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# *Dividends Taxation In Kenya Post Finance Act 2018 – Absolute Clarity*

Our attention has been drawn to various publications on taxation of exempt income distributed to shareholders which have resulted to requests for clarifications. The publication provides an analysis on the coming into effect of the Finance Act 2018 amendments on dividends taxation. The Finance Act 2018 (FA 2018) was assented to on 21st September 2018 with the effective dates of the various provisions provided for in the FA 2018. This alert concentrates only on the dividend taxation regime in Kenya pre-& post FA 2018.

## A. Taxation of dividends pre – FA 2018

**Dividends distributed from untaxed profits**
Pre-FA 2018, the taxation of dividends distributed from untaxed profits was covered by the now repealed Section 7A the Income Tax Act (ITA).

Due to various tax incentives, a company can have an accounting profit but tax losses. An example of this is where a company claims investment deductions of 150%. The said company can then make accounting profits but due to the huge investment deduction it has tax losses.

Where such a company distributes the profits to its shareholders, the entity is ideally distributing the tax incentive provided by the state. Any tax incentives from an economic perspective should be reinvested in the business, not distributed to the shareholders.

To curb the distribution of tax incentives, Section 7A, required companies to maintain a dividend tax account. In a nutshell, the dividend tax account would tax any dividends paid out from untaxed profits at the rate of 3/7, approximately 42.8%. This tax was known as compensating tax.

**Taxation of dividends distributed from untaxed profits**
For dividends that were distributed from taxed profits, the taxation was at source through withholding tax as follows;

- ✓ 0% where the dividend is paid to a resident company in Kenya which controls directly or indirectly more than 12.5% shareholding of the company paying the dividend;
- ✓ 5% for other residents;
- ✓ 5% for residents of the East African Community Partner States;
- ✓ 10% for non-residents whose countries do not have Double Taxation Agreements (DTAs) with Kenya;
- ✓ 0% for dividends paid by Special Economic Zone enterprises, developers or operators to a non-resident t; and
- ✓ 5-10%, as provided by the respective DTAs for dividends paid to non-residents whose country Kenya has a ratified DTA.

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## B. Taxation of dividends post- FA 2018

Paragraphs 3 & 4 of the Finance Act 2018 amended two sections relating to taxation of dividends as follows;

### 1. Broadening of what constitutes a dividend

Dividends now includes;

- ✓ any cash or asset distributed for the benefit of a shareholder or any related person;
- ✓ Discharge from any obligations on behalf of a shareholder or related person;
- ✓ Use of any amount for the benefit of the shareholder or related person;
- ✓ any debt payment owed by the shareholder or related person
- ✓ amount representing additional taxable income or reduced assessed loss of that company by virtue of any transaction with the shareholder or related person to such shareholder, resulting from an adjustment.

The above amendment was effective 1st July 2018.

### 2. Dividends distributed from untaxed profits

The aforementioned Section 7A that dealt with compensating tax was deleted and replaced with the following;

***7A.*** *Where a dividend is distributed out of gains or profits on which no tax is paid, the company distributing the dividend shall be charged to tax in the year of income in which the dividends are distributed at the resident corporate rate of tax on the gains or profits from which such dividends are distributed. Provided that this section shall not apply to registered collective investment schemes.*

The above amendment was effective 1st July 2018.

The amendment abolishes compensating tax and replaces it with taxation of untaxed profits at the rate of 30%. This amendment effectively reduces the taxation of dividends distributed from untaxed profits from a high of 42.8% to 30%.

### 3. Perceived contentious amendments & clarification

#### Holding Companies

Most companies in Kenya will have holding entities that have more than 12.5% shareholding. When these holding companies receive dividends from their subsidiaries, there is no withholding tax on the dividends distributed.

There has been interpretations that when a holding company receives the dividends that are exempt from tax and distributes the perceived non-taxed dividends, then 30% corporate tax will apply on these dividends' distributions.

This interpretation is incorrect in our opinion. In the hands of the holding company the dividends are untaxed. But before distribution by the subsidiary, the gains or profits were taxed at 30% either;

- ✓ as part of the normal corporate tax when the subsidiary has taxable profits; or
- ✓ As part of the 30% corporate tax on untaxed profits where the subsidiary has distributed non-taxed profits.

Hence the distributed dividends is from gains or profits that 30% corporate tax has been paid by the subsidiary.

The amendment looks at the gains/profits in totality without reference to the entity that has paid the tax. In all instances the subsidiary has already paid the corporate tax thus, the holding companies' dividends are not untaxed gains/profits.

#### Tax Incentives claw back

Where the income tax Act provides for specific tax exemptions on gains or profits earned, then that income can be construed to be fall within the 30% corporate taxation for untaxed profits.

In our opinion exempt income, such as interest earned from tax exempt infrastructure bonds and which is distributed to the shareholders will remain exempt.

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## C. Case Law & Interpretation

There are various rules for interpretation of tax laws. In this part we examine some of them and how they impact the amendments on taxation of dividends.

### Literal Interpretation

The foremost principle of interpretation rules of interpretation of tax statutes in every system of interpretation is the rule of strict interpretation which provides that where the words of the statute are clear and unambiguous, recourse cannot be had to the principles of interpretation other than the literal rule.

The amendment states that only untaxed profits or gains will be subject to the 30% corporate tax when the profits are distributed. The amendment does not state which is the entity that should tax the profits. In literal terms then the profits that are taxed in the hands of a subsidiary and later distributed as a dividend to the holding company which distributes to the ultimate shareholders do not fall under untaxed profits.

While we understand the confusion as a result of the subsidiary and the holding company being two legally different persons, the amendment only mentions untaxed profits. The amendment should be read in totality.

Therefore, the conclusion that the dividends distributed to holding companies will be taxed at 30% when distributed to the ultimate shareholders is completely incorrect.

### Harmonious interpretation

Interpretation of the tax statutes must be so construed that the meaning of such a provision must harmonise with the intention of the drafters and the enactment of the tax statute in general.

Clearly the intention of the amendment in the FA 2018 is to tax the distribution of profits untaxed under corporate tax not the dividends distributed to holding entities owning more than 12.5% shareholding or specifically exempt income.

### Two interpretations – one favourable to the tax payer to be adopted

Taxing laws should be plain and precise, for they impose a burden. That imposition should be explicitly and distinctly revealed. If the Legislature/tax authority fails so to express its intention and meaning, it is the function of the Judiciary to construe the statute strictly and resolve doubts and ambiguities in favour of the taxpayer and against the taxing powers.

In the case of ***Commissioner of Income Tax v Westmont Power (K) Ltd Nairobi Income Tax Appeal No. 626 of 2002***, the High Court held that taxation laws must be clear of ambiguity and where there is ambiguity, the law should be interpreted in favour of the taxpayer and not the taxing authority.

Thus even if the tax authority was to conclude that the dividends paid to a holding company and then paid to ultimate shareholders are subject to Thus,30%, this should and would be challenged under this interpretation rule.

## D. Conclusion and opinion

It’s our position that the interpretation of the tax amendment on taxation of untaxed profits to include dividends received by holding entities and then distributed to ultimate shareholders as well as various other exempt income is incorrect. If this was the intention, the provisions relating to holding entities and other exempt income would have been repealed.

Secondly amendments introduced are beneficial to investors as they do away with the punitive compensating tax regime – reduction from 42.8% to 30%.

Further the amendments bring a uniform taxation regime between Limited Liability Companies (LLCs) and Limited Liability Partnerships (LLPs). Previously LLPs offered better structures in terms of profits distribution in relation to compensating tax. This is as only LLCs were required to prepare tax dividend accounts, thus being exposed to compensating tax. Effectively, therefore, the issue of Compensating tax did not arise in an LLP.

We are aware that many taxpayers would want to avoid any tax disputes as a result of this amendments. We would thus propose requesting KRA for a binding private ruling.

For further information or should you require a binding private ruling from the KRA on this issue, kindly contact your regular Taxwise Consulting analyst or the below named person.

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