Tax Bites

8 October 2021: A memorable day for International taxation

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The 8th of October 2021 could be considered a historic day in international taxation as 136 out of 140 member countries of the Inclusive Framework (IF) finalised the Two-Pillar Solution for taxing large multinational enterprises (MNEs) across the world. Countries that did not sign this solution are Kenya, Nigeria, Pakistan, and Sri Lanka. Under the agreed principles countries will be able to tax some profits of MNEs within their market jurisdiction and a minimum tax rate will exist for large MNEs. This article explains the Two-Pillar solution (the Solution) agreed by the IF and why Nigeria was reluctant to sign.

A brief background

The existing international tax rules were introduced in the 1920s by the League of Nations who prescribed that taxes should be based on the existence of a physical presence or nexus. These rules are no longer fit for purpose due to changes brought about by digitisation. Business models such as streaming services, e-commerce, e.t.c have made it possible to derive income from countries without necessarily paying taxes there.

This is further complicated by the existence of some "tax-friendly" countries that are only able to compete economically by attracting MNEs with their low tax rates. This allows MNEs to implement tax avoidance strategies. To solve the problem of taxing the digital economy, the Inclusive Framework consisting of the Organisation for Economic Cooperation and Development (OECD), the G20 and other nations have been developing rules since 2015 which culminated in the Solution.

Pillar 1

The overall objective of this solution is to ensure that taxes are being paid where value is created by reallocating profits to these market jurisdictions. It is estimated that it will generate an additional revenue of $100 billion to governments across the world. The elements of Pillar 1 are highlighted below:

Amount A

The MNEs in scope are those (except regulated financial and extraction services) with global turnover of €20billion and net profit margin above 10%. A quarter (the Quantum) of the excess profit margin of such MNE above 10% (residual profit) will be allocated for tax to certain countries that have signed on to the Solution, and from which the MNEs generate a minimum turnover of €1million (the Nexus). The Nexus can be likened to a connector such as an umbilical cord between a mother and a baby. For a small country (i.e.GDP of €40billion), the Nexus is €250,000.

Example: Consider "Dynamic Group" which earned a global revenue and net profit margin of €161.27billion and 22% respectively. Under Amount A, a quarter of 12% of the profits of the Group (i.e. €4.8billion) will be available to be taxed in market jurisdictions.

Amount B

Amount B is based on the arm's-length principle (i.e. pricing that is comparable to what obtains between unrelated parties). To avoid shifting of profits by related-parties, Amount B sets a fixed and unbiased return to be earned for basic marketing and distribution activities performed by related-parties.

Tax certainty

Another important factor under Pillar 1 is "tax certainty". It is expected that whenever there is a dispute, this will be settled through arbitration and signing members of the IF are to mandatorily abide by the decision reached. Developing countries however, have the option of seeking an alternative course of redress after meeting certain conditions.

Pillar 2

The objective of this solution is to create a minimum tax that discourages profit shifting from high-tax to low-tax jurisdictions. It will also address unhealthy competition by nations who lower their taxes to attract MNEs (i.e. "*the race to the bottom").* A revenue of $150 billion is expected to be generated under Pillar 2.

Pillar 2 has two categories of changes with two elements each. These are domestic based and treaty based.

a. Domestic based elements

These elements are commonly referred to as the Global Anti-Base Erosion (GloBE) rules. They include the Income Inclusion Rule and Undertaxed Payment Rule. Under these rules, the profits of MNEs with a global revenue of €750million are to be taxed at an effective minimum tax rate of 15%.

i. Income Inclusion Rule (IIR)

The IIR allows the country of the ultimate parent company of the MNE to further charge a top-up tax on the Group consolidated revenue when its effective tax rate (ETR) is below 15%.

Example: Entity A in the US has an ETR of 15%. Entity B is a subsidiary of Entity A and is resident in Ireland where it has an ETR of 13%. If this results in a global ETR of 14% for the Group, under the IIR in place, the US has the right to tax the Group's income in Ireland in order to bring the Group consolidated ETR to 15%.

ii. Undertaxed Payment Rule (UTPR)

Using the same scenario above, where the US chooses not to exercise its right to tax the income of Entity B, the UTPR allows Ireland to take up this right by disallowing deductible related-party payments made by Entity B to Entity A in order to raise the Group's global ETR to 15%.

b. Treaty based element

i. Subject To Tax Rule [STTR]

Under the STTR, a minimum withholding tax (WHT) of 9% is levied on related-party payments such as interest, royalties e.t.c. Although most countries charge a rate of 10% on such payments, some countries have treaties among themselves to give concessions and lower the WHT rate.

Under the STTR, these incentives could be taken out either partially or totally when incorporated in the treaties of member countries. This allows a paying country to apply a top-up tax on related-party payments to a receiving country where the effective tax rate (ETR) in that country is below 9%.

Example: Nigeria and South Africa (SA) being members of the IF, have a double tax treaty agreement (DTA) with each other. Say we have an Entity A in SA which is a parent company to Entity B in Nigeria. If Entity B makes royalty payments to Entity A, such royalties will be taxed at a rate of 7.5%.

Let us assume the following:

i.) Nigeria agrees to the Solution and successfully requests for the inclusion of the STTR in its DTA with SA; and
iii.) SA does not tax royalties brought into the country.

Nigeria will initially apply a WHT of 7.5% on the royalty payment made to SA. SA upon receiving the royalty proceeds will exempt such proceeds from further tax; Nigeria will subsequently apply the top-up tax of 1.5% to effectively bring the tax rate to 9%.

ii. Switch-Over Rule [SOR]

Considering that DTA exemptions might be nullified by the IIR, the SOR allows for a switch from the exemption benefit to a credit benefit to compensate for treaty losses.

Where is Nigeria in all of this?

For Pillar 1, the Federal Inland Revenue Service (FIRS) estimated that out of the 100 MNEs intended to be taxed by the IF based on the €20billion threshold, less than 10 MNEs would become taxable in Nigeria. The Nexus (€1million or ₦460million) for which an MNE would be taxed is higher than what is currently obtained under the Significant Economic Presence Order (SEP[₦25million]). Without signing the Solution, the FIRS projects to earn an estimate of ₦5trillion in 2022 from the activities of digital companies. The Finance Bill 2021 seeks to empower the FIRS to tax digital companies based on turnover where it is unable to ascertain their profits.

With respect to tax disputes, the conditions for developing countries to go for an elective dispute resolution mechanism is strict and difficult to comply with.

A few thoughts

Given the Solution hasn't been implemented, it seems prudent to wait and study its impact on other nations. Nigeria clearly does not have to worry about Pillar 2 which could impact the country whether it signs or not. It is advisable however to examine the tax incentives available to MNEs as any incentive that brings down the ETR below the minimum threshold will only shift benefits to other countries.

It is important that Nigeria along with the Africa Tax Administration Forum researches solutions that could be implemented by the IF to ensure that developing countries are fairly considered at the international tax stage.The downside for Nigeria not signing the Solution is that, the SEP would continue to be overridden by existing DTAs which prevents Nigeria from earning the anticipated revenue for services provided remotely from treaty-partner countries. This could also lead to tax planning opportunities for MNEs to provide services to Nigeria from treaty-partner countries.

Finally, negotiating future treaties would be complicated as the template for Nigeria would deviate from standard articles incorporating the principles of the Solution.

For a deeper discussion, please contact:

Kenneth Erikume
Tax Partner
kenneth.y.erikume@pwc.com

Abiodun Kayode-Alli
Manager
abiodun.kayode-alli@pwc.com

Bomate Ogaree-Lawson
Associate
owabomate.ogaree-lawson@pwc.com