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TAX PLANNING IN 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 greater aggressiveness and sophistication of the Kenya Revenue Authority and other tax collecting bodies. The trend of increased aggressiveness and sophistication in tools and methods is occurring against a backdrop of a public policy of domestic sources being the primary sources of revenues for budgetary purposes. This results in governmental pressure on tax collecting agencies to improve their revenue collection performance. The result of this trend is the more stringent enforcement of taxation laws. Many individuals and corporate entities who in the past did not pay due taxes 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, despite spirited resistance, of Electronic Tax Registers for businesses is just one tool for effecting greater compliance with tax laws. With the imperative for massively greater public spending to achieve developmental goals, this overall trend of stringent tax law enforcement can be expected to continue (assuming of course continuity in the governmental policy referred to above).

With such seemingly inexorable trends, the question of tax mitigation by legitimate avoidance naturally occurs. How can Kenyan individuals and businesses arrange their affairs within the current legal environment so as to minimize their tax burden? The past and present practice by many of outright evasion is, and likely will continue to be, fraught with risk. 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.

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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

Income tax laws have for the last 17 odd years 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. An employee's contribution to any registered defined benefit fund or defined contribution fund is now an admissible deduction in arriving at the employee's taxable pay of the month. The employee's deductible contribution is the lesser of:

a) 30% of pensionable pay.
b) Employee's actual contribution.
c) Ksh.20,000 per month

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 received from contributions made during income earning years.

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. Further, and as a result of changes brought about by the Finance Bill 2007, pensions for persons over 65 are now totally tax exempt.

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NOTE:

a) Maximum allowable Pension/Provident Fund contribution had been increased from Kshs. 17,500 per month to Kshs. 20,000 per month (i.e. Kshs. 240,000 per annum), **effective 1st January 2006.**

Contributions to a Registered Home Ownership Savings Plan

The Income Tax Act has for some time provided that contributions to registered schemes designed and established to enable savings for purchase of residences can be deducted from gross income up to a maximum of Ksh 4,000/= per month (Ksh 48,000/= per annum). This has been enhanced by making interest earned on deposits of up to Ksh 3 million into such a scheme tax free.

A depositor (employee) shall in any year of income commencing on or after 1st January, 1999 be eligible to a deduction up to a maximum of Kshs. 4,000 /- (Four thousand shillings) per month or Kshs. 48,000/- per annum in respect of funds deposited in "approved Institution" under "Registered Home Ownership Savings Plan", in the qualifying year and the subsequent nine years of income. *Further, with effect from 1st January 2007 interest earned on deposits not exceeding Kshs. 3 million which deposits are made in qualifying institutions shall be exempt from tax* provided that:-

- Employer has evidence to confirm that the Home Ownership Savings Plan with which employee wants to save is registered by the Commissioner of Domestic Taxes.
- Employer will be the one to deduct and remit the amount to the Institution on behalf of the employee.
- Employers will attach to Form P9A (HOSP) a declaration duly signed by the eligible employee. The declaration so signed will serve as verification and confirmation by the employer that the employee does not directly or indirectly own interest in a permanent house. Form P9A (HOSP) as shown in Appendix 3A is to be used for this purpose.

This avenue for savings and tax mitigation still remains relatively unattractive, however, since the enabling rules and regulations are difficult for banks to abide with. As a result, so far only one financial institution, Housing Finance, has launched a savings product for this purpose.

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2. Mortgage Interest Deduction

Interest incurred on personal mortgages is deductible from gross income before arriving at taxable income, subject to a limit of Ksh 12,500/= per month or Ksh 150,000/= per annum.

Section 15(3)(b)-In ascertaining the total income of a person for a year of income interest paid on amount borrowed from specified financial institution shall be deductible. The amount must have been borrowed to finance either:-

(i) the purchase of premises or

(ii) Improvement of premises - which he occupies for residential purposes.

The amount of interest allowable under the law must not exceed Kshs.150,000 per year (equivalent to Kshs.12,500 per month).

If any person occupies any premises for residential purposes for part of a year of income the allowable deduction shall be limited to the period of occupation.

3. Individual Investment in Various Assets so as to Avoid Taxes on Gains

Section 3(2)(a) of the Income Tax Act provides that income tax is chargeable upon gains or profits from a business. In the definitions section of the Act "business" is defined to include any trade, profession or vocation, and every manufacture, adventure or concern in the nature of trade. This clearly captures regular personal trading in assets of whatever nature. It should be carefully noted that tax exemption is where the acquisition and disposal of assets is not a business activity carried on under the guise of personal investments.

This exemption can be enjoyed by investment through Unit Trusts or other Collective Investment Schemes such as mutual funds. Such investment vehicles are subject only to withholding tax on dividends and interest income that they receive, with subsequent distributions from such entities to members being tax exempt.

4. 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

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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.

5. 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. Section 13 provides that the income of a registered trust is exempt from income tax.

The Finance Act 2006 further provides that contributions made to a tax exempt entity shall be exempt from tax.

6. Lower Rate of Taxation of Partial Motor Vehicle Benefit

An employee who enjoys the use of a company car is taxable on the higher 2 percent of the initial cost of the motor vehicle per month and the Commissioner's prescribed rate. Following the 2007/2008 Budget, the determination of motor vehicle benefit for employees provided with their employers' vehicle, shall take into account the purpose and extent of use of the vehicle. This shall serve to reduce the value of taxable benefit where the employee does not enjoy unrestricted use of the vehicle for company and personal purposes. Previously, the benefit was determined purely by reference to the value of the vehicle and did not take into account the purpose and extent of use. The benefit is the higher of 2% per month of the initial cost of the vehicle or the prescribed rates. For leased vehicles the benefit is the cost of leasing.

The minimum taxable aggregate value of a benefit, advantage or facility is ***Kshs. 3,000*** per *month or Kshs. 36,000 per annum*. **This is with effect from 1st January 2006.**

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7. Remuneration by way of Shares

While remuneration by way of stock options or restricted stock is uncommon in Kenya, a few companies have established Employee Share Ownership Schemes (ESOPs) under which they grant stock options to employees. Such remuneration is taxable at the earlier of the date when the option vests on the employee and the date of exercise of the options, (for an ESOP), or at the end of the period of restriction under a restricted stock scheme. This possibly creates a possible tax exemption (as capital gains) for any increase in the value of the shares from the date the shares vest (and are taxed) to the date of actual exercise of the options.

8. Insurance Relief

Individuals are entitled to relief of 15 percent of premiums paid on life insurance policies, education (with a maturity of at least 10 years) or health policies taken out for oneself or for one's spouse or child. This combined relief is subject to a maximum of Ksh 60,000= per year.

9. Charitable Donations

Donations to charitable organizations which hold a tax exemption certificate 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. Section 16(2)(j) of the Income Tax Act provides that interest on debt that is in excess of thrice the shareholders' equity of a company (not being a bank) controlled by a non-resident, is not tax deductible.

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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 enables companies to charge their income with certain allowances on capital expenditure. These allowances include Wear and Tear Allowance for fixed assets, and Investment Deduction. They are covered in Section 15(2) and the Second Schedule of the Act. These allowances serve as investment incentives.

Notably, there is an investment deduction of 100 percent on industrial buildings used for manufacture, as well as on hotels that will be constructed from 2008.

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. The Commissioner is in the process of developing guidelines for the write off of bad debts. It is also possible to get a refund of Output VAT paid on bad debts, within a period of 2 years after the expiry of 3 years since the bad debts came into existence.

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 businesses 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.

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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. From the 11th year to the 20th year EPZ pay a corporate tax rate of 25%

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.

7. Registered Venture Capital Companies

The Income Tax Act provides that dividends received by a registered venture capital company are tax exempt. The Act further provides that gains arising from trade in shares of a venture company earned by a registered venture capital company are tax exempt.

These tax incentives can benefit investment companies that can secure the approval of the Commissioner to operate as registered venture capital companies.

8. Stock Dividends and Share Repurchase Programs

Payment of withholding tax on dividends can be avoided if companies pay dividends to shareholders by way of bonus shares or by way of a share repurchase program. Bonus shares

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issued on a pro rata basis to existing shareholders are not currently taxable. While the definition of dividend in the Income Tax Act conceivably includes stock dividends, Section 7(1)(f) of the Act provides that stock dividends are taxable only in cases where they are not issued on a pro rata basis to shareholders.

The distributions to shareholders under repurchase programs are not currently subject to capital gains tax.

9. 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.

10. Sectoral and General Tax Incentives

From time to time, the government offers tax incentives to various economic sectors to encourage investment. A recent example is the incentive in the 2007/2008 Budget 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 business.

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. Accurate records will also help 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.

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3. Challenging Tax Assessments in Legal Tribunals

The tax statutes provide avenues for individuals and companies to challenge tax assessments made upon them by tax authorities.

Further, tax demands can be challenged in courts. An example of the latter is the recent successful judicial review application brought by a beverage company against the Kenya Revenue Authority on an assessment and demand on the company for Excise, Value Added and Income Taxes cumulating to about Ksh 1.1 billion.

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. However, it is not illegal to arrange one's affairs in such a manner as to minimize their tax burden.