

## DEMYSTIFYING COMPENSATING TAX

Compensating tax is a tax that is only applicable to Kenya resident companies. Compensating tax was introduced to discourage the distribution of dividends where a company has been granted tax incentives. The idea is that the incentives should be re-invested and not distributed. In a nutshell, a compensating tax liability accrues when a dividend distribution is made to the shareholders of a company from unsatisfactorily taxed gains or profits. The object of compensating is therefore to ensure that dividends are matched with taxable profits.

Owing to its nature or the circumstances that trigger the occurrence of compensating tax, it is not frequently encountered in ordinary business dealings where a company is established to be the vehicle of choice. As such, if one earns employment income, files returns as an individual and never files returns for a company, they may never come across compensating tax. Below, we demystify this tax.

In considering compensating tax, it is first important to establish if the company has satisfactorily paid tax on the gains or profits made before distribution of a dividend to the shareholders of the company. The governing provisions are captured under Section 7A of the Income Tax Act.

In summary, all companies resident in Kenya that make distributions in the form of dividends are required to maintain a dividend tax account. A dividend tax account is merely a memorandum account and does not form part of the statutory accounts. In order to calculate whether a compensating tax liability arises or not, you add to the dividend tax account balance brought forward from the previous year: -

- Any corporate income tax paid during the year,
- Any compensating tax paid during the year, and
- 3/7 times any dividends received during the year.

From this you deduct: -

- Any corporate income tax repayments made during the year, and
- $\frac{3}{7}$  times any dividends paid during the year.

If the result is a negative balance, compensating tax sufficient to reduce the balance to zero must be paid. The fraction  $\frac{3}{7}$  is tied to the corporate income tax rate which is currently 30%. If this rate were to change, the fraction would change accordingly.

The illustration below offers a computation of compensating tax based on the formula highlighted above.

#### Illustration

Assuming a company incorporated in Kenya (resident company) received dividends of KShs. 210,000 in the year 2015. Let us further assume that the company sold a piece of land and made a gain of KShs. 1,000,000 in the same year. The directors of the company pay make a decision to pay dividends amounting to KShs. 700,000 to the shareholders. Will compensating tax arise?

#### Solution

<b>Credit side:</b>	
Capital gains tax (1,000,000*5%)	50,000.00
Dividends received (210,000 *30/70)	90,000.00
Compensating tax	160,000.00
<b>Total</b>	<b>300,000</b>
<b>Debit side:</b>	
Dividends paid (700,000*30/70)	300,000.00
<b>Total</b>	<b>300,000.00</b>

### Dividend Tax Account

Dr		Cr	
Dividends Payable (Distributable Reserves*(1- t))(700,000*30/70)	300,000.00	Capital Gains Tax Paid	50,000.00
		Dividends Received	90,000.00
		<b>Compensating Tax Payable</b>	<b>160,000.00</b>
<b>Total</b>	<u>300,000.00</u>	<b>Total</b>	<u>300,000.00</u>

In the above scenario, the company will be liable to pay compensating tax of KShs. 160,000 when a dividend distribution of KShs. 700,000 is paid to the shareholders. This tax should be paid on the date when the company files its returns. The compensating tax liability arising above reflects that the distribution of KShs. 700,000 has not been taxed satisfactorily prior to distribution.

The above represents only one of many scenarios that can trigger compensating tax when a company distributes dividends to its shareholders.

It is important for all companies resident in Kenya to ensure that the provisions of Section 7A of the Income Tax Act are applied correctly prior to making a dividend distribution.



If you would like to know enquire more about compensating tax and its applicability in your company, please contact Mr. Cosmus Gateri on [CGateri@vivaafriCALLP.com](mailto:CGateri@vivaafriCALLP.com) or contact us on [info@vivaafriCALLP.com](mailto:info@vivaafriCALLP.com).

Want to change how you receive these emails?

You can [update your preferences](#) or [unsubscribe from this list](#)

*The information contained in this news alert is for general information only and is not intended to provide legal or financial advice. This alert is prepared for the general information of our clients and other interested persons. Information contained in this alert should not be acted upon in any specific situation without appropriate legal and financial advice. We do not accept responsibility or liability to users or any third parties in relation to use of this news alert or its contents. All copyright, trademarks and other intellectual property in or arising out of the materials vest solely in Viva Africa Consulting LLP.*