WAMAITHA GICHAMBA
& Co. Advocates

LEGAL ALERT:

CHANGES BROUGHT ABOUT BY THE FINANCE ACT, 2021

INTRODUCTION

It has been said that the difference between tax avoidance and tax evasion is simple: **jail walls**! Well, in light of the tax changes brought about by the Finance Act, 2021 (the "**Act**"), some of which have increased the tax burden, a tax payer will need a proper understanding of these changes to plan their affairs and give to Caesar what is rightfully his.

The Act was assented to on 29th June, 2021. Some provisions of the Act took effect on 1st July, 2021, while others will take effect on 1st January, 2022.

In this alert, we highlight the legal amendments brought about by the Act:

1. INCOME TAX

a. The definition of "control" expanded

The Act has expanded the definition of the term "control" to include, *inter alia*, circumstances where:

- a person holds at least 25% of the voting rights in a company. This was the previous definition under the Income Tax Act;
- a loan advanced constitutes at least 75% of the book value of the total assets of the borrower. The value of the advanced loan will however exclude a loan from a financial institution that is not associated with the lender;
- the guaranteed amount constitutes at least 75% of the total indebtedness of the borrower. The value of the guaranteed amount however should not include a guarantee from a financial institution that is not associated with the guarantor;
- a person appoints more than half of the board of directors of another person or at least one director or executive member of the governing board of that person;
- a person supplies at least 90% of the supply of the purchases of another person;
- a person purchases or designates a person to purchase at least 90% of the sales of another person; or
- a person has any other relationship, dealing or practice with another person which the Kenya Revenue Authority (the "**KRA**") may deem to constitute control. This provision is a blank cheque to the KRA to determine what should falls within the definition of control and may be subject to interpretation battles between the KRA and the taxpayers.

The import of the foregoing is that even non-shareholding arrangements may be caught by the definition of "control" and businesses will need to assess all transactions to avoid falling foul of the deemed interest provisions discussed elsewhere in this bulletin.

Effective date: 1 July, 2021

b. <u>Digital service tax clarified</u>

The Act has clarified that only non-resident persons will be subject to digital service tax ("**DST**"). Income subject to DST should be derived from or accrue in Kenya through a business carried out over the internet or an electronic network including through a digital marketplace. The definition of a digital market place has been expanded to mean "*an online or electronic platform which enables users to sell or provide services, goods or other property to other users.*" It was previously defined as "*a platform that enables the direct interaction between buyers and sellers of goods and services through electronic means*".

Of note is that DST will be due on or before the 20th day of the month following the end of the month in which the digital service was offered. This has shed more light on the due date for payment of DST.

Effective date: 1 July, 2021

c. <u>Minimum tax</u>

Minimum tax was introduced by the Finance Act, 2020, a and came into effect on 1st January, 2021. This tax is levied at the rate of 1% of the gross turnover as opposed to taxable income. Due to the perceived financial difficulty on the tax payer, a case challenging its imposition (**Constitutional Petition No. E005 of 2021 - Kitengela Bar Owners Association vs Commissioner General of the Kenya Revenue Authority & 2 Others**), was filed at the High Court in Machakos. In a ruling delivered by the Court on 19th April, 2021, conservatory orders restraining the KRA from enforcement of minimum tax pending the hearing and determination of the petition was issued. The matter is still pending in court and thus the fate of minimum tax hangs in the balance. Having said that, the Act has now amended the minimum tax provisions by clarifying that the following persons will not be required to pay minimum tax:

- persons engaged in business whose retail price is controlled by the Government. This exemption had been introduced by the TLAA and has been retained in the Income Tax Act;
- persons engaged in insurance business. This exemption had been introduced by the TLAA and has also been retained in the Income Tax Act;
- persons engaged in manufacturing and their cumulative investment in the preceding four years from assent is at least ten billion shillings. In our view, this provision does little to cushion micro, small and medium enterprises ("**MSMEs**") in the manufacturing sector whose cumulative investment for four (4) years falls way below the set threshold. Such MSMEs would therefore be required to pay minimum tax;

- persons licensed under the Special Economic Zones Act, 2015; and
- persons engaged in distribution business whose income is wholly based on a commission.

Effective date: 1 July, 2021

d. Thin capitalization

Thin capitalization regulations require a company controlled by foreign shareholders to be adequately capitalized. These regulations limit the deductibility of interest on loans to the extent that the debt-to-equity ratio exceeds 3:1 for foreign controlled companies. Where this ratio is exceeded, the interest on the loans which so exceeds is non-deductible.

The Act has repealed this provision by outlining that with effect from 1st January, 2022, gross interest paid or payable on all loans to related persons and third parties in excess of 30% of earnings before interest, taxes, depreciation and amortization ("**EBITDA**") of the borrower in any financial year will not be allowable for purposes of computation of income tax. Thin capitalisation will therefore be based on EBITDA as opposed to the debt to equity ratio discussed above. Of note is that any exempt income shall be excluded from the calculation of EBITDA and these provisions will not apply to banks or financial institutions and micro and small enterprises registered under the Micro and Small Enterprises Act, 2012.

Effective date: 1 January, 2022

e. Deemed interest provisions retained

Deemed interest rules apply in respect of interest-free loans where the same is advanced by a non-resident person who controls the resident person. Where a non-resident person has extended a loan to a resident company on an interest-free basis, the resident company is required to compute a deemed-interest charge based on the prevailing Treasury Bill rates and remit to the KRA withholding tax on the notional (deemed) interest computed in the above manner.

Where transactions fall within the definition of control, companies will need to document proper transfer pricing policies setting out applicable interest rates for any loan arrangements to comply with deemed interest rules.

Effective date: 1 January, 2022

f. Deduction of tax losses

Businesses in a tax loss position will now be allowed to deduct tax losses while computing taxable income for the year in which the loss is incurred and the succeeding years of income. Previously, the tax losses would be carried forward for ten (10) cumulative years.

This is a welcome amendment as it will shield businesses that are in perpetual tax loss positions especially in the formative years.

Effective date: 1 July, 2021

g. Country by country reporting introduced

The Act has introduced reporting requirements for an ultimate parent entity ("**UPE**") of a multinational enterprise group ("**MNEG**"). A UPE is defined as an entity that: (a) is tax resident in Kenya; (b) is not controlled by another entity; and (c) owns or controls an MNEG. An MNEG is a group that includes two or more enterprises which are resident in different jurisdictions including an enterprise that carries on business through a permanent establishment or through any other entity in another jurisdiction.

With effect from 1st January, 2022, a UPE of an MNEG shall submit to the KRA a return describing the group's financial activities in Kenya, where its gross turnover exceeds the prescribed threshold, and in all other jurisdictions where the group has taxable presence, not later than twelve months after the last day of the reporting financial year of the group. The return submitted shall contain the prescribed information on the group's aggregate information including information on revenue, profit or loss before income tax, income tax paid, income tax accrued, stated capital, accumulated earnings, number of employees and tangible assets other than cash or cash equivalents with regard to each jurisdiction in which the group operates.

The change is based on the Base Erosion and Profit Shifting ("**BEPS**") Action 13 which is to the effect that all large multinational enterprises should prepare a country-by-country ("**CbC**") report with aggregate data on the global allocation of income, profit, taxes paid and economic activity among tax jurisdictions in which it operates. This CbC report will be shared with the KRA for use in high level transfer pricing and related tax risk assessments.

Effective date: 1 January, 2022

h. National Hospital Insurance Fund contributions to qualify for insurance relief

Employees and all persons who voluntarily make contributions for the National Hospital Insurance Fund "**NHIF**" will, with effect from 1st January, 2022, enjoy an insurance relief. This will be a reprieve, albeit minimal, which will reduce the tax payable. This relief comes shortly after the Pay As You Earn ("**PAYE**") rates were revised for the benefit of the employees by the TLAA from 1st January, 2021.

Effective date: 1 January, 2022

i. Rates for investment deductions

Effective 1st January, 2022, investment allowances will be deducted in equal instalments, after the first year of use, instead of the current reducing balance method which is to the effect that the amount of investment allowance that is deducted reduces each subsequent year. This amendment is aimed at simplifying computation of investment allowances and will ultimately ensure entities comply with the provisions of the second schedule.

Effective date: 1 January, 2022

j. Tax rebates for apprenticeship training

An employer who hires at least ten (10) university or technical and vocational education and training students for a period of at least six (6) months in a year will be eligible for tax rebate in the year subsequent to the year of such engagement. Currently, employers qualify for this rebate if they hire at least ten (10) university students. With the advent of vocational education and training institutions, employers will be incentivized to employ more students.

Effective date: 1 January, 2022

2. VALUE ADDED TAX (VAT)

a. Casting the VAT net to supplies made over the internet or an electronic network

The Act has expanded the scope of goods subject to VAT to include supplies made over the internet or electronic network. Initially, the charge to VAT under this sub-section was limited to supplies made through a digital marketplace. Notably, the unit of currency in tax records for non-resident persons carrying on business through a digital marketplace shall be in convertible foreign currency as approved by KRA.

Effective date: 1 July, 2021

b. Persons not registered for VAT required to also remit tax by the 20th

Prior to July 2021, VAT was due and payable by a registered person not later than the 20th day of the month following the month in which the tax became due. The Act has however aligned most provisions of the Value Added Tax Act, 2013 to require even persons not registered to remit VAT to the extent that the liability to pay VAT has accrued.

Effective date: 1 July, 2021

c. Reclassification of supplies

i. From exempt to vatable supplies

- Milk specially prepared for infants - Tariff no. 0402.99.10
- Other milk in powder granules or other solid forms of a fat content by weight exceeding 1.5% - Tariff no. 0402.21.10
- Ordinary bread

Making these goods taxable will inevitably increase the cost to the final consumer.

Effective date: 1 July, 2021

ii. From vatable to exempt supplies

- Vitamin C and its derivatives – Tariff no. 2936.27.00
- Malaria diagnostic test kits – Tariff no. 3002.11.00
- Insulin – Tariff no. 3003.31.00
- Milk in powder, granules or other solid forms, of a fat content, by weight, exceeding 1.5%, not containing added sugar or other sweetening matter – Tariff no. 0402.21.00
- Other milk in powder granules or other solid forms, of a fat content, by weight, exceeding 1.5% - Tariff no. 0402.29.00
- Other milk – Tariff no. 0402.99.00
- Specialised equipment for the development and generation of solar and wind energy upon recommendation to the Commissioner by the Cabinet Secretary for Energy.
- Medical ventilators and inputs from the manufacture of medical ventilators upon recommendation of the Cabinet Secretary for Health.
- Biogas

This is a welcome change as it will reduce the cost of these supplies especially in the wake of a global pandemic.

Effective date: 1 July, 2021

iii. From zero-rated to exempt supplies

- Exportation of taxable services.
  This move has been faulted in many quarters due to its potential to increase the cost of taxable services in the service industry. The impact of the change is that suppliers of the said services cannot claim input VAT suffered in the supply of such services. Notably, treatment of VAT on export of services has for a long time been the subject of court cases between the KRA and the tax payers engaged in cross border supply of services.

Effective date: 1 July, 2021

a. Internet data services

With effect from 1st July, 2021, where excise duty has been paid in respect of internet data services by a licensed person who purchases the data in bulk for resale, the excise duty paid shall be offset against the excise duty payable by that person on services supplied to the final consumer.

This move will shield internet data service providers from payment of a colossal sum of duty to the KRA. The excise duty rate has however been increased from 15% to 20% and the net effect may be minimal.

Effective date: 1 July, 2021

b. Excise duty on betting, gaming, price competition and lotteries [re]introduced

Excise duty on betting had been introduced by the Finance Act, 2019, at a rate of 20% of the amount wagered or staked. Following lobbying efforts by betting industry players, the requirement was done away with by the Finance Act, 2020. The Act has however reintroduced excise duty on betting at a rate of 7.5%. Further, excise duty on gaming, price competition and lotteries has been introduced at the same rate.

Effective date: 1 July, 2021

c. Fees or commissions earned in respect of loan to be subject to excise duty

Fees or commissions earned in respect of a loan were prior to July 2021 exempt from excise duty. The Act has however deleted them from the definition of other fees which essentially will subject them to excise duty at a rate of 20%.

Banks will therefore need to factor this cost in processing loans. This will increase the cost of accessing bank facilities for the borrowers. As at the date of this alert, several banks have already issued notices to their clients regarding this change.

Effective date: 1 July, 2021

d. Skiza tunes to be exempt from excise duty

Mobile service providers who sell ring back tunes to their subscribers will get reprieve as these services will not attract excise duty. This will subsequently reduce the cost of the skiza tune services to the subscriber.

Effective date: 1 July, 2021

4. TAX PROCEDURES

a. Common reporting standards

The Act has introduced the Common Reporting Standards ("**CRS**") regime to effect automatic exchange of financial and accounting information on tax matters. The reporting is to be done by all financial institutions resident in Kenya, including Kenyan branches of non-resident financial institutions but excluding foreign branches of Kenyan financial institutions. The reporting will be done by way of filing returns with the KRA on reportable accounts. The Act requires the Cabinet Secretary to publish regulations prescribing the common reporting standards. The Regulations are expected to provide for, *inter alia,* due diligence procedures, record keeping requirements and guidance on how a reporting financial institution will identify reportable accounts.

Financial institutions, including insurance companies, will need to comply with the CRS requirements failing which the penalties under the Act will ensue.

Effective date: 1 July, 2021

b. Amnesty on tax on rental income abolished with effect from 1st July, 2021

c. Interest and penalties on ascertained refunds

The Act has introduced new sections shielding taxpayers from being charged interest and penalties on any outstanding tax liabilities that can be offset once a tax refund has been ascertained and approved. The penalties and interest will stop accruing from the date of notification by the KRA. However, any tax liability that remains outstanding after the KRA has applied the refund amount towards payment of an outstanding tax liability shall continue accruing interest and penalties.

Effective date: 1 January, 2022

d. KRA PIN will be mandatory for all businesses carried out over the internet or an electronic network including a digital marketplace.

Effective date: 1 July, 2021

5. MISCELLANEOUS FEES AND LEVIES

In a move aimed at increasing high value foreign direct investments, the Act has reintroduced the exemption from import declaration fee and railway development levy on importation of goods which the Cabinet Secretary may determine to be in the public interest or to promote investments of not less than KES 5 billion.

Effective date: 1 July, 2021

6. OTHER AMENDMENTS

a. <u>Insurance</u>

i. *Closed fund business*

The Act has amended the Insurance Act by introducing provisions relating to closed fund businesses which may be carried out by an insurer. A closed fund business is defined as the continuance of insurance business for the purpose of maintaining, without renewal, any policy or contract of insurance issued before the appointed date. An insurer will be allowed to carry on closed fund business without registration under the Insurance Act. It is important to note that the KRA may require an insurer to furnish particulars of the insurance business as specified in the notice. Penalties for failure to comply with the provisions relating to closed fund businesses are also outlined in the Act.

Effective date: 1 July, 2021

ii. *Payment of prescribed fee*

With effect from 1st January, 2022, an insurer with a license will be required to pay the prescribed annual fee.

Effective date: 1 January, 2022

b. <u>Retirement benefits</u>

i. *Recognition of corporate trustees*

A corporate trustee is defined as a limited liability company registered under the Companies Act, 2015, and has authority to undertake trusts. A corporate trustee will need to be registered upon meeting the requirements that have been introduced by the Act. The application for registration will need to be made to the Retirement Benefits Authority (the "**RBA**")in the prescribed form.

Effective date: 1 July, 2021

ii. *KRA empowered to collect unremitted contributions from defaulting employers*

Where an employer an employer has failed to remit contributions, the trustees, after demonstrating that they have taken all reasonable effort to recover unremitted contributions, may with the approval of the RBA, appoint the KRA, as an agent, to collect unremitted contributions, interests, and penalties. The KRA will give a twenty one day notice to the defaulting employer failing which agency notices will issue to the defaulting employer's bankers.

This move is meant to enforce compliance and employers will need to comply to abate freezing of their bank accounts on account of failure to remit contributions that are due to a retirement benefits scheme.

Effective date: 1 July, 2021

Please do not hesitate to contact us in case of any questions.

WAMAITHA GICHAMBA & CO. ADVOCATES

COOL BREEZE GARDENS, OFFICE NO. F,

MUTHAIGA

THIKA SUPERHIGHWAY

P.O. BOX 11622-00400

NAIROBI

TEL: +254 719 311 563

EMAIL: wamaitha@wamaithagichambaadvocates.com

WEBSITE: https://wamaithagichambaadvocates.com/

Dorcas Wamaitha

ADVOCATE &

FOUNDER, WGA