Expanding the Tax Base in Kenya: A Case for Innovation

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TABLE OF CONTENTS


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WE MUST
COLLECT TAX

Introduction

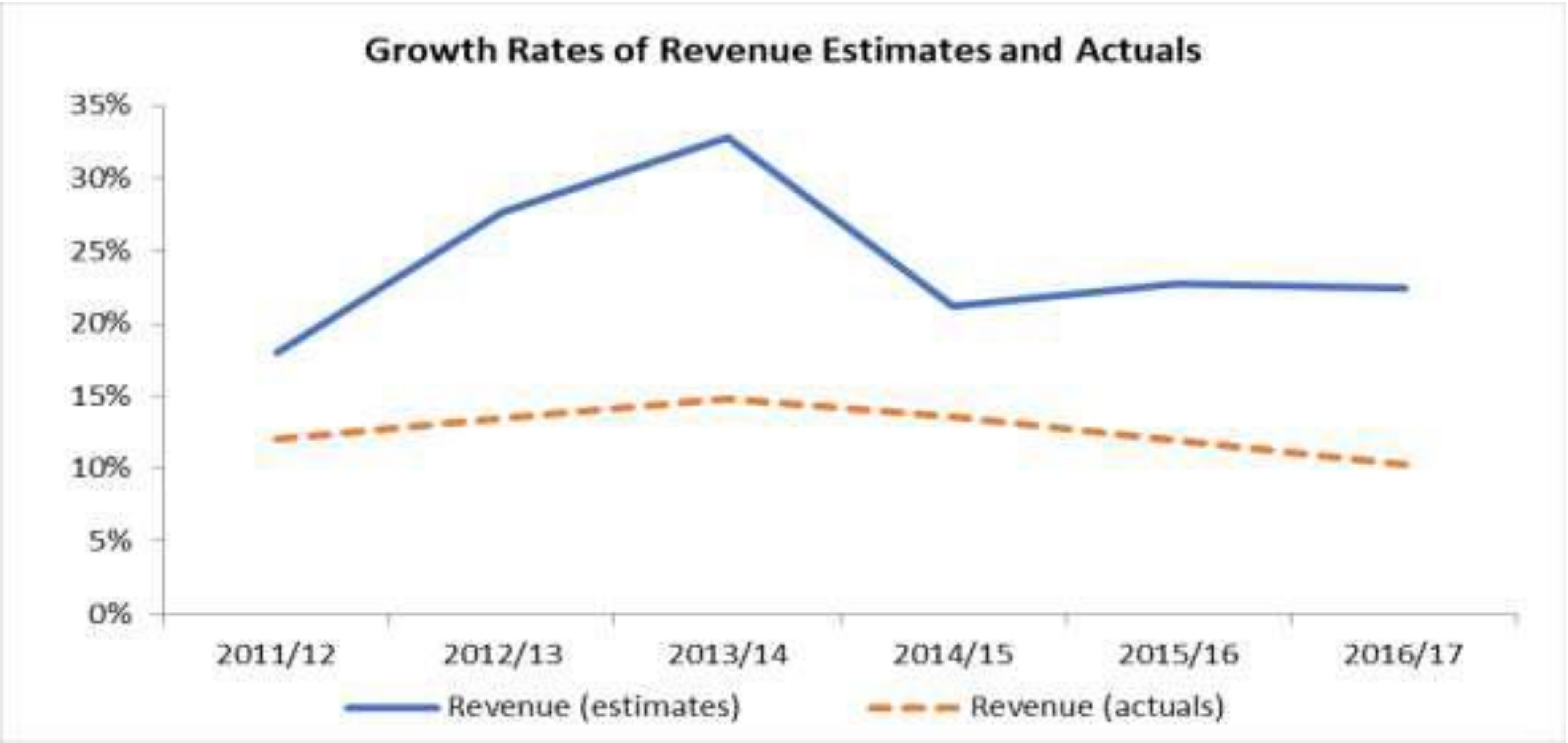
Introduction

ICPAK
Uphold Public Interest

- Taxation is the largest source of government revenue in Kenya
- The expansion of the economy has seen an increase in the National Budget to ***KES 2.287 Tn*** for FY 2017/18
- Revenue collection targets for Kenya Revenue Authority (KRA) *- **KES 1,549.4 Tn*** in FY 2016/17
- Revenue collection increased by 13.8% between FY 2016/17 and FY 2015/16

Broadening the tax base vis à vis raising taxes

An ambitious plan…

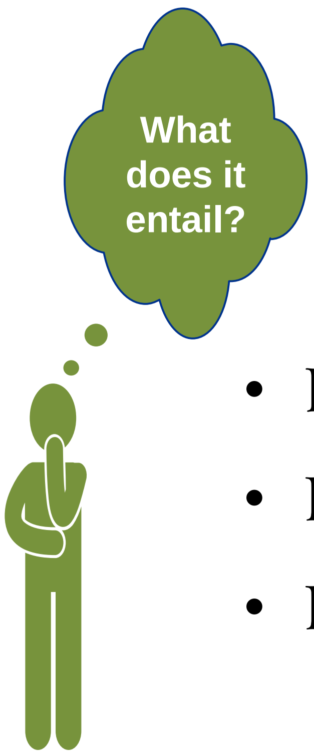


Actual vs Estimated Revenues – the gap.

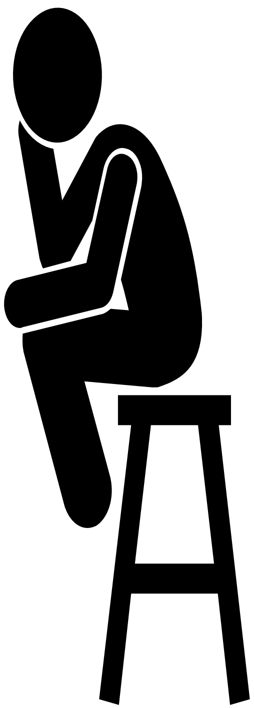
Source PBO, Aug 2017

Broadening the tax base

- Identifying the ideal tax base
  - ✓ Increase the economic activity subject to tax
  - ✓ Economic efficiency is key
  - ✓ Disadvantageous tax treatment is not a base broadener even if it increases revenue
- Eliminating tax loopholes
- Remove preferential regimes
- Revenue-neutral tax reform



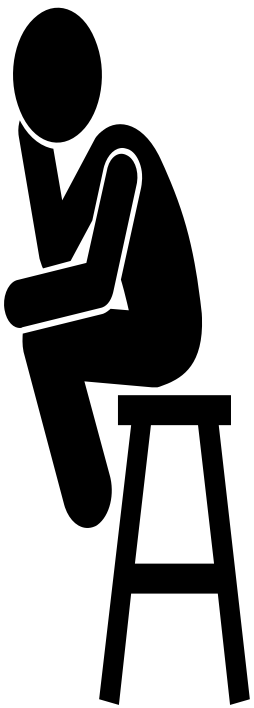
Why broaden the tax base?



- Reduce distortion in the economy (tax should not influence business decisions - inversions)
- Increase revenue collection
- Promote economic growth and Foreign Direct Investment (FDI)
- Reduce opportunities for evasion and avoidance
- Equitable distribution of tax burden amongst citizens

Introduction

Why do we need to expand the tax base?



- Efficiency – tax distortions impede economic growth, tax systems should be neutral!
- Equity – income redistribution through taxation, horizontal equity vs vertical equity
- Simplicity and compliance – complexity introduces compliance risks!

Does the Kenyan system respond effectively to the above?

Trends in Taxation

Global Trends…BEPS

Uphold Public Interest

Address the tax challenges of the digital economy 1

Neutralise the effects of hybrid mismatch arrangements 2

Strengthen CFC rules 3

Limit base erosion via interest deductions & other financial payments 4

Counter harmful tax practices more effectively, taking into account transparency and substance 5

Prevent treaty abuse 6

Prevent the artificial avoidance of PE status 7

Global Trends…BEPS

Develop rules to prevent BEPS by moving *intangibles* among group members 8

Develop rules to prevent BEPS by *transferring risks* among, or allocating excessive capital to, group members 9

Develop rules to Prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties 10

Establish methodologies to collect and analyze data on BEPS and the actions to address it 11

Require taxpayers to disclose their aggressive tax planning arrangements 12

Re-examine transfer pricing documentation 13

Make dispute resolution mechanisms more effective 14

Develop a multilateral instrument 15

Global Trends…MLI

A) Multilateral Instrument (MLI)

- Action 15 of the Base Erosion and Profit Shifting (BEPS) Action Plan introduced the Multilateral Convention
- Objective - to swiftly implement the international tax rules to bilateral tax treaties
- The Multilateral Convention is aimed at implementing Tax Treaty Related Measures to Prevent profit shifting.
- The signing ceremony of the Multilateral Convention took place in June 2017
- 70 countries have signed the MLI including Mauritius, Nigeria and Cameroon

Global Trends…MLI

- Objectives of the MLI
    - Inhibit treaty abuse
    - Neutralize effect of hybrid mismatch agreements,
    - Prevent artificial avoidance of PE status; and
    - To make dispute resolution mechanisms more effective
- Expected to increase the tax base for developing countries
    - ✓ BEPS looks to address these frictions in a way that respects tax sovereignty and resolves existing gaps

Global Trends

- ✓ BEPS introduces standards that ensure the coherence of corporate income taxation at the international level
- ✓ BEPS cannot succeed without transparency, certainty and predictability

Is Africa ready for BEPS under MLI?

- ***Our revenue authorities have skewed objectives***
- ***Our technical capacity requires significant development***
- ***Our taxpayer compliance can barely keep up!***
- ***BEPS is a developed country response to developed country issues***

Other Global Trends

B) Carbon Emissions Tax / Environment Tax

- A carbon emission tax on emissions encouraging, people, businesses and governments to produce less CO_2 and other greenhouse gases
- The carbon tax burden would fall most heavily on energy-intensive industries and lower-income households
- Policymakers could use the revenue to offset the impact of the gases, invest in clean energy, and climate adaption or for other uses
- Carbon emission tax could raise a substantial amount of revenue while still helping in the eradication of global warming

Other Global Trends

C) The EU tax regime

- **Trend towards consumption taxes**
- Lower proportion from taxes on labour and other direct taxes
- VAT typically accounts for 54% and 75% of the Implicit Tax Rate (ITR) on consumption
- In Sweden, VAT represents just over 75% of the ITR which is the highest in the EU
- Energy taxes make up approximately 17% of the ITR consumption
- Tobacco and alcohol taxes account for 7% of the ITR on average across Europe

Global Trends…the EU

- High VAT rates with the highest being in Hungary at 27% followed by Croatia, Denmark and Sweden all at 25%
- The lowest rate is Luxembourg at 17% and Malta at 18%.
- The EU average top rate of tax on corporate income fell from 22.5% in 2016 to 21.9% in 2017
- The EU countries have shown a general trend towards reducing the corporate tax and increasing the indirect taxes such as VAT
- Environmental tax revenue as a percentage of the GDP has seen a steady rise since 2009 now at a rate of 2.4% of the GDP

Should we reduce corporate income tax? Or introduce a graduated scale to encourage SMEs?

Local Trends…KRA is watching

- Some of the measures being taken by the KRA to prevent tax avoidance and evasion include:
  - Implementation of BEPS action plans – sharing of information, Tax Inspectors Without Borders (TIWB)
  - Changes in legislation – countering aggressive tax planning?
  - Deactivation of inactive PINs
  - Withholding rental income agents
  - Limitation of benefits rules
  - Taxation of foreign assets

Local Trends…KRA is watching

- Increased and intelligence driven tax audits
- Income Tax overhaul
- Re-organisation at the KRA: Customs & border control and ITO department

Greater:

- regulation of tax agents
- revenue pressures - more stringent application of penalties
- convergence of regulation
- swing towards transactional taxes

Preferential regimes – are they necessary?

Preferential Regimes - NIFC

A) Nairobi International Financial Centre

- The Nairobi International Financial Centre Act, 2017, establishes the Nairobi International Financial Centre (NIFC)

  Financial Centre – city or district that has a heavy concentration of financial institutions, that offers a highly developed commercial and communications infrastructure and where a great number of domestic and international trading transactions are conducted. The Financial Institutions would get preferential treatment in Kenya.

- The Tax Justice Network has debated the applicability of this Act – it runs counter to the **general global trend to reduce tax havens so as to increase the tax base**

How does NIFC fit into revenue raising objectives?

Preferential Regimes

- Tax incentives provide preferential regimes for certain industry players
- Often only fully realized by large industry players – MNCs
  - ✓ New motor vehicle assembler incentive
  - ✓ Operation of SEZs to attract 'FDI' – does the race to the bottom attract FDI?
  - ✓ VAT on construction of hospitals, medical equipment and apparatus

Does a harmonized, efficient, simple and equitable system attract greater FDI over and above fragmented incentives?

Preferential Regimes

- Such tax incentives are often referred to as "***tax expenditures***" and lead to increase in other forms of taxation or necessitate reduction of government spending
- Incentives may decrease the tax base
- Incentives encourage Multinationals to limit their operational reach
- Incentives don't always help the domestic player who hasn't realized economies of scale

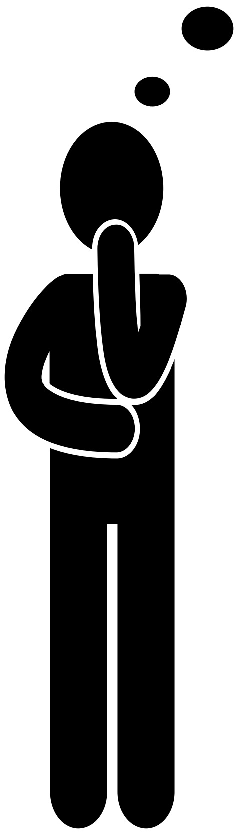
Identifying new or un-taxed bases

Expanding the base

Important factors to consider

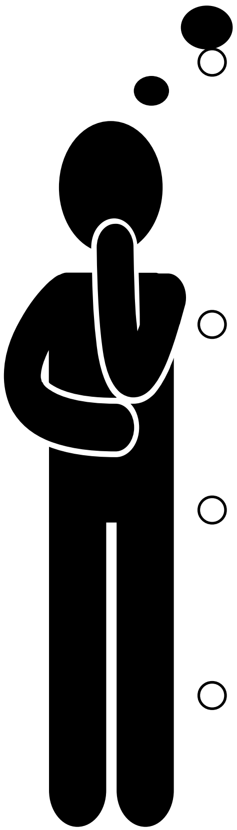
- What are the virgin revenue bases?
- Increasing tax rate may not translate into a direct increase in the tax base in Kenya
- Do tax incentives help or hurt?
- Tax Reform should broaden the tax base and minimize tax avoidance opportunities
- Tax reform should encourage economic growth…to spur consumption and result in more tax revenues

Expanding the base



- Environment taxes
- Increase indirect tax rate and scope
- Zero rate more basic goods to ensure equity
- Taxation of the informal sector
- Reduction of excessive tax incentives that act as tax expenditures to the system
- Tax the capital gains on listed securities – holding provisions?
- Reintroduce inheritance tax
- Super tax bands for higher taxable-income thresholds to better match the skewed distribution of income – graduated CIT?

Expanding the base



- Alternative Minimum Tax (AMT) for loss making entities?
- Introduce a Stamp Duty Land Tax on the purchase of an additional home – UK introduced an SDLT in 2016 at a graduated scale in addition to Stamp Duty
- Can we make a case for tax credits for growing families and lower income households?
- Greater focus on taxing consumption over investment – money spent now vs money spent later
- Increase accountability – public resource distribution reports to justify tax collection…a *quid pro quo*?

Expanding the base

The role of policy making

- Evaluate the trade offs between growth and equity – what are the effects of reform on the fiscal regime?
- Are individual taxes progressive or regressive?
- Can tax benefits increase the disposable income of poorer households rather than reduced VAT?
- Technocrats vs experts? How can we influence policy making?

Expanding the base

Taxation of Informal Sector

- In 2012 it was estimated that the informal sector in Kenya contributes in excess of 35% to the GDP and employs close to 80% of the workforce
- The KRA estimates that tax losses from the sector amount to between *KES 60 billion* to *KES 80 billion* a year
- Turnover tax – applicable to persons whose turnover from business does not exceed *KES 5 million* during any year of income.
- Practicality of the turnover tax?

Expanding the base

Indirect taxation

- **Generally goods consumption has gotten smaller while service consumption has increased (Netflix vs VHS or DVDs)**
- If a country is taxing a small number of things, the rate has to be higher to make up for it, increase the base of consumption taxes while reducing the income taxes
- Often politically easier to increase rate than to add traditionally exempt transactions to the base
- **Countries are moving towards the expansion of indirect taxes**

Redefining the current tax base

Redefining the current base

- Broadening the tax base should include:
  - ✓ Establishing a simpler and more equitable tax code
  - ✓ Ending preferential tax regimes for certain economic activities
  - ✓ Eliminating distortionary provisions – high rate of CIT for large and small taxpayers
  - ✓ Efficient allocation of resources
  - ✓ Harmonizing taxes – CIT, VAT, PAYE, Customs and Excise should complement one another
  - ✓ Review our policy making objectives – tax

Redefining the current base

- ✓ Transparency and accountability will be key to identifying opportunities for taxation
- ✓ Develop taxpayer knowledge – KRA tax alerts and guides?
- ✓ Transparency about expenditure of tax revenue
- ✓ Efficiency and equity should be at the centre!

Broadening the tax base requires boldness

INTERACTIVE SESSION