

## Taxation and the digital economy



### 1. What is the digital economy?

The internet has brought about significant changes to the global economy. In particular it has changed business models in retail: the world's biggest retailers, such as Amazon and Alibaba, no longer operate shops. Entertainment and information services that were once provided via physical media (books, newspapers, compact disc, tapes, etc) can now be provided via the internet.

At the same time, completely new business models have emerged as companies such as Facebook and Google have explored ways to leverage information derived from users who often don't make a direct payment for the service that they use. Whilst business models are constantly evolving, the following table summarises some of the key models that have emerged so far:

Social networks	Search engines	Intermediation platforms	Online content providers	E-retailers	Digital software and hardware
Users create and share their own content	Match users with content	Match users with other users	Provide content	Online shopping	Digital or hardware solutions
<ul style="list-style-type: none"> <li>• Facebook</li> <li>• LinkedIn</li> <li>• Instagram</li> <li>• Tumblr</li> </ul>	<ul style="list-style-type: none"> <li>• Google</li> <li>• Yahoo</li> <li>• Yandex</li> </ul>	<ul style="list-style-type: none"> <li>• Ebay</li> <li>• Amazon Marketplace</li> <li>• Tinder</li> </ul>	<ul style="list-style-type: none"> <li>• YouTube</li> <li>• Netflix</li> <li>• Spotify</li> <li>• Amazon Prime</li> </ul>	<ul style="list-style-type: none"> <li>• Amazon</li> <li>• Alibaba</li> </ul>	<ul style="list-style-type: none"> <li>• Apple</li> <li>• AVG</li> <li>• Microsoft</li> </ul>

The methods by which these companies generate their income fall into two broad categories:

- Sales of goods or services via the internet to customers who may be private individuals or other businesses; and
- Free-to-use, internet-based services where the provider generates most of its revenue by selling advertising and/or data to third parties.

In both cases, the provider accumulates data about its users which becomes a key asset of the business enhancing its ability to target more goods and services at users.

## 2. Why is the digital economy a challenge for existing tax systems?

For several years, the amount of tax paid by key participants in the digital economy has been the focus of public scrutiny. There has been criticism that companies such as Amazon and Facebook do not pay “fair” amounts of tax in jurisdictions where they have a significant online presence. The reason for this is that our current tax systems evolved to cope with a ‘bricks and mortar’ economy where goods and services were usually provided to customers from a fixed base: a shop, cinema, office, etc.

The need for physical premises made the job of the tax collector relatively straightforward. The new digital business environment has made the tax collector’s job much more difficult. This is best illustrated by examples. Firstly, let’s consider the case of Desmond, a customer in Country A who enjoys video games. Desmond purchases and downloads two video games online: *Space Force: Pluto Mission* and *American Car Theft*. The first game is sold by a company which is registered in Country A for tax purposes: it pays income tax on its profits in Country A and charges Desmond VAT at 15% on his purchase. But the company that he buys the car stealing game from is based in Country B, which is a low tax jurisdiction. It pays no income tax or VAT to the Country A revenue authorities, even though the game is bought, downloaded and played in Country A.

In the second case, let’s consider Sonia, who breeds goats in Country C. Sonia decides she needs to find a billy goat to entertain her herd of lonely nanny goats. She hears from a friend about Get my Goat, a new goat dating app developed by American Goat Corporation, a USA-based company. Sonia downloads this to her smartphone. Using this she finds an eligible billy goat close by and fixes a date for her nanny goats. The goat dating app is free to download and use, but when Sonia uses it, she is shown adverts from businesses advertising goat-related goods and services. None of the advertising revenue that American Goat Corporation generates is subject to direct or indirect tax in Country C, even though Sonia makes some purchases as a result of seeing the adverts.

### a) *Direct tax issues*

The examples of Desmond and Sonia illustrate businesses providing goods or services in a jurisdiction but not paying taxes on profits there. Under existing norms of international taxation, a foreign company is not subject to tax on profits generated in a jurisdiction unless it has created a permanent establishment (‘PE’), sometimes also referred to as a branch. Whilst definitions of the terms PE and branch vary between different jurisdictions, the essential characteristic is the existence of a physical presence through which business activities are carried on, for example warehouses, offices, factories, mines, etc.

In the age of the internet, a company may have a significant online presence in a market, but have no physical presence at all, meaning it does not create a PE or branch. Whilst it may be possible to apply withholding tax (‘WHT’) on revenue streams in the case of transactions with domestic businesses, this is not practical in the case of transactions with private customers. Moreover, as in the case of businesses like American Goat Corporation, it may be difficult to attribute revenues or profits to activities in the market as these do not arise directly from the user (who does not pay for the service provided).

### b) *Indirect tax issues*

The collection of taxes on the importation of goods (mainly customs and VAT) has traditionally been a key method by which governments raise revenue. Whilst this can apply to digital products provided on physical media such as CDs or DVDs, the import of digital services via the internet removes the opportunity to apply such taxes. In the case of services used by a domestic business, the application of reverse charge VAT, where the customer self-charges the applicable VAT, has been a long-standing method of accounting for tax due. In the case of individual consumers this route is not available, and there exists a risk that tax may not be collected at all, as in the case of Desmond’s purchase of *American Car Theft*. The case of advertising revenue generated by American Goat Corporation via its dating app is even more problematic from an indirect tax perspective as neither that company, nor the advertisers have a physical presence in Country C, where Sonia sees the adverts.

## 3. How can existing tax systems be adapted?

As digital business becomes more and more important, many great minds have started to focus on the challenges it creates for tax collectors. This initiative has coincided with and been subsumed into the G20’s BEPS (Base Erosion and Profit Shifting) action plan (see our previous article <http://cristaladvocates.com/?mdocs-file=22083>). The report on BEPS Action 1 (Tax challenges arising from digitalisation) was issued in 2015 and significant work has been undertaken by the OECD

since that date to identify potential solutions, though it has clearly been difficult to build a consensus. The EU Commission has also worked on potential changes to taxation of digital business in the European Union.

Discussions to date have focused on two main approaches:

- a) A profits-based approach which would attribute some of the taxable profits of a digital business to jurisdictions where users are located; and
- b) A revenue-based approach which would introduce a new tax on the gross revenue attributable to certain activities of a digital business in a particular jurisdiction. (Some EU members have already announced that they will introduce such taxes as an interim measure, pending international consensus on a profits-based approach.)

In both cases, there may be de minimis limits to exclude smaller businesses. One of the main challenges with both approaches is determining what proportion of total profits or revenue relates to activities in any given jurisdiction. Achieving a consensus is proving very difficult as, amongst other things, there is a conflict between the jurisdictions where users are located and the jurisdiction where the head office is sited over how to allocate profits and revenues. This was highlighted by the adverse reaction of the USA (home to most of the major digital businesses) when France enacted a 3% digital service tax in July 2019. As a result of US pressure, France agreed to offset any tax paid against French profits tax ultimately due when the profits-based approach is finally rolled out.

In December 2018, the Uganda Revenue Authority announced that it would enforce the provisions of the Value Added Tax Act introduced by amendments in 2011 and 2018 that require non-resident vendors to register or appoint local agents to account for the VAT arising on their supplies in Uganda. It remains to be seen whether this measure largely targeted at digital and intellectual property transactions will be effective considering that no legislation has yet been introduced in Uganda to address the direct tax consequences of the digital economy.

#### 4. What happens next?

The Organisation for Economic Co-operation and Development ("OECD") is the principal body driving forward the attempt to create a unified global approach to taxing the digital economy. It has repeatedly highlighted the risk of countries acting individually and inconsistently, which could result in damaging double economic taxation or leave opportunities for profits to escape tax. In October 2019, the OECD secretariat issued a proposal to the 130 governments participating in the Inclusive Framework (the global alliance implementing the BEPS actions). This proposal is intended to form the basis for consensus around how to allocate profits and it is hoped to achieve this by the middle of 2020.

The OECD proposal focuses on digital and consumer businesses and does not recommend the adoption of a revenue-based approach. Instead the proposal aims to create a basis for jurisdictions to tax profits arising from digital business where these do not create a PE/branch under existing domestic laws or tax treaties. Where the arm's length principle is not considered to give a reasonable allocation of profits it will be possible to use a formula-based approach, and this could include consideration of profits generated within a group of companies, rather than within a single corporate entity. The proposal acknowledges the importance of achieving simplicity and predictability. The need for agreement between multiple jurisdictions where a digital business is active is also emphasised. The OECD has set a very ambitious timetable to reach agreement on the way forward. We will return to this issue in future publications as the shape of the final recommendations becomes clearer.

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Denis is the Managing Partner at Cristal Advocates where he also leads the energy and tax practice. He is qualified both as a Lawyer and Chartered Accountant with vast experience serving various industries in Sub Saharan Africa. Before joining Cristal Advocates, he had worked for close to 10 years with Deloitte and Touche where he started his career and rose to senior managerial positions.

At Deloitte, he lived and worked in Uganda, Kenya, Tanzania and the United Kingdom for over 6 years and subsequently became the firm's chief of staff for the Energy and Resources Industry Group seeing him play a lead advisory role in Uganda, Kenya, Tanzania, Mozambique, South Sudan, Somalia and Ethiopia.

Denis is widely published and a regular commentator in the local, regional and international media and speaker at various forums regarding the taxation and financing of energy projects as well as the protection of large capital projects within the framework of international investment law.

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Bill is a Senior Advisor with Cristal Advocates. He has concentrated on working with energy companies with a particular focus on cross border transactions and M&A since 1989 and is a leading global energy and tax practitioner with wide international experience. Between 1986 and 1998, he worked in London with the UK tax authorities and Big Four accounting firms. From 1998 to 2004, he was based in Kazakhstan working across the Caspian region with Deloitte. He was in the region at the time it was developing its infrastructure for crude oil production with international investment following the collapse of the Soviet Union.

From 2004 to 2008, he worked in Russia where he led Deloitte's oil and gas industry group and established Deloitte's office in Sakhalin. He moved to East Africa in 2009 leading Deloitte's energy and resources industry group in Uganda, Kenya, Tanzania, Rwanda, Ethiopia and Mozambique. He was initially based in Kampala, Uganda later relocating to Dar es Salaam, Tanzania. Bill returned to the UK in 2014 supporting Deloitte UK teams working on outbound projects investing in Africa and was a key member of Deloitte UK's energy and resource practice until his retirement from the firm in September, 2018.

Bill is a graduate of Oxford University and completed his inspectors' training with the UK Inland Revenue in 1989. ■

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John leads the public policy and advocacy practice at the firm and combines unique public and private sector experience.

Prior to joining Cristal Advocates, he had worked as a Private Secretary to the President of the Republic of Uganda. During this time, he participated in several public and private sector engagements that included advising and coordinating activities relating to oil and gas as well as infrastructural projects of national significance. John had earlier worked with the Post Bank Uganda Limited and Shonubi Musoke and Co. Advocates.

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Dickens leads the oil and gas practice at Cristal Advocates. He has an in depth appreciation of Uganda's oil and gas sector having served as the maiden Company Secretary of the Uganda National Oil Company (UNOC) and the Uganda Refinery Holding Company Limited (URHC). UNOC represents the Government of Uganda commercial interests in the oil and gas sector while URHC represents government interests in the refinery project as well as managing the petrol based industrial park.

Dickens was instrumental in UNOC's formation and initial period of operation and also served as its head of Contracts, Negotiations and Advisory until May 2018. Prior to joining UNOC, Dickens was Legal Counsel at the Petroleum Directorate of the Ministry of Energy playing key legal advisory roles on the negotiation and implementation of PSAs, Joint venture and other oil and gas agreements. He was also part of the team that shepherded the process of enacting the current Ugandan oil and gas Legislations and Regulations including the local content requirements.

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He joined Cristal Advocates from Kizza, Tumwesige, and Ssemambo Advocates. He previously worked with the Advocates Coalition for Development and Environment (ACODE). He also undertook a traineeship with the oil and gas division of Webber Wetzel in Johannesburg, South Africa.

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