

THE INTERNATIONAL JOURNAL OF BUSINESS & MANAGEMENT

The Capital Gains Tax- Boon or Bane: A Case of Kenya

George M. Nduruchi

Student, Department of Economics, Accounting and Finance,
Jomo Kenyatta University of Agriculture and Technology, Kenya

K'Odongo K. Kaire

Student, Department of Economics, Accounting and Finance,
Jomo Kenyatta University of Agriculture and Technology, Kenya

Abstract:

This paper assesses the viability of the capital gains taxation in Kenya. Taxation being the only predictable source of government revenue to finance public spending and manage economy regarding economic development. The optimal tax model informs the government of the way to maximize the tax revenue enforcement and collection and promotion of the economic wellbeing. A tax introduced in the system should maximize revenue earning for the government as well as spur economic growth. The re-introduction of the capital gains tax in January 2015 on the capital assets and basing on the gains realized thereafter on the disposal of assets has proved to be productive and persuasive to economic growth. The robust real estate sector and high performing stock market through the Nairobi securities exchange (NSE) has widened the tax net and increased tax revenue collection for the government. It remains an ideal that maximizes revenue as well as promoting economic grow. Moreover, on regional integration perspective, the re-introduction of Capital Gains tax is seen as a step towards bridging the differences in fiscal and tax policies between the East African States by aligning Kenya to its neighboring countries that impose tax on capital gains. With ever increasing merits the capital gains tax should be enforced in our economy.

Keywords: Assets, capital gains, ownership, tax avoidance, tax evasion, transfer, tax base

1. Introduction of Capital Gains Tax

Taxation being the predictable government revenue source for financing public spending and manage their economy regarding economic development in most countries across the world. (Gitonga and Memba, 2018; Widiyanto, 2015). As such, the 2002 Monterrey Consensus documented taxation's central role in resource mobilization, an acknowledgment made at the 2008 United Nations conference on development financing convened at Doha (Akinboade, 2015). Taxation being one of the significant elements in administration of state income, especially in developing countries and has played an vital role in enlightened societies from the time when they were born thousands years ago. Tax, which a compulsory financial charge, enforced by government or other bodies mandated in law to raise revenue, on earnings, expenses, or property, for which the taxpayer receives nothing in particular as return (Barako G. G., 2015). One such obligation being the Capital Gains Tax imposed on the profit realized on the disposal of assets.

The local Revenue Authority (KRA) views the profit realized on the exchange of property as the surplus realized from the transfer price over the adjusted cost of assets that was transferred. The surplus is subjected to a 5% charge. The exchange value of the assets is the value of consideration or compensation for transfer, abandonment or loss of the assets fewer accompanying costs on such legal. The adjusted cost is the sum of the cost of possession or erection of the assets, expenses for improvement and preservation of the assets; cost of defending title or right over assets, if any; and the incidental costs of acquiring the assets. A 'Capital Gain' can be ordinarily defined as the difference between the purchase price and the selling price of certain assets. Consequently, 'Capital Gains Tax' (CGT) is the income tax due on the gain/profit made on the sale (disposal) of a capital asset.

Capital Gains Tax was introduced in Kenya in 1975 and suspended on 13 June 1985, when Kenya was in quest to jump start economic development in the mining sector, property market and deepening local involvement in capital markets. These goals come into view to have been achieved with the Nairobi Securities Exchange (NSE) time and again being favourably ranked among the best performing bourses in Africa and the healthy growth and returns witnessed in the real estate sector which had been cited as an important pillar of economic growth particularly over the last decade. The Capital Gains Tax was brought back through the Finance Act 2014, to take effect of enforcement on 1st January, 2015. Capital Gains Tax was to be declared and paid by transferor of the property. Capital Gains Tax is compulsory on whole of profit accruing to a person on exchange of assets found in Kenya whether acquired on or before January 2015.

1.1. Optimal Design of Tax System

Optimal tax theory or the theory of optimal taxation involves the study of the design and how to implement taxes that take advantage of public benefit role against financial constraints. The public benefit role applied is usually a function of individuals' advantages, usually considered as a form of beneficial practice, so the tax system is chosen to capitalize on the accumulation of personal benefits. Tax income is requisite for funding of public commodities as well as bridging wealth inequality. However, most taxation obligations alter personal response, since the base of taxation becomes comparatively less attractive; a case in point, taxes imposed on employment income decreases the motivation to work. The optimization dilemma involves reduction of the distortions brought about by taxation, and at the same time as achieving preferred levels of redistribution and income. Lump-sum taxes are less distorting that is where individuals cannot change their behaviour to reduce their tax burden; and Pigouvian taxes, where the market consumption of a good is wasteful despite tax obligation bringing spending closer to the efficient level.

2. Applicability of Capital Gains Tax

Taxation base is the basis on which a tax is charged. Taxation base include; earnings from interest, dividends, employment, royalties, or self-employment, whether it's in the form of services, money, or property. Capital gains is the base for charging capital gains tax. It basically refers to the profit you make from selling capital assets. Capital assets include just about any property, such as land, computers or vehicles.

Capital Gains tax is levied on the exchange of assets located in Kenya acquired on or before 1st January 2015. It is declared and paid by transferor of property. The rate of tax is 5% of the net gain. It is a final tax. Capital Gains are not subject to further taxation. Net Gain is Sales Proceeds minus the Acquisition and Incidental cost including the stamp duty. Capital Gains tax is on gains emanating from sale of assets. Assets include land, buildings and shares.

The following basics may be applied to necessitate a charge of income-tax capital gains:

- Nature of the asset and its use;
- Length of time the asset is held and frequency of similar transactions;
- Work expended to bring property into marketable condition;
- Reasons for the sale; and
- The intention of acquiring property
- There must be a capital asset.
- The capital asset must have been transferred.
- The exchange should be affected in the preceding year.
- There must be a gain arising on such exchange of property

Consequently, the following constitute the Exemptions and Exclusions to capital gains tax enforcements:

- Income that's taxed elsewhere like property dealers;
- Issuance by a company of its own shares and or debentures;
- Transfer of machinery including motor vehicles;
- Vesting of property to a liquidator or receiver;
- Individual residence occupied at least three years immediately prior to the transfer;
- Sale of land by individual where the proceeds is less than Ksh. 3 Million
- Agricultural land that is less than 100 acres and situated outside the municipality or urban area;
- Exchange of property during reorganization/restructuring by companies approved by Treasury to be in public interest;
- Transfer of securities by a body expressly exempted under the Income Tax Act.
- Transfer of securities by retirement benefits scheme registered with Commissioner
- Transfer of securities traded at Nairobi Securities Exchange.
- Transfer of property for securing a debt/loan
- The exchange of property involving husband and wife or former spouses or relatives as a component of claims settlement;
- Property transferred or disposed off with an intention of managing the deceased person's property, two years after his/her demise or court ruling.

The capital gains tax is enforced by other countries in the region. In the east Africa; Uganda and Tanzania charge 30% and 20% respectively on the profits realized on the transfer of properties. This makes Kenya's the least taxed.

2.1. Pros of Capital Gains Tax

2.1.1. Potentially Lower Rates

The tax is charged at very low rate compared to the ordinary income tax rate. In 2015 through to 2019, particularly in Kenya, it was charged at the rate of 5 percent compared to maximum ordinary income tax rate of 30 percent. To qualify for this lower rate, you have to have owned the property for at least one year. For instance, you dispose your property owned for two years, your profit will be taxed at just 5 percent rather than 30 percent.

2.1.2. Deferred Taxation

The tax is enforced where the tax payer has actually realized gains through the disposal of property owned. The notion that property appreciated in value does not culminate in the eligibility of tax payer having tax liability. For instance, if

your assets were revalued at higher value in this case land Ksh 500,000.00, and still was owned into foreseeable future it does not constitute a base for taxation. Taxation base only arises after disposal.

2.1.3. Does Not Apply to Stock

The property held ordinarily in the course of business including land constitute stock. The proceeds thereafter the disposal is treated as part of ordinary income subject to income tax at the maximum rate of 30 percent. However, property held as ownership for more than one year qualifies for capital gains tax as long as it was not held in the due course of business.

2.1.4. Does Not Apply to Corporate Income

If you've incorporated your business, the capital gains preference doesn't apply to gains for the corporation because all corporate gains are taxed at the same rate. For example, if you've incorporated your business and the corporation sells land it has owned for 10 years and has a gain of Ksh 2 million, your corporation still pays taxes on that gain at the corporate tax rate, not the long-term lower capital gains tax rates.

2.1.5. Capital Gains

By the very nature, capital gains are fluctuating in character and therefore, even if the tax payer is compelled to pay, won't mind to because it gains wasn't expected at first. Consequently, the tax paid will not increase the burden of taxation on the taxpayer.

2.1.6. Property Market

The ever-rising market of property makes it persuasive to invest in the real estate. The increase in the pressure of population and income are responsible for the rise in the value of houses, land and all other kinds of property without any effort and investment on the part of the owner. Hence even if they are taxed, it will not adversely affect the initiative and incentive to invest on such properties.

- Economic stability: capital gains tend to occur during the period of inflation and not at deflation. Consequently, the tax on such gain will not only earn revenue for the government but may be helpful in capping of inflationary pressure and achieving economic stability.
- Reduction of tax avoidance: Companies have a tendency of re-investing into business any taxation avoided which is later distributed as capital gains.
- Bridging the wealth inequality: Equity brings all tax payers to an equal position of paying taxes. Since the property is subjected to Capital Gains Tax are more or less owned by rich people, the tax will ensure fair distribution of wealth.

2.2. Cons of Capital Gains Tax

- The increase in tax paying capacity of an individual due to capital gains is less than that of other kinds of income of an identical amount arising because of other reasons.
- Some people believe that the evils of inflation are so great that taxation on capital gains may not seriously check inflationary pressure and remove inequalities in the distribution of income and wealth.
- Capital gains are irregular and unusual and are difficult to locate. Hence taxpayers believe that casual and irregular incomes should be excluded from taxation. Moreover, all incomes should be treated equally.
- Taxation on capital gains will adversely affect the incentive to invest in risky enterprises and thus may affect production and national income.
- Some taxpayers believe that Capital Gains Tax may encourage tax avoidance instead of reducing it. This is because when tax is introduced there's a danger of tax avoidance being stimulated by attempts to pass off as capital gains what may otherwise have been included taxable income.
- The biggest problem of Capital Gains Tax is that of administration. Capital Gains Tax is difficult to administer as evidenced by many countries that have attempted and failed to introduce Capital Gains Tax.

3. Conclusion

The re-introduction of the capital gains tax in Kenya during the robust real estate sector and high performing stock market through the Nairobi securities exchange (NSE) has widened the tax net and increased tax revenue collection for the government. It remains an ideal that maximizes revenue as well as promoting economic growth. In addition, from a regional integration perspective, the re-introduction of Capital Gains tax is seen as a step towards bridging the differences in fiscal and tax policies between the East African States by aligning Kenya to its neighboring countries that impose tax on capital gains.

4. References

- i. Aiyagari, R. S. (1994). Uninsured Idiosyncratic and Aggregate Saving. *Quarterly Journal of Economics*, 109(3), 659-684.
- ii. Akinboade, O. A. (2015). Correlates of Tax Compliance of Small and Medium Size businesses in Cameroon. *Managing Global Transitions*, 13(4), 389-413.

- iii. Atkinson, A., & Stiglitz, J. E. (1976). The Design of Tax Structure: Direct versus Indirect Taxation. *Journal of Public Economics*, 6, 55-75.
- iv. Barako, G. G. (2015). Efficacy of ITax System on Tax administration in Kenya. *Unpublished*.
- v. Barro, R. J. (1974, December). Are Government Bonds Net Wealth? *The Journal of Political Economy*, 82(6), 1095-1117.
- vi. Carey, D., & Robesona, J. (2004). *Tax Ratios on Labor and Capital Income and on Consumption in measuring the Tax burden on Capital and Labor*. (MA, Ed.) Cambridge: MIT Press.
- vii. Chamley, C. (1986). Optimal Taxation of Capital Income in General Equilibrium with Infinite Lives. *Econometrics*, 54, 607-622.
- viii. Conesa, J. C., Sagiri, K., & Dirk, K. (2009). Taxing Capital? Not a Bad Idea after all! *American Economic Review*, 99(1), 25-48.
- ix. Gitonga, G. N., & Dr. Memba, F. (2018). Determinants of Tax Compliance by Public Transport Savings and Credit Co-operative Societies in Kenya: A case study of Kiambu County. *International Journal of Social Sciences and Information Technology*, IV(IX).
- x. Judd, K. (1985). Redistribute Taxation in a simple Perfect Foresight Model. *Journal of Public Economics*, 28, 59-83.
- xi. Mankiw, G. M. (2000, May). The Savers-Spenders Theory of Fiscal Policy. *American Economic Review*, 90, 120-125.
- xii. Mirrless, J. A. (1971). An Exploration in the Theory of Optimal Income Taxation. *Review of Economic Studies*, 38, 175-208.
- xiii. Muraya, L. N. (2013). Taxation and Revenue stability in Kenya. *Unpublished*.
- xiv. Ramsey, F. (1928). A Mathematical Theory of Saving. *Economic Journal*, 38(December), 543-559.
- xv. Wadianto, R. (2015). The effects of demographic factors on Individual Tax Compliance in Duren Sawit (East Jakarta, Indonesia). (T. N. International Institute of Social Studies. The Hague, Ed.) *Unpublished Thesis*.