

INTERNATIONAL JOURNAL OF LAW MANAGEMENT & HUMANITIES

[ISSN 2581-5369]

Volume 7 | Issue 5

2024

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Double Taxation in the Digital Economy: Implications and Challenges in Tanzania

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ABSTRACT

In recent years, the taxation of the digital economy has been an important discussion topic. Businesses now regularly perform activities in jurisdictions without maintaining a physical presence, by not having a legal entity or branch. This may result in misalignment between where value is created for certain (digital) activities and where the current international tax regime allocates the taxing rights. Therefore, the fundamental concepts of tax residence and source on which the current international tax system is based is viewed to be problematic.

Despite the attempts to reach a consensus at a global EU level, international initiatives have not yet led to adjustments of the international rules of taxation of certain digital activities. This in turn leads to the creation of the issue of double taxation where nations dispute over which has the right to taxation on the digital services provided.

Hence, more than twenty countries worldwide (including the UK, France, Italy, Spain, India and Canada) have implemented or proposed to implement a so-called Digital Services Tax (“DST”). These unilateral DSTs are generally meant as an interim solution until there is an agreement at international level for the taxation of income generated by multinational enterprises with digital services. It is intended to have a coordinated repeal of unilateral measures, such as DSTs, when agreement is reached on OECD/G20’s Pillar One (Pillar One and Transfer Pricing).

Keywords: *Double Taxation, Digital Service Tax (DSTs), Multinational Enterprises (MNEs), Permanent Establishment, Transfer Pricing.*

I. INTRODUCTION

Double taxation in the digital economy refers to a situation where a taxpayer's income or transactions are subject to taxation in multiple jurisdictions, resulting in potential overlapping tax liabilities. It is a complex issue that arises due to the global nature of digital transactions, which often transcend national borders and traditional tax frameworks. Double taxation in the digital economy can occur when a company operates in multiple countries, and each country has its own tax laws. The company may be required to pay taxes on the same income in both

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countries², which can result in a significant financial burden. This issue is particularly relevant in the digital economy, where companies can operate globally without a physical presence in a particular country. As a result, it can be difficult to determine which country has the right to tax the company's income.

Due to the international nature of digital transactions which frequently transcend national borders and don't easily fit into conventional tax frameworks double taxation presents a serious difficulty in the digital economy³. This happens when a taxpayer has overlapping tax responsibilities as a result of having their income or transactions taxed by many countries. This might result in paying taxes on the same income in many jurisdictions for businesses that operate internationally, which can be quite expensive.

Businesses can operate remotely in the digital economy and receive revenue from clients in other nations without having a physical presence there. Because of this, tax authorities find it challenging to decide which country has the authority to tax the revenue and how to divide taxable earnings. As online companies keep growing and expanding globally, resolving the issue of double taxation becomes increasingly important to ensure a fair and efficient tax system.

In the digital economy, businesses can operate remotely and generate income from customers located in different countries without having a physical presence in those jurisdictions⁴. This creates challenges for tax authorities in determining the appropriate allocation of taxable profits and the jurisdiction entitled to tax them.

Double taxation in the digital economy can occur when a company operates in multiple countries, and each country has its own tax laws. The company may be required to pay taxes on the same income in both countries, which can result in a significant financial burden. This issue is particularly relevant in the digital economy, where companies can operate globally without a physical presence in a particular country. As a result, it can be difficult to determine which country has the right to tax the company's income

² Organisation for Economic Co-operation and Development (OECD), Addressing the Tax Challenges of the Digital Economy (OECD/G20 Base Erosion and Profit Shifting Project 2015), <https://www.oecd.org/ctp/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report-9789264241046-en.htm>

³ International Monetary Fund (IMF), *Tax Policy for a Digitalizing Economy*, IMF Policy Paper No. 19/01 (2019), <https://www.imf.org/en/Publications/Policy-Papers/Issues/2019/03/10/Tax-Policy-for-a-Digitalizing-Economy-46620>

⁴ F. Boccia & R. Leonardi, *The Challenge of the Digital Economy: Markets, Taxation and Appropriate Economic Models* (Springer International Publishing 2017).

II. DOUBLE TAXATION

Double taxation has become a huge inconvenience especially in the digital economy. For instance, a foreign corporation which provides its services across its borders. Upon payment for the digital service, the consumer is subjected to withholding tax (WHT), but also the amount is subject to Value Added Tax and is required to be registered⁵ and finally the service provider pays an income tax at the rate which is not fixed and varies from country to country. For instance, in Kenya, the rate of income tax on digital services for non-residents used to be 0.5% but their laws have since been amended to remove it completely and currently they only have withholding tax. In our country, Tanzania, the rate still stands at 2%⁶ for all electronic services for non-resident entities without a physical presence within our borders⁷. After all this, they also have to pay taxes as per their own laws stipulates.

Digital service tax is different from income tax where by digital service is a tax on revenue generated by companies that provide digital services to customers in a particular country. The scope of digital service tax can vary depending on the country, but it typically applies to companies that provide services such as online advertising, social media platforms, and digital marketplaces. The tax is usually calculated as a percentage of the revenue generated by the company in the country where the tax is being applied⁸. Unlike income tax, which is based on profits, DST is levied directly on gross revenue, adding another layer of complexity and potential tax liability for digital businesses operating globally.

The OECD tried to conjure up a solution⁹ by providing the Two Pillar Solution where by Pillar one would reallocate some taxing rights over large multinational enterprises (MNEs) from their home countries to markets where they have businesses activities and earn profits, regardless of their physical presence. These rules would apply to MNEs with global turnover above €20 billion and profitability above 10%, with 25% of profit above the 10% threshold to be reallocated. Regulated financial services and extractives (e.g., mining) would be excluded. This still leaves out on developing countries where enterprises do not generate as much revenue

On the other hand, Pillar Two would introduce a global minimum corporate tax rate of 15% to

⁵ Regulation 4 of the Value Added Tax (Registration of Non-Resident Electronic Service Suppliers) GN NO 478Q

⁶ Section 70 of the Finance Act, 2022; *The principal Act is amended by adding immediately after section 90, Section 90A to cover Tax payment on income realized through digital market place.*

⁷ Regulation 4 of Tax (Registration of Non-Resident Electronic Service Providers) GN NO. 478U

⁸ P. Kibuuka, Tanzania in International Tax Law: Towards a Fair, Effective and Efficient Digital Tax Policy (1), The Citizen (2021), <https://www.thecitizen.co.tz/tanzania/oped/tanzania-in-international-tax-law-towards-a-fair-effective-and-efficient-digital-tax-policy-1--2699286>

⁹ International Tax Reform: OECD Releases Technical Guidance for Implementation of the Global Minimum Tax, OECD (2023), <https://www.oecd.org/tax/beps/international-tax-reform-oecd-releases-technical-guidance-for-implementation-of-the-global-minimum-tax.htm>

put a floor on competition over corporate income tax for companies with revenue above €750 million. It would still leave out the enterprises which do not generate as much revenue to have a uniform rate so each of these counties have their own rates and dispute over who has the taxing rights often having each of the territories tax the same digital entity.

III. TANZANIA'S INITIATIVES TO SUCCEED IN TAXING THE DIGITAL ECONOMY

In the last 10 years in Tanzania, the initial digital economy has contributed to better service delivery, revenue collection efficiency, increased payments ecosystem efficiency, and enhanced human capital and employment opportunities management. What is being articulated in this brief analysis is that undeniably the digitization of the economy is one of the most critical issues of our time.

(A) The Finance Act

This law amended the Income Tax Act¹⁰ by adding a section¹¹ which redefines the word "Business" to include a transaction or activity carried out through the internet or an electronic means including an electronic service or transaction conducted in the digital market place regardless of the manner in which such transaction is carried out. The term "digital market place" was also amended to mean a platform that enables direct electronic communication between buyers and sellers of goods and services through the use of internet and electronic means without having to meet physically¹².

(B) The Value Added Tax (VAT) Act

Through the Finance Act, the law was amended to provide a provision which requires all non-resident digital businesses with no physical presence in the country to be registered under VAT laws of the country due to services provided required to include VAT so the country may institute VAT Claims on such services provided in order to broaden the revenue stream¹³

IV. HISTORICAL BACKGROUND OF DIGITAL ECONOMY AND THE ERUPTION OF DOUBLE TAXATION

Emergence of Digital Technologies: The digital economy began to take shape with the advent of technologies such as computers, the internet, and electronic communications in the late 20th century. These technologies enabled the digitization of information, communication, and business processes, giving rise to new business models and opportunities. Traditional Tax

¹⁰ CAP 332 R.E 2019

¹¹ Section 59 of the Finance Act, 2022

¹² *Ibid.*

¹³ Regulation 4 of Tax (Registration of Non-Resident Electronic Service Providers) GN NO. 478U

Frameworks: At the time when digital technologies started to emerge, traditional tax frameworks were primarily designed for a physical and tangible business economy. These frameworks were based on the concept of a physical presence or permanent establishment, which served as a nexus for taxing businesses.

OECD's BEPS Project: In 2013, the organization for Economic Co-operation and Development (OECD) launched the Base Erosion and Profit Shifting (BEPS) project. The project aimed to address tax avoidance strategies used by multinational corporations, including those operating in the digital economy. BEPS provided recommendations and guidelines to update international tax rules and prevent tax base erosion.

Due to the fact that two or more States' tax claims overlap, the concept has been defined more broadly and less precisely. In the context of taxation, international double taxation, narrowly defined, occurs when two States¹⁴ impose a comparable income tax with respect to the same item of income on the same taxable person.

In 1928, the League of Nations developed its first model tax treaty to prevent double taxation and this was the foundation of the 2010 OECD Model, the UN Model and of modern tax treaties. Bilateral tax treaties aim to eliminate the concept of international double taxation, which is broader than the specific definition. It includes some forms of economic double taxation, or taxation that results in the imposition of multiple burdens with respect to a single source of income. States used to address the issue of double taxation unilaterally through domestic tax laws, it typically did not achieve unilaterally many of the goals of a bilateral tax treaty. Domestic legislation is a unilateral act by a State and hence it was determined that bilateral treaties would be more effective

V. CHALLENGES ARISING FROM DIGITAL ECONOMY GROWTH

(A) Nexus and Permanent Establishment

The rapid eruption of the digital economy in the market has led to multiple global issues such as. Traditional tax rules are based on the concept of a "permanent establishment" (PE), which refers to a fixed place of business. However, in the digital economy, it can be challenging to establish a PE since businesses can provide services or sell products remotely. This lack of physical presence complicates the determination of which jurisdiction has the right to tax the

¹⁴ International Fiscal Association: The Revised OECD Model Double Taxation Convention on Income and Capital: Proceedings of a Seminar held in Vienna in 1977 during the Thirty-first Congress of the International Fiscal Association, Introduction by Dr. M. Widmer, pg. 9

income¹⁵. Such issues did not disrupt the flow of trade when all the elements in taxation required physical presence. These are key concepts in international taxation, particularly relevant in the context of cross-border business activities, including those in the digital economy. They help determine a country's right to tax the income of foreign entities.

Nexus refers to the connection or link between a business and a jurisdiction that justifies the imposition of tax by that jurisdiction. In simpler terms, it is the threshold that determines whether a business has sufficient presence or activity in a country to be subject to its tax laws. Traditionally, nexus was established through physical presence, such as an office, employees, or property within the jurisdiction. However, in the digital economy, businesses can operate and earn income in a country without any physical presence, challenging the traditional concept of nexus. To address this pressing issue, some countries have introduced new rules to establish nexus based on significant economic presence rather than physical presence. For example, digital service taxes (DSTs) or other forms of digital taxation are often tied to revenue generated from a country's market, regardless of whether the company has a physical presence there.

Permanent Establishment (PE) is a more specific concept than nexus and refers to a fixed place of business through which the business of an enterprise is wholly or partly carried on. Under international tax treaties, A nation has the authority to tax income due to a permanent establishment if a corporation has a permanent establishment there. Construction sites, factories, offices, and branches are examples of traditional permanent establishment settings.

(B) Source versus Residence-based Taxation

Countries have different tax systems, and they generally apply either source-based or residence-based taxation. Source-based taxation focuses on income generated within a specific jurisdiction, while residence-based taxation considers the taxpayer's country of residence. The mismatch between these systems can lead to potential double taxation.

(C) Transfer pricing

This is another issue which inadvertently leads to double taxation in the digital economy. Transfer pricing refers to the pricing of goods, services, or intangible assets within multinational corporations. It is a key concept in international taxation, particularly for multinational corporations (MNCs). It refers to the rules and methods for pricing transactions within and between enterprises under common ownership or control. In the digital economy, transfer pricing issues can arise when transactions occur between related entities located in different

¹⁵ Nella H. & Chris E., *Taxation in the Digital Economy: New Models in Asia and the Pacific* (Routledge 2022)

jurisdictions. Tax authorities aim to ensure that transfer prices are set at an arm's length basis to prevent profit shifting and tax avoidance. It may either occur through Divergent Tax Systems where different countries have their own tax systems and rules for determining taxable income and profits. These systems can be based on different principles, such as source-based taxation or residence-based taxation. This can lead to differences in how income is allocated and taxed between jurisdictions¹⁶. Or by manipulation of Transfer Prices, it involves setting the prices for goods, services, or intangible assets exchanged between related entities within multinational corporations. Companies may manipulate these prices to shift profits from high-tax jurisdictions to low-tax jurisdictions, reducing their overall tax liabilities¹⁷. This can be done by overpricing or underpricing transactions.

(D) Digital Services Taxes

Some countries have introduced or proposed digital services taxes (DSTs) specifically targeting digital companies. These taxes are often imposed on gross revenue generated from digital services, regardless of whether the company has a physical presence in the jurisdiction. The introduction of DSTs can further complicate the issue of double taxation specifically through lack of International Consensus. DSTs have been a subject of debate and controversy among countries. Some countries argue that digital companies should pay their fair share of taxes, particularly in jurisdictions where they generate substantial revenue but have limited physical presence. On the other hand, other countries express concerns about the discriminatory nature of DSTs and their potential to undermine existing tax frameworks. The absence of international consensus on DSTs can aggravate the complexities and inconsistencies in the tax treatment of digital services, increasing the risk of double taxation.

VI. CONCLUSION AND RECOMMENDATIONS

In order to recognize and address the issues in avoiding double taxation and efficiently taxing digital enterprises, policy makers and forums such as the OECD should review implementing some reforms and measures as provided below;

(A) Tax Treaties

Bilateral tax treaties between countries whose residents regularly contract among each other through either service providers or individuals provide mechanisms to avoid or mitigate double

¹⁶ D. Kapfumvuti, Making Digital Tax Work for Tanzania, The Citizen (2023), <https://www.thecitizen.co.tz/tanzania/oped/making-digital-tax-work-for-tanzania-4091834>

¹⁷ United Nations, *Tax Issues Related to the Digitalization of the Economy: Report of the Secretary-General*, United Nations Document E/C.18/2021/CRP.10 (2021), <https://www.un.org/development/desa/financing/document/tax-issues-related-digitalization-economy>

taxation. They typically include provisions for allocating taxing rights between jurisdictions and resolving disputes. These can help smoothen the rough relations that already exist regarding the issues of taxing rights of foreign businesses with no physical presence.

(B) Base Erosion and Profit Shifting (BEPS)

The Organization for Economic Co-operation and Development (OECD) has been working on the BEPS project, which aims to address tax avoidance strategies used by multinational companies, including those in the digital economy. The project provides recommendations for updating international tax rules to align them with the digital economy. It would be profitable to all parties involved to adopt this strategy because it would alleviate all problems concerning avoidance of tax.

(C) Digital Economy Taxation Reforms

Countries are considering or implementing reforms to their tax systems to capture revenue from digital transactions more effectively. These reforms may include introducing new tax rules, revising existing tax frameworks, or implementing specific measures for the digital economy.

Generally, it is important to note that the landscape of double taxation in the digital economy is evolving rapidly, and countries are actively working to address these challenges. The specific rules and regulations can vary across jurisdictions, and seeking professional advice from tax experts or authorities is recommended for individuals or businesses operating in the digital economy in order to avoid these challenges. On the other hand, Tax regimes can do well to identify and isolate rules that may easily govern digital economy businesses so that they may operate smoothly without restraints from overlapping tax laws from different jurisdictions.

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