Kenya Revenue Authority

Tulipe Ushuru, Tujitegemee!

Taxing the Digital Economy in Kenya

Policy Brief

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International Relations & Diplomacy

Introduction

Imagine the number of Kenyans who connect to digital sources of news and information every day, search for information on Google, Facebook, Twitter including those who trend and their followers, how many are on WhatsApp. The new normal to meetings is no longer held in the expansive and executive boardrooms but on executive Skype, google chat, webinars, Zoom just to name a few. Many Kenyans are on LinkedIn, and with the lockdown and kids on extended Holidays, have subscribed to Netflix and other media streaming sites. The traditional taxi has been overtaken by take Uber trips, Wasili, Taxify etc.

Kenya has seen tremendous growth in ICT in the last few years. According to the Communication Authority of Kenya, mobile data subscriptions stood at 46.63 million users; number of mobile commerce transactions was 526.991 million; value of mobile commerce transactions was Kshs. 1.552 Trillion; broadband subscriptions were 20.9 million; and data/ internet subscriptions stood 42.204 million (Economic Survey 2018), during the quarter ending September, 2018. With the rising levels of internet penetration, the country has seen a rise in electronic commerce. In fact, the growth in mobile money transfer services has been aggregated at a total of Kshs. 2.027 Trillion between July to September, 2018. (CA,2018).

The need for more revenue to finance Kenya's development priorities has overtime put pressure on Kenya Revenue Authority (KRA) performance targets, making the institution rely on new mechanisms to 'get the money". As such, KRA has over time invested on technological interventions and data driven intelligence as a magic cocktail to mobilise revenue and expanded its tax base. KRA's spirited implementation of the Revenue Administration Reforms and Modernization Program (RARMP) in 2003 in both tax and customs operations, for instance, speaks to this ambition.

However, shrinkage of global markets and aggressive global integration facilitated by technological innovation has brought in a new challenge, which is at least common knowledge all-over the world – digital economy and digital taxation. Over the last ten years alone, online business and sales in Kenya has grown to worth of 390 billion shilling in 2018 up from 345 billion in 2017. This translates to 2.9 % of the Gross Domestic Product (GDP) under the watch of policy makers, but in a complex policy environment that still struggles to put in place mechanisms and determine how best to rake in revenue from a promising and lucrative sector. Kenya is determined to re-examine its domestic laws on taxation of cross border business to ensure alignment and guard its taxing rights of digital businesses. Mpesa a mobile money transfer platform synonymous with Kenya has facilitated both financial inclusion and made it convenient to transact business within and across borders. According to the Central Bank of Kenya (CBK), Sh3.98 Trillion was transferred on this platform in 2018 with the figure expected to rise in 2019. Statistics from the Kenya Bureau of Statistics (KNBS) further shows that the value of mobile commerce transactions was estimated at over 6 Trillion in 2018.

Kenya amended its tax laws; through Finance act of 2019 and 2020 to net digital businesses. . The laws seek address the gaps in Vat law and income Tax act with respect to taxation of digital economy. In these laws the digital service will include the supply of downloadable digital content, subscription-based media, software programs, supplies on online marketplaces, digital media content, data management services, search engine services, among others, and include any other supply as determined by the Commissioner hence covering digital space in totality and leaving everything to the discretion of the Commissioner Domestic Taxes. A major point to note in the regulation is the role of the supplier in B2B to B2C business models where the supplier must be registered for digital tax. In the laws the B2C will be registered to for VAT while B2B is already handled under reverse VAT mechanism.

The laws as amended are still not operational given that for VAT, in absence of a regulations which have not been published. On the Income tax, the Digital Service Tax will take effect in January 2021 owing to lack of regulations

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Introduction

The proposed regulations highlights that a non-resident person should be registered if:

1. In a B2C transaction the supplier is based outside Kenya and the recipient in Kenya; or
2. The supplier either conducts business in Kenya, or the place of supply is in Kenya, or the recipient is in Kenya, or the supplier has a business based/registered in Kenya, or the payment to the supplier originates from Kenya.

The key determinants for registration are therefore if the payment, place of supply or recipient is in Kenya. In the case of the place of supply this includes if the recipient of the supply, payment proxy or residence proxy are based in Kenya. The proxies include intermediaries who either facilitate supply of services, invoicing or collection of payments. This includes financial institutions, local representatives/offices, and agents, among others.

With growth of intangible businesses, Kenya is expected to collect revenues through taxation and grow its tax base. The digital economy – and subsequently digital tax – remains a fine and promising starting point, with a valid business case that Kenya will not afford to ignore. According to Strathmore Law Review (June 2019), the growth of the digital economy is characterised by an unparalleled reliance on intangibles, the massive use of data, and widespread adoption of multi-sided business models capturing value from externalities generated by free products, and the difficulty of determining the jurisdiction in which value creation occurs.

This has become a world phenomenon and global concern. There are also multinational companies (MNCs), which hide behind their corporate structures to transfer intangibles to tax havens or low tax jurisdictions, as such eroding the tax base. Tax administrations and governments, Kenya included, are expeditiously working to find solution to taxation of intangibles with rafts of proposals being discussed to achieve workable consensus.

This paper assesses Kenya's experience with digital taxation, and its engagement in international platforms to find a credible solution to utility of taxation of digital transactions to broaden the tax base. It proposes three recommendations for adoption and for learning by sister revenue agencies especially in Africa and the South. The recommendations find their genesis in Kenyan law, but with possible regional and international ramifications for international tax management.

International Efforts

Kenya has been part of the continental and global efforts in addressing digital taxation. Kenya's active membership at the the Africa Tax Administration Forum (ATAF) has placed the country and KRA (Competent Authority on tax matters) at the heart of the international digital economy and taxation debate. Kenya currently chairs ATAF's technical committee, which is instrumental in steering ATAF members' efforts in managing digital taxation.

The committee is critical and plays an advisory role at the Organization for Economic Co-operation and Development (OECD) on digital economy. It is through the committee's efforts at the OECD that challenges of Base Erosion and Profit Shifting (BEPS), BEPS Action 1 – Digital Economy, are attracting policy attention and measures aimed at bringing the expanding digital economy within the tax net.

Action 1 which calls for taxing the digital economy using a unified approach as opposed to the various country unilateral approaches which would lead to double taxation and hamper the growth of the digital economy.

Challenges & Prospects

In late May 2018, the Ugandan parliament passed legislation that introduced a tax on the use of the so-called Over The Top (OTT) social media platforms offering voice and messaging services.
As of 1st July, 2018, users were required to pay 200 shillings a day (about $0.05) to access any of the more than 60 such OTT platforms. This translates into about $1.5 a month and $19 a year, in a country where millions live on less than $1 a day.
The government says the measure will bring in much-needed revenue to turn the country into a middle-income one by 2020.

Al Jazeera News, 1st July, 2018

Organization for Economic Cooperation & Development (OECD)

Digital taxation action has brought with it some challenges. As noted by the UN Committee of Experts on International Cooperation in Tax Matters in 18th session sub-committee meeting held in New York April 23-26, 2019, one key challenge is the source jurisdiction and its inability to tax digital economy under physical criteria of the tax treaties. The traditional business models allowed jurisdictions to tax businesses under existing rules. However, with globalization buoyed by technological advancement, and absence of domestic legislation to tax new business models of digital economy that do not require physical presence, countries are losing significant amount of revenue.

As the effort to identify optimal solution gathers momentum, it must take into account avoidance of double taxation and make it simple for all to comply.

There is also a challenge in relation to application of international instruments. Most jurisdictions including Kenya designed their tax treaties around two models; The United Nations (UN) model and the Organization for Economic Cooperation and Development (OECD) model tax convention. These models should be reviewed in the context of the current conversation on digital taxation to streamline revenue administration.

For example, Article 5 on Permanent Establishment (PE) of the OECD model defines PE as fixed place of business and taxing rights is accorded the jurisdiction where income is derived. With the digital model of business, entities have economic presence without necessary having a physical presence. The BEPS Action 1 Report took cognisance of this issue as presenting critical challenges for international taxation and taxing rights from cross border activities.

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Challenges & Prospects

There have been different proposals to tackle these challenges by modifying the proposal on taxing rights by countries. Group of third world countries, for instance, have made proposals on businesses having Significant Economic Presence (SEP). The proposal states:

"a taxable presence in a country would be created when a non-resident enterprise has a significant economic presence on the basis of factors that are evidence of purposeful and sustained interaction with the economy of that country via technology and other automated means".

In doing so, the proposal considered factors such as revenue generated on a sustained basis from a jurisdiction, the user base and the associated data input, the volume of digital content collected through a digital platform from users and customers habitually resident in that country.

The other proposal is based on the principle of taxing profits in countries where value is created, calling for amendment of rules based on this principle. The user proposal relies on platforms such as social media and online marketing while marketing perspective applies to businesses that have significant marketing intangibles. Both perspectives agree that a business with a physical location outside of a market jurisdiction can be deemed to have an active presence or participation in that jurisdiction and generate value in that jurisdiction through its user or customer-related activities. In the case of Kenya, There are specific challenges in implementation of these the tax regimes, which include:

- Restrictive nature of physical presence provisions especially on definition of Permanent Establishment under section 2 of the Income Tax Act and the various Double tax treaties in determination of income taxable in Kenya.
- Challenge of collection of taxes from non-residents without a presence in Kenya especially for VAT cases as detailed under section 8(2) of the VAT Act 2013.
- The difficulty of defining the place of consumption also referred to as the destination principle in relation to VAT and other indirect taxes.
- Difficulty in having a list of the taxpayers which would enhance, identification of the services provided, resident or non-resident, the quantity of services provided in terms of money's worth/value and compliance level with the relevant tax laws.
- Difficulties in identifying and tracking online transactions due to inadequate access to data from online digital transactions.
- Non-disclosure and characterization of income earned.
- Lack of consensus on taxation of the digital economy at global levels.

Kenya's Proposal

Kenya has introduced a digital services tax payable at the time of the transfer of the payment for the service to the service provider at the rate of 1.5% of the gross transaction value. The tax will be chargeable on income from digital services accrued in or derived from Kenya through a digital market place. In respect of a resident person or a non-resident person with a permanent establishment in Kenya, the tax will represent an advance tax. Moreover, it seeks to empower the Commissioner of Income Taxes at the Kenya Revenue Authority to appoint agents for the purpose of collection and remittance of the digital services tax. In driving compliance, KRA seeks to work with the Communications Authority of Kenya (CA) to obtain transactions data by resident and foreign-based app developers doing business in Kenya.

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Kenya’s Proposal

Provision of online platforms for use by third parties is a taxable supply under the Value Added Tax (VAT) Act 2013. Businesses that generate more than Ksh5 million ($50,000) in annual sales are required to register for VAT obligations for supplies, in addition to corporate tax at 30 percent for resident companies and 37.5 percent for foreign entities.

Efforts to tax online platforms has however been criticized by a section of Kenyans and businesses, for lack of clarity of the income tax act and labelling the tax ‘archaic’ in nature. One of the issues raised is income accrued in Kenya and Kenya being source of payments. Some business entities have proposed for Kenya to borrow a leaf from the experience of France which imposed flat digital tax rate on activities of the companies trading online thereby defining when such income is subject to Kenyan tax.

The Small and Medium Size Enterprises (SMEs) see this attempt as one that will encourage flight from the sector and hamper growth of the sector owing to digital innovations reducing operational costs of running business from physical space. Other business sees this as double taxation particularly where VAT on supplies is concerned therefore stifling innovations.

According to Mukora A, et al, (2020) well thought-out international tax agreements may be the key to minimising the risk of endangering cross-border trade. That digital creatures lack defined territorial boundaries and are always evolving faster than the law. It is therefore important that the proposed law is in tandem with the existing VAT act and existing regulations.

Conclusion

OECD in BEPS Action 8 emphasizes need to establish consistent rules on international taxation in order to solidify international efforts in combating base erosion and profit shifting. Transfer pricing on intangibles is one of the components of the BEPS project. Action 8 also outlines definition, characterization, identification of intangibles and attribution of profits to entities.

The Kenyan tax regime has not fully exploited the value of its intangible trade - for example trademarks and copyrights. Further, the tax laws have not expanded beyond the traditional model of business based on physical location. The amendment of the laws to recognize the changing nature of businesses in an inter-connected world is a welcome idea. Legal framework must also be enhanced to tackle companies that set up elaborate governance structures to avoid taxes.

Based on the foregoing, the influence of digital economy cannot be overemphasized. Digital transactions transcend boundaries involving different race and nationalities. KRA will continuously invest in, the people, skills, technology and prioritize data-driven compliance to ensure effective digital taxation for expanded tax base. There is hope for positive revenue growth story as this takes effect.

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