IS MINIMUM TAX STILL A VIABLE OPTION FOR KENYA?

LESSONS FROM OTHER COUNTRIES

2024

IS MINIMUM TAX
STILL A VIABLE
OPTION FOR
KENYA?
Individual Income Tax Return
Last name
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ELECTRONIC
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EXECUTIVE SUMMARY

In the recent past there has been a resurgence of global interest in minimum taxes, driven by declining effective corporate income tax rates, which in part has been due to a multiplicity of tax incentives, tax evasion and tax avoidance. Within the context of international taxation, a minimum tax is crucial to reduce tax avoidance practices, particularly base erosion and profit shifting (BEPS) by multinational enterprises (MNEs). Minimum tax serves as a "backstop" to corporate income tax, ensuring businesses contribute to a country's revenue basket even when they report low or no profits.

Through the Finance Act, 2020, Kenya introduced a minimum tax which was to be levied at 1% of a business's gross turnover. The purpose of this tax was to ensure that all businesses, regardless of their profitability, contribute to tax revenue. However, this move faced legal challenges and was deemed unconstitutional for violating principles of equity in taxation and unfairly targeting loss-making businesses. Despite this setback, the Kenyan government through the Medium-Term Revenue Strategy (MTRS) 2024-2027 has indicated that it remains committed to reintroducing a minimum tax.

The government will need a well-designed approach that addresses previous objections, and the goal of this paper is to provide inputs to this new minimum tax policy. We therefore reviewed country cases on minimum tax to draw lessons for Kenya. We discuss key tax principles, consider advantages and disadvantages of existing strategies, and offer some recommendations.

There are three key considerations in developing an effective minimum tax regime: the tax base, the tax rate, and exemptions or tax holidays. The tax rate is highly dependent on the tax base, but it is generally lower than the standard corporate income tax rate, because there are minimal or no deductions under a minimum tax. Moreover, a minimum tax often targets substantial capital/income bases, such as gross turnover, which necessitates a lower tax rate.

There are three alternative tax bases for a minimum tax: turnover, assets or profits/modified income. A turnover-based minimum tax is levied on gross turnover. This is the most common tax base for a minimum tax due to its simplicity, and ease in administration and compliance. It is less susceptible to evasion but can impose an unequal tax burden on businesses with different profitability. An asset-based minimum tax is based on the value of a company's gross or net assets and can be more equitable than turnover tax, but given its likely detrimental impacts in investment Kenya should not consider introducing an asset-based minimum tax. A profit-based minimum tax is charged on profits before taxes or earnings before interest, taxes, depreciation, and amortization (EBITDA). This form of a minimum tax is closely aligned with a company's actual financial performance; however, just like the standard corporate income tax, it is vulnerable to accounting adjustments and tax planning.

In addition to the tax base and rate, exemptions and/or tax holiday are important considerations to ensure the minimum tax does not disproportionately affect certain sectors, particularly start-ups, businesses recovering from economic downturns, capital-intensive sectors, and businesses with narrow profit margins. The Kenyan courts were particularly concerned about this problem.

Our review illustrates that different countries have taken different approaches to minimum tax implementation, providing valuable lessons for Kenya. These examples underscore the need for clear definitions of tax base and loss positions, as well as the importance of balancing simplicity and fairness in tax policy design. Our review established that minimum taxes are intrinsically inequitable, and in some countries, minimum taxes have been challenged in court on equity grounds, as in Kenya. Nonetheless, following good practices in designing such taxes can mitigate these challenges. Given the government's intention to reintroduce the minimum tax, Kenya can adopt the following measures:

- *First, Kenya can adopt Nigeria's definition of gross turnover, which avoids taxing assets or equity. This would cure the problem noted by the High Court that the turnover-based minimum tax would require loss-making companies to pay tax on their capital. In addition, the government should be clear on what constitutes operational activities and exclude incomes such as interest, rent and royalties in computing minimum tax obligation as they cannot be linked to the firms' operating activities.*
- *Adopt a grace period of at least three years for new businesses to be allowed to report losses after which the minimum tax kicks in. In the event there is a global shock, such as the COVID-19 pandemic, businesses are likely to genuinely make losses, the government can consider including a special provision to allow businesses to report losses and not pay the minimum tax. Drawing from Tanzania, a business can be allowed to declare losses for three years but must pay minimum tax in its fourth year of loss-making.*
- *Furthermore, the government should ensure stakeholder engagement in the designing of the tax to prevent it being declared unconstitutional as occurred to the first minimum tax.*

A well-designed minimum tax can generate additional revenues and enhance the fairness of Kenya's tax system. However, its introduction cannot erase the need for broader reforms to broaden the CIT base, especially reforms aimed at eliminating ineffective and inefficient preferential tax measures for corporates. These measures make the tax system less efficient and creates loopholes for tax avoidance. Therefore, the government should also rationalize tax incentives

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1 BACKGROUND AND CONTEXT

One of the key challenges in corporate taxation lies in the consistent underperformance of revenue collection, largely due to tax avoidance and evasion. Both domestic and international firms engage in these practices: multinationals through base erosion and profit shifting (BEPS), and domestic firms through the underreporting of taxable profits. In response, various governments around the world have introduced minimum taxes aimed at boosting revenue, curbing tax avoidance and evasion, and promoting equity in taxation.[1] However, these minimum taxes have sparked significant debate, particularly regarding their fairness. The daunting task for governments, therefore, lies in striking a balance: how can they design minimum taxes that effectively curtail tax evasion while ensuring that the principle of equity is upheld, such that businesses without the financial capacity to pay are exempt from the tax?

Kenya faced this exact challenge in designing its first minimum tax, introduced through the Finance Act. 2020. The tax, set at 1% of a business's gross turnover, was intended as an alternative to corporate income tax.[i] The government defended the tax as a tool to promote equity, arguing that it would minimize opportunities for tax evasion and avoidance by ensuring that companies that underreport profits pay a minimum tax. [2] However, both the High Court and the Court of Appeal struck down the law, declaring it unconstitutional for violating the very equity principle it sought to uphold.[ii] The courts emphasized that the tax unfairly burdened loss-making companies, because as designed, these businesses would be forced to pay the tax out of their capital.[iii] Additionally, since the minimum tax was an alternative tax to corporate income tax, its failure to allow for deductions in calculating taxable income (gross turnover) similar to CIT was deemed inequitable.[iv] These factors ultimately led to the collapse of Kenya's initial attempt to implement a minimum tax.

Despite the setback, Kenya's Medium-Term Revenue Strategy (MTRS) for the FY 2024/25 - 2026/27 period proposed a redesign of the minimum tax considering the objections raised in court.[3] Given the government's resolve to reintroduce a minimum tax, this paper sought to explore alternative approaches to the design and implementation of the minimum tax that will enhance and promote equity, borrowing from experiences from other countries that have employed more equitable minimum taxes. The paper begins with an overview of the concept of minimum tax, followed by an analysis of the design features that caused the failure of Kenya's first minimum tax. It further delves into a discussion of design features of a new minimum tax such as alternative tax bases (turnover, assets and profits); tax rates; and strategies for equity such as exemptions and tax holidays, that Kenya could adopt.

i Finance Act 2020, Clause 4.

ii Waweru and 3 Others (Suing as Official of Kitengela Bar Owners Association) v National Assembly & 2 Others [2021] eKLR; Kenya Revenue Authority v Waweru & 3 Others; Institute of Certified Public Accountants & 2 Others (Interested Parties) [2022] eKLR

iii Waweru and 3 Others (Suing as Official of Kitengela Bar Owners Association) v National Assembly & 2 Others [2021] eKLR para 427- 431.

iv Kenya Revenue Authority v Waweru & 3 Others; Institute of Certified Public Accountants & 2 Others (Interested Parties) [2022] eKLR para 58.

2 UNDERSTANDING THE MINIMUM TAX: CONCEPT AND RATIONALE

The concept of a minimum tax is not new. It dates to the early 20th century, when countries such as France, Germany and the United States levied a gross receipts tax, or what is now known as a turnover tax. The initial motivation for levying a turnover tax was to increase revenues especially at the height of the Great Depression when revenues from property and income taxes were dwindling. As global economies evolved turnover tax was discarded. States realised that the tax was inequitable as it placed a heavier burden on businesses with low profit margins, by focusing only on sales, rather than how much profit a business made.[i] Nonetheless, there has been a resurgence of minimum taxes in different forms.

2.1 CATEGORIES OF MINIMUM TAXES

There are two broad categories of minimum taxes: global minimum taxes targeting multinational enterprises (MNEs) and local minimum taxes targeting businesses operating within the borders of a country.

Within the context of international taxation, the goal of a minimum tax is to limit tax planning among MNEs by curtailing their ability to reallocate profits from high to low-tax jurisdictions to reduce their tax liability. MNEs achieve a lower tax liability by taking advantage of differences in domestic tax laws to shift profits across borders. This is commonly referred to as base erosion and profit shifting (BEPS). To counter BEPS, minimum taxes have gained popularity in international tax frameworks such the Organization for Economic Cooperation and Development (OECD) Inclusive Framework (OECD-IF) and in country-specific tax laws. The OECD introduced a Global Minimum Tax (GMT) targeting profits of MNEs. Some, mostly developed, countries, such as Australia, Canada, Germany, Ireland and Netherlands have already or are in the process of aligning their domestic tax legislations to the OECD-IF. Recently, Kenya joined the ranks of countries that have aligned their legislations with OECD-IF. The National Treasury through the withdrawn Finance Bill 2024 had proposed introduction of a minimum top-up tax targeting MNEs with a consolidated turnover of EUR 750 million and whose combined Effective Tax Rate (ETR) for a given year is less than 15 percent.[ii]

Within the context of domestic tax legislation, different countries have introduced minimum tax with the objective of addressing the challenge of tax avoidance on corporate income tax among local businesses. The minimum tax thus works as a safeguard against domestic tax base erosion by offering an alternative to corporate income tax (CIT), especially where local businesses report losses, or their taxable income is reduced due to tax incentives. This minimum tax can either be structured based on the turnover, assets or profits of a business. A detailed examination of these design approaches as well as their adoption by various countries will be addressed later in the paper.

i. The Institute of Certified Public Accountants of Kenya (ICPAK) (n 3 above).

ii Finance Bill 2024, Clause 9.

2.2 THE DEBATE ON MINIMUM TAX

Critics of minimum taxes have however put up a strong case against their implementation. First, they argue that a minimum tax is likely to result in double taxation as business-to-business transactions are often not exempt, which means that the same economic value is taxed more than once. Second, a minimum tax would disproportionately affect companies with low profit margins and high production volumes especially where turnover is used as base for the tax. The impact on start-ups would also be more dire because they normally incur losses in their formative years. Because of these drawbacks, some countries have opted for different rates for different industries, but this approach has often introduced more complexities to the tax system, undermining simplicity, which is one of the core goals for a minimum tax.[iii]

Despite these concerns, minimum taxes remain a necessary "backstop" for corporate income tax (CIT). This is particularly so in cases where a country's tax administration is not strong enough to enforce collection of CIT, for instance, through regular assessments to detect and counter sophisticated accounting practices aimed at tax avoidance.[4] A minimum tax in this regard sets a floor on tax payable, thus reducing instances of tax avoidance and evasion. Moreover, it ensures that corporations contribute a fair share to the national revenue especially where certain corporates report lower taxable income due to tax incentives. However, the imposition of this tax needs to be approached with caution to ensure that it excludes or lessens the burden of genuine loss-making corporations.

iii Watson, G. (2019). Link.

3 WHAT DESIGN FEATURES CAUSED THE FAILURE OF KENYA'S FIRST MINIMUM TAX?

Kenya introduced a minimum tax through the Finance Act, 2020 with the intention of increasing revenue and discouraging tax avoidance and evasion. This minimum tax was to be levied at the rate of 1% of the gross turnover and was intended as an alternative to corporate income tax (CIT).[i],[ii] Corporates whose retail price is regulated by the government as well as insurance companies were exempted from this tax.[iii] The Kenya Revenue Authority (KRA) published the Guidelines on Minimum Tax to define gross turnover and enhance the effective application of the minimum tax.[iv] Despite these efforts, Kenya's first minimum tax was declared unconstitutional on several grounds.

First, the minimum tax violated the principle of equity by placing an undue burden on loss making companies compared to profit-making firms. The High Court in its rationale argued that because the tax was based on turnover, loss making businesses would be forced to tap into their capital reserves to pay the tax, while profit-making companies would retain their capital untaxed.[v]Concurringly, the Court of Appeal contended that, as it was an alternative to corporate income tax, it should have allowed for deductions in the calculation of turnover. The Court of Appeal argued that since profit-making companies are allowed to deduct tax expenses while calculating their taxable income, loss-making companies' expenses should also be deducted from the turnover to ensure that the principle of fairness is promoted.[vi] Since such was not considered, the Court of Appeal upheld High Court's ruling of the inequitable nature of the tax.

Second, the courts argued that the tax violated the right to dignity and fair treatment. Both the Court of Appeal and High Court argued that subjecting loss-making companies to such a tax on the basis that it would help reduce tax evasion was flawed and a violation of the right to dignity. This is because the rationale assumed that all loss-making companies were engaging in tax evasion. Since tax evasion is a criminal act, this presumption unjustly labelled genuine loss-making businesses, which the courts recognized as a violation of their right to dignity and fairness. [vii] The High Court established that the government had better mechanisms of preventing tax evasion without resorting to a policy that penalized legitimate loss-making companies.[viii] Thus, lumping together genuine loss-making corporations with tax evaders was contradictory to the principle of fairness and dignity.

i Finance Act 2020, Clause 4; Clause 9.

ii Finance Act 2020, Clause 4.

iii Finance Act 2020, Clause 4.

iv Kenya Revenue Authority, Guidelines on Minimum Tax (2020) section 2.

v Waweru and 3 Others (Suing as Official of Kitengela Bar Owners Association) v National Assembly & 2 Others [2021] eKLR para 427-431.

vi Kenya Revenue Authority v Waweru & 3 Others; Institute of Certified Public Accountants & 2 Others (Interested Parties) [2022] eKLR para 58.

vii Kenya Revenue Authority v Waweru & 3 Others; Institute of Certified Public Accountants & 2 Others (Interested Parties) [2022] eKLR para 67-69.

viii Waweru and 3 Others (Suing as Official of Kitengela Bar Owners Association) v National Assembly & 2 Others [2021] eKLR para 362.

Third, the court found that the published Guidelines on Minimum Tax were unconstitutional for failing to follow the laid-down procedure under the Statutory Instruments Act. The High Court found that these guidelines, being part of subsidiary legislation, provided essential details on how the minimum tax was to be implemented. Since section 5(1) of the Statutory Instruments Act, 2013 requires consultation or public participation, the failure to consult businesses on the guidelines further made the design of tax unconstitutional.[ix]

From the two decisions, it is evident that despite Kenya's intentions, its first design failed to meet constitutional thresholds of equity, dignity, fairness and public participation. As Kenya remains committed to developing a minimum tax, the critical question is: what design features should Kenya consider in the development of a new minimum tax? Can we learn from other countries?

ix Waweru and 3 Others (Suing as Official of Kitengela Bar Owners Association) v National Assembly & 2 Others [2021] eKLR para 404.

4 LESSONS FROM OTHER COUNTRIES: WHAT DESIGN FEATURES SHOULD KENYA CONSIDER IN THE DEVELOPMENT OF A NEW MINIMUM TAX?

Globally, there are three approaches to defining the base of a minimum tax: **i) turnover-based; ii) asset-based; and iii) profit-based minimum tax.**[5] The discussion in this section will review country cases of each of the alternative designs and then identify lessons for Kenya. In doing so, the analysis will answer three key questions:

- **First,** *what tax base (profits, assets or turnover) and tax rate have been applied globally, and which approach would work best for Kenya?*
- **Secondly,** *what exemptions and/or tax holidays have other countries adopted, and what should the Kenyan government consider in this regard?*
- **Thirdly,** *what design alternative will address most, if not all, issues that the courts raised?*

4.1 TAX BASE AND TAX RATE

4.1.1 Turn-over based Minimum Tax

A turnover based minimum tax is levied on gross turnover or gross receipts of a business. It is the most common form of minimum tax because of its simplicity and ease of administration and compliance. A turn-over based minimum tax serves as a presumptive tax targeting certain businesses, based on their size or sector.[i] For these businesses the overall cost of complying and administering the standard corporate income tax are too high, necessitating an alternative simplified regime.[ii] Thus a turnover based minimum tax becomes an alternative for their CIT liability.

A key advantage of the turnover-based minimum tax is that it is more difficult to evade compared to a profit-based tax. This is because turnover tax targets sales (output) that are less likely to be underreported than profits. This is because of the incentives created by the VAT system: firms need to recover their rebates from VAT input, which is challenging if they underreport sales. VAT therefore makes it less attractive for corporates to underreport sales, so a turnover-based minimum tax is aligned with firm incentives and naturally reduces the problem of evasion.[6]

Despite this core strength, a turnover-based minimum tax is still problematic. First, turnover or gross sales as a measure of business activity ignores the profitability of a business. Businesses can have equal turnover but have different cost structures, hence their profitability varies. Charging a standard tax rate based on turnover results into an unequal tax burden for

i A presumptive tax refers to a tax levied on an estimated net taxable income through indirect methods. It is usually relevant where actual taxable income is difficult to assess accurately, and the government is aiming at reducing costs for compliance and tax administration. A turnover tax thus qualifies as a presumptive tax, as it is premised on a business's gross receipts (approximate net taxable income) of a business, lessening compliance and administrative costs. Further, given the complexities of imposing a minimum tax, treating turnover as a presumed tax able income aligns with the definition of a presumptive tax. To read more on presumptive tax regimes, see M Mas-Montsarrat and Others, "The Design of Presumptive Tax Regimes" (2023) OECD Working Papers.

ii Aslam, A., & Coelho, M. D. (2021). Link.

these businesses. Secondly, business that make genuine losses, or have yet to achieve break-even, suffer the burden of their capital being taxed. The applicable rate of the turnover-based minimum tax therefore becomes a major determining factor in the survival or closure of a business. This partly explains why turnover-based minimum taxes are levied at a lower rate which, while not entirely resolving this concern, nevertheless reduces the tax burden on struggling businesses.

Aslam and Coelho (2021) reported that as of 2018, over 31 countries, most of which were low- and lower-middle-income, were implementing a turnover based minimum tax. The rates ranged between 0.2 percent to 3 percent, with an average rate of 1.2 percent. While these countries all have turnover as their preferred tax base, implementation differs in terms of the definition of gross turnover and the applicable tax rate.

Nigeria and Tanzania have had their minimum taxes in place for a while; Nigeria first introduced its minimum tax in 1991 through the Finance (Miscellaneous Taxation Provisions) Decrees No.21 and No. 63 of 1991 while Tanzania first introduced its alternative minimum tax in 2009 through its Finance Act, 2008. Whereas their implementation has not been without challenge, they have been able to navigate through these challenges through amendments to legal provisions on their minimum taxes. For example, Nigeria has reviewed its definition of 'turnover' severally to address some of the issues that taxpayers have raised. Tanzania on its part expanded the scope of its minimum alternative tax to not only address base erosion due to incentives but also accounting innovations that would result in companies not paying taxes. Specific lessons that Kenya can draw from these countries are discussed below.

Nigeria imposes a minimum tax on gross turnover of businesses less "franked investment income," meaning that turnover excludes dividend income from other companies.[iii] It further defines gross turnover *for the purpose of a minimum tax as* ***"gross inflow of economic benefits (cash, revenues, receivables, other assets) arising from the operating activities of a company, including sales of goods, supply of services, receipt of interest, rent, royalties or dividend".***[7] However, the term "operating activities" has been controversial, with taxpayers and the Federal Inland Revenue Service (FIRS) differing over its interpretation.

The Federal Inland Revenue Service (FIRS) through an information circular clarified that gross turnover referred to all operating income or revenues and the definition of gross turnover was ***"gross inflow of economic benefits during the period arising in the course of the operating activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants, including sales of goods, supply of services, receipt of interest, rents, royalties or dividends".***[8] Following this clarification, some taxpayers aligned their tax returns, but others argued that some of these items are not operating activities and should be excluded in calculating their minimum tax liability. Their core contention is that incomes such as interest, rent and royalties should only be subjected to the minimum tax if they were earned through a firm's operating activities. For example, they would argue for exclusion of interest from bank deposits, as this cannot be linked to the firm's

iii Franked investment income refers to the dividend received by one company from another after deduction of the withholding tax. The exclusion of franked investment income ensures that the government does not tax assets or equity income and eliminates the possibility of double taxation of this income because it is subject to withholding tax. This means that any dividends that have not been subjected to withholding tax do not qualify as franked investment income and should not be deducted from gross turnover for the purposes of minimum tax. Further, franked investment income qualifies as deductible only when it has been included in gross turnover.

operating activity. Further, charging a minimum tax on disposal of assets would amount to double taxation as these are already subject to capital gains tax.[9]

Tanzania's minimum tax, like Nigeria's, is chargeable on gross turnover of corporations that have incurred perpetual **unrelieved losses**[iv] for three consecutive years. The objective is to ensure that corporations contribute to the tax revenue regardless of their profitability status. The minimum tax rate is set at 0.5% of a corporation's turnover. [10]

4.1.2 ASSET-BASED MINIMUM TAX

Some countries have opted for assets as a tax base for their minimum tax. Compared to profits, assets provide a wider and stable tax base and therefore guarantee stable revenues. A fundamental challenge is in valuation of assets, which some countries have overcome by adopting the books value of assets.[v] A bigger challenge in implementing an asset-based minimum tax is that a country must balance generating revenues and promoting investment. A tax on assets would exert a higher burden on capital-intensive sectors and could possibly influence investment in these sectors. Evidence from the United States indicates that the corporate alternative minimum tax (CAMT) forced capital-intensive firms to shift from purchasing to leasing depreciable assets due to the changes in allowable depreciation under the law.[11] Some have argued that the efficacy of CAMT is questionable and does not address base erosion and profit shifting.[12] In addition, Argentina's experience demonstrates that an asset-based minimum tax would not meet the thresholds defined by Kenyan courts. The Argentine Supreme Court declared minimum tax unconstitutional in that taxation of assets did not consider whether they had the potential to generate income in future.[13] Both cases provide evidence that implementation of an asset-based minimum tax would face numerous challenges and therefore, we do not recommend its consideration in Kenya.

4.1.3 PROFIT-BASED MINIMUM TAX

A profit-based or modified corporate income in its design is very similar to the standard CIT, but allows for variations in deductions, tax credits and other allowances. Because of the tax base, tax rates under this form of minimum tax are typically higher compared than on turnover or asset-based minimum tax. The base can either be on profits before tax (as is the case with India) or earnings before interest, depreciation, taxes, and amortization (EBIDTA).

The profit-based minimum tax based on EBIDTA is preferred over that of profits before tax since the former has a larger base (gross rather than net profits). It also neutralizes the bias in favour of debt because interest is not allowed as a deduction, thus deductions are lower compared to the standard CIT regime and as mentioned earlier in this paper, over-reporting deductions is a primary cause of base erosion. Some deductions remain, which set this tax apart from a turnover tax. The only allowable deductions are variable costs.[vi] Limiting deductions to variable costs limits the scope for accounting manipulation. Compared to fixed costs, variable costs have a lower range of possible distortions that are of lesser value.

In the case of profits before tax, as is case with

iv The amount of a loss that has not been deducted in calculating a person's income under Tanzania's Income Tax, Act

v Aslam and Coelho (2021)

vi Variable costs refer to direct costs incurred in production good and services such as raw materials, piece-rate labor, production supplies, commissions, delivery costs, and packaging supplies.

the standard CIT, determining which profits constitute the tax base is a complex process and is prone to creative accounting and tax planning. This makes this form of minimum tax less ideal as the core basis for minimum taxes is to prevent base erosion caused by accounting gimmicks. By allowing deductions, this form of a minimum tax creates a perverse incentive for businesses to report accounting losses and cannot address the weaknesses in the standard CIT regime. Attempts to define what deductions to include and exclude complicates this form of minimum tax and for this reason it is more common in advanced economies. While India opted for a profit-based minimum alternate tax, it has been criticized for introducing more complexities in an already complex tax system.[14]

4.2 TAX HOLIDAY/EXEMPTIONS

The imposition of a minimum tax causes an undue tax burden to certain businesses, thus justifying the need for tax holidays or exemptions. For instance, start-up businesses would be significantly affected as they would be required to pay a minimum tax despite their businesses taking time in their formative years to break even from the substantial initial investments. Further, if the minimum tax is premised on turnover or value of assets, companies which have high turnover or substantial assets may face a heavier burden despite having low income or incurring losses. Therefore, when re-developing Kenya's minimum tax regime, it is vital to consider appropriate exemptions to enhance equity and ensure that companies pay a fair share of taxes in line with their ability to pay.

In determining the tax base for the purposes of a minimum tax, other countries have included some exemptions. Nigeria for example has exempted the following from the minimum tax: companies with less than N25million gross turnover; companies carrying on agricultural trade or business as defined in section 11(4) of CITA; any company in its first four calendar years of business operations. On the other hand, Tanzania exempts: agricultural companies; companies engaged in provision of health or education services; tea processing businesses (proposed in the Tanzania's Budget Statement for the FY 2024/25).

Both Nigeria and Tanzania give new businesses in a loss-making position a grace period before the provisions of minimum tax kick in. In Nigeria, the grace period is four years while for Tanzania it is three. The rationale behind the grace period is that a company cannot make losses for more than three years and remain in operation. This is in part a relief for new businesses in a genuine loss-making position before they break-even.

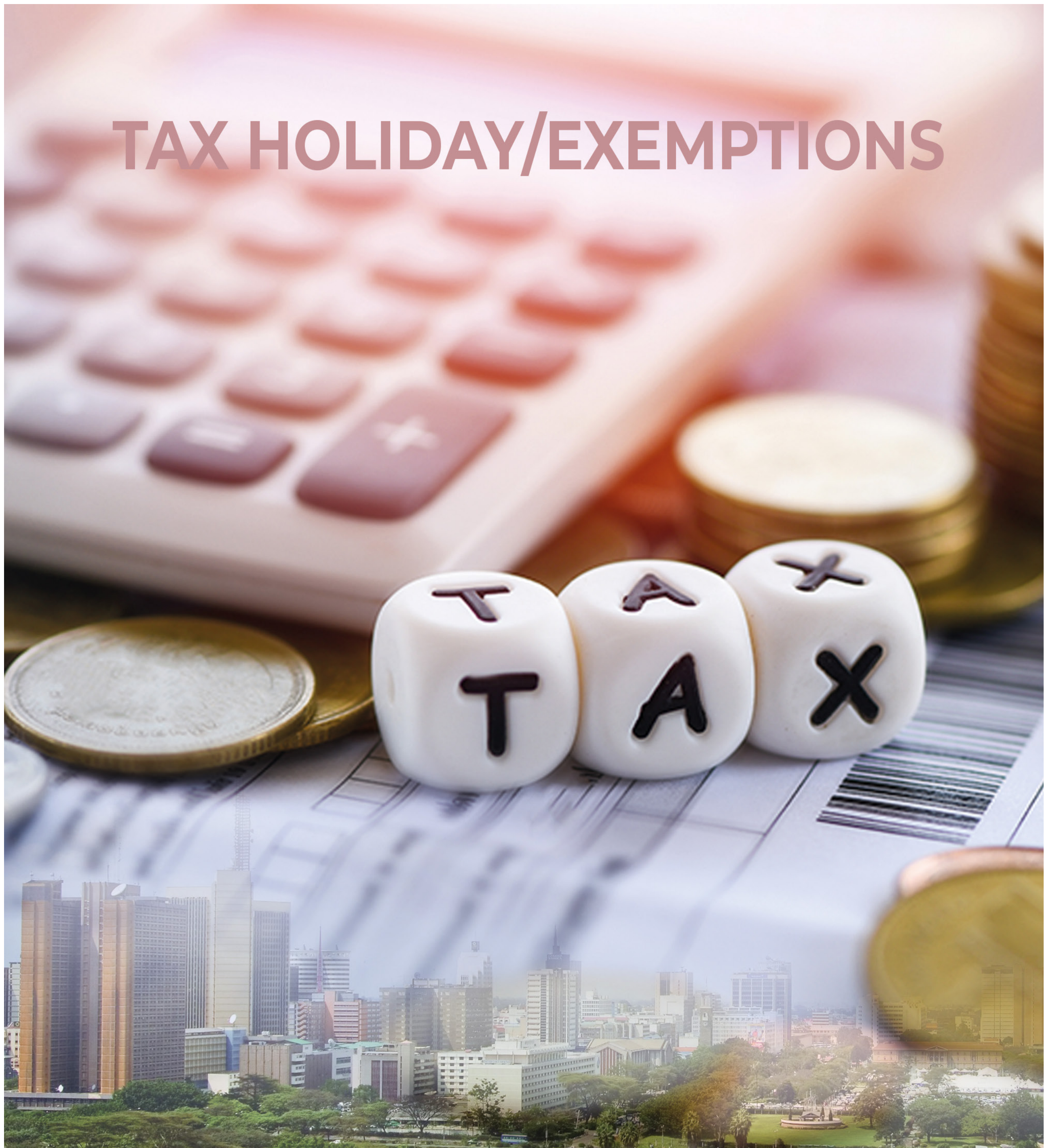
India exempts income from life insurance businesses, foreign companies without a permanent establishment (PE) in India, foreign companies deriving their income from shipping business, exploration of mineral oils, aircraft business, civil construction in turn-key projects.[15]Whereas some exemptions may be justified, others are equivalent to tax expenditures. Before offering any similar exemptions, Kenya should scrutinize them carefully and provide justifications for any such exemptions.

Kenya had proposed exemptions of businesses whose retail price is controlled by government, which are mostly oil-marketing companies. In the development of the new minimum tax, the government should consider widening the exemptions to cover industries with very low profit margins.[16] **Thus the government can consider:**

- *A grace period, of at least three years for new businesses to be allowed to report losses after which the minimum tax kicks*

in. In the event there is a global shock such as was the case of the COVID-19 pandemic, the government of Kenya can consider including a special provision to allow businesses to report losses and not pay the minimum tax. Drawing from Tanzania, a business can declare losses for three years but must pay minimum tax in its fourth year of loss-making.

- *Exempt multinational corporations because they are likely to be covered under the minimum top-up tax which is a form of minimum tax addressing base erosion and profit shifting at the global level.*



5 CONCLUSION AND WAY FORWARD FOR KENYA

Countries all over the world and for at least a century have introduced minimum taxes into their tax regimes, with the key motivation of protecting their corporate income tax base. Minimum taxes also contribute to perceived equity of a country's tax system. A minimum tax may be particularly useful in cases where there are political and administrative constraints in reforming the standard CIT regime. In addition to contributing to a country's revenue basket, a minimum tax contributes to improved compliance because of the perceived fairness of a country's tax system.

From the review above, it is evident that a minimum tax has inherently inequitable attributes which must be addressed through policy design. In some countries, this inequity has resulted into legal challenges akin to those experienced in Kenya. Nonetheless given the government's intention to reintroduce the minimum tax, Kenya can adopt the following measures:

- First, Kenya can adopt Nigeria's definition of gross turnover, which avoids taxing assets or equity. This would cure the problem noted by the High Court that the turnover-based minimum tax would require loss-making companies to pay tax on their capital. In addition, the government should be clear on what constitutes operational activities and exclude incomes such as interest, rent and royalties in computing minimum tax obligation as they cannot be linked to the firm's operating activity. Furthermore, the government should ensure stakeholder engagement in the designing of the tax to prevent it being declared unconstitutional just as the first design of the minimum tax.

- Adopt a grace period, of at least three years, for new businesses to be allowed to report losses after which the minimum tax kicks in. In the event there is a global shock such as was the case of the COVID-19 pandemic businesses are likely to genuinely make losses, the government can consider including a special provision to allow businesses to report losses and not pay the minimum tax. Drawing from Tanzania, a business can be allowed to declare losses for three years but must pay minimum tax in its fourth year of loss-making.

- Ensure stakeholder engagement in the designing of the tax. Previously, the government failed to involve stakeholders as prescribed by the Constitution and the Statutory Instruments Act in the development of the Minimum Tax Guidelines.

It is important to note that introducing a minimum tax cannot erase the need for broader reforms to CIT tax base erosion, especially eliminating redundant preferential tax measures for corporates. These measures make the tax system less efficient and create loopholes for tax avoidance, and thus erode the CIT tax base.

Endnotes

1 Aslam and M Coelho, "A Firm Lower Bound: Characteristics and Impact of Corporate Minimum Taxation" (2021) IMF Working Paper pg 4.

2 The Institute of Certified Public Accountants of Kenya (ICPAK), "Position Paper on the Introduction of the Minimum Tax in Kenya" (2020) Link.

3 Republic of Kenya. The National Treasury and Economic Planning (2023). The Medium-term revenue Strategy (An Approach for Enhancing Domestic Revenue) FY 2024/25- 2026/27. Link.

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5 Aslam, A., & Coelho, M. D. (2021). A Firm Lower Bound: Characteristics and Impact of Corporate Minimum Taxation. International Monetary Fund. Link.

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