# The Kenyan tax regime for the Oil and Gas Sector: An International Tax Perspective to Policy and Practical Challenges*

# El régimen fiscal de Kenia para el sector de petróleo y gas: una perspectiva fiscal internacional para la política y los desafíos prácticos

Anne Wanyagathi Maina[1]

## Abbreviations and Acronyms

| | |
|---|---|
| BEPS | Base Erosion and Profit Shifting |
| EBITDA | Earnings Before Interest Income and Expense, Depreciation And Amortisation |
| EPZs | Export Processing Zones |
| FHTP | Forum on Harmful Tax Practices |
| GDP | Gross Domestic Product |
| IP | Intellectual Property |
| ITA | Income Tax Act |
| KNBS | Kenya National Bureau of Statistics |
| MNEs | Multinational Enterprises |
| NRI | Natural Resource Income |
| OECD | Organization for Economic Co-operation and Development |
| PEPA | Petroleum (Exploration and Production) Act |
| PSC | Production Sharing Contract |
| SEZs | Special Economic Zones |
| VAT | Value Added Tax |
| WDI | World Development Indicators |


## Abstract

Many countries, especially the developing countries, offer various tax incentives to attract foreign investment for sectoral growth and development. This phenomenon presents even more in the extractive industry because the sector is not only highly specialized but is also capital and technology intensive. There is currently a major concern of illicit financial flow from Africa and the threat it posess on domestic resource mobilization. The Mbeki report (2015) highlights tax incentives, abuse of tax treaties, transfer


* DOI: https://doi.org/10.18601/16926722.n14.10

[1] Certified Public Accountant (CPA), Masters of Arts in Tax policy and Tax Administration. E-mail:wanyagathi@yahoo.com

pricing, weak tax administrations, poorly designed tax regimes and poorly negotiated extractive contracts as some of the main causes of illicit financial flows. It follows that granting tax incentives, especially if not properly designed, to the extractive industry can exacerbate the problem.

Eastern Africa has in recent years become an area of interest for many international oil and gas companies. Oil was discovered in Uganda and Kenya in 2006 and 2012, respectively, while Tanzania and Mozambique have vast gas reserves (Augé, 2015). This presents an opportunity for the region to prepare the ground by putting in place the right legislative framework to benefit fully from the extractive activities. The paper examines the policy and practical challenges of the oil and gas tax regime from an international tax perspective. The paper analyzes tax incentives available in the oil and gas sector and whether they are harmful or not within the scope OECD BEPS Action 5, international tax risk areas, available interventions in the current law, and makes policy recommendation.

The tax regime has addressed most of the international tax risk areas. The ITA requires arm's length pricing of transactions. Tax incentives should target specific industries, apply for a limited time period, leave little room for personal discretion, and be reviewed to ensure their efficiency and effectiveness. The ITA has Transfer Pricing Rules, Ring-fencing rules, thin capitalization rules and provides for taxation of net gain on indirect transfers However, there are challenges such as inadequate capacity to audit costs, lack of quality comparables data, exploitation of the debt to equity ratio interest restriction through increasing capital, and dispute resolution. The paper recommends building more capacity, enhancement of legislation and cooperation between government agencies to keep up with the growing needs of the industry.

**Keywords:** Tax Incentives, Extractive Industry, Oil & Gas.

**Resumen**

Muchos países, especialmente los países en desarrollo, ofrecen diversos incentivos fiscales para atraer inversiones extranjeras para el crecimiento y el desarrollo sectorial. Este fenómeno se presenta aún más en la industria extractiva porque el sector no solo es altamente especializado, sino que también es intensivo en capital y tecnología. Actualmente existe una gran preocupación por el flujo financiero ilícito de África y la amenaza que representa para la movilización de recursos nacionales. El informe Mbeki (2015) destaca los incentivos fiscales, el abuso de los tratados tributarios, los precios de transferencia, las administraciones tributarias débiles, los regímenes tributarios mal diseñados y los contratos extractivos mal negociados como algunas de las principales causas de los flujos financieros ilícitos. De ello se deduce que otorgar incentivos fiscales a la industria extractiva, especialmente si no están diseñados adecuadamente, puede exacerbar el problema.

África oriental se ha convertido en los últimos años en un área de interés para muchas compañías internacionales de petróleo y gas. El petróleo se descubrió en Uganda y Kenia en 2006 y 2012, respectivamente, mientras que Tanzania y Mozambique tienen vastas reservas de gas (Augé, 2015). Esto presenta una oportunidad para que la región prepare el terreno estableciendo el marco legislativo adecuado para beneficiarse plenamente de las actividades extractivas. El documento examina la política y los desafíos prácticos del régimen fiscal del petróleo y el gas desde una perspectiva fiscal internacional. El documento analiza los incentivos fiscales disponibles en el sector de petróleo y gas y si son dañinos o no dentro del ámbito de acción de la OCDE BEPS 5, las áreas de riesgo fiscal internacional, las intervenciones disponibles en la ley actual y hace recomendaciones de políticas.

El régimen fiscal ha abordado la mayoría de las áreas de riesgo fiscal internacional. El ITA requiere la determinación de precios de las transacciones. Los incentivos fiscales deben dirigirse a industrias específicas, solicitar un período de tiempo limitado, dejar poco espacio a la discreción personal y ser revisados para garantizar su eficiencia y eficacia. El ITA tiene reglas de precios de transferencia, reglas de cercado, reglas de capitalización delgada y prevé la tributación de la ganancia neta en las transferencias indirectas. Sin embargo, existen desafíos como la capacidad inadecuada para auditar los costos, la falta de datos comparables de calidad, la explotación de la deuda en capital, ratio de restricción de intereses mediante el aumento de capital, y la resolución de conflictos. El documento recomienda desarrollar más capacidad, mejorar la legislación y la cooperación entre las agencias gubernamentales para mantenerse al día con las crecientes necesidades de la industria.

**Palabras clave:** Incentivos Fiscales, Industria Extractiva, Petróleo y gas.

## I. Introduction

Many countries around the world have tax incentives to encourage investment in their economies or in some specific sector of the economy. Investors are looking for opportunities for capital investment to get the highest return and will pick the venture that gives the highest return among competing alternatives.

Tax incentives are offered, mostly by developing countries, to attract foreign investment for economic growth and development. Different countries will try to increase their competitive edge by trying to outdo other countries in offering better or more incentives. Ultimately, all the countries end up as losers. This has sometimes been described as a 'race to the bottom' (TJRN and ActionAid, 2012, Razin and Sadka, 2011).

Tax incentives are given at the expense of foregoing potential tax revenue. Incentives rank low among factors attracting investment[2]. Other factors, such as political and economic stability, rank high on the list. Tax incentives do not compensate for weak investment climate (James, 2013).

Common tax incentives offered include tax reliefs for export processing zones, reliefs for special economic zones, incentives in the extractive industries and capital allowances among others.

[2] UNIDO, 2011, Africa Investor Report: Towards evidence-based investment promotion strategies.

The extractive industry is highly specialized and thus requires a huge investment in capital and technology. Therefore, most developing countries offer incentives specific to the industry to attract foreign investment, at the expense of foregoing the much-needed revenue for development. Multinational oil companies have the capital, technology, and enjoy economies of scale, to engage in oil exploration and production in these countries. Multinational enterprises (MNEs) are also known for aggressive international tax planning[3]. Due to their international presence, MNEs are able to reduce their tax liability through base erosion and profit shifting (BEPS). They can achieve this through the use of debt instruments, financial arrangements, financial hybrid instruments, transfer of mispriced assets, and management and procurement services from related entities.

Recent discoveries of oil in East Africa has increased the prospects of the region for investment by international oil companies. Discovery of commercially viable oil reserves in Uganda in 2006, led to further exploration in the neighboring countries, Kenya and Ethiopia (Augé, 2015). Kenya discovered oil in 2012. Tanzania and Mozambique have huge gas deposits that both countries started to develop in 2004. None of the countries has started commercial production except for Sudan which has been producing oil since 1999. The region has great potential that is underexplored; offshore exploration continues (Augé, 2015).

Since the discovery of oil in 2012, Kenya's legislation on extractive industry has continued to evolve to incorporate the new developments. Recent changes include the introduction of a separate schedule to the Income Tax Act on taxation of the extractive industry in 2014, which separates the taxation treatment of mining and petroleum operations. Kenya's tax regime offers incentives to attract foreign investment, which include Special Economic Zones (SEZs), Export Processing Zones (EPZs), enhanced capital allowances, and exemption from import duty and value added tax (VAT). All exports are zero rated for VAT.

Ideally, the revenue generated from the foreign investment should be retained in the country. However, the high level of illicit financial flow from Africa[4] (Mbeki, 2015) threatens domestic revenue mobilization for development. Between 2002 and 2011, Kenya lost revenue equivalent to 7.8 percent of its GDP from trade misinvoicing[5] (GFI, 2014).

Kenyan government has an obligation both to ensure that the tax incentives are economical and at the same time, the granting of tax incentives falls within the international standards. OECD BEPS Action 5 focuses on countering harmful tax practices, to ensure a leveled playing field for countries. The OECD 1998 Report[6] on harmful tax practices outlines the factors that determine whether a tax regime is harmful or not, in terms of

[3] OECD (2013), *Addressing Base Erosion and Profit Shifting*, OECD Publishing, Paris, https://doi.org/10.1787/9789264192744-en.
[4] Thabo Mbeki (2015) Illicit Financial Flow, Report of the High Level Panel on Illicit Financial Flows from Africa.
[5] Global Financial Integrity, GFI (2014) Hiding in Plain Sight Trade Misinvoicing and the Impact of Revenue Loss in Ghana, Kenya, Mozambique, Tanzania, and Uganda: 2002-2011.
[6] OECD (1998). Harmful Tax Competition, An Emerging Global Issue; available at https://www.oecd-ilibrary.org/taxation/harmful-tax-competition_9789264162945-en

creating fair competition among countries, and also provides the criteria for evaluating preferential regimes. A tax regime can be harmful if it has preferential features that allows some incomes to be subject to low or no taxation, or where the effective tax rate on some incomes is low compared to other countries, regime is ring fenced (restricted to non-residents or isolated from the domestic economy), lack of transparency or exchange of information. Most of the incentives international companies are likely to enjoy, that fall within the scope of Action 5, are under the special economic zones.

As much as the extractive industry is likely to generate the much-needed resource revenue for development, the domination of the industry by MNEs, exposes the sector to challenges of international taxation. Simultaneously, tax incentives, which are common in the industry, erode the tax base, thus threatening the sought-after tax revenue. This paper gives an analysis of the tax regime of the oil and gas sector from an international tax perspective. The writer discusses the tax incentives and international tax challenges facing the sector and investigates any legislative interventions.

The objective of the study is to examine the policy and practical challenges of the oil and gas tax regime from an international tax perspective. The paper analyzes tax incentives available in the oil and gas sector and whether they are harmful or not as per the international standards. The paper discusses the international tax risk areas for the oil and gas, available interventions in the current law, and makes policy recommendation.

The research covers the taxation of upstream oil and gas operations, specifically exploration and development activities, which have high future growth prospects. Kenya is yet to start production of oil and gas. Mining and quarrying are still in small scale hence it will be out of scope of this study. The findings can be expanded to other Eastern African countries facing similar conditions, in future. The objective was achieved through analysis of the relevant laws, government documents, and other relevant literature, and best practice.

The next section discusses the harmful tax practices as per the OECD Action 5 of the BEPS Project, section three the status of the extractive industry in Eastern Africa, preferential tax regime in Kenya and fiscal regime and tax incentives for oil and gas sector. Section four discusses the policy and practical challenges in the oil and gas sector in Kenya, and section five concludes.

## II. Action 5 on Harmful tax practices

The OECD 15-point Action Plan of the BEPS project provides countries with a set of international tax rules to realign taxation with economic activities and value creation, and increase certainty and predictability to taxpayers. Action 5[7] builds on the OECD 1998 Report6 on Harmful Tax Competition and expands the role of Forum on Harmful Tax Practices (FHTP)[8] that was formed as per the

[7] OECD (2015).
[8] The role of FHTP under Action 5 is as follows: *Revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings*

recommendations of the 1998 Report. FHTP has the mandate to review whether preferential regimes in participating countries around the world result in harmful tax competition.

The OECD 1998 Report, in chapter two, describes harmful tax practices in form of tax havens and harmful preferential tax regimes applying to geographically mobile activities such as financial and other service activities, and provides criteria for identification of harmful regimes. A tax regime can be harmful if it has preferential features that allows some types of income to be subject to no or low effective tax rate, if the regime is ring fenced (restricted to non-residents or isolated from the domestic economy), and there is lack of transparency or exchange of information with respect to the regime. The level of substantial activity also determines whether a preferential regime is potentially harmful. The FHTP defines the approaches to determine substantial activity level to assess preferential regimes, and focusses on improved transparency through exchange of rulings on preferential regimes (OECD, 2015).

Countries agreed on the nexus approach to determine substantial activity for preferential regimes (both intellectual property (IP) and non-IP regimes) (OECD, 2015). The nexus approach aligns expenditure to income. An entity benefits from an IP regime to the extent that it has incurred qualifying research and development expenditures that gave rise to the IP income. This takes into account the proportion of expenditure relating to developing the IP (the real value added) out of the overall expenditure by the taxpayer.

Substantial activity with reference to non-IP regimes refers to the core income generating activities required to produce a specific income covered by the preferential regime (OECD, 2015). An entity will benefit if it has undertaken core income generating activities in the jurisdiction providing the benefits. The core activities depend on the type of regime. Types of non-IP preferential regimes include holding company, headquarter, distribution centre, service centre, financing and leasing, fund management, banking, insurance, and shipping company regimes. The application of a regime will also vary from one country to another.

Improved transparency requires mandatory spontaneous exchange on six categories of taxpayer-specific rulings: rulings relating to preferential regimes; unilateral advance pricing agreements (APAs) or other cross-border unilateral rulings in respect of transfer pricing; cross-border rulings providing for a downward adjustment of taxable profits; permanent establishment (PE) rulings; related party conduit rulings; and any other type of ruling agreed by the FHTP (OECD, 2015).

## III. Status of the Extractive industry in Eastern Africa

Eastern Africa has become an area of interest for many international oil and gas companies (Thuo, 2015). Countries in the region are struggling with high poverty levels and the prospects of oil and gas sector is likely to generate the much needed revenue to deal with poverty challenges. Oil was discovered in Uganda in 2006, which has led to more

*related to preferential regimes, and on requiring substantial activity for any preferential regime. It will take a holistic approach to evaluate preferential tax regimes in the BEPS context* (OECD, 2013).

discoveries in Kenya in 2012 (Augé, 2015). Tanzania and Mozambique have vast gas reserves (Augé, 2015). Further exploration is still ongoing in Kenya, Ethiopia and Somalia (Augé, 2015).

None of the countries in Eastern Africa mentioned has started commercial production, except for South Sudan and Sudan, which started production in 1999 (Augé, 2015). Most of the oil discoveries were made in remote areas and thus a need for the extensive development of infrastructure before extraction can commence[9]. This presents an opportunity for the region to prepare the ground by putting in place the right legislative framework to ensure the countries benefit fully from the extractive activities. The activities of oil and gas production are relatively new in the region and thus have attracted many international players. This calls for proper policy to address emerging issues in the industry. Tax policy is central to this, to enhance future production sharing agreements - the current agreements might not be affected by such changes since most of them have stabilization clauses which prevent the host country from altering the terms of the agreement in a way that adversely affects the Contractor[10].

Many developing countries face similar challenges in the taxation of cross-border taxation in the extractive industry, which include inadequate transfer pricing rules, inadequate capacity, political interference, lack of proper coordination between intergovernmental agencies, and difficulty in getting taxpayer's information (Readhead, 2016; Sunley, et al., 2003). Some resource-rich countries in Africa, such as South Africa, Tanzania and Zambia[11], have enacted policies counter tax evasion by MNEs. In 2015, South Africa introduced restriction of interest deduction of amounts above 40 percent of taxable earnings before interest, taxes, depreciation, and amortization (EBITDA), adjusted according to changes in South African Reserve Bank interest rate (Readhead, 2017). Tanzania has set up a special agency to audit mining companies[11]. Zambia legislation on mining has undergone numerous changes recent one being the introduction of price based royalty on Copper, replacing royalty based on profits, and further, require mining companies to use publicly quoted benchmark prices[11].

### *A. Extractive industry in Kenya*

Kenya belongs to the lower middle-income group, according to the World Bank, with a real GDP per capita of USD 1,169.3 in 2017[12] (WDI, 2018) and an average economic growth rate of 5 percent[13] (KNBS, 2017). Its major source of revenue is taxes: taxes fi-

[9] The State of Oil and Gas in East Africa; available at https://www.mmaks.co.ug/sites/mmaks.co.ug/files/article-attachments/2017/07/state-oil-and-gas-east-africa.pdf

[10] Clause 40 of Production Sharing Contract between the Government of the Republic of Kenya and Camac Energy Kenya Limited; available at http://downloads.openoil.net/contracts/ke/ke_Block-L-16_dd20120510_PSC_Camac.pdf

[11] Lassourd and Readhead (2017). Securing Mining Revenues: Good Practice from Zambia, Tanzania, South Africa; available at https://resourcegovernance.org/blog/securing-mining-revenues-good-practice-zambia-tanzania-south-africa

[12] World Development Indicators (WDI); available at http://databank.worldbank.org/data/

[13] Economic Survey (2018); available at https://www.knbs.or.ke/download/economic-survey-2018/

nanced 60.7 per cent of the budget during the financial year 2016/201713 (KNBS, 2017).

Mining industry in Kenya is relatively small, only accounting for 0.8 per cent of the GDP in 201613 (KNBS, 2017). Some of the minerals include soda ash, fluorspar, base titanium, coal, magnesite and gypsum. British company Tullow Oil discovered oil reserves in 2012 - the oil reserves are estimated to be 600 million barrels (Augé, 2015). On June 3, 2018, the president flagged off the first consignment of Kenya's crude oil under the Early Oil Pilot Scheme (EOPS)[14]. Commercial production is expected to start in 2021. Hence the focus of the paper is on upstream operations which involve the exploration and development activities.

Key institutions[15] in the extractive industry are the Ministry of Energy and Petroleum, Ministry of Petroleum and Mining, the National Oil Corporation of Kenya Limited (NOCK), National Land Commission, County Governments and Kenya Revenue Authority.

### *B. Preferential Tax Regimes in Kenya*

Tax incentives in the Kenyan tax regime under the current law[16] include Special Economic Zones (SEZs), Export Processing Zones (EPZs), capital allowances, exemption from import duty and VAT. EPZ was reviewed by FHTP and its status is out of the scope of work of FHTP[17]. FHTP reviews regimes which applying to geographically mobile activities such as financial and other service activities - regimes meant to attract plant, building and equipment are outside the scope of FHTP8. SEZ is currently under review. Kenya does not have IP preferential regime.

EPZ is meant to promote the country's exports. It is outside the customs territory and hence exempt from paying import duty and VAT on its imports under the Value Added Tax Act and Customs and Excise Act. Enterprises in EPZ produce for export. All exports are zero rated for VAT. An export processing zone enterprise is licensed by Export Processing Zone Authority (Export Processing Zones Act, 1990). EPZ enterprises are exempted from paying any corporation tax for the first 10 years of operation, but the corporation rate of tax will be 25 percent for the next 10 years and the normal corporate tax rate of 30 percent thereafter (Third Schedule to the Income Tax Act, ITA). Dividends paid to non-resident shareholders from the tax exempt profits are exempt from the 10 percent withholding tax (ITA).

SEZs are new in Kenya introduced by the Special Economic Zones Act, 2015, to attract

[14] Kiplang'at Jeremiah (2018, June 3) Kenya beats odds to become first EA nation to export oil. Daily Nation; available at https://www.nation.co.ke/news/Kenya-s-journey-as-an-oil-exporter-starts/1056-4593378-j9fim8z/index.html

[15] Conducting Oil and Gas Activities in Kenya; available at https://www.africalegalnetwork.com/wp-content/uploads/sites/22/2017/05/Conducting-Oil-Gas-Activities-Kenya-1.pdf

[16] Income Tax Act, 1973, Chapter 470 of the Laws of Kenya, Value Added Tax Act, Excise Duty Act, East Africa Management Act, Customs and Excise Act, and bilateral agreements granting special tax treatment to the parties).

[17] Harmful Tax Practices –2017 Progress Report on Preferential Regimes Inclusive Framework on BEPS: Action 5 (Update as of 9 May 2018); available at https://www.oecd.org/tax/beps/update-harmful-tax-practices-2017-progress-report-on-preferential-regimes.pdf

foreign investment. Just like EPZs, SEZS are outside the customs territory and hence exempt from paying import duty and VAT on its imports under the Value Added Tax Act and Customs and Excise Act. SEZ do not exclusively produce for export, hence any local sales are subject to VAT at the standard rate. SEZs could comprise of agricultural zone and business service park including business process outsourcing (BPOs) and industrial park. Special economic zone enterprise, developer or operator, licensed under the Special Economic Zones Act, enjoy a reduced corporate tax rate of 10 percent for the first 10 years of operation and thereafter 15 percent for another ten years. The corporate tax rate for other local companies is 30 percent. Dividends received by a registered venture capital company special economic zone enterprises, developers and operators licensed under the Special Economic Zones Act are tax exempt. Payments other than dividends made to non-residents by SEZs are subject to withholding tax the rate of 10 percent. This can be compared with a rate of 20 percent withholding tax rate applicable on management or professional fee paid to a non-resident (Third Schedule to the ITA)

The Second Schedule to the ITA grants investment allowance on specific capital expenditure incurred by entities in the furtherance of business, such as capital expenditure incurred in acquisition of machinery by a manufacturing firm. The government also exempts from duties and VAT some items procured by some specific industries or projects that are a priority in the development agenda. Nonetheless, these incentives might not fall within the scope of focus of Action 5 which is geographically mobile activities such as financial and other services activities.

### *C. Fiscal Regime for Oil and Gas in Kenya*

Kenya has been continuously improving its legislation to keep up with the recent developments in oil and gas sector in the country. Currently, the major laws guiding the operations of oil and gas are; The Constitution; Petroleum (Exploration and Production) Act[18](PEPA), Chapter 308 of the Laws of Kenya; Petroleum (Exploration and Production) Regulations, 1984; and Income Tax Act[19] (ITA), Chapter 470, Laws of Kenya (the Ninth Schedule).

The Minister of Energy and Petroleum, on behalf of the government, licenses companies that want to engage in petroleum operations in the country (PEPA). The Minister negotiates petroleum agreements with contractors and issues exploration permits. The PEPA Regulations contain the model Production Sharing Contract[20] (PSC) which forms the basis of negotiations between the contractors and the Government. The PSC contains the terms, rights and obligations of parties, the fees payable and sharing of revenue under the contract. The profit share

[18] Government of Kenya (GoK). *The Petroleum (Exploration and Production) Act*; available at https://www.nationaloil.co.ke/pdf/petroleum_act_kenya.pdf

[19] The Income Tax Act, Chapter 470, Laws of Kenya; available at https://www.kra.go.ke/notices/pdf2015/Income-Tax-Act-2014.pdf

[20] Government of Kenya (GoK). *The Model Production Sharing Agreement*; available at https://nationaloil.co.ke/pdf/Model_PSC_2015_-_210115.pdf

of the government is based on the profit oil and the share increases as production increases. Only companies incorporated or registered in Kenya can enter into petroleum agreements with the Government. Petroleum agreement is signed for a specified contract area (specified geographical area that the Government may authorize a contractor to engage in petroleum operations under a petroleum agreement). The government share of revenue from oil is based on profits as provided for in the PSC. The government share in the model PSC increases as production increases, from 50 percent to 78 percent of profit oil (Annex 1). The subnational government is to receive 20 percent and the local community 5 percent of the government share of the oil revenue[21]; the rest (75 percent) remains in the national kitty.

The Income Tax Act (ITA) provides the general tax regime, while the Ninth Schedule to the Income Tax Act contains the specific tax regime for the extractive industry. The overhaul of the Ninth Schedule through the Finance Act 2014[22], ushered in a new, more comprehensive, regime for the taxation of the extractive industry that distinguished taxation of mining operations from petroleum operations, which was not the case before. Gains and profits of the contractors in the extractive industry are taxed at the corporation tax rate of 30 percent for residents and 37.5 percent for non-residents. The income tax from the petroleum operations by the contractors is carved out of the Government's share of production. Expenditure or losses incurred in a contract area under a petroleum agreement is only deductible against income of that contract area. In case of a loss, the loss can be carried forward until it is exhausted or the operations of the contract area have ceased. Losses can be carried back for up to a period three years from the year in which the loss arose. The ITA does not allow loss carry back under the general tax rules.

Net gain from disposal of interest under a Production Sharing Contract (PSC is also taxed at the corporate tax rate of 30 percent for residents and 37.5 percent or non-residents. Natural Resource Income (NRI) or royalties are subject to withholding tax of 5 percent for residents and 20 percent for non-residents. The withholding tax rate may be lower that this if the recipient of the income is resident in a country that has a tax treaty with Kenya. The ITA defines NRI as an amount paid as consideration for the right to take minerals or a living or non-living resource from land or sea, or an amount calculated in whole or in part by reference to the quantity or value of minerals or a living or non-living resource taken from land or sea. Direct or indirect transfers of interest in Kenya are subject to capital gains tax (ITA).

Thin capitalization rules apply whereby interest expense is deductible to the extent that the debt to capital ratio does not exceed two to one (2:1). The rate of withholding

[21] Business Daily (2018, May 18). Uhuru: All clear for oil production after govt-county deal; available at https://www.businessdailyafrica.com/news/Governments-strike-agreement-on-oil-production/539546-4570134-dh71ij/index.html
[22] The Finance Act 2014; available at http://kenyalaw.org/kl/fileadmin/pdfdownloads/Acts/Finance_Act_16of2014Final.pdf

tax on dividends is 10 percent on the gross amount; the rate is 15 percent on interest for non-residents (Ninth Schedule to the ITA).

*1. Tax incentives in oil and gas sector*

Oil and gas sector enjoy other special tax treatment due to the nature of their operations. Oil exploration is a high-risk venture which involves high sunk costs years before any production can begin. The government, therefore, needs to provide a conducive environment that will attract investors into the sector, which may entail, among other things, a favourable tax treatment.

Capital expenditure incurred during exploration and development is deductible expense against taxable income. Machinery first used to undertake exploration operations enjoy an accelerated depreciation at the rate of a 100 percent (Ninth Schedule to the ITA). The imports of equipment by contractors and subcontractors for exploration and development activities are exempt from VAT and customs duty under the model PSC[23].

The contractors are allowed to carry forward losses indefinitely, and if operations cease, they are allowed to carry back losses up to a period of three years (Ninth Schedule to the ITA). The general tax regime only allows loss to be carried forward up to a period of ten years and does not allow carrying back of losses.

Service fee paid to a non-resident subcontractor in respect of petroleum operations is subject to a withholding tax at the rate of 5.625 percent on the gross amount. Management, training and professional fee paid by a contractor to any other non-resident person is subject to withholding tax of 12.5 percent on the gross amount. Both rates are lower compared to the general withholding tax rate of 20 percent charged on management and professional fee including contractual fee, payable to non-residents (Ninth Schedule to the ITA).

*2. Adherence to international Standards*

The special tax regime discussed above would not be considered to be potentially harmful, as per OECD BEPS Action 5, because, first, the tax rate applicable on gains from petroleum is not low, it is the corporate tax rate of 30 percent for residents and 37.5 percent for non-residents. Secondly, the regime is open to both residents and non-residents; it is not ring-fenced from the domestic economy. Thirdly, there is substantial activity on the various sites of oil exploration. And lastly, the incentive regimes are open to the public, such as the model PSC and the provisions of the ITA.

Where a preferential regime is potentially harmful, the FHTP recommends for either abolish of the regime; or the remove the features that create the harmful effect.

That said, it is important to ensure tax incentives conform to best practice to increase their efficiency and effectiveness for the benefit of the country. Some incentives

[23] : Clause 32(3) of the Model Production Sharing Agreement. Government of Kenya (GoK); available at https://nationaloil.co.ke/pdf/Model_PSC_2015_-_210115.pdf

may have adverse effects to the economy. A working group by World Bank (2015) provides a report on some guiding principles for low-income countries' effective and efficient use of tax incentives. Tax incentives targeting the export-oriented sector are seen to be more effective than those for domestic sectors. Cost based tax incentives such as capital allowance are seen to be more effective than profit based incentives such as tax holidays. Incentives should target specific industries; apply for a limited time period; leave little room for personal discretion; and be reviewed regularly to check their efficiency and effectiveness (James, 2013; World Bank, 2015). James (2013) also advocates for regional cooperation to avoid the race to the bottom.

Further taxation issues are laid out in the next section.

## IV. Policy and Practical Challenges in the oil and gas sector in Kenya

The taxation regime for the oil and gas sector in Kenya is relatively new and is still evolving. As observed, this is a specialized sector and thus has a distinct tax regime. The policymakers have to balance between attracting investment and optimizing tax revenue for development. At the same time, the law should address the challenges in the taxation of MNEs, which dominate the sector. The law should be adequate and tax administrators need to be well equipped to administer it.

Some of the challenges in the taxation of the sector include; overstatement of exploration and development costs, transfer pricing issues, thin capitalization, ring-fencing, indirect transfers, and valuation of the product. The first four issues are discussed further in paragraphs that follow. Kenya is yet to start oil production, and currently, the Ninth schedule only covers the scope of exploration and development activities, hence product valuation is not covered in the current tax legislation.

### *A. Overstatement of exploration and development costs*

The operations of the petroleum industry involve huge exploration and development before the production can begin. Exploration expenditure is incurred in finding or discovery of the resource. It is defined in the Ninth Schedule to the ITA, to include exploration costs authorized under the petroleum agreement before the development phase begins. These are costs of; acquisition of an interest in the petroleum agreement or petroleum information; geological, geophysical, and geochemical surveys; aerial mapping; stratigraphic tests; drilling of test wells; or any other work that is necessarily connected with exploration activities (ITA).

Exploration expenditure is allowable against income of a contract area during the year in which the expenditure was incurred (Paragraph 9(3) of Ninth Schedule to the ITA). The machinery first used to undertake exploration operations enjoy an accelerated depreciation at the rate 100 percent; hence cost of such equipment should be correctly valued.

Development expenditure is incurred to get access to the discovered resource and facilitate commercial production. It is defined in paragraph one of the Ninth Schedule to the ITA, as including capital expenditure incurred by a contractor when carrying out operations authorized under a development plan in a petroleum agreement. Development expenditure is an allowable deduction at the rate of 20 percent per annum until it is exhausted (Paragraph 10(1) of Ninth Schedule to the ITA).

Costs of borrowing capital equipment used in the exploration and development phase are capitalized (Ninth Schedule to the ITA) and may form part of the exploration or development expenditure.

A company can hire a related party to conduct some of these exploration and development activities, which poses a risk for tax revenue. The key institutions lack adequate capacity to audit the cost at the exploration and development stage to ensure costs are not overstated, and are accorded appropriate treatment. This poses another risk since the contractors can claim substantial artificial costs.

The regulators, tax administrators, and the relevant government ministries or departments should monitor these costs closely during the exploration and development phase to ensure that the costs are at arm's length and are correctly valued.

***B. Transfer pricing issues***

Expenses wholly and exclusively incurred in furtherance of the business are allowable deductions (ITA). Management and professional fees, and service fees to subcontractors allowed for tax purposes. The service fees are also subject to withholding tax at a lower rate (Ninth Schedule to the ITA). The fees are also subject to manipulation, especially where a related party provides the services. Kenya has Transfer Pricing Rules, 2006, which provides for various methods of determining an arm's length price. Related party transactions should be stated at arm's length prices, as per the Transfer Pricing Rules, 2006 (ITA).

Nonetheless, just like other developing countries with a large number of MNEs, Kenya faces the risk of tax base erosion through mispricing of cross-border transactions. Despite having transfer pricing rules in place, they are not sufficiently detailed hence the taxpayer has to refer to international guides such as the OECD and UN Model Convention. Other challenges that tax administrators face in implementation of transfer pricing rules in the mining sectors are difficulty in getting access to the taxpayer's documentation, lack of comparables data to compute arm's length prices, political interests and resolution of transfer pricing disputes (Readhead, 2016; Sunley, et al., 2003).

***C. Thin capitalization***

A company is thinly capitalized if it finances its operations mainly through debt as opposed to equity. Thinly capitalized companies are likely to have huge interest expenses. Interest expense is deductible against income, thus debt financing can be used by companies for tax planning. As a result, various countries have established thin capitalization rules to limit the interest expense deductible. In Kenya, interest expense deduction for oil and gas companies is limited to the extent that the debt to equity ratio does not exceed 2:1 (Ninth Schedule to the ITA). Equity is defined as the sum of the revenue reserves and the issued and paid-up capital of all classes of shares of the company, and debt means loans, overdrafts, ordinary trade debts, overdrawn current accounts or any other form of indebtedness for which the company is paying a financial charge, interest, discount or premium (Section 16(2) (j) of ITA).

However, interest restriction based on the debt to equity ratio can still be exploited by some companies, which use the debt to acquire more capital. That's why South Africa made a shift from the debt to equity ratio to interest restriction based on EBITDA (Readhead, 2017). This is in line with the recommendations of OEC BEPS Action 4[24].

### *D. Ring-fencing rules*

Ring-fencing in the extractive industry prevents the consolidation of income and expenditure from different activities carried out by the same taxpayer (Sunley, et. Al., 2003, par.2, pp.5). Consolidation may encourage further exploration since the company is able to recoup its costs in time, but it may also give room for tax avoidance whereby the company continues doing other exploration activities to increase their deductibles, so as to remain in a loss position. Governments introduce ring-fencing rules to protect their tax base (Sunley, et. Al., 2003).

The Ninth schedule to the ITA has ring-fencing rules per contract area, that is, per petroleum agreement. The expenditure incurred on one contract is only deductible against income derived by the contractor from the same contract area. A loss incurred in a contract area can only be carried forward and deducted against income of that contract area. Thus the calculation of taxable liability is done separately for each contract area. This protects government revenue.

### *E. Indirect transfers*

Indirect transfers in the extractive industry has been an issue of concern for many developing countries, and is now one of the areas addressed in the toolkit for "The Taxation of Offshore Indirect Transfers", developed by The Platform for Collaboration on Tax[25]. The Platform was formed in 2016 to develop capacity for developing countries on international tax matters. The toolkit22 defines an indirect transfer as the disposition of an indirect ownership interest in an asset, in whole or in part. The authorities of the jurisdiction in which the asset is located run the risk of missing out on taxing the net gain on an indirect transfer of such an asset if the transfer happens overseas. This is likely to happen if the local law is inadequate or due to lack knowledge about the transfer.

Capital gain that accrues on transfer of property situated in Kenya is taxable in Kenya (ITA, the date of acquisition of property is irrelevant). Under the Ninth Schedule to the ITA, a contractor is required to notify the tax

[24] OECD (2016), *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2016 Update: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris; available at https://doi.org/10.1787/9789264268333-en.
[25] The Platform for Collaboration on Tax. *The Taxation of Offshore Indirect Transfers— A Toolki*t; available at http://documents.worldbank.org/curated/en/322921531421551268/a-toolkit-draft-version-2

administrator in case of a change in the underlying ownership (change of 10 percent or more). The net gain from disposal of interest, if the interest derives its value directly or indirectly from immovable property in Kenya, is subject to capital gains tax under the ITA; as from January 2015. Immovable property means a mining right, an interest in a petroleum agreement, mining information or petroleum information (ITA). This includes a sale of petroleum exploration licences. This is the source of an ongoing dispute between Africa Oil and Kenya Revenue Authority[26]. The details of the case are not open to the public access yet, since it is still ongoing Court matter.

Another dispute of a similar nature was Heritage Oil and Gas Vs Uganda Revenue Authority (URA)[27], 2011. Heritage Oil sold its exploration licences in Uganda to Tullow Oil Uganda Limited for US$ 1.45 billion, after which Heritage Oil ceased operations in Uganda. URA demanded 30 percent of the sales proceeds as capital gains tax. Heritage Oil objected to the tax assessment, arguing that the sale did not take place in Uganda, and Heritage Oil was not incorporated in Uganda but in Mauritius. They further argued that the Product Sharing Agreement did not provide for capital gains tax, and the Tax Appeals Tribunal in Uganda did not have the jurisdiction to determine the matter. URA on the other hand, argued that the assets sold were located in Uganda, and the sale was made with the consent of the Uganda government, hence subject to the Uganda Law. The Tribunal ruled in favour of URA[28], upholding the tax assessment on Heritage Oil.

The contractor has an obligation to notify the Commissioner of Taxes if there is any change in ownership of at least 10 percent (Ninth Schedule to the ITA). Where the contractor fails to notify the Commissioner of Taxes about a transfer oversees of a local asset, the Commissioner may not know the details of such a transaction. The model PSC provides for arbitration in accordance with the arbitration rules adopted by the United Nations Commission on International Trade Laws. This might undermine the local Courts jurisdiction, in determining any disputes arising.

## V. Conclusion

Kenyan legislation has kept pace with the developments in the oil and gas sector in the country. The overhaul of the Ninth Schedule to the Income Tax Act, in 2014, brought in a new taxation regime for extractive industry. The tax incentives enjoyed by the industry, under the current tax regime, may not be considered to be potentially harmful under the OECD BEPS Action 5 on Harmful Tax Practices; the tax rate applicable to gains from petroleum is not low, the regime is not ring-fenced from the domestic economy and there is substantial activity taking place on the various sites of oil exploration.

[26] Irungu, G. (2018. August 20). *KRA in Sh5.2bn tax row with Turkana oil firm*; available at https://www.businessdailyafrica.com/news/KRA-in-Sh5-2bn-tax-row-with-Turkana-oil-firm/539546-4720406-14eomxiz/index.html
[27] Understanding the Tax Dispute: Heritage, Tullow, and The Government of Uganda; available at http://www.acode-u.org/Files/Publications/infosheet_16.pdf
[28] Ruling of the Heritage v URA; available at https://www.scribd.com/document/148699647/Ruling-of-the-Heritage-v-URA-Income-Tax-Dispute

The tax regime has addressed most of the international tax risk areas. The ITA requires arm's length pricing of transactions, and the Transfer Pricing Rules, provide methods of determining an arm's length price. Interest deduction is restricted for thinly capitalized companies, where the debt to equity ratio exceeds two to one. Ring-fencing rules apply to a contract area, and net gain on indirect transfers of interest derived from petroleum agreement or petroleum information is taxable in Kenya. However there are still challenges in the following areas: inadequate capacity of the regulators to audit exploration and development cost; challenges with application of transfer pricing rules such as lack of quality comparables data; exploitation of the debt to equity ratio interest restriction through increasing capital; lack of information on indirect transfer happening overseas; and dispute resolution.

Tax incentives should also be efficient and effective to attract investment for development. Best practice advocates for incentives that are cost-based as opposed to profit based, targeting specific industries; apply for a limited time period, leave little room for personal discretion, and reviewed regularly (James, 2013; World Bank, 2015).

It is important for the regulators, tax administrators, and the relevant government ministries or departments, to monitor costs closely, especially during the exploration and development phase, to ensure they correctly accounted for and are at arm's length, to counter tax avoidance. The regulator should ensure withholding taxes applicable are duly paid. Monitoring and enforcement are key to ensure compliance with the law and will protect government revenue.

Further improvements need to be made, such as building more capacity, enhancement of legislation and cooperation between government agencies, to keep up with the growing needs of the industry. Currently government share of revenue is based on the profit oil which may not be ideal, due to huge tax deduction; the share could be based on oil revenues. With production expected to start in about three years, that is the year 2021, legislation on taxation at the production phase should be put in place tax legislation on product valuation, which is not yet in place.

## References

Augé, B. (2015). Oil and Gas in Eastern Africa: Current Developments and Future Perspectives. Retrieved from http://www.ocppc.ma/sites/default/files/OCPPC-Ifri-PN1502.pdf

James, S. 2013. *Tax and non-tax incentives and investments: Evidence and Policy Implications*, Investment Climate Advisory Services. World Bank Group. Retrieved from https://dx.doi.org/10.2139/ssrn.2401905

Kenya National Bureau of Statistics (KNBS). (1960-2016). *Economic Survey*. Nairobi: Government Printers.

OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing, Paris. Retrieved from http://dx.doi.org/10.1787/9789264162945-en

OECD (2015), *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. Retrieved from http://dx.doi.org/10.1787/9789264241190-en

Razin, A., & Sadka, E. (2011). Tax competition and migration: the race-to-the-bottom hypothesis revisited. *CESifo Econ6omic Studies*, *58*(1), 164-180.

Readhead, A. (2016*) Preventing Tax Base Erosion in Africa: a Regional Study of Transfer Pricing Challenges in the Mining Sector*. National Resource Governance Institute (NRGI). Retrieved from https://resourcegovernance.org/sites/default/files/documents/nrgi_transfer-pricing-study.pdf

Readhead, A. (2017). *Preventing Base Erosion: South Africa's Interest Limitation Rules*. National Resource Governance Institute (NRGI). Retrieved from https://resourcegovernance.org/sites/default/files/documents/preventing-base-erosion-south-africa-limitation-rule.pdf

Sunley, E. M., Baunsgaard, T., & Simard, D. (2003). Revenue from the oil and gas sector: Issues and country experience. *Fiscal policy formulation and implementation in oil-producing countries*, 153-183. Retrieved from http://siteresources.worldbank.org/INTTPA/Resources/SunleyPaper.pdf

Tax Justice Research-Africa (TJRN-A) & ActionAid, (2012). Tax competition in East Africa: A race to the bottom?

Thuo, D. N. (2015). Petroleum Contracts and Taxation: is East Africa Prepared? In K. Olsen (Ed.), *Special issue on International Taxation in the Energy Sector, 13(4). Oil, Gas & Energy Law Intelligence* (OGEL). Retrieved from

https://karuspace.karu.ac.ke/bitstream/handle/20.500.12092/1668/Petroleum%20Contracts%20and%20Taxation.pdf?sequence=1

World Bank. (2015). *Options for low income countries' effective and efficient use of tax incentives for investment: a report to the G-20 development working group by the IMF, OECD, UN and World Bank (English)*. Platform for Collaboration on Tax. Washington, D.C.: World Bank Group. Retrieved from https://www.imf.org/external/np/g20/pdf/101515.pdf

World Bank (WB). (2018). *World Development Indicators (WDI)*. Retrieved from http://databank.worldbank.org/data/

## VI. Appendix

### *Annex 1: Government share of profit from oil*

The profit oil share of the government and contractor depends on the daily production. The percentages provided in the model production sharing agreement (2015) are as follows:

| Incremental Production Tranches | Government Share | Contractor Share |
|---|---|---|
| 0 - 30,000 barrels per day | 50% | 50% |
| Next 25,000 barrels per day | 60% | 40% |
| Next 25,000 barrels per day | 65% | 35% |
| Next 20,000 barrels per day | 70% | 30% |
| Above 100,000 barrels per day | 78% | 22% |

Source: Clause 27(3) of the Model Production Sharing Agreement. Government of Kenya (GoK). https://nationaloil.co.ke/pdf/Model_PSC_2015_-_210115.pdf

### *Annex 2: Kenyan oil and gas blocks*

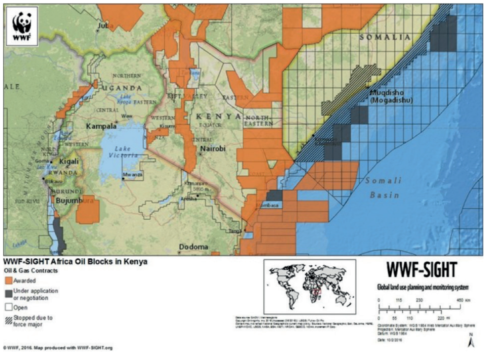


**Figure 1.**
**Oil and Gas Blocks**

http://extractives-baraza.com/resources/overview-of-kenyas-extractive-industry/oil-and-gas