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Global Tax Alert

Kenya revises taxation applicable to the Oil & Gas and Mining sectors

Executive summary

The 2014 Finance Act which was published in Kenya's Official Gazette on 19 September 2014 repealed the 1984 Ninth Schedule, titled *Taxation of Petroleum Companies* replacing it with a new Ninth Schedule titled *Taxation of Extractive Industries*. The scope of the new schedule has been expanded and now covers not only the taxation of petroleum companies, but also companies in the mining sphere. The provisions are effective as of 1 January 2015.

The new Ninth Schedule is applicable to the following persons as defined therein:

- Licensee – a person who has been issued with, or granted a mining right
- Contractor – a person with whom the Government has concluded a petroleum agreement and includes any successor or assignee of the person
- Subcontractor – a person supplying services other than a person supplying services as an employee to:
  - A licensee in respect of mining operations undertaken by the licensee

    Or
  - A contractor in respect of petroleum operations undertaken by the contractor

This move is motivated by the Government's objective of streamlining the taxation regime of the extractive industry which covers Oil & Gas, Mining Companies and their service providers.

Detailed discussion

Changes introduced with respect to petroleum companies

Taxation of Sub-contractors

A distinction has been made between taxation of subcontractors with a Permanent Establishment (PE) in Kenya and those without a PE. Sub-contractors without a PE will be subject to withholding tax while those with a PE in Kenya will be taxed on business profits.

Building a better working world

This clarification is especially important in application of treaties where previously, petroleum service subcontractors who were resident in a contracting state and who did not have a PE in Kenya were not subject to tax in Kenya on the basis that the now repealed Ninth Schedule provided for taxation of subcontractors on their business profits.

Deductibility of certain PE expenses

The provision in the Ninth Schedule which allowed for deduction of expenses by a PE of a nonresident petroleum company where such expenses are generally not deductible under other provisions of the Income Tax Act (the Act) has been removed.

The repealed Ninth Schedule allowed a PE to deduct executive and general administrative expenses incurred outside Kenya including management or professional fees and interest, subject to certain conditions. This provision has been removed in the new Ninth Schedule to ensure consistency with other provisions in the Act.

Introduction of tax laws specific to mining companies

New tax laws specific to mining companies have been introduced in the Ninth Schedule as follows:

- Transferability of losses: Where mining operations under a mining right in a license area ceases, a licensee may apply to the Commissioner to treat the loss as a deduction against income from mining operations of the licensee in another license area falling wholly within the area covered by the license area in which the loss has been incurred. Such loss is also carried forward as a deduction until it is fully deducted.
- Capital deduction for mining companies: The rate of depreciation for machinery first used to undertake operations under a prospecting right shall be 100%. Previously, the Act provided for capital allowances on such expenditure at 40% in the first year and at 10 % in the subsequent years.
- Taxation of subcontractors: The gross amount of service fee paid by licensee to a nonresident subcontractor[1] with no PE in Kenya is subject to withholding tax (WHT) at 20%. The tax is deductible by the licensee at the time of actual payment or crediting the subcontractor's account whichever is earlier.

Taxation rules applicable to both petroleum companies and mining companies

Withholding tax on payments by a contractor or licensee

Below are the WHT rates which were applicable to petroleum companies under the repealed Schedule as well as the rates applicable to both the petroleum and mining companies under the new Schedule.

Description	Repealed Schedule	New Schedule
Interest	10%	15%
Dividends	Not specified	10%
Royalties or natural resource income[2]	Not specified	20%
Management professional fees	12.5%	12.5%

Withholding tax on "service fees"

The rate of WHT on service fees[3] paid by a contractor (oil & gas) to a nonresident sub-contractor now attracts WHT at a rate of 5.625% while that on service fees paid by a licensee (mining) to a nonresident sub-contractor attracts WHT at a rate of 20%.

Deductibility of interest

Interest expense for petroleum and mining companies is to be restricted where the Debt: Equity ratio exceeds 2:1.

Under the repealed legislation, deduction of interest by a petroleum company was deductible in full, provided that: (i) it was at arm's length, (ii) the loan in respect of which that interest was paid was applied to operations by the petroleum company in Kenya, and (iii) the WHT thereon had been paid.

This provision introduces stringent debt financing rules for companies in the extractive industry.

Infinite carryforward of losses

Losses incurred by a licensee or a contractor in respect of mining or petroleum operations respectively can now be carried forward indefinitely or until the operations in the license area or contract area cease.

Under the repealed legislation, losses incurred by a petroleum company could only be carried forward for a maximum of four years (as is applicable to all other sectors), except where the Commissioner approved an extension, following an application.

Carryback of losses
The amount of loss from mining and petroleum operations can be carried backward as a deduction against income to a maximum of three previous years of income from the year of income in which the loss arose and the operations ceased. However, the licensee or contractor will be required to apply to the Commissioner to treat the loss as such.

Deductibility of development and extractive expenditures
Deduction of development and extractive expenditures will be deductible over a period of five years. However, the amount deductible in the year of income in which commercial production commences shall be apportioned. Under the repealed legislation, development expenditure incurred by a petroleum company was still deductible at the same rate (20%) but there is no provision on the amount deductible in the year in which commercial production commences.

Taxation of the consideration for disposal of interest in a mining right or petroleum agreement or information
The net gain from the disposal of interest in a person (where the interest derives 20% or more of its value from immovable property in Kenya) is subject to tax.[4] Immovable property has been defined to include a mining right, an interest in a petroleum agreement, mining information or petroleum information.

Under the repealed legislation, withholding tax was based on the gross amounts payable from the sale of property or shares in respect of mining and oil companies. This definition also covered any assignment of rights.

The applicable rates of tax are 20% for nonresidents and 10% for resident companies. Tax withheld on resident companies or companies with a PE shall be final tax, except in the case of assignment of rights. The WHT mechanism for taxing nonresidents has been scrapped. This therefore casts doubt over how collection of such tax will be done.

Recovery of extraction or development expenditure
Where the licensee or contractor recovers the extraction or development expenditure so deducted, the amount so recovered shall be chargeable to tax as gains or profits from business in the year of income in which the expenditure is recovered.

Establishment of an escrow account or rehabilitation fund
An escrow account or rehabilitation fund (for petroleum companies and mining companies respectively) is to be created for the purpose of decommissioning or rehabilitation of petroleum and mining operations. Contributions to an escrow account or rehabilitation fund as well as expenditure incurred under an approved decommissioning or rehabilitation plan shall be allowed as a deduction.

Amount accumulated in or withdrawn from an escrow account or rehabilitation fund to meet expenditure under the approved decommissioning or rehabilitation plan is exempt from tax. However, surplus amount upon completion of the decommissioning or rehabilitation plan or amount withdrawn and returned to the contractor or licensee is taxable as gains or profits from business in the year in which the amount was returned.

Indirect transfers of interest
A licensee or contractor is required to notify the Commissioner immediately in case of change in the underlying ownership of a licensee or contractor of 10% or more. Where the interest is disposed by a nonresident, the licensee or contractor shall be liable, as the tax-agent of the nonresident person, for tax payable as a result of the disposal.

Farm-Out agreements
If interest is transferred at the time of the agreement, the consideration shall not include value of any work undertaken by the transferee on behalf of the licensee or contractor. If the transfer of interest is deferred until some or all of the work undertaken by the transferee is completed, the amount payable to be included in the taxable income of the contractor or licensee as gains or profits from business in the year of income, the amount is payable excluding the value of the work undertaken by the transferee on behalf of the licensee or contractor.

Hedging transactions as separate sources of income
Hedging transactions entered into by a licensee or a contractor to manage commodity price risk shall be treated as specified source of income unless the transaction entered has an annual turnover of less than ten million shillings and is approved by the Commissioner.

Ring-fencing
Ring fencing rules apply. Expenditure incurred by a contractor or licensee in undertaking operations in a contract area during a year of income can be allowed only against income derived by the contractor or licensee from operations in the contract area during the year.

Endnotes

1. Nonresident subcontractor refers to a subcontractor that is not a resident and includes a subcontractor that is a foreign government or foreign government body.
2. Natural resource income means any amount paid as consideration for the right to take minerals or a living or non-living resource from land or sea. The rate of 20% applies to payments made by nonresidents. Residents will be required to account for WHT at the rate of 5%.
3. The services typically provided by sub-contractors include geological, geographic and geochemical surveys, aerial mapping, investigations of subsurface geology, drilling services, seismic surveys etc.
4. Where the interest derives between 20% and 50% of its value directly or indirectly from the immovable property, the net gain is taxable based on a prescribed formula. Where the interest derives more than 50% of its value from the immovable property, the whole gain is subject to tax.

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