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Digital Taxation in Kenya

Charting Pathways towards Fair, Inclusive and Sustainable Policy Reforms

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Executive Summary

To ensure that digital businesses contribute equitably to public revenue and support economic growth, Kenya has in recent years, implemented a range of direct and indirect digital taxes. Among these is the Digital Services Tax (DST), introduced in 2021, which levies a 1.5% tax on the gross transaction value of digital services rendered within Kenya.

Taxes are essential for governments to effectively and predictably mobilize the revenue required to fund public expenditures and deliver essential services. However, the rapid digitalization of economies has exposed the shortcomings of century-old international tax frameworks, underscoring the urgent need for new rules that are better suited to the modern digital age.

With the digital economy becoming an integral part of the global economic landscape, extensive discussions have taken place for over a decade at both national and international levels regarding the taxation of digital activities. Despite these discussions, progress towards a comprehensive global solution has been slow and complicated, prompting a number of countries to introduce unilateral taxes targeting big technology companies such as Alphabet, Meta, Netflix and Amazon, which are accused of not paying their fair share of taxes in the jurisdictions where their revenue is derived.

Kenya, along with other countries, has taken various measures aimed at raising revenue from its rapidly growing digital economy. To ensure that digital businesses contribute equitably to public revenue and support economic growth, Kenya has in recent years, implemented a range of direct and indirect digital taxes. Among these is the Digital Services Tax (DST), introduced in 2021, which

levies a 1.5% tax on the gross transaction value of digital services rendered within Kenya.

Additionally, a Value Added Tax (VAT) on Digital Marketplace Supply was established to capture taxes from online sales and services. In 2023, additional taxes in the form of a digital assets tax (DAT) and withholding tax (WHT) on content creators were introduced.

Further to these taxes, the contentious Kenya Finance Bill, 2024 had proposed three additional taxes: the Significant Economic Presence (SEP) tax, excise tax, and expansion of the withholding tax (WHT). However, due to widespread protests across the country rejecting the proposed tax hikes, the Bill was withdrawn.

Still, the implications of these tax measures on businesses and the broader economy are substantial, necessitating careful consideration of their potential impact on growth and development.

The introduction of various digital taxes in Kenya is motivated by several key factors. First and foremost, the primary driver is the urgent need for revenue generation by the government to meet its obligations. Given the country's significant debt burden, digital taxation presents a new and potentially substantial source of funding for the government.

Additionally, these taxes are designed to ensure that digital businesses contribute their fair share to the tax base, thereby promoting equity within the tax system. Moreover, implementing digital taxes could enhance the country's economic sovereignty by providing greater control over its economic resources and digital infrastructure.

Finally, adapting the country's tax system to align with the rapid growth of the digital economy is crucial, as it ensures that taxation mechanisms evolve in tandem with technological advancements.

Nevertheless, Kenya is still confronted with the challenge of effectively taxing digital economic activities. To start with, establishing a taxable presence (i.e. nexus) for digital businesses is difficult as digitalisation allows companies to engage in significant business activities without meeting a criteria for a permanent establishment in the country.

Second, characterizing the nature of digital transactions as well as income for tax purposes can be challenging, as existing tax rules and regulation may not adequately address the unique features of the digital economy.

Third, ensuring taxpayer compliance can be time-consuming, complicated and costly, hence making it difficult for the revenue authority to enforce.

Fourth, administration of digital taxes is

made difficult owing to insufficient technical expertise, inadequate digital infrastructure, and limited resources for enforcement.

Fifth, the high tax uncertainty creates ambiguity for businesses and makes it difficult for them to make informed decisions regarding compliance, expected liabilities, as well as long-term planning.

Sixth, the challenge of accessing user data, combined with the intricacies involved in accurately valuing and attributing data for tax purposes, introduces an additional layer of complexity.

These challenges make it difficult for the government to effectively tax digital activities without causing distortions in the economy. Like other forms of taxation, digital taxation has significant implications for various stakeholders and the broader economy. For businesses operating in multiple jurisdictions, these taxes increase the risk of double taxation, potentially reducing profitability and undermining the perceived fairness and stability of the tax system.

Moreover, digital taxes may increase the cost of doing business in the country, which could adversely affect investment decisions and the overall business environment, potentially stifling digital innovation and growth. For the government, the unilateral digital taxes increase the administrative burden, requiring additional resources to manage compliance and enforcement. Furthermore, they risk provoking trade disputes with other countries whose businesses operating internationally may face conflicting tax obligations.

In addition, they can undermine fiscal sustainability by creating an unstable revenue base, leading to unpredictable funding for public services. More importantly, these actions can erode public trust in government, as citizens may perceive unilateral tax measures as unfair or as a sign of ineffective governance.

For consumers, there is a potential for increased prices as businesses may pass on the tax burden, affecting the affordability and accessibility of various goods and services. This potential increase in costs for consumers could hinder the widespread adoption of digital services, which are essential for economic modernization and inclusion.

Furthermore, taxpayers are likely to evade paying the digital taxes, leading to lower voluntary compliance and higher costs for tax enforcement.

CONCLUSION

In conclusion, the study offers five recommendations aimed at creating a fair, inclusive, and sustainable digital taxation landscape in Kenya:

1. Enhancing taxpayers' trust through transparency in policy making.
2. Simplifying Digital Taxation for Efficiency and Compliance.
3. Promoting Inclusivity in Digital Tax Policymaking through a Multistakeholder Approach.
4. Balancing Innovation and Taxation for Fiscal Sustainability.
5. Promoting Fairness in Kenya's Digital Tax Regime.

Implementing these recommendations could help the country develop a digital taxation framework that not only meets its short-term revenue needs but also supports sustainable economic growth and development in the long term, ultimately benefiting the nation as a whole.

Abbreviations and Acronyms

ATAF	–	African Tax Administration Forum
BEPS	–	Base Erosion and Profit Shifting
B2C	–	Business-to-Consumer
DAT	–	Digital Assets Tax
DMST	–	Digital Market Supply Tax
DST	–	Digital Services Tax
E-Commerce	–	Electronic Commerce
EAC	–	East African Community
EU	–	European Union
GDP	–	Gross Domestic Product
GST	–	Goods and Services Tax
MLC	–	Multilateral Convention
MNEs	–	Multinational Enterprises
MTRS	–	Medium Term Revenue Strategy
ITA	–	Income Tax Act
IMF	–	International Monetary Fund
IP	–	Intellectual Property
KICTANet	–	Kenya ICT Action Network Trust

KRA	–	Kenya Revenue Authority
NFTs	–	Non-Fungible Tokens
OECD	–	Organization for Economic Co-operation and Development
PE	–	Permanent Establishment
SMEs	–	Small and Medium Enterprises
SEPT	–	Significant Economic Presence Tax
TFDE	–	Task Force on the Digital Economy
UN	–	United Nations
US	–	United States
USTR	–	United States Trade Representative
VAT	–	Value Added Tax
VAT-DMS	–	VAT on Digital Market Supply
WHT	–	Withholding Tax
WTO	–	World Trade Organization

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1.0 Introduction to Digital Taxation

The digital economy encompasses a wide range of activities, including e-commerce, online services, digital platforms, and the use of emerging technologies such as big data and artificial intelligence. These digital activities integrate seamlessly with traditional economic sectors, driving productivity gains and creating new avenues for value creation.

1.1 Overview of the Digital Economy

The digital economy has experienced remarkable growth since the commercialization and widespread adoption of the internet in the 1990s,[1] and thus significantly transformed the global economic landscape, ushering in numerous opportunities for growth, innovation, and increased economic efficiency across different sectors.

While there is no universally accepted definition of the term "digital economy," Bukht and Heeks describe it as "that part of economic output derived solely or primarily from digital technologies with a business model based on digital goods or services."[2]

Going by this definition, the digital economy encompasses a wide range of activities, including e-commerce, online services, digital platforms, and the use of emerging technologies such as big data and artificial intelligence.[3] These digital activities integrate seamlessly with traditional economic sectors, driving productivity gains and creating new avenues for value creation.[4]

The Organization for Economic Co-operation and Development (OECD)'s Task Force on the Digital Economy (TFDE) has identified three key characteristics that define the digital economy:

- The ability to achieve significant scale "without any significant physical presence,"
- The importance of intellectual property (IP) and intangible assets, and
- The important role of data and user participation in value creation.

1. Manel Bondi, Digital Taxation: A Comparative Study Between the OECD & UN Proposals (Riyadh: Digital http://www.gdi.manchester.ac.uk/research/publications/working-papers/di/
2. Rumana Bukht and Richard Heeks, "Defining, Conceptualising and Measuring the Digital Economy," Working Paper Series, no. 68. (2017): 13, accessed May 25, 2024, http://www.gdi.manchester.ac.uk/research/publications/work ing-papers/di/
3. Ibid.
4. Organisation for Economic Co-operation and Development (OECD), Tax Challenges Arising from Digitalis, https://doi.org/10.1787/9789264293083-en.

Furthermore, the digital economy often operates through multi-sided platforms, where value is generated from network effects and externalities associated with free or subsidised products.[5]

These distinct features have enabled the rise of digital companies with diverse business models such as content platforms like Facebook and YouTube, platforms trading tangible goods such as Amazon, eBay and Alibaba, as well as sharing economy firms such as Airbnb and Uber. [6] These platforms leverage innovative technologies to connect multiple user groups, thereby creating ecosystems that enhance user engagement, facilitate transactions and enable interactions that generate value and drive economic activity across different sectors.

While the digital economy has brought many benefits to citizens and companies, the emergence of disruptive digital activities and novel business models has become a growing challenge for existing taxation systems in many countries.

[7] These challenges include how to redefine rules for businesses operating without physical presence in the tax jurisdictions where their commercial activities are carried out ("Nexus" rules), methods for identifying and valuing how user data and activities contribute to the multinational enterprises' (MNE's) profits and determining the relevant share of the company's profits that will be subject to tax in a given jurisdiction (the "profit allocation" rules), and classifying profits from intangible/digital assets and transactions .("Characterization" rules). [8]

Figure 1: Challenges to Taxation Systems brought about by Digitalisation

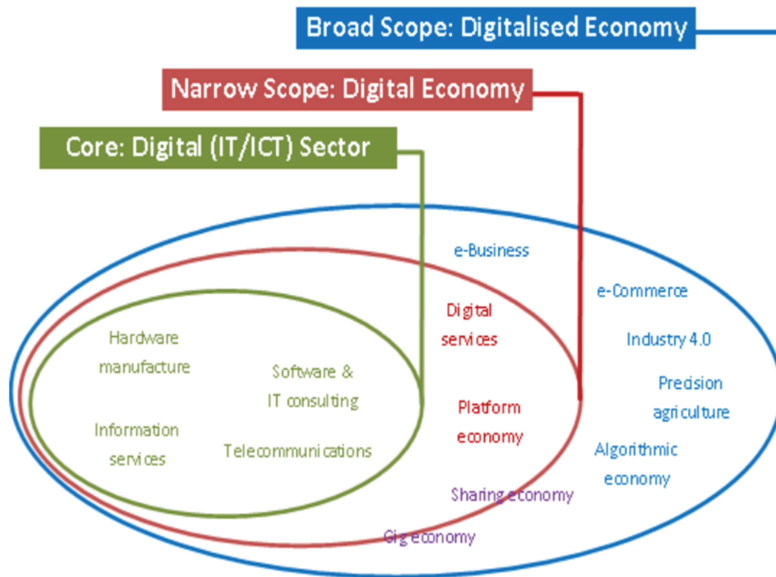
Challenges related to Nexus	How to redefine rules for businesses operating without physical presence in the tax jurisdictions where their commercial activities are carried out
Challenges related to Profit Allocation	Methods for identifying and valuing how user data and activities contribute to the multinational enterprises' (MNE's) profits and determining the relevant share of the company's profits that will be subject to tax in a given jurisdiction
Challenges related to Characterization	How to classify profits from intangible/ digital assets and transactions.

Source: Bondi, 2022

These complex challenges arising from the rapid digitalization of economies have made obvious the inadequacy of century-old international tax rules to address the needs of today's global economy, highlighting the need to develop new rules that are adapted to the evolving digital environment. [9]

5. OECD, "Introduction to Tax Challenges of the Digital Economy," in Addressing the Tax Challenges of the Digital Economy (2014), accessed May 14, 2024, https://www.oecd-ilibrary.org/introduction-to-tax-challenges-of-the-dig ital-economy_5jxv8zhcgrzOrganisation for Economic Co-operation and Development (OECD), Tax Challenges Arising from Digitalisation –Interim Report 2018: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, paras. 32–35 (Paris: OECD Publishing, 2018), httpsp.pdf.
6. Bukht and Heeks, "Defining, Conceptualising and Measuring the Digital Economy," 12-13. 7. OECD, Addressing the Tax Challenges of the Digital Economy: Action 1 – 2015 Final Report (Paris: OECD Publishing, 2015), 6, accessed May 14, 2024, https://www.oecd.org/tax/Addressing-the-Tax-Challenges-of-the-Digital-Economy-Action-1-2015-Final-Report
7. OECD, Addressing the Tax Challenges of the Digital Economy: Action 1 – 2015 Final Report (Paris: OECD Publishing, 2015), 6, accessed May 14, 2024, https://www.oecd.org/tax/Addressing-the-Tax-Challenges-of-the-Digital-Economy-Action-1- 2015-Final-Report.
8. Manel Bondi, Digital Taxation: A Comparative Study Between the OECD & UN Proposals (Riyadh: Digital Cooperation Organization, 2022), https://dco.org/wp-content/uploads/2022/08/Digital-Taxation-White-Paper-3.pdf
9. Ibid.

Figure 2: Scoping the Digital Economy



Source: Bukht & Heeks (2017) [11]

1.2 Taxing the Digital Economy

In response, countries around the world have attempted to address the taxation challenges posed by digitalization in a variety of ways.[10]

At the multilateral level, one key initiative aimed at reforming the international tax system is the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS), which resulted in an agreement in June 2021 on a two-pillar approach. Pillar One involves revised profit allocation and nexus rules, while Pillar Two introduces a global minimum tax.[12]

Emerging from the OECD/G20 Inclusive Framework BEPS negotiations in 2023, the Multilateral Convention to Implement Amount A of Pillar One (the MLC) represents a significant step towards addressing the tax challenges posed by the digitalization of the global economy. The MLC is part of global efforts to modernise international tax rules, ensuring that large and highly profitable MNEs pay a fair share of taxes in jurisdictions where they generate significant revenues, regardless of their physical presence.

10. Bid

11. Bukht and Heeks, "Defining, Conceptualising and Measuring the Digital Economy."

Patrick Marley, Peter Macdonald, and Taylor Cao, "136 Countries Agree to OECD/G20 Inclusive Framework's Two-Pillar Solution to International Tax Reform," Osler, October 12, 2021, https://www.osler.com/en/insights/updates/136-countries-agree-to-oecd-g20-inclusive-framework-s-two-pillar-solution-to-international-tax-refor/.

The MLC co-ordinates a reallocation of taxing rights to market jurisdictions with respect to a share of the profits of the largest and most profitable multinational enterprises operating in their markets. This reallocation aims to reflect the value created by these companies in different markets more accurately. By doing so, the MLC seeks to improve tax certainty, reduce disputes, and promote fairness in the international tax system, while also eliminating the need for unilateral digital services taxes, fostering a more coordinated global approach.[13]

The Multilateral Convention to Implement Amount A of Pillar One (the MLC) represents a significant step towards addressing the tax challenges posed by the digitalization of the global economy.

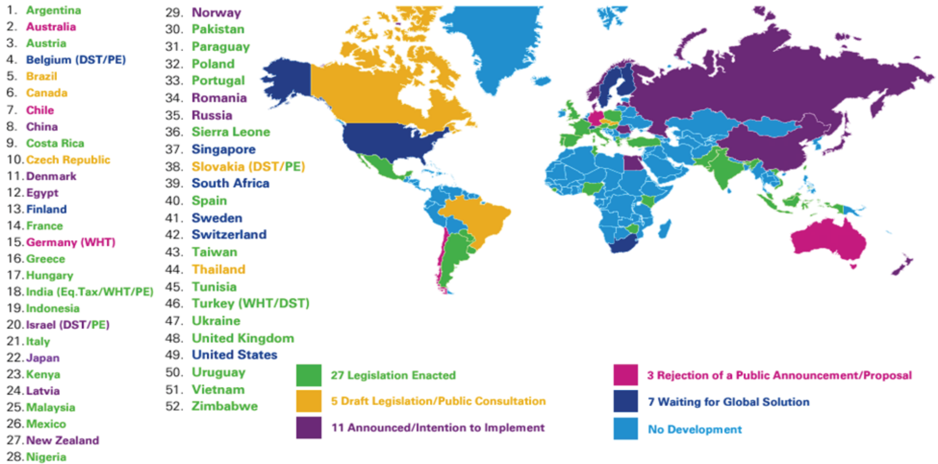
Owing to the initial lack of multilateral consensus coupled with the slow and complicated process involved in ratifying of the MLC by countries, various jurisdictions have resorted to introducing unilateral rules targeting digital companies as well as unilateral and multilateral rules redefining traditional tax concepts.[14] These unilateral tax measures include:

- Alternative applications of the permanent establishment (PE) threshold;
- Withholding taxes;
- Turnover tawxes;
- Regimes to deal with large MNEs.[15]

These tax measures and tax proposals targeting the digital economy often disregard traditional tax theory principles, which emphasize neutrality, efficiency, and fairness in tax policy design and administration.The unilateral measures can lead to double taxation, increased administrative burdens, and trade disputes, complicating the international tax landscape. This underscores the urgency of a coordinated, global approach to the taxation of the digital economy as proposed under the MLC.[16]

13. "OECD, Multilateral Convention to Implement Amount A of Pillar One (October 2023), accessed May 14, 2024, https://www.oecd.org/en/topics/sub-issues/reallocation-of-taxing-rights-to-market-jurisdictions/multilateral-convention-to-implement-amount-a-of-pillar-one.html
14. "Lilian Faulhaber, "Taxing Tech: The Future of Digital Taxation," Virginia Tax Review 39, no. (2019): 145–96.
15. OECD, "Tax Challenges Arising from Digitalisation – Interim Report 2018," 32–35.
16. Cristian Óliver Lucas-Mas and Raúl Félix Junquera-Varela, Tax Theory Applied to the Digital Economy: A Proposal for a Digital Data Tax and a Global Internet Tax Agency (Washington, DC: The World Bank, 2021). Lilian Faulhaber, "Taxing Tech: The Future of Digital Taxation," Virginia Tax Review 39, no. 2 (2019): 145–96

Figure 3: Direct Taxes Global Map



Source: KPMG (2022)[17]

With digital services trade currently the fastest-growing segment of international trade, digital taxation has become a major discussion point within the World Trade Organization (WTO) e-commerce negotiations. Of particular concern is the moratorium on customs duties on electronic transmissions, which has been periodically extended since its introduction in 1998. The moratorium prohibits tariffs on digital imports, thereby contributing to a stable and predictable policy environment for digital trade.[18]

A much-debated point in discussions revolves around the fiscal implications of the quarter-century old agreement, as some countries fear that the current rules could hurt their revenue potential and constrain their policy space.[19]

A number of countries want the WTO to terminate the moratorium, arguing that it limits their ability to generate revenue from the digital economy, as they cannot impose customs duties on electronically transmitted goods and services. This concern is particularly pronounced in developing countries, which may rely more heavily on customs duties as a revenue source.[20]

17. KPMG, Taxation of the Digitalized Economy – LATAM Focus: Developments Summary, February 3, 2022, 5, https://assets.kpmg.com/content/dam/kpmg/xx/pdf/2020/08/taxation-of-the-digitalized-economy-latam.pdf

18 Michele Ruta and Adam Jakubik, "Why Digital Trade Should Remain Open," IMF Blog, December 13, 2023, https://www.imf.org/en/Blogs/Articles/2023/12/13/why-digital-trade-should-remain-open

19. Ibid.

20. Nana Ama Sarfo, "A Guide to the WTO E-Commerce Moratorium Debate," Tax Notes, March 4, 2024, https://www.taxnotes.com/featured-analysis/guide-wto-e-commerce-moratorium-debate/2024/03/01/7j877.

Likewise, tax authorities across Africa are increasingly recognizing the impact of the burgeoning digital economy on their fiscal landscapes in the form of foregone tax revenues. To mitigate against this, several countries are actively seeking to adapt their tax policies to capture these revenues.[21] However, African countries, like other nations across the globe, find that with the consistent revenue loss, they are left with very limited options given the delay in the consensus-based global solution to addressing tax challenges arising from digitalisation.[22]

Tax authorities across Africa are increasingly recognizing the impact of the burgeoning digital economy on their fiscal landscapes in the form of foregone tax revenues. To mitigate against this, several countries are actively seeking to adapt their tax policies to capture these revenues.

To help support these efforts, the African Tax Administration Forum (ATAF) on 30 September 2020 released its Suggested Approach to Drafting Digital Services Tax Legislation. It proposes a rate between 1 and 3 percent on gross annual digital services revenue earned by a company or multinational enterprise (MNE) in a country.[23] This rate is designed to be balanced - high enough to generate significant revenue, but low enough to avoid discouraging digital business activities, particularly for start-ups and small and medium enterprises (SMEs). The ATAF's guidelines provide a structured approach for countries to draft and implement DSTs, addressing key issues such as the definition of taxable digital services, the determination of tax liability, and compliance requirements.[24]

For Kenya, which has limited sources of non-tax revenues, the prospect of increasing revenues by levying taxes on its growing digital sector seems like an easy way to broaden the tax base and grow its tax revenue.[25] Consequently, the country has amended its tax laws, allowing it to levy various direct and indirect taxes while proposing new ones.[26]However, its approach to taxing the digital economy has been met with substantial criticism and challenges. Multinational corporations are particularly concerned about the lack of predictability, complexity of compliance and the potential for double taxation.There are also concerns that these taxes could stifle innovation, deter foreign investment, and slow the growth of the digital sector.[27]

21. PWC, VAT in Africa: Digital Services (2024): 2, accessed June 15, 2024, https://www.pwc.co.za/en/assets/pdf/vat-and-digital-services-in-africa.pdf.
22. African Tax Administration Forum (ATAF), "ATAF Publishes an Approach to Taxing the Digital Economy,"October 1, 2020, https://www.ataftax.org/ataf-publishes-an-approach-to-taxing-the-digital-economy.
23. ATAF, Suggested Approach to Drafting Digital Services Tax Legislation, (September 30, 2020), accessed May 28, 2024, https://events.ataftax.org/index.php?page=documents&func=view&document_id=79.
24. Ibid.
25. Catherine Ngina Mutava and Bernadette Wanjala, Taxing for a More Equal Kenya (Nairobi: Oxfam, 2017), v, accessed May 23, 2024, DOI: 10.21201/2017.1190.
26. Kenya Revenue Authority (KRA), Taxing the Digital Economy in Kenya, September 2020, accessed May 28, 2024, https://www.kra.go.ke/images/publications/Policy-Brief---Taxing-the-Digital-Economy-in-Kenya.pdf.
27. Dominic Omondi, "MPs Hand Multinational Tech Firms Tax Reprieve in Changes," Business Daily, June 19, 2024, https://www. businessdailyafrica.com/bd/economy/mps-hand-multinational-tech-firms-tax-reprieve-in-changes--4662324

Additionally, Kenya's unilateral implementation of digital taxes, amidst ongoing global discussions on taxation frameworks, raises risks of international trade disputes and retaliatory measures. Despite coming under pressure to drop its digital tax, Kenya is reluctant to adopt the OECD's global minimum corporate tax, preferring to retain its digital tax due to strained state finances and the need to preserve revenue. [28]

As the digital economy continues to evolve, it is crucial for governments, businesses, individuals, and other tax stakeholders in Kenya and beyond to understand the nature and scope of digital taxation in Kenya. Further, they need to recognize how it will impact their tax systems and identify the adaptive measures they need to take to minimize its disruptive impact.

Accordingly, this study provides a critical examination of the country's current digital taxation landscape, explaining the rationale behind the various digital tax measures, the obstacles encountered in their implementation, and the potential impact on various stakeholders, while offering suggestions for maximizing domestic resource mobilization.

1.3 Methodology

This study employed a mixed-methods approach, combining insights from a half-day workshop with extensive desk research. The workshop, held on 29 May 2024, in Nairobi, Kenya, gathered key stakeholders and experts to provide valuable input on digital taxation in Kenya.

These diverse perspectives and contributions were meticulously documented through detailed notes and recordings. To complement the workshop findings, desk research was conducted, involving an extensive review of relevant literature, reports, and data. The desk research allowed for a broad examination of existing knowledge and practices related to digital taxation, providing a solid foundation for the analysis.

The integration of these two approaches—practical insights from the workshop and theoretical knowledge from desk research—enabled a well-rounded and robust analysis. This mixed-methods approach also facilitated the development of informed conclusions and actionable recommendations in this report.

Moreover, the approach demonstrates the commitment to evidence-based policymaking and the incorporation of diverse stakeholder perspectives in addressing the challenges, opportunities and prospects related to digital taxation in Kenya.

1.4 Organization of the Study

The paper is organised as follows:

- **Section one** introduces digital taxation, providing an overview of global efforts to tax the digital economy;
- **Section two** reviews and analyses the

28. Africa Intelligence, "Nairobi Still Reluctant to Sign Up to OECD Global Minimum Corporate Tax," April 9, 2024,accessed May 15, 2024, https://www.africaintelligence.com/eastern-africa-and-the-horn/2024/04/09/nairobi-still-reluctant-to-sign-up-to-oecd-global-minimum-corporate-tax,110202482-gra

applicable and proposed digital taxes in Kenya;

- **Section three** discusses the rationale for taxing the digital economy;
- **Section four** address the specific challenges faced in implementing digital taxation in Kenya;
- **Section five** the distortive impact of digital taxation; Section six offers concluding thoughts and makes crucial recommendations aimed at strengthening Kenya's digital tax framework.

2.0 Digital Taxation in Kenya

2.1 Overview of Digital Taxes

Digital taxes refer to policies that specifically target revenues from businesses which provide products or services through digital means using a special tax rate or tax base. These taxes are tailored to address challenges arising from the digital economy's unique characteristics, where businesses can generate significant income without physical operations in a country.

The goal of digital taxation is to ensure fair allocation and taxation of profits where economic activities and value creation occur.

The goal of digital taxation is to ensure fair allocation and taxation of profits where economic activities and value creation occur. This includes transactions, services, and business models conducted primarily online, such as e-commerce, digital advertising, cloud services, streaming platforms, and monetization of user data. With governments and revenue authorities wrestling with how the digital economy affects their tax bases and tax administration efficiency, [29] digital taxation offers governments new opportunities to boost tax revenues and create fiscal space.[30]

Taxes on the digital economy can take a variety of forms. Some are as simple as consumption taxes on internet purchases or service subscriptions, while others that aim to assess profitability and separate digital companies from other parts of the economy are more complicated. [31] Added to this are the presumptive taxes that aim to capture revenue or turnover generated by digital service providers. These digital tax measures can be broadly organised into three main categories as illustrated in Table 1.

29. Chris Evans et al., "Introduction: New Frontiers for Tax in the Digital Age," in Taxation in the Digital Economy: NewModels in Asia and the Pacific, eds. Nella Hendriyetty, Chris Evans, Chul Ju Kim, and Farhad Taghizadeh-Hesary (Manila: Asian Development Bank Institute; New York: Routledge, 2023), 1–18. DOI: 10.4324/9781003196020-1.
30. Lucas-Mas and Junquera-Varela, "Tax Theory Applied to the Digital Economy: A Proposal for a Digital Data Tax and a Global Internet Tax Agency," ix.
31. Rebecca Christie, "Taxing Tech: Digital Services Taxes Take Shape in the Shadow of the Pandemic," Finance and Development 58, no. 1 (March 2021): 54-57, Washington, DC: International Monetary Fund, https://www.imf.org/external/pubs/ft/fandd/2021/03/pdf/taxing-big-tech-and-the-future-of-digital-services- tax-christie.pdf.

Table 1: Types of Digital Taxes

CATEGORY	TYPE OF TAX	EXAMPLES	PURPOSE
Turnover Taxes	Digital Market Supply Tax (DMST)	• India's Equalization Levy (2%)	Taxation of a broad range of Didital transactions (goods, services, content)
	Digital Services Tax (DST)	• Europe/ France's DST (3%) • Canada's DST (3%) • Kenya's DST (1.5%)	Taxation of revenue accrued from providing dig, Service/ Marketplace
Consumption Taxes	Value Added Taxes (VAT)	• EU'S VAT on digital products (*) • India's GST Tax (18%) • Kenya's VAT on dig, suppl (16%)	Taxation of products/supplies offered through a digital platform/marketplace
	Excise Duty	• Kenya's Proposed Excise Tax • (* rate not clear yet)*	Duty on digital services offered by non-resident firms
Income Taxes	Significant Economic presence Tax (SEPT)	• Nigeria's SEPT • Kenya's Proposed SEPT (3%)*	Taxation based on the level of economic engagement even in the absence of physical presence
	Withholding Tax (WHT)	• India's WHT (1%) • Kenya's Proposed WHT: 5% • (resident persons) or 20% (non-resident)*	Tax payments for income that is accrued by foreign Digital Marketplace/Platform Owners
	Data and Cloud Service Tax	• Proposed in some jurisdictions	Tax revenue from the collection and monetization of user data

Source: Researcher's Own Compilation (2024) [32]

To ensure that digital businesses contribute their fair share to the public coffers and support economic growth and development, Kenya levies several direct and indirect digital taxes. It is also considering additional ones for the future. The following section discusses these digital taxes in more detail.

2.2 Current Taxes on the Digital Economy

In 2020, Kenya introduced two types of taxes targeting the digital economy, namely: the digital services tax (DST), a direct tax; and, the value-added tax (VAT) on Digital Marketplace Supply, an indirect tax. [33] In 2023, two additional taxes in the form of a digital assets tax (DAT) and withholding tax (WHT) on content creators were introduced. These four taxes are discussed in the following section.

2.2.1 Digital Services Tax

Digital services tax (DST) is a type of presumptive tax imposed on the gross revenues of large multinational companies that own digital platforms providing goods or services online and amassing hundreds of millions of dollars in global revenues.[34]The tax is payable by both residents and non-residents who are either digital service providers or digital marketplace providers.

32. Some of the proposed taxes were in the rejected Kenya Finance Bill 2024 and will therefore not be introduced inthe current financial year.
33. Obed Nyambego et al., "Kenya Introduces Taxes for the Digital Economy," PWC, January 2021, accessed May 15, 2024, https://www.pwc.com/ke/en/assets/pdf/kenya-introduces-taxes-for-the-digital-economy.pdf
34. Obed Nyambego et al., "Kenya Introduces Taxes for the Digital Economy," PWC, January 2021, accessed May 15,2024, https://www.pwc.com/ke/en/assets/pdf/kenya-introduces-taxes-for-the-digital-economy.pdf

DSTs have been unilaterally imposed as a temporary measure by countries seeking to tax the digital service activities of the world's tech giants for business activity generated within their borders, even in cases where the company's headquarters, employees, or assets are not located within the country.[35] They apply only to a limited scope of user-related and platform-based digital businesses such as social media platforms, search engines, and online marketplaces.[36]

However, they have been criticised as discriminatory towards U.S. tech giants, and there have been calls for their removal in exchange for a globally negotiated unified solution.[37] Several countries have pledged to eliminate unilateral DSTs if an international consensus on digital tax reforms is reached, underscoring the urgency of a coordinated, global approach to the taxation of the digital economy.

The MLC and Pillar One represent significant steps towards achieving this goal, aiming to create a fairer and more stable tax environment. However, reaching this consensus requires overcoming substantial political, legal, and administrative challenges. The successful implementation of the MLC would mark a major milestone in international tax cooperation, fostering a more equitable global tax system and reducing economic friction between nations.

In Kenya, DST is imposed on income accrued by digital service providers from the supply of goods and services through a digital platform or marketplace to customers located within the country. This includes services offered via the Internet, electronic networks, applications, or websites. The DST was introduced by the Finance Act of 2020 and became effective on the 1st January 2021. [38]

DST is taxed at the rate of 1.5 per cent of the gross transaction value of the payment to the service provider. For residents and companies with a permanent establishment in Kenya, it is an advance tax offset against income taxes. For non-residents and companies without a permanent establishment, it is a final tax.[39] Collection of DST is aimed at ensuring a level playing field for Kenyan digital service providers, expanding the tax base and increasing tax collection.[40]

35. Raymond Onuoha and Alison Gillwald, "Digital Taxation: Can It Contribute to More Just Resource Mobilisation in Post-Pandemic Reconstruction?" Digital New Deal for Africa Series, policy paper 2 (January 2022): 1-24, Cape Town: Research ICT Africa, accessed May 29, 2024, https://researchictafrica.net/wp/wp-content/uploads/2022/02/Digital-Taxation-can-it-contribute-to-more-just-resource-mobilisation-in-post-pandemic-reconstruction.pdf

35. Riley Stotzky and Arianna Fano, "Taxation in the Digital Economy: Digital Services Taxes, Pillar One, and the Path Forward," Bipartisan Policy Center, October 26, 2023, accessed June 2, 2024, https://bipartisanpolicy.org/blog/taxation-in-the-digital-economy-digital-services-taxes-pillar-one-and-the-path-forward/

36. Young Ran (Christine) Kim, "Digital Services Tax: A Cross-Border Variation of the Consumption Tax Debate," Alabama Law Review 72 (2020): 131, University of Utah College of Law Research Paper No. 371, March 30, 2020, at SSRN: https://ssrn.com/abstract=3578348.

37. United Nations Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, Report on the Twenty-Second Session, (virtual session, 19–28 April 2021), accessed May 15, 2024, https://documents.un.org/doc/undoc/gen/n21/135/59/pdf/n2113559.pdf?token=qnaTce7Nu16qGTewD

38. KRA, Taxing the Digital Economy in Kenya (Policy Brief, September 2020), 3, accessed May 19, 2024, https://www.kra.go.ke/images/publications/Policy-Brief---Taxing-the-Digital-Economy-in-Kenya.pdfd&fe=trues

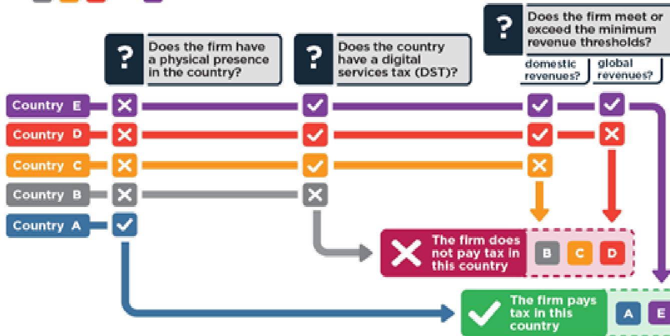
39. Rhoda Wambui, "Demystifying Digital Services Tax," KRA Blog, January 27, 2021, accessed May 19, 2024, https://www.kra.go.ke/news-center/blog/1074-demystifying-digital-services-tax#:~:text=It%20is%20a%20 tax%20that,and%20services%20through%20electronic%20means.

40. Gary Clyde Hufbauer and Megan Hogan "How Do Digital Services Taxes Work?" Peterson Institute for International Economics (PIIE), March 8, 2022, accessed May 12, 2024,https://www.piie.com/research/piie-charts/how-do-digital-services-taxes-work.

Figure 4: How Digital Services Taxes Work

How do digital services taxes work?

A large multinational technology firm headquartered in Country A sells digital services to clients abroad in four countries: B, C, D, and E.



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Design by Nia Kitchin and Oliver Ward

Note: Digital services taxes apply to covered services that are consumed by clients or users with a device internet protocol (IP) address or other geolocation tag located within the jurisdiction. The digital services covered varies depending on the jurisdiction.

Source: Adapted from Gary Clyde Hufbauer and Megan Hogan's blog, "Canada's digital services tax threatens global effort to curb tax havens," and Policy Brief, *The European Union renews its offensive against US technology firms.*

Source: Hufbauer and Hogan (2022)[41]

The Kenyan government, through the now withdrawn Finance Bill 2024, proposed to repeal the Digital Service Tax (DST) that has been criticized for violating principles of tax neutrality and introduce a new tax called the Significant Economic Presence Tax (SEP tax).[42] This move came amid growing pressure on Kenya to abandon its unilateral digital tax measure and adopt a globally negotiated unified solution.[43]

The proposed introduction of the SEP tax was likely a response to the ongoing negotiations at the OECD level to develop a consensus-based solution to the tax challenges of the digital economy.

2.2.2 Value-Added Tax

Value Added Tax (VAT) is an indirect tax levied on the consumption of goods and services by consumers and households. The tax is collected from, but in principle not borne by, businesses through a staged collection process. [44]

Over the last few decades, VAT has grown in popularity and now generates the largest share of tax revenue in many developing countries due to its broad application across various goods and services. The neutrality principle of VAT design ensures fair competition by applying VAT evenly

41. Gary Clyde Hufbauer and Megan Hogan "How Do Digital Services Taxes Work?" Peterson Institute for International Economics (PIIE), March 8, 2022, accessed May 12, 2024, https://www.piie.com/research/piie-charts/how-do-digital-services-taxes-work.
42. Harry Clynch, "Kenya to Maintain Low Digital Service Tax on Tech Giants Despite OECD Pressure," African Business, April 26, 2024, accessed May 26, 2024, https://african.business/2024/04/technology-information/kenya-to-maintain-low-digital-service-tax-on-tech-giants-despite-oecd-pressure
43. Liam Ebrill et al., eds., The Modern VAT (Washington: International Monetary Fund, 2001).
44. Richard Bird and Pierre-Pascal Gendron, VAT in Developing and Transitional Countries (Cambridge: Cambridge University Press, 2007), https://doi.org/10.1017/CBO9780511619366.

to domestic and foreign businesses, preventing trade distortions and preserving consumer choice. This is achieved through the destination principle, which exempts exports from VAT and taxes imports at the same rate as domestic supplies. [46]

In the context of the digital economy, neutrality means that digital services and goods should be taxed in the same way as their physical counterparts, preventing market distortions. The VAT rules aimed at the digital economy are designed to create a level playing field between domestically purchased services and those provided remotely so that a savvy consumer would not receive a price reduction from simply buying certain services from abroad or a business would not receive an undue economic advantage simply from being established abroad. [47]

Accordingly, governments are taking steps to ensure VAT is collected on cross-border e-commerce transactions to maintain tax neutrality, prevent revenue losses, and enable businesses to engage in cross-border trade. In line with a global trend, where 101 countries have implemented VAT or Goods and Services Tax (GST) on cross-border online sales.[48]

Kenya amended its VAT Act in 2019 by introducing a VAT on Digital Market Supply (VAT-DMS) aimed at taxing goods and services supplied through a digital marketplace by both local and foreign suppliers.[49] As a result, all adverts purchased on Meta platforms (Facebook, Instagram and WhatsApp) whether for commercial or non-commercial purposes, have attracted 16% VAT since November 1, 2022.[50]

The VAT-DMS was replaced by the updated and expanded VAT (Electronic, Internet and Digital Marketplace Supply) Regulations, 2023 that were meant to keep pace with evolving business models, while maintaining a simplified compliance framework for non-resident suppliers. [51]It also represents a significant step towards modernizing Kenya's tax system to accommodate the digital economy, ensuring fair taxation and contributing to the country's fiscal stability.

2.2.3 Digital Assets Tax

In many countries, cryptocurrencies are classified as virtual digital assets (VDAs) and are subject to both direct and indirect taxation.[52] Generally, current tax rules for cryptocurrency transactions mirror those for other types of assets, though practices vary widely among countries, often remaining unclear and influx.[53]

Typically, cryptocurrencies are treated as property for income tax purposes and are subject to capital gains tax rules.[54]However, some crypto-friendly jurisdictions, like Portugal and El Salvador, exempt crypto-holdings from capital gains tax.

45. OECD, International VAT/GST Guidelines (Paris: OECD Publishing, 2017), https://doi.org/10.1787/9789264271401-en.
46. Lachlan Wolfers and Philippe Stephanny, "The future of indirect taxation in a digital world. Proposition 5: Turnover taxes on digital transactions," KPMG, 2022, accessed May 24, 2024, https://kpmg.com/xx/en/home/insights/2022/09/proposition-5-turnover-taxes-on-digital-transactions.html
47.Cristina Enache, "Digital Taxation around the World," Tax Foundation, April 2024, accessed May 24, 2024, https://taxfoundation.org/wp-content/uploads/2024/04/FF833.pdf
48. Samuel Mwaura and Maryann Kamau, "The Value Added Tax (Digital Marketplace Supply) Regulations, 2020," Grant Thornton Tax Alert, 2020, accessed May 24, 2024,
49. Meta, "About Kenya Value-Added Tax," 2022, accessed June 4, 2024,https://www.facebook.com/business/help/187911129790766
50. PWC, "Key provisions applicable under the VAT EIDMS Regulations to non-resident suppliers," April 2024, accessed June 4, 2024, https://www.pwc.co.za/en/publications/vat-in-africa-ess/kenya-overview.html
51. Katherine Baer et al., "Taxing Cryptocurrencies", (IMF Working Paper No. 2023/144, Washington, DC: International Monetary Fund, June 2023), accessed June 12, 2024, https://www.imf.org/-/media/Files/Publications/WP/2023/English/wpiea2023144-print-pdf.ashx
52. Todd Phillips and Alexandra Thornton, "Congress Must Not Provide Statutory Carveouts for Crypto Assets" (Washington: Center for American Progress, 2022), accessed May 12, 2024, https://www.americanprogress.org/article/congress-must-not-provide-statutory-carveouts-for-crypto-assets/.
53. Baer et al., "Taxing Cryptocurrencies," 11.
54. Alexandra Thornton and Jean Ross "Cryptocurrency Income is Taxable Income" (Washington: Center for American Progress, January 11, 2024), accessed May 12, https://www.americanprogress.org/article/cryptocurrency-income-is-taxable-income/

Nonetheless, the underlying principle remains that all income, including from cryptocurrency transactions, is taxable. [55]

Still, policymakers are struggling to accommodate cryptocurrencies within tax systems that are not designed to handle them. The primary obstacles to implementing Digital Asset Taxes (DATs) include the quasi-anonymity of cryptocurrencies, which complicates third-party reporting, and the dual nature of cryptocurrencies as both investment assets and means of payment.[56] These complexities necessitate ongoing dialogue and adaptation of tax frameworks to effectively address the unique characteristics of digital assets.

In Kenya, virtual digital assets have become a significant and growing part of the digital economy, prompting the need for appropriate taxation. The Finance Act of 2023 introduced the Digital Assets Tax (DAT), a new income tax specifically for cryptocurrencies, which took effect on 1 September 2023. Under this framework, all cryptocurrency transactions are subject to a fixed tax rate of 3%. [57]

This means that every time a cryptocurrency is bought, sold, exchanged, or transferred, a 3% tax is charged on the transaction amount. The DAT encompasses various types of cryptocurrency transactions, including airdropped tokens, sales of tokens for stablecoins, exchanges between different tokens, and the purchase or sale of non-fungible tokens (NFTs).[58]

However, the Blockchain Association of Kenya (BAK) filed a petition before the High Court of Kenya challenging the legality and constitutionality of the DAT. BAK's concerns included taxing the total value of asset exchanges regardless of profit or loss and the impracticality of the five-day deadline for remitting collected taxes.[59]

The legal challenges posed by industry stakeholders indicate significant concerns regarding the implications of such taxation on the growth and innovation within the digital economy.

2.2.4 Withholding Tax

Withholding tax (WHT) is a tax that is deducted at the source of income, meaning it is taken out of an individual's or entity's earnings before they receive the payment. This tax is typically withheld by the payer (such as an employer or financial institution) and then remitted to the government on behalf of the payee (the person or entity earning the income).

It is commonly applied to various types of income, including salaries, wages, dividends, interest, and royalties. Withholding taxes (WHTs) are used by some jurisdictions instead of corporate taxes or consumption taxes to tax the revenue of digital firms connected to transactions within a jurisdiction. [60]

A high withholding tax rate might cause non-resident service providers to pass on the tax cost to customers in the source state. Also, a withholding

55. Baer, et al., "Taxing Cryptocurrencies."
57. KRA, "Highlights of the Finance Act 2023." https://www.kra.go.ke/popular-links/key-highlights-of-the-finance-act-2023#:~:text=Introduce%20tax%20on%20the%20income,at%20a%20rate%20of%203%25.&text=Individuals%20to%20claim%20mortgage%20interest,from%20a%20co%2Doperative%20society
58. Joseph Wachira "How are Cryptocurrencies Taxed in Kenya?" May 17, 2024, accessed May 28, 2024, https://www.cleartax.co.ke/crypto-taxation-in-kenya-what-you-need-to-know-about-the-3-percent-digital-asset-tax.html
59. Sam Adeyemo, "Blockchain Association of Kenya Drags Government to Court over Crypto Tax," Mariblock, September 1, 2 Joseph Wachira "How are Cryptocurrencies Taxed in Kenya?" May 17, 2024, accessed May 28, 2024, https://www.cleartax.co.ke/crypto-taxation-in-kenya-what-you-need-to-know-about-the-3-percent-digital-asset023, accessed May 28, 2024, https://www.mariblock.com/blockchain-association-of-kenya-drags-government-to-court-over-digital-assets-tax/
60. Enache "Digital Taxation around the World."

tax rate higher than the foreign tax credit granted in the service provider's residence state might deter trades in the source state.[61]

WHT on digital services create or acts as a collection mechanism for taxing payments made by residents to non-residents and can be especially effective for taxing non-residents with no physical presence in a jurisdiction. As part of the government's efforts to widen the tax base, Kenya's Finance Act 2023 introduced a WHT on digital content monetization payments to residents at 5% and 20% to non-residents persons.[62]

Following the introduction of the WHT, the government faced significant backlash from various stakeholders, primarily due to concerns about the potential adverse effects on the growth and competitiveness of Kenya's burgeoning digital content industry. For instance, digital content creators expressed concern the WHT would substantially reduce their earnings and make it hard to sustain their operations. Notably, many content creators rely on monetization platforms such as YouTube, Instagram, and TikTok, where their earnings come from advertisements, sponsorships, and viewer contributions.[63]

Given that in Kenya, WHT is not a final tax, the implementation of WHT introduced an additional tax and administrative burden for content creators who must now meticulously track their earnings throughout the year and maintain detailed financial records. At the year's end, they are required to compile these records to accurately determine their total income and calculate the final tax payable.[64]

Consequently, complying with WHT regulations can be cumbersome and time-consuming, diverting their focus from content creation to administrative tasks.

2.3 Proposed Taxes

Three types of digital taxes, the significant economic presence (SEP) tax, excise tax, and expansion of the withholding tax (WHT) were proposed by Kenya's Finance Bill 2024. However, with the withdrawal of the Bill following mass protests across the country rejecting tax proposals therein,[65] it remains to be seen whether the government will re-introduce these taxes in the future.[66] These taxes are discussed in the following section.

61. Manel Bondi (July 2022). Digital Taxation: A comparative study between the OECD & UN Proposals. Digital Cooperation Organization, p.10.
62. KRA, "Highlights of the Finance Act 2023."
63. Michael Akuchie, "Content Creators in Kenya Fault Govt's 15% Tax, Call for Formation of Union to Fight Exploitation," Technext, May 23, 2023, https://technext24.com/2023/05/23/withholding-tax-kenya-content-creator/
64. Ronald Agak, "Kenya's Content Creators Reject Tax Proposals," AfricaNews, June 7, 2023, https://www.africanews.com/2023/06/07/kenyas-content-creators-reject-tax-proposals/
65. James Mbaka, "Explainer: How MPs will withdraw Ruto's Finance Bill", The Star, 27 June 2024 https://www.the-star.co.ke/news/2024-06-27-explainer-how-mps-will-withdraw-rutos-finance-bill/

2.3.1 Significant Economic Presence Tax

A significant economic presence (SEP) tax is a direct tax that targets companies operating in the digital economy based on their significant economic presence in a jurisdiction, even if they do not have a physical presence there. SEP is a concept proposed by the OECD that extends the traditional tax nexus rules by establishing a corporate tax liability (i.e. taxable presence) based on the level of economic engagement within a jurisdiction.

In contrast to a DST, which continues to treat the firm as foreign but claims part of the income as an effectively domestic source, the significant economic presence test folds some firms into the arms of the tax authority by redefining the threshold to tax residence. Businesses that are likely subject to the SEP threshold include those providing streaming services, search engines, transportation services and accommodation services that operate on a digital platform.[67]

While it aims to align with international tax practices, the effective implementation of SEP remains a work in progress for many jurisdictions.

In a bid to broaden the tax base to include a wider range of digital activities and align with international tax practices, particularly those recommended by the OECD, Kenya's Finance Bill 2024 proposed to repeal the current 1.5% Digital Service Tax (DST) that non-resident digital service providers are paying [68] and replace it with the SEP tax.

Under the proposed SEP tax, a non-resident person whose income from the provision of services is derived from or accrues in Kenya through a digital marketplace will be liable to pay the tax. The taxable profit is deemed to be 20% of the gross turnover, which is then subject to a 30% income tax rate. This means that the effective SEP tax rate is 6% of the gross turnover.

However, ride-hailing companies such as Uber and Bolt have opposed the proposed SEP tax, claiming it will increase customer costs and may force them to leave the Kenyan market. They have requested a reduction of the SEP tax rate from 6% to 1.5%, matching the current DST rate.In response, the Finance Committee reviewed the 2024 Finance Bill and suggested reducing the deemed taxable profit from 20% to 10% of gross turnover, effectively halving the SEP tax rate to 3%.[69]

67. Allison Christians and Kimia Towfigh, "Significant Economic Presence (SEP): Threshold to Taxing Digital Profits," CTF Digital Tax Log, entry #4, August 21, 2020, accessed May 23, 2024,
68. Ernst & Young (EY), "Kenya Proposes Tax Changes under the Finance Bill, 2024," Tax News Update, May 21, 2024, https://globaltaxnews.ey.com/news/2024-1032-kenya-proposes-tax-changes-under-the-finance-bill-2024 https://ctf.ca/EN/Newsletters/Blogs_and_Reports/Digital_Services_Updates/Entries/Entry04.aspx
69. Dominic Omondi, "MPs Hand Multinational Tech Firms Tax Reprieve in Changes," Business Daily, June 19, 2024, accessed June 2, 2024, https://www.businessdailyafrica.com/bd/economy/mps-hand-multinational-tech-firms-tax-reprieve-in-chang
es--4662324

2.3.2 Excise Tax

Excise tax (also referred to as excise duty in Kenya) is a type of consumption tax that is imposed on a range of specific goods and services, either at a fixed rate or based on the value of the item. Excise taxes are typically justified by economic principles or as revenue-raising measures.[70]

The responsibility for paying excise duty lies with the producers or manufacturers of these goods and services, rather than the final consumers. However, in most cases, producers tend to pass on the cost of excise duty to consumers by incorporating it into the selling price of the product or service. As a result, consumers ultimately bear the burden of excise duty, even though they are not directly liable for its payment.[71]

An excise tax usually raises the total price that consumers pay for a product or service and only very rarely reduces the business revenue available to a company. Since excise taxes are borne by consumers and are usually flat-rated, they are inherently likely to be regressive. [72] Due to its low administrative costs and the substantial revenue collected from it, excise tax is often the go-to tax for governments seeking to raise extra revenues.[73]

In Kenya, excise tax has evolved from the 'sin tax' used to discourage or deter the consumption of harmful products such as cigarettes and alcohol with negative externalities and is now being used by the government as a revenue mobilization tool targeting several goods and services. [74] The purview of excise duty has been expanded over time and is now typically charged on locally manufactured goods, excisable services supplied in the country, or on excisable goods imported into Kenya. [75]

Currently, there's no excise duty specifically applied to digital services offered in the country by non-residents via digital platforms. However, the Finance Bill 2024 had proposed the introduction of excise duty on excisable services provided in Kenya by non-residents via digital platforms. The excise duty was going to be payable by the non-resident person offering the service.

This proposal sought to expand the scope of excise duty to capture revenue from excisable digital services offered by non-resident companies. The proposal also sought to address the current imbalance by extending excise duty to non-resident companies offering digital services in Kenya, thereby creating a more level playing field for Kenyan providers who were previously disadvantaged. [76]

70. Sean Lowry "Digital Services Taxes (DSTs): Policy and Economic Analysis," Congressional Research Service, February 25, 2019, accessed May 23, 2024, https://crsreports.congress.gov/product/pdf/R/R45532

71.International Monetary Fund (IMF), A Manual of Government Finance Statistics, (Washington DC: IMF, 1986), cited in Bruce Bolnick & Jonathan Haughton, "Tax Policy in Sub-Saharan Africa: Re-Examining The Role of Excise Taxation," Journal of African Finance and Economic Development 4, no. 1, (2001): 31-64.

72.IMF, Fiscal Policy and Income Inequality, IMF Policy Paper (Washington DC: IMF, 2014), .https://www.imf.org/en/Publications/Policy-Papers/Issues/2016/12/31/Fiscal-Policy-and-Income-Inequality-PP4849

73.Mutava and Wanjala, "Taxing for a more equal Kenya."

74. Kenya Revenue Authority, "Taxation for Companies & Partnerships," https://www.kra.go.ke/business/companies-partnerships/companies-partnerships-pin-taxes/excise-duty; Republic of Kenya, "Excise Duty Act, 2015", https://www.kra.go.ke/images/publications/Excise-Duty-Act-2015-Revised-2021.pdf

75. Titus Mukora and Gideon Rotich, "Excise Duty," PWC Africa Podcasts, July 27, 2023, accessed June 10, 2024, https://www.pwc.com/ke/en/publications/finance-act-insights/excise-duty.html

76. GrantThornton, "Analysis of the Finance Bill, 2024," Tax Alert, Issue No. 6 of 2024 (May 2024), https://www.grantthornton.co.ke/globalassets/1.-member-firms/kenya/insights/pdf/grant_thornton_039_s_analysis_of_the_finance_bill_2024_2025_tax_alert_issue_no.6_of_2024.01.pdf

2.3.3 Withholding Tax

As part of its revenue generating measures, the Finance Bill 2024 proposed to amend section 10 of the Income Tax Act (ITA) to introduce a WHT on the owners or operators of digital marketplaces or platforms when making or facilitating payment in respect of digital content monetisation, goods, property or services at the rate of five per cent (5%) for residents and twenty per cent (20%) for non-residents. This measure was intended to impact sellers of goods and services earning income within these digital marketplaces.[77]

Additionally, the bill broadened the definition of digital marketplaces to include a wider range of online platforms and services, extending beyond the current focus on the supply of digital content and services, thereby bringing more digital businesses into the ambit of the tax. [78]

77.Ibid.
78. Mathini et al., "Kenya: The Finance Bill 2024."

3.0 Rationale for Digital Taxation

Like other countries, Kenya is increasingly implementing digital taxation for several compelling reasons. This section explores four key motivations behind this trend:

3.1 Revenue Generation

> **As part of its revenue mobilisation efforts, Kenya has joined a growing list of countries that are seeking to increase their tax revenue by introducing digital taxes aimed at capturing tax revenues from digital activities taking place within their jurisdiction.**

The primary policy goal of taxation is to provide a fair, efficient, and predictable way of financing government expenditures and delivery of public services. Achieving this requires robust domestic resource mobilisation, including effective taxation of the digital economy. [79] It is worth noting that despite past efforts to enhance revenue, Kenya's revenue yield remains below the desired East African Community (EAC) target of 25 percent of gross domestic product (GDP). [80]

To finance its development agenda, support fiscal consolidation, and achieve Vision 2030, Kenya needs to enhance its domestic resource mobilisation. [81]The country's Medium-Term Revenue Strategy (MTRS) provides a framework for tax system reforms aimed at boosting domestic revenue, which has been declining over time. The Strategy aims to achieve an optimal tax-to-GDP ratio of 25 percent by 2030. [82]

As part of its revenue mobilisation efforts, Kenya has joined a growing list of countries that are seeking to increase their tax revenue by introducing digital taxes aimed at capturing tax revenues from digital activities taking place within their jurisdiction.[83]In the financial year 2022/2023, the Kenya Revenue Authority (KRA) collected a total of KES 5.328 Billion from the digital economy, a 207.9% increase compared to the same period in the financial year 2021/2022. [84]

79. Raul Katz, "The Impact of Taxation on the Digital Economy," GSR15 Discussion Paper (2015): 7, https://www.itu.int/en/ITU-D/Conferences/GSR/Documents/GSR2015/Discussion_papers_and_Presentations/GSR16_Discussion-Paper_Taxation_Latest_web.pdf
80. The National Treasury and Economic Planning, The Medium-Term Revenue Strategy: An Approach for Enhancing Domestic Revenue, FY 2024/25 - 2026/27 (October 2023), 2, accessed May 28, 2024, https://www.treasury.go.ke/wp-content/uploads/2023/12/Medium-Term-Revenue-Strategy-2023.pdf
81. The National Treasury and Economic Planning, National Tax Policy, Sessional Paper No. 02 of 2023 (2023), https://www.treasury.go.ke/wp-content/uploads/2024/05/7.05.-2024-National-Tax-Policy.pdf
82. The National Treasury and Economic Planning, "The Medium-Term Revenue Strategy: An Approach for Enhancing Domestic Revenue," 2.
83. John Walubengo, "Digital Taxation – Is It a Double-Edged Sword?" KICTANet Blog, March 2, 2023, accessed May 23, 2024, https://www.kictanet.or.ke/digital-taxation-is-it-a-double-edged-sword/
84. KRA, "KRA Sustains Revenue Growth Despite Economic Shocks," July 14, 2023, KRA Website, https://www.kra.go.ke/news-center/press-release/1956-kra-sustains-revenue-growth-despite-economic-shocks

3.2 Fair Taxation

Although a large proportion of revenue is generated by consumption taxes like VAT, the political sensitivities surrounding digital tax 'fairness' mean that governments need to be seen to be bringing in more corporate tax on digital transactions. [85]

Given the public pressure on governments to bring digital companies into the corporate tax net, [86] the main argument for altering how the digital economy is taxed is that the current tax system is unfair, partly because traditional companies are said to pay more in taxes compared to companies operating in the digital economy and partly as a result of how tax revenues are distributed between different countries. [87]

This creates an uneven playing field, allowing digital firms to gain an unfair competitive advantage over traditional businesses. Accordingly, taxing digital businesses ensures that they contribute equitably to public finances in jurisdictions where they have significant economic activities, similar to traditional brick-and-mortar businesses.

Implementing fair taxation addresses the BEPS issues aimed at minimizing their tax liabilities, ensuring that digital businesses pay taxes where they generate economic value. The OECD estimates that the resulting corporate tax avoidance costs $100 billion to $240 billion annually, which amounts to four to ten per cent of global corporate tax revenue. [88]

3.3 Economic Sovereignty

Globalization and digitalization have led to the emergence of new business models based on the remote provision of services. Many of these digital companies have access to consumers in countries all over the world despite not having a physical presence in these countries. As a result, their profits remain untaxed.[89]

With countries across the globe seeking ways to gain more control over their tax systems and to better ensure that businesses benefiting from their market are contributing to their tax base, proponents argue that digital taxation is necessary to protect countries' economic sovereignty and ability to raise revenue in the digital age. Without such measures, profits from economic activity within a country's borders could continue to be shifted elsewhere for tax purposes.

According to reports, Kenya has resisted pressure from the OECD to join its global minimum tax initiative, underscoring its desire to maintain "sovereignty in tax policy," expressing concerns that adopting the OECD's standards could lead to significant revenue losses.

Kenya's digital economy and the associated tax revenues are vital to its fiscal stability, especially in a context where state coffers are already strained. Kenya therefore faces the challenge of balancing its national interests with the broader push for global tax coordination. This balance is crucial for ensuring long-term economic sustainability and maintaining international relationships. [90]

85. GrantThornton, "Taxing the Digital Economy: Digital Taxation Risks Double Taxation for All Businesses," 2019, 2, accessed June 23, 2024, https://www.grantthornton.global/globalassets/1.-member-firms/global/insights/article-pdfs/2019/taxing-digital-economy_double-taxation.pdf?_gl=1*qcxo98*_ga*MTIyNzc5MDQ2LjE3MTk2OTE3MjE.*_ga_JL-RBBJ6PTP*MTcxOTY5MTcyMC4xLjAuMTcxOTY5MTcyNC42MC4wLjA.
86. Ibid.
87. Pernilla Rendahl "Risk of Double Taxation on Digital Services if Proposals Drafted by the EU and the OECD Are Turned into Law," Press Release, April 21, 2021, https://www.sns.se/en/category/press-release/
88. OECD, OECD/G20 Inclusive Framework on BEPS, 5th Meeting of the Inclusive Framework in Lima,Peru (June 27–28, 2018).
89. Nelly Popova, "Challenges to the Taxation of the Digital Economy," in EMAN 2020 Conference Proceedings (2020): 233–41, https://doi.org/10.31410/EMAN.2020.233
90. Harry Clynch "Kenya to Maintain Low Digital Service Tax on Tech Giants Despite OECD Pressure," AfricanBusiness, April 26, accessed June 10, 2024, 2024, https://african.business/2024/04/technology-information/kenya-to-maintain-low-digital-service-tax-on-tech-giants-despite-oecd-pressure.

3.4 Adaptation to Digital Economy

Unlike the manufacturing and distribution of physical goods, digitization offers more opportunities for flexible tax optimization by companies seeking to reduce their tax liabilities in income-producing locations, thereby leading to significant tax erosion for governments.[91]

Kenya introduced a 1.5% DST through the Finance Act of 2020 on the gross transaction value of digital services provided in the country. This measure was part of broader efforts to ensure that digital companies contribute fairly to the national tax base.

In Kenya, as in many other countries, the rise of digital businesses has heightened concerns about tax erosion. The Kenyan government has recognized that traditional tax frameworks are ill-equipped to handle the complexities of digital transactions. This has led to the introduction of digital service taxes (DST) aimed at capturing revenue from the digital economy. For example, Kenya introduced a 1.5% DST on the gross transaction value of digital services provided in the country.This measure was part of broader efforts to ensure that digital companies contribute fairly to the national tax base.

Despite these efforts, the challenge remains significant, as the effectiveness of these taxes is often questioned, as multinational corporations (MNCs) continue to find ways to minimize their tax liabilities. Efforts like the OECD's BEPS project and global minimum tax proposals are steps towards addressing these issues. It is therefore important to emphasize that Kenya must balance global coordination with protecting its revenue streams and maintaining fiscal sovereignty.

However, it is also worth noting that while digitalization creates problems for revenue authorities, it also provides opportunities offered by advanced digital solutions. For example, tax administrations can take advantage of developments in artificial intelligence, robotics, blockchain, and big data, as well as many other technological advances to secure better outcomes for governments and taxpayers in the administration of the tax system. [92]

91. Katz, "The impact of taxation on the digital economy."

92. Evans et al., "New Frontiers for Tax in the Digital Age," 2.

4.0 Challenges of Digital Taxation in Kenya

While significant progress has been made in transforming Kenya's tax system, the country still faces challenges in taxing the digital economy in a manner that ensures the principles of taxation are upheld and businesses are not unfairly burdened by taxes. These challenges are discussed in the following section.

Jurisdictions can tax companies only if the 'tax nexus' is determined to exist in a given jurisdiction. However, digitalisation allows companies to engage in significant business activities without meeting the criteria for a permanent establishment in the jurisdiction.

4.1 Establishing Nexus and Permanent Establishment

A foreign enterprise is taxable only if it has a presence that is equivalent to a permanent establishment, which is broadly defined as the place where the business of a given company is wholly or partly conducted. Jurisdictions can tax companies only if the 'tax nexus' is determined to exist in a given jurisdiction.[93]

However, digitalisation allows companies to engage in significant business activities without meeting the criteria for a permanent establishment in the jurisdiction. [94]Such commercial presence need not be accompanied by a physical presence, which can lead to a situation in which taxes do not reflect the value and profits created by an enterprise as assets and activities of digital businesses can easily be moved across jurisdictions to avoid a taxable presence in those where taxes are higher.

Furthermore, there is a risk that vendors on online platforms can skip registration in third countries where they effectively conduct transactions. Additionally, digital companies may create value, or parts of it, in a different jurisdiction from where they are physically present. These practices render the determination of the jurisdiction competent to tax a multinational or digital company complex and current rules that might result in substantial activity without a right of taxation.[95]

93. For taxation purposes, nexus can be defined as the tax liability of the taxpayer in a specific tax jurisdiction.
94.This is what the OECD calls 'scale without mass'.
95.Marcin Szczepański, "Digital Taxation: State of Play and Way Forward," Briefing, European Parliamentary Research

Despite engaging in business in the country, many digital firms do not have offices in Kenya, as digital companies can often operate across borders without a substantial local footprint. These businesses rely heavily on intangible assets, such as IP, data and algorithms, rather than tangible, physical assets. This makes it difficult to establish a clear physical presence and nexus for tax purposes. [96]

Despite engaging in business in the country, many digital firms do not have offices in Kenya, as digital companies can often operate across borders without a substantial local footprint.

4.2 Characterization of Transactions and Income

The digital economy often involves complex, multi-sided business models and new types of transactions, such as the provision of digital services, the use of data, and the monetization of user participation. Characterising the nature of these digital transactions as well as income for tax purposes can be challenging, as existing tax rules and regulations may not adequately address the unique features of the digital economy. This complexity can lead to uncertainty around the appropriate tax treatment and computation of the tax liabilities, thereby resulting in potential disputes between taxpayers and tax authorities [97] and taxation mismatches and loopholes.[98]

In response to these challenges, governments are increasingly looking to implement new tax measures tailored to the digital economy. Kenya, which is facing a significant public debt burden, has been progressively increasing its tax yields from the burgeoning digital economy, reflecting the government's recognition of the growing importance of digital platforms and services in its economy. However, the country's tax system is not fully equipped to deal with the rapidly evolving business models applied in the digital economy.

Service, (March 2020), 2, accessed June 10, 2024, https://www.europarl.europa.eu/RegData/etudes/BRIE/2020/649340/EPRS_BRI(2020)649340_EN.pdf
96. Alvarez and Marsal, "Global Trends in Digital Taxation: An In-Depth Look," April 28, 2024, accessed June 10, 2024, https://www.alvarezandmarsal.com/insights/gloal-trends-digital-taxation-depth-look.
97. OECD, Addressing the Tax Challenges of the Digital Economy, OECD/G20 Base Erosion and Profit Shifting Project (Paris: OECD Publishing, 2014), 126, https://doi.org/10.1787/9789264218789-en, https://www.oecd-ilibrary.org/docserver/9789264218789-en.pdf?expires=1719675014&id=id&accname=guest&checksum=67DC982A5F316060E452D52BFB41A75F
98. Szczepański, "Digital Taxation: State of play and way forward," 3.

This has led to certain digital activities being left out of the tax net. The proposed introduction of targeted digital taxes are efforts to modernise the system and ensure a more comprehensive capturing of value created through digital channels. [99]

However, the government must balance this with the need to foster a conducive environment for innovation and digital growth. Ensuring compliance and fair taxation without stifling the digital economy's potential is crucial for economic recovery and sustained economic growth.[100]

4.3 Enforcing Compliance by Taxpayers

Tax non-compliance often arises not just from intentional evasion but also from the time-consuming, complex, and costly nature of tax payment processes,[101] along with obstacles such as insufficient taxpayer knowledge, difficulties in filing,[102] using the complicated online tax portals such as iTax [103] and integrating business operations with KRA eTIMS. [104]

Undoubtedly, digital taxation adds further compliance challenges for governments, businesses, and individuals. For instance, there is a risk that vendors on online platforms skip registration in third countries where they effectively conduct transactions. [105] A case in point is Kenya's DST, which has proven challenging to enforce as identifying non-residents doing business in Kenya for recruitment has proven difficult.[106]

Moreover, the low value of some transactions can lead companies to perceive the accurate calculation and timely remittance of VAT on numerous small transactions as burdensome. Added to this, the requirement by the VAT (Electronic, Internet and Digital Marketplace Supply) Regulations, 2023, for non-resident firms to voluntarily register in Kenya and remit VAT poses a challenge for Kenya's tax authority since it has no apparent enforcement mechanism.[107]

To address these compliance issues, KRA has embarked on an ambitious tax digitalisation effort that involves leveraging innovative technological solutions such as e-filing and e-payment systems to reduce compliance costs and facilitate easier compliance by taxpayers.[108] To this end, it is investing heavily in digital transformation and automation of its revenue systems. [109]

4.4 Administration of Digital Taxes

Robust tax administration is necessary to achieve a well-functioning tax system. It guarantees that the tax system operates efficiently, fairly, and in accordance with legal frameworks, thus creating trust in the tax system while enabling

99.The National Treasury and Economic Planning, "National Tax Policy," 18.
100. Luke Anami, "Kenya Tax Plan Will Hurt Business and Dim Economic Recovery, Economists Warn," The East African, May 19, 2024, accessed on June 7, 2024, https://www.theeastafrican.co.ke/tea/business/kenya-tax-plan-will-hurt-business-dim-economic-recovery-4626970
101. Adrienne Lees, "Tackling the Hidden Costs of Taxation: Can Digitalisation Help?" International Centre for Tax and Development (ICTD) Blogs, April 14, 2023, accessed on June 7, 2024, https://www.ictd.ac/blog/tax-compliance-costs-digitalisation/
102.The National Treasury and Economic Planning, "National Tax Policy," 18.
103.Kenya Revenue Authority, iTax Online eServices https://itax.kra.go.ke/KRA-Portal/
104. Kenya Revenue Authority, eTIMS Tax Payer Portal, https://etims.kra.go.ke/
105.Szczepański, "Digital Taxation: State of Play and Way Forward," 2.
106.Nickson Omondi "KRA's Experience on Unilateral Measures in Taxation of the Digital Economy," n.d., accessed on June 7, 2024, https://www.addistaxinitiative.net/sitesdefault/files/resources/Day%203_Kenya_Digital%20Service%20Taxes_Technical%20session%203.pdf
107. Ibid.
108. Celeste Scarpini and Fabrizio Santoro, "Kenya Is Going Digital to Boost Tax Revenue – There Are Lessons to Learnfrom Other African Countries," ICTD Blogs, August 11, 2023, accessed on June 7, 2024, https://www.ictd.ac/blog/kenya-going-digital-tax-lessons/
109. Brian Ambani, "Digital Shift Tests KRA's Tax Collection Limits," Nation, March 14, 2023, accessed on June 7, 2024, https://nation.africa/kenya/business/digital-shift-tests-kras-tax-collection-limits-4156800

tax authorities to enforce laws, collect taxes, and manage the overall system efficiently. All these factors optimise tax collection and positively influence tax policies as a whole. [110]

At the core of tax administration are the essential processes of capturing, processing, analyzing, and responding to information provided by taxpayers and others concerning taxpayers' tax affairs. These processes include the registration of taxpayers, the processing of tax returns, the recording of taxpayer's tax liabilities and payments, risk assessment, and systematic follow-up actions required when some form of intervention is called for (e.g., the collection of tax debts, enforcement of the filing of overdue returns, or audits).[111]

KRA has made significant strides in improving tax administration, demonstrating capacity in areas such as taxpayer registration, tax collection, and compliance enforcement. In particular, the introduction of the iTax online portal, has streamlined tax processes and has, despite its complexity and drawbacks in user experience, significantly increased efficiency. The iTax provides fully integrated and automated administration of all domestic taxes, allowing the taxpayer to register, file, pay, and inquire about status online with real-time monitoring of accounts.[112]

However, the borderless nature of the digital economy produces specific administrative issues around identification of businesses, determination of the extent of activities, information collection and verification, and identification of customers. [113]

These challenges call for further enhancement of KRA's administrative capacity to effectively capture revenue from digital transactions, ensure compliance, expand the tax base and maintain fairness in the tax system. [114]

Some of the gaps in the administration of digital taxes include insufficient technical expertise, unprofessionalism, corruption, opaque processes, inadequate digital infrastructure, and limited resources for enforcement. [115] These deficiencies hinder effective tax collection and compliance, posing challenges in tracking and taxing digital transactions and services, ultimately affecting revenue generation and economic growth. Achieving this will require greater investment in technology, fostering international cooperation, and developing specialised skills within the tax administration framework.

4.5 High Tax Uncertainty

In Kenya, tax policies are revised annually as part of the national budget process. These frequent amendments create unpredictability within the tax system, making it challenging for businesses and individuals to plan and comply with their tax obligations, in addition to increasing the cost of tax administration. Also, despite the constitutional requirements for meaningful public participation, stakeholder views are often disregarded without

110. OECD, Competitiveness in South East Europe 2021: A Policy Outlook, Competitiveness and Private Sector Development, (Paris: OECD Publishing, 2021), https://doi.org/10.1787/dcbc2ea9-en.
111. Njuguna Ndungu, "Digitalization in Kenya: Revolutionizing Tax Design and Revenue Administration," in Digital Revolutions in Public Finance, eds. Sanjeev Gupta, Michael Keen, Alpa Shah, and Genevieve Verdier (Washington, DC: International Monetary Fund, 2017), 247, DOI: https://doi.org/10.5089/9781484315224.0717.
112. OECD, "Addressing the Tax Challenges of the Digital Economy," 137-138.
113. The National Treasury and Economic Planning, "The Medium-Term Revenue Strategy: An Approach for Enhancing Domestic Revenue."
114. Manny Anyango, "Bribery, corruption claims painting KRA in bad light - Ruto", The Star, 26 May 2023, https://www.the-star.co.ke/news/realtime/2023-05-26-bribery-corruption-claims-painting-kra-in-bad-light-ruto/
115. Alex Mathini et al, "Kenya: Court of Appeal declares the entire Finance Act, 2023, unconstitutional" Bowmans, https://bowmanslaw.com/insights/kenya-court-of-appeal-declares-the-entire-finance-act-2023-unconstitutional/

reasons in the formulation of tax policies and laws, thereby resulting in legal challenges.[116] To infuse predictability into Kenya's tax administration, the government through the National Tax Policy aims to establish clear, stable, and consistent tax laws and regulations, which are crucial considerations for investors.[117]

Despite the constitutional requirements for meaningful public participation, stakeholder views are often disregarded without reasons in the formulation of tax policies and laws, thereby resulting in legal challenges.

The importance of effective stakeholder engagement and predictable and stable taxation policies in driving the realisation of a country's socio-economic goals cannot be overemphasized. For investors, a stable tax regime allows businesses to consciously make investment decisions without worrying about the uncertainty and costs associated with reviews of taxation laws. An unstable and unpredictable tax regime including tax policies and laws developed without meaningful stakeholder engagement does the opposite – it hinders investors progress, thus stagnating a country's growth.[118]

For the government, tax uncertainty due to unpredictable tax laws creates a volatile fiscal environment, making it difficult to accurately forecast revenue. This lack of clarity hinders effective budget planning, disrupts funding for development projects, and undermines long-term economic stability and growth. In response to this recurrent problem, the MTRS aims to provide a comprehensive approach to reform Kenya's tax system in order to ensure clear revenue projections for the Government over the medium term and provide taxpayers with certainty on tax policy and administrative changes.[119]

4.6 Accessing User Data and Attribution of Value Created by Users

Access to high-quality tax-related data is essential for enhancing tax compliance and improving management efficiency within tax authorities.[120] When tax administrators have access to accurate and comprehensive data, they can effectively identify and evaluate the activities and revenues of digital businesses. This capability extends

116. Alex Mathini et al, "Kenya: Court of Appeal declares the entire Finance Act, 2023, unconstitutional" Bowmans, https://bowmanslaw.com/insights/kenya-court-of-appeal-declares-the-entire-finance-act-2023-unconstitutional/

117. The National Treasury and Economic Planning, "National Tax Policy."

118. Anthony Mwangi, "Why We Need a Stable and Predictable Tax Regime in Kenya," Kenya Association of Manufacturers, February 17, 2023,https://kam.co.ke/why-we-need-a-stable-and-predictable-tax-regime-in-kenya/

119.The National Treasury and Economic Planning, "The Medium-Term Revenue Strategy: An Approach for Enhancing Domestic Revenue," 2

120. Peng Jin, Zhangwei Feng, Guiping Li, "The Effect of Platform Data Quality on Tax Compliance in Digital Economy: A Multiagent Based Simulation," Complexity, vol. 2023 (December 8, 2023): 1-16, https://doi.org/10.1155/2023/5511572

to understanding the value generated by users through various interactions, transactions, and content creation. With precise data, tax authorities can ensure that these businesses pay their fair share of taxes based on the actual value created within the country, thereby reducing tax evasion and avoidance. Advancements in technology have significantly facilitated the collection and processing of such data, enabling tax authorities to perform faster and automated analyses of large datasets, which minimizes errors and conserves time.[121]

It is imperative that principles of privacy and data protection are upheld in tax administration. Respecting individuals' rights to privacy and data protection is crucial for maintaining public trust and ensuring compliance with legal standards

However, despite the KRA's proactive approach to capturing data from digital businesses, challenges persist in identifying and tracking certain online transactions due to limited access to relevant data.[122] For instance, peer-to-peer transactions conducted through various platforms often obscure user identities and payment amounts, creating opportunities for tax fraud. [123]

This limitation complicates revenue attribution and hampers the authority's ability to accurately assess and collect taxes from such online businesses, potentially resulting in significant revenue losses. In response to these challenges, KRA is investing in systems designed to enhance the tracking and monitoring of digital transactions, thereby improving the enforcement of tax laws and regulations.

Reports indicate that KRA plans to enhance its tax surveillance capability by integrating its systems with telecommunications companies to achieve real-time visibility of transactions for taxation purposes. This integration aims to provide KRA with comprehensive insights into mobile-money transactions, enabling it to identify tax non-compliance effectively.[124]

However, the proposal in the Finance Bill 2024 to exempt the KRA from the ambit of the Data Protection Act, 2019 by exempting it from the requirement to obtain court orders prior to accessing personal information held by data controllers and processors

121. Luisa Scarcella, "Tax Compliance and Privacy Rights in Profiling and Automated Decision Making," Internet Policy Review 8, no. 4 (October 22, 2019), https://doi.org/10.14763/2019.4.1422.
122. KRA, "Taxing the Digital Economy in Kenya," 3.
123. Constant Munda, "KRA to Mine Data from Telco Systems to Net Tax Cheats," Business Daily, August 25, 2023, https://www.businessdailyafrica.com/bd/economy/kra-to-mine-data-from-telco-systems-to-net-tax-cheats--4346504
124. KICTANet, "Memorandum on The Finance Bill, 2024 (National Assembly Bills No. 30 of 2024)," https://www.kictanet.or.ke/?mdocs-file=49768

was objected to by various stakeholders including KICTANet,[125] and ultimately rejected by Parliament.[126] It is imperative that principles of privacy and data protection are upheld in tax administration. Respecting individuals' rights to privacy and data protection is crucial for maintaining public trust and ensuring compliance with legal standards, such as the Data Protection Act, the Access to Information Act and the Tax Procedures Act. Thus, while high-quality tax-related data is vital for improving compliance and operational efficiency, it must be accessed lawfully and managed responsibly to safeguard individual rights.[127]

125. Dominic Omondi, "House team rejects taxman's bid to spy on M-Pesa deals, bank accounts", Business Daily,19 June 2024 https://www.businessdailyafrica.com/bd/economy/house-team-rejects-taxman-bid-to-spy-on-m-pesa-deals--4662294
126. Luisa Scarcella, "Tax compliance and privacy rights in profiling and automated decision making."
127.GrantThornton, "Taxing the Digital Economy: Digital Taxation Risks Double Taxation for All Businesses," 2.

5.0 Distortive Impact of Digital Taxation in Kenya

If not carefully designed and implemented, digital tax policy can have a distortive impact across various dimensions, affecting business, government and consumers. This section looks at the implications for each of them in detail.

5.1 Impact on Businesses

5.1.1 Risk of Double Taxation

Digital platforms are also facing growing compliance costs as they navigate varying tax rules across different jurisdictions. Complying with the patchwork of overlapping digital taxes across various jurisdictions increases administrative burdens and costs for these companies

A lack of international consensus on taxing an increasingly digital global economy is creating a vacuum which individual countries are filling with their own varied set of unilateral tax measures. [128] An example of this type of disruptive tax measure is Kenya's DST which was enacted in 2019.

The poorly coordinated implementation of these unilateral DSTs has created a patchwork of disparate tax rules across various countries. With the borderless nature of the digital economy, a single digital transaction can involve multiple countries. Under the current unilateral DST regimes, businesses may be subject to tax in the country where the user is located, the country where the payment is made, and the country where the digital service provider is based.

This creates a risk of businesses being taxed in multiple jurisdictions for the same income, thus reducing profitability and undermining the perceived fairness and stability of the tax system. To address these issues, there is a growing consensus that a coordinated global solution is needed to tax the digital economy effectively and prevent double taxation.

128.Edwin Mutai, "Uber, Bolt Threaten to Pull Out of Kenya Over Proposed Taxes," Nation, June 6, 2024, https://nation.africa/kenya/business/uber-bolt-threaten-to-pull-out-of-kenya-over-proposed-taxes--4648138

5.1.2 Increased Costs of Doing Business

Digital services taxes often target the revenues of large tech companies, rather than their profits. This can result in a higher effective tax rate compared to traditional corporate income taxes. For example, the initial proposal in the Kenya Finance Bill 2024 to repeal the DST of 1.5% and replace it with the SEP tax charged at 6% (later revised to 3%) on the Kenyan-derived revenues of digital service providers was criticised as punitive as it would increase the cost of doing business.[129]

Increasingly, digital platforms are also facing growing compliance costs as they navigate varying tax rules across different jurisdictions. Complying with the patchwork of overlapping digital taxes across various jurisdictions increases administrative burdens and costs for these companies such as hiring tax experts and investing in compliance systems. These additional costs could ultimately get passed on to consumers through higher prices.

5.1.3 Deterrent to Innovation and Investment

High or unpredictable digital taxes may have a "chilling effect" on innovation and growth by increasing costs for businesses. Moreover, evidence shows that countries which constantly change tax policies introduce another layer of complexity for firms planning future investment, making it very difficult for operators to plan future capital investments. This fragmented approach to digital taxation may impede innovation without generating substantial revenue.[130]

For Kenya, the introduction of frequent and elevated digital taxes risks driving businesses to more tax-friendly jurisdictions, thereby diminishing local economic activity and potential tax revenues.[131]To illustrate this point is the response by digital companies to the proposal in the Finance Bill 2024 to remove the DST and replace it with a SEP Tax of six percent on gross turnover for non-resident firms. Two major ride-hailing firms, Uber and Bolt, had warned that the proposed SEP Tax, coupled with the existing tax obligations and industry-specific challenges, could significantly impact the viability of ride-hailing platforms in Kenya. They warned that if implemented, it could lead to reduced service availability for consumers and potential job losses for drivers, as Uber and Bolt may be forced to scale back their operations or exit the Kenyan market altogether.[131]

In light of these concerns, the Parliamentary Departmental Committee on Finance and National Development recommended a reduction in the deemed taxable profit rate for the proposed SEP Tax from 20% to 10% of gross turnover, effectively lowering the tax burden from six percent to three percent. This adjustment reflects a recognition of the potential adverse effects of high digital taxes on the viability of Kenya's digital economy and aims to create a more favorable environment for investment and growth. [133]

129. Edwin Mutai, "Uber, Bolt Threaten to Pull Out of Kenya Over Proposed Taxes," Nation, June 6, 2024, https://nation.africa/kenya/business/uber-bolt-threaten-to-pull-out-of-kenya-over-proposed-taxes--4648138

130. Katz, "The impact of taxation on the digital economy," 5.

131. Ruud A. De Mooij, Alexander D. Klemm, and Victoria J. Perry, eds., Corporate Income Taxes under Pressure: Why Reform Is Needed and How It Could Be Designed (Washington, DC: International Monetary Fund, 2021), https://doi.org/10.5089/9781513511771.071

132.Mutai, "Uber, Bolt threaten to pull out of Kenya over proposed taxes."

133. Alex Kanyi et al., "Kenya Budget Speech," Tax & Exchange Control Alert, CDH Incorporated, June 19, 2024, https://www.cliffedekkerhofmeyr.com/news/publications/2024/Practice/Tax/budget-speech-kenya-19-June-2024

5.2 Impact on Government

5.2.1 Increased Administrative Burden

The requirement by the VAT (Electronic, Internet and Digital Marketplace Supply) Regulations, 2023[134] for all providers of imported digital services to register for VAT in Kenya, regardless of their turnover, introduces several challenges for tax administration. Previously, a 5 million shillings turnover threshold determined registration, allowing smaller entities to remain outside the VAT system.

By mandating that all digital service providers register, tax authorities must now handle a significantly higher volume of registrations, including those from small and potentially numerous foreign digital service providers. This will increase the administrative burden, necessitating more resources to process and manage these registrations.

Additionally, ensuring compliance from international entities with no physical presence in Kenya will be difficult, complex and costly for Kenya's tax authority.

5.2.2 Potential for Trade Disputes

Unilateral tax measures such as the DST aim to reallocate tax rights from other countries, particularly the United States, which hosts the major digital companies such as Alphabet, Meta, Amazon and Netflix amongst others. [135]The DST's have the potential to lead to an economically harmful tax and trade war with host countries and should therefore be avoided.[136]

A case in point is the U.S.-France dispute following the enactment of DST by the French government. The United States Trade Representative ("USTR") adopted trade sanctions on France (currently suspended due to the pending global negotiations) and has threatened to adopt similar sanctions against other countries implementing DSTs.[137]

There were concerns that the introduction of unilateral digital tax measures such as the DST and the proposed SEP Tax could provoke threats of similar retaliation by the U.S. against Kenya as was the case in France. [138]

5.2.3 Eroded Fiscal Sustainability

While states have the authority to use residence- and source-based taxation to obtain resources for public purposes from their citizenry and their territory, this power needs to be exercised judiciously to maintain fiscal sustainability.[139] Accordingly, when developing fiscal policies, governments need to consider the trade-offs between revenue generation and the potential negative impact on the development of the digital sector.[140]

134.Value Added Tax (Electronic, Internet and Digital Marketplace Supply) Regulations 2023, http://kenyalaw.org/kl/fileadmin/pdfdownloads/LegalNotices/2023/LN29_2023.pdf
135. Lucas-Mas and Junquera-Varela, "Tax Theory Applied to the Digital Economy: A Proposal for a Digital Data Tax and a Global Internet Tax Agency." 136. Enache, "Digital Taxation around the World."
136. Enache, "Digital Taxation around the World."
137. Reuven Avi-Yonah,Young Ran Kim, & Karen Sam, "A New Framework for Digital Taxation," Harvard International Law Journal 63, no. 2 (2022): 274-341.
138. Agence France Presse. "Spain Risks US Ire after Approving Digital Services Tax." The Guardian, February 18, 2020. https://www.theguardian.com/world/2020/feb/18/spain-digital-services-tax
139. Lucas-Mas and Junquera-Varela, "Tax Theory Applied to the Digital Economy: A Proposal for a Digital Data Tax and a Global Internet Tax Agency," xvii.
140. Katz, "The impact of taxation on the digital economy."

In the case of Kenya, even as the government seeks to widen the tax base and address recurrent revenue shortfall by targeting digital businesses, it needs to design and implement balanced tax policies that capture revenue from the digital economy without causing excessive economic disruption or increasing the tax burden. Analysts have warned that implementing inefficient or overly burdensome tax policies proposed in the Finance Bill 2024 could in the immediate term reduce consumer purchase behaviour, thus hampering the revenue growth of digital companies. In the long term, they could negatively impact the digital economy and fail to generate consistent tax revenue, thereby undermining the government's ability to meet its debt obligations, fund public services and maintain long-term economic stability. [141]

When developing fiscal policies, governments need to consider the trade-offs between revenue generation and the potential negative impact on the development of the digital sector

5.2.4 Undermining Trust in Government

Mobilization of domestic revenues through non-resource taxation can serve as a powerful catalyst for state building and enhancing accountability between citizens and the state. [142] However, governments often introduce new tax measures such as digital taxes without sufficient public consultation, evidence-based research, clear communication about their goals, implementation and regulatory impact assessment. In addition, the lack of transparency about what taxes are collected and how the money is used are likely to erode the public's trust in government.[143]

If digital taxes are seen as arbitrary or primarily revenue-driven rather than well-thought-out policy measures, public perception can turn negative. For instance, the Kenyan government came under intense criticism following the introduction of digital taxes,[144] with both citizens and rights groups terming them as unfair and excessive and warning that they would raise the cost of living once they come into effect.

141. James Opiyo, "Kenya's Tax Increase a Risky Gamble," Business Daily, May 28, 2024, https://www.businessdailyafrica.com/bd/opinion-analysis/letters/kenya-s-tax-increase-a-risky-gamble-4638966
142. Mark Miller, Bryn Welham and Abraham Akoi. Fiscal Governance and State Building (London: ODI, 2017), 15, accessed December 13, 2020, https://www.odi.org/sites/odi.org.uk/files/resource-documents/11758.pdf
143. OECD, Citizen–State Relations: Improving Governance through Tax Reform (Paris: OECD/DAC Governance Network/OECD, 2010), 33, accessed June 7, 2024, https://www.oecd.org/dac/conflict-fragility-resilience/governance/docs/46008596.pdf 139.Lucas-Mas and Junquera-Varela, "Tax Theory Applied to the Digital Economy: A Proposal for a Digital Data Tax anda Global Internet Tax Agency," xvii.
144. Article 19 East Africa, "Kenya Proposed Digital Service Tax in Finance Bill Should Guarantee Digital Rights," (2018), accessed May 2024, https://www.article19.org/resources/kenya-proposed-digital-service-tax-in- finance-bill-should-guarantee-digital-rights/#:~:text=In%202018%2C%20the%20imposition%20of,months%2C%E2%80%9D%20continued%20Mugambi%20Kiai.

5.3 Impact on Consumers

5.3.1 Increased Prices of Goods and Services

Higher taxes usually translate into higher prices for end users as providers of goods and services often pass on the tax burden to them through price increases.[145]

The implementation of digital taxation has been shown to potentially increase the costs of doing business for digital companies, which may ultimately be passed on to consumers through higher prices for a wide range of digital products and services. For example, the introduction of France's DST was estimated to have caused a 2-3% price increase in services for consumers. This occurred as Amazon increased commission rates by 3% for businesses selling on their French platform, potentially prompting vendors to pass on part of these commission costs to consumers through higher prices. [146]

Similarly, following the enactment of the DST in Canada, there are fears that it would lead to higher prices for products and services that rely on digital platforms, such as online purchases, ride-sharing, meal delivery, and vacation rentals.[147]

5.3.2 Reduced Affordability of Digital Goods and Services

Evidence has shown that consumption taxes such as VAT and excise duties can influence user behavior concerning digital goods and services. In the short run, price-sensitive consumers may alter their behavior in response to higher costs occasioned by taxation, either by ceasing to purchase the goods and services entirely or by cutting back on their usage. For example, Kenyan businesses and subscribers of mobile money services have resorted back to using cash in response to the introduction of aggressive tax collection measures and increased taxes on mobile money transactions.[148]

In the long run, the reduced affordability may significantly decrease demand for affected digital goods and services, potentially hindering the growth of online services and limiting their economic benefits. [149]

5.3.3 Low Compliance by Individual Taxpayers

The information asymmetry between tax authorities and taxpayers in the digital economy makes it hard for tax authorities to obtain real tax-related data because transactions are characterized by digitization, virtualization, and conceptualization, especially for individuals, who can achieve transactions even without tax

145.Analysis Mason, Impact of Taxation of Social Media in Africa: Background Paper on Taxation of Internet Access and Content Services (London: Analysis Mason, March 2019), accessed June 27, 2029, https://www.analysysmason.com/consulting-redirect/reports/impact-of-taxation-on-social-media-africa-may2019

146. Elke Asen and Daniel Bunn, "Amazon Passes France's Digital Services Tax on to Vendors," Tax Foundation, August 6, 2019, https://taxfoundation.org/blog/amazon-france-digital-tax/

147. Canadian Chamber of Commerce "Costing You More... 5 Ways the Proposed Digital Services Tax Will Impact You," 2024, accessed June 7, 2024, https://chamber.ca/5-reasons-why-the-digital-service-tax-will-create-major-trouble-for-canadian-consumers-and-businesses/

148. Jacktone Lawi, "600,000 Subscribers ditch their mobile money accounts" The Star, 20 May 2024, https://www.the-star.co.ke/business/2024-05-20-600000-subscribers-ditch-their-mobile-money-accounts/;Martin K.N Siele, "Kenyan businesses are dropping the world's favorite mobile money service", Semafor, 26 October 2023, https://www.semafor.com/article/10/25/2023/kenyan-businesses-are-dumping-m-pesa-mobile-money

149. Katz, "The impact of taxation on the digital economy," 6.

registration. Therefore, digital economy taxpayers are more likely to evade taxes, especially if they see the taxes as unfair or disproportionately affecting certain businesses or consumers, leading to lower voluntary compliance and higher costs for tax enforcement. [150]

By their own admission, Kenya's tax authority faces difficulties in identifying and tracking online transactions due to inadequate access to data from online digital transactions. [151]

150. Peng Jin, Zhangwei Feng, Guiping Li, "The Effect of Platform Data Quality on Tax Compliance in Digital Economy: A Multiagent Based Simulation," Complexity 2023 (December 8, 2023): 1-16, https://doi.org/10.1155/2023/5511572
151. KRA, "Taxing the Digital Economy in Kenya," 3.

6.0 Conclusion and Recommendations

This final section provides concluding thoughts and makes several recommendations geared towards strengthening Kenya's digital tax framework. The recommendations emphasize the importance of building trust, improving compliance, engaging stakeholders, ensuring revenue sustainability, and observing fairness.

Implementing these recommendations will help the country develop a digital taxation framework that not only meets its short-term revenue needs but also supports sustainable economic growth and development in the long term, ultimately benefiting the nation as a whole.

Kenya can develop a digital tax system that promotes the growth of the digital economy while ensuring fair and effective taxation.

6.1 Enhancing Transparency to Build Taxpayers' Trust

Transparency is a crucial aspect of tax policy and legislation, as it helps ensure fairness, accountability, and public trust in the tax system. Governments that prioritise transparency provide clear and comprehensive explanations for their tax policy decisions, including the rationale, objectives, and expected impacts.

Transparency is particularly important in Kenya, where digital taxation is a relatively new and evolving area that needs greater understanding and support from stakeholders. When the public understands the necessity and potential advantages of tax reforms, they are less likely to resist them.

This, in turn, can lead to increased compliance and a more effective tax system overall. Furthermore, transparent communication helps to ensure accountability, as the public can scrutinise the government's actions and hold them responsible for the outcomes of their tax policies.

6.2 Streamlining Digital Taxation for Improved Efficiency and Compliance

Streamlined and harmonised tax policies, coupled with advanced technological solutions, can significantly reduce compliance costs, alleviate administrative burdens, and facilitate more efficient tax collection. This approach not only benefits taxpayers by simplifying their obligations but also enhances the capacity of Kenya's revenue authority to administer and enforce tax laws effectively.

By implementing initiatives such as a unified registration process, standardised filing requirements, simplified filing processes and intuitive payment mechanisms, Kenya can develop a digital tax system that promotes the growth of the digital economy while ensuring fair and effective taxation.

Also, the adoption of citizen portals like eCitizen, iTax, eTIMS and M-Service demonstrates a commitment to digitise tax services and drive digital transformation within the country. However, to enhance efficiency and compliance, these online portals should adopt a coherent and intuitive design philosophy that ensures they are user-centric, simple, innovative, accessible, context-specific, responsive to user needs, service-focused, consistent in user experience, open and secure.

6.3 Encouraging Inclusivity through a Multistakeholder Approach

Inclusivity in digital tax policymaking entails ensuring that all relevant stakeholders, including both traditional and digital businesses, have a voice in shaping tax policies. An inclusive approach allows for genuine participation and consideration of diverse perspectives in the tax policy development process. Given the complexities inherent in implementing digital taxation, a multi-stakeholder approach will help to identify practical solutions, streamline administrative processes, and enhance the overall effectiveness of digital tax frameworks.

By regularly engaging and including input and evidence-based research from a wide array of stakeholders, such as academia, civil society, businesses, industry associations, tax experts, media, technical community and policymakers, Kenya can better navigate the challenges associated with digital taxation while promoting fairness, transparency, and compliance in the tax system.

This inclusive approach recognizes the interconnectedness of the digital space and the need for a global perspective when addressing digital taxation issues. It also underscores the importance of clear policy guidelines, stakeholder participation, and balancing revenue generation with fostering growth within the digital sector.

6.4 Balancing Innovation with Taxation for Fiscal Sustainability

Concerns over the impact of the evolving digital economy on fiscal sustainability has prompted Kenya to adjust its tax framework to include digital businesses.This adaptation aims not only to expand the country's tax base but also to capture the economic value generated by digital transactions and activities. Sustainable digital taxation policies are essential for expanding Kenya's tax base while maintaining the digital economy's long-term viability.

Policymakers must create a regulatory environment that supports innovation including technology start-ups, and growth in the digital economy while ensuring that tax policies are robust enough to

prevent erosion of the country's tax base. This process requires policymakers to strike a delicate balance between protecting tax bases and maintaining a favourable environment for the digital economy to thrive by avoiding over-taxation of digital activities.

Achieving this balance will ensure long-term fiscal stability, attract investment, and encourage technological advancement within Kenya's digital ecosystem. Regular review and adjustment of policies, based on data and stakeholder feedback, are essential for the long-term effectiveness and sustainability of digital taxation.

Kenya's tax policies should be designed to treat all businesses equally with regards to tax obligations and benefits. Regardless of whether a business operates via e-commerce, provides digital services, or engages in traditional brick-and-mortar activities, the tax system should apply neutrally.

6.5 Promoting Fairness in Kenya's Digital Taxation Regime

Ensuring fair tax policies during the digital transformation requires an equitable distribution of tax burdens and benefits across all business types, regardless of their operational model. This fairness is essential to maintain balance in the tax system, preventing distortions that could favour digital businesses over traditional ones or vice versa. In practical terms, this means that Kenya's tax policies should be designed to treat all businesses equally with regards to tax obligations and benefits.

Regardless of whether a business operates via e-commerce, provides digital services, or engages in traditional brick-and-mortar activities, the tax system should apply neutrally. As Kenya adapts its tax frameworks to align with the evolving digital landscape, it is essential to maintain equity in taxation by designing tax policies that foster a level playing field by treating both digital and traditional businesses equally.

This will require incorporating international tax rules into the national tax system to ensure comprehensive and fair tax practices. In addition, they must be complemented with tax administration systems, practices and processes that are professional, just and free from corruption and unethical practices.

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