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Implementation of the reintroduced Capital Gains Tax

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Abstract

This paper presents results of the evaluation of the process of effecting capital gains tax that was reintroduced in Kenya after suspension of close three and half decades. In addition, the paper outlines recommendations that if adopted would enhance administration and general operation of the tax. It further provides recommendations on areas for future research that may in the long run improve the overall efficiency of the tax system. Data was obtained through interviews and administration of structured questionnaires on populations comprising of registered valuers, registered estate agents and tax officials (KRA staff). Random sampling was used in the selection of estate agents and valuers while purposive sampling was used in selecting of KRA officials dealing with CGT. The study established that implementation of capital gains tax faced numerous challenges including: lack of awareness; lack of documentation required for computing CGT; lack of consideration for time value of money in appreciation of property value; lack of clear methodology in computation of 'capital gain' in properties that are partly let and partly owner occupied; lack of involvement of valuers in computation of capital gains and lack of clarity on CGT payment in case of auction or foreclosure of a property. Recommendation: The study recommends that KRA conducts CGT awareness campaigns; factor in indexation and involve valuers and other professionals in the determination of 'capital gains 'and clarification on parties paying capital gains tax in case of auction.

Keywords: Capital gains, Challenges, Administration and Implementation

Introduction

Capital Gains a tax was first introduced in Kenya in the year 1975 but suspended in 1985. This was arguably to spur investment in the country, especially in real estate and securities' market. Later attempts to re-introduce the tax system had failed (Earnest and Young, 2014). The main objective in reintroducing the tax is to widen the tax base and obtain funds to bridge the budget deficit. Thus it was finally re-introduced by the Finance Act No. 16 of 2014 through Kenya Gazette Supplement No. 141 on 19th September 2014 with an applicable rate of 5% of the net gain and was announced to be effective on 1st January 2015. The applicable rate was recently increased to 15% of the net gain. However, this tax system has faced stiff opposition by different groups. The reintroduction of the tax in Kenya was to facilitate mobilisation of financial resources needed development of new infrastructural and related expenses.

In Kenya capital gains tax is chargeable on the whole of a gain which accrues to a company or an individual on the transfer of property situated in Kenya. The properties include marketable securities that are capable of being sold as stock which are both listed and unlisted securities, buildings, and land. The tax is to be paid

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by the person (resident or non-resident) transferring the property, that is, the transferor. The transferor can either be an individual or a corporate body. For investment in shares, while the tax incidence is on the transferor, the responsibility to collect and account for the tax is be on the stockbrokers.

The reintroduction of the tax was met with opposition by those who saw it as having negative effects on the economy. This group largely cite arguments that the tax would among others; affect the economy negatively through its lock in effects of the tax; constraining mobility of capital and likely negative impact on investment and general economic stagnation (Amatong, 1968; Veldhuis, N. et al; 2007, and Agersnap, O. and Zidar, O. 2010). On the other hand, supporters of the capital gains tax argue based its progressive nature, fairness and equity reasons (Amatong, 1968, Bhatia, 2008). In this paper our discussions are however limited to evaluation of the implementation process, identifying the challenges and proposing recommendations that other countries and/or Kenya could learn from when implementing a new tax system.

Literature Review

Capital gains refers to the difference between the price you paid for acquiring an asset and the price you sell it for (Irish Tax and Customs, 2015). In general it refers to the price of an asset when it is sold compared to its original purchase price. A capital gain occurs if the value of the asset at the time of sale is greater than the initial purchase price. As a tax it helps raise revenues for government but arguably at considerable economic costs to the economy as they reduce returns on investment and thereby distort decision making by individuals and businesses (see Clement et al, 2014).

The Carter Commission's recommendations in 1966 in respect of the Canadian tax system and capital gains tax stated;

> "A dollar gained through the sale of a share, bond or piece of real property bestows exactly the same economic power as a dollar gained through employment or operating a business." (Musgrave, 1968).

Similarly, when capital gains tax was introduced in the United Kingdom in 1965, the following noteworthy comments were made by James Callagham; the then Chancellor of the Exchequer;

> "The failure to tax capital gains is widely regarded … as the greatest blot on our existing system of direct taxation. There is little dispute nowadays that capital gains confer much the same kind of benefit on the recipient as taxed earnings more hardly won. Yet earnings pay tax in full while capital

> gains go free. This is unfair to the wage earner. It has in the past been one of the barriers to the progress of an effective incomes policy … Moreover, there is no doubt that the present immunity from tax of capital gains has given a powerful incentive to the skilful manipulator of which he has taken full advantage to avoid tax by various devices which turn what is really taxable income into tax-free capital gains." (Hansard, 6th April, 1968; UK Parliament).

South African Revenue Service (2000) noted that the absence of a capital gains tax creates many distortions in the economy, by encouraging taxpayers to convert otherwise taxable income into tax-free capital gains. It also observed that sophisticated taxpayers had engaged in these conversion transactions, thereby eroding the corporate and individual income tax bases. This erosion reduces the efficiency and equity of the overall tax system. A Capital Gains Tax is, therefore, a critical element of any income tax system as it protects the integrity of the personal and corporate income tax bases and can materially assist in improving tax morality. However, the announcement of the reintroduction of the tax in Kenya led to fears, anxiety and uncertainty. As a result, it became a popular subject of study for researchers and students for instance, Karinga (2015), Kimani, (2015) and Obadha, (2019) all focused their studies on the performance of the securities market following announcement and implementation of capital gains tax. The results of these studies have been mixed, for instance, Karinga (2014) concluded that the announcement of the tax had a positive effect on the performance of stocks at the Nairobi Securities Exchange. On the other hand, Kimani (2015) concluded that capital gains tax contributions to the reduction in investment in securities.

However, the study by Wambui (2015) only addressed aspects of the tax and more so on real estate transactions. This study has been useful in mapping tax administration in Kenya and has been useful in informing this research on the tax administration system of capital gains tax in Kenya.

According to Clemens et al, (2014), capital gains tax significantly impacts on three key areas including: i) reallocation of capital, ii) stock of capital; and iii) the level of entrepreneurship. It impacts through lock-in effects, cost of capital and capital mobility. The lock in effect it should be understood refers to the incentive for owners of capital to retain their current investments even if more profitable and productive opportunities are available. Capital that is locked into suboptimal investments and not reallocated to more profitable opportunities hinders economic output. Consider an investor who wishes to divest an asset and reinvest the proceedings in a new project. The profit received from the sale of the asset is reduced by the capital gains

tax. In order for the investor to reallocate his or her capital, the new investment must provide a rate of return high enough to recoup the funds paid in taxes plus yield a reasonable rate of return.

In addition, capital gains taxes have a significant impact on the stock of capital by increasing the cost of capital to businesses. By triggering market responses such as the lock-in effect, capital gains taxes make the gathering of capital more difficult, and create more obstacles for investment activities. It makes capital investments more expensive and therefore less investment occurs. Less capital has a number of negative consequences including decreasing the productivity of workers and ultimately lowering living standards. However, the extent to which capital gains taxes reduce the stock of capital depends on how sensitive businesses are to the cost of capital (see Amatong, 1968; Gourio and Miao, 2010; and Agersnap and Zidar, 2021).

The effects of capital gains is best exemplified by the case of entrepreneurs who risk their own capital (and that of venture capitalists and other financiers) and time in the hopes of ultimately profiting from an unproven technology, product, or service. The trade-off is that they expect to be compensated if the business matures and generates financial returns. This process is key to a successful economy because it produces new technologies, products, and services, and ultimately leads to job creation and increased wealth. This explains why in some countries securities that have been held for longer periods are exempted from the tax. In Canada, as noted by Clemens et al (2014), capital gains taxes reduce the return that entrepreneurs and investors receive from the sale of a business. This diminishes the reward for entrepreneurial risk-taking and reduces the number of entrepreneurs and the investors that support them. The result is lower levels of economic growth and job creation.

Capital gains taxes also affect an entrepreneur's ability to attract managers from traditional business sectors. Start-up firms cannot typically offer salaries that are competitive with established businesses and therefore often recruit managers using equity stakes. Capital gains taxes reduce the returns that these managers receive, thereby diminishing the likelihood that start-ups will be able to attract the talent that growth requires. This is an area that has attracted lots of studies especially in the west (Bastain and Walderstrom, 2020).

Several authors have come to the conclusion that capital gains tax leads to compliance and enforcement costs and that there is need to consider these costs when conceptualizing a tax system (see Speer, et al; 2014; and Clement, 2014). Given that it is a fairly complex tax – its design need to address its inherent weakness attributed to its very nature that contributes to its avoidance (Amatong, 1968).

In addition, the tax presents a problem of double taxation (Romero, 2017). Double taxation, it is argued arises because companies already pay tax on their profits. Taxing those profits in the hands of investors again, either as capital gains (on that company's stock) or dividends, implies some high marginal tax rates on investment. This is one of the main reasons capital income is taxed at low rates in most countries. A further challenge is that preventing double taxation of capital gains is a little more complicated, but the answer may lie in setting up a quarantined investment pool that companies can move profits into. Profits moved into this pool would not be subject to tax and, once in the pool, the money could only be used for certain legitimate investment activities. This would effectively remove taxation on profits going toward genuine reinvestment, as opposed to fattening bonus checks.

It should be noted that operationalisation of capital gains tax requires that it be applied on both natural and legal persons. As South African Revenue Service (2000) highlights any natural person (individual) or any legal person (including a company, a corporation or a trust) who is a resident in a country is liable to pay capital gains tax on gains made during transactions of items stipulated in the tax laws of a particular country. In the event of a cessation of residence, deemed disposal rules will take effect in order to prevent tax avoidance.

Where a natural or legal person is not a resident in the country, a liability in respect of capital gains tax will arise in respect of; i) immovable property (including mineral rights) or interests in immovable property situated in the country. For example, land held directly or through a 'closely held' entity (closely held being where the entity is controlled by a small number of shareholders or members.); ii) assets of any permanent establishment, fixed base, branch or agency in the country through which a trade, profession or vocation is being carried on. This treatment is considered consistent with international best practice.

South African Revenue Service (2000) further notes that a number of rules will deem a disposal to have occurred and they include the following: i) where a natural person (an individual) or a legal person (an

entity) ceases to be resident in the Country, ii) where ownership of an asset does not change but for all intents and purposes disposal does occur. For example, certain derivative and value shifting transactions; and iii) where the beneficial interest in a trust changes. It has to be appreciated that capital gains tax is a transaction-based tax where realised or deemed realised capital gains or losses are brought to account on an annual basis by way of inclusion in the normal income tax return. No special arrangements are proposed for the payment of CGT in the case of a deemed disposal. As CGT forms part of the income tax regime, a taxpayer has ample time from the date of the deemed disposal to the date of tax return submission and ultimately final assessment to make the necessary payment arrangements.

Research Methodology

A descriptive cross-sectional study design was adopted for the study largely due to limitation of the study period. The approach was useful in providing a snapshot of the outcome and characteristics associated with the phenomenon (Hinton, 2010). Furthermore, the adopted method was useful in collection of relevant information for the study (Mella, 2012; Bryman, 2004; Leedy and Omrod, 2001). This position is further reinforced by Patton's (1990) assertion that given the multiplicity of approaches available to accomplish research, the method-selection process demands due consideration to the nature of questions posed, the type of data required to address the study's objectives, the characteristics of the respective respondents, and the field conditions.

Data was collected using interviews for primary data, while secondary data was obtained through literature review. The interviews were undertaken with different stakeholders and included: i) Individual discussions with key stakeholders as well as key informant interviews. The key informants included tax officials, Estate Agents and Valuers who are engaged in property transactions. Overall about 79 respondents were interviewed comprising of 4 tax officials; 40 valuers and 35 Estate Agents). On the other hand, secondary data was obtained through reviewing existing and available literature.

Results and Discussions

The procedure of effecting capital gains tax in Kenya prior to publication of the procedure in the public notice (through official gazette) requiring that the payment of stamp duty and capital gains tax be initiated through the *iTax* platform (an online integrated system for managing the payment of all taxes) effective 1st October 2016. Full implementation begun on the 30th of January, 2017, when KRA demanded that capital

gains tax must be paid before property is transferred simultaneously with the payment of stamp duty, previously, capital gains tax was payable before the 20th of the month in which the transfer was done. They noted that this is in recognition of the fact that real estate and /or property transactions are the largest sources of capital gains tax in Kenya, with the exemption of listed securities, and therefore an attempt to ensure effective tax collection just as proof of payment of stamp duty must be given to the lands registry before any transfers are done.

Solved challenge: – Clarity on point of sale

Initially it was a challenge to establish the point of sale that is when a sale has occurred and when to make payment of capital gains tax. It was noted that Kenya Revenue Authority requires that the payment of capital gains tax be initiated through the *iTax* platform (an online integrated system for managing the payment of all taxes) and must be paid simultaneously with the payment of stamp duty before the property is transferred. Previously, capital gains tax was payable before the 20th of the month in which the transfer was done.
In addition, the study established the following:

Lack of awareness on Capital Gains Tax: This research established that most potential taxpayers of capital gains tax are not aware of the existence or implementation of the tax upon sale of a property and how it is administered. This therefore shows that a lot more needs to be done to ensure the property sellers and all potential taxpayers are sensitized and made aware of the operationalization of capital gains tax in Kenya.

Lack of documentation required for computing capital gains tax: As noted above, the taxpayer is required to have several documents when computing capital gains tax to be used as proof for: cost of acquisition; incidental costs on acquisition such as estate agency fees; cost of construction of the property; expenditure for enhancement of value and/or preservation of the property such as management fees, schedules of repair and maintenance showing the incurred expenses; cost of defending title or right over property, such as legal fees and property consultants' fees and incidental costs of selling/disposing the property i.e. agency fees. The research revealed that most individuals/taxpayers do not have these documents to be used as proof of funds spent on the above listed items and therefore they experience challenges in fulfilling this requirement.

Lack of consideration of time value of money in computation of capital gain: This research established that time value of money is an important factor that has not been considered by the Kenya Revenue Authority

in the computation of capital gains tax. The value of money at the point of acquisition versus the time of sale may indicate a huge capital gain if the time period in between is long, but it does not necessarily mean that the value of money was low at the time of acquisition as reflected by the monetary figures. The response of the valuers was almost unanimous that time value of money and inflation rates should be considered when establishing the capital gain. It was noted that failure to incorporate the time value of money in the computation of capital gain generally leads to high 'gains' which may be erroneous from an economic point of view and eventually leading to high capital gains tax. This therefore shows the need for the Kenya Revenue Authority to incorporate this factor by engaging valuers in the computation of capital gains.

Computation of 'capital gain' in properties that are partly let and partly owner occupied: The Capital Gains Tax Regulations by Kenya Revenue Authority indicates that the properties exempted from capital gains tax include individual residence occupied by the transferor for at least three years before the transfer. However, there is a challenge where a property is partly owner occupied and partly let. In a scenario whereby a residential house is occupied by the owner on one wing while the other wing is let to monthly tenants. Such a house may have amenity like land that is jointly used by the owner of the property and the tenants for gardening, parking and play area for children. In such a case, computation of capital gains tax is difficult in the event of a sale of such a property since there is one price for the entire property where one wing is exempted while the other is not.

Lack of involvement of valuers in computation of capital gains: Property valuers are the best placed professionals with technical knowledge in computation of property values. They are able to carry out retrospective valuations on when a property was purchased, factor in the existing developments and their associated costs and compare the value with the current selling price to obtain the capital gain. This can be helpful in scenarios whereby the property sellers have no documentation required as proof of expenditure in computing capital gains.

Lack of clarity on capital gains tax payment in case of auction or foreclosure: It is also not clear who is liable for the payment of capital gains tax in the event of auction of properties by debt collectors and financial institutions foreclosing a property.

Technological difficulties by the tax payers: As noted above, Kenya Revenue Authority issued a public notice requiring that the payment of stamp duty and capital gains tax be initiated through the *iTax* platform (an online integrated system for managing the payment of all taxes) effective 1st October 2016.

It emerged that although most taxpayers are computer literate, most of them are not well conversant with the technology involving obtaining such taxation information from the computers. This poses a challenge to them in obtaining the CGT 1 forms from the KRA website and subsequently submitting the final details on *iTax* platform.

Recommendations

From the findings above, the researcher would recommend the following to address the mentioned challenges:

Need for Awareness campaigns by Kenya Revenue Authority: The Kenya Revenue Authority should carry out awareness campaigns on Capital Gains Tax to ensure all professionals in the real estate sector and the taxpayers are aware of its existence and operationalization. This can be done through frequent seminars organized by the relevant professional bodies in conjunction with KRA including the Institution of surveyors of Kenya to sensitize valuers and estate agents, who will in turn sensitize their clients. It can also be done through newspaper advertisements, broadcast media, publications, billboards etc to effectively reach the general public. Awareness on capital gains tax would ensure compliance when property transfer occurs.

Need for valuers and estate agents to advice their clients on appropriate record keeping of property expenses: As noted above, the taxpayer is required to have several documents when computing capital gains tax to be used as proof for: cost of acquisition; incidental costs on acquisition such as estate agency fees; cost of construction of the property; expenditure for enhancement of value and/or preservation of the property such as management fees, schedules of repair and maintenance showing the incurred expenses; cost of defending title or right over property, such as legal fees and property consultants' fees and incidental costs of selling/disposing the property i.e. agency fees. Valuers and estate agents should therefore be encouraged to sensitize their clients on the need for record keeping of expenditures incurred on a property

including management fees, repair and maintenance costs, refurbishment and renovation costs, valuation fees etc.

Involvement of property valuers in the computation of capital gains: KRA should consider involving property valuers since they are the best placed professionals with technical knowledge in computation of property values. They are able to carry out retrospective valuations on when a property was purchased, factor in the existing developments and their associated costs and compare the value with the current selling price to obtain the capital gain. This can be helpful in scenarios whereby the property sellers have no documentation required as proof of expenditure in computing capital gains.

In addition, KRA should always consult registered valuers in carrying out valuation of properties that are partly let and partly owner occupied to apportion the two sections, determine 'capital gain' and tax payable. This is because this apportionment requires technical knowledge in properties, which only valuers have, to compute the capital gain.

Involvement of other property consultants: As noted above, the taxpayer is required to have several documents when computing capital gains tax to be used as proof for: cost of acquisition; incidental costs on acquisition such as estate agency fees; cost of construction of the property; expenditure for enhancement of value and/or preservation of the property such as management fees, schedules of repair and maintenance showing the incurred expenses; cost of defending title or right over property, such as legal fees and property consultants' fees and incidental costs of selling/disposing the property that is agency fees.. In instances whereby such documents are not available, Kenya Revenue Authority should create a mechanism to involve professionals to estimate the incurred costs. For example quantity surveyors to assess the costs of construction of buildings, site works and fencing while surveyors may be contacted to estimate survey costs incurred by the taxpayer in subdivision or amalgamation of plots.

Indexation in computing capital gains: In order to incorporate the time value of money and address the inflation effects on the computation of 'capital gains', Kenya Revenue Authority should consider adopting indexation in the methodology. It should be appreciated that indexation incorporates the Consumer Price Index and is effected whereby the adjusted cost is increased by multiplying it with a factor based on the Consumer Price Index (CPI) or Retail Price Index (RPI).

Illustration: Consider an example of Indexation Table set out below

Table 2 Indexation Table

Year	CPI
1980	150
1990	125
2000	100
2010	10
2014	1.5
2015	1.00

Source: Ernest Young (2015)

Below is an example of the computation of Capital Gains Tax without considering Indexation

Table 3 Computation of Capital Gains Tax without Indexation

Year	Action	Kshs.	Kshs.
2015	Gross revenues from sale		503,000,000
	Incidental Costs:		
1985	Cost of purchase	(2,000,000)	
1985	Stamp Duty	(50,000)	
1985	Estate Agency fees	(100,000)	
1989	Land Improvement Expenses	(100,000)	
2015	Land Advertising Expenses and Agency Fees	(750,000)	(3,000,000)
	Capital Gain		**500,000,000**
	Capital Gains Tax at 5%		25,000,000

Source: Ernest Young (2015)

The capital gain as computed above is Kshs. 500 Million taxable at 5% generating capital gains tax of Kshs. 25Million. This is high since time value of money or inflation has not been factored.

Below is an example of the computation of Capital Gains Tax incorporating indexation.

Table 4 Computation of Capital Gains Tax with Indexation

Year	Action	CPI Index	Kshs.	Kshs.
2015	Gross revenues from sale	1.00		503,000,000
	Incidental Costs:			
1985	Cost of Purchase	150	(300,000,000)	
1985	Stamp Duty	150	(7,500,000)	
1985	Estate Agency Fees	150	(15,000,000)	
1989	Land Advertising Expenses and Agency Fees	150	(15,000,000)	
2015	Land Advertising expenses	1	(750,000)	(338,250,000)
	Capital Gain			**164,750,000**
	Capital Gains Tax at 5%			8,237,000

Source: Ernest Young (2015)

The capital gain as computed above is Kshs. 164,750,000/= taxable at 5% generating capital gains tax of Kshs. 8,237,000/=. This is lower compared to Kshs 25Million tax when indexation had not been factored. As illustrated above, indexation ensures that property sellers do not pay tax on gains brought about by inflation but they only pay tax on actual gains.

Need for clarification by KRA on payment of capital gains tax on properties under foreclosure or auction: Kenya Revenue Authority should clarify on who pays the capital gains tax in the event a property is auctioned or foreclosed by financial institution.

Setting up tax-help centres: Kenya Revenue Authority should set up help desks in various areas for to ease accessibility by the taxpayers. As highlighted in the research, taxpayers are required to effect the payment of capital gains tax through the *iTax* platform which it was established most taxpayers are not conversant with. *Huduma Centres* are spread out across the country and they would be ideal location for KRA agents with knowledge of capital gains tax to offer assistance to taxpayers.

Areas for future research: Given that the tax is new in the Kenyan economy, its complexity and attributes that may affect general investment in the economy we recommend that following areas may require to be

studied in the near future: i) the impact of capital gains in the property transactions; ii) patterns of investments in the economy; and iii) factors influencing investments in different sectors of the economy.

Conclusions

The arguments for capital gains are in general well-grounded as they relate to fairness, equity and justice that are indeed key principles of taxation. Thus despite opposition, the tax is adequately justified. However, its implementation requires more than technical design and competence of the administrators but a need for inclusivity of all stakeholders. This will ensures that acceptance and compliance levels are higher leading to efficiency in its operation.

The re-introduction and implementation of capital gains tax in Kenya since 2015 has faced various challenges. This is despite the fact that the methodology used in computing the 'capital gain' is simplified by form CGT 1. The approach, however, overlooked at a critical aspect, that is, time value of money. It is also not clear how the gains can be apportioned among the let and the owner-occupied segments of a residential property with one sale price. The procedure for effecting the tax is simplified by *iTax,* although most taxpayers are not conversant with it. Generally, researcher can conclude that the administration of capital gains tax in Kenya is well structured, but would need more participation from various stakeholders to address the challenges experienced in its implementation.

In addition, as argued by various scholars capital gains tax is complex and requires well thought strategies to avoid pitfalls of double taxation and tax avoidance. This is an area that remains fairly challenging both in developed and developing economies.

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