POSITION PAPER ON CAPITAL GAINS TAX IN KENYA

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Introduction

The Kenya Finance Act 2014 re-introduced a 5% Capital Gains Tax in Kenya since its suspension in 1985. Taxation of capital gains was suspended in 1985 through an amendment to the Eighth Schedule to the Income Tax Act. The move was geared towards encouraging investors in property and marketable securities.

The 5% Capital Gains Tax will be effective as from 1 January 2015 and will apply to property acquired before 1 January 2015. This will be a final tax and will be applied on the net gains arising from the sale of property, marketable securities and transactions in the extractive industry in Kenya.

Capital gains tax (CGT) is defined as a tax on capital gains, the profit realized on the sale of a non-inventory asset that was purchased at a cost amount that was lower than the amount realized on the sale. The most common capital gains are realized from the sale of stocks, bonds, precious metals and property.

For tax purposes it is important that a distinction be made between realized and unrealized gains. A gain is not realized until the security that has appreciated is sold. For example if one buys some stocks from Safaricom and investment grows steadily at 10% for one year, and at the end of the year he decides to sell the shares he will be subjected to Capital gains tax if it was already enacted in the Income tax laws. So as a general rule tax is paid upon realizing a gain.

Properties you may pay capital gains on

The most common capital gains are realized from the sale of stocks and shares in a company, building, land or a lease. Typical types of property you might pay Capital Gains Tax on include;

- A property youôve bought as an investment
- Business premises, such as a shop
- Land, such as agricultural land

Investments liable to Capital Gains Tax when you sell or dispose of them include;

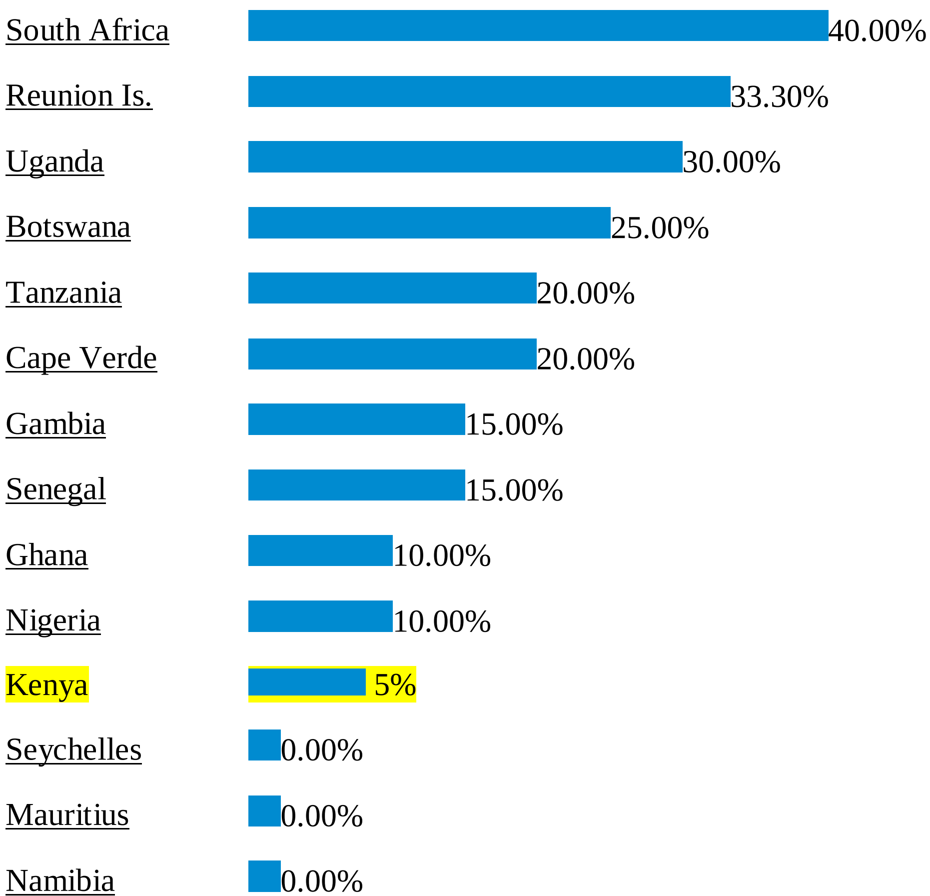
- Stocks and shares in a company,
- Units in a unit trust,

- Debentures and bonds

Capital Gains Tax in Africa- Comparative analysis.

It is worth noting that all countries in East Africa have domesticated the Capital Gains Tax (CGT) except Kenya. The diagram below provides an analysis of Capital Gains Tax throughout the continent.

Capital Gains Taxes (%) - Kenya Compared to Continent



Source: http://www.globalpropertyguide.com/Africa/Kenya/capital-gains-tax

Capital gains tax in other Jurisdictions

Australia

Capital gains tax in Australia is only payable upon realized capital gains, except for certain provisions relating to deferred-interest debt such as zero coupon bonds The tax is not separate in its own right, but forms part of the income tax system. The proceeds of an asset sold less its 'cost base' (the original cost plus addition for cost price increases over time) are the capital gain. Discounts and other concessions apply to certain taxpayers in varying circumstances.

For individuals, the most significant exemption is the family home. The sale of personal residential property is normally exempt from Capital Gains Tax, except for gains realized during any period in which the property was not being used as an individual's personal residence (for example, being leased to other tenants) or portions attributable to business use. Capital gains or losses as a general rule can be disregarded for CGT purposes when assets were acquired before 20 September 1985 (pre CGT).

Belize

Located not so far from the tourist-filled beaches of Cancun and the Yucatan Peninsula, Belize has been an expat friendly haven for decades. Formerly known as British Honduras, the country has made itself one of the more attractive places for expats with cash. Considering Belize is a small, independent, English-speaking country, itôs no surprise so many expats would flock there.

Belgium

Belgium is living proof that capital flight is real. Actor Gerald Depardieu famously moved a few miles over the French border to escape Franceôs high income tax regime, and it was widely noted that Belgium has no capital gains tax. Bernard Renault, the billionaire head of luxury giant LVMH, also moved from France to Belgium for ñfamily inheritance reasonsò, but most surmised it was to avoid a new ñsuper taxò imposed by French socialists.

Hong Kong

The freest economy in the world for years now, Hong Kong is one of the best places on earth for investors. And the Special Administrative Region of China is a bastion of expats, with bankers and professionals from all over the world. As part of its tradition of respect for capital, Hong Kong does not tax capital gains.

Malaysia

In Malaysia Capital gains are generally not subject to income tax. However the Malaysian government has enacted into law real property gains tax which is levied on gains arising from the disposal of real property in Malaysia or of interest, options or other rights in or over such land as well as the disposal of shares in real property companies. Effective 1 January 2012, gains realized in real property is taxed between 0% and 10% depending on the holding period and is based on net gains as follows:

- Disposal of one unit residential property once in a lifetime by an individual who is a citizen or a permanent resident of Malaysia is tax exempt;
- Gains from disposal of property between parents and children, husband and wife, grandparents and grand children is tax exempt;
- All related costs such as purchase price, renovation costs and incidental cost e.g legal fees are deductable for tax purposes; and
- Exemption up to RM10,000 or 10% of the net gains, whichever is higher, is given to an individual

New Zealand

One of only six ñfreeò economies in the world according to the Heritage Foundation. New Zealand offers stability and independence and is a growing ñsafe havenò jurisdiction for assets. New Zealand does not impose a capital gains tax on the sale of equities or other investments. It does have a formal law stating that real estate purchased for the express purpose of resale can be made subject to capital gains taxes; however this law is rarely enforced. The Labour Party proposed a fresh tax on capital gains several years ago, only to see their worst election returns in years.

South Africa

Capital gains tax was introduced in South Africa in 2001 to bring the country in line with international practice and also to widen the tax net. The tax is payable by all residents and non South African residents who make a profit or loss when selling fixed property of a capital nature located in South Africa. It does not affect primary residence provided the property is smaller than two hectares and the profit is less than R1 million.

Homeowners will however be liable for CGT on second properties or holiday homes that are not occupied as a primary residence or any portion of a primary residence that is used for business purposes. In calculating net amount taxable from Capital gains, the effects of inflation and the cost of the asset (Maintenance and repairs and insurance premiums) will be deducted. To ensure that persons to do evade paying this tax, the South African Revenue Services (SARS) has computer software, the New Income Tax System (NITS), which is interfaced with systems in the deeds registry, motor vehicle registry, Securities exchange and financial institution.

Merits and demerits of Capital Gains Tax

Policy analysts have had diverging views of the effects of Capital Gains Tax on any given economy. Most critics of CGT argue that a tax on capital hurts the economy by reducing the incentive to save and invest. They pose the following reasons to back-up the argument[1]:

1. **Capital Gains Tax is complicated and costly to administer**

Capital gains taxes for practical and political reasons are perpetually riddled with exemptions and exceptions making them complicated to administer and to comply with. The big complication is determining the true capital gain net of inflation after netting out the purchase price and the cost of maintenance and investment in the asset over the years.

2. **Capital gains tax easy to avoid**

The decision to pay a capital gains tax is entirely up to the taxpayer. It's the easiest tax to avoid because you just don't sell your asset.

3. **Capital gains tax chokes the economy**

The heart of a vibrant, prospering society is wealth-creating trades that shift productive resources to ever higher valued uses. A capital gains tax chokes those trades and the economy at large.

Imagine you can an increase the value of a productive asset by ten percent. That's a big gain that the economy can ill-afford to miss out on. In the absence of a capital gains tax you would easily make an offer to the present owner in which both of you are better off through the trade and the economy gets a ten percent gain. That gain won't happen with a capital gains tax.

[1] See http://www.interest.co.nz/opinion/54435/opinion-why-capital-gains-tax-very-very-bad-idea

4. **Capital gains taxes double-tax income**

The value of say a business is simply the net present value of its expected income stream. The income stream is taxed and so the capital value of the business is after tax. This is a key point. Cut the tax rate and the business will be worth more. That shows that the capital value of productive assets is always after-tax.

Corporate share values generally equal the present value of expected future earnings. If expected earnings rise, shares will increase in value, creating a capital gain to the individual. But those future earnings will be taxed at the corporate level when they occur; thus hitting individuals now with a capital gains tax is double taxation.

5. **Lock-In Effect**

Capital gains are taxed on a realization basis, which creates lock-in. Taxpayers delay selling investments that have large unrealized gains to avoid the tax hit. As a result, people hold assets too long and forgo beneficial diversification opportunities[2].

For the overall economy, lock-in reduces growth because it blocks the beneficial shifting of resources from lower- to higher-valued uses.

Recommendations

After reviewing the Finance Act 2014 and the related clauses in relation to taxation of capital gain (Finance Act 2014, Income tax act Cap 470 EIGHTH **SCHEDULE, Sections 3(2) (f), 15(3) (f)), section 34 and section 36, it is clear we need to review several areas.**

Although the rate seems reasonable compared to its neighbors and its intention by the government will be to broaden the tax base, increase tax revenue collection and align Kenya with other neighboring countries, the following are areas in the law that should be refined to prevent slump in the property market and NSE in Kenya and ensure general equity in taxation.

1. In Eighth Schedule 6(2), we need to have a clause that will cover transfer of property between close relationship as a gift that allows the deferral of the taxation of any gains until the time the property is sold or transferred to a third party.
2. In Eighth Schedule 6(2), we need to have a clause that will cover transfer of property during incorporating family businesses to limited liability companies just like under stamp duty

[2] http://www.cato.org/publications/commentary/six-reasons-keep-capital-gains-tax-rates-low

provisions where such companies are exempted. We can have deferral of the taxation of any gains until the time the property is sold or transferred to a third party.

3. There is need to review eighth Schedule part II 15 to be in harmony with section 3(2)(f). The rate for 3(2)(f) is 5% while in part II (15) is 7.5%
4. There is need to differ the capital gain tax where insurance compensation is utilized to replaced the destroyed asset.
5. We propose to increase the threshold limit for taxation in First schedule 34(d) (1) from the old value of Ksh 36,000 to a value that will make administrative of these taxes more efficient.

Since Capital gains tax does not apply to persons dealing in business of property and shares and who are required to pay income tax or corporation tax on their chargeable income, there is a need for the legislators to introduce indexation allowance(Adjusting the cost price with the time value of money) just as other developed economy like UK.

General Information

As Kenya introduces capital gain, the risk of revenue loss by the country to other states within the East Africa community becomes a reality. It will be possible for companies to change its residence from Kenya a partner within the block under the tax arrangements of free movement of persons and goods to benefit from the current capital gain tax incentives for investors market.

There is also need for National government and county governments to collaborate in order to eliminate double taxation in the property market.

Although Kenya may look to have a lower rate, the overall costs in property markets is likely to escalate due to additional costs arising from insecurity, high interest and legal charges by the bank to secure properties, risk of face titles, poor infrastructure in most areas leading to additional expenses that may not be found in other competing tax jurisdiction.

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