

This newsletter is designed to inform our clients of recent developments in the law in Kenya, Uganda and Tanzania. If you would like us to e-mail this newsletter direct to anyone in your organisation please contact Pamela Nabwire at [pwn@africalegalnetwork.com](mailto:pwn@africalegalnetwork.com)



## Kenya

### THE PRIVATISATION PROGRAMME IN KENYA<sup>1</sup>

The Finance Minister, Honourable David Mwiraria, at an International Investment Conference which took place in March, 2004 in Nairobi commented on the Kenya Government's stand on the issue of privatisation. He stated that the Government recognises the benefits that can accrue from a well-planned and implemented privatisation programme that has been conducted transparently.

In its Interim Investment Programme for the Economic Recovery Strategy for Wealth and Employment Creation 2003-2007 the Government earmarked privatisation as a component of its policy strategy to stimulate economic recovery. The privatisation programme targets key service providers including Telkom (Kenya) Limited, Kenya Railways Corporation, Kenya Power and Lighting Company and Kenya Ports Authority.

The recently published Privatisation Bill forms the core of the legislative framework for the privatisation programme that the Government is intending to implement. The Bill aims at introducing an explicit strategy for effecting privatisation with a clear implementation plan and timetable. The key objectives of the Bill are:

- To provide a statutory mechanism for the sale of assets and operational control of public entities to private persons.
- Establish a Commission which will formulate a privatisation programme.
- Ensure transparency and fairness in the privatisation process.
- Lay down procedures pursuant to which persons aggrieved by decisions of the Commission will have a formal channel for resolution of their grievances.

The Government's efforts towards privatisation is evidenced by its recently announced decision to opt for joint concessioning in relation to Kenya Railways Corporation which will result in the splitting of Kenya Railways Corporation into three entities. Once the concessioning is complete, it is proposed that the parastatal will be split into Kenya Railways Company, Kenya Railways Management Authority and Kenya Railways Safety Authority. Reportedly, the winning bidder will have a sixty percent stake in the process and the remaining forty percent will be distributed equally to institutions and individuals. A more recent development is the identification and licensing of the second landline telephone service provider following the expiry of Telkom Kenya's monopoly in June, 2004 which is soon to be announced. The three bidders for this licence are Telenor Group/Telenor Management Partner AS, ZTE/CNC/Kensim and Pegrume Group/Telecommunications Consultants India/Tata Infotech/Premier Contacts Agency LLC.

Finally, expressions of interest were also recently invited for work relating to the Kenya – Uganda oil pipeline.

### APPOINTMENT OF RECEIVERS – NEW CHALLENGES

The deep recession affecting the Kenyan economy has lead to a number of high profile business failures. As a result of this fact the incidence of banks appointing receivers under their debenture security has also increased. A bank's ability to appoint a receiver has been subject to considerable judicial scrutiny and two decisions of the Courts in Kenya have severely limited the ability of a bank to appoint a receiver.

The two cases in question are Fina Bank Limited v Spares & Industries Limited (the "Fina Bank Case") and Jambo Biscuits (Kenya) Limited v Barclays Bank of Kenya Limited and others (the "Jambo Biscuits Case"). The position prior to the Fina Bank Case and Jambo Biscuits Case was that the Courts would not generally interfere with the appointment of a receiver except where one of the well established grounds for challenging the appointment of a receiver had arisen. These grounds included the case where the security created was *ultra vires* the company (that is, the company did not have the power or adequate power in

<sup>1</sup> The writer has published a detailed article on this subject in the Euromoney publication "Privatisation and Public Private Partnership Review 2004/2005"

its constitutional documents to create the security), the security was not stamped as required by the Stamp Duty Act or that the registration requirements under the Companies Act had not been complied with.

The Court of Appeal in the Fina Bank Case took the banking and legal fraternity by surprise in not following an established line of legal authorities on a bank's right to appoint a receiver. The Court placing reliance on an unreported High Court case confirmed a mandatory injunction which had been granted by the High Court in compelling the receivers to vacate the borrower's premises and stated that where a party exercises a statutory right "oppressively" the Court would have a right to interfere. In Kenya the right to appoint a receiver is contractual and not statutory and as such the basis of the Court's reasoning is far from clear. Of more concern, however, was the acceptance by the Court of the argument that a bank must not act "oppressively" when appointing a receiver without the Court laying down any objective guidelines on the conduct or circumstances that might constitute an act of "oppression". The upshot of this decision is that it is likely that defaulting borrowers will claim "oppression" when they wish to set aside the appointment of a receiver. As the Court of Appeal did not attempt to define the term "oppression" and did not set any guidelines as to actions that could constitute an act of "oppression" it will be difficult for a bank to establish whether or not the appointment of a receiver would in any particular case be "oppressive". The right to appoint a receiver is the only effective remedy open to a bank under debenture security and as such this decision is of grave concern to banks in Kenya holding debenture security.

The decision in the Jambo Biscuits Case has further weakened the position of the banks. The Court in this case upheld an application to restrain receivers on a number of rather technical grounds. It was claimed, inter alia, that the debenture was not drawn up strictly in accordance with the provisions of the Advocates Act (the name and address of the firm that had drawn the debenture was not apparent on the debenture instrument) and that the letter of appointment of the receiver was ineffective for lack of attestation. It must be said that there were other grounds in the Jambo Biscuits Case on which the Court placed reliance but it is of some concern that mere technical defects were recognised by the Court as giving sufficient grounds for attacking the enforceability of a bank's right to appoint a receiver under a debenture.

It will be appreciated that the decisions in the Fina Bank Case and Jambo Biscuits Case have considerably increased the scope for borrowers to challenge the appointment of receivers and has resulted in well established legal principles that governed a bank's rights to appoint a receiver under debenture security being cast aside. The uncertainty created by these two decisions will impact on the credit evaluation by

banks proposing to provide secured finance which cannot be good news for the economy which desperately requires fresh investment in the corporate sector.

## TAXATION

### THIN CAPITALISATION... ON THIN ICE!

The Income Tax Act contains provisions on thin capitalisation of foreign controlled companies. Thin capitalisation arises where a company incorporated in Kenya is controlled by a non-resident person alone or together with four or fewer other persons and the highest amount of all loans advanced to that company at any time during the year are more than three times the sum of the revenue reserves and the issued and paid up capital of that company. Where a company is thinly capitalised the Kenya Revenue Authority will disallow for tax part of the interest charged in proportion to the amount of debt that exceeds the prescribed ratio of debt to capital. In addition, the deduction of exchange differences are also restricted.

The Income Tax Act until recently did not define the term "loan" in this context and the established practice had been that loans comprised long term indebtedness and bank overdrafts only. However, the legislation has been amended to now define the term "loan" to mean loans, overdrafts, ordinary trade debts, overdrawn current accounts or any other form of indebtedness. In this regard it should also be borne in mind that "loans" cover both local and foreign loans.

It will be appreciated that the broad definition now given to the term "loan" will have far reaching consequences for foreign controlled companies which are thinly capitalised. Representations have been made to the KRA making the point that this amendment will not encourage foreign investment which Kenya so badly requires particularly after the repeal of the exchange control regime in 1996 resulted in a non-resident person being entitled to own shares in a private company without the necessity of obtaining any consents previously required under the exchange control legislation. To date, however, no amendments have been made to the definition of "loan". The term "control" in relation to a body corporate is also broadly defined in the Income Tax Act and includes control whether by means of the holding of shares, possession of voting power or by means of any contractual arrangements that confer a right on a person to regulate the affairs of a body corporate. The

definition also covers indirect control of a body corporate. Therefore, it is important for a foreign investor to consider the implications of the thin capitalisation rules when arranging the shareholding and finances of its Kenyan subsidiary company as a failure to do so could have unfortunate taxation consequences.

Another tax rule which the KRA is more alert to concerns "transfer pricing". Transfer pricing is relevant in the case of a resident person carrying on business with a related non-resident person who between themselves arrange matters in such a way that the resident person generates no or less than ordinary profits from the business than had they been transacting at arms length. The transfer pricing rules permit the KRA to tax the resident person on the amount of profits which the resident person could have been expected to accrue had the business been carried on at arms length.

## TRADEMARKS

Many third world countries, like Kenya, have remained content with land and other property laws (including intellectual property law) that may be considered archaic in more progressive jurisdictions. However, due to pressure from the international community to have universal protection of intellectual property rights, various amendments to existing legislation have had to be considered. The core intellectual property rights are embodied in statute law most of which is based on English legal principles. The Trade Marks Act (Chapter 506, Laws of Kenya) for example, has with the influx of international professional services and consultancy firms, been recently amended to cover service marks. An act of parliament has been passed which repeals the Industrial Property Act (Chapter 509, Laws of Kenya) and replaced it with a new statute, the Industrial Property Act, 2001. This new Act governs patents, industrial designs, utility models and technovations. The Copyright Act (Chapter 130, Laws of Kenya) has also been repealed by the Copyright Act, 2001. The gist of the amendments is to bring these statutes in line with current trends to grant universal (as opposed to national) protection of intellectual property rights and to adopt standard procedures for registration and enforcement of these rights.

## ADMIRALTY JURISDICTION IN KENYA

Arrest of vessels in the territorial waters of Kenya can only be effected by the application of English Admiralty law. As Kenyan maritime law makes no provision for arrest of vessels in Kenya, the High Court is solely reliant on Admiralty Law as applied in the High Court of England (Section 4 Judicature Act - Chapter 8, Laws of Kenya).

In the admiralty case of Admiralty Cause No.2 of 1998

the issue faced by the Kenyan courts was whether the Kenyan Admiralty Court had jurisdiction to hear a claim for salvage brought under S.21(2)(j) of the Supreme Court Act 1981, where salvage was not initially pleaded and the vessel was arrested. One of the Notices of Motion filed by the owners of the arrested vessel was that the action in rem brought against the tanker vessel "Joey" and her cargo, bunkers, stores and freight be struck out and the warrant of arrest issued be set aside as the action did not fall within the ambit of section 21(2)(j) of the Supreme Court Act 1981 and the court had no jurisdiction to hear and determine the same. The defendants claimed that the Court had no jurisdiction under the Act to entertain the arrest of the vessel as the services rendered to the *Joey* were governed by a towage contract, and the claimant's pleadings referred only to towage services rendered and not salvage.

The Kenyan High Court held that although amendments to pleadings were made after filing but before the hearing of the Notice of Motion, in law amendments to pleadings go back to the original pleadings. It is therefore the "further amended writ of summons" which constitutes the action in rem. The case of Central Kenya Limited V. Trust Bank Ltd. & 4 others (CA 222/98) cited stated:

" it is also trite law that as far as possible a litigant should plead the whole of the claim which he is entitled to make in respect of the cause of his cause of action. Otherwise the court will not later permit him to reopen the same subject of litigation only because they have from negligence, inadvertance or accident omitted that part of their case. Amendment of pleadings and joinder of parties is meant to obviate this. Hence the guiding principle in applications for leave to amend is that all amendments should be freely allowed and at any stage of the proceedings, provided that the amendment or joinder as the case may be, will not result in prejudice or injustice so as to result in any prejudice or injustice to the other party which cannot be properly compensated for in costs". The court therefore allowed the writ of summons to be amended to include other claims.





## Uganda

### A NEW REGULATORY REGIME FOR FINANCIAL INSTITUTIONS IN UGANDA

It has been said that the history of regulation is one of abuse and reaction to abuse. The Financial Institutions Act (No.2 of 2004) illustrates this point to perfection.

Coming in the wake of bank failures, closures and near failures over the last 5 years or so it was only appropriate that the law reflect changes to cure the perceived ills and shortcomings of the Financial Institutions Act (Cap.54) of 1993.

The FIA which came into force on 26<sup>th</sup> March 2004 appropriately raises the minimum capital requirements for banks to Ug.Shs.4,000,000,000/= (approximately US \$ 2.328 million) and for non-bank financial institutions to Ug.Shs.1,000,000,000/= (approximately US \$580,000.00) representing a four fold increase. Interestingly the previous requirement for higher capital for foreign companies has been deleted. The FIA creates eight different types of licences ranging from a commercial bank licence to a finance house each allowing different specified powers to the holder.

The provisions regulating the shareholding in a financial institution have also been strengthened significantly with a whole schedule to the Act being dedicated to detailing criteria for the determination of suitability to become a director or substantial shareholder in a financial institution. The Act prohibits ownership of more than 49% by a single individual or entity and requires Central Bank approval for a transfer of more than 5% of the shares.

The provisions relating to prohibited and restricted activities for financial institutions has been strengthened and a whole section on corporate governance has been introduced.

The Central Bank's powers to intervene in the affairs of a financial institution are enhanced and appropriately in keeping with the times, anti-money laundering provisions have been introduced.

The Deposit Protection Fund has been retained with the size of a protected deposit yet to be determined by statutory instrument. A credit reference bureau has been introduced and is expected to greatly combat debtor migration and assist credit evaluation.

With the privatization of the Government stake in DFCU Limited coming up this month, the whole Uganda financial institution sector will become totally private. It is hoped that the Central Bank, with all its new and enhanced powers will be more than equal to the task of regulating this sector.

### REGULATING OF MICROFINANCE

Growing like mushrooms in the dark, the micro-finance sector in Uganda has seen phenomenal growth over that last few years. With their market penetration, variety of products and close community contact, the micro-finance institutions have been able to extend credit further and deeper than the traditional financial institutions (banks and other credit institutions).

It is therefore perhaps timely and appropriate that this sector should come under Central Bank regulation. Hence the Micro Finance Deposit Taking Institutions Act (No. 5 of 2003).

The Act creates a simpler form of tier regulation for deposit-taking micro-finance institutions mirrored along the lines of financial institutions.

The Act provides for a minimum capital requirement of Ug.Shs.500,000,000/= (approximately US \$295,000.00, on going capital adequacy requirements, restrictions on certain transactions, and a whole section on corporate governance. The Act also provides for a credit reference bureau and sets up a Deposit Protection Fund.

The Act may however be limited in scope and effect in so far as it only seeks to regulate those micro finance institutions that take deposits from the public.

There has been some outcry from the public about the interest rates charged and recovery methods of some of these micro-finance institutions. Operating as they do mainly among the informal sectors and rural communities, there is some need for further regulatory oversight.



## THE INCOME TAX ACT, 2004 ... TRA GOES TO TOWN

One of the principal legal developments that has taken place in Tanzania recently is the enactment of the Income Tax Act 2004 (the "Act") which came into force on 1st July, 2004. The Act is aimed at transforming Tanzania's taxation regime and increasing the Tanzania Revenue Authority's revenue streams by tightening and in some cases closing various schemes previously utilized by businesses to avoid tax. The irony is that whilst Tanzania is attempting desperately to encourage much needed foreign investment the Act does little to bolster the confidence of such investors or, indeed, to make such investments attractive from a tax perspective.

The Act is also a matter of serious concern for persons deemed to be resident in Tanzania for the purposes of the Act in that the Act considerably widens the tax net to extend and apply to the worldwide income of such persons. For the relatively large expatriate community working in Tanzania the effect of this rule will have potentially far reaching financial consequences. Furthermore, Tanzania only has a handful of double tax treaties in place, and none with its significant development partner states which would have served to reduce the impact of the application of the Act to the worldwide incomes of foreigners resident in Tanzania.

The Act revises the treatment of business income, the tax consequences of realization of assets and taxation of trusts. In addition, the Act contains numerous revisions to existing legislation relating to employee benefits, presumptive income tax, tax thresholds, pensions, capital allowances and repatriation of income. Set out below, are certain salient issues covered in the Act:

**Capital Gains:** An asset sold by a Tanzanian individual will still attract a capital gains tax of 10% (which is consistent with the previous legislation). However, a disposal by a non-resident person will now attract a capital gains tax of 20%. Indexation allowances have also been abolished. Accordingly, it will now be inefficient for tax purposes to set up an off-shore holding company structure in Tanzania as the off-shore entity will be subject to capital gains tax at 20% on a disposal of on-shore assets. There is still some uncertainty on the capital gains tax payable by a resident body corporate on a disposal. It is widely believed that such gains will be taxed at the highest corporate tax rate of 30%.

**Thin Capitalization:** This is a new concept in Tanzania introduced by the Act whereby interest deductibility on

loans for companies who are 25% or more owned, inter alia, by non-resident persons is deferred where the interest payable exceeds more than 70% of income before net interest cost. In this regard foreign controlled companies will need to be careful in considering gearing and profits when they seek debt financing and should not assume tax deductions will be available automatically.

**Transfer Pricing:** New provisions that address arms length transactions between associated companies have been introduced. Whether these are congruent with or similar in effect to the OECD guidelines remains to be seen. Income splitting for tax avoidance is also addressed by the Act.

**Change in Control:** Where a company seeks to change ownership by more than 50% as compared to ownership in the previous three years, it shall be treated as realizing its assets and liabilities. It will also lose any tax losses brought forward and unutilized bad debt provision credits. Furthermore, such change of ownership will result in a split of its accounting period.

However, these provisions will cease to apply where the company continues to carry on the same business for a period of twelve months after the change of control. These provisions are aimed at restricting the acquisition of companies purely for tax losses or for asset stripping and, as such, will require share acquisitions to be carefully planned and structured.

**Taxation of Trusts:** Under the Act a trust is liable to tax separately from its beneficiaries. Distributions by a non-resident trust fund shall be included in calculating the income of the trust's beneficiaries resident in Tanzania. In addition, a foreign controlled trust or corporation shall be treated as distributing its unallocated income to its beneficiaries at the end of each year of income. This provision is aimed at closing the loophole of establishing off-shore trusts and companies for siphoning of company profits.

The Act provides for accounts to be prepared on generally accepted accounting principles (GAAP) and streamlines accounting periods and deadlines for submission of accounts and tax returns to the TRA.

It is generally recognized that the TRA will need to undertake substantial tax-payer education as knowledge and understanding of the implications of the Act is still relatively limited amongst taxpayers who will be affected by the changes brought about by the Act. As will be observed from the foregoing, the Act aims to widen the tax net and calls for a more sophisticated level of tax planning for businesses and investors in Tanzania.

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