

**Deloitte.**



**Current and Deferred Tax:**

Solving the Puzzle

February 2020

# Current Tax

# Outline

- Introduction
- Imposition of Income Tax
- Ascertainment of Total Income-  
Deductions allowed and  
deductions not allowed
- Capital deductions
- IFRS 16 and current tax
- Changes arising from Finance  
Act 2019



# Income Tax in Kenya

## Administration

- The National Treasury (formerly Ministry of Finance)
- Kenya Revenue Authority (KRA)
- Domestic Taxes Department deals with Income Tax, Value Added Tax and Excise duty
- Domestic Taxes Department that includes Medium and Small Taxpayers (MST) Office and Large Taxpayers Office (LTO)
- Investigations & Enforcement

## Applicable law

- Income Tax Act (ITA)
- Tax Procedures Act (TPA)
- Subsidiary legislation - Schedules, Income Tax Rules
- Income Tax Departmental / Administrative instructions
- Case Law

# Kenyan Tax structure

## Direct Taxes

- Income Tax-Corporate & Individual

## Indirect Taxes

- Value Added Tax
- Excise duty
- Customs Duty

## Other Taxes/levies

- Stamp duty
- Airport Tax
- Catering levy
- Standards levy
- Road maintenance levy
- Import Declaration Fee (IDF)
- Railways Development Levy (RDL)
- Second hand motor vehicle purchase tax

# Imposition of Income Tax



# Basis of charge to tax

- Tax is charged on the basis of source and/or residence
- Income Tax is charged on all income of a person whether resident or non-resident which accrues in or is derived from Kenya
- For business carried on partly within and partly outside Kenya, the whole of the profit from that business is taxable in Kenya, e.g. transporters

# Charge to tax

## Resident companies

### **A company is resident for any year of income if:**

- It is incorporated under a Law in Kenya
- Management and control is exercised in Kenya
- It has been declared resident by a notice in the Kenya Gazette by the Cabinet Secretary for the National Treasury

## Non-resident companies

### **Non-resident company with a permanent establishment in Kenya:**

- A permanent establishment is a fixed place of business e.g. a branch or a Liaison office. A building site, a construction or assembly project which has existed for six months or more is deemed to be a fixed place of business
- Tax on income of such an entity will be determined at the prevailing non-resident tax rate
- The significance of resident and non-residence is that the rates of corporate tax are 30% and 37.5% respectively;
- There are other favorable rates to incentivize certain sectors or industries.



# Charge to tax – source

## Chargeability to tax – Individuals

- Non-residents - income paid by a resident employer or permanent establishment of a non resident employer
- Resident individuals – Kenya and worldwide employment income
- Communication apparatus established in Kenya
- Farming, mining, manufacturing operation in Kenya
- Property located in Kenya
- Funds collected in Kenya by banks

## Residence rules for individuals

- Permanent home and presence in Kenya in that year of income
- No permanent home, but:
  - 183 days presence in Kenya in that year of income.
  - 122 days or more in that year and each of the two preceding years

# Taxable income constitutes

## Gains or profits from:

- Any business
- Use or occupation of property – rent
- Capital gains (effective 1 January 2015)
- Dividends
- Interest

## Sundry Income:

- Insurance claims
- Releases from provisions
- Trading receipts
- Balancing charges (business ceased)
- Any other deemed taxable income

What are your **sources of income**? Do they constitute taxable income?

Do you generate any **exempt income**? And how do you currently treat the **exempt income** and **related expenses** for tax purposes?

Ascertainment of  
Total Income-  
deductions allowed  
and deductions not  
allowed



# General rules

- Wholly and exclusively incurred in the production of chargeable income - allowable business expenses
- Not wholly and exclusively incurred in the production of income - non-business expense disallowed
- Revenue expenditure – allowable
- Capital expenditure – not allowable

# Allowable deductions

- Bad and doubtful debts (specific)
- Capital deductions
- Advertisements
- Losses of business income brought forward from prior years (carry forward limited to four years from 2010)
- The period for carrying forward tax losses now extended to ten years from the current five years. Taxpayers with huge capital investment had faced a risk of losing the benefit due to the short period of tax loss utilization
- Pre-trading expenses
- Repairs and maintenance
- Lease rentals
- Diminution in value of implement, utensil or similar article employed in production of gains or profits (plant and machinery not included)
- Legal costs & incidental expenses for purposes of listing in NSE without raising additional capital

# Allowable deductions

- Contributions to a registered pension or provident fund;
- Legal and incidental costs relating to authorization and issue of shares and securities to the public
- Legal costs and stamp duty relating to leases for premises if the lease does not exceed 99 years
- Non-resident branch taxes where the income is taxable in the hands of the Kenyan parent company
- Cash donations to registered charitable organizations whose income is exempt from tax or any project approved by the Cabinet Secretary for the National Treasury
- Capital expenditure on the construction of public schools, hospitals, roads or any similar social infrastructure (CS's prior approval required);
- Expenditure on sponsoring sporting activities with the prior approval of the Cabinet Secretary responsible for sports.
- Tax rebate of 50% of the amount of salaries and wages to employer who engages at least 10 university graduates as apprentices for a period of 6 to 12 months.

# Deductions not allowed

- Capital Expenditure
- Software
- Provisions
- Expenses for personal use
- Depreciation and amortization
- Contributions to unregistered pension schemes or funds
- Income taxes
- Excess interest under thin capitalization (from 12 June 2010 includes deemed interest on interest free loans)
- Subsidiary or related entity costs
- Trade subscriptions made to trade associations that are not taxed
- Staff medical insurance expenses paid to insurance companies that are not registered with IRA
- Shareholders costs
- Bad debts that do not meet the commissioners guidelines



# Capital Deductions



# Capital deductions

These are deductions/incentives provided to businesses under the Income Tax Act

They include:

- Investment Deduction
- Industrial Building Deductions
- Commercial Building Deductions
- Mining Deductions
- Farming Deductions
- Wear & Tear Deductions including software deductions

# Capital deductions

These are deductions/incentives provided to businesses under the Income Tax Act

## Investment Deduction

- Available for buildings and machinery used for manufacturing
- Manufacturing means the *making (including packaging) of goods or materials from raw or partly manufactured materials or other goods, or the generation of electrical energy for supply to the national grid or the transformation and distribution of electricity through the national grid but does not extend to any activities which are ancillary to manufacture, such as design, storage, transport or administration*
- Claimable at a rate of 100%.
- 150% where the investment is outside Nairobi, Mombasa and Kisumu but value of investment is at least KES 200m

# Capital deductions

## Industrial Building Allowance

10% per annum on qualifying cost of industrial building.

Industrial building include:

- Mills, factories
- Docks, bridges, water and electricity works
- Storage e.g. godowns
- Prescribed dwelling houses
- Civil works or structures
- Hotel buildings

50% for hostels or educational buildings

25% for rental residential buildings



# Capital allowances

## Farm works Allowance

- Available in a year of income the owner or tenant of ***agricultural land*** incurs capital expenditure on the construction of farm works
- Agricultural land means land occupied wholly or mainly for the purposes of a trade of husbandry;
- Farm works" means farmhouses, labour quarters, any other immovable buildings necessary for the proper operation of the farm, fences, dikes, drains, water and electricity supply works other than machinery, windbreaks, and other works necessary for the proper operation of the farm.

# Capital deductions

## Wear & Tear deductions

### **Capital Deductions on machinery. Machinery includes:**

- Vehicles
- Ship
- Aircraft
- Plant & machinery
- Software
- Furniture and fittings
- Office equipment

# Capital allowances

Classes of machinery	Rates (%)
I. Tractors, combine harvesters, heavy earth moving equipment, other self-propelling machines of similar nature (including buses and lorries)	37.5
II. Computer and related hardware, calculators, copiers and duplicating and fax machines	30
III) Other vehicles and aircrafts	25
IV) All other machinery, including ships	12.5

## Software

- Prior to 2009 there was uncertainty on claiming capital deductions on software
- Finance Bill 2009 introduced a rate of 5% period between 12 June 2009 and 31 December 2009
- Finance Act 2009 set the rate to 20% but effective from 1 January 2010

# Capital deductions

## Commercial Building Deductions (CBA)

- Commercial building includes a building for use as an office, shop or showroom but does not include a building which qualifies for any other deduction
- Available effective from 1st January, 2013
- Entails capital expenditure on the construction of a commercial building including roads, power, water, sewers and other social infrastructure
- Capital allowance rate -25% applied on a straight line basis



# Current tax-Determination

<b>Start</b>	Profit before tax per accounts
<b>Add</b>	Non-allowable expenses
<b>Less</b>	Exempt/non-taxable income
<b>Less</b>	Capital allowances
<b>Result</b>	Adjusted profit/(loss) for tax
<b>Less</b>	Current tax payments (withholding tax, instalments, advance taxes)
<b>End</b>	Current tax liability/(asset)

# **IFRS 16 implications**



# IFRS 16

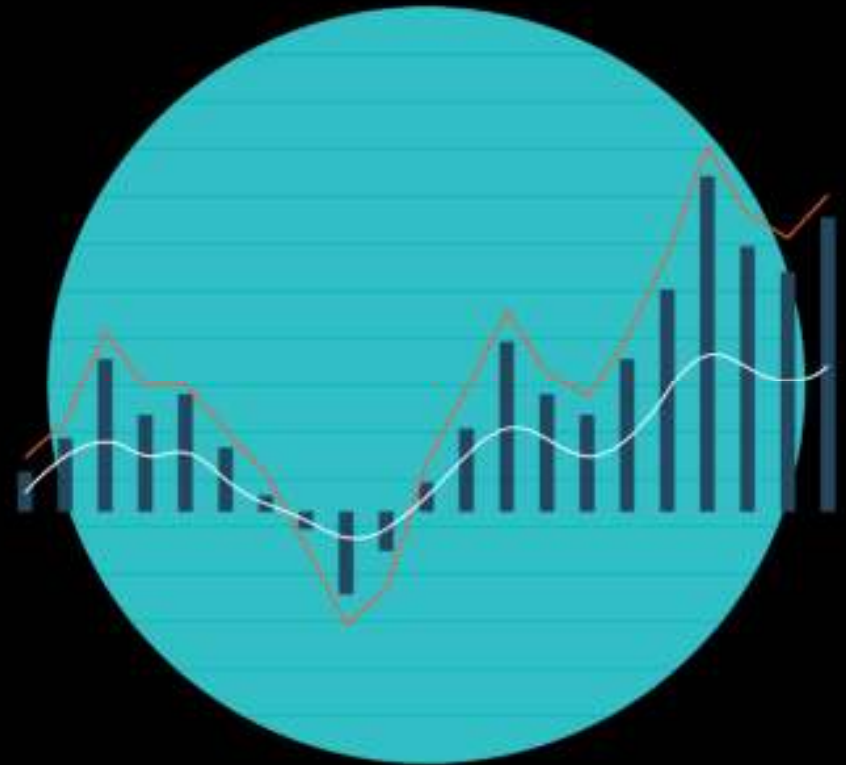
The International Accounting Standards Board (IASB) in 2016 promulgated a new standard on the accounting for leases; IFRS 16. This standard effectively replaced IAS 17, accounting for leases with effect from January 2019. The standard eliminated the distinction between operating and finance lease initially provided for by IAS 17. Effectively, IFRS 16 introduced:

1. A new lease asset (representing the right to use the leased item for the lease term) and lease liability (representing the obligation to pay rentals) for all leases except for the exempted short term leases (12 months or less) and low value asset leases. Leases are 'capitalized' by recognizing the present value of the lease payments and showing them either as lease assets (right-of-use assets) or together with property, plant and equipment;
2. Depreciation - Paragraph 32 of IFRS 16 provides that if ownership will transfer to the lessee, then depreciation on the right of use asset will be calculated on a straight line basis on the life of the asset. If however the ownership does not transfer to the lessee, then the depreciation will be calculated on the shorter of the useful life of the asset or lease term;
3. Interest expense on lease liabilities; and
4. Separate the total amount of cash paid into a principal portion (presented within financing activities) and interest (typically presented within either operating or financing activities) in the cash flow statement.

## Tax Implication of Adoption of IFRS 16

- Depreciation on the right of use of the asset will not qualify as a corporate tax deduction based on the provisions of Section 16(1) (b) of the Income Tax Act, which prohibits a deduction in respect of “capital expenditure, or any loss, diminution or exhaustion of capital”.
- Interest expense is an allowable cost for corporation tax in line with the provision of the ITA. Where this interest expense is unwound in CBAI’s profit and loss account, there will be no further corporate tax implications.
- The lessor should ideally be entitled to a deduction of the full amount of the lease payments made to the lessor. This deduction is normally effected manually on the tax computation as the lease payments will not be line items in the profit or loss account.
- Any reversals of the IFRS 16 entries in the financial statements are not expected to have any impact on corporation tax given that the entries are expected to have been made in this financial year. Ideally, reversals should not cause any variance.

# Finance Act 2019 Changes



# Changes introduced by Finance Act 2019

## **Taxation of the digital economy**

### **The measure**

Finance Act 2019 (the Act) has introduced a new paragraph under Section 3 of the Income Tax Act, which provides emphasis that income accruing through a digital marketplace is chargeable to tax.

The Cabinet Secretary(CS) for the National Treasury has also been empowered to publish regulations that will provide the mechanisms of subjecting such income to tax.

Digital market place has been defined to mean “a platform that enables the direct interaction between buyers and sellers of goods and services through electronic means”.

## **Companies implementing projects under the affordable housing scheme**

### **The measure**

The Income Tax Act has been amended in Section 16(2)(j) by introducing a provision that excludes companies implementing projects under the affordable housing scheme from the interest deductibility restrictions because of thin capitalization.

# Changes introduced by Finance Act 2019

## Clarification of the scope of compensating tax

### The measure

The Finance Act has introduced a provision under Section 7A of the Income Tax Act, which excludes any income that is exempt from tax under the Income Tax Act from the compensating tax regime.

## Non-resident ship owners to pay tax on demurrage charges

### The measure

The Act has amended the ITA by introducing a provision in Section 9 (1), which clarifies that all income of a non-resident ship owner, including demurrage charges, fall within the scope of the taxable income of a non-resident ship owner.

## Interest income accruing from green bonds with at least 3 years maturity

### The measure

The First Schedule to the Income Tax Act has been amended by including interest income accruing from all listed bonds, notes or other similar securities used to raise funds for infrastructure, projects and assets defined under Green Bonds Standards and Guidelines, and other social services in the list of incomes exempt from tax.

These securities should however have a maturity period of at least 3 years for the interest income to be exempt from tax.

# Changes introduced by Finance Act 2019

## **Tax exemption extended to investee companies of Real Estates Investment Trusts (REITs)**

### **The measure**

The Income Tax Act has been amended in Section 20 by extending income tax exemptions to investee companies of REITs.

Investee companies of REITs are companies through which REITS hold property.

## **Capital gains tax (CGT) rate to be maintained at 5%**

### **The measure**

The proposal contained in the Finance Bill 2020 to increase the rate of capital gains tax from 5% to 12.5% has been dropped.

## **CGT exemptions on corporate re-organizations**

### **The measure**

The Act has amended Paragraph 13 of Eighth Schedule to the Income Tax Act by introducing CGT exemptions on the transfer of property that is necessitated by a transaction involving the incorporation, recapitalisation, acquisition, amalgamation, separation, dissolution or similar restructuring of a corporate entity as a result of:

- a. legal or regulatory requirement;
- b. directive or compulsory acquisition by the government; or
- c. an integral restructuring within a group which does not involve a transfer to a third party.



# Changes introduced by Finance Act 2019

## **Repeal of Section 72D**

### **The measure**

Section 72D of the Income Tax Act, which provided for a penalty of 20% on late payment of tax, has been repealed.

## **Reduced tax rate for a company operating a plastics recycling plant**

### **The measure**

The Act has introduced a reduced corporate tax rate of 15% to any company operating a plastics recycling plant. The rate will be applicable for the first five years from the year of commencement of the company's operations.

## **Income of the National Housing Development Fund exempted from tax**

### **The measure**

The scope of income tax exemptions under the First Schedule to the ITA has been expanded to include the income of the National Housing Development Fund.

# Q & A



# Principles of Deferred Tax



# Outline

- Definitions
- Objectives of IAS 12
- Determine and recognize Current Taxes
- Determine and recognize Deferred Taxes
- Things to note
- Model example



# Definitions

- **Current tax:**-The amount of tax estimated to be payable or recoverable in respect of the taxable profit or loss for a period, along with adjustments to estimates in respect of previous periods.
- **Deferred tax:**-Estimated future tax consequences of transactions and events recognized in the financial statements of the current and previous periods
- **Deferred tax liabilities:** the amounts of income taxes [i.e. corporation tax] payable in future periods in respect of taxable temporary timing differences.
- Deferred tax assets are the amounts of income taxes [i.e. corporation tax] recoverable in future periods in respect of (a) deductible temporary differences (b) the carry forward of unused tax losses; and (c) the carry forward of unused tax credits.

# Definitions

- **Timing differences:**- differences between an entity's taxable profits and its results as stated in the financial statements that arise from the inclusion of gains and losses in tax assessments in periods different from those in which they are recognized in financial statements. Timing differences originate in one period and are capable of reversal in one or more subsequent periods.
  - If the income, or expense, is taxed wholly or partially in another period, an accrual for tax is needed in this period to reflect this.
  - A timing difference means that:
    1. A transaction is recorded in a different period from a tax point of view as opposed to an accounting point of view.
    2. At a point in time, the transaction will be recorded from both an accounting and tax perspective.
    3. The only issue is that they were recorded in separate accounting periods and as a result deferred tax must be raised.
- **Temporary differences:**-differences between the carrying amount [i.e. book value] of an asset or liability in the balance sheet and its tax base [i.e. tax value].

# Definitions

- Permanent differences: - Differences between taxable income and reported income for a period that originate in the current period and will not reverse in subsequent periods.”
- A permanent difference occurs when:
  - There is a difference between an accounting treatment as opposed to the tax treatment.
  - The different treatment will never change; consequently there will always be a disparity between tax and accounting results

# Objectives of IAS 12

- The objective of IAS 12 is to prescribe the accounting treatment for income taxes.
- The principal issue in accounting for income taxes is how to account for the current and future tax consequences of:
  - transactions and other events of the current period that are recognized in an entity's financial statements; and
  - the future recovery (settlement) of the carrying amount of assets (liabilities) that are recognized in an entity's balance sheet.
- An entity will always recognize an asset or liability because it expects to recover or settle the carrying amount of that asset or liability. If it is probable that recovery or settlement of that carrying amount will make future tax payments larger (smaller) than they would be if such recovery or settlement were to have no tax consequences, this Standard requires an entity to recognize a deferred tax liability (deferred tax asset), with certain limited exceptions.



# Current tax



# Current tax

- It is the tax that the entity expects to pay (recover) in respect of a financial period. It is that determined in accordance with the rules established by the tax authorities, upon which income taxes are payable (recoverable)
- IAS 12's basic requirement is that, to the extent that current tax for the current and prior reporting periods is unpaid, it should be recognized as a liability. Conversely, if the amount already paid in respect of current and prior period exceeds the amount due for those periods, the excess should be recognized as an asset (IAS 12:12).
- Similarly, an asset is recognized if a tax loss can be carried back or recover the current tax paid in an earlier period.
- Generally, Current tax is recognized in profit and loss.
- In other cases, it is recognized in equity through other comprehensive income.

# Deferred tax

Deferred tax is neither deferred, nor tax: it is an accounting measure, more specifically an accrual for tax.

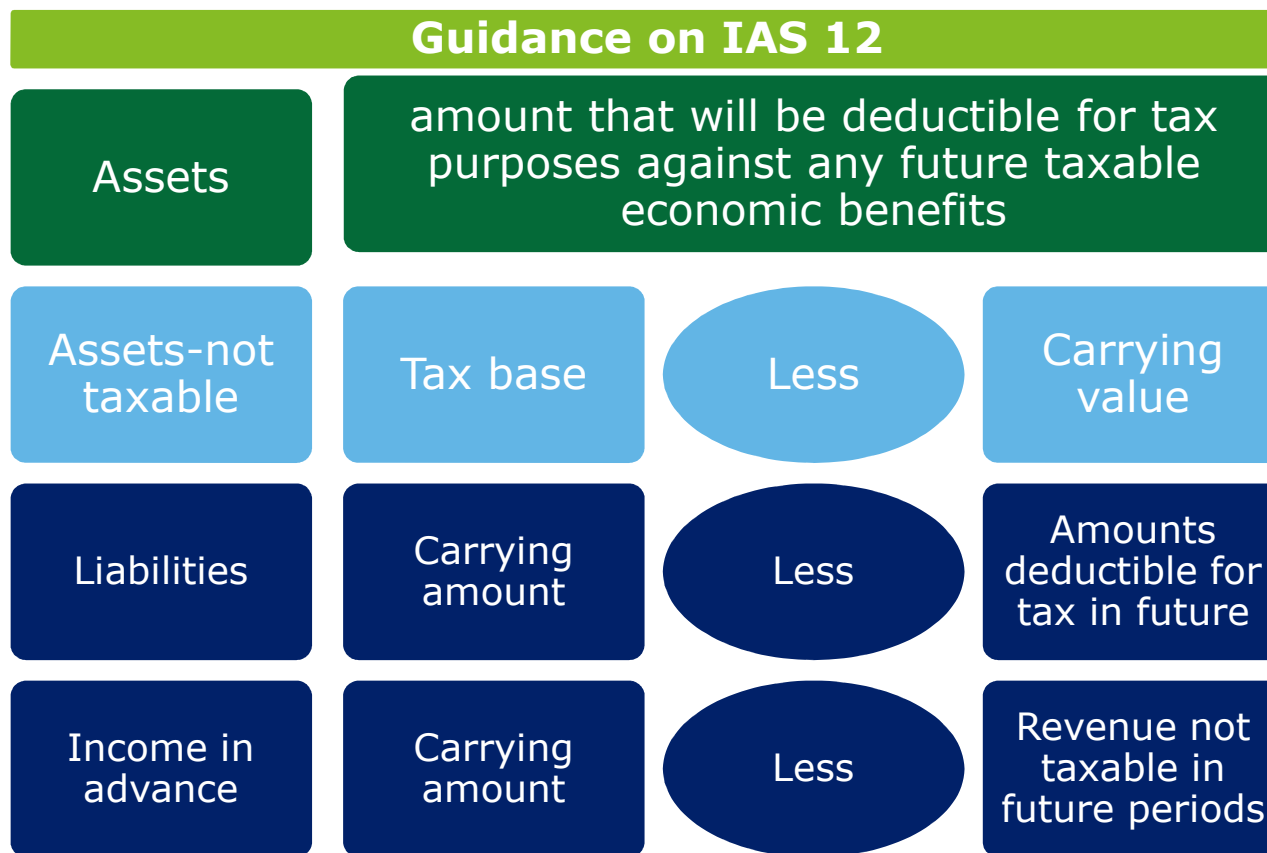
# Deferred tax

- IAS 12 focuses on the balance sheet by recognizing the tax effects of temporary differences.
- Deferred tax liabilities are defined as the amounts of income taxes payable in future periods in respect of taxable temporary differences. [IAS 12:5]
- Deferred tax assets are defined as the amounts of income taxes recoverable in future periods in respect of:
  - deductible temporary differences;
  - the carryforward of unused tax losses; and
  - the carryforward of unused tax credits.
- Deferred tax should:
  - be recognized in respect of all timing differences that have originated but not reversed by the balance sheet date;
  - not be recognized on permanent differences.

# Deferred tax-Calculation steps

## Step 1: Calculate the tax base

**Tax base:** *The amount attributed to an asset or liability for tax purposes*



# Deferred tax-Calculation steps

## Step 2: Calculating the temporary difference

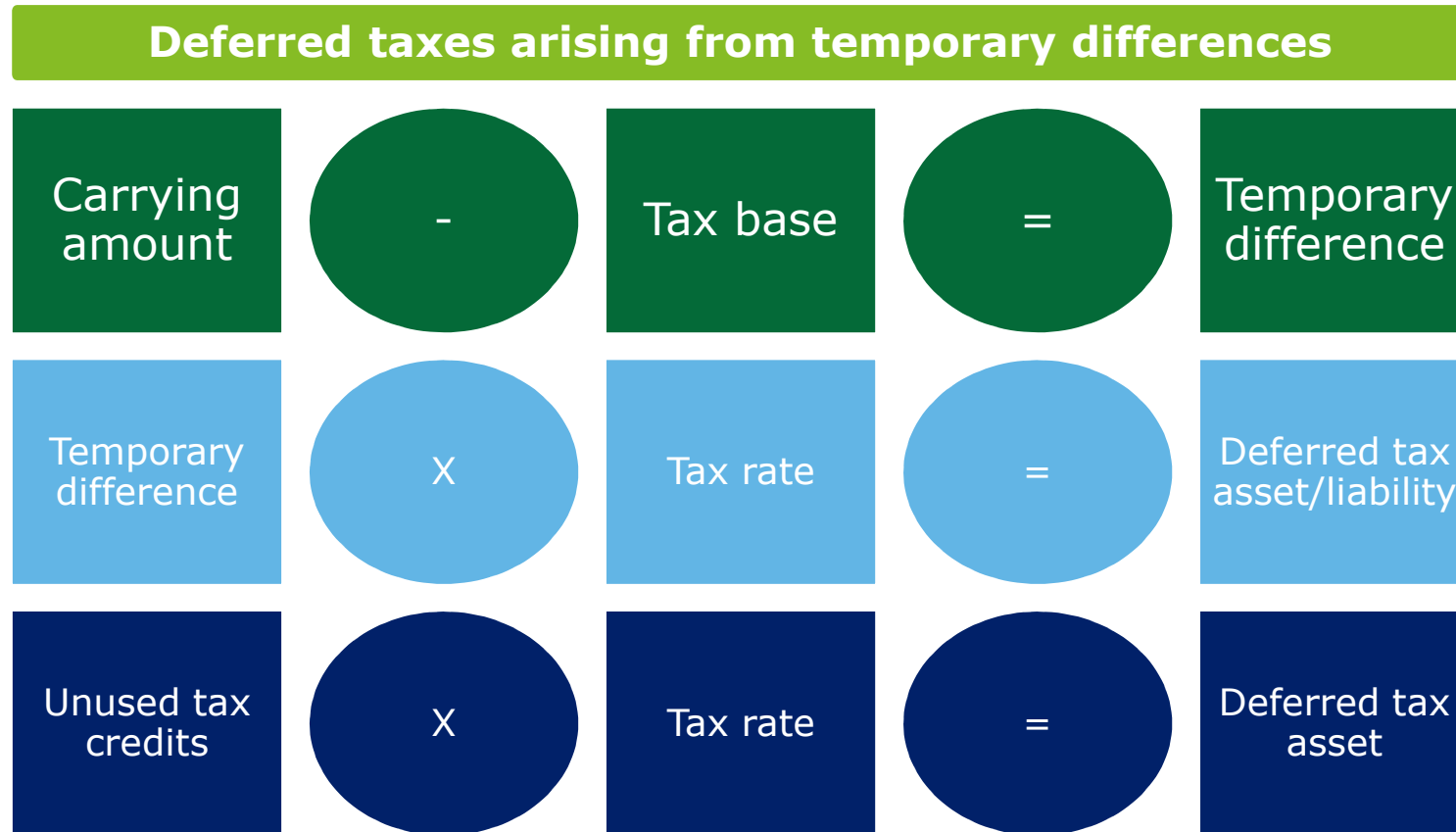
- Temporary differences are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base. Temporary differences may be either: taxable temporary differences or deductible temporary differences.
- Taxable temporary differences: Temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled
- Deductible temporary difference: Temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled
  - Examples of temporary differences:
    - Accelerated capital allowances;
    - Provisions for doubtful debts;
    - Tax losses carried forward;
    - General provisions

## Deferred tax-Calculation steps

Step 3: Determine the temporary differences that give rise to deferred tax

# Deferred tax-Calculation steps

## Step 4: Calculating the temporary difference

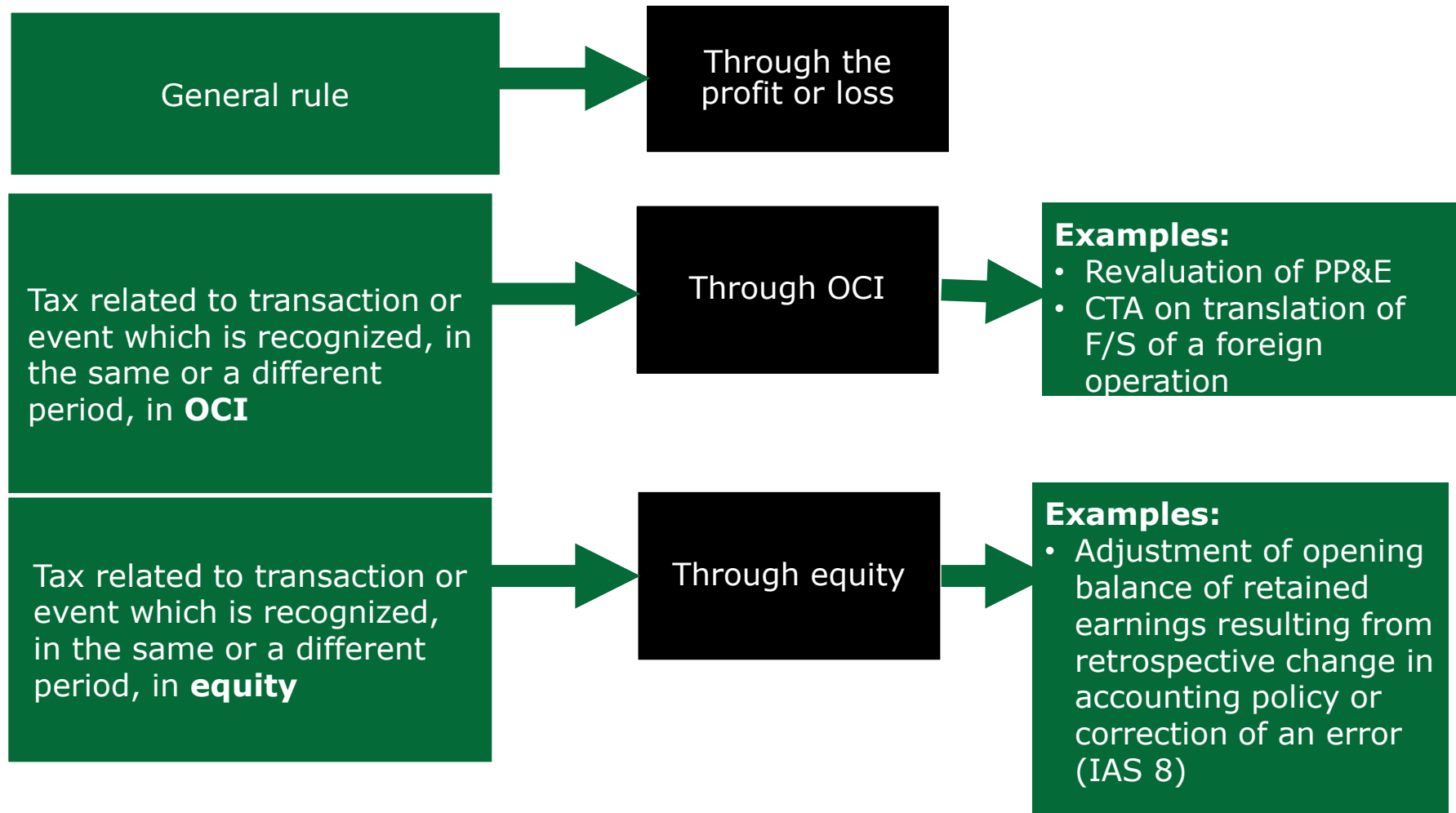




# Things to note



# Recognition of current and deferred tax



# Tax disclosures

- Tax numbers feeding into the financial statements:
  - Income tax charge:
    1. Current tax
    2. Deferred tax-of each type of temporary difference and unused tax loss;
    3. Prior year adjustments (current tax, deferred tax, per assessments/returns)
  - Deferred tax asset/liability;
  - Current tax asset/liability;
  - Cash payments;
  - Proof of tax, showing major categories of permanent differences.
- Other numbers of management interest
  - Proof of tax rate-reconciliation between the standard and effective tax rate. Reconciling items are p/differences, assessed losses utilized.

# Tax disclosures

- When preparing a tax computation, the primary risk normally relates to permanent differences, as timing/temporary differences will only affect the split between the current tax account and deferred tax balance on the balance sheet. There will be no effect on the income statement.
- There are some exceptions to the rule:
  - A change in tax rate / transition levy
  - The company is in an assessed loss position, with a deferred tax credit balance i.e. The assessed loss is not sufficient to wipe out deferred tax
  - The company is in deferred tax asset position - either due to the assessed loss or net reversing timing differences, and a deferred tax asset has not been raised.

# Review of a model deferred tax computation

# Q&A





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