EAST AFRICA TAX AND GOVERNANCE NETWORK (EATGN)

TAX PROPOSALS ON ECONOMIC POLICY MEASURES

PUBLIC SUBMISSION ON THE FISCAL BUDGET FOR THE FINANCIAL YEAR 2019/2020

EATGN
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Table of Contents

CONTRIBUTORS

The East Africa Tax and Governance Network (EATGN) is a collaborative initiative of various East African civil society organisations with diverse interests on tax issues within the region. EATGN stands for a just, transparent, accountable and citizen driven tax system in East Africa and it aims to mobilize citizens to advocate for equitable tax policies and practices through capacity building, research and campaigning. This is due to recognizing a conscious need for a greater understanding of taxation, tax justice and public financial management issues within the East African Community (EAC).

INTRODUCTION

Tax provides East African governments with the funding required to finance the infrastructure on which the region's economic development and growth is based. It also creates an environment in which business and wealth creation is carried out. It therefore plays a defining role in shaping the way in which the activities of government are conducted especially with regards to service delivery demands placed upon them by various constituencies. Consequently, EATGN views itself as a critical entity in galvanising citizen voices around these issues.

EATGN is hereby making proposals to the Cabinet Secretary, National Treasury and Planning following the call for public submissions on economic policy measures including taxation proposals to help in transforming the lives of all Kenyans. EATGNs submission is based on studies under its Providing Appropriate Tools Required to Interpret and Observe Tax Structures (PATRIOTS) in Kenya, namely: *The Relational Analysis Between the Income Tax Bill 2018 and the Tax Laws (Amendments) Act, 2018* and *An Assessment of the Finance Act 2018 against the Background of Kenya's Anti-Money Laundering and Counter-Terrorism Financing Obligations*.

TAX PROPOSALS

In line with tax reforms under implementation of the third Medium Term Plan 2018-2022 (MTP 3) to expand the "tax base by targeting informal sector, pursue non-filers and increase focus on taxation of international transactions and transfer pricing."[1] This submission will help prevent the potential for serious inconsistency in relation to the goal of reducing inequality in Kenya as envisioned by the Big Four Agenda of the Jubilee Administration and Vision 2030. This is so that:

1. The national taxes do not overly burden the poor as opposed to the rich;
2. Presumptive taxes on small businesses are rationalized in order not to hinder entrepreneurship needed to provide livelihoods; and
3. Current laws prevent the extension of counterproductive and blanket amnesty from the Proceeds of Crime and Anti-Money Laundering Act (POCAMLA) to facilitate the fight against corruption.

EATGN therefore believes that the discussions, contributions, development and passage of the budget in the Financial Year 2019/2020 should aim to clarify and tighten implementation that seeks to broaden the tax base further rather than deepen it.

PROPOSAL 1 - The Relational Analysis Between the Income Tax Bill 2018 and the Tax Laws (Amendments) Act, 2018

Introduction

Article 209 (1) of the Constitution of Kenya, 2010 ('Constitution') provides the basis for taxation in Kenya. The Article identifies four distinct categories of taxes that can only be imposed by the national government. These taxes are; the income tax, value added tax, customs duties and other duties on import and export goods; and the excise tax.

[1] Medium Term Plan 2018-2022

Article 209 (3) goes a step further to confer counties with the conditional power to impose tax subject to three criteria - that the taxation and revenue raising powers of a county shall not be exercised in a way that prejudices: first, national economic policies; Second, economic activities across county boundaries and third, the national mobility of goods, services, capital or labour. Article 210 expressly requires the enactment of legislation to impose, waive or vary taxes in the country.

The current Income Tax Act ('ITA')[2] is the primary source of legislation that defines and sets out Kenya's tax structure and revenue base. The ITA predominantly borrowed from the 1920 Income Tax Ordinance and has remained unchanged save for piecemeal amendments, revisions and reform over the years.

Other statutes such as the Stamp Duty Act,[3] the Value Added Tax Act,[4] Miscellaneous Levies Act[5] and the Excise Duty Act[6] supplement the ITA by providing additional revenue sources for the government and regulating the business environment. The Tax Procedures Act[7] and the Tax Appeals Tribunal Act[8] are recent additions to the governance aspect of tax in Kenya. These two statutes explain the procedure that facilitates the administration and management of taxation on the one hand, and on the other, how to resolve tax disputes.

The Income Tax Bill, 2018 ('ITB') is the most recent attempt by the government to align tax legislation with Article 10 (2) of the Constitution and the Big Four Agenda to enhance the growth of the economy and to simplify doing business in Kenya. The government aspires to broaden its tax base with the proposals made in the ITB and to reduce the inconsistencies within the tax regime that led to ambiguity in the application of the law and covert tax avoidance/evasion practices.

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[2] Income Tax Act, Chapter 470 of the Laws of Kenya
[3] Stamp Duty Act, Chapter 480, Laws of Kenya
[4] Value Added Tax Act, No. 35 of 2013.
[5] Miscellaneous Levies Act, No. 29 of 2016
[6] Excise Duty Act, No. 23 of 2015
[7] Tax Procedures Act, No. 29 of 2015, Laws of Kenya
[8] Tax Appeals Tribunal Act, No. 40 of 2013

The Problem

Regrettably, the ITB proposals to broaden the tax base are not linked to the principles set out under Article 10 (2) of the Constitution. The ITB does not reflect the principles of equity, social justice, inclusiveness, equality, human rights, non- discrimination and protection of the marginalised.

The ITB fundamentally shifts the traditional understanding of taxation within the parameters of the current ITA by proposing three distinct tax features. One, to increase tax rates and remove exemptions. Two, to tighten restrictions on expense deductions for the determination of taxable income and three, to broaden the provisions that deem income derived by a non- resident from Kenya to be taxable in Kenya.

The ITB is silent on incorporating international best practice from the implementation of the four minimum standards of the Organisation for Economic Co-operation and Development (OECD) Inclusive Framework on Base Erosion and Profit Shifting (BEPS) and in realigning the taxation of services and intellectual capital to consider their key role in Kenya's business environment.

Situation Analysis

The National Treasury under Treasury Circular No 14/2016 issued guidelines to all Ministries, Departments and Agencies on the process and procedures for preparing the Medium-Term Budget for the Financial Years 2017/18 – 2019/20. The upcoming budget for 2019/2020 therefore, seeks to continue the policy and strategic reform measures that the government set out in the Economic Transformation Agenda[9] detailed in the 2016 Budget Policy Statement, and thereafter presented to parliament as the Medium-Term Budget 2017/18 - 2019/20.

[9] The National Treasury. 2016. Budget Policy Statement. Sustaining Prosperity in a Volatile Global Economy. https://www.internationalbudget.org/publications/kenya-budget-policy-statement-2016/

The policy to be undertaken by the government aims to create a sustainable fiscal framework that will achieve higher growth, generate employment and reduce poverty and inequality thereby realising the aspirations under Vision 2030. The input therefore, is that the Draft Income Tax Bill 2018 (ITB) makes to the realisation of the Economic Transformation Agenda is to scale up levels of investment in economic infrastructure, support rapid economic growth and development, and sustain macro-economic stability.

The achievement of these objectives is observed in the provisions of the ITB that propose to introduce graduated tax scales and withholding tax on repatriated profits at a rate of 10%; revising the thin capitalisation threshold from the current debt-equity ratio of 3:1 to 2:1; increasing capital gains tax rate from 5 to 20%; abolishing tax holidays for Special Economic Zones (SEZs) and Export Processing Zones (EPZs); abolishing the 150% investment allowance and reduction of various capital allowances on buildings and machinery used in manufacturing, commercial real estate, film and education sectors; removal of tax exemptions; regulations to tax the digital economy, and introducing the presumptive tax at a rate of 15%.

Recommendations

1. **Lower presumptive tax rate and Capital Gains Tax (CGT)** - The aim of the Economic Transformation Agenda was to reduce the cost of doing business and to make the Kenyan market competitive. The broadened tax base as contemplated in the ITB therefore, approbates and reprobates this aim. While an increase in taxes would result in additional revenue to meet the social and economic needs of the country, it also presents a burden to the different categories of taxpayers.

While non-resident and foreign based multinational companies are deprived of the tax incentives under the ITA, small and medium sized enterprises ('SMEs'), youth led organisations, women owned businesses and persons living with disabilities face restrictions in developing their businesses and limiting their capacity for growth pursuant to the application of the presumptive tax.

This in turn would limit investment in rural development by SMEs, youth, women and persons living with disabilities. It restricts their ability to then venture out in business and business led activities. The increase in the capital gains tax further imposes upon these tax payers an additional financial burden that is not commensurate with the levels of rural poverty and unemployment in the country.

Various studies have demonstrated a strong link between taxation and people's livelihoods[10] and the negative impact taxes can have on small businesses and women.[11] A reconsideration of the 15% presumptive tax rate to align with the Ugandan rate set at between 1.5-3% would set a harmonised trend within the EAC. It will provide the informal sector with the incentive to move towards tax compliance.

In view of this, it is recommended that a specific percentage of tax collected from the presumptive tax and the capital gains tax be directed into the Equalisation Fund set up under Article 204 of the Constitution so that the counties from whence these taxes are collected are redirected towards provision of basic services including water, roads, health facilities and electricity to rural and marginalised areas within the counties.

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[10] World Bank. 2011 Facilitating Cross-Border Trade Between the DRC and Neighbours in the Great Lakes Region of Africa: Improving Conditions for Poor Traders, Washington, DC: World Bank; Pimhidzai, O. and Fox. L. 2012. Taking from the poor or local economic development: The dilemma of taxation of small informal enterprises in Uganda, Washington, DC: World Bank; Titeca with Kimanuka, C. 2012. Walking in the Dark: Informal Cross-Border Trade in the Great Lakes Region, London: International Alert; Bahiigwa, G., Ellis, F., Fjeldstad, O-H. and Iversen, V. 2004. Rural Taxation in Uganda: Implications for Growth, Income Distribution, Local Government Revenue and Poverty Reduction, Uganda: Economic Poverty Research Centre, and Ellis, F. 2005. Local Government Taxation Reform in Tanzania: A Poverty and Social Impact Analysis, Washington, DC: The World Bank Social Development Department.

[11] Fjeldstad and Heggstad. 2012. Building Taxpayer Culture in Mozambique, Tanzania and Zambia: Achievements, challenges and policy recommendations, Bergen: Chr. Michelsen Institute; D'Arcy, M. 2012. Taxation, Democracy and State-Building: How Does Sequencing Matter?, Gothenburg: University of Gothenburg Quality of Governance Institute; Itriago, D. 2011. Owning Development: Taxation to fight poverty, Oxford: Oxfam International, and Train4Dev. 2009. Increasing Revenue Collection Without Damaging the Livelihoods of the Poor, http://www.oecd.org/dac/povertyreduction/47466718.pdf

The principles on equity, social justice, inclusiveness and sustainable development under Article 10 (2) of the Constitution can be made meaningful in terms of previous civil society proposals to parliament to demonstrate the application of tax justice and fiscal legitimacy in the allocation of the newly contemplated additional taxes towards rural development. This can be done by parliament providing for a revenue allocation criterion under regulations stemming from the ITB.

2. **<u>Lower threshold for application of 35% tax rate</u>** - The guidelines for the preparation of the medium-term budget for the period 2019/20 – 2021/22 were circulated via Treasury Circular No. 8/2018 in accordance with section 36 of the Public Finance Management (PFM) Act, 2012.

The guidelines recognise the country's limited fiscal space and therefore, leverages on the private sector. As such paragraph 3 of the Third Schedule to the ITB that introduces changes to the corporate rate of tax is not in tandem with this goal. The schedule has reduced the rate to 30% for both resident companies, and non-resident companies having a permanent establishment in Kenya whose income does not exceed Kshs 500 million.

For taxable income exceeding Kshs 500 million, a rate of 35% will apply. This is an ineffective provision as Kenya does not have a lot of companies that make it to this threshold. Tax legislation in so far as practical should reflect the context within which companies operate in its jurisdiction. Accordingly, it is recommended that the threshold of Kshs 500 million be lowered to at least Kshs 100 million to ensure there is higher tax collection from those that earn more and generate available revenue to limit the growing debt crisis.

3. **<u>Match ITB to service delivery</u>** - The ITB does not indicate how its provisions link to the Big Four Plan, or at least one of them. Neither does the ITB match any of its provisions to service delivery, in the guidelines setting out the process and planning for the 2019/20 budget, in which the government aims to pursue a fiscal

consolidation policy targeted towards reducing the overall fiscal deficit and debt accumulation.

The Cabinet Secretary for finance, should in accordance with the PFM Act give details of how tax measures "take into account the principles of equity, certainty and ease of collection". Therefore, this will ensure that tax measures from the Treasury, as encapsulated by the ITB, will clearly elaborate responsiveness to these principles because they have a direct effect on public expenditure.

4. **Sustainable expansion of the tax base** - Increase in tax mobilisation serves to address the fiscal deficit and debt crisis. However, such increases must be commensurate with the market. It is hereby recommended that the following areas merit parliament enacting subsidiary legislation or regulations to align the ITB to the global tax agenda.
    a. First, *the higher rate of tax at 35% that is proposed to be imposed upon any individual earning more than KES 9 million per annum (KES 750,000 per month) results in a very narrow tax base or none at all*. The taxpayer pool earning this stipulated amount is supposedly only a handful and that does not translate into any tax at all. The 35% rate should instead apply to individuals earning Kshs 500,000 per month.
    b. Second, *the tax base has not fully been exploited by the ITB due to a disconnect between technology taxation and sustainable revenue mobilisation.* Therefore, introduce regulation and taxation of digital currencies; impose the digital service tax for companies trading and providing services online. This captures the modern developments of the market economy. A tax system should respond to the emerging market trends. In so doing the tax regime creates a sustainable design that is all inclusive of business trends. In this regard, the taxing of SMEs falls within the equality principle when tax rates are also applied to foreign companies with a digital market presence.

c. Third, *Double Taxation Agreements (DTAs) have been exploited by tax dodging companies, thereby re-routing untaxed profits and income out of Kenya.* This in turn has led to income inequality and erosion of the Kenyan tax base inhibiting spending on social rights, such as health, education and welfare. ITB to expressly set out Transfer Pricing (TP) rules; country by country reporting measures; taxation of value additions and apply the African Tax Administrative Forum (ATAF) Model Tax Agreement definition on permanent home as measures to combat Illicit Financial Flows (IFF).

5. **Remove application of CGT for SMEs** - The CGT rate proposed at 20% unfairly tips the rich against the poor. SMEs are defined as the cornerstone of economies.[12] In this respect, Kenya should borrow from the South African Chamber of Business that has condemned CGT as having adverse implications for entrepreneurship and job creation. Citing France, Germany and Italy as examples, it was argued that the South African government's decision to levy CGT on SMEs was a possible contradiction of its stated objective of tax equity aimed at combating poverty.[13]

PROPOSAL 2 - An Assessment of the Finance Act 2018 against the Background of Kenya's Anti-Money Laundering and Counter-Terrorism Financing Obligations.

The Problem

In evaluating the 'amnesty' created through the Finance Act, 2018 in the context of Kenya's municipal and international anti-money laundering and Counter-Terrorism

[12] POTERBA, J. 1989. Venture capital and capital gains tax; Manuel, T. 2010. Budget speech (2010). Available at: http://www.treasuary.gov.za
[13] POTERBA, J. 1989. Venture capital and capital gains tax; Moore, S., and Silva, J. 1995. The ABCs of capital gains tax. Cato Institute: Policy Analysis, No. 242, October; Ededes, J. 2000. Capital gains tax. Financial Mail, 15 April.

Financing (AML/CTF) obligations, the section 37B (4) exemption poses *legal, policy, and practical threats* to the economy's financial architecture.

Kenya has many laws that make provisions for the combating of money laundering and terrorism financing, and related challenges. The framework is still in its nascent stages, with the laws having been enacted less than ten years ago and the Financial Reporting Centre (FRC) having become operational only six years ago in 2012.[14] These laws and legal institutions are no guarantee that Kenya will succeed in combating money laundering in the country as well as play its part in combating the vice on the global stage.

It will take vigilance, enhancement of the capacities of the concerned authorities to exercise their mandate, respect for the laid down law and institutions and a culture of that commits to integrity in financial dealings both in public and private sectors. Thus, the broad exemption from Anti-Money Laundering and Counter Terrorism Financing (AML/CTF) laws for foreign cash inflows introduced by section 37 B (4) is a step in the wrong direction for the following reasons:

A. The provision creates a gap in the AML/CTF law, a loop hole that can be exploited to repatriate proceeds of crime into Kenya. It could open room for money that is a product of economic crimes committed in Kenya or elsewhere to get back into the country's financial system, and indeed the global financial system.

It is noteworthy that the exemption does not cover funds "derived from proceeds of terrorism, poaching and drug trafficking. "This provision is of course intended to address questions that would be elicited by this blanket exemption. In other words, the proviso notes that money can be remitted into Kenya under the amnesty except for dirty money derived from these three crimes. This proviso is unhelpful for two reasons: first, money does not come with labels. In fact, illicit money is always disguised.

The illicit source of funds can only be identified upon inquiry and investigations and seeking to understand its source. Thus, barring any inquiry will mean money, legitimate or otherwise, will pass under the amnesty and exemption created by section 37 B. Second, poaching and drug trafficking are not the only predicate offences that are often the source

[14] http://frc.go.ke/about-frc/background.html

of illicit money. As noted above, the list is long and includes bribery and other forms of corruption, outright theft of public funds, human trafficking, and trade in counterfeit goods among other offences. As already noted, Kenya has suffered and continues to suffer from these problems.

B. In exempting money remitted under the amnesty from the provisions of Proceeds of Crime and Anti-Money Laundering Act, 2009 (POCAMLA) or any other Act relating to reporting and investigation of financial transactions" this law interferes with the mandate and operations of FRC, the Central Bank of Kenya (CBK) and other regulators of the financial sector to carry out inquiries into transactions or financial affairs of beneficiaries of income repatriated under the amnesty.

This is because the obligation of a financial institution to report a transaction that is "unusual or suspicious" is waived with respect to funds transmitted under the amnesty. In addition, it would follow that a reporting institution is not obliged to inquire into the source of funds or the intended beneficiaries. Similarly, a customer seeking to transact in money received under the amnesty is not obliged to answer any inquiries from the reporting institution, FRC, or any other law enforcement agency since the money enjoys a blanket amnesty from the laws on "reporting and investigation of financial transactions."

In short, the provision weakens the effectiveness of the system to detect, prevent and suppress inflow of illicit money as it restrains financial institutions, respective regulators, and the FRC in their obligations.

C. The provision also offends know principles of public policy. It contradicts special laws enacted for the specific purpose of combating money laundering and terrorism financing. The AML/CTF legal and institutional framework discussed above is a gatekeeping strategy to safeguard the Kenyan economy from inflow of illicit funds. It is a known principle of public law that encouraging behaviour results in more of it; supressing results in less of it.

The AML laws seek to hinder flow of illicit funds and to deny criminals the proceeds of crime. To exempt any money from AML laws opens a loop hole that offends this principle and could have a snowball effect of spurring predicate economic crimes such as corruption, poaching, and drug trafficking, not to mention internal security threats, and possible economic distortions that money laundering is known to cause.

D. AML/CFT strategies such as the Financial Action Task Force (FATF) Recommendations are multilateral efforts anchored in law. Kenya's own AML/CTF laws are the country's attempts to comply with international standards and meet its international legal commitments. The exemption created by section 37 B (4) creates a weakness that makes Kenya's legal and institutional framework fall short of the FATF Recommendations.

This puts the country at risk of being returned to Pre-2014 position where Kenya had been listed as a country "with strategic deficiencies on AML/CTF "and made subject to FATF monitoring. Should this happen, it will reverse the gains made in positioning the country as a regional financial hub. It should be recalled that the United States State Department retains Kenya as a country of "Primary Concern" as far as money laundering and other financial crimes are concerned.

Recommendations

1. The Government, both the National Assembly and the Executive, should take steps to repeal section 37 B (4) of the Tax Procedures Act, 2015. The Executive should initiate the process since it is the law enforcement arm charged with AML/CTF enforcement in the country. On its part, the National Assembly should legislate to drop this section since the power to make and unmake laws of this nature rests with it.
2. Pending any legal amendments to repeal section 37 B (4), players in AML/CTF enforcement should device strategies on how best to interpret the section in a fashion that will cause the least disruption and safeguard the effectives of the financial reporting and investigations mechanisms notwithstanding the coming into force of section 37B (4).

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