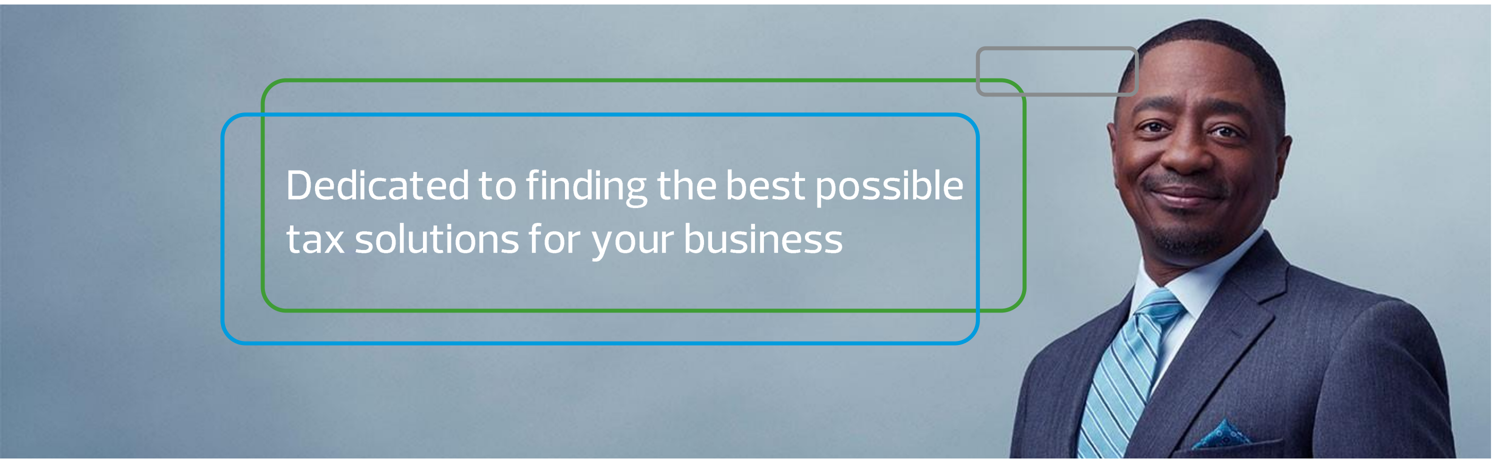

PERMANENT ESTABLISHMENT AND TAX IMPLICATION IN KENYA

Background

Globally, tax authorities have placed significant emphasis on transactions involving Multinational Companies and non-resident entities with the aim of collecting the requisite taxes arising from such transactions in their jurisdictions. In principle, income is taxed either based on the source of that income or the residency status of the person earning that income. Kenya operates a source-based taxation system which implies that any income accrued in or derived in Kenya by a resident or a non-resident person will be taxable in Kenya.

What is a Permanent Establishment (PE) in Kenya?

In general, a Permanent Establishment crystallizes when a non-resident person conducts business activities in another tax jurisdiction over a given period leading to a taxable presence in that territory. From a Kenyan perspective, the definition of a PE has largely been borrowed from the Organization for Economic Co-operation and Development (OECD) guidelines.

Prior to the enactment of the Finance Act 2021, the Income Tax Act of Kenya (ITA) recognized the crystallization of a PE in Kenya based on having a fixed place of business in Kenya for six or more months and having a dependent agent in Kenya. The enhanced definition of a PE as per the Finance Act 2021 now covers the following parameters in the determination of a PE in Kenya:

- A fixed place of business in Kenya through which business is wholly or partly carried out including a place of management, a branch, an office, a factory, a workshop, a place of extraction of natural resources for a period of six months or more;
- A warehouse in relation to a person whose business is providing storage facilities to others, a farm, a plantation or other place where agricultural, forestry plantation or related activities are carried on and a sales outlet for a period of six months or more;
- A building site, a construction, assembly or installation project or any supervisory activity connected to the site or project, where it continues for a period of more than six months. NB: where related enterprises carry out connected activities on the same building site or installation project for an aggregate of thirty days or more each, these will be summed up in determining whether the threshold period of six months has been attained by the first enterprise that started the said activities;
- The provision of services, including consultancy services, by a person through employees or other personnel engaged for that purpose, for a period exceeding the aggregate of ninety-one days in any twelve-month period.
- An installation or structure used in the exploration for natural resources where the exploration continues for a period of ninety-one days or more;
- Presence of a dependent agent who acts on behalf of the non-resident person in respect of that person's activities in Kenya. As per ITA's definition, a dependent agent is an agent who has the authority and mandate to conclude contracts in Kenya on behalf of the non-resident person or plays the principal role leading to the conclusion of contracts without material modification by the non-resident person. However, the following auxiliary activities in relation to a dependent agent do not lead to the crystallization of a PE, viz:

- Use of facilities solely for the purpose of storage, or display of goods or merchandise belonging to the enterprise;
- Maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, or display;
- Maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
- Maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information for the enterprise;
- Maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity.

Tax implications

Where a PE crystallizes, the non-resident person shall have created a taxable presence in Kenya and therefore subject to tax on the proportionate income that will be accrued in or derived from the business activities carried on in Kenya. The tax implications attributable to the PE in Kenya include:

- Corporate Income Tax – the proportionate income derived from Kenya will be subjected to tax at the non-resident rate of 37.5%; In line with Section 18(4),(5) of the ITA, some of the expenses incurred by the PE are not allowable for tax purposes, e,g, remuneration paid to non-whole time service non-resident directors which is in excess of KSh. 150,000 p.a, executive and general administrative expenses (subject to the Commissioner's approval), interest, royalties, management/professional fees paid by the PE to the non-resident person and any foreign exchange gain/loss arising from assets or liabilities established between the PE and the non-resident person;
- Pay As You Earn (PAYE) – the non-resident entity (PE) will be considered to be an employer in line with the definition of an employer as per Section 2 of the ITA and hence the requirement to account for PAYE on the emoluments paid to its employees in Kenya;
- Other employment-related statutory deductions e.g. National Social Security Fund (NSSF), National Hospital Insurance Fund (NHIF) and National Industrial Training Authority Levy (NITA).
- Withholding tax requirements – where the PE makes payments that are subject to withholding tax as per Section 35 of the ITA, the PE will be required to account for the withholding tax due;
- Value Added Tax (VAT) – Upon crystallization of a PE in Kenya, the non-resident person will be viewed to be doing business in Kenya and thus will be subjected to the VAT Act provisions e.g. registration requirement, accounting for VAT on taxable supplies and also reverse VAT (where applicable) among others;
- Transfer pricing considerations - With the creation of a PE in Kenya, this will also lead to a transfer pricing risk. Section 18(3) of the ITA read together with the Income Tax (Transfer Pricing) Rules, 2006 requires a taxpayer in Kenya (including a branch and a permanent establishment of a foreign company) having transactions with its non-resident related parties to prepare and maintain a transfer pricing (TP) policy supporting the arm's length nature of the intercompany transaction(s).

Conclusion

It is imperative that non-resident persons doing or intending to do business-related activities in Kenya evaluate the risk of establishing a PE in Kenya inadvertently. A pro-active approach will therefore be required to mitigate the inherent PE crystallization risks which include incurring tax liabilities, penalties, interests, payroll and other employer reporting obligations that were unforeseen.

Where PE risks are identified well in advance and properly managed, this enables an enterprise to plan on the most efficient tax structure and save on unnecessary non-compliance costs.