

**CHALLENGES FACED BY THE CURRENT KENYAN TAX LAW IN DEALING WITH
ELECTRONIC COMMERCE**

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DECLARATION

I, MARCIANA NEKESA SIGADAH, do hereby declare that this research is my original work and that to the best of my knowledge and belief, it has not been previously, in its entirety or in part, been submitted to any other university for a degree or diploma. Other works cited or referred to are accordingly acknowledged.

Signed: *MKS*

Date: *25/5/2018*

This Research Proposal has been submitted for examination with my approval as University Supervisor.

Signed: *Ngina Mutava*

Date: *22/4/2018*

CATHERINE MUTAVA

DEDICATION

I dedicate this dissertation to my parents whose efforts in educating me have enabled me to be in a position to do this research. I also salute my brothers and sisters who in one way or another have helped and encouraged me during my academic journey. Finally, I thank the Almighty God who gave me life, good health and strength thus seeing me through this work.

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ABSTRACT

The internet has greatly revolutionized the traditional physical modes of conducting business to the current use of electronic devices either partially or wholly to conduct businesses. Many sectors of the Kenyan economy are now being run using electronic medium. This change in the mode of transacting has led to a shift of the base of income from the traditional markets to that from electronic commerce. This paper is aimed at achieving fairness of sharing the burden of taxation as provided in article 201 of the Constitution of Kenya. Income from electronic commerce however, in some cases ends up untaxed due to the nature of the digital commerce. Electronic commerce challenges the traditional principles for basing taxation. E-commerce poses challenges such as anonymity and defying of geographical boundaries which then makes the income earned from e-commerce inapplicable to tax laws and therefore making e-commerce income earners not to participate in sharing the burden of taxation.

Taxation of income from e-commerce requires laws that are made in contemplation of its nature. The traditional principles for basing taxation require physical presence in a state for such a state to assert tax rights over a person. E-commerce on the other hand is virtual and makes it possible for one to earn income from a particular state without having physical presence in that state. Such aspects of e-commerce need to be contemplated by the law for income from e-commerce to be applicable to tax laws.

A number of countries mostly being developed and experiencing the same challenges have made advancements towards addressing these issues. Regional and International organizations have also been formed to address the same issues. This research borrows greatly from the Organization for Economic Cooperation and Development and two countries India and South Africa used as comparative case studies on how to address the challenges e-commerce poses to taxation.

ABBREVIATIONS

BEPS	Base Erosion and Profit Shifting
B2B	Business-to-business
CFA	Committee on Fiscal Affairs
DTA	Double Taxation Agreement
EAC	East African Community
EC	Electronic Commerce
ICT	Information Communication Technology
ITA	Income Tax Act
OECD	Organization for Economic Cooperation and Development
SARS	South African Revenue Service
UNCTAD	United Nation Conference on Trade and Development
VAT	Value Added Tax

CHAPTER 1

1.1 Background of the study

The internet has been revolutionizing many aspects of modern business to the current use of electronic commerce and promises to bring even more radical changes in the future.¹ Electronic commerce, commonly known as e-commerce is the performance of transactions involving exchange of goods or services between two or more parties using electronic tools and equipment. Globally e-commerce is being used more often and as a result, it is slowly replacing the traditional physical markets with digital platforms.² The traditional physical market places have been replaced by online platforms and electronic modes of money payments.

Several surveys have been carried out to measure the extent of growth of e-commerce in Kenya. Africa Internet Group (AIG), a leading e-business that provides internet platform to over 25 African countries conducted a survey to evaluate the top seven countries for technology and e-commerce growth in Africa. It ranked Kenya second after Senegal.³ Another survey was conducted locally by the Kenya Bureau of Statistics in 2015. The survey reported that information communication technology (ICT) was one of the sectors that had the biggest growth in Kenya. It further reported that Kenya's internet penetration was at 54.8% of its population which was approximately 22.3 million users.⁴ Globally, about 3 billion people of the world population access the internet. This is about 40% of the total global population. These statistics show that Kenya's penetration is above average.⁵

The statistics relayed reveal the potential of e-commerce growth in Kenya. Many businesses have become digitalized and exchange of goods and services is now done electronically. The internet has become the market platform for many businesses both local and international such as Uber, Jumia, Facebook, Amazon, OLX, M-Pesa and other small individual businesses. All these businesses generate income which is not all taxed. Section 3 of the Income Tax Act of Kenya requires all income

¹Peter Lee U, *Towards a national Tax policy for E-commerce*, Philippine APEC study Center, PASCN Discussion Paper No. 2002-08.

²Richard Hill & Ian Walden, *The Draft UNCITRAL Model Law for Electronic Commerce: Issues and Solutions*, (1996).

³Nur Bremmen, *7 African countries with blooming e-commerce markets*, 18th December 2014 <http://ventureburn.com/2014/12/7-african-countries-booming-ecommerce-markets/> on 30 January 2017.

⁴<http://www.techweez.com/2015/04/29/internet-penetration-in-kenya-2015/> on 30 January 2017.

⁵<http://www.techweez.com/2015/04/29/internet-penetration-in-kenya-2015/> on 30 January 2017.

gained or accrued in Kenya be taxed.⁶ Unfortunately, the current tax laws are insufficient in taxing income gained from e-commerce.

1.2 Statement of the problem

In Kenya, taxes are the government's main source of revenue.⁷ The Income Tax Act requires that all income accrued in Kenya be taxed.⁸ Income earned from e-commerce however does not fully meet the requirements needed by the law to be taxed in the country.⁹ This is because of e-commerce's peculiar characteristics which were not contemplated at the time the laws were being made.¹⁰ Kenyan tax laws are source based. This requires that, aspects such as permanent establishment and some requirements of residency be met when establishing the source of an income for it to be taxed in a particular country. When such aspects are considered, e-commerce ends up untaxed as it lacks a physical presence.¹¹

The nature of e-commerce businesses is that they are virtual in that they exist on the internet, barely physically in any country and their transactions defy geographical boundaries.¹² The mode of payment for e-commerce transactions may also be done digitally via the internet with electronic money and depending on the type of software used, the users can be anonymous.¹³ Electronic money leaves little or no traces of a transaction having taken place.¹⁴ Such characteristics of e-commerce make it difficult to determine the source of the income and therefore the country to tax such income. These characteristics of e-commerce make it difficult to tax local and foreign e-commerce companies that generate income from Kenya while located outside the country or on the internet.

⁶Section 3, *Income Tax Act*, (Cap 470 Laws of Kenya).

⁷The Institute of Certified Public Accountants Kenya, 'A Historical Perspective to Revenue Performance in Kenya', *Kenya Revenue Analysis 2010-2015*.

⁸Section 3, *Income Tax Act*, (Cap 470 Laws of Kenya).

⁹Benjamin Musau, *The newest legal issues regarding income tax characterization with respect to international taxation of digital products and services*, 13 March 2014 <http://www.bmmusau.com/article-the-newest-legal-issues-regarding-income-tax-characterization-with-respect-to-international-taxation-of-digital-products-and-services/> on April 2017.

¹⁰ <http://www.bmmusau.com/article-the-newest-legal-issues-regarding-income-tax-characterization-with-respect-to-international-taxation-of-digital-products-and-services/> on April 2017.

¹¹John Sweet, *Formulating International Tax laws in the life and age of Electronic Commerce; Based taxation in the era of eroding traditional Income Tax Principles*, 146 U.P.A., 1960-72.

¹²Klarich A, 'The Nature of E-commerce', *Thompson Rivers University*, (2003/2004), 161.

¹³Ruppert P, 'Privacy, Tax evasion and the Development of Cryptocurrencies', *Georgetown Law Technological Review* (2017).

¹⁴Department of Communications Republic of South Africa, 'A green paper on electronic commerce for South Africa.

E-commerce poses a challenge when determining the jurisdiction to tax its income as the traditional requirements to tax income do not relate to e-commerce. The current tax laws have not addressed this loophole which is against the spirit of taxation. When e-commerce businesses are not taxed, the government loses a significant amount of revenue. This paper therefore sees the need to address the challenges that e-commerce poses to taxation because the tax current laws are insufficient when dealing with e-commerce. The paper also intends to analyze how different jurisdictions have addressed such challenges and come up with comprehensive recommendations that address the challenges.

1.3 Justification of the study

Article 201 of the Constitution of Kenya provides for principles that should guide aspects of public finance and among them includes that the burden of taxation be shared fairly and in a manner that promotes an equitable society.¹⁵ This provision requires that all persons eligible for taxation be taxed fairly without discrimination of the mode used to acquire the income for example the use e-commerce. The Constitution in Article 209 vests the national government with the right to levy taxes on any income gained or accrued in Kenya.¹⁶ The Income Tax Act provides that taxes ought to be charged on all the income of a person, resident or non-resident accrued or derived in Kenya.¹⁷ Article 27 of the Constitution of Kenya as well provides that every person has a right to equal protection and benefit of the law.¹⁸ This principle of equality justifies this study by requiring all income earners be treated equally.

The current tax laws were made prior to the emergence of the digital commerce. The principles that were being applied then are insufficient in taxing the internet based commerce.¹⁹ The insufficiency of the current tax regime is due to the diverse nature of e-commerce as compared to the traditional form of transacting. E-commerce poses different issues and complications from those faced by the

¹⁵Article 201(b)(i) *Constitution of Kenya*.

¹⁶Article 209 (1). *Constitution of Kenya*.

¹⁷Section 3, *Income Tax Act*, (Cap 470 Laws of Kenya).

¹⁸Article 27 (1). *Constitution of Kenya*.

¹⁹<http://www.bmmusau.com/article-the-newest-legal-issues-regarding-income-tax-characterization-with-respect-to-international-taxation-of-digital-products-and-services/> May 18 2011.

traditional physical commerce. E-commerce eliminates geographical or physical boundaries, and this tends to hide, blur or confuse the character and source of the income accrued from it which therefore makes it difficult to tax such income.²⁰ There are many other complications that e-commerce poses which the current taxation laws had not contemplated rendering the laws insufficiently applicable. Some of them vary depending on the type of e-commerce.

E-commerce can be categorized into three types; e-commerce in tangible products, e-commerce in intangible products and e-commerce in services. The three types of e-commerce pose different levels of difficulty when it comes to taxation. All the three types of commerce are global in that they observe no physical boundaries. Other difficulties that vary depending on the type of e-commerce are the level of anonymity of the buyers and sellers and the level of physical and virtual existence. The more virtual or anonymous the type of e-commerce is, the harder it is to tax. Hence while e-commerce in tangibles is hard to tax, e-commerce in services proves to be even much harder to tax.²¹

This research asserts that income accrued from e-commerce is often untaxed and the government constantly loses a significant amount of revenue due to this. Therefore, the intention of this research is to highlight the loopholes that tax laws leave when applied to e-commerce and propose guidelines applicable for e-commerce taxation. This research intends to compare e-commerce tax laws of two countries; India and South Africa whose e-commerce usage is relatively the same as Kenya and use the contributions of the Organization for Economic Co-operation and Development as well as other relevant literature to propose a guideline for taxing e-commerce in Kenya.

1.4 Statement of objective

The main objective of this research is to propose guidelines for taxing e-commerce in Kenya since the current taxation laws do not sufficiently cover this form of commerce. To achieve this, the research

²⁰Benjamin Musau. *The newest legal issues regarding income tax characterization with respect to international taxation of digital products and services*. 13 March 2014 <http://www.bmmusau.com/article-the-newest-legal-issues-regarding-income-tax-characterization-with-respect-to-international-taxation-of-digital-products-and-services/> on April 2017.

²¹David R. Johnson & David G. Post, *Law and Borders—The Rise of Law in Cyberspace*, 48 *Stanford Law Review* 1367, 78.

will carry out a comparative analysis of e-commerce taxation laws and guidelines of India and South Africa to help it propose the intended guidelines.

1.5 Research questions

This research seeks to answer the following questions:

- a. Are there any laws dealing with e-commerce taxation in Kenya?
- b. Does India and South Africa have tax laws that deal with e-commerce?
- c. Do the e-commerce tax laws of India and South Africa address the issue of permanent establishment for e-commerce transactions?
- d. Are the current taxation laws in India and South Africa sufficient to deal with e-commerce for Kenya to emulate?
- e. Are the e-commerce tax laws of India and South Africa in line with the OECD guidelines?
- f. How can the e-commerce tax laws of India and South Africa be applied in Kenya?

1.6 Literature Review

In Kenya there is limited literature on e-commerce taxation. Nevertheless, Attiya Waris, a Kenyan professor on tax wrote a paper titled *Taxation without principles*. Her paper focuses on the history and background of taxation in Kenya in a bid to inform the present tax legislation. The paper affirmed that the colonial imposed tax laws needed reform and advocated for a strong principled taxation system that is more relatable to the current trends.²²

The Organization for Economic Co-operation and Development (OECD), a 29-member group of industrialized nations has made several contributions to the literature of taxation of e-commerce. The first conference was held in Turku, Finland. It was titled 'dismantling the barriers to global electronic

²²Attiya Waris, *Taxation without Principles: a Historical analysis of the Kenyan Taxation System*, *Kenya Law Review*

commerce²³. It discussed the challenges posed by e-commerce and identified its opportunities. The next conference was held in 1997 in Ottawa, Canada.²³ The Ottawa conference was titled 'borderless world- realizing the potential of e-commerce.' It set out principles that ought to guide countries on e-commerce taxation. The principles are; neutrality, efficiency, certainty and simplicity, effective and fairness as well as flexibility.²⁴

In 2000, the OECD developed the OECD Model Tax Convention, a model for negotiation of tax treaties and later on developed a commentary on the model. A year later, the OECD developed a discussion paper on applying the existing principles of double taxation on e-commerce.²⁵

The green paper on electronic commerce for South Africa was compiled by the department of communications of South Africa. The paper was a discussion aimed at changing the South African tax laws from being source based to being residence based so as to accommodate e-commerce taxation. The paper observed that source based taxation system did not apply to e-commerce taxation. It further contributed towards the development of the current policy framework for electronic commerce in South Africa.²⁶ Currently South Africa's tax laws are resident based and e-commerce taxation is governed by the South African Income Tax Act.²⁷

1.7 Hypothesis

In line with the tax principle of neutrality one of the aims of Kenyan tax laws is to tax all avenues that generate income in the country. E-commerce is a new way of transacting where exchange of goods and services are done through electronic platforms. The current tax laws do not sufficiently address e-commerce. The mere fact that e-commerce is different from the traditional way of transacting is not a sufficient reason for it to be exempted from taxation. Tax laws that address e-

²³Kershnee Naickerthe, The taxation of e-commerce: An examination of the impact and challenges posed by electronic commerce on the existing tax regime, *published LLM thesis, School of Law University of Natal Pietermaritzburg*, 25 August 2003.

²⁴OECD Committee on Fiscal Affairs "Electronic Commerce: Implementing the Ottawa Taxation Framework Conditions".

²⁵Kirti and Namrata Agrawal, Research Scholar at Banasthali University, Rajasthan, Professor at NIFM, Faridabad, India.

²⁶A green paper on electronic commerce for South Africa' *Department of Communications Republic of South Africa*.

²⁷*Income tax Act 58 of 1962 (South Africa)*.

commerce need to be developed to achieve equality by taxing all income generated in Kenya including that which arises from e-commerce.

1.8 Research Design & Methodology

A qualitative research method would best apply to this research problem. This research intends to examine the income tax approach of e-commerce tax laws of two countries; India and South Africa as the case studies for this research. The research intends to analyze the e-commerce tax laws of India, South Africa, guidelines from the OECD and other relevant literature so as to borrow some e-commerce taxation principles that may be applicable to Kenya. The choice of this research to use the two countries as case study is because they have advanced e-commerce tax laws yet they are developing countries making their progress possible and within the reach of Kenya. Use of the OECD literature is because of its determination to address the issue of e-commerce tax challenges and its universal acceptance.

This research intends to be guided by the following design; the research intends to relay the current state of Kenyan tax laws in relation to e-commerce. To state the steps that the two countries have taken to address the challenges of e-commerce taxation then use the information to analyze it in relation to the research objectives, questions and the theories that inform this research. The research will then conclude with its findings from the analysis made, make recommendations for the development of e-commerce tax laws and suggest other problems related to the topic that other researches can expound on.

This research will primarily rely on secondary sources of data. The sources intended to be used will be majorly; books, journal articles, statutes, commentaries, reports, dissertations and internet sources related to e-commerce taxation.

1.9 Assumptions

This research is carried out with assumptions that;

- a) The level of usage of e-commerce in India and South Africa is relatively the same as Kenya.
- b) The reception of the taxation laws in the two countries will be the same in Kenya.

1.10 Limitations of the study

This research will be limited in the following ways;

- a) Literature on e-commerce taxation in Kenya is limited.
- b) Taxation laws on e-commerce are not static but constantly evolving since new ways of carrying out e-commerce keep emerging.
- c) Taxation laws of countries are different depending on the extent of use of e-commerce in the different countries.

CHAPTER 2: THEORETICAL FRAMEWORK

2.1 Introduction

Taxes are compulsory levy imposition on individuals or entities by the government.²⁸ They are inevitable and paid by all citizens either directly or indirectly. Libertarians and in particular Robert Nozick consider taxation as government's interference with peoples' lives and a form of slavery.²⁹ This interference by the government is however perceived differently by people. Some see taxation as a good thing and beneficial to the whole society while others like libertarians despise it in its entirety viewing it as "a means of acquisition for the lazy," and an "unjust burdening of the people by government."³⁰ Despite peoples' views about taxation this research seeks to evaluate the authority and rationale for taxation informed by taxation theories.

The legitimacy of taxation is drawn from the people governed. The agreement for citizens to be taxed is formed after individuals agree that they would be better off under the protection of the state than if they were in a state of nature. This agreement then justifies tax impositions of the state to its citizens which is a transition from a state of absolute freedom to that of limited freedom with greater opportunities.³¹ The agreement then becomes a social contract of the people which is executed through a government. The social contract contains certain agreed terms whereby citizens have to give up certain rights in return for some benefits. Terms pertaining to how and the extent that people should be taxed ought to be agreed for taxation to be a smooth and clear process. The authority for taxation therefore comes from citizens' consent. This rationale is drawn from theories such as the social contract theory and distributive justice theory which is under the theory of justice which all inform this research.

²⁸<https://thelawdictionary.org/tax/> on 10 September 2017.

²⁹Robert Nozick, *Anarchy, State and Utopia*; Basic Books.

³⁰Kant, I., *Metaphysics of Morals* (MM), in *The Cambridge Edition of the Works of Immanuel Kant: Practical Philosophy*, trans. by Mary Gregor, Cambridge: Cambridge University Press, 1999.

³¹http://masshumanities.org/ph_taxes-the-social-contract-and-adam-smith/ on 15 September 2017.

2.2 The social contract theory

The social contract theory justifies government's imposition of taxes on its citizens. The basic idea of the social contract theory is people giving up some of their rights to obtain a certain benefit which can only be granted by a government which is also responsible to ensure that everyone keeps their end of the agreement of giving up the agreed rights. The benefit that citizens obtain is usually social goods or assurance of security and protection of property which individuals cannot guarantee themselves in the state of nature. In relation to taxes, people accept taxation as the social contract whereby they give up a portion of their income and in return the government assures them of protection of their rights and properties which is not assured in man's state of nature. The philosophers behind this theory include Thomas Hobbes, John Lock and Jacques Rousseau among others.

According to John Lock, the state of nature we live in is one where there are no social goods and the only way to enforce one's rights is through the use of violence. He then states that that state of nature is what necessitates the need for man to reach to a consensus with one another to give up some rights for protection of other rights by a third party who in most cases is the government.³² He further states that in this state of nature people may still get their rights. However, society will always be in a state of continual of warfare as fear will dominate since the rights are not guaranteed.³³ To avoid this state of warfare, people consent to form a government that protects and assures them of their rights in return for them giving up some of their rights which aid the government to keep its end of the bargain as the third party. The consent of the people then becomes the only legitimate claim to obedience for the protection of their rights.

Thomas Hobbes' contribution to the social contract theory is almost similar to that of John Lock. However, the only difference is that he claims that we exist in a state of nature that makes life 'poor, nasty brutish and short' because of human conditions such as equality of need, scarcity and limited altruism.³⁴ In this state of nature there are no social goods hence the need for social cooperation. To achieve this social cooperation two things ought to be fulfilled that is; guarantee that people will not

³²Hobbes, T; *Leviathan*, Cambridge: Cambridge University Press, 1651.

³³Hobbes, T; *Leviathan*, Cambridge: Cambridge University Press, 1651

³⁴<http://www.csus.edu/indiv/g/gaskilld/ethics/sct.htm> accessed on 20 September 2017.

harm one another and that people must be able to rely on one another to keep their agreements. This then necessitates the need for a government. People then give up some of their rights to form a social contract. Each person agrees to follow the laws of the state on the condition that everyone else does the same. That way, we are all relatively safe from each other and we all benefit from the other social goods that will result.

Jacques Rousseau on the other hand justifies the compulsory nature of taxes as he states that “In the state of nature we enjoy physical freedom of having no restraints on our behavior.” People then form a social contract whose general will is formation of laws that are accepted as just and those who do not follow the general will are breaking the law.³⁵ Jacques Rousseau advocates for forcing people to follow the law because it is in everyone's best interest to do so.³⁶ According to Rousseau, citizens are allowed to do what they please as long as it does not interfere with public interest. He further states that humans have two personalities; public and private. He does not distinguish the personalities but considers that the public persona takes precedence over the private self hence taxation which is part of the public life of human takes priority.

Taxation is part of the social contract agreement. This contract requires individuals to give up some of their rights; in this case it is a portion of their income so as to receive certain social benefits. Rousseau's contribution to the social contract theory requires that for tax laws to be accepted they are to be just and contributed by all for those who fail to contribute are considered as breaking the law. This requires tax laws be made on fair and just principles and be contributed by all including electronic-commerce users.

From the assessment of the three scholars the general agreement is that a third party is required to assure individuals protection of their properties and rights as well as to provide social goods for the individuals. Taxes levied by the government achieve this purpose. For example, in Kenya taxes which are the governments' main source of revenue are used to fund the creation and provision of social goods such as public roads, hospitals, schools and the Kenya Defense Force among others. Provision

³⁵R.A. Leigh. *Unsolved Problems in the Bibliography of J.-J. Rousseau*; Cambridge, 1990), 22.

³⁶<http://www.sparknotes.com/philosophy/socialcontract/> accessed on 17 September 2017.

of such goods by the government is more efficient in terms of cost and time as compared to each individual being left to provide such goods for themselves which is the case in a state of nature. Taxation therefore serves as the solution to mans' anguish in the state of nature justified by his consent in the social contract.

2.3 Distributive justice theory

Distributive justice is about just allocation of goods in society. In relation to taxation, distributive justice corresponds to the distribution of wealth among taxpayers in accordance with the principle of equality. John Rawls argues for the use of the tax system as a means of achieving distributive justice.³⁷

According to Rawls, the distributive justice theory is based on the idea that society is composed of a system of cooperation for mutual advantage between individuals. He advocates that society needs to have a form of social contract to achieve social cooperation. This move for agreement among citizens is what places Rawls' justice as fairness within the social contract tradition of Locke, Rousseau and Kant.

The social contract needs to establish appropriate ways of distributing benefits and burdens in society. Rawls considers justice as the most important principle when it comes to distribution of resources.³⁸ He sees justice as a principle that free and rational people whose intention is to further their own interest would agree on in an initial position of equality. He further states that the principles agreed on need to be defended and any inequalities ought to be justified.³⁹

Rawls suggests that in coming up with the social contract each citizen needs to be represented as free and equal. The representatives ought to be governed by principles that eliminate any possibility of bias for example bias towards certain social status, profession, gender, race or age.⁴⁰ To achieve these, Rawls says that they need to be covered by a veil of ignorance meaning that the principles need to be

³⁷J. Rawls, 'A theory of Justice': *"Laws and institutions no matter how efficient and well-arranged must be reformed or abolished if they are unjust."*3 (1971)

³⁸Michael Lacey, 'Rawls and Nozick on justice', Routledge Taylor and Francis group.

³⁹Michael Lacey, 'Rawls and Nozick on justice', Routledge Taylor and Francis group.

⁴⁰<https://plato.stanford.edu/entries/rawls/#OriPos> .

agreed on without knowledge of what our future positions in society might be. In the veil of ignorance, there is absence of bias which makes sure that the principles designed do not favor a particular condition and are fair to all.

Rawls calls this hypothetical thought experiment that seeks to make vivid to ourselves restrictions that seem reasonable to impose on arguments for principles of justice the 'original position'. In relation to taxation, the theory advocates for members outcomes to be based on their outputs. People who invested large amounts of input ought to receive more than those who invested little. He also says that taxes ought to be paid based on the ability to pay. Income tax can be treated as society's distributive mechanism and hence it has to be governed by laws that are in line with the principles of justice.

The second principle of Rawls theory is the difference theory. As we have seen in his first principle, that is the in the original position, people will always agree to equal distribution of basic liberties. The difference principle allows inequality but to a certain amount and that is if it is to the advantage of everyone. He supports inequality that will always be to the advantage of the least advantaged people in society.⁴¹ Rawls argues that this inequality may promote hard work as it may work as an incentive for people to generate more wealth.⁴² A certain level of material well-being is guaranteed in the difference principle hence everyone can do better and spur economic growth. According to Rawls, a capitalistic system might work better to better the least advantaged. This can be achieved by rewarding productive behavior as an incentive to increase productivity and prosperity.⁴³ In relation to taxation both the rich and the poor would benefit. Tax incentives would motivate the rich to work harder and the least advantaged would get some necessities all of which would end up in benefiting the state as it would spur economic growth.

2.4 Conclusion

⁴¹<http://www.encyclopedia.com/social-sciences-and-law/sociology-and-social-reform/sociology-general-terms-and-concepts-93> accessed on 20 August 2017.

⁴²<http://www.encyclopedia.com/social-sciences-and-law/sociology-and-social-reform/sociology-general-terms-and-concepts-93> accessed on 20 August 2017.

⁴³<https://ethicalrealism.wordpress.com/2011/04/26/three-theories-of-justice/> accessed on 10 August 2017.

From the theories stated, both theories have expressed the need for a social contract which in this is considered as agreement to fair and just tax laws. Adam Smith, though a capitalist philosopher, recognizes that taxes are part of a social contract and the need for them to be guided by good principles. He stated that taxation should be guided by four principles. His first principle is that taxes ought to be based on a person's ability to pay and on the revenue one receives under the protection of the state. He emphasized the point of progressive taxation stating that it was not unfair for the rich to contribute to public expenses more than in proportion to their income. His other principles specified that taxes ought not to be arbitrary, ought to be as low as possible and convenient to pay.⁴⁴

Such principles have been adopted by international bodies such as the OECD to guide taxation laws. Taxation laws need to be flexible to ensure that the system continues being fair. New technological developments or new ways of earning incomes need to be easily included for taxation such as e-commerce usage to ensure there is justice in the system. Just taxation laws that are inclusive of e-commerce need to be included in taxation laws.

⁴⁴http://masshumanities.org/ph_taxes-the-social-contract-and-adam-smith/ accessed on 10 August 2017.

CHAPTER THREE: COMPARATIVE CASE STUDY

3.1 Introduction

This chapter will relay the current position of Kenya with regards to e-commerce tax laws. It will discuss the progress Kenya has made in an attempt to have tax laws that deal with e-commerce. The chapter will further discuss the position of South Africa, India and the OECD in relation to e-commerce tax laws.

3.2 E-commerce tax laws in Kenya

This chapter will relay the current position of Kenya with regards to e-commerce tax laws. It will discuss the progress Kenya has made in an attempt to have tax laws that deal with e-commerce. The chapter will further discuss the position of South Africa, India and the OECD in relation to e-commerce tax laws. Kenya does not have income tax laws that deal specifically with e-commerce taxation. The Constitution of Kenya however contains a general provision in Article 209 vesting the national government with the right to levy taxes on any income gained or accrued in Kenya.⁴⁵ The general provision could be implied to be inclusive of income gained through e-commerce provided it is derived from a Kenyan source. The Income Tax Act further provides that for a person's income to be taxed in Kenya, it needs to have been derived from a Kenyan source irrespective of whether the person is a resident or a non-resident.⁴⁶

Section 2 of the Income Tax Act defines a resident in relation to an individual as one who has a permanent home in the country and was present in the country for any period for a particular year of income under consideration or one who has no permanent home but has been in the country for an aggregate period of 183 days in that tax year.⁴⁷ In relation to a body of persons, a resident means that the body is a company incorporated under the laws of Kenya.⁴⁸ The same section defines a permanent establishment as a fixed place of business where one carries on business and which constitutes a

⁴⁵Article 209 (1), *Constitution of Kenya* (2010).

⁴⁶Section 3 (1), *Income Tax Act* (Cap 470 Laws of Kenya).

⁴⁷Section 2, *Income Tax Act* (Cap 470 Laws of Kenya).

⁴⁸Section 2, *Income Tax Act* (Cap 470 Laws of Kenya).

building site, a construction or assembly project that has existed for six months or more where that person wholly or partly carries on their business.⁴⁹

E-commerce falls under the definition of a business and generates income to persons who use it as their means of transacting. This makes income from e-commerce if derived from Kenya to be subject to taxation in Kenya. However non-residents who earn income from a Kenyan source through e-commerce fall short of the requirement to be taxed in the country as they would not meet the requirement of having a permanent establishment or physical presence in the country. The nature of e-commerce does not allow such e-commerce earned income of non-residents to be taxed in the country when subjected to the current tax laws.

The challenges that e-commerce poses to taxation in Kenya is its lack of a permanent establishment or physical presence in the country as well anonymity of e-commerce transaction which make it difficult to trace the source of the income for it to raise a right to be taxed in the country.⁵⁰ These challenges are caused due to the nature of e-commerce which was not contemplated at the time the current tax laws were made.⁵¹ The nature of e-commerce is that it is global and virtual meaning it does not recognize geographical boundaries or require physical presence. Payment of e-commerce can also be done using digital money and its users can be anonymous therefore making it difficult to trace the source of such income and hence the income may end up untaxed.

Kenya has made some efforts to address these issues at a regional level. It has made joint efforts with the East African Community (EAC) to establish a harmonized framework for cyber laws.⁵² The United Nation Conference on Trade and Development (UNCTAD), working with the EAC member states, has helped formulate policies that address the issues of e-commerce taxation as well as suggest

⁴⁹Section 2, *Income Tax Act* (Cap 470 Laws of Kenya).

⁵⁰ [http://www.bmmusau.com/article-the-newest-legal-issues-regarding-income-tax-characterization-with-respect-to-international-taxation-of-digital-products-and-services/May 18 2011](http://www.bmmusau.com/article-the-newest-legal-issues-regarding-income-tax-characterization-with-respect-to-international-taxation-of-digital-products-and-services/May%2018%202011).

⁵¹ [http://www.bmmusau.com/article-the-newest-legal-issues-regarding-income-tax-characterization-with-respect-to-international-taxation-of-digital-products-and-services/May 18 2011](http://www.bmmusau.com/article-the-newest-legal-issues-regarding-income-tax-characterization-with-respect-to-international-taxation-of-digital-products-and-services/May%2018%202011).

⁵²The United Nation Conference on Trade and Development, "harmonizing cyber laws and regulation: the experience of the East African Community East African Community annual report", 2013.

recommendations for the community to implement so as to enable it form tax policies that include income from e-commerce sources.⁵³

The EAC has made several recommendations for member states concerning e-commerce. Among those recommendations are;

- That laws concerning electronic transactions to address the issue of the time and place of an electronic transaction;
- That a comprehensive set of statutory definitions be incorporated into the electronic transactions legislation;
- That partner states reform their national tax rules and adopt international best practice i.e. the OECD's definition of the concept of 'permanent establishment' for clarity purposes so as to establish when an online business meets the applicable criteria;
- That the rules and procedures governing tax administration be re-examined to accommodate online businesses and enable revenue authorities to have adequate and technically secure means to collect remit and audit the collection of taxes in an online environment;⁵⁴ and
- That the countries address these issues jointly.

These have however not been implemented despite the good recommendations which would have addressed most of the issues this research intends to resolve.

3.3 South African e-commerce tax laws

South Africa just like Kenya faces the same e-commerce taxation problems. The difference however, is that South Africa has already began discussions towards addressing the problems. Even though it has not succeeded in fully addressing all the issues it has made progress that Kenya can learn from.

⁵³The United Nation Conference on Trade and Development, "harmonizing cyber laws and regulation: the experience of the East African Community East African Community annual report", 2013.

⁵⁴The United Nation Conference on Trade and Development, "harmonizing cyber laws and regulations : the experience of the East African Community East African Community annual report", 2013; Annex 2: Recommendations Draft framework phase 2.

South Africa changed the basis of its tax system on 1st January 2001 from that of source based to that of residence based.⁵⁵ This decision was made after several commissions were established to reform the South African tax system. The commissions that led to the change of tax regime in South Africa are; the Katz commission named after its chairman Michael Katz, the Margo commission and the Davis committee.⁵⁶ The Katz commission was appointed by the government to study the South African tax system and make recommendations for reform for an even expropriation tax system as the tax regime then had raised several concerns about inequalities in tax payments which were introduced during the apartheid times and hence inconsistent with the new South Africa's constitution.⁵⁷ The Katz commission did not touch on e-commerce but it formed an important foundation for the growth of e-commerce tax laws in South Africa. Among the key changes that resulted from the recommendations of the commission was the establishment of an independent tax and customs administration; the South African Revenue Service (SARS).⁵⁸

In 1999, the SARS reported that the application of traditional concepts of source to connect the source of an income with to a specific geographical location is difficult and close to impossible in the world of cyberspace.⁵⁹ The report elaborated on the nature of e-commerce as borderless, intangible and does not require a physical presence all of which make it difficult to locate the source of an income for taxation purposes. While still using the source based principle of taxation, SARS could only levy taxes to income restricted to that which was sourced within South Africa's fiscal jurisdiction. The Katz commission however in its fifth interim report advised that active income to continue to be taxed using the source based principles of taxation while passive income to be taxed using residence based principles of taxation.⁶⁰ Taxation of e-commerce was therefore to be accommodated by the residence based system as passive income.

⁵⁵<https://sataxguide.wordpress.com/briefing-note-on-residence-basis-of-taxation/> on 27 March 2018.

⁵⁶Katz commission report, 'Ninth Interim report of the commission of Inquiry into Certain Aspects of the Tax Structure of South Africa' (1997), by Pemsel Staff;18th August 2016.

⁵⁷Katz commission report, 'Ninth Interim report of the commission of Inquiry into Certain Aspects of the Tax Structure of South Africa' (1997), by Pemsel Staff;18th August 2016.

⁵⁸*The Davis Tax Committee*: <http://www.taxcom.org.za/> accessed 16 January.

⁵⁹ Oguttu and Van der Merwe, *Mercantile Law Journal* 305, 2005

⁶⁰Commission of Inquiry into certain Aspects of the Tax Structure of South Africa 1997
<http://www.polity.org.za/polity/govdocs/commissions/katz-5.html>

The change in the basis of taxation meant that individuals who are ordinarily residents of South Africa were then to be taxed on all the income they accrued worldwide and not just in South Africa and persons who are not ordinarily residents could be taxed in South Africa only if they met the requirements of physical presence according to South Africa's income tax laws. The physical presence test requires that persons who have been physically present in the country for a period exceeding ninety one days in aggregate during that year of tax assessment be taxed on income that is deemed to have been derived from a South African source.⁶¹

The Davis report on the other hand was what led to the changes in the tax approach for e-commerce in South Africa. The committee submitted a report that there were limited chances for South African residents using e-commerce to shift their profits to tax haven jurisdictions. On the other hand it reported that it was prevalent for non-residents transacting with South African customers to shift their taxes to other jurisdictions which is in contravention with South African tax laws that requires non-residents to pay taxes on income they derive from a South African source.⁶² This report showed that non-resident e-commerce participants were the ones who were mostly untaxed.

The Davis committee report made the following recommendations with regards to e-commerce;

- That new rules be enacted requiring e-commerce to be taxed based on the place of consumption of the digital goods and services;⁶³
- That rules be made requiring non-residents who derive income from a South African source to be taxed despite them not having a permanent establishment in the country;⁶⁴
- That there be implemented a withholding tax system that requires residents to withhold tax upon payment of e-commerce transaction to a non-resident so as to ensure non-residents register for tax.⁶⁵

⁶¹5th Report - Basing the South African income tax system on the source or residence principle - options and recommendations, Chapter 1; principles of taxation.

⁶²Discussion paper: E-commerce country case study, South Africa; by Adheesh Budree, August 2017.

⁶³Discussion paper: E-commerce country case study, South Africa; by Adheesh Budree, August 2017.

⁶⁴Discussion paper: E-commerce country case study, South Africa; by Adheesh Budree, August 2017.

⁶⁵Discussion paper: E-commerce country case study, South Africa; by Adheesh Budree, August 2017.

- Creation of a level playing field to make South African companies dealing with digital goods and services on the same level as other non-digital companies⁶⁶ and
- That there be included provisions in the Electronic Communications and Technology Act to identify the location of taxpayers as well as their transactions which is supposed to solve the difficulty of identifying e-commerce users.⁶⁷

Following the recommendations of the Davis Committee report new laws relating to e-commerce were proposed to be made in South Africa's Value Added Tax (VAT) Act.⁶⁸ In 2014 South Africa amended its VAT Act and included provisions to compel suppliers to South African residents to register as VAT vendors if the source is South African.⁶⁹ The instituted laws compelled foreign merchants to register as a South African VAT vendor where the foreign merchant provides electronic services to South African consumers or where he receives payment for electronic services from a South African bank and the amount exceeded 50,000 South African Rand.⁷⁰

In 2015 the Minister of Finance declared that South Africa would make amendments to change its tax laws to include the digital economy. The proposed amendments were to be made in line with the guidance that the OECD had issued in its report on base erosion and profit shifting (BEPS). This was also a follow up on the recommendations of the Davis Committee report. The change that resulted from this was the re-definition of the term 'permanent establishment' in its Income Tax Act to mean permanent establishment as defined from time to time in Article 5 of the Model Tax Convention.⁷¹

Other than the commissions discussed above, South Africa also held several discussions from as early as 2000 to identify the issues posed by e-commerce which the commissions expounded on. The early

⁶⁶Electronic Communications and Transactions Act, No. 25 of 2002.

⁶⁷Discussion paper: E-commerce country case study, South Africa; by Adheesh Budree, August 2017.

⁶⁸'new tax rules proposed for e-commerce transactions' by the tax department, 22 April 2015.

<https://www.ensafrica.com/news/new-tax-rules-proposed-for-e-commerce-transactions?Id=1773&STitle=tax%20ENSight> accessed on 14th January 2017.

⁶⁹Webber Wentzel, 'VAT and e-commerce, South Africa falls behind; stays behind', 12 December 2017 <https://www.itweb.co.za/content/WKBpdg7pX617LEew> on 10 February 2018.

⁷⁰Webber Wentzel, 'VAT and e-commerce, South Africa falls behind; stays behind', 12 December 2017 <https://www.itweb.co.za/content/WKBpdg7pX617LEew> on 10 February 2018.

⁷¹Pinch A. And Smit N., 'proposed expansion of "permanent establishment" definition' *ENS Africa* <https://www.ensafrica.com/news/Proposed-expansion-of-permanent-establishment-definition?Id=2129&> on 11 February 2018

discussions were what led to the release of the green paper on e-commerce which identified the issues arising from e-commerce and encouraged further discussions on the topic. The paper proposed that there be established legal and regulatory framework to govern e-commerce which would maintain confidence and privacy of electronically performed transactions, enhance information infrastructure and encourage distribution of e-commerce opportunities in the entire country.⁷²

Currently, South Africa is governed by the VAT Act as the main legislation for taxing e-commerce transactions.⁷³ On the 28th March 2014, the South African government gazetted a number of qualifying electronic services that ought to be taxed.⁷⁴ South Africa uses VAT which is a tax on consumption to levy taxes to foreign merchants on consumption of digital services in the country. The foreign merchants are required to register as South African VAT vendors.

3.4 India's e-commerce tax laws

India's e-commerce growth rate has been rated as one of the highest in the world at an annual rate of 51%. In India, e-commerce is the fastest growing mode of commercial transactions.⁷⁵ E-commerce, just as it has been in other countries, has posed the same challenges to India. Just like South Africa, India has had numerous efforts to reform its laws so as to address the challenges of taxing e-commerce. In 1999 India constituted a committee known as the High Powered Committee to study aspects of e-commerce that pose challenges to it being taxed and to suggest measures that address the challenges.⁷⁶ The Committee suggested that a withholding tax that is as low as possible be introduced on e-commerce transaction so as to safeguard it against base erosion.⁷⁷

The issues that were keenly looked at and which also influenced the reformation of tax laws in India are; e-commerce lack of a physical presence and non-resident's lack of a permanent establishment in the country. The two requirements are key to raise a right to be taxed in India. Section 6(3) of the

⁷²South Africa, Department of Communications: *A Green Paper on Electronic Commerce for South Africa*, November 2000 http://www.gov.za/sites/www.gov.za/files/electronic_commerce_1.pdf accessed 3 July 2017.

⁷³Webber Wentzel, 'VAT and e-commerce, South Africa falls behind; stays behind', 12 December 2017 <https://www.itweb.co.za/content/WKBpdg7pX617LEew> on 28 February 2018

⁷⁴ Webber Wentzel, 'VAT and e-commerce, South Africa falls behind; stays behind', 12 December 2017 <https://www.itweb.co.za/content/WKBpdg7pX617LEew> on 28 February 2018.

⁷⁵. 'ASSOCHAM-Forrester: India Country commercial guide, 27 July 2017 <https://www.export.gov/article?id=India-e-Commerce> on 28th December.

⁷⁶Kirti and Namrata Agrawal, 'Impact of e-commerce on taxation', Banasthali University, India, 2014.

⁷⁷Kirti and Namrata Agrawal, 'Impact of e-commerce on taxation', Banasthali University, India, 2014.

Indian Income Tax Act defines a resident company for the purpose of taxation as one which has been incorporated under the Indian laws or one which is fully managed from India.⁷⁸ E-commerce being almost completely virtual falls short of this requirement. The case 'Right Florist v Income tax on Google and Yahoo advertising' brought to the Indian tax appellate tribunal court elaborated on the controversial topic of determining what aspects of the internet can be attributed as having formed physical presence in a country.

In the case, a florist had paid two companies; Google and Yahoo to advertise his business online. Both companies did not have a permanent establishment in India, they were not managed wholly from India and did not have their servers located in India hence they were not subject to Indian tax laws.⁷⁹ Google was a resident in Ireland and Yahoo was resident in the USA. Both USA and Ireland had a double tax avoidance agreement with India.⁸⁰ The question to be determined was whether websites amounted to physical presence in a country. The tribunal held that the interpretation of permanent establishment in that context did not include websites unless the servers which hosted the websites were located in the same country.⁸¹ In determining this question, the tribunal referred to the High Powered Committee Report's position. The Committee was of the opinion that the concept of permanent establishment as was previously interpreted, be abandoned and it recommended that a new meaning be drawn from the OECD's explanation of permanent establishment. The tribunal therefore held that Google and Yahoo had not met the requirements to arise a right to be taxed in India. ⁸²

In 2016 India took another bold step to curb the issues of e-commerce taxation by introducing an equalization tax on its digital economy. This step was in line with the proposed report by the OECD's BEPS Action Plan 1 that states should introduce an equalization levy as an option to tax digital

⁷⁸Section 6(3), *Income Tax Act* 1999, (India).

⁷⁹In the Income Tax Appellate Tribunal, kolkata Vs Right Florists Pvt Ltd I.T.A. No.: 1336/ Kol. / 2011 Assessment year: 2005-06.

⁸⁰In the Income Tax Appellate Tribunal, kolkata Vs Right Florists Pvt Ltd I.T.A. No.: 1336/ Kol. / 2011 Assessment year: 2005-06.

⁸¹In the Income Tax Appellate Tribunal, kolkata Vs Right Florists Pvt Ltd I.T.A. No.: 1336/ Kol. / 2011 Assessment year: 2005-06.

⁸²In the Income Tax Appellate Tribunal, kolkata Vs Right Florists Pvt Ltd I.T.A. No.: 1336/ Kol. / 2011 Assessment year: 2005-06.

transactions in order to equalize the tax burden on remote and domestic suppliers of similar goods and services.⁸³

India's Finance Minister, Arun Jaitley, pushed for the insertion of a chapter in the Finance Bill 2016 titled 'Equalization Levy'.⁸⁴ The chapter defined equalization levy as tax that to be levied on consideration received or receivable by nonresidents who did not have a permanent establishment in India, from a resident who carries out a business or profession or a nonresidents who has a permanent establishment in India for any specified service.⁸⁵ The tax is levied at 6% on the specified services including; online advertisements and any other provision for digital advertising space or any facility or service for the purpose of online advertisement. ⁸⁶

The tax is only applicable to Business-to-Business (B2B) transactions. Income of nonresidents subjected to equalization tax is exempted from further taxation under India's Income Tax Act 1961. The equalization tax is applicable to; residents who carry out businesses or professions or to non-residents who have a permanent establishment in India. Such persons are required to withhold this levy when making payments to nonresident service providers. This provision is similar to that of the normal withholding tax. The compliance obligation is for both Indian residents as well as for non-resident service providers. This compliance is being encouraged through sanctions; delayed payments are penalized at 1% on the outstanding levy for each month that the payment is not done.⁸⁷

3.5 Discussion of OECD reports

The OECD has published numerous reports and guidelines which have shaped the gradual tax changes of the two jurisdictions; South Africa and India. Among the OECD reports that have greatly impacted e-commerce taxation literature are the, Model Tax Convention, the Ottawa Principles, the BEPS Action Point 1 Report which identified that e-commerce enterprises avoid paying taxes and shift their

⁸³Global Tax Alert, 'OECD issues final report on the tax challenges of the digital economy' Action 1(2015).

⁸⁴India introduces equalization levy on digital-commerce transactions in 2016 budget', 2nd March 2016, *EY Global Tax Alert Library*.

⁸⁵Chapter 8, *Finance Act 2016* (India).

⁸⁶Report of the Tax Committee on taxation of e-commerce. 'Proposal for equalization levy for specified transaction' 2016.

⁸⁷EY Global Tax Alert Library; 'India introduces equalization levy on digital-commerce transactions in 2016 budget', 2nd March 2016.

profits to low or no tax territories among others. The two countries have used the recommendation of the OECD as well as their own internal recommendations to form their current tax laws.

Article 4 of the Model Tax Convention addresses the issue of who is subject to taxation and to which jurisdiction. The Article contemplates situations where persons could be tax residents in more than one jurisdiction which is common for e-commerce businesses. The Article defines a resident and the criteria to be followed when persons are liable to taxation in more than one tax jurisdiction.⁸⁸ The convention defines a resident as persons who under the law of a particular state are liable to tax by reason of domicile, residence, place of management or any other criterion of a similar nature.⁸⁹ Article 4(2) of the Convention provides that when such a person is a resident in both countries then it should be identified where the person has a permanent establishment. If such person has a permanent establishment in both then he shall be deemed to be resident to the state which his personal and economic relations are closer.⁹⁰ E-commerce easily fits as a business that takes place over a number of countries hence can qualify to be resident in more than one country.

The Commentary on Article 4 of the Model Tax Convention further elaborates on the location of a transaction and the place of taxation. It provides that the place of consumption ought to be the place of taxation.⁹¹ It further provides that in instances where a person has many locations, a contract should provide sufficient indication for the business and tax administrations to determine the country of consumption.⁹² The rationale of taxing income at the country of consumption is to avoid double taxation problems.

⁸⁸Article 4, *Model Tax Convention*.

⁸⁹Article 4, *Model Tax Convention*.

⁹⁰Article 4(2), *Model Convention with respect to taxes on income and on capital*.

⁹¹Draft Commentary to Article 4 of the Model Tax Convention.

⁹²Draft Commentary to Article 5 of the Model Tax Convention.

3.6 When does e-commerce create a permanent establishment?

Article 5 of the Model Tax Convention defines a permanent establishment as a fixed place business from where a business or an enterprise is managed wholly or partly.⁹³ The Article further provides examples of what could amount to a permanent establishment which includes; a branch, an office, a place of management, a factory, a mine, an oil and gas well, quarry or a place of extraction of natural resources.⁹⁴ This definition however does not include a computer, a website or a server which leaves e-commerce out of the picture as most of the examples given only contemplate businesses that have a physical presence. E-commerce makes it possible for people to trade without having physical presence in a country hence falls short of this definition. This therefore leaves us with the question of when does e-commerce create to a permanent establishment.

The permanent establishment query was addressed in 2000 following some amendments made to the definition of 'permanent establishment' in the Model Tax Convention to include e-commerce. The OECD made the following changes to the Commentary of Article 5 of the Model Tax Convention. It clarified the following areas on permanent establishment to fit e-commerce:

- That a website cannot in itself constitute a permanent establishment.⁹⁵
- That human intervention is not a necessary requirement for the existence of a permanent establishment.⁹⁶
- That the issue of whether computer equipment at a given location constitutes a permanent establishment will depend on whether the functions performed through that equipment exceed the preparatory or auxiliary threshold, something that can only be decided on a case by case basis.⁹⁷

⁹³Article 5, *Model Tax Convention*.

⁹⁴Article 5, *Model Tax Convention*.

⁹⁵Draft Commentary to Article 5 of the Model Tax Convention.

⁹⁶Draft Commentary to Article 5 of the Model Tax Convention.

⁹⁷OECD Committee on Fiscal Affairs, 'Clarification on the application of the permanent establishment definition in e-commerce: Changes to the commentary on the model tax convention on article 5, (2000).

- That computer equipment at a given location can only constitute a permanent establishment if it meets the requirements of being fixed. In order to constitute a fixed place of business a server will need be located at a certain place for a sufficient period of time so as to become fixed.⁹⁸

The rationale behind the above mentioned conclusions about e-commerce forming a permanent establishment was discussed in the Draft Commentary to Article 5 of the Model Tax Convention addressing e-commerce. In the commentary, it states that normally, automatic equipment operated by an enterprise amounts to a permanent establishment. However, the same does not apply for computer equipment though it could, in some circumstances, it constitutes a permanent establishment. A website on the other hand is intangible and constitutes a combination of software and data which is stored and operated by a server hence cannot form a permanent establishment or constitute a 'place of businesses. However, the server where a website is operated is equipment which requires physical location and may amount to a fixed place of business of an enterprise.⁹⁹ Therefore a server and not a website can constitute a place of business.

Article 5 of the Draft Commentary further elaborates on the concept of 'permanent establishment'. It states that the concept of a permanent establishment determines the right of a Contracting State to tax the profits of an enterprise of the other Contracting State.¹⁰⁰ Article 7 of the Model Tax Convention provides that a Contracting State can only tax the profits of an enterprise if it has a permanent establishment in that country.¹⁰¹ The two Articles show the importance of including e-commerce in the definition of the term 'permanent establishment'. Article 5 of the Commentary expands the meaning of the term permanent establishment to include persons acting on behalf of an enterprise.¹⁰²

⁹⁸OECD Committee on Fiscal Affairs, 'Clarification on the application of the permanent establishment definition in e-commerce: Changes to the commentary on the model tax convention on article 5,(2000).

⁹⁹Draft Commentary to Article 5 of the Model Tax Convention.

¹⁰⁰Draft Commentary to Article 5 of the Model Tax Convention.

¹⁰¹Draft Commentary to Article 7 of the Model Tax Convention.

¹⁰²Levine H., 'When does e-commerce result in a permanent establishment? OECD initial response' Robbert and Holland LLP, 2000 <https://www.robertsandholland.com/news-page?itemid=105> on 10th February 2018.

Such a person however needs to have his activities limited to specific exclusions. This provision makes it possible for foreign enterprises to have a permanent establishment in a Contracting State without necessarily having a ‘fixed place of business’.

The OECD’s BEPS package discussions and reports have greatly informed this research and have addressed some of the challenges of e-commerce taxation. The 2015 Report on Action Plan 1 identified three possible options that were recommended by the European Union (EU) to address the challenges of e-commerce taxation. The options suggested are; an equalization levy, a withholding tax and an elaborate definition of permanent establishment that is nexus based hence includes significant economic presence such as ‘virtual permanent establishment’.¹⁰³ Although these recommendations were by the EU and not the OECD, the OECD BEPS Action Plan 1 report encouraged states to adopt them.¹⁰⁴ The report states that more work is still required to be done and relies on other action plans to address the e-commerce tax issues.

¹⁰³Pieron A. and Helleputte C., ‘taxation of the digital economy; Toward a new equalization levy in Europe’ Mayer Brown legal update.

¹⁰⁴Pieron A. and Helleputte C., ‘taxation of the digital economy; Toward a new equalization levy in Europe’ Mayer Brown legal update.

CHAPTER 4 : ANALYSIS/ DISCUSSION

4.1 Introduction

This chapter analyses whether the two countries under study; South Africa and India have addressed the challenges of e-commerce taxation which is an objective of this research. The chapter will further analyze whether the two countries have answered the research questions. This entails analyzing whether the countries have e-commerce tax laws that sufficiently address the challenges e-commerce poses. The chapter will then conclude by answering whether the comparative study is appropriate for Kenya to borrow and learn from.

To assess whether the two countries have addressed the challenges that e-commerce poses, focus will be given to the following questions; whether the two countries have a comprehensive definition of the term 'permanent establishment' that encompasses e-commerce transactions, whether the countries have specified the aspects of e-commerce that attribute to it having formed a place of effective management and whether the countries have dealt with the issue of anonymity of taxpayers and their transactions.

4.2 India

India has laws that touch on e-commerce taxation. These are found in the country's Finance Act and its Income Tax Act. The Income Tax Act as discussed in the previous chapter is not comprehensive to include taxation of all income earned from e-commerce. The Act came to force in 1961 at a time when digital commerce had not been envisioned. The emergence of the digital commerce revolutionized the operation of business and challenged the key principles that used to guide taxation

of the traditional physical markets.¹⁰⁵ E-commerce challenged the principle of physical presence that forms the basis for assessing tax liability in India.¹⁰⁶

The rampant growth of e-commerce is what led to the need for re-evaluation of the country's tax laws so as to incorporate e-commerce. The challenges that needed to be addressed were those of incorporating laws that require income to be taxed in India without an enterprise necessarily having a permanent establishment in the country and that of anonymity of some e-commerce transactions as well as its users.

To address the challenge of lack of a permanent establishment, India, through the Tax Committee proposed to institute an equalization levy which is in line with the recommendations of the report of the OECD BEPS Action 1 that the EU had suggested.¹⁰⁷ It then became the first country to use this approach of introducing an equalization levy under its domestic law.¹⁰⁸ The committee reported that the purpose of the levy was to equalize the income disadvantage faced by resident e-commerce companies and to encourage an environment that allows e-commerce companies to compete with foreign companies.¹⁰⁹ This approach is also in accordance with the Ottawa tax principle of neutrality laid out by the OECD which entails treating all taxable income equally hence taxing all income including income from e-commerce.¹¹⁰

Chapter 8 of the Finance Bill 2016 proposed an equalization levy of 6% on specified digital services.¹¹¹ The levy was to start operating on 1st June 2016. It was to be charged only to specified payments of online digital advertisements and on payments in excess of US \$ 1,500 in a financial

¹⁰⁵Ramachandra G., 'India: concept of permanent establishment and Electronic commerce', *Indian Corporate Counsel Association 2003*.

¹⁰⁶Ramachandra G., 'India: concept of permanent establishment and Electronic commerce', *Indian Corporate Counsel Association 2003*.

¹⁰⁷Pieron A. and Helleputte C., 'taxation of the digital economy; Toward a new equalization levy in Europe' *Mayer Brown legal update*.

¹⁰⁸Deloitte, 'equalization levy, is it equitable?' 2016.

¹⁰⁹Report of the Tax Committee on taxation of e-commerce, 'Proposal for equalization levy for specified transaction' 2016.

¹¹⁰ Report from The Forum on Strategic Management to the Committee on Fiscal Affairs 'Tax administration aspects of electronic commerce: Responding to the challenges and opportunities' February 2001.

¹¹¹*The finance bill, 2016* (India).

year to foreign enterprises that do not have a permanent establishment in the country.¹¹² The Government however left an open window to include other digital services. Payers to such non-resident enterprises are required to withhold the levy and the tax would be a final tax.¹¹³

The idea of the equalization levy was to create a level playing ground for foreign and local e-commerce users by subjecting all of them to taxation. This is however not achieved as the equalization levy charged on foreign e-commerce companies is lower than the normal rate of income tax charged to local enterprises. Also the equalization levy is only applicable to B2B transactions and excludes certain payments such as payments made by individuals for posting blogs, payments made by Government Departments to sensitize the public and payments made by Non-Government Organizations (NGOs).¹¹⁴ The levy is not equitable as it still gives foreign e-commerce enterprises an added advantage over local ones. Despite this inequality the equalization levy is still an advancement towards taxing income from e-commerce and can be amended with time to make it equitable.

4.3 South Africa

South Africa like India has e-commerce tax laws that try to address the same issues that challenge the e-commerce taxation. The first approach that South Africa took to address the challenges was to change the basis of its taxation from source based to residence based. This change indirectly worked in favor of e-commerce as the scope of residence based taxation is much broader than the source basis of taxation.¹¹⁵

To include income earned from e-commerce in its tax laws, the Income Tax Act defined the term 'permanent establishment' to mean permanent establishment as defined from time to time in Article 5 of the Model Tax Convention.¹¹⁶ This makes any change made to the definition of Article 5 of the

¹¹²Report of the Tax Committee on taxation of e-commerce, 'Proposal for equalization levy for specified transaction' 2016.

¹¹³Report of the Tax Committee on taxation of e-commerce, 'Proposal for equalization levy for specified transaction' 2016.

¹¹⁴Deloitte, 'equalization levy, is it equitable?' 2016.

¹¹⁵Green paper on electronic commerce for South Africa- public discussion file:///C:/Users/User/Downloads/green_paper_on_electronic_commerce.pdf on 5th February 2018.

¹¹⁶Pinch A. And Smit N., 'proposed expansion of "permanent establishment" definition' ENS Africa <https://www.ensafrica.com/news/Proposed-expansion-of-permanent-establishment-definition?Id=2129&> on 11th February 2018.

Model Tax Convention to automatically apply in South Africa. This approach of extending the permanent establishment definition to include virtual establishment that South Africa chose is in line with the recommendations of the OECD BEPS Action 1 report.¹¹⁷

South Africa's approach to tax e-commerce is through VAT. South Africa's VAT Act requires suppliers to South African residents to register as VAT vendors.¹¹⁸ It further requires residents to withhold tax when they enter into an e-commerce transaction with non-residents hence withhold payments made to non-South African residents.¹¹⁹

An analysis of the two countries; India and South Africa shows that they have used two different approaches to tax e-commerce. Both countries approaches however are aligned with the guidelines of the OECD. Both countries have their definition of the term 'permanent establishment' the same as with that of the OECD. Also, the approach to tax e-commerce is in line with the OECD BEPS Action Plan 1 report which encouraged countries to adopt the methods proposed by the EU; India adopted the equalization levy to its domestic laws while South Africa used the withholding VAT approach.¹²⁰

Though the two countries have made advancements to address the challenges of e-commerce taxation, not all issues have been addressed. The issue of anonymity of taxpayers is one that both countries have not elaborated on. Anonymous e-commerce users can still avoid paying taxes on the income earned in the country. Despite the shortcomings of the two countries in arriving at an equitable method to tax e-commerce, they are still better placed for Kenya to emulate as they are not too developed and neither are their tax laws. This makes the two countries appropriate for Kenya to emulate since it is in its very early stages of addressing this issue and the progress made by the two countries are not too advanced and are easy to adopt.

¹¹⁷Pieron A. and Helleputte C., 'taxation of the digital economy; Toward a new equalization levy in Europe', *Mayer Brown legal update*, December 2017.

¹¹⁸Webber Wentzel, 'VAT and e-commerce. South Africa falls behind; stays behind', 12th December 2017.

¹¹⁹Webber Wentzel, 'VAT and e-commerce. South Africa falls behind; stays behind', 12th December 2017.

¹²⁰Pieron A. and Helleputte C., 'taxation of the digital economy; Toward a new equalization levy in Europe' *Mayer Brown legal update*.

CHAPTER 5; CONCLUSION AND RECOMMENDATION

5.1 Recommendation

One of the objectives of this research was to come up with recommendations for Kenya after analyzing the e-commerce tax laws of India and South Africa. The research also intended to borrow some literature from the OECD whose contribution to taxation has been relied on by many developed as well as developing countries when forming e-commerce tax laws including the two countries under study. This chapter will therefore make recommendations based on findings of the two countries under study as well as the contributions of the OECD. The recommendations given are designed in a way that they give a solution to the challenges e-commerce poses to the current Kenyan tax laws.

The challenges that this research will be providing recommendations for are; out dated tax laws that do not include income from e-commerce, lack of clear e-commerce tax laws, anonymity of e-commerce transactions and its participants and double taxation issues of e-commerce users. This research is aimed at recommending guidelines that would help Kenya address the challenges of taxing e-commerce hence the need to address the challenges.

5.1.1 Out dated tax laws

E-commerce is a relatively new way of conducting business that came about due to technological advancements. The Kenyan Income Tax Act came into force in 1974 when e-commerce had not been contemplated. Currently e-commerce has revolutionized the market and many aspects of e-commerce are not applicable to tax laws. This calls for a change or amendment of tax laws to include e-commerce. Technology advances very quickly and if tax laws remain rigid and outdated tax laws become inapplicable to the income intended to be taxed hence it ends up being untaxed. Flexibility is a tax law principle that needs to be adopted by having constant review of tax laws to adapt to the changes in technology.

South Africa and India began discussions on e-commerce taxation and they have been able to make good progress with the laws they have implemented. Kenya should also start the process as the two countries' progress can be achieved in Kenya too. This research therefore recommends a review and reform of the Kenyan tax laws to include provisions that are applicable to income gained from e-commerce.

5.1.2 Unclear e-commerce laws

Kenyan income tax laws have no specific provision on e-commerce. The constitution as well as the Income Tax Act generally provide that income accrued from Kenya be taxed. E-commerce, as this research has established, needs more than just a general provision to avoid creation of a tax haven for e-commerce. Clear and simple tax law is one of the principles that the Ottawa Conference advocated for e-commerce tax laws. E-commerce laws need to have a clear definition of the terms 'e-commerce' and 'permanent establishment', persons who are to be taxed- hence the need to address anonymity, when e-commerce income is subject to taxation and the jurisdiction to tax the income.

Kenyan tax laws need to be reviewed so as to include an elaborate definition of e-commerce that corresponds with that of the OECD. The question of when e-commerce income ought to be taxed can be addressed by having a comprehensive definition of the term 'permanent establishment' that is applicable to e-commerce. The OECD's amended Model Tax Convention has a clear provision (which has been discussed in the previous chapter) on when e-commerce can create a permanent establishment. Kenya can therefore borrow from Article 5 of the Draft Commentary on the Model Tax Convention provision as this provision is the missing link in the Kenyan tax laws that incorporate the technicalities of e-commerce to be included in the law.

As for the jurisdiction to tax e-commerce, this research recommends that Kenya adopts a withholding VAT system similar to the one South Africa uses. This would require legislation be made requiring residents to withhold tax on payment of services rendered by non-residents to make them register as tax vendors in the country. The idea of using withholding VAT tax system would be more appropriate

as VAT it is much lower than the rate of income tax which makes it attractive to foreign merchants while at the same time it benefits the country as it gets a share of the income gained from e-commerce. The withholding VAT tax method would also help solve the challenge of anonymous e-commerce participants as it will make it easier to identify the participants and transaction taking place when the payments are being done. Withholding VAT system imposes tax on consumption hence a country is able to tax non residents who gain their income in a country despite them having a permanent establishment. This approach helps to reduce base erosion and profit shifting especially by foreign enterprises

5.1.3 Anonymity of e-commerce users and their transactions

As was earlier discussed, identifying e-commerce users can be difficult depending on the products involved or even the websites used for e-commerce. Transactions that occur in the deep web in websites such as Tor are characterized by anonymity whereby it completely hides who the users are, their location, the transaction concluded and even the amount paid especially if electronic money was used. One method of curbing such occurrences is by incorporating changes at the level of the architecture of the internet to make it apparent whenever a transaction takes place in the internet. This however requires advanced technology, significant financial outlay and years for Kenya to be able to do it. Therefore, this research recommends that this be a long term aim rather than one that is to be implemented in the near future.

The use of laws to make it mandatory for internet users to comply with some requirements does not always work. For example, requiring e-commerce enterprises to request customer details such as their name, place of domicile, age and identity number is not an assurance that the information given will always be true. The 1998 OECD's Committee on Fiscal Affairs developed guidance principles that requires internet business identification, transaction information, verification requirements for

customer status and jurisdiction, record-keeping and accountability of electronic payment systems.¹²¹ This however has not been successful as it has been reported that electronic books and records can be easily concealed hence deny tax authorities access to them. This research therefore recommends that such requirement as suggested by the Committee on Fiscal Affairs be incorporated into law. The option of using technology is too advanced for Kenya as even South Africa and India have not been able to adequately address this issue.

5.1.4 Double taxation possibilities of e-commerce transactions

Countries have different basis of how they tax income. Kenya's basis is that of source based while South Africa's and India's is residence based. In many cases where there is no uniformity on the basis of taxation, there arises instances of double taxation. To avoid double taxation, states have to agree on the jurisdiction to tax the income. Most states establish double taxation agreements to determine the state to tax the income when a certain income qualifies to be taxed by more than one country. E-commerce defies jurisdictional boundaries and even blurs the source of the income which makes it difficult for countries to agree on the state with taxing rights over a certain income. The general ideal of double taxation agreements is that the state with the closest or one that has the most nexus with an individual or company is the one allowed to tax. To avoid double taxation of e-commerce, it would be ideal if all countries adopted one standard way of taxation that is all countries to have the same basis of taxation. However the odds of this happening is close to impossible which makes formation double taxation agreements more reasonable.

5.2 Conclusion

E-commerce is ever growing as innovation of new technology keeps on advancing. More people are shifting from the traditional markets to trading almost everything on e-commerce platforms. Many countries, especially the developed ones, have taken steps to create tax laws that include income from

¹²¹"Implementation of the Ottawa Taxation Framework Conditions", Ottawa, 2003 Report, 7.

e-commerce. Kenya on the other hand has stood on the window for way too long watching this income go untaxed which is not only an unfair deprivation for the government but also unjust for other income tax payers. The challenges e-commerce pose are global hence the need for joint effort of countries to address this common issue. This research recommends international cooperation with organizations that are determined to address these challenges such as the Committee on Fiscal Affairs, UNICTAD and the OECD for more comprehensive laws that address e-commerce tax laws.

Further research may need to focus on how other countries other than the ones this research had limits to have addressed the challenges of anonymity of e-commerce users and transactions. This research has not been able to find comprehensive solution to this problem as the two countries that this research was limited to have also not addressed this issue.

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