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Factors Affecting Taxation of Ecommerce: An Empirical Study of the Kenyan Market

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Abstract: *The Pareto principle implies that 80% of revenue is from 20% of the population. This stands true for KRA's statistics in revenue collection. This position may to some extent be a true reflection of the economy. It may also be a reflection of shortfalls on KRAs ability to net in persons from some sectors of the economy like ecommerce, thereby focusing on those who are already in its radar. It is imperative for KRA to keep abreast with changes in technology in order to optimize delivery of its mandate. Several internal systems have been put in place to this end. However, they have failed to keep up with changes in technology and business environment in general. This paper identifies various challenges and proposes measures that KRA should explore for the sake of ensuring that ecommerce is brought into the tax net. These changes include; policy changes, cooperative compliance, information sharing and evolution of the tax collection business to accommodate technology.*

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I. Introduction

Taxes have existed since the period when civilization began. An American statesman Franklin (1706-1790) wrote that, there was nothing in the world that was certain except death and taxes. Tax is a compulsory contribution to state revenue, levied by the government on workers' income and business profits, or added to the cost of some goods, services, or transactions. Bustable (1917) defined tax as a compulsory contribution of the wealth of an individual, or that of legal persons, towards the service of the public. Taxation is not voluntary; Adams (2006) noted that, it was the lack of consent to taxation that led to the war in Holland in the 16th century and the American War of Independence. Taxation is the means by which governments raise money to fund their expenditure. Required revenue is to be raised by proportionate taxes on some or all uses of income (Ramsey, 1927). Different countries levy different rates of tax on their peoples' incomes, goods and services. Adams (2006) also observed that, sooner or later, in one way or another, taxes affect us all, young or old, be it as employers, or businessmen building the nation, or as faithful employees, or consumers of goods and services, there is a tax obligation for every person, legal or natural.

The increasing rate of globalization has resulted in radical changes in how businesses start up and operate. Businesses do not need to exist in the brick-and-mortar form; rather, they can now exist online or even as web applications. This implies that, while businesses are currently less in physical existence, they enjoy a vast global audience. As such, businesses are able to carry on in their jurisdictions at times going unnoticed by the tax authority of the land. Likewise, consumers need not leave the comfort of their homes or offices to enjoy shopping even beyond their national boundaries and this is gaining traction as the preferred mode of consumerism.

Value Added Tax in Kenya was introduced in the year 1990. It required that every trader dealing in supply of goods and services, (except those specified as exempt in the VAT Act Cap 476) charge, collect and remit the requisite proportion of the value of the goods, less the VAT paid on purchases subject to the matching principle limitations. To improve on this regime, it became necessary to introduce fiscal receipts to ensure proper recording of goods and services sold by the traders. This saw the introduction of the Electronic Tax Register (ETR).

The use of ETRs in Kenya became a mandatory requirement to all traders registered for VAT in the fiscal year 2004/05. This implied that an ETR generated receipt had to accompany every transaction from a VAT registered trader for it to be recognised as a legitimate sale or purchase. Similarly, any claim of input tax had to have an ETR generated receipt.

1.1 Background of the Problem

Since the 1980s, a large number of developing countries have been in the process of making reforms in their financial and government sectors (Das, 2011). Cheeseman and Griffiths (2005) noted that before the reforms, tax revenues in Kenya were a result of heavy taxation on a limited tax-base; a small group of people were charged large amounts as well as high taxation of imports and exports. Reisen and Trotsenburg (1988) observed that many developing countries urgently needed to mobilize resources to service their growing public debt. Tax reforms in Kenya were introduced majorly because of the increasing need to raise more tax revenue on behalf of the government. These reforms aimed at improving tax collection, reducing revenue leaks, rationalizing government spending and aligning the national budget with development needs of the country. These justifications were highlighted by (Fjeldstad and Rakner, 2003) who noted that, despite important differences in economic and cultural background, developing countries tended to modify their tax systems towards roughly the same direction. The trends noted in the modification of tax systems in different countries were:

- Introduction of the Value Added Tax (VAT) on consumption;
- Lower personal and corporate income taxes;
- Simplification of the tax bands and broadening of the brackets for personal and corporate income taxes;
- Reduction of import duties and simplification of the rate structure;
- Simplification of the excise duty structure; and
- Abolition of export taxes.

As the reforms and modifications took place, KRA faced challenges in the expansion of its tax base on the backdrop of accusations that it was over-taxing a few of the taxpayers within its tax base and letting a large portion of the populaltion majority 'run free'. This affected most of the tax-heads, but in particular VAT.

VAT in its current form in Kenya suffers impediments, partly because of changes from the traditional transactions of how sales and purchases took place. The fact that it is a form of a sales tax implies that, in every transaction of VATable commodities, KRA ought to have a stake in it; however, consumers have changed how they source for their goods and services. Consumers have been venturing into the online world, where the use of ETRs is minimal at best. According to Max Behlke (2017) tax revenue collection needs to keep up with the pace at which the business environment is evolving[1].

Ordinarily, a merchandiser is required to collect VAT where he has physical presence, such as an outlet or a distribution store. This implies being registered for the requisite tax obligations and making required periodical returns and payments commensurate to the business undertakings. However, there are those who exist wholly and exclusively as online stores. These merchandisers range from multi-national enterprises (MNEs) to locally incorporated enterprises with no physical existence therefore slipping through the tax net. This goes against the tenets of taxation that require each taxpayer to bear their rightful tax burden. Taxation in general and administration thereof is not keeping up with evolution of businesses and effects of globalization as it should.

1.2 Statement of the Problem

Taxpayers' compliance comes as a result of the probability of audit, coupled with the probability of accruing penalties from underpayment of taxes (Aizenman and Jinjarak, 2005). This implies that, it is scarcely voluntary. As a result, taxpayers mainly honour their obligations because there are repercussions to noncompliance. The level of efficiency in revenue collection is affected by various factors, which include: - taxpayer ignorance, lack of sufficient workforce to enhance compliance of the entire taxable population, evolution of business environment, low levels of information penetration and high levels of illiteracy among other causes (Waweru, 2005).

Ecommerce has been a thorn in the flesh for KRA. This is because of the cross border nature of the transactions, the fact that the businesses only exist virtually, the ability of the parties involved to conceal their identities as well as the slow pace of progression of enforcement measures by the revenue authority on online activity. With enhancement of voluntary compliance still being a struggle for KRA, enforcement measures present the next best option for collection of taxes. Question that arises then, what new tax collection techniques can KRA adopt for ecommerce sector?

1.3 Objective of the Study

The objective of this study is to establish the challenges and hindrances to collection of VAT from the ever-growing ecommerce sector within the Kenyan perspective and further, propose a framework that would ensure that taxpayers pay the correct amount of tax due from them and at the correct time, that is, when the taxes fall due.

1.4 Justification of the study

The findings of this study will be critical in broadening the tax base with regard to netting in online tradesmen. This would result in enhancement of the Authority's collection levels as well as identification/making of

1 Source: http://money.cnn.com/2017/03/29/technology/amazon-sales-tax/

proposals of necessary policy enhancements required to collect revenue from cross-border online businesses and those that only exist in the internet.
The findings would also give guidelines to the Kenyan government in the formulation of appropriate laws and policies that would ensure that all businesses pay their rightful share of taxes for the sake of nation building.

1.5 Chapter Summary
This chapter was an introduction to the entire study. It brings to light the background and the reasons that make the study necessary, as well as the purpose and scope of the study. The chapter also creates a supporting framework for chapter two, which go into further detail about taxation of ecommerce in Kenya.

II. Analysis of Current Practice and Challenges

2.1 Introduction
This chapter seeks to explore the current practices in Kenya, highlighting the challenges faced by Kenya Revenue Authority in the collection of revenue from ecommerce.

Taxes enable countries, to ensure that their operations and development goals are met. For most developing countries, taxes and foreign aid are the core sources of government revenue. They ensure provision of security, meeting of basic needs as well as fostering of economic developments. The ability of tax authorities to collect taxes is directly proportional to the peoples' willingness to pay the taxes; so much so that if the people, particularly the small taxpayers with less disposable income, are unable to associate the taxes to something tangible, then they will attempt to avoid paying taxes. However, all taxation involves the actual or implied threat of exercise of state power: individual taxpayers are obliged to hand over their money, with no firm guarantee of reciprocity (Brautigam, Fjeldstad and Moore).

For a long time, brick-and-mortar retailers have complained about the unfairness in the application of the law with regards to online businesses. They have argued that their online competitors have had an unfair advantage in that, they do not charge, collect or remit VAT, and do not often declare income tax. The online businesses are therefore said to enjoy lower costs as a result, translating into them being able to have lower charges for the same (or similar) transactions.

In the USA, various bills that were supposed to level the playing field had for a long time stalled in Congress. For years, one of the key online operators in the USA was among the leaders in the fight to keep online purchases 'tax free'. The company now however does remit sales tax in all states, apart from some key states that are not required to levy sales tax.[2] This position was arrived at as a result of several court battles between the IRS and the online operator. This has played a huge role in leveling the playing field for enterprises as well as increased government revenues.

2.2 Definition of a Business
The VAT Act Cap 476 Laws of Kenya defines a business as a trade, commerce or manufacture, profession, vocation or occupation. This definition does not, strictly speaking, incorporate ecommerce. The implication of this being that, enforcement of tax laws on ecommerce is being governed by the same laws that govern the brick-and-mortar salesmen. In other words, the online merchandisers are required to account for their revenues and pay the commensurate taxes in the same way as their brick-and-mortar counterparts under the self-assessment regime.

The main challenge with this is that, these online tradesmen are virtual entities and information on what they do and the extent of their trade, is limited to the web content that is accessible to the general public online. Therefore, in the event that need rises for a tax audit, the books of accounts and trail of movement of stock are not very straightforward or easy to access.

2.3 VAT and other business registration requirements
According to VAT Act, VAT shall be charged on: -

- A taxable supply made by a registered person in Kenya;
- The importation of taxable goods; and
- A supply of imported taxable services

This implies that it is the transaction that attracts the VAT and not the trader. A trader then dealing in supply of the goods and services that attract VAT should then register for the obligation; factoring in the rules of registration, especially the lower limit of Kshs. 5M turnover for compulsory registration. For traders below the Kshs 5M threshold, VAT registration can only be on voluntary basis. However, for all traders, a declaration of business income has to be done in the annual Income Tax return and commensurate tax paid.

[2] Source: http://www.cnbc.com/2017/03/24/the-holiday-is-over-amazon-will-collect-sales-taxes-nationwide-on-april-1.html

To conduct business in Kenya, among the requirements is that a person, natural or otherwise, acquires trading licenses and permits that are issued by the Government of Kenya in addition to being legally incorporated in Kenya. However, there are still plenty of businesses that operate 'under the radar', without meeting the legal requirements. This is as a result of the evolution of the business environment as well as laxity on the part of the government in enforcement of these requirements.

Globalization has led to situations where for instance, Uganda can sell fabric to a consumer in Kenya without any formal documentation. This has been made possible by: -

- Evolution of modes of payment; the use of mobile money transfer is wide spread and globally accepted
- Social media has provided a ready market that spans the entire world, literally creating a global village.
- Evolution of technology; absolutely every field is evolving technologically, and businesses are not exception.

Table 1: Registration and Tax Status of Natural Hair Oil Brands in Kenya[3]

Natural Hair Oil Brand	Type of Registration	Status
Brand 1	No registration details found	No details found
Brand 2	No registration details found	No details found
Brand 3	No registration details found	No details found
Brand 4	No registration details found	No details found
Brand 5	No registration details found	No details found
Brand 6	No registration details found	No details found
Brand 7	Sole Proprietorship	Nil filer for 2016
Brand 8	No registration details found	No details found
Brand 9	No registration details found	No details found
Brand 10	Limited company	Up-to-date with returns and payments
Brand 11	No registration details found	No details found
Brand 12	No registration details found	No details found
Brand 13	No registration details found	No details found
Brand 14	No registration details found	No details found

The table above shows the outcome of a google search on natural hair oil brands in Kenya. Out of 14 brands, only two were identifiable as having registered/incorporated businesses, and out of those registered businesses, only one files returns, having declared business income and makes commensurate payments. This goes to show how easy it is to operate an online business unnoticed particularly by the tax authority. It also indicates a common tendency to have a different trading name from the registration name, thus resulting in difficulty in ability to trace taxpayers.[4]

Keeping up with transactions of this nature may be a difficult task for revenue authorities world over.

2.4 Residence in the Taxation Perspective

According to the Income Tax Act, Cap 470, Laws of Kenya; A resident person for tax purposes means that: -

i) A body was incorporated under the laws of Kenya
ii) The management and control of the affairs of the body were exercised in Kenya in a particular year of income
iii) The body was declared a resident by the Minister by notice in the gazette.

Likewise, an individual (which includes sole proprietorships) is resident for tax purposes if: -

i) He has permanent home in Kenya
ii) Has no permanent home in Kenya, but was present for periods totalling $\geq$ 183 days in that year of income
iii) Has no permanent home in Kenya, but was present for periods totalling more than 122 days in that year of income and in each of the two preceding years of income.

Any individual or corporation that does not qualify as a resident according to the laws of Kenya, is considered non-resident and their incomes are subjected to a higher tax rate in Kenya (37.5% for non-individuals) as well as the taxation laws of the jurisdiction in which they are resident. This implies that for a person, natural or otherwise; whose trading within the boundaries of Kenya shall be subjected to VAT whether resident or not.

Entity 1 is an ecosystem of online commerces, marketplaces and classifieds websites and applications created in 2012. Started in 2012 in Lagos, the company has a presence across 23 African countries. Entity 1 provides a host webpage, where third parties sell on their webpages and pay to Entity 1 a transaction based commission.

[3] Source: Google
[4] Source: KRA DTD systems – (iTax and Legacy)

Entity 2, founded in 2006, is a global online marketplace, operating in 45 countries, and is the largest online classified ads company in India, Brazil, Pakistan and Poland. Having created a wide reaching advertising platform, third party retailers pay advertising fee for every transaction.

Entity 3 was formed in Kenya in September 2007 by a Chinese entrepreneur, in the wake of Kenya's growing e-commerce space. It offers two e-commerce operations, that is, online shopping, where local companies sell their products on the platform, and global shipping, where Entity 3 sources products that are not available locally and delivers them to its customers.

These are three of the commonly used web marketplaces in Kenya, all of which are multinationals; only Entity 3 was found to have been locally incorporated and has a personal identification number (PIN). In addition, they have their periodical tax returns filed. Entities 1 & 2 on the other hand ought to be registered in Kenya and declaring the commissions and advertising fees as income earned in Kenya, and therefore giving the Kenyan 'Caesar' what is due to him.

Non-resident persons (both natural and otherwise) who operate 'under the radar' repatriate profits to their country of residence, therefore depriving Kenya of taxes as well as ploughed back profits.

2.5 Chapter Summary

Administration of tax laws from ecommerce would be successful when the different factors hindering tax collection are addressed. This implies that; the definition of a business has to encompass ecommerce and clearly include guidelines on taxation thereof; compliance measures have to be stepped up so as to keep abreast with businesses; timely evolution of the tax authority is necessary in-order to net in this untapped area; This would include, having functional information systems and well trained personnel for collection of taxes.

III. Best Practice and Recommendations

3.1 Policy changes

Ambiguity in tax law more often than not shifts the preference to the taxpayer's interpretation. Having this in mind, it is imperative that all Acts and laws that govern tax administration, have ecommerce and all that pertains to taxation thereof stipulated clearly to remove any ambiguity.

Kenya needs to make it mandatory for online businesses to include PIN details as requirements for setting up a web application or a web page that would be for operation of a business. This brings these traders into the taxpayer base, making their monitoring for tax purposes possible. It also helps in consumer protection in that, it will make follow up and escalation of complaints to proper authorities easier as the tradesmen are easily identified and held accountable.

3.2 Electronic Invoicing

Electronic invoicing (eInvoicing) is the exchange of the invoice document between a supplier and a buyer in an integrated electronic format. Traditionally, invoicing like any heavily paper-based process is manually intensive and is prone to human error/manipulation resulting in increased costs and processing lifecycles for companies.[5]

In-order to keep up with the trends of evolution, it is necessary for the ETR regime to evolve into the online world. Having a fiscal web application form of ETR (eInvoice) as a requirement for online traders would ensure that every transaction for which a receipt is issued, is recorded and an audit trail of these can be followed with ease. These applications can be easily embedded into the receipting system.

eInvoicing would entail having the KRA system iTax supporting generation of e-invoices by the taxpayers. This implies that for a tradesman to generate a sales receipt, they have to have an iTax profile (that means being registered by KRA) which they log into and generate the receipt. This would be advantageous in that, KRA would have all the data pertaining to all receipts generated by the tradesman as well as for the tradesman; that is, assuming that it is made a compulsory requirement and online traders take it up.

eInvoicing would also be of vast advantages to tradesmen in that, it is possible to authenticate the eInvoice as a record of the transaction would be available to all the parties involved in the transaction. Therefore, there would be reduction in cases of falsification of invoices for claim of inputs.

Electronic invoicing in Brazil for example, is compulsory for nearly all enterprises in Brazil. It is managed by the Tax Authority (Fazenda) in collaboration with the relevant state level offices. "Nota Fiscal Eletronica" is a document that is sent and stored electronically with the purpose of documenting commercial transaction between buyers and sellers. It is both an obligation set by the government, as well as an opportunity for businesses to reap the rewards of electronic invoicing such as quicker collection times and lower costs associated with document processing. The legal validity of Brazilian electronic invoices depends upon the

[5] Source: http://ec.europa.eu/internal_market/payments/docs/einvoicing/activity4_definitions-2012_09_26_en.pdf

electronic signature of the sender, and its legal declaration to the relevant tax authorities (Secretaria de Fazenda) before being sent to its destination.[6]

3.3 Cooperative Compliance

Tax authorities are faced with the never-ending burden of low rates of tax compliance as well as ever-scarce resources. This has resulted in the need of the introduction of a form of enhanced cooperation between tax authorities and large corporations. This cooperation is based on mutual trust, transparency and understanding between the involved parties with the understanding that it would cost large corporations less in terms of time and resources to be compliant than the contrary.

The cooperative compliance framework promotes new forms of communication and enhanced cooperation between the tax administration and taxpayers, as well new mechanisms for dispute resolution. Countries like Italy, UK and Malaysia that have implemented this framework enjoy higher rates of compliance at lower costs as well as greater satisfaction on levelled playing fields in the business front.

In the USA, one of its key online operators is required by the IRS regulations to file a return (form 1099-K) for U.S. taxpayer sellers who meet the following thresholds in a calendar year:

- More than $20,000 in unadjusted gross sales, and
- More than 200 transactions.

These regulations require non-U.S. taxpayers to provide an exemption form (form W-8BEN) to the online operator in order to be exempt from U.S. tax reporting requirements.

3.4 Information Exchange Framework

Appropriate information sharing will improve outcomes taxpayers and the community through more coordinated services and increased operational efficiency. KRA and other government agencies ought to have symbiotic relations for the sake of information sharing. One such relationship should be an Inter-Agency Cooperation with the Communications Authority of Kenya (CA).

The CA is the regulatory authority for the communications sector in Kenya responsible for facilitating the development of the Information and Communications sectors including; broadcasting, multimedia, telecommunications, electronic commerce, postal and courier services.[7]

Amongst the responsibilities of the CA is facilitating the development of e-commerce while protecting consumer rights within the communications environment. The CA is able to do all this because they have information on who gets on the internet and what they do while online.

Currently, the requirements for an individual to conduct business online are non-existent, pliable at best. This implies that, armed with the internet, any individual is able to conduct business, while enjoying a vast global audience. Inter-Agency cooperation with CA would foster ease of policy changes like requiring any person conducting online business in Kenya to have a registered PIN and a notification sent to KRA in-order ensure that the Authority is aware of all businesses taking place; and can anticipate collection of the commensurate revenues from the online businesses. This will reduce the occurrence of tradesmen operating under the radar, which undercuts the legitimate traders. The CA also has within its reach vast amounts of information on the full extent of online trade of any one particular person. This information would be very instrumental in conducting of audits on these tradesmen whenever necessary.

3.5 Chapter Summary

It is the necessary for KRA to keep up with the changes in technology and the changes in the business environment. This is for enhancement of tax compliance, in line with KRA Vision 2018 and the 6th corporate plan. It is also necessary for KRA to join hands with other Government Agencies for a symbiotic relationship that would result in higher revenues.

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[6] http://www.edicomgroup.com/en_US/solutions/einvoicing/LATAM_einvoicing/brazilian_einvoicing.html

[7] Source: http://ca.go.ke

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