

**TAXATION OF MERGERS AND ACQUISITIONS UNDER THE INCOME TAX
ACT OF KENYA**

**A THESIS SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS
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DECLARATION

This Thesis is my original work and has not been presented for a degree at the University of Nairobi or any other University or examination body.

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DEDICATION

First, I appreciate the guidance of my supervisor Professor Arthur Eshiwani for his undying commitment and supervision throughout the process of this thesis.

Secondly, I dedicate this project to my lovely family for their support, understanding, tolerance and encouragement. To my father, Augustine Nyapara and my mother Mary Nyapara, I do thank you for your prayers during this challenging process.

Lastly, I cannot forget to mention dedicated Mrs. Elizabeth Meyo for her continued support and encouragement. Her presence and prayers were indeed very helpful.

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LIST OF CASES

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2. *Unilever Kenya Ltd and Commissioner of Income Tax(the Unilever case)(Income Tax Appeal No. 753 of 2003)*
3. *James Snook & Co. Ltd v Blasdale*(1952) 33 T.C. 244
4. *Commissioner Of Income Tax v Kencell Communications Limited (Now Airtel Kenya Limited) [2016] eKL(Income Tax Appeal No. 272 of 2015)*
5. *Vodafone Essar (Gujarat) vs. The Department of Income Tax*
6. *Royal Insurance Company v Watson*(1897) 3 T.C. 500
7. *New Zealand Dairy Farm Mortgage Co. Ltd v C. Of T (1941) N.Z.L.R. 83*
8. *Foley Bros. Pty. Ltd vs F.C of T(1965) 13 A.T.D. 562*
9. *John Fairfax & Sons Pty. Ltd v F.C. of T(1959) 101 C.L.R. 30*
10. *CIT Bombay Dying and Manufacturing Company Ltd(1996) 3 SCC 496: AIR 1996 SC 3309*
11. *Saraswati Industrial Syndicate v. CIT (AIR 1991 SC 70)*
12. *Ramsay Ltd v Inland Revenue Commissioner (1992) AC 300*

ACRONYMS AND ABBREVIATIONS

MJEC	-	Maastricht Journal of European and Comparative Law
MLR	-	Morden Law Review
TCGA	-	Taxation of Chargeable Gains Act
LQR	-	Law Quarterly Review
JLS	-	Journal of Legal Studies
AJCL	-	American Journal of Comparative Law
NBER	-	National Bureau of Economic Research
TLR	-	Texas Law Review
AJJ	-	American Journal of Jurisprudence
JTIA	-	Journal of Taxation Institute of Australia
PSLR	-	Penn State Law Review
NLSIUJ	-	National Law School of India University Journal
JGM	-	Journal of General Management
KLR	-	Kenya Law Review
ACTS	-	African Centre for Technology Studies
UFLCLR	-	University of Florida Levin College of Law Review
HLR	-	Harvard Law Review
M &A	-	Mergers and Acquisitions
IJMBS	-	International Journal of Management and Business Studies
JPID	-	Journal of Poverty, Investment and Development
Commissioner	-	Commissioner of Kenya Revenue Authority

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ABSTRACT

In recent times, mergers and acquisitions have become a prevalent research area, not only for academia, but equally for tax practitioners as well. With proliferation of mergers and acquisitions domestically and internationally, the common denominator that is central to the success of the transaction is the tax dimension. Taxation has become an important due diligence factor in the completion of mergers and acquisitions. Greater deal of attention has been paid on tax aspects of mergers and acquisitions. Understandably so, countries have devoted substantial effort in their tax codes to ensure certainty and efficiency in taxation of M&A transactions.

In light of the above, this study is premised on the assessing the efficacy of Kenya's Income Tax Act in dealing with ensuing issues in mergers and acquisitions. It critically examines this subject in both the domestic and cross border context of mergers and acquisitions.

CHAPTER ONE: AN INTRODUCTION TO THE STUDY

1.0. Background

Corporate growth through mergers and acquisitions is one of the core components of success of many entities operating in any economy. Mergers and acquisitions have necessitated many organizations worldwide to expand faster and effectively to novel opportunities.¹ As a result, they have enabled the organizations to maintain and re-establish their competitive advantage. Across the globe, during the late 20th Century and beginning of 21st century, corporate reorganizations through mergers and acquisitions are the driving force of new financial and economic environment.² In ever increasing and competitive global market, both domestic and cross border M&As offer opportunity for entities that would want to survive and expand its market share. The success of the M&As transactions is therefore of great significance to companies. In cross border context, mergers and acquisitions occupy a significant place in globalization process. It enables firms to geographically expand and acquire competitive advantage in a fast and effective way.

Considering competition in the world market and pressure from corporate sphere, Kenya companies consider mergers and acquisitions as critical vehicles for growth and business strategy. Kenya is reported to be 4th overall in Africa after South Africa, Nigeria and Ghana as the most sought after country for foreign investors for mergers with local firms.³ As a regional leader in the East Africa M&As market, Kenya is the preferred point for companies wishing to expand further in the region. This is due to among others its strategic geographical

¹ Kuwar Kaur, 'Impact of Takeovers: A Step Ahead or Behind?' (PHD Thesis, Guru Nanak Development University 2005) 1

² Kumar DSN, 'Strategic Acquisition Through Value Based Management: A Case Analysis' (2007) 24(4) Abhigyan 42,42

³ Available at <http://mman.co.ke/2015/05/25/6-quick-points-on-mergers-in-kenya/> accessed on 10th November,2017

location, well established private sector, robust human capital and developed infrastructure.⁴ Most of the mergers and acquisition deals, as the evidence suggests, are predominantly in the financial services sector involving large corporations. For example, there were three deals in the year 2010, 18 in the year 2013 and seven in the year 2014 involving the insurance sector only.⁵

Mergers and acquisitions are therefore becoming a more strategic tool in Kenya. They enable companies in the allocation of resources in the society by generating synergies through combination of complimentary resources⁶. On this perspective, there has been a thorough examination and review of Kenya's existing regulatory framework on mergers and acquisitions with due consideration paid to the breadth and depth of the existing laws.⁷

With the increased focus on M&As, one potential area that can no longer be ignored is its taxation aspects. Tax has become an essential component in processes involving M/As transactions. This is because tax is an important business cost, especially when competing with other domestic and global market players. Imperatively, during the analysis of any development of market and society, the significance of tax law cannot be underestimated. Substantial literature confirms that tax affect decisions on where to invest.⁸ Imperatively, tax perspective of M&As is one of the critical factors for any business restructuring process.

Whereas taxes may not drive mergers and acquisition deal, the structure of the deal nevertheless almost invariably has one or more significant tax impacts.⁹ While framing any schemes of mergers and acquisitions, an entity must fulfill operating regulatory laws but must

⁴ Sheel G, 'Mergers and Acquisitions in Kenya' (KPMG, 2015) available at < <file://kra-upm-01/KRA-Fdr/k00010387/Documents/Downloads/mergers-and-acquisitions.pdf> > Accessed on 30th September 2017

⁵ *ibid*

⁶ Alan J, David R, 'The Impact of Taxation on Mergers and Acquisitions' in Alan J (eds), *Mergers and Acquisitions* (University of Chicago Press 1987) 69

⁷ See the Companies Act, 2015 and Competition Act, 2012 which provides for the regulation of Mergers and Acquisitions.

⁸ Rosanne A, Harry G and Scott N, 'Has U.S. Investment Abroad Become More Sensitive to Tax Rates?' (1998) NBER Working Paper 6383/1998 < <http://www.nber.org/papers/w6383> > accessed on 20th January 2018

⁹ Available at <http://www.woodllp.com/Publications/Articles/pdf/PLI.pdf> accessed on 20 November 2017

equally look after taxation aspects. Tax issues largely contribute to the successful completion of transactions on mergers and acquisitions irrespective of whether the transactions are cross-border or an internal reorganization.¹⁰ Early involvement and development of a tax efficient structure is therefore imperative as this maximizes the return on deal. Having a proper taxation regime is important as it serves two purposes. First, it ensures that mergers and acquisition processes are subjected to proper confines of tax statute. Second, a proper tax framework acts as engineering tool that supports and facilitates commercial practices. The central role tax plays in M&As transactions therefore, is the heart of arguments and analysis of this study.

Given the historical perspective of the concept of M&As, many countries, in their fiscal statutes, right from the beginning, provide special rules in order to minimize ambiguities in ascertaining tax treatment of the M/A transactions.¹¹ Income tax, as widely acknowledged, is important amongst all tax laws which affect amalgamation of companies from the perspective of tax savings and corresponding treatment in the books of account.¹² As such it is important to look at the Kenya's Income Tax Act from the beginning to ascertain its sufficiency in dealing with M&A ensuing issues.

This study therefore outlines the taxation regime of mergers and acquisitions in Kenya within the context of the Income Tax Act. More importantly, an inquiry of the whole literature is made in an attempt to determine the sufficiency of the Act in dealing with consequential issues in both domestic and cross-border M&As.

¹⁰ Ernst and Young, *Master Guide to Mergers and Acquisitions in India -Tax and Regulatory* (3rd edn, Wolters Kluwer 2014) vii

¹¹ See for example India's Income Tax Act, as illustrated in the contribution of Ramanjam S, *Mergers et al: Issues, Implications and Case Law in Corporate Restructuring* (3rd edn, LexisNexis Butterworth Wadhwa Nagpur 2012)914-915.

¹² Arneet Kaur, 'Mergers and Acquisitions in the Indian Corporate World: Legal Trends in the Emerging Scenario' (PHD thesis, University of Guru Nanak Dev.2014) 340

1.1. Statement of the Problem

Over the last decade, the role and place of M&As in corporate development and growth has received increased attention. Special emphasis has been placed in tax statutes of most developed and developing countries in this area of commercial law.¹³ They have designed reorganization provisions in the form of M&As in their tax codes. The purpose of these provisions is to guide the taxation framework of M&As which balances the efficiency perspectives of the transactions on the one hand and minimizes the risk of tax avoidance on the other hand. This is on the backdrop of realization that increased number of M&As could be as a result of tax advantages within the income tax rules which either defeats the purpose of efficiency gains in the transactions or results in tax avoidance schemes. Indeed, several studies points towards this end.¹⁴ In the context of Kenya's Income Tax Act, not much has been achieved in this regard since it was enacted in 1974. Piecemeal provisions introduced across the years have failed to address the substantive aspects of M&As¹⁵ especially in dealing with various tax advantages arising from the M&As transactions. The fragmented and inadequate provisions have led to a shortfall in the law as the same do not holistically address the taxation aspects of these commercial trends.¹⁶ A number of practitioners have also cautioned about lack of transparency of M&As transactions in Kenya, specifically from tax perspective.¹⁷ This is illustrative of the fact that there are indeed practical challenges on tax implications of M&As in Kenya.

¹³ For example, the US, India and UK Tax Codes puts much emphasis in this area in their reorganization rules

¹⁴ See for example studies by Francis A, 'Factors Motivating Mergers and Acquisitions in Kenya' (2015)10, JPID 60 and Joseph et al, 'Role of Mergers and Acquisitions on the Performance of Commercial Banks in Kenya (2012)2(4) IJMBS 7

¹⁵ For example, 8th Schedule, Paragraph 13 of the Income Tax Act, introduced exemption from Capital Gains Tax on mergers transactions undertaken through public interest.

¹⁶ As illustrated in chapter three and four of this study, there are a number of fragmented provisions under the Income Tax act which has a bearing on taxation of mergers and acquisitions. In domestic M&As context, they include section 15 and 16, section 3(2)(f) read together with 8th Schedule of the Act, section 27 of the Act etc. in cross border context, they include section 23, section 41, section 18(3) of the Act etc.

¹⁷ Sheel G(n4)

It is clear that there has never been a discernable effort to objectively look at the scope of the Income Tax Act with a view to providing rules on corporate reorganization processes in the form of M&As. Indeed, while designing the Act, it is apparent that the drafters neglected and more often forgotten provisions for the M&As. The tax implications of M&As thus continue to be brought out only by applications of private rulings.

In addition, even with the growing literature and focus on mergers and acquisition in Kenya, there is hardly any analytical work done to evaluate the essence of Income Tax Rules on M&As despite the apparent significance of this area in the corporate arena. Research to date tends to focus on M&As under other areas of law especially its regulatory framework with income tax law relegated to 'other sector laws.' Indeed, economic, business and corporate law literature in Kenya is majorly concerned with different aspects of M&As transactions other than tax rules. The position of this study is that even where corporate reorganization in the form of M&As may not take place quite often; it makes sense to have a clear set of tax rules to deal with various tax attributes in M&As to ensure certainty and neutrality in their treatment. Therefore, the argument is that there should be some legal provisions in the Income Tax Act to govern M&A transactions. Comparative studies including provisions in the UK, US, India and Nigeria income tax codes points towards this end.

In the context of cross border mergers and acquisitions, the problem that this study seeks to interrogate is how to address the concerns of potential tax flight as a result of 'movement' of entities across the jurisdictions. It is contended that cross border M&As typically involve transfer, creation or cessation of tax jurisdiction from one country to another. The international tax aspects come into play and how Kenya reacts to the new reality of losing tax jurisdiction where an entity merges or is acquired by another in a separate country is indeed the point of inquiry in this study. Whereas there are a number of instruments like double tax

agreements and general avoidance provisions that seeks to address this concern, the scope of these measures, as illustrated in chapter four, are inadequate.

Therefore, the above arguments from the basis and motivation of this study with an ambition to analyze and inquire into the tax issues ensuing from both domestic and cross border M&As with specific focus on examination of the sufficiency of the Kenya's Income Tax Act. The objective is to suggest reforms that ensure proper taxation of the M&As regime.

1.2. Justification of the Study

In spite of the continuing uncertainty and underlying concerns about economic fortunes of many developed and developing countries, M&As have remained a central agenda for many companies. The focus on tax aspects have also increased as it becomes more significant to deal processes and valuations than ever before.¹⁸

This study is based upon the need to contribute to knowledge and spur reforms on the taxation of mergers and acquisition within the context of Kenya's Income Tax law. The canons of a better tax system are its efficiency, equity and simplicity. Accordingly, it is proper to have a tax system that achieves these objectives. In recent years, there has been a keen interest of mergers and acquisitions as a model of economic growth. Due to this, it is important to have a better understanding of income taxation aspects of M&As.

It is contended that tax is a key driver to any commercial success and performance in terms of ease of doing business. Understanding the rules of commerce in this growing field is desirable in order to design a better tax system through policy and reforms. A study in this area is necessary at this time and in the prevailing commercial environment.

The significance of this study therefore is twofold. First, it presents brief, powerful and popular approach to taxation of mergers and acquisition. It is therefore an improvement on

¹⁸ Ameet Kaur(n12) 436

existing knowledge on taxation of mergers and acquisitions. Second, the study affords an opportunity to suggest reforms to the Income Tax Act in order to fill a loophole on mergers and acquisitions.

1.3. The Research

1.3.1. Research Methodology

The research methodology adopted in this study is of a qualitative nature based on a detailed interpretation and analysis of the literature. An extensive literature review and analysis of key secondary sources is undertaken that includes the following key sources: books; cases; electronic databases; relevant statutes, working papers, journals, thesis, publications etc.

There are various reasons supporting the choice of this approach. First, due to time and cost constraints relating to the use of primary source of information, thorough research of the range of secondary sources provide a cost effective way to collect data. Second, it gives a basis for evaluation of already documented research materials which allows for comparison over time.

1.3.2. Research Objectives

1.3.2.1 General Objective

To establish the sufficiency of Kenya's Income Tax Act on taxation of mergers and acquisitions so as to propose law reform measures towards designing a proper tax regime for mergers and acquisitions within the context of Income Tax Act.

1.3.2.2 Specific objectives

- i. To investigate the tax implications of mergers and acquisitions with a view to designing effective reform measures under the Income Tax Act.
- ii. To establish the taxation aspects of domestic and cross border M&As in Kenya with a view of assessing the sufficiency of the Income Tax Act.

- iii. To establish and propose requisite law reform measures in the Kenya's Income Tax Act necessary to model an effective and sustainable taxation of mergers and acquisitions.

1.3.3. Research Questions

This study sought to answer the following research questions:

- i. What are the various tax dimensions of mergers and acquisitions in Kenya?
- ii. Is the Income Tax Act sufficient on the taxation of domestic and cross- border mergers and acquisitions?
- iii. What lessons can be drawn to reform the income tax law on taxation of mergers and acquisitions?

1.3.4. Hypotheses

- i. Various tax dimensions on mergers and acquisitions determine the reforms to the Kenya's Income Tax Act.
- ii. Kenya's Income Tax Act is not sufficient on taxation of both domestic and cross-border M&As.
- iii. There are important lessons that can be drawn to ensure that Income Tax Act is sufficient on the taxation of mergers and acquisitions.

1.4. Theoretical Framework

This study adopts multidisciplinary theoretical approaches that draw from a variety of schools of thought. It is thus not limited to the analysis of legal rules. Its scope includes the contributions of both legal and non-legal theorist and practitioners.

The study is in search for effective approach on dealing with taxation dimensions of mergers and acquisitions. It is therefore pro-reform to ensure that taxation laws adopt the best approach on mergers and acquisitions. No single theory adequately addresses the concerns of this study. A number of theories have been advanced before, and on their own, they have proved inadequate. As a result, it appears that the search for effective theory is truly still

ongoing. Nevertheless, in order to underscore the importance of having a proper taxation framework on mergers and acquisition within scope of the Income Tax Act, this study adopts several theories as outlined below:

1.4.1. The theory of legal anthropology

This theory explores uses direct observation to explore the origin, function of law and legal action within societal set up.¹⁹ Proponents of this theory believe that society's way of life can better be understood through observation. This is because a society has its own rules to guide its social order.²⁰ Llewellyn and Hoebel support this position in their book, *Cheyenne way*.²¹ They found out that legal rules are those that satisfy the authority among the people and satisfy the demands of members of the society.²² They conclude that these rules are effective in the ordering of the society because they have 'legality' as opposed to 'legalism' which is marked by 'unsatisfactory results'.²³ They posit that in order to have effective law in a particular society, the focus is to discover norms and rules that are properly felt for controlling behaviour.²⁴ There is also need to discover practice or 'what really happens' in a given societal scenario.²⁵

When linked and considered in the context of the problem under investigation in this study, this theory is relevant in many ways. It advocates for law reformers to focus on the social order of the society and determine rules that work for the society. It occupies a central place in the process of legal reform. As such, the sufficiency of tax laws on mergers and acquisitions should be considered in light of how the transaction is structured. The tax rules should appreciate the realities of transactional nature of mergers and acquisitions. Ultimately, the aim is to design special rules that are in reality with the nature of merger and acquisition

¹⁹ Malinowski B, *Crime and Custom in Savage Society* (Routledge & Kegan, Paul London 1926)

²⁰ Ibid,126

²¹ Llewellyn K and Hoebel A, *The Cheyenne Way*, (Norman: The University of Oklahoma Press 1941) 284-288.

²² ibid

²³ Llewellyn K and Hoebel A (n20)288

²⁴ ibid

²⁵ ibid

transactions. The gaps under the Income Tax Act can easily be identified and reformed by observing the structure and model of the mergers and acquisitions transactions. It enables the tax rules to appreciate mergers and acquisitions by creating special rules to guide transactions.

Despite the relevance of the theory, its limitations can be pointed out. Its critics argue that its approach to legal reform is narrow in light of the realities of globalization as a result of growing technology.²⁶ Mc Dougal supports this position by stating that in the contemporary world, there is increasing demand for common values that transcends the limits of the nation-states. The need for interdependence necessitates widening of the demands of societal values beyond the boundaries of the nation- state.²⁷

1.4.2. The Theory of Law and Economics

This theory is predicated on the premise that people are rational maximizers of their satisfactions in making non market decisions. Therefore, the purpose of rules of law is to impose prices on or subsidize these non-market activities thereby altering the character of the activity.²⁸ Its proponents believe that in order to change human behaviour, a corresponding change of rules of law is necessary.²⁹ The proponents of this theory support their arguments by using the economic analysis of law approach. The approach has both positive and normative aspects.³⁰ The positive aspect is based on the efficiency principle and states that judges in fact treat efficiency enhancement as important purpose of law.³¹ From this perspective, economic analysis of law attempts to predict the natural consequences of legal

²⁶ Bonface KC, 'The Development of African Capital Markets: A Legal and Institutional Approach (PHD Thesis in law, Nottingham Trent University 2014) P 40

²⁷ McDougal MS, 'The Comparative Study of Law for Policy Purposes: Value Clarification as an Instrument of Democratic World Order' (1952) 1 AJL, 24

²⁸ Posner RA and Parisi F, 'Law & Economics: An Introduction' in Posner RA and Parisi F (Eds) *Law and Economics* (Elgar, 1997) 7.

²⁹ Bonface(n 26)41

³⁰ Mariusz G, 'Economics of Law as a Jurisprudential Theory' (2002) German Working Papers in Law and Economics Paper 3/2002, 3
<<http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.331.6721&rep=rep1&type=pdf>> accessed 19 November 2017

³¹ Posner R, 'The Economic Approach to Law', (1975) 53*TLR* 757,777

rules by explaining and developing the law according to economic principles.³² A valuable suggestion is that a behaviour is affected by legal rules and that economic efficiency concept determines the behavioural responses to the rules.³³ The normative aspect on the other hand, suggests that where a portion of legal system fails to promote efficiency, then such rules ought to be amended to ensure that the legal system is efficient.³⁴

Its main assumption is that the process of decision making should be consistent with the demands of the market.³⁵ Therefore, it demands the law to be analyzed from the economic efficiency perspective.³⁶ It aims to reflect the principle of economics to legal decision making process. This largely borrows from Chicago School which successfully implemented welfare economics with its theory of self-interest, price and efficiency³⁷.

As a tool of law reform, the focus of this theory is the efficiency approach. It requires law reformers to foremost define an efficient way of dealing with a set of a particular problem and then proceed to derive specific rules, legal structure or institutions that are deemed mostly likely to achieve the efficient outcomes.³⁸

There are, however, criticisms that have been brought out on this theory, mainly on its philosophical foundation. The main controversy has been whether it is a comprehensive theory that challenges the traditional approaches to law.³⁹ In addition, its reliance on rationality of economic actors is ill-conceived in so far as economic development reforms are

³² Von GK and Ronald KI, *Economic Analysis of Tax Law: Current and Past Research Investigated from a German Tax Perspective* (Martin Luther Universitat:Halle- Wittenberg 2003)

³³ *ibid*

³⁴ Mariusz Gi(n30)3

³⁵ Robert C and Thomas U, *Law and Economics* (6th Edition, Addison-Wesley 1997)41

³⁶ *ibid*

³⁷ Mariusz G (n 30) 3

³⁸ Landes WM and Posner RA, 'Tort Law as a Regulatory Reform for Catastrophic Personal Injuries' (1984) 13 JLS, 417

³⁹ Kornhauser L, 'The Economic Analysis of Law' in Edward Zalta (ed) *The Stanford Encyclopaedia of Philosophy* (Metaphysics Research Lab 2014)

concerned.⁴⁰Indeed, there is realization among law and economics theorists that the ‘rational actor’ model of human motivation is rather too crude.⁴¹

This theory is important for this study since its efficiency approach is the basis of formulation and implementation of the requisite taxation laws on mergers and acquisitions. In cross border context, the desire to provide a potential efficiency advantages by creating tax neutrality provides a great link between this theory and the problem statement under investigation in the study.

1.4.3. The Theory of Legal Transplant

Akin to comparative law, the concern of this theory is the transfer of significant attributes of law including its rules, systems, institutions, doctrines, ideas and methods from one country, organization or jurisdiction to another.⁴²Its proponents states donor systems of legal rules may be successfully borrowed even where there are fundamental difference of social, economic, geographical and political circumstances of the.⁴³The focus is to consider an idea in the foreign legal system which can be transformed and assimilated to form part of the law of the host country.⁴⁴ Kahn Freund seems to support this position. He argues that the degree to which a rule can be transplanted substantially depends on how it is closely linked with foreign power structure.⁴⁵ In this context, the use of comparative method requires an idea of both the social and political context of the foreign law.⁴⁶ He opines that comparative law for only becomes an abuse where its context is ignored and it is merely informed by the legalistic spirit.⁴⁷ The argument arising from the proponents of this theory is that law is a culturally

⁴⁰ Bonface(n 26)41

⁴¹ ibid

⁴² Allan W, *Legal Transplants: An Approach to Comparative Law* (Scottish Academic Press, Edinburgh1974) 21

⁴³ Watson A ‘Legal Transplants and Law Reform’, (1976) LQR 79,80.

⁴⁴ ibid

⁴⁵ Kahn-Freund O, ‘On Uses and Misuses of Comparative Law’ (1974) 37(1) MLR

⁴⁶ Ibid, 27

⁴⁷ ibid

determined artefact, and cannot be adopted by a formal transplant of rules.⁴⁸ Accordingly, any attempt to transplant a legal rule while leaving behind its particular culture merely amounts to a ‘meaningless form of words’.⁴⁹

Attempts have been made to find a middle ground on the extreme position of this theory. Du Plessis puts forward what he describes as Mixed Legal System Concept.⁵⁰ He describes it as an appreciation of the existence of the foreign rules in the domestic jurisdiction. The task of lawyers in recipient jurisdictions is to identify the foreign origin of their laws and appreciate the idea that law derived from foreign environment attains a new meaning in its new environment.⁵¹ He further argues that since culture is not genetic and can be learnt, both legal rules and culture can be transplanted. Accordingly, the experience of the mixed legal system is a powerful evidence for successful borrowing of laws according to functional synthesis.⁵²

This theory is relevant in this study since most of the experiences on the taxation of M&As are largely borrowed from other jurisdictions. Specifically, the use of this theory is justified on the perspective of the Du Plessis’ Concept of Mixed Legal System. From this perspective, the gaps in the Income Tax Act and the attendant reforms can best be borrowed from the experiences of other jurisdictions. Even where the culture in a particular jurisdiction is different, analysis of legal transplant in Du Plessis perspective enable the laws or rules to be borrowed.

1.4.4. Positivists Theory of Law

Some of the common proponents of this theory are Thomas Hobbes, H.L.A Hart, Jeremy Bentham, John Austin, Hans Kelsen, and Herbert Hart.

⁴⁸ Legrand P, ‘The Impossibility of “Legal Transplants”’ (1997) 4 MJECL 111

⁴⁹ *ibid*

⁵⁰ Plessis J, ‘Comparative Law and the Study of the Mixed Legal System’ in Reimann and Zimmermann (eds), *The Oxford Handbook of Comparative Law* (Oxford University Press, Oxford 2006) 478 - 510.

⁵¹ *Ibid*, 488

⁵² *Ibid*, 489

The theory emphasizes on the positive norms, i.e. norms enacted by law making organ, common law or case law.⁵³The overwhelming premise of the theory is that a given norm considered as valid and therefore forming part of the law is dependent on its sources not its merits.⁵⁴ Accordingly, the merits of the laws do not determine the existence of the law or its legal system. John Austin emphasizes this position in his literature. He states that the existence of a norm does not depend on how just, wise, efficient, or prudent it is. On the contrary, the fact that it is unjust, unwise, inefficient or imprudent is not a sufficient reason to doubt its existence.⁵⁵

The backdrop of the forgoing is that law is based on social facts not on moral claims.⁵⁶ It holds the view that the social facts are posited or assertions from authoritative figures in order to qualify as law. These authoritative figures could be the judges, legislature etc.⁵⁷

Within the positivists' legal theory, two separate categories have evolved. One is referred to as soft positivism (inclusionary positivism) and the other called to as hard positivism (or exclusionary positivism)⁵⁸

Inclusionary positivism is put forth by H.L.A Hart. He states that laws of a legal system may consist in, though not necessarily dependent, on morality in exercise and adjudication.⁵⁹ On the other hand, John Raz, a principled advocate of exclusionary positivism, argues for the interpretation of law on social grounds, excluding any moral claims on the law. Exclusionary positivism therefore denies any reliance of law upon morality.⁶⁰

The main criticism of this theory, at least within the scope of this study, is that it seeks to exclude law from all other factual disciplines within the domain of legal theory. The theory's

⁵³ Internet Encyclopedia of Philosophy available at <http://www.iep.utm.edu/legalpos/> accessed 25 November 2017

⁵⁴ John G, 'Legal Positivism: 5 ½ Myths' (2001) 46 AJJ 199 ,201

⁵⁵ John A, *The Province of Jurisprudence Determined* (Cambridge: Cambridge University Press,1995)

⁵⁶ Jonathan C, 'Legal Positivism: An Analysis' (PHD thesis, Utah State University 2011)1

⁵⁷ *ibid*

⁵⁸ Jonathan C (n 56)3

⁵⁹ Hart H.L.A, *The Concept of Law* (3rd edition, Clarendon Law Series 2012) 181 -82

⁶⁰ John G (n 54) 6

assertion on the dichotomy between law and morality is disturbing since law should be seen in context of other disciplines that shapes the acts of society. Law and economics which this study is premised, is one such area that can no longer be ignored.

The consistent theme of the study is that in order to bring clarity and certainty on the taxation of mergers and acquisitions, proper guiding laws need to be enacted in the Income Tax Act.

This position, based on positivists' theory, finds support in the case of *Ramsay Ltd v Inland Revenue Commissioner*⁶¹, where the court stated that 'a subject is only to be taxed on clear words not upon intendment, or upon the "equity" of an "Act". Any taxing Act of parliament has to be construed in accordance with this principle. What are "clear words" is to be ascertained upon normal principles; but do not confine the Courts to literal interpretation...'

The relevance of this theory is based on the hypotheses indicated in the context of the present study. Since there is a legal shortfall in the taxation regime of mergers and acquisitions under the Income Tax Act, the logical solution is to fill the hole through enactments that ensure clarity and certainty on the subject.

1.5. Literature review

A growing body of literature has investigated mergers and acquisitions processes. Significantly, a number has examined taxation regime of these processes. What is clear from the onset is that taxation laws on mergers and acquisitions are designed in a way that balances the need to encourage M&As on the one hand, and the need to minimize tax risks in the transactions. The objective of this study therefore is to review recent research into the income taxation regime on mergers and acquisitions. It focuses on the understanding of this subject within the perspective of Income Tax Act in Kenya and whether the tax laws are sufficient to deal with ensuing tax issues in M&As. However, there has been little discussion and research about this subject in the context of Kenya's income tax laws.

⁶¹ (1992) AC 300

Tax aspects in mergers and acquisitions are considered as part of larger dimension of taxation issues of corporate reorganization. Frans Vanistendael⁶² has written extensively on taxation of corporate reorganizations. He underscores the importance of having special provisions in commercial or civil law that that would guide mergers and acquisitions transactions, and about their tax implications. He states it is not economically efficient to tax corporate reorganizations, a policy view shared by most countries. The justification is that there is no sufficient change in economic position to merit taxation of reorganizations in the form of mergers since it is tantamount to legal restructuring of the same business unit.⁶³

Yariv Brauner studied tax treatment of significant volume of mergers and acquisitions in the United States' Internal Revenue Code. He undertakes analysis whether reorganizations in the form of M&A are efficient from IRC perspective. He comes to a rather neutral standpoint on this issue. On one end, efficiency justifications for reorganizations is premised on the fact that M&A transactions are generally wealth creating and socially desirable in and of themselves.⁶⁴ On the other hand, he is convinced by the fact that reorganizations provisions apply to and only benefit stock transactions. As such, the social value of these transactions disappears when the stock elements are isolated.⁶⁵

Studies have shown that whereas mergers and acquisitions deals are typically driven by strategic or commercial objectives rather than tax considerations, the latter play an important role for both vendors and purchasers when buying and selling shares or assets in mergers and acquisitions transactions.⁶⁶ The parties' various and often competing tax interests need to be managed and balanced if the deal is to proceed on satisfactory terms.⁶⁷ This view is supported

⁶² Frans V, 'Taxation of Corporate Reorganizations', in Victor T (edn), *Tax Law Design and Drafting* (Kluwer Law International 1998)2

⁶³ *ibid*

⁶⁴ *Ibid*, 25

⁶⁵ *ibid*

⁶⁶ Andrew R, 'Taxation Aspects of Mergers and Acquisitions' (2007) 41(9) JTIA 30,302

⁶⁷ *ibid*

by Arneet Kaur⁶⁸, who argues that the requirements under company law or any other regulatory framework are by and large procedural in nature. Therefore, as much as the fulfillment of these statutory requirements results in the merger or acquisitions being legally allowed to materialize, the long term success or failure of the transaction largely depend on how tax aspects are framed.⁶⁹

There are several reasons why tax components are of utmost significance in M&As transactions. One of the significant prepositions is the need to utilize tax attributes. Tax attributes are characteristics of a tax system which are attributable to a taxpayer and are carried forward to future periods.⁷⁰ They include tax value of assets, carry forward of losses and liabilities and tax credits. These are largely technical matters of domestic law and how they are dealt with in a tax code determines the sufficiency of the code to deal with consequential issues in mergers and acquisitions transactions. Yariv Brauner describes ways in which these tax attributes determine the materialization of M&A transaction. He confirms that corporations engage in M&A transactions in order to better utilize the benefits of these tax attributes. In addition, he adds that the potential tax benefits to shareholders in the form of tax deferral in certain transactions play a part to drive M&As transactions.⁷¹ Indeed, most countries pay much attention to the treatment of these tax attributes in M&As transactions.

In terms of taxation style to be adopted, Andrew Rider points out that income tax character of the assets being acquired and how the purchase price is allocated between these assets is an important aspect of the deal for both the purchaser and vendor in M&As transactions. He categorized these assets as revenue or capital assets.⁷² This illustrates that taxation regime of acquisitions transactions largely depend on the model adopted. Different jurisdictions

⁶⁸ Arneet Kaur(n12) 340

⁶⁹ ibid

⁷⁰ Peter H and David, *International Commercial Tax* (Cambridge University Press, New York 2010) 416

⁷¹ Brauner Y, 'A Good Old Habit or Just an Old One? Preferential Tax Treatment for Reorganizations (2004) *BYU L. Rev.* 1, available at <http://scholarship.law.ufl.edu/facultypub/8>

⁷² Andrew R (n 66) 303

subscribe special names to these structures depending on their reorganization rules. In United States for example, tax rules of the acquisitions reorganization is to the effect that it determines whether a transaction should be a taxable transaction or 'tax-free reorganization.'⁷³

Different tax rules apply to these models. This view is supported by Vinod George Joseph earlier writing on tax implications of reverse mergers in India.⁷⁴ He describes the model as a merger of a healthy unit into a sick unit.⁷⁵

Arneet Kaur examined extensively the taxation aspects of M&As under the Indian law. He underscores the different taxation treatment of mergers and acquisitions. He has also brought out the important role of the courts in checking tax evasion in schemes of amalgamation. He states that a court is unlikely to sanction mergers if the only objective for which it is undertaken is to derive a tax benefit or eliminate tax liability that would otherwise arise.⁷⁶ This is a significant point since the court should not be a roadblock for efficiency gains arising out of amalgamation processes.

Ronald M. Richler in his analysis of amalgamation and wind ups under the Canadian law draws attention to important tax considerations during amalgamation (mergers) process. He discusses the subject matter by focusing on the tax rules applicable to shareholders, other security holders and at corporate level.⁷⁷ He states that on amalgamation under the Canadian law, tax deferrals are usually available at both the shareholder and predecessor corporation levels. In addition he confirms that transfer taxes are not applicable.⁷⁸

⁷³ Michael S, 'Basic Tax Rules in Acquisition Transactions' (2012) 116(3) PSLR 879,881

⁷⁴ Vinod GJ, 'Tax Implications of Reverse Mergers'(1998) 10 NSLIJ 38, <https://www.nls.ac.in/students/SBR/issues/vol10/vol10.pdf> accessed on 25 November 2017

⁷⁵ ibid

⁷⁶ Arneet Kaur (n 12)373

⁷⁷ Ronald Richler, 'Amalgamation and Wind Ups' (2010) http://www.cba.org/cba/cle/PDF/Tax10_Richler_Ron_Paper.pdf accessed on 20 November 2017

⁷⁸ ibid

Marcela Zarova and Jana Skalova examined the tax aspects of cross border M/As transactions in Europe. They assert the importance of having a satisfactory tax regime on mergers that promotes tax neutrality and minimizes double taxation.⁷⁹

The important question is whether taxation models of M&As explained in this literature is indeed advantageous or efficient. This is because studies have shown that opportunities for tax avoidance in a tax law can be a driver of M&As. The growing literature on this issue considers tax motives in mergers and acquisitions. Professor Francis Ofunya Afande⁸⁰ has researched on the factors that motivate mergers and acquisitions among the listed firms on Nairobi Stock Exchange. He indicates that there are several factors motivating mergers and acquisitions in Kenya. Tax benefits form the core of these factors by stepping up the basis of the assets acquired or use of tax deductions or credits. Auerbach and Reyschus⁸¹ analyzed tax factors as a possible motivation for M&As. Their study focused on the influence of loss carry forwards and excess tax credits on the decision to acquire a specific firm. In their findings, there was no evidence for the relevance of the target firm's tax characteristics, but weak evidence for tax characteristics of the acquiring firm. Even though this study realized mixed results, it was indeed a great pointer that a given taxation regime can be a motivator for tax avoidance schemes in M&As transactions. Therefore, it is important to design a taxation framework that balances between the tax risks for mergers and acquisitions especially in cross border context and the need to ensure equity, fairness and efficiency of the tax system.

The literature review points to the desire to take advantage of tax rules during the M&As processes. The use of tax attributes in the M&As transactions necessitates the need for specific rules to provide guidance to the transactions. In light of this reality as pointed out in

⁷⁹ Marcela Z and Jana S 'Tax Aspects of Mergers in Process of Realization Cross-Border Mergers in Europe' (2014) 4(55) Socio-Economic Research Bulletin 137

⁸⁰ Francis A, 'Factors Motivating Mergers and Acquisitions in Kenya: Case of Firms Listed on the Nairobi Stock Exchange' (2015) 10Journal of Poverty, Investment and Development 60,61

⁸¹ Alan A and David R, 'The Impact of Taxation on Mergers and Acquisitions in Alan Auerbach(eds.), *Mergers and Acquisitions* (University of Chicago press 1987) 69-85

the literature, the essence of this study is to ensure that the Kenya's Income Tax Act is adequate to confront these emerging issues of M&As. In both domestic and cross border context, the specific rules on treatment of various tax attributes ensures that tax avoidance loopholes in the law are filled without affecting the efficiency gains of the M&As transactions.

1.6. Limitations of the Study

This study faced the challenge of a lack of or inadequate literature on taxation of mergers and acquisitions in Kenya. This is probably as a result of little interest in the area or due to lack of better understanding of the subject matter. To surmount this challenge, an analysis of literature in other jurisdiction is undertaken. It attempts to juxtapose this to Kenya's legal framework and circumstances.

1.7. Chapter Breakdown

Chapter one begins by outlining the background of mergers and acquisitions as emerging business processes and why it is important to bring out taxation aspects of it. Specifically, this chapter focuses on the theoretical framework and key research objectives that inform this study. The discussion on this chapter reflects upon the hypothesis of this study which is based on the premise that there are weak provisions in the Income Tax Act to address the ensuing issues of M&As.

Chapter two discusses the tax dimensions of M&As. It also brings out briefly how the concept of M&As is reflected in Kenya's legal and regulatory framework. The chapter then broadens the scope of inquiry by interrogating their tax implications. The purpose is to set the tone for interrogating the sufficiency of the Income Tax Act to deal with ensuing issues of M&As.

Chapter three provides a discussion on taxation of domestic M&As under the Kenya's Income Tax Act. A realistic appreciation of salient features of the Income Tax Act is brought

out, followed by a critique which aims to bring out the inherent shortcomings of the Act. It explores the sufficiency of the Income Tax Act. The purpose is to underscore the hypothesis of the study that the Act is inadequate to address consequential issues of M&As.

In chapter four, the study reviews the current framework on taxation of cross border M&As. The discussion is comparative in nature and is substantially based on increasing, but not yet satisfying body of literature. The chapter demonstrates the inadequacy of the current provisions of the Income Tax Act in resolving the challenges in cross border taxation of mergers and acquisitions. It does so by analyzing few attempts by countries to deal with dilemma in taxation of cross border M&A deals, primarily through the tax treaties. The most important comparative context used in this chapter is the European Merger Directive, a model for international coordination in dealing with taxation of cross border mergers and acquisitions.

Chapter five wraps up the study by bringing out modest observations and proposed recommendations for improvement of Income Tax Act in dealing with both domestic and cross border M&As, which is generally an increasing industry. In cross border context, the study concludes by exploring possible solutions to taxation dilemma facing the area. The focus, specifically, is to ensure tax coordination and cooperation across jurisdictions.

CHAPTER TWO: INCOME TAX DIMENSIONS IN MERGERS AND ACQUISITIONS

2.0. Introduction

The objective of this chapter is to conceptualize mergers and acquisitions and bring out the interface between mergers and acquisition and taxation. Specifically, the chapter deals with how mergers and acquisitions are reflected in the Kenyan legal regime. The emphasis is how the legal framework shapes the tax dimensions of mergers and acquisitions. The purpose is to set the background of tax aspects of mergers and acquisitions. The chapter therefore sets the tone for subsequent discussion and analysis on the sufficiency of the Income Tax Act to deal with ensuing issues of mergers and acquisitions transactions.

2.1. Tracing the History and Development of Mergers and Acquisitions

Mergers and acquisitions, which this study is based upon, can be traced as far as 21st Century. Whereas its development can be divided into five phases, the third phase is most relevant in the context of this study as it exhibited the increased need to use tax as an incentive for M&As transactions.

The first phase, which peaked around 1890s, was dominated by horizontal combinations, perhaps the largest monopolies of the present day.⁸² The wave is said to be a reflection of a period of industrial revolution as it tempted entrepreneurs' allure for high scale gains due to development of heavy industries.⁸³ This wave ended with increased regulation of competition law namely by passing both the Sherman Act and the Clayton Act. The second wave lasted from 1916 to 1929. There was increased merger of industries resulting in oligopolistic rather than monopolistic structures.⁸⁴ The need for industrial development after the First World War encouraged the rise of this phase. In addition, technological development, coupled by

⁸² Gaughan P, *Mergers, Acquisitions and Corporate Restructurings* (3rd Edition, John Wiley & Sons 2002) 23

⁸³ Ferhan A, Can T, 'Contemporary Look On the Historical Development of Mergers and Acquisitions' (2016) 4(2) *International Journal of Economics, Commerce and Management* 183-200, 193

⁸⁴ Hampton GF. 'Commentary: The Bill of Rights as a Limitation upon Antitrust' (1979) 48 *Antitrust Law Journal* 1417

government support boosted trade between companies. This period sadly ended following great economic depression of 1929, thereby resulting into the establishment of the Securities and Exchange Commission in 1930s.⁸⁵ The next wave was delayed until 1960s during which antitrust legislation continued to tighten and M&As were prevalent in smaller firms and more often was driven by tax rather than business considerations.⁸⁶ This was when empirical studies on tax aspects of mergers and acquisitions started to arise. There was a realization that tax aspects played a significant role in the realization of mergers and acquisitions. Asset acquisitions were dominant as they were not treated within the scope of Clayton Act until 1950s.⁸⁷ The third wave introduced big conglomerates which were keen to leverage on improved economic development and a more favorable tax and accounting treatment by using stock as a compensation method to target shareholders.⁸⁸ The fourth wave took place in 1980s, and contributed to market efficiency through hostile takeovers as a business strategy.⁸⁹ For the first time, there was evident international M&As activities necessitated by large economic expansion.⁹⁰ It was confined mainly in United States. The fifth wave occurred in 1990s, when firms sought to recover from 1990/91 economic recession.⁹¹ It is a result of the first four waves and is considered the most evolved stage of mergers. During this period, M&As activities were strategic with increased use of equity financing. It was also less hostile and had more international perspective outside the US as evidenced during the fourth wave. There were more efficient and synergy driven transactions.⁹² It is a reflection of a more

⁸⁵ Ferhan A and Can T (n 83) 194

⁸⁶ Gaughan P (n 82) 32

⁸⁷ Ferhan A and Can T (n 83) 194

⁸⁸ Brauner Y (n 71)21

⁸⁹ Gaughan P (n 82) 44

⁹⁰ Johanson J and Vahlne J, '*The Internationalization Process of the Firm: A Model of Knowledge Development and Increasing Foreign Market Commitments*' (1977) *Journal of International Business Studies* 23

⁹¹ Gaughan P (n 82)

⁹² *Ibid*, 51-54

globalized M&As activities especially with the development of a more unified market structure within European Union and the erosion of nationalistic barriers to trade.⁹³

2.2. Conceptualization of Mergers and Acquisitions

Mergers and acquisitions are continuum of definitions and are more often used as a business rather than a legal term. It is commonly understood by practitioners to involve ownership and deliberate transfer of a business.⁹⁴ It may be defined as the strategy and management of corporate finance with focus on consolidation and acquisition of different companies' assets by another company.⁹⁵ It may also involve different transactions including purchase and sale of undertakings, alliances, corporation, joint ventures, formation of companies, management buy out and buy in, change of legal forms and restructuring.⁹⁶

Conceptualization of mergers and acquisitions in broader sense could be misleading since they entail variety of transactions ranging from strategic alliance to pure mergers.⁹⁷ It is therefore important to focus on the narrower sense of M&As.

Merger is a term of imprecise definition. Some scholars argue that it is a transaction that involves entities of similar size combining, with one being absorbed.⁹⁸ It is also described as an amalgamation of two or more companies' undertakings or any part of it. In a merger transaction, the transferor ceases to exist by the operation of the law, and not on the basis of contractual agreement between parties or through liquidation.⁹⁹ In most cases, it results into

⁹³ Office for Official Publications of the European Union, 'EU Competition Law: Rules Applicable to Merger Control' (*Antitrust Law*, 1 April 2010) <<https://www.ftc.gov/tips-advice/competition-guidance/guide-antitrust-laws/antitrust-laws>> accessed 10, September, 2018

⁹⁴ John C, 'Mergers, Acquisitions and Restructuring: Types, Regulation and Patterns of Practice' (2006) The Harvard John M. Olin Discussion Paper Series 781/2014, 2 http://www.law.harvard.edu/programs/olin_center/

⁹⁵ Gordon H, 'Effects of Cross Border Mergers and Acquisitions on the Value of Firms Listed at the Nairobi Securities Exchange' (Master's Thesis, University of Nairobi 2011)

⁹⁶ Picot, G. *Handbook of international mergers and acquisitions: Preparation, Implementation and Integration* (1st edn, Palgrave Macmillan 2002)

⁹⁷ Nakamura H, 'Motives, Partner Selection and Productivity Effects of M&As: The Pattern of Japanese Mergers and Acquisition' (PHD Thesis, Stockholm School of Economics 2005)

⁹⁸ Lustig P, Morck R and Schawb B, *Managerial Finance in a Canadian Setting* (5th Edn Toronto, John Wiley & Sons 1994) 1

⁹⁹ Frans V (n 62) 4

the two companies' shareholders maintaining mutual ownership of the newly combined entity.¹⁰⁰

Acquisition, on the other hand entails the purchase of one company by another whereby neither the shareholders nor the directors of the purchased company retains any interest in the purchaser's company.¹⁰¹ It may not necessarily be by mutual agreement.¹⁰² The purchase of the shares and assets of the target's firm by acquirer's firm is by way of transfer and the acquirer gains control of those assets and operations.¹⁰³

It can be in the nature of asset or share acquisition whose motivation is to achieve a managerial influence.¹⁰⁴ In asset acquisition, one or more companies transfers its assets and liabilities to a preexisting or newly established company. The consideration for the transaction includes shares, securities, cash, and assets in kind, or transfers of liabilities.¹⁰⁵ The transferor company may continue to exist or undergo complete liquidation where upon it distributes its proceeds to its own shareholders.¹⁰⁶ To qualify as reorganization, there must be a significant economic, legal and structural change of the transferor. This requires a substantial transfer of all the transferor's assets.¹⁰⁷ On the contrary, where the transfer involves only smaller portion of the assets, the same is treated as a mere sale not a reorganization process.

Share acquisition occurs where there is transfer of shares a pre-existing company or a newly established one, with consideration of any kind, including shares, securities, cash, assets in

¹⁰⁰ Gordon H (n 95) 2

¹⁰¹ Poopola MA., 'Mergers & Acquisitions- Tax Implications' (unpublished paper delivered at annual CITN Tax Conference: May 2005)

¹⁰² Jagersma P (2005) 'Cross-border Acquisitions of European multinationals (2005) JGM 30 (3) 13-34

¹⁰³ Sudarsanam S, *Creating Value from Mergers and Acquisitions: The Challenges* (2nd Edn, Harlow: Prentice Hall 2010)

¹⁰⁴ European Central Bank, *Mergers and Acquisitions Involving the EU Banking Industry: Facts and Implications* (European Central Bank 2000)

¹⁰⁵ Frans V (n 62) 5

¹⁰⁶ *ibid*

¹⁰⁷ *ibid*

kind, or assumption of liabilities¹⁰⁸ just as asset acquisition, it is considered a reorganization only where the transferee acquires a substantial holding of the affairs of the acquired corporation.

2.3. Reflection of Mergers and Acquisitions under Kenya's legal Regime

The justification for analysis of other legal regimes in Kenya relating M&As is premised on one fundamental ground. Although priority in this study is to ensure that the existing tax law is sufficient to deal with M&As, it is important to think about rules in corporate law that would allow M&As particularly how the same correlate with taxation aspects. This is because prior to application and interpretation of any tax law in relation to a transaction, private law as well as other regulatory provisions has substantial bearing on the tax treatment and qualification of such transactions. Whereas the legal framework on mergers and acquisitions in Kenya largely deals with procedural and notification requirements of mergers and acquisitions, some of the provisions are therefore worth noting in the context of this study.

Under the Capital Markets (Takeovers & Mergers) Regulations, 2002¹⁰⁹ a merger entails an arrangement whereby the assets of two or more companies vests in or is controlled by another company.¹¹⁰ This is replicated in the Competition Act which defines a merger as any acquisition of shares, business or other assets, resulting in the change of control of the business or its assets.¹¹¹ As such it occurs where one or more undertakings acquire a direct or indirect control of the whole or part of a business of another.¹¹² Control is defined to include among others a situation where there is a direct or indirect beneficially ownership of more than half of the issued share capital of another entity.¹¹³ Control requirement is important in relation to reorganization provisions under the Income tax law. Unless a given threshold of

¹⁰⁸ *ibid*

¹⁰⁹ These Regulations were made under the Capital Markets Act, Chapter 485A Laws of Kenya

¹¹⁰ Capital Markets (Takeover and Mergers) Regulations, 2002

¹¹¹ Section 2 of the Competition Act, 2010

¹¹² Section 4(1) of the Competition Act, 2010

¹¹³ Section 41(3) of the Competition Act, 2010

control is achieved, it does not amount to reorganization in the form of mergers and acquisitions and this affects their tax treatment.

The Companies Act similarly defines a merger as a scheme where a company's undertakings, property and liabilities are transferred to either a new or existing company.¹¹⁴ The draft merger agreement should contain various particulars including the date from which the transactions of a transferor company vests to the transferee company.¹¹⁵ This provision is significant for tax purposes since it determines the point of tax liability on the transferor or transferee companies. The Act contemplates completion of merger transaction by two options i.e through absorption or formation of a new company.¹¹⁶ The tax treatment is different where the merger is actualized either through absorption or formation of a new company.¹¹⁷

There is no conceptual definition of what amounts to acquisitions under above stated laws. However, this is provided for in section 2 of the East African Community Competition Act, 2006. Accordingly, acquisition involves any direct or indirect control of the whole or part of one or more other undertakings, regardless whether the same is effected by merger, consolidation, take-over or purchase of securities or assets. Similarly, control is required for consummation of acquisition transaction. Reorganization provision under various income tax codes requires a given threshold of control before the transaction is characterized as an acquisition for tax purposes.

Other sector specific laws on M&As include the Banking Act and the Insurance Act. They do not define what mergers and acquisitions entail and substantially relate to notification requirements.

¹¹⁴ Section 933 of the Companies Act, No. 17 of 2015

¹¹⁵ Section 934(2) e of the Companies Act, No. 17 of 2015

¹¹⁶ Section 933(a) and 933(b) of the Companies Act, No. 17 of 2015

¹¹⁷ Frans V (n 62) 5

In the context of the Income Tax Act, there has never been any precise definition of a merger or a judicial jurisprudence of the same for tax purposes. However, the landmark ruling of the Supreme Court of India in the case of *Saraswati Industrial Syndicate v. CIT*¹¹⁸ defined its scope. The court in this case stated that amalgamation involves a combination of two or more existing undertakings into one undertaking. The shareholders of participating company become substantially the shareholders of the combined entity. Amalgamation may occur either by transfer of undertakings to either a new company or to an already existing company. The court reiterated that the amalgamating company loses its identity in a merger transaction. The Supreme Court in this case faulted the High Court and reiterated that after amalgamation of the two companies, the transferor company becomes non-existent. It stated that it is not sustainable in law for the High Court to hold that on amalgamation, corporate personality of the transferor company remains alive. The dictum of the court in above case is synonymous with the legal character of merger transaction. In designing tax implication of the transaction, it is important to consider a taxation regime consistent with the transaction model.

2.4. Tax implications of Mergers and Acquisitions

Depending on how the transaction is structured, tax is imposed at both the shareholder level and on corporate entity and its implications can be analyzed from both the transferor and transferee perspective.

2.4.1. Shareholder Level taxation

The shareholder of both transferor company may either be taxable or not depending on special rules present or the how the transaction is structured. Where they are deemed taxable, the shareholders are subjected to capital gains tax, which is determined by rules of taxation of capital gains in a particular country.

¹¹⁸ AIR (1991) SC 70.

From the perspective of transferor company, its shareholders receive various forms of consideration whenever there is a transfer of shares in M&As transactions. Depending on how the transaction is structured, the payments to the shareholders may either be taxable or non-taxable. Capital gains tax is imposed where the payments are deemed taxable.¹¹⁹ On the contrary, the shareholders may not be taxed at the point of transaction and the same is deferred. The shareholders then pay no tax until there is a further sale of their shares in the acquiring company.¹²⁰ The later scenario poses a tax avoidance challenge, since the shareholders are less likely to sell their shares in the acquiring company in order to be subjected to capital gains tax. To mitigate this problem, most tax jurisdictions classify this corporate combination as tax free reorganization and place certain conditions on the transaction. They may include limiting the consideration paid to the shareholders in the acquired company to shares only and ensuring that the tax attributes of the acquired company are taken over by the acquiring company.¹²¹ The objective is to restrict the use of cash as a consideration in the transaction. Further, it limits the capacity of the acquiring company to utilize tax attributes in the form of step-up of asset bases of the acquired company assets.¹²²

Reorganization transactions produce a tax benefit to the shareholders since they acquire a diversified portfolio in the acquired company without paying for capital gains or realize their shares.¹²³ However, this limits the tax benefits accruing from the corporate level.

Alternatively, there can be special rules in a tax statute on tax free reorganization. Most industrialized, developing and transitional economies have specific rules for tax free

¹¹⁹ Alan J, 'Mergers and Acquisitions' in Alan J and Davis R (eds), *The Impact of Taxation on Mergers and Acquisitions* (University of Chicago Press 1987) 71

¹²⁰ Ibid.

¹²¹ ibid

¹²² ibid

¹²³ Ibid, 72

reorganizations in their laws.¹²⁴ The purpose of the rules is to ensure that there are no tax advantage or disadvantage by neutralizing tax consequences of the reorganizations.¹²⁵ It therefore underscores the principle of tax neutrality in business reorganizations which has two aspects. The first stage ensures that there is no tax is levied at the point of the reorganization. At the second stage, which is after the reorganization, the tax elements initially available to transferor company and its shareholders before the reorganization process determine the taxable profits of the transferee company and its shareholders.¹²⁶ Whereas the detailed rules on tax free reorganization vary from one country to another, there are two basic conditions, being the requirement of continuity of business enterprise and continuity of shareholder interest.¹²⁷

2.4.2. Corporate Level Taxation

At transferee corporate level, the tax implications of mergers and acquisitions depend on various factors. These include the cost base of the transferred assets and treatment of key tax attributes like loss carryovers and transferor's tax benefits.¹²⁸ First, the cost base of transferred assets is determined in the hands of the transferee. The valuation is at the point of merger. This means that new valuation is assigned to the assets during merger transaction. The profits, depreciation, capital gains or capital losses on the assets are determined on the basis of the new valuation.¹²⁹ The old value of the assets is not considered. Unless there are special rules to the contrary, in asset transfer, tax law takes the position of discontinuity and considers merger as a sale of assets for tax purposes, resulting in their revaluation.¹³⁰

¹²⁴ Hugh J, Brian J, *Comparative Income Taxation. A Structural Analysis* (3rd Edition, Kluwer Law International 2010)

¹²⁵ Frans V (n 62) 13

¹²⁶ *ibid*

¹²⁷ *Ibid*, 14

¹²⁸ Frans V (n 62)10

¹²⁹ *Ibid*, 9

¹³⁰ *ibid*

With respect to taxable reorganizations like a merger where the transferor company disappears, any tax credits, exemptions and other benefits expire with the transferor and are automatically canceled.¹³¹ This is the similar treatment in cases of tax losses carryovers. To avoid a situation in which profitable companies merges or acquires companies with losses in their books of accounts in order to utilize the loss carryovers, tax systems usually limit the carryover of tax losses from one company to another during reorganization process.¹³² In this scenario, the transferor can only offset the loss against the gain realized in the transfer.¹³³ However, the case may be different where there is tax free reorganization. Tax free reorganization is subject to two conditions, namely the continuity of shareholders' interest and the business enterprise. When this happens, the acquired corporate taxation is deferred.¹³⁴ To the acquiring firm, there are advantages relating to this mode of transaction. It benefits from tax attributes relating to carried forward unused tax credits or tax losses. Further, it will be entitled to future 'built in' tax losses that the acquired incurs.¹³⁵ The losses may result where the assets of an entity have a high basis and projected depreciation allowance but insignificant economic value.¹³⁶ In most jurisdictions, this tax benefit is limited by statute. For example, the United States Internal Revenue Code applies the principle of substance over form and requires the acquisition to have an economic substance.¹³⁷

Secondly, the acquired may first be liquidated and then later absorbed in the form of its component assets. In this case, the acquiring firm is allowed to enjoy the tax attribute in the

¹³¹ Ibid, 10

¹³² Ibid

¹³³ ibid

¹³⁴ Alan J. (n 119)) 72

¹³⁵ ibid

¹³⁶ ibid

¹³⁷ ibid

form of step up basis of the assets. This makes the depreciable and depletable assets receiving higher allowances than would otherwise been permitted.¹³⁸

2.4.3. Tax implications in cases of acquisitions

Acquisitions can either be in the form of share or business acquisition. The tax implications affect both the transferor and the transferee.

When share or business is transferred, any gain results in capital gains tax. The computation of the capital gain depends on whether the transaction was a slump or itemized sale.¹³⁹ In slump sale, a business is sold as a going concern without attaching specific value to the individual assets and liabilities.¹⁴⁰ The calculation of the capital gain is based on the excess of the full value of the sales consideration compared to the cost of acquisition of the undertaking¹⁴¹. On the other hand, itemized sale can be of two types. First, it entails where the entire business undertaking is transferred as a going concern with a fixed consideration which allocates each asset and liability separately. Secondly, it may also involve a scenario whereby the individual assets and liabilities are cherry picked and transferred at a price fixed at a price fixed for each asset or liability separately.¹⁴² Similar to slump sale, any gain from itemized sale that arise due to transfer of the assets is subjected to capital gains tax.

2.5. Conclusion

Tax is a significant factor in the success of M&As. Correspondingly, the desire of tax law is to ensure that loopholes for tax avoidance in M&As transactions are minimized without compromising the efficiency advantages. How tax laws respond to this reality is a key determinant in assessing its sufficiency. This chapter provides a solid background for the

¹³⁸ *ibid*

¹³⁹ Ernst and Young, *Master Guide to Mergers and Acquisitions in India (Tax and Regulatory)* (Wolters Kluwer 2012) 268

¹⁴⁰ Ameet Kaur(n12) 416

¹⁴¹ *ibid*

¹⁴² Ernest & Young (n 139) 291

subsequent discussion that addresses the sufficiency of the Income Tax Act to deal with tax issues ensuing from M&As.

CHAPTER THREE: TAXATION OF DOMESTIC MERGERS AND ACQUISITIONS: SUFFICIENCY OF THE INCOME TAX ACT

3.0. Introduction

The purpose of this chapter is to consider a number of consequential tax issues in mergers and acquisitions. This is discussed in view of the relevant provisions of the Income Tax Act with the key objective of reflecting on the sufficiency of the Act.

3.1. Brief Background to Income Tax Act

Since this study is based on the provisions of the Income Tax Act, it is important to briefly bring out the journey it has come through across the years. The purpose is to underscore the desire to reform the Act and demonstrate the fact that only in limited circumstances have there been attempts to provide for reorganization provisions in the form of mergers and acquisitions. The history of the Act can be traced back before 1897, when Kenya was made up of multifarious tribal based societies with its own sociological and geographical background.¹⁴³ During this period, the principles and systems of taxation were informal.¹⁴⁴

Upon the annexation of Kenya's territory by the British on the 12th August 1897, a more formal approach to taxation appeared. There was introduction of Hut Tax which was in the form of regulations and Poll Tax which was premised on Poll Tax Ordinance.¹⁴⁵ These taxes lacked common taxation principles since their main objective was to colonize Kenyans. Attiya Warris argues that the Poll and Hut Taxes were crude and were used as a channel for property ratings in the rural areas.¹⁴⁶ The period between 1922 and 1924 marked increased activism and agitation to provide for humane way of taxation. This however resulted in

¹⁴³ Attiya W, 'Taxation Without Principles: A Historical Analysis of the Kenyan Taxation System' (2007)1 *KLR* 272

¹⁴⁴ *ibid*

¹⁴⁵ *ibid*

¹⁴⁶ Attiya W (n 143)

mixed results. On the one hand, a graduated personal tax was created in 1933.¹⁴⁷ On the other hand, Moyne Report¹⁴⁸ was unveiled in 1932 to address the concerns on the Poll and Hut taxes in order to abolish the payment of extra tax on extra hut.

Further forward to 1936, another Commission was formed to study the Kenya's taxation regime.¹⁴⁹ The Commission, which was chaired by A.H Webb, recommended a raft of measures including raising of taxable age and reduction of payment because of extra huts,¹⁵⁰ abolishment of the non-native graduated Poll Tax and education taxes¹⁵¹ and modification of the traders and professional licenses. In 1937, a Devonshire White Paper was introduced through the Income Tax Ordinance 1937.¹⁵² The tax base on the Ordinance was on the business profits, salaries and wages, as well as rent and income from agricultural produce or livestock.

In 1948, the three governors of the East African countries formed the East Africa Income Tax Department.¹⁵³ The Department was later disbanded to allow each country manage its own income tax. Kenya came up with its own income tax department and enacted Income Tax Act (Cap 470) Laws of Kenya in 1974.¹⁵⁴ The scope of the Act is to charge, assess, ascertain and collect income tax. It also provides for both administrative and general matters relating to the Act.¹⁵⁵ It is evident that even during these early stages before and after enactment of the Income Tax Act, there were hardly any conviction to provide for taxation of reorganization

¹⁴⁷ Augustine Mutemi, 'History of Income Tax Law in Kenya' (2015) Available at <https://uonbi.academia.edu/MutemiMutemi> accessed on 1st October 2018

¹⁴⁸ Lord Moyne, *Report of The Financial Commissioner on Certain Questions in Kenya*, (Cmd 4093, 1932)

¹⁴⁹ Webb AH, *Report of the Commission Appointed to Enquire into and Report upon Allegations of Abuse and Hardships in the Collection of Graduated Poll Tax and of Native Hut and Poll Tax* (Chapter XP 247-251 APP.408, 1936) 15

¹⁵⁰ *ibid*

¹⁵¹ *ibid*

¹⁵² Andrew R, *History of Africa: 1905-1940* (Cambridge University Press 1976) 193

¹⁵³ McNeil and Bechgaard, *East African Income Tax* (Durban, Butterworths and Co. (Africa) Ltd 1960) 1-8

¹⁵⁴ *ibid*

¹⁵⁵ The Preamble of the Income Tax Act, (Cap 470) Laws of Kenya.

provisions in form of mergers and acquisitions. Perhaps one may argue that these were nascent periods in the history and development of mergers and acquisition. However, the stubborn literature indicates it was during these period when there was a realization that M&As transactions took advantage of income tax rules.¹⁵⁶

Since the promulgation of the Income Tax Act, it has undergone piece meal amendments, introduced through Finance Acts. However, less effort has been placed to reform the Act so as to conform to emerging business models, like mergers and acquisitions. Perhaps, the most significant revision ever made exemption of capital gains tax on transactions involving corporate restructuring and mergers where the same is undertaken on public interest¹⁵⁷. Recently, there are also attempts to overhaul the Act with the introduction of Income Tax Bill, 2018. It is however debatable whether the width and breath of the Bill adequately address the substantive aspects of mergers and acquisitions.

3.2. The Sufficiency of the Income Tax Act

The tax point for various sources of income and related transactions is based on accrual basis.¹⁵⁸ This is the realization based approach to income tax. In the context of M&As, realization is achieved upon exchange of consideration, usually in the form of cash, asset or stock. This automatically triggers capital gains/losses which is a taxable source of income.

This approach however is not generally applicable in many countries, which adopts different perspectives. Some provide for deferral of taxation until subsequent disposition of the exchanged property.¹⁵⁹ Example is U.S.A which has special rules on taxation of corporate reorganizations. Other countries impose capital gains tax and do not have any special rules on

¹⁵⁶ Ferhan A and Can T (n 83) 194

¹⁵⁷ 8th Schedule, Paragraph 13 of the Income Tax Act (Cap 470) Laws of Kenya

¹⁵⁸ Section 3 of the Income Tax Act (Cap 470) Laws of Kenya

¹⁵⁹ Hugh J, and Brian J, *Comparative Income Taxation: A Structural Analysis* (3rd Edn, Wolvers Kluwer 1997)194-201

the transactions. Such transactions are generally treated as other exchanges.¹⁶⁰ Further, other countries neither impose capital gains tax nor have any special rules for M&As.¹⁶¹ There are also other jurisdictions that tax capital gains in general, but exempt from taxation in certain situations, such as capital gains arising from trade in listed stock.

Since Kenya's Income Tax Act does not have any special rules on mergers and acquisitions, it may be argued that it treats such transactions as accruing capital gains tax upon transfer or exchange, subject to certain exemptions. Whether this is the best approach or is sufficient enough to deal with M&As related transactions is the matter of interest and discussion in this chapter.

3.2.1. Adequacy of Procedural Aspects

Prior to completion of M&As transactions, various procedural requirements need to be addressed to ensure that the transaction is compliant in every respect. Key among them includes consents and approvals from various statutory bodies. Tax is an important component in M&As transactions. The position of this study is that Kenya Revenue Authority is an important body in M&As transactions and therefore its direction or ruling should be a specific requirement under the Income Tax Act prior to completion of any form of M&As.

While section 65 of the Tax Procedure Act provides that a person may request for a private ruling, it is not a specific obligation designed for M&As transactions. A requirement for Commissioner's approval needs to be provided before any merger, takeover, transfer or restructuring of a trade or business takes place. This enables the Commissioner to issue appropriate guidelines on all ensuing tax issues related to M&As transactions. All clearances relating to any tax due and payable from the transaction should be obtained. For purposes of

¹⁶⁰ Brauner Y (n 71)

¹⁶¹ Frans V (n 62)

issuing guidelines on the intended M&As transactions, an application to the Commissioner should be accompanied with various documents. These include merger plans, audited accounts for companies involved, income tax computations based on these accounts or any other necessary documentation to enable the Commissioner issue the appropriate guidance. Approval from the Commissioner is an important requirement, despite the transactional, administrative and compliance costs involved. It acts as a control mechanism against tax avoidance schemes.

The second issue relates to the determination of the accounting year end dates. A uniform end year dates is necessary for the merged entity where merging companies have varying accounting year dates. The normal rules under the Income Tax Act¹⁶² allow companies to elect, subject to certain conditions; the accounting rules to enable them make their accounts. The section appears to confer the right of election only to the taxpayer, not the Commissioner. As such the Commissioner cannot impose a different date from that proposed by the taxpayer or reject the taxpayer's adopted accounting date. The completion of M&As transactions is dependent on an appointed date. The date is specifically important as it determines the point of tax liability for the merging parties. This is because it forms the basis of assessing the tax liabilities of the transferor company and when the assets vests in the transferee company.¹⁶³ The date also determines the exchange ratio of assets and liabilities of both companies.¹⁶⁴

Analysis of the Act illustrates that no adequate provisions are made regarding procedural requirements for M&As. Indeed, the absence necessary approval from the Commissioner sidelines it in an M&As arrangements. This means that most companies' complete mergers without necessarily understanding the tax implications of their transactions. This leaves them

¹⁶² Section 27 of the Income Tax Act (Cap 470) Laws of Kenya

¹⁶³ Ameet Kaur(n12) 371

¹⁶⁴ *ibid*

exposed to possible tax compliance queries and additional assessments from the Commissioner.

3.2.2. Mergers and Acquisitions costs/expenses

Mergers and acquisitions ordinarily entail significant costs mainly in the form of professional fee. These include legal accounting, valuation, financial services, and those occasioned by the regulatory bodies.¹⁶⁵ It is necessary to determine whether these costs are allowable deductions for tax purposes. Allowable deductions are provided for under section 15 of the Income Tax Act. The basic test is whether the expenses are wholly and exclusively incurred in the production of the income. The section also provides for circumstances under which specific expenses are allowable. No deduction is allowed where it relates to a capital expenditure, or any loss, diminution or exhaustion of capital.¹⁶⁶

Therefore, only revenue expenditure is allowable as per the provisions of the Act and any expenditure of capital nature is not tax deductible. The scope of section 15 and 16 of the Act is akin to that provided for in the decision of the *Commissioner of Income Tax v Kencell Communications Limited (Now Airtel Kenya Limited) [2016] eKL*.¹⁶⁷ In this case, it was clarified that a capital expenditure is one which creates a new asset, strengthens an existing one or opens new fields of trading not ordinarily available to the taxpayer.

It was further stated that the court should the following considerations in making a determination in the matter:

- i. The manner of the expenditure: a one-time expenditure, as opposed to recurrent expenditures, would tend to suggest that the expenditure is capital in nature, although this factor is not conclusive; and

¹⁶⁵ Central Bank of Nigeria Technical Advisory Committee, 'Report of Sub-committee on Accounting and Tax Issues' (March 2005) 17

¹⁶⁶ Section 16 of the Income Tax Act (Cap 470) Laws of Kenya

¹⁶⁷ Income Tax Appeal No. 272 of 2015

ii. The consequence or result of the expenditure: if the expenditure strengthens or adds to the taxpayer's existing core business structure, it is more likely to be capital in nature. The emphasis of the court was that the term 'core business structure' refers to the permanent (but not necessarily perpetual) structure of the taxpayer's business which is utilized for the generation of profits. However, where the expenditure is for 'assets' which are themselves the stock-in-trade of the business (or which comprise the cost of earning that income itself), such expenditure is more likely to be revenue in nature.

The approach was also adopted in the Indian Tax Appellate Tribunal made in the case of *Vodaphone Essar (Gujarat) vs. The Department of Income Tax* where it was stated as follows:

"In *Bombay Steam Navigation's Co, 1953 Ltd's* case, it was held that the question whether a particular expenditure is revenue expenditure incurred for the purpose of business must be viewed in the larger context of business necessity or expediency. It was held that if the outgoing or expenditure is so related to the carrying on or the conduct of the business, that it may be regarded as an integral part of the profit earning process and not for acquisition of an asset or a right of a permanent character, the possession of which is a condition to the carrying on of the business, the expenditure may be regarded as revenue expenditure.'

Distinction therefore has to be made on whether the expenses relating to M&As transactions are of capital or revenue in nature. There are a number of interesting instances that needs to be carefully considered in this regard. For example, M&As sometimes involves considerable job losses occasioned by retrenchment as a result of the reorganization and restructuring process.¹⁶⁸ Its expenses normally include payment of gratuity and related compensation for

¹⁶⁸ Lustig P Morck R & Schawb B, *Managerial Finance in a Canadian Setting* (5th edn, John Wiley & Sons1994) 860

loss of office. Ordinarily, compensation arising from termination of employment services following a merger or acquisition is treated as revenue expenditure. This is premised on the ground that the same is made in the interest of business.¹⁶⁹ However, where discharge of employees is a precondition of the M&As transactions and is treated as a cost of the transaction, it is considered a capital expenditure and therefore not tax deductible. This was decided in the case of *Royal Insurance Company v Watson*¹⁷⁰ whereby discharge of the managing director was a precondition of the takeover process. A similar determination was made in the case of *James Snook & Co. Ltd v Blasdale*.¹⁷¹ In this case, parties signed an agreement for the sale of shares which required the acquirer to pay for the compensation for the loss of office of the other company's directors and auditor.

Another head of expenditure that needs careful analysis relates to legal expenses. It is no doubt that mergers and acquisitions transactions incur substantial deductions on legal expenses. The presence of legal expenses on its own is not a sufficient indicator to justify automatic deduction. The purpose of the expenditure has to be closely scrutinized. The common view is that where the expenses relate to business assets, they are treated as capital expenditure and are not tax deductible. On the contrary, they are deductible where the same are incurred in production of gross income. The position was reiterated in the case of *New Zealand Dairy Farm Mortgage Co. Ltd v C. Of T*¹⁷² where it was held that legal expenses incurred on the issue of debentures were of capital expenditure nature and not tax deductible. In the context of mergers and acquisitions, the Australian case of *Foley Bros. Pty. Ltd vs F.C of T*¹⁷³ concurred by affirming that legal expenses relating to reorganization of a company were to be treated as capital expenditure. The same treatment was reiterated in a case where

¹⁶⁹ See the case of *IRC v Patrick Thompson Ltd* where it was held that the amounts paid to the managing directors of certain companies which had been acquired were tax deductible as the payment was meant to relieve the new enterprise from onerous contracts.

¹⁷⁰ (1897) 3 T.C. 500

¹⁷¹ (1952) 33 T.C. 244

¹⁷² (1941) N.Z.L.R. 83

¹⁷³ (1965) 13 A.T.D. 562

there is a tussle between companies in M/A transactions. For example, in the Australian case of *John Fairfax & Sons Pty. Ltd v F.C. of T.*¹⁷⁴, the litigation fees that were incurred were treated as capital expenses. In this case, there was a takeover tussle involving two companies over the control and ownership of a third company one of the companies had desired to integrate with its own operations the expenses incurred were held to be exclusively connected to its organization and structure. However, in cases where the legal expenses results from a compromise and arrangement between the company and shareholders in order to remove restrictions from the charter, it is treated as a deductible expense since no new asset is created.¹⁷⁵

Section 15 of the Act makes no reference to this head of expenditure. However, it may fall within the basic test espoused under section 15 and case laws stated above. Nevertheless, it is one of the expenses that need to be specifically stated as it could result in subjective technical interpretation. The significance for express provision of these expenses is well captured by the Indian case of *CIT Bombay Dying and Manufacturing Company Ltd.*¹⁷⁶ In this case; professional charges paid by the assessee transferee company to its solicitors for effecting amalgamation were held to be tax deductible as business expenditure. This landmark judgment prompted the Indian authorities to specifically provide for deductions of this head of expense vide the Finance Act, 1999.

A further area worth consideration relates to interest payments. Usually, M&As transactions may be financed using loan capital which obliges the transferee to be liable to interest payments. Whereas interest is specifically stated as being allowable under the provisions of the Act,¹⁷⁷ it needs to provide for the scope of interest allow ability for tax purposes. This is because the interest payments may be used by the transferee in tax avoidance schemes by

¹⁷⁴ (1959) 101 C.L.R. 30

¹⁷⁵ See the case of *CIR v Carron and Co.*

¹⁷⁶ (1996) 3 SCC 496: AIR 1996 SC 3309

¹⁷⁷ Section 15 of the Income Tax Act (Cap 470) Laws of Kenya

characterizing the payments as consideration for the merger. The provision relating to thin capitalization rule under the Act¹⁷⁸ may apply in this case, but it is unduly restrictive as it relates to interest made to non- resident companies.

3.2.3. Adequacy of Capital Gains Tax Regime

Capital Gains Tax is charged pursuant to section 3(2)(f) as well as Eighth Schedule of the Income Tax Act. It is levied at a flat rate of 5% on the adjusted gain and is treated as final tax.¹⁷⁹ It applies on the whole gain which accrues to a taxable person whether resident or non-residents on the transfer of property situated in Kenya. Since transactions involving sale or transfer of shares, assets or business of a company are subject to CGT,¹⁸⁰ it is evident that mergers and acquisitions transactions are heavily affected since they involve the transfer of shares, transfer of assets or transfer of business. It appears that property owned by Kenya residents but situated offshore is not subjected to CGT on disposal. Where there are no capital gains realized, taxpayers are allowed to offset such capital losses in the year of income against capital gains in the subsequent years.¹⁸¹ The offset of the losses is for a period of nine years and can only be made against a similar source of income.

Transfer is deemed to occur where there is a sale, exchange or disposal of a property in any manner including offering it as a gift.¹⁸² Halsbury's Laws of England reiterate the requirements of transfer to include disposal of assets, accrual from that disposal, and accrual of that gain being to a person chargeable to capital gains.¹⁸³ These conditions were also approved in the case of *Law Society of Kenya v Kenya Revenue Authority & Another*.¹⁸⁴ The Act also lists activities that are not subject to CGT. Among the transactions exempt from

¹⁷⁸ Section 16(2j) of the Income Tax Act (Cap 470) Laws of Kenya provides for the thin capitalization rule. Thin Capitalization is where a company is leveraged to the effect that it is greatly financed by loans as opposed to share capital.

¹⁷⁹ Section 34(1)(j) of the Income Tax Act (Cap 470) Laws of Kenya

¹⁸⁰ Gatuyu T J, 'What Is Your Gain? Intricacies of Capital Gains Tax On Property Transactions in Kenya' (2018) 14(1) LSKJ 87,69

¹⁸¹ Section 15(3)(f) of the Income Tax Act (Cap 470) Laws of Kenya

¹⁸² 8th Schedule of the Income Tax Act (Cap 470) Laws of Kenya

¹⁸³ Halsbury, 4th Edition, Vol. 5 paragraph 26

¹⁸⁴ *Law Society of Kenya v KRA & Another* (2017) eKLR, Petition No. 39 of 2017

CGT involves gains or losses where transfer of property involves restructuring of corporate entity in the form of amalgamation, recapitalization, acquisition, separation and dissolution.¹⁸⁵ However, this is limited to the transactions which in the discretion of the Cabinet Secretary, National Treasury, are of public interest. The term ‘public interest’ is unruly horse and no guidance is in place as to its exact scope. However, it may appear that transactions involving acquisitions of sick companies may fall in this category. Sickness of industrial undertakings is a matter of national interest and laws need to specifically provide for mechanisms of dealing with the same. More can be borrowed from the elaborate provisions of the Indian Income Tax Act. Section 72A was introduced to provide for reviving of the financially non-viable business undertakings.¹⁸⁶

It is clear from forgoing discussion that that Income Tax Act provides for special relief in cases of mergers and acquisitions. It gives specific exemption from capital gains tax with respect to mergers and acquisition transactions. It is not clear whether the scope of the exemption relates to transferor company only or equally to its shareholders. In addition, the provision does not specifically provide whether the exemption domestic mergers or also extend to cross border mergers and acquisitions. In Indian Income Tax Regime for example, it specifically provides for exemption to the amalgamating company and its shareholders.¹⁸⁷

The interplay of CGT and Compensating tax is also worth noting. Compensating Tax is charged under section 7A of the Income Tax Act. It ensures that companies pay ‘adequate’ tax on their profits.¹⁸⁸ It is calculated after the year end on the basis of Dividend Tax Account.¹⁸⁹ It arises where a company has paid lower tax or no tax at all in any year of income and thus is not allowed to use the increased cash available to support the increased

¹⁸⁵ 8th Schedule, Paragraph 13 of the Income Tax Act (Cap 470) Laws of Kenya

¹⁸⁶ Ameet Kaur(n12) 25

¹⁸⁷ Section 47(vi) and 47(vii) of the Income Tax Act, 1961

¹⁸⁸ Gatuyu T J (n 180) 82

¹⁸⁹ Section 7A (1)(4) of the Income Tax Act (Cap 470) Laws of Kenya

dividend payments.¹⁹⁰ An example is where a company receives significant investment deductions on the purchase of capital equipment thus reducing tax liability for the year of the income.¹⁹¹

The purpose of compensating tax is to ensure that dividends are matched with taxable profits. Its introduction was to cover the gaps left after the suspension of the CGT. It is a punitive tax on the distribution of untaxed income or payment of dividends by a company which has been granted a tax incentive. It also applies where a company distributes dividends from the gains made on the same asset thus making the company liable to pay tax on the distribution.¹⁹² Before the introduction of CGT, compensating tax would be charged on untaxed gains vide section 7A of the Income Tax Act. However, the gains are now subject to CGT and the presence of the compensating tax can only cause duplication and confusion. This uncertainty results in double taxation. To avoid this situation, it is important to streamline the CGT and compensating tax regime. One way is to amend section 7A of the Income Tax Act and completely remove the compensating income tax regime. Indeed, the Income Tax Bill, 2018 proposes to scrap the compensating tax provision.

3.2.4. Adequacy of Loss carry forwards and capital allowances

Loss carry forwards and capital allowances are one of the significant tax attributes in tax treatment of mergers and acquisitions. Most jurisdictions give special emphasis to these attributes in their M&As tax rules. The treatment of loss reliefs and capital allowances in any M/As depend on the type of mergers and what is transferred during the transaction.

It appears that the Income Tax Act lacks specific provisions for loss reliefs for mergers and acquisitions. The determination of income under the various sources is treated to be mutually

¹⁹⁰ Gatuyu (n 180) 82

¹⁹¹ *ibid*

¹⁹² *Ibid*, 83

exclusive.¹⁹³ This only recognizes losses with respect to the specific source from which it is incurred.¹⁹⁴ That said, reliefs on losses are deductible from the profits of business, or specified source of income of a person in respect of which they are claimed. The Act provides for the treatment of income and expenditure where there is cessation of business.¹⁹⁵ Any income that is received after cessation that was not initially declared is deemed to be income in the year it is received.¹⁹⁶ Similarly, any sum that is deductible prior to cessation of business and which had not been deducted is allowed as a deduction in the year of income it is paid.¹⁹⁷ If these provisions are anything to go by, neither parties shall enjoy the reliefs since the person entitled to the relief shall have disposed off the business.

In order to avoid this scenario, various jurisdictions have devised specific rules to deal with carry forward of losses. Under the Nigerian income tax law, the losses which are carried forward are treated as the assets of the company and are transferable during the process of mergers and acquisitions. As a result, the transferee company enjoys the reliefs provided that its business is similar to that of the transferor.¹⁹⁸ Similarly, the Indian Income Tax Act specifically provides for treatment of losses in a closely held transferee company.¹⁹⁹ In cases of amalgamation, there are provisions for carry forward and set off of accumulated losses and unabsorbed depreciation allowance.²⁰⁰ The purpose of this provision was to ensure that technology companies that are economically viable but faces financial strain are revived and rehabilitated.²⁰¹ Ultimately, the transferee company enjoys the benefit of accumulated loss or

¹⁹³ Section 15(7c) of the Income Tax Act (Cap 470) Laws of Kenya

¹⁹⁴ Section 15(7) (a) (Cap 470) Laws of Kenya

¹⁹⁵ Section 281 of the Income Tax Act (Cap 470) Laws of Kenya

¹⁹⁶ Section 28(1) of the Income Tax Act (Cap 470) Laws of Kenya

¹⁹⁷ Section 28(2) (Cap 470) Laws of Kenya

¹⁹⁸ Balogun B, 'Tax Considerations for Mergers and Acquisitions' Paper presented at the workshop on mergers and acquisitions organized by the Nigerian Insurers Association on 14th December 1999

¹⁹⁹ Section 79 of the Indian Income Tax Act

²⁰⁰ Section 72A of the Income Tax Act, 1961

²⁰¹ Kaur (n12)364

unabsorbed depreciation of the transferor company for the previous year in which the transaction was effected. Several conditions are set for this provision to apply.²⁰²

Where shares rather than assets are to be transferred, the carried forward losses are treated differently. Ordinarily the purchase of shares preserves loss reliefs which are later utilized by the transferee after the consummation of merger.²⁰³ However, this should be treated with caution since it can be used as a rich avenue for tax avoidance. Entities may use it to transfer shares in conduit companies which have losses carried forward as their main asset in order to shield income in a new business line.

Section 15(4) of the Income Tax Act provides for the treatment of deficit in any year of income. The deficit is treated as an allowable deduction which is claimed in the succeeding year of income. It appears from the wording of this provision that this benefit is only limited to a particular taxpayer and therefore is not transferrable. The deficit or loss can only be deducted from specified source of income of that person.²⁰⁴ These provisions of the Act are consistent with the dictates of section 28 of the Income Tax Act. The section provides for the treatment of income and expenditure after cessation of business. Any expenditure incurred after cessation of business, prior to cessation of such business, is tax deductible in the year the same is incurred. Alternatively, the deduction may also be made in the year of income in which the business ceased. Since the transferor ceases to exist by operation of the law, it may be argued that section 28 of the Act is relevant in that context. However, the provision is

²⁰² The conditions include among others: where the amalgamation involves a transferor company owning industrial undertaking, the transferor company is engaged in business in which the accumulated loss incurred or depreciation remains absorbed for three or more years, the transferee company continues with the business of the transferor's for a minimum period of 5 years from the date of the transaction etc

²⁰³ Banwo and Ighodalo, Tax Considerations in Mergers and Acquisitions' (2006) available at <http://www.banwo-ighodalo.com/assets/resources/81bdbda6e9b8183d9c50bd73d24ccf9.pdf> accessed on 20th September, 2018

²⁰⁴ Section 15(7) of the Income Tax Act (Cap 470) Laws of Kenya

silent whether the cessation of business is as a result of transfer of business, assets or shares to another entity as in cases of mergers or acquisitions.

3.3. The necessity for special tax rules in domestic mergers and acquisitions

The requirement for any special tax rules for M&As is a deliberate policy decision that takes account several factors. It reflects the confidence that policymakers have in the benefits of such preferential tax treatment of M&As transactions balanced with the need to protect domestic tax base from the risk of tax avoidance schemes.²⁰⁵ The special tax rules ascribed to M/A transactions vary but common patterns can be identified from various jurisdictions. First, where the subject of the transaction is the use of cash, it is taxable in every aspect.²⁰⁶ Secondly, both the target corporation and its shareholders are neither subjected to taxation upon their transfer or exchange of shares in the acquiring corporation nor is there a step up of tax basis in the new stock.²⁰⁷ The conditions imposed, in some jurisdictions like USA Reorganization Rules is the requirement of Continuity of Shareholder's Interest. The premise is that the ownership of the business has remained practically unchanged, thus there is no material transaction to trigger the current taxation.²⁰⁸ Similarly, the acquiring corporation is not upon issuance of stock as long as the transaction is qualified. In United States for example, the qualification is based on the requirement of the Continuity of Business Enterprise. This means that for the acquired business to enjoy the preferential treatment, the underlying business must remain basically the same.²⁰⁹ Thirdly, the shareholders of the acquiring corporation are exempted from taxation. The justification is that although their economic position has been altered or diversified, technically, they did not directly participate in any exchange during the transactions.²¹⁰ Lastly, the tax attributes of the target corporation

²⁰⁵ Alan J (n 119) 41

²⁰⁶ Frans V (n 62) 909-913

²⁰⁷ Alan J (n 119) 4142

²⁰⁸ Frans V (n 62)912

²⁰⁹ Ibid

²¹⁰ ibid

may be inherited by the acquiring corporation, subject to limitations that may be imposed by a particular country.²¹¹

Another argument for preferential treatment of M&As is based on the efficiency ground. The argument is that M&As transactions are on average, wealth creating and therefore it is important not to tax such transactions at the point of transfer or exchange of shares as this may discourage them.²¹² However, the argument is based on a weak premise since the preferential or the reorganization rules are limited only to stock transactions. Accordingly, if the stock transactions are isolated, the efficiency grounds of M&As largely disappear.²¹³ Another criticism is that tax deferral preferences rarely play significant role in decisions to enter into transactions. They are considered largely undesirable, purely tax driven inefficient transactions.²¹⁴

This study therefore, underscores the need for tax rules on corporate reorganizations, especially on mergers and acquisitions. There are several justifications for this. The rules ensure that mergers and acquisition transactions are not impeded by tax system. They also enhance investors' confidence by creating certainty on the tax approach of mergers and acquisitions.

3.4. Conclusion

It is clear that the Kenya's Income Tax Act has limited provisions relating to mergers and acquisitions that exists in more progressive jurisdictions like USA and UK where M&As are common practice in the corporate world. In Kenya, M&As are still relatively a recent development and the tax laws have not adequately evolved to tackle them. However, with increased M&As activities in the country, it is hoped that effective reforms will be

²¹¹ Frans V (n 62) 909-915

²¹² Brauner Y ' Taxing Cross Border M & A in a Globalizing World' (2003) Public Law and Legal Theory Research Paper Series 63/2003, p 18 Available at http://ssrn.com/abstract_id=410106

²¹³ *ibid*

²¹⁴ *ibid*

commenced in order to address the inherent tax challenges associated to the transactions especially on the treatment of tax attributes. This chapter largely considered the adequacy of the Income Tax Act in relation to domestic M&As. The purpose of next chapter is to discuss the tax consequences of cross border M&As with a view of drawing the sufficiency of the Act to deal with the ensuing issues.

CHAPTER FOUR: TAXATION OF CROSS BORDER MERGERS AND ACQUISITIONS: SUFFICIENCY OF THE INCOME TAX ACT

4.0. Introduction

Cross border mergers involve a corporation (acquirer), which is resident in one country (the home country) acquiring from another corporation, the transferor, a business located in another country (the host country). The acquirer in return issues shares to the transferor or the transferor's shareholders.²¹⁵ The transferor may either be a resident in the host country and if not, it is presumed to constitute a host country PE.

The rise of cross border M&As is attributed to increased commercial competition, foreign direct investments, globalization and free flow of capital across jurisdictions thereby resulting in reduced trade barriers.²¹⁶ Indeed, the market for cross border mergers and acquisitions transactions has of late expanded well beyond the regulatory reach of a single country.²¹⁷ It has in the past decade represented growth in international production, surpassing greenfield investments.²¹⁸ The literature on cross border M&As has also been on the upward trend, occasioned by significant growth in number and size of cross border M&As.²¹⁹ It is argued that M&As allow firms to geographically expand their competitive advantage in a fast, effective and supposedly cheap manner.²²⁰ With this boom in cross border M&As, there is increased drive to understand and manage the complex tax issues arising from the international expansion. Except for domestic legislation in some countries, there is little tax law or globally accepted norms on how to deal with taxation aspects of cross border mergers

²¹⁵ Peter H and David (n 70) 438

²¹⁶ Mohd A and Assim H, 'A Study of Reverse Mergers in India: Tax Implications' (2014) 2(5) IOSR Journal of Economics and Finance 24, 24

²¹⁷ Pervez N and Peter J, 'International Mergers and Acquisitions: Past, Present and Future' in Cooper C and Gregory A (edn), *Advances in Mergers and Acquisitions* vol. 2 (Elsevier Science Limited, 2003) 207

²¹⁸ The United Nations World Investment Report 2000, *Cross-border Mergers and Acquisitions and Development* (UNCTAD, 2000) 10 & Chapter IV

²¹⁹ Sara BM and Frederik PS, 'Are Cross-Border Acquisitions Different from Domestic Acquisitions? Evidence on Stock and Operating Performance for U.S. Acquirers (2002) Working Paper. Available at http://papers.ssrn.com/sol3/delivery.cfm/SSRN_ID311543_code020529500.pdf?abstractid=311543

²²⁰ The United Nations World Investment Report (n 237)140-144.

and acquisitions.²²¹ Yet the viable approach is to design a tax law that better accommodates cross border M&As.

4.1. Understanding the Concepts Behind Cross Border Taxation Aspects of Mergers and Acquisitions

The consequential tax aspects of cross border M&As involve interplay of various underlying concepts. These concepts assist to understand their taxation models.

Under the previous part of this chapter, it was noted that cross border M&As arise majorly from globalization. Globalization has significantly changed the manner in which multinationals and other international entities structure their business activities. It has also caused increased source /host country activity by way of cross border M&As.

Twin taxation aspects prevalent in these transactional cross border activities include changes in source and residence jurisdiction. This is because cross border M&As have an effect of creating, transferring, terminating or varying these jurisdictions. The changes of source/host country jurisdictions or residence/ home country jurisdictions are largely technical matters of individual country's domestic law. They are rarely regulated by international tax norms such as the OECD or UN Models.²²²

4.1.1. Change of source jurisdiction

Most countries having worldwide approach to taxation may subject income of an individual by the fact that the same is accrued in or derived from the country.²²³ The country thus acquires taxation rights on the basis of source jurisdiction. In globalized business practices like cross border mergers and acquisitions, source jurisdiction is likely to change from one country to another. The change is usually between the home and host country.

²²¹ Gupta, Sayantan, ' Cross-Border Mergers and Acquisitions: Addressing the Taxation Issues from an Indian Perspective' (2008) 13(6) Corporate Professionals Today, 525 Available at <https://ssrn.com/abstract=1311102>

²²² Peter H and David (n 70)437

²²³ Section 3 of the Income Tax Act (Cap 470) Laws of Kenya

Where assets or shares are transferred from the host to the home country, the transaction gives rise to change in host country's source jurisdiction. Since the transfer has effect on the tax base of the host and home countries, the treatment of such a transfer is usually reserved to the domestic law. The home and host countries may take differing views on this matter. As a result, where there is no tax treaty between the two countries, any gain, arising from such a transaction, may be subject to double or non-taxation.

4.1.2. Change of residence jurisdiction

Taxation right may also be acquired by a country through residence jurisdiction. Whereas source jurisdiction can be transferred, residence on the other hand is a matter particular to a person and cannot be a subject of transfer.²²⁴ In fact, save only in exceptional circumstances, it may not even be possible to vary residency status.²²⁵ Changes in residency jurisdiction can only occur through creation or cessation of the residency status.²²⁶ In transactions involving cross M&As, the taxation aspects of creation or cessation of residency status is of utmost importance. This is because it determines how various tax attributes may be affected and treated during and after the creation and cessation of the residency status. In cross border mergers and acquisitions, residency commences at the home country where the acquirer is located. Cessation of jurisdiction on the other hand is at the host country where the transferor is located.

With respect to commencement of residency jurisdiction, the important tax attributes typically involves the cost base (tax value) of the assets in the home country²²⁷. The choice usually is whether the value of acquirer's assets at the time residency status is assumed should be determined on the basis of historical or step up costs.²²⁸ Different countries uses

²²⁴ Peter H and David (n 70)448

²²⁵ Ibid.

²²⁶ ibid

²²⁷ Peter H and David (n 70) 448

²²⁸ ibid

varied approaches on treatment of this tax attribute as it is a matter of domestic legislation. The choice whether to use the historical costs or the step up costs depends on various factors including the need to attract foreign investments by reducing tax costs. In UK, step up in cost base is not granted when residency is commenced. This is to allow taxation of any gain arising when the person subsequently disposes the asset to a UK residence.²²⁹

Other types of tax attributes like carry forward losses are unlikely to be recognized by the home country when the person commences residency. As a result, where the transferor had carried forward loss in the host country, this is not recognized in the home country, which assumes the residence jurisdiction.

Whereas domestic legislation ordinarily provides for the rules of residency, administrative difficulties are bound to arise on the time of the year in which the transferor commences residency in the home country. This is because there may arise situations where the entity is a resident in both countries i.e the host and the home country. As a result, issues may arise on whether residency status should be assumed for full years only or there can also be residency for a part of a year.²³⁰ If a person is considered to be resident for only part of the year, concerns may arise with regards to treatment of exemptions, credit and rate thresholds. This is because they are applicable only to residents and the question is whether these thresholds can be apportioned where a person is resident for part of the year only.²³¹ Kenya's tax administration approach accepts that a person can be a resident for a part of a tax year,²³² but does not generally seek to apportion exemptions, credits and rate thresholds.

Cessation of residence may also give rise to similar set of issues. Cessation involves a loss of tax jurisdiction over assets located in the host country. In case of non-individuals, the loss of

²²⁹ *ibid*

²³⁰ *ibid*

²³¹ *Ibid*, 449

²³² Section 2 of the Income Tax Act (Cap 470) Laws of Kenya

residence may involve moving the effective management of an entity to the home country followed by disposal of assets in the host country. The fundamental tax attribute is whether to treat the assets as disposed of at the market value. Ordinarily, this disposal is deemed in what is commonly referred to as an 'exit charge'.²³³ The purpose of the charge is to crystallize the host country's tax right on chargeable gains before jurisdictions over those gains are lost. In this case the transferor is treated as disposing off all its assets at market value just before residence ceases. The domestic tax rules of the host country determine whether the charge may be postponed to a later period. In UK, the tax charge may be postponed if the emigrating corporation is a 75% subsidiary of another UK corporation. In this case, the charge is triggered by certain future events including the sale of the emigrated subsidiary.²³⁴

4.2. Challenges to Efficient Cross Border Taxation of mergers and acquisitions

Tax laws are essentially domestic and where business and investment activities cross border as a result of globalization process, substantial taxation problems are likely to arise. Even where international tax rules are effected through bilateral tax agreements; there is usually lack of genuine coordination of tax policies at supranational level.²³⁵

There is pressure for both the host and home countries where these cross border M&As occur to protect their tax bases. Whereas some countries allow for some tax deferral as a benefit to M&As transactions, others are less enthusiastic to provide the incentives. The primary justification for beneficial tax deferral in some countries is premised on the fact that the 'change that occurs in the transaction is not material enough to justify their current taxation.'²³⁶ On the other hand, countries that are less enthusiastic to provide for tax benefits are concerned with the risk of the tax escaping jurisdiction and the general tax avoidance in

²³³ Peter H and David (n 70) 450

²³⁴ TCGA 1992, sec 187

²³⁵ Brauner Y (n 212) 8

²³⁶ Frans V (n 62) 23

cross border transactions.²³⁷ Indeed, the efficiency considerations present in domestic rules largely disappear in cross border context, as revenue protection efforts outweigh the social implications of the transactions.

Therefore, tax policy in cross border M&As is a delicate balance between the desire to promote the transaction by not taxing them and the unwillingness to forgo tax jurisdiction over the apprehension of capital flight and tax base erosion. The risk and dilemma of revenue flight, specifically, is not a domestic problem but it arises from the fact that there is little desire of cooperation in tax matters among the international community.²³⁸ This is because a country's freedom to impose certain policies as it may wish may be limited by other countries response to the same. They may circumvent such policies by introducing measures that causes revenue flight in that country.²³⁹

The balance between protecting local tax base and encouraging investment represent the current design of tax rules in cross border M&As. The grounds are premised on two basic policy standards, namely the Capital Export Neutrality (CEN) and the Capital Import Neutrality (CIN). The former aims to eliminate tax incentives as a decision to export capital.²⁴⁰ It dictates that tax should not be a factor in a decision between taking over a domestic target corporation or a foreign target or investment.²⁴¹ It states that it is undesirable and frustrates this standard a requirement to impose 'exit' tax on M&As solely because they cross borders.²⁴² The exit tax for example, may create more uncertainty in a tax system, increase administrative costs and potentially leads to inefficient business decisions.²⁴³ Its

²³⁷ Brauner Y (n 212) 8

²³⁸ Reuven S, 'Globalization, Tax competition, and the Fiscal Crisis of the Welfare State' (2000) 113(7) HLR 1573

²³⁹ Brauner Y (n 212) 2

²⁴⁰ Graetz, M., 'Taxing International Income - Inadequate Principles, Outdated Concepts, and Unsatisfactory Policy' (2001) Faculty Scholarship Series 1618

²⁴¹ Brauner Y (n 212) 9

²⁴² *ibid*

²⁴³ Brauner Y (n 212)51

imposition therefore, needs to be carefully considered in light of In modern realities in in their commercial engagements where countries seek to encourage free movement of people and right to establishment of entities across borders. This follows that a delicate balance should be created that minimizes host country's tax base erosion and the need to encourage free movement of people and entities across borders. Within the EU member states, for example, there are serious discussions whether exit charge is consistent with freedom of movement and establishment of individuals or corporate entities. Case laws indicate that it may not be appropriate for individuals, though some proportionate measures may be acceptable.²⁴⁴ In case of corporate entities, the acceptability and scope of the exit charge is unclear. This is illustrated under prior UK tax law, where a corporate entity needed Treasury consent before moving its residence out of UK. ECJ seemed to support this position in its earlier direct case of *R v HM Treasury & CIR(ex Parte Daily Mail and General Trust Plc)*²⁴⁵ where it refused to find that the requirement of consent by UK Treasury was contrary to the freedom of establishment.

The European Council has guidelines with respect to exit charges including change of corporate residence.²⁴⁶ The guidelines recognize the right to impose exit charges by member states whether on current or deferred basis. Where the right is exercised, it requires the home country where the corporation is moved to allocate a market value cost to assets for tax purposes.²⁴⁷ These guidelines however do not bind the member states or ECJ in applying fundamental freedoms of establishment.²⁴⁸ European Merger Directive 1990 is viewed as

²⁴⁴ See the cases of *Hughes de Lasteyrie du Saillant* [2004] ECR I-2409(ECJ) and the case of *N v Inspecteur Van de Belastingdiest Oost/Kantoor Almelo* [2006] ECR I-7409(ECJ)

²⁴⁵ [1988] ERC 5483(ECJ)

²⁴⁶ Peter H and David (n 70) 451

²⁴⁷ *ibid*

²⁴⁸ *ibid*

recognizing the right to impose exit taxes. It only prevents exit charges on assets having connection with a PE in the state from which the corporation is emigrating.²⁴⁹

Capital Import Neutrality on the other hand aims to discourage the imposition of an 'entry tax'. It eliminates tax wedges between the domestic and foreign investments locally.²⁵⁰ The importance of these standards is debatable, and may not be achieved unless a worldwide tax rate harmonization is realized.²⁵¹ Nevertheless, they provide a potential efficiency advantages by creating neutrality in tax rules.

From tax perspective, there are issues of concern for either the acquirer's country or the host country. These issues, considered as a whole, are majorly premised on recognition of any gain of the disposal of the business and treatment of carried forward losses in addition to other tax attributes already stated above. There are also issues of cost base (tax value) of shared that are issued in the hands of the transferor or transferor's shareholders.²⁵² In cross border M&As, if the target entity in the host country may have outstanding expenses or losses in their books of account that may affect the profit base of the acquirer in another jurisdiction. This is particularly so because most jurisdictions recognize worldwide income against worldwide losses of the particular entity in question. It is possible to have losses with respect to one activity in a particular jurisdiction while equally having profits with respect to another. Since these activities takes place in different jurisdictions, the immediate concern for most tax authorities is whether and in what manner losses from one activity in a particular jurisdiction may be offset or affect the taxation of profit of another activity in another jurisdiction. Therefore, the issue is whether losses of the target in the host jurisdiction in a M&A transaction may reduce profit of the acquirer in the home jurisdiction and so tax

²⁴⁹ Articles 12, 13 and 14 of the Mergers Directive 1990.

²⁵⁰ Graetz, M (n 240)

²⁵¹ *ibid*

²⁵² Peter H and David (n 70) 438

charged on those profits. In transactions within members of a corporate group, the treatment of the losses may be quite straight forward. This is because many countries in their domestic tax laws permit the recognition and netting of losses and profits within the members of the corporate group.²⁵³The tasking issue however is whether the losses of the host group member may be used to reduce the profit of the home member in the particular M&As transactions.

4.3. Sufficiency of the Income Tax Act

The issues discussed in this chapter involve matters that may arise where there are cross border mergers and acquisitions. In essence, the topic is concerned with consequential M&As transactions where multiple parties are involved in a cross border setting. Whereas the rules that govern this situation are typically as extension of the rules in domestic situation, it is regrettable that there is a shortfall in this regard under the Income Tax Act. As such the tax treatment of this area in the international plane is discussed majorly to draw lessons that can be beneficial in the Kenyan context.

4.3.1. Assessing Kenya's Bilateral Tax Treaties.

Bilateral tax treaties network form part of current tax world regime. The Income Tax Act empowers the Cabinet Secretary to negotiate a Double Tax Agreement.²⁵⁴ The principle aim of the Agreements is to avoid double taxation of income. Kenya's treaty network on double tax agreements has increased over the years. Statistics indicate that as at 2016, there were nineteen double tax agreements between Kenya and other jurisdictions.²⁵⁵ Eight treaties are already in force while others are awaiting notification and ratification between the parties. The double tax treaties currently in force include those between Kenya and Canada, Denmark, France, Germany, India, Norway, Sweden, United Kingdom and Zambia.²⁵⁶

²⁵³ Peter H and David (n 70) 313

²⁵⁴ Section 41 of the Income Tax Act (Cap 470) Laws of Kenya

²⁵⁵ http://www.treatypro.com/treaties_by_country/kenya.asp accessed on 20 September, 2018

²⁵⁶ *ibid*

The treaties are ordinarily negotiated through the OECD or UN Model Tax Conventions. Most Double Tax Agreements between Kenya and other jurisdictions are based on the OECD Model, which does not mention any M&A tax rules in its articles. Following this format, Double tax agreements between Kenya and other jurisdictions do not directly touch on M/A tax rules. Whereas article 13 of the OECD Model Tax Convention takes into account the tax deferral benefits by granting the right to tax gains from sale or exchange of shares to the country of residence of the transferor taxpayer, it does not address the concerns of the home country on loss of tax jurisdiction.

Some Bilateral Tax Treaties have deviated from this general provision by taxing capital gains at source contrary to the tax right accorded to the country of residence as stated under various articles of their Model Tax Convention.²⁵⁷ France and Mexico Double Tax Treaty for instance, maintain the tax right to the source country in some instances where the foreign seller maintains substantial stake in the domestic entity.²⁵⁸ It is one of the bilateral tax treaties that take corporate structural changes into account. Similarly, the double tax treaty between France and Belgium specify that shares of the acquiring company which are distributed in a fully domestic merger to the shareholder of the target company are not exempt from taxation at the country of residence.²⁵⁹ The provision ensures that foreign and domestic shareholders are accorded neutral treatment in the bilateral context. Lastly, the 1986 Canada Netherlands Income Tax Treaty provides for special transitional rules taking into account corporate structural changes.²⁶⁰

²⁵⁷ Article 13(4) of the OECD Double Tax Convention and corresponding Paragraph 30 of the Commentary on the Article

²⁵⁸ Their reservations on Article 13(4) of the OECD Model, in para. 36 & 49 to the commentary on this article. Israel, which is not an OECD member has a similar position.

²⁵⁹ Article 15(6) [a “dividends” article], which became article 15(8) after the amendments of the 1971 Protocol to the Treaty.

²⁶⁰ Article 30(4)(b).

Whereas above illustrate limited country specific cases providing for tax treatment of cross border M&As, the alternative approach is to utilize limited roles of the competent authorities in bilateral tax treaties. Virtually all bilateral tax treaties provide for Mutual Agreement Procedure (MAP) through the constituent parties' competent authorities.²⁶¹ There is a need to effectively utilize the central role of the competent authorities as a remedy for tax aspects of cross border M&As. An example is the 1974 Income and Capital Tax Treaty between Austria and Switzerland which specifically provides that competent authorities should consult 'with a view to examine how inequitable hardship due to the effects of domestic law can be avoided.'²⁶² Canada has consistently inserted these provisions in its bilateral tax treaties.²⁶³ In Kenyan context, little information is available on the utilization of competent authority as a mechanism of resolving cross border tax disputes. It has not been widely used and its reliance is considered problematic.²⁶⁴ Evidence from most double tax agreements between Kenya and other jurisdictions indicate that there are neither specific provisions on treatment of cross border M&A nor provisions enabling use of competent authorities in dealing with taxation aspects of mergers and acquisitions.

However, it is noted that countries that have adopted this approach are those with stable corporate tax system, similar tax rate schedules, long term corporation and relatively sophisticated tax authorities.²⁶⁵ Therefore, the approach has been rarely copied to date.

²⁶¹ Article 25 of the OECD Model Tax Convention on Income and Capital

²⁶² Negotiator's Protocol of February 1, 1973 to the Treaty.

²⁶³ Various double tax agreements between Canada and other countries illustrate this position. For example, Article 13(5) of the Canada – Estonia 1995 Income and Capital Tax Treaty, Article 13(4) as amended by article 5(3) of the 1987 Protocol to the Canada – France 1975 Income and Capital Tax Treaty, article 13(5) of the Canada - Germany 2001 Income Tax Treaty, article 13(5) of the Canada – Hungary 1992 Income and Capital Tax Treaty. Other Treaties incorporating this provision include article 13(5) Treat between Canada and Iceland Italy, Latvia, Lithuania, Mongolia, Switzerland, Peru, Mexico. Other double tax treaties include article 13(6) between Canada and Luxembourg, Netherlands, and Tanzania. The provision is also incorporated in a double tax agreement between Canada and Norway, article 13(9); Canada and U.S., article 13(8), as amended by article 8 of the 1994 & 1995 to the treaty; and article 14(6) of the Canada – Zimbabwe Double Tax Treaty.

²⁶⁴ PriceWaterhouse Coopers, 'International Transfer Pricing 2015/16' (2015) <https://www.pwc.com/gx/en/international-transfer-pricing/assets/itp-2015-2016-final.pdf>, accessed on 3rd October 2018

²⁶⁵ Brauner Y (n 212) 51

4.3.2. Lack of adequate provision on taxation of beneficial ownership in cross border setting

The current provision of the Income Tax Act provides for taxation of capital gains on the transfer of legal ownership of a capital asset. The forms of the transfer include outright sale, relinquishment of any right, exchange, or compulsory acquisition. These gains arise from the transfer of the capital asset in Kenya are treated as accruing in Kenya. Where the transfer is done in cross border context, the situs of the capital assets provides a suitable guide on the state having the tax right under the applicable double tax agreement. Usually, it is the state where the shares are situated.

However, barring any provision in the Double Tax Treaty, this concept, especially in cross border context is not provided for in the current Income Tax Act.

4.3.3. Assessing the Transfer Pricing regime

The Income Tax Act requires that any business which is carried out between a non-resident and a related Kenyan resident to be conducted at arm's length.²⁶⁶ It empowers the Commissioner to make any adjustments on the profit of Kenyan resident where the transaction is not at arm's length.²⁶⁷ Transactions that are subject to adjustments include sale, transfer, purchase, lease or use of tangible and intangible assets.²⁶⁸ As such, any cross border M&A transaction involving the sale or transfer of tangible and intangible assets should comply with the requirement of arm's length principle.

Until the year 2006, there was no Transfer Guidelines in place to address the mechanisms on how to arrive at the arm's length price. This culminated in the landmark case of Unilever Kenya Ltd and Commissioner of Income Tax (the Unilever case).²⁶⁹ The Income Tax

²⁶⁶ Section 18(3) of the Income Tax Act (Cap 470) Laws of Kenya

²⁶⁷ *ibid*

²⁶⁸ PriceWaterhouse Coopers (n 264) 643

²⁶⁹ Income Tax Appeal No. 753 of 2003

(Transfer Pricing) Rules, 2006²⁷⁰ was eventually published under section 18(8) of the Income Tax Act to guide on the process of arriving at the arm's length prices.

Despite this, there are still concerns on the adequacy of the transfer pricing regime to spur tax compliance on complex corporate transactions.

First, section 18 of the Income Tax Act requires that the entities must be related. It defines the relationship as a situation where the entity or another third party directly or indirectly participates in the management and control of the other. Whereas the threshold of control is not specifically provided for under this section, it is stated in paragraph 32(1) of the Second Schedule of the Income Tax Act. It applies where an entity holds shares with voting power of 25% or more. This definition of control is inconsistent with the standard required of a merger under section 41(3) of the Competition Act, 2010. The Competition Act requires that control in a merger transaction means having more than one half of issued share capital of an undertaking.

Secondly, it is debatable whether the penalty regime for non-compliance with transfer pricing rules is adequate. Presently, no special penalties apply in relation to additional assessments where transfer pricing adjustments are made. General penalty applicable under tax Procedure Act applies.²⁷¹ This is grossly inadequate taking into account the complexity of the transfer pricing cases and the potential tax amount involved.

Thirdly, there is inadequate provision on transfer pricing documentations. It has been argued that the transfer pricing rules makes no express statutory requirement to enable taxpayers support transfer pricing documentation.²⁷² PWC, in their International Transfer Pricing Report for Financial Year 2015/16 indicate that the lists of documents stated under the

²⁷⁰ Legal Notice No. 67 of 2006

²⁷¹ Section 84 of the Tax Procedure Act, 2015, which provides for a 20% penalty on principal tax and payment interest of 2% per month.

²⁷² PriceWaterhouse Coopers, 'International Transfer Pricing 2015/16' (2015) <https://www.pwc.com/gx/en/international-transfer-pricing/assets/itp-2015-2016-final.pdf>, 643 accessed 3rd October 2018

transfer pricing rules are not comprehensive.²⁷³ In addition, in providing the guidance on the nature of the documentation required, rule 9(2) does not provide any fast and hard rules on nature of documentation or process to follow therefrom.²⁷⁴

Lastly, Kenya's transfer pricing policy currently lack procedures in place for Advance Transfer Pricing Arrangements (APA). This limits taxpayers' ability to address transfer pricing issues post their transactional arrangements.

4.3.4. Assessing the General Anti Avoidance Provision

Any transaction which is of commercial nature can be subject to tax avoidance scheme. Tax avoidance is an area of concern internationally. It is generally an outcome of action or arrangement taken by a taxpayer neither of which is forbidden by law nor illegal.²⁷⁵ tax avoidance scheme is undertaken in order to obtain a tax benefit.²⁷⁶ Since it involves artificial arrangements or structures that are economically undesirable, there is need to check the same by making GAAP provision. GAAP is an anti-avoidance measure empowering the Commissioner to categories a business arrangement or transaction as an impermissible avoidance arrangement.²⁷⁷ This implies that the arrangement is not for commercial substance but rather to obtain a tax benefit only.

In cross border M&A transactions, the focus should not only to provide a far and efficient tax rules, but also to ensure that the tax rules do not permit arrangements designed to avoid tax. GAAP provision plays a significant role to minimize the incidences of tax avoidance. It is therefore a welcome provision in dealing with taxation aspects of not only domestic M&As, but equally cross border M/A transactions.

²⁷³ *ibid*

²⁷⁴ *ibid*

²⁷⁵ KPMG, Expert Committee Report on General Anti-Avoidance Rules, (GAAR)', retrieved from <http://www.kpmg.com/Global/en/IssuesandInsights/ArticlesPublications/taxnewsflash/Documents/-india-sept5-2012no.1.pdf> accessed on 23rd September, 2018

²⁷⁶ *ibid*

²⁷⁷ Dipanshu S, 'Indian GAAR Story', <http://thefirm.moneycontrol.com/storypage.php?autono=784709> accessed on 20th October, 2018

GAAP was introduced under section 23 of the ITA. The scope of this provision is too wide with no sufficient safeguards. It seems to cover any transaction which in the opinion of the Commissioner, is meant to avoid tax liability. The Commissioner is also granted unfettered powers in exercise of discretion on matters relating to this provision. This flies on the face of long held tax principle that requires certainty and predictability. Further, there are no specific substantive or procedural rules to guide the Commissioner on how to apply this provision. Much can be learnt from the India's experience. Its Finance Act introduced GAAR in 2013. The GAAR provision incorporates the procedural mechanisms for invocation of the rule.²⁷⁸ It is defined as a transaction which is not carried out for bona-fide purposes. It also creates rights and obligations between persons not deemed to be at arm's length.²⁷⁹ The provision relates to an 'impermissible arrangement.'²⁸⁰ The principle objective of the arrangement is to obtain a tax benefit. It also lacks commercial substance in whole or in part and results directly or indirectly in the misuse of the provision of the Act.²⁸¹

4.4. Case Study on Cross Border Taxation of Mergers and Acquisitions

The literature discussed above illustrates the difficulties in taxation of cross border M&As transactions. These challenges are likely to continue in the foreseeable future unless a viable international intervention is made. Nevertheless, European Merger Directive demonstrates a few international best practices that are worth noting. These include the UK approach and the European Merger Directive.

4.4.1. European Merger Directive

The closest international legal framework dealing with taxation of cross border mergers and acquisition is the European Merger Directive. Within the EU, the legal framework governing

²⁷⁸ Section 144BA of the Indian Income Tax Act

²⁷⁹ Section 96 of the Indian Income Tax Act, 1961

²⁸⁰ Section 96 of the Indian Income Tax Act, 1961

²⁸¹ *ibid*

taxation of cross border mergers and acquisition is the Merger Directive 90/434/EC of 23rd July. Its scope was further extended in 2005 to cover among others partial divisions of companies. The Directive aims to abolish tax challenges relating to cross border company reorganizations within the EU.²⁸² The two directives are hailed as giant steps towards creation of a more harmonized tax rules relating to cross border corporate restructuring within the European Union, one of the complex matters in the area of direct taxation.

The Merger directive has several primary rules that guide its application by EU member countries. The directive neither applies to purely domestic transactions nor cases involving physical transfer of business across borders. No capital gains tax is realized in cases of stock compensation.²⁸³ The directive applies to certain corporate forms which are subject to corporation tax and registered for tax purposes in the individual member states.²⁸⁴ It also applies only to mergers, divisions, assets for stock and voting majority stock transactions.²⁸⁵ Pre transaction losses cannot be transferred to acquiring corporation. This has been argued as undesirable since it limits competitiveness of the EU business.²⁸⁶

Presently, most member states and acceding candidates permit deferral of gains on some corporate structural changes subject to certain limitations.²⁸⁷ Where deferral is granted, the existing tax base in the old shares is transferred to the new shares.²⁸⁸ This implies that the directive does not permit step up of tax bases .Presumably, the directive adopted basic norms

²⁸² Peter H and David (n 70) 440

²⁸³ Section IIIA of the Merger Directive

²⁸⁴ *ibid*

²⁸⁵ *ibid*

²⁸⁶ Commission of the European Communities, 'Company Taxation in the Internal Market' (2001) Commission Staff Working Paper 1681/2001, 239
https://ec.europa.eu/taxation_customs/sites/taxation/files/docs/body/company_tax_study_en.pdf accessed 3rd October 2018

²⁸⁷ *Ibid*, 36

²⁸⁸ *ibid*

of the laws of the countries that grants special (deferral) treatment of the M&As transactions.²⁸⁹

The utility of the directive has been questioned since matters of fraud or tax evasion do not fall within its scope.²⁹⁰ Some countries have expanded the use of the clause in order to maintain as much power as possible. As a result, not all member states have adopted the rules of the Directive and have resorted to enacting own divergent domestic legislations. This has hampered complete implementation of the directive by member states. A lot of recommendations have been advanced to introduce corrective measures to necessitate more effective application of the directive. One such remedial action is the re-introduction of the community legislation on company law as well as several amendments to the Directive.²⁹¹

The experience of the EU Merger Directive is a significant step towards a model tax framework on cross border M&As. Whereas the process of harmonization of these rules was difficult and complicated, it nevertheless provides an opportunity to form a truly regional tax coordination forum. Moving forward, many jurisdictions can borrow much from their experience to introduce a better tax framework on cross border M&As.

4.5. Conclusion

The main purpose of this chapter was to present a framework to attract discussion on the best model of taxation of cross border M&As. To achieve the desired fit-for –all, neat and long standing solution, much more research and brainstorming is necessary. The literature brought out in this study has demonstrated the importance of efficiency based perspective as well as cooperative and coordination based approaches as viable solution for on taxation of cross border M&As. The driving theme of this chapter is that tax policy for cross border M&As

²⁸⁹ Brauner Y (n 212) 53

²⁹⁰ Article 11 of the European Merger Directive

²⁹¹ Commission of the European Communities (n 286) 330-333

must be coordinated across jurisdictions, contrary to the current unilateral nature of most relevant rules.

CHAPTER FIVE: CONCLUSION AND RECOMMENDATIONS

5.0. Conclusion

This study set out to determine whether the Income Tax Act is sufficient to deal with ensuing issues of mergers and acquisitions. Having looked at the literature in this study, analysis up to this point demonstrates that there is more reliance on M&As as a means of corporate synergies. This can be attributed to the unique benefits of mergers and acquisitions. Among the numerous advantages that M&As offer include accelerated business, increased synergy and increased cross border collaboration to enable the companies withstand global competition.

Even though there are numerous laws and regulations that together constitute the M&As control regime in Kenya, the focus on its tax aspects has drawn little interest. Indeed, the findings of this study are that few provisions exist in the Income Tax Act to deal with M&As. Even where these provisions exist, they are largely insufficient to deal with consequential issues relating to M&As.

The discussion in this chapter supports the desirability of having at least one basic reorganization or special rules provisions on M&As in the Income Tax Act. This serves the twin purposes of ensuring that efficiency gains are not impeded by M&As on the one hand and that M&As are not used as conduit for tax avoidance schemes on the other hand. Indeed, even investors' confidence is enhanced when there is a realization that the legal system in general, and specifically the taxation system provides for the special rules. In cross border transactions, the study has demonstrated the existence of various instruments to mitigate risks of tax flight are largely insufficient. Whereas some of the rules of cross border M&As transactions exist, confronting their tax challenges require more coordination and collaboration across jurisdictions.

5.1. Recommendations

From the onset, this study avoids bringing out firm recommendations on this subject matter. Its exploratory approach recognizes the need for further research before any concrete recommendations is drawn on the taxation dimensions of M&As in the Income Tax Act. The recommendations of this study are discussed from the perspective of both domestic and cross border M&As.

5.1.1. Domestic context

First, this study recommends exclusive and preferential provision on treatment of M&As in the Income Tax Act. Previous efforts had been placed to address specific technical problems in the design of the Income Tax Act. An example was the introduction of specific tax regime on extractive industries. Far less attention however, has been paid both in procedural and substantive aspects to deal with taxation of corporate restructuring activities relating to mergers and acquisitions. To avoid this uncertainty, a contextual definition of mergers and acquisitions should be provided for under the Income Tax Act. Control is a significant aspect in mergers transactions. The requirement of control however is treated differently in various corporate laws relating to mergers and acquisitions. The study therefore proposes the threshold for control under the Income Tax Act be harmonized to conform to the provisions under other sector laws.

Second, there is need to address the procedural aspects of mergers and acquisitions transactions. This requires that consideration of M&As applications be made to Kenya Revenue Authority. Presently, the absence prerequisite approval from the Authority sidelines it in an M/As arrangements. This means that most companies' complete mergers without necessarily understanding the tax implications of their transactions. The companies therefore become exposed to possible tax compliance queries and additional assessments.

Third, the study proposes for specific introduction of M&As costs/expenses subject to deductions. These include expenses relating to job losses, treatment of legal expenses and interest expenses. The purpose is to avoid uncertainty in treatment of these deductions.

Fourth, the study advocates for the reform to the capital gains tax regime. The scope of exemption currently is limited only to the transactions which are made in public interest. There are no guidelines that enable proper application of this exemption. The provision should also be clear whether the exemption is in relation to the shareholders or corporate level taxation. Provision on compensating tax needs to be completely scrapped. The intention of compensating tax regime was to ensure that dividends are matched with taxable profits. Its introduction is to cover the gaps left after the suspension of the CGT. However, the gains are now subject to CGT and the presence of the compensating tax can only cause duplication and confusion. This uncertainty results in double taxation and discourages transactions in the form of mergers and acquisitions.

Lastly, the study advocates for provision of specific rules to address tax attributes inherent in mergers and acquisition transactions. These include rules on carry forward of losses and capital allowances to the transferor in M&As transactions. Currently, it appears that the provisions in these aspects are far and wide. This is because the approach of determination of income from various sources is treated to be mutually exclusive. Therefore, reliefs on losses are only enjoyed from the profits of business or specific sources of income, from which they are claimed. This defeats the purpose of mergers especially those involving entities under financial strain.

5.1.2. Cross Border Context

Analysis of taxation aspects of cross border M&As is still at preliminary stages. It is hard to reach any decisive conclusion on the best model. It is an area that poses numerous challenges to tax policy makers due to various competing interests at play. Hard and fast tax policy

solutions may not be possible and the objective of this study is to provide some of the proposals that should form a basis of discussion on the subject. Since tax aspects on cross border mergers and acquisitions is a wider context of international tax law, the recommendations of this study are largely drawn from the desire to resolve common international tax issues like problems associated with double tax agreements, transfer pricing etc. These recommendations tie into the problem of inquiry in this study by providing proposals on how Kenya can navigate through the challenges of cross border M&As primarily the risk of revenue flight. Whereas some of the recommendations focus on strengthening the provisions of the Income Tax Act, the overwhelming premise is that the challenges associated with cross border taxation of M&As must be coordinated across jurisdictions contrary to the common desire for unilateral approaches.

First, one of the crudest measures perhaps is to introduce the exit or entry tax within the Income Tax Act. On the face value, this prevents the loss of revenue in the cross border M&As transactions. As earlier stated in the previous chapter, the imposition of these taxes needs to be carefully considered however, in light commercial practices in modern times which seek to encourage free movement of people and right of establishment of entities across borders.

Second, there is need to strengthen the existing the existing and future treaty networks and provide for taxation aspects of M&As. This requires effective utilization of bilateral tax treaties to safeguard the desire of parties to ring fence their tax jurisdiction. Kenya particularly, has not adequately taken advantage of this opportunity. In the absence of special tax rules to militate against tax flight in cross border transactions, negotiating these provisions in the bilateral tax treaties is a welcome idea. According to Brauner Yariv, the use of tax treaties is a viable option only to a limited extent, especially where countries have similar tax regimes, history of cooperation in tax matters and effective platform of exchange

of information.²⁹² It is also effective in countries with worldwide and branch tax.²⁹³ As already mentioned in the previous chapter, double tax agreements between Kenya and other jurisdictions do not directly touch on M&As tax rules. There is also little evidence on the use of Mutual Assistance Procedure and use of competent authorities as a dispute resolution mechanism. Few countries have incorporated these mechanisms in their bilateral treaties, and in most treaties that have them, use it in a very weak form.²⁹⁴ There is need to effectively utilize the central role of the competent authorities in providing a remedy for cross border aspects of mergers and acquisitions. Canada has consistently inserted these provisions in its bilateral tax treaties Nevertheless, it can be a lesson point on how to deal with taxation aspects of cross border M&As. In addition, this study recommends that Kenya adopts and takes advantage of the Multinational Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.²⁹⁵ With the treaty taking effect on 1st July 2018, a significant step has been made at international level to update the existing treaty networks with the aim of reducing opportunities for tax avoidance among members of multinational entities.²⁹⁶ This will require a reconsideration of each individual treaty in order to conform to the requirements of the Convention by way of incorporation of the special provisions of the convention in renegotiating the treaties.

Third, it is important to develop a revenue sharing scheme between the home and host countries where the cross border M&A occurs. Whereas this is not entirely a novel idea, it has never been developed to a workable, long standing operation, except for a brief cooperation over Valued Added Tax between Israel and Palestinian Tax Authorities.²⁹⁷ This is particularly so, when dealing with intangibles. Intangibles may be exploited worldwide,

²⁹²Brauner Y (n 212)60

²⁹³ *ibid*

²⁹⁴ *ibid*

²⁹⁵ Available at www.oecd.org accessed on 27th October 2018

²⁹⁶ Available at <http://www.oecd.org/tax/treaties/milestone-in-beps-implementation-multilateral-beps-convention-will-enter-into-force-on-1-july-following-slovenia-s-ratification.htm> accessed on 20th October, 2018

²⁹⁷ Brauner Y (n 212)61

with little evidence of country specific costs. This proposal must go hand in hand with improved cooperation and information exchange between the jurisdictions involved. This approach should not be adopted on priority basis, especially where other solutions are most efficient. It may be too excessive and its viability could be challenged on the basis of general scope and functions of revenue authority in a particular jurisdiction.

Fourth, and more importantly, one of the less contentious initiatives is to strengthen information exchange mechanisms across jurisdictions. Currently, a number of legal instruments exist on exchange of information. They include the use of Global Forum's Mutual Administrative Assistance in Tax Matters (MAA), Tax Information Exchange Agreements (TIEA), Intergovernmental Agreements (IGA) and section 26 of both OECD and UN Model Tax Conventions.²⁹⁸ Kenya has made good strides in this regard. In the year 2006, she became a party to the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (MCMAA).²⁹⁹ The Convention provides for common reporting standards,³⁰⁰ which creates a framework for sharing of tax related information. This approach looks good, at least theoretically, but in practice, may be difficult to implement. The nature of information that is shared may be sophisticated especially when it comes in form of systems and languages that are alien to a particular jurisdiction. As such, the country may not be well equipped to utilize the information more efficiently and the whole effort becomes wasteful.

Fifth, one of the less problematic methods is to develop global norm for attribution of income other than use of direct revenue sharing agreement matrix, which is less popular and inherently difficult to implement. This is majorly used in transfer pricing cases. Nevertheless, its application needs to be expanded in order to address difficulties arising from taxation of

²⁹⁸ East African Community (2014) *A Handbook on Exchange of Information On Tax Matters In The East African Community* (East African Community Arusha, 2014) 5

²⁹⁹ Moses Michira, 'Kenya Signs Global Treaty to Access Secret Information' *Standard Newspaper*(Nairobi, 13th February 2016) available at <https://www.standardmedia.co.ke/business/article/2000191511/kenya-signs-global-tax-treaty-to-access-secret-information>

³⁰⁰ Multilateral Convention on Mutual Administrative Assistance in Tax Matters (MCMAA)

cross border M&As. International bodies like the United Nations and OECD can frontier this international framework.

Lastly, Kenya needs to strengthen transfer pricing regime. With increasing volume of mergers and acquisitions largely in the financial sector, transfer pricing regime should be strengthened to make it more stable, reliable and transparent. Even though this study established the existence of transfer pricing provision and rules in the Income Tax Act, the need to scale up in international trade through a robust transfer pricing regime cannot be overstated. To this end, Kenya has to reinvigorate its transfer pricing law. This window of opportunity should aim to focus on introducing provisions of Advance Transfer Pricing Agreement and Safe Harbour Provisions in the Income Tax Transfer Pricing Rules. This will bring the transfer pricing regime to international standards and mitigate tax avoidance schemes in cross border M/As transactions.

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