Direct Taxes

Review of tax provisions governing the extractive sector

In 2013, the Income Tax Act introduced a withholding tax on proceeds arising from the sale of property and shares by oil companies, mineral companies and mineral prospecting companies. The withholding tax was a punitive tax measure as it taxed the consideration without giving any allowance for costs incurred by the seller. This amendment indeed dampened the spirit of stakeholders in this sector.

In the budget statement, the Cabinet Secretary proposed significant changes in the taxation of the extractive sector. To begin with the Cabinet Secretary proposed to tax petroleum and mining companies on the net gain from farm-in transactions. This is in line with the existing international best practice and has come about after concerted efforts by the stakeholders. This reflects the appreciation by Government of the significant investment in the extractive industry, and will go a long way in spurring growth in this sector.

Government has made its intention known that the current taxation of the extractive sector needs to be updated. While the proposed amendments are yet to be published, we expect that the government will align the provisions of the Production Sharing Contracts (PSC) with the Income Tax Act.

In this regard, there is an expectation that a revamped Ninth Schedule will be introduced soon to replace the current version which has been in existence since 1986. Some of the expected changes in the revamped Ninth Schedule include:

- Taxation of farm-out transactions including indirect transfers,
- Ring fencing of blocks,
- Possible introduction of a royalty regime,
- Certainty of the payor of the taxes on production,
- Changes on withholding tax regime on payments to non-residents,
- Tax implications on funding and
- Issues relating to taxation of subcontractors.

We would also expect the new Ninth Schedule to consolidate the taxation of the extractive sector to include mining companies. It also would be critical to ensure that the provisions of the Production Sharing Contract are aligned with the tax legislation.

As we expect that the legislative changes relating to the extractive sector will be extensive, we intend to
issue a more detailed bulletin once the Finance Bill 2014 has been published.

**New Income Tax Act on the way**

For the second year running, the Cabinet Secretary proposed to review the Income Tax Act by introducing a new bill from July this year. The current law was enacted in 1973 following the breakup of the East African Community leading to each country introducing its own act. Since then, some our partners in the East African Community, Uganda and Tanzania, have introduced new acts in 1997 and 2004 respectively, while Kenya has maintained its 1973 legislation albeit with numerous amendments.

The Cabinet Secretary in his budget statement indicated that the proposed act is meant to adopt international best practice, simplify the tax code and improve revenue collection. What lessons are there to be learnt as we embark on writing a new income tax act? The International Monetary Fund model Income Tax Act advocates for a complete and comprehensive legislation with a broad tax base and limited exemptions. It must be noted that the Uganda and Tanzania acts align taxable profits with the accounting profits in order to minimize tax adjustments and we hope that Treasury will take note. Furthermore, the process should seek to have wider participation of stakeholders. In this regard, we welcome the commitment to consider contributions from bodies like the Institute of Public Accountants of Kenya, other tax experts, submissions from various stakeholders and the attempt to benchmark the new Bill to international best practices.

Taxpayers should actively engage with Treasury in order to shape the new act and ensure that the envisaged law is consistent with modern thinking and practices.

Cabinet Secretary also introduced the Tax Procedures Bill that will contain uniform procedures across the three tax legislations, namely VAT, Excise duty and Income Tax. This is in line with changes introduced last year regarding tax appeals procedures of consolidating procedures previously residing in various acts.

**Special Economic Zones - a regime to anchor regional hub ambitions**

The Cabinet Secretary has allocated KES 600m for the establishment of Special Economic Zones (SEZ). This budgetary allocation is in our view an indication of the government’s commitment to have the SEZ legislation which has been the subject of debate since 2009.

SEZs are selected geographic areas with highly developed infrastructure and which have the potential to be developed into agro-industrial, industrial, tourist/recreational, commercial, finance and technology centres.

SEZs provide numerous investment incentives (both tax and non-tax incentives) through policy and regulatory flexibility for a wide range of economic activities. Such incentives include tax holidays/exemptions, reduced tax rates and relaxed administrative procedures.

Establishment of SEZs is therefore expected to generate greater economic activity and employment thereby hastening industrialization in line with the Vision 2030. SEZs are designed to address the challenges presented by the Export Processing Zones which is biased towards manufacturing for export oriented businesses and to create competitiveness.

There is a global shift from EPZs to SEZs with countries such as China, India and Philippines deriving immense benefits. This is therefore a
step in the right direction and will promote Kenya as a desired destination for Foreign Direct Investment (FDI) and setting up of regional headquarters offices as well as establishment of other business activities not covered under the EPZ.

The SEZ Bill, 2014 needs to be harmonized with the Constitution and other tax legislation. In addition, rules and guidelines need to be put in place.

Enhancing transparency and tax compliance

Currently companies are required to only disclose information on name and address of related/associated enterprises outside Kenya in the self-assessment return. However, companies will now be required to furnish KRA with records and information on any change of corporate structure and business lines. This move aims at aligning the compliance requirements to sharing information on taxpayers and will facilitate identifying companies engaging in cross border investment and trade.

The KRA seeks to have a global view on cross border transactions as an attempt to widen its tax net as it seeks to meet its revenue collection targets. By introducing the proposed change the regulator fails to take cognisance of the additional compliance burden on companies.

What are some of the current challenges?

Tax losses time limits

The Income Tax Act restricts the carrying forward of tax losses to a maximum of four years after the year in which the tax losses arose. The four year period may not be sufficient especially where the tax losses arise from the accelerated capital allowances. The impact is to negate the benefit due to the time restriction. There are provisions for a taxpayer to apply to the Commissioner to use discretionary powers and extend the limit but there is no guidance on criteria to be used.

Investors require certainty to guide the investment decisions and urge the government to issue guidelines with respect to the applications for extension when writing the new Income Tax Act that would take into account the reasons for the tax losses e.g. whether it is from capital allowances or merely operating losses. This would then impact the decision on the extension of limit request.

KRA should immediately introduce guidelines on the criteria they will use to approve the applications and also consider increasing the time limit from four to say seven years.

Deemed interest

In the budget speech for 2011, the Minister deemed an interest rate on interest-free loans provided by a non-resident to a thinly capitalised related Kenyan resident. The deemed interest rate is pegged to the average 91 day Treasury Bill rate.

An attempt was made in 2012 by prescribing rules on calculating deemed interest and amending the enabling withholding tax provisions. The impact of the above amendments has seen the resident taxpayer bear the withholding tax cost.

Our view is that the provision should be abolished in line with international best practice.

Thin capitalisation

The current tax law contains thin capitalization rules that seek to penalize a taxpayer whose ratio of debt to equity exceeds 3:1 by disallowing a portion of the interest cost.

This ratio is suited to more developed countries. We believe that in order for Kenya to continue to attract foreign direct investment FDI, the ratio should be significantly increased to
perhaps 6:1 to make it less punitive and easier for businesses that seek funding.

**Is interest income a specified source?**

The current tax law ring fences income and expenditure on specified sources such as farming, employment and rent of property.

However, the law is not explicit with regard to interest income which has led to the KRA taking an aggressive interpretation. This has been reinforced by recent court rulings, which in our view is not based on the correct reading of the law.

Most interest income is earned as a consequence of the company managing its funds on a short term basis as they wait to embark on major projects.

Our view is that interest income should be treated as business income and not reinforced.