

# **Taxation of Extractive Industries (EI)**

**ICPAK Annual Tax Seminar - Msa**

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# Scope of Presentation

- ✓ *Background of EI*
- ✓ *Nature of EI*
- ✓ *Stakeholders in EI*
- ✓ *Overview of EI Sector Laws*
- ✓ *Background of the EI Tax Legislation*
- ✓ *General Principles*
- ✓ *Key Highlights for the Ninth Schedule of the Income Tax Act*
- ✓ *Persons Assessable*
- ✓ *Taxation of Licensees & Contractors: Income Tax Act; Value Added Tax (VAT)*
- ✓ *Customs Issues Affecting EI*

# Background of Extractive Industries

- Kenya had no known commercial reserves of petroleum, despite 50 years of exploration
- In March, 2012 Tullow Oil (UK) and Africa Oil (Canada) announced an oil discovery in the Tertiary Rift Basin
- Current oil resources are estimated over 750 million barrels, awaiting development
- In light of the oil and gas discoveries, the Second Medium Term Plan 2013-17 added the petroleum sector as 7<sup>th</sup> key sector for development
- Kenya also has large deposits of minerals across different counties e.g. titanium, soda ash, fluorspar, diatomite, gold, coal, rare earths etc.

# Nature of Extractive Industries

- Capital intensive/large capital investment
- Long development and timeframes
- Non Renewability - Revenue from EIs is once off opportunity due to exhaustibility nature of the resources
- Exceptional high risk
- Dominated by large integrated multinational oil companies
- May generate exceptional profits
- High levels of exports and imports

# Stakeholders in EI

- State Department of Petroleum - Responsible for licensing the oil and gas exploration companies to carry out exploration (upstream)
- State Department of Mining - Responsible for licensing mining companies to carry out mining operations
- The National Treasury - Responsible for policy formulation
- Commission of Revenue Allocation
- Office of the Auditor General

## **Other Stakeholders:**

- Kenya Oil and Gas Association (KOGA)
- Chamber of Mines - Represents the interests of Kenya's mining companies

# Overview of the EI Sector Laws

The current law governing the extractive industries in Kenya include;

- The Constitution
- Petroleum Act, 2019 came into effect on 28<sup>th</sup> March 2019 repealing the Petroleum (Exploration and Production) Act, Cap 308 which was in force since 1984
- Mining Act 2016, came into effect on 27<sup>th</sup> May 2016 repealing the Mining Act, Cap 306
- Ninth Schedule of the Income Tax Act, Cap 470 - Overhauled in 2014
- The East African Community Customs Management Act, 2004
- Other laws governing environment, trade, company law etc

# Background of the EI Tax Legislation

- The 2014 Finance Act repealed the 1984 Ninth Schedule, titled *Taxation of Petroleum Companies* replacing it with a new Ninth Schedule titled *Taxation of Extractive Industries*
- The scope of the new schedule expanded to cover taxation of both petroleum companies and companies in the mining sphere
- The provisions took effect from 1<sup>st</sup> January 2015
- Motivated by the Government's objective of streamlining the taxation regime of the extractive industry
- To covers **Oil & Gas**, **Mining** Companies and their **service providers** - Subcontractors

# General Principles in Taxation of EI

- **Charge to Tax**

- ✓ Income tax shall be charged for each year of income upon all the income of a person, whether resident or non-resident, which is accrued or was derived from Kenya. ....**Section 3(1)**
- ✓ Subject to section 15(5A), the net gain derived on the disposal of an interest in a person, if the interest derives 20% or more of its value, directly or indirectly, from immovable property in Kenya; and .....**Section 3(2)(g)**
- ✓ A natural resource income .... **Section 3(2)(h)**
- ✓ *Entire Ninth Schedule*



# Key Highlights of the Ninth Schedule

- Taxation of mining and petroleum operations
- Introduction of new definitions and expansion of existing ones
- Provisions which limits the ability to utilize losses from on license/contract area against others (Ring-fencing)
- Determination of consideration in farm out/share sale transactions
- Specific thin capitalisation ratio of 2:1
- Income or losses from hedging transactions treated as a separate source.

## ***Definitions (Para 1)***

- ***Licensee*** - A person who has been granted a mining right under the Mining Act
- ***License area*** - Area that is subject of a mining right
- ***Prospecting expenditure*** - Expenditure incurred in undertaking operations authorised under a prospecting right
- ***Extraction expenditure*** - Capital expenditure incurred by a licensee when undertaking mining operations

## ***Definitions (Para 1)...***

- **Contractor** - A person with whom the Government has concluded a petroleum agreement
- **Contract area** - Area that is subject of a petroleum agreement
- **Exploration expenditure** - Expenditure incurred by a contractor in undertaking exploration operations
- **Development expenditure** - Capital expenditure incurred by a contractor when undertaking development & production operation
- **Subcontractor** - Person supplying services other than a person supplying services as an employee to a licensee or to a contractor
- **Farm-out agreement** - This is when a licensee or a contractor enters into a farm-out agreement with a person (“transferee”) for the transfer of an interest.

# Persons Assessable-Section 3(2)(a)(i) & 4(f)

- The Ninth Schedule is applicable to the following persons as defined therein:
  - (i) Licensees - involved in mining operations
  - (ii) Contractors - involved in petroleum operations
  - (iii) Subcontractors - Person supplying services to a licensee or contractor

# **Taxation of Licensees and Contractors ( Para 2 & 7)**

- Licensees and contractors taxed in accordance with the Act, subject to modifications in that Ninth Schedule
- Other parts of the Act therefore apply fully
- Where there is any inconsistency with the Schedule and the Act, the Schedule shall prevail (Para. 2(2) & 7(2))
- Part III of the Second Schedule to the Income Tax Act which provided for the deductibility of mining expenditure was repealed
- Deductions shall therefore be granted to mining operations as outlined in the Ninth Schedule.

# Taxation of Licensees and Contractors ( Para 2 & 7)

## ✓ *Tax Rates - % rate*

- Licensee that is a company and a contractor operating through a resident company (9<sup>th</sup> Sch. Para. 2(3) & 3<sup>rd</sup> Sch. Head B 2(a) and 9<sup>th</sup> Sch. Para. 7 (3)(a)) - **30%**
- Non-resident company having a permanent establishment (9<sup>th</sup> Sch. Para. 7 (3)(b)) - **37.5%**

# Taxation of Licensees and Contractors ( Para 2 & 7)

## *Taxation - Specified Sources of Income - s15(7)(e)*

- Specified Sources - Gains or profits from one specified source shall be computed separately from the gains or profits from another specified source and separately from any other income of that person
- “Income of a licensee from one license area or a contractor from one contract area as determined in accordance with the Ninth Schedule”...**Section 15(7)(e)(ivB)**
- Losses incurred in the license/contract area can be carried forward and utilized against income derived from the same license/contract area

## ***Expenditure incurred in mining and petroleum operations ( Para 4,5,9,10)***

- Prospecting/Exploration expenditure incurred by a licensee/contractor will be an allowable deduction in the year in which the expenditure is incurred - **100%**
- A deduction for extraction/development expenditure can be claimed in the year of income when the expenditure is incurred and in the following 4 years - **20% on a straight line basis**
- Machinery used for prospecting/exploration is subject to wear and tear allowance at the rate of **100%.**



# *Common Rules Applicable to Mining and Petroleum Operations*

## *Taxation of Subcontractors (Para 15)*

- Payments to non resident subcontractors for services will be liable to WHT at the rate of **5.625% on gross for licensees & contractors**, which is a final tax
- Penalties for failure to deduct and remit WHT will apply
- Non resident subcontractors with PE's will be taxable at the non resident corporate tax rate - **37.5%**. They will be required to file returns of income and provide accounts
- Resident subcontractors will be taxable at the resident corporate rate - **30%**

# *Common Rules Applicable to Mining and Petroleum Operations*

## *Other Payments (Para 16)*

- WHT rates applicable for other payments made by contractors to non residents are as follows : -
  - 10% of gross dividends payable
  - 15% of gross interest payable
  - 20% of the gross amount of the royalty payable
  - 12.5% of the gross amount of the management, training or professional fee payable
- Note that these rates are subject to the provisions of the double taxation agreements

# *Common Rules Applicable to Mining and Petroleum Operations*

## ***Farm-outs:***

- **Farm-out agreement** arises when: - A licensee or a contractor enters into a farm-out agreement with a person (“transferee”) for the transfer of an interest
- **Consideration** - the total amount received or receivable for the disposal, including the fair market value of any amount in kind determined at the time of disposal
- **Cost** - means the total consideration given for the acquisition of the interest, right, or information, including the fair market value of any amount given in kind determined at the time the amount is given.

# ***Common Rules Applicable to Mining and Petroleum Operations***

## ***Farm Out - Tax Implications***

- The consideration received by the licensee or the contractor for the interest shall not include the value of any work undertaken by the transferee on behalf of the licensee or the contractor
- If the transfer is deferred until the transferee completes some or all of the work commitments, then:
  - (i) The amount in money payable under the agreement before the transfer of the interest shall become taxable in the year of income in which the amount is payable
  - (ii) The value of work undertaken by the transferee on behalf of the licensee or the contractor shall be excluded in the consideration

# ***Common Rules Applicable to Mining and Petroleum Operations***

- The debt to equity ratio for **thin capitalisation** purposes for licensees/contractors will be 2:1 (***Para. 18***)
- **Hedging transactions** entered into by a licensee or contractor will be considered a separate/specified source of income (***Para 19***)
- Hedging transactions are defined as transaction entered into by a licensee or contractor to manage commodity price risk
- Social Infrastructure expenditure (e.g. public schools, hospitals) will be tax deductible subject to approval by the Cabinet Secretary for the National Treasury (***Para1(4); S. 15(2)(x) )***

# ***Other Transactions***

## ***Capital gains***

- Capital gains tax, which had been suspended since 1985, was reintroduced effective 1 January 2015.
- Gains arising on the disposal of all qualifying assets by oil and gas companies (except share and license interest disposals) are subject to capital gains tax at the rate of 5%

## ***Transfer pricing***

- The Act provides for general provisions in respect of transactions carried out between related parties
- There are detailed transfer pricing requirements set out in the rules enacted in 2006 that establish the guidelines for determining the arm's length price of goods and services transacted between related parties.

# ***Value Added Tax (VAT)***

- Section 68(4) of the VAT 2013 - Transitional Clause, lapsed
- This section refers oil and gas companies to Section 23(3)(c) of the repealed VAT Act, Cap 476
- *Where a remission of tax was granted under the repealed Act on any taxable goods or services, such remission shall continue to remain in force for a period of five years from the date of commencement of this Act - lapsed in Sep. 2018*

# *Customs Issues Affecting EI*

## Customs Exemptions & Remissions:

- The law caters for exemption of duty under Section 114 (1) to (3) of the EACCMA 2004
- Where it provides that:-
  - a) Duty shall not be charged on the goods listed in Part A of the fifth Schedule of the EACCMA Act, when imported, or purchased before clearance through the customs, for use by the person named in that Part in accordance with any condition attached thereto as set out .....;
  - b) Duty shall not be charged on the goods listed in Part B of the Fifth Schedule to this Act when imported in accordance with any condition attached thereto.



# END

## *Comments/Questions*