The ICT sector is a growth engine for the economy

An increase in broadband penetration leads to economic growth and job creation across the economy and to higher tax revenues for the state.

Kenya’s ICT sector is already over taxed

ICT sector-specific taxes impact the poor disproportionately by increasing prices and handicap the digitalisation of the economy, impacting a country’s competitiveness.

Digital taxation is a global problem that requires a global solution

The taxation of digital companies and corporate income tax avoidance cannot be solved unilaterally and requires international cooperation. The OECD framework tackles these two challenges. A unilateral DST risks retaliation from trading partners.

Kenya should sign the OECD Inclusive Framework

By signing the Framework, Kenya can continue to shape it. The immediate tax revenues may not be substantial but there are significant and positive medium term effects.

Executive Summary

Accessible, reliable and affordable broadband Internet is the foundation of the digital economy and digital inclusion. Improved broadband penetration is associated with substantial socioeconomic benefits, contributing to enhanced productivity, facilitating information exchange, and improving service delivery across the economy.

The ICT sector in Kenya is taxed heavily. Consumer taxes represent 21% of the total cost of mobile services, compared to 14% for the rest of Africa (GSMA 2020). Mobile service excise duties alone contributed 2.2% of total tax revenue for the 2020 Financial year, compared to the sector’s GDP contribution of 3.1%. Other taxes such as WHT, VAT and corporate income tax still need to be added in.

The digitalisation of the global economy amplified the problem of tax avoidance and tax fairness and led to a rise in digital taxes around the world, leading to an increase in trade law challenges. Kenya is one of the countries that has introduced a Digital Service Tax (DST).

This policy brief shows that there is an alternative option to a DST for Kenya. The context surrounding this policy brief is an unprecedented new global tax framework that was adopted by the OECD in October 2021. This framework solves the main challenge that many unilateral DST’s cannot address: a fair allocation of taxing rights so that the home country is no longer the sole beneficiary of taxation of multinational companies (MNEs). It also prevents MNEs from avoiding corporate income tax.
Introduction

The direct ICT sector contribution to GDP is increasing in Kenya due to the digitalisation of the economy. It rose from 2.3% in 2013 to 3.1% in 2020.

Apart from the direct contribution, the ICT sector has an impact on productivity across all sectors. Accessible, reliable and affordable broadband internet is the foundation of the digital economy and digital inclusion. Improved broadband penetration is associated with substantial socioeconomic benefits, contributing to enhanced productivity, facilitating information exchange, and improving service delivery across the economy. An additional 10% in mobile broadband penetration yields 2.46% of additional GDP growth in Africa (ITU(2020). For Kenya, that means a 10% higher broadband penetration would bring USD 2.4 billion in GDP and USD 386 million in tax revenues annually. Boosting broadband penetration should be the key component of any economic growth strategy.

Table 1: Additional GDP and tax revenues for a 10% increase in broadband penetration

<table>
<thead>
<tr>
<th></th>
<th>Kenya</th>
<th>Sources</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP USD million</td>
<td>98,843</td>
<td>WDI 2020</td>
</tr>
<tr>
<td>Additional GDP USD million</td>
<td>2,432</td>
<td>ITU 2020</td>
</tr>
<tr>
<td>Tax-to-GDP Ratio %</td>
<td>15.9%</td>
<td>WDI 2019</td>
</tr>
<tr>
<td>Additional Tax USD million</td>
<td>386</td>
<td>Calculated</td>
</tr>
</tbody>
</table>

Kenya removed some taxes and increased the threshold for others as a response to the COVID-19 pandemic. As a COVID measure to reduce cash handling, the government ordered that transactions below Ksh 1000 be excluded for mobile money excise duty and some interbank cash transactions were free. Total excise revenue

Table 2: ICT sector specific taxes in Kenya

<table>
<thead>
<tr>
<th>Tax type</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Digital Service Tax</td>
<td>1.5% on gross revenues of a non-resident digital marketplace (excluding advertising)</td>
</tr>
<tr>
<td>Excise duty on mobile services</td>
<td>20% on mobile services</td>
</tr>
<tr>
<td>Excise duty on Mobile money</td>
<td>12% on transaction fees</td>
</tr>
<tr>
<td>Customs duties on SIM cards</td>
<td>25% on cost, insurance and freight (CIF) value</td>
</tr>
</tbody>
</table>

Table 3: Excise duty revenue

<table>
<thead>
<tr>
<th></th>
<th>KSh million</th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mobile services</td>
<td>26,285</td>
<td>28,610</td>
<td>37,211</td>
<td></td>
</tr>
<tr>
<td>Total excise duty</td>
<td>93,283</td>
<td>116,858</td>
<td>102,715</td>
<td></td>
</tr>
<tr>
<td>Total tax revenue</td>
<td>1,544,262</td>
<td>1,532,236</td>
<td>1,669,832</td>
<td></td>
</tr>
<tr>
<td>Mobile excise duty as % of total excise duty</td>
<td>28.2%</td>
<td>24.5%</td>
<td>36.2%</td>
<td></td>
</tr>
<tr>
<td>Mobile Excise Duty as % of total tax revenue</td>
<td>1.7%</td>
<td>1.9%</td>
<td>2.2%</td>
<td></td>
</tr>
</tbody>
</table>

Source: KNBS (2021)
declined because of these changes, as well as entertainment venues and bars being closed.\textsuperscript{1}

![Figure 2: Total Agent Cash in Cash Out (Value KSh billions)](image)

The adverse effect of excise duties is clearly demonstrated in the case of mobile money. As the Central Bank of Kenya notes, when excise duties are reduced, a "significant increase of mobile money usage has been noted over the period the measures have been in place, demonstrating that they were timely and effective. For instance, the monthly volume of person-to-person transactions increased by 87 percent between February and October 2020. Over this period the volume of transactions below Ksh.1,000 increased by 114 percent, while 2.8 million additional customers are using mobile money. Business-related transactions also recorded significant growth over the same period" (CBK, 2020b)

Kenya’s Digital Service Tax (DST)

The final version of the Digital Service Tax (DST) was put into effect on the 1st of January 2021. The DST is set at a rate of 1.5% of gross transaction value and is applicable only to non-resident companies or corporations without a physical presence in Kenya. It applies to digital marketplaces, which "means an online or electronic platform which enables users to sell or provide services, goods or other property to other users".\textsuperscript{3}

The scope of digital services subject to the DST is wide and include (Kenya Ministry of Finance, 2020):

- Downloadable digital content, including downloadable mobile applications, e-books and films;
- Over-the-top services, including streaming television shows, films, music, podcasts and any form of digital content;
- Sale of, licensing of, or any other form of monetising data collected about Kenyan users which have been generated from the users’ activities on a digital marketplace;
- Provision of a digital marketplace;
- Subscription-based media, including news, magazines and journals;
- Electronic data management, including website hosting, online data warehousing, file-sharing and cloud storage services;
- Electronic booking or electronic ticketing services, including the online sale of tickets;
- Provision of search engine and automated held desk services including supply of customised search engine services;
- Online distance training through pre-recorded media or e-learning, including online courses and training; and
- Any other service provided through a digital marketplace.

The 2021 Act excluded mobile services and income from online advertising as part of the DST.

- Section 7c of the Act states that a “digital service tax shall not apply to income chargeable under section 9(2) or section 35” of the Income Tax Act of 2021. Section 9(2) excludes the transmission of messages and therefore excludes communications providers such as Mobile Network Operators (MNO) or Internet Service Providers (ISP) from paying the DST.
- Section 35 excludes “sales promotion, marketing, advertising services” from the DST. This means that nearly all of Meta and Google’s revenues are excluded from the DST.

Online advertising is excluded from the DST because advertising is already subject to a

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\textsuperscript{1} KNBS, 2021 page 91
\textsuperscript{2} CBK: https://www.centralbank.go.ke/national-payments-system/mobile-payments/
\textsuperscript{3} Finance Act of 2021, section 3(b)
withholding tax. The purpose of a withholding tax (WHT) is to widen the tax base and ensure that income is taxed that the tax authorities would not normally be aware of. For example, a firm purchasing advertising space on Facebook would be subject to WHT because Meta is a non-resident company. The WHT for marketing and advertising services is 20%. The WHT is withheld by the Kenyan firm and remitted to the KRA every month.

The DST is discriminatory because only non-resident firms have to pay it. If Kenya were a bigger market, the tax is likely to be appealed to the WTO under the General Agreement on Trade in Services non-discrimination clauses. The United States Trade Representative (USTR) is monitoring the Kenya DST and it has previously filed Section 301 claims against Austria, India, Italy, Spain, Turkey, and the United Kingdom. These claims were all suspended when the OECD tax deal was signed.

The DST is likely to result in over-taxation or double taxation. There are no double taxation agreements in force with the countries where digital companies are headquartered (like the Netherlands and the USA). This means that a tax could be paid in Kenya and then again on the same revenues in another country. Because there is likely no double taxation agreement for the big tech firms, the firm is unable to claim a credit on the taxes already paid. The OECD has warned that the imposition of unilateral taxes on revenues rather than net income will result in a higher tax burden than the nominal value of the DST.

The costs of compliance are likely higher than the revenues from the DST. The KRA requires non-resident companies to pay the DST via a resident tax representative. This means that a non-resident company cannot register for the DST themselves but must register by proxy. The KRA has not defined what the relationship between the proxy and the non-resident company is to be (legal agreement, subsidiary, what type of legal agreement). The OECD remarked: “The taxing jurisdiction may also encounter difficulties in auditing and verifying the accuracy of the returns filed and payments made by non-residents”. Since KRA has no access to non-resident companies financial statements regarding the revenues from Kenya, disputing figures from non-resident companies would be difficult. The DST is applicable to any transaction that is made using a Kenyan IP address, a debit or credit card located in Kenya, has a Kenyan phone number or a Kenyan address. KRA would need to implement systems to cross reference each of these transactions in order to track and verify DST returns.

Kenya is one of several African countries that have or are implementing a DST. Kenya is also among 25 African countries that are members of the OECD Inclusive Framework initiative. Kenya is one of the four countries (out of 141 member countries) that have declined to commit to the OECD framework. This is somewhat surprising given that Kenya is also an active member of the African Tax Administration Forum (ATAF) that successfully lobbied to incorporate an African position into the OECD initiative (ATAF, 2020). Kenya seems to be expecting higher revenues from the DST than from the OECD deal. KRA is expecting to raise Ksh 5Billion (USD 44.2 million) in the first half of 2021 by bringing up to 1,000 companies and individuals into the DST (Paul, 2021).

Lowering Excise duty to boost tax revenues

The Tax Impact Calculator estimates the impact of reducing or increasing excise duties on tax revenues, GDP growth and employment. The tax revenue impact of a change in excise duties can be assessed for direct and indirect tax revenues as well as the total change in overall tax revenues.

A reduction in excise duty on mobile services in Kenya will result in higher overall tax receipts. The removal of the 20% excise duty is likely to lead to an increase of 16% in overall tax revenues. A reduction of 10% would increase tax revenues by 8% and a 5% reduction would result in 4% more tax revenue. Kenya’s high tax-to-GDP ratio of 15.9% means that any GDP growth has an outsized effect on tax revenue growth. The benefits from productivity increases across the economy outweigh the decrease in direct tax revenues from lowering excise duties.

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4 The calculator is publicly accessible through the RIS website: www.researchictolutions.com
The digital tax challenge

The digitalisation of the global economy amplified the problem of tax avoidance and tax fairness and led to a rise in digital taxes around the world, leading to an increase in trade law challenges. The US, in particular, is keen to stop taxes that disproportionately target large US-based tech businesses such as Meta, Alphabet, Apple and Amazon. Tax avoidance was made a priority by the G7 in 1996. The negotiations on the Base Erosion and Profit Shifting (BEPS) project started in 2013 and culminated in a final deal when the OECD announced a ground-breaking tax deal for the digital age called the Inclusive Framework on Base Erosion and Profit Shifting (IF) on October 8th 2021.

The two problems that are addressed by the IF are linking taxation rights to where value is created, and reforming the current corporate tax system.

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income tax system to disincentivize transfer pricing to the jurisdiction with the lowest tax rate. Figure 4 illustrates the two problems using the hypothetical example of an offshore streaming service serving Kenyan consumers. In the first problem, taxing rights reside with the country where the firm has a physical presence. Because that streaming service does not have a physical presence in Kenya, it is not liable for any CIT, even though it sells services to Kenyans. The second problem is the transfer payment from the streaming service incorporated in, for example, the Netherlands to the Cayman Islands. By paying a royalty fee to its Cayman Islands subsidiary, the parent company in the Netherlands can claim very low profits and therefore pay a very low CIT. The CIT in the Cayman Islands is zero, so the streaming service has no corporate tax obligation on the money it transferred from its Netherlands based parent company.

**OECD’s two-pillar approach**

The OECD’s two-pillar approach takes unilateral digital tax measures off the table and avoids trade wars over digital service taxes. The new tax deal, signed by 137 out of 141 member states, representing over 90% of global GDP, will allocate around USD 125 billion in...
profits to countries around the world. Member countries that sign onto the OECD deal agree not to impose any unilateral DSTs.

**Pillar One**

**Pillar One of the OECD proposal creates a mechanism to redistribute the profits of large multinational enterprises (MNEs), not based on their headquarters, but based on value creation.** The OECD estimates that taxing rights on more than USD 125 billion of profit will be reallocated to market jurisdictions around the globe annually.

Several safeguards are in place to prevent excessive tax administration and overtaxing of companies with low profit margins:

1) The Pillar 1 provision only applies to MNEs with global revenues in excess of €20 billion.

2) A key step is to determine the value of taxation rights to be allocated. The way the calculation works is that 25% of the total profit above a 10% profit margin is allocated as a taxation right to countries that have revenues above a certain threshold in that country. The OECD calls it the residual profit. The value of the taxing rights is called "Amount A".
   • Residual Profit = Profit - (10% * Revenue)
   • Amount A = 25% * Residual Profit

3) The next step is to identify countries that will receive taxation rights. Taxation rights are allocated to countries where that MNE has operations and generates at least €1 million in revenue (€250k for countries with a GDP of less than €40 billion).

4) The final step is to determine the allocation of Amount A for each respective country. Amount A will be allocated to participating countries through an allocation key. The allocation key is not yet set in stone and may involve revenue shares of countries, customers or user numbers.

**Not all countries will receive taxation rights.**

For countries with an annual GDP higher than €40 billion, an MNE must generate at least €1 million of revenues. For countries with an annual GDP of less than €40 billion, the threshold for MNE revenues is €250,000.

Kenya would fall into the higher GDP bracket. If Kenya joins the OECD deal, then an MNE must generate at least €1 million of revenues in order for Kenya to receive taxation rights on the revenues of that MNE.

**Pillar Two**

**Pillar Two sets the minimum tax rate for MNEs to 15%.** In comparison, the average tax rate in Africa is 28.5%. African countries would not be constrained by the minimum CIT. The importance of Pillar Two is that it closes one of the gaps where MNEs would transfer their profits to tax havens to avoid paying tax. There is no obligation for countries to lower their CIT to 15% and Kenya can maintain its existing tax rates of 30%.

**Pillar Two applies to MNE’s with a global turnover of more than €750 million.** Countries are not obligated to agree to Pillar 2 (known as a ‘common approach’), but they have to accept its application by other Inclusive Framework members. Pillar Two has two domestic rules and one treaty-based or international rule and these rules are referred to as the Global anti-Base Erosion (GloBE) Rules:

- **Income Inclusion Rule (IIR)** - this means that if a subsidiary is taxed below the 15% minimum, then the parent company can be taxed the difference.

- **Undertaxed Payment Rule (UTPR)** - this rule prevents companies from claiming deductions for IIR.

- **Subject to Tax Rule (STTR)** - some MNEs make transfer payments of interest or royalties to parent companies, thereby reducing their taxable revenues. The STTR would ensure that

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12 KPMG, July 2021, KPMG Report: OECD/G20 Inclusive Framework on BEPS 2.0, page 8
all interest or royalty deductions would be subject to a minimum tax of 9%.

Pillar 2 would be implemented at the same time as Pillar 1, some time in 2023.

The OECD framework is superior to unilateral digital service taxes

Pillar One solves the main challenge that many unilateral digital service taxes (DSTs) cannot address: it provides a fair allocation of taxation rights so that the home country is no longer the sole beneficiary of taxation. This study estimates that Pillar One of the OECD framework could bring in between USD 4 and 10 million in tax revenue to Kenya, Tanzania and Uganda. This represents their share of the USD 125 billion in residual profit under the OECD Framework. Currently, there is no definitive allocation key, aside from the fact that it is not clear how much revenue companies under Pillar 1 generate from Kenya, Tanzania and Uganda. Without a definite allocation key, this study estimates the tax revenue from the share of GDP at market prices for 2019. The actual distribution key will be based on the revenue share of a country or the number of customers or users of the respective company.

Kenya could generate US$386 million from improving broadband penetration. The returns from a DST are far more uncertain and likely to distort the economy, reduce innovation and increase prices. The OECD deal is a relatively low risk alternative that brings in some revenue, brings Kenya in compliance with the vast majority of countries and allows Kenya to focus on expanding broadband penetration instead.

Recommendations

• Join the OECD Inclusive Framework and ensure that Kenya has a seat at the table during negotiations on the IF and can influence its final format.
• Drop the DST and focus on improving broadband penetration in order to drive economic growth and employment.

Table 5: GDP at market prices for residual profits

<table>
<thead>
<tr>
<th>Country</th>
<th>GDP at market prices in USD billion</th>
<th>% of GDP</th>
<th>Taxing rights (of USD 125 billion in residual profit) in USD million</th>
<th>Estimated tax revenues at 30% CIT in USD million</th>
</tr>
</thead>
<tbody>
<tr>
<td>World</td>
<td>87,437</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kenya</td>
<td>96</td>
<td>0.11%</td>
<td>34.1</td>
<td>10.2</td>
</tr>
<tr>
<td>Tanzania</td>
<td>61</td>
<td>0.07%</td>
<td>21.9</td>
<td>6.6</td>
</tr>
<tr>
<td>Uganda</td>
<td>35</td>
<td>0.04%</td>
<td>12.6</td>
<td>3.8</td>
</tr>
<tr>
<td>Sources</td>
<td>World Bank WDI</td>
<td></td>
<td></td>
<td>Calculation</td>
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</tbody>
</table>
Rebalance ICT sector taxation, shifting from short term revenue generation to medium and long term economic growth and job creation. Removing, or at least reducing, excise duties will increase tax revenues and stimulate higher usage of digital services like mobile money.

References

- OECD (2021b). Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy, October 2021, https://tinyurl.com/bdh8a4sy/