

How the new tax rules on natural resource income affect the upstream oil, gas and mining sector in Kenya



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Definitions

Unless the context otherwise requires, the following words and acronyms used in this publication have the meaning ascribed to them below:

CGT: Capital Gains Tax;

GDP: Gross Domestic Product;

GoK: Government of Kenya;

IMF: International Monetary Fund;

IRR: Internal Rate of Return

KITA: Kenya Income Tax Act;

KRA: Kenya Revenue Authority;

NPV: Net Present Value;

PE: Permanent Establishment;

PEPA: Petroleum Exploration and Production Act;

TITA: Tanzania Income Tax Act;

UITA: Uganda Income Tax Act;

WHT: Withholding tax.

Introduction

The KRA recently issued guidelines with respect to the imposition of income tax by way of WHT on natural resource income. These guidelines in Appendix 1 are however brief and do not comprehensively address all the related queries that taxpayers may have.

Kenya now follows in the path of Uganda and Tanzania who already apply income tax on the same albeit with variations in the mechanics of operation. This new tax measure took effect from 1 January 2015. It was however dwarfed by the re-introduction of CGT and the new rules regarding the taxation of the extractive industry that hogged media headlines and gripped public attention.

In this publication, we discuss the operation and impact of this new tax measure on the upstream oil, gas and mining industry but also briefly highlight how other natural resources are affected. We also provide a comparative overview of Uganda and Tanzania's approaches to the taxation of natural resource income.



3. Chargeability of natural resource income

Section 3(2) (g) of the KITA as amended imposes income tax for each year of income on natural resource income earned by resident or non-resident persons to the extent it is sourced in Kenya. The definition of natural resource income under the KITA as amended substantially mirrors that of Uganda and Tanzania. We have discussed this in the comparative section of this paper.

Natural resource income is defined under section 2 of the KITA as:

- An amount including a premium or such other amount paid as consideration to take minerals or a living or non-living resource from land or sea or;
- An amount calculated in whole or part by reference to the quantity or value of minerals or living or non-living resources taken from land or sea.

Section 10(c) of the KITA sets out the parameters that are applied to determine whether natural resource income is sourced from Kenya and thus subject to income tax in Kenya. Any payment of natural resource income by a resident person or person having a PE in Kenya is deemed sourced from Kenya provided it is incurred in the production of income or in connection with any business carried on or to be carried on in Kenya. However payments of natural resource income made by a PE in Kenya of a non-resident person to that non-resident person or other offices of that non-resident person are excluded.

Natural resource legislation in Kenya including but not limited to the Mining Act and the PEPA vests the ownership of the underlying natural resources to the GoK in trust for the people of Kenya. Governments commonly authorise private persons to exploit these resources upon payment of a resource charge by whatsoever name called. Such payments would ordinarily fall within the domain of natural resource income as set out by the KITA. However, income derived by the Central and County Governments is customarily exempt from income tax meaning any natural resource payments they receive are exempt from income tax.

4 Payments in the sphere of natural resource income

Natural resource income is defined by the KITA in two parts. It means any amount including a premium or such other amount paid as consideration to take minerals or a living or non-living resource from land or sea. The guidelines issued by the KRA provide that all payments for the right to enter land or seas to remove minerals, living and non-living things fall within this definition of natural resource income. Examples of natural resources that the guidelines list include minerals, quarry, fish and timber. We also consider hunting fees would fall within this definition.

In the second part, natural resource income means an amount calculated in whole or part by reference to the quantity or value of minerals or living or non-living resources taken from land or sea. The guidelines list private overriding royalties but we also consider production payments fall in this category. Overriding royalties and production payments largely apply to the oil, gas and mining industry as our subsequent discussion explains.



5 Natural resource income in the oil, gas and mining sector

Transactions in the oil, gas and mining sector falling in the domain of natural resource income include overriding royalties and production payments. These are popular techniques for financing oil, gas and mining development operations.

a) Overriding royalty interest

These are also known as overrides. They arise in two ways. An entity that assembles a prospect may divest their stake but retain an overriding interest in the natural resources to be exploited. Similarly, it could sell an overriding royalty interest as a means of raising capital.

An overriding royalty interest gives its holder the right to a percentage share of production or the value derived from production which is free of all costs of production. The overriding royalty is created and borne by a working interest holder in the license. Sale of an overriding royalty interest enables the license holders to raise funds at reasonable cost to fund their operations while retaining control of their assets. On the other hand, the overriding royalty interest holder is assured a steady income stream calculated by reference to the value of the resource produced.

b) Production payment

Production payment is another popular means of financing oil, gas and mining development operations. It represents an arrangement where a party advances upfront funds to the extractive company in return for a specified share of net production free of costs of production which is used to repay the advance. The interest terminates when a specified amount of production has been received by the interest holder. The first major project financed transaction in the North Sea petroleum development in the early 1970s was by way of a production payment or forward purchase. This was the British Petroleum's Forties field, which raised about £ 1 Billion.

Production payments are conceptually similar to overrides the difference being that the overriding royalty interest continues for the term of the extractive license whereas the production payment terminates when the specified amount of production has been received by the interest holder.



6 Mechanics of the income tax on natural resource income

Section 35 of the KITA obliges every person that makes a payment of natural resource income to a non-resident person, PE of non-resident person and resident person to deduct WHT. The rate of WHT on the gross payment to the non-resident persons is 20% and 5% for payments to resident persons or PEs of non-resident persons. The WHT is a final tax if deducted from a non-resident person. It is however creditable against the corporation or income tax payable at the end of the year if it is deducted from a PE of a non-resident person or resident person in Kenya.

The WHT must be deducted and remitted to the KRA not later than the 20th day following the month of payment. The KITA does not however directly define the term payment. Its meaning can however be inferred from the definition of the term paid set out in the KITA. Paid is defined to include distributed, credited, dealt with or deemed to have been paid in the interest or on behalf of a person. KRA's interpretation of the foregoing provision is that WHT on qualifying payments arises at the time the payment in question is credited or earned by the recipient irrespective of whether any cash or equivalent payment has been made. This position was somewhat buttressed by the 2002 case of Republic versus KRA *ex parte* Cimbria. In this case, Cimbria contended KRA was not entitled to any WHT or penalties as had been assessed given that it had not made any actual payments for interest, management fees and local assistance. The Court held that if indeed the Cimbria parent company that advanced the loan was credited with interest as alleged, then "paid" includes the word credited because it was a benefit to Cimbria. The interest was thus deemed to have been paid and therefore subject to WHT at the time it was credited to the parent company.

There is however a subsequent 2012 case that held otherwise. In that case, the High Court ruled that payment is deemed to be made where the party credits the bank account of the other party or credits an inter-company account in the case of related parties. The High Court accordingly held that payment meant "delivery of money or some other valuable thing." In accordance with this case, WHT is payable when the physical cash or equivalent payment is made or some valuable consideration that extinguishes the liability, e.g. an offset. This foregoing position notwithstanding, we are aware that KRA appealed against this decision in a higher Court and maintains its earlier stance that WHT on qualifying payments arises at the time it is credited or earned by the recipient irrespective of whether any cash or equivalent payment has been made.

In terms of implementation of the new WHT provisions, it will be interesting to see how the KRA will follow up with individuals who make qualifying payments to enforce compliance. Given the wide definition of natural resources, the tax will affect many businesses/ individuals and there would be need for sensitisation to ensure they are not caught unawares.

7 East African countries comparative overview

The table below provides a comparative summary of Uganda, Kenya and Tanzania's income tax legislation pertaining the taxation of natural resource income. The definition of natural resource income is substantially the same except for a slight tinkering with the terminology used. There are also differences in the rates of tax applied.

Issue	Uganda	Kenya	Tanzania
Definition	S.2 (tt) of the UITA defines a natural resource payment to mean: a) a payment including a premium or like payment, made as consideration for the right to take minerals or a living or non-living resource from the land. b) a payment calculated in whole or in part by reference to the quantity or value of minerals or a living or a non-living resource taken from the land.	S.2 (d) of the KITA defines natural resource income to mean: 1. an amount including a premium or such other like amount paid as consideration for the right to take minerals or non-living resources from land or sea or 2. an amount calculated in whole or part by reference to the quantity or value of minerals or a living or non-living resource taken from land or sea.	Section 2 of the TITA defines a natural resource payment to mean any payment, including a premium or like amount, for the right to take natural resources from land or the sea or calculated in whole or part by reference to the quantity or value of natural resources taken from land or the sea.
On payment to a non-resident person	15% WHT on the gross payment It is a final tax	20% WHT on the gross payment It is a final tax	15% WHT on the gross payment It is a final tax
Payment to a resident person or PE	Nil	5% of the gross payment Not a final tax and can be credited against any arising corporation or income tax at end of year.	Nil

8 Our view



The imposition of income tax on natural resource income in theory expands Kenya's tax base though it remains to be seen whether this will translate into substantial tax collections. Whereas there is the ever present need to grow tax revenues to fund the increasing Government budget, there is some general consensus that this should be done without increasing the tax burden on the already heavily taxed segments of the society. Therefore, any measure that widens the tax net would be viewed as a step in the right direction towards boosting revenue collection.

As highlighted in our discussion above, the financing of oil, gas and mining development involves the use of sophisticated techniques. This new fiscal measure applies WHT on the gross earnings value of overrides and production payments which is punitive especially where the funds originally received are invested in the development of the oil, gas and mining fields. There may be merit in considering whether revisiting this new tax measure and aligning it to taxing net profits or charges similar to interest could be more palatable to the players in extractive sector. Applying WHT tax on the gross value of production is akin to taxing both the loan repayment and interest charges.

It should further be noted that the new tax measure would only yield revenue when oil, gas and mineral production commences. The majority of the upstream petroleum projects in Kenya are at exploration phase with some looking at development. A decision to proceed to development in respect of some discoveries already made shall take into account project economic considerations including financing aspects. The imposition of WHT especially on a gross basis on the above discussed potential financing techniques may escalate financing costs thus adversely impacting project economics measures such as NPV and IRR which may lead to a decision not to proceed to development.

Appendix 1



GUIDELINES FOR WITHHOLDING TAX ON NATURAL RESOURCE INCOME

The Finance Act, 2014 introduced Withholding Tax on Natural Resource Income with effect from **1st January, 2015**.

1. What is Natural Resource Income?

Natural Resource Income means:-

- (a) an amount including a premium or such other like amount paid as consideration for the right to take minerals or a living or non living resource from land or sea; or
- (b) an amount calculated in whole or in part by reference to the quantity or value of minerals or a living or non-living resource taken from land or sea.

Paragraph 1(a) above covers all natural resource royalties such as the right to enter land and remove a natural resource (minerals or living or non living resources, for example timber)

Paragraph 1(b) covers all private overriding royalties paid in relation to an exploration or prospecting right. The amount is calculated by reference to the quantum or value of resources taken notwithstanding that the recipient of the payment may have no rights in those resources.

Natural resources include but are not limited to: minerals, sand, quarries, fish, timber e.t.c

2. Who is liable to pay the tax?

The person (whether resident or non-resident) making a payment constituting a natural resource income to a resident or non-resident should deduct the withholding tax before making the payment.

This withholding tax does not apply to payments made to persons who are exempt from income tax.

3. What is the rate of tax?

- (a) A payment to a resident person is subject to withholding tax at the rate of **5%** of the gross amount payable.
- (b) A payment to a non-resident person is subject to withholding tax at the rate of **20%** of the gross payable.

4. What is the due date?

The tax is to be paid on or before the **20th day** of the month following the month of deduction.

5. Declaration and Payment

The tax shall be declared and paid using the withholding tax return available in the iTax system under the stream of income: - **Royalty/Natural Resource Income.**

6. Offences

Failure to deduct and remit the withholding tax is an offence and penalties will apply in accordance with the Income Tax Act.

7. Information on Withholding Tax on Natural Resources Income

Taxpayers can obtain further information/clarification from our contact persons as follows:

Ann Irungu on Tel: 020 2815036 or Email: Anne.Irungu@kra.go.ke ; Moses Maina on Tel: 020 2815076 or Email: Moses.Maina@kra.go.ke ; and Martin Tsalwa on Tel: 020 2715540 Ext 2035 or Email: Martin.Tsalwa@kra.go.ke

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