

# Sagamore Hill. TAX NEWSLETTER.



"Global Tax Compliance Insights: OECD Guidelines for Export of Services and Global Practices"

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Intangibles,  
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In the recent past, the issue of VAT and export services has been a thorn in the flesh both to the legislators and the businesses not just in Kenya but across the globe. This has been occasioned by many factors, such amongst them, technological advancement, businesses expansion to different jurisdictions, and the complexities that revolve around today's business operations.

In our newsletter for the month of April, we'll look into this issue and shed light on what our country can do to get it right, highlighting the best practices across the globe with examples of countries that, have, to a great extent, figured out how to go about this.

### **The dilemma in the case of Kenya.**

In the year 2020, the Tax Appeal Tribunal decided on the case between [COCA-COLA Central East and West Africa LTD v Commissioner of Domestic Taxes](#) whereby, Coca Cola Export had contacted Coca Cola Africa to advise and guide Coca Cola Export in areas of marketing, advertising and sales promotion for its brands, including funds necessary for promotion and advertising of the beverages; recommendations with respect to Coca Cola Export's participation in the marketing or promotion expenditures; researching and determining economic, regulatory, technical and marketing conditions that impact upon production and marketing of the beverages, advice and guidance in connection with management information services and advice on implementing the rights and obligations of Coca Cola Export and its affiliates.

The marketing and promotion activities Coca Cola Africa was to undertake, were for purposes of implementing marketing strategy for the brands owned by Coca Cola Company with a view to promoting those brands here in Kenya.

The court in determination of who the consumer of the promotional services was, it had to establish who the beneficiary of the advertising and promotion services was. The service agreement was important in determining the

destination principle for, in as much as the marketing and all other aforementioned services were offered in Kenya, the same would not necessarily be consumed in Kenya.

Coca Cola Export which was based in the USA, commissioned the agreement with Coca Cola Africa based in Kenya. The objective was to promote through advertising, Coca Cola brands to local potential customers.

Thereafter, Coca Cola Export would decide what to do with the information it would have obtained from this marketing and promotion exercise. That, really, would be the meaning of use or consumption in the context of the advertising and marketing of those brands.



Consumption, if any, would come in only after Coca Cola Export decided what to do with the brands that had been marketed and promoted, or if the brands were offered for sale usually on a future date. It is also worth noting, that according to the agreement, Coca Cola Africa provided marketing and promotion as the main service directly to Coca Cola Export, an overseas company, but did not receive remuneration from Kenyan public. Remuneration for marketing and promotion was to be paid by Coca Cola Export. The court concluded that what had been provided was an export service which was exempt from VAT.

A similar case was decided between [Google Kenya Limited vs Commissioner of Domestic Taxes](#) and in both of the decisions, one thing was consistent, that, the consumer of the goods was not necessarily where the marketing was done, but the party who benefited from the marketing and promotion services, that is the consumer or the user of the services.

For a long time, Export services have been zero rated for the purpose of VAT here in Kenya, they were later exempted for VAT and recently in the finance bill of 2022, their deletion in the exempt schedule meant that they are no longer exempt but standard rated W.E.F July 2022, a matter that has been contested in the courts that in March 2023, the High court upheld that indeed Export services are standard rated.



### Best practice across the globe.

The general practice on the application of VAT is based on two principles.

- The **neutrality** principle, whereby VAT is a tax on final consumption that should be neutral for businesses.
- The **destination** principle whereby internationally traded services and intangibles should be subject to VAT in their jurisdiction of consumption or use.

### VAT and international trade: the destination principle

The biggest concern as regards VAT in cross-border activities is whether VAT should be levied in the country of Origin or the country of destination. In the case of country of origin, VAT is charged in the country where value was added whilst in the destination principle, tax is levied on the final consumption that takes place in the jurisdiction that has the taxing rights.

The most important reason as to why the destination principle is favoured to the origin principle is that, the destination principle gives level playing field of the businesses operating in the said jurisdiction, whereby, all companies importing services will have to account for tax on their imports and claim output tax on their exports. The net tax paid for the value added is paid in the country determined by the rules of the jurisdiction of its consumption. The destination principle in VAT therefore achieves neutrality in international trade.

Implementation of the destination principle is relatively straightforward due to the fact that most jurisdictions have measures in place to determine when services are imported in their country for consumption. These jurisdictions have in place many ways, which include but not limited to, existence of border controls and VAT on imports is generally collected at the same time as custom duties even though in some countries, this is done when the consumer is declaring their next VAT return after importing the goods or services. Implementing the destination principle with respect to international trade in services and intangibles is more difficult than with respect to international trade in goods. The nature of services and intangibles is such that customs controls are largely ineffective for confirming their exportation and their consequent right to be free of VAT in the country of export. Similarly, custom controls are largely ineffective for imposing VAT on services and intangibles as they cross the border upon importation.



With respect to the level of taxation, foreign businesses should not be disadvantaged nor advantaged compared to domestic businesses in the jurisdiction where the tax may be due or paid. VAT systems are designed to apply in a fair and even-handed way to ensure there is no unfair competitive advantage afforded to domestic businesses that may otherwise discourage international trade and limit consumer choice.

This is achieved by the application of the destination principle (exports are free of VAT and imports are taxed on the same basis and at the same rate as local production), which ensures that the tax levied on imports does not exceed the tax levied on the same supplies in the domestic market. In addition, it also ensures that the amount of tax which is refunded or credited in the case of exports is equal to the amount of tax that has been levied.

However, in some practice, there are a number of cases where the rules may not be standard and businesses engaged in international trade will incur VAT on jurisdictions where they are neither registered or established. Such jurisdictions have, over time developed ways in which to counter this. Many countries may use a combination of different ways depending on the case by case they receive or guided by the economic policies they have in place. Some of these approaches used by such countries include but not limited to;

- Making supplies free of VAT
- Granting purchase exemption certificates
- Application of direct refunds of VAT incurred locally
- Enabling tax refunds through local VAT registration.
- Shifting the responsibilities to local customers or locally registered suppliers.

All the above mentioned approached ensure that foreign companies do not incur VAT that they cannot recover. This too is geared to ensure that VAT consideration (cost of compliance, the staff

required to ensure compliance, VAT paid...) are **not the primary driver for business decisions**. As these jurisdictions do this, they have to put in place measures to curb possible instances of fraud, and tax avoidance.

Further to the above, some of the business decisions that inconsistency in levying VAT may give rise to, include;

- Whether to sell to a customer in the specific jurisdiction.
- Whether to operate in a specific jurisdiction
- Whether the business will outsource activities such as manufacturing or production or support services to be carried in the other jurisdiction
- Whether the business will operate in a jurisdiction.

In some instances, there are countries that require the granting of refunds to foreign businesses be conditional upon similar relief being granted by the jurisdiction of the foreign business claimant. These requirements for reciprocity generally take two forms: a formal bilateral agreement between jurisdictions or a unilateral decision to recognize jurisdictions considered as having (or not having) appropriate features in their legislation.

### **Business to Business supplies and destination principle.**

Generally, VAT is not chargeable in business to business transactions. However, business to business transactions that involve intangibles and services can be difficult to identify who the final consumer is. In the business-to-business context, the destination principle is generally implemented by allocating the taxing rights over internationally traded supplies to the jurisdiction where business use is deemed to occur, as this facilitates the ultimate goal of ensuring that tax is paid and revenue accrues to the jurisdiction where the supply to the final consumer occurs. This ensures that services and intangibles supplied across borders are taxed according to the rules of the

customer's jurisdiction irrespective of where they are obtained, thus creating a level playing field. Businesses acquiring such services are therefore driven by **economic, rather than tax considerations**.

#### **VAT on services and intangibles.**

Tax administrators may have a challenge in determining the jurisdictions in which services and intangibles are used. Take for example, a company that contracts another company to develop a software, and thereafter, the contracting company uses the software developed in a different jurisdiction all together, perhaps in a conference et el. Not only does this pose the challenge of identifying whether the services were used, it equally possesses the challenge of placing a monetary value on the service so that the taxing jurisdiction can tax upon final consumption.

Few methods or guidelines can be applied in determining the final customer as detailed below.



**Use of the business/service agreement.** The business agreement is an important element of that Guideline in that it will assist the supplier, the customer and tax administrations in identifying the nature of the supply and the identity of the parties to the supply. A typical business agreement should have irreducible minimums such as general correspondence, service level agreements, purchase orders, invoices, payment instruments and receipts. These requirements in a service agreement may differ from one county to another, between industries, Kenya can therefore

**draw up an almost exhaustive list** of items required in a service agreement.

#### **Establish the location of the consumer.**

Where a company operates in one or more jurisdiction, it is imperative to establish which company in it's umbrella received the services. In such a case, the location where the customer establishment uses the service or intangible, in whole or in part, is the jurisdiction that has the taxing rights over the service or intangible. In specific, taxing of such a business that had multiple locations, taxing rights are done in two steps.

In the first step, taxing rights are allocated to the country where the customer establishment that enters into the business agreement is located. In the second step, taxing rights are allotted to the country where the customer establishment that uses the service or the intangibles under a recharge agreement is located.

In a **recharge arrangement**, a service supplied by an external supplier to a business that operated in numerous countries, will be paid for by one of the establishment that has entered into the agreement, thereafter, the cost is distributed to other establishments using the service or intangible, in accordance with corporate tax, accounting or other regulatory requirements. In instances where necessary recharge is not done, VAT is applied as if recharge systems are in place so as to effectively ensure that taxing rights accrue to the country of use.

While cross border transactions present difficulties occasionally necessitated by the businesses optimizing their operations, we look into a few situations and how to handle them.

1. *Where the supplier makes the supply direct to the customer who the contracting business intended to make the supply to.* In such a case, the customer remains to be as

defined by the agreement between the contracting businesses and it is the customers' location that determine the jurisdiction with that has the taxing rights.

2. *A customer supplies the services to the jurisdiction of the supplier to a different customer.* This is occasioned by the fact that multi-location enterprises have a centralized purchase department that procures in large quantities so as to have an upper hand in their bargaining power rather than have individual establishments entering into low value agreements. In such a scenario, any onward supply of a service will have to have a different business agreement and the location of the customer who enjoys or consumes such services in the subsequent business agreement will determine the country that has the taxing rights.
3. *Where the supplier is paid directly by a different party other than the customer in the business agreement.* It is generally common for multinationals to have to have a **paymaster** a company within the group that centrally pays for services received. For example, services rendered to a subsidiary may be paid for by the parent company. In such an instance, the direction or flow of the payment are not relevant in determining the jurisdiction with taxing rights. The payment flows are consideration for the supplies under the relevant business agreements but do not, in themselves, create additional supplies, alter the supplies, nor identify the customer or customer location. The supplier is therefore entitled to make a supply free of VAT to an overseas customer even if that supply is paid by a third party

located in the same jurisdiction as the supplier.

In light of the discussion above, the customer is obliged to pay any tax due on the supplies made to them under the **reverse-charge** system regardless of:

1. The services are not supplied directly to the customer. This is because the business agreement will have defined the customer irrespective of who the supply is made to.
2. The customer makes an onward supply of the service or intangible.
3. The customer doesn't pay for the supply.



In other cases, allocation of centrally procured services, for example, legal or marketing services may not be as direct and obvious to the eye and therefore, when a business that has multiple locations is allocating the costs for the shared services, it should do so in a reasonable manner and allocate what is *fair, just and reasonable*. This includes a fair share of estimation or approximation but a few indicators may well tell how much to allocate to each establishment for the shared service. These include;

- i. Number of employees.
- ii. Square meter of the office space.
- iii. Number of fleet cars.
- iv. Computer usage.
- v. Number of accounting entries.
- vi. Number of invoices processed.

In light of the above discussion, which primarily focuses on using the main rule of using the location of the customer as the basic determinant of allocating rights to the taxing jurisdiction, there are other instances where *specific rules* can be applied on individual cases, to mean the determinant of the customers' jurisdiction must not always be the common denominator. Some of the circumstance where such specific rules may be appropriate are;

- The location where the service is used in readily available.
- If the services or intangible are supplied both to consumers and businesses.
- Where for the service to be performed, the physical presence of the supplier and the customer is required.

For internationally traded services and intangibles for business-to-business directly related to immovable properties, the taxing would be reasonable that the taxing rights be to the country where immovable properties are located as the main rule of taxing rights belonging to the destination of the consumer may not be appropriate. Such circumstance includes:

- Service that are physically performed on the immovable property such as maintaining, constructing or altering the immovable property.
- Sale, lease, transfer or right to use, occupy or enjoy an immovable property.
- Other supplies of services that are at the heart of immovable property for example, certain intellectual services, such as architectural services that relate to clearly identifiable, specific immovable property, could be considered to have a sufficiently close connection with immovable property.

### Cases across the globe.

Different countries across the globe have in place some cases where the destination principle is not applied in full, where some services are rated on export.

Here are some examples of countries that charge VAT on exported services:

1. Australia: In Australia, GST (Goods and Services Tax) is generally not charged on exports of services. However, there are some exceptions to this rule, such as if the services are related to real property.
2. Canada: In Canada, exports of services are generally exempt from GST/HST (Goods and Services Tax/Harmonized Sales Tax). However, there are some exceptions to this rule, such as if the services are related to real property.
3. Russia: Russia imposes VAT on certain services provided to non-residents, such as advertising and marketing services.

We also note Russia tried to use the country of origin concept other than the destination principle for purposes of VAT. However, this was not successful.

As discussed above, VAT legislation in Kenya on import of services should be done with care as taxing all export services will make them less competitive in the global market. In addition, this defies on of taxation cannon of equality and neutrality.

In closing, it is our recommendation that the Kenya legislative arm gives this issue the attention and keenness it deserves by considering the discussion contained herein.

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