The Taxation of the Extractive Industries (Mining, oil and gas)

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Masters class Workshop

KSMS

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Presentation Outline.

- ✓ Overview of Industry Activities in Kenya,
- ✓ Production Sharing Contracts(PSC)/Mining Leases,
- ✓ Legal Framework,
- ✓ Key notes from the 9th Schedule to the Income Tax Act,Cap.470
- ✓ Anti-Avoidance Provisions,
- ✓ Compliance Risk Management Process,
- ✓ Emerging Issues in the Extractive Industries.

Overview of Industry Activities in Kenya

Oil and gas subsector

- Oil was discovered in 2012 in the Northern part of the country,Turkana County.
- Gas exploration activities are also taking place at the Lamu basin,
- Potential areas are in the Rift Valley basin and offshore in the Kenyan Indian Ocean Territory..
- Plans to move from the exploration phase to the development phase in the oil sector, this includes the EOPS (Early Oil Pilot Scheme) , design of the crude Pipeline from Northern Kenya to Lamu,etc.

Mining subsector

- Largest activity in Kenya is the mining of Rutile,Zicron & Ilmenite(Titanium) along the coast , mining of Soda Ash in Lake Magadi, Cement production , Gold mining in the Rift Valley , precious and semi precious stones in Taita, Carbon Dioxide in the Rift Valley .

Production sharing contracts(PSC)/Mining Leases

- There mainly 4 different types of contracts in the oil & gas industry:-
  - Prod. Sharing contracts,
  - Shared profits contracts,
  - Licensed contracts,
  - Services contracts.
- Kenya has adopted the Production Sharing Contract(PSC) model , with a pay on behalf component in the contract .
- The contract is signed between the MPM and contractor .
- The contractor must avail to MPM the work programme and budgets for evaluation.
- The PSC stipulates that the contractor must pay taxes.
- The PSC has stabilisation clauses .
- The PSC layout out the treatment payment of windfall profits, cost recovery ,share of profit oil ,social license, ring fencing, decommissioning cost.
- A Mining Lease bestows mining rights and is granted for the exploitation of a mineral deposit which has been discovered following successful prospecting and exploration .
- Adherence to the tax laws, ring-fencing, rehabilitation expenditure, payment of royalties is done using the export value .

Taxation of Extractive Industries

Background

- The 2014 Finance Act published in Kenya's Official Gazette on 19 September 2014 repealed the 1984 Ninth Schedule, titled *Taxation of Petroleum Companies* replacing it with a new Ninth Schedule titled *Taxation of Extractive Industries*.
- The scope of the new schedule has been expanded and now covers not only the taxation of petroleum companies, but also companies in the mining sphere.
- The provisions took effect from 1st January 2015.
- The move was motivated by the Government's objective of streamlining the taxation regime of the extractive industry which covers Oil & Gas, Mining Companies and their service providers.

Legal framework

Persons Assessable -....Section 3(2)(a)(i) & 4(f).

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

i. **Licensee** – a person who has been issued with, or granted mining rights(including prospecting and extraction),

ii. **Contractor** – a person with whom the Government has concluded a petroleum agreement (including exploration and development, production and transportation of petroleum and natural gas up to point of export or into a refinery but excludes refining) and includes any successor or assignee of the person,

iii. **Subcontractor** – a person supplying services other than a person supplying services as an employee to:-

a. A licensee in respect of mining operations undertaken by the licensee, or

b. A contractor in respect of petroleum operations undertaken by the contractor.

Geothermal operations to be taxed similarly to mining operations excluding immovable property (royalties etc.).

Legal framework

- Ring fencing provisions which will limit the ability to utilize losses from on license/contract area against others.
- Rules for determination of consideration in farm out/share sale transactions - WHT regimes abolished.
- Allowance of funds set aside for rehabilitation & decommissioning expenditure.
- Income or losses from hedging transactions treated as a separate source.
- Interest payments are restricted in proportion to the extent that the highest amount of loans held by the company at any time during the year of income exceed two times the sum of the revenue reserves and the issued and paid up capital of that company.(Thin Capitalization).
- First Schedule para. 29 of VAT 2013 *exempts taxable supplies* (goods and services), excluding motor vehicles, imported or purchased for direct and exclusive use in oil exploration, by a company granted specified licenses, upon recommendation by the Cabinet Secretary responsible for the Ministry concerned.

Key notes from the 9 th Schedule -ITA

- Withholding Tax(WHT)Rates applicable for other payments made by contractors to non residents are as follows : -
  - 10% of gross dividends payable
  - 15% of gross interest payable
  - 20% of the gross amount of the royalty payable or natural resource income
  - 12.5% of the gross amount of the management or professional fee payable.
- Rates are subject to the provisions of the double taxation agreements,
- Hedging transactions entered into by a contractor will be considered as a separate/specified source of income.
- Disposal of interest is defined to include change in ownership through a sale, transfer assignment or exchange.
- The applicable Corporate rate of tax as per the Ninth Schedule – **30% for residents** and **37.5% for non residents with a PE.**
- Payments to non resident subcontractors for services will be liable to WHT at the rate of **20% on gross for licensees and 5.625% for contractors**, which is a final tax.
- Non resident subcontractors with PE's will be taxable at the non resident corporate tax rate - **37.5%.** They will be required to file returns of income and provide accounts.
- Resident subcontractors will be taxable at the resident corporate rate – **30%**

Anti-Avoidance Provisions

❖A licensee or a contractor shall immediately notify the Commissioner, in writing;-

✓ if there is a 10% or more change in the underlying ownership.

✓ Underlying ownership - an interest in the person held directly or indirectly through an interposed person or persons, by an individual or by a person not ultimately owned by the individual.

❖ The licensee or the contractor is liable, as an agent of the non-resident person, for any tax payable under this Act by the non-resident in respect of the disposal.

Compliance risk management process

- KRA has a compliance risk management policy and an Audit/Compliance manual/governance framework,
- For the Oil and Gas sub-sector, these are some of the risks that we monitor;-

✓ Related party transactions(transfer pricing);

✓ Undervaluation of commodity export sales;

✓ Overvaluation of marketing costs, commissions;

✓ Overvaluation of insurance costs ;

✓ Payments for intellectual property;

✓ Capital costs;

✓ Overstated operating costs;

✓ Mispricing of services;

Compliance risk management process

- ✓ Forward sales/price hedging;
- ✓ Non reporting of by-products ;
- ✓ Direct and indirect transfers of interest ;
- ✓ Abuse of thin capitalization, capitalization of interest and abusive interest rates;
- ✓ Existence of related parties in low tax jurisdictions ;
- ✓ Misclassification of assets for capital allowances;
- ✓ Abuse of exemptions system;
- ✓ Stabilization clauses;
- ✓ Rehabilitation/decommissioning costs.

Emerging issues in the extractives industry

- ASM(Artisinal Small Scale Mining) impact in the extractive industry.
- Valuation of minerals to determine the correctness and use of proper benchmarking such as the London Metal Exchange(LMX) Valuations.
- Transportation by Pipeline for crude oil and gas.
- Knowledge transfer to improve skills across board in the industry supported by the government and donor agencies.
- Value addition of the products produced in the extractives.
- Use and selling of By-products in the extractives industries.
- Lack of sufficient Data in the industry.

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