Tax Alert

Tax Changes Effective 1 January 2022 Through the Finance Act 2021 and other Notable Tax Matters

Introduction

The Finance Act, No. 8 of 2021 (FA 2021), which was assented to by the President on 29 June 2021 amended various tax laws as highlighted in our Tax Alert Issue No. 5 of 2021.

Whereas most of the amendments became effective on 01 July 2021, there are a number of amendments which became effective on **01 January 2022.**

This alert highlights the amendments which became effective on 01 January 2022 through the FA 2021. Additionally, this alert provides an overview of the recent developments with respect to Value Added Tax (Electronic Tax Invoice) Regulations, 2020 and the draft Regulations on Country by Country (CbC) Reporting requirements for Multinational Enterprises and on Common Reporting Standards (CRS). Our detailed analysis of the above tax changes is contained in the subsequent paragraphs.

1. Interest restriction

The FA 2021 introduced the restriction of tax deductibility of interest expense on any gross interest amounts paid or payable to either related persons or third parties in excess of 30% of Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA). This has replaced the former thin capitalization provisions where interest payments in a year of income by a foreign controlled entity were not either partly or fully tax deductible depending on the ratio of debt to equity which was 3:1 respectively.

This new provision is applicable to interest on all loans, payments that are economically equivalent to interest and expenses incurred in connection with raising the finance and shall apply to all entities including those in the extractive sector.

This provision, however, exempts the following entities from interest restriction:

a) Banks or financial institutions licensed under the Banking Act; and
b) Micro and small enterprises registered under the Micro and Small Enterprises Act, 2012.

The new provision is in tandem with Action 4 of the Base Erosion and Profit Shifting (BEPS) Project which aims at limiting base erosion through the use of tax deductible interest deductions and other financial payments. Action 4 recommends the restriction of an entity's net interest deductions to its level of economic activity, which is measured using EBITDA.

2. Country-by-Country reports for ultimate parent entities of Multi-National Enterprises resident in Kenya

The FA 2021 introduced the definition of a Multi-National Enterprise (MNE) group as 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. The Ultimate Parent entity means an entity that:

a) is tax resident in Kenya for tax purposes;
b) is not controlled by another entity; and
c) owns or controls a MNE group.

The Ultimate Parent Entity of the MNE shall now be required to submit to the Commissioner a return describing the group's financial activities in Kenya and in all other jurisdictions where the group has taxable presence. The return shall be submitted not later than 12 months after the last day of the reporting financial year of the group. Additionally, the return shall contain information on the group's aggregate information on revenue, profit and 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.

This provision highlights Kenya's efforts to implement the OECD BEPS Action 13 on Country by Country (CbC) reports. Action 13 seeks to provide revenue authorities with

a high-level overview of the operations and tax risk profiles of MNE groups.

By submitting to the revenue authorities information on the MNE and all the constituent group entities on an annual basis, revenue authorities are able to assess on a high level any inherent Transfer Pricing (TP) risks.

This amendment is in line with KRA's continued scrutiny on MNEs to ensure they pay their fair share of taxes in Kenya.

3. Insurance Relief on NHIF contributions

Individual taxpayers will from 01 January 2022 claim insurance relief on contributions made to the National Hospital Insurance Fund ("NHIF") in a year of income.

Insurance Relief is computed at 15% of the premiums paid, subject to a maximum of KShs. 60,000 per annum.

4. Expansion of scope of tax rebate scheme for apprenticeship program

Employers who engage graduates from Technical and Vocational Education and Training ("TVET") for a period of 6 to 12 months will now be entitled to a tax rebate scheme. Prior to 01 January 2022, the scheme was only available to employers who engage 10 university graduates as apprentices for a period of 6 to 12 months.

5. Investment allowances deduction method

The FA 2021 amended the capital expenditure deduction criteria on all assets that were previously on reducing balance basis to equal installments. The new capital deduction rates applicable from 01 January 2022 are as follows:

Item	Previous	Current
Hotel buildings, buildings used for manufacture, hospital buildings and Petroleum or gas storage facilities	50% in the first year and 25% on the residual value per year on reducing balance basis	50% in the first year and 25% on the residual value per year on equal instalments
Commercial and educational buildings including student hostels	10% per year on reducing balance basis	10% per year on equal instalments
Machinery used for manufacture, hospital equipment and ships and air crafts	50% in the first year and 25% on the residual value per year on reducing balance basis	50% in the first year and 25% on the residual value per year on equal instalments
Motor vehicles and heavy earth moving equipment	25% per year on reducing balance basis	25% per year on equal instalments
Computer and peripheral, computer hardware, computer software, calculators, copiers and duplicating machines	25% per year on reducing balance basis	25% per year on equal instalments
Furniture and fittings and telecommunication equipment	10% per year on reducing balance basis	10% per year on equal instalments
Filming equipment	25% per year on reducing balance basis	25% per year on equal instalments
Machinery used to undertake operations under prospecting right and machinery used to undertake exploration operations under a mining right	50% in the first year and 25% on the residual value per year on reducing balance basis	50% in the first year and 25% on the residual value per year on equal instalments
Other machinery	10% per year on reducing balance basis	10% per year on equal instalments
Fibre optic cable	10% per year on reducing balance basis	10% per year on equal instalments
Farm works	50% in the first year and 25% on the residual value per year on reducing balance basis	50% in the first year and 25% on the residual value per year on equal instalments

6. Clarifications on definitions relating to investment allowances

The FA 2021 made the following clarifications in relation to investment allowances qualification which became effective from 01 January 2022:

- Machinery used in the generation of electricity for own consumption or for distribution to other persons without necessarily being through the national grid is subject to investment allowance at the rate of 50% in the first year and 25% on the residual value per year on equal instalments;
- Civil works include roads and parking areas, railway lines and related structures,water, industrial effluent and sewer age works, communications and electrical posts and pylons and other electrical supply works, and security walls and fencing. Civil works relating to a building used for manufacture shall qualify for investment allowance at the rate of 50% in the first year and 25% on the residual value per year on equal instalments while civil works relating to a commercial building shall qualify for investment allowance at the rate of 10% per year on equal instalments; and
- Farm works include farmhouses, labour quarters, any other immovable building necessary for the proper operation of the farm, fences, dips, drains, water and electricity supply works and other works necessary for the proper operation of the farm shall qualify for investment allowance at the rate of 50% in the first year and 25% on the residual value per year on equal instalments.

7. Re-introduction of Investment Deduction at the rate of 100%

Investment Deduction (ID) at the rate of 100% was re-introduced w.e.f. 01 January 2022 where:

- The cumulative investment value in the preceding three years outside Nairobi and Mombasa Counties is at least KShs 2 billion;
  or
- The investment value outside the Counties of Nairobi and Mombasa is at least KShs 250 million;
  or
- The capital investments are made in a Special Economic Zone (SEZ).

The 100% ID criteria based on the investment values is now applicable to all entities not only those operating under the SEZ framework.

8. Special transition of accelerated ID at the rate of 150%

Where a person had made investments in the preceding three years on or before 25 April 2020 cumulatively amounting to KShs 2 billion, and would have qualified for ID at the rate of 150% they shall now be eligible for investment deduction at the rate of 150% for the investment made on or before 25 April 2020.

Majority of taxpayers who have already filed their tax returns for the 2020 year of income can take advantage of this by amending their tax returns.

9. Amendments to the Ninth Schedule to the Income Tax Act, CAP 470

The FA 2021 aligned the capital deductions criteria for machinery used to undertake operations in the extractive industry under a prospecting right to equal installments from a reducing balance basis as per the Second Schedule. The FA 2021 also increased the withholding tax rate for service fees paid by a contractor or a licensee to 10% from 5.625% and reduced the withholding tax to be deducted by a contractor in the case of management, training or professional fees to 10% from 12.5%. Interest expense restriction in the Ninth Schedule to the ITA will w.e.f. 01 January 2022 be aligned to 30% of EBITDA.

10. Tax Refunds

The FA 2021 provided that in cases where the Commissioner ascertains and notifies a taxpayer of a tax refund and the refund due is utilized to offset other outstanding taxes, the interest and penalties of the taxes due will no longer accrue from the date the Commissioner informs the taxpayer. However, if there is any outstanding tax after such an application, then the outstanding tax shall continue to accrue interest and penalties in accordance with the provisions under the Tax Procedures Act, 2015 (TPA). Additionally, the FA 2021 introduced a provision relating to offsetting overpaid tax against future tax liabilities when the Commissioner is satisfied that there is an overpayment of tax. This amendment reinforces the Commissioner's position that taxpayers with tax overpayments must apply for a refund and it is only when he approves the tax refunds that taxpayers can use them against future tax liabilities.

This introduction under Section 47 of the TPA is an emphasis by KRA on taxpayers having to apply for refunds on tax overpayments.

11.Miscellaneous Fees and Levies Act - refunds for overpaid fees and levies

The FA 2021 introduced a provision to allow for refund of any fees and levies overpaid or paid in error under this Act in line with the refund of overpaid tax provisions under Section 47 of the TPA. The fees and levies under this act are Export Levy, Import Declaration Fee, Railway Development Levy, Anti-Adulteration Levy, processing fees on duty free motor vehicles, and duty on goods for home use from an Export Processing Zone (EPZ). The Commissioner will also have powers to determine the resultant penalties and interest if the levies and fees remain unpaid.

Other notable tax changes

1. Draft Regulations on Common Reporting Standards

The FA 2021 introduced and defined the principles that will govern the application of Common Reporting Standards (CRS) regime in Kenya. The CRS regime effects the automatic exchange of financial information on tax matters in Kenya. CRS entails the reporting and due diligence standards for the automatic exchange of financial account information by financial institutions that are tax resident in Kenya. These financial institutions are required to share with the Commissioner an information return on reportable accounts held, managed or administered. The reporting is to be done by all financial institutions that are tax resident in Kenya, including Kenyan branches of non-resident financial institutions, but excluding foreign branches of Kenyan financial institutions. The CRS provisions became effective from 1 July 2021.

The CRS regime is an indication that Kenya is stepping up its efforts to join global tax transparent jurisdictions in connection with the exchange of information on foreign accounts for tax purposes.

To effect the implementation of CRS, the Cabinet Secretary (CS) National Treasury was mandated to prescribe CRS regulations. To this end, the CS issued the Draft Tax Procedures (Common Reporting Standards) Regulations, through a public notice published on 14 December 2021 for public participation in line with the Statutory Instruments Act.

The Regulations will set out the rules for the implementation of the agreements signed by Kenya on the automatic exchange of information on financial accounts in accordance with the OECD common reporting standards and the Multilateral Competent Authority Agreement.

The Regulations will also describe the reporting obligations and due diligence requirements to be adhered to by the reporting financial institutions and the date and manner of filing the CRS information.

The CRS provisions became effective on 01 January 2022 but it is imperative to note that the final regulations are yet to be published.

2.Country-by-Country Reporting Draft Regulations

The FA 2021 introduced the Country-by-Country (CbC) reporting requirements for Ultimate Parent Entities of a Kenyan tax resident MNE through Section 18B of the Income Tax Act. The CS National Treasury was mandated to issue the regulations that would effect the implementation of the CbC regime.

The CS issued the Draft Income Tax Act (Country-by-Country Reporting Standards for MNEs) Regulations, 2021 via a public notice dated 19 November 2021. The CS subsequently invited the public to give their views on the draft regulations in line with the Statutory Instruments Act.

The regulations are meant to guide on the applicable entities for CbC reports, the filing and notification procedure, the contents of the CbC reports and the form and manner of delivery of the CbC reports. Additionally, the regulations will stipulate the time of filing and the use and confidentiality of the CbC reports.

The final CbC regulations are yet to be published.

3.Compliance with the Value Added Tax (Electronic Tax Invoice) Regulations 2020

The Value Added Tax (VAT) (Electronic Tax Invoice) Regulations, 2020 were gazetted through Legal Notice No. 189 on 10 September 2020 and published on 25 September 2020. This is in line with Regulation 9 of the VAT Regulations, 2017 which provides the requirements of a valid tax invoice.

These regulations require persons registered under Section 34 of the VAT Act, 2013 to maintain a tax register which has the Tax Invoice Management System (TIMS). This is to enable the transmission of invoice data to the KRA system, real-time. The list of approved Electronic Tax Register (ETR) manufacturers and suppliers can be accessed on the KRA website. However, if a taxpayer's business billing system is fully automated, they will be required to use compliant Electronic Signature Devices (ESD).

The regulations detail the use of a register, availability of the register, obligations of the user of the register, specifications of the register, transmission of the invoice data and security, amongst others.

In addition to this, KRA notified the general public through a Public Notice dated 09 July 2021 that the roll out of the Electronic Tax Invoice pursuant to the provisions of the regulations were effective from 01 August 2021 and that all VAT registered taxpayers are required to comply with the requirements within a period of twelve (12) months therefrom, that is by **31 July 2022**.

However, where a person is unable to comply with the above stipulated timelines, they can apply to the commissioner in writing for an extension of time. The time extension shall not exceed a period of six (6) months and should be made at least thirty (30) days before 31 July 2022, that is on or before 01 July 2022.

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