Rental Income

Tax Principles Workshop
ICPAK

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22nd January 2016

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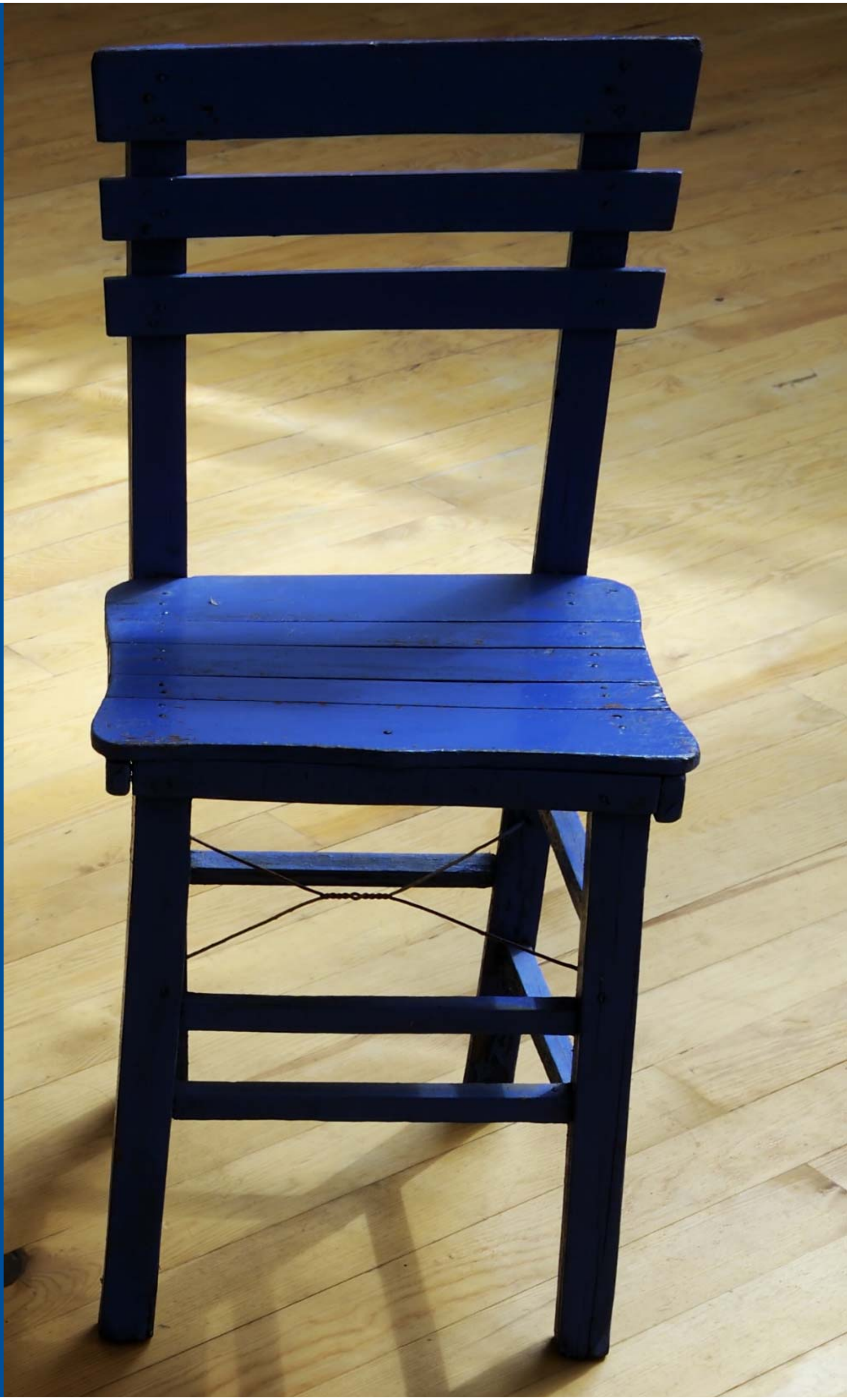
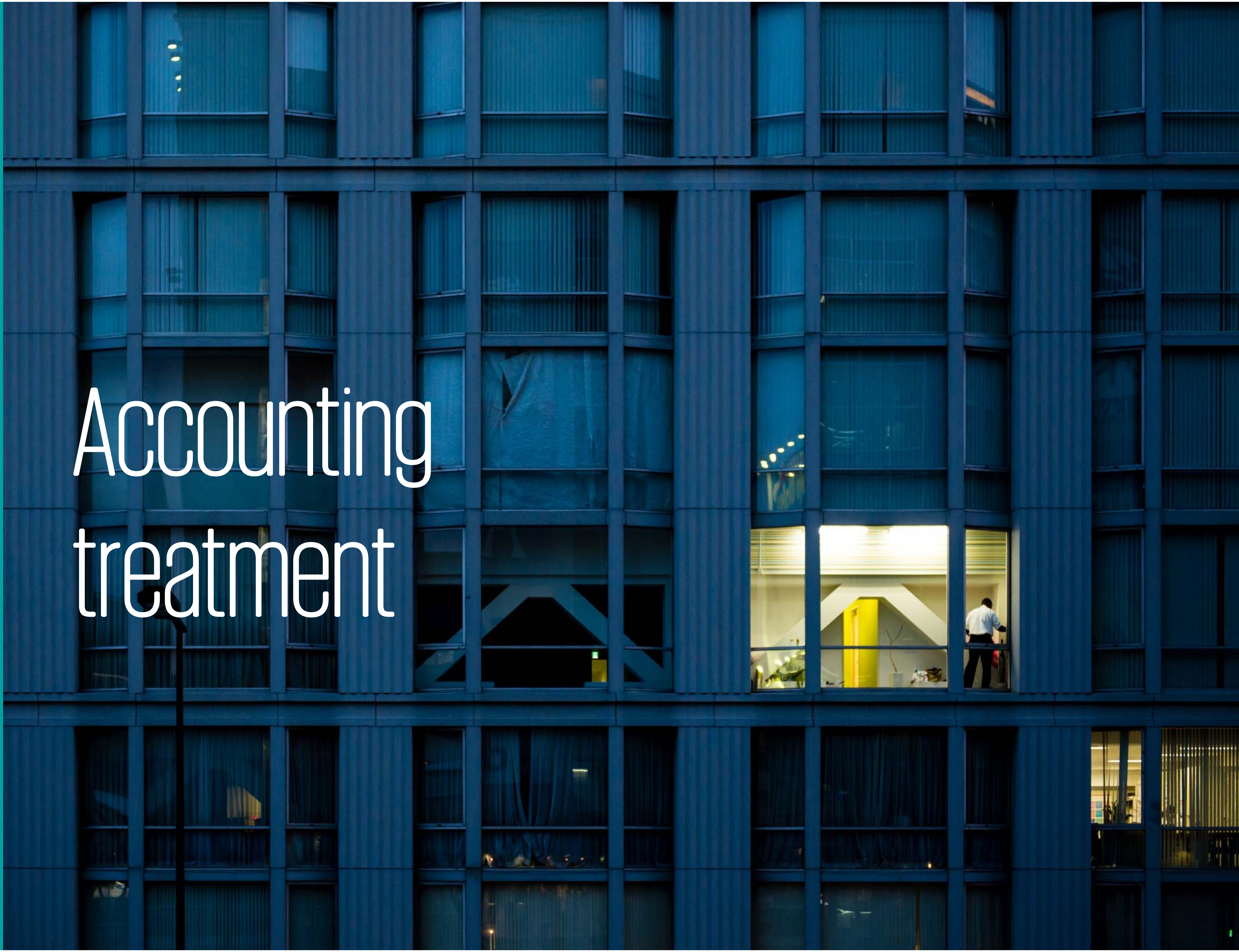


Background

Background

- Rental income is any income earned from the permitting another to use property that one owns or has rights over
- Arises from the renting of a house, apartments, rooms, space in an office building, or other real or moveable property
- The earning of rental income can be the core business of a person or can be incidental to their core business

Accounting treatment



Accounting treatment

- Rental income for business entities is mainly received in form of lease rentals under lease agreements
- The accounting treatment applicable to leases, for lessees and lessors is covered under International Accounting Standard (IAS) 17 – Leases and IAS 40 – Investment Property

Accounting treatment

- Leases are required to be classified as either:
  - Finance leases – transferring substantially all the risks and rewards of ownership and give rise to asset and liability recognition by the lessee and a receivable by the lessor; or
  - Operating leases – resulting in expense recognition by the lessee and the asset being recognised by the lessor.
- Whether a lease is a finance lease or an operating lease depends on the substance of the transaction
- A lease will be deemed to be a finance lease where it transfers ownership of the asset to the lessee by the end of the lease term or lessee has the option to purchase

Tax treatment

Tax treatment of rental income

- Taxable on anyone in receipt of rental income unless they are tax-exempt
- Section 3(2)(a)(iii) of the Income Tax Act (ITA) provides that income arising from a right granted to another person for the use or occupation of property constitutes income chargeable to tax

Tax treatment of rental income

- The earning of rental income can be the core business of a person or can be incidental to their core business
- Where a person has several sources of income, the ITA provides for the taxation of rental income as a separate source of income
- Sec 6(1) of the ITA provides for the taxation of rental income: 'gains or profits' includes a royalty, **rent,** premium or similar consideration received for the use or occupation of property
- This may include*:*
  - Advance rent
  - Any amounts paid to cancel a lease; and
  - Security deposits?

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Tax treatment of rental income

- Expenditure incurred in the production of rental income is an allowable deduction under the ITA
- Sec 15 provides that - for the purpose of ascertaining the total income of a person for a year of income there shall…be deducted **all expenditure incurred** in **that year of income which is expenditure wholly and exclusively incurred by him in the production of that income**

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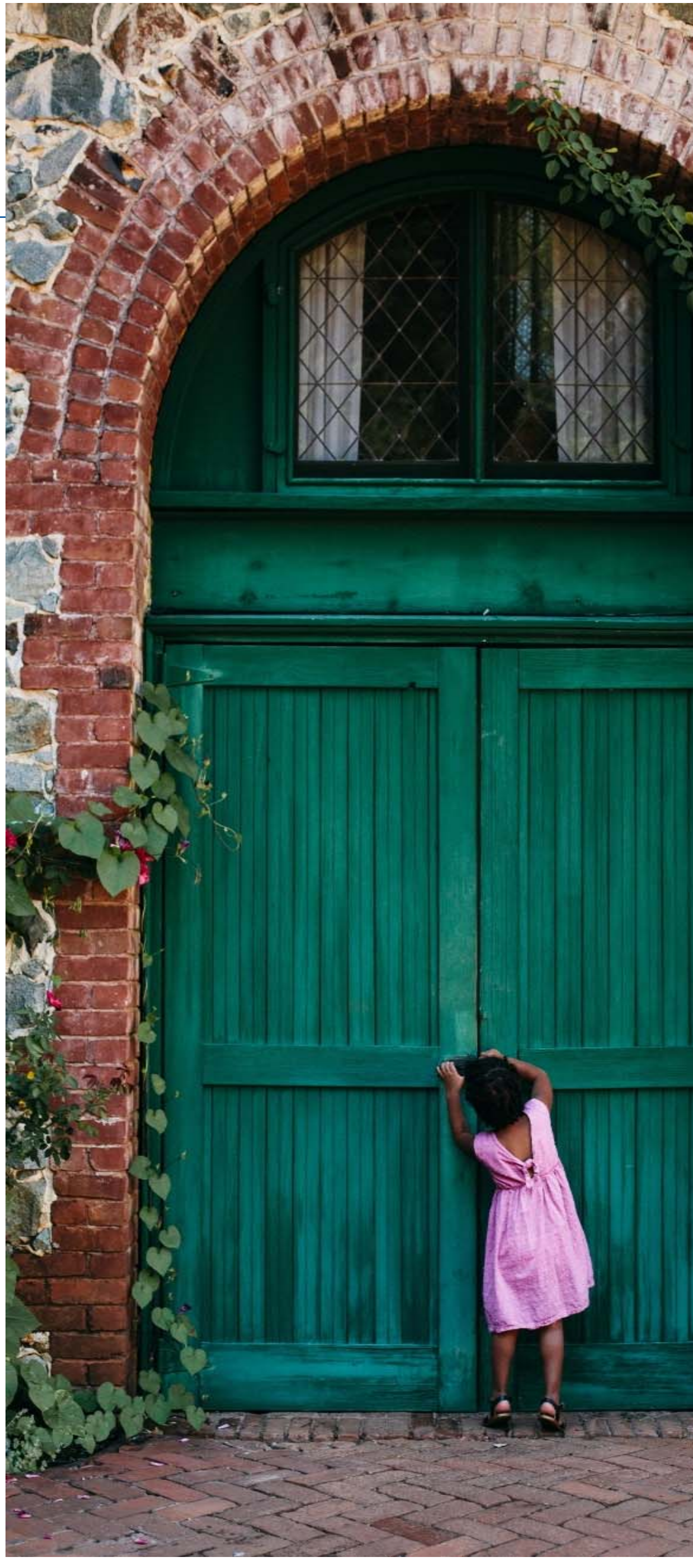
Allowable expenses on rental income

- The allowable deductions for rental income:
  - For the owner of premises, any amounts used for structural alterations to the premises necessary to maintain the existing rent (S15(2)(f));
  - Expenditure incurred by a lessee in the case of a lease or similar transaction (15(2)(t);
  - Interest paid in respect of money borrowed wholly and exclusively for production of investment income (15(3)(a));

Allowable expenses on rental income

- Land rent and rates
- Agent fees
- Grounds keepers expenses or
- Insurance

- Non-residents cannot claim any of the above expenses – income taxed as a WHT at 30%



Other allowances with respect to property

- The following allowances are also available with respect to property:
  - Commercial building allowance, cost of construction – Paragraph 5(1)(f) and 5(1)(ff) of the Second Schedule of the ITA
  - Wear and tear allowance on machinery and equipment in accordance with the Second Schedule of the ITA
  - Mortgage relief for owner occupier income - S15(3)(b) of the ITA

Non-allowable expenses

- Any expenses that are not incurred wholly and exclusively in the production of rental income are not allowable i.e.
  - Principal loan repayment
  - Cost of construction – Commercial building allowance
  - Any expenditure of a personal nature

Residential and Commercial Rental Income Tax

- There is a distinction between ‘commercial rental income’ and ‘residential rental income’ for tax purposes
- Commercial rent attracts VAT while residential rent does not
- The Finance Act 2015 introduced special provisions relating to taxation of residential rental income in a bid to make more taxpayers declare residential rental income

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Kenya Revenue Authority lays out rental income tax formula

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Comments

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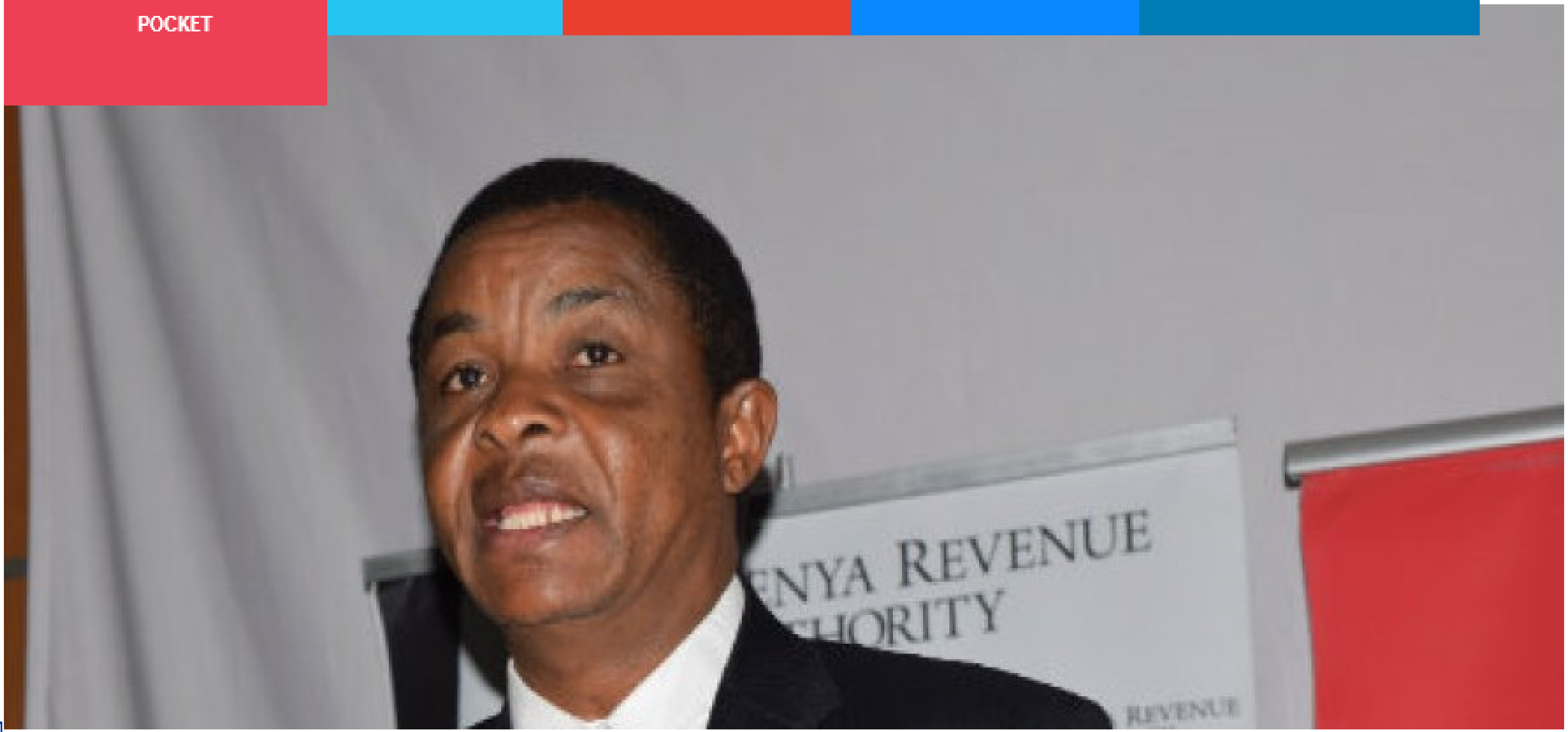

Residential Rental Income Tax

- The Finance Act 2015 introduced the residential rental income tax with effect from 1st January 2016
- Section 6A of the ITA - residential rental income tax shall be payable by **any resident person** from income accrued in or derived from Kenya for the use or occupation of **residential property**, and which **does not exceed *KShs 10m*** in a year of income
- This tax shall be a final tax payable on a monthly basis
- Taxpayers who wish to remain under the previous rental income tax regime may elect to do so by writing to the commissioner
- Tax rate is a flat rate of 10% on gross rents received

Commercial Rental Income Tax

- VAT is chargeable on commercial rent and the following are required:
  - Preparation of the VAT Account (or VAT Reconciliation) showing the VAT charged to tenants (output) and allowable VAT on purchases incurred in the period (input)
  - Completed VAT returns, submitted on the 20^{th} day of the following month.
  - All invoices or receipts issues to tenants should be in compliance with the VAT Regulations, under the repealed VAT Act, and the VAT Act, 2013

Non-residents and withholding tax

Non-residents

- Section 3 of the Third Schedule of the ITA provides that income in respect of rent, premium or similar consideration for the use or occupation of immovable property will be chargeable to tax at a rate of **30%** of the gross amount payable
- Non-residents may not deduct any expense to arrive at taxable income
- Tax collected under the WHT mechanism by the tenant

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Requirements at the end of the accounting period

Income tax on rental income:

- Preparation of the rent schedule for all let property indicating the number of the properties, gross rent received and all expenses incurred on the properties
- Deduction of allowable and supported expenses to arrive at chargeable rent
- A completed tax return including the rent schedule as support
- Submission of the self-assessment return (SAR) within six months after the end of the accounting period

Implementation Issues and amnesty

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POLITICS AND POLICY

Rotich sets tough rules for rental income tax waiver

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Implementation and Compliance Issues

- Prior to the amnesty (1st January 2016), landlords were unwilling to declare rental income tax – legacy liabilities after years of non-compliance
- In 2012 KRA revealed that less than 40% of landlords and developers had complied with tax requirements
- Additionally, KRA ability to effectively identify and capture all landlords in the tax net is not optimal
- Cash transaction - rent paid in cash further frustrates the enforcement of the tax
- A number of land owners continue to understate income

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Implementation and Compliance Issues

- Taxpayer compliance is affected by the overall perception of the tax system:
  - ➢ Is it too punitive? (tax burden concerns)
  - ➢ Are there high costs of compliance?
  - ➢ Do taxpayers understand their obligations? (knowledge of the tax)
  - ➢ Can the taxes collected be seen to be efficiently put to use?
- The KRA sought to obtain information about landlords from utility companies and requested tenants to report their landlords.
- This perceived lack of trust demonstrates the difficulties with implementing and collecting rental income tax

Encouraging Compliance

- Although the real estate sector in Kenya has continued to grow, the revenue that KRA had been collecting was not equal to that growth, as a result the KRA launched an aggressive tax compliance campaign in July 2012 increasing revenues – "block management"
- The following challenges were experienced:
  - Huge back taxes
  - Poor record keeping particularly on expenses and
  - Informal practices and a complex tax system
- In 2015 KRA sought to encourage 20,000 building owners to join the tax net with an aim of collecting at least KShs **3 Bn**

Encouraging Compliance

- KRA intends to create a database through agents who collect data relating to buildings and their owners
- Agents will include:
  - property management companies who collect rent on behalf of landlords
  - Government ministries, departments and agencies that pay rent to act as withholding agents for rental income
  - Independent entities who collect data
- The Commissioner General - KRA pursuing a more collaborative rather than punitive approach

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LANDLORD, YOU ARE

FORGIVEN

TAX AMNESTY FOR RENTAL INCOME

The Tax Amnesty for Rental Income is your once-in-a-lifetime chance to redeem your tax record. If you pay tax on your rental income for 2014 and 2015 today, all is forgiven. Yes, tax on your rental income for all previous years will be zero. You will owe nothing. So act now and make a new start.

For further clarification,
Website: www.kra.go.ke Email: rentalincome@kra.go.ke
twitter.com/KRACare facebook.com/KRACare
Call Centre: Tel: +254 (020) 4999 999 / +254 (0711) 099 999

KENYA REVENUE AUTHORITY

Amnesty - The Finance Act 2015

- The Finance Act 2015 introduced amnesty for landlords in order to reduce the tax burden and cost of compliance
- W.e.f. 1 July 2015, The Commissioner, will refrain from assessing or recovering taxes, penalties or interest in respect of any period before or during 2013 year of income and any penalties or interest for 2014 and 2015 on rental income
- Persons seeking amnesty who have no documentation to support expenditure will be allowed to deduct 40% of the gross rent, premium or similar consideration

Amnesty - The Finance Act 2015

- Amnesty will benefit landlords who voluntarily disclose undeclared rental income for **2014 and 2015** between 1 July 2015 and 30 June 2016 and who submit their tax returns online via ***iTax*** and pay all principal taxes due
- The amnesty extends to both individuals and corporations
- In order to qualify for amnesty, applicants should download and fill the form from the KRA website
- Once application has been submitted there is no requirement to apply for a waiver of the penalties or interest

Amnesty - The Finance Act 2015

- The tax due shall be computed as follows:
  - Calculate the gross rental income and deduct all allowable expenses to obtain net taxable rental income
  - In event of expense records not being available, deduct 40% of gross rent
  - Apply the relevant tax rates to net rental income to compute tax due (individual rates and corporation rates)

Returns and timelines

Returns, tax rates and timelines

- Taxes are paid in four instalments on the 20th of the 4th month, 20th of the 6th month, 20th of the 9th month and 20th of the 12th month of the accounting period
- Any balance of tax is payable by 30th of the fourth month after the end of the accounting period.
- Tax rates depend on whether the person is an individual or a corporation and whether they are resident or non-resident

Returns, rates and timelines

- For resident individuals the annual tax rates on total annual income including net rent income are:
  - On the first KShs 121,968 ....10%
  - On the next KShs 114,912 .... 15%
  - On the next KShs 114,912 .... 20%
  - On the next KShs 114,912 ....25%
  - On all income over KShs 466,704.........30%

Returns, rates and timelines

- For resident companies, net annual income together with other incomes (separate sourced rental income) are taxed at 30%
- For non-residents only Withholding Tax is applicable at a rate of 30% on gross rent. This is a final tax
- In a partnership, one rent declaration is submitted and partners are taxed on their respective shares of rent income

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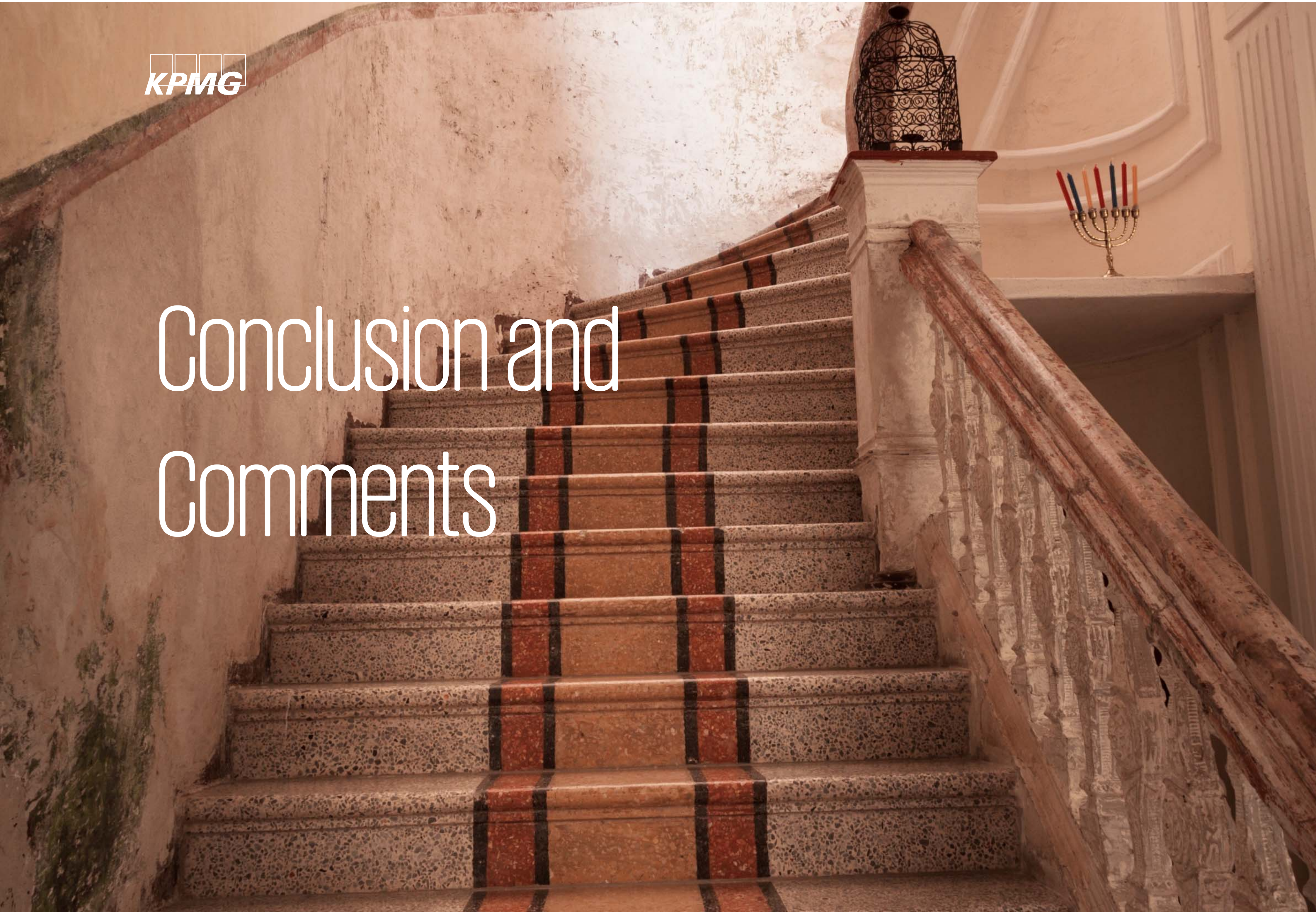
Conclusion and Comments



Conclusion and Comments

- The taxation of rental income is universal
- In the United Kingdom for instance, those earning income from land and property are required disclose to HMRC
- The rental income should be declared in the tax returns and the applicable tax rates applied
- However, income of less than ***GBP 4,250*** pa does not attract rental income tax
- This exemption applies under the rent-a-room allowance scheme. Rent-a-room allowance applies to the letting out of furnished accommodation in a person's home

Conclusion and Comments

- In the United States cash or the fair market value of property received for the use of real estate or personal property is taxable as rental income
- Taxpayers can then elect to deduct expenses of renting property from their rental income
- Allowable deductions include mortgage interest, property tax, operating expenses, depreciation and repairs
- In Germany rental income tax is based on a progressive graduated scale

Outlook…my perspective

- Increased use of IT to profile rental income streams
- Focused study of rental income trends and economic impacts
- Lifestyle profiling
- Convergence of KRA's role - collecting stamp duty and devolution
- Enhanced recovery measures - charges over properties?
- Stringent Anti-Money Laundering and Proceeds of Crime & Financing Terrorism regulations
- International clamp down on tax evasion - BEPS and Automatic Exchange of Information

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Outlook...my perspective

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Q&A