An Analysis of Unilateral Digital Tax Measures vis-à-vis Redefined Fiscal Social Contracts and Inertia towards Global Consensus: A focus on the Post-COVID-19 Era

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“It is the best of times; it is the worst of times”, the infamous words of Charles Dickens have never been more relevant. The Coronavirus disease 2019 (COVID-19) is changing the way states make decisions, and it is expected that its influence on state decision making will spill over to the Post-COVID-19 era.

Although the current period is characterized by uncertainty, arguably, this period has necessitated the need for states to look inward from a fiscal perspective and contemplate what is most important to them and also
deliberate as to whether the existing bilateral and multilateral tax regimes are best for the individual states. In an effort to provide economic stability and amidst redefined fiscal contracts between states and its constituent citizens, the post-COVID-19 era is likely to be plagued with unilateral tax measures by states as a result of a global economic conundrum that is compelling states to consider their interests in a bid to maximize tax revenues.

Since the onset of the Pandemic, the world has moved from a place where trade and the movement of goods and services knew no boundaries to an era that has significantly slowed down the pace of inter-state trade and movement of goods and services. As a result of this, states are faced with the ever-challenging task of determining how to most effectively cut down spending and increase revenue to fit the times at hand. Now more than ever, it has become important for states to revisit their fiscal social contracts. These fiscal social contracts stem from the very conceptualization of the social contract, believed to be as old as society itself, or at the very least, believed to date back to the era of Epicurus with the contemporary social contract theories drawing their relevance from Thomas Hobbes who opined that the social contract is characterized by the mutual transferring of a right or rights. Hobbes’ theory was expounded on and distinguished from by the likes of John Locke, Jean-Jacques Rousseau, Immanuel Kant and John Rawls but in substance, the aspect of the transfer of rights remains a distinguishing trait. In the fiscal setting, this is even more prominent as state spending and revenue collection influence the livelihoods of the citizens of the state, and this is more so the case during this COVID-19 period. Speculatively, the same will extend to the post-COVID-19 era since the world economy will be recovering from this rather apocalyptic dystopian period.

From a tax perspective, the digital economy which has been booming as a result of movement restrictions imposed by Governments across the world has gained a lot of focus by tax authorities during the COVID-19 period, and it is expected that this focus will continue post-COVID-19. Taxing the digital economy has been received differently by different states, with most jurisdictions adopting unilateral measures in a bid to enhance tax revenues as traditional brick and mortar businesses continue to face challenges which have resulted in a reduction of tax revenues. Against this backdrop, Kenya has
recently introduced Digital Services Tax at the rate of 1.5%, which will be effective on 1 January 2021. Kenya is one of the few countries on the Continent to impose a unilateral DST regime, and other jurisdictions are expected to adopt similar measures.

This variance on how to approach digital taxation has triggered unilateral tax measures, and some have viewed this as unconscionable and unsustainable. Be that as it may, the challenge of moving towards a global consensus on the same has also proved difficult and challenging, especially given the unique circumstances faced by various states. To expound on this further, as a consequence of reduced physical movement and the thriving of the digital economy which is believed to know-no borders and therefore lucrative given the prevailing health situation, different states will continue to look for ways of maximizing tax revenues from the digital marketplace and claim their share, with the developing states proving to be more vulnerable than the developed states that are presumed to be more capable in weathering the storm that is the prevailing global economic depression.

Many countries are already acting unilaterally to address taxation of the digital economy. For example, Israel and India have introduced significant ‘economic presence tests’ as a mechanism in an attempt to impose a tax on multinational entities operating in their jurisdictions without a physical presence; specific tax regimes for multinational enterprises (MNEs) have been introduced, for example, by the UK and Australia with diverted profits taxes and by the United States of America (USA) with its base erosion and anti-abuse tax; and, turnover taxes have been introduced for targeted sectors, such as Hungary’s tax on digital advertising and Italy’s levy on digital transactions. Interestingly, recently, interim measures and a long-term solution has been proposed by the European Union’s (EU) digital tax strategy. Additionally, we have seen the European Council (EC) state its inclination towards a coordinated tax policy response to the challenges raised by the digitalization of the economy at the global level. Despite its inclinations, the EC also believes interim measures are needed due to the lack of consensus and the limited progress made at the Organisation for Economic Cooperation and Development (OECD) level in implementing a global standard that is only possible through a global consensus.
What does this mean for Kenya and other developing countries?

While there is pressure to enhance tax revenues and unilateral tax measures in the digital economy are therefore expected to increase, these measures need to be carefully implemented to ensure that they do not stifle the growth of the nascent digital sector, especially in developing countries.

Some of the issues which need to be considered include the introduction of reasonable revenue thresholds and incentives for start-ups to ensure that taxes in the early years of investment do not hinder growth. For multinationals whose income may already be subject to withholding taxes as well as additional taxes in their home countries, these unilateral measures should not impose an additional tax burden, and there should be mechanisms in place to allow for offsets against extant taxes. The DST tax rates also need to be reasonable to ensure that businesses have an opportunity to recover from the Pandemic, noting that some of the businesses in the digital sector have seen a significant erosion of their tax base as a result of the Pandemic. Lastly, the unilateral measures should include sunset provisions which should result in an automatic repeal of the unilateral measures once the OECD reaches an agreement on a consensus-based solution.

The post-COVID-19 era is likely to provide an interesting setting for the regulation of digital taxation given fiscal pressures and the eccentric existing unilateral application of digital taxation, as the world seeks to move towards a global consensus. In the meantime, revenue authorities, especially in developing countries, should approach unilateral measures carefully, to safeguard the success and continued growth of the digital services sector in their respective jurisdictions.

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