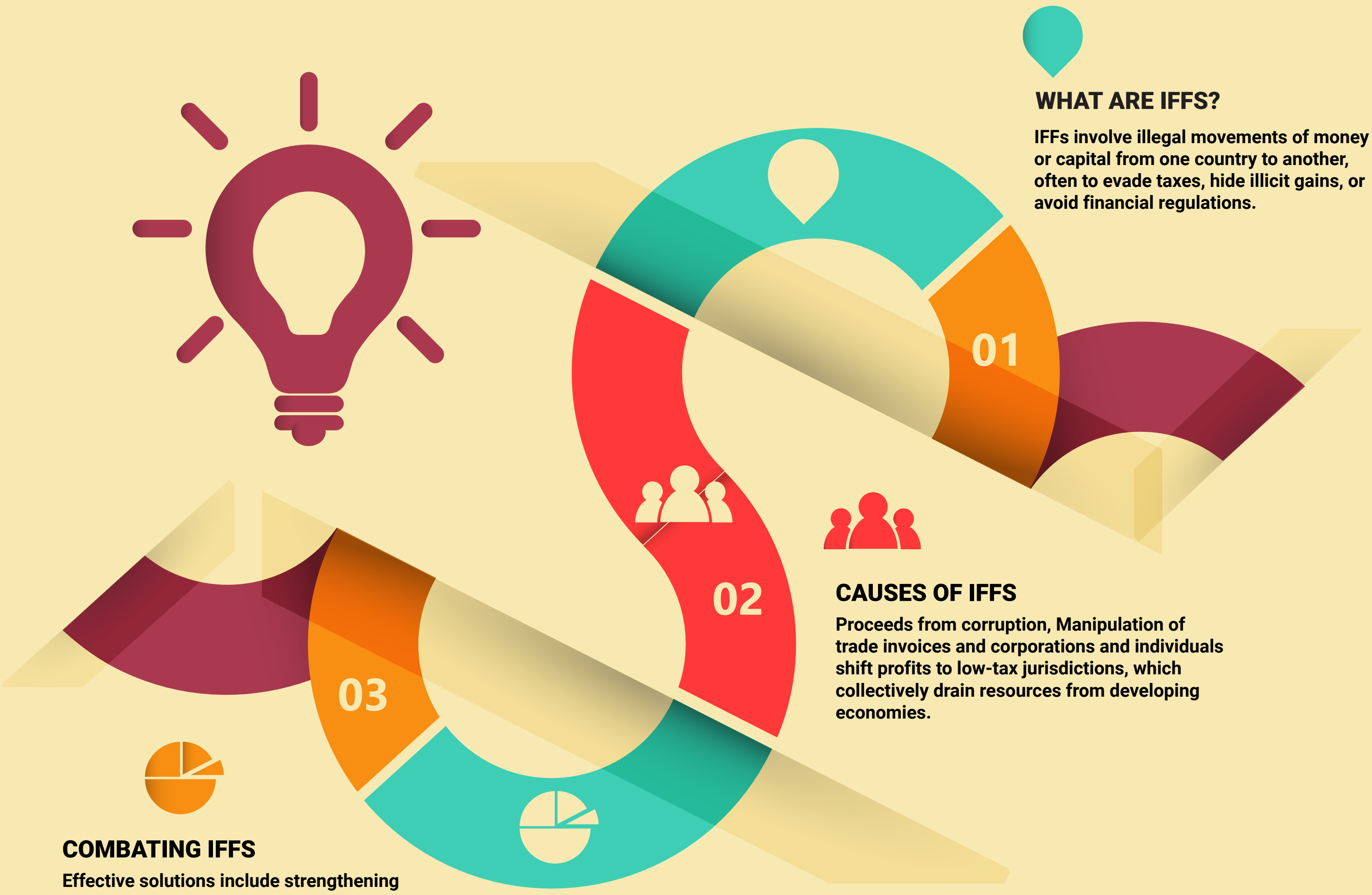
National Taxpayers Association
pesa zetu, haki yetu

BRIEFING NOTE ON ILLICIT FINANCIAL FLOW CONVENING



WHAT ARE IFFS?

IFFs involve illegal movements of money or capital from one country to another, often to evade taxes, hide illicit gains, or avoid financial regulations.

CAUSES OF IFFS

Proceeds from corruption, Manipulation of trade invoices and corporations and individuals shift profits to low-tax jurisdictions, which collectively drain resources from developing economies.

COMBATING IFFS

Effective solutions include strengthening financial transparency, enhancing international cooperation, and implementing robust legal reforms to close loopholes and track illicit activities.

August, 2024

Introduction

The purpose of this review is to understand the level of integration of measures aimed at addressing Illicit Financial Flows(IFFs) that are incorporated into the revenue-raising measures (Finance Bills and Finance Acts) and other substantive legislation that have a direct bearing on IFFs in Kenya.

NTA undertook a desk-based review of the Finance Bill 2024 and Finance Acts from Financial Year 2022 – Financial Year 2024. However, within the period of review, the Finance Act, 2023 was repealed and the Finance Bill, 2024 was deleted. The review interrogated the extent to which they proposed to give effect to best practice at a regional, international and national level that seek to address the risk to Domestic Resource Mobilization (DRM), by practices that perpetuate IFFs. Expert interviews were undertaken, eliciting responses from academia, legal practitioners, financial advisors, revenue administrators and the Civil Society Organizations (CSOs).

The findings establish that the proposals in the Bills of Financial Year 2022 to Financial Year 2024, by a large extent, are a positive step towards domesticating best practices in addressing IFFs. For instance, what can be perceived as a novel front for taxation was the provision for taxing gains from digital assets. Practitioners and CSOs should explore how these proposals will be buttressed and incorporated in the next cycle of revenue raising measures.

The briefing note did not interview actual taxpayers but focused on academia, legal practitioners, financial advisors and revenue administrators. Their perspective was important and will be incorporated in the subsequent reviews.This briefing importance comes in the wake of contestation in Kenya, where the citizens and the corporates have raised concerns about the level of taxation and the different types of taxes that are deemed as not pro poor. On the other hand, the government of Kenya is grappling with high debt that crowds the fiscal space for the realization of the Sustainable Development Goals (SDGs) and the provision of essential services. Therefore, it is significant as it provides an alternative path to raise revenue that does not focus on taxation of essential goods and services, and does not add a layer of taxes on taxpayers and sectors that already have multiple taxes.

Panel Discussion Feedback

Convening to Discuss Policy Gains and Misses on Curbing Illicit Finacial Flows in Kenya.

Nixon Omondi

Digital Economy Tax Office Lead. Kenya Revenue Authority (KRA)

- **Combating Illicit Financial Flows and Revenue Collection**

The Finance Act 2023 and Finance Bill 2024 in Kenya introduce measures to tackle illicit financial flows (IFFs) and enhance revenue collection. Key proposals included:

1. Enhanced Reporting: Stricter financial reporting and disclosure requirements to improve transparency and profit shifting initiative;
2. Increased Penalties: Higher fines for non-compliance and fraudulent activities;
3. Anti-Money Laundering: Strengthened customer due diligence and abuse of incentives;
4. Tax Information Exchange: Expanded agreements for sharing tax information with other countries i.e. Country to country approach; and
5. Taxation on digital markets: Better monitoring and taxation of e-commerce and digital transactions.

The measures aimed at closing loopholes, increase transparency, and reduce opportunities for hiding illicit funds.

- **Impact of IFFs on Tax Base and Budget Planning**

Illicit financial flows (IFFs) erode the national tax base, making it difficult to generate sufficient revenue for budget planning. The Finance Bill 2024 introduced two key measures:

Minimum Top-Up Tax: This tax ensures that multinational corporations pay a minimum level of 15% tax, even if they shift profits to low-tax jurisdictions; and

Significant Presence Tax: This tax targets companies with significant economic activities in a country, even if they do not have a physical presence there.

These measures primarily aim to expand the tax base and enhance domestic revenue mobilization (DRM). While they help address tax avoidance linked to IFFs, their primary focus appears to be broadening the tax base rather than specifically targeting IFFs from commercial transactions.

“ *The Finance Bill 2024 aims to close loopholes and enhance transparency to combat illicit financial flows.*

Nixon Omondi

Robert Maina

Member - *The Institute of Certified Public Accountants of Kenya(ICPAK), Public Finance and Tax Committee*

- **Strengthening Anti-Money Laundering (AML) Measures and Pro-Poor Policies:**

Trusts, including family trusts, can be used as vehicles for tax avoidance, particularly when they are structured to shield income or assets from taxation. The Finance Bill 2024's proposal to delete the exemption of income for registered family trusts likely aimed to close loopholes that allowed high-net-worth individuals to avoid paying taxes by shifting wealth into trusts.

This proposal aligns with broader efforts to strengthen anti-money laundering (AML) measures and ensure that wealthier individuals contribute fairly to the tax base. By removing such exemptions, the government likely intended to prevent the misuse of trusts for tax avoidance, promoting greater tax equity and enhancing revenue collection for pro-poor policies.

- **The Bill proposed a 5% WHIT on new bonds**

The proposed 5% withholding tax on new bonds in the Finance Bill 2024 aims to enhance domestic revenue mobilization (DRM) by taxing interest income, including that earned by non-residents. While it might reduce the attractiveness of Kenyan bonds for some investors, particularly those seeking arbitrage opportunities or to "clean" money, it strengthens DRM by ensuring interest income is taxed, potentially discouraging tax avoidance.

- **International Collaboration and Information Sharing:**

Illicit financial flows (IFFs) drain resources that could be allocated to social spending and pro-poor programs. The government's proposed changes in the Special Economic Zones (SEZ), particularly the introduction of Capital Gains Tax (CGT) on property transfers within SEZs, aim to curb IFFs by ensuring these transactions are taxed.

However, the effectiveness of this measure in addressing IFFs may be limited if the government continues to create new agreements that override existing regulations. Such agreements can create loopholes or preferential treatments that undermine efforts to tax property transfers and combat IFFs effectively. To truly address IFFs and protect resources for social spending, consistent and transparent enforcement of tax policies across all agreements is crucial.

"Proposed measures ensure wealthier individuals contribute fairly, promoting greater tax equity.

Robert Maina

Catherine Ngina Mutava
Associate Director of the Strathmore Tax Research Centre

- **International best practice on tax breaks and preferential treatment of Special Economic Zones (SEZs) and Economic Processing Zones(EPZs); the tax expenditure dilemma;**

Preferential Treatment in SEZs/EPZs: Tax breaks in SEZs and EPZs are seen internationally as "tax expenditures," often linked to IFFs like profit shifting. Kenya excludes these from its tax expenditures report, likely viewing them as necessary for economic growth rather than lost revenue. This should be addressed since it facilitates IFFs as well as a big loss to the efforts being made to increase DRM.

- **The Medium Term Revenue Strategy(MTRS) states that the V.A.T tax head is a key driver of tax expenditures and aims to reduce this in the next 3 years**

The MTRS aims to reduce VAT tax expenditures, focusing on essential goods to keep them affordable for consumers. For multinational corporations(MNCs) and corporations, the approach involves reducing tax incentives and closing loopholes to improve revenue and compliance. This strategy balances protecting vulnerable populations while addressing tax avoidance among larger entities.

Taxation is predominantly a National level function, with limited taxes and levies domiciled at County level

Counties can advocate for addressing IFFs by collaborating with national agencies and participating in intergovernmental discussions. They can highlight the impact of IFFs on local resources and push for reforms without needing direct legal changes, focusing on policy influence and revenue sharing improvements.

"Reducing tax incentives and closing loopholes is crucial for increasing revenue and compliance.

Ngina Mutava

Dennis Moroga

Lecturer Moi University, Partner Moroga Wangwi Advocates

- **The misses and hits in the Finance Act 2022, the Finance Act 2023 with regard to combating IFFs**

Section 6A of the Finance Act 2023 introduced significant changes to address illicit financial flows (IFFs): Beneficial Ownership Disclosure: Section 6A requires companies to disclose their beneficial owners. This aims to increase transparency by ensuring that the individuals who ultimately own or control companies are identifiable. This provision helps prevent the misuse of corporate structures for money laundering, tax evasion, and other illicit activities.

Enhanced Reporting: It also tightens reporting requirements for entities involved in financial transactions, ensuring that suspicious activities are reported to authorities. These measures are designed to combat IFFs by making it harder for illicit actors to hide behind complex corporate structures and ensuring more transparency in financial dealings.

- **The Kenya's context includes Advocates as reporting agents**

Advocates as reporting agents aim to improve transparency and combat IFFs by involving more professionals in monitoring financial transactions. However, concerns include potential conflicts with lawyer-client confidentiality and the practical burden on advocates. The provision's success depends on balancing these concerns with effective reporting requirements.

- **Factors Contributing to Backlash Against New Taxes**

1. Public opposition to newly introduced taxes often stems from several interconnected issues. One key factor is the method of implementation. Finance Bills, which frequently introduce tax changes, can generate significant backlash if stakeholders perceive the process as rushed or lacking adequate consultation. This abrupt nature of policy changes erodes public trust and fosters resentment.
2. Furthermore, a lack of public understanding about emerging business models and their corresponding tax implications exacerbates the issue. When taxpayers are unclear about how new economic activities should be taxed, confusion and resistance are likely to arise. This knowledge gap often leads to accusations of unfairness and inequality.
3. Finally, political considerations and lobbying efforts by affected industries can significantly influence the fate of proposed tax measures. To appease powerful interest groups or maintain political support, governments may be compelled to withdraw or modify tax policies, even when they are economically sound. This perception of tax changes being driven by political expediency rather than public interest further fuels public discontent.

In essence, the combination of sudden tax changes, inadequate public understanding, and political maneuvering can drive opposition and legal challenges.

"*Enhanced reporting and transparency are key to preventing misuse of corporate structures for illicit activities.*

Dennis Moroga

Recommendations

- Enhanced data sharing to improve detection and tracking of illicit financial flows, foster international collaboration, optimize resource allocation, and strengthen legal frameworks, boosting overall effectiveness in combating financial crimes. For instance, the KRA will be able to track all transactions for suspected individuals;
- Tax expenditures can reduce the tax base, create loopholes for illicit activities, and complicate enforcement, potentially hindering revenue mobilization and efforts to combat illicit financial flows effectively;
- Proper integration and visibility of transactions enhance Kenya's ability to detect and address illicit financial flows, improve tax compliance, and streamline enforcement, thereby boosting revenue mobilization and financial system integrity; and
- The double tax argument can aid revenue mobilization by highlighting gaps in tax agreements that illicit financial flows exploit. Addressing these gaps can enhance transparency and enforcement, thus reducing tax evasion and increasing revenue for Kenya.






Convening to Discuss Policy Gains and Misses on Curbing Illicit Finacial Flows in Kenya.

Conclusion

In conclusion, it was established that the increased state of corruption and inaction on governance, has made any conversation on taxation unpalatable. This means that gains made on matters of addressing IFFs that are fueled by commercial transactions, have been negatively affected. Further, mis-information and disinformation in the media, requires a guided and balanced discussion on the revenue proposals. Finally, the lack of sufficient information by the legislators on the revenue proposals and how these have been informed by discussions at the EAC level, at the regional and international level, resulted in losses in regard to IFFs fueled by commercial transactions.

NTA proposes that a deeper study is undertaken that looks at the proposals in the Finance Bill and Finance Acts of Financial year 2020 – Financial Year 2024. Some of these legislation have been deleted or rejected but from the review, we established that some are critical in addressing IFFs and will increase DRM. Additionally, NTA proposes to undertake select scoping of substantive laws such as the special economic zone Act and use the scoping studies to inform advocacy for their amendments, aimed at alignment with best practice on IFFs. Further, NTA proposes that anti-corruption work and action is strengthened, so as to ensure that the current situation of low tax morale informed by the reality of corruption, does not negatively affect Kenya's DRM strategies. The National Tax Policy provides that taxes can only be reviewed after 3 years, NTA proposes that in the intervening period, research on the revenue laws, education of media and politicians and strategies aimed at addressing corruption are instituted in readiness of the next cycle of revenue raising discussions.

Annex 1

Serial	Amended Act	Amendment	Explanation	Effect on IFFs
1	Definition of "digital content monetization	Offering for payment entertainment, social, literal, artistic, educational or any other material electronically through various medium or channels as listed in the Act	This amendment introduced taxation of digital content monetization and to be subjected to WHT at the rate of 5% for residents and 2o% for non-residents without a permanent establishment in Kenya.	Withholding tax being levied on content monetization ensures that content creators, which is a way of life for most people on social media (Influencers), pay their taxes in source countries and reduces chances of moving the money to countries where rates are very low.
	introduced a definition of "related person"	That in the case of two persons where a person who participates directly or indirectly in the management, control or capital of the business of another person	The amendment clarified that related persons include participation directly or indirectly in another business.	This ensures that businesses hiding under the old definition that was only limited to direct control and in specific sections are now covered. This enhances transparency in declarations.
	Restriction of Forex losses where a company is thinly capitalized	The law amended section 4A to introduce the limitation of forex losses using the same formula for section 16(2)(j) which is 30% of EBITDA	This means that where there are forex losses occasioned by a foreign loan borrowed, the losses are limited to 30% of EBITDA based on interest on foreign loans and they are deferred for 5 years.	Interest and forex are mechanisms of perpetuating tax avoidance by claiming excessive expenses, which do not have economic basis. By restricting the forex losses, the IFF mechanism is curbed as it includes repatriation of income to Low Tax Jurisdictions.
	Taxation of Repatriated income	Non-resident companies having a PE in Kenya is now required to pay income tax at a reduced rate of 30% from the current 37.5%. This The amendment was to treat residents and non-residents fairly and To boost foreign direct investment.	While residents pay WHIT when they declare dividends, the PEs will be required to pay WHT on repatriated profits by the PE of the non-resident person to be determined on the basis of a formula provided below;. Repatriated Profit= Net Assets (beginning)+ Net Profit for the year -Tax Payable- Net Assets (end) The WHIT is at 15% "net assets" shall not include revaluation of assets.	Profit shifting to Investment hubs and low tax jurisdictions has been the greatest enabler of commercial IFF. This provision will ensure that any shifted profits to low tax countries is taxed in Kenya in the hands of the PE.

Serial	Amended Act	Amendment	Explanation	Effect on IFFs
	Non refund of WHIT paid when an audit adjustment is done to the payment subject to WHIT	The amendment is to the effect that any WHIT paid on a deduction disallowed during an audit in cross border trade is not allowable.	This has the effect of avoiding double claims and increased tax avoidance.	The measure is against tax avoidance and repatriating taxes abroad especially where there is no tax or low tax jurisdictions.
	Taxation of Digital Assets	The law introduced taxation of exchange of crypto assets	The exchange is required to Withhold the amount so exchanged at 3% and remit to the commissioner.	Kenya is in the top 5 in Africa in trading of Cryptos. Cryptos have also been found to enhance IFF through money laundering and criminal activities. By having this tax, visibility is enhanced of such activities and taxes is collected.
	Use of eTims- Electronic invoicing mechanism	Introduction of non-allowance of any expenditure borne but not supported through the eTims system.	This amendment is to ensure that save for transactions that are exempt, all other have to be passed and authenticated through eTIMS invoice.	Phantom and fictitious invoices are eliminated in this requirement. Tax avoidance is therefore reduced.
	Amending Section 16(2)(j)	The law added exemptions to those subject to thin cap/ interest restriction.	The Act, removed interest restriction on local loans, allowed interest expenses on foreign loans in excess of 30% of EBITDA to be claimed within 3 years as opposed to the earlier complete disallowance and also removed the exemption for Manufacturing companies with cumulative investment of at least KShs five billion	This effectively introduced wasteful incentives by still allowing the expenditure to be claimed within 3 years and exempting local loans, which are also subject to IFF when related parties loan one another. The move to delete manufacturing from exemption is to remove wasteful incentives.
	Taxation of income in preferential regimes	The law introduced what proportion of income can enjoy preferential rate of tax in EPZ/SEZ in line with BEPS Action 5.	The law will proportionately limit IP income subject to lower rate of tax based on the formula of research and development expenditures made by the taxpayer and IP income.	The amendment seeks to limit the amount of income of a Multinational Enterprise that can be taxed at a preferential tax rate to that portion of income that is related to actual Research & Development costs contributed. This will Address effects of base erosion and profit shifting.
	Clarification of Country-by-Country Reporting and introduction of new definitions to CBCR.	1. Clarifying who is to file CBCR	CBCR Reports to be filed annually by Kenya and be visible to other countries and Kenya to get CBCR reports from other jurisdictions.	CBCR is key in enhancing tax transparency across jurisdictions in line with BEPS Action 13.

Serial	Amended Act	Amendment	Explanation	Effect on IFFs
	Taxation of Members' Clubs and trade associations	The removal of election and exemption non-business receipts of Members Clubs and Associations.	Members clubs carry on commercial activities including real Estate, consultancy, restaurants etc. like other persons. While the income of members clubs is income derived from carrying on business, this was previously only taxable where less than three-quarters of the gross income, (excluding gross investment receipts), is Received from the members of the club.	This measure ensures fair treatment of various business formations and reduces instances of non-taxed income being repatriated to low tax jurisdictions.

Serial	Amended Act	Amendment	Explanation	Effect on IFFs
	Exemptions List	The Act added a list of exempted income from tax; 1. Royalties paid to a non-resident person by a company undertaking vaccine manufacture 2. Income earned by a non-resident contractor, subcontractor, consultant or employee involved in the implementation of a project financed through 100% grant under an agreement with GOK and the development partner as spelt out in the agreement. 3. Gains on transfer of property within a special economic zone enterprise, developer or operator 4. Royalties, interest, management fees, professional fees, training, consultancy, agency, contractual paid by a SEZ person in the first 10 years of establishment to anno-resident.	This adds to the list of exemptions and incentives given to various organizations	Exemptions more so to SEZ exacerbates IFFs due to wasteful tax expenditure. SEZ has mobile income that would perpetuate treaty shopping and tax avoidance.
	Clarification for accelerated investment allowance	The law clarified that accelerated allowance 100% and 150% only available for buildings and machinery and hotel buildings.	This has an effect giving an allowance to entities that are involved in manufacturing and capital investment at rates of 100 and 150% provided its accumulated to 2B in 3 years.	Such incentives have been abused to ensure that entities do not pay any tax for a long period coupled with other anti avoidance mechanisms. Profit shifting therefore is encouraged with more that the cost of capital investment allowance.

Serial	Amended Act	Amendment	Explanation	Effect on IFFs
	Offshore indirect transfer of property	The law was amended to introduce CGT on offshore transfer of property where at least 20% of the transfer value is derived from Kenya.	Key in curbing indirect transfer abroad of property held in Kenya. This aligns to Article 13 of the OECD and UN Model tax Convention as an anti-abuse provision.	This is key in reducing issues around IFFs as many MNEs tend to transfer offshore entities in countries without CGT while the transferred value is derived from countries with CGT.
	Harmonizing VAT on petroleum products with others	The law was amended to increase the VAT rate on petroleum products form 8% to 16%	This is to reduce refund/ credit instances since all input of the petroleum traders incur 16% input tax.	Key in ensuring fair and equal treatment and reducing abusive refund regimes.
	Timeline for payment of excise duty and WHT on winnings	This has been moved from 20th to within 24 hours	This timeline was to enable integration and real time payment of the taxes by the betting sector.	Integration has achieved much in enhanced collections and non-residents own reduced tax avoidance given most of the betting companies.
	International Tax agreements	TPA introduces a provision for multilateral mutual agreements on collection of taxes	This is key in Kenya assisting other tax authorities and vice versa in collection of taxes on cross border trade	Articles 27, MAAC and such instruments are effected through this amendment to enable Kenya collect tax claims or recover taxes where a non-resident has not paid the requisite taxes in Kenya. This is a key initiative to reduce IFF.

Links to Closing Remarks from the Panelists, and Moderators.

- https://youtu.be/3Clo4XH90Zo?feature=shared
- https://youtu.be/OpofAdk1FLY?feature=shared
- https://youtu.be/MJCeoWgGt4c?feature=shared
- https://youtu.be/proLRqoCn-Y?feature=shared
- https://youtu.be/mpeazLlyk1g?feature=shared
- https://youtu.be/Z9wsBqLi1Ik?feature=shared

Photos link:

- https://photos.app.goo.gl/S3NcAJYh9EHdhrYN7