ICPAK Tax Seminar – Jan 2012

Business Tax and Tax Planning

Quality In Everything We Do

PRESENTER

Francis Kamau

Ernst & Young

Member, Public Finance Committee of ICPAK

francis.kamau@ke.ey.com

BUSINESS TAX

Introduction

Corporation Tax

Accounting Income Vs Taxable Income

- To the accountant, income is income, lumped together under all incomes.
- The accountant takes all the sales less all the expenses to arrive at accounting profit or loss.
- What about the taxman?
  - classifies into specified sources
  - the taxman has some guidelines to decide expenses to allow or disallow.

Corporation Tax

Key Exposures

- Income Tax Act (ITA) does not recognize the guiding accounting concepts (IFRS)
  - Recognition of income (IAS 18)
  - IAS 41 Vs Section 17 of ITA – Income from Agricultural activities
  - Group activities – amalgamations, acquisitions, mergers, etc (IFRS 3)
  - Provisions and contingent liabilities / assets (IAS 37)
  - Construction contracts – IAS 11
  - Leases – IAS 17
- Capital gains
- Goodwill
- Prepayments (rent deposits, ‘booking’ cash)

Corporation tax

Taxable Income:

- Income of a resident or non resident person is chargeable to tax in Kenya if – it was accrued in or was derived from Kenya.
- Concepts
  - Who is a person?
  - Who is a resident person?
  - Accrued in or derived from Kenya
  - Specified sources (covered later in details)

Corporation tax

Residency Rules: S.2

- Individual is deemed to be resident in Kenya if:
  - One has a permanent home in Kenya and was present in Kenya for any period in a particular year of income under consideration, or;
  - Was present in Kenya:
    - Aggregate period (s) of 183 days or more in a particular year
    - Average period (s) exceeding 122 days in a year of income and in each of the 2 preceding years.
- A resident is liable to tax on worldwide employment income (S.2).
- A non-resident is taxable on income which is accrued in or derived from Kenya (S.3(1)).

General format

Profit before tax				XXXX	
Add:	Disallowable expenses		XXX		
	Write backs/ realized income	XXX	XXX		
Less:					
	Non taxable income		(XXX)		
	Unrealized income and capital gains	(XXX)			
	Capital deductions		(XXX)	XXX	
Taxable profit	**(TP)**				XXX
Tax thereon 30% (37.5) of TP			**XXX**		

Illustration 1

► Profits as per accounts	10,000
► Depreciation	100
► Loss on disposal of assets	500
► Gain on disposal of assets	100
► Wear and tear deduction	400
► Tax penalties	100
► Donations	100

Answer

Profit as per accounts		1,000
Add:		
Depreciation	100	
Loss on disposal of assets	500	
Tax penalties	100	
Donations	100	800
Less:		
Gain on disposal	(100)	
Wear & Tear	(400)	(500)
Taxable income		1,300
Tax thereon (1,300*30%)		**390**

BUSINESS TAX

Deductible and Non-deductible Expenses

Corporation tax

Deductible costs – Section 15

- Bad debts (S.15 (2) (a))
- Capital expenditure under the Second Schedule (S.15 (2) (b))
- Capital expenditure for prevention of soil erosion (S.15 (2) (c))
- Capital expenditure on legal costs and stamp duties (S.15 (2) (d))
- Expenditure before commencement of business (S.15 (2) (e))
- Structural alterations to the premises (S.15 (2) (f))
- Diminution in value of any implements, utensil (S.15 (2) (g))
- An entrance fee or annual subscription to a trade association which has made an election under S. 21(2) (S.15 (2) (h))
- Capital expenditure on scientific research (S.15 (2) (n))
- Employer s' contributions to retirement benefits scheme (S.15 (2) (o))
- "Reasonable" advertising expenses (S.15 (2) (p))

Corporation tax

Deductible costs – Section 15 cont'

- Club subscription paid by an employer (S.15 (2) (v))
- Cash donations (S.15 (2) (w))
- Capital expenditure, with the <u>prior approval of the Minister</u>, for the construction of a public school, hospital, road or any similar kind of social infrastructure (S.15 (2) (x))
- Capital expenditure incurred in the purchase or acquisition of an indefeasible right to use a fibre optic cable by a telecommunication operator – <u>5%</u> per annum. (S.15 (2) (y))

Bad Debts Guidelines

- A debt shall be considered to have become bad if it is <u>proved to the satisfaction of the Commissioner</u> to be uncollectable.
- A debt shall be deemed to have become uncollectible where
  - creditor loses contractual right via a court order;
  - no form of collateral is realisable or proceeds from collateral unable to cover the entire debt;
  - debtor adjudged insolvent by a court of law;
  - cost of collecting the debt exceeds the debt itself; or
  - Efforts to collect the debt abandoned for another reasonable cause.
  - Deductible as an expense if incurred in normal business course.
  - A bad debt of capital nature not an allowable expense.

LN No. 37 (2011)

Donations

- S.15(2)(W): Cash donations to an income exempt charitable organization or to a Minister's approved project are allowable deductions (WEF 01 Jan 2007)
- Conditions:
  - Organization should be of a public character and established for purposes of poverty relief or education advancement.
  - A proof of donation in form of a receipt and certified by the donation recipient.
  - Proof of donation to be accompanied by exemption certificate and donee's declaration.
  - Not refundable or repayable to the donor.
  - Should not confer any benefit to the donor.

  LN. No. 101 (2007)

Corporation tax

Non - deductible costs – Section 16

- Expenditure or loss not wholly and exclusively incurred (S.16 (1) (a))
- Capital expenditure/loss, diminution or exhaustion of capital (S.16 (1) (b))
- Expenditure by a person in the maintenance of himself (S.16 (2) (a))
  i. hotel, restaurant or catering expenses
  ii. vacation trip expenses
  iii. educational fees of employee's dependants or relatives
  iv. club fees including entrance and subscription fees except as provided in section 15(2)(v)
- Expenditure /loss recoverable under any insurance contract (S.16 (2) (b))
- Income tax or tax of a similar nature (S.16 (2) (c))
- sums contributed to a registered or unregistered pension, savings, or provident scheme or fund (S.16 (2) (d))
- Expenditure incurred by a non-resident person not having a P.E within Kenya to earn income under S.10 (S.16 (1) (f))

Corporation tax

Non - deductible costs – Section 16 cont'

- A loss incurred in a business where the owner, partners have a beneficial interest therein – 25% of revenue rule (S.16 (2) (h))
- Expenditure payable on or after 18th June, 1976 under a contract of hiring of a road vehicle other than a commercial vehicle (S.16 (1) (i))
- Restriction of interest (Thin cap rules) (S.16 (2) (j))

BUSINESS TAX

Specified Sources of Income

Corporation tax

Specified Sources of Income (S.15(7)(e))

- Rights granted for use or occupation of immovable property
- Employment income/ self employment
- Wife's employment income/ wife's self-employment income
- Agricultural, pastoral, horticultural, forestry or similar activities
- Surplus funds to an employer in respect of registered pension or registered provident funds
- Other sources of income chargeable to tax under section 3 (2) (a) not falling within subparagraph (i), (ii), (iii) or (iv) of this paragraph

Is interest income a separate source of income?

Local Committee ruling in a company in Energy Sector!

Specified Sources of Income (Continued)

- Wife's employment income, professional income and wife's self-employment except income derived by her as an employee of:
  - a partnership in which her husband is a partner;
  - her husband
  - a company the voting power of which is held to the extent of 12.5% or more at any time during the year of income by her or her husband or by both jointly, either directly or through nominees.
- Before 1 January 2009, rent income and income from dividends/interest did not fall under wife's self-employment income (S.2)

Corporation Tax

Interest Income

- Interest income from financial institutions and government bearer bonds to ***non-individuals***
  - taxed at the corporate tax rate
  - credit is given for tax withheld at source.

Dividend Income

- The Act does not expressly exempt dividends to further taxation at the corporate tax rate of 30%
- Whether withholding tax on dividends is the final tax (or not) has been a point of departure for many interested players

BUSINESS TAX

Capital Deductions

Corporation tax

Capital Deductions

1. Industrial building allowance

- IBA is deductible where a person incurs capital expenditure on construction of industrial building to be used on: In business carried on by him; or his lessee

IBD; Qualifying expenditure	Rate (%)
Industrial buildings	2.5 (W.e.f. 1.1.2010 - 10%)
Hostel, Educational & Training buildings	10 (W.e.f. 1.1.2010 - 50%)
Rental residential building (W.E.F 12th June 2009)	5 (W.e.f 1.1.2010 - 25%)
Commercial Buildings	25% (W.e.f 1.1.2010)

Industrial Buildings Cont'

- Include:
  - a building in use as a hostel or an educational building or a building used for training – certified by the Commissioner. 2nd Sch. Para. 5 (1) (e) – 50%
  - a building in use as a rental residential building constructed in a planned developed area approved by the Minister responsible for Housing. 2nd Sch. Para. 5 (1)(f) – 25%
  - a building in use as a commercial building. 2nd Sch. Para. 5 (1)(ff) – 25%

S.1 (1) (ee) " in a case referred to in paragraph 5(1)(f) – rental residential building or 5(1)(ff) – commercial building for any year of income commencing on or after 1st January 2010, where roads, power, water, sewers and other social infrastructure have been provided by the person incurring the capital expenditure, twenty-five percent".

Dwelling House Cont'

- Should be certified by a Labour Officer – Commissioner of Labour, a Senior Deputy Commissioner of Labour, a Deputy Commissioner of Labour, an assistant Commissioner of Labour, a Chief Industrial Relations Officer, a Deputy Chief Industrial Relations Officer, a Senior Labour Officer, an Industrial Relations Officer or a Labour officer.

  The Income Tax Rules LN 8 / 1974

2. Wear & Tear Allowance

Qualifying expenditure	Rate (%)
Heavy self-propelling machinery such as tractors and combine harvesters	37.5
Computer and peripheral computer hardware, calculators, copiers and duplicating machines	30
Other self propelling vehicles and aircrafts (cost of non-commercial motor vehicles is restricted to KShs. 2 million with effect from 1.1.2006)	25
All other machinery including ships	12.5
Computer software (W.E.F 1 Jan 2010)	20
Indefeasible right to use a fibre Optic cable	5
Telecommunication Equipment (W.E.F 1st Jan 2010)	20
Concession arrangements	Spread over period

Wear and Tear Allowance Cont'

- Computer Software
  - KRA initially disallowed Wear and Tear on Software
  - Local Committee ruled that it should be classified under class IV (12.5%)
  - 2nd Sch. Para. 31B : Now claimable at 20%.**WEF 01 Jan 2010**

3. Investment deduction

Investment Deduction; Qualifying expenditure	Rate (%)
Building and machinery used for manufacturing purposes and hotel buildings	100
Civil works and structures forming part of an industrial building used for purposes of manufacturing	100
Ships	40
Filming Equipment (W.E.F 12th June 2009)	100
Investment made outside Nairobi, Kisumu and Mombasa (W.E.F 12th June 2009) **Investment qualifying cost is Kshs. 200 million**	150

Investment Deduction Cont'

- Building
  - 150% ID to be granted on a building installed with machinery outside Nairobi, Mombasa or Kisumu cities with the value of investment being greater than 200 million shillings.

    2nd Sch. P.24 (1) (f) and 2nd Sch. P.24 (2) (c)
  - Highlight
    - It is not clear whether the ID claim at 150% is restricted to manufacturing.
- Electricity
  - Generation of electrical energy for supply to the national grid or the transformation and distribution of electricity through the national grid qualifies for Investment Deduction (ID).

    2nd Sch. Para 24 (3) (e) - WEF 01 Jan 2010

Corporation Tax

4. Farm Works Deduction

- Deduction granted on construction of farm works by a farmer.

Year (s)	Rate
Before 1 Jan 1985	20%
Between 1 Jan 1985 and 31 Dec 2006	33.33 %
Between 1 Jan 2007 and 31 Dec 2010	50%
1 January 2011 and thereafter	100%

5. Mining Allowance

- Based on capital expenditure incurred in mining specified minerals
  - First year - 40%
  - 2nd to 7th year - 10%

BUSINESS TAX

Instalment Taxes
and
Penalties

Corporation tax

Filing of Returns

- Self assessment return is due by the 6th month after year end.
- The return should be accompanied by audited financial accounts for companies (not a requirement for individuals)

Payment of taxes

- Instalment tax is payable by the 20th day of the 4th,6th,9th and 12th months in that year of income
  - Where a person derives more than two-thirds of his income from agricultural, pastoral, horticultural or similar activities, Instalment tax is payable by the 20th day of the 9th and 12th months in that year of income
- Tax balance payable by the last day of the 4th month after the end of the financial year

Corporation tax - Payment of tax

Instalment Tax Regime (Sec 12)

- Introduced on 1 January 1990.
- A taxpayer shall not be required to pay the instalment tax:
  - if to the best of his judgment he will have no income chargeable to tax for that year of income other than emoluments; and
  - if the whole of the tax payable by him in respect of those emoluments will be recovered under Section 37
- The amount of instalment tax payable by any person for any current year of income shall be the lesser of –
  - The total income for the current year; or
  - the amount specified in the preceding year assessment multiplied by 110%.

Corporation tax - Payment of tax

Instalment Tax Regime (Sec 12)

- The instalment tax payable shall be reduced by the aggregate of the tax that has been or will be paid in the current year by way of deduction under section 12A (advance tax), 35 (withholding tax), 37 (PAYE) or 17A (presumptive tax) except that the deductions under S.17A shall not apply to individuals.

- No instalment tax shall be payable by an individual in any year of income where the total tax payable for that year of income is an amount not exceeding KShs 40,000.

Corporation tax - Payment of tax

Instalment Tax Regime (Twelfth Schedule)

- Where the company's immediate preceding year consists of less than 365 days, the tax payable for the preceding year will be annualized
- Where the company that is making payment was formed as a result of amalgamation of two or more companies, the tax assessed and payable for the immediately preceding year will be deemed to be the aggregate of the tax that would have been payable by all the predecessor companies
- Where the company that is making payment has had transferred to it during winding up in the year preceding the year of income all or substantially all the property from any of the companies which it controls by means of the holding of shares or possession of voting power, the company's tax payable in the preceding year will be deemed to be the aggregate of its own tax payable together with that of the company that it controls

Corporation tax - Payment of tax

Instalment Tax Regime (Twelfth Schedule)

- Where the company's immediate preceding year consists of less than 365 days, the tax payable for the preceding year will be annualized
- Where the company making payment has commenced its business in that year of income, the company's preceding year of income will be deemed to be NIL
- "tax assessed and payable for the preceding year” taken to mean the amount payable immediately before the due date for the instalment tax and shall disregard any subsequent amendments and adjustments
- where under this Act, a person has been permitted to make up the accounts of his business for a period greater than twelve months, the person shall calculate the instalment tax payable on annualized basis.

Corporation tax - Payment of tax

Instalment Tax Regime (Twelfth Schedule)

The payment of instalment tax payable shall be accompanied by the following information:-

- a declaration of the choice of method adopted by the person in computing the instalment tax payable
- where the tax is computed on the basis of an estimate of the current year of income,
  - total income of the person making the payment for that year of income including income deemed to be his which is chargeable to tax based on all information available to him at the date upon which the return is made and which he believes to be true
  - the tax chargeable on that income calculated by reference to the appropriate reliefs and rates of tax in force at the date of the payment

Corporation tax - Payment of tax

Instalment Tax Regime (Twelfth Schedule)

- where the tax is computed on the basis of the preceding year assessment, the amount of tax assessed for the preceding year; and
- a declaration by the person making the payment or by the person in whose name he is assessable that the instalment payment of a full and true estimate to the best of his knowledge and belief.

Corporation tax - Payment of tax

Instalment Tax Regime (Sec 12)

- Introduced on 1 January 1990.
- The instalment tax payable is based on either 110% of the preceding year's tax assessment or an estimate of the current year's income.
- Where assessment for the preceding year has not been made the tax may be estimated.
- Credit of any withholding tax paid or expected to be paid should be given before arriving at the estimated tax for the year

Payment of tax

Illustration- Estimation of instalment tax by prior year basis

- A company's 1st Instalment tax for the year ending 31 December 2010 is due for payment by 20th April 2011 is computed as follows:

	KShs
2010 Tax Liability	3,560,776,897
Add: 10% assumed growth	356,077,690
2011 Estimated tax payable	**3,916,854,587**
2011 1st instalment tax @ 25%	**979,213,646**

Payment of tax

- Income tax payments are due and payable as follows:

Instalment Tax	Due Date	% of Tax Payable
1st	20th of the 4th month during the year of income	25
2nd	20th of the 6th month during the year of income	25
3rd	20th of the 9th month during the year of income	25
4th	20th of the 12th month during the year of income	25
Tax Balance	End of the 4th month after the year end	
Self Assessment Return and Compensating Tax	End of the 6th month after the year end	

Ernst & Young
Quality In Everything We Do

Corporation tax – penalties

- Late submission of the self assessment return is 5% of the tax balance for the period subject to a minimum of Kshs. 10,000 (Kshs 1,000 for individuals)
- Late payment of tax balance attracts 20% on the tax due and thereafter interest at the rate of 2% per month
- Penalty for underpayment of instalment tax is 20% of the difference between the amount of instalment tax payable and the instalment tax actually paid
- The general penalty for offences is a fine not exceeding Kshs.100,000 or imprisonment for a term not exceeding six months or both

Corporation tax - miscellaneous

- Late payment interest capped at 100% of the principal tax owing (in-duplum rule).W.e.f 13 June 2008

- Tax loss carry forward restricted to four years
  - Period extendable by the Minister on Commissioner's recommendation (Finance Act 2009)

- Set-off of import duty repealed (Finance Act 2009)

Corporation tax

Penalties

Penalty type	Penalty
Late submission of SAR	5% of tax balance with minimum of KShs. 10,000
Late payment of tax balance	20% on the tax due and thereafter interest at the rate of 2% per month
Penalty for underpayment of instalment tax is	20% of the difference between the amount of instalment tax payable and the instalment tax actually paid multiplied by 100%
The general penalty for offences (S.107)	A fine not exceeding KShs.100,000 or imprisonment for a term not exceeding six months or both

BUSINESS TAX

New developments and controversial Matters

Tax information exchange agreements

- S. 41: Minister empowered to enter into Double Tax Agreements (DTA's)
  - Most DTA's have a clause on Tax Information Exchange Agreements (TIEA)
  - DTAs take long to conclude – Kenya has only 9 DTAs
- New Section 41A inserted
  - to allow Minister to enter into TIEAs with other countries to safeguard the revenue tax base
- Implications
  - KRA to share information with other jurisdictions on reciprocal basis
  - TIEAs has potential of significantly reducing revenue losses from cross border related party transactions

Tax information exchange agreements cont'

- Implications cont'
  - Expected that KRA will use the OECD Model TIEA
    - To provide KRA with wide ranging powers to request for tax payer's records
    - KRA to interview persons from another country
    - KRA able to attend investigations by other tax authorities
- Challenges
  - Lack of financial information on overseas related parties
  - Taxpayer confidentiality provisions
  - TIEA is not a "blank cheque" for KRA to engage in fishing expeditions overseas
- Effective date: 01 January 2012

Real Estate Investment Trust(REIT)

- REIT is a security that sells like a stock on the major exchanges and invests in real estate directly, either through properties or mortgages.
  - REITs receive special tax considerations and typically offer investors high yields, as well as a highly liquid method of investing in real estate.
  - The REIT concept was launched in Australia in 1971. REITs can be classified as equity, mortgage or hybrid.
- S.20 amended to include REIT as an investment vehicle;
  - Other investment vehicles under S.20 include Unit Trusts and Collective Investment Schemes
  - REIT – investors pool resources to invest in real estate
  - Shareholders of REIT to acquire units tradable in Stock Market

Real estate investment trusts cont'

- Tax incentives for Commissioner registered REIT:
  - Income of REIT is exempt from corporation tax except dividend and interest attributable to taxable unit holders
  - Income earned by investor and sales of shares by Unit holders of REIT exempted from tax
- Implications
  - Incentive expected to attract investors in real estate sector
- Challenges
  - The Income Tax (Registered Unit Trust/Collective Investment Schemes) Rules, 2003 are yet to be amended to include REIT
  - **Effective date: 01 January 2012**

Record keeping and tax registration

- Income Tax Act amended by inserting a new S. 51A:
- Implications
  - Records to be maintained in English or Kiswahili
  - Reporting currency to be in Kenya Shillings
  - Move to ensure harmonization and clarity in the returns and records

Effective date: 09 June 2011

- S. 132 (2): Commissioner may compel a person to register for a Personal Identification Number (PIN)
  - Amendment enhances the Commissioner's powers to recruit and register taxpayers

Effective date: 09 June 2011

Non-distribution of Dividends to avoid Tax

- S. 24: Commissioner to direct part of a company's income to be treated as having been distributed as dividends.
- A company can enquire to the Commissioner before making a distribution of dividends, whether they are sufficient.

- Recent Development
  - An Income Tax Tribunal set-up in 2010 to deal with issues on S.23 and S.24) – **S.86 (1) (a), S.83, Tribunal Rules of 1974**

Capital Gains

- Thin line between Business Income and One-off event.
- KRA notice of taxation of income related to sale of property
- Controversy:
  - Determination based on frequency of sales.
  - Determination based on amount of income generated.
  - Determination based on the motive of the business
  - Back-door 'capital gains tax' through compensating tax

Refund of tax overpaid

- S. 105: The Commissioner should refund the amount of the excess, together with any interest which may be payable thereon under the ITA.
- Claim for repayment should be made within 7 years after the expiry of the year of income to which the income relates.

- Challenge
  - The ITA does not provide for the applicable interest rate.
  - Delay in response by KRA

Compensating Tax

Balance b/fwd		XX
Dividends Paid (X*30%/70%)	XX	
Dividends Received(X1*30%/70%)		XX
Tax Paid		XX
Balance C/fwd/Compensating Tax	**XX**	**XX**
	XX	**XX**

Valuation of farming stock

- S. 17 (1): Stock at the beginning and end of each period to be taken into account at the value determined by the Commissioner to be just and reasonable.

- Challenge
  - Delays in valuation of stock
  - Conflicts: IAS 41 requirements versus Commissioner's view
  - Delays in response from KRA

BUSINESS TAX

Thin Capitalization

Introduction

- What is the relevance of thin capitalization?

- Debt to Equity Ratio: **3:1**

Legal provisions

1. Interest allowability

In line with the provisions of Section 16 (2) (j) of the Act :

- Interest expense is not allowable where the highest amount of all loans held by the company at any time during the year of income exceeds the greater of; -
  - three times the sum of the revenue reserves and the issued and paid up capital of all classes of shares of the company; or
  - the sum of all loans acquired by the company prior to the 16th June, 1988 and still outstanding in that year,

Legal Provisions (contd)

- Applicable where the company controlled by a non resident person alone or together with **four or fewer other persons** and where the company is not a bank or a financial institution licensed under the Banking Act; and for the purposes of this paragraph **"control"** shall have the meaning ascribed to it in paragraph 32 (1) of the second schedule."

Legal Provisions (contd)

- **"control",** in relation to a body corporate, means the power of a person to secure, by means of the holding of shares or the possession of voting power in or in relation to that or another body corporate, or by virtue of powers conferred by the articles of association or other document regulating that or another body corporate, that the affairs of the first mentioned body corporate are conducted in accordance with the wishes of that person; and in relation to a partnership, means the right to a share of **more than one-half** of the assets **or of more than one-half of the income of the partnership**……. provided that in the case of a body corporate, unless otherwise expressly provided for by the articles of association or other documents regulating it, "control" shall mean the holding of shares or voting power of **twenty-five percent** or **more**.

;

2. Foreign exchange loss

Section 4A of the Act provides inter alia:

“a foreign exchange gain or loss realized on or after 1st January 1989 in a business carried on in Kenya shall be taken into account as a trading receipt or deductible expense in computing the gains and profits of that business for the year of income in which that gain or loss was realized:

Legal Provisions

Provided that –

The foreign exchange loss shall be deferred (and not taken into account)-Where the foreign exchange loss is realized by a company with respect to a loan from a person who, alone or together with four or fewer other persons, is in control of that company and the highest amount of all loans by that company outstanding at any time during the year of income is more than three times the sum of the revenue reserves (retained earnings) and the issued and paid up capital of all classes of shares of the company."

Practical Applications

- Exchange losses are deferred until the status reverses

- Interest restriction

NB: Accumulated losses (negative reserves) qualify for consideration in assessing whether a company is thinly capitalized

Conclusion

- Consider the highest loan amount (not the total loan); review schedule of loans to obtain highest loan amount
- The debt/equity ratio should be maintained at or below 3:1
- The company may increase equity to counter thin capitalization status

Clarification on deemed interest

- S. 16(2)(j): Interest in respect of thinly capitalized entities disallowed
  - Thin cap status: loans advanced by a controlling non-resident entity exceeds its equity by more than three times
  - Effective 11 June 2010, the aspect of deemed interest on interest free loans was included under S. 16(2)(j)
- New S. 16 (5) inserted
  - Commissioner to prescribe the form and manner for deemed interest computation and the period applicable
- Wef 09 June 2011, S. 35 (1)(e) amended to include deemed interest under the ambit of withholding tax

Ernst & Young
Quality In Everything We Do

Clarification on deemed interest cont'

- Non-resident entities may not accept to incur tax liability on non existent loan interest
  - Resident entities are therefore unable to transfer the withholding tax on deemed interest to non-resident entities hence likely to bear the 15% tax burden as their own cost
- Resident tax payer to carry the 30% corporate tax burden on the disallowed non-existent interest

- Challenges
  - Section 18 (3) prescribes the arm's length concept which probably would supersede the Commissioner's prescribed rules
  - The rates under Commissioner Guidelines should be in line with average 91 day Treasury Bill Rate as per Section 16(3)

- **Effective date: 09 June 2011**

Clarification on deemed interest cont'

- For the purposes of S.16 (5) of the ITA the prescribed rate of deemed interest is 10% for the months of October, November, and December 2011. The deemed interest shall attract WHT at the rate of 15%.

Questions

TAX PLANNING

Key aspects.....

Tax Planning Defined

Tax Planning:

- It is the advanced assessment of the tax implications on various decision alternatives with the objective of minimizing the burden or maximizing the benefits

Income Tax Planning

Tax planning measures

- Tax compliance to avoid unnecessary penalties
- Taking advantage of tax incentives
- Tax amnesty
- Timing of tax payments to avoid lateness
- Training
- Engage tax professionals
- Use of lobbies for review of tax laws
- Appeal to tax arbitration bodies
- Internal tax function
- Review of policies and contracts by tax advisors

Tax Planning

Why should the entities plan for tax?

- Tax is a major expense in company’s P&L;
- To take advantage of the available tax incentives;
- To minimize tax penalties and interest;
- The be ready for KRA recent aggressiveness in collecting taxes;
- To improve cash management and forecast.

Tax Planning

Tax a major cost in P&L:

- The company pays huge amounts of money to KRA;
- 30% of company's profits are paid to KRA as corporate taxes;
- Practically, most taxes are paid in advance even before the estimated profits crystallize as liquid cash.

Tax Planning

Tax incentives existing for the company include:

- Capital allowances;
- Tax losses used to reduce taxable income;
- Tax refunds used to reduce tax payable;
- Lower tax rate on listing at NSE.

Tax Planning

Ways of minimizing tax penalties and interest:

- Compliance with tax law;
- Timing of the tax payment to avoid lateness;
- Need for tax consultants on various transactions;
- Paying taxes at the right rates.

Tax Planning

Reasons for the current KRA aggressiveness:

- KRA has recruited a large, experienced, highly qualified and well trained manpower;
- Government's pressure to KRA to meet high tax collection targets;
- New era orchestrated by signing of performance contracts by top government executives;
- Government's effort to ward off corruption through the Kenya Anticorruption Authority.

Tax Planning

Tax planning embraces cash flow management, thus:

- Tax payments involves a lot of funds, hence proper cash forecast;
- Payment of corporate taxes based on instalments hence need for appropriate investment decisions;
- Short term planning required for some taxes e.g. VAT, PAYE;
- Tax refunds to be used to sort out cash flow problems*;*

Tax Planning

Who should embrace tax planning?

- Human Resource;
- Finance;
- Procurement and Logistics;
- Marketing ; and
- Board of Directors.
- - Why?

EMPLOYMENT CONTRACTS

Extra caution to be taken while signing employment contracts:

- Employment contracts should not unfairly burden the company. Possible burdens to the employer could be as a result of:
  - Tax free remuneration;
  - Temporary employees where PAYE is not deducted;
  - Fringe benefits;
  - Casual labourers for prolonged periods;
  - Contribution of retirement benefits above allowable limits;
  - Huge allowances that are not subjected to tax.

ALLOWANCES

Tax exposure areas include:

- Unsupported round-sum allowances – this is deemed to be taxable benefit;
- Amount not paid in cash but credited to an employee's account with the employer –this is deemed to be taxable benefit;
- Reimbursement of expenses incurred in production of income – this is not taxable, so long as it is in form of a refund.

EMPLOYMENT BENEFITS

Tax planning areas include:

- Non-cash benefits: Not taxable to a maximum of KShs 36,000 P.A;
- Car benefit is 2% of the original cost of the vehicle;
- School fees for dependants not allowable on the company for tax purposes unless it has been taxed on the employees;
- Value of free medical services is a non-taxable benefit to full time employees and directors;
- Premium on life insurance, education and health policies qualify for tax relief.

HOUSING

Tax planning areas include:

- The value of housing is the higher of 15% of gains from employment and value of premises less rent charged;
- The value is reduced relative to the period of occupation for premises occupied for part of the year only;
- The value is the fair market rental value of the premises where the premises are owned by employer.

RETIREMENT SCHEMES

Tax planning areas include:

- Scheme to be registered with both KRA and RBA;
  - Contributions to registered schemes are allowable;
- The maximum combined limit for both employer and employee is KShs. 240,000.

OTHER REGULATIONS

Tax planning areas include:

- Penalty for paying an employee who has no PIN: KShs 2,000 per month per employee;
- Temporary employees subject to tax if paid monthly;
- Casual wages subject to NSSF - 5%.

CASH FLOW

Tax planning areas:

- Proper cash budgeting is required to enhance timely payment of all taxes so as to avoid penalties and interest;
- Finance manager should prepare a calendar or a diary listing all taxes due for the year;
- Taxes under consideration include VAT, PAYE, corporate instalment tax, withholding tax, customs and excise, among others.

TAX COMPLIANCE

Tax planning areas:

- To pay all taxes by the due date to avoid late payment penalties;
- Tax compliance audits;
- Tax consultants to be involved while making decisions likely to have tax implications e.g. capital budgets, contracts, etc.

ALLOWABLE COSTS

Tax planning areas:

- Capital expenditure, loss, diminution, exhaustion of capital;
- Cost classification and analysis;
  - Legal costs and other incidental expenses relating to authorization & issue of shares, debentures or similar securities offered for purchase by the general public;
  - Capital expenditure on rating for purposes of listing on security exchange;
  - Personal entertainment expenses;

PROVISIONS AND ACCRUALS

Tax planning areas include:

- All expenses, write offs and provisions should be supported or have a proper reconciliation;
- General provisions for debtors are not allowable for tax;
- Specific provisions for debtors should be supported;

W/TAX ISSUES

Tax planning areas include:

- Invoices should correctly describe the service provided;
- Confirm whether tax should be withheld while paying;
- Tax to be withheld at appropriate rates;
- Reconcile interest expense and tax withheld;
- A copy of the exemption certificate to be obtained if a payment is made to an exempt body;
- Filing of the withholding tax return.

VAT ISSUES

- A tax payer may not be required to register for VAT if the turnover threshold of KShs 5 million has not been met. However, the company may register voluntarily:
- Advantages of registration:
  - Claim of input VAT;
  - Compliance with the law.
- Disadvantages of registration:
  - Increase in administration costs;
  - Penalties in case of lack of compliance.

VAT ISSUES

- Other VAT planning issues:
  - VAT should be loaded on the taxable goods and services;
  - An invoice should meet the requirement of a tax invoice;
  - Reversal VAT is to be paid on paying for an imported service;
  - The company may set off the VAT refunds against other taxes;
  - Reduce debt collection period;
  - Input tax to be claimed on a timely basis;
  - Lodge claim for refund of VAT on bad debts.

DOUBLE TAX AGREEMENTS

Tax planning areas:

- Lower rates for withholding tax are applicable for countries that have DTA with Kenya;
- Entities to consider DTA while importing any service;
- Entities to seek tax consultant’s advise before signing treaties;
- Tax clauses in treaties should be critically reviewed;
- Consider engaging locally based entities rather than the non-resident head office for multinationals.

CUSTOMS AND VAT ISSUES

Tax planning areas:

- Company, and not the clearing agent, to be the custodian of customs records;
- Confirmation of the correct tariff codes and duty rates of items prior to importation;
- Proper timing on payment of customs to avoid penalties and demurrage charges;
- Confirmation of the VAT status of a service or a good before raising an LPO

TAX COMPLIANCE

Tax planning areas include:

- To be conscious of withholding taxes and the related certificates;
- Payment to media house for direct marketing is not subject to withholding tax;
- Payment to a consultant for the preparation of artworks should be subjected to withholding tax.

ALLOWANCES

Tax planning areas include:

- Reimbursable expenses should be treated as non-taxable benefits;
- Support all expenses incurred;
- Personal entertainment is taxable on the employee;
- Entertainment of clients is tax allowable;
- Provision of a car for personal use is a taxable benefit.

VAT ISSUES

Strategic decisions/plans require tax input:

- Price setting to consider VAT;
- Free samples should be subjected to VAT.

GENERAL ISSUES

Tax planning areas include:

- Restructuring;
- Acquisition and mergers;
- Lobbying through relevant bodies for tax concessions in the sector.

CORPORATE TAX CRIMES

Key aspects.....

Tax Crimes

Corporate Tax Crimes:

- Tax systems are designed on the basis /assumptions of voluntary compliance. Voluntary compliance means that taxpayers are responsible for filing required tax returns and paying correct amounts of tax.

Tax Crimes

Tax Avoidance

- Tax avoidance is the arrangement of a person's financial affairs so as to **legitimately** reduce tax liability.

Tax Evasion

- Tax evasion is the illegal arrangement of financial affairs so as to minimize tax burden.

Tax Crimes

Sole Proprietorships

- Income tax evasion on:
  - Real estate sales.
  - Automobile sales.
  - Restaurants taking unreported cash receipts.
- False income tax returns.
- Failure to file tax returns.
- Deliberate underreporting/omitting of income.
- Keeping two sets of books.
- Claiming false deductions.

Tax Crimes

Sole Proprietorships Cont'

- Hiding or transferring assets or income.
- Inflated personal/business expenses.
- Transferring unreported income to tax havens.
- Using business funds for personal expenses.
- Paying employees in cash and not remitting statutory deductions.

Employers should plan staff packages so as to minimise the formers payroll burden and maximise the latter's take home pay. However one should be aware of anti-avoidance legislation.

Tax Crimes

Incorporated Entities

- Failure to keep records even though they are prescribed by the Income Tax Act and the Companies Act.
- Maintenance of parallel records with regards to virtually all the items in accounts i.e. purchases, sales, bank statements, etc
- Inflation of expenses
- Creation of huge provisions of specific bad debts.
- Creation of tax losses and abuse of their roll over.
- Treatment of private expenses as allowable business expenditure and these are craftily concealed.

Tax Crimes

Incorporated Entities Cont’

- **Examples**
  - Travel allowances.
  - Company cars allocated to private use by employees treated as pool vehicles.
  - Untaxed housing benefit.
  - Over expenditure on business entertainment that is allowable.

Tax Crimes

Anti-Evasion Legislation

- Anti-evasion legislation reduces the scope for tax evasion.
  - The most important and general anti-evasion provision under Kenya Income Tax Act is covered in Sec.23.
  - The Commissioner of Income Tax has powers to direct that adjustments should be made as respects liability to tax to counteract the avoidance or reduction of liability to tax.
  - This is done where the Commissioner is of the opinion that the main purpose or one of the main purposes for which a transaction was effected was avoidance or reduction to tax.

Questions