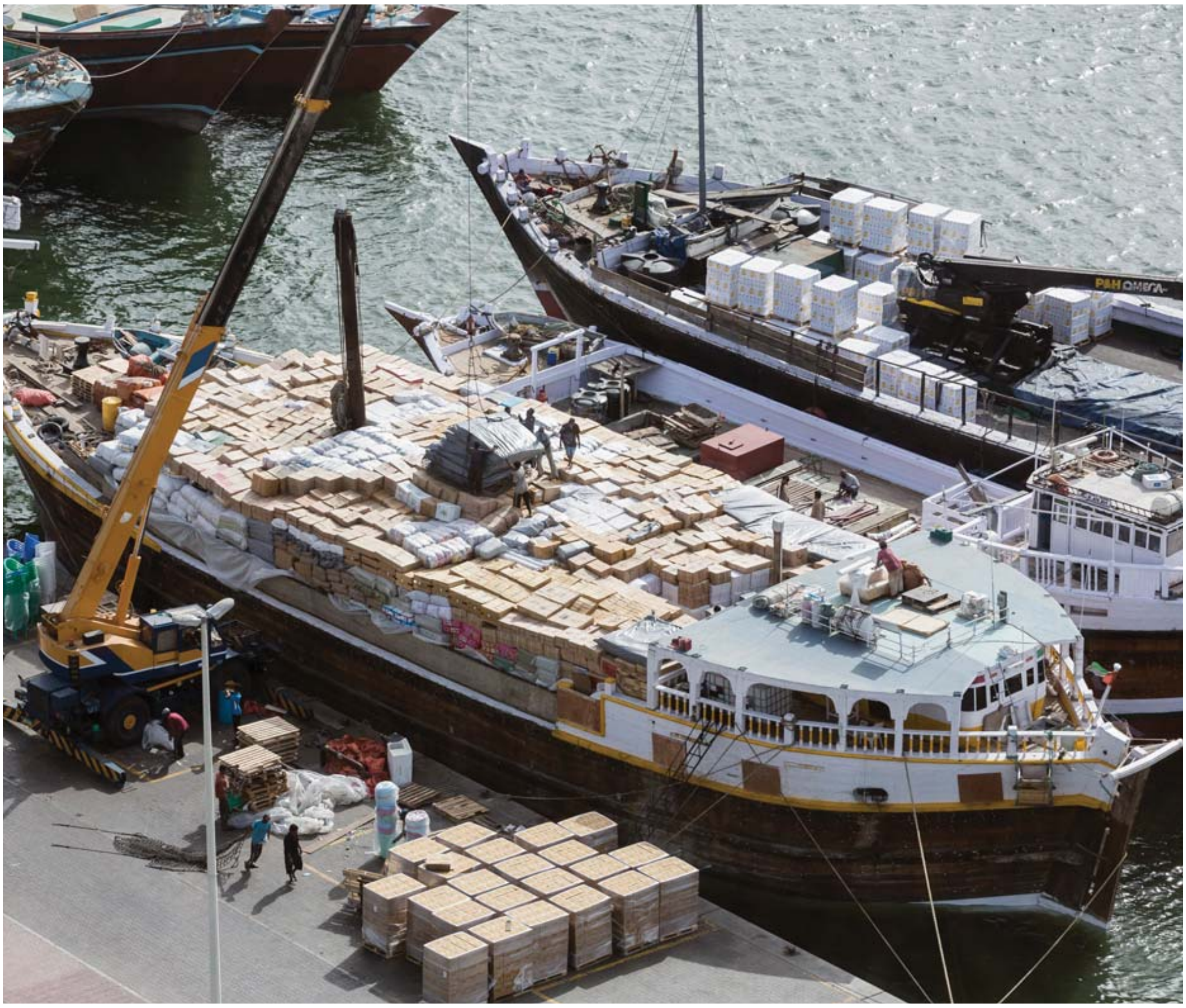
Navigating the Grey: National Budget/June 2014

Tax Matters

Special Edition



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Foreword

We welcome you to a special edition of Tax Matters where we speak about taxes that affect the country as a whole.

With a budget of 1.8 trillion the Kenyan tax legislation has an array of tax incentives that are meant to attract investments and this is discussed by Obed Nyambego in his article on why the government should *Assess effectiveness of investment deduction as a tax incentive* designed to encourage a particular economic activity.

Meanwhile in developing countries as well as developed ones there has been an increasing shift from an income-based tax system to a consumption-based tax system. The shift takes a number of tax reforms and there is a lot of advocacy to increase the value added taxation (VAT), Apollo Karumba talks about this in his article on the *Shift from income to consumption tax and its effects to Multinational Companies*

The National Treasury and by extension, the Kenya Revenue Authority (KRA) has the unenviable tasks of looking for and collecting tax revenue. The amount of tax collected is heavily influenced by the level of activity in the economy thus we have to *Improve tax revenue collection without obstructing Kenya's growth* as discussed by Osborne Wanyoike. To further aid the country's growth, *East Africa's excise duty rates need to be harmonised* among the Partner States so as not to hinder the free movement of goods. Cynthia Mayaka delves into the reasons that call for this harmonisation.

The biggest concern for the public is the likely impact of VAT on the prices of commodities and in extension the cost of living especially because of the introduction of VAT on basic commodities.

Jurgen Murungi covers *Innovative ways of addressing the VAT issues.* Another concern is the taxation at county level. The uproar over this is loud and troubling and Maryam Kombo analyses this in *No taxation without (County!) representation.*

If the National Treasury fulfils its intention to reintroduce the capital gains tax, there is little doubt that it will impact Kenya's economy.

The tax would affect the property and financial markets most acutely if the exemption on marketable securities such as shares is not retained. Kaajal Raichura covers this in *Is it that easy to tax capital gains?* Another big question *Is what is deemed interest,* who is the target and when was the concept was introduced.

Tom Kavoi explains that the concept of deemed interest was introduced in the 2010 Finance Act and according to the Income Tax Act, the interest is considered to be income accrued in or derived from Kenya and hence subject to withholding tax at the rate of 15%.

With the current developments and progress in the implementation of the East African Community (EAC) regional integration, it is important for the *EAC countries to implement a single window system.* This is explained by Cynthia Mayaka and Malone Tuva in their article.

The rapid development of Kenya's infrastructure and increasing urbanisation are expected to grow the construction sector. The 2012 Finance Act introduced a capital allowance of 25% on expenditure incurred on construction of a commercial building for business use. Peter Mungai and Kenneth Njuguna delve into this in *Commercial buildings: Will the 25% allowance aid devolution?*

We are living in the information age where information and data is readily accessible through the internet, social media and other channels.

Simon Ngure in his article on *Transparency on cross border transactions* digs into why tax authorities have such little information on taxpayers. Apollo Karumba on the other hand says that once the taxpayer gets the basics right, then accounting for VAT should not be mind boggling. *This is in his piece on VAT need not to be complex.*

We look forward to hearing your views and suggestions. Let us know what other areas you would like us to cover in this publication.

PwC Kenya Tax team

Government should assess effectiveness of investment deduction as a tax incentive

The Kenyan tax legislation has an array of tax incentives that are meant to attract investments. One of the tax incentives that is provided for under the Income Tax Act is the ability to claim the full cost of machinery and hotel building certified as an industrial building as investment deduction against taxable income.

Further, the law provides a generous investment deduction amounting to 150% of the cost of construction of a building or purchase and installation of machinery outside the City of Nairobi or the Municipalities of Mombasa or Kisumu.

For one to qualify for this deduction, the value of the investment must be at least KSh 200 million. A tax incentive is a part of a country's tax legislation designed to encourage a particular economic activity. The incentives are aimed at providing benefits to specific industries or advancing desired social policies in a country.

The most common forms of tax incentives includes deductions against taxable income, exemptions of certain incomes from being subject to tax and ability to set off tax credits against tax payable.

The question to be asked is whether the investment deductions available on capital expenditure have had the desired impact in attracting investments. There is no readily available data to answer this question. However, from my experience as a tax advisor, the envisaged tax incentives have been negated by other provisions in the law. One such counter-productive provision is the introduction of a four year time limit during which a company can carry forward its tax losses for set-off against future taxable income. Although Treasury has discretionary powers to extend this time limit, it remains to be seen how the KRA will apply these powers.

What is clear, however, is that investors require certainty in making their investment decisions and the discretionary provisions makes the tax incentives less attractive.

Another hindrance that makes investment deductions less attractive is the provision that triggers payment of a "compensating tax". A compensating tax liability arises where a company pays dividends from untaxed profits.

This situation can be caused by a company incurring substantial capital expenditure and then claiming investment deductions on that expenditure. If such a company were to distribute dividends to its shareholders, it could give rise to a compensating tax liability whose rate is approximately 43%, which is higher than the corporate tax rate of 30%. This provision normally affects new investors setting up manufacturing plants or existing companies that wish to expand operations.

The policy makers of the Kenyan tax laws should undertake a critical review of the tax incentives provided to investors to determine their effectiveness. Any shortcomings such as those identified above should be addressed if the incentives are to achieve their objective of attracting investments.

Further, while tax incentives contribute to Kenya's attractiveness as an investment destination, the Government must continue to pay special attention to other factors such as access to the regional and international markets, political and economic stability, security and trade agreements which are equally or even more influential in positioning Kenya as a preferred investment destination.

Obed Nyambego i*s a Director with PwC Kenya's Tax Services practice.*

Shift from income to consumption tax, its effects to multinational companies

In the developing countries as well as developed ones there has been an increasing shift from an income-based tax system to a consumption-based tax system.

The shift takes a number of tax reforms. There is a lot of advocacy to increase the value added taxation (VAT). For instance in Kenya, the VAT Act, 2013 scrapped off the long list of zero rated and exempt goods which are now subject to tax at the standard rate of 16%, with an aim of increasing tax revenue under consumption.

The consequences of this shift have far-reaching implications for Multinational Companies (MNCs) and their in-house tax functions, which, up until now, may have had more experience of managing direct taxes. Now than ever before they need to consider the likely impact of this trend on tax compliance, planning and risk.

The taxpayers are now required to deal with very complex VAT laws in most countries. They also have to deal with different rules in multiple jurisdictions. The companies are expected to comply with the tax legislation in each country, regardless of the VAT laws in other jurisdictions in which they are operating.

The VAT systems in Africa are not aligned; this has a major effect on a company's operating and financial systems. However, the tax authorities expect compliance with the set VAT laws in their respective jurisdictions. As a result the compliance burden on MNC may be quite arduous. The main challenges faced by the businesses includes the application of the VAT principles, VAT rates, the registration of VAT, output tax, exemptions, zero-rating, input tax, prohibition of input deduction, international trade in goods and services, VAT accounting and record keeping.

VAT compliance burden for MNCs is potentially high. It takes far longer for companies to comply with the VAT rules than corporate income tax. The businesses are operating in a stringent penalty regimes.

For instance, in Kenya penalties of up to Kes 10,000 are payable per month in the case of not filing a VAT return or 5% of the tax due whichever is higher, plus interest of 2% compounded per month on the unpaid tax. In South Africa, additional tax of up to 200% may be imposed for the evasion of tax, including criminal prosecution.

Various countries in Africa have different VAT tax rates ranging from 5% to 20%. Some of the countries still have different rates for some supplies which becomes cumbersome to administer. For MNCs to prepare for a change in the tax mix as the way forward means, they need to be aware of how developments in indirect taxes as instigated by the shift have an impact on tax compliance, tax planning, tax accounting and tax risk.

Preparing for a change in the tax mix will mean looking closely at the whole tax function and how it is managed. For global companies, the real issue is the number, complexity and frequency of indirect tax changes around the world.

The pace and amount of change – even where it involves simplification – greatly increases the level of complexity they face and therefore increases their level of tax risk and the potential of future tax controversy.

***Apollo Karumba** is a Senior Consultant with PwC Kenya's Tax Services practice.*

We can improve tax revenue collection without obstructing Kenya's growth

The National Treasury and by extension, the Kenya Revenue Authority (KRA) has the unenviable tasks of looking for and collecting tax revenue. The amount of tax collected is heavily influenced by the level of activity in the economy. If the economy grows, then tax revenue grows—and the reverse is also true.

Kenya's economy grew by at least 5% in 2013 while tax revenue is expected to grow by 20%. Why is tax revenue growing at a faster rate than the economy? The answer is that KRA has become more effective at assessing and collecting tax. It may also indicate that new sources of tax revenue have been discovered including taxpayers who have, until now, escaped paying Caesar his dues.

The National Treasury has set an even higher tax revenue target for the KRA in 2014/2015. The target tax-to-GDP ratio of 25% in 2014/2015 would bring in at least KES 100 billion a month in collections. This is a tall order for two main reasons. The first is that the economy has yet to achieve a double-digit GDP growth rate; if it did, collecting KES 100 billion a month would be within reach.

The second is that the Government tends to rely on taxes such as Pay As You Earn, withholding taxes and indirect taxes. PAYE is easy to collect as the obligation to deduct the tax from employees' guaranteed remuneration falls squarely on the shoulders of employers. There is a punitive penalty of 25% if the tax is not deducted. But KRA cannot rely on PAYE to drive up tax revenue. This is because the withholding of the tax leaves the individual with only two-thirds of his monthly earnings to save and spend.

Continued erosion of the taxpayer's earnings would make the individual taxpayer more reliant on the Government for social needs such as health and retirement security.

Many individuals in the informal sector are not paying their fair share of taxes. Arguably, it is more difficult to assess and collect taxes from the informal sector, but that is no excuse. It is time to leverage innovative information technology to collect taxes from this sector.

An innovative solution does not necessarily require spending lots of money. An appropriate app could quickly and conveniently facilitate the collection of tax from the informal sector. We know that the sector is driven by the simple concept of 'cash-in, cash-out'. A businessperson in the sector does not wait for the end of the year to compute profits or losses, as they do not maintain books of account. Expecting them to file tax returns annually is downright ambitious.

The existing provision of turnover tax should be enforced. It recognizes that keeping books and filing returns is not a priority for the informal sector and therefore allows small and medium-sized taxpayers to pay a fixed amount of tax regularly based on sales turnover. The solution is not to introduce new and more stringent tax laws. The laws are fine as they are.

They are not perfect but they should be made to work. KRA should focus on enforcing compliance with the existing tax regime even as it proceeds with the revamping of the Income Tax Act. Meanwhile, the National Treasury should revise its expectations so that revenue expectations are less punitive.

Osborne Wanyoike *is a Senior Manager with PwC Kenya's Tax Services practice.*

East African excise duty harmonisation would be helpful now

Excise duty rates have yet to be harmonised among East African Community Partner States, hindering the free movement of goods. The reasons for this are historical and fiscal—with different States applying different rates in different ways, in some cases for as long as 60 years with little change.

These reasons are not inconsequential. However, a common excise management act that harmonizes policies across the Partner States would go a long way in reducing this inequalities and Partner States should take action to progress it. Ultimately, our economies will benefit—and so will government revenue coffers.

Partner States use excise duty as a revenue boosting tax, which partly explains why harmonisation is such a thorny issue. Their various budgetary needs determine the rates of excise duty for excisable commodities in their countries. But Partner States also differ with regard to their ability to handle excise taxes. Legislation in Tanzania and Uganda dates back to the 1950s. Kenya, Tanzania and Uganda have set specific procedures for approval to trade in excisable products. Burundi has no Excise Taxes Act. Rwanda does not have formal approval procedures.

Different Partner States also harbour different definitions of excisable products for purposes of levying excise duty. For example, the definition of beer in Kenya is based on whether it is malt or non-malt while beer in Burundi is defined based on the brand. Furthermore, EAC Partner States have different policies governing the provision of excise duty remissions and refunds.

The current state of affairs with regard to excise duty rates in the region encourages cross border grey markets for goods whose duty differential among Partner States is significant to merit substantial trade.

Traders in the region support excise duty harmonisation because it will create a level playing field and eliminate unfair competition brought about by diversion and smuggling and the diversion of excisable goods.

In almost every other regard, the East African Community is well on its way towards full integration barring any unforeseen challenges. The EAC has progressed with its Customs Union and the Common Market Protocol coming into force in 2005 and 2010 respectively. Integration of the EAC as per the treaty and protocol necessitates the harmonisation of taxes within the EAC region. So far, customs duties have been harmonised and discussions have been held on the steps forward for the harmonisation of other taxes within the common market. However, excise duties still have yet to be harmonised to facilitate the free movement of goods in the common market.

As Partner States limp towards little progress on excise duty harmonisation, Kenya is moving forward with legislation of its own. Kenya is in the process of drafting the Kenya Excise Management Bill which will modernise the tax policy on excisable goods currently contained in the Kenya Customs and Excise Act, Cap 472. Kenya is one of the more developed economies in the EAC and should provide direction on matters of integration and regional development.

This then begs the question: in line with the principles and provisions of the EAC common market protocol on integration, shouldn't Kenya be on the front lines agitating for harmonisation of excise duties in the region as opposed to developing an in-country Excise Management Act?

Cynthia Mayaka *is a Manager with PwC Kenya's Tax Services practice and an indirect tax specialist.*

Seek innovative ways of addressing the Value Added Tax (VAT) problem

When the initial draft of the VAT Act 2013 was released to the public for stakeholder comments, the overriding complaint was the introduction of VAT on basic commodities. The biggest concern among the public was the likely impact of VAT on the prices of these commodities and in extension the cost of living.

In the various stakeholder forums many proposals were tabled to zero rate the basic consumer commodities, the government however due to the influence of the Kenya Revenue Authority (KRA) exempted these items instead of zero rating them. This did not solve the problem, rather it appeared more of pyric victory and a cosmetic solution to the tax payers agitating for the changes.

The question then is why is exemption from VAT not a good thing for the consumers? When a commodity is exempt from VAT, it means that the manufacturer incurs VAT on the raw materials yet they can't recover VAT on the sales. The manufacturer is therefore forced to adjust prices of the commodities to compensate for the irrecoverable VAT.

This has in effect caused an increase in the prices of the basic consumer commodities such as milk, bread and tea leaves and medicaments since the enactment of the VAT Act 2013. The argument against zero rating of the basic consumer commodities has been that this leads to an increased administrative and financial burden of VAT refunds and that it eats into government revenue.

The government has to find ways of addressing the consumer concerns while at the same time collecting the revenue required to finance development projects. This can only be achieved by embracing more innovative ways of counterbalancing these opposing needs without creating unnecessary administrative burden on the KRA.

One of the best ways of achieving this is by having a graduated VAT rate. Under this kind of legislation, the VAT rate will be split into three categories namely; a lower rate for basic consumer commodities which could be set at maybe 30% of the standard; a standard rate for all the other commodities and a higher rate for specific categories of commodities which are viewed as not very essential or harmful to both the population and the environment. This could be set at 130% of the standard rate.

In having such a system the government could help ensure price stability around the basic consumer commodities as the manufacturers will be able to recover input VAT without having to adjust prices. It will also ensure that the government can use VAT to influence consumer behavior around certain products by subjecting them to a higher rate of VAT.

A good example is in the United Kingdom (UK) where there exist three rates of VAT. A preferential rate of 5% is granted to certain goods such as energy saving materials, a standard rate of 20% is charged on all other goods and a higher rate of 22% is charged on plastics.

With such an arrangement, the governments concern regarding the impact of zero rating of goods on revenue collection will be eased while the KRA's concerns on administrative burden will also be eased. The government will also lend itself a helping hand in its efforts to reduced consumer uptake of certain undesired products.

***Jurgen Murungi** is a Manager with PwC Kenya's Tax Services practice.*

Is it that easy to tax capital gains?

Since last year's budget speech, we have seen no movement on the reintroduction of the capital gains tax on real estate, marketable securities and other saleable assets. The Cabinet Secretary for the National Treasury had expressed its intention to clarify their intentions on this issue in his 2014-2015 budget speech, and clarity is precisely what Kenya's investors and the growing middle class require.

Kenya's capital gains tax exists as legislation but it has been suspended since 1985 to encourage investment in properties and securities. If the legislation were in effect, tax would be collected upon the sale or transfer of land, houses, stocks, bonds and similar assets.

If the National Treasury fulfils its intention to reintroduce the capital gains tax, there is little doubt that it will impact Kenya's economy. The tax would affect the property and financial markets most acutely if the exemption on marketable securities (such as shares) is not retained.

Kenya's construction and property markets are currently growing at a rapid pace and hence would contribute a large share of capital gains tax revenue.

We should consider whether the sectors impacted by the reintroduction of the capital gains tax are sufficiently mature to make this contribution, without the tax adversely impacting growth. We should also consider whether the proposed tax regime for capital gains tax adequately addresses a number of factors that may not have been prevalent in 1985.

First, does the tax regime provide definitions of terms like disposal, chargeable events, chargeable assets, qualifying assets, qualifying shares etc.? Sales, gifts and exchanges would be instances of natural disposals.

Second, would a transfer between husband and wife be a chargeable transfer? What about disposals of private motor vehicles, tangible moveable property (chattels like household goods and personal effects, worth less than a defined amount) and the receipt of winnings from betting (including pool betting, lotteries or games with prizes)?

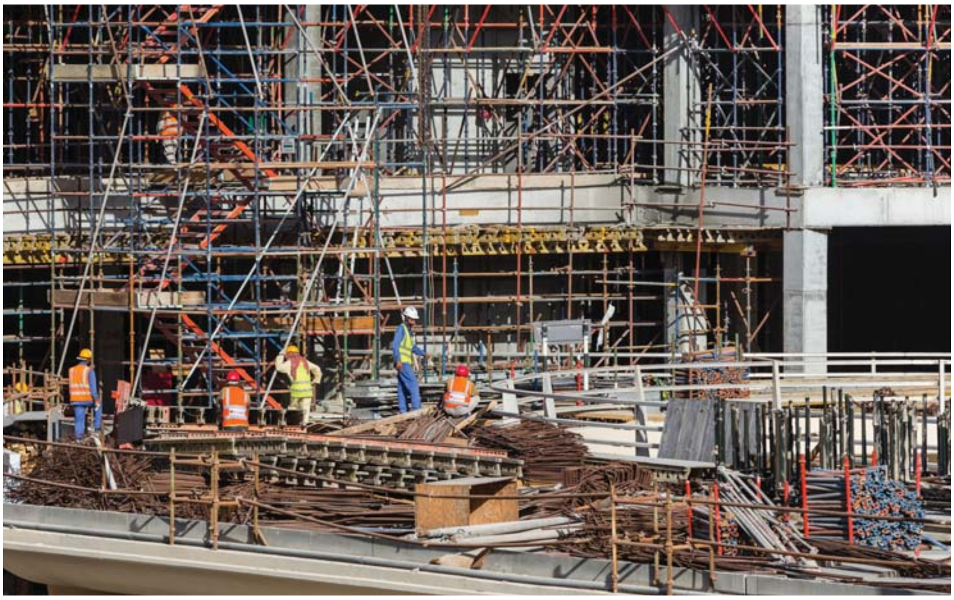
Third, would the capital gains tax regime provide relief for first-time homeowners? The purpose of the relief would be to enable a person to replace their existing home with another home of similar value by ensuring that the proceeds of the sale of the old home are not diminished by a capital gains tax.

So in most cases the gain arising on the disposal of a person's home would be relieved from capital gains tax. Private residence relief would be available where a gain arises from the disposal of an interest in a dwelling house, or part of a dwelling house, which has at some time been its owners only or main residence.

Fourth, would the capital gains tax regime provide relief when assets or property are reinvested or reorganised? This type of roll-over relief would enable traders to modernise, expand and relocate without loss of capital to an immediate tax charge.

There could also be roll-over relief for individuals whereby it would allow chargeable gains on qualifying disposals of certain shares to be rolled over where the chargeable gain was reinvested in qualifying shares.

Fifth, we should ask whether the National Treasury or other agencies will use technology to track property and its owners. This property could include financial instruments or physical assets such as land and buildings. Technology would help Treasury to track assets, which in turn should make it easier for them to collect revenues arising from capital gains. There could also be other benefits such as preventing terrorist financing.



Finally, we should ask whether gains arising due to inflationary pressures will be taxed, and whether an indexing factor will be considered for the valuation of costs of property. The basic principle would be that capital gains tax would be charged on the actual gain from the date of acquisition.

It could, however, be argued that capital gains tax is a tax on gains in true money terms. Therefore the price actually paid by a taxpayer should be reassessed to take into account the fall in value of the shilling. Would the KRA consider introducing tax relief for inflation? In most jurisdictions around the world, there is the concept of 'indexation allowance' in respect of calculating capital gains.

Ideally, the process of reintroducing Kenya's capital gains tax should be consultative and take into account the views of relevant stakeholders.

Tax revenue allows Kenya to achieve many of its development goals but as we craft a more modern tax regime to finance development, we must also consider the impact of tax collection on growth. It is a delicate balancing act, requiring deep and meaningful dialogue. We look forward to this process in the weeks and months ahead.

***Kaajal Raichura** is a Manager with PwC Kenya's Tax Services practice.*

No taxation without (County!) representation

The uproar over County-level taxation is loud and troubling. Kenya's Constitution directs our Counties, led by their Governors, to oversee public responsibilities in the agriculture, health, sanitation and transport sectors, among others.

Our Constitution also grants them the responsibility for generating tax revenue at the County level. But citizens may rightly wonder whether their County-level tax regime is fair, understandable and equitable. Meanwhile, the national government has yet to devise a framework for regulating County level taxes, which is exacerbating the uncertainty and frustration.

The fact is that taxation is a means to an end. County governments must communicate the value of service delivery and deliver upon the promises they have made. If these responsibilities are met, then the uproar over taxation should subside. Citizens will understand how their taxes are collected and why, and what outcome to expect.

County governments can build trust in their capacity to fulfil this mandate. They can avoid imposing unfair taxes under the guise of raising revenue for operations. The taxes that they may impose include property taxes, entertainment taxes, fees and licenses (such as for business, catering, parking, land rents etc.), cess levies, sewerage and water charges and any other tax that is authorised by an Act of Parliament. Revenues generated by these tax policies will go a long way towards developing the Counties, if revenues are collected fairly and allocated transparently.

Conversely, citizens may worry that complex and uncontrolled taxes, levies and rates will be counterproductive to both service delivery and economic growth. Regional players may be concerned that County-level taxes could deter the free movement of goods and services across East Africa, as Counties levy taxes on goods transiting through them. County-level taxation could be chastised as 'double taxation' and therefore require more complex tax planning. Similar taxes could be levied inconsistently by different Counties. The Courts may be called in to assess the Constitutionality of various County-level taxes. Counties may be obliged to pay refunds at some later date.

County governments can meet these challenges head-on by enhancing compliance levels to bolster revenue collection. They can structure their tax regimes effectively and clearly, looking beyond a simplistic tax regime model to diversify revenue generation opportunities according to their County-level economic strengths. They can grow revenues by raising taxes and creating more of them, or they can reduce tax rates but broaden tax collection to include a wider net of taxpayers.

Before embarking upon the taxation journey, however, County governments should undertake value-for-money assessments. Every shilling must be fully accounted for and deployed for maximum benefit. Citizens must trust that this is the case. But a rushed transition to County-level taxation could set Counties up to fail until they have the capacity to carry out this responsibility.

A devolved government with efficient tax systems at the County level will go a long way towards improving living standards, employment and education and reducing poverty. Government fiscal discipline will benefit society through better coordination of services and faster, informed decision-making.

Citizens at the County level should be engaged in determining what will be taxed, the amounts to be taxed and how their taxes will be collected and channelled. Clearly, they want more transparency and a justifiable means of collecting tax. County governments are responsible for more than just policy-making. They must communicate the value of their policies and build trust. Otherwise, the uproar over County-level taxation—and all of the confusion surrounding this issue—will only continue.

Maryam Kombo *is a Manager with PwC Kenya's Tax Services practice.*

What is deemed interest and who is the target?

As a tax advisor, I struggle to explain to many of my clients the law relating to deemed interest. I am sure that I am not alone. Deemed interest is the amount of notional interest assumed to be payable by a resident person in relation to any outstanding loan provided or secured by a non-resident person, where such loan has been provided interest free. Allow me to explain.

Many long term investments require a large initial capital outlay and the risks involved in these investments can be very high. Furthermore, it takes a long time before an investor can recoup the capital invested and start enjoying a return on the investment. A good example of long term and high risk investments are those in the oil exploration and mineral prospecting sectors.

In the oil exploration industry, foreign parent companies pump in large amounts of money during the exploration stage. These companies usually finance exploration through a mix of debt (loans) and equity. Because oil exploration is considered high risk, few financial institutions are willing to lend funds to companies involved in exploration. That leaves the local company with no alternative but to borrow funds from its parent or affiliated company free of interest. When a foreign parent company advances an interest free loan to its subsidiary resident in Kenya, such a loan would be subject to the deemed interest provisions under our Income Tax Act.

To avoid the incidence of deemed interest the affiliated lender would be required to charge interest on the loan. But charging interest on such a loan does not make commercial sense to the Group because its Kenyan operations have not yet started generating any income. Worst case, the companies record a total loss after investing huge sums in a well which turns out to be dry.

If the lender opts not to charge interest deemed, interest provision would apply. The notional interest charged would give rise to a withholding tax liability. We can reasonably argue that the withholding tax on deemed interest increases the cost of doing business in Kenya.

It is unfair to impose withholding tax on deemed interest in cases where the initial outlay is financed through interest free loans from a non-resident parent company, particularly when the Kenyan operations financed by such loans have not yet started generating income. This could not have been the intention of introducing the law on deemed interest.

The concept of deemed interest was introduced in the 2010 Finance Act and according to the Income Tax Act, the interest is considered to be income accrued in or derived from Kenya and hence subject to withholding tax at the rate of 15%. The Commissioner prescribes a rate of interest on a quarterly basis that should be applied to compute the deemed interest amount. The prescribed rate is usually equal to the average 91-day Treasury Bill rate.

The big question is, who was the real target of deemed interest when the concept was introduced? Currently, all interest free loans secured or advanced by a non-resident person to a resident person are subject to withholding tax on the deemed interest.

In my view, imposing withholding tax on assumed (notional) income amounts to creating an additional cost to investors who invest / intend to invest in Kenya especially during the period prior to the commencement of income generation.

If Kenya wants to brand itself as an investment hub in Africa, the Government should come up with regulations to cushion investors from this additional cost.

By providing clarity on deemed interest provisions, the application of the law will be more acceptable. Alternatively, the law on deemed interest should be removed from our tax laws.

__Tom Kavoi__ is a Manager with PwC Kenya's Tax Services practice.

It is time to retire the SIMBA system!

The Kenya Revenue Authority (KRA) implemented the Simba 2005 Customs Management System (SIMBA) in July 2005 which superseded the Bishops Office Freight Forwarders Integrated Network (BOFFIN) system that was introduced in 1989. The Simba system was implemented amidst complaints of inefficiency in Customs Management by KRA the BOFFIN system and was meant to streamline the Customs revenue collection system.

Currently Kenya's partners in the East Africa Community are using the Automated System for Customs Data (ASYCUDA ++) system which is developed by the United Nations Conference on Trade and Development (UNCTAD) and boasts secure customs revenue collection, improved efficiency in customs operations and standardized data extraction which serves as management information on international trade.

The importation and exportation process is usually a fully supported and dependent Customs management system; its users being the KRA officers and clearing agents who represent and make declarations on behalf of importers. Therefore, any shortcomings in the system will affect trade and movement of goods. The Customs management system also acts as a link for traders transporting goods through countries where in modern Customs management systems, the different countries have a system interface to enable the use of single window system.

The single window is a single entry point where traders and customs officials can submit and access import/export information and fulfill import and export related regulatory and statutory requirements. The window can preferably be electronic with a single agency directing combined controls and informing other agencies.

With the current developments and progress in the implementation of the East African Community (EAC) regional integration, it is imperative / important for the EAC countries to implement a single window system. The aim is to fully implement a paperless cargo clearance process in the region and facilitate faster and efficient trade and development thus easing the cost and pain of doing business in the region.

In addition, the single window system allows for data exchange between inter-governmental and partner states government agencies for goods cleared through any port within the region thus easing the management and expedition of cross-border trade. Currently Kenya, Uganda and Rwanda have launched the single window clearance for some of their transactions, chief being the clearance of transit goods.

The Kenya National Electronic Single Window System was launched in October 2013 and it was expected that all border posts would switch to automated systems by 31 October of the same year. The single window system is beneficial to both the respective governments and the individual traders. For the governments, the single window system ensures properly accounted for revenue yields, improved trader compliance and the effective and efficient deployment of resources. At the same time, it ensures cost cuts through the reduction of delays and mundane customs processes and faster clearance and release of cargo for the individual traders.

For Kenya to achieve the benefits above and for the move to effective completion of the EAC integration process, Kenya needs to replace the Simba system. Logically, Kenya should consider joining its partners in the EAC in utilizing the gains of the ASYCUDA ++ Customs management system. The government has already sought for bids for the provision of an automated Customs management system from interested suppliers and has forecasted 2015 as the year in which the new system shall be piloted.

Although the change from Simba to an integrated system would be costly to the Government, the benefits derived from the EAC integration will supersede the expenses and eventually be worthwhile for both the Government and individual traders. This will involve making the transition from the current system to ASYCUDA ++ or a preferred integrated Customs management system in the shortest time possible to allow for trial runs and effective implementation.

Cynthia Mayaka *is a Tax manager while* ***Malone Tuva*** *is a Tax Consultant both at PwC Kenya's indirect tax team.*

Commercial buildings: Will the 25% allowance aid devolution?

The 2012 Finance Act introduced a capital allowance of 25% on expenditure incurred on construction of a commercial building for business use. This move is in line with the current boom in Kenya's construction sector which currently contributes approximately 7% of Kenya's GDP.

The rapid development of Kenya's infrastructure and increasing urbanisation are expected to grow the construction sector even further. Through tax incentives like the 25% allowance for the construction of commercial buildings, government can support this growing sector as well as devolution and development at the county level.

The allowance took effect from January 2013. A commercial building qualifying for the allowance is defined as a building for use as an office, shop or showroom but excludes a building which qualifies for any other deduction. In order to qualify for this allowance, a taxpayer is required to provide roads, power, water, sewers and other social infrastructure.

Whereas this was a welcome tax incentive, the conditions precedent for the allowance to be claimed may prove to be onerous especially for taxpayers who construct commercial buildings outside the major cities of Nairobi, Mombasa and Kisumu where there is no easy access to sewerage, power and road infrastructure.

As various government services are devolved to the local level, and with the expected increase in economic activity following devolution, Kenyans can expect investors to seize the opportunity and provide various amenities to county governments and private businesses in the counties. These amenities include the construction of commercial buildings for use as offices, shops and showrooms.

However, country-level infrastructure like roads, sewerage and electricity may not be very well developed in some areas and as such, the prerequisite for taxpayers to provide such infrastructure before qualifying to claim the commercial buildings allowance may discourage investment in these areas. They may prefer to invest in developed urban areas where connection to extant infrastructure is readily available.

As the government formulates tax incentives, it must also consider deliberate measures to support devolution so that investors venture out of urban areas. The investment deduction allowance which is granted at enhanced rates for investments outside key cities is a good example of incentives which encourage investors to concentrate investments outside urban areas.

Similar enhanced rates for commercial buildings outside key cities should also be considered and a 100% commercial building allowance would be a good start. The threshold regarding infrastructure should be relaxed for investments in counties to a basic level.

Kenya also requires clarity with regard to what constitutes 'other social infrastructure' with regard to the infrastructure investment requirements as the term is open to broad interpretation. A lack of clarity leads to uncertainty and many taxpayers who would have otherwise qualified for the allowance opting not to claim it.

To support devolution, it is essential that attractive tax incentives are put in place to stimulate investment in counties other than those harbouring the main cities of Nairobi, Mombasa and Kisumu. This will assist in creating new business opportunities, easing congestion in urban areas and developing infrastructure outside urban areas which will help drive county economies.

Such incentives will also drive the construction industry by encouraging investors to put up commercial buildings in counties which will not only support economic development, but will also create employment opportunities. Ultimately, increased construction activity will boost tax revenues for both national and county governments since commercial building rental income would be subject to VAT if the requisite threshold is attained.

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Transparency on cross border transactions

We are living in the information age. Information and data is readily accessible via the internet, social media and other channels. It is therefore quite surprising how little information some tax authorities have about taxpayers. This becomes more pronounced whenever tax authorities are reviewing the tax arrangements and transactions of companies with overseas affiliates.

Efforts by various tax authorities to examine the transactions of taxpayers with their affiliates are hamstrung by limited information. Local tax legislation has proved inadequate to assist tax authorities with accessing information on taxpayers that is not within their jurisdiction. In addition, confidentiality and privacy laws (including data protection) have also limited the extent to which tax authorities can access information.

In the global environment, there is no respite from demands for multinational enterprises (MNEs) to be more transparent and accountable in respect of their tax affairs. A recent report issued by the Organisation of Economic Cooperation and Development (OECD), Harmful Tax Competition: An Emerging Global Issue, identified 'the lack of effective exchange of information' as one of the key considerations in determining harmful tax practices.

In the UK, the Public Accounts Committee has been especially vocal in pressing MNEs to disclose how much profit is earned by overseas affiliates. Similarly, the US Senate's Permanent Subcommittee on Investigations of the Committee of Homeland Security and Government Affairs has been leading the charge against certain tax arrangements adopted by US MNEs. South Africa, India and China have also stepped up their efforts to ensure increased transparency in respect of tax matters. The chair and vice chair of the Global Forum on Transparency and Exchange of Information for Tax Purposes steering group are currently held by South Africa and China representatives respectively.

A broader push for reform in respect of tax information is being carried out by the OECD. Under the Base Erosion and Profit Shifting initiative popularly referred to as BEPS, information that MNEs will be required to provide to tax authorities will increase. Increased transparency is a key theme under BEPS.

Under Action 13 of the BEPS Action plan on transfer pricing documentation, there is a suggestion for MNEs to carry out country by country reporting.

Though it is not yet clear how this will work in practice, it is likely that MNEs will be required to provide information regarding how profits are allocated among various entities, taxes paid in various countries where the MNE operates and other important indicators of MNE economic activities including location of key employees. This information would be accessible by tax authorities around the world.

Some of these global initiatives have gone live and are already affecting Kenyan entities. Locally, Kenya banks have had to get up to speed on the Foreign Account Tax Compliance Act (FATCA).

This is a US Act that requires banks to automatically provide the US Internal Revenue Service with information about bank accounts held by Americans citizens and MNEs. Failure of compliance would result in punitive penalties such as getting locked out of the US banking system.

Given the developments currently going on globally, it does indeed seem inconsistent that Kenya is not taking measures to empower the KRA to access to critical information held by other tax authorities. The intention may be there, what is likely to be missing is implementation.

In 2012, Kenya enacted a provision in the Income Tax Act allowing for exchange of information between the Kenya Revenue Authority (KRA) and other tax authorities. To date, however, we are not aware that any exchange of information agreements have been signed by Kenya with any other jurisdiction. Some of the double tax treaties that Kenya is currently negotiating with its various trade partners that would allow for information exchange have not yet being ratified.

Kenya still relies on 'old methods' of taxing income derived from Kenya by non-resident entities through withholding taxes and stiff penalties. A better approach is to analyse the full economic value of cross-border transactions and tax them accordingly.

Kenya is on weak footing—or at the very least, a step behind—when it comes to analysing cross-border transactions due to the ongoing absence of a legal framework enabling KRA to access information held overseas. This needs to change.

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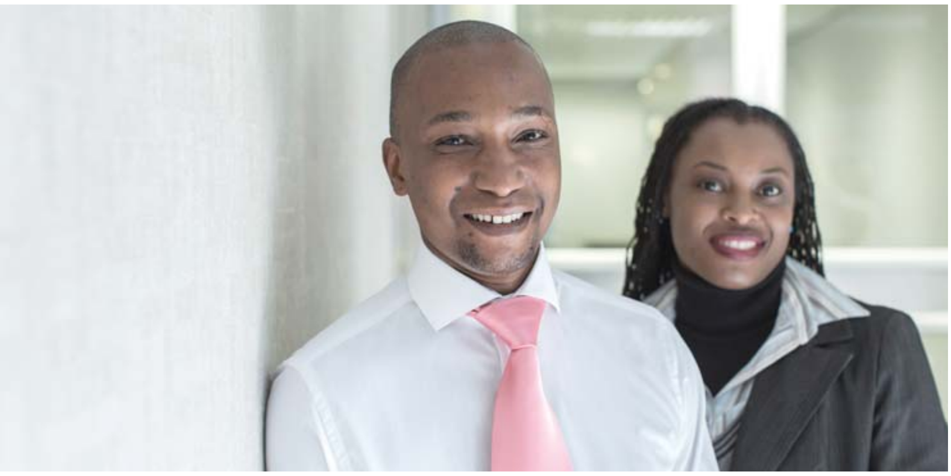
Value Added Tax (VAT) need not to be complex

VAT is levied and paid on sales of goods and services. "VAT is a tax on the supply of goods and services which is eventually borne by the final consumer but collected at each stage of the production and distribution chain" - Statement of Standard Accounting Practice (SSAP) No.5 UK. The value added is the amount of value a firm contributes to a good or service by applying its own factors of production may it be land, labor, capital or entrepreneurial capacity.



The concept of VAT was first devised by a German economist during the 18th Century. The tax was however first adopted by France in 1954. In Britain it was introduced in 1973, South Africa 1988 and close home in Kenya in 1989.

Businesses that are legible to register for VAT and when

Not all businesses need to register for VAT. The VAT threshold for registration in Kenya is for business making sales or who anticipate making sales of Kes 5,000,000 (five million per annum). The threshold is meant to reduce administrative burden on Kenya Revenue Authority (KRA) and compliance burden on small businesses. Once a business is registered for VAT, it is required to account for VAT charged on the taxable goods or services sold to other businesses and customers commonly known as output VAT. On the other hand, it can claim as input VAT it pays on the taxable goods or services it acquires from other businesses.

The output VAT and the claim for input Vat is reported to KRA using a prescribed return commonly known as VAT 3 return. Where there is tax payable (output being higher than input) then the amount is paid to the KRA before 20th of the subsequent month following the month the transaction occurred.

Even where there is no tax to be paid, the taxpayer is required to file the return whether the figure is nil or there is a credit balance which should be used to offset future VAT obligations.

Working out VAT

Businesses would have to charge VAT on every sale made to other business or customers - in other words, they have to add it to the price. This is done by multiplying the actual cost by the VAT rate, then adding that to the price of the supply.

The VAT amount is indicated separately on the invoice or on receipt, showing the price before VAT (exclusive of VAT), the VAT, the rate that was charged at, and then the total price (inclusive of VAT). The taxpayers are required to maintain records of all VAT transactions undertaken.

VAT is a 'pass through tax'

VAT is supposed to be borne by the final consumer, for instance, think through a scenario where A sells to B who sells to the C, the final customer. In essence, B will act as the conduit for the total amount of VAT collected from C and remitted to Kenya Revenue Authority. Everything else is just matching ins and outs.

For example, B buys a product from A which is priced at shs 1,000 before VAT. B will buy A shs 1,160 and A will need to declare as output Vat of shs 160. B then modifies the product and sells it to C, the final customer for shs 1,500 before VAT. B will charge C shs 1,740 (the price of 1,500 plus Vat of 240. In its accounting to KRA for VAT, B will account for output of 240 and deduct the input VAT of 160 and pay KRA shs 80. In total, KRA will collect shs 240 (the final VAT amount) – shs 160 from A and shs 80 from B.

If you are B and A doesn't charge you VAT because he isn't registered then you pay A Kes1,000 and your input VAT is nil. Your output VAT is Kes 320 (Kes 2,000 x 16%). You pay the Kes 320 you collected from C customer over to KRA. At the end of all of this you are neutral in terms of VAT, C customer has suffered Kes 320 of VAT and KRA has Kes 320 in its coffers. Once the taxpayer gets the basics right, then accounting for VAT should not be mind boggling.

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