# Proposed Amendments to the Capital Gains Tax in Kenya

*Presented to The Cabinet Secretary, National Treasury By Business Member Organizations Comprising of:*

*KBA, KASIB, ICPAK, KCM, LSK, PIEA, KPDA, KAM, KNCCI & KCM*

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# 1 CGT as an important aspect of Kenya's Economic plan

CGT was first incorporated within the Kenyan income tax legislation in 1975, as entrenched in the Eighth Schedule to the ITA. In 1985, the tax was suspended so as to encourage growth in the real estate sector.

Since 1985, Kenya has witnessed tremendous economic growth, in particular, in recent years, the boom in the Kenyan property development and real estate sector has seen Kenya ranked in first place (in 2011 and 2012) representing the worldôs fastest growing property market as measured by rise in property prices by Knights Frankôs Prime International Residential Index. The notion that the big winners in the real estate market go untaxed therefore has not augured well with the principle of equity, in taxation.

Further, the numerous infrastructural flagship project under Vision 2030 all aim to elevate Kenya from a low income to middle income economy by the year 2030. One of the core pillars entrenched within Vision 2030 is to enhance prosperity of the populace through economic development. Additionally, one of the Jubilee Government main campaign promises contained in its pre-election manifesto is to attain an average economic growth rate of 7-10% and reduce the public debt.

In order to finance all these initiatives, it is clear that the government needs additional revenues raised through taxation and other means.

Therefore, with a growing economy and increased interest in the extractive sector, re-introduction of CGT was long overdue. The CS for Treasury therefore amended the Eighth Schedule to the ITA through the Finance Act 2014 by providing for tax at 5% on gains accruing to a company or an individual upon the transfer of property in Kenya on or after January 1, 2015.

Whereas as all stakeholders represented by ICPAK welcome the re-introduction of CGT, many have raised concern relating to the implementation of the 1975 law in this current economy.

This paper therefore consolidates the general concern expressed by various industries in Kenya and provides the recommendations and proposed changes to the CGT legislation so as to enhance its implementation and administration.

## 1.1 Implementation hurdles of the CGT law

Stakeholders have raised a number of concerns on the reintroduction of this tax, whereas it is not in doubt that CGT is an important aspect of Kenyan economy, concerns have arisen on a number of issues. We summarize these issues as follows;

### 1.1.1 Lack of an indexation allowance

CGT is aimed at taxing actual gain that has accrued on disposal of property, whether the gain has accrued in one year or over a period of time.

The increase in the value of property is eroded by the inflationary changes year-on-year. Therefore, CGT should aim to tax only the actual gains arising on the property by adjusting the change in property value and eliminating the inflation effect on the value. Failure to adjust the inflationary changes creates inequity, since a transferor is taxed on unearned income.

After 40 years the economic conditions in Kenya have significantly changed, it is therefore imperative that the proposed CGT regime reflects these changes and adopts an indexation formula either through the use of retail price index or base year cost of market values.

We note that with the introduction of CGT in 1975, indexation of costs was provided for in the Eighth Schedule, however, the re-introduction of CGT in 2015 has not factored the indexation allowance. We therefore propose that the Government amend the Eighth Schedule so that a form of indexation allowance can be factored in.

Indexation of costs or indexation allowance is not a novel thing for CGT, other countries have implemented the allowance successfully. E.g Uganda, France, UK, Australia and Spain.

### 1.1.2 Documentation challenges of historical costs and adjusted cost

The burden of proving the historical cost and adjusted cost undoubtedly lies on the owner of the property. Various factors come into play that would make it difficult for a taxpayer to benefit from the computation of adjusted costs. Some of these factors include:

- Some property has been in the family line for decades and has been passed on either through gift or through testamentary process and hence documentation on the historical cost of the property may not be in existence or accurate;
- During the period that CGT was suspended, the owner of the property need not have kept a record of every transaction of the cost or expenditure incurred to enhance or preserve the value of the property;
- Further, the ITA has put a cap of seven years for keeping documentation and maintaining financial records, hence even the diligent record keeping owner of the property maybe unable to produce supporting documents for costs and expenses incurred more than seven years ago.

With the lack of records, owner of the property will suffer a tax injustice for not being able to claim any adjusted cost which he canॠt prove.

This issue ties in with the indexation allowance, which would enable the owner of the property adjust their cost for CGT purposes and therefore reduce the disadvantages brought about by the CGT law.

### 1.1.3 Taxation of shares listed on the NSE

The current CGT law aims to tax the gains made by individuals on shares listed on the NSE. Some of the challenges faced by this move include;

- The NSE is still a growing stock exchange and needs to attract investors. By introducing CGT on listed shares, the NSE risks losing its appeal to investors who would opt to buy shares in countries without CGT. It is worth noting that Rwanda, Tanzania, Nigeria and Ghana are among the countries that have exempted their stock exchange from the CGT regime.

  Where cross listing of a company is possible, companies may opt to list in the exchange that provides maximum return to its shareholders ( i.e countries without CGT on listed shares) in which case, Kenya would lose the listing to any of its EAC counterpart.

  As noted during the first quarter of this year, with the introduction of CGT, the trade volume at the NSE dropped by over 70% due to the apprehension caused by the law.

- With an average of 3,000 trades per day, stockbrokers would face an administrative nightmare in trying to calculate the gain arising from each transaction. An attempt to review each of the 3,000 daily transactions would involve an expensive and unnecessary investment by the 19 licensed stock brokers. Therefore, the CGT requirement as currently drafted negates the canon of economy which stipulates that the cost of tax collection should be lower than the amount of tax collected.

- Further, a daily analysis of 3,000 transactions would create a huge backlog in clearing trading at the NSE and would practically render the automated system used by the NSE inoperable. This would further dent Kenyaǿs stock market at the international level and negate Kenyaǿs effort of enhancing operational efficiencies in all sectors of the economy.
- With 80% of the NSE trades valued at KShs 100,000 or less, the gain arising from these transactions would be minimal and cannot outweigh the cost of collection of the tax.
- The difficulties in computing gains at the NSE are further evidenced when an investorhas purchased shares of the same company at different dates and different prices. At the time of disposal, what purchase price will be used to compute the gain? First- in-first-out? Or a weighted average? Any such computation will be onerous and especially where the shares traded are below KShs 100,000 in value.
- Investors (residents and non-residents) normally use a local custodian to hold securities. When an investor changes the custodian, the underlying assets have to be transferred to the new custodian in which case the CDS account is changed. In view of this, the change in CDS account is not a change in beneficial ownership of the securities and should therefore be excluded from CGT computations.
- Investors also use omnibus structures through which the assets of various clients are held in one account. Some of these investors are exempt from tax resulting in a huge administrative challenge of isolating taxable and exempt clients at the point of disposal of the securities.

Due to the practical difficulties of accounting for CGT at the NSE level, the Government should consider using the NSE to effect a transactional fee for every disposal of shares, whether a gain has been made or not.

Currently the NSE charges a fee of 0.12% for every transaction at the exchange; this fee earned the NSE income of KShs 373m in 2013 and KShs 517m in 2014.As evidenced from the NSE income, the government can also be able to earn a similar income that would be easy to determine and collect, and would not adversely affect trade at the NSE. Further, this fee would increase as the number of trading activities in the NSE increase.

More than 30 countries, including the United Kingdom, South Korea, India, Hong Kong and Brazil apply a levy on the stock exchange. Other countries including Germany, Italy, France, Spain are in the process of adopting a similar transaction levy.

#### 1.1.4 Different economic times

As discussed above, the Eighth schedule to the ITA was written in 1975, precisely 40 years ago. Since then there has been significant changes in the economy and specifically inflation rates. By using the same Act of 40 years ago, some of the provisions in the 8$^{th}$schedule are out of sync with the current economic setting.

For example, the exempt transfer of land was then pegged at KShs 30, 000. With the current speculation and the ballooning costs of land, the value of KShs.30, 000 does not reflect the current economic reality.

### 1.1.5 The treatment of capital losses for CGT

The 8th Schedule does not prescribe any limitation for capital losses incurred in the course of a property related transaction. However the KRAõs guidelines issued in January 2015stipulate that the capital loss may be carried forward to be offset/deducted against a capital gain over a period of four years.

We note that by its very nature, CGT applies to the non-recurrent transactions of a tax payer and hence, especially for individuals, transactions attracting CGT may span over a much longer period than four years. The capping of carry forward losses to four years should therefore be excluded for capital loses.

### 1.1.6 The treatment of company restructuring

Paragraph 13of the 8th Schedule requires companies undertaking restructuring to obtain exemption from CGT, after seeking approval from the CS. The approval is only granted if such restructuring is in the interest of the public.

Company restructuring can occur without any change in the ownership of the company, and hence taxing such a transaction would not be equitable since there is no gain or loss in the transaction.

To eliminate the ambiguity surrounding the interpretation of what amounts to public interest, we propose that the CGT law should be aligned to Section 95 and 96 of the Stamp Duty Act that provides for exemption in restructuring cases.

Further, in line with Legal Notice 92 of 2007, we propose that the transfer of a family property to a limited liability company whose shares are wholly owned by the family should also be exempt from CGT.

### 1.1.7 CGT should be catered for under the self-assessment tax regime

The disposal of property can either be normal business income or CGT, depending on the tax status of the transferor. To enable a taxpayer to efficiently manage their transactions, CGT should be collected through the self-assessment basis, in which the taxpayer would declare their total income in the SAR and pay any tax by the end of the fourth month after the end of the accounting period.

The self-assessment system, especially when administered through *iTax* will enable KRA to validate the taxpayers annual transaction at the click of a button and make it easier for KRA and the taxpayer to assess the level of transactions involved and correctly capture the income as trading gains or capital gains. This system will also eliminate the recording of CGT on a transaction by transaction basis and hence reduce the amount of time taken by KRA to verify the annual gain or loss.

### 1.1.8 Guideline on business income *vis-à-vis* capital gain/loss

One of the aspects of tax that determines the success or failure of compliance with a particular legislation lies with the certainty of the legislation. The concept of trade as envisaged in business income is sometimes subject to differing interpretation from one tax payer to the next.

We therefore propose that the Government puts guidelines in place to enable taxpayers differentiate between business income and capital gains.

### 1.1.9 The taxation of gifts

The 8th schedule imposes tax on transfer of gifts; this does not make an exception on transfer of gifts among family members. Whereas the First Schedule provides an exemption for property transferred by the deceased estate, no exception has been provided to cater for gifts transferred during the lifetime of a person.

The nature of gifts is that no consideration is given to the transferor, therefore no gain or loss occurs. We therefore propose that to provide an avenue for spouses and children to exchange gifts, during the lifetime of the donor, the CGT law should provide for exemption for transfers between close family members. The recipient of the gift would then inherit the cost base used by the original owner and once the property is disposed to a third party, the entire gain accruing would be taxable.

## 1.2 Submissions by various stakeholders

In the backdrop of the challenges highlighted above, ICPAK, LSK, KASIB, KBA, KAM, KPDA, KNCCI, ISK and KCM have prepared the following recommendations on the CGT law.

## 2 Summary of submissions from stakeholders

| | Current Law (ITA) | Issue (s) | Proposed solution | Proposed Law | Impact |
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| **1** | 8th Schedule Para 2provides that *tax is chargeable on the whole of the gain which accrues…on or after 1st January 2015* | • The current law does not provide for an indexation allowance and hence taxes gains and inflation that have accrued since suspension of CGT in 1985.<br>• Due to the historical nature of property acquisitions and also the limit of the period one is required to maintain records, taxpayers may be unable to prove the cost or the adjusted cost.<br>• The viable solution for this predicament is to allow for indexing of the properties acquired in the past. | Provide for cost indexation, which would eliminate inflation for assets owned for over three years.<br>The indexation formula can be based on either;<br>• The Retail Price Index; or<br>• Allowing the market values as at 31st December 2014 to be the base cost. | The Eighth Schedule to the Income Tax is amended in paragraph 2 by inserting the following new proviso -<br>a) The cost base for purposes of calculating the gain under this Schedule will be the market value as at 31 December 2014;<br>or<br>b) The cost base for purposes of calculating the gain under this Schedule will be indexed as follows;<br>$\frac{\text{RPI as at date of sale}}{\text{RPI as at date of purchase}}$ | Indexation will eliminate inflation from CGT workings and enable CGT to only tax actual gains earned. |
| **2** | 8th Schedule Para 4 (2), Section 15 (3) (f) and Section 52B | The law is not clear on offset of capital losses against capital gains.<br>Section 15 (3) (f) only refers to losses arising from enforcing a security, charge | The Act should be clear that capital losses are available for offset against capital gains.<br>Further, the due date for CGT should be based on the self-assessment tax regime for | a) Section 15 (3) of the Income Tax Act is amended by deleting paragraph (f) and substituting the following new paragraph -<br>(f)The amount of any loss realized in computing, in | The changes will provide an equitable ground for offsetting capital gains against losses. |

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| | | or encumbrance<br><br>Further the guidelines issued by KRA in January 2015, stipulate that the restriction of losses to four years will apply to capital gains. Capital gains are by their nature not recurrent and hence the four year restriction may not be practical in such a case. | companies and individuals. | accordance with paragraph 4 (2) of the Eighth Schedule, gains chargeable to tax under section 3(2)(f). The amount of any such loss incurred in a year of income shall be deducted only from gains under section 3(2)(f) in that year of income and, in so far as it has not already been deducted, from gains in subsequent years of income.<br><br>b) Section 15 of the Income Tax Act is amended by inserting the following new proviso in Paragraph (4) -<br><br>v) this section shall not apply to any deficit loss realized pursuant to Paragraph 4(2) o the Eighth Schedule.<br><br>c) Section 52B of the Income Tax Act is amended by inserting the words ñincluding a return of capital gains or lossesò immediately after the words ñreturn of incomeò appearing inSection 52B (1) (a) and (1) (b)<br><br>d) The Eighth Schedule to the Income Tax Act is amended by deleting Paragraph 5 (2). | The self-assessment regime will make it more efficient for the transferor to declare the total gains and losses made in a year of income. |

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| **3** | 1st Schedule Paragraph 36 (d) (i) exempts from CGT on transfer of land worth KShs30,000 or less | KShs30,000 was the base used in 1975, since then inflation rate has increased and therefore the amount does not reflect the current land prices.<br>The amount is too low to reasonably act as a tax incentive. | The exempt limit of KShs. 30,000 needs to be adjusted to take into account inflation and the current economic reality. | The First Schedule to the Income Tax Act is amended by deleting Paragraph 36 (d) (i) and substituting therefore with the following new paragraph<br>(i) the transfer value is not more than 2,000,000 shillings; | This change will align the exempt value to the current economic position of the country. |
| **4** | 8th Schedule Para 6 (1) (b)<br>Allows for a taxpayer to reinstate destroyed or lost property with similar property without incurring CGT. | The timeframe for reinstating the property is set at one year from the date of loss or destruction.<br>This period is too short and may not be practical in view of the timeframe required before insurance proceeds are received and a replacement is made for the property. | Increase the timeframe to three years from the date of receipt of insurance proceeds. | The Eighth Schedule to the Income Tax Act is amended by deleting the words ówithin one year of the lossô appearing in paragraph 6 (1) (b) and substituting therefore with the words ówithin three years of approval of building plans by the respective Government institution, or within three years of receipt of insurance proceeds for all other cases. | This will minimize the applications that the Commissioner has to contend with to approve every application to extend the period. |
| **5** | 8th Schedule Para 6 (1) (a) includes gifts for purposes of establishing CGT | This provision introduces CGT on gifts to spouses or children.<br>Transfer of property between spouses and children where there is no gain or loss on the transaction, should not be captured under CGT. | Any CGT arising from transfer between spouses or to the children should be deferred until the property is sold or transferred to a third party.<br>The spouse or child will inherit the base cost(first owners acquisition cost) and will be taxed on the entire gain upon | The Eighth Schedule to the Income Tax Act is amended in paragraph 6 (1) (a) by inserting the following new proviso -<br>Provided that this Section shall not apply to transfer of property between spouses or to a child, or from a child to a parent. | This will allow for transfer of property between close family members without the need to convey the property through a will. |

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| | | | disposal to a third party. | | |
| **6** | The 8th Schedule para 13 exempts from CGT companies undertaking ownership restructuring after seeking approval from the Cabinet Secretary and the approval is only granted if such restructuring is in the interest of the public. | CGT is aimed at taxing realized gains on sale.<br><br>Restructuring can occur without any change in ownership, in such a transaction, there is no gain or loss.<br><br>The transaction should therefore be excluded from CGT.<br><br>Without clear guidelines on what amounts to public interest, internal restructuring would be subjected to CGT without an actual sale occurring. | Align the CGT provisions to Section 95 and 96 of the Stamp Duty Act which allow for group restructuring where the ultimate ownership of the group does not change.<br><br>The transfer of a family property to a limited liability company whose shares are wholly owned by the family should also be exempt from CGT. | The Eighth Schedule to the Income Tax Act is amended in paragraph 13 by inserting the following new proviso -<br><br>Provided that no gain or loss shall be included in the computation of income under section 3 (2) (f) in the case of transfer or property which is exempt from stamp duty pursuant to Section 95 or 96 of the Stamp Duty Act or Legal Notice 92 of 2007. | This will avoid charging tax on unrealized gains. |
| **7** | The 8th Schedule part II paragraph 15 provides for CGT on listed shares owned by individuals. It also places the responsibility of account for the tax on the stockbrokers | Taxing shares listed on the NSE is bound to have negative effects on the stock exchange.<br><br>The administration of the law would also be cumbersome since the stockbrokers would be required to evaluate the gain made by the individual.<br><br>As the stock market handles on average 3,000 | Provide for a transaction fee for sale of shares at the NSE. This can be aligned to the current rates used at the NSE. | a) The Eighth Schedule to the Income Tax Act is amended by deleting Part II.<br><br>b) The Eighth Schedule to the Income Tax Act is amended in paragraph 1by -<br><br>i) Inserting the words ñbut excludes shares that are listed and traded on the Nairobi Stock Exchangeòimmediately after the words ñStamp Duty Actòappearing in the | This will remove the hurdles involved in computing the gain arising from NSE trading. |

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<td>transactions per day, such a process would slow down trading</td>
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<td>definition of ñMarketable Securityò<br>ii) Inserting the words ñmarketable securities andò immediately after the word ñincludesòappearing in the definition of ñPropertyò<br>c) The Capital Markets (Licensing Requirements) (General) (Amendment) Regulations are amended as follows;<br>The principal Regulations are amended in the Fifth Schedule as follows</td>
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<tr><td>Consideration (Transaction Value)</td><td>Minimum Net Brokerage Commission %</td><td colspan="4">Transaction Fees</td><td colspan="2">Investor Compensation Fund Fee</td></tr>
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<tr><td>Above<br>KShs. 100,000</td><td>1.36</td><td>0.12</td><td>0.12</td><td>0.12</td><td>0.06</td><td>0.01</td><td>0.01</td></tr>
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<td>8</td>
<td>8th Schedule</td>
<td>The manner for attributing</td>
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| | Para 8(3) provides that é .the shareholder shall allocate in the manner prescribed, the cost of existing shares between the old shares and new shares | cost between new and old shares has not been prescribed. | | ambiguity in allocation of costs |
| **9** | N/A | The difference between capital gain and business income is subject to varying interpretations | Provide guidelines which seek to clarify how to determine business income and capital gains | Removes ambiguity in what amounts to capital gain |
| **10** | 8th Schedule Para 7(3) and Para 9 | Provides for use of market value on transfer of property. The process of determining the market value has not been prescribed | Introduce regulations to guide the process of determining the valuation of property | This will create certainty to all players for purposes of determining the value of property |

## 3 Abbreviations & Acronyms

| | |
|---|---|
| CDS | Central Depository System |
| CGT | Capital Gains Tax |
| CS | Cabinet Secretary |
| EAC | East Africa Community |
| ICPAK | Institute of Certified Public Accountants of Kenya |
| ISK | Institute of Surveyors- Kenya |
| ITA | Income Tax Act |
| KAM | Kenya Association of Manufacturers |
| KASIB | Kenya Association of Stock Brokers and Investment Bankers |
| KBA | Kenya Bankers Association |
| KCM | Kenya Chamber of Mines |
| KNCCI | Kenya National Chamber of Commerce |
| KPDA | Kenya Property Developers Association |
| KRA | Kenya Revenue Authority |
| LSK | Law Society of Kenya |
| NSE | Nairobi Securities Exchange |