CASE STUDY

Navigating Complex Tax Consultations

An Assessment of Kenya's Engagement in the OECD Inclusive Framework (IF)

KENYA REVENUE AUTHORITY

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1.0 Introduction

A key strategic goal of Kenya Revenue Authority (KRA's) Eighth Corporate Plan is to achieve exceptional customer service through, among others, tax simplification, improved trade facilitation, improved dispute resolution processes, service excellence, enhanced brand awareness and structured stakeholder engagement.

To enhance stakeholders' engagement, KRA developed the 2020-2023 Stakeholder Engagement Strategy (SES) which builds on the gains achieved in the implementation of the 2016 – 2019 SES as well as the results of the 2020 Stakeholder Relational Health Audit (SRHA).

The key pillars of this strategy include: a) Building 'integrated value' which places as much emphasis on fostering healthy networks of relationships as on growing a healthy bottom line because healthy relationships are an organisation's most valuable asset and the foundation of trust; b) Adopting a continuum approach to stakeholder engagement that does not overly focus on information dissemination, but that uses all engagement approaches which include, informing, listening, advocacy, consultations, dialogue and collaboration; and c) Implementing a culture change programme that makes skill in stakeholder engagement part of KRA's intellectual capital, a core organisational competence and differentiator.

This case study aims to expose the effectiveness of KRA's approaches to stakeholder engagements, with special focus on complex negotiations around international tax matters. The study utilizes Kenya's – and KRA's – engagement in the Organisation for Economic Co-operation and Development (OECD) Inclusive Framework (IF) as a case study. The short study finds that, while there may not be a one-size-fits-all approach to stakeholder engagements, public institutions have the opportunity to curate their stakeholder engagement solutions to fit their purpose or nature of issues at hand.

2.0 The Inclusive Framework (IF): A Case of Kenya

Digitalisation and globalisation has had a massive impact on trade, businesses, lives and livelihoods across the world, accelerated by amongst other things the COVID-19 pandemic. This has brought about a new and unique challenges to the tax structures and rules which have been in existence for over a century. One of the challenges for tax jurisdictions occurs where highly digitalised Multinational Entities (MNEs) participate in economic activity and derive profits from within a tax jurisdiction without the need to have a physical presence, thereby making it hard for that jurisdiction to tax those profits.

The OECD has been working to develop new rules and processes to strengthen the international tax system, To make it more responsive to current trade practices and tackle tax avoidance under the Base Erosion and Profit Shifting (BEPS) initiative, operationalized in 2015. The Inclusive Framework (IF) was established to make sure that interested jurisdictions (developed and developing countries) participate on an equal footing to tackle tax avoidance, improve the coherence of International Tax rules, and ensure more transparent environment. Kenya joined the IF in January 2017.

Multinational Enterprises (MNEs), whose operations have grown with an ever more integrated global economy comprise a large proportion of global GDP. The main concern addressed by the IF relates to Base Erosion and Profit Shifting (BEPS), which refers to strategies by MNEs that exploit tax gaps and mismatches in tax rules to artificially shift profits to jurisdictions with low or no tax rates - and where in those jurisdictions, the MNEs have no or little value-creating economic activity.

A key focus of the BEPS action plan is around digitalization of the economy. This led to establishment of a new international tax reform framework, in October 2021, in which 137 countries joined the IF initiative – called the Statement. This is articulated within the OECD Two Pillar solution in which members of the IF signing up to the Statement are obliged to withdraw unilateral measures such as digital services tax which has been implemented in Kenya and other countries in Europe, Africa and the Asia, and Equalization levy as implemented in India and similar taxes.

The proposed OECD IF Two-Pillar solution for the taxation of digital economy is as follows:

A. Pillar 1:

- Pillar One rules create a new taxing right in market jurisdictions like Kenya, that go beyond the current physical presence - Permanent Establishment (PE) - and Transfer Pricing (TP) rules currently embodied in in domestic laws and double tax treaties/agreements.
- The rules provide for the reallocation of a part of the residual profits of the most profitable and largest MNEs to the market jurisdictions where users of the services/goods are located.
- The rules will require MNEs with a global turnover above Euro 20 billion and profitability above 10% to reallocate a portion of their residual profits to market jurisdictions with sale greater than EUR 1M or EUR250m for jurisdictions with GDP lower than EUR 40Billion. This amount of residual profits to be reallocated to markets with jurisdictions referred to as ***Amount A***.
- The OECD states that this new taxing right is expected to result in more than USD 100 billion of profit each year to be allocated to market jurisdictions.
- Separate from Amount A, an MNE will be required to allocate a fixed return for tax purposes to routine distribution and baseline marketing activities that take place in the market jurisdictions. This further amount to be allocated is known as ***Amount B***. The rate for Amount B is subject to agreement. Amount B seeks to simplify transfer pricing rules and processes for such kind of services.

B. Pillar 2

- Pillar Two rules aim to counter the strategies used by MNEs to artificially shift profits from market jurisdictions to low or no tax jurisdictions traditionally referred to as Tax Havens
- This Pillar introduces a global minimum tax which would ensure that MNEs pay a minimum amount of tax with respect to their global profits.
- The global minimum effective tax rate has been set at 15% and the OECD projects that it might generate more than USD 150 billion in additional global tax revenues per year to tax jurisdictions.
- For developing countries, the two-Pillar approach also provides for additional source state taxation on certain types of base eroding payments (like interest, royalties, dividends etc) through a ***"Subject to Tax Rule" (STTR)***, available to all countries through a bilateral treaty implementation.
- The minimum tax is expected to lead to counter the tax jurisdictions for incidences of tax avoidance and profit shifting. This will improve the ability of source countries to ensure they are able to protect their tax base from base erosion and profit shifting.
- Finally, the global minimum tax might also affect taxation in developing countries. It will eliminate the need for developing countries to provide excessively generous tax incentives to attract Foreign Direct Investment.

3.0 The Concerns:

Kenya – together with other countries including Nigeria, Indonesia & Pakistan – is among the jurisdictions that did not join the Statement for various reasons. The primary concern is that developing countries had already implemented unilateral regimes such as Digital Service Tax which are fit for developing countries and have helped to expand the revenue base.

The other concerns put forward by Kenya include:

1. The change of revenue threshold from 750 million euros to **20 billion euros and a profitability above 10%**. This automatically reduces the number of in-scope companies to just about **100 MNEs**. Out- of- scope companies will not be included in the tax brackets of market jurisdictions even though they participate in the economic life of these jurisdictions. This does not amount to fair treatment of taxpayers. Kenya opposed this proposal and submitted a counter proposal for this threshold to be lowered to **Eur 250 million**. This would bring in more MNEs within the scope of the new rules and accord developing countries more opportunities to receive the reallocated profits.

2. For a market jurisdiction to be eligible to receive the reallocation of the residual profits, the MNE has to derive at least **Euro 1 million** of revenue from that jurisdiction. A lower threshold of Eur 250 million was set for smaller jurisdictions with a GDP lower than Euro 40 billion. The rationale for this was to only capture the MNEs that participate in a sustained and significant manner in the economic life of the market jurisdiction. Kenya opposed this proposal since it would again deny many developing countries the right to receive the reallocated profits. The revenue amounts that would be considered insignificant by MNEs could be significant for most developing countries which should be given the right to receive the reallocated profits that were partially derived from their jurisdictions.

3. The OECD proposed a global minimum tax rate of 15% which MNEs must pay. Kenya considers this rate to be low and proposed a higher rate of 20%. This would prevent a race to the bottom especially among African countries where the average corporate tax rate is 27%.

4. Joining the consensus on the Two Pillar proposal meant that IF members withdraw all unilateral and other relevant tax measures. But Kenya already adopted the Digital Service Tax, which it would have to forego. The OECD provided statistics that show Pillar One will re-allocate taxing rights of approximately USD **100 billion** to countries. It is however not certain how much Kenya as a country would obtain, if at all - There is no certainty that Pillar One will result in replacement of any foregone tax revenues in the implementation of the Two Pillar proposal.

5. *Dispute Prevention and Resolution Mechanisms:* Kenya expressed concern about the mandatory and binding nature of dispute resolution in relation to Amount A. Developing countries may not have the capacity to participate in dispute resolution. Additionally, transfer pricing disputes would be included within the mandatory binding dispute resolution framework: This is because adjustments made due to transfer pricing audits may affect Amount A. Kenya would thus lose the ability to domestically resolve transfer pricing disputes under the proposals.

6. A key challenge of such a multilateral approach is the difficulty in reaching consensus and achieving a fair deal for all parties: The possibility of small jurisdictions being cowed during negotiations, implementation challenges including costs and complexity, as well as securing jurisdiction compliance may prove a hurdle for a developing country like Kenya.

7. It is possible for MNE's with a growing global turnover to re-structure and to adjust their profitability to avoid being in scope of the new tax rules. As a result, these rules could be subject to abuse. Each jurisdiction is however able to monitor and apply its anti-abuse provisions while administering unilateral measures.

8. Amidst these concerns, Kenya acknowledges the need to remove all unilateral measures. This is critical in order to realize the following:
    a. Cooperation in assertion of tax sovereignty
    b. Flexibility in tax administration
    c. Speed in making necessary tax law amendments,
    d. Tailored tax policies to nation specific economic situations and
    e. Simplicity in tax administration.

To achieve these benefits, Kenya commenced comprehensive stakeholder engagements with both national and international entities to unlock the teething challenges hampering its sign-up to the much needed OECD IF Two-Pillar Consensus.

4.0 The Complexity

But stakeholder engagement on this matter, if any, portends complexity on multiple fronts.

First, the Two-Pillar solution for taxation of the digital economy is a complex technical issue. While its implementation is for the general public's good, consultations around it are managed in technical corridors that may not be open to the entire public. This means the entities must first mobilize the 'right' people to engage and they must be adequately competent enough to understand, not only the intentions of the proposals, but also their consequences.

Second, this engagement is multi-level - borrowing from Putnam's model of international negotiations. There are OECD-level consultations, with countless meetings in Paris and other countries – the main being to objectively push for consensus around the IF Two-Pillar solution. Regionally, African tax jurisdictions were also engaging the Africa Tax Administration Forum (ATAF) – who also input into the OECD negotiations. There is then the domestic conversation with concerned entities and authorities who also need to be convinced and persuaded that the solution will be of utmost value to the country – Kenya in this case. This multiplicity of negotiation platforms creates natural tensions across the levels which need to be managed. Ignoring one negates the other.

Third, Kenya, in acknowledging the need for international cooperation in managing international tax matters, still remained – and rationally so – focused on revenue. The country had already adopted DST as part of its tax regime and made revenue projections to defend its revenue base. It was going to do all it could to ensure the negotiations, regardless of the outcome, do not erode its achievements on the revenue front.

5.0 Unlocking the Impasse: The Anatomy of Stakeholder Engagement

Kenya walked into the complex OECD negotiations with a pursuit for consensus. It has continued to express optimism in arriving at an agreeable position within the OECD framework; one which promises not to reverse the gains accrued in the digital tax space yet still acceptable within the world-wide community of member states.

In order to achieve this, the major players who inform policy and decision makers driving policy were identified, profiled and unique interventional measures curated to address specific concerns – especially as regards the subject of taxation of the digital economy

Kenya prioritized the following stakeholder engagement platforms:

I. **The National Treasury:** - Engagement with the Treasury and National Planning Ministry is perhaps the most critical of all. The National Treasury (NT) is responsible for the fiscal health of the nation and tasked with formulating financial and economic policies which oversee effective coordination of Government financial operations. It is mandated by law to enter into binding pacts and agreements on behalf of the state within local and international jurisdictions - including Bilateral & Multi-lateral agreements. When entering into such agreements, it is widely presumed that Treasury officials would be well versed and fully furnished with all the requisite information before committing to any agreements.

   In order to be better appraised of the mechanics of the OECD, meetings between the National Treasury team and subject matter experts was of necessity. These deliberations would ensure the negotiating teams front the best possible policy options in Kenya's interest.

   In total, the National Treasury held about 5 engagements with consultation with the Office of the Attorney General, the Ministry of Foreign Affairs and Kenya Revenue Authority.

II. **Public Participation Meetings**: - The other stakeholder engagement approach included public participation meetings with relevant stakeholders' - especially players in the digital economy whose views on digital tax remain varied and sometimes contentious. Players in the digital economy space are an important subset of the digital tax ecosystem and their buy-in would influence policymaking in taxation of the digital economy. It was therefore imperative to address their concerns and tap into their repository of knowledge.

III. **The Tax Summit:** The KRA's Annual Tax Summit is a platform for multi-stakeholder dialogue between KRA, Government of Kenya, private sector, civil society, multilateral agencies, development partners, and individuals to generate policy learnings and ideas that enhance tax administration practice to global standards.

   The last Tax Summit forum held between 13-14th October, 2021 held extensive discussions with representatives from the Organization for Economic Co-operation and Development (OECD), Inter-American Centre of Tax Administrations (CIAT), and the African Tax Administration Forum (ATAF) with a special focus on the Inclusive Framework and its impact on Africa - highlighting the opportunities developing countries hoped to take advantage of to enhance and protect their tax base. During the discussions, Kenya and Nigeria presented their cases and the reasons for not joining the consensus in the July 2021 Statement which are highlighted in the case above as concerns which are unique to developing countries.

   A follow up engagement was held with OECD, Centre for Policy and Administration (CTPA), the National Treasury and the Ministry of Foreign Affairs on 24th to 26th January, 2022 to discuss collaboration on the two-pillar approach on areas of mutual cooperation and partnership. The meeting was a key step towards anticipating the possible benefits and consequences of the two pillar international tax deal, as well as leveraging on existing cooperation to deepen Kenya's commitment to multilateralism on international tax matters.

   In the meeting, OECD reiterated its support in the African Tax and Crime Academy by exploring opportunities for enhanced numbers of cohort training. It is safe to report that both parties would continue partnering to implement various initiatives to improve international tax standards and enhance tax transparency globally.

IV. **The Ministry of Foreign Affairs (MFA):** The Ministry of Foreign Affairs (MFA) is yet another crucial stakeholder in Kenya's journey towards OECD's inclusiveness. As the parent ministry primarily responsible for the management of Kenya's foreign policy, the MFA is also tasked with promoting and protecting Kenya's interests and image globally. Kenya's multilateral relations with the OECD around the two-pillar proposal hence falls squarely within the mandate of MFA.

Alongside its stipulated roles, MFA is mandated to sign international treaties and agreements on behalf of the country. It is also the competent authority mandated with jumpstarting domestication of international treaties in line with national policies and constitutional provisions. It is then the responsibility of the Ministry to master local considerations and interests when entering/negotiating international treating on behalf of the country.

6.0 Now & Beyond

Kenya is yet to sign on the two pillar framework and has made the following proposals to OECD with regard to the same:

i. Reduce the revenue threshold from EUR 20 billion to EUR 750 million,

ii. To bring more companies in scope within the jurisdiction.

iii. Developing countries to retain taxing rights on DST for out-of-scope companies.

iv. Allow for a non-binding arbitration process.

v. For subject to tax rule (STTR), establish a minimum tax on royalties.

vi. Exclude financial institutions and extractive industries.

Kenya is among developing countries pursuing discussions aimed at fine tuning the various aspects of the two-pillar solution of the inclusive framework and shall continue to engage to ensure that the tax issues are properly addressed.

While this is work in progress, developing countries continue to consolidate their competencies in international taxation through continued engagement with the process; capacity development in tax policy and administration; investment in technology for tax administration; deployment of political and diplomatic assets in future tax negotiations; and through development of suitable options for implementing international tax reforms.

The country remains committed to international cooperation in taxation matters – a key part of the country's tax diplomacy profile over the years. Continuous stakeholder engagement will remain part and parcel of this endeavor. The future is brighter and Kenya looks forward to being part of the deal sooner than expected.

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