TAX PLANNING IN KENYA

UHY Kenya

Background

A question that appears to generate surprisingly little debate in Kenya is the scope for legally mitigating taxes payable by individuals and corporate entities. Quite apart from the right of taxpayers to arrange their affairs so as to minimize taxes payable, tax planning is bound to gain increasing significance with the ever-increasing aggressiveness of the Kenya Revenue Authority to collect more and more taxes. This trend of increased aggressiveness and sophistication in tools and methods employed to collect is occurring against a backdrop of a public policy that domestic sources be the primary sources of revenues for budgetary purposes. This results in governmental pressure on tax collecting agencies to improve their revenue collection performance. The consequence of this, is more stringent enforcement of taxation laws.

Many individuals and corporate entities who in the past did not pay the correct taxes due on any or all of their income are now having to do so or face severe consequences. The same scenario is playing out with regard to Customs and Excise duties as well as Value Added Tax. The introduction and implementation of the VAT Automated Assessments and the Electronic Tax Invoice Management Systems is just one of many tools for effecting greater compliance with tax laws. With the imperative for massively greater public spending to achieve developmental goals, this zeal by the KRA to rigorously enforce tax laws can be expected to continue.

The efforts by KRA to collect taxes are also buttressed by provisions of tax laws that allow the Commissioner to make adjustments to certain transactions where he/she is of the opinion that the MAIN purpose for which such transaction was effected, was the specific avoidance or reduction of a tax liability.

With the above in mind, the question of tax mitigation by legitimate avoidance/planning naturally occurs. How can Kenyan individuals and businesses legally arrange their affairs within the current legal and tax environment so as so minimize their tax burden? This paper attempts to survey the laws and point out legitimate ways to mitigate the tax burden. We do this under three broad sections, first addressing individuals, then considering businesses and lastly any cross-cutting issues.

A. Individual Tax Planning

There are a limited number of methods, vehicles and techniques by which individuals can avoid taxes. These are highlighted below.

1. Tax Deductible Contributions to Retirement Benefit Schemes

i. Income tax laws have for the last two decades provided that contributions to registered Retirement Benefit Schemes can be deducted from gross income before taxable income is determined. The tax deductible contribution is currently set at a maximum of Ksh. 20,000/= per month (Ksh. 240,000/= per annum). These contributions achieve the twin aims of building retirement savings and reducing

taxes paid.

It should be noted that upon reaching the set retirement age, the retirement savings are still taxable under certain conditions;-

- When the individual desires to receive his retirement savings as a lump sum, a sum of Ksh 48,000/= per full year worked subject to a maximum of Ksh 480,000/=, is deductible from the lump sum before the balance is taxed under applicable tax bands for individual income.
- In addition, individuals who retire after 50 years or retire on medical grounds are liable to tax on the balance of the lump sum at wider tax bands, effectively reducing the tax rate.

Overall, the option of accessing retirement savings as a lump sum may therefore significantly reduce the tax savings made from contributions done during your income earning years.

ii. Members of pension schemes, or members of an individual retirement scheme who opt to use their retirement savings to purchase an annuity (which will generate a periodic pension), will have various advantages;-

- The first Ksh 180,000/= of the total pensions or retirement annuities received annually are tax exempt.
- Secondly, personal relief is applied to reduce the taxable income.

iii. Monthly pension granted to a person who is sixty- five years of age or more is tax exempt in accordance with the amendment introduced by Section 8(c) of the Finance Act, 2020.

iv. In registering an occupational pension scheme, an employer applies for tax exemption so that tax relief is received on any allowable contribution made into the scheme. The employer therefore deducts the contribution from a member's gross pay before calculating tax. Additionally, the law allows a tax relief of up to a maximum Kshs. 20,000 per month or Kshs. 240,000 per annum for amount contributed to a registered scheme.

2. Contributions to a Registered Home Ownership Savings Plan

The home ownership savings relief for workers ended on 1st July 2020 when the Finance Act, 2020 came into effect. The Amendment brought to an end the 24-year old relief that was introduced on January 1, 1996 with its rates being adjusted for the last time in 2007/08 financial year.

3. Mortgage Interest Deduction & Affordable Housing Relief

i. Effective 1st January 2017, interest payments on loans borrowed for the purposes of improvement or construction of residential premises are deductible, subject to a limit of Kshs.300,000 per annum (Kshs. 25,000 per month).
ii. Moreover, affordable housing relief under Section 30A of the Income Tax Act is available to a resident

individual who satisfies the Commissioner that in a year of income that the person—

- is eligible to make an application under an affordable housing scheme;
- has applied and is awaiting the allocation of a house under an affordable housing scheme; and
- is saving for a purchase under an affordable housing scheme approved by the Cabinet Secretary in charge of housing.It is important to note that one can only be eligible for the affordable housing relief once. One cannot be re-eligible for a subsequent relief.

4. Individual Investment in various Assets so as to avoid taxes on gains

The reintroduction of Capital Gains Tax (CGT) in 2015 had the implication that individual investment in various assets such as property is not wholly tax exempt. A capital gains tax is a tax on the profit/gain realized on the sale of a non-inventory asset such as property. Capital Gains Tax is charged at the rate of 5% of the gains.

Ordinarily, the disposal of property held as an investment will only attract Capital Gains tax liability as the only ensuing tax. However, if the disposal of the asset constitutes a 'trade', the overall gains will equally be subjected to corporation tax at the prevailing rate of 30%.

There is a need to clearly evaluate as to whether the gains ensuing from the disposal of a non-inventory asset amounts to a trading gain or a capital gain. The instructive test for determining as to whether the proceeds amount to a trading gain was elaborated in the 'Badges of Trade' as formulated in the 1955 report by the Royal Commission on the Taxation of Profits and Income. The test has become an integral part of the Common Law. The badges of trade provide a multifaceted approach based on the inherent characteristics of the transaction and the circumstances surrounding it. The badges of trade are as follows;

1. Principal activities of the seller.
2. Profit seeking motive.
3. The number of transactions.
4. The source of finance.
5. Changes to the asset.
6. Interval of time between purchase and sale.

5.Conducting Business Using a Corporate Entity so as to Enable Comprehensive Deductions of Business Expenses

While expenses legitimately incurred in the production of income are tax deductible regardless of the form of business, conducting business using a corporate entity enables clearer segregation of business and personal expenses, thus enhancing the deduction of certain expenses. This is especially in light of the fact that the Domestic Taxes Department will carefully scrutinize expenditure in the course of audits to determine if it was of a personal nature or not.

Individuals engaged in various professions, including entertainment can set up companies, labeled Personal Service Companies, to which they direct their income. This enables them to reduce taxable income by charging their gross income with certain tax deductible expenses they most probably would

fail to deduct if they conducted their business as individuals.

However, it is important not to underscore the principles underpinning the deductibility of expenses as outlined in Section 15 of the Income Tax Act. The expenses can only be deducted if they were wholly incurred in the production of the taxable income. Moreover, the person seeking to deduct must clearly demonstrate that not only were the expenses incurred but also that they were incurred for the purpose of making the taxable income.

6.Establishment of Charitable Trusts or Foundations

Section 10 of the First Schedule of the Income Tax Act provides that the income of an institution, body of persons or irrevocable trust, of a public character, established solely for the purposes of poverty alleviation or distress of the public, or the advancement of religion or education, all for public benefit, shall be tax exempt.

Recently, the Finance Act, 2021 amended Section 11 of the Income Tax Act to provide that money paid from Registered trusts is taxable except (See Section 5 of the Finance Act, 2021);

a. payments from the trust for the exclusive purpose of education, medical treatment or early adulthood housing;
b. income paid to a beneficiary that amounts to less than KES ten million per year of income;
c. any other amount prescribed by the Commissioner.

7. Lower Rate of Taxation of Partial Motor Vehicle Benefit

An employee who enjoys the use of a company car is taxable on the higher two percent (2%) of the initial cost of the motor vehicle per month and the Commissioner's prescribed rate.

The determination of motor vehicle benefit for employees provided with their employers' vehicle, takes into account the purpose and extent of use of the vehicle. This serves to reduce the value of taxable benefit where the employee does not enjoy unrestricted use of the vehicle for company and personal purposes. One will have to prove to the satisfaction of the Commissioner that the vehicle is used for a restricted purpose eg. purely business use.

8. Insurance Relief

Individuals are entitled to relief of 15 percent of premiums paid on life insurance policies, education policies (with a maturity of at least 10 years) and health policies taken out for oneself or for one's spouse or child. The Finance Act 2021 amended the Income Tax Act by adding that a contribution made to the National Hospital Insurance qualifies for relief.

9. Charitable Donations

Donations to charitable organizations [registered or exempt from registration under the Societies Act (Cap. 108) or the Non-governmental Organizations Co-ordination Act, 1990 and whose income is exempt from tax under paragraph 10 of the First Schedule to this Act or to charitable projects approved by the

finance minister are tax deductible.

B. Corporate Tax Planning

As with individuals, the scope for tax mitigation for corporate entities is not particularly wide in Kenya. Avenues to attain this goal are detailed below.

1. Use of Debt in the Capital Structure

In Kenya, as in many other countries, interest on corporate debt is tax deductible. Companies can take maximum advantage of this tax deductibility by determining the optimum amount of debt that they can carry and working with it. It should be noted that the revenue authorities attempt to limit abuse of tax deductibility done by overleveraging companies specifically MNE's.

The now repealed section 16(2)(j) of the Income Tax Act provided that interest on debt that is in excess of three times the shareholders' equity (share capital + retained earnings) of a company (not being a bank) controlled by a non-resident, is not tax deductible.

Following the amendment and effective 1st January 2022, the gross interest paid or payable to related persons and third parties in excess of thirty per cent (30%) of earnings before interest, taxes, depreciation and amortization of the borrower in any financial year is not tax deductible (in excess of 30% before EBITDA).

The practice of overleveraging companies with debt from associated sources so as to minimize taxable income (known as thin capitalization) is well known and tax authorities look out for it. Hence companies wishing to take advantage of tax deductibility should do so within the letter and spirit of the Income Tax Act.

One technique for taking advantage of debt is the use of lease financing arrangements for the acquisition of assets, rather than outright purchase with company funds as (for the time being) the lease payments made under both capital and operating leases are tax deductible on the lessee.

2.Capital Investment Allowances

The Income Tax Act provides for certain allowances on capital expenditure which may be deducted when computing the gains or profits of a business. These allowances include Wear and Tear Allowance for fixed assets, and Investment Deduction on purchase or construction of certain business buildings and/or machinery. These allowances are covered in Section 15(2) and the Second Schedule of the Act and serve as investment incentives.

Notably, the Second Schedule has undergone certain changes through amendments introduced by the Finance Act, 2021. Effective 1st January 2022, the allowable investment deductions shall be as summarized in the table below;-

Hotel buildings	50% in the first year of use, 25% per year on the residual value **in equal instalments**
Building used for manufacture	50% in the first year of use, 25% per year on the residual value in **equal instalments**
Hospital buildings	50% in the first year of use, 25% per year on the residual value, in **equal instalments**
Petroleum or gas storage facilities	50% in the first year of use, 25% per year on the residual value**, in equal instalments**
Educational buildings including student hostels	10% per year, in **equal instalments**
Commercial buildings	10% per year**, in equal instalments**
Machinery used for manufacture	50% in the first year of use, 25% per year on the residual value**, in equal instalments**
Hospital equipment	50% in the first year of use, 25% per year on the residual value, in equal instalments
Ships or aircraft	50% in the first year of use, 25% per year on the residual value in **equal instalments**
Motor vehicles and heavy earth moving equipment	25% per year, in **equal instalments**
Computer and peripheral computer hardware and software, calculators, copiers and duplicating machines	25% per year, in **equal instalments**
Furniture and fittings	10% per year, in **equal instalments**
Telecommunications equipment	10% per year**, in equal instalments**

Filming equipment by a local film producer licensed by the Cabinet Secretary responsible for filming	25% per year**, in equal instalments**
Machinery used to undertake operations under a prospecting right	50% in the first year of use and 25%, **in equal instal-ments**
Machinery used to undertake exploration operations under a mining right	50% in the first year of use and 25% per year, in **equal instalments**
Other machinery	10% per year, in **equal instalments**
Purchase or an acquisition of an indefeasible right to use fiber optic cable by a telecommunica-tion operator	10% per year, **in equal instalments**
Farm works	50% in the first year of use and 25% per year **in equal instalments**

3. Write Off of Bad Trade Debts and Inventory and Charging Other Allowable Deductions

Section 15(2)(a) of the Income Tax Act allows the tax deductible write off of bad debts subject to the approval of the Commissioner. Before you can claim this deduction, it is important to look at the Guidelines for allowability of bad debts published under Legal Notice No. 37 of 2011.

It is also possible to get a refund of output VAT paid on bad debts, if claimed within a period of 2 years after the expiry of 3 years since the bad debts came into existence (Section 31, VAT Act, 2013). Inventory written off as defective or obsolete is similarly tax deductible.

There are many other allowable deductions detailed in the Income Tax Act which would enable busi-nesses to reduce their taxable income if they actually utilize them.

4. Procuring Business Inputs from Well Selected Sources

Businesses can mitigate their tax burden by sourcing intelligently. Firstly, those subject to Value Added Tax should ensure that they source from suppliers who will charge VAT. That way, the business buying can deduct input VAT from their output VAT and lower tax payable. While this is a matter of course in many well-established businesses, many others, especially Small and Medium Sized Enterprises do

not do this.
Another way of mitigating the tax burden is by importing inputs from tax advantaged countries. This entails, for example, importing from within the East African Community or the Common Market for Eastern and Southern Africa. Customs duty on imports from such sources is lower than duty on imports from other countries. These areas will eventually become Free Trade Areas, enabling duty free imports within them.

5.Export Processing Zones

Businesses whose principal markets are foreign can set up in licensed Export Processing Zones and enjoy a raft of tax incentives. These include a 10-year corporate tax holiday, significant capital allowances and Value Added Tax exemption. It should however be noted that sales within the East African Community do not constitute exports for this purpose.

6. Offshore Business Structures

The sparse collection of Double Taxation Treaties to which Kenya is a party subjects international business and investment to multiple taxes on the same income. In practice, few businesses take advantage of the tax credit scheme under Section 42 of the Income Tax Act, with many multinationals simply taking foreign taxes paid as a tax deductible business expense.

Businesses can mitigate their tax burden on offshore investment by establishing offshore entities, specifically in countries with relatively lower tax rates or that could even be tax free. Such jurisdictions include Mauritius, Hong Kong, and Dubai. The benefit of establishment in such jurisdictions is that they have a broad network of Double Taxation Treaties and/or relatively lower tax rates on income wherever it is generated or accrues.
However, it should be noted that if the sole purpose of establishing these businesses is “treaty-shopping”, a company may be prohibited from realizing the benefits conferred on residents of the treaty states. It is therefore important to subject your company to the limitation of benefits clause contained in the treaties.

7. Investment Companies

Investment companies engage in purchase and sale of equity and fixed income securities, among other asset classes. Some of the positions they hold might have unrealized gains. Taxes payable can be minimized by deferring for as long as possible the realization of their gains on such positions.

8. Sectoral and General Tax Incentives

From time to time, the government offers tax incentives to various economic sectors to encourage investment. An example is the tax incentive to developers of qualifying low-income residential projects. Another is the lower corporation tax rate for companies that list their shares on a stock exchange. Such incentives would reduce taxes for qualifying businesses.

C. Cross Cutting Issues

Individuals as well as corporate entities can mitigate their tax exposure by keeping the following points in mind as they conduct their affairs.

1.Keeping Complete and Accurate Records

Proper record keeping enables individuals and companies, first, to support allowable deductions from their gross income. Secondly, complete, proper and accurate records will minimize the burden in the event of a tax audit or other proceedings against the taxpayer.

2.Getting Timely, Competent Tax Advice

Working with a competent tax consultant enables individuals and corporate entities to conduct their affairs in compliance with existing tax laws.

3. Challenging Tax Assessments in Legal Tribunals

The tax statutes provide avenues for individuals and companies to challenge tax assessments issued upon them by the KRA.

This can be done through Objections to the tax assessments and if unsatisfied with the Commissioner's response to the Objection, the same can be further challenged through the Tax Appeals Tribunal with the option for appeal to the higher courts.

4. Compliance

Taxpayers can avoid exposure to tax problems (stiff penalties, interest, possible shutdown of business, and distractions from usual activities) by complying with established laws and requirements.

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