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LAW AND PRACTICE:

Contributed by Anjarwalla & Khanna

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Law and Practice

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Contents

Anjarwalla & Khanna has an established tax practice, with a dedicated team of one partner and nine associates. The team advises on tax liability in the region, including on tax structuring, efficient tax practices for organisations, negotiating tax warranties and indemnities, customs duties and levies, capital gains tax, and providing tax planning advice across various sectors. A&K is the founder and key driver of ALN, an alliance of leading corporate law firms currently in 16 key African jurisdictions, including some of Africa's fastest growing jurisdictions: Algeria, Botswana, Ethiopia, Guinea, Kenya, Madagascar, Malawi, Mauritius, Mozambique, Morocco, Nigeria, Rwanda, Sudan, Tanzania, Uganda and Zambia; ALN also works closely with affiliates in UAE and Mauritius. ALN is at the heart of A&K's approach to its Africa strategy. The tax team has developed specialist expertise in several practice areas, including all aspects of complex tax transactions, with a particular emphasis on mergers and acquisitions, corporate restructurings, tax dispute resolution, customs duties and levies, setting up of local and foreign businesses in East Africa, private equity transactions and structuring investment funds.

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1. Types of Business Entities Commonly Used, Their Residence and Their Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

General Background

By way of general background, Kenya is in the process of reviewing its income tax regime through the enactment of the Income Tax Bill, 2018 (ITB) which will lead to the repeal of the Income Tax Act, Chapter 470, Laws of Kenya (the ITA). The ITB was released by the National Treasury in mid-2018 to the public for their comments. The ITB aims to simplify compliance, widen the tax base and align Kenyan tax legislation with international best practices. The ITB is currently undergoing public participation as part of the legislative process before being introduced to the National Assembly for debate and enactment. It is expected that the ITB will be enacted in the course of 2019.

To this effect, we have referred to some of the proposed changes in this corporate tax guide (where relevant).

Business Forms

Businesses generally adopt corporate forms for the purposes of carrying on business in Kenya. The most prevalent forms of business organisations in Kenya are companies limited by shares (either private or public) established under the Companies Act, 2015 (the Companies Act); branches of foreign companies in Kenya registered under the Companies Act, 2015; and limited liability partnerships (LLPs) established under the Limited Liability Partnership Act, 2011. Companies limited by shares and LLPs are separate and distinct legal persons while foreign branches are not separate legal persons under Kenyan law, but adopt the legal personality of their foreign head offices.

The key difference between LLPs and companies limited by shares is that for tax purposes, LLPs are regarded as being "tax transparent" with the income of the LLP being taxed in the hands of the LLP partners. Companies limited by shares are taxed on their income, distinct from their shareholders who receive dividend distributions from the after-tax profits. Companies limited by shares are the most prevalent form of business vehicle and as such the law and practice around corporate governance, dispute resolution and liquidation is well developed. LLPs as a business vehicle are fairly recent (introduced in 2011, when the enabling legislation was enacted).

1.2 Transparent Entities

The most commonly used transparent entities are partnerships (both incorporated and unincorporated), which are generally treated as transparent for tax purposes in Kenya. Before 2012, it was only possible to establish an unincorporated partnership in Kenya and these types of entities were mainly used by professional service firms, such as audit firms and law firms. In 2012, Kenya introduced LLPs, which are corporate vehicles with a separate legal personality from their partners. While LLPs are now becoming increasingly popular, they remain relatively new and are currently primarily used in the real estate market for tax planning reasons, on account of the ease of debt funding and profit extraction. However, more professional service firms are converting to LLPs due to the fact that they have a legal personality separate from that of their partners. Thus as it stands, the business sector and investment groups mainly use a limited liability company as their investment vehicle.

Having said this, it is also becoming common to find a foreign company, such as a Mauritius global business company, being used as an investment vehicle for investments made in Kenya; this is particularly common for private equity and hedge funds with investments in Kenya.

1.3 Determining Residence

A company is tax resident in Kenya if:

- it is incorporated under Kenyan law;
- the management and control of its affairs are exercised in Kenya for any given year of income. The "management and control" test would include reviewing where the strategic policy and direction of a company is exercised through location of board meetings, location of the head office, company records and administrative matters; or
- if the Cabinet Secretary for the National Treasury declares the company to be tax resident for a particular year of income in a notice as published in the Kenya Gazette.

Under the ITB, the above definition of a resident company has been retained save for the fact that the Cabinet Secretary no longer has powers to declare a company to be tax resident in Kenya.

For tax-transparent entities such as LLPs, the LLP itself will be regarded as being tax resident in Kenya. The residence of an LLP's partners (in whose hands LLP income is taxed) will depend on whether they are individuals or corporate partners. Foreign corporate partners would be regarded as non-resident unless they meet any one of the tests above, particularly the "management and control" test. Foreign corporate partners of a Kenyan LLP would also need to consider whether by virtue of their Kenyan activities, they have created a permanent establishment (PE) in Kenya. A PE is created when the foreign corporate partner has either a fixed place of business in Kenya or a "dependent agent" who has and habitually exercises authority in Kenya to enter into contracts on behalf of the foreign corporate partner. A PE of a foreign corporate partner would be taxable at a rate of 37.5% of the non-resident person's business income attributable to the Kenyan PE.

Residency for individual partners is determined by two factors:

- An individual will be deemed to be resident in Kenya if he/she has a permanent home in Kenya and was present in Kenya at any time during the year of income in question; or
- A person with no permanent home in Kenya will be considered a tax resident if present in Kenya for an aggregate of 183 days or more in the tax year or an average of 122 days over the previous three years (including the current tax year).

1.4 Tax Rates

The current corporate tax rate applicable to corporations resident in Kenya is 30% adjusted net profits while a non-resident company with a PE in Kenya is taxed at the rate of 37.5% on the business income of the non-resident person attributable to the Kenyan PE.

However, the ITB proposes to reduce the corporate tax rate for non-resident companies with a PE in Kenya from 37.5% to 30%. The ITB also seeks to introduce a tax of 10% on repatriated income applicable on a non-resident person who carried on business in Kenya through a PE, based on a prescribed formula as a factor of net assets. The ITB also proposes to introduce a new tax rate of 35% for companies that have taxable income in excess of USD5 million.

Taxable profits are based on adjusted accounting profits. Therefore, a company's taxable profits comprise the excess of a company's net accounting profit having added back non-deductible expenses and having deducted allowable expenses and allowances. Generally, expenses such as capital expenditure, restricted loan interest due to thin capitalisation, personal expenses, unrealised foreign exchange losses and depreciation would be disallowed for tax purposes. On the other hand, capital allowances ranging from 12.5% to

37.5% would be allowed against taxable income for equipment used in the production of income.

There are preferential tax rates available for newly listed companies on the Nairobi Securities Exchange, pursuant to which the tax rates range from 20% to 27% for a period ranging from three to five years. The preferential rates depend on the percentage of listed shares made available to the public through the Nairobi Securities Exchange, as follows:

- 20% rate, if 40% of issued share capital is listed – (five year period);
- 25% rate, if 30% of issued share capital is listed – (five year period); and
- 27% rate, if 20% of issued share capital is listed – (three year period).

The ITB proposes to replace the preferential tax rates available for newly listed companies on the Nairobi Securities Exchange with a fixed tax rate for a period of time. The ITB also proposes to maintain preferential tax rates for companies listing at least 40% of their issued share capital, in which case such companies will be taxed at the corporate tax rate of 25% for the first five years as opposed to the current rate of 20%.

For businesses owned by individuals directly or through transparent entities, the individuals are taxed in graduated individual tax brackets which range from 10% to 30%. These rates apply on income earned by tax resident individuals. With effect from 1 January 2018, monthly income in excess of USD470 earned by an individual is subject to tax at the highest bracket on the graduated scale (ie 30%). For non-resident individuals, the withholding tax regime would apply on passive income streams such as interest (15%), management and professional fees (20%), royalties (20%) and dividends (10%), subject to lower tax rates available under double taxation treaties.

While the ITB proposed to introduce a new bracket of 35% income tax for individuals who earn monthly income in excess of USD7,500, it has been subsequently announced by the Cabinet Secretary for the National Treasury that the highest tax bracket of 30% (for monthly income in excess of USD470) will be retained.

Presumptive tax applies at a rate of 15% of the amount payable for a business permit or trade licence issued by a County Government, and applies as final tax to resident individuals whose annual business turnover does not exceed KES5 million. Presumptive tax does not apply to incorporated companies or income derived from management/professional fees or rental business.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Profits are taxed on an accrual basis for each tax year. Taxable profits are based on the adjusted accounting profit, which is calculated by adding back non-deductible expenses to the accounting profit and deducting allowable expenses and allowances. Generally, expenses such as capital expenditure, restricted loan interest due to thin capitalisation, personal/non-business expenses, unrealised foreign exchange losses and depreciation are disallowed for tax purposes. On the other hand, capital allowances ranging from 12.5% to 33.3% are allowed against taxable income for equipment used in the production of income. There are also investment deductions which may be available as a deduction against taxable income, and which are discussed below.

2.2 Special Incentives for Technology Investments

While there is no patent box regime in Kenya, there is an important provision in the ITA which allows for expenditure of a capital or revenue nature incurred in scientific research for the purposes of business carried on to be fully deducted in a year of income. This is unlike other types of capital expenditure which are not deductible in full against income but are instead capitalised and receive capital allowances according to the applicable rates.

It is, however, important to note that the ITA provides that the following expenditure falls within the meaning of "scientific research":

- expenditure of a capital nature on scientific research;
- expenditure not of a capital nature on scientific research;
- a sum paid to a scientific research association approved for the purposes of this paragraph by the Commissioner as being an association which has as its object the undertaking of scientific research related to the class of business to which the business belongs; or
- a sum paid to a university, college, research institute or other similar institution approved for the purposes of this paragraph by the Commissioner for the scientific research mentioned above.

In addition, the following technology-related capital allowances are available:

- computer software – 20% on cost;
- telecommunication equipment – 20% on cost; and
- Indefeasible Right of Use on fibre optic cable – 5% on cost.

The ITB proposes to amend the above rates by introducing the following technology-related investment allowances:

- computer software – 25% on cost;
- telecommunication equipment – 10% on cost; and
- Indefeasible Right of Use on fibre optic cable – 10% on cost.

2.3 Other Special Incentives

The ITA provides various specific tax incentives, particularly geared towards investment. They include Investment Deduction (ID) currently pegged at 100% on buildings and machinery used for manufacturing purposes; ID at 150% on the construction of a building, or purchase and installation of machinery valued for at least KES200 million and undertaken outside the city of Nairobi or the municipalities of Mombasa or Kisumu. Industrial Building Allowances (IBA) range between 10% and 25% for industrial and hotel buildings and educational and training buildings; Mining Deductions Allowance (MDA) is at a rate of 40% in the first year and 10% for the remaining six years on a straight-line basis; and Farm Works Deductions (FWD) are at the rate of 20% on a straight-line basis for five years of income.

In the real estate sector, developers who construct 100 residential units annually enjoy a 15% corporate tax, subject to the approval of the Cabinet Secretary for housing. Further, for local motor vehicle assemblers, a 15% corporate tax rate applies for the first five years from commencement of operations, provided that such 15% corporate tax rate can be extended for a further five years if the company achieves a local content equivalent to 50% of the ex-factory value of the motor vehicles.

However, the ITB proposes to amend the above tax incentives by introducing the following investment allowance provisions:

- buildings used for manufacturing purposes (in the first year of use) – 100%;
- machinery used for manufacturing purposes – 100%;
- hotel buildings - 60% in the first year of use and 25% per annum in subsequent years in equal instalments;
- educational and training buildings – 10% per annum in equal instalments; and
- FWD at the rate of 100%.

Companies in the Export Processing Zones (EPZs) enjoy a ten-year corporate tax holiday and a 25% tax rate on profits thereafter (except for commercial activities). EPZ companies also enjoy a ten-year withholding tax holiday, as well as exemption from payment of import duty, stamp duty and VAT.

Effective 1 January 2016, a concessionary rate of 10% corporate tax is applicable for companies under the Special Economic Zones (SEZs) regime and a 15% rate is applicable for the subsequent ten years, with these entities enjoying exemption from all other taxes and levies.

The ITB, however, proposes that companies in EPZs shall be taxed at 10% for the first ten years from date of first operation and thereafter 15% for another ten years, after which they shall be taxed at the resident corporate tax rate of 30% to ensure consistency between the corporate tax rates for EPZs and SEZs.

2.4 Basic Rules on Loss Relief

With effect from 1 January 2016, tax losses are deductible in the year in which they are incurred and can be carried forward for the subsequent nine years. If the losses are not exhausted within those nine years, an application can be made to the Commissioner of Domestic Taxes (the "Commissioner") to extend the period for claiming the tax losses beyond this period of ten years. The Cabinet Secretary for the National Treasury has powers to extend the tax loss utilisation period indefinitely. The ITB proposes to retain the ten-year tax loss utilisation period but upon expiry of the period the Cabinet Secretary can only extend the tax utilisation period tby a maximum of two years.

For companies in the mining, oil and gas industries, any losses incurred in a year of income can be carried forward indefinitely. These companies are also allowed to carry back tax losses for a period of three years, from the year of income in which the loss arose and operations ceased. The licensee or contractor is, however, required to apply to the Commissioner to allow the tax loss carry-back. The ITB, however, proposes to limit the period of carrying losses forward for companies in the mining, oil and gas industries to 14 years.

2.5 Imposed Limits on Deduction of Interest

Kenya has thin capitalisation rules which restrict the deductibility of interest of a resident company in the following circumstances:

- Where a company is "controlled" by a non-resident person alone or together with four or fewer other persons; and
- The company's debt-to-equity ratio exceeds 3:1.

A company is considered to be "controlled" by a non-resident person where the non-resident person holds 25% or more of the issued share capital in the company. "Debt" is deemed to comprise all types of financial indebtedness while "equity" is deemed to comprise all classes of share capital (including redeemable preference shares). Where the debt-to-equity ratio exceeds 3:1 such a company is said to be thinly capitalised and the interest on the loan which exceeds the ratio will be non-deductible for tax purposes. Additionally, where a company is thinly capitalised the foreign exchange losses (whether realised or unrealised) in respect of loans are deferred and hence not tax deductible until the Kenyan entity ceases to be thinly capitalised.

Thin capitalisation rules do not, however, affect financial institutions licensed under the Banking Act. Additionally, for contractors and licensees in mining and petroleum operations the debt-to-equity ratio for thin capitalisation purposes is 2:1.

The ITB proposes to change the definition of "control" to restrict it further, and the ratio is proposed to be reduced to 2:1.

The ITB has also proposed to lower the thin capitalisation ratio from 3:1 to 2:1 but limit the definition of "debt" for purposes of determining the debt-to-equity ratio to loans from a non-resident person. The reduction in the ratio will lead to a higher interest expense restriction and result in a higher taxable income for companies that exceed the debt-to-equity ratio.

2.6 Basic Rules on Consolidated Tax Grouping

Each company in a group is taxed in its own right and its losses are accounted for separately without affecting the taxation of the other companies in the group. Further, tax losses are not transferable within groups.

Where significant tax losses exist in one group company and not another, transfers of business from one group company to another have been considered with a view to utilising the tax losses in one company by another member of the group. However, this is in practice a complicated process and therefore rarely undertaken.

2.7 Capital Gains Taxation

Capital Gains Tax (CGT) was reintroduced in Kenya with effect from 1 January 2015 after being suspended in 1985. CGT is chargeable on the whole gain which accrues to a resident/non-resident corporation on the transfer of property situated in Kenya, at a rate of 5% of the gain. This gain for CGT purposes is the excess of the transfer value of the property over the property's adjusted cost. The property which is subject to CGT of a company includes goods, choses in action, land and property of every description, whether movable (save for business assets which have enjoyed wear and tear allowance) or immovable; and also obligations, easements and every description of estate, interest and profit, present or future, vested or contingent, arising out of or incident to property.

CGT is only applicable where the property is situated in Kenya, thus the sale of shares in an offshore holding company which owns shares in a Kenyan company (an indirect transfer) does not trigger CGT in Kenya. With effect from 1 January 2016, there is no CGT arising on the sale of securities listed on a securities exchange in Kenya.

There are a number of transactions which are exempt from payment of CGT, primarily: vesting property in a liquidator through a court order; issuance of a company's shares or debentures; and transfer of assets between family members and to a family-owned company among others. A CGT exemption is available in the case of a corporate reorganisation but it is not automatic; it can only be granted by the Cabinet Secretary for the National Treasury, at his/her discretion, having been satisfied that it is in the public interest for him/her to do so.

The ITB proposes to increase the rate of CGT from 5% to 20% but in turn introduces an indexation allowance based on the Consumer Price Indices published by the Kenya National Bureau of Statistics. It is anticipated that the indexation system will cushion sellers from paying CGT on inflationary increases in prices. However, it has been subsequently announced by the Cabinet Secretary for the National Treasury that the 5% CGT rate will be retained.

Further, the ITB proposes to grant CGT exemption for internal business reorganisations that are necessitated by a legal or regulatory requirement or compulsory acquisition by the government.

It is noteworthy that restructuring transactions by private entities will only be exempt from CGT where such restructuring is undertaken pursuant to a legal or regulatory requirement, as a result of directive or compulsory acquisition by the government or in the public interest and approved by the Cabinet Secretary for the National Treasury.

2.8 Other Taxes Payable by an Incorporated Business

Value-Added tax

Value-added tax (VAT) is a consumption tax charged on the supply of taxable goods or services made in Kenya and on the importation of taxable goods or services into Kenya from outside Kenya. The rate for VAT is either 0% or 16%, with 8% VAT applying on petroleum products. All traders who have a turnover of taxable supplies of at least KES5 million per annum are required by law to register for VAT and charge, collect and remit VAT on their taxable supplies, with an allowance to recover VAT paid on their purchases (input VAT).

Only registered traders are required to charge VAT, though there is an allowance for voluntary registration where the KES5 million threshold has not been met. The supply or importation of goods or services that are designated as exempt are not subject to VAT and as such their sale does not constitute a taxable supply for VAT registration purposes. Zero-rated VAT is applicable to goods and services exported from Kenya, goods and services supplied to EPZs and SEZs, and the supply of coffee and tea for export to coffee and tea auction centres. All zero-rated supplies are considered as "taxable supplies". For imported services, the Kenyan importer is required to account for "reverse charge VAT" only to the extent that such importer makes exempt supplies; as such, an importer of services who makes only taxable supplies would not be required to account for "reverse charge VAT".

Any non-resident person who qualifies for VAT registration but does not have a fixed place of business in Kenya is required to appoint a resident person as his/her tax representative for VAT compliance purposes. Should such non-resident person not do this, the Commissioner has the authority to appoint a tax representative for such non-resident person and apply a penalty of KES200,000 (approximatelyUSD2,000) or imprisonment, upon conviction, for a term not exceeding two years.

Stamp Duty

Stamp duty is charged according to the value of the transaction or the nominal rates on certain financial instruments and transactions. Stamp duty of 1% is payable on the transfer of shares and registration of share capital. However, no stamp duty is charged on the transfer of shares in companies listed on the Nairobi Securities Exchange.

A stamp duty of 4% of the value of the land is payable on the transfer of the land in towns/urban areas, and 2% the transfer of land in rural areas. Land purchased for the expansion and development of schools is exempt from stamp duty, provided the land does not revert to any other use after such a purchase.

Stamp duty also applies at varying rates on registration of debentures and mortgages, on leases and on stamping of various registrable instruments.

Other relevant taxes applicable on goods imported into Kenya are import duty, excise duty, catering levy, import declaration fee (2% of customs value) and railway development levy (1.5% of customs value), subject to specific exemptions. Import duty is charged on the importation of goods depending on their nature and value. Import duty ranges from the rate of 0% on raw materials, 10% on semi-finished goods and 25% on fully finished goods, in accordance with the East African Community Common External Tariff. Certain imported and locally manufactured goods also attract excise duty at varying rates based on either *ad valorem* (value) or quantity of the excisable goods or services.

3. Division of Tax Base Between Corporations and Non-Corporate Businesses

3.1 Closely Held Local Businesses

Most closely-held local businesses operate in corporate form as private limited liability companies. As indicated above, although legislation on LLPs was introduced in 2012, limited liability companies remain the predominant investment vehicle.

3.2 Individual Rates and Corporate Rates

The highest Pay As You Earn (PAYE)/employee tax rate is 30%, which is applicable to employment income above KES564,709 (approximately USD5,647), and is largely comparable to the resident corporate tax rate of 30%. There are as such no rules to prevent individual professionals from earning income at corporate rates.

3.3 Accumulating Earnings for Investment Purposes

If, in the opinion of the Commissioner of Domestic Taxes, dividends have not been paid out to shareholders which ought to have been paid out within a period of 12 months after a company's accounting year-end, the Commissioner may deem such dividends as having been distributed and charge withholding tax thereon.

The ITB proposes to give the Commissioner power to direct that an amount not less than 60% of the accounting profits shall be deemed as having been distributed as dividends.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Any distribution, whether in cash or kind, made before or during winding-up by a company to its shareholders with respect to their equity interest in the company is regarded as dividends for purposes of taxation. Further, the Finance Act, 2018 amended the ITA to expand the definition of dividends to include the following transactions:

- cash or assets are distributed/transferred by a company to a shareholder for the benefit of the shareholder or to a person related to the shareholder by a company;
- the shareholder or a person related to the shareholder is discharged from an obligation measurable in money which is owed to the company;
- any amount is utilised by the company for the benefit of a shareholder or a person related to the shareholder of a company;
- any debt owed by a shareholder or a person related to the shareholder to a third party is settled by the company; or
- amounts representing additional taxable income or reduced assessed loss of a company arising from a transaction with a shareholder or a person related to the shareholder of the company.

In addition to the expanded definition under the Finance Act, 2018, the ITB provides that the following shall also be considered dividends:

- where profits (including profits realised on the disposal of assets) are distributed when a company is being voluntarily wound up; or

- where a company issues ordinary shares, debentures or redeemable preference shares to its shareholders at a discount, the difference between the market value of the shares and the price at which the shares are issued to the shareholders shall be deemed to be a payment of a dividend.

The above transactions will therefore be deemed to be a distribution of dividends and thus subject to withholding tax.

For dividends paid to Kenyan residents or to citizens of the East African Community, the rate of withholding tax on dividends is 5%. A rate of 10% is applicable to non-residents. Where a dividend is paid to a resident company that holds directly or indirectly more than 12.5% of the shares of the underlying company there shall be no withholding tax. This 12.5% exemption does not apply to individual shareholders. The ITB proposes to increase the shareholding threshold for corporate shareholders from 12.5% to 25%.

CGT is applicable at the rate of 5% on the excess of transfer value over adjusted cost on the gains from the sale of unlisted securities. See **2.7 Capital Gains Taxation** for more information.

A company may be liable to a tax known as compensating tax at a rate of up to 42.86%, if it makes a distribution from previously untaxed earnings or income taxed at a rate lower than the applicable corporate tax rate of 30%. In essence, every company resident in Kenya is required to establish and maintain a dividend tax account which matches dividends paid out by the company against incomes which have been subjected to income tax.

Where a company has earned exempt income or income which is subject to a tax rate lower than the corporation tax rate of 30%, and such income is distributed to shareholders by way of dividends, the dividend tax account requires a payment of compensating tax to reduce the balance to zero.

Where a company is liable for compensating tax, it is required to make payment of compensating tax by the end of the sixth month following a company's financial year-end.

The Finance Act, 2018 repeals the compensating tax provisions and replaces it with a new tax on untaxed distributions. Thus with effect from 1 January 2019 where a company distributes dividends from untaxed profits, the company will be charged tax in the year of income in which the dividends are distributed at the resident corporate tax rate (30% in the case of resident companies) on the dividends distributed. The Finance Act, 2018 also does not expressly require companies to maintain a dividend tax account.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Dividends received from a publicly traded company are taxable on the same basis as those received from a private company, ie 5% for a resident and 10% for a non-resident, as a first and final tax.

Gains on sale of shares of publicly traded corporations are subject to CGT on the same basis as shares of private companies, except where the shares of the corporation are listed and traded on a licensed securities exchange in Kenya. Publicly traded shares on over-the-counter (OTC) markets do not receive this exemption from CGT.

In addition, shares in a Kenyan company are considered property situated in Kenya and are therefore subject to stamp duty at the rate of 1% on the higher of the consideration and the market value of the shares as certified by the company's auditor. The transferee in such a case would be responsible for payment of stamp duty.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Royalties are subject to withholding tax at a rate of 5% when paid to resident persons and 20% when paid to non-resident persons, on the gross royalty payment made.

Interest when paid to both resident and non-resident persons is liable to withholding tax at 15% on the gross interest paid, with the exception of interest from housing bonds to resident persons which is subject to withholding tax at the rate of 10% on the gross interest paid. Interest on loans from a foreign source invested in the energy or water sector or in roads, ports, railways or aerodromes is exempt from withholding tax.

Dividends when paid to residents and citizens of the East African Community Partner States are subject to withholding tax at a rate of 5%, while a rate of 10% is applicable to dividends paid to non-residents.

Where a double tax treaty exists between Kenya and a foreign country, lower withholding tax rates for royalties, interest and dividends may apply, if the recipient of such passive income qualifies under the limitation of benefits provisions.

4.2 Primary Tax Treaty Countries

Increasingly, equity investments into Kenya are made through a Mauritius vehicle, although it should be noted that the double tax treaty between Kenya and Mauritius is yet to come into force. Mauritius as a destination is primarily a consideration owing to the wide double tax treaty Mauritius has on the African continent.

Kenya has double tax treaties (which are in force) with a number of countries including the United Kingdom, Germany, Sweden, France, India, Zambia, Canada, Denmark, Norway, Iran, South Korea, Qatar, the United Arab Emirates (UAE) and South Africa. Kenya has also signed double tax treaties with the following countries, but these are not yet in force: Seychelles, Mauritius, Italy, Kuwait, China, East African Community Member States, Portugal, Singapore and the Netherlands.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

Treaty benefits are not available to non-treaty country residents.

The Finance Act, 2014 introduced a restriction on the applicability of double tax treaties that Kenya has concluded with other countries that took effect on 1 January 2015. Under the new restriction (limitation of benefits clause), for a foreign entity to be entitled to the benefits arising from a double tax treaty at least 50% of its underlying ownership should be held by persons who are tax resident in the relevant foreign jurisdiction or the entity should be listed in the stock exchange of the relevant foreign jurisdiction. In effect, benefits under a tax treaty concluded between Kenya and another contracting state shall not be available to a resident person of the other contracting state if 50% or more of the underlying ownership of that person is held by an individual or individuals who are not residents of that other contracting state. ‘Underlying ownership’ is defined as an interest in the person held directly, or indirectly through an interposed person or persons, by an individual or by a person not ultimately owned by the individuals.

The ITB proposes to introduce further restrictions on the applicability of tax treaties that Kenya has concluded with other countries. Under the ITB a foreign entity shall only be entitled to the benefits arising from a double tax treaty if the entity is a company listed on the stock exchange of the contracting state. Where the foreign entity is not listed on the stock exchange of the contracting state, the foreign entity shall only be entitled to the benefits arising from a double tax treaty where at least 50% of the underlying ownership of the company is held by individuals who are residents of the other contracting state in addition to the following requirements:

- the underlying ownership existed for a period of at least 183 days in that year; or
- a person is engaged in the active conduct of business in the other contracting state, other than: (i) operating as a holding company; or (ii) providing overall supervision or administration of a group of companies; or (iii) providing group financing (including cash pooling); or (iv) making or managing investments.

4.4 Transfer Pricing Issues

The Commissioner can conduct an audit and make adjustments in the taxable profit of a company and demand corporate tax where applicable. Particularly, the Commissioner can adjust the profits accruing to a resident company from a course of business conducted with related non-resident persons to reflect such profits as would have accrued if the course of business had been conducted by independent persons dealing at arm’s length. In effect the Commissioner can adjust prices in cross-border transactions involving related parties to reflect an arm’s length price. The onus is on the person who avers the existence of an arm’s length price in respect of related-party transactions to demonstrate it. Therefore, a detailed transfer pricing policy with respect to all related-party transactions should be developed.

A detailed transfer pricing policy is important because the Kenya Revenue Authority (KRA) regularly requests transfer pricing documentation from local corporations with cross-border related-party transactions with the intention of risk-profiling them for the purpose of conducting transfer pricing audits. In particular, inbound management services and payments relating to the use of intellectual property (such as trade marks), marketing and advertising services are ordinarily queried by the KRA.

Transfer pricing applies to transactions between a head office and its subsidiaries and branches as well as between such individual subsidiaries and branches. The ITA considers branches as separate and distinct entities from their head offices for transfer pricing purposes. Under the ITA there are no specific transfer pricing penalties; however, as stated above, the Commissioner can adjust the taxable profit of a company and demand tax where applicable following an audit. The ITB proposes to introduce a penalty of 2% of the value of the transaction where a company fails to provide transfer pricing documentation. The ITB further provides that the imposition of the penalty does not prevent the Commissioner from assessing and recovering any taxes due.

Additionally, the ITB proposes to extend transfer pricing to transactions between resident companies and non-resident companies (including unrelated entities) situated in preferential tax regimes (defined as regimes that have tax rates of less than 16%, do not have effective exchange of information arrangements, do not allow access to banking information or lack transparency on the details of its application including details of: corporate structure, ownership of the legal entities located in the country, beneficial owners of income or capital, or financial disclosure).

Under the current ITA, transfer pricing rules apply only to transactions between related parties. The ITB, however, expands the application of transfer pricing rules to include transactions between parties that are not related, where one of the parties operates in a preferential tax regime or beneficial tax regime.

A beneficial tax regime is defined as a regime anchored in any legislation or regulation that provides a preferential rate of taxation to any income including reduction in the tax rate or tax base. This would include businesses operating in an SEZ or an EPZ.

4.5 Related Party Limited Risks Distribution Arrangements

Limited risk distribution arrangements are common in Kenya, especially in the alcoholic beverages and fast-moving consumer goods sectors. Although limited risk distribution arrangements are usually scrutinised carefully by the KRA, such arrangements will only be challenged where the operations on the ground do not align with the basic principles on which the model is based.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

The Kenyan transfer pricing rules are broadly modelled on the principles set out in the OECD Guidelines. Further, Kenyan courts have used the OECD Guidelines and commentary to form jurisprudence where the domestic tax law does not set out equivalent provisions.

5. Key Features of Taxation of Non-Local Corporations

5.1 Taxing Differences

A local branch of a non-local corporation is treated as a taxable presence of the non-resident person whereas a local subsidiary of a non-local corporation is treated as a resident person for tax purposes.

The corporate tax rate applicable to a local branch is 37.5% of its adjusted annual taxable income. A branch's taxable income comprises gross income earned in or derived from Kenya after deducting expenses wholly and exclusively incurred in the production of income. In ascertaining a branch's taxable income, the local branch's gains or profits realised from a business carried on in Kenya are ascertained with no deductions allowed in respect of expenditure incurred outside Kenya by the non-local corporation head office, other than such expenditure in respect of which the Commissioner determines that adequate consideration has been given in Kenya. The Commissioner may, however, determine such executive and general administrative expenses are just and reasonable in his/her sole discretion as being allowable expenses for tax purposes.

Under the ITA, repatriated profits of a branch are not subject to any further taxes. The ITB, however, proposes to bring to tax at the rate of 10% any notional repatriated income, earned for the year of income. The ITB also proposes to reduce the corporate tax rate for a branch from 37.5% to 30%. Thus effectively the corporate tax rate for a branch and subsidiary under the ITB will be the same (30%).

On the other hand, a local subsidiary is treated as a resident corporation for tax purposes. The tax rate applicable to subsidiaries is 30% of its annual taxable income. However, for a subsidiary with a non-resident shareholder, a further 10% withholding tax is applied on dividends. As such the effective tax rate for a subsidiary is 37%. Therefore, the tax difference between a subsidiary and a branch is not significant, particularly where it is intended that profits are distributed to non-resident shareholders on an annual basis.

5.2 Capital Gains of Non-Residents

CGT is chargeable on the gain accruing on the transfer of property situated in Kenya. However, the Finance Act, 2015 exempted sale of shares in a listed company from CGT, effective as of 1 January 2016. Thus CGT will be applicable where non-residents sell stock in local corporations since the shares are located in Kenya.

Gains accruing from the disposal of shares of a non-local holding company (ie an indirect disposal) will not be subject to CGT in Kenya, based on current law, as this would not constitute property situated in Kenya.

Some double tax treaties signed by Kenya exclude CGT on the sale of shares by a resident of a counterpart contracting state when such person sells shares in a company resident in Kenya. Such a benefit would, however, only accrue where the non-resident seller has fulfilled the limitation of benefits test under the ITA, ie 50% underlying ownership of the non-resident seller owned by tax residents of the foreign counterpart state.

5.3 Change of Control Provisions

Section 54(B) of the ITA imposes an obligation to notify the Commissioner if there is a 10% or more change in the shareholding of a person carrying on business, but imposes no tax obligation on account of an indirect holding change.

A separate taxation regime applies for petroleum companies engaged in the oil and gas industry. Paragraph 14 of the Ninth Schedule to the ITA extends this obligation to cases where there is a 10% or more change in the underlying ownership of a company operating in the mining, oil and gas sector. Underlying ownership is defined as an interest in the person held directly or indirectly through an interposed person or persons, by an individual or by a person not ultimately owned by the individuals. The net gain from the indirect disposal of shares in petroleum companies is subject to tax in a manner similar to taxation of assignment of rights, as below:

- where the interest derived directly or indirectly from immovable property is below 20% of the total value of the interest, the net gain is not taxable;
- where the interest disposed is between 20% and 50%, the net gain will be taxable using a prescribed formula; and
- where the interest disposed is above 50%, the net gain will be fully taxable.

5.4 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

The income of foreign-owned local affiliates is taxed at the resident corporate tax rate of 30%, with no tax distinction being made on account of their foreign shareholding. However, transfer pricing considerations require that all transactions between related parties are at arm's length, failing which the Commissioner can make an adjustment to cater for the application of any price that is not an arm's-length price.

5.5 Deductions for Payments by Local Affiliates

As outlined in **5.1 Taxing Differences**, the local branch's gains or profits realised from a business carried on in Kenya are ascertained with no deductions allowed in respect of expenditure incurred outside Kenya by the non-local corporation head office, other than such expenditure in respect of which the Commissioner determines that adequate consideration has been given in Kenya. The Commissioner may, however, determine such executive and general administrative expenses are just and reasonable in his/her sole discretion as being allowable expenses for tax purposes.

5.6 Constraints on Related Party Borrowing

There are thin capitalisation rules (3:1 debt-to-equity ratio) applicable in Kenya pursuant to the provisions of the ITA which are relevant where the foreign lender is a shareholder in the Kenyan entity. For more see **2.5 Imposed Limits on Deduction of Interest**.

Where a non-resident shareholder has extended a loan to a resident company on an interest-free basis, the resident company is required to calculate a deemed-interest charge based on the prevailing Treasury Bill rates and the withholding tax of 15% remitted to the KRA. To avoid the requirement to account for withholding tax, a notional interest may be charged on the loan, on which withholding tax at 15% would be accounted for (though such interest would need to be at arm's length in accordance with transfer pricing requirements). Lastly, as deemed interest is notional in nature, it would not be considered a tax-deductible expense when calculating the company's taxable profit.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

Business income earned by local corporations is not tax exempt. Section 4(a) of the ITA provides that where a business is carried on or exercised partly within and partly outside Kenya by a resident person (such as a local corporation), the whole of the gains or profits from that business shall be deemed to have accrued in or to have been derived from Kenya. Such income will be taxed similarly to income derived in Kenya. Therefore, foreign income would be taxable at 30% as business income generated by a resident company.

The same is maintained under the ITB.

6.2 Non-Deductible Local Expenses

The ITA provides that all expenses incurred wholly and exclusively in the generation of business income are deductible in calculating the taxable profit of a local corporation.

6.3 Taxation on Dividends from Foreign Subsidiaries

In Kenya, foreign dividend income is exempt from tax. Any expenses which are directly attributable to such exempt income are non-deductible for tax purposes in Kenya.

6.4 Use of Intangibles

The use of a local corporation's intangibles by foreign related parties such as non-local subsidiaries needs to comply with transfer pricing requirements that the price paid for royalties needs to be at arm's length. From a VAT perspective, the use of local intangibles by foreign related parties is considered an exported service for VAT purposes and therefore a zero-rated supply.

6.5 Taxation of Income of Non-Local Subsidiaries Under CFC-type Rules

CFC-type rules do not apply in Kenya for both non-local subsidiaries and branches of local corporations. Section 4(a) of the ITA, however, provides that where a business is carried on or exercised partly within and partly outside Kenya by a resident person, the whole of the gains or profits from that business shall be deemed to have accrued in or to have been derived from Kenya. Such income will be taxed similarly to income derived in Kenya, at a resident corporate tax rate of 30%.

6.6 Rules Related to the Substance of Non-Local Affiliates

Presently, there is no explicit provision that determines the substance of a non-local affiliate company. The current position is that since a non-local company could be resident in Kenya if managed or controlled from Kenya, there is a risk that a non-local affiliate may be deemed to be resident in

Kenya if its directors and shareholders are all located in Kenya. It is, however, the case that the ITA does not state what the position would be if the non-local affiliate company lacks substance but is not managed or controlled from Kenya.

Having said this, where a double tax treaty exists, the ITA restricts a foreign company in a treaty country from accessing double tax treaty benefits in Kenya where at least 50% of underlying ownership is not held by citizens of the treaty country.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

Capital gain on sale of shares in a non-local affiliate is not taxable in Kenya but may be subject to tax in the foreign country where the non-local affiliate is resident.

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

The ITA provides that where the Commissioner is of the opinion that the main purpose, or one of the main purposes, for which a transaction was effected was the avoidance or reduction of liability to tax for a year of income, or that the main benefit which might have been expected to accrue from the transaction in the three years immediately following the completion thereof was the avoidance or reduction of liability to tax, he/she may, if he/she determines it to be just and reasonable, direct that such adjustments shall be made as respects liability to tax as he/she considers appropriate to counteract the avoidance or reduction of liability to tax which could otherwise be effected by the transaction.

The Tax Procedures Act, 2015 also penalises any tax avoidance schemes by a taxpayer. Tax avoidance is defined under the Tax Procedures Act, 2015 as any transaction or scheme designed to avoid liability to pay tax under any tax law. The Tax Procedures Act, 2015 provides that where the Commissioner has applied a tax avoidance provision in assessing a taxpayer, the taxpayer shall be liable to a tax avoidance penalty equal to double the amount of tax that would have been avoided but for the application of the tax avoidance provision. The Commissioner does not have authority to remit/waive a tax avoidance penalty as is the case with other penalties levied under different tax laws.

8. Other

8.1 Regular Routine Audit Cycle

There are no regular routine tax audits in Kenya. However, the practice by the KRA is for audits to be done on a three to five year period as this corresponds to the audit limitation period of five years. In particular, the Large Taxpayers Office of the KRA (which audits companies with turnover of approximately USD10 million and above) usually audits all taxpayers under its ambit every three years.

Tax audits were common in the past, with the KRA making physical visits to a taxpayer's premises to ascertain the taxpayer's level of tax compliance. Section 58 of the Tax Procedures Act, 2015 gives an authorised officer of the KRA the power to inquire into the affairs of a person under any tax law, and full and free access to all lands, buildings and places to inspect all goods, equipment, devices and records, whether in the custody of a public officer or a body corporate or any other person, and make extracts from or copies of those records.

However, since 2015, the KRA has adopted a more data-driven approach with the onset of the KRA's online portal, *i* Tax. *i* Tax allows taxpayers to update their tax registration details, file tax returns, register all tax payments and make status enquiries in real time. The KRA routinely requests transfer pricing documentation from all taxpayers with cross-border related-party transactions with the intention of risk-profiling them for the purpose of conducting transfer pricing audits. In this regard, all multinationals are potential targets for transfer pricing/ permanent establishment audits. In addition, the KRA has in the recent past focused on the audit of VAT refund claims made by Kenyan VAT registered persons making exports of services, and raised tax assessments on IT and software companies providing cross-border services.

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