

What is deemed interest and who is the target?



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As a tax advisor, I struggle to explain to many of my clients the law relating to deemed interest. I am sure that I am not alone. Deemed interest is the amount of notional interest assumed to be payable by a resident person in relation to any outstanding loan provided or secured by a non-resident person, where such loan has been provided interest free. Allow me to explain.

Many long term investments require a large initial capital outlay and the risks involved in these investments can be very high. Furthermore, it takes a long time before an investor can recoup the capital invested and start enjoying a return on the investment.

A good example of long term and high risk investments are those in the oil exploration and mineral prospecting sectors.

In the oil exploration industry, foreign parent companies pump in large amounts of money during the exploration stage. These companies

usually finance exploration through a mix of debt (loans) and equity. Because oil exploration is considered high risk, few financial institutions are willing to lend funds to companies involved in exploration.

That leaves the local company with no alternative but to borrow funds from its parent or affiliated company free of interest.

When a foreign parent company advances an interest free loan to its subsidiary resident in Kenya, such a loan would be subject to the deemed interest provisions under our Income Tax Act.

To avoid the incidence of deemed interest the affiliated lender would be required to charge interest on the loan. But charging interest on such a loan does not make commercial sense to the Group because its Kenyan operations have not yet started generating any income. Worst case, the companies record a total loss after investing huge sums in a well which turns out to be dry.

If the lender opts not to charge interest deemed, interest provision would apply. The notional interest charged would give rise to a withholding tax liability.

We can reasonably argue that the withholding tax on deemed interest increases the cost of doing business in Kenya. It is unfair to impose withholding tax on deemed interest in cases where the initial outlay is financed through interest free loans from a non-resident parent company, particularly when the Kenyan operations financed by such loans have not yet started generating income.

This could not have been the intention of introducing the law on deemed interest. The concept of deemed interest was introduced

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in the 2010 Finance Act and according to the Income Tax Act, the interest is considered to be income accrued in or derived from Kenya and hence subject to withholding tax at the rate of 15%.

The Commissioner prescribes a rate of interest on a quarterly basis that should be applied to compute the deemed interest amount. The prescribed rate is usually equal to the average 91-day Treasury Bill rate.

The big question is, who was the real target of deemed interest when the concept was introduced? Currently, all interest free loans secured or advanced by a non-resident person to a resident person are subject to withholding tax on the deemed interest.

In my view, imposing withholding tax on assumed (notional) income amounts to creating an additional cost to investors who invest / intend to invest in Kenya especially during the period prior to the commencement of income generation.

If Kenya wants to brand itself as an investment hub in Africa, the Government should come up with regulations to cushion investors from this additional cost. By providing clarity on deemed interest provisions, the application of the law will be more acceptable. Alternatively, the law on deemed interest should be removed from our tax laws.