



# Corporation Tax

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# Presentation agenda



- ☐ Introduction
- ☐ Allowable and disallowable expenses
- ☐ Capital allowances
- ☐ Transfer pricing
- ☐ Thin capitalization and deemed interest
- ☐ Capital Gains
- ☐ Excess pension contributions
- ☐ Compliance Issues
- ☐ Recent changes and emerging issues
- ☐ Q & A

# Introduction....



- “**Business**” is defined to include any trade, profession or vocation and every manufacture, adventure and concern in the nature of trade
- Business does not include **employment**
- The dictionary definition of “trade” is the act of buying and selling goods and services
- Examples of business activities: farming, manufacturing, trading, marketing among others

# Introduction....



- Income tax is chargeable on:
  - Business;
  - Employment or service rendered;
  - Rent;
  - Dividends and interest;
  - A pension, charge or annuity; or
  - Any amount deemed to be the income of a person under the ITA.

# Separate sourcing....



- Separate sourcing of income applies as follows:
  - Rent
  - Income from agriculture (farming income)
  - Surplus funds withdrawn by (or refunded to) an employer from registered pension or provident schemes
  - Natural resource income
  - Employment income - *Self and/or Wife*
  - Interest income
  - Business income (other sources of income)

# Income exempt from tax...



- The first schedule to the ITA provides various income that is exempt from income tax. Examples of these are:
  - Interest income accruing from all listed bonds, notes or other similar securities used to raise funds for infrastructure and other social services, provided that such bonds, notes or securities shall have a maturity of at least three years;
  - income of a registered pension scheme; and
  - income of a registered trust scheme;

# Sample tax computation



Details	Amount	Amount
Profit/loss as per accounts		XX
<b>Add Back:</b>		
Expenses disallowed under Section 16	XX	
Expenses Relating to exempt Income	XX	
Lease income – principal amount + interest	XX	XX
<b>Deduct:</b>		
Exempt Investment Income	(XX)	
Capital Allowances	(XX)	
Interest from lease income	(XX)	
<b>Taxable Income</b>		XX
<b>Tax @ 30%</b>		XX

# Sample Dividend Tax Account...



	KES
Dividend tax account opening balance b/f	XX
Add: Income taxes paid for the year of income	XX
Less: Income tax refunds received in the year of income	(XX)
Add: Total dividends received	
.3/7 thereon	XX
Less: Total dividends paid	
.3/7 thereon	(XX)
Final balance in compensating tax account c/f /(compensating tax due)	<u>XX/(XX)</u>

# Allowable expenses



- Expenditure *wholly and exclusively* incurred in the production of income for that year of income
- Legal and other costs in publicly issuing shares and debentures
- Expenses incurred prior to the commencement of business that would have been deductible if incurred after the date of commencement
- Cost of structural alterations to premises, incurred by a landlord to maintain the rent (non-capital)
- Expenses incurred by a lessee, in leasing transactions
- Expenditure on scientific research

# Allowable expenses...



- Sport sponsorships subject to prior approval by the Cabinet Secretary responsible for sports – FA 2016
- Donations to approved charitable organizations
- Bad debts written off which satisfy the following Commissioner's guidelines:
  - The debt was *wholly and exclusively* incurred in the normal course of business;
  - The debt is not of a capital nature; and
  - The debt has become uncollectable

# Allowable expenses – Bad debts



A debt shall be deemed to have become uncollectible where:

- The creditor loses the contractual right that comprises the debt through a court order;
- No form of security or collateral is realizable whether partially or in full;
- The securities or collateral have been realized but proceeds fail to cover the entire debt;
- The debtor is adjudged insolvent or bankrupt by a court of law;
- The costs of recovering the debt exceeds the debt itself; or
- Efforts to collect the debt are abandoned for another reasonable cause

# Disallowable expenses



- Expenditure not wholly and exclusively incurred in the production of income
- Capital costs and losses
- Income tax, compensating tax and similar taxes
- Personal expenses, other than those incurred specifically in the course of business
- Expenditure or losses that are recoverable under any insurance or indemnity contract
- A loss incurred in a business which the Commissioner considers is not being carried on with a view to realize profits
- Deemed interest and restricted interest

# Disallowable expenses...



- Donations – except those made to:
  - approved charitable organizations;
  - made to the Kenya Red Cross, County Governments or other national disaster management bodies to alleviate the effects of calamities which have been declared national disasters by the President

# Capital allowances



- Wear and Tear Allowance;
- Commercial Building Allowance;
- Industrial Building Allowance;
- Farming Allowance;
- Investment Deduction; and
- Soft Furnishings under Section 15(2)(g);

# Wear and tear allowances



Class	Qualifying asset	Rate
	Assets qualifying for reducing balance allowances	
I	Heavy self-propelling machines such as tractors and heavy earth moving vehicles.	37.5%
II	Computers and peripheral computer hardware, calculators, copiers and duplicating machines	30%
III	Other self-propelling vehicles including aircraft	25%
IV	All other machinery, including ships	12.5%

# Thin Capitalization



- A company is ‘Thinly capitalized’ when:
  - it is foreign controlled; and
  - there is a definite bias towards using debt as opposed to equity financing
  
- The safety margin is to have at least **25%** equity financing or **3:1** debt equity ratio

# Thin Capitalization

## Computing restricted interest



$$\text{Total interest expense / realised loss} \times \frac{\text{Highest amount of all loans in year} - 3 \times (\text{IC} + \text{RR})}{\text{Highest amount of all loans in year}}$$

Where:

**IC** – Issued capital

**RR** – Revenue reserves (including accumulated Accounting losses)

Consequences of being thinly capitalized :

- Interest restriction
- Deferral of foreign exchange losses

# Transfer pricing



- **Transfer price:** “The amount charged by a subsidiary of a corporate group for a product or service that it supplies to another subsidiary of the same corporate group”
- **Transfer mis-pricing:** “Shifting of taxable income from a subsidiary entity located in a high tax jurisdiction through incorrect transfer prices to a related entity in a low tax jurisdiction”
- **Arm’s length principle (ALP):** “Prices applied to transactions between related party should be at arm’s length, that is similar to prices applied by unrelated parties in similar transactions under similar circumstances in the open market”

# Transfer pricing



- In 2001 60% of international trade was carried out within multinational enterprises (MNEs)
- In 2013 a study performed by UNCTAD found that global value chains administered by MNEs accounted for 80% of international trade
- Transfer pricing has gained increasing attention for several reasons:
  - ✓ Relocation of production of final products and components
  - ✓ Concentration of service functions within MNEs
  - ✓ 24HR trading in commodities and financial instruments

# Transfer pricing



- Political reasons have also played a role:
  - ✓ Governments accusing MNEs of paying little/no tax
  - ✓ Media reporting on MNEs tax avoidance
  - ✓ Tax justice movements



# Transfer pricing guidelines



- The Organization for Economic Co-operation and Development (OECD) TP Guidelines were created for:
  - ✓ MNEs to address compliance with laws and administrative requirements that differ between jurisdictions
  - ✓ Tax administrations on a policy level to establish their taxing rights and on a practical level due to accessibility of information outside their jurisdiction
- OECD Model Tax Convention (MTC) gave rise to the OECD TP Guidelines through the following articles that affect the taxation of MNEs:
  - ✓ Article 4 – Residence
  - ✓ Article 5 and 7 – Permanent Establishment
  - ✓ Article 9 – Profits of associated enterprises and ALP

# Transfer pricing guidelines



- ✓ Articles 10, 11 and 12 – dividends, interest and royalties
- ✓ Articles 24, 25 and 26 – Non-discrimination and MAPs
- UN work on TP (UN TP Manual) was a response to the needs of developing countries with regards to:
  - ✓ Clearer guidance on policy and admin aspects of applying transfer pricing analysis
  - ✓ Assist policy makers and administrators in dealing with complex TP issues
  - ✓ Assist taxpayers in their dealings with tax administrations

# Transfer pricing in Kenya



- Under Section 18(3) of the ITA, transactions between a resident entity and its related non-resident entity should be at arm's length.
- The Income Tax (Transfer Pricing) Rules, 2006 (TP Rules) made under Section 18(8) of the ITA apply to:
  - a) transactions between associated enterprises within a multinational company, where one enterprise is located in, and is subject to tax in, Kenya, and the other is located outside Kenya; and
  - b) transactions between a permanent establishment and its head office or other related branches, in which case the permanent establishment shall be treated as a distinct and separate enterprise from its head office and related branches.

# Capital gains tax



- Capital gains tax (CGT) is provided for under the Eighth Schedule to the ITA.
- Suspended in 1985 and reintroduced on 1<sup>st</sup> January 2015
- Applicable on the **net gain** (gains minus allowable expenses e.g. legal fees, stamp duty and other taxes) which accrues to a company or an individual on the **transfer of property situated in Kenya**, whether or not the property was acquired before 1st January, 2015.
- CGT is chargeable at 5%

# Capital gains tax



## Transactions exempt from CGT

- income that is taxed elsewhere as in the case of **property dealers**;
- transfer of securities traded on any securities exchange licensed by the Capital Markets Authority;
- transfer of **machinery subject to wear and tear allowances** including motor vehicles;
- disposal of property for purpose of administering the estate of a deceased person;
- vesting of property in the hands of a **liquidator or receiver**;
- transfer of individual residence occupied by the transferor for at least three years before the transfer;

# Capital gains tax



- transfer of asset between spouses and also as part of divorce settlement
- sale of land by an individual where the proceeds are less than *KES 3 Million*;
- sale of agricultural land by individuals outside gazetted townships where the property is less than 50 acres;
- transfer of securities by retirement benefits scheme registered with Commissioner
- Transfer of property for the purpose only of securing a debt or loan or on a transfer by a creditor for the purpose only of returning property used as a security for a debt or a loan
- Transfer of an asset between spouses or former spouses or their immediate family where immediate family means children of the spouse or former spouse

# Excess pension contributions



- Under Section 22A(1) of the ITA, deductible pension contributions to a registered pension scheme are the lesser of:
  - the sum of the contributions made by the employee to registered funds in the year; or
  - thirty per cent of the employees pensionable income in the year; or
  - two hundred and forty thousand shillings (or, where contributions are made to registered funds of the employer in respect of a part year of service of the member, twenty thousand shillings per month of service).
- Companies should compute excess pension on the basis of *KES 240,000* per employee per annum and disallow the excess pension contribution.

# Compliance Issues – Instalment tax



Bases of estimation

- Current year (25% of estimated tax payable for the current year); or
- Prior year (25% of 110% of tax assessed for the previous year)

**NB:**

Current year basis is more appropriate where the operating results fluctuate substantially.

In case of variance of 10% or more, penalties and interest are levied

# Compliance Issues – Instalment tax



Instalment taxes are paid as follows:

- 25% by 20th day of the 4<sup>th</sup> month in the accounting period (AP)
- 25% by 20th day of the 6<sup>th</sup> month in the AP
- 25% by 20th day of the 9<sup>th</sup> month in the AP
- 25% by 20th day of the 12<sup>th</sup> month in the AP

Any balance of tax payable by the last day of the 4<sup>th</sup> month after the AP

# Compliance Issues



Description	Late Filing Penalty
Interest on late payment of tax	1% per month (simple interest) for all taxes
Penalty of underpayment of instalment tax	20% of the underpaid tax
Penalty for unpaid tax after due date	20% of the unpaid tax
Failure to register or deregister for tax purposes	<i>KES 100,000</i> per month but not more than <i>KES 1 Million</i>
Late submission of returns	The higher of 5% of the tax payable or <i>KES 20,000</i>

# Compliance Issues



Description	Late Filing Penalty
Failure to keep documents	Higher of 10% of tax payable under the tax law to which the document relate or <i>KES 100,000</i>
Failure to submit a document	<i>KES 1,000</i> for each day of default subject to a limit of <i>KES 50,000</i>
Failure to honour the Commissioner's summons	<i>KES 10,000</i> for an individual and <i>KES 100,000</i> for a company
Fraudulent claim/ tax avoidance	Double the amount claimed
Use of false PIN or PIN obtained fraudulently	Fine not exceeding <i>KES 1,000,000</i> or imprisonment for a period not exceeding 3 years or both.
General Penalty	<i>KES 1,000,000</i>

# Compliance Issues



- Where one makes a mistake and files a wrong return and probably pays more tax, he/she can make an application to the Commissioner of Income Tax (CIT) for relief
- Return amendments should be done within 5 years of filing the original return
- The Commissioner inquires into the matter and gives such relief as is reasonable and just.  
(Discretion)

# Compliance Issues – tax evasion and tax avoidance



Guidance on tax evasion/ avoidance

*Section 23 of the ITA*

Commissioner has powers to adjust the tax liability as he considers appropriate to counteract the avoidance or reduction of liability to tax

Tax evasion

Failure to adhere to the law i.e.

- Failure to file returns
- Failure to pay tax already due

Tax avoidance

- Tax planning
- Structuring to reduce tax that would arise

# Compliance Issues – tax evasion and tax avoidance



## Guidance on tax evasion/ avoidance

### *Section 85 of TPA*

If the Commissioner has applied a tax avoidance provision in assessing a taxpayer, the taxpayer is liable for a tax avoidance penalty equal to **double the amount of the tax** that would have been avoided, but for the application of the tax avoidance provision

# Common issues identified during KRA audits



Below are some of the common issues identified during KRA audits:

- Non-compliance with **Transfer Pricing** regulations;
- Non-compliance with **filing and payment deadlines**;
- **Lack of maintenance of proper records** e.g. unsupported expenses;
- **Underpayment of taxes due**

# Recent changes & emerging issues



- Kenya's budget speech was read on 30 March 2017 with the Finance Act 2017 subsequently published and assented to.
- Some of the key changes proposed in the Finance Act include:
- Donations to the Kenya Red Cross Society is an allowable expense for tax purposes.
- Entities with local related entities incorporated in Special Economic Zones will be subjected to “transfer pricing” reviews – prices between these entities should be at arms length.

# Recent changes & emerging issues



- Incentives to encourage investments in Special Economic Zones:
- Dividends paid to non-resident persons are exempt from WHT
- 100% capital allowances accorded to SEZ enterprises which construct a building or install new machinery
- Preferential WHT rates for payments made to non-residents

	Current non-resident rates	SEZ rates
Management, professional or training fee	20	5
Royalties	20	5
Interest	15	5

# Q & A

