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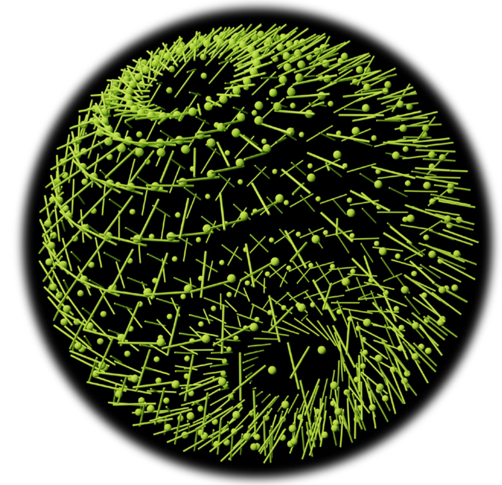
What are the key lessons on taxation of the digital marketplace?



In last year's Budget Speech of 13 June 2019, the (then) CS Treasury acknowledged that the challenges posed by the fast-evolving digital economy revolve around unparalleled reliance on intangibles, massive use of data, widespread adoption of multi-sided business models and the difficulty of determining the jurisdiction in which value creation occurs. Such challenges resulted in erosion of the country's tax base hence low tax revenue. To address the foregoing challenges, the CS proposed a number of tax measures aimed at taxation of income generated from the digital economy. The main purpose of DST is to expand the tax base by bringing the digital economy, which may not necessarily have a physical presence in the jurisdiction to the tax net. This is on the basis that resident persons and local branches of non-resident companies are taxed under the income tax regime in Kenya based on their presence in the country.

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It is important to note that charging tax on digital transactions was already broadly covered in the Kenyan income tax legislation. Under the Act, digital marketplace is defined as *"means a platform that enables the direct interaction between buyers and sellers of goods and services through electronic means"*. What is currently missing are regulations to ensure unambiguous administration of this tax.

The Finance Bill, 2020 proposes to introduce digital services tax (DST) payable on income, which is deemed to be derived from or accrued in Kenya through a digital marketplace at the rate of 1.5% of the gross transactional value. Based on the above definition of a digital marketplace, this would be expected to include the following non-exhaustive list of business models: online search engines, social media platforms, online intermediation platforms (including the operation of online marketplaces, irrespective of whether used by businesses or consumers), digital content streaming, online gaming, cloud computing services, and online advertising services.

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In the case of residents and non-residents with permanent establishments ("PE") in Kenya, the tax shall be available for offset against their income tax liability for the year. The proposed DST adopts an advance tax mechanism for resident entities and branches, which would negatively affect their cash flow flows given that such entities will have paid instalment taxes. In addition, it is likely to result to perpetual tax refunds especially for businesses with low profit margins or those that are in losses. This is because DST is based on gross transaction values, which needs to be further defined as transaction values could have various components.

The tax shall be due at the time of the transfer of the payment for the service to the service provider. In this regard, we foresee administrative challenges, which could increase complexity and uncertainty. Although the Commissioner may appoint third party processing intermediaries to withhold DST, the intermediaries may not have access to specific details of the underlying transactions especially on low value transactions. For certainty, the services covered should be clearly defined since the current definition is quite extensive and many businesses have some element of their services provided through electronic means.

From a VAT perspective, The VAT Act, 2013 endeavoured to tax certain digital transactions which are categorised as electronic services. The Finance Act 2019 empowered the CS to publish regulations to assist in implementing provisions relating to digital marketplace supplies. The draft regulations, which appear fairly comprehensive, were circulated for public participation in May 2020. This would be an opportune time for digital marketplace players to provide their input before the regulations are gazetted.

On the international scene, although there are ongoing discussions, there is still no consensus on how to tax the digital marketplace. The views of the Organisation of Economic Corporation and Development (OECD) on taxation of digitalized economy shed some light on the challenges of DST. Digital economy is characterised by extensive use of intangible assets and business to business (B2B) transactions in

various jurisdictions. An example is social networking platforms, which have many users across the world, creating a wealth of consumer data, used to provide paying customers with valuable data for marketing and advertising. It is therefore difficult to determine the jurisdiction where value is created which increases the risk of double taxation.

According to the OECD, the tax base can be determined by applying the global profit rate of the multinational group to the revenue (sales) generated in a particular jurisdiction. The tax base would be apportioned by taking into account factors such as sales, assets and employees. Such an approach contemplates that for those businesses for which users meaningfully contribute to the value creation process, users would also be taken into account in apportioning income. The approach requires collaboration between tax administrators on the possibility of sharing of information on transactions and data of the multinational. The EU Commission on the other hand proposes to tax the profits of the companies via the detour of gross revenues. Understood as direct tax, this approach taxes the gross income rather than the net income of the company. Under this option, companies with low profit margins (often start-up companies) or companies with losses would be affected severely if gross income would be chosen for the tax base. The EU adopts the term "value creation" by noting that the profits are not necessarily taxed in the country of the user (and viewer of the advert), but rather in the country where the advertising algorithms has been developed, for example.

During the **G20 Summit** of 2019, taxation of the digital economy including giant technology multinationals featured as a top agenda. These multinationals operate in virtual space rendering it cumbersome to bring them under the local tax radar. The revenue generated by leading players could be quite significant in some jurisdictions prompting a number of countries such as France, India, Italy, Hungary, Malaysia, etc. to take unilateral measures under their local tax laws to tap the revenues generated within their country.

In 2016 and 2018, **India** introduced provisions within its tax legislation requiring multinational companies to pay tax on domestic income accrued from a digital platform. The US, in reprisal, capped the number of non-domestic workers from India.

In 2019, **France** imposed a digital tax on the huge technology multinationals. This move was deemed by the US as a potentially unfair trade practice. In a span of two months upon introduction of this tax, US and France reached a concession. France opined that it would continue to tax the multinationals but abolish it immediately the Organisation for Economic Cooperation and Development (OECD) model is finalised.

Italy introduced digital service tax in 2019 under two conditions: firstly, the tech companies generating revenues from the digital services which involve user participation; and secondly, the taxable entities generates total worldwide revenues on their digital service not less than €750 million, with not less than €5.5 million of their revenue generated from Italy.

The **UK**, pending completion of the OECD model, introduced digital services tax on the revenues of giant tech companies providing internet search engines, social media platforms and online marketplaces to UK users. The US has also been forthright against the implementation of this tax considering that UK is a crucial market for US large tech companies. The implications post-Brexit atmosphere is yet to be seen.

Based on the above issues and trends, taxation of the digital marketplace is not likely to be a walk in the park for the Kenyan tax authorities. It is likely that implementation of the tax could prompt a trade war with some countries who may view it as unfairly targeting their corporates. It hoped that consensus will be reached on the international guidelines for taxation of the digital economy, due for release by OECD in 2020 to avert some of the disputes.

In the meantime, the National Treasury would do well to take into account stakeholder input to ensure that the Kenyan legislation and regulations for taxation of the digital marketplace are more specific and practical to make it easier to implement.

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