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Taxwise

Taxation of Pensions, Gratuities & Savings

In this edition

Kenya's taxation framework for pensions, gratuity payments and savings has significantly restructured in the past few years. These changes are as a result of dynamic policy shifts that respond to different economic climates while incentivizing long term retirement planning, providing financial security for the aging population.

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A. Taxation of Pensions

In Kenya, the taxation of pensions is primarily structured around tax exemptions, allowable deductions and specified tax rates based on set withdrawal criteria. The legal framework highlights the tax treatment of investment income, contributions and withdrawals from the various retirement benefit schemes in Kenya.

To understand the taxation of pensions, it is important to understand what constitutes of pension income subject to income tax. This will be dependent on the residency status of the individual and their source of income.

For resident individuals, the following pension related incomes are to be considered as derived in Kenya for taxation purposes;

- Pension payments received from nonresident pension funds or schemes to the extent of employment or services rendered; and
- Pension received in respect of employment or services rendered in Kenya.

For non-resident individuals, pension or retirement annuities received from pension funds or pension schemes established in Kenya, or from annuity contracts concluded in Kenya are taxable under the Kenyan jurisdiction.

Pensions received in respect of employment, or services rendered to the East African Community or its related corporations are taxable in Kenya, where;

- Received by a resident individual; and
- Received by a non-resident individual if the pension payments are made by a resident individual in Kenya.

The administrative bodies in relation to the governance of pensions as recognized by the legislature, Income Tax Act and Retirement Benefits Act, comprise of:

- Pension Schemes and pension funds;
- Provident Funds;
- Individual retirement funds;
- National Social Security Fund (NSSF); and
- Registered home ownership savings plan.

1. Deductions on contributions to pension schemes

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Contributions made to registered pensions and provident funds are deductible by both employers and employees aimed at reducing their taxable income.

Before the enactment of the Tax Laws Amendment Act (TLAA) 2024, employees could deduct the lesser of:

- **Kshs 240,000** per year, equivalent to **Kshs 20,000** per month;
- The total sum of the contribution; and
- 30% of their pensionable income.

Similarly, employers contributing to defined contribution retirement funds deduct the lesser of:

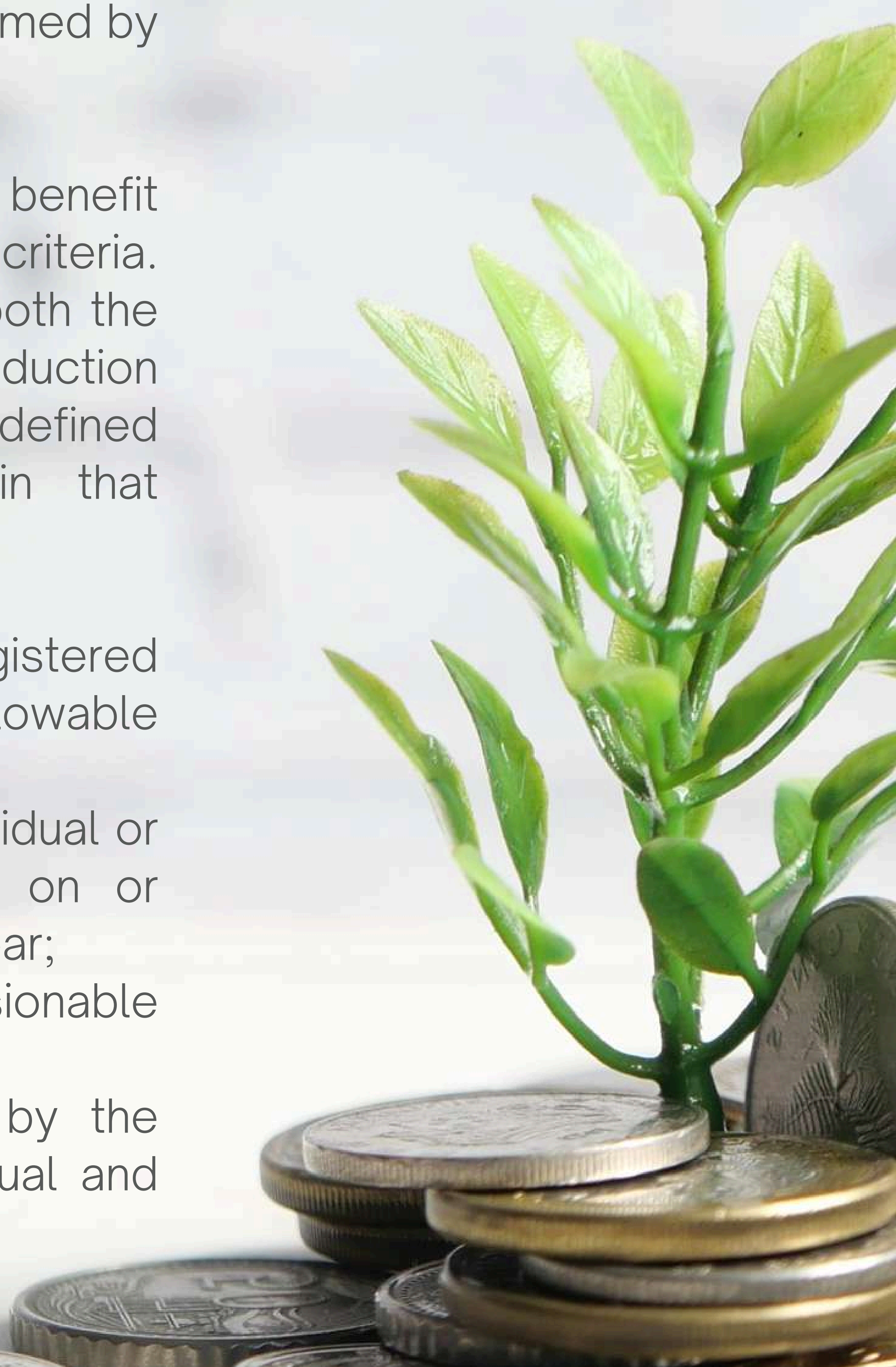
- The total contribution made by the employer and employees;
- 30% of the pensionable income of all covered employees; and
- **Kshs 240,000** per year for each employee, equivalent to **Kshs 20,000** monthly per employee.

However, the employer deductions must be adjusted by any deductions already claimed by the employee.

Employer contributions to defined benefit schemes apply the same deduction criteria. The allowable amount is adjusted by both the employee claimed deductions and deduction claimed by the employer from defined contributions to retirement funds, in that hierarchical order.

In respect of contributions made to registered individual retirement funds, the allowable deductible amount was the lesser of:

- Total contribution made by the individual or on his behalf by their employer on or before the **31st December** for the year;
- 30% of the of the individual's pensionable income for the year; and
- **Kshs 240,000** annually reduced by the contributions made by both individual and employer to the NSSF.



The TLAA 2024, raised the yearly deduction of the deductible amount for both employer and employee from **Kshs 240,000** per annum to **Kshs 360,000** per annum, equivalent to **Kshs 36,000** monthly effective **27th December 2024**, on contributions to these registered schemes and funds.

However, not all contributions made to registered or unregistered pensions, savings, or provident schemes or funds are eligible for deduction, otherwise as established under tax law.

2. Exemptions granted to pensions

Before the enactment of the TLAA 2024 and the Finance Act 2025, retirement benefit schemes offered multiple exemptions to attract investments and secure long-term financial security.

Below, we outline the exemptions on pensionable income;

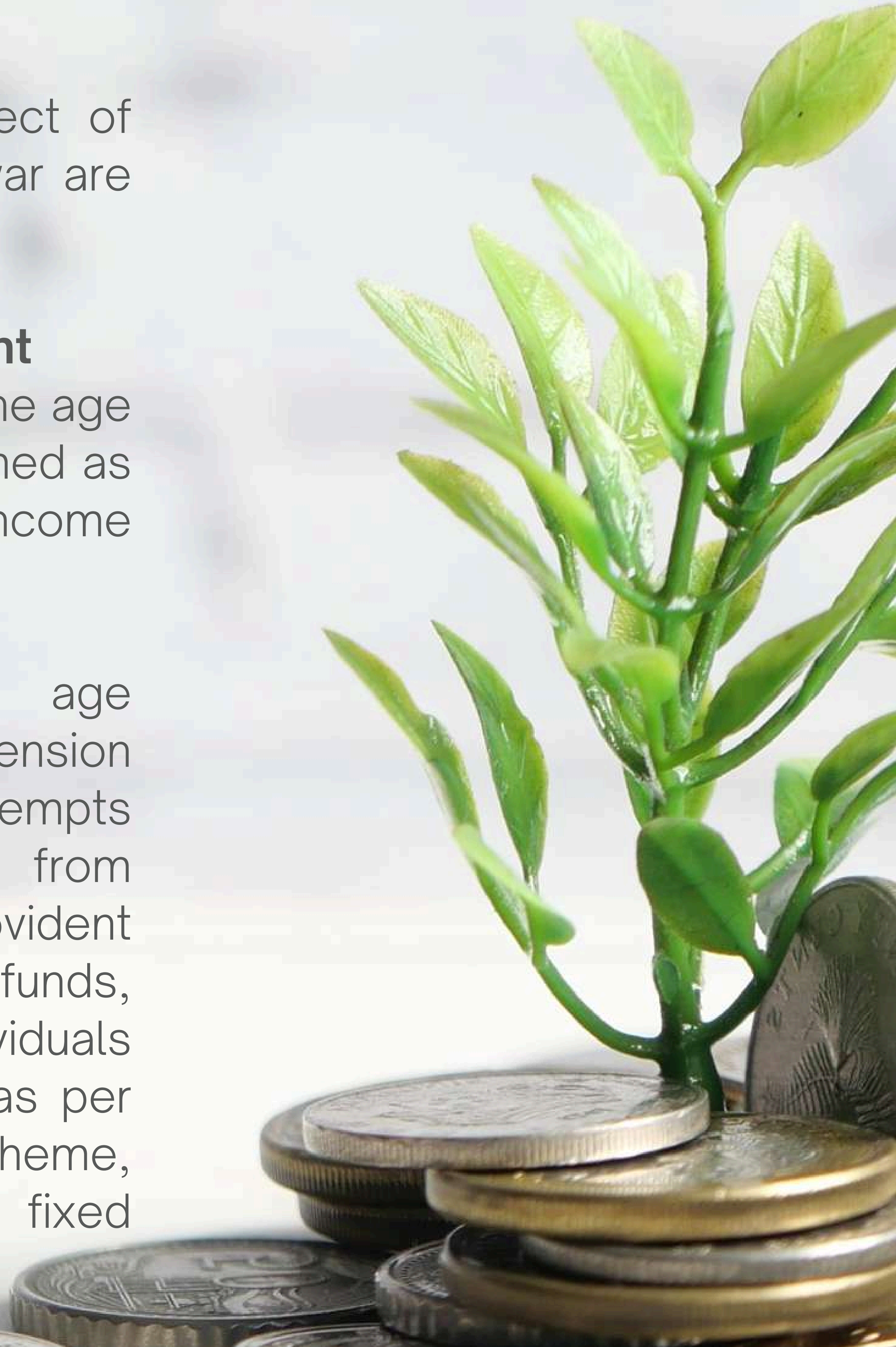
i.Pension in relation to disabilities

Pensions or gratuities granted in respect of wounds and disabilities as a result of war are exempt from income tax.

ii.Pension in relation to age of retirement

Monthly pension granted to persons at the age of 65 years and above, which was deemed as the retirement age, is exempt from income taxation.

The TLAA 2024, restructured the age qualification of exempt income from pension schemes.The introduced amendment exempts payments from pension benefits from registered pension fund, registered provident funds, registered individual retirement funds, public pension scheme or NSSF to individuals who have attained the retirement age as per the agreements of the fund or scheme, eliminating the requirement of a fixed retirement age.



Further, the amendment extends the exemption to **gratuity payments or other allowances paid under a public pension scheme**, payments of retirement annuities, premature withdrawals due to ill health and withdrawals of the fund after 20 years from the date of registration.

The amendments effected on 27th December 2024, seemingly portrayed generosity towards the tax welfare available to pensioners, by expanding the scope of exemptions available to pension-related income.

iii. Withdrawals exempt from Income Tax

Before the enactment of the Finance Act 2025, exemption on withdrawals was granted according to specified criteria as outlined below:

- The first **Kshs 300,000** of the total pensions and retirement annuities from registered funds and NSSF;
- The first **Kshs 600,000** lump sum commuted from a pension or individual retirement fund
- Upon termination of employment: the lesser of the first Kshs 600,000 or the first **Kshs 60,000** per year of pensionable service which is dependent on set timelines as outlined by tax law.
- Lump sums paid out of registered provident funds: The lesser of first **Kshs 600,000** or **Kshs 60,000** per year of pensionable service. With further specifications to exempt lump sum withdrawals from contributions made prior to 1st January 1991.
- The first **Kshs 600,000** of a benefit paid out of the NSSF
- Unregistered funds and schemes: The total pension, retirement annuities, or individual retirement payments received by a resident from an unregistered fund or scheme are not taxable, provided that the contributions were not tax-deductible and the income earned by the fund has already been taxed.

- Withdrawals by dependents of beneficiaries of provident funds: Upon death of an employee, their dependents will receive similar benefits and exemptions as the employee provided by the fund. In the case, where the registered fund only offers lump sum payments, the first **Kshs. 1,400,000** is exempt from tax.

The Finance Act 2025, effected on 1st July 2025 expunged these exemptions on specified withdrawals. This results in an interpretation that there is not limit on lumpsum withdrawals from the registered schemes and funds, public pension schemes and NSSF provided the specified age has been attained and 20-year time period from the date of joining the scheme, has lapsed.

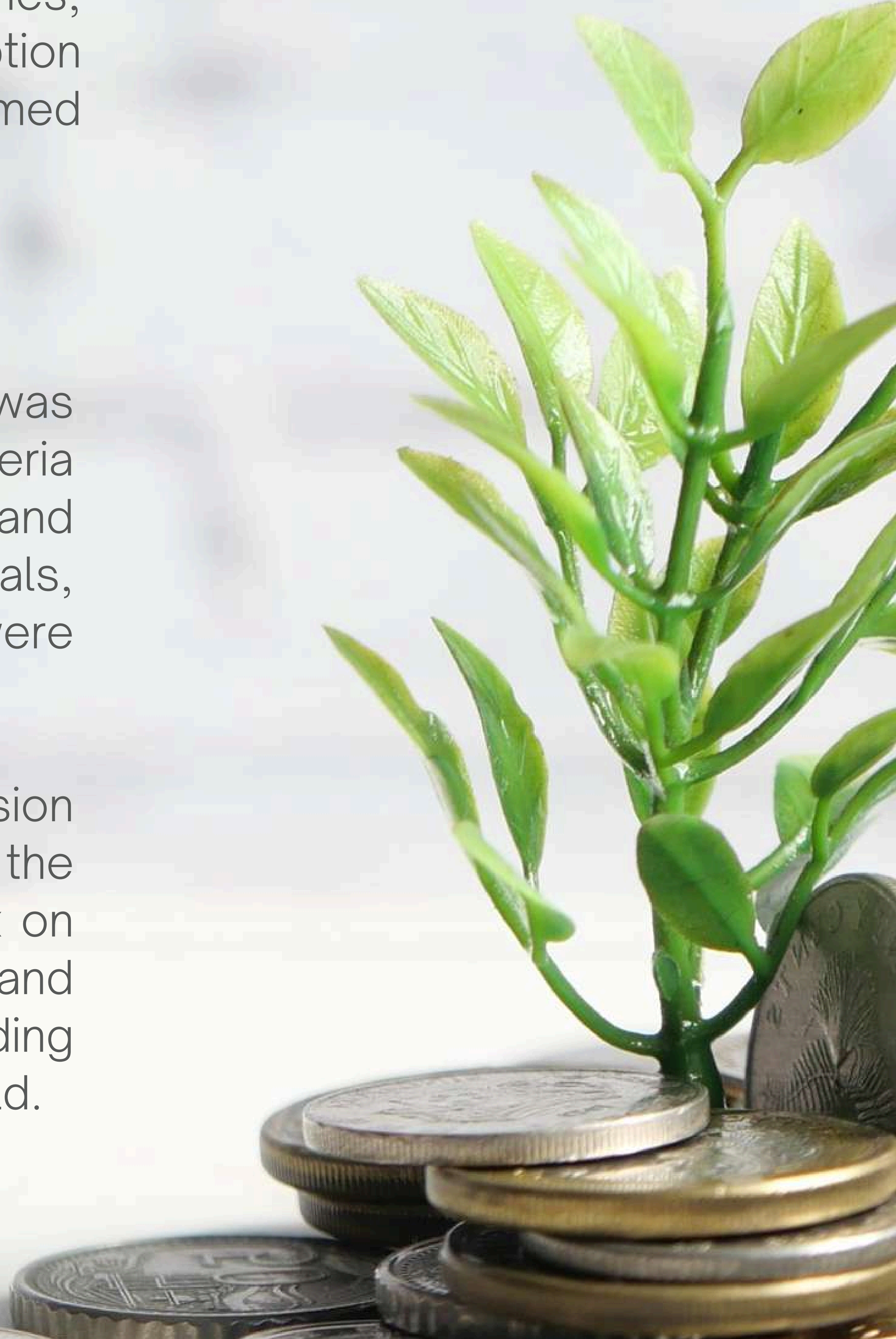
However, this change does not encompass unregistered funds or schemes as they are no longer addressed under exemptions, effectively eliminating guidelines for their taxation treatment.

Additionally, the deletion of provisions concerning the taxation benefits to dependents of deceased beneficiaries, creates ambiguity resulting in the assumption that the pensionable income will be deemed fully taxable.

3. Rates of Taxation

The taxation of pension benefits was determined based off the specification criteria upon withdrawal. Tax free limits and exemptions applied to lump sum withdrawals, while amounts exceeding the threshold were treated as taxable under individual income.

For resident individuals accessing their pension benefits and withdrawals upon meeting the stipulated timelines, were subjected to tax on a graduated scale. The maximum rate and amount being, 30% of any amount exceeding **Kshs 1,600,000** above the tax-free threshold.



Conversely, premature withdrawals from their pension funds and NSSF, the maximum tax rate was 30% imposed on any amount above **Kshs 388,000** in excess of the tax-free thresholds.

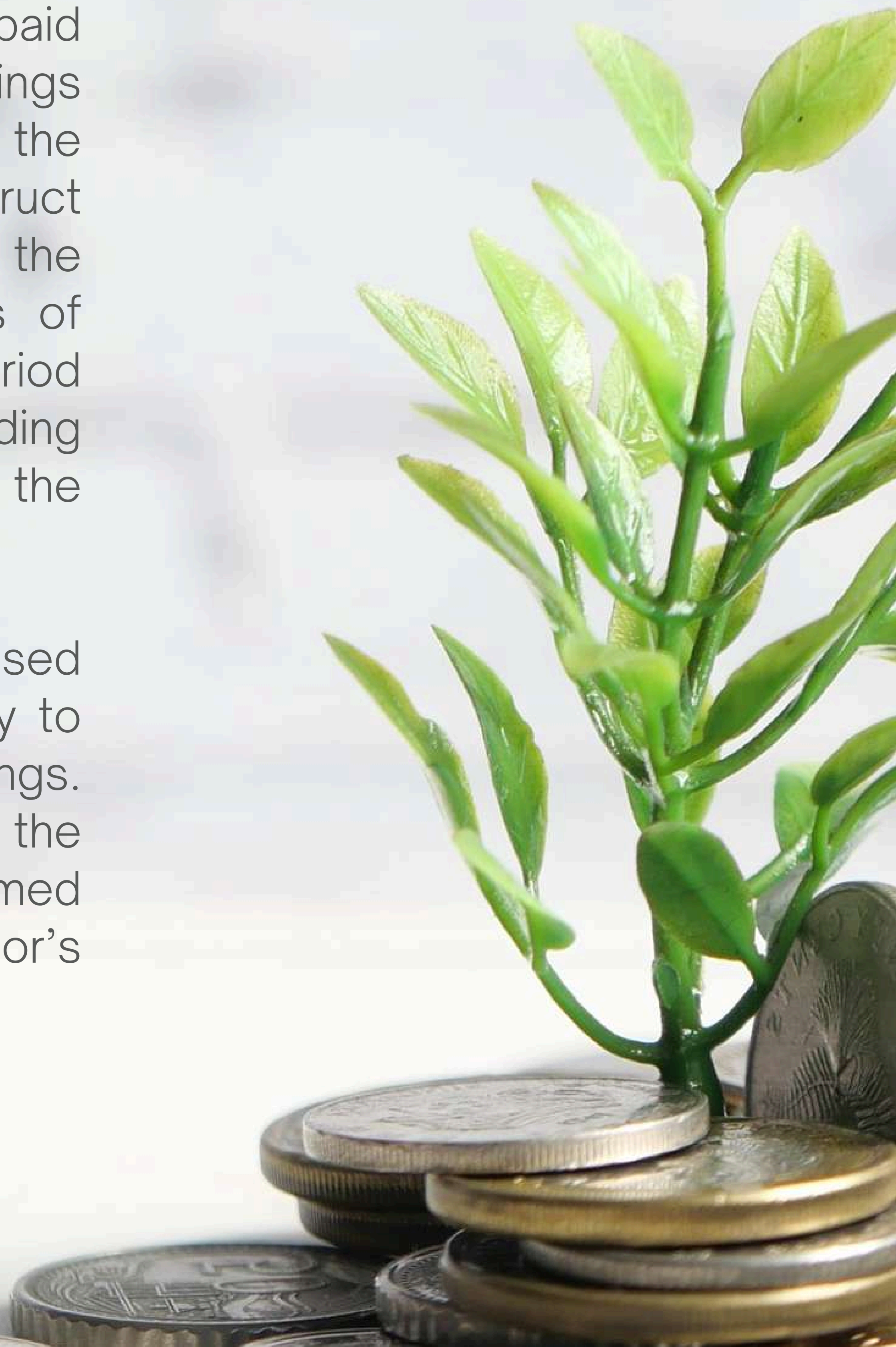
The TLAA 2024, repealed the tax rates applicable for resident individual accessing their pension benefits from registered pension funds, registered provident funds, NSSF or registered individual retirement funds, which is in line with the introduced scope of exemption applicable to income from these registered schemes.

However, both the TLAA 2024, and the Finance Act 2025 did not address the tax rates applicable to individuals who access their pension funds prematurely. This is contradictory in nature as the specific provisions providing guidance to impose this tax has been repealed by the Finance Act 2025.

B. Taxation of Savings

Prior to the Finance Act 2025 lumpsums paid out of registered home ownership savings were exempt from income tax, provided the withdrawn amount was purposed to construct or purchase a permanent house for the depositor's occupation within 12 months of withdrawal. The 12-month time period highlights the intention of the law in providing ample allowance for individuals to utilize the tax-free funds towards home acquisition.

Additionally, dependents of deceased beneficiaries were allowed the opportunity to maintain the tax-free status of the savings. Initially, upon the death of a beneficiary, the balance of the funds is to be deemed withdrawn and to be included in the depositor's taxable income in the year of death.



However, the exemption status could be maintained if the depositor had granted ownership to another depositor, thus enabling transfer subject to the Commissioner's written approval. Similar provisions are applicable to dependents of beneficiaries under a registered individual retirement fund.

The legal framework further allowed for maintenance of exemption status on the funds in the event a registered home ownership plan had their registered status withdrawn by the Commissioner. The framework allowed for a transfer of the savings balance to a similar plan in an approved institution, within 12 months from the date of status withdrawal.Which would otherwise be taxable under the depositor's income in such occurrence.

On the hand, where a registered individual retirement fund had their registered status withdrawn, the balance of funds will be included in the income of the beneficiary for the year for tax purposes.

Effective 1st July 2025, the Finance Act 2025, repealed these provisions and did not introduce a transitional framework addressing the effect of these changes on existing savings under home ownership plans. These amendments create ambiguity in interpretation on the tax treatment of savings, particularly for existing home ownership plans. The direct interpretation is that savings in home ownership plans are deemed taxable under the depositor's income, which reduces the incentive to invest in the plans.

In contradiction, the changes remove taxation risks where the benefit schemes lose their registration status. Previously, the pending balances would be deemed taxable for individual retirement funds and for home ownership plans if certain conditions were met. Currently, the direct interpretation is that individuals are able to recoup their balances without taxation upon the deregistration of these benefit schemes.

C. Taxation of Gratuities

Gratuities refers to payments made by an employer to an employee in relation to retirement or termination of employment. The payments are included in gains or profits for purposes of income taxation.

However, gratuity payments paid by an employer in respect of employment or services rendered to a registered pension scheme are not subject to income taxation. Provided that the gratuity does not apply to individuals eligible for deductions on contributions to registered pension or provident funds, and the amount does not exceed **Kshs 240,000** per annum, which was increased to **Kshs 360,000** per annum by the TLAA 2024.

The exemption explicitly applies to gratuities paid by the employer directly to the registered pension scheme and not to the employee, and the employee does not claim deductions in their personal income tax return. Provided the exemption is only applicable to amounts not exceeding **Kshs 240,000** prior to 27th December 2024, and **Kshs 360,000** going forward.

The amount of gratuity exceeding the threshold is subject to personal income tax at the rates applicable on the relevant year it was earned. Therefore, where gratuity relates to past years of service and is liable to income tax, it is taxed according to the corresponding year it was earned.

However, where the payments are related to gratuity earned more than four years prior to the date of receipt, for taxation purposes the gratuity will be taxed accordingly for the preceding 4 years, and the gratuity intended for the remaining years are to be aggregated and taxed accordingly with the income tax rate of the preceding fifth year.

The above highlight the tax treatment of gratuity payments earned prior to 1st July 2025. Additionally, as previously mentioned, gratuity paid out of public pension schemes were granted exemption effective from 27th December 2024. However, the Finance Act 2025, clarified the exemptions granted to gratuity payments are not limited to public pension schemes. The exemption extends to payments of gratuities in accordance the broader provisions outlining its taxation treatment.

Conclusion

The amendments introduced and implemented by the Tax Laws Amendment Act 2024, and the Finance Act 2025, reflect a clear intention to regulate taxation of pensions, gratuities and savings under a simplified and more accessible framework. This is evident in the direct granting of exemptions and less restrictions imposed on eligibility to access exempt pension benefits. However, the changes brought forward some elements of ambiguity as taxation treatment on unregistered benefit schemes, taxation treatment of registered ownership savings plan and dependents of deceased beneficiaries are yet to be addressed.

LET'S TALK

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