STATES & LOCAL FINANCE

The IGR Initiative

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Taxation of online businesses

THE DIGITAL ECONOMY is fast overtaking the traditional economy in many ways and may perhaps achieve over 80 percent displacement before the end of the century. With the recent COVID-19 pandemic, the acceleration towards digitalization reached a blazar jet speed, with more people working remotely, shopping online, and using digital services. However, the pace and extent of this transition vary across industries, regions, and countries. Some sectors, such as finance, media, and technology, are already heavily digitized, while others, such as healthcare, education, and manufacturing, are still catching up. As of August 2021, the Nigerian broadband penetration rate was 45.07 percent, up from 33.31 percent in 2019, according to the Nigerian Communications Commission (NCC). The projected broadband penetration rate in 2023 is 70 percent, hopefully, achievable by leveraging infrastructure development, spectrum optimization and investment incentives. All things being equal, increased broadband penetration should lead to higher tax earnings for the government because digital services and e-commerce transactions ideally are subject to various taxes. As more Nigerians use digital services and engage in e-commerce, the potential tax base for the government increases. Sadly, there is a significant mismatch between broadband penetration and the pace of e-commerce and tax earnings by governments in Nigeria. The digital economy permits massive business transactions without any physical presence making it more challenging for tax authorities to collect taxes due to such economic activities.

Selling products and services, communicating with customers, and conducting transactions through various online platforms and channels is the new entrepreneurial life. Online businesses leverage internet and digital technologies to reach a global audience, operate without the need for a physical presence, and provide convenient and accessible experiences for customers. They can range from small-scale ventures run by individuals or small teams to large multinational corporations. Examples include e-commerce, such as online retail stores that sell products directly to customers through websites or online marketplace operations; service-based businesses, such as consulting, web design, digital marketing, freelance writing, or online tutoring; affiliate marketing facilitating the earning of commissions by promoting and selling other companies' products or services; online advertising; dropshipping; subscription-based services like Netflix, Spotify, or membership sites offering access to premium content, software, or services on a subscription basis and online marketplaces. Online businesses often require a website, secure payment gateways, effective marketing strategies, and customer support systems to succeed in the digital marketplace.

Online businesses offer several advantages that contribute to their popularity and success. The capacity of e-businesses to access a global audience is their primary and most important advantage. With the internet as their platform, online businesses can transcend geographical boundaries and sell products or services to customers worldwide. The second is its constant availability. E-businesses typically operate round-the-clock. Websites and online platforms allow customers to browse and make purchases at any time that suits them, accommodating different time zones and customer preferences and enhancing convenience sales. Thirdly, running an e-business typically involves lower overhead costs compared to physical stores. There is no need for expenses related to renting or maintaining physical space, utility bills, or extensive inventory. Online businesses can often operate with smaller teams, reducing labour costs. This cost-effectiveness allows e-businesses to offer competitive prices and potentially higher profit margins. Fourth, e-businesses prioritise customer convenience by offering easy and quick access to products or services. Customers can use numerous devices, such as smartphones or tablets, to shop while at home or on the road. Fifth, online businesses can target specific customer segments more precisely through data-driven marketing strategies. With tools like search engine optimization (SEO), social media advertising, and targeted online campaigns, e-businesses can reach their ideal customers effectively and tailor their offerings to meet their needs. The sixth is that the government leverages these advantages in its launch of the cashless policy. Among other underlying benefits such as reducing the volume of cash in circulation, minimising the incidences of robbery and kidnapping, and facilitating financial intermediation and inclusion, is the minimization of revenue leakages and invariably the increase in internally generated revenue.

But non-tax compliance rates are very high in online businesses for many reasons. The first is that the rapid growth of online businesses outpaces the development of tax laws and fails to match the underlying complexity. For instance, it is very easy and indeed many online businesses operate in legal grey areas, which makes it challenging for governments to enforce tax compliance. The second is that the physical exchange of commodities and services over the internet is not generally characterised by distinct, fixed geographic lines of transit. Online businesses can operate across national borders, making it difficult for tax authorities to identify and track these businesses. Determining the tax liability of businesses with no physical presence in a particular country can be complex and require international cooperation. The contention that an employee never entered Nigeria might undercut the PAYE tax system, which is based on a physical approach or residency rule.

The third reason is the technological complexity associated with online businesses and digital platforms. Tax authorities in Nigeria, particularly at the subnational government level, may struggle to keep up with evolving technologies and adapt their tax collection methods accordingly. For instance, it might be difficult to keep track of the number of transactions that take place online and determine when and how much to tax people or businesses concerning transactions conducted through E-Trade or e-commerce. These technological complexities can make it easier for businesses to engage in tax planning strategies that minimise their tax obligations. The fourth reason is the limited resources and expertise available to most tax administrations at the state and local government levels. Tax authorities face resource constraints and a lack of specialised knowledge or tools to effectively monitor and assess the tax liabilities of online businesses. The constantly evolving nature of the digital economy requires ongoing training and technical expertise to navigate complex tax issues. The fifth is that the virtual nature of online transactions can make it easier for businesses to go unnoticed by tax authorities, reducing the likelihood of voluntary compliance. Profit-shifting tactics, which are fundamentally tax planning and not illegal, is a good example.

Many state government tax revenue sources easily affected by online transaction platforms include personal income tax, withholding tax, capital gains tax, and lottery and gaming taxes. Some or all of the underlying activities for these taxes are executable completely online and most of the challenges already mentioned apply to each of them. For instance, tax authorities will naturally face the challenges of obtaining accurate and comprehensive information about online business activities to enable their computations of personal income taxes. It is even worse when dealing with individual online transactions. Unlike traditional businesses that have reporting obligations to the state and local government tax administrations, online platforms and businesses may not always provide detailed data on their employees, service users, or transactions to tax authorities. Limited information sharing between online platforms and tax authorities can impede the effective collection of personal income taxes. Again, enforcing tax compliance in the online environment can be more difficult in an activity like lotteries and gaming than in its traditional form. Online platforms can easily change names, locations, or ownership structures, making it harder for tax authorities to track and enforce tax collection. Additionally, the global nature of the internet means that online operators can be based in jurisdictions with different tax laws, making it challenging to ensure consistent and effective enforcement.

Before the Finance Act of 2020, the Nigerian government tax authorities were largely hamstrung in taking reasonable advantage of the opportunities in huge and rapidly growing online transactions because the tax laws governing cross-border transactions stood on the permanent establishment concept. The concept of Permanent Establishment ensures that businesses conducting cross-border activities are subject to taxation in the jurisdictions where they generate profits and have a significant physical presence, thereby promoting fairness and preventing tax avoidance. It determines when a business activity in a foreign country creates a taxable presence for that business in that country and helps allocate taxing rights between different countries. However, the 2020 Finance Act replaced the idea of a permanent establishment with the idea of a significant economic presence. Significant Economic Presence (SEP) addresses the challenges posed by the digital economy. It recognizes that a business can have a SEP in a country without having a traditional physical presence, such as a Permanent Establishment, as defined under traditional tax rules. The SEP concept focuses on factors such as user participation, data collection, and digital engagement to determine whether a business has a significant economic presence in a particular country.

Given this litany of challenges, subnational governments must continuously find innovative ways of leveraging huge tax revenue opportunities in online businesses. Some of the steps it can take in this direction include sharing data with the Federal Inland Revenue Service. While many of these appear to be in place, more aggressive scanning, identification and tracking of online operations with a significant presence in some states and local governments is required. For instance, working with the joint tax board, subnational governments can track many online training, music streaming, and online content providers regardless of whether they are formally registered as firms or through collaborative individual coordination or not and determine which states and local governments can harvest their personal income and other taxes. Although some of these providers register their operations overseas, they carry out most of their production activities in-country. Adequate integration of national identity number [NIN], taxpayer identification number [TIN] and bank verification number databases will make it easier to track tax payments, albeit may still be challenging to discriminate against online-based transactions. Again, the introduction and adoption of e-accounting, e-match, e-audit, and e-assess among others will invariably make it easier for online business operators willing to comply to do so effortlessly. Overall, subnational government tax authorities need to aggressively build the capacity of their workforce in digital technologies and in conducting the assessment and collection through the same channels.

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