Principle Response under FACTI

The UN FACTI Panel supports an international tax architecture that is based on the principles of accountability, legitimacy, transparency, and fairness. It sees these principles as

[12] UN FACTI Panel Report 2021.

key determinants to foster financial integrity. These principle are a requirement to curb illicit financial flows which adversely impact the African fiscal space. Since principles cannot operate in isolation, FACTI Panel recommends the setting up of 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, 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. Such discussions, being principle led, will also promote related discussions on financial information sharing through a coordinated system facilitating open financial exchange of data between states and digital multinational enterprises. While the Global Forum on Transparency and Exchange of Information already provides such a platform, it is limited in membership and 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 digitalization of the economy, there are several strategic alternatives to resolve difficulties under the OECD BEPS Pillar 1 and 2 approaches.[13] Efforts have been led by the OECD 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 recommendations that are important to evaluate considering their potential to solving 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. **These norms and reform measures should steer the discussion on the implementation of the digital tax towards foreign debt service if the world is to restrict austerity measures and increase the financial burden on the world's poor.**

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 which can impact or contribute to the operational challenges under the BEPS project. The section starts by drawing attention to the operational 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 simply 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 for purposes of taxing their global

[13] 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).

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 on an MNC as a group – the difficulty here is that some of these MNCs operate as part of separately negotiated bilateral agreements. Therefore, assessing an MNC groups global profit will require consensus under BEPS to rework any double taxation agreements which defaults to the separate entity regime which of course ousts digital financial flows from the tax net. A formula still needs to be agreed upon to tax Big Tech corporations such as Google, Amazon, 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.[14] To overcome the challenge of who gets to tax and tax what, all digital tax should be applied towards supporting foreign debt service. This should be addressed by the UN Tax Committee.

Clearly there are problems in imposing digital tax under Pillars 1 and 2. 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 by focusing on the profit assessment of an MNC 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 MNC 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 there is financial information sharing by the MNC showing user participation, value creation and monetised data on which these fairer rules would apply to delineate taxing allocation rights.

The FACTI Panel 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 as applied to the taxation of the digital economy? The Pillar 2 Model Rules are designed to ensure large MNCs pay a minimum level of tax on the income arising in each jurisdiction where

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[14] Latif, L., The Evolving 'Thunder': The Challenges Around Imposing the Digital Tax in Developing African Countries [2020] International Journal of Digital Technology and Economy, Vol 4, No. 1.

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 the creation of fairer rules on global minimum corporate tax recommended by the FACTI Panel? 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 intergovernmental level in the absence of an effective automatic exchange of tax and financial information?

Going back to recommendations 4A and 4C -these can be properly enforced if they are applied with recommendations 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 transparent exchange of information between revenue authorities. Is it envisaged under Pillar 2 Model Rules the exchange of information on consolidated revenue that is 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 MNCs to determine income earned from a taxing jurisdiction and access financial information adjusting intra group 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 and use the disaggregated data to support foreign debt service of countries the digital MNC sourced its gains from.

But for these recommendations under 3B and 8A to be implemented and enforced the FACTI Panel report suggest 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 that would be responsible to assist states impose the digital tax. This is the stage at which discussions to establish the digital tax, its calculations and country attributions be considered from bigger picture of generating this additional tax base – that it be used for foreign debt service.

4. Conclusion: Towards an African Coordinated response

Implementing the OECD BEPS project 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. If this can be done, the next stage would be to consider the use of this newly sourced tax to offset debt obligations. The application of Amount A and Amount B is subject to transparent and clear financial information provide 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. **Being guided by human rights, the UN body would be more open towards considering the proposal to apply digital taxes towards debt service. This would leave domestic states with tax revenue for redistribution towards the achievement of social and economic rights.**

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