Transfer Pricing

Payments by a permanent establishment to its head office are now subject to withholding tax

Increased scrutiny on cross border transactions

Permanent establishments now subject to transfer pricing provisions

As foreign direct investment in Kenya increases, the Kenya Revenue Authority continues to grapple with cross border tax issues. The definition of a Permanent Establishment (PE) is to be expanded to include a place of management, branch or office. We wait to see whether the updated definition will include a dependent agent PE. Inclusion of a dependent agent PE would significantly broaden the PE definition.

PEs and branches are also now specifically covered under the arm's length section of the Income Tax Act (ITA). Previously, the section only applied to transactions between resident persons i.e. companies incorporated in Kenya and their related non-resident persons and required such transactions to be conducted at arm's length. There was ambiguity as to whether PEs and branches were covered under the arm's length section of the ITA.

The Cabinet Secretary has resolved this issue by amending the arm's length section of the ITA to include PEs and branches.

In Kenya, PEs and branches are common in the banking, oil & gas and construction industries. Previously, their transactions with their head office were not strictly subject to the arm's length requirements. It is now clear that PEs and branches will be required to comply with the arm's length principle.

Payments by permanent establishments to head office now subject to withholding tax

The Cabinet Secretary appears to have introduced withholding tax on certain payments e.g. management fees, interest and royalties made by PEs to their head office. Further, other proposed amendments to the Income Tax Act appear to clarify that management fees, interest and royalties paid by a PE to its head office are not deductible for tax purposes.

Previously, such payments were not subject to withholding tax. The proposed amendments appear to be punitive as they impose withholding tax on payments from a PE to its head office and still restrict their deductibility.

The proposed amendments are likely to significantly increase the effective tax rate of PEs.

Commissioner seeks powers over DTAs

Clash between tax treaties and domestic laws

There appears to be an intention to amend the provisions of the Income Tax Act that relate to relief from double taxation i.e. Double Tax Agreements (DTA). There are proposals to restrict the benefits arising from the DTA where the entity is owned by individual(s) who are not resident in the contracting state to the extent of 50% or more. The intention of the amendment is to prevent abuse of DTA through what is commonly known as treaty shopping.

In principle, where there are conflicts between the DTA and local tax legislation, the DTA will override the local tax legislation. It appears that the proposed amendment seeks to empower the Commissioner to override the provisions of the DTA.

It is unclear why the KRA has selected this route to prevent treaty shopping. DTAs already have provisions relating to beneficial ownership to counter this type of abuse.