
Taxation of the Digital Economy and Significant Economic Presence: The Focus on Nigeria's Finance ACT 2020

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Abstract

Before the enactment of the Finance Act 2020, Non-Resident Companies (NRCs) with digital presence in Nigeria were not subject to taxation until a significant economic presence (SEP) was established. This study aims to assess the viability of imposing digital taxation on NRCs concerning their digital economic activities, following the new fiscal provisions of the Nigeria Finance Act 2020. Using a systematic review methodological approach, the findings of the study reveal that the country stands to benefit from the newly enacted regulation by imposing taxes on previously untaxed digital transactions. It is important to recommend that the taxation of digital economic activities should be reconsidered, shifting from a profit-based to a revenue-based approach to reduce tax evasion strategies. Additionally, creating an enabling environment among industry players to sustain and promote the use of digital platforms is crucial. This is expected to stimulate the revitalization of the economy through increased tax revenues and higher inflows of foreign exchange into the country.

Keywords: Taxation of Digital Economy, Nigeria Finance Act 2020, Significant Economic Presence

1. Introduction

Globally, taxation plays a crucial role in maintaining fiscal stability. Governments levy taxes on various goods and services in the real sector to generate revenue for national development. However, recent technological advancements have led to more complex ways of conducting business, leading to the emergence of a digital economy activities. This practice that gave rise to a digital economy, has facilitated rapid economic growth, innovation, increased employment opportunities, and access to a wide range of services. It is worth noting that a considerable number of electronic business transactions are often considered tax-free due to the absence of a legal framework (Ibrahim, Haruna, Zannah & Babangida, 2021) or regulatory provisions in some jurisdictions (Vuković, 2019).

The digital economy encompasses any economic activity that involves business models consisting of one or more digital elements, such as digital content, digital automation, digital communication, digital distribution, digital payment, or other electronic business. This classification pertains to digital economic activity (Lucas-Mas & Junquera-Varela, 2021). Thus, the taxation of digital economy is an emerging issue within the purview of international taxation as there is no universally acceptable practice on the way and manner upon which

income derived from digital economic activities should be taxed. Hence, every tax jurisdiction design and implements its own model.

Consequently, the concept of significant economic presence is ultimately used as a major determinant of digital economic activities in a host nation (Lyla, 2021). In recent times, the digital economy seems to spur the world’s GDP in an unprecedented manner as evidenced by the rapid rise in sale of goods and services over the internet, especially during the COVID-19 pandemic (UNCTD, 2019). Nonetheless, it appears Governments are not making the most of the digital boom in generating revenues through appropriate tax policies. For instance, the United Nations Conference on Trade and Development (UNCTD, 2019) reports that the digital economy has grown from 4.5% to 15.5% from 2017-2020 of the world’s economy. It is surprising that despite being the economic giant of Africa, Nigeria has not seen significant revenues from digital economic activities, despite being the second largest economy in Africa. Ntiamoah and Asare (2020) have highlighted the potential repercussions of exempting digital economic activities from taxation, suggesting that such a practice could serve as a disincentive for those compliant with traditional tax obligations. Additionally, Goolsbee (2019) observed a correlation between high sales tax regions and increased preference for online purchases compared to low sales tax regions. Moreover, Aslam and Shah (2020) portrayed non-resident companies (NRCs) with digital presence as paying minimal to no tax in the locales where they provide services. Consequently, policymakers are beginning to question the adequacy of the existing tax framework in yielding sufficient revenue from digitalized transactions.

In addressing these challenges, scholars have advanced policy recommendations to restrict tax avoidance by enacting new legislation or amending extant laws to confront the issue of taxation within the digital economy (Edirin, Okoye, Adeniyi, James, 2019). Nigeria, akin to numerous other emerging economies, is experiencing considerable revenue loss due to its insufficient regulatory framework, which impedes the taxation of digitalized business models. Despite its status as the most populous nation in Africa, with a populace exceeding 200 million and over 40 million active users of digitalized business models, Nigeria remains incapable of generating substantial revenues from digital economic activities. Table 1.1 below further underscores this situation by identifying the primary social media platforms utilized in Nigeria as of the third quarter of 2020, alongside pertinent digital components.

Table 1.1 Most used social media platforms in Nigeria.

Characteristic	Share of internet users (%)
WhatsApp	93
Facebook	86.2
YouTube	81.6
Instagram	73.1
FB Messenger	67.2
Twitter	61.4
Telegram	56.3
LinkedIn	32.8
Tiktok	31.9
Snapchat	31.2
Pinterest	26.8
Skype	12.1
Goggle Handouts	11.6

Source: Adopted from Statista (2021)

Table 1.1 illustrates the prominent social media platforms utilized in Nigeria, generating substantial revenue from Nigerians through streaming, advertisement, and other digital content. These platforms operate without remitting taxes to the Nigerian government due to the absence of a comprehensive framework for incorporating these digital business models into the country's tax regime. Given Nigeria's sizable digital user population, there exists considerable

potential to harness the digital economy for driving growth, fostering innovation, and advancing economic development. Failure to exploit these opportunities may result in the country's isolation and economic stagnation.

It is in the light of these issues that this study examines the tax liability of non-resident companies in Nigeria and determines the tax base from digital economic activities in accordance with the new fiscal provisions of the Nigeria Finance Act 2020. Moreover, it elucidates the concept of Significant Economic Presence (SEP). The study also clarifies the issue of SEP and extends existing knowledge on the benefit received theory of taxation. The study's relevance is underscored by the dearth of research on taxing the digital economy, particularly with regard to Nigeria.

The scope of this study is mainly confined to the Nigeria Finance Act 2020 and the inferences drawn there from were also limited to Nigeria context. Thus, the paper comprises of five sections. Following the introduction, section two of the paper reviews and synthesizes literature on the new tax laws. The benefits received theory of taxation was further review and logically linked to the concept of taxation of the digital economy. Furthermore, the review of related empirical studies was also highlighted. Section three and four comprises of methodology as well as discussion of findings respectively. The last section is summary and conclusions.

2. Literature Review

2.1. Digital Economy

Digital economy primarily relies on non-resident company (NRC) harnessing technology for its customers and clients to interact globally without physical existence but have significant economic presence (digitally presence) or permanent establishment within the host nation (Aslam & Shah, 2020). The digitalization of the economy drives innovations and creates employment opportunities which in turn lead to economic growth. It has also been defined as a diverse range of economic activities such as the digital elements that used digital contents as key factors of production. Through the digital contents, data is collected, analyzed, stored and retrieved via the internet for commercial reasons by foreign entities and their clients, cloud computing, big data, Fintech among another technological hub (Aladdin, 2018).

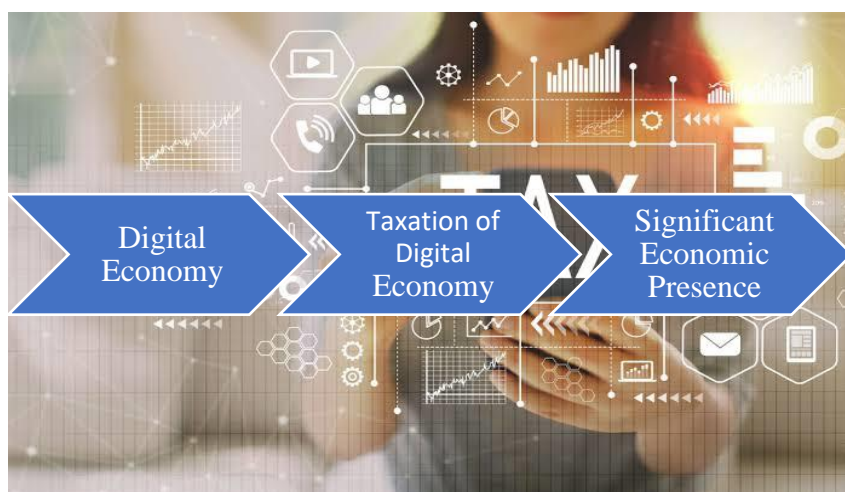


Figure 2.1: Conceptual Model - Taxation of Digital Economy and Significant Economic Presence

Source: Adopted from Ibrahim et.al (2021)

Figure 2.1 above conceptualizes the idea behind the taxation of digital economy. The model describes how digital economic activities such digital elements which include the digital contents, digital automation, and digital communication among others can be taxed due to

digital presence (the establishment of the significant economic presence). The SEP is the basis that determines the eligibility upon which digital corporations are liable to pay digital tax in a host nation. Hence, the model reflects a paradigm shift towards improved tax revenue in the country. The model attempts to develop a framework that overcomes the perceived inadequacy associated with digital taxation and further proffers solutions to the taxation of digital economic activities in Nigeria.

The Finance Act 2020 affirms that NRCs should be subjected to company income tax. This implies that foreign entities that have NRC status in Nigeria and generate profit through digital economic activities within Nigeria should be taxed. However, this study argues that subjecting digital corporations with SEP in Nigeria to profit based tax may not be advantageous because the NRCs may resort to tax evasion strategies such as understating profits and overstating expenses by capitalizing on cyber security and other logistic estimates that are complex to verify. Hence, this would pave way for tax evasion by foreign enterprises. In this regard therefore, this study suggests implementation of revenue-based taxes on digital economic activities in Nigeria because it would enhance transparency and engender harmonious relationships between businesses and the government. As a result, the Government in collaboration with other tax jurisdictions may determine the amount of the income derived through the digital economy with accuracy through segmental reporting. This system offers a more flexible and accurate basis compared to the profit-based tax that could be distorted through window dressing or profit shafting among other techniques.

2.2 Taxation of the Digital Economy

The taxation of the digital economy means the application of conventional tax principles to the digitalised business model (foreign enterprises with digital presence). Advancements in technology in recent times has paved way for digitalization of economic and social activities leading to borderless trade between economic entities across the globe. Consistent with these developments, tax authorities determine tax jurisdiction by relying on the concept of significant economic presence or permanent establishment to ascertain the basis upon which digitalised business transactions may be subjected to tax or not (Lyla, 2021).

Digitalization has not only brought about economic prosperity but also poses a major challenge for tax jurisdictions across the globe regarding the taxation of digitalized business model. Thus, as a result of the tax policy implications of digitalization, political leaders across the globe debate over whether or not the international tax rules continue to fit into the present circumstance. This however, gave birth to Base Erosion and Profit Shifting (BEPS) principles. The BEPS was the action plan issued by organizations of economic community and development (OECD) and revolves around three (3) key pillars namely; improving coherence in the domestic rules that affect cross-border activities; reinforcing substance requirements to ensure alignment of taxation with the location of economic activity and value creation, and enhancing transparency and certainty for businesses and government. The action plan aims to neutralize the undue advantage imposed by the multinational companies (MNCs) as a result of the perceived lacuna existing in the domestic tax laws which artificially reduce taxable income or shift profit to low-tax jurisdiction in which little or no economic activity is performed (OECD, 2015)

Table 2.1: Different approaches to digital taxation across the continents of the world

Africa

Country	Type of digital activity taxed	Tax Details
<i>Nigeria</i>	Digital transactions by NRCs	NRCs which derive income of N25 million (USD 60750) or its equivalent in other currencies from Nigeria in a year of assessment are liable to company income tax (Finance Act, 2020) effective date 2021 year of assessment.
<i>Uganda</i>	Social media	0.5% transaction tax to access social media (social media tax) (Excise Duty (Amendment) (No.2) Act, 2018).
<i>Tanzania</i>	Online content creation	Registration and license fees for online content creators [(online content) Regulations, 2018]
<i>Benin</i>	Communication	5% fee on texting and calls (for using over the top services) 218 Decree 341-25 of July 2018
<i>Mozambique</i>	Online media	Media fees for local and foreign journalists. Decree 40/2016, 23 July 2018
<i>Zambia</i>	Communication	Daily tariff rate on internet calls (Press statement by the Cabinet, 2018).

Asia/Middle East

Country	Type of digital activity taxed	Tax details
<i>Saudi Arabia and Kuwait</i>	Online trading	Introduced the concept of virtual permanent establishment (PE) – any services performed for a period longer than the tax treaty threshold (183 days) under cross border agreements between a non-resident and consumers in Saudi Arabia/Kuwait will create a virtual PE (EY, Global Tax Alert, 2015).
<i>India</i>	Online advertising	Equalization levy on online advertising revenue earned by non-resident ecommerce companies introduced in 2016. Tax base is the value of transactions, not the profits (Gupta, 2017).
<i>Taiwan</i>	Digital services	All foreign businesses that supply digital services to Taiwan residents to pay VAT effective 2017 (PWC. Taiwan Tax, 2018).
<i>Turkey</i>	E-Business	Withholding tax (WHT) on payments made through e-business and other online activities effective 2016. Introduced the concept of an electronic PE [Law on Regulation of Content Published on the Internet (Act No. 5651)].
<i>China</i>	E-Commerce	Import of retail goods through e-commerce subject to customs duty, VAT and consumption tax.

European/Pacific

Country	Type of digital activity taxed	Tax details
<i>France</i>	Online content distribution	2% tax on distribution of audio-visual content introduced in 2016 (referred to as the YouTube tax) [Decree No. 2017-1364 of 20 September 2017].
<i>Italy</i>	Digital transactions	3% levy on digital transactions based on value of taxable transactions effective 1.1.2019. Less than 3000 taxable transactions exempted [Law 27 December 2017, n. 205].
<i>Hungary</i>	Online advertisement	5.3% advertisement tax for entities exceeding HUF100million introduced in 2014 (Regulations of the Act XXII of 2014 on Advertisement Tax [AT Act], 2017).
<i>Australia</i>	Online advertisement	3% levy on advertising revenue from 'globally significant enterprises' with annual turnovers of more than AUD1 billion (PWC, Tax Transparency in Australia, 2018).
<i>New Zealand</i>	Online services	Extended the scope of its goods and services tax (GST) to digital 'remote' services provided offshore (Inland Revenue, 2016).

Source: Adapted from Lyla (2021).

Table 2.1 highlights the different approaches to taxation of digital economy across the continents of the world. However, it is apparent that African nations are lagging behind in conceptualizing the imposition of the tax around digital suppliers and consumers when other continents target NRCs (digital corporations). Lyla (2021) claim that if the trend persists without considering the private sector, then substantial parts of tax revenue would be lost to traditional approaches of not to taxation in modern world.

2.3. An Overview of the Concept of Significant Economy Presence (SEP) in Nigeria

The SEP order issued by the minister of finance covered the digital transaction and services.

2.3.1. Digital Transactions

The Finance Act 2020 stipulates that a foreign entity involved in digital transactions will be deemed to have created an SEP in Nigeria and therefore liable to tax if it derives income of N25m or equivalent in other currencies from Nigeria in a year or uses Nigerian domain name (.ng) or registers a website address in Nigeria, or has a purposeful and sustained interactions with persons in Nigeria by customizing its digital platform to target persons in Nigeria e.g. by stating the prices of its products or services in Naira. Figure 2.2 summaries the revenue to be derived from digital transactions in Nigeria as contained in the Finance Act, 2020.



Figure 2.2: Revenue to be derived from Digital Transactions in Nigeria

Source: Adopted from Ibrahim et.al (2021)

Figure 2.2 summarizes the sources of revenue to be derived from Nigerians digital economic activities as streaming or downloading of digital contents, transmission of data collected about users in Nigeria, provision of goods or services directly or through a digital platform, intermediation services that link suppliers and customers in Nigeria among others. In addition, activities carried out by connected persons shall be aggregated to determine the N25m threshold (where applicable). However, the new fiscal provisions suggest that any company covered under any multilateral agreement to which Nigeria is a party will be treated in accordance with those agreements from the effective date in Nigeria.

2.3.2 Digital Services

The Finance Act 2020 further states that a foreign entity providing technical services (including training, advertising, supply of personnel), professional, management or consultancy services shall have an SEP in Nigeria in any accounting year if it earns any income or receives any payment from a person resident in Nigeria or a fixed base or agent of a foreign entity in Nigeria. However, payments to employees of foreign entity or for teaching in an education institution are exempted. Accordingly, the Nigeria Investment Promotion Commission (NIPC) projected that the Nigeria digital economy is to generate \$8 billion and create 3 million jobs as the Federal Government targets 15% tax to GDP ratio with the implementation of the Finance Act 2020 by the end of 2021 fiscal year.

2.4 Review of Related Empirical Studies

There are many studies that have looked at various aspects of digitalization across the globe. For instance, Lyla (2021) advocates for unilateral digital taxation flat rate of 5% across the regional bloc to enable developing African states nurture the digital economic activities because existing systems do not benefit member nations due to bilateral treaties signed with countries whose companies have a digital presence in African markets. Thus, foreign enterprises providing online services (for example, Amazon, Uber, Alibaba, etc.) to users in the form of e-commerce and decentralized financial services such as MoneyGram, Western Union, without physical presence in the country where the recipients of such services are, create a mismatch between tax rules and digitalization. Hence, this has resulted in domestic states losing substantial tax revenue.

Etim, Jeremiah, and Dan (2020) examine the effect of digitalization of economy on tax compliance in Nigeria. Data was obtained from primary source and questionnaires issued and analyzed using descriptive and inferential analyses. The findings suggest that digitalization of economy had negative effect on tax compliance in Nigeria due to lack of modern technology in curbing tax evasion as well as the absence of legal framework to checkmate non-compliance especially the NRCs. In addition, Komolafe and Chukwuani (2020) opined that the enactment of Nigeria Finance Act 2020 does not only address the controversy surrounding taxing the digital economy in the nation, but a paradigm shift for a new regime. This has become necessary to address the loopholes in digital assessment through yearly amendments to the Finance Act to meet emerging challenges therefrom.

Ntiamoah and Asare (2019) found that the main challenges facing the taxation of digital economy especially in the developing nations originates from the world's super power whose cross-border trade and commerce resulted to double taxation treaties. The world trade organization (WTO) believes that digital business transmissions should not be considered as importations. In contrast, the general agreement on trade and tariffs (GATT) Article II suggests that electronic transmissions could supposedly be considered as importations and subject to tax. These contradictory views suggest that there is lack of synergy between the WTO and GATT as to whether digital business transactions fall under the importation of goods or not. Additionally, Sweet (2020) affirms that United States of America (USA) opposed digital taxation due to several risks and adverse consequences that would negatively impact trade and investment, innovation, growth as well as proliferation of digital businesses.

Anderson (2019) affirms that some tax jurisdictions such as India recently established new digital economy law tagged India Finance Act, 2019 aimed at addressing the issue of SEP into its tax law. Thus, businesses that have a SEP would be subjected to a tax levy of 6%. This is in tandem with the European Commission ruling out 3% flat rate on the gross revenue of business derived from online advertisement and associated transactions. The proposal seeks to establish virtual taxable presence with a threshold over £750 million and an annual total revenue of over £50 million from digital activities in the region. Further, Brummer and Gorfine (2014)

report that countries such as China, Singapore and Malaysia have also aligned their tax regulations to promote FinTech and eliminate artificial barriers for entry therefrom to foster the development of FinTech with the aim of increasing market competition and ultimately financial inclusion.

Put together, empirical studies suggest that many countries amended their tax laws to capture digital economic activities in their territory and the implication of ignoring digital economic activities is significant loss of from tax revenues. It is in the light of these issues that this study argues for the implementation of the Finance Act on taxation of Non-resident companies with significant economic presence in Nigeria to enhance the country's tax revenues.

2.5 Theoretical Framework

2.5.1 Benefits Received Theory of Taxation

The benefits received theory was propounded by Buchanan and Tullock (1908). The benefits received theory is built on the premise that individuals and corporate entities pay taxes in return for benefits received or enjoined through the provision of public goods such as infrastructural facilities and other social amenities. This principle serves as a medium for assessing the efficiency of tax system and appraising fiscal policy. The prominent economists of all time of Stockholm School were credited with this postulation.

The research is anchored on the benefits received principles which justifies taxing foreign enterprises with digital presence in Nigeria in line with new regulations as enshrined in the Nigeria Finance Act 2020 since they derive income from the country. Furthermore, bringing such enterprises into the tax net signifies the benefits received in return for the uninterrupted broad band and other infrastructural facilities enjoyed in carrying on their business transactions via digital elements such as digital content, digital automation, digital communication, digital distribution, and digital payment been classified as digital economy activities. In addition, Section 13(2), (c), (e) as amended by Section 4 of the Finance Act 2020 also includes provision of technical, management, professional or consultancy services in Nigeria by foreign firms. This suggests that inclusion of digital economic activities does not only raise revenue for government but also ensures the principle of fairness to other taxpayers in the country.

3. Research Methodology

The paper employed a systematic review based on a review of relevant scholarly articles, proceedings, journals, and reports comprising both academic and professional literature on taxation of digital businesses in drawing its inferences. The systematic review was employed because it is most suitable to identify, appraise and synthesize evidenced-based findings from academic and professional literature on taxation of digital economic activities as well as the gazetted Finance Act 2020 in order to make valuable inference therefrom. Furthermore, this approach is also in line with prior studies (Campbell, 2006; Collins & Fauser, 2005; Crombie & Davies, 2006).

4. Discussion of Findings

The conclusions drawn from the systematic review indicate that non-resident companies (NRCs) are required to pay taxes when they earn an annual gross turnover of N25 million or its equivalent in other currencies through engaging in digital economic activities in Nigeria. This also applies to NRCs that use Nigerian domain names (such as .ng), register a website address in Nigeria, or customize their digital platform to target individuals in Nigeria and offer billing options for payment in Naira currency. The findings also emphasize the need for the government to enhance the tax administrative infrastructure through training and expertise in digital economy taxation and to equip tax officials with advanced modern technology to prevent tax evasion tactics and improve tax revenue from digital transactions in Nigeria. The

study argues that while Nigeria could implement a profit-based tax rather than a revenue-based tax for taxing digital business models in the country, there is a risk of NRCs engaging in profit shifting or understating profits when profits are used as the basis for taxation.

Therefore, the study recommends implementing a revenue-based tax to mitigate the abuses of NRCs. Additionally, the government could enhance the administrative infrastructure with cutting-edge technologies by collaborating with other foreign tax jurisdictions around the world to share intelligence information related to digitalized business models in their respective countries. As the Federal Government aims for a 15% tax-to-GDP ratio with the implementation of the Finance Act 2020, it is important to continue supporting and encouraging the use of digital platforms by creating a conducive environment for industry players. However, certain areas still require clarification, especially the issue of double taxation, to which the country is a signatory in international tax treaties, such as with the Commonwealth nations.

5. Conclusion, Recommendation and Implication of Findings

5.1 Conclusion

The study provides an overview of the implications of the Nigeria Finance Act 2020, focusing on the concept of Significant Economic Presence (SEP) and its impact on the taxation of digital business models for Non-Resident Companies (NRCs). It also highlights the opportunity for increased investments in digital infrastructure as a means to boost employment and stimulate digital economic activities. This initiative is expected to improve the business environment and help address fiscal challenges by enhancing foreign exchange inflows. Furthermore, the study proposes a comprehensive framework for taxing the digital economy in Nigeria, advocating for a revenue-based tax model over a profit-based approach, taking into account the unique characteristics of the digital economy in the country.

5.2 Recommendations

Based on the foregoing findings, the study delineates the following recommendations: It is recommended that the government bolster collaboration with other tax jurisdictions in database management. The taxation of digital economic activities should be reconsidered, shifting from a profit-based to a revenue-based approach to mitigate tax evasion strategies. Furthermore, the creation of an enabling environment among industry players to sustain and promote the utilization of digital platforms is essential.

5.3 Implication of the Finding

The study contributes to the existing knowledge on the taxation of the digital economy literature and clarifies the issue of Significant Economic Presence (SEP) in the Nigerian context. The study is also supported by the benefit-received theory of taxation, which justifies the need for foreign enterprises with a digital presence to pay taxes in return for the benefits received, especially if they derived income in Nigeria, through the state's ease of doing business. In practical terms, Non-Resident Companies (NRCs) with SEP in Nigeria are required to file a return after registering for income taxes and prepare financial statements for their business operations both in Nigeria and abroad. The Nigerian financial statements are expected to be duly audited by an independent auditor in Nigeria. Consequently, the incidence of the taxation would be borne by Nigerians, who are the ultimate users of the product or services, therefore contradicting the concept of ease of doing business in the country. Taken together, the findings of this research would serve as policy inputs and pave the way for further empirical research in the area of digital taxation for government regulators, academics, and students.

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