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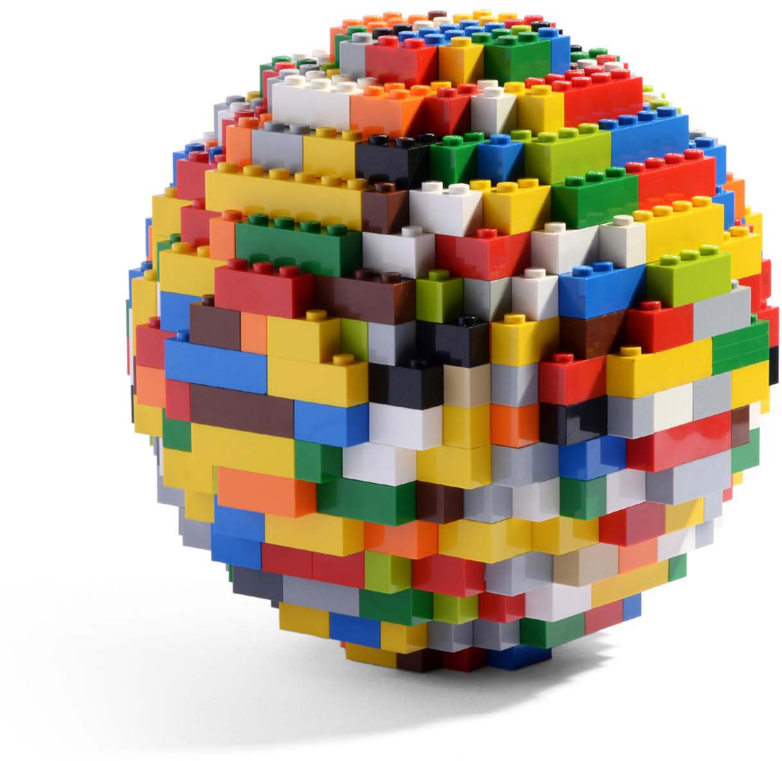

A case of equity?

By Jenipher Oduor

The Kenyan taxpayer is all too familiar with the consequences that accompany a missed tax deadline. A good number of taxpayers are also familiar with the frustration and agony that comes with seeking a tax refund from the Kenya Revenue Authority (KRA).

The refund process has for a long time been a frustrating experience for taxpayers. The system has been unfair and inequitable given that whilst the KRA has levied heavy penalties and interest on outstanding tax due to the exchequer, it has held huge amounts of refunds due to taxpayers without paying any interest thereon.

The recently enacted Finance Act 2016 has just introduced some welcome changes with regard to refunds due to taxpayers. The Finance Act 2016 has amended Section 47 of the Tax Procedures Act by introducing a new sub-section 5 which now compels the KRA to refund overpaid tax within a period of two years from the date of application for the refund of such overpaid tax. Where there is failure by the KRA to do so, the amount due shall henceforth attract interest of 1% per month or part thereof after the period of two years. The change in legislation is a welcome move and takes effect from 1 January 2017.

Tick Tock on the refunds clock!

The tax refund process is now time bound. Previously, the process was at the discretion of the KRA as well as the National Treasury, in terms of the allocation of funds towards approved refunds. In addition, the verification process to determine the legitimacy of the claim was arduous. From 1 January 2017 onwards, the determination of a refund is to be done within **90 days** after application. Once the refund has been determined by KRA to be correctly due, it shall be utilized in the following order:

- Settling any outstanding income tax liability;
- Offsetting tax owed by the taxpayer under any other tax law (VAT, Customs and Excise); and
- Any remainder shall be refunded to the taxpayer.

The remainder of the overpaid tax due to the taxpayer should be refunded no later than **two years** from the date of application to avoid the interest charge discussed above.

Applications for non VAT refund claims are supposed to be done within **five years** from the date on which the tax was paid. On the other hand, the timeline for VAT refund claims are governed by the provisions of Section 17 (5) of the VAT Act 2013. A taxpayer lodging a VAT refund claim arising from making zero rated supplies is supposed to lodge the claim within **twelve months** from the date the tax becomes due and payable.

Despite the efforts being made to speed up the repayment process, the period taken to process refunds is still far from satisfactory considering that inflation and the impact on taxpayers' cash flows and finance costs are not factored in. In addition, an interest charge of 1% per month is levied on taxpayers without delay when there is non-compliance whereas the tax man is given a grace period of two years before he is subjected to the interest charge. Much as the legislative change requiring the KRA to pay interest on repayments due to taxpayers is a step in the right direction the playing field is not yet level. More needs to be done to create equity in taxation matters such as this one. For instance, it would be more equitable if the interest is levied immediately after the 90 day window within which the KRA has to review and verify the refund application. Furthermore, where a refund is erroneously rejected by the KRA, there should be penalties when the same is found to have been a valid claim.

The new provisions also begs the question, 'will the interest earned from the KRA be considered tax exempt or will the taxman want to have a piece of it by subjecting the amount to tax'? This legislation will need to undergo further refinement to address the concerns raised above and ensure that both the affected taxpayers are treated fairly.

A New Transfer Pricing Era?

By Wendy Kodhiambo and Doris Gichuru

Transfer pricing ("TP") has emerged as a key focus area both globally and locally. This is mainly driven by the concern by governments that multinationals may be exploiting their corporate structures through intercompany pricing such as transfer of licensing rights, inter-group financing, management fees and other similar transactions in order to legally reduce or eliminate tax liabilities for the group.

As usual, there are always two sides to a story. Whereas on the one hand the concern about aggressive tax avoidance and possible evasion is a valid one, on the other hand, it is imperative for businesses to develop effective business models for their cross-border operations. One would also appreciate that in an era of increased competitiveness, tax is often a factor that cannot be ignored and therefore multinationals, and indeed every other business, consider tax planning as a critical success factor in strategic and executive decision-making. And governments too consider tax as an important subject in policy making to ensure their countries meet not only the goals of revenue mobilisation but also facilitating business and attracting investment to spur economic growth.

Base erosion and profit shifting ("BEPS") actions focus on bridging gaps that enable multinationals to adopt tax avoidance strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations.
On 5 October 2015, the Organisation for Economic Co-operation and Development ("OECD") released final reports on all 15 focus areas in its Actions.

BEPS Action 13

BEPS Action 13 is aimed at providing more information to tax authorities and this could potentially change the face of TP documentation and audits. The Action plan recommends a three tier global standard for TP documentation, including a common template for country-by-country information to be reported to tax authorities.

Based on various discussions with the Kenya Revenue Authority ("KRA"), including the presentation by the KRA during the Deloitte BEPS TP workshop, the KRA is expected to adopt the BEPS actions including Action 13. There is no agreed timings though the KRA indicates that this could be done in 2017.

What to expect...

There is increased transparency around the tax affairs of the multinationals by requiring them to provide information to tax authorities regarding the global allocation of income, taxes paid, and key indicators of economic activities performed in the tax jurisdictions in which multinationals operate.

The three-tiered approach involves:

- **Master file**- this provides information on the global business operations and transfer pricing policies of a multinational enterprise. It includes the organizational structure, global business operations, TP policies and the financial and tax positions of the group;
- **Local file**- this provides information on the related-party transactions and business activities in a particular jurisdiction. The file provides a local tax authority with information on the related-party transactions, the amounts involved and the company's analysis of the transfer pricing determinations made on those transactions; and
- **Country by Country (CbC) reporting template**- this includes information on revenue (related and unrelated party), profits, taxes paid, employees, retained earnings and assets (tangible & intangible) for each tax jurisdiction in which the multinational operates. The template also shows all the entities within the group and the business activities each entity conducts.

What does this mean?

The CbC reports will be helpful to revenue authorities for TP risk assessment purposes. Any inconsistencies in the information provided could raise questions as to whether inappropriate tax planning has taken place. Notably, there are mechanisms for the automatic exchange of the CbC reports among different tax authorities.

Multinationals should develop sustainable processes and responsibilities with regard to the new reporting requirements. A careful review of the data should be performed to determine whether any of the information could be misinterpreted by the tax authorities. In addition, multinationals should review the global tax structure to determine if they would be considered to be "fair" & "legal" in the current TP era.

Which way Excise Goods Management Systems (EGMS)?

By Clifford Otieno

I recall there was a time in the recent past when the local media was awash with news that some multinationals had threatened to stop their operations in Kenya and relocate to other countries with friendlier tax regimes. The bone of contention was the planned move by the KRA to force them to install Excise Goods Management Systems (EGMS) in their production lines. The companies argued that such a move would lead to unnecessary burden on them owing to the high costs of the excise stamps. An excise stamp is basically a stamp affixed to some excisable goods to indicate that the required excise tax has been paid by the manufacturer or importer of the excisable good. The excise stamps are supplied by the KRA to the manufacturers and importers of excisable goods at a cost.

Why EGMS?

These news got me thinking on just how important the EGMS is to the taxman. EGMS is a system for protection of excise tax revenue which comprises of an enhanced excise stamp with multiple security layers. The system makes use of enhanced excise stamps with a track and trace functionality. Hence, the KRA will launch an application that will enable the public to send an SMS with the code appearing on the excise stamp to a number to enable the sender to verify whether the stamp is genuine or fake. The EGMS is envisaged to help curb revenue leakages for Government by ensuring that excisable goods have excise stamps affixed onto them and the excise duty thereon remitted to the revenue authority. The EGMS also aims at reducing health exposures due to consumption of illicit products like spirits by ensuring that alcoholic products being sold in the market are produced from approved facilities that have met the regulatory standards. By roping in all manufacturers and importers of excisable goods into the tax net, the EGMS is expected to assist in expanding the tax base, as well as ensuring that only quality goods are in circulation. Excisable goods such as wines, spirits and cigarettes have been brought on board the new system, with KRA planning to expand its implementation to other excisable goods, except those goods which would not require to have excise stamps affixed, e.g. motor vehicles and motor cycles.

Pros and Cons

The EGMS is expected to have numerous benefits upon its complete implementation. Such benefits include ensuring that all excisable goods manufactured or imported are recorded and properly taxed, encouraging fair competition where all players in the affected sectors correctly account for taxes due on excisable goods, promoting public safety through circulation of standard goods in the market and equally helping in the battle against influx of substandard and potentially dangerous goods, especially in the area of alcoholic drinks.

On the flipside, businesses which are expected to implement the EGMS are likely to face increased cost of doing business in the form of having to bear the costs of excise stamps and also the administrative burden of having to undertake excise stamps reconciliations. Excise stamp reconciliations would have to be periodically undertaken by manufacturers and importers of excisable goods to ensure that all excise stamps have been fully accounted for, i.e. production or import numbers ought to tally with the numbers of excise stamps affixed. Any variances resulting from the reconciliation should be explained and documented to mitigate the risk of the revenue authority demanding taxes on variances. Undertaking such a reconciliation exercise would prove to be a burdensome activity for companies that undertake bulk production and would even require the companies to have dedicated resources to handle the reconciliations.

Way forward

Though expected to have numerous benefits, initial implementation hurdles are inevitable and ought to be addressed in a sober manner. The KRA should engage the affected businesses to ensure concerns relating to costs or administrative burden are addressed so that a win-win outcome is achieved. In terms of cost, the KRA should consider cheaper forms of excise stamps that will not adversely impact the businesses implementing the system. Such stamps could for instance come in the form of electronic signatures such as the batch numbers normally printed on products during production. Further, taxpayers who might be adversely affected by the EGMS should consider having consultative forums with the KRA to enable them to mutually come up with the best way to address the grey areas relating to the implementation of this system.

Relief at last!

By Maureen Kimamo

Foreclosures. Bad loans. Bad mortgages. These are all terms familiar to the Kenyan financial environment. With the high interest rates that have characterized our financial landscape for a long time, many borrowers and would be home owners have found themselves on the inconvenient side of things with more being expected of their pockets. Reports in the media have often indicated that the rates of default on mortgages was alarming and something needed to be done to arrest this situation. Property rates have also soared in the past decade making it extremely difficult to acquire real estate without financing arrangements.

And relief has come knocking.
The year 2016 would see the government respond by capping the margins chargeable by our financial institutions. Though the long-term benefits of this remain to be seen, this move was welcomed from many quarters especially by those who had borne the heavy burden of what was seen as prohibitive interest rates. Homeowners who financed purchase through mortgages expressed joy at the news, relieved that they would now enjoy lower interest rates.

In addition to the capping of interest rates, the government through the Finance Act 2016 increased, with effect from 1 January 2017, the allowable interest deduction for individuals for money borrowed for the purchase or improvement of owner-occupied houses from KES 12,500 per month to KES 25,000 per month. This is a significant increase in the relief available to

individuals who have borrowed to finance their residential property. In determining the total taxable income of a person for a year of income, interest paid on an amount borrowed from specified financial institutions is deductible where the money is borrowed to either purchase or improve premises which the taxpayer resides in. However, no person is allowed to claim this deduction on more than one residence. In addition, in an arrangement where spouses jointly own a home, only one of them would be eligible to enjoy this incentive. As such, employers must be vigilant as they grant this payroll incentive to their staff by putting in place mechanisms to ensure that similar claims are not made by their employees' spouses/partners.
Corporates are not left out since any property developer who invests in at least four hundred (400) residential units annually will enjoy a corporate tax rate of 15% on adjusted income (revenue less allowable costs) against a prevailing rate of 30% for residents and 37.5% for non-residents subject to approval by the Cabinet Secretary responsible for housing. This incentive takes effect from 1 January 2017.

We believe that these incentives will be well received to facilitate attainment of many a home ownership dream and bring prosperity.

Don't we all wish for more tax incentives?

Capital Vs Revenue

By Jenipher Oduor

The rules of deductibility of expenses for tax purposes are laid out in sections 15 and 16 of the Income Tax Act. Section 16 of the ITA which deals with disallowed deductions in paragraph (1) states that "no deduction shall be allowed in respect of "**capital expenditure**, or any loss, diminution or exhaustion of capital." However, ask a taxpayer to distinguish between a revenue and a capital expenditure and you'll realise that this is no easy task.

The distinction between capital and revenue expenditure has not always been clear cut. In addition, the Kenya Income Tax Act neither expressly defines capital expenditure nor spells out the characteristics of such expense. In the absence of a definition or guidelines on how to distinguish capital from revenue expenditure, there has always been the risk of misclassification and disputes with the Kenya Revenue Authority regarding the tax treatment of such expenditure. However, a recent ruling by the high court of Kenya has moved our legislation a step closer to clarity. The ruling has set precedence and provided guidelines to be used in drawing the line between capital and revenue items.

In **Commissioner of Income Tax V. Kencell Communications Limited (Now Airtel Kenya Limited)**, the High Court held that the operations license fees of USD 55 million paid by the respondent (Airtel Kenya Limited) upon commencement of its operations is capital in nature. The rationale put forward by the High Court Judge was that Kenya will accord such license fees the same treatment as done in other jurisdictions that have matured in terms of law. As a result, the Local Committee's decision which had allowed the cost as revenue expenditure and against which the Commissioner had appealed to the High Court was overturned and the license fees were declared a capital expense.

The High Court relied heavily on the case of **BFH vs. Comptroller of Income Tax [2013] SGCH**, Singapore in which a similar ruling was delivered. While the case involved a telecommunications company, it generally brought forward some key tests that will cut across all taxpayers when classifying expense items. Under the above ruling, the key factors to be put into consideration to determine the nature of an expense item are as follows:

- **The purpose of the expense**. This is the core factor to be considered while classifying an expense item. If the expense creates a new asset, strengthens an existing one or opens a new field of trading then it qualifies as capital expenditure;
- **Nature of the expense.** Secondly, one should test and see if the expenditure is a one off payment or of a recurring nature. Generally, capital expenses involve one off lump sum payments whereas revenue expenses are recurring in nature. But there is a caveat to this test. There are some expenses that may be made more than once but due to the nature of the benefit that they provide, they are considered capital. This brings us to the third test to be applied;
- **The nature of the benefit accruing to the company**. Finally, if the expense produces a benefit of a long lasting but not necessarily a perpetual nature to the business then it is without a doubt a capital item.

We need to appreciate the fact that this case has brought to light an area that most, if not all, taxpayers have struggled with for long. Some of the common areas of this maltreatment has been "low value" assets. More often than not, taxpayers perceive assets with low value as revenue expense items. In addition, it is common to see repairs and maintenance items as well as consultancy and legal fee payments related to capital items being expensed.

It is important that a great deal of attention is given when classifying contentious expense items. A misclassification could significantly reduce your tax liability and lead to the KRA demanding back taxes including heavy penalties and interest. However, whilst the court case discussed above gives useful guidelines on how to distinguish capital from revenue expenditure it is worth emphasizing that some cases may be unique and it is therefore important to analyze each case on its individual merits.

A penny saved...

By Linet Kiilu

Come January 2017, individual taxpayers will have a reason to smile. After prolonged silence by the National Treasury on taxation of individuals, the Finance Act 2016 amended the income tax act by increasing the individual tax bands on annual income by 10% as summarized below:

	Rate in each shilling
On the first Shs. 134,164	10%
On the next Shs. 126,403	15%
On the next Shs. 126,403	20%
On the next Shs. 126,403	25%
On all income over Shs. 513,373	30%

The new tax bands will reduce the tax burden for individual taxpayers with greater relief being felt by the lower income earners as illustrated in the table below. Personal relief enjoyed by taxpayers has also been increased from KES 13,944 to KES 15,360 per annum providing further relief to the already overburdened taxpayers.

Let's do the math...

The expansion of tax bands will have the following impact on different levels of taxable salary w.e.f. 1 January 2017:-

Salary per month	Tax payable under current band	Tax payable under new band	Effective percentage change
15,000	580	411	29%
25,000	2,334	2,075	11%
50,000	8,932	8,324	7%
100,000	23,932	23,324	3%
150,000	38,932	38,324	2%
1,000,000	293,932	293,324	0%

Given the current difficult economic times, the change will cushion households, albeit negligible, by ensuring that they have more at their disposal. The common 'mwananchi' at the lowest end of the income bands is set to benefit the most as their tax bill will reduce by 29%. However, the absolute amounts are not significant, and considering that the bands remained unchanged for about a decade, many would have expected that the National Treasury would have expanded the bands significantly in line with cost of living indices. The government should also strive to widen its tax base by bringing more Kenyans especially those in the informal sector into its tax net to contribute their fair share to the public coffers enjoyed by all and ultimately reduce the burden placed on the formal sector employees from a personal tax perspective.