



Accounting for Capital Gains Tax in Kenya

Accounting Perspectives

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Background and overview

A 'Capital Gain' can be ordinarily defined as the difference between the purchase price and the selling price of certain assets. Consequently, 'Capital Gains Tax' (CGT) is the income tax payable on the gain/profit made on the sale (disposal) of a capital asset.

CGT was introduced in Kenya in 1975 and suspended on 13 June 1985 – when Kenya was seeking to spur growth in the mining sector, real estate market and deepening local participation in capital markets. These hitherto distant aims appear to have been realized with the Nairobi Securities Exchange (NSE) consistently being ranked among the top five bourses in Africa and the robust growth and returns witnessed in the real estate sector which has been cited as a significant pillar of economic growth particularly over the last decade.

The Finance Act 2014 amended the Eighth Schedule of the Income Tax Act ("ITA") and as a consequence, CGT was reintroduced with effect from 1 January 2015. The reintroduction of the capital gains tax regime in Kenya is expected to widen the tax net and increase tax revenue collection for the government. In addition, from a regional integration perspective, the reintroduction of CGT is seen as a step towards bridging the differences in fiscal and tax policies between the East African States by aligning Kenya to its

neighboring countries that impose tax on capital gains.

Applicability of CGT

CGT is chargeable on the net gain accruing to a company (interpreted widely) or an individual (resident or non-resident) on or after 1st January 2015 on the transfer of **property** situated in Kenya, whether or not the property was acquired before 1st January 2015, at a rate of 5% of the net gain. CGT is a final tax and cannot be offset against other income taxes.

Property is defined by law (under the Eighth Schedule to the Income Tax Act) and includes **land, buildings** and **marketable securities**. **Marketable securities** are termed as 'securities capable of being sold and stock as defined in Section 2 of the Stamp Duty Act'. CGT therefore applies to the transfer of unlisted securities. Listed securities have been excluded from the application of CGT under the Finance Act 2015.

A **transfer** takes place where a property is sold, exchanged, conveyed or disposed of in any manner; or on the occasion of loss, destruction or extinction of property; or on the abandonment, surrender, cancellation or forfeiture of, or the expiration of rights to property.

The Kenya Revenue Authority (KRA) views a capital gain as the excess of the **transfer value** over the **adjusted cost** of the property that has been transferred with the difference being subjected to a 5% tax. The transfer value of the property is the amount or value of consideration or compensation for transfer, abandonment or loss of the property less incidental costs on such transfer. The **adjusted cost** is the sum of the cost of acquisition or construction of the property, expenditure for enhancement and preservation of the property; cost of defending title or right over property, if any; and the incidental costs of acquiring the property. The adjusted cost shall also be reduced by any amounts that have been previously allowed as deductions under Section 15(2) of the Income Tax Act. Further guidance is provided by the KRA for instances where the acquisition cost is not available with additional guidance provided under Paragraph 9 of the Eighth Schedule.

CGT is a transaction based tax and should therefore be paid upon transfer of property but not later than the 20th day of the month following that in which the transfer was made.

Accounting for CGT



Whereas CGT is applicable with effect from 1 January 2015, from an accounting perspective, tax laws are applicable from the period they are enacted or substantively enacted (in this case September 2014 when the President Uhuru Kenyatta assented to the Finance Bill). Granted that the tax payable aspects are applicable and payable with effect from 1 January 2015, deferred tax (i.e. the amount of income tax payable/recoverable in future periods as a result of past events)

immediately becomes applicable with reference to the capital assets or 'property' in question.

From an accounting perspective, guidance is provided under the IFRS framework (in particular, IAS 12 – *Income Taxes*). IAS 12 paragraphs 47 states that *'Deferred tax assets and liabilities shall be measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.'*

This means that entities with year ends falling after the presidential assent to the Bill will need to account for the deferred tax as at that point (for instance this is applicable for 31 December 2014 year ends) and not wait to account for it following the effective date of CGT (i.e. post 1 January 2015).

Once CGT is effective, an entity will be required to assess whether the manner of recovery of the asset is through sale or use or dual intentions. This is in line with IAS 12 paragraph 51 which states that *'The measurement of deferred tax liabilities and deferred tax assets shall reflect the tax consequences that would follow from the manner in which the entity expects, at the end of the reporting period, to recover or settle the carrying amount of its assets and liabilities.'* The applicable tax rate therefore depends on how the carrying amount of an asset or liability is recovered or settled. In jurisdictions where the applicable tax rate depends on how the carrying amount of an asset or liability is recovered or settled, then, management's intention is key in determining the amount of deferred tax to recognise.

If the manner of recovery is through **sale**, deferred tax will be applicable at the **capital gains tax rate**: if, however, the recovery of the asset is through **use**, deferred tax will be applicable at **the income tax rate**.

Investment property and land

IAS 40 – *Investment Property* allows assets classified as investment property to be measured using either the fair value or cost model. Per IAS 12 paragraph 51 C, if a deferred tax asset or liability

arises from investment property measured at fair value there is a rebuttable presumption that the carrying amount of the investment property will be recovered through sale. Accordingly, unless the presumption is rebutted, the measurement of a deferred tax asset or liability pertaining to the investment property reflects the tax consequences of recovering the carrying amount of the investment property entirely through sale – and therefore deferred tax would be measured at the CGT rate. If an investment property comprises freehold land only, then because the land is not depreciable, the presumption cannot be rebutted...' and as such deferred tax would be accounted for at the CGT rate. However, for leasehold land which are depreciable, an entity will need to determine whether the manner of recovery is through sale or use and apply the guideline provided above. The presumption is rebutted if the investment property is depreciable and is held within a business model whose objective is to consume substantially all the economic benefits embodied in the investment property over time, rather than through sale. If this is the case deferred tax is measured at the normal income tax rate.

Likewise, if a single investment property comprises land and buildings, then the presumption may be rebutted for the building component only (which is depreciable and recovery of the asset (building in this case) deemed to be through use. If this is the case, then the value of the investment property is split into component parts to determine the amount of deferred tax. In some cases, this may result in additional valuation work being required to determine the split – and the deferred tax will be applicable to the distinct portions of the land and

buildings at the applicable rates (CGT rate and income tax rate respectively).

Deferred tax on non-depreciable assets

IAS 12.51B provides that “If a deferred tax liability or a deferred tax asset arises from a non-depreciable asset measured using the revaluation model in IAS 16, the measurement of a deferred tax liability or a deferred tax asset shall reflect the tax consequences of recovering the carrying amount of the non-depreciable asset through sale regardless of the basis of measuring the carrying amount of that asset. Accordingly, if the tax laws specifies a tax rate applicable to the taxable amount derived from using an asset, the former rate (sale rate) is applied in measuring the deferred tax liability or asset related to a non-depreciable asset.

This mostly applies to freehold land which is carried at revalued amounts. Deferred tax should be charged at the CGT rate irrespective of management’s intention. For lease hold land which is depreciable deferred tax will apply at corporation tax rate.

Where an entity makes capital losses, section 15(3)(f) of the Income Tax Act allows the amount of any loss realized to be carried forward and deducted only from gains under section 3(2)(f) in that year of income and, in so far as it has not already been deducted, from gains in subsequent years of income. As a result an entity should assess whether to recognize deferred tax on tax losses carried forward.

Financial assets

The tax treatment of a financial asset should be consistent with management’s intentions for the financial asset. For financial assets held for trading, the entity should apply corporation tax rate since these are transactions carried out in the normal course of trade. For financial assets classified as available-for-sale, management should determine whether it intends to recover the carrying amount of the assets through sale (in which case CGT rate apply) or the receipt of interest or dividends and the repayment of capital (in which case normal tax rates apply). However, consideration should be given to the KRA interpretation of the transaction (trading or capital transaction) to ensure the appropriate tax rate is used.

Investments in listed and unlisted securities

Under the Finance Act 2014, the rate of CGT chargeable on the sale of listed securities in the Nairobi Securities Exchange was 5% of the net gain and was collected and accounted for by stockbrokers on behalf of their clients. The tax was due upon transfer of the securities but not later than the 20th of the month following that in which the transfer was made. The CGT on listed securities was suspended in the Finance Act of 2015.

Under the Finance Act 2015, the rate of CGT for the transfer of real property (land and buildings) and private/unlisted securities remains at 5% of the net gain made on such transfers and is accounted for by the transferor.

Capital gains tax on insurance business

Section 3(2)(f) of the Income Tax Act, Cap 470 of the Laws of Kenya (ITA) provides that gains (capital gains) accruing in circumstances prescribed in the Eighth Schedule are subject to income tax.

The Eighth Schedule provides guidelines for the determination and taxation of capital gains. These are profits that an investor realizes from the disposal of a capital asset for a price that is higher than the purchase price net of the resultant acquisition and disposal costs.

Section 19 (1) of the ITA provides that notwithstanding anything in the ITA, the section shall apply for the purpose of computing the gains or profits of insurance companies from insurance business which is chargeable to tax.

Under Section 19(3) (a) (ii), the gains or profits for a year of income from the insurance business, other than life insurance business, of a resident insurance company shall include other income from that business, including any commission or

expense allowance received or receivable from reinsurers and any income derived from investments held in connection with that business.

From the above, the income that is taxable under the provisions of Section 19 is income from the insurance business and any income derived from investments held in connection with that business.

The capital gains accruing from an insurance business, other than life insurance business would ordinarily qualify as business income since it relates to income derived from investments held in connection with that business.

However, if an insurance company disposes of capital assets which are not held as investments in connection with that business the gains may not be taxable under Section 19 but under the provisions of Section 3(2) (f) and the Eighth Schedule, subject to the exemption under Paragraph 3(1) of the Eighth Schedule to the ITA for qualifying business assets. In this case CGT will apply to the assets.



As the ITA does not define how to determine which disposal consists of a capital asset held as property, plant and equipment as opposed to the disposal of an asset for ordinary income (in connection with the business), the following factors amongst others may be considered:

- Nature of the asset and its use;
- Length of time the asset is held and frequency of similar transactions;
- Work expended to bring property into marketable condition;

- Reasons for the sale; and
- The intention of acquiring property

It is important to note that the burden of proof of the intention of acquiring the property lies with the taxpayer, consequently consistency in accounting treatment and the documentation of intention prior to investment and during the holding period may be critical.

Application

Management will need to take note of the nature of the assets falling within the CGT brackets and account for the requisite deferred tax per the guidance prescribed under IAS 12 – *Income Taxes*.

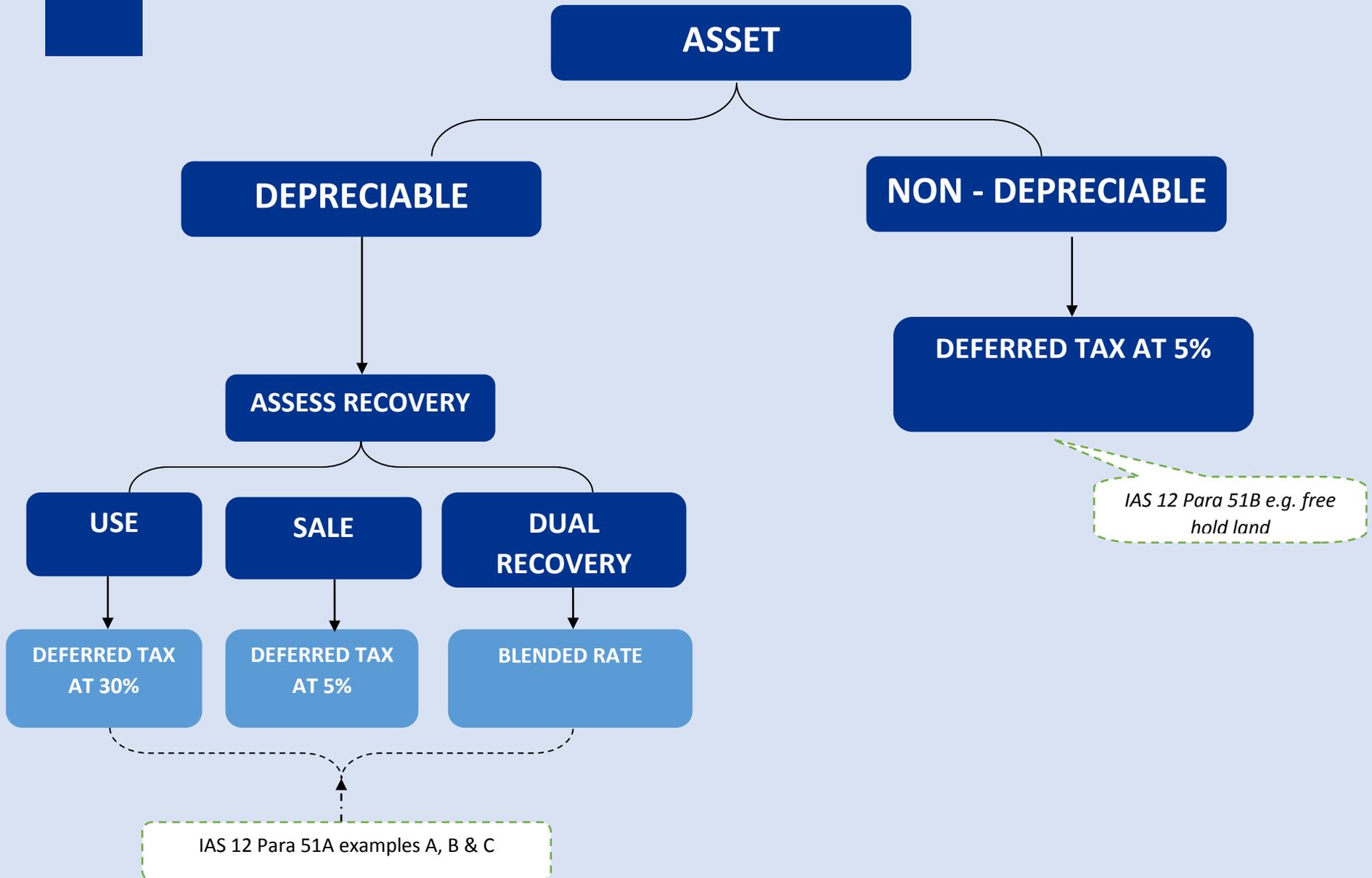
For practical applicability from a tax liability/payment perspective, the KRA, in line with the amendments to the Eighth Schedule has issued guidance that is accessible through its website (www.kra.go.ke) on among others the following areas:

- the determination of the net gains;
- capital gains tax for companies;
- capital gains tax for individual;
- considerations for related party transactions;
- the due date/tax point;
- declaration of the taxes;
- considerations where a capital loss is made;
- documentation/information required by the Authority;
- exemptions from CGT;
- treatment of the extractive industry.

References:

- *International Accounting Standard (IAS) 12*
- *The Kenya Revenue Authority (www.kra.go.ke)
Capital Gains Tax – What you need to know....*
- *Finance Act 2014*
- *Finance Act 2015*
- *Income Tax Act*

FLOW CHART FOR DEFERRED TAX CONSIDERATION FOLLOWING THE RE-INTRODUCTION OF CAPITAL GAINS TAX IN KENYA



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