

SECTION 4
SUBJECT NO. 10

TAXATION
STUDY TEXT

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ISBN NO: 9966-760-19-9

© 2009 STRATHMORE UNIVERSITY PRESS

First Published 2009

STRATHMORE UNIVERSITY PRESS

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Design Concept & Layout - Simplicity Ltd - P.O Box 22586-00400 Nairobi. Email: info@simplicityltd.com

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Acknowledgment

We gratefully acknowledge permission to quote from the past examination papers of **Kenya Accountants and Secretaries National Examination Board (KASNEB)**.



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CHAPTER ONE



STUDY TEXT

THEORY OF TAXATION



CHAPTER ONE

THEORY OF TAXATION

► 1.0 OBJECTIVES

At the end of this chapter, the student should be able to:

- Understand the various types of taxes imposed in Kenya
- Explain the importance of taxes in a country
- Explain the principles of taxation
- Differentiate between direct and indirect taxation
- Establish the different taxation systems
- Explain the economical effects of taxation
- Explain the role of taxation in achieving budgetary objectives

► 1.2 INTRODUCTION

We start our study of taxation with a look at the basic concepts and purposes of taxation. The chapter covers the general theory of taxation and forms the foundation of taxation. It contains major definitions that will be helpful in the subsequent chapters.

► 1.5 DEFINITION OF KEY TERMS

Tax: A compulsory payment by a tax payer to the state through the revenue authority without involving a direct repayment of goods and services in return.

Budget: A budget is a statement which consists of the revenue and expenditure estimates of the government for one particular year.

► 1.3 EXAM CONTEXT

In this chapter the main focus is to ensure that the student is conversant with all the basic concepts and the purpose of taxation, the student should be able to demonstrate his understanding of the same.

► 1.4 INDUSTRIAL CONTEXT

As indicated above, the chapter contains the general theory of taxation that will enable any one including tax consultants and budget analysts gain a general understanding of the taxation framework in Kenya.

1.6 TAXATION DEFINED

Taxation is the part of public finance that deals with the means by which the government raises revenue from the public by imposing taxes which revenue is used by the government to provide goods and services to the public or its citizens (to carry out government functions). Taxation may be referred to as the revenue raising activity of the government.

Public Finance is the department of economic theory that deals with public expenditure and revenue. Economics deals with resource allocation and seeks to answer the three questions of: who to produce, how to produce and for whom to produce.

We will start by exploring the government expenditure, which is characterised by the expected activities of a government. We will then look at the taxation as source of revenue to finance the government expenditure.

Government activities

A government is expected to carry out some activities as part of its service to the public. These activities are generally of universal application, but where applicable, a Kenyan example is given.

These activities are:

1. To maintain internal security and external defence and carry out general administration. In this respect, it will incur expenditure relating to:
 - The cost of police and judiciary for maintenance of law and order.
 - The cost of the armed forces such as the army, navy and airforce for defence against external aggression.
 - Cost of provincial administration and general administration of law and order.



2. To provide infrastructure and communication such as:
 - Cost of constructing roads, railways, airports and harbours.
 - Cost of constructing electricity and telephone networks, television and radio systems etc.
3. To provide basic social services such as the cost of:
 - Medical services and medicine in hospitals.
 - Education in schools, colleges and universities.
 - Water supply and sewerage.
 - Sports and cultural activities.
 - Entertainment and information on radio and television.
4. To participate in the production and marketing of commercial goods and services:
 - Cost of establishing public enterprises such as parastatals.
 - Combining with private business through purchase of shares in commercial enterprises. There is pressure all over the world for government to divest or privatise business enterprises. The Kenya government in the 1991 budget announced its plans to divest in 139 business enterprises.
 - Providing forms of easy loans not obtainable in financial institutions, and providing cheap business premises such as the Kenya Industrial Estates, Export Processing Zones etc.
 - Guaranteeing markets through protection from competition and preferential purchases.
5. Influencing and guiding the level and direction of economic activities through various regulations:
 - Monetary policy (relating to interest and money supply);
 - Fiscal policy (deliberate manipulation of government income and expenditure so as to achieve desired economic and social goals).
6. Redistributing income and wealth through taxation and public spending:
 - Taxing the rich and those able to afford tax.
 - Cost of providing basic needs to the poor such as free education, medical care and housing.
 - Cost of relief of famine and poverty which may arise from unemployment, sickness, old age, crop failure, drought, floods, earthquakes etc.

To perform the above functions effectively and adequately, the government needs funds. Taxation is an important source of government income. The income of the government from taxes and other sources is known as public revenue.

☐ Public Revenue Sources

Public revenue is all the amounts which are received by the government from different sources. The main sources of public revenue are as follows:

■ (a) Taxes

Taxes are the most important source of public revenue. Any tax can be defined as an involuntary payment by a tax payer without involving a direct repayment of goods and services (as a "**quid pro quo**") in return. In other words, there are no direct goods or services given to a tax payer in return for the tax paid. The tax payer can, however enjoy goods or services provided by the government like any other citizen without any preference or discrimination.

The following features are common in any tax system:

■ Taxing authority

This is the authority with the power to impose tax e.g. the central government or a local authority. The taxes are received as public revenue. The taxing authority has power to enforce payment of tax. The central government imposes tax through the Kenya Revenue Authority (KRA).

■ Tax payer

The person or entity that pays the tax e.g. individuals, companies, businesses and other organizations. The amount of tax is compulsory and there is punishment for failure to pay.

■ Tax

The amount paid to the taxing authority as direct cash payment or paid indirectly through purchase of goods or services. The tax is not paid for any specific service rendered by the tax authority to the tax payer. The tax paid becomes revenue and is used to provide public goods and services to all citizens.

In addition to the above common features of tax, the definitions of tax by some tax experts as listed below are important:

- a. A compulsory contribution to a public authority, irrespective of the exact amount of service rendered to the tax payer in return.
- b. A compulsory contribution from a person to the government to defray the expenses incurred in the common interest of all.
- c. A compulsory contribution of wealth by a person or body of persons for the service of the public. There is a portion of the produce of the land and labour of country that is placed at the disposal of the government for the common good of all.



Kinds of taxes

- i. **Income tax** — this is tax imposed on annual gains or profits earned by individuals, limited companies, business and other organisations. The income tax will be explained in chapters 2 to 5.
- ii. **Value added tax (V.A.T.)** — This is tax imposed on sale of commodities and services introduced in Kenya with effect from 1.1.90. VAT is discussed in detail under chapter 6 herein..
- iii. **Turnover Tax** — Is charged on income or receipts from business by taxable persons of a turnover between Sh. 500,000 and Sh. 5 million within a period of 12 months with effect from 1.1.2008. The Turnover Tax is explained in chapter 5 in detail.
- iv. **Sales tax** — This is tax imposed on sale of commodities which was abolished in Kenya on 31.12.89 and replaced with value added tax.
- v. **Excise duty** — This is tax imposed on commodities produced locally or imported. It targets specific commodities, for example, luxuries and commodities that are detrimental to health. The details of this are in chapter 7.
- vi. **Customs and excise duty** — This is tax imposed on import or export of commodities. The details of this tax are in chapter 7.
- vii. **Stamp duty** — This is tax that is aimed at legitimizing transactions. It is imposed on increase of share capital, transfer of shares, mortgages, charges, the transfer of property among others. The details of this tax are in chapter 8.

■ (b) Land rent and rates

These are levies imposed on property. Rent is paid to the Central Government on some land leases while rates are paid to the Local Authority based on the value of property. This is discussed further in Chapter 8.

■ (c) Fees

Fees is an amount which is received for any direct services rendered by the Central or Local Authority e.g. television and radio fees, national park fees, airport departure fee, airport landing and parking fee, port fee by ships, university fee, etc.

■ (d) Prices

Prices are those amounts which are received by the central or local authority for commercial services e.g. railway fare, postage and revenue stamps, telephone charges, radio and television advertisement etc.

■ (e) External borrowing

This is done from foreign governments and international financial institutions such as World Bank and International Monetary Fund (IMF).

■ (f) Fines and Penalties

If individuals and firms do not obey the laws of the country, fines and penalties are imposed on them. Such fines and penalties are also the income of the government.

■ (f) State Property

Some land, forests, mines, national parks, etc. are government property. The income that arises from such property is also another source of public revenue. The income will arise from payment of rents, royalties, or sale of produce.

■ (g) Internal Borrowing

The government usually raises revenue through issue of treasury bills and treasury bonds in the local market.

■ ■ ■ 1.7 WHY THE GOVERNMENT LEVIES TAXES

The raising of revenue is not the only purpose for which taxes are levied. The taxes are levied for various purposes as follows:

a. Raising Revenue

The main purpose of imposing taxes is to raise government income or revenue. Taxes are the major sources of government revenue. The government needs such revenue to maintain the peace and security in a country, to increase social welfare, to complete development projects like roads, schools, hospitals, power stations, etc.



b. Economic Stability

Taxes are also imposed to maintain economic stability in a country. In theory, during inflation, the government imposes more taxes in order to discourage the unnecessary expenditure of the individuals. On the other hand, during deflation, the taxes are reduced in order to encourage individuals to spend more money on goods and services. The increase and decrease in taxes helps to check the big fluctuations in the prices of goods and services and thus maintain the economic stability.

c. Protection Policy

Where a government has a policy of protecting some industries or commodities produced in a country, taxes may be imposed to implement such a policy. Heavy taxes are therefore imposed on commodities imported from other countries which compete with local commodities thus making them expensive. The consumers are therefore encouraged to buy the locally produced and low priced goods and services.

d. Social Welfare

Some commodities such as wines, spirits, beer, cigarettes, etc. are harmful to human health. To discourage wide consumption of these harmful commodities, taxes are imposed to make the commodities more expensive and therefore out of reach of as many people as possible.

e. Fair Distribution of Income

In any country, some people will be rich and others will be poor due to limited opportunities and numerous hindrances to becoming wealthy. Taxes can be imposed which aim to achieve equality in the distribution of national income. The rich are taxed at a higher rate and the amounts obtained are spent on increasing the welfare of the poor. That way, the taxes help to achieve a fair distribution of income in a country.

f. Allocation of Resources

Taxes can be used to achieve reasonable allocation of resources in a country for optimum utilization of those resources. The amounts collected from taxes are used to subsidise or finance more productive projects ignored by private investors. The government may also remove taxes on some industries or impose low rates of taxes to encourage allocation of resources in that direction.

g. Increase In Employment

Funds collected from taxes can be used on public works programmes like roads, drainage, and other public buildings. If manual labour is used to complete these programmes, more employment opportunities are created

1.8 PRINCIPLES OF AN OPTIMAL TAX SYSTEM

These are the principles of an optimal tax system, what are known as Canons of taxation, some of which were laid down by Adam Smith.

1. Simplicity

A tax system should be simple enough to enable a tax payer to understand it and be able to compute his/her tax liability. A complex and difficult to understand tax system may produce a low yield as it may discourage the tax payer's willingness to declare income. It may also create administrative difficulties leading to inefficiency. The most simple tax system is where there is a single tax. However, this may not be equitable as some people will not pay tax.

2. Certainty

The tax should be formulated so that tax payers are certain of how much they have to pay and when. The tax should not be arbitrary. The government should have reasonable certainty about the attainment of the objective(s) of that tax, the yield and the extent to which it can be evaded. There should be readily available information if tax payers need it.

Certainty is essential in tax planning. This involves appraising different business or investment opportunities on the basis of the possible tax implications. It is also important in designing remuneration packages. Employers seek to offer the most tax efficient remuneration packages which would not be possible if uncertainty exists.

3. Convenience

The method and frequency of payment should be convenient to the tax payer e.g. PAYE. This may discourage tax evasion. For example, it may be difficult for many tax payers to make a lump-sum payment of tax at the year-end. For such taxes, the evasion ratio is quite high.



4. Economic/Administrative Efficiency

A good tax system should be capable of being administered efficiently. The system should produce the highest possible yield at the lowest possible cost both to the tax authorities and the tax payer.

The tax system should ensure that the greatest possible proportion of taxes collected accrue to the government as revenue.

5. Taxable Capacity

This refers to the maximum tax which may be collected from a tax payer without producing undesirable effects on him. A good tax system ensures that people pay taxes to the extent they can afford it. There are two aspects of taxable capacity.

- a) Absolute taxable capacity
- b) Relative taxable capacity

Absolute taxable capacity is measured in relation to the general economic conditions and individual position e.g. the region, or industry to which the tax payer belongs.

If an individual, having regard to his circumstances and the prevailing economic conditions pays more tax than he should, his taxable capacity would have been exceeded in the absolute sense.

Relative taxable capacity is measured by comparing the absolute taxable capacities of different individuals or communities.

6. Neutrality

Neutrality is the measure of the extent to which a tax avoids distorting the workings of the market mechanism. It should produce the minimum substitution effects. The allocation of goods and services in a free market economy is achieved through the price mechanism. A neutral tax system should not affect the tax payer's choice of goods or services to be consumed.

7. Productivity

A tax should be productive in the sense that it should bring in large revenue which should be adequate for the government. This does not mean overtaxing by the government. A single tax which brings in large revenues is better than many taxes that bring in little revenue. For example Value Added Tax was introduced since it would provide more revenue than Sales Tax.

8. Elasticity or Buoyancy

By elasticity we mean that the government should be capable of varying (increasing or reducing) rates of taxation in accordance to the circumstances in the economy, e.g. if government requires additional revenue, it should be able to increase the rates of taxation. Excise duty, for instance, is imposed on a number of commodities locally manufactured and their rates can be increased in order to raise more revenue. However, care must be taken not to charge increased rate of excise duty from year to year because they might exert inflational pressures on the economy.

9. Flexibility

It means that there should be no rigidity in taxation i.e. the tax system can be changed to meet the revenue requirement of the state; both the rate and structure of taxes should be capable of change or being changed to reflect the state's requirements. Such that certain old taxes are discouraged while new ones are introduced. The entire tax structure should be capable of change.

10. Diversity

It means that there should be variety or diversity in taxation. That the tax base should be wide enough so as to raise adequate revenue and also the tax burden is evenly distributed among the tax payers. A single tax or a few taxes may not meet revenue requirements of the state. There should be both direct and indirect taxes.

11. Equity

A good tax system should be based on the ability to pay. Equity is about how the burden of taxation is distributed. The tax system should be arranged so as to result in the minimum possible sacrifice. Through progressive taxation, those with high incomes pay a large amount of tax as well as a regular proportion of their income as tax.

Equity means people in similar circumstances should be given similar treatment (horizontal equity) and dissimilar treatment for people in dissimilar circumstances (vertical equity).

There are three alternative principles that may be applied in the equitable distribution of the tax burden:

- a. The benefit principle
- b. The ability to pay principle
- c. The cost of service principle



■ The Benefit Principle

This dictates that tax is apportioned to individuals according to the benefit they derive from government activity and spending. The state is regarded as a market and taxes are treated as a payment for the goods and services provided by the state.

According to the principle, the provision of government goods and services, will, like the provision of private goods and services be dictated by market demand. This provision is inadmissible as it goes against the aims of taxation, which are also the duties of the government in a market economy, namely the redistribution of income and the clearing of market imperfections. In addition, the principle may have application in limited areas where a close relationship between government expenditure and benefit to the tax payer can be identified. For example road licenses charges are paid by the owners of vehicles who are the road users. However, even in such instances, the road users may not obtain benefit from such payment if the revenue so raised is not applied for the benefit of road users.

■ The Ability to Pay Principle

This is concerned with the equitable distribution of taxes according to the stated taxable capacity of an individual or to some criterion of ability to pay. This is in keeping with one of the principal aims of taxation, namely the distribution and stabilization objectives.

The difficulty in the application of this theory is in determining the criterion of the ability to pay. Three propositions have been advanced; income, wealth and expenditure. Should individuals be taxed according to their income, wealth or expenditure?

A wealth-based tax may be useful in the redistribution of income and wealth but may not provide sufficient revenue by itself. An expenditure tax ensures that both income and wealth are taxed, when they are spent. Most tax regimes would, therefore, be partly income-based and partly expenditure based.

■ The Cost of Service Principle

This is the cost to the authority of the services rendered to individual tax payers. Tax is a payment for which there is no "**quid pro quo**" between the tax authority and the tax payer; the tax payer does not necessarily have to receive goods and services equivalent to the tax paid.

For this reason, the principle cannot be applied in relation to services rendered out of the proceeds of taxes e.g. police, judiciary and defence. Rather, it may be applied for such services as postal, electricity, or water supply where the price of these services are fixed according to this principle, i.e. the price paid for postal services is the cost incurred in providing the service. It can therefore be stated that this principle may have limited application areas

1.9 CLASSIFICATION OF TAXES

There are five major classifications of taxes. These are:

1. Direct Taxes

A direct tax is one whose impact and incidence are on the same person. The impact of a tax is its money burden. A tax has impact on the person on whom it is legally imposed. The incidence of a tax is on the person who ultimately pays the tax whether or not it was legally imposed on him. Therefore a direct tax is one which is paid (incidence) by the person on whom it is legally imposed (impact). Examples are Pay As You Earn, corporation tax among others.

2. Indirect Taxes

Indirect tax is one whose impact is on one person, but paid partly or wholly by another. An indirect tax can be shifted or passed on, as opposed to a direct tax which cannot. Examples are taxes on commodities such as a sales tax, duty and excise tax.

A tax is not held to be indirect merely because it is collected from one person and paid by another. For example, tax on employment income, Pay As You Earn (PAYE) which is collected from the employees and paid by the employer.

Taxes are also classified according to how the marginal rates of tax vary with the level of income as explained herein below.

3. Progressive Taxes

A tax is progressive when the marginal rate of tax rises with income. A good example of a progressive tax in Kenya is the income tax on individuals.



Individual income tax rates for Kenya in 2009

Monthly taxable pay (Shillings)	Rates of tax % in each shilling	Annual taxable pay (Shillings)	Rates of tax % in each shilling
1-10164	10%	1 - 121968	10%
10165 - 19740	15%	121969 - 236880	15%
19741 - 29316	20%	236881 - 351792	20%
29317 - 38892	25%	351793 - 466704	25%
Excess over 38892	30%	Excess over 466704	30%
Personal Relief	(Sh.1,162 per annum)	Personal Relief	(Sh.13, 944 per annum)

4. Proportional Taxes

A tax is proportional when the same rate of tax is applied to all tax payers, for example the corporation tax which currently stands at 30% for all firms.

5. Regressive Taxes

A regressive tax is one where the rate of tax falls as income rises. Here, the poor are called upon to make a greater sacrifice than the rich.

6. Digressive tax

These are taxes that call upon the higher income earners to contribute less than their due contribution compared to the lower income earners. i.e.

- The burden is relatively less since the tax is mildly progressive-the rate of progression is not sufficiently steep. Or
- There is progression up to a certain point beyond which the rate becomes proportional.

>>> Illustration: Tax versus base of tax

Taxes can be classified on the basis of the object of taxation i.e. the tax base.

For example:	Income tax	-	tax based on income
	Turnover tax	-	tax based on income from business
	Sales tax	-	tax based on expenditure
	Wealth tax	-	tax based on wealth.

Progressive taxes are favoured for their redistribution of income. Progressive taxes take a larger proportion of an individual's gross income, the larger his/her income is.

In a free market economy, the allocation of goods and services is achieved via the price mechanism, (according to demand which is backed by purchasing power). The price mechanism fails because production of goods and services is not raised to the socially desirable level. Individuals would not be able to satisfy even their basic wants if they do not have the ability to purchase those goods. For example, no entrepreneur will set up private schools or hospitals in remote poverty stricken areas because of lack of demand.

The government intervenes to correct the market imperfection by taxing heavily the relatively affluent via a progressive income tax system, in order to fund the provision of essential goods and services at subsidized rates or at zero prices to all.

However, a steeply progressive tax system may discourage enterprise. This will be examined later under the effects of taxation.

Advantages of Direct Taxes As Opposed To Indirect Taxes

1. They are economical in collection. For example, with income tax the collection is done through employers who are unpaid "tax collectors".
2. Direct taxes, if progressive, can be made to fall equitably on all tax payers having regard to their relative abilities to pay. Indirect taxes tend to be regressive; i.e. they take more from the poor and relatively less from the rich.
3. Direct taxes are relatively more certain in quantity as opposed to indirect taxes e.g. a sales tax whose yield would depend on the elasticity of demand for the goods taxed.
4. They are usually less inflationary than indirect taxes. Usually indirect taxes are imposed on goods thus raising the price of goods (through forward shifting). The cost of living rises and this may trigger off serious confrontations between workers and employers, as the workers seek salary increases. If the employers grant such increases, it will lead to higher costs of production and prices. Higher prices will affect workers leading to a damaging wage-price spiral.



Disadvantages of Direct Taxes As Compared To Indirect Taxes

1. They are costly to administer, for example, every individual liable to income tax would have to be assessed independently depending on his/her taxable capacity. Indirect taxes have fewer collection points leading to administrative efficiency.
2. They are not flexible hence not adaptable to differing circumstances. They cannot be varied so quickly as indirect taxes and therefore, it takes longer for changes to take effect in the economy.
3. Indirect taxes as opposed to direct taxes lack announcement effect i.e. people are often unaware that they are paying tax or even how much they are paying. Direct taxes have direct effect on income and therefore may act as a deterrent to effort and enterprise. On the other hand, indirect taxes, although resulting in higher prices, encourage enterprise as people are induced to work harder so as to afford articles desired.
4. Higher levels of income tax reduce the incentive to save. On the other hand, high levels of indirect taxes may encourage saving when goods become unaffordable, and purchasing of goods is delayed in the hope that tax will later be reduced.
5. Some forms of direct taxes are paid annually as a lump sum. It may be difficult for the tax payer to find a lump sum and it gives opportunities for evasion by the submission of fraudulent returns of income.

1.10 TAX SHIFTING AND INCIDENCE OF A TAX

Tax Shifting

This is the transfer of the burden of a tax from the person on whom it is legally imposed to another person.

>>> Illustration

New KCC Ltd. buys milk from dairy farmers at Sh 5 per litre and after processing sells it at Sh 10. Assuming that a tax of 20% is imposed on every litre of milk sold, demonstrate how the tax can be shifted?

1. If New KCC Ltd. bears the whole tax i.e. it does not change the buying price or the selling price, there will be no tax shifting.
2. If New KCC Ltd. transfers the whole tax to the consumers by raising the selling price by Sh 2 to Sh 12 i.e. 20% of Sh 10, it is referred to as forward shifting.

3. New KCC Ltd. could transfer the whole burden to dairy farmers so that the buying price of milk is lowered by Sh 2 to Sh 3. This is referred to as backward shifting.
4. The tax could be shifted partly forward to the consumers and partly backwards to the farmers.
5. New KCC Ltd. could bear part of the tax shift forward partly and shift backwards partly.



Tax Burden

There are four aspects of tax burden, namely:

- a. The direct burden;
- b. The indirect burden;
- c. The money burden;
- d. The real burden.

1. The total direct money burden of a tax is its yield to the government. For every shilling of tax received by the treasury there corresponds a shilling of **direct money burden** upon someone.
2. The payment of tax constitutes a sacrifice of economic welfare or utility to the tax payer. The sacrifice is relatively greater, for example, to a poor man who parts with a shilling than to a rich man paying the same amount. This is referred to as the **direct real burden** of tax.
3. A tax on a commodity which is shifted forward to the consumers has the effect of raising its price. This may force the consumers to partake less of that commodity. The reduced consumption is the **indirect real burden** of the tax.
4. In the illustration above, the dealer would pay the tax to the government even before the commodity is sold and the tax recovered from the consumers. Some time will elapse, occasioning an opportunity cost to the dealer equivalent to the interest he could have earned on the money paid to the tax authorities. This constitutes the **indirect money burden** of the tax. Other examples of indirect money burden of tax would include tax consultancy fees, and the cost of remitting tax.



Tax Incidence

The incidence of a tax is the direct money burden of the tax. It deals with who ultimately pays the tax.

From the illustration given above the incidence of the tax collected from the dealer is:

1. Wholly on the consumer if, as a direct result of the tax, the price of the commodity rises by at least the full amount of the tax;
2. Wholly on the dealer if the price does not rise at all;

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3. Partly on the dealer if the price rises by an amount less than the full amount of the tax.

■ The Importance of Tax Incidence

There are numerous objectives of taxation. An efficacious tax system must be designed having regard to the possible incidence of the taxation. For example, if a tax is imposed on cigarette sales in order to discourage smoking and hence cut expenditure on health, it must be ascertained whether the smokers will be affected "adversely" by the tax. The importance of tax incidence can be summarised as follows:

- It ensures that there is an equitable distribution of the tax burden according to who pays the tax.
- The government needs to know who ultimately bears the money burden of any tax which shows the final resting point of any tax.
- It helps identify reactions and repercussions of any tax.

■ Incidence and effects of a tax distinguished

Incidence of a tax is its direct money burden equal to the total tax collections going to the treasury.

Effects of a tax refer to its real burden both direct and indirect e.g. sacrifice of economic welfare or reduced consumption of a commodity.

Incidence of a tax leads to the effect of the tax. It is the incidence of a tax that may be shifted.

■ 1.11 TAXABLE CAPACITY

Taxable capacity

This is the measure of an individual's ability to pay tax. There are two aspects of taxable capacity. These are:

■ • Absolute taxable capacity

This is the maximum amount of tax that can be collected from an individual or community without causing a diminishing effect in economic welfare. If adverse effects result from the operation of a given tax system, it can be held that the taxable capacity has been exceeded in an absolute sense.

■ • Relative taxable capacity

It refers to the distribution of the tax burden between two or more persons, communities or countries according to certain criterion of ability to pay. If one person contributes more than his due proportion of tax, it may be held that his taxable capacity has been exceeded in the relative sense.

Taxable capacity depends on the ability to pay tax and also on the ability of the government to collect the tax. Ability to pay mainly depends on the per capita income in excess of the subsistent requirements. The ability of the government to collect taxes depends on the administrative efficiency and effectiveness.

Factors affecting taxable capacity

■ • Number of inhabitants or population size

The larger the number of inhabitants or population size, the greater the taxable capacity of the country. This is the case at least in the absolute sense.

■ • Distribution of income and wealth

If incomes or wealth is relatively low and more equally distributed then taxable capacity will be correspondingly reduced and vice versa.

■ • Method of taxation

A good tax system with wide base with various tax types will yield more tax revenues.

■ • Purpose of taxation

If the purpose of tax is to promote the welfare of the people they will be more willing to pay the tax. If the tax is for fighting famine, drought, disease and the results are evident then tax payers are more willing to contribute towards such popular causes but if the public funds are raised to maintain expensive emoluments for civil servants then the taxable capacity will shrink.



■ • Psychology of tax payers

It depends on tax payer's attitude towards their government. A popular government can stimulate the spirit of the people and prepare them for great sacrifice.

■ • Stability of income

Where incomes are uncertain then the scope for further taxation is limited.

■ • Inflation

It lowers the purchasing power of persons and this would limit the ability to sacrifice for common good.

1.12 BUDGETARY OBJECTIVES

A budget is a statement which consists of the revenue and expenditure estimates of the government for one particular year. The budget is an important instrument that every government uses to define the direction of its national policy, the cost implications of government programmes, and the possible sources of revenues during a fiscal year. Budgetary objectives include:

- Price stability.
- Capital accumulation.
- Raising government revenue for provision of government services.
- Equitable distribution of income and wealth
- Collection and allocation of scarce resources to priority sectors]
- Provision of public goods and services by government; and
- The budget strives to ensure economic stabilization, social order and harmony, as well as acting as a measure of government performance and accountability. Though the concept of the budget as an indicator of performance is relatively new in many developing countries, it is steadily gaining ground with the advent of an increasing demand for transparency and accountability in government action plans.

In Kenya, the budgetary process proceeds in three main stages, namely:

- the drafting stage,
- the legislation stage, and
- the implementation and audit stage.

Its contents include a policy statement, an inventory of programme priorities, distribution/ allocation of the corresponding resources as well as budget implementation/evaluation reports for the previous budget cycle..

1.13 ROLE OF TAXATION IN ACHIEVING BUDGETARY OBJECTIVES

Taxation is the process of imposing compulsory contribution on the private sector to meet the expenses which are incurred for a common good. The role of taxation in achieving budgetary objectives includes:

a. Raise revenue

The revenue is required to pay for the goods and services which the government provides. These goods are of two types – public and merit goods. Public goods, such as defence and police are consumed collectively and no one can be prevented from enjoying them if he wishes to do so. These goods have to be provided by governments. Merit goods, such as education and medical care, could be, and often are, provided privately but not necessarily in the amounts considered socially desirable and hence governments may subsidize the production of certain goods. This may be done for a variety of reasons but mainly because the market may not reflect the real costs and benefits of the production of a good. Thus, the public may be subsidized because the market does not take account of all the costs and benefits of the public transport system.

b. Economic stability

These are imposed to maintain economic stability in the country. During inflation, the government imposes more taxes in order to discourage the unnecessary expenditure of the individuals. During deflation, taxes are reduced in order to enable the individuals to spend more money. In this way, the increase or decrease helps to check the big fluctuations in the prices and maintain economic stability.

 **c. Fair redistribution of income**

A major function of taxation is to bring about some redistribution of income. First, tax revenue provides the lower income groups with benefits in cash and kind. Second, the higher income groups, through a system of progressive taxation, pay a higher proportion of their income in tax than the less well-off members of the society.

 d. Pay interest on National debt

Taxes are also levied by the government to pay interest on national debt.

 e. Optimum allocation of resources

Taxes are also imposed to allocate resources of the country for optimum use of these resources. The amounts collected by the Government from taxes are spent on more productive projects. It means the resources are allocated to achieve the maximum possible output in the given circumstances.

 f. Protection policy

Taxes are also imposed to give protection to those commodities which are produced in the country. The government thus imposes heavy taxes on the import of such commodities from the other countries. In the view of these taxes, the individuals are induced to buy local products.

 g. Social welfare

The government imposes taxes on the production of those commodities which are harmful to human health e.g. excise duty on wines, cigarettes among others.

1.4 FISCAL POLICY REFORMS AND THEIR IMPACT ON GOVERNMENT REVENUE, EXPENDITURE AND ECONOMIC ACTIVITIES

Fiscal policy

Fiscal policies are measures arrived at achieving desirable economic objectives by the government. Fiscal policy is made up of: Public debt, public expenditure and public revenue as the major instruments. The major source of public revenue is tax hence taxation policy is an important part of fiscal policy.

The objectives of fiscal policy in a developing country such as Kenya are:

- Achievement of desirable wealth distribution
- Encouragement of flow of investment into desirable areas of the society
- Attract foreign and local investments e.g. through tax incentives
- Promote import substitution
- Achievement of desirable level of development
- Promote accountability in public finance and recourses i.e. good governance of public institutions
- Increasing the level of employment

A budget is a statement which consists of the revenue and expenditure estimates of the government for one particular year.

Where government estimate expenditure is greater than the revenue, a **deficit budget** arises. If estimate revenue is greater than the expenditure the budget is referred to as a **surplus budget**.

A budget is prepared on an annual basis, presented by the Minister of Finance before Parliament for approval.

A budget may be of two kinds:

- Revenue budget.
- Capital budget.



Revenue budget relates to normal income and expenditure items while capital budget relates to development projects. The main sources of revenue for the revenue budget include:-

- Income and corporation tax.
- Customs and excise duties.
- Income from state properties.
- Fines

The main expenditure heads for the revenue budget include:

- Administration.
- Defence.
- Education.
- Health.
- Tax collection.

Capital budget

Sources of income for the capital budget are:

- Loans and grants obtained by the government from other sources.
- Planned expenditure made up of government contribution to foreign financed projects.

Budgetary Policy

This is the sum total of all measures designed to achieve clearly designed budgetary objectives with a view to regulate the economy.

Budget as an instrument of planning

A budget is an instrument of development planning. In a planned economy, a budget is a plan of national resources and output capacity. It is the overall regulator of all the determinants of economic growth. A budget can encourage or discourage private expenditure.

Government budget can be used to increase the rate of capital accumulation and economic growth.

Budget ensures sound finance in light of the ever increasing responsibility of the requirements for spending.

Note: the government uses both fiscal and monetary instruments in order to achieve budgetary objectives. Budgetary policies may be separately designed to answer particular needs of uses fiscal and monetary instruments to achieve this.

□ Budget Surplus and Deficit

Where the government operates a **budget surplus**, by increasing taxation, all other factors constant, there will be a decrease in private bank balances. With no excess reserves in banks, there will be a decline in the total money supply and hence interest rates will rise.

Decreased bank balances will reduce bank credit and the resultant high interest rate reduces private borrowing and investment, a deflationary effect on aggregate economic activity results.

Where the government operates a budget deficit, then such deficit has to be financed through:

■ Short term strategies for financing budget deficit

- Running down cash reserves.
- Use of fiduciary issues or paper monies.
- Use of open market operations e.g. sale of government bonds or securities, assets, property.
- Borrowing both locally and abroad.

This approach will expand the money supply and drive interest rates down. It will induce an expansionary influence on the level of economic activity

■ Long term strategies in reducing budget deficit include:

- To increase borrowing both internally and externally so as to increase revenue. The problem with this strategy is that there is the cost of servicing the loan as well as final repayment of the loans which can be a burden to the state.
- Reduce the deficit by cutting down on the expenditures such as debt repayment, defence and public administration.
- Increasing taxes bearing in mind the taxable capacity. Indirect taxes would be more favourable.



■ Role of the Parliament in the budgetary process

- Budget proposals are presented to Parliament by the Finance Minister in June each year.
- The proposals are debated upon by the Members of Parliament.
- Each Ministry will seek authority from parliament to get funds from the consolidated fund.
- Parliament will monitor budget implementation through the Public accounts Committee, Public Investment Committee.
- The Public Accounts Committee scrutinizes the use of funds and makes a report to parliament. The PAC will scrutinize the performance of funds which are meant for public investments.

CHAPTER SUMMARY

- A tax can be described as the compulsory contribution imposed on individuals to meet the expenses which are incurred for a common cause. There is no direct benefit expected for this contribution.
- The principles of an optimal tax system are; Equity, Simplicity, Certainty, Convenience, Administrative efficiency, Efficiency, Neutrality, Productivity, Diversity, Flexibility and Elasticity among others.
- Taxes can broadly be classified into two groups namely:
 1. Direct taxes
 2. Indirect taxes.
- Taxes can also be classified as follows
 - i. Progressive taxes:
 - ii. Regressive taxes
 - iii. Digressive taxes
 - iv. Proportional taxes
- Tax incidence is the direct money burden of the tax. It deals with who ultimately pays the tax.
- Tax shifting this is the transfer of the burden of a tax from the person on whom it is legally imposed to another person
- Taxation plays a crucial role in achieving the budgetary objectives of a country.



CHAPTER QUIZ

Question One

Briefly explain the principles or canons of taxation.

(10 marks)

Question Two

Define a direct tax and explain some of its benefits

(10 marks)

Question Three

Explain the Benefit Theory.

(5 marks)

Question Four

Distinguish between regressive and digressive taxes

(5 marks)

(Total: 30 marks)

CHAPTER QUIZ ANSWERS

Question One

Principles/ canons of Taxation

1. Simplicity

A tax system should be simple enough to enable a tax payer to understand it and be able to compute his/her tax liability. A complex and difficult to understand tax system may produce a low yield as it may discourage the tax payer's willingness to declare income. It may also create administrative difficulties leading to inefficiency. The most simple tax system is where there is a single tax. However, this may not be equitable as some people will not pay tax.

2. Certainty

The tax should be formulated so that tax payers are certain of how much they have to pay and when. The tax should not be arbitrary. The government should have reasonable certainty about the attainment of the objective(s) of that tax, the yield and the extent to which it can be evaded. There should be readily available information if tax payers need it.

Certainty is essential in tax planning. This involves appraising different business or investment opportunities on the basis of the possible tax implications. It is also important in designing remuneration packages. Employers seek to offer the most tax efficient remuneration packages which would not be possible if uncertainty exists.

3. Convenience

The method and frequency of payment should be convenient to the tax payer e.g. PAYE. This may discourage tax evasion. For example, it may be difficult for many tax payers to make a lump-sum payment of tax at the year-end. For such taxes, the evasion ratio is quite high.

4. Economic/Administrative Efficiency

A good tax system should be capable of being administered efficiently. The system should produce the highest possible yield at the lowest possible cost both to the tax authorities and the tax payer.

The tax system should ensure that the greatest possible proportion of taxes collected accrue to the government as revenue.



5. Neutrality

Neutrality is the measure of the extent to which a tax avoids distorting the workings of the market mechanism. It should produce the minimum substitution effects. The allocation of goods and services in a free market economy is achieved through the price mechanism. A neutral tax system should not affect the tax payer's choice of goods or services to be consumed.

6. Productivity

A tax should be productive in the sense that it should bring in large revenue which should be adequate for the government. This does not mean overtaxing by the government. A single tax which brings in large revenues is better than many taxes that bring in little revenue. For example Value Added Tax was introduced since it would provide more revenue than Sales Tax.

7. Elasticity or Buoyancy

By elasticity we mean that the government should be capable of varying (increasing or reducing) rates of taxation in accordance to the circumstances in the economy, e.g. if government requires additional revenue, it should be able to increase the rates of taxation. Excise duty, for instance, is imposed on a number of commodities locally manufactured and their rates can be increased in order to raise more revenue. However, care must be taken not to charge increased rate of excise duty from year to year because they might exert inflationary pressures on the economy.

8. Flexibility

It means that there should be no rigidity in taxation i.e. the tax system can be changed to meet the revenue requirement of the state; both the rate and structure of taxes should be capable of change or being changed to reflect the state's requirements. Such that certain old taxes are discouraged while new ones are introduced. The entire tax structure should be capable of change.

9. Diversity

It means that there should be variety or diversity in taxation. That the tax base should be wide enough so as to raise adequate revenue and also the tax burden is evenly distributed among the tax payers. A single tax or a few taxes may not meet revenue requirements of the state. There should be both direct and indirect taxes.

10. Equity

A good tax system should be based on the ability to pay. Equity is about how the burden of taxation is distributed. The tax system should be arranged so as to result in the minimum possible sacrifice. Through progressive taxation, those with high incomes pay a large amount of tax as well as a regular proportion of their income as tax.

Equity means people in similar circumstances should be given similar treatment (horizontal equity) and dissimilar treatment for people in dissimilar circumstances (vertical equity).

Question Two

Definition of a direct tax

A direct tax is one whose impact and incidence are on the same person.

A direct tax is one which is paid (incidence) by the person on whom it is legally imposed (impact). Examples are income tax and corporation tax.

Advantages of direct taxes

1. They are economical in collection. For example, with income tax the collection is done through employers who are unpaid "tax collectors".
2. Direct taxes, if progressive, can be made to fall equitably on all tax payers having regard to their relative abilities to pay. Indirect taxes tend to be regressive; i.e. they take more from the poor and relatively less from the rich.
3. Direct taxes are relatively more certain in quantity as opposed to indirect taxes e.g. a sales tax whose yield would depend on the elasticity of demand for the goods taxed.
4. They are usually less inflationary than indirect taxes. Usually indirect taxes are imposed on goods thus raising the price of goods (through forward shifting). The cost of living rises and this may trigger off serious confrontations between workers and employers, as the workers seek salary increases. If the employers grant such increases, it will lead to higher costs of production and prices. Higher prices will affect workers leading to a damaging wage-price spiral.

Question Three

The benefit theory

This dictates that tax is apportioned to individuals according to the benefit they derive from government activity and spending. The state is regarded as a market and taxes are treated as a payment for the goods and services provided by the state.

According to the principle, the provision of government goods and services, will, like the provision of private goods and services be dictated by market demand. This provision is inadmissible as it goes against the aims of taxation, which are also the duties of the government in a market economy, namely the redistribution of income and the clearing of market imperfections. In addition, the principle may have application in limited areas where a close relationship between government expenditure and benefit to the tax payer can be identified. For example road licenses charges are paid by the owners of vehicles who are the road users. However, even in such instances, the road users may not obtain benefit from such payment if the revenue so raised is not applied for the benefit of road users



Question Four

Regressive Taxes

A regressive tax is one where the rate of tax falls as income rises. Here, the poor are called upon to make a greater sacrifice than the rich.

Digressive tax

These are taxes that call upon the higher income earners to contribute less than their due contribution compared to the lower income earners. i.e.

- (a) The burden is relatively less since the tax is mildly progressive-the rate of progression is not sufficiently steep. Or
- (b) There is progression up to a certain point beyond which the rate becomes proportional.

PAST PAPER QUESTIONS ANALYSIS

The following is an analysis on how the chapter has been examined in the past. The questions are listed in this format: Month/year e.g. 6/01 represents June or May 2001.

Taxation 1: 6/08, 6/07, 6/06, 6/05, 12/05, 6/04, 12/03, 6/03, 6/02, 6/01, 12/00

EXAM QUESTIONS

Question one

(a) Distinction between a single and multiple tax system (4 marks)

(b) Explain the reasons why a country might prefer a multiple tax system over a single tax system (8 marks)

(Total: 12 marks)

(Tax 1: June 2008 Question 1)

Question two

- (a) Name and briefly explain the principles of a good tax system.

(Total: 16 marks)

(Tax 1: May 2001 Question 5 (a))

Question three

- (a) (i) Define the term “fiscal policy”. (2 marks)

- (ii) State six objectives of fiscal policies with specific reference to the needs of developing countries. (6 marks)

(Tax 1: June 2007 Question 3)

Question four

- (a) Distinguish between forward and backward shifting of a tax (2 marks)

- (b) Briefly explain the extent to which the following taxes can be shifted.

(i) Income tax (2 marks)

(ii) Customs duty (2 marks)

- (c) Outline four advantages of progressive taxes. (4 marks)

(10 marks)

(Tax 1: June 2005 Question 2)

Question five

- a) Define the following terms

i) Impact of a tax

ii) Incidence of a tax

(4 marks)

(Tax 1: June 2006 Question 2)

(Total: 50 marks)

CHAPTER TWO



STUDY TEXT

TAXATION OF INCOMES OF PERSONS



CHAPTER TWO

TAXATION OF INCOMES OF PERSONS

► 2.0 OBJECTIVES

- Establish the tax liability of different individuals, partnerships and body corporates
- To be able determine a resident and a non resident for taxation purposes
- Establish the different incomes to be taxed and the non taxable incomes
- Explain the treatment of different incomes in the computation of tax
- Evaluate the taxation of married women in Kenya

► 2.1 INTRODUCTION

In the previous chapter we were introduced the general taxation framework in Kenya. In this chapter, we identify the various incomes to be taxed. We also see how to collect together all of an individual's income in a personal tax computation, and then work out the tax on that income. In addition, we shall study how to compute tax of partnerships and body corporates. Further, we will look at the expenses that are allowable and not allowable against income of a taxable person. In the next chapter we will look at the taxation of specific sources of income of a taxable person.

► 2.2 DEFINITION OF KEY TERMS

Residence - The term residence is a concept used to determine the tax treatment of a person. It applies both to individuals and companies as discussed herein below.

Taxable income - This is income of a person that is subject to tax under the taxation Acts. It includes, employment income, business income, income arising from rights granted for use of property among others.

► 2.3 EXAM CONTEXT

In this chapter the main focus is to ensure that the student is conversant with the computation of the tax on the income of an individual, partnerships and body corporates. This chapter is highly examinable.

► 2.4 INDUSTRY CONTEXT

This chapter will assist the accountant be able to compute tax on salaries (PAYE) and also on their other incomes. Further, it will help the firm or company's management ascertain their respective tax liability. This will help the accountant in ensuring compliance with the tax law.

2.5 IMPOSITION (CHARGING) OF INCOME TAX

Income Tax, or the tax on income, is charged on income of a person for each year in accordance with section 3(1) of the Income tax Act. It is worth examining the charging section in detail.

S 3(1)"..... a tax to be known as income tax shall be charged for each **year of income** upon all the **income** of a **person**, whether **resident** or **non-resident**, which **accrued in or was derived from Kenya.**"

The words and phrases highlighted above are crucial in the taxation of income and it is important to understand their meaning in detail.

Year of income

Year of Income is a period of 12 months commencing 1 January and ending on 31 December in each year. It is the same as calendar year.

Income tax is charged for each year of income.

The year of income should be distinguished from the accounting year. There is a date to which accounts of a business are prepared each year, and this date would indicate the accounting year end. The accounting year ending on 31 December would coincide with the year of income. Other accounting year-ends would however fall in a given year of income and the profit or loss per the accounts would be for that year of income. For example, an accounting date ended 30 May 2008 would fall to be treated as the year of Income 2008.

(Taxable) income

The Act does not defined income, but taxable income is said to include gains or profit from various sources, for example:

- business profits;
- employment salary, wages, bonus, commission etc;
- investment income e.g. interest and dividend income;



(Taxable) person

A person whose income is taxed is either:

- a) An individual i.e. a natural person; or
- b) A legal person e.g. a company. The company here includes a Trust, Co-operative Society, Estate, Club, Trade Association etc.

A taxable person does not include a partnership. A partnership is not taxed on its income, but the partners are taxed on their share of profit or loss from the partnership. However, under Turnover Tax ((TOT), a taxable person has been defined to include a partnership.

■ Resident and non-resident persons

There are conditions for being a resident in case of an individual and also in case of a body of persons.

a) **Resident in relation to an individual means that the individual:**

- i) Has a permanent home in Kenya and was present in Kenya for **any** period during the year of income under consideration; or
- ii) Has no permanent home on Kenya but was present in Kenya for a period or periods amounting in total to 183 days or more during the year of income under consideration; or
- iii) Has no permanent home in Kenya but was present in Kenya for any period during the year of income under consideration and in the two preceding years of income for periods averaging **more than** 122 days for the three years.

>>> **Example**

Gatonye and Mosesti visited Kenya between 2003 and 2005 as follows.

Year	Days in Kenya	
	Gatonye	Mosesti
2005	365	364
2006	1	1
2007	3	1
Total days	369	366
Average for the three years	123 days	122 days

Gatonye was a resident in 2007 as the average days for the three years is more than 122 days. Mosesti was not a resident in 2007 as the average days for the three years at 122 is not more than 122 days.

Note: Kenya includes the air space which is a distance up in the sky considered to be part of Kenya. It also includes the Territorial waters which is a distance into the sea considered to be part of Kenya.

b) Resident in relation to a body of persons means that:

- i) The body is a company incorporated under the laws of Kenya; or
- ii) The management and control of the affairs of the body was exercised in Kenya in the year of income under consideration; or
- iii) The body has been declared, by the Minister for Finance by a notice in the Gazette, to be resident in Kenya for any year of income.

c) Non-Resident:

- Means any person (individual or body of persons) not covered by the above conditions for resident.

Note

- Residents have some tax advantages over non-residents which relate to tax reliefs, rates of tax, and expenses allowable against some income.

(Income) Accrued In or Derived From Kenya

- The income which is taxable is income arising from or earned in Kenya.
- Under certain conditions, some business and some employment income derived from outside Kenya is taxable in Kenya.

2.5.2 SOURCES OF TAXABLE INCOMES

Some items of income are subject to tax and others are not. The Act has listed the income upon which tax is charged. The income which is taxed is income in respect of:

- a) Gains or profits from business;
- b) Gains or profits from employment or service rendered;
- c) Gains or profit from rights granted to other persons for use or occupation of property e.g. rent;
- d) Dividend and interest;
- e) Pension, charge or annuity, and withdrawals from registered pension and provident funds;
- f) An amount deemed to be income of a person under the Act or rules made under the Act;



Any person (individual or legal person) who receives all or some of the above income in a given year of income is taxed on the income. Each item of taxable income will be examined in detail to see the various components that make up the particular item of income.

2.5.3 NON TAXABLE INCOMES/ EXEMPT INCOME

There are items which are commonly referred to as income but are not included in the above mentioned list of taxable income. A number of such non-taxable incomes come to mind such as:

1. Dowry
2. Gifts - (however, tip arising from employment are taxable)
3. Harambee collections
4. Inheritance
5. Charity sweepstake winnings
6. Premium bonds winnings
7. Income or interest on post office savings bank account
8. Profit on selling isolated assets
9. Honoraria
10. Pension or gratuities earned or granted in respect to disability
11. The income of a registered pension fund or trust scheme or provident funds.
12. Monthly or lumpsum pension granted to a person who is 65 years of age or more.
13. That part of the income of the president of the republic of Kenya that is exempt e.g. a salary duty, allowances, entertainment allowances paid or payable to him from public funds
14. Allowances to the speaker, deputy speaker and MP payable to them under the National Assembly remuneration
15. Interest up to Sh.100,000 per individual on housing bonds, account with Housing Finance Corporation of Kenya (HFCK), Savings and loans of Kenya Ltd, East Africa Building Society, Home Loans and Savings. (With effect from June 1987, interest up to Sh 300,000 is qualifying while the excess is non qualifying.)
16. Income of parastatals bodies
17. Dividend received by a resident company from another resident company where it controls 12 ½ % or more of the voting power or share capital
18. Cost of passage to and from Kenya of a non-citizen employee borne by the employer.
19. Employer's contribution to pension funds or provident funds
20. Benefits, advantages/facilities of an aggregate value of less than Sh.36,000 p.a. in respect of employment or services tendered.(W.e.f.1.1.2006, non cash benefits are taxed if their aggregate value is more than Sh 36000 p.a or Sh 3000 p.m.)
21. The income of agricultural bodies
22. The income of any local authorities
23. Interest on any tax reserve certificates issued by the Kenya Government.
24. The income from the investment of annuity as defined under Section 19 of the Income tax Act, of an insurance company

2.5.4 TAXABLE AND NON TAXABLE PERSONS AND INSTITUTIONS

Taxable person

A person whose income is taxed is either:

- c) An individual i.e. a natural person; or
- d) A legal person e.g. a company. The company here includes a Trust, Co-operative Society, Estate, Club, Trade Association etc.

A taxable person does not include a partnership. A partnership is not taxed on its income, but the partners are taxed on their share of profit or loss from the partnership. However, under Turnover Tax (TOT) regulations, a taxable person has been defined to include a partnership.

Non taxable persons and institutions

1. The President: That part of the income of the President derived from salary, duty allowance and entertainment allowance paid or payable to him from public funds in respect of or by virtue of his office as President.
2. The income of :
 - The Tea Board of Kenya, The Pyrethrum Board of Kenya,
 - The Sisal Board of Kenya, The Kenya Dairy Board,
 - The Canning Crops Board, The Central Agricultural Board,
 - The Pig Industry Board, The Pineapple Development Authority,
 - The Horticultural Crops Development Authority, The National Irrigation Board,
 - The Mombasa Pipeline Board, The Settlement Fund Trustees,
 - The Kenya Post Office Savings Bank, the Cotton Board of Kenya.
3. Charitable organizations as defined by the Act.
4. The income other than income from investment of an amateur sporting association.
5. Profits or gains of an agricultural society accrued in or derived from Kenya from any exhibition or show held for the purposes of the society, which are applied, solely to those purposes, and the interest on investments of that society.
6. The income of any local authorities
7. Interest on any tax reserve certificates issued by the Kenya Government
8. The income of any registered pension scheme.



9. The income of any registered provident fund.
10. The income of any registered trust scheme.
11. The income from the investment of an annuity fund defined in Sec.19 of the Income Tax Act, of an Insurance Company.
12. Pensions or gratuities granted in respect of wounds or disabilities.
13. Interest on a savings account held with the Kenya Post Office Savings Bank.
14. Interest paid on loans granted by the Local Government Loans Authority.
15. The income of a non resident person who carries on the business of air transport provided the country where that person is resident offers the same facility to Kenya residents in the similar business.
16. The income of a registered individual retirement fund.
17. The income of a registered home ownership savings plan.
18. Allowances to the Speaker, Deputy Speaker and Members of the Parliament payable under the National Assembly Remuneration Act.
19. Interest up to a maximum of ShSh 300,000 per individual earned on housing bonds with:
 - Housing Finance Corporation of Kenya (HFCK)
 - Savings and Loan Kenya Limited
 - East African Building Society
 - Home Loans and Savings

Any interest in excess of Sh.300,000 is subject to 10% withholding tax. This means that after the withholding tax at 10%, the interest will not be subject to any tax.

2.6 TAX RATES: RELIEF AND WITHHOLDING TAXES

2.6.1 RATES OF TAX

Rates of tax

After determining the taxable income, also referred to as assessable or chargeable income/loss of a person, the person is taxed.

- a) Loss is carried forward on the basis of specified sources until the person makes a profit to off-set the loss. The loss from one specified source can only be off-set against future income from the same specified source.
- b) Income is taxed at the prescribed rates of taxation.
There are Corporation rates of tax applicable to companies (legal persons) and there are individual rates of tax applicable to individuals (natural persons)

Corporation Rates of Tax

The corporation rates of tax apply to legal persons such as companies, trusts, clubs, estates, co-operatives, associations etc.

- 1) Corporate rate of tax from years 2000 to date is 30% for resident corporations.
- 2) From year 2000 to date, a non-resident company with a permanent establishment in Kenya is taxed at 37½%.



■ Listed companies

Companies newly listed on any securities exchange approved under the Capital Markets Act enjoy favorable corporation tax rates as follows:

- If the company lists at least 20% of its issued share capital listed, the corporation tax rate applicable will be 27% for the period of three years commencing immediately after the year of income following the date of such listing.”
- If the company lists at least 30% of its issued share capital listed, the corporation tax rate applicable will be 25% for the period of five years commencing immediately after the year of income following the date of listing.”
- If the company lists at least 40% of its issued share capital listed, the corporation tax rate applicable will be 20% for the period of five years commencing immediately after the year of income following the date of such listing.

The corporate tax rate applicable to the company may therefore change if the percentage of the listed share capital exceeds 20% of the issued share capital. The applicable tax rate will depend on the percentage of the issued share capital listed at the Nairobi Stock Exchange.

□ Tax rates for individuals

An individual is taxed at graduated scale rates such that the higher the income, the higher the tax as follows:

2002 - 2004	Bands of taxable income	Taxable income	Tax rate on band	Tax on band	Cumulative tax on income
	Sh	Sh	%	Sh	Sh
First	0	116,160	10	11,616	11,616
Next	109,440	225,600	15	33,840	45,456
Next	109,440	335,040	20	67,008	112,464
Next	109,440	444,480	25	111,120	223,584
OVER	444,180		30		
2005 to date	Bands of taxable income	Taxable income	Tax rate on band	Tax on band	Cumulative tax on income
	Sh	Sh	%	Sh	Sh
First	0	121,968	10	12,196.8	12,196.8
Next	114,912	236,880	15	17,236.8	29,433.6
Next	114,912	351,792	20	22,982.4	52,416.0
Next	114,912	466,704	25	28,728	81,144.0
OVER	466,704		30		

Providing certain conditions are satisfied, the above rates also apply to a wife's employment, wife's professional and wife's self employment income. The liability on wife's employment income, wife's professional and wife's self employment income is calculated separately but assessed together with that of the husband's income. However, the wife can opt to be taxed on her income and as such file a separate assessment.

2.6.2 RELIEFS

Personal Relief

The personal relief is **claimed and granted only to resident individuals**. The relief reduces tax payable by an individual.

■ General Application:

- 1) The personal relief reduces tax payable by a resident individual only.
- 2) Any resident individual is entitled to claim personal relief. The relief does not apply to non-resident individuals or to companies.
- 3) The personal relief is currently Sh.13,944 p.a (1,162 pm) granted on the basis of number of months worked during the calendar year.

Insurance Relief

A resident individual will be entitled to an insurance relief at the **rate of 15% of the premiums** paid subject to a maximum of Sh5000 p.m (**Sh. 60,000 p.a**) if he proves that;

- He was paid premium for an insurance made by him on his life, or the life of his wife, or his child and that the insurance secures a capital sum payable in Kenya and in the law full currency of Kenya.
- His employer paid premium on the insurance of the life of the employee which has been charged to tax in the hands of the employee.
- Both employer and employee have paid premiums on the insurance.

NB

Premiums paid for an educational policy with a monthly period of at least 10 years shall qualify for this relief.



2.6.3 WITHHOLDING TAX

A resident person is required to withhold tax on various payments, under section 35 of the Income Tax Act. Withholding tax is applicable on payments to both residents and non-residents. Such payments include dividends, interest, royalties, management and professional fees and agency, consultancy and contractual fees.

The importance of deducting withholding tax is that it makes tax collection easy and it also ensures that some incomes do not escape taxation. The withholding tax should be viewed as income tax paid in advance.

A person making payments of incomes subject to withholding tax is legally required to deduct the withholding tax or the tax at source at appropriate rates before effecting the payment and:

- Remit the tax so deducted to the Domestic Taxes Department;
- Pay the payee the amount net of tax; and
- Issue the payee with a certificate of the withholding tax or tax paid at source e.g. interest certificate or a dividend voucher. For any given year of income, the payee is assessed on gross income and is given credit for the tax paid at source except in cases where the withholding tax is the final tax.

The withholding tax rates are as follows:

WITHHOLDING TAX RATES			
Payments	Notes	Tax Rates	
		Residents	Non-Residents
		%	%
Dividends		5%	10%
Interest - Housing Bonds	(a)	10%	15%
- Other sources	(b)	15%	15%
Insurance Commission	(c)		
- Brokers		5%	20%
- Others		10%	20%
Royalties		5%	20%
Pension and retirement annuities	(d)	0%-30%	5%
Management and professional fees, training fees	(e)	5%	20%
Sporting or entertainment income			20%
Real estate rent			30%
Lease of equipment		3%	15%
Contractual fee	(e)	3%	20%
Telecommunication service fee	(f)		5%

Notes:

- (a) Qualifying interest in respect of Housing Bonds is limited to Sh 300,000 per year.
- (b) Withholding tax on interest income received by a resident individual from the following sources is final:
 - Banks or financial institutions licensed under the Banking Act.
 - Building societies licensed under the Building Societies Act.
 - Central Bank of Kenya.
- (c) Commissions payable to non-resident agents for purposes of auctioning horticultural produce outside Kenya are exempt from withholding tax.
- (d) Tax deducted at source on withdrawals from provident and pension schemes in excess of the tax-free amounts made after the expiry of fifteen years or on the attainment of the age of fifty years, or upon earlier retirement on health grounds are final.
- (e) Withholding tax on payments to resident persons for management and professional fees applies to payments of Sh 24,000 or more in a month to both registered and non-registered business.

The tax rate in respect of consultancy fees payable to citizens of the East African Community Partner States is 15%.

- (f) The tax is subjected to payments made to non-resident telecommunication service providers and is based on gross amounts.

Note: Various reduced rates of withholding tax apply to countries with double tax relief treaties with Kenya.

The incomes of the non-residents are taxed gross, that is, no expenses are allowed against the income.

The withholding tax must be remitted to the Domestic Taxes Department within 20 days of its being deducted. There is no further tax for the non-resident after the withholding tax is paid as far as Kenya is concerned.



2.6.4 OTHER TAXES AT SOURCE

There other taxes that are deducted at source in addition to withholding tax. These are:

Employment income (PAYE)

The employment income is taxed at source monthly under the Pay As You Earn (PAYE) tax deduction system. The tax is referred to as Income tax. It will apply to salaries, wages, directors' fees, benefits, etc. paid monthly to any employee.

Every employer is legally required to operate a PAYE deduction system. The main features of the PAYE system are:

- (i) The employers deduct PAYE tax monthly on all employment income they pay to their employees;
- (ii) A PAYE tax deduction card (form P9) is maintained for each employee, showing monthly gross pay, benefits, allowed deductions, PAYE deducted , personal relief and net pay;
- (iii) The details above must be given to every employee by the employer per month, i.e. the pay slip or pay advice;
- (iv) The PAYE deducted must be paid to the Domestic Taxes Department (banked using credit slip paying-in-book called P11) by the 9th day of the month following the one in which PAYE was deducted;
- (v) The employer is required to issue a certificate of pay and tax (form P39) at the end of each calendar year or whenever an employee leaves employment;
- (vi) At the end of each calendar year, every employer is required to submit the PAYE end-of-the-year documents as follows:
 - a) The tax deduction cards (form P9) for all employees;
 - b) Personal relief claim forms duly signed (forms P1, 2 and 4) for all employees concerned;
 - c) Certificate showing total monthly PAYE deducted for the year (form P10);
 - d) List of employees and total PAYE deducted from each for the year of income (form P10A).

(You are advised to study the PAYE rules in the Income Tax Act.)

Presumptive income from some agricultural produce

As stated earlier, the gross sale amounts of maize, wheat, barley, rice, sugar cane, pyrethrum, tobacco leaf, tea leaf, coffee, raw cashew nuts, pigs, fresh milk, raw cotton, hides and skins, are presumed to be income and subject to Presumptive Income Tax (PIT).

PIT was re-introduced with effect from 1.1.2000 at 2%.

The PIT deducted for individuals, co-operative societies and partnerships is final tax. Where the PIT is the final tax, the agricultural income does not require to be returned to the Domestic Taxes Department.

For companies, however, the PIT is treated as income tax paid in advance and is used to reduce the company's tax payable for the year. This means that companies with agricultural produce are taxed on net profit or loss and they get credit for the PIT as tax paid in advance.

2.6.5 REMITTING OF TAX DEDUCTED AT SOURCE TO THE DOMESTIC TAXES DEPARTMENT

- 1) The withholding tax or the tax at source deducted must be paid to the tax authority within 20 days after the deduction is made. However, tax due date has been harmonized to be on 20th day of month following month of deduction of the tax.
- 2) The PAYE deducted must be remitted by the 9th of the month following the one in which they are deducted.
- 3) Any failure to remit withholding tax would mean penalties and collection of the amount as debt owed to the Government.



2.7 TAXATION OF INDIVIDUALS, PARTNERSHIPS AND BODY CORPORATES

2.7.1 TAXATION OF INDIVIDUALS

An individual is taxed in respect of the incomes he receives. As highlighted above, there are various specified sources of income. In this section, we will highlight the taxation of individuals receiving business income and employment income.

Gains Or Profits From Any Business, For Whatever Period of Time Carried On

The Income Tax Act has defined **business** to include any trade, profession or vocation, and every manufacture, adventure and concern in the nature of trade, **but** does not include employment.

Trade	means buying and selling for gain;
Profession	means professional practice such as by a doctor, lawyer, accountant etc;
Vocation	means a calling or career;
Adventure	would include smuggling and poaching;
Concern	would mean any commercial enterprise.

Business may be carried on for a short time or a full year. The period a business is carried on is irrelevant in taxing the income (gains or profits) and so the use of the phrase "for whatever period" of time (business is) carried on.

The Act charges tax on gains or profits from any business. One person may carry on illegal business and another one may carry on a legal business. Both would be taxed on gains or profits from business as the Act is not concerned with the legality of the business when it comes to taxing the business income (gains or profit).

The following items whenever they arise will form part of the gains or profits from business:

- 1) An amount of gains from ordinary business arising from buying and selling as a trade e.g. butchery, grocery, manufacture, transport etc.

- 2) Where business is carried on partly within and partly outside Kenya, by a resident person, the gains or profits is deemed to be derived from Kenya. A good example of this is a transporter who transports goods from Mombasa to Kigali (trading in Kenya) and then transports goods from Kigali to Kampala and to Mombasa (trading outside Kenya).
- 3) An amount of insurance claim received for loss of profit or for damage or compensation for loss of trading stock.
- 4) An amount of trade debt recovered which was previously written off.
- 5) An amount of balancing charge. This arises where business has ceased and the machinery in a class of wear and tear is sold for more than the written down value. For example:

■ Wear and tear computation

Class III

	Sh
Sale proceeds (business ceased)	35,000
Written down Value	<u>30,000</u>
Balancing Charge (taxable income)	<u>5,000</u>

This concept will be clear to you later in the course when dealing with the calculation and claim for wear and tear deduction, which at this point may be viewed as the standard depreciation for tax on machinery used for business.

- 6) An amount of trading receipt. This arises where business is continuing and all the machinery in a class of wear and tear is sold for more than the written down value. For example, the same figures as in 5 above can be used:

■ Wear and tear computation

Class III

	Sh
Sale proceeds (business continuing)	35,000
Written down Value	<u>30,000</u>
Trading receipts (taxable income)	<u>(5,000)</u>

- 7) An amount of realized foreign exchange gain. If the foreign exchange gain is not realized, it is not taxable.



Gains or Profits from Employment or Service Rendered

An employee can be said to be a holder of a public office or other appointment for which remuneration is paid. The remuneration is the reward or pay for work or service rendered, for example, in the case of a minister, civil servant, company directors, company secretary, accountant, clerk, engineer, and all those commonly referred to as employees.

An employer will include:

- a) The person having the control of payment of remuneration; or
- b) Any agent, manager or other representative in Kenya of a branch of an overseas company; or
- c) Any paying officer of the Government or other public authorities.

The above definitions are particularly important in relation to Pay As You Earn (PAYE) operations. This is the system of deducting tax, monthly, when the employer is paying emoluments.

Gains or profits from employment or service rendered will include cash as well as non-cash payments.

1) Cash payments to employees will include:

- a) Wages, salary, leave pay, sick pay, payment in lieu of leave, director's fees, overtime, commission, bonus, gratuity, compensation for the termination of any contract of employment or service etc.
- b) Cash allowances and all round sum expense allowances, for example, house or rent allowance, cost of living allowance, clothing allowance, etc however named.
- c) Employees' private expenditure paid by employer. The bills in this case would be in the name of the employee who is responsible for meeting the expenses. The examples of such expenses would include house rent, grocery bill, electricity bill, water bill, school fees, insurance premium etc.
- d) An amount of subsistence, travelling, mileage, and entertainment allowance. When these are paid to employees as mere reimbursements (refunds) of expenses of employer, they are not taxable employment income. As reimbursement (refund) they must be documented, that is claimed with supporting documents.
- e) Amounts deemed to be gains or profits from employment derived from Kenya:
 - i) An amount paid to resident person for employment or service rendered inside or outside Kenya if resident at the time of rendering service. A resident is therefore taxed on worldwide employment income.
 - ii) An amount paid for employment or service rendered to an employer who is resident in Kenya or with a permanent establishment in Kenya. A non-resident person is therefore taxed on income from service rendered to a resident person.

2) Non-cash Employment Income will include:

- a) The benefit, advantage, or facility arising from employment. These are taxed if they aggregate (total) in value to (Sh 36,000) or more in a year of income.

The benefits that are taxed are:

- (i) Facilities e.g. free lunch, transport, gift by employer etc.
- (ii) Servants provided by employer, for example house servants, cooks, watchman (day and/or night), ayah, and gardener. The Commissioner of Domestic Taxes has quantified the value of the benefits as shown below. An employee is taxed on the cost of providing the benefit or the quantified value of the benefit, whichever is higher. If there is no quantified value, the higher of the market value and the cost is taken.
- (iii) Services provided by employer, for example, water, telephone, electricity, furniture, and radio and electronic alarm system. The Commissioner of Domestic Taxes has quantified the value of some benefits as shown below. The employee is taxed on the market value or the cost of providing the service, whichever is the higher, except in the cases of telephone, furniture, and electricity from a generator to agricultural employees.
- (iv) Motor car provided by employer. The Commissioner of Domestic Taxes (CDT) has quantified the value of the benefit on the basis of the engine capacity rating. Employees are taxed at the quantified value or 24%p.a. of the initial expenditure on the motor vehicle, whichever is higher. If the motor vehicle is leased/hired by the employer, the taxable benefit on the employee shall be the higher of:
- 1) 24% p.a. of cost or
 - 2) Hire charges paid.

**VALUE OF TAXABLE BENEFITS PRESCRIBED BY CIT (YEAR 2009)****Taxable Employment Benefits - Year 2009**

RATES OF TAX (Including wife's employment, self employment and professional income rates of tax).

Year of income 2008/ 2009

Taxable Employment Benefits - Year 2008/2009

Monthly taxable pay (shillings)			Annual taxable pay (shillings)			Rates of tax % in each shilling
1	-	10,164	1	-	121,968	
10,165	-	19,740	121,969	-	236,880	15%
19,741	-	29,316	236,881	-	351,792	20%
29,317	-	38,892	351,793	-	466,704	25%
Excess over	-	38,892	Excess over	-	466,704	30%

Personal relief Sh1,162 per month (Sh13,944 per annum)

Prescribed benefit rates of motor vehicles provided by employer

			Monthly rates (Sh.)	Annual rates (Sh.)
Capital allowances:				
Wear and tear allowances				
Class I	37.5%			
Class II	30%			
Class III	25%			
Class IV	12.5%			
Industrial building allowance:				
Industrial buildings	2.5%			
Hotels				
2006	4.0%			
2007 to date	10%			
Farm works allowance				
2006	33%			
2007 to date	50%			
Investment deduction allowance:				
2003	-	70%		
2004	-	100%		
2006 to date		100%		
			(i)	Saloon, Hatch Backs and Estates
			Upto	- 1200 cc
			1201	- 1500 cc
			1501	- 1750 cc
			1751	- 2000 cc
			2001	- 3000 cc
			Over	- 3000 cc
			(ii)	Pick-ups, Panel Van (Unconverted)
			Upto	1750 cc
			Over	1750 cc
			(iii)	Land Rovers/ Cruisers
			OR 2% of the initial capital cost of the vehicle for each month, whichever is higher.	

Shipping investment deduction 40%

Mining allowance:

Year 1	40%
Year 2 - 7	10%



Commissioner’s prescribed benefit rates

Services	Monthly rates	Annual rates
	Sh.	Sh.
(i) Electricity (Communal or from a generator)	1,500	18,000
(ii) Water (Communal or from a borehole)	500	6,000
(iii) Provision of furniture (1% of cost to employer) If hired, the cost of hire should be brought to charge		
(iv) Telephone (Landline and mobile phones)	30% of bills	

Agricultural employees: Reduced rates of benefits

(i) Water	200	2,400
(ii) Electricity	900	10,800

Low interest rate employment benefit:

The benefit is the difference between the interest charged by the employer and the prescribed rate of interest.

Other benefits:

Other benefits, for example servants, security, staff meals etc are taxable at the higher of fair market value and actual cost to employer.

Note

Range Rovers and vehicles of a similar nature are classified as Saloons.

b) Housing Benefit. – Section 5 (3)

A housing benefit arises where an employee is housed by the employer. The employer may own the house or lease it from other parties.

To determine the amount of housing benefit, the employees are classified into six groups and the value of the housing benefit will depend on this classification:

(i) Ordinary Employee

15% of his gains or profits from employment (i.e. monthly cash pay plus benefits); excluding the value of those premises, minus rent charged to the employee; subject to the limit of the rent paid by the employer if that is paid under agreement made at arm’s length with a third party.

(ii) Agricultural employees

(Including a whole-time service director) who is required by terms of employment to reside on a plantation or farm:-

10% of his gains or profits from employment – (i.e. monthly cash pay plus benefits), minus amount of rent charged to the employee.

STUDY TEXT

This is subject to employer obtaining prior approval from Domestic Taxes Department – Note also reduced rates of benefits for agricultural employees.

(iii) Director

Determination of housing benefit for whole time service directors and non whole time service directors was clarified in the 2008 Finance Act as:

- For **non whole time service director**,

The higher of:

- a. 15% of the total income, excluding the value of the premises,
- b. market rental value and
- c. Rent paid by the employer.

- For **whole time service director**,

The higher of

- a. 15% of the total employment income, excluding the value of the premises,
- b. market rental value and
- c. rent paid by the employer

Effective date: 13 June 2008.

Notes:

- In calculating the housing benefits the employer is required to deduct rental charges recovered from the employee or director. The amount remaining is the chargeable value to be included in the total taxable amount.
- If the premises are occupied for part of the year only, the value is 15% of employment income relative to the period of occupation less any rental charges paid by employee/director.
- Any employee who provides other than normal housing to an employee should consult his local Income Tax office regarding the value of such housing.
- Whole-time service director is a director who is required to: -
 - (a) Devote substantially the whole of his time to the service of the company in a managerial or technical capacity; and
 - (b) Does not own or control, directly or indirectly, more than 5% of the share capital or voting power of such a company. Shares owned by spouse or own shares in the company are included in computing the 5% control.

Note

Fair market rental value should be taken to mean the amount of rent the premises would attract if it were floated in the open market for the purposes of leasing. The valuation should be carried out by an independent registered land valuer (i.e. No relation with the employer). Any cases of doubt should be referred to the local Income Tax Office for advice.

**>>> Example**

A whole-time service director who earns basic salary of Sh.56,000 per month plus other benefits – (e.g. Motor Car, House Servants etc.) – Sh 9,900 is housed at Runda Estate – Nairobi. Employer pays the Landlord Sh 35,000 per month (i.e. Sh 420,000 per annum) under an agreement made at arm's length.

Calculation for Quarters

Basic Salary	-	Sh.56,000
Add:		
Benefits	-	<u>Ksh.9, 900</u>
Total	-	Sh.65, 900

$$15\% \text{ of value of Quarters } \frac{65,900 \times 15}{100} = \text{Ksh.9, 885}$$

Rent paid by the employer Sh.35,000 per month is the amount to be brought to charge and not 15% of value of Quarters.

Total taxable income = 65900 + 35000 = 100900 p.m

Loans to employees (Low interest and fringe benefit)

If an employee acquires a loan from his employer at a rate of interest that is lower than the prescribed rate of interest, then the difference between the prescribed rate of interest and employer's interest is a benefit from employment. This benefit can be brought to charge as follow:

i) Low Interest Rate Benefit:

This benefit arises from the difference between the prescribed rate and the interest rate charged by the employer for loans provided by the employer on or before 11th June 1998. This benefit is taxable on the employee.

>>> Example:

- Loan provided	Ksh. 500,000
- Employer's Loan Interest Rate	2%
- Prescribed Rate	10%

$$\begin{aligned} \text{Low Interest Benefit:} \\ = (10\% - 2\%) \times 500,000 &= \text{Sh. 40,000 p.a} \end{aligned}$$

i) Fringe Benefit

This benefit arises from the difference between the Market Interest rate and the employer's interest rate for loans provided after 11th June 1998 or loans provided on or before 11th June 1998 whose terms and conditions have changed after 11th June 1998. Such a benefit is taxable on the employer at the corporation Tax Rate.

The Tax on Fringe Benefits is known as Fringe Benefit Tax.

Example

Loan Amount	Sh. 800,000
Interest Rate charged by Employer	2%
Market Interest Rate for the month	12%

Fringe Benefit

$$(12\% - 2\%) \times 800,000 = \text{Sh. } 80,000 \text{ p.a.}$$

Fringe Benefit Tax

$$= 80,000 \times 30\% = \text{Sh. } 24,000 \text{ p.a. or Sh. } 2,000 \text{ p.m.}$$

School fees

Where the employer pays school fees for the employee's child, dependent or relative, such payment becomes a taxable benefit on the employee if not already taxed on the employer.

Educational fees for dependants of low income employees paid or foregone by an educational institutional employer are not taxable on either the employer or the employee. A low income employee is defined as one earning not more than Sh. 29, 316 per month, i.e. employees at income tax bracket of 20% and below. (Effective date: 13 June 2008)

Compensation for termination of employment

This is compensation for termination of an employment contract. An amount received as compensation for termination of a contract of service whether or not provision is made in the contract for payment of that compensation is a taxable benefit on the employee.

The taxable amount will be calculated as follows:

An amount received as compensation for termination of a contract of service whether or not provision is made in the contract for payment of that compensation is a taxable benefit on the employee.



The taxable amount will be calculated as follows:

(a) Specified term

Where there is a specified term, the amount of the compensation will be spread over the unexpired period at equal amounts and taxed accordingly.

>>> Illustration

Mr. Okari's employment contract for 5 years is terminated on 31st Dec 2006 after it had run 3 years. Compensation of Sh. 1.5 Million is paid to the employee and the employee's rate of earning as at the date of termination was Sh. 500,000 p.a.

Required

Establish the amount of the compensation that will be assessed to tax showing clearly the years to which it relates.

Solution

Mr. Okari

Determination of the assessable amount of compensation

	Sh
Amount of compensation	1,500,000
Contract period	5 years
Unexpired period	2 years
<u>Compensation is spread as follows:</u>	
Year 2007	750,000
Year 2008	<u>750,000</u>
Assessable or taxable Amount	<u>1,500,000</u>

(b) Unspecified term with a provision for terminal payment

Where the contract is for unspecified term and provides for terminal payment, then the compensation will be spread forward and assessed at the rate of the employee's remuneration p.a immediately before termination.

STUDY TEXT

>>> Illustration

Mr. Muchiri had a contract for an unspecified term providing for payment of Sh 700,000 as compensation in the event of termination. It is terminated on 31st Dec 2006 and the employee's rate of earnings was Sh 300,000 p.a.

Required

Establish the amount of the compensation that will be assessed to tax showing clearly the years to which it relates (the spread).

Contract is for unspecified term and provides for compensation

Mr. Muchiri**Determination of the assessable amount of compensation**

	Sh
Rate of earning p.a	300,000
Compensation	700,000
<u>Compensation is spread as follows:</u>	
Year 2007	300,000
Year 2008	300,000
Year 2009	<u>100,000</u>
Assessable or taxable amount	<u>700000</u>

Suppose the amount of compensation was 1,500,000

Mr. Muchiri**Determination of the assessable amount of compensation**

	Sh
Rate of earning p.a	300,000
Compensation	1,500,000
<u>Compensation is spread as follows:</u>	
Year 2007	300,000
Year 2008	300,000
Year 2009	300,000
Year 2010	300,000
Year 2011	<u>300,000</u>
	<u>1,500,000</u>



(c) Unspecified term and no provision for terminal payment

Where the contract is for unspecified term and does not provide for terminal payment, the compensation is to be spread forward in equal amounts for three years.

>>> Illustration

Mr. Olenkeri had a contract for unspecified term that had no provision for payment of compensation upon termination of employment. The contract is terminated on 31st Dec 2006 and Sh 1.5 million is compensation. Immediately before termination, the employee's rate of remuneration was Sh 48,000 p.a.

Required

Establish the amount of the compensation that will be assessed to tax showing clearly the years to which it relates (the spread).

Contract is for unspecified term and provides for compensation

Mr. Olenkeri

Determination of the assessable amount of compensation

	Sh
Rate of earning p.a	480,000
Compensation amount	1,500,000
<u>Compensation is spread as follows:</u>	
Year 2007	500,000
Year 2008	500,000
Year 2009	500,000
Assessable or taxable amount	<u>1,500,000</u>

Tax free remuneration

There are certain instances where an employer wishes to pay his employee salaries negotiated net of tax. In such cases, the employer bears the burden on behalf of those employees. The tax so paid by the employer on behalf of the employee becomes benefit chargeable to tax on the employer.

Employee share option plans (ESOPS)

- The granting of bonus share for better performance by the firm is a benefit in kind received for employment services rendered thus a taxable benefit
- Where shares are given free, the taxable benefit is based on the prevailing market price per share (MPS).
- When shares are issued at a price lower than the market price per share, the taxable benefit will be (MPS-issue price) X number of shares issued.

Limiting of benefits

Where a benefit is enjoyed for a period of less than a year, the taxable value of the benefit is proportionately reduced to the period enjoyed. For example, if an employee was provided with furniture for three months in 2005, he would be taxed on one quarter of the benefit as follows: Assuming the price of the furniture was Sh 800,000

$$\text{Taxable benefit} = 12\% \times 800,000 \times 3/12 = 24,000$$

Benefits excluded from Employment Income

(Tax free employment benefits):

1. Expenditure on passage for expatriates only.

This is expenditure on traveling between Kenya and any other place outside Kenya borne by the employer for the expatriate employee and family.

Conditions for qualifying for passage:

- (i) The employee must not be a citizen of Kenya.
- (ii) The employee must be recruited or engaged from outside Kenya. However, an expatriate employee does not lose the free passage by changing jobs in Kenya.
- (iii) The employee must be in Kenya solely for the purpose of serving the employer. The expatriate may fail to qualify for passage if he engages in commercial activities in addition to employment.
- (iv) The employer obtains tickets or reimburses the expatriate or employee the passage cost.

Where cash is paid for passage and the employee does not travel or in fact uses the money for personal expenses, then the cash sum is taxable on the employee.



2. Medical Expenses:

Where an employer has a written plan or scheme, or by practice provides free medical services to all the employees (non-discriminative), the value of such medical expenses is a non-taxable benefit for employees and whole time service directors. However, for the non whole time service directors the medical benefit is limited to Sh. 1,000,000, effective 1st Jan 2006. Where there is no medical scheme or plan for all employees, the payment of any medical bills is a taxable cash payment to the beneficiary. It is permissible to have different schemes for different categories of employees.

3. Fringe benefit

4. Benefits in kind whose value does not exceed Sh. 36,000 p.a. (3000 p.m).

Note:

A director other than whole time service director is excluded from any tax free medical scheme. However, w.e.f 1/1/2006, medical benefits received by such directors is tax free as long as it does not exceed Sh. 1,000,000 p.a.

5. The amount of contribution by an employer, on behalf of an employee, to a pension fund or scheme whether the fund is registered with the Commissioner of Domestic Taxes or not.
6. With effect from 12.6.87, the amount contributed by an employer, on behalf of an employee, to a provident fund which is registered with the Commissioner of Domestic Taxes.
7. Educational fees paid by the employer for the employee as long as such fees are taxed on the employer (disallowable expense).

Expenses that are deductible against employment income:

- c) Mortgage interest (owner occupier interest) paid on loan from the first 4 financial institutions specified in the 4th Schedule of the Income Tax Act to buy or improve his residential house to the maximum of Sh150,000 (w.e.f 1/1/2006). Where the mortgage interest paid is less than the maximum, the actual interest paid is claimed. Where the mortgage interest paid is more than the maximum, only the maximum can be claimed. The mortgage interest is also deductible against other incomes and will appear later on in the list of specific expenses deductible against taxable income. If any person occupies the premises for residential purposes for part of a year of income, the allowable deduction shall be limited to the period of occupation.

NB. The first 4 financial institutions mentioned in the fourth schedule to the Income Tax Act are:

- A bank of a financial institution licensed under the Banking Act,
- An insurance company licensed under the Insurance Act,
- A building society registered under the Building societies Act and
- The National Housing Corporation established under the Housing Act

- d) Amounts contributed by employee to a registered pension or provident and individual retirement schemes to the following limit:

	1998	1999	2000	2001	2007
	Sh	Sh	Sh	Sh	Sh
Pension: the lower of					
- actual contribution and					
- 30% of pensionable income					
or – Set limit p.m.	10,000	12,500	15,000	17,500	20,000

- (c) Annual subscriptions to professional associations such as LSK, ICPAK, KMA etc
- (d) Contribution to a Registered Home Ownership Savings Plan Hospital up to Sh.48,000 p.a. (Sh. 4,000 p.m)
- (e) Amount of NSSF contributions to a maximum of Sh. 2,400 p.a. (200p.m)

2.8 EMPLOYMENT INCOME WHICH IS EXEMPTED FROM TAXATION

The following employment incomes are not taxed as they are exempted from taxation:

- i) Employment income of foreign embassy staff excluding locally recruited staff.
- ii) Employment income of Organization of African Unity (OAU) staff, foreign and locally recruited.
- iii) Employment income of United Nations Organization (UNO) staff, foreign and locally recruited.
- iv) Allowances payable to the Speaker, Deputy Speaker, Vice-President, Ministers, Assistant Ministers, and Members of Parliament. The salaries are however taxed.
- v) Salaries, allowances, and benefits paid from public funds to the President of Kenya.
- vi) Foreign allowances paid from public funds to Kenya officers serving abroad.
- vii) Monthly pension granted to a person who is 65 years of age or more
- viii) The first Sh.2000 paid to an employer per day as an allowance while on official duty shall be deemed to be a reimbursement and therefore not taxable
- ix) Non-cash benefits up to a maximum of Ksh. 36,000 per year



Gains or profits from rights granted to any other person for use or occupation of property

This is consideration received for the use or occupation of property and includes:

- Royalty for copyrights, patents, trademarks etc.
- Rent which is the tenant's periodic payment for the use of land, building or part of the building etc.
- Rent premium or key money being inducement to lease out a property.



2.8.1 Income In Respect of Dividend and Interest

1. Dividend:

Dividend is the amount of profit of a company which it pays to its share-holders in proportion to their share holding in any particular year.

It is income in the hands of the recipients.

The following are deemed to be payments of dividend to those receiving:

- In a voluntary winding up of a company, amounts distributed as profits whether earned before or during winding up, whether paid in cash or otherwise.
- Issue of debentures or redeemable preference shares for no payment. The dividend is taken to be the greater of nominal or redeemable value e.g.
 - nominal value Sh. 100
 - redeemable value Sh. 110

Taxable dividend is Sh. 110, (the greater of the two).

- Payment for debentures or redeemable preference shares for less than 95% of the nominal value and redeemable value whichever is greater e.g. payment of Sh. 70 in (b) above.

$95/100 \times \text{Sh. } 110 = \text{Sh. } 104.5$. The payment of Sh. 70 is less than 95% of Sh. 110 which is Sh. 104.5. The difference Sh. 40 is taxable dividend income i.e. $\text{Sh. } 110 - \text{Sh. } 70 = \text{Sh. } 40$

The following dividends **received by a resident company** are not taxed on the company:

Dividend received by a company which owns or controls 12½ % or more of the voting power (shares) of the paying company.

Note:

- (i) Foreign dividends not earned in Kenya are not taxable.
- (ii) Dividends are subject to withholding tax (tax at source) at 5% which is deducted by the person paying and remitted to the Domestic Taxes Department. This constitutes the final tax i.e. no further tax is chargeable for Kenya residents. Dividends are treated as income of the year in which they are received.

W.e.f. 13.06.2008, Dividends received by financial institutions is subject to withholding tax.



2. Interest

This means interest payable in any manner in respect of any loan, deposit, debt, claim, or other rights or obligations, e.g. loans by banks and financial institutions, deposits to banks and financial institutions etc.

Interest is assessed on a cash basis, which means that it is taxed when received not when earned if not paid.

Interest income exempted from taxation:

- a) Interest from Post Office Savings Bank Account. The Post Office Savings Bank does not accept deposits of more than Sh 500,000. The interest from Fixed Deposit with the Post Office Savings Bank is exempted from taxation.
- b) Part exemption:

The interest of up to Shs.300,000 from housing development bonds called the "qualifying interest" is partly exempted from taxation, i.e. the first Sh.300,000 of interest on housing bonds is subject to 10% withholding tax as final tax.

The "qualifying interest" here means interest received by an **individual** which does not exceed Sh 300,000 in any year of income in respect of housing development bonds held by that individual with a financial institution licensed under the Banking Act or a Building Society registered under the Building Societies Act and which has been approved to issue housing development bonds.

The housing development bonds are issued by a financial institution on payment of money and the money earns interest. The money raised through issue of housing development bonds is supposed to help in housing development.

The qualifying interest is taxed at the "qualifying interest rate of tax" which is the resident withholding tax of 15%.



2.9 Income In Respect Of Pension, Charge Or Annuity, And With Effect From 1st January 1991, Any Withdrawals Or Payments From Registered Pension Fund Or Registered Provident Fund

A pension fund is created by contributions from employer, or from employees, or both. An employee receives pension from this fund when he/she retires because of old age or for any other reason. Normally, the retiring employee is paid a lump sum on retirement, and thereafter, a stated amount per month for life or for a stated period.

A provident fund is also created by contributions from employee or from employer or both. An employee, on leaving employment is paid a lump sum from the fund depending on the contributions made to the fund.

- (i) Pension is received for past service and after retirement.
- (ii) Pension annuity of up to Sh. 180,000 p.a is exempted from taxation where received by a resident individual.
- (iii) Lump sum payments from registered pension fund and registered provident fund by resident individuals are exempted from taxation as follows:

First Sh. 480,000

Any amount received in excess of exempt amounts is taxed as follows above Sh. 480,000 tax exempt.

1 st Sh. 400,000	@ 10%
Next Sh. 400,000	@ 15%
Next Sh. 400,000	@ 20%
Next Sh. 400,000	@ 25%

Excess of Sh. 1,600,000 @ 30%

- (iv) Pension received by a non-resident is not exempted from taxation and is in fact subject to withholding tax of 5% of Gross Income. No portion of the income is exempted.

Income In Respect Of Any Amount Deemed To Be The Income Of A Person Under The Income Tax Or Rules Made Under The Income Tax Act.

- i. All the income from business carried on partly outside and partly inside Kenya is deemed to be income derived from Kenya, and is taxed in Kenya.
- ii. For a resident individual, income from employment or service rendered inside or outside Kenya is deemed to be income derived from Kenya, and is taxed in Kenya.
- iii. For a non-resident individual, income from employment or services rendered to a resident employer inside Kenya is deemed to be income derived from Kenya, and is taxed in Kenya.
- iv. The income of a married woman living with her husband is deemed to be the income of the husband and is taxed on the husband except as provided for below.

2.10 PRESUMPTIVE INCOME

- (i) The gross proceeds of specified agricultural produce is presumed to be income and Presumptive Income Tax (PIT) is charged on the gross sales.

The specified produce which are subject to PIT are gross sales of maize, wheat, barley, rice, sugar cane, pyrethrum, tobacco leaf, tea leaf, coffee, raw cashew nuts, pigs, raw cotton, hides and skins.

- (ii) PIT was re-introduced with effect from 1.1.2000 at 2%.
- (iii) PIT is deducted at source by authorised agents appointed by the Commissioner of Domestic Taxes. These are normally the respective marketing organizations, for example, Kenya Seed Company, National Cereal and Produce Board, Farmers Association, Kenya Breweries Ltd, National Irrigation Board for grains:

Sugar Mills for cut sugar cane;

Pyrethrum Board of Kenya for pyrethrum;

BAT(K) Ltd and Mastermind Tobacco(K) Ltd for tobacco Leaf;

Tea Factories for tea leaf;

Ginneries for raw cotton;

Tanneries for hides and skins;

Coffee Board of Kenya for coffee;

Farmers Choice Ltd and Uplands Bacon Factory Ltd for Pigs;

Kenya Cashewnuts Ltd and National Cereal and Produce Board for raw cashewnut;

KCC, Kitinda Dairy Co-operative society, and Meru Central Farmers Co-operative Society for fresh milk.

- (iv) The buyers of specified produce who have not been appointed agents must report to the Commissioner of Domestic Taxes within thirty(30) days of their dealing in specified produce, otherwise the PIT supposed to be deducted may be collected from them.



- (v) The PIT deducted must be remitted to Commissioner of Domestic Taxes by the 20th day of the month following the deduction and the agent must:
 - a) provide the Commissioner of Domestic Taxes with a return showing amount of gross payment, PIT deducted, name of payee, and the type of agricultural produce; and
 - b) Provide taxpayer with a certificate showing gross sale proceeds and PIT deducted.
- (vi) In cases where an authorized agent produces specified produce subject to PIT, the gross sale proceed is deemed to be the price that would be paid to farmers for similar purchases.
- (vii) For individuals, partnerships and co-operatives, PIT is final tax which means that the income from specified produce does not attract any more income tax. They are, therefore, not required to compute farming income if their income is only from specified produce subject to PIT.
- (viii) For companies, PIT is a tax at source and reduces any tax which is finally calculated as payable.

2.11 INCOME OF A MARRIED WOMAN

1. The income of a married woman living with her husband is deemed to be the income of the husband and is taxed on the husband. However, when calculating the tax on the husband, the wife's employment income, and the wife's professional income have specified treatment. The wife's income can be from any source e.g. employment, rent, business, profession, dividend, interest etc.

Note

2. With effect from 1 January 2006, the income of a married woman will not be treated as the income of her husband provided she opts to file a separate return.
3. With effect from 1st January 2009, wife's income from interest, dividend and rent are also taxed on her if earned at arm's length.

A married woman will be treated as living with her husband and her income taxed on the husband **unless:**

- a) They are separated under an order of a court or written agreement of separation;
- b) They are separated in such circumstances that the separation is likely to be permanent;

Note A husband working in Nairobi and wife living in the rural home is not separation;

- c) She is a resident person and the husband is non-resident.



1. Wife's Employment Income and self-employment income.

For purposes of calculating tax payable, wife's employment and self employment income qualifying for separate taxation is segregated from the husband's income and the tax on it separately calculated at wife's employment income rate, which is the same as individual rate of tax.

The wife's income will not qualify for separate taxation if she is employed by any of the following:

- a) a partnership in which her husband is a partner;
- b) her husband;
- c) a company where the husband and/or wife or both jointly control 12 ½% or more of the voting power directly or indirectly, of the company;
- d) a trustee or manager of a trust created by her husband.

The wife's employment position is then said to be not at arm's length and, therefore, the income is not separately taxed.

Note: Self employment income for a married woman means business by the wife where husband is not a partner nor employs the wife.



2. Wife's Professional Income

Wife's professional income is also segregated from the husband's income and the tax is separately calculated at "wife's employment and wife's professional income rate which is the same as individual rate of tax.

The professions whose income qualify for separate taxation are accountancy, medical, dental, legal, survey, architecture, veterinary medicine and engineering. Those who qualify are the professionals registered under the respective professional bodies e.g. doctors, engineers, lawyers, accountants, veterinary, doctors, architects, quantity surveyors etc.



The wife's professional income will not qualify for separate taxation if it is from a partnership where her husband is a partner.

The wife's loss is also deemed to be the loss of the husband. The deficit at the time of marriage becomes the husband's deficit to be off-set against future income of the wife which is taxed on the husband.

In case of more than one wife, income is still deemed to be the husband's.

Where the husband fails or is unable to pay tax due, the Commissioner of Domestic Taxes can collect a portion of the tax from the wife which relates to her income taxed on the husband.

Note

4. With effect from 1 January 2006, the income of a married woman will not be treated as the income of her husband provided she opts to file a separate return.
5. With effect from 1st January 2009, wife's income from interest, dividend and rent are also taxed on her if earned at arm's length.

Specified (Separate) Sources Of Income

Up to 31.12.78 a person was taxed on net income or loss from all sources.

Example:

MR. MALIMOTO INCOME (LOSS)	
Source	Income/(loss) Shs.
Employment income	3,000
Business Loss	(1,000)
Farming Loss	<u>(4,000)</u>
Loss carried forward/ tax	<u>(2,000)</u>

Any Pay As You Earn (PAYE) tax deducted from employment in the above cases was refunded. Where tax deducted at source was high, tax refunds were also high.

The concept of specified (separate) sources of income was introduced in 1979 as an anti-avoidance measure, some taxpayers had set up loss-making businesses which cleared taxable income from other sources and thus ended up not paying any tax.

With effect from 1.1.79 the income of a person is computed on the basis of specified sources of income, and income or loss from each source separately determined.

- a) The loss from a specified source can only be off-set against future income from the same source.
- b) The income from specified sources are added together and taxed as the total income of a person.

2.12 SPECIFIED SOURCES OF INCOME ARE

- 1) The right granted to other persons for use or occupation of property e.g. rent and royalty.
- 2) Employment remuneration, e.g. salary, wages, benefits etc.
- 3) Professional income from practicing profession e.g. lawyer, doctor, engineer etc. A loss from professional practice can be offset against employment income. Professionals rarely make losses.
- 4) Employment and any self-employed professional vocation.
- 5) Farming including agricultural, pastoral, horticultural, forestry, fishing and similar farming activities.
- 6) Business e.g. shop, hotel, butchery etc and any other source of income chargeable to tax as gains or profits but not included in (1) to (3) above.
- 7) Dividend and interest with effect from 1.1.87.
- 8) Unspecified sources. These are sources of income that do not fit into any of the above e.g. pension, annuity or charge and withdrawals or payments from registered pension and provident funds.

It is important to note that loss brought forward as at 31.12.78, called deficit of total income, can be offset against all income from specified sources.

2.13 TAXATION OF PARTNERSHIP PROFITS

The definition of a taxable person in the Act does not include a partnership. The income/loss of a partnership is assessed and taxed on the partners. The gains or profits of a partner from a partnership are the aggregate of:

- a. Remuneration payable to him/her.
- b. Interest on capital receivable, less interest on capital (drawings) payable by the partner to the partnership.
- c. His/Her share of adjusted partnership profits.

	Sh	Sh
Partnership salary	XX	
Interest on capital receivable	<u>XX</u>	
	XX	
Interest on capital payable	<u>(X)</u>	
	XX	
Share of profits/(loss)	<u>X</u>	
		<u>XX</u>



The profits of a partnership that are apportioned to each partner are calculated after:

- i) Deducting remuneration payable.
- ii) Deducting interest on capital payable to partners.
- iii) Adding interest on capital (drawings) payable by a partner to the partnership.

Where the adjustment of the partnership profits results in a loss, the gain or profit from the partnership of a partner is the excess of the remuneration and interest received, less interest payable, over the loss.

Steps in Computing Partnership Income

- 1) Determine or compute the adjusted income or loss for the partnership in the normal way, except that: -
 - (a) Salary to partners is not allowable expense
 - (b) Interest paid to partners is not allowable
 - (c) Interest paid by partners is not taxable
 - (d) Wife's salary is not allowable
 - (e) Drawings of commodities dealt with in the partnership are added back at cost. Note that no profit is to be made from another partner.
- 2) Allocate the income adjusted to the partner by first isolating salaries to partners, interest on capital (net) to partners, bonus to partners, commissions, etc. The balance is either profit or loss to be shared out among partners according to profit sharing ratio or as per partnership agreement.

Income Tax Computation of a Partnership

Net profit as per A/C	Sh	Sh
		XXX
Add back:		
Partnership salaries	XX	
Interest paid to partners	XX	
Goods taken by partners	XX	
Goodwill written off	XX	
Partner's insurance	XX	
Legal fees on Partnership agreements	<u>XX</u>	<u>XX</u>
Less:		
Non taxable income	X	
Capital deductions allowed	<u>X</u>	<u>(XX)</u>
Adjusted partnership profits		<u>XXX</u>

Income Allocation to Partners

	<i>Total</i>	<i>Partner A</i>	<i>Partner B</i>
	<i>Sh</i>	<i>Sh</i>	<i>Sh</i>
Salary	XXX	XX	XX
Interest on capital	XX	XX	XX
Interest on drawings	(X)	(X)	(X)
Share of profit	<u>XX</u>	<u>XX</u>	<u>XX</u>
	<u>XXX</u>	<u>XX</u>	<u>XX</u>

Note

The figure of the total profits to be shared is derived from the difference between the adjusted profits plus interest on drawings minus salaries and interest on capital. It is apportioned to the partners in their profit and loss sharing ratio.

>>> Example

A, B and C are in partnership, trading as X enterprises. They share profits and losses in the ratio of 2:2:1. In the year 2007, they reported a loss of Sh. 200,000 after charging the following items.

		Sh.
Depreciation		100,000
Salaries A		400,000
	B	300,000
	C	200,000
Interest on capital	A	100,000
	C	100,000
Commission	B	200,000
Stationery		50,000
Office expenses		100,000

Calculate the adjusted partnership profit/(loss) and its distribution among the partners.

**X enterprises adjusted Business Income.**

	Sh.	Sh.
Loss as per account		(200,000)
Add back: Depreciation	100,000	
Salaries A	400,000	
B	300,000	
C	200,000	
Interest on Capital A	100,000	
C	100,000	
Commission B	<u>200,000</u>	<u>1,400,000</u>
Partnership income		<u>1,200,000</u>

Distribution of Adjusted Profit to Partners

	A	B	C	Total
Salaries	400,000	300,000	200,000	900,000
Interest on capital	100,000	-	100,000	200,000
Commission	-	200,000	-	200,000
Share of loss:	<u>(40,000)</u>	<u>(40,000)</u>	<u>(20,000)</u>	<u>(100,000)</u>
	<u>460,000</u>	<u>460,000</u>	<u>280,000</u>	<u>1,200,000</u>

Partners' Taxable Income from Partnership

A	460,000
B	460,000
C	<u>280,000</u>
	<u>1,200,000</u>

2.14 TAXATION OF COMPANIES

Resident body corporates are taxed at the corporation tax rate of **30%** while non resident companies are taxed at **37.5%**.

All body corporates incorporated in Kenya are expected to pay **instalment tax** before the end of the accounting year. Therefore, the amount of tax payable shall be determined at the beginning of each year. This is based on the higher of:

- The budgeted profits of the year or
- **110%** of the last year's tax liability.

Once determined, the instalment tax is payable as follows.

1st instalment	25% of tax due by 20 th day of the 4th month during the year of income.
2nd instalment	25% of tax due by 20 th day of the 6th month during the year of income.
3rd instalment	25% of tax due by 20 th day of the 9th month during the year of income.
4th instalment	25% of tax due by 20 th day of the 12th month during the year of income.
final tax (tax balance)	Actual tax payable minus total instalment tax paid on the last day of the fourth month after the end of the year of income.

However for firms in agriculture sector, instalment tax is payable as:

1st instalment	75% of tax due by 20 th day of the 9th month during the year of income.
2nd instalment	25% of tax due by 20 th day of the 12th month during the year of income.
final tax (tax balance)	Actual tax payable minus total instalment tax paid on the last day of the fourth month after the end of the year of income.

2.13 TAXATION OF ENTERPRISES OR COMPANIES IN THE EXPORT PROCESSING ZONE (EPZ)

An **E.P.Z** is an area within a country which is free of duty or government red tape. The main objectives of establishing **E.P.Z.s** are:

1. To create employment;
2. To attract foreign investment;
3. Export promotion—as a means to boosting foreign exchange earnings;
4. Technological transfer.

**Enterprises operating within EPZ have the following benefits:**

1. A ten year tax holiday –This is an exemption from corporation tax for the first ten years of trading.
2. A lower corporation tax rate of 25% for the subsequent 10 years after the ten years tax holiday.
3. An exemption from all Withholding tax on dividends and other payments to non residents during the first 10 years.
4. Investment deductions are 100% of the capital expenditure claimable in the 11th year after commencement of production.
5. Zero rated for purposes of VAT
6. There is a refund of import duty on raw materials to manufacture exports.

Note

- ◆ EPZ enterprises must submit annually returns of income and supporting accounts to the commissioner of income tax.
- ◆ Emoluments paid to employees and resident directors of EPZ enterprises must subject to PAYE deductions as required by law even during the period the enterprise is exempt from tax.

2.13.1 Allowable and non allowable deductions (Expenses or Deductions Allowed Against Income Under Section 15, Second Schedule, And Ninth Schedule Of The Income Tax Act)

Expenses or Deductions Not Allowed Against Income (Section 16)

Introduction

Taxable and non-taxable incomes were discussed in detail in Lesson Two. From the discussion, a conclusion can be reached that any item of income is either taxable as defined in the Income Tax Act or not taxable if it is left out in the list of taxable incomes.

When it comes to expenditure, it can be similarly stated that an item of expenditure is either allowable or not allowable against taxable income as provided in the Income Tax Act.

As would be expected there are expenses that must be incurred in order to earn the income which is taxed. The Income Tax Act has listed expenses or deductions which are allowed against taxable income. There are also expenses or deductions which are not allowed against taxable income and these are also listed in the Income Tax Act. The expenses are looked at in more detail below.

Expenses or deductions allowed against income

As per section 15 of the Income Tax Act, expenses are either generally allowed against taxable income or are specifically stated to be allowable against taxable income.

Expenses or deductions generally allowed against income

Section 15(1) of the Income Tax Act generally allows expenditure which is wholly and exclusively incurred in the production of taxable income. The section reads as follows:

Section 15(1)

For the purpose of ascertaining the total income of a person there shall be deducted all expenditure which is expenditure wholly and exclusively incurred (by the person) in the production of that income.

This can be said to be a general provision for allowing expenses of a business:

- a) which are charged in the profit and loss account under normal accounting practice subject to any prohibition or extension made by the Income Tax Act;
- b) which are the usual commercial expenses of a business or profession e.g. wages, rent, purchases, transport, salary, water etc.

The nature of the business is very important in determining the expenditure which is wholly and exclusively incurred in the production of income. Given a type of business, there are expenses which are certainly expected to be incurred in the production of its income for example:

Butchery	-	purchase of meat, purchase of beef livestock.
Coffee farmer	-	picking, fertilizer, mulching, wages for farm labourers
Transport	-	fuel and oils, tyres, salaries of drivers.
Hotel	-	purchase of food, soft drinks, beer and salaries of workers.
Clinic	-	purchase of medicine, detergents and salary of a nurse.

This is the nature of expenditure wholly and exclusively incurred in the production of taxable income which is allowed.



Expenses specifically allowed against taxable income

In addition to S. 15(1) allowing expenditure which is wholly and exclusively incurred in the production of taxable income, Section 15(2) allows specific items of expenditure against taxable income. The items of expenditure listed below must be allowed against taxable income where the expenditure is incurred:

- a) Trade bad debts and doubtful debts. Trade debts means debts arising in the course of trade e.g. on the sale of trading stock or service on credit.

The following are allowable against taxable income:

- (i) The amount of trade bad debts written off;
- (ii) The amount of provision for specific doubtful trade debts. This is a provision of a debt owed by an identifiable individual or legal person.

The following are not allowable against taxable income:

- i) The amount of general provisions for bad debts e.g. a provision of 5% on all debts.
- ii) The amount of any bad debt on sale of capital item and on other non-trade activities like friendly loans.

Arising from the above, the following should be noted:

- a) If a trade debt was previously written off and is recovered, it is taxable income for the year in which it is recovered.
- b) A debt previously not allowed as a write off is not taxed when recovered.
- c) Allowed provisions no longer required or no longer necessary are taxed in the year they are no longer required e.g. if a specific doubtful debt is provided for in full in a given year and one half of the debt is paid in the following year, then 50% of the provision would not be required and the amount would be taxed by adding it to the trading income.

- b) Any capital expenditure for the prevention of soil erosion in a farm land. The capital expenditure should be incurred by the owner or occupier of the farm land. For example, on construction of dams, terraces, wind breaks etc.
- c) Any capital expenditure on clearing agricultural land or on clearing and planting permanent or semi-permanent crops. The common examples of permanent crops are cashew nuts, citrus, coconuts, coffee, passion-fruit, paw-paw, pineapples, pyrethrum, sisal, sugar-cane, tea, apples, pears, peaches, plums, bananas, roses, pine, cypress, Eucalyptus etc.
- d) The pre-trading expenses, that is, expenditure incurred before the commencement of business which would be allowable if the business was operating. The pre-trading expenses are allowable when business commences.

Two examples of pre-trading expenses are:

- i) In case of a new hotel-the cost of recruiting and training of staff before the hotel opens for business.
- ii) In case of new coffee or tea farmer-of cultivation, fertilizer, and other farm expenses for two to three years before picking commences.

This does not include expenditure related to the formation of the business.

- e) The legal costs and stamp duty for registration of a lease of business premises. The lease period must not be in excess of or capable of extension beyond 99 years.
- f) The expenditure on structural alterations to enable premises to be let e.g. subdivision of open rooms in a house which is necessary to maintain existing rent. The expenses relating to extension or replacement of premises are not part of structural alterations and are therefore not allowed against rent income.

If there is a rent increase as a result of the structural alterations, the expenditure is disallowed against rent income.

- g) The diminution or decrease in value of implements, utensils or similar articles e.g. loose tools in workshop or factory; crockery, cutlery, kitchen utensils in hotels or restaurants; jembes, pangas etc. in a farm.

These are not machinery or plant for which wear and tear deduction is given as will be seen later in the Study text. In practice, the Domestic Tax Department accepts taxpayer's valuation of tools and implements and generally, most taxpayers take the life of loose tools to be about three years thus writing off their cost over the three years.

- h) The entrance fees or annual subscription paid to a trade association e.g. Kenya National Chamber of Commerce and Industry and Kenya Association of Manufacturers. The trade association must have elected to be treated as trading by giving notice to the Commissioner of Domestic Taxes under S.21(2) of the Income Tax Act.

Members' Clubs and trade associations are deemed to be trading but if 75% or more of their gross receipts, other than gross investment receipts (interest, dividends, royalties, rents etc) are from members, it is deemed to be trading. It can then elect by notice to CDT to be treated as trading and entrance fee deemed income from business.

- i) Club subscription paid by an employer on behalf of an employee;
- j) Expenditure of a capital nature incurred in that year of income by a person on legal costs and other incidental expenses relating to authorisation and issue of shares, debentures or similar securities offered for purchase by the general public. This is the expenditure for turning a company public and thus enabling it to be quoted on the Nairobi Stock Exchange. The allowing of these expenses is intended to boost the capital market (buying and selling of shares). This also includes expenditure incurred in increasing the authorized share capital in order to sell shares to the public.



- k) Expenditure of a capital nature incurred in that year of income by a person, on legal costs and other incidental expenses, for the purposes of listing on any securities exchange operating in Kenya, without raising additional capital.
- l) Expenditure of a capital nature incurred in that year of income by a person on rating for the purposes of listing on any securities exchange operating in Kenya.
- m) The expenditure incurred for scientific research whether capital or revenue expenditure.
- n) The amount of contribution to a scientific research association which undertakes research related to the class of business of the contributor. The research association must be approved by the CDT e.g. Ruiru Coffee research, Fresian Cattle Society etc.
- o) The amount of contribution to university, college or research institution approved by CDT for scientific research e.g. Nairobi University, Kenya Polytechnic, AMREF, Kenya Medical Research Institute (KEMRI), Kenya Agricultural Research Institute (KARI) etc.

The research must be related to the class of business of the contributor e.g. a farmer contributing to KARI or to an agricultural university carrying on agricultural research.

- p) Any sum contributed in that year of income by an employer to a national provident fund or other retirement benefits scheme established for employees throughout Kenya by the provisions of any written law.
- q) The expenditure on advertising. This includes expenditure intended to advertise or promote directly or indirectly, the sale of goods or services provided by a given business e.g. advertisement in television, radio, press, calendars, sponsoring sports like football clubs, golf tournament, rally cars, horse races, Olympic teams etc.

The advertisement in the form of passenger sheds at bus stops and signboards are capital expenditure and not allowable. As will be seen later in the lesson, the expenditure qualifies for wear and tear deduction.

- r) Mortgage interest (also called owner occupier interest) to the maximum of Sh150,000 w.e.f. 1.1.2006. This is the interest on loan obtained for purchase or improvement of a residential house. For the interest to be allowed the loan must be obtained from any of the following institutions:
 - Banks and financial institutions licensed under the Banking Act;
 - Insurance companies licensed under the Insurance Companies Act;
 - Building society licensed under the Building Societies Act;
 - National Housing Corporation established by the Housing g Act

The following points should be noted:

- i) Where the mortgage interest paid is less than the maximum of Sh150,000, the actual interest paid is the amount allowed against income.
- ii) Where the mortgage interest paid is more than Sh.150,000 in year 2007, then only the maximum is allowed against taxable income.
- iii) Only individuals can claim mortgage interest and on only one residential house.

- iv) If the house is occupied for less than a year, the mortgage interest allowable is restricted to the period of occupation.
- v) The maximum amount has been increased to Sh. 150,000 p.a. w.e.f 1/1/2006.

- s) The amount of loss brought forward from previous year(s) of income. The losses should be on the basis of specified sources.
- t) The amount of trading loss. The trading loss arises where business is continuing and all the assets in a class of wear and tear are sold for less than the written down value e.g.

Wear & Tear Class

Written down value	50,000
Sale of all assets (business continuing)	<u>40,000</u>
Trading loss-allowable against income	<u>10,000</u>

The concept will be clear later in the lessons when the calculation and claim for Wear and Tear Deduction is explained.

- u) The amount of balancing deduction. The balancing deduction arises where business has ceased and all the assets of a class of wear and tear are sold for less than the written down value e.g.

Wear & Tear Class

Written down value	50,000
Sale of all assets (business has ceased)	<u>40,000</u>
Balancing deduction-allowable against income	<u>10,000</u>

The concept will be clear later in the lessons when the calculation and claim for Wear and Tear deduction is explained.

- v) The amount of interest on money borrowed and used in the production of income e.g. interest on loan, overdraft, debentures etc.
- w) The amount of realised foreign exchange loss (capital or revenue) with effect 1.1.'89. If the foreign exchange loss is not realised or incurred, it is not allowed against taxable income.
- x) Capital deductions under the second schedule of the Act, namely:
 - i) The amount of wear and tear deduction (allowance) on machinery used for business.
 - ii) The amount of industrial building deduction (allowance) on industrial buildings used for business.
 - iii) The amount of farm works deduction (allowance) given to farmers only on construction of farm works used for farming.



- iv) The amount of investment deduction (allowance) given only once to an investor on some industrial buildings and machinery used for business.
- v) The amount of mining deduction (allowance) on capital expenditure incurred in the mining of specified minerals. The calculation and claiming of the capital deductions above which are allowed under the Second Schedule to the Income Tax Act, is explained in detail after the next topic regarding expenses and deductions not allowed against taxable income.
- y) Cost of provision of meals to employees.

EXPENSES OR DEDUCTIONS NOT ALLOWED AGAINST TAXABLE INCOME

S.16 of the Income Tax Act lists expenses which are either generally not allowable against taxable income or are specifically stated not to be allowable against taxable income.

Expenditure generally not allowed against taxable income

S.16(1) of the Income Tax Act generally disallows expenditure which is not incurred in the production of taxable income. The section reads as follows:

S.16(1) "..... for the purpose of ascertaining the total income of the person no deduction shall be allowed in respect of expenditure which is **not** wholly and exclusively incurred by the person in the production of income."

This is a general provision for disallowing:

- a) Expenses which under normal accounting practice are not allowable against income, subject to any extension made by the Income Tax Act; and
- b) Expenses which are not commercial expenses of a business e.g. notional rent, salary to self etc.

Specific items of expenditure not allowable against income

In addition to S.16(1) generally disallowing expenditure which is **not** wholly and exclusively incurred in the production of taxable income, S.16(2) disallows specific items of expenditure if charged against taxable income. The items of expenditure listed below must be disallowed where charged against taxable income:

- a) The amount of capital expenditure, loss, diminution or exhaustion of capital e.g. depreciation, amortisation, write-off of all assets, loss on sale of asset etc. These are disallowed unless specifically allowed in the Income Tax Act.

- b) The amount of personal expenditure incurred by any individual in the maintenance of himself, his family, or for domestic purpose. With effect from 1.6.'91, the disallowed expenditure includes:
- i) entertainment expenses for personal purposes;
 - ii) hotel, restaurant, or catering expenses except:
 - a) on business trip;
 - b) during training or work related conventions or conferences; and
 - c) meals provided to low income employees on employers premises.
 - iii) vacational trips except those provided to expatriates;
 - iv) education fees, if not taxed on the employee(s):
- d) The amount of expenditure or loss recoverable under insurance contract or indemnity.
- e) The amount of income tax paid, or any tax on income. Other taxes may be allowed.
- f) The amount of premium paid under an annuity contract, that is, paid to an insurance company for the purpose of receiving annuities (regular amounts annually) in future.
- g) The amount of expenditure in the production of income by a non-resident person with no permanent establishment in Kenya. The income is taxed gross at source at non-resident rates of tax. The expression "permanent establishment" is defined in the Act as a fixed place of business in which that person carries on business. A fixed place of business means a building site, or a construction or assembling project, which has existed for six months or more in relation to a person.
- h) The amount of loss from hobby business. This is business not carried on with a view to making profit e.g. keeping of three cows at the estates of Karen in Nairobi. The issue of losses from hobby business has been weakened by the concept of specified sources of income.

Where more than 25% of the business expenditure is of personal or domestic nature, the business is outright hobby business.

- i) The amounts of lease hire rentals for assets relating to lease hire agreements entered into with effect from 17.6.'88. The lease hire agreement entered into before the above date was allowable.
- j) The amount of reserves and provisions. These are not business expenditure incurred. It should be noted that the provision for specific trade bad debts is specifically stated to be allowable expenditure.



INCOME AND EXPENDITURE AFTER CESSATION OF BUSINESS

Where a person receives a sum of money after the cessation of his business which, if it had been received prior to the cessation, would have been included in the gains or profits of that business, that sum shall be income of that person for the year of income in which it is received.

Where a sum is paid by a person after the cessation of his business, which if it had been paid prior to the cessation, would have been deductible in computing his gains or profits from that business, it shall be deducted in ascertaining his total income for the year of income in which it is paid.

2.14 TAX DEFICITS / TAX LOSS

Tax deficits are an allowable deduction in ascertaining the total taxable income of a person in a succeeding year of income. As such, a tax deficit is carried forward indefinitely in the following period (s).

Section 15 (4) of the Income Tax Act provides that *“where in ascertainment of the total income of a person results in a deficit for a year of income, the amount of that deficit shall be an allowable deduction in ascertaining the total income of that person for the next succeeding year of income.”*

Provided that:-

- a) A deficit for the year of income 1973 shall be regarded for the purposes of this subsection as having arisen entirely in that year of income;
- b) Where the income of a married woman is deemed to be the income of her husband, the amount of a deficit in her total income existing at the date of her marriage shall be an allowable deduction in ascertaining the total income of her husband for that year and, insofar as that deficit has not already been deducted, subsequent years of income, to the extent of the amount of her income which is assessed on her husband in those years of income.

Note that the tax loss or deficit is carried forward on the basis of specified sources until the person makes a profit to off-set the loss. The loss from one specified source can only be off-set against future income from the same specified source.

Please note that for petroleum companies, tax deficits in the year the petroleum company closes its business is carried backwards for a maximum of three years.

2.14.1 TAX COMPUTATIONS

The income tax computation is a process in which an effort is made to reconcile the financial statements (accounts) with the requirements of the Income Tax Act as regards taxable/non-taxable income and expenses allowable/not allowable against income. The Income tax computation can also be looked at as a process of arriving at the taxable income/loss of a person for a year of income. The income tax computation is also a process of computing or determining the taxable income/loss of a person for a year of income.

In computing or determining the taxable income/loss, you will rely heavily on your knowledge of accounting in the preparation of financial statement, and particularly the net profit/loss for the accounting period. You will also be required to have a good knowledge of taxable/non-taxable income, and deductible/non-deductible expenses.

The income tax computation involves:

- a. Determining (computing) income or loss to be taxed. The Income is taxed and losses are carried forward for each specified source of income to the next year of income and so on until there is income to off-set it.
- b. Adjusting the net profit/loss per the accounts to comply with the requirements or provisions of the Income Tax Act.
- c. Reviewing various incomes appearing in the accounts to determine whether they are taxable or not.
- d. Reviewing the various expenses appearing in the accounts to determine whether allowable against income or not.

We will now look at the items of income and expenditure appearing in the accounts and how some are adjusted in the income tax computation in arriving at the taxable income/loss for the year. The adjustments are necessary because:

- a. Non-taxable income may be included in the accounting net profit/loss or taxable income may be omitted in the accounting net profit/loss.
- b. Non-deductible expenses may be included in arriving at the accounting net profit/loss or deductible expenses may be omitted in arriving at the accounting net profit/loss.



Income

Income is either:

- a. taxable (chargeable, assessable) to tax, that is, it is included in the definition of taxable income as per the Income Tax Act e.g. salary, rent, business profit etc; or
- b. not taxable (not chargeable, not assessable) to tax, that is, it is excluded from the definition of taxable income or is exempted from being taxed as per the Income Tax Act e.g. dowry, Post Office Premium bond winnings, Charity Sweepstake winnings, Post Office Savings Bank interest (exempt), interest from the Tax Reserve Certificate (exempt) etc.



Expenses

An item of expenditure is either:

- a. Allowable or deductible (can be deducted) against income e.g. in case of a grocery shop, salary of shop assistant, rent of business premises, purchase of trading stock etc; or
- b. Not allowable or not deductible against income e.g. capital expenditure; and in case of individuals, personal expenditure such as school fees, family food, house rent, and other living expenses.

Where accounts are involved and an income tax computation is to be prepared, always start with the net profit/loss per the accounts. The items of income or expenditure are then adjusted by adding to or deducting from the net profit/loss depending on how the items have affected the net profit/loss.

■ Rules for adjusting income items in the income tax computation

- i) Where an amount of taxable income is omitted in the accounting net profit/loss—add back the amount, that is; add the amount to the net profit/loss to include the omitted income.
- ii) where an amount of income which is exempt from taxation, not taxable, or is assessable separately as a specified source, is included in arriving at the accounting net profit/loss—deduct the amount, that is, deduct the amount from the net profit/loss.

■ Rules for adjusting expenditure items in the income tax computation:

- i) Where an amount of expenditure which is not allowable has been included in arriving at the accounting net profit/loss—add back the amount, that is, exclude it in arriving at the net profit/loss.
- ii) Where an amount of allowable or deductible expenditure has been omitted in arriving at the accounting net profit/loss—deduct the amount, that is, deduct the amount from the net profit/loss to include it in arriving at the net profit/loss.

Income Tax Computation - Format

	Shs	Shs
Net profit/(loss) per the accounts		XX
Add back:		
1. all expenditure items charged in the P&L account in arriving at the net profit or loss which are not allowable against income—list the items.	XX	
2. all items of taxable income which are omitted in arriving at the net profit/loss—list the items.	<u>XX</u>	<u>XX</u> <u>XX</u>
Deduct:		
1 All items of income which are exempt, not taxable or are taxable separately as specified sources of income—list the items.	(XX)	
2 All allowable items of expenditure which have been omitted in arriving at the net profit or loss — list the items	<u>(XX)</u>	<u>(XX)</u>
Adjusted profit/(loss) for tax		<u>XX</u>

Note that the above FORMAT for the income tax computation is used for individuals, partnerships and companies.

For partnerships, there is a schedule of allocation of profit/loss to partners in addition to the above computation. The allocation is explained in the section dealing with partnership return of income.

**>>> Example**

The profit and loss account of Mambo Walia, a trader at Eastleigh, Nairobi, show the following for the year ended 31.12.2008

	Sh	Sh
Sales		100,000
Opening stock	25,000	
Add: Purchase	<u>50,000</u>	
	75,000	
Less: closing stock	<u>35,000</u>	
Cost of goods sold		<u>40,000</u>
GROSS PROFIT		60,000
Other Income:		
Post Office Savings Bank interest	15,000	
Tax Reserve Certificate interest	3,000	
Barclays bank interest—gross	2,000	
Sweepstake winning	<u>5,000</u>	<u>25,000</u>
		85,000
Less: Sundry expenses		<u>50,000</u>
NET PROFIT		<u>35,000</u>

The following information is given:

- i) An amount of Sh 8,000 received from Kenya National Assurance Company as compensation for trading stock destroyed by fire has been included in drawings.
- ii) Owing to new found friendship, a creditor Mrs. Matata wrote-off amounts payable to her by Mr. Walia of S 4,000. The amount is included in drawings.
- iii) The sundry expenses in the Profit and Loss Account include:
 - a. Cost of a bicycle used in the shop bought in May 2008 for Sh 3,500.
 - b. Alimony paid to a former wife he divorced Sh 2,400.
 - c. Subscription of Sh 1,000 to Matumbo Welfare Association of which he is a member.
 - d. Depreciation of assets Sh 2,200
- iv) He paid with amounts drawn and included in his drawings accounts:
 - a. Insurance premium of Sh 2,500 against fire in respect of trading stock.
 - b. Painting of business premises Sh 800.
 - c. Stationery Sh 500.
- v) Wear and tear deduction of Sh 1,500 has been agreed with the Domestic Tax Department.

Required

Compute the taxable income for the year ended 31.12.2008

Solution

The following steps are helpful if followed:

1. Always start with the net profit/(loss) per the accounts as in the format above.
2. Review the items of expenditure and add back or deduct in the income tax computation as per the rules explained above.
3. Review the items of income and add back or deduct in the income tax computation as per the rules explained above.
4. The items added back are listed together and the items deducted are listed together.
5. Briefly indicate why an amount has been added back or deducted in the income tax computation.

Mambo Walia

Taxable Income for the year ended 31.12.2008

	Sh	Sh
Net profit/(loss) as per the accounts		35,000
Add back: Disallowable expenses (Note 1)		
Bicycle - capital expenditure	3,500	
Alimony - personal expenditure	2,400	
Depreciation - not allowable given WTD	<u>2,200</u>	8,100
Add back omitted taxable income		
Insurance compensation	8,000	
Written off liability	<u>4,000</u>	<u>12,000</u>
		55,100
Less non taxable income		
P.O.S.B. interest	(15,000)	
Tax Reserve Certificate interest	(3,000)	
Bank interest (tax at source Sh 300)	(2,000)	
Sweepstake winning	<u>(5,000)</u>	(25,000)
Less allowable expenses not deducted		
Insurance premium	(2,500)	
Painting of business	(800)	
Stationery	<u>(500)</u>	(3,800)
Wear and Tear Deduction (Note 2)		<u>(1,500)</u>
Total taxable income for 2008		<u>24,800</u>

Notes

1. All amounts added back to net profit are listed together whether they are income or expenditure items, likewise all deductions are listed together whether income or expenditure items.
2. Capital deductions namely wear and tear deduction, investment deduction, industrial building deduction, and farm works deductions are, where calculated, deducted in the income tax computation.
3. Subscriptions to clubs are allowable.



2.15 INCOMPLETE RECORDS (BACK DUTY & IMPROPER RECORDS)

The obligation to declare all incomes for tax purposes rests with the taxpayer whether or not he has been specifically told to do so by the Domestic Taxes Department (DTD).

Back-duty refers to collection of all kinds of tax in arrears. The Income Tax Act requires every person assessable to tax to notify his liability within four months after the end of the year of income. Return forms/materials will be sent to taxpayers in the DTD records and the Department is not obliged to issue necessary returns/materials.

Tax arrears normally arise under the following conditions:

1. Under declaration of income (incomplete and incorrect returns)
2. Non-declaration of income
3. Taxpayer claims expenses, allowances, reliefs he is not entitled to.

An offence will have been committed by a taxpayer under the above mentioned circumstances and his affairs will be dealt with as a back-duty case i.e. back-duty investigation will be instituted into the affairs of the taxpayer. Penalties may be charged including interest charges. Where the above circumstances are due to:

- i) Gross or willful negligence on the part of the tax payer and his accountant, or;
- ii) Fraud on part of taxpayer

Sources of information resulting to back-duty will be from:-

- Taxpayer himself
- Informers
- Public media
- Income tax departments
- Farming organizations
- Registrar General's office
- Licensing Department offices etc.

Determination of Income through Back-duty cases

1. The taxpayer can declare income acceptable to the department supported by accounts and other relevant documentation.
2. A capital statement may be prepared as sufficient estimation of growth in assets and therefore estimate income for such taxpayer if there are no reliable records/accounts. A capital statement consists of details of assets and liabilities as at a given date or period. This would show changes in total worth of a taxpayer between two or more periods. The capital statement also considers capital losses or gains, living expenses, income tax paid etc.

Where the capital statement covers more than one year, the resultant figures will be divided by number of years involved giving rise to a uniform figure as estimate measure per year.

STEPS:

- 1) Add all assets of taxpayer both tangible and intangible for a given period. Deduct all liabilities both personal and business used to finance the assets. Net result will be NET ASSETS for the period.
- 2) Calculate the growth or loss in Net assets for each time period by taking the Net Assets of the period and comparing it with the Net Assets of the previous period. This represents additional assets that the taxpayer acquired or disposed in the time period.
- 3) Deduct any non-taxable income that was used to finance the above growth in Net assets – e.g. income or assets from a legacy or inheritances, capital gains, gifts, money from friends and relatives.
- 4) If looking for only the undeclared business profits taxable, then deduct any non-trading business income from growth in Net Assets. The net figure would represent Net Business savings.
- 5) Add to the balance (4) living expenses such as water & electricity, income tax paid, interest on loans, premium on various types of insurance, rents and rates as supported by bills or invoices. Add also personal expenses such as food, services, clothing, toiletries, medical expenses, house servant, holidays, amusements, private motor vehicle running and maintenance costs, harambee contributions, donations and any cash stolen from house or shop etc.
- 6) If capital assets are sold at a loss, ADD THE LOSS. If sold at a profit, DEDUCT THE PROFIT. Deduct any income declared during the year – balance is UNDECLARED INCOME.
- 7) **Other considerations**
 - Taxpayers' standard of living/lifestyle/cost of living, property and assets alienated to other persons.
 - Any remittances abroad
 - Marital status or status in society
 - Dwelling place.

Further Procedures

Determine the capital at the beginning and end of the period. An increase in capital may be due to: -

- a) Fresh capital introduced (not income).
- b) Profit earned (may or may not be taxable)
- c) Gifts, awards, windfall gains (may not be taxable)



A decrease in capital may be due to: -

- a) Capital withdrawn
- b) Losses (allowable or non-allowable)

The increase in capital is adjusted for the following items:

DEDUCT:

Legacies, gifts not taxable, income already taxed at source and not subject to further taxation, relief and allowances, windfall gains, inherited wealth/property, life policies matured/surrendered.

ADD:

Taxes paid, gifts or donations made, non-allowable losses e.g. loss on sale of investments/assets, personal expenditures, unexplained payments.



FURTHER INFORMATION THAT MAY BE REQUIRED

1. Are there other expenses not deductible?
2. Does the taxpayer have any other income source?
3. Does the taxpayer lease the freehold land or does he farm it and what is the income?
4. Why has the taxpayer not claimed capital allowances?
5. Does the taxpayer have a life insurance policy with a Kenyan company? If so, how much are the premiums he pays?



2.16 APPLICATION OF CASE LAW



Taxation of Individuals

Income from employment or services rendered S.3 (2)(a)(ii)

Income tax is imposed on the gains or profit from **any** employment or service rendered. Employment is not legally defined but covers any relationship between master and servant arising from a contract or agreement. The scope of S.3 (2)(a)(ii) extends to services rendered by one person to another other than in the course of employment or as part of business.

D.S TRIVEDI v CIT

The appellant, a practicing accountant, was asked by a friend, the managing director of a company, to try to effect the sale of an estate belonging to the company. The appellant took little action to find a purchaser but succeeded in effecting a sale to another friend and was paid commission of £7,500. The appellant had never previously negotiated the sale of any property.

The appellant was assessed to income tax on the commission. He appealed to the Local Committee on the grounds that the commission was not a taxable receipt as it arose from services rendered and not either from business or employment. The appeal went up to the Court of Appeal for Eastern Africa.

Held:

1. The Commission was gains or profits from a business and was taxable.
2. The Commission was also gains or profits from employment.



Basis of recognizing employment income

For the purposes of S.3 (2)(a)(ii), S5(2)(a) lists the types of payment which constitute gains or profits from employment or services rendered. It states:

"For the purposes of subparagraph (a)(ii) of subsection (2) of Section 3 of this Act, "gains or profits" includes-

- a) any wages, salary, leave pay, sick pay, payment in lieu of leave, fees, commission, bonus gratuity, or any subsistence, travelling, entertainment or other allowances received in respect of employment of services rendered, **and any amount so received in respect of employment or services rendered in a year of income other than the year of income in which it is received shall be deemed to be income in respect of such other year of income".**

This implies the amounts shown above are charged on an "earnings" basis and not on a "receipts" basis.

For example if a bonus is earned in 1994 and is actually paid in 1995 it will be assessed in the year of income 1994.

S.5(2)(a) enumerates cash payments chargeable to tax. S.5(2)(b) extends the scope of chargeability to include the value of any benefit, advantage or facility whose total value is Sh. 36,000 or more in a year.

The value of a benefit is usually the cost to the employer. Some benefits may not entail a cost to the employer but are still chargeable to tax e.g. the option to subscribe for shares at a favourable price. The important criterion is that the benefit has some monetary value.



WEIGHT v SALMON

An employee of a company was given the privilege of obtaining unissued shares at value, which was less than the prevailing market value.

Held:

Although the employee did not sell any of the shares, there was no restriction to do so if he wished. The privilege represented money's worth for services rendered to the company equivalent to the difference between the par and market value was accessible.

Other gains or profits from employment or services rendered are:

- Section 5(2)(c): Amount received as compensation for the termination of a contract of employment.
- Section 5(2)(d): Balancing charge.
- Section 5(2)(e): Value of premises provided by an employer for occupation by his employee for residential purposes.
- Section 5(2)(f): Premium paid by an employer on an insurance on the life of an employee.



Gifts by employer to employee

Generally gifts are not treated as income in the hands of the recipient. This rule applies to personal gifts e.g. a gift by a person to his friend.

However if a gift is received by virtue of an employment or services rendered it is a gain from employment and it is taxable e.g. tips to a waiter. This also includes gifts made to employees as "Christmas gifts" or "Long-service awards".

WESTON v HEARN

An employee received a sum of money on completion of twenty-five years of service.

- Held:**
1. Not a personal gift;
 2. The sum is an emolument by way of bonus and because the employee had not left employment the gift was from the employer and therefore assessable.

In **CALVERT v WAINWRIGHT** it was held that a taxi driver was assessable in respect of his tips. "Tips received by a man as a reward for services rendered, voluntary gifts made by people other than the employer, are assessable to tax as part of the profits arising out of the employment if given in the ordinary way as a reward for services, but on the other hand, personal gifts which mean gifts to a man on personal grounds, irrespective of and without regard to the question of whether services have been rendered or not are not assessable".

The important principle that emerges from case law is that for a gain to be assessable the motive of the payment must be to reward present and past services rendered.

BALL v JOHNSON

A bank had a scheme of giving cash awards to its employees who passed the Institute of Bankers Examination.

- Held:**
1. The reason for the payment was not services rendered but the personal success of the employee in passing examinations and not remuneration for services.
 2. The payments were not taxable.

CHAPTER SUMMARY

- Where a benefit is enjoyed for a period of less than a year, the taxable value of the benefit is proportionately reduced to the period enjoyed.
- Where there is no medical scheme or plan for all employees, the payment of any medical bills for the beneficiary is taxable.
- Loss from a specified source can only be off-set against future income from the same source
- A person making payments of incomes subject to withholding tax is legally required to deduct the withholding tax or the tax at source at appropriate rates before effecting the payment
- The personal relief is claimed and granted only to resident individuals
- Housing benefit is computed depending on the type of employee
- The first Sh.2,000 paid to an employee per day as an allowance while on official duty shall be deemed to be a reimbursement and therefore not taxable on the employee.
- A low income employee is a person earning not more than Sh. 29, 316 per month.
- School fees paid by the employer for the employee's dependants is taxed on the employee if not taxed on the employer.



CHAPTER QUIZ

Question one

Explain briefly the following income tax terms:

- a) Year of Income.
- b) Business.

(6 marks)

Question Two

Specify Persons liable to Tax.

(5 marks)

Question Three

Discuss the treatment of tax deficits under the Income Tax Act

(5 marks)

Question Four

Differentiate between Low interest benefit and fringe benefit

(4 marks)

(Total: 20 marks)

CHAPTER QUIZ ANSWERS

Question One

- a. Year of income means the period of twelve months commencing on 1st January in any year and ending 31st December in that year. Where the accounting period of a person does not coincide with the year of income as defined, then, for the purposes of ascertaining his total income for a year of income, the income of an accounting period ending on that other date, (say 30.6.99) shall be taken to be income of the year. This will not apply to individuals earning employment income only.
- b. Business includes any trade, profession, or vocation and every manufacture, adventure and concern in the nature of trade, but does not include employment. This will include business carried on partly in Kenya and partly outside Kenya by a **resident person**.

Question Two

Persons liable to tax

1. An individual i.e. a natural person; or
2. A legal person e.g. a company. The company here includes a Trust, Co-operative Society, Estate, Club, Trade Association etc

Question Three

Tax deficits are an allowable deduction in ascertaining the total taxable income of a person in a succeeding year of income. As such, a tax deficit is carried forward indefinitely to the following period.

Section 15 (4) of the Income Tax Act provides that *“where in ascertainment of the total income of a person results in a deficit for a year of income, the amount of that deficit shall be an allowable deduction in ascertaining the total income of that person for the next succeeding year of income.”*

Provided that:-

- c) A deficit for the year of income 1973 shall be regarded for the purposes of this subsection as having arisen entirely in that year of income;
- d) Where the income of a married woman is deemed to be the income of her husband, the amount of a deficit in her total income existing at the date of her marriage shall be an allowable deduction in ascertaining the total income of her husband for that year and, insofar as that deficit has not already been deducted, subsequent years of income, to the extent of the amount of her income which is assessed on her husband in those years of income.

Please note that for petroleum companies, tax deficits in the year the petroleum company closes its business is carried backwards for a maximum of three years.



Question Four

Low interest Benefit	Fringe benefit
<p>This benefit arises from the difference between the prescribed rate and the interest rate charged by the employer for loans provided by the employer on or before 11th June 1998. This benefit is taxable on the employee</p>	<p>This benefit arises from the difference between the Market Interest rate and the employer's interest rate for loans provided after 11th June 1998 or loans provided on or before 11th June 1998 whose terms and conditions have changed after 11th June 1998. Such a benefit is taxable on the employer at the corporation Tax Rate. The Tax on Fringe Benefits is known as Fringe Benefit Tax.</p>

PAST PAPER QUESTIONS ANALYSIS

The following is an analysis on how the chapter has been examined in the past. The questions are listed in this format: Month/year e.g. 6/01 represents June or May 2001.

Taxation 1- 12/08, 12/07, 6/07, 12/06, 6/06, 12/05, 6/05, 6/04, 12/03, 6/03, 6/02, 12/01, 6/01, 12/00, 6/00.

Revision Questions

QUESTION ONE

- Explain the tax position of the income of a deceased person. (2 marks)
- What is 'set-off' tax? (2 marks)
- Mrs. Ongera works with Anga Ltd. and has provided you with the following information for the year ended 31 December 2007.

Pension from previous employment Sh.20,000 per month.

Salary sh.120,000 per month (P.A.Y.E Sh.42,000 per month)

Mrs. Ongera and her husband own a company whose taxable income was agreed at Sh.500,000 after charging husband's salary of Sh.250,000 per month (P.A.Y.E sh.60,000 per month).

Anga Ltd. provided a company house to Mrs. Ongera in South B where rent of similar houses was Sh.20,000 per month.

Mrs. Ongera works over-time and her over-time income averages Sh.10,000 per month.

Mrs. Ongera enjoyed medical benefit of Sh.160,000 during the year. She is a senior manager and the company has medical cover for all its employees.

She obtained free consumables from the company as a Christmas gift worth Sh.30,000 during the year.

Mrs. Ongera owns rental property at Komarock Estate and receives Sh.50,000 as rental income per month. During the year, She incurred Sh.60,000 in renovations, repairs and painting before letting the property. She had obtained a mortgage loan from Housing Finance Company amounting to Sh 3,000,000. She paid Sh 900,000 during the year of which Sh 500,000 was principal.

Mrs. Ongera owns 20% of the shares of Anga Ltd.

Required:

- (i) The taxable income for Mr and Mrs Ongera for the year of income 2007. (10 marks)
- (ii) Tax payable on the income computed above. (4 marks)
- (iii) Mrs. Ongera did not fill her self assessment return form for 2007. State the penalties due, if any. (2 marks)

(Total: 20 marks)

(Dec 2000 Question 1)

QUESTION TWO

- (a) Comment on whether the following individuals and companies were residents of Kenya for tax purposes for the year ended 31 December 2007. Justify your comment in each case.
 - (i) Mr. Charles Owino has a permanent home in Kenya. He works for a company based in the United Kingdom (UK) where he lives. He came to Kenya for a one-month holiday on 1 September 2007 but had not returned to the UK by 31 December 2007. (1 mark)
 - (ii) Mapato Ltd. is registered in South Africa where its headquarters are based. The company opened a branch in Kenya on 1 March 2007. (1 mark)
 - (iii) Mrs. Frida Aloo, a Kenyan citizen, is married to a citizen of Canada. She was employed in Kenya until 31 August 2007 when she resigned to join her husband in Canada (1 mark)



- (iv) Zawadi Ltd. Was registered in Kenya where the company operated until 15 July 2007. The company thereafter relocated its operations to Kampala, Uganda.

(1 mark)

- (b) Joel Kivu is a general manager with Ukweli Ltd. He has provided you with the following information on his income for the year ended 31 December 2007

1. He is paid a basic salary of Sh.75,000 per month (PAYE Sh.15,000 per month).
2. He is housed by the employer in a house leased at Sh 30,000 per month. The house was furnished by the employer at a cost of Sh 200,000. his private telephone charges averaging Sh1,800 per month are also paid by the employer.
3. He is a member of a golf club where the employer contributes Sh 5,000 per month for him.
4. He holds a life assurance policy with Maisha Assurance Company Ltd. The employer paid the premiums on the policy for year 2007 amounting to Sh 48,000.
5. He is a member of a registered collective investment scheme. During the year, he earned an income of Sh.40,000 from the scheme. The scheme invests in shares and fixed deposit accounts.
6. He separated with his wife on 1 October 2007. With effect from 31 October 2007, he has been paying alimony of sh20,000 per month to his wife as required by a court order.
7. He is provided with a motor vehicle (2000cc) by the employer which was purchased on 1 January 2006 at a cost of Sh1,500,000.
8. He contributed Sh 25,000 per month towards a registered pension scheme.
9. On 1 December 2007, his monthly salary was increased by ten per cent backdated to 1 July 2007.
10. He owns a pig-rearing farm in Limuru. The farm reported revenue of Sh 1,800,000 for the year ended 31 December 2007 before deducting the following costs:

	Sh
Salary to farm manager	300,000
Wages to farm labourers	160,000
Construction of pig stays	48,000
Purchase of a plastic water tank	22,000
Purchase of pig feed	410,000
Cost of renovating the farmhouse	<u>130,000</u>
	<u>1,070,000</u>

Required:

- (i) Taxable income of Mr. Joel Kivu for the year ended 31 December 2007.
(14 marks)
- (ii) Tax liability from the income computed in b (i) above.

(2 marks)

(Dec 2007 Question 2)

Question Three

- (b) Alex Kipkoech is employed by Zintac Ltd. as a salesman. He provided the following information relating to his income and that of his wife for the year ended 31 December 2007:
1. His monthly basic salary is Sh. 60,000 (PAYE Sh. 15,000 per month).
 2. He is also entitled to a commission based on 5% of all extra sales he makes above Sh. 200,000 per month. His sales for the months of March, June, August and October 2007 amounted to 250,000, Sh.300,000, Sh.220,000 and Sh.215,000 respectively.
 3. He lives in a company house and pays a nominal rent of Sh. 8,000 per month. The market rental value of the house is Sh. 45,000 per month.
 4. The company reimburses him for all out-of- pocket expenses incurred on the official use of his car. In the year 2007, the amount reimbursed was Sh. 90,000, he had purchased the car in the year 2004 at cost of Sh. 800,000. the car has an engine capacity of 1600cc.
 5. The education fees for his two children amounting to Sh. 200,000 was paid by the company during the year. This amount was charged to the company's income statement.
 6. He earned a net interest income of Sh. 150,000 during the year from his investments in housing development bonds.
 7. He is contemplating purchasing a house for his residence in the near future. In the year 2007, he invested Sh. 100,000 in a registered home ownership savings plan and earned an interest income of Sh. 10,000.
 8. He has a life insurance policy for self and family for which he pays a total premium of Sh.45,000 per annum.
 9. He has a farm which generated a surplus of Sh. 120,000 during the year. A tax of Sh. 15,000 had been deducted under presumptive tax regulations.
 10. His wife has invested in the shares of a quoted company. She received a dividend of Sh. 12,000 (net) from the shares in the year 2007.

Required:

- (i) Compute the total taxable income of Alex Kipkoech for the year ended 31 December 2007. (10 marks)
- (ii) Determine his tax liability from the income computed in (i) above. (4 marks)

(Total: 20 marks)
(Dec 2006 Question 5)

**Question four**

- (a) Comment on the treatment for withholding tax purposes of each of the following incomes received by a resident tax payer:
- (i) Management fees
 - (ii) Royalties
 - (iii) Insurance commission
 - (iv) Rent
- (b) The management of Mapato Ltd. presented the following income statement of the company for the year ended 31 December 2007:

Mapato Ltd
Income Statement for the year ended 31 December
2007

	Note	Sh.
Gross Profit		1,864,000
Investment income	1	284,636
Profit on sale of shares		<u>216,324</u>
		<u>2,364,960</u>
Directors remuneration	2	1,020,000
Interest	3	273,000
Audit fees and expenses	4	216,000
Bad debts	5	158,400
Depreciation		344,760
Miscellaneous expenses	6	<u>133,600</u>
		<u>2,146,360</u>
Net profit		<u>218,600</u>

Notes

1. Investment income:

	Sh.
Dividends from shares in Ushindi Commercial Bank Ltd	72,000
Interest on fixed deposit account	58,760
Interest on Treasury bills	93,876
Dividends from a subsidiary company	<u>60,000</u>
	<u>284,636</u>

2. Directors remuneration:

	Sh.
Directors fees	240,000
Travelling expenses – directors	400,000
Payment to directors pension scheme	160,000
Compensation to a former director for wrongful termination contract	<u>220,000</u>
	<u>1,020,000</u>

3. Interest expenses

	Sh.
Interest on bank overdraft	151,200
Interest on loan from a foreign bank	50,400
Interest on loan to purchase investment shares	<u>72,000</u>
	<u>273,600</u>

4. Audit fees and expenses:

	Sh.
Audit fees	68,000
Tax appeal against assessment	32,000
Book-keeping fees	48,000
Audit expense paid in relation to a discontinued business line	<u>68,000</u>
	<u>216,000</u>

5. Bad debts:

	Sh.
Embezzlement by staff	21,600
Insurance compensation on embezzlement	(12,000)
Bad debts written off	28,800
General provision for bad debts	<u>120,000</u>
	<u>158,400</u>

6. Miscellaneous expenses:

	Sh.
Acquisition of a 100 year lease on business premises	28,000
Directors Christmas party	24,000
Subscription to a trade association	30,000
A.S.K show contribution	10,000
Donation to a children's home	<u>41,600</u>
	<u>133,600</u>



Required:

Determine the adjusted taxable profit or loss of Mapato Ltd. for the year ended 31 December 2007. (16 marks)

(Total: 20 marks)

(Dec 2005 Q.5)

Question five

Ali and Salama are in partnership trading as Alisa enterprises and sharing profits and losses in the ration of 3:2 respectively. They have presented the following profit and loss account for the year ended 31 December 2007:

Income:	Sh.
Sales revenue	6,882,000
Proceeds from sale of fixed assets	190,000
Refund of VAT	41,250
Interest on post Bank savings account	8,750
Dividend (net)	<u>42,800</u>
Total income	<u>7,164,800</u>
Expenditure:	
Cost of sales	1,591,500
National Hospital Insurance Fund(NHIF) contributions	108,750
National Social Security Fund(NSSF) contributions	170,000
Lorry maintenance expenses	1,005,750
Salaries to partners	800,000
Household expenses-Ali	96,250
Repairs and maintenance- buildings	75,000
Advertising	156,750
Insurance premiums	125,000
Interest on loan	200,000
Subscriptions to trade associations	40,000
Donations	20,000
Legal expenses	98,000
Income tax	240,000
General expenses	86,650
Bad debts	61,750
Water and electricity	81,000
Depreciation	<u>19,500</u>
	<u>4,975,900</u>
Net profit	<u>2,188,900</u>

Additional information:

1. Included in sales revenue were goods valued at Sh. 150,000 consumed by the partners. These goods had cost Sh. 80,000 which was included in cost of sales.
2. Insurance premiums include Sh. 70,000 incurred on the life insurance policy of

Salama.

3. Bad debts comprise:

	Sh.
Increase in general provisions	20,000
Increase in specific provisions	<u>41,750</u>
	<u>61,750</u>

4. Interest on loan and legal expenses relate to a mortgage acquired by Ali for purchase of his house.

5. Salaries to partners comprise:

	Sh.
Ali	500,000
Salama	<u>300,000</u>
	<u>800,00</u>

6. NSSF and NHIF contributions relate to the employees of the firm.

Required:

- (i) The adjusted partnership profit or loss for the year ended 31 December 2007. (10 marks)
- (ii) An allocation of the adjusted profit or loss between the partners. (2 marks)

(Total: 20 marks)

(June 2006 Q.5)

CHAPTER THREE



STUDY TEXT

TAXATION OF SPECIFIC SOURCES OF INCOME



CHAPTER THREE

TAXATION OF SPECIFIC SOURCES OF INCOME

► OBJECTIVES

- Explain the specific sources of income
- Explain the tax implications of the various specific sources of income

► INTRODUCTION

In the previous topic, we studied the taxation rules relating to individuals, partnerships and companies. We also studied the specified sources of income but in a summary basis. In this chapter, we have covered the specified sources of income in detail together with their various tax implications.

► DEFINITION OF KEY TERMS

- **Dividend** is a share of profit of a business which it pays to its shareholders based on their shareholding in that business
- **Royalty** - These are incomes arising from rights granted to other persons for the use of intellectual property.

► EXAM CONTEXT

This topic is highly examinable. The various aspects of the topic may be examined separately or as part of a tax computation question.

► INDUSTRY CONTEXT

This topic would assist the tax payers to be able to ascertain the proper amount of tax payable when they are in receipt of many sources of income. It should be noted that if one does not appreciate the various taxation rules in this topic, there is a risk of non compliance to tax.

3.1 DIVIDENDS

Dividend means any distribution (whether in cash or property, and whether made before or during a winding up) by a company to its shareholders with respect to their equity interest in the company, other than distributions made in complete liquidation of the company of capital which was originally paid directly into the company in connection with the issuance of equity interest. Dividend paid by resident companies to the individual share holders are taxable income.

In comparison to employment income which is brought to tax in the year it is earned, dividend income is taxable in the year it was paid out.

For tax purposes, the following amounts are taken to be dividend income:

- Cash dividends
- The distribution of profits in case of voluntary winding up (whether cash or non cash)
- The issue of debentures or redeemable preference shares without any payment. Dividend in this case shall be **higher** of the nominal value or Redeemable value.
- The issue of debentures without ay payment
- Issuance of Debentures or redeemable Preference shares for part payment i.e. at a discount.

Non Taxable Dividend/Exempt

- (a) Dividend received from an investment outside Kenya (foreign dividend).
- (b) Dividend received **by a resident** company from another resident company where it controls **12.5% or more** of the share capital.
- (c) Dividends received by Insurance Company from its life **assurance** Fund.
- (d) The issuance of debentures or redeemable shares for free or for part payment in the care of a body corporate.



Classification of Dividends

Dividends are classified into two, namely;

- Qualifying dividend
- Non qualifying dividend

■ Qualifying dividend

There are dividends which are subjected to withholding tax only. i.e withholding tax in this case is a final tax.

The withholding tax rate is **5% on the gross amount** for residents. The non resident rate is **10%** as final tax.

Are paid out by:

- Private Companies
- Public Companies
- SACCOs (Savings and Credit Cooperative Societies)

Examples of SACCOs are; {Harambee SACCO, Mwalimu SACCO, Magereza SACCO}

■ Non Qualifying dividend

- These are dividends paid out by Cooperative Societies other than SACCOs .e.g
 - a. Kiambu Farmers Coop society
 - b. Kariokor Women Coop society
 - c. Tetu Farmers Cooperative Societies
- The Withholding tax rate is **15% which is not a final tax**.
- The Non qualifying dividend will be aggregated with other incomes of that person and taxed further and any withholding tax suffered will be allowed as a **set off tax**.

Compensating tax and Dividend tax account

Compensating tax was introduced in 1993 under Section 7 A of the Income Tax Act. It is an additional tax imposed on companies and arises if a company pays dividends from untaxed profits. Untaxed profits would occur in cases where the company declares dividends out of profits arising from sale of fixed assets, investments or other gains that are not taxable. Note that capital gains tax was suspended in 1985 and stands suspended to date.

Companies are required to maintain a dividend tax account to monitor the incidence of compensating tax. According to the Income Tax Act, the **initial balance in the dividend tax account** will be either:-

- (a) Zero; or
- (b) Sum of the total taxes paid and tax on dividends received, less tax on dividends distributed and tax refunded by the company with respect to 1988 to 1992 years of income. Thereafter the account is adjusted in the same way for each subsequent year of income as follows:

Dividend Tax Account format		
Particulars	Sh	Sh
	Debit	Credit
Dividend Tax Account Opening Balance b/forward as above (1 January 199x)		X
Total income taxes paid during the year		X
Tax on total dividends received during the year (dividends x 0.3/0.7)		X
Total Refunds by KRA of taxes previously paid and included in the calculation of income taxes earlier paid	X	
Tax on total dividends distributed (dividends x 0.3/0.7)	X	
Balance carried forward (if debit)	X	
Compensating tax payable (if credit)		X
	XX	XX

A credit balance is carried forward to the next year while a debit balance indicates the compensating tax payable. Where the tax is paid in a given year the balance carried forward to the next year is zero. The tax is due for payment by the last day of the 6th month following the end of the accounting period.

>>> Illustration

ABC Ltd had a closing balance of the dividend tax account for the year 2008 of Sh. 500,000. During the year 2009, the company paid tax of Sh. 200,000. It distributed dividend of Sh. 5,000,000 and received dividends of Sh. 2,000,000. Compute the compensating tax payable (if any) for the year 2009.

**Solution**

ABC Ltd		Sh	Sh
Dividend Tax Account			
Balance b/f			500,000
Tax paid			200,000
Dividend received	(2000000 x 0.3/0.7)		857,143
Dividend paid	(5000000 x 0.3/0.7)	2,142,857	
Compensating tax payable			585,714
		2,142,857	2,142,857

The amount of compensating tax payable is **Sh. 585,714**.

3.2 INTEREST

Interest is defined as the amount paid for the use of money.

For tax purposes, it is defined as interest payable in any manner in respect of a loan, deposit and other debts or obligations.

When is interest taxable?

- When it has been credited to ones account.
- When it has been paid out.
- When it has matured.

>>> Illustration

Miss Bosibori deposited **Sh. 4 million** with **Barclays Bank** for a period from 1st April 2004 to 31st March 2005 at an interest rate of 25% p.a.

Compute Interest taxable for years 2004 and 2005.

Solution**Miss Bosibori****Computation of Taxable Interest income for years 2004 and 2005**

Since the deposit was for a fixed period, it means that interest payable upon maturity i.e.

- 2 Nil
- 3 2005 25% x 4million =1000 (taxable in year 2005)


Interest Income exempt from taxation

1. **Interest arising from tax reserve certificates-** These are certificates sold or issued by the government and for the time being they are held by the government. Interest accrues which is fully exempt from taxation. These certificates will then be used to pay taxes when tax becomes due.
2. **Interest from Post Office Savings Bank Account.**
3. **Interest arising from government stocks and Nairobi City council stocks in the case of a non resident only.**
4. **Interest on East Africa High Commission in the case of non residents only.**
5. **Interest arising from a registered retirement Fund.** (encourages savings for old age)
6. **Interest on a deposits in Home Ownership Savings Plan to purchase a permanent house for own occupation through recognised financial institutions with effect from 1/1/96.**
7. **Interest accrued or earned outside Kenya.**

Note

- ◆ Interest on housing development bonds by approved institution such building society. The first **Sh 300,000** of the interest will suffer withholding tax only otherwise any excess interest will be subject to further taxation
- ◆ Interest received by a body corporate from financial institutions will be subject to withholding tax at the rate of 15% but this will not be final tax. Interest paid by other persons not financial institutions is fully taxable.

**>>> Illustration**

Mr. Omoding deposited Sh 3,000,000 in Housing Finance development Bonds in year 2004 and earned gross interest of Sh 450,000.

Required,

- Calculate withholding tax on the interest.
- How much of the interest suffers further taxation.

Solution

	<u>Sh'000'</u>
(a) Gross income	450
Withholding tax at 10%	45
(b) Interest on further taxation	(450 - 300) = <u>150</u>

 Classification of Interest income

Interest income can be classified into two, namely;

- Qualifying Interest
- Non qualifying Interest

Qualifying Interest

This is the aggregate interest receivable by an individual in any year of income from financial institutions e.g. Banks, insurance companies, treasury Bills and bonds,

Interest is subject to Withholding tax as final tax at a rate of **15%**;

In the case of Housing development bonds, the qualifying amount is **the first Sh 300,000**, the rest is non qualifying.

Non qualifying Interest

Non qualifying interest is the interest that is taxed further i.e. withholding tax is not a final tax.

It is aggregated with other incomes of that person and any withholding tax suffered will be allowed as asset off tax. Examples include:

- All interest income accruing to persons other than individuals.
- Interest in excess of Sh 300,000 of housing development bonds.
- Interest accruing to individuals other than from financial institutions

3.3 RENTAL INCOME

This is income earned by a person for rights granted to others to occupy his property. Rent income is made up of key money or goodwill, normal rent and premium.

Taxation of rental income depends on whether one is a resident individual or a non resident.

(a) Non residents

- i. They are taxed at a **flat rate of 30% on gross rent income** and this is the final tax.
- ii. **No expenses** are allowed against gross rent income.

(b) Residents

For residents, rental income will be brought to tax at the graduated scale rates for individuals and at the corporation tax rate for the companies. However the following points are relevant in arriving at the net taxable rental income:

Allowable deductions against Rent

The general principle is that expenses allowed as deductions from incomes where they are **wholly and exclusively incurred in the production or generation of the chargeable income**. Expenses incurred prior to period of production are not allowable

■ Allowable expenses include:

1. Interest on an overdraft or mortgage where funds have been raised to purchase the property. e.g mortgage interest. Interest is **allowable in full irrespective** of the source of the loan provided that the premises have been rented for 12 months. If let for less than 12 months, the amount is apportioned accordingly.
2. Structural alterations to maintain existing rents. E.g. demolishing walls to create more room or to create a fire outlet.
3. Capital allowances e.g.
 - a. Diminishing in value of any implements, utensils or similar articles if included in the rentals.
 - b. Wear and tear, industrial building allowance, investment etc may be allowed as deduction.
4. Legal costs and stamp duties on acquiring a lease of not more than **99 years**.



5. Any reasonable advertising and promotional costs.
6. Municipal water rates, land and ground rates.
7. Repairs, renewals and replacements in order to maintain the existing rent e.g. repair of walls, water supply network, fences, re-decorating etc.
8. Rent collection costs, estate agent' fees and legal costs in operation.
9. Cost of valuation for insurance of the building and its contents as well as insurance premiums paid.
10. Expenses incurred during regular or normal inspection by the agent.
 - (a) Wages of any staff looking after premises including garden maintenance.
 - (b) If included in the rentals, heating, lighting as well as telephone bills.
 - (c) If let furnished, an allowance for wear and tear and for replacement of furnishings and fittings.

Note

- (a) Cost of **structural extension** cannot be allowed as a deduction.
- (b) Capital expenditure such as building of additional garage, additional servant's quarters are not allowable
- (c) Where property such as a holiday cottage is kept for letting out for short periods, **a full year's expense will be allowed.**
- (d) Expenses incurred by the owner for normal inspection of the property are not allowed.
- (e) Expenses will **not be apportioned where** the premises are not occupied for the remaining part of the year so long as it is not more **than 6 months.**
- (f) Expenses incurred prior to period of production are not allowable.

Expenses relating to a whole year **are apportioned** if the property is rented for a period of less than 12 months

3.4 ROYALTIES

This is income earned by a person for rights granted to others to use his intellectual properties. These are incomes arising from rights granted to other persons for the use of intellectual property.

Royalties means a payment made as a consideration for the use of:

- (a) A copyright of literary, artistic or scientific work.
- (b) A cinematograph film including film or tape used in radio and television broadcasting.
- (c) A patent, trademark, design or model, plan, formula, process.

- (d) Any industrial, commercial or scientific equipment or the use of information concerning industrial, commercial or scientific equipment or any experience thereof as well as gains derived from the sale or exchange of any right or property.

Taxation of royalties

Taxation of royalties depends on whether one is a resident individual or a non resident.

(a) Non residents

- i. They are taxed at a flat rate of 20% of gross royalty income
- ii. This is a withholding tax which is a final tax.
- iii. No expenses are allowed against the gross income.

(b) Residents

- i. Expenses are allowed against gross royalty income to arrive at the taxable royalty.
- ii. Expenses incurred prior to the period of production of royalty income are not allowed e.g. expenses in the nature of researching, testing, development before commencement of generation of the royalty income.
- iii. The net royalty income will be aggregated with other incomes of that resident individual and assessed on him using graduated scale rates in the case of an individual and corporation tax rate in the case of a body corporate.
- iv. There is a withholding tax at source at 5% to be set off against gross tax liability of the person.

3.5 PENSION AND ANNUITIES

Pension fund is long-term as it continues after employment. Provident fund would normally cease upon ceasing employment

Are of 2 categories:

- A. Benefit as a contributor
- B. Benefit after employment

Benefit as a contributor

Contribution may be under;

- (a) Contributory scheme-both employer and employee contributes.
- (b) Non contributory scheme-Only where one party contributes, either employer or employee.



Generally, **Employer's contribution** towards a registered or unregistered scheme on behalf of the employees is **not taxable** on the employee (except where the employer is not taxable or where it exceeds the tax exempt limit of Sh. 240,000 p.a).

The combined employer-employee contribution to a registered or approved fund or scheme on behalf of a member is unlimited. However, the employee's tax allowable amount or deductible contribution is limited to the lower of:

- ◆ **30% of Pensionable pay**
- ◆ Employee's **actual contribution**.
- ◆ Sh240,000 per annum Or sh.20,000 per month. (Before 1.1.2006, it was Sh.17,500 per month or 210,000 per annum.)

Employer's contributions to unregistered pension scheme or excess contributions beyond the allowable limit of Ksh.240, 000 by an employer not taxable in Kenya are taxable on the employees.

Non taxable Employer's Contributions to Registered Or Unregistered Pension Scheme or Provident Fund

Contributions paid by a non taxable **employer** to unregistered pension scheme or excess contributions paid to a registered pension scheme, provident fund or individual retirement fund; shall be employment benefit **chargeable to tax on the employee**

Benefit after employment

The benefits after employment arise as a result of withdrawals made by the employee. Such withdrawals can be :

- Periodic withdrawals or
- Lumpsum withdrawals

■ **(a) Periodic withdrawals or annuities**

Pensions or retirement annuities (periodic payments) up to **Sh 180, 000** p.a received by a resident individual are **tax exempt** so long the scheme or fund is registered.

■ **(b) Lump sum withdrawals**

Lump sum withdrawals from a Pension or retirement up to **Sh 480,000** p.a received by a resident individual are **tax exempt** so long the scheme or fund is registered.

Where the period of contribution is less than 10 years, then the exempt amount of the pension lump sum shall be **48,000 x number of years of contribution**. E.g. if the contributions were made for 6 years then the tax exempt amount would be computed as: $6/10 \times 480,000 = 288,000$ or $48,000 \times 6$.

Note, the first **1.4 million** payable to the estate of a deceased person is tax exempt.

Note

- Maximum allowable Pension/ Provident Fund had been increased from **17500 per month to 20000 per month (240000) w.e.f 1st Jan 2006**.
- Contribution made to **NSSF (National Social Security Fund)** also qualify as a deduction with effect from 1.1.97. However, Where an employee is a member of a pension scheme or fund and at the same time the National Social Security Fund (NSSF) the maximum allowable contributions should not exceed **Sh 20,000 per month** in aggregate.

CHAPTER SUMMARY

- Pensions or retirement annuities (periodic payments) up to Sh 180,000 p.a. received by a resident individual are tax exempt so long as the scheme or fund is registered.
- Lumpsum withdrawals from a pension scheme are tax exempt up to Sh. 480,000 if the person has been a member in the scheme for at least 10 years.
- Interest and dividends attract withholding tax either as final tax or not.
- Dividend tax Account is used to check the incidence of compensating tax which arises from distributing dividend from untaxed accumulations.
- Contributions by the employer on behalf of the employee towards a Pension or provident scheme are not taxable benefits arising from employment.



CHAPTER QUIZ

Question one

Briefly discuss the taxation of royalties under the Income Tax Act.

Question Two

List four dividend incomes exempt from Taxation in Kenya

Question Three

List the allowable expenses against rental income.

CHAPTER QUIZ ANSWERS

Question One

This is income earned by a person for rights granted to others to use his intellectual properties. These properties include:

- i. Copyright, Literary, artistic or scientific works.
- i. Cinematograph including film or tape used in radio or any other form of broadcasting.
- ii. Patents, trademarks, designs, model, plan or formula.
- iii. Any industrial, commercial or scientific equipment or information concerning industrial commercial or scientific equipment.

Expenses will be allowed as long as they were incurred wholly and exclusively in earning such income.

Note

For non-residents the income is taxed at 20% with-holding tax which is a final tax. No expenses are allowed.

For residents, a 5% withholding tax is first deducted before determining net royalty income. It is then deducted from gross tax liability of the resident individual as a tax credit.

Question Two

Dividends exempt from tax;

- i. Dividends from outside Kenya or from non-resident companies
- ii. Dividends received by a resident company which controls more than 12 ½ % of the voting power of the resident company paying the dividend
- iii. Dividends received by a resident insurance company from its investments income of the life insurance fund
- iv. Dividend amount being the discount factor on the issue of debentures or redeemable preference shares or ordinary shares if it is less than 5% of par value

The Dividends received by a financial institution specified in the fourth schedule are no longer exempt from tax following an amendment in the 2008 Finance Act that is applicable with effect from 13.06.2008



Question Three

This is income earned by a person for rights granted to others to occupy his property. In determining the taxable rent income, all expenses incurred wholly and exclusively in earning such income are allowed (deducted) against such income. These expenses include the following:

- a) Bad debts and rental losses.
- b) Advertising and promotional costs of revenue nature.
- c) Legal costs and stamp duty on acquiring a lease of less than 99 years.
- d) Water and rates
- e) Management and Agency fees.
- f) Insurance
- g) Staff wages and salaries.
- h) Repairs and maintenance
- i) Structural alterations on the building necessary to maintain existing rent.
- j) Heating and lighting.

Note

- 1) Any cost incurred with the intention to increase rent will be disallowed.
- 2) Any cost in respect of extension or replacement of the building or part thereof is not allowable.
- 3) All costs of a capital nature are not allowed.
- 4) For non-residents the income is taxed at a rate of 30% with-holding tax which is a final tax. No expenses are allowed.

PAST PAPER QUESTIONS ANALYSIS

The following is an analysis on how the chapter has been examined in the past. The questions are listed in this format: Month/year e.g. 6/01 represents June or May 2001.

Taxation 1- 6/05,

Revision Questions

Question one

- (a) With reference to the Income Tax Act (Cap 470), explain the tax treatment of the following incomes received by a company:
 - (i) Dividend (4 marks)
 - (ii) Interest (2 marks)
 - (iii) Rent (2 marks)

- (b) The management of Mali Limited has presented the following income statement for the year ended 31 December 2007:

Mali Limited

Income Statement for the Year ended 31 December 2007

	Sh.	Sh.
Gross profit		5,292,000
Other incomes:		
Dividend from a subsidiary company	200,000	
Interest from foreign bank accounts	4,000	
Discount received	28,000	
Refund of VAT	12,000	
Gain on sale of motor vehicle	<u>14,000</u>	<u>258,000</u>
		5,550,000
Expenditure:		
Salaries and wages	800,000	
NHIF contribution	30,000	
Subscription to a trade association	50,000	
Hire purchase interest	15,000	
Bad debts written off	60,000	
General expenses	80,000	
Depreciation	25,000	
Legal expenses	40,000	
Insurance premiums	124,000	
Rent	66,000	
Electricity	34,000	
Purchase of furniture	<u>26,000</u>	<u>(1,350,000)</u>
		<u>4,200,000</u>

Additional information:

- Capital allowances were agreed with the Revenue Authority at Sh.75,000
- Included in bad debts is a loan of Sh.15,000 due from a former employee of the company who was dismissed in October 2007.
- Legal expenses include Sh.20,000 incurred in defending a manager against a traffic offence.
- Insurance premiums include Sh.24,000 paid to the National Hospital Insurance Fund (NHIF) as a penalty for late submission of contribution.
- The company paid stamp duty of Sh.6,000 relating to a piece of land purchased in August 2007. This payment is included in the rent expense for the year ended 31 December 2007.

Required:

- (i) Compute the adjusted taxable profit or loss of Mali Limited for the year ended 31 December 2007. (10 marks)



- (ii) Calculate the tax liability (if any) of the company for the year ended 31 December 2007.

(2 marks)

(Total: 20 marks

(May 2005 Question 5 (a))

Question two

Distinguish between the tax treatment of rent income on resident and non-resident individuals.

(4 marks)

(Dec 2003 Q 1)

CHAPTER FOUR



STUDY TEXT

CAPITAL DEDUCTIONS/ ALLOWANCES



CHAPTER FOUR

CAPITAL DEDUCTIONS/ALLOWANCES

► OBJECTIVES

- Explain the different classes of capital allowances
- Classify different items for capital deductions
- Determine the computation of different capital allowances
- Establish the effect of capital allowance on taxable income
- Explain the economical effect of capital allowances

► INTRODUCTION

In chapter three we discussed on a general platform the expenses that are allowable and disallowable against taxable income of a taxable person. We noted that capital allowances are among the expenses that are deductible. In this chapter, we shall study in detail the principles regarding the capital allowances. By the end of the chapter, one should be able to compute the capital allowances available.

► DEFINITION OF KEY TERMS

Investment deduction: Is a capital deduction given on cost of buildings and machinery which are used for manufacture, on cost of a ship, and on cost of a hotel building.

The investment deduction on buildings and machinery is intended to encourage new investments in the manufacturing sector

The investment deduction is deducted in the income tax computation, or in arriving at the taxable income/loss

Industrial Building allowance: This is a capital deduction or allowance given in respect of capital expenditure on an industrial building

The amount of industrial building allowance is deducted in the income tax computation or in arriving at the taxable income/loss for year or period

Wear and Tear allowance: The wear and tear deduction is a capital deduction on machinery used for business. The deduction is made against income

Farm works deduction: This is a capital deduction granted only in respect of capital expenditure on agricultural land. The farm works deduction is deducted in the income tax computation

► EXAM CONTEXT

It is important that you be conversant with the various rules for computing the capital allowances. Questions on this topic do not miss in the examinations. The student should also be keen on the application of these rules in the computations.

► INDUSTRY CONTEXT

This chapter provides various incentives for investment by the government. The chapter would be helpful in understanding the incentives and as an investor focusing your efforts to areas that have higher allowances. The chapter would also form a basis for advocating for allowances in other sections that may not have been covered.

4.1 WHAT ARE CAPITAL ALLOWANCES?

While discussing allowable expenses above, the deductions or allowances on some machinery and buildings used for business were stated to be some of the expenses specifically allowed against taxable income.

The deductions or allowances are at standard rates for all taxpayers depending on the nature of the capital expenditure incurred.

The capital deductions are important because:

- a) Some offer incentives to business by allowing capital expenditure otherwise not claimable.
- b) Some act as standard depreciation for income tax purpose. The depreciation and similar charges are not allowable expenses against taxable income.

These are referred to as deductions (allowances) under the Second Schedule to the Income Tax Act.

The manner of calculating and computing the various capital deductions or allowances is given below.



4.2 WEAR AND TEAR DEDUCTION (ALLOWANCE)

The wear and tear deduction is a capital deduction on machinery used for business. The deduction is made against income. As we shall see later, the deduction is made in the income tax computation (or in arriving at the taxable income or loss for the year) after disallowing any depreciation and similar charges against taxable income.

As noted earlier any capital loss, diminution, exhaustion of capital, such as depreciation, amortisation, loss on sale of assets, obsolescence, provision for replacement, are not allowable expenditure against income.

But the Income Tax Act recognises the loss of value of assets used in business through usage, passage of time or obsolescence and so grants the wear tear allowance.

As per paragraph 7 of the Second Schedule to the Income Tax Act ... “where during a year of income machinery owned by a person is used by the person for the purpose of his business, there shall be made in computing the person’s gains or profits ... a deduction ... referred to as a ‘wear and tear deduction’.”

It should be noted that machinery qualifies for wear and tear deduction where:

- i. Owned by a person, and
- ii. Used by the person for business anytime during the year of income.



Procedure for Wear and Tear Deduction

1. The first step is to identify the machinery which qualifies for wear and tear deduction. The machinery for wear and tear deduction has a wide meaning and includes tractors, lorries, motor cars, plant and machinery, furniture, aircraft, ship, etc.

It is important to note that implements, utensils, tools and similar articles, qualify for diminution or reduction in value. See specific deduction allowable in the previous lesson.

2. The machinery which qualify for wear and tear are classified as follows:

Class I This is a class for heavy earth moving equipment and heavy self-propelling (producing own power to move machinery e.g (37.5%) tractors, combined harvesters, lorries of load capacity of 3 tons and over, tippers, buses, loaders, graders, bulldozers, mounted cranes etc.

Class II This is a class for office equipment bought on or after 1.1.'92 e.g. computers, printers (30%) electronic calculators, adding machines, photocopiers, and duplicating machines.

Class III This is a class for other self-propelling vehicles including aircrafts, examples include (25.0%) pick-ups motor cars, aircraft, motor cycles, lorries of less than 3 tons load capacity, vans.

Class IV This is a class for other machinery including ships e.g. factory plant and (12.5%) machinery, fixtures and fittings, bicycles, partitions (temporary or movable), shop counters and shelves, safes, typewriters, sign boards, fridges, freezers, advertisement stands etc.

- The third step in the procedure for wear and tear deduction is that an appropriate percentage rate on the balance of machinery of each class is allowed as a deduction— Class I (37.5%), Class II (30%), Class III (25%), and Class IV (12½%).

Wear and tear computation — format

XZY Limited

Computation of Wear & Tear Allowance

For the year ended 31 December 2008

	I (37.5%)	II (30%)	III (25%)	IV (12.5%)
	Sh.	Sh.	Sh.	Sh.
Written down value start 1.1.08	XX	XX	XX	XX
Additions				
Cost of new machinery bought in the year- qualifying cost	XX	XX	XX	XX
Less				
Disposal (amounts realized on disposal)	(XX)	(XX)	(XX)	(XX)
Value for WTA	XX	XX	XX	XX
W.T.A.	(XX)	(XX)	(XX)	(XX)
Written down value at the end	<u>XX</u>	<u>XX</u>	<u>XX</u>	<u>XX</u>

Summary of Wear & Tear Allowance

Class I	XX
Class II	XX
Class III	XX
Class IV	<u>XX</u>
Total W & T allowance	<u>XX</u>

It is very important particularly for examination purposes, to give notes showing details of how the figures of addition or disposal for each class are made up.



Computing the wear and tear deduction

The wear and tear deduction for each class is computed separately as follows:

- a) Take the balance brought forward at the commencement of the accounting year (period) referred to as the Written Down Value (WDV) for each class. Sometimes there is no balance brought forward from previous accounting period.
- b) Add to the balance brought forward for each class, the value of any additional machinery (assets) purchased or made, new or old during the year. There would be a sub-total for each class.
- c) Then deduct from the sub-total in (b) above the amount of cash or cash equivalent on sale of machinery (assets) purchased for each class. There would again be a sub-total for each class involved.
- d) Finally, the appropriate percentage rate is applied on the sub-total in (c) above for each class and the result is the amount of Wear and Tear Deduction (Allowance) for the year.

As will be seen later, the amount of wear and tear deduction calculated as above is deducted in the Income Tax Computation as a deduction against taxable income or loss. The concept of the Income Tax Computation will be explained later in this lesson.

Commercial and non-commercial vehicles for wear and tear deduction

The motor vehicles as machinery for wear and tear deduction may fall under either Class I or Class III depending on the nature of the motor vehicle. For the vehicle under Class III, the value for additions as well as the value for disposal is restricted if the vehicle is a non-commercial vehicle.

The Income Tax Act defines a commercial vehicle as a road vehicle which the Commissioner of Domestic Tax is satisfied:

- a) Is manufactured for the carriage of goods and is so used in connection with trade or business e.g. Lorry, pick-up, van etc; or
- b) Is a motor omnibus within the meaning of that term in the traffic act e.g. All public service vehicles (PSV vehicles) like buses and matatus, or
- c) Is used for the carriage of members of the public for hire or reward e.g. taxi and tour operator vehicles.

Any vehicle which does not fit the definition of a commercial vehicle is referred to as a non-commercial vehicle.

For the purpose of wear and tear, the value of addition of any non-commercial vehicle is restricted to Sh.1 million (w.e.f. 1/1/2006, the restricted value will be Sh. 2 million.)

Restriction Cost

1961-1980	30, 000
1981-1989	75000
1990 – 1996	100,000
1997	500,000
1998 – 05	1,000,000
2006 to date	2,000,000

Where the value of a non-commercial vehicle was restricted and the vehicle is sold, the amount of sale proceeds is also restricted by a factor of:

$$\frac{\text{Sales Proceed}}{\text{Cost}} \times \text{Restriction Value Applicable in the year of purchase.}$$

>>> Example of Wear and Tear Computation

Molo Co. Ltd., a company dealing in hardware, prepares its accounts to 30 June each year. The following information relates to the year ended 30 June 2008.

i) Written down value of assets brought forward for Income Tax purpose:

	Class I 37½%	Class III 25%	Class IV 12½%
	Sh	Sh	Sh
Written Down Value 30.6.2007	175,000	180,000	87,000

ii) Disposals during the year:

	Cost	Net Book Value	Sales proceeds
	Sh	Sh	Sh
Isuzu Lorry	280,000	175,000	260,000
Motor car (purchased in 1.3.2007)	2,160,000	1,015,000	800,000

iii) Additions during the year

	Sh
Mercedes Benz sports car for director	4,000,000
Second-hand Tractor	80,000
Trailer occasionally used by tractor	80,000
Shop fittings	60,000
Computer bought 1.3.2008	250,000
Telephone system bought 1.9.2007	72,000



- iv) the office safe which cost Sh 30,000, in 2002 was traded-in for a more modern safe costing Sh 40,000. The old safe was valued at Sh 20,000 and the company paid the balance of Sh,20,000 to acquire the new safe. The net book value of the old safe was Sh 22,968 at 30.6.2008.

Required

Calculate the wear and tear deductions due to the company for the year 2006.

Solution

MOLO Co. LTD

Wear and tear computation for the year ended 30.6.'08

	Class I 37.5% Sh	Class II 30% Sh	Class III 25% Sh	Class IV 12.5% Sh
WDV as at 1.7.2007	175,000	—	180,000	87,000
Additions:				
Mercedes Benz car (restriction)—Note 1				2,000,000 ^R
Second-hand Tractor	80,000			
Trailer—Note 2				80,000
Shop fitting				60,000
Computer—Note 3		250,000		
Telephone system—Note 3				72,000
New Safe (cash + trade-in) Note 4	<u> </u>	<u> </u>	<u> </u>	<u>40,000</u>
	255,000	250,000	2,180,000	339,000
Disposal (Sales):				
Safe (trade-in-value)				(20,000)
Isuzu car	(260,000)			
Motor car—Note 5	<u> </u>	<u> </u>	<u>(370,370.37)</u>	
	(5,000)	250,000	1,809,629.63	490,000
Trading Receipt—Note 6	5,000	—	—	—
Wear and tear deduction/allowance	<u>NIL</u>	<u>(75,000)</u>	<u>(452,407.41)</u>	<u>(39,875)</u>
WDV as at 30.6.2008	<u> </u>	<u>175,000</u>	<u>1,357,222.22</u>	<u>279,125</u>

Wear and tear deduction:

	Sh
Class I	—
Class II	75,000
Class III	452,407.63
Class IV	<u>39,875</u>

Total amount to be deducted in the Income Tax Computation 567,282.63

Trading receipt of Sh 5,000 is taxable and is added back in Tax Computation.

STUDY TEXT

Notes

1. Mercedes Benz sports car is not a commercial vehicle and its cost for wear and tear deduction is therefore restricted to Sh.2,000,000.
2. The trailer is occasionally pulled by the tractor and is detached and not part of the tractor and therefore falls under Class IV (12.5%).

Note that a trailer permanently pulled by lorry is part of the lorry and falls under Class I together with the lorry.

3. Computers and computer hardware, calculators, copiers and duplicating machines bought on or after 1.1.92 fall under Class II (30%) of wear and tear.
4. The purchase price of the safe is Sh. 40,000 arrived at as follows:

	Sh
Trade in value of old safe	20,000
Cash paid	<u>20,000</u>
Total purchase price	<u>40,000</u>

The trade-in value of Sh 20,000 is the value taken for disposal (sale) for wear and tear.

5. a. The car sold is not a commercial vehicle which means that it was restricted to Sh 2,000,000 as addition in 2006. The sale proceeds of Sh 800,000 must therefore be restricted by a factor of 2,000,000 cost as follows:

$$\frac{800,000}{2,160,000} \times 2,000,000 = 370,370.37$$

6. Trading receipt arises in a continuing business where the sale proceeds in a class of wear and tear machinery exceeds the written down value as has happened in Class I in our example.

Note that the tractor is still owned and used and does not prevent trading receipt being recognised.

Where business is continuing and all the assets in a Class of wear and tear are sold for less than the written down value, the result is a trading loss.

Where business has ceased, the trading receipt is referred to as a balancing charge, and trading loss is referred to as balancing deduction. They are taxable income and allowable expense respectively, as will be explained later.



Things to remember in computing wear and tear allowance

1. Written Down Value (WDV)

The WDV at the close of the accounting year/period is the opening WDV for the following accounting year/period.

2. Addition for Wear and Tear

The cost of assets which qualify for wear and tear additions are:

- a) The historical cost of qualifying assets whether new or old and whether made in the business or purchased.
- b) The expenses after purchase and before machinery is used e.g. customs duty, transport, installation expenses including alterations to buildings incidental to installation like widening room or building a stand for machinery.
- c) The trade-in and part exchange values plus the cash paid in purchasing the asset. In other words, the full value of an asset acquired is taken as an addition for the respective class of wear and tear as in the case of the safe in the above example.
- d) In hire purchase, the cash price is taken as the value of addition. The hire purchase interest is charged in the profit and loss account and is allowed for tax.
- e) For assets brought into the business without being purchased, the most likely open market price of such assets is taken as the value for addition.
The Commissioner of Domestic Taxes has normally accepted taxpayers' own valuation of assets brought into the business unless such values are unreasonable.
- f) The non-commercial vehicles in Class III are restricted as additions in wear and tear computation where the cost of any such vehicle exceeds the restriction level as follows:

To Sh 1,000,000 with effect from 1.1.1998 – 31/12/2005

To Sh. 2,000,000 with effect from 1/1/2006

- g) With effect from 1.1.'87, where machinery for wear and tear also qualifies for investment deduction, the addition for wear and tear is taken to be the cost net of investment deduction. The investment deduction is explained later in the lesson.

3. Disposal or Sales for Wear and Tear.

Some details of sale proceeds which qualify as sales for wear and tear:

- a. The amount of cash proceeds or cash equivalent on sale of wear and tear machinery is taken as the sale amount for wear and tear.
- b. The amount of sale proceeds for non-commercial vehicles which has been restricted as addition is also restricted on sales as follows:

$$\frac{\text{Sales Proceeds}}{\text{Cost}} \times \text{restricted cost in the year of purchase.}$$

- c. The trade-in amount or part-exchange value is taken as sale proceeds for wear and tear.
- d. The amount of insurance claim received for wear and tear machinery lost in theft, fire or accident is taken as sale proceeds for wear and tear.
- e. In a continuing business:
 - i. If the amount of sale proceeds in any class of wear and tear is more than the written down value, there is a trading receipt. The amount of trading receipt is taxable income and is added back in the tax computation. It is in a way, wear and tear over-provided.
 - ii. If all the items in a class of wear and tear are sold, and the amount of sale is less than the written down value, there is a trading loss. The amount of trading loss is allowable against income and is deducted in the income tax computation. It is Wear and Tear Deduction under-provided.
- f. In case of business which has ceased to operate:
 - i) If the amount of sale proceeds is more than the balance (WDV) in any class of wear and tear, the excess is called balancing charge. The balancing charge is taxable income and is added back in the income tax computation. It is wear and tear deduction over-provided.
 - ii) If all the items in a class of wear and tear are sold for less than the written down value the difference is a balancing deduction. The amount of balancing deduction is allowable against income. It is wear and tear deduction under-provided.

Where the balancing deduction cannot be absorbed by the income of the year in which it arises, the Income Tax Act provides for it to be spread in the preceding years to the maximum of six years.

4. Wear and Tear Deduction.

- a. The amount calculated as wear and tear deduction is deducted in the income tax computation.
- b. The annual rate of wear and tear is applied on the reducing balance in each class.
- c. Where business is carried on for a full year, full rate of wear and tear is given irrespective of the date the qualifying assets were bought e.g. a wholesaler and a farmer who have accounting date as 31 December, bought a lorry and a tractor respectively on 31 December, the last day in their accounting year. The lorry and tractor qualify for full wear and tear deduction at 37.5% as business operated for a full year.
- d. Where business is operated for less than 12 months, the annual wear and tear deduction is restricted to the period the business operated e.g. for business which operated for 6 months:

Annual wear and tear deduction \times 6/12 = wear and tear deduction claimable.



- e. Where business is operated for more than 12 months, the annual wear and tear deduction is proportionately increased to the period the business operated e.g. for a business which operated for 18 months and prepared accounts for such period,

Annual wear and tear deduction $\times 18/12$ = wear and tear deduction claimable.

- f. For assets partly used for business and partly used privately e.g. a motor car, the wear and tear deduction to be deducted in the income tax computations is restricted to the proportion of business use. If it is established that private use of motor car is about $1/5$ and business use is $4/5$, then only $4/5$ of the wear and tear deduction should be deducted in the income tax computation being the proportion of business use. However, full wear and tear deduction for such a vehicle is taken into account in the wear and tear computation.
- g. Where there is succession to business without paying any money, WDV continues as if there is no change e.g. a son taking over from father.
- h. Where a person owns machinery which is leased to another person who uses the machinery for his business, wear and tear deduction is claimed by the lessor (owner).

4.3 FARM WORKS DEDUCTION (ALLOWANCE)—F.W.D.

This is a capital deduction granted only in respect of capital expenditure on agricultural land as per paragraph 22 and 23 of the Second Schedule to the Income Tax Act. Only farmers can claim farm works deduction. The farm works deduction is deducted in the income tax computation or in arriving at the taxable income/loss. Where the owner or tenant of any agricultural land incurs capital expenditure on the construction of farm works a deduction (Farm Works Deduction) shall be made when computing the gains or profits from the farm.

The rate for Farm Works Deduction with effect from 1.1.'85 is $33\frac{1}{3}\%$ ($1/3$) of qualifying cost per year for three years. However, w.e.f 1.1.2007, the rate applicable is 50% of the qualifying cost per year for two years.

Agricultural Land means land occupied wholly or mainly for the purpose of trade in farming e.g. crop farming—tea, coffee, horticulture, pyrethrum, maize, wheat, sugar cane etc. or animal farming—dairy cattle, ranching, pigs, chicken, fish, snakes for serum etc.

Farm Works means:

- a. Farmhouses, labour quarters, any other immovable building necessary for the proper operation of the farm, fence, ditches, drains, water and electricity supply works other than machinery and other works necessary for the proper operation of the farm such as—fish pond, coffee factory, horse stable, cow shed, drains, windbreak, roads, stores, irrigation network etc.

- b. In case of farm house, only one third of the initial cost of the farm house qualifies for farm works deduction.

Where the size of the farm house is out of proportion to the nature and extent of the farm e.g. a 20 roomed farm house, the Commissioner of Domestic Taxes can reduce the fraction of cost which qualify for farm works deduction.

Only one farm house qualifies for the deduction.

Note that a company does not have any farm house as directors and other employees would occupy any house in the farm as employees in which case the house would be labour quarters.

>>> Example

Mr Tononoka, a farmer, incurred the following capital expenditure in his farm for the year ended 31.12.2008

	Sh
Extension to labour line	30,000
Fenced paddocks	15,000
Extension to farm house - Note 2	270,000
Electric generator	32,000
Gabion for soil erosion	20,000

There is a balance of unclaimed Farm Work Deduction brought forward in 2008 of Sh 25,000

Required

Compute the capital deductions for the year 2008.

Solution

Farmworks deduction

Item	Cost Sh	FWD	FWD carried forward
		2008 Sh	2009 Sh
Extension to labour lines	30,000		
Fenced paddock	15,000		
1/3 of farm house extension	90,000		
	135,000	67,500	67,500
Farmworks carried forward	25,000	25,000	
	160,000	92,500	67,500



The Farm Works Deduction claimed for each year would be deducted in the respective year's income tax computation.

Wear and tear deduction

	CLASS IV
	12½ %
	Sh
WDV as at 1.1.2008	—
Addition: Electric generator	<u>32,000</u>
	32,000
Wear and Tear Deduction	<u>(4,000)</u>
WDV as at 31.12.2008	<u>28,000</u>

Notes

1. The cost of construction of a gabion of Sh 20,000 for the prevention of soil erosion is a capital expenditure which the Income Tax Act allows against income.
2. The cost of farm house extension is Sh 270,000, but only one third, i.e. Sh 90,000, qualifies for farm works deduction.

Things to note in the calculation of capital deduction of a farmer.

- i) Full farm works deduction is given for items constructed during any accounting year without limitation if the farming business was carried on for a full year.
- ii) A farmer taking over a farm will take over the proportion of the farm works deduction not yet claimed up to date of purchase. Any apportionment of the unclaimed farm works deduction would be done on the basis of period of ownership.
- iii) A farmer can also claim other capital deductions where applicable e.g. wear and tear deduction.

4.4 INVESTMENT DEDUCTION / ALLOWANCE

PARAGRAPH 24-26 OF THE SECOND SCHEDULE TO THE INCOME TAX ACT

The investment deduction is another capital deduction given on cost of buildings and machinery which are used for manufacture, on cost of a ship, and on cost of a hotel building.

There are four types of investment deduction:

- a. Investment deduction in respect of buildings and machinery used for ordinary manufacture.
- b. Investment deduction in respect of building and machinery used for manufacture under bond, that is, goods manufactured for export only. It was introduced 1988. It is commonly referred to as Investment Deduction Bonded Manufacture (IDBM).
- c. Investment Deduction in respect of a hotel building certified by the Commissioner of Domestic Taxes to be an industrial building.
- d. Shipping Investment Deduction (S.I.D) in respect of a ship.

The investment deduction on buildings and machinery is intended to encourage new investments in the manufacturing sector. Previously, the government wished to attract investments outside Nairobi and Mombasa by offering higher rates of allowance. With effect from 1.1.'95 there is a uniform rate of 60%.

The investment deduction is deducted in the income tax computation or in arriving at the taxable income/loss and is granted once and for all when the building and machinery are used, that is, in the "year of first use" of building or machinery.

Cost of building and machinery qualifying for investment deduction

The cost which qualifies for Investment Deduction is capital expenditure incurred:

- a. On the construction of a building and on the purchase and installation therein of new machinery, and the owner or lessee of that building uses that machinery in that building for the purpose of manufacture. (New building + new machinery qualify for ID).



With effect from 1.1.'92 a building used for manufacture qualifies for investment deduction on its own, provided that it had not been used for other purpose prior to being used for manufacture; or

- b. On the purchase and installation of new machinery used for manufacture in any part of a building other than a building previously used for the purpose of manufacture (new machinery installed in old building qualifies for investment deduction).

With effect from 1.1.'92 either new or old machinery qualifies for investment deduction if installed and used for manufacture. This now allows investors to invest in phases without losing investment deduction as was the case previously. With effect from 1.1.'93 machinery does not need to be installed to qualify for the allowance.

- c. On the construction of a hotel building which is certified as an industrial building by the Commissioner of Domestic Taxes; or
- d. On the construction of a building and on the purchase and installation therein of **new** machinery, and the owner of that building uses that machinery in that building for the purpose of manufacture under bond; that is, manufacture for export only.

- "building" includes any building structure and if used for manufacture, then with effect from 1.1.'95 the qualifying cost of the building include major renovations and civil works such as roads, parking areas, drainage systems, etc.
- "Manufacture" means making (including packaging) of goods or raw materials from raw or partly manufactured materials to other goods.
- "New" means not having previously been used by any person, or acquired or held by any other person except the dealer (supplier) in normal course of business.
- "Installation" means affixed (fixed) to the fabric (wall or floor) of the building in a manner necessary for and appropriate to the proper operation of the machinery concerned.
- "Machinery" means machinery and equipment used directly in the process of manufacture, and includes, with effect from 1.1.'95, machinery used for the following ancillary purposes:
 - generation, transformation and distribution of electricity;
 - clean-up and disposal of effluents and other waste products;
 - reduction of environmental damage; and
 - water supply or disposal.
- With effect from 1.7.1999, Workshop Machinery used for the maintenance of machinery used for manufacture qualifies for investment deduction.
- With effect from 1.7.2000, power generation equipment also qualifies for investment deduction.

Note

1. In case a building is converted into a factory and new machinery installed for manufacture then only machinery qualify for investment deduction.
2. In a bid to encourage investment in industrial building machinery and equipment, the level of investment deduction has been increased to 100% for 18 month period with effect from 1.7.2000. Thereafter it will reduce to 85% during year 2002, 70% in 2003, finally reverting back to 100% in year 2004 and thereafter.

☐ Cost which does not qualify for investment deduction:

- Cost of land on which the building is constructed.
- Stamp duty, legal costs and other incidental expenses on acquisition of land.
- Cost of items or activity which are supplementary to manufacture such as design, storage, transport, administration, security, etc.
- Replacement machinery.

☐ Rates of Investment Deduction on Building and Machinery

Once the qualifying cost for investment deduction is determined, the appropriate rate of investment deduction is applied to obtain the amount of investment deduction that can be claimed.

1. Rates of investment deduction for building and machinery used for ordinary manufacture and for hotel building.

Year of Income	% ID RATE
1995 – 30.6.2000	60
1.7.2000 – 31.12.2001	100%
1.1.2002 – 31.12.2002	85%
1.1.2003 – 31.12.2003	70%
1.1.2004 to date	100%

Note the favourably high rates for locating building and machinery outside Nairobi and Mombasa municipalities that applied up to 1994.

2. Rates for investment deduction for building and machinery for manufacture under bond (for export only) with will be covered later herein.

■ Things to remember in calculating investment deduction

1. Where non-qualifying capital expenditure of the building such as office, showroom, shop is not more than 10% of the total cost of the building (qualifying and non-qualifying), then it is included in the calculation of investment deduction.
2. Where an existing building is extended by further construction, the extension is treated as a separate building for the calculation of investment deduction.
3. Where a building is sold before use:
 - a. take the cost of construction or the purchase price paid whichever is lower; and



- b. where sold by a person carrying on the business of constructing and selling buildings as a trade (a builder) take the price paid as qualifying cost for investment deduction. If sold more than once before use, take the last price paid by the person who uses the building, or the construction cost, whichever is the lowest.
4. A building qualifying for investment deduction automatically qualifies for industrial building deduction. Industrial building deduction is dealt with later in this lesson.
5. Up to 31.12.'86, investment deduction was granted over and above other capital deductions (Industrial

Building Deduction and Wear and Tear Deduction). An investment deduction of 20% or 50% on cost as applicable was granted on the qualifying cost and such cost also qualified for industrial building deduction and wear tear deduction. **Shipping Investment Deduction—S.I.D.**

The shipping investment deduction is given where a resident ship-owner incurs capital expenditure:

- a. on the purchase of new, power-driven ship of more than 495 tons tare weight; or
- b. on the purchase and subsequent refitting for the purpose of shipping business of a used power-driven ship of more than 495 tons tare weight.

The rate of shipping investment deduction is 40% (2/5) of qualifying cost. The deduction is made in computing the taxable income/loss of a person for the year of income in which the ship is first used for business, that is, the year of "first use of the ship".

With effect from 1.1.'87, the wear and tear deduction for a ship is calculated on the qualifying amount net of shipping investment deduction.

Limitations on shipping investment deduction:

1. A given ship can only get one shipping investment deduction in its life.
2. If a ship is sold within 5 years after the year of income in which shipping investment deduction is given, the shipping investment deduction is withdrawn and the deduction treated as income of the year of income in which the sale takes place e.g.

4.5 INDUSTRIAL BUILDING DEDUCTION (ALLOWANCE) — I.B.D.

This is a capital deduction or allowance given in respect of capital expenditure on an industrial building as per paragraph 1 to 6 of the Second Schedule to the Income Tax Act.

"... Where a person incurs capital expenditure on the construction of an industrial building, and the industrial building is used for business carried on (by the person) or a lessee.... a deduction called industrial building deduction shall be made in computing (the person's) gains or profits from the business."

The amount of industrial building allowance is deducted in the income tax computation or in arriving at the taxable income/loss for year or period.

The rates for industrial building deduction are:

- a. The standard rate of 2.5% (1/40) of the qualifying cost per year for 40 years, except in two cases below. The life of an industrial building is deemed to be 40 years.
- b. A rate agreed with the Commissioner of Domestic Taxes. Where a taxpayer considers that the life of an industrial building is less than 40 years, the taxpayer can apply for a greater rate than 1/40 and if the Commissioner of Domestic Taxes agrees, that will be the agreed rate of industrial building deduction. The life of an industrial building may be shorter than 40 years due to the type of construction or the use to which the industrial building is put.
- c. In the case of a hotel building which is certified by the Commissioner of Domestic Taxes to be an industrial building, the industrial building deduction rate is 4% (1/25) of qualifying cost per year for 25 years.

It is important at this point to know what is an industrial building which qualifies for the industrial building deduction.

Industrial Building means

a) A building in use:

- i) For the purpose of a business carried on in a mill, factory or other similar premises e.g. bakery, saw mill, soap factory, posho mill, etc.
- ii) For the purpose of a commercial undertaking of transport, dock, bridge, tunnel, inland navigation, water, electricity, or hydraulic power e.g. old Nyali bridge, old Karen water supply, repair dock in Mombasa, Kenya Bus Depot at Eastleigh etc.
- iii) For the purpose of a business of manufacture of goods or materials, or the subjection of goods or materials to any process e.g. East African Industries, Kenya Breweries, BAT Kenya Ltd etc.
- iv) For the purpose of a business which consists in the storage of goods or materials which are raw materials for manufacture of other goods or materials, finished goods, or on their arrival by sea or air into any part of Kenya.
- v) For the purpose of agricultural services e.g. ploughing, cultivation, threshing of crops etc. on agricultural land but not owned by the farmer. This is normally buildings used by agricultural contractors.



- vi) For the purpose of a business declared by the Minister for Finance by a notice in the Gazette as qualifying for industrial building deduction.
- a) A prescribed dwelling-house e.g. dwelling-house constructed for and occupied by employees e.g. Tusker Village for Kenya Breweries employees and BAT Shauri Moyo houses.
 - b) A hotel building or part of a hotel building which the Commissioner of Domestic Taxes has certified to be an industrial building, including any building directly related to the operations of the hotel such as kitchens, staff quarters and entertainment and sporting facilities.
 - c) A building used for the welfare of workers employed in any business or undertaking referred to in (a) above e.g. canteen, sports-house etc.
 - d) With effect from 1.1.'95 where a building is an industrial building, the following civil works or structures on the premises of the building shall be deemed to be part of the building where they relate or contribute to the use of the building:
 - i) roads and parking areas;
 - ii) railway lines and related structures;
 - iii) communications and electrical posts and pylons and other electricity supply works;
 - iv) water, industrial effluent and sewage works; and
 - v) security walls and fencing.

The following costs do not qualify for industrial building deduction:

1. The cost of acquisition of land on which the industrial building is constructed, and other incidental costs on acquisition such as stamp duty and legal fees.
2. The costs of items treated as machinery for wear and tear e.g. partitioning, shelves, counters etc.
3. The cost of retail shop, showroom, office, dwelling house etc. **EXCEPT** where the cost is not more than 10% of the total capital expenditure (the industrial building plus shop, office etc.)

Things to remember in the calculation of industrial building deduction.

1. Where an industrial building is used for part of the accounting year, the annual industrial building deduction is proportionately reduced to the period of the year that the building is used e.g. if used for 6 months during the accounting year, 6/12 of the annual industrial building deduction would be claimed. The annual industrial building deduction would be extended if accounting period exceeded 12 months. The practice of the Domestic Tax Department is to have a minimum apportionment of one full month where days are involved.

2. Where an industrial building in use is sold and continues to be an industrial building used by the purchaser or his lessee, the industrial building deduction continues to be given to purchaser as before and the purchase price is not considered for any capital deduction. In other words the buyer takes over the residue of expenditure as at the date of purchase.
3. Where capital expenditure is incurred on the construction of an industrial building and the industrial building is sold before it is used, then the purchaser is deemed to have incurred capital expenditure for the purpose of industrial building deduction equal to the **lower** of construction cost and the purchase price paid.

If the building is sold more than once before being used as an industrial building, the last purchase price is compared with the construction cost e.g. A → sells to B → C → D, and D uses the building as an industrial building. The cost qualifying for industrial building deduction is the lower of construction cost to (A) and the price paid by (D).

4. Where the cost of constructing an industrial building is incurred by a person carrying on the business of constructing buildings with a view to selling them (a builder) and he sells the industrial building before use, then the capital expenditure which qualifies for IBD is equal to the price paid for such a sale. The construction cost is ignored in this case.
5. Where a building is not used as an industrial building for a period, a notional industrial building deduction is calculated for the purpose of determining the residue of expenditure to be carried forward.

■ >>> Example

A factory closed down for two years in 2005 and 2006 and the residue on 31.12.'2004 was Shs 420,000 and the annual IBD of Sh 14,000.

2005 notional IBD Sh 14,000

2006 notional IBD Sh 14,000

2007 when it operates again, the Sh 14,000 is claimed as industrial building deduction in the income tax computation or in arriving at the taxable income/loss for 2007. The residue of expenditure as at 31.12.06 is Sh 392,000, that is,
 $\text{Sh } 420,000 - (14,000 \times 2) = \text{Sh } 392,000.$

6. With effect from 1.1.'87, for an industrial building which qualifies for investment deduction the amount qualifying for industrial building deduction is the cost net of investment deduction.



4.6 MANUFACTURE UNDER BOND: (MUB)

This is a programme by the government to encourage the production of goods for exports. In this programme, the Manufacturer of the goods writes a Bond to cover the goods being manufactured.

Bond: This is a promise (agreement) by a person to pay to the commissioner of Customs and Excise an amount of money if the conditions of the manufacturing agreement are not met.

Goods manufactured and exported will not be charged any duty. However, if such goods are not exported, then duty must be paid. Such duty is secured by the Bond.

INVESTMENT DEDUCTIONS FOR MUB

This is granted to firms operating in the MUB programme. It is granted in the first year the building and machinery are brought to use. It is based on capital expenditure incurred in building and installation therein of new machinery. Such buildings and machinery must be used for MUB.

However, the cost of land is not included.

The investment deduction for MUB operations for MUB is 100% as shown below:

Where 1 st year of use is any year commencing on or after	Investment Deductions	Additional Investment Deductions for MUB	Total Investment Deductions
1.1.1996	60%	40%	100%
1.7.2000	100%	-	100%
1.1.2002	85%	15%	100%
1.1.2003	70%	30%	100%
1.1.2004 to date	100%	-	100%

MUB Conditions:

Where a person who has been granted Investment deductions for MUB ceases to manufacture under Bond within 3 years from the date of commencement, then the investment deduction for MUB is withdrawn and treated as a taxable income in the year of income in which he ceases to manufacture under Bond. However, he is granted Wear and Tear Deductions and IBD for the years he has operated. The amount is taxable income similar to trading receipt e.g.

	Sh	Sh
IDBM claimed first year of use (100% of cost)		XX
Less: deductions that would have been claimed if not an investment deduction bonded manufacturer case:		
ID ordinary manufacture	(XX)	
Industrial Building Deduction	XX	
Wear and Tear Deduction	<u>(XX)</u>	<u>(XX)</u>
Claimed back (added back) as taxable income		<u>XX</u>

>>> Example

ABC Limited constructed a building and installed new machinery for the manufacture of spoons for export. The building cost Sh. 15,000,000 and the machinery cost Sh. 10,000,000. Manufacturing commenced on 1.1.2003 and ceased on 1.1.2007. Compute the capital allowances for the year 2003-2007

Investment Deductions @ 70%:

2003

Assets	Qualifying	I.D	IDBM	WDV
Cost	(70%)	(30%)		
Building	15,000,000	10,500,000	4,500,000	-
Machinery	10,000,000	<u>7,000,000</u>	<u>3,000,000</u>	-
		<u>17,500,000</u>	<u>7,500,000</u>	

2004 - 2006

No Investment Deductions (ID)

2007

The IDBM is treated as income. However, IBD and WTD in respect of this amount is granted as follows:-

IBD

	Qualifying Cost	Residual Value b/f	IBD (2.5%)	Residual value C/f
2003	4,500,000	-	112,500	4,387,500
2004	4,500,000	4,387,500	112,500	4,275,000
2005	4,500,000	4,275,000	112,500	4,162,500
2006	4,500,000	4,162,500	112,500	4,050,000
2007	4,500,000	4,050,000	<u>112,500</u>	3,937,500
			<u>562,500</u>	

**WTD**

	WDV	WTD (12.5%)	WDV C/f
2003	3,000,000	375,000	2,625,000
2004	2,625,000	328,125	2,296,875
2005	2,296,875	<u>287,109</u>	2,009,766
2006	2,009,766	<u>251,220.75</u>	1,758,545.25
2007	1,758,545.25	<u>219,818.15</u>	1,538,727.09
		<u>1,461,272.9</u>	

The taxable trading receipt will be as follows:

IDBM claimed back	Sh.	Sh.	7,500,000
Less: IBD	562,500		
WTD	<u>1,461,272.9</u>	<u>(2,023,772.9)</u>	
Net Trading Receipt		<u>5,476,227.1</u>	

Note

For the year 2004 and thereafter, the I.DBM is 100% just like normal I.D

4.6 MINING DEDUCTIONS

This refers to capital allowances granted to a person carrying on the business of mining.

**Qualifying Costs:**

- 1) Cost of exploring and prospecting for minerals.
- 2) Cost of acquiring rights over the mine and minerals but does not include cost of land/site.
- 3) Cost of buildings and machinery (mining equipments) which will have little or no value if mining ceased,
- 4) Cost of development and general administration and management incurred prior to commencement of production or during a period of non-production (temporary stoppage).

NB

- 1) If a mining operation is transferred during a year of income, then the deduction will be apportioned between the new and old owner on time basis.
- 2) If someone operates many mining operations that are not related then each mining operation is treated separately and granted its own deductions.
- 3) When a person incurs qualifying expenditure in relations to a mine and without having used such assets for mining he sells such assets to a person who will be entitled to such deductions and the qualifying cost will be the price paid by him for such assets (purchase price).

**Mining Deductions Rates:**

Mining operation is usually expected to last for 7 years. The deductions are granted as follows:

Year	Rate (%)
1	40%
2	10%
3	10%
4	10%
5	10%
6	10%
7	10%

Taxation Rate

Corporation tax rate for mining concerns is 27.5% for the first 4 years and thereafter the normal rate of 30%

>>> Example 1

Mr Jackson Tele manufactures animal feeds at Thika with effect from 1.1.2005. He constructed the factory building at a cost of Sh 800,000 and installed machinery costing Sh 500,000. He prepares accounts to 31 December each year.

Required

1. Calculate the investment deduction for 2005

**Solution**

1. Investment deduction — 2005

Item	Cost Sh	ID at 100% Sh
Building for manufacture	800,000	800,000
Machinery for Manufacture	<u>500,000</u>	<u>500,000</u>
	<u>1,300,000</u>	<u>1,300,000</u>

With effect from 1.1.'87, the investment deduction is deducted from the qualifying cost after which other capital deductions of Industrial Building Deduction, and Wear and Tear Deduction are calculated. If I.D rate is 100%, the residual for IBD and WTA would be Nil hence no IBD and WTA is applicable in the Example 1 above .

>>> Examples

1. Mr Metameta who prepares his accounts to 31 December every year constructed a soap factory and related buildings in Industrial area Thika and used them with effect from 1.1.2005 at a cost of Sh 1 million (factory, including land Sh 400,000), canteen for workers Sh 80,000, showroom Sh 20,000, office Sh 44,800, stone wall round the factory Sh 100,000, and gate Sh 30,000. He installed factory plant and machinery costing Sh 800,000.
2. Mr Metameta constructed a store at a cost of Sh 120,000 and labour quarters at a cost of Sh 100,000 and used them with effect from 1.7.2005.

Required

Calculate the capital deductions in each case.

Solution

As with the calculation of other capital deductions, it is important to recognise the capital cost which qualifies for industrial building deduction. Then the appropriate rate of industrial building deduction is applied to the cost to obtain the amount of industrial building deduction. This will be done in the solution to the above examples.

In tackling questions of capital deductions, always start with calculation of investment deduction where applicable particularly so with effect from 1.1.'87 where industrial building deduction and wear and tear deduction are calculated on amounts net of investment deduction.

1.

a. **Investment Deduction (ID) (using year 2005 rates)**

	Cost At 100% Sh	investment deduction Sh	Balance for WTD or IBD Sh
Factory (Note iv)	664,800	664,800	Nil
Plant and machinery	<u>800,000</u>	<u>800,000</u>	Nil
Total	<u>1,464,800</u>	<u>1,464,800</u>	Nil

The amount of investment deduction of Sh 1,594,800 is deducted in the income tax computation, (or in arriving at the taxable income/loss for the year).

b. **Industrial Building Deduction (IBD)**

Building	Q. Cost	Residual b/f	IBD @ 2.5%	Residual c/f
Canteen	80,000	-	2,000	78,000
Labour quarter	100,000	-	W1 1,250	98,750
Store	120,000	-	W2 <u>1,500</u>	118,500
Stone wall	100,000	-	<u>2,500</u>	97,500
			<u>7,250</u>	

$$\text{Working 1} \quad 100,000 \times 2.5\% \times \frac{6}{12} = 1,250$$

$$\text{Working 2} \quad 120,000 \times 2.5\% \times \frac{6}{12} = 1,500$$

Note and workings:

ii) The Qualifying cost for factory is determined as follows

	Sh
a) Factory cost	1,000,000
b) Less cost of land	<u>(400,000)</u>
	<u>600,000</u>

iii) A staff canteen is a building used for the welfare of workers, it therefore automatically qualifies for IBD. However, it is not used for manufacture. Therefore, it does not qualify for I.D.

iv) The cost of showroom and office qualify for I.D as it is not more than 10% of the total cost of buildings e.g.

$$\frac{20,000 + 44,800}{600,000 + 20,000 + 44,800} = \frac{64,800}{664,800} \times 100$$



- v) The IBD of Sh. 4,250 will be deducted in arriving at the taxable income/loss for each year for 40 years, or be deducted in the income tax computation per year for 40 years.
- vi) Residue of expenditure is the capital expenditure qualifying for IBD but the residual or balance after deducting 100% I.D is Nil

Concluding Remarks On Capital Deduction

1. Tackling examination questions on capital deductions
When tackling questions involving capital deductions, it is advisable to follow the following steps:
 - a. Identify the capital costs incurred for a year/period.
 - b. list the capital cost under the respective capital deduction headings including those not qualifying e.g.

Cost Item	ID Sh	IBD Sh	FWD Sh	WTD Sh	Non-Qualifying Sh
 - c. Apply the appropriate rates of capital deduction where applicable to obtain the capital deduction for the year/period.
 - d. Always start with the calculation of investment deduction whenever it applies as this will affect figures for industrial building deduction, and wear and tear deduction with effect from 1.1.'87.
2. The topic of Petroleum Company Deduction will be covered in the Advanced Taxation syllabus.

4.7 OTHER DEDUCTIONS

Diminution in Value of Loose Tools

Section 15(2) of the IT Act specifically allows diminution in value of loose tools and implements as an allowable expense against taxable income.

The loose tools and implements are usually susceptible to loss and breakage as one of the main features.

The definition of loose tools and implements depends on the nature of the business i.e.

1. In a farm engaged in **agriculture** which is also claiming farmworks deduction, loose tools include pangas, slashers, rakes, forks, shears etc
2. In a **workshop** where vehicles and machinery are repaired loose tools include spinners, screw drivers, bolts, nuts, clamps, mallet and hammers
3. In a **hotel building** loose tools include a kettle, utensils, cutlery, crockery etc

The rate for computation in diminution in value is **33 $\frac{1}{3}$ % p.a.** on a straight-line basis. The qualifying cost is written off over a period of **three years**.

CHAPTER SUMMARY

- The annual rate of wear and tear is applied on the reducing balance in each class.
- Wear and Tear allowance is granted for the whole year irrespective when the asset was bought provided the business traded for the whole year.
- Where the value of a non-commercial vehicle was restricted and the vehicle is sold, the amount of sale proceeds is also restricted by a factor of:

$$\frac{\text{Sales Proceeds}}{\text{Cost}} \times \text{Restriction value applicable} \quad \textit{in the year of purchase.}$$

- w.e.f 1.1.2007, the rate applicable for farm work deduction is 50%.
- Investment Deduction is granted on the first year of use of an asset.
- cost of land on which a building is constructed does not qualify for investment deduction

**CHAPTER QUIZ**

- a) Distinguish between farm-work deductions and capital deductions.
b) John Moturi, a farmer, constructed a farmhouse on 2 January 2005 for Sh.6,000,000 and incurred the following additional expenditure:

		Sh
2.1.2005	Cattle dip	1,000,000
30.6.2005	Irrigation system	1,500,000
30.9.2005	Labour quarters	1,200,000
30.10.2005	Milking machinery	1,120,000

John Moturi sold the farm on 2.1.2006 to his brother, Peter Muturi, who is also a farmer. Their sale agreement contained the following particulars:

	Sh
Cattle dip	1,200,000
Farmhouse	6,700,000
Irrigation system	1,200,000
Milking machinery	980,000
Labour quarters	2,800,000

Required

Calculate the capital deductions from:

- (i) John Muturi (8 marks)
(ii) Peter Muturi (2 marks)

(Total: 15 marks)

1.3 QUIZ ANSWERS

- (a) Strictly speaking, it is not possible to distinguish between farm works deductions and capital deductions.
Capital Deductions refers to allowances granted under the Income Tax Act in respect of capital Investments incurred by a person in the course of business. Farm works refers to such allowances which are granted to a person in the trade of husbandry in respect of capital investments incurred in the construction of Farmworks. It is granted to encourage capital expenditure in agriculture sector. It is a portion of capital deductions.

(b)

Farm-work deductions

Expenditure	Total cost Sh. 000	2005 Sh. 000	2006 Sh. 000
Farmhouse ($\frac{1}{3} \times 6m$)	2,000	667.667	667.667
Cattle dip	1,000	333.333	333.333
Irrigation systems	1,500	500	500
Labour quarters	2,400	800	800
Milking machinery (Given wear and tear)	NIL	NIL	NIL

When a farmer takes over farm works (in this case Peter Muturi) from another farmer (John Moturi) he will continue to claim the remaining deductions regardless of the price paid for the farm works

Where farm works are transferred during the year, the deductions for that year in respect of the transferred farm works will be apportioned to the farmer on a time basis.

Wear and Tear Allowance

	Class IV 12½% Sh '000'
Written down value 1.1.2005	Nil
Additions in the year	<u>1,120</u>
	1,120
Wear and Tear	<u>(140)</u>
WDV at 31.12.2005	<u>980</u>



(i) Summary (John Moturi)

	2005	2006
	Sh '000'	Sh '000'
Farm works	3,450	-
Wear and Tear	<u>140</u>	<u>-</u>
	<u><u>3,590</u></u>	<u><u>-</u></u>

(ii) Summary (Peter Muturi)

	2005	2006
	Sh '000'	Sh '000'
Farm works	-	3,450
Wear and tear	<u>-</u>	<u>123</u>
	<u><u>-</u></u>	<u><u>-</u></u>
WDV at 1.1.2006		980
Wear and tear		<u>(123)</u>
WDV 31.12.2006		857

PAST PAPER QUESTIONS ANALYSIS

The following is an analysis on how the chapter has been examined in the past. The questions are listed in this format: Month/year e.g. 6/01 represents June or May 2001.

12/08, 6/08, 12/07, 6/07, 12/06, 6/06, 12/05, 6/05, 12/04, 12/03, 6/03, 12/02, 12/01, 6/01, 12/01, 6/00.

1.6 REVISION QUESTIONS

Question 1

Mapa Ltd. is a manufacturing company operating in Nairobi industrial area. The following information was obtained from the books of the company for the year ended

31 December 2007.

1. The reported profits for the year before capital allowances amounted to Sh4,296,000
2. The written down values of assets for capital allowance purposes as at 1 January 2007 were as follows

	Sh
Computers	390,000
Plant and machinery	3,640,000
Tractors	940,000
Furniture and fittings	120,000
Motor vehicles	740,000

3. The factory building constructed on 1 January 2002, and put into use on 1 January 2003 had a written down value of Sh1,665,000 as at 1 January 2007.

4. The following assets were constructed or acquired during the year.

Asset	Cost (Sh.)
Warehouse	784,000
Security wall	160,000
Showroom	348,000
Computer and peripherals	96,000
Motor vehicles	2,000,000
Lorry (3 tonnes)	1,290,000
Office cabinets	84,000
Conveyor belts	180,000
Processing machinery	680,000

5. During the year, a motor vehicle (saloon) which was purchased in 1997 for sh600,000 was disposed of for sh240,000.
6. The company demolished a factory extension in July 2007 at a cost of Sh180,000 in order to conform to industry safety standards.
7. The company sunk a water borehole at a cost of Sh 560,000 which was put into use on 1 September 2007.

Required:

- (i) Capital allowances due to the company for the year ended 31 December 2007
(12 marks)
- (ii) Adjusted taxable profit or loss for the year ended 31 December 2007
(2 marks)

(Dec 2007 Question 3)



Question Two

Maji Mazuri Ltd produces water tanks from recycled plastic containers. The company started operations on 1 July 2006 with the following assets:

Asset	Cost (Sh)
Factory building	4,400,000
Production machinery	4,200,000
Drainage system	840,000
Treatment plant	720,000
Delivery truck	1,560,000
Staff canteen	960,000
Standby generator	360,000
Tractor	860,000
photocopier	300,000

Additional information:

- Prior to commencement of production, the company had received a loan of Sh12 million at an interest rate of 10% per annum from a bank to finance the acquisition of some of the assets. The loan was to be repaid over a 5-year period.
- The cost of production machinery includes:
 - Plastic recycling equipment acquired on hire purchase at Sh800,000. The cash price for the equipment was Sh 680,000.
 - Important duty of Sh 400,000 which was waived by the Minister for Finance.
- Factory building includes:
 - A godown constructed at a cost of Sh.700,000 and which was put into use on 1 January 2007
 - Office space partitioned at a cost of Sh420,000 and put into use on 1 August 2006
 - A showroom costing Sh640,000 utilized from 1 January 2007.
- A factory extension was constructed and utilized from 1 January 2007 at a cost of Sh1,600,000.
The following assets were acquired and installed in the factory extension:

	Sh
Conveyor belts	600,000
Production machinery	180,000
Surveillance cameras	90,000
Computer systems	300,000

5. The company constructed a perimeter wall at a cost of Sh150,000 which was completed on 1 July 2007
6. On 1 September 2007, the company incurred Sh200,000 on electrical posts which were fixed within the premises for use in power distribution.
7. A recreation hall was constructed for the employees and used from 1 November 2007. the cost of construction was Sh.800,000.
8. The company reported a loss of Sh2,500,000 for the year ended 31 December 2006 and a profit of Sh1,800,000 for the year ended 31 December 2007. The company has not accounted for capital allowances or loan interest for year 2006 and 2007.

Required:

For each of the two years ended 31 December 2006 and 2007, determine for Maji Mazuri Ltd;

- (i) Capital allowances. (12 marks)
- (ii) Taxable profit or loss. (2 marks)

(Total: 20 marks)

(June 2007 Question 1)

**Question Three**

- (i) List four types of buildings that qualify for industrial buildings deduction (IBD) under the second schedule of the Income Tax Act (Cap 470) (4marks)
- (ii) X Ltd. a manufacturing company constructed an industrial building at a cost of Sh. 5,000,000 on 1 May 2007. The company sold the building before use to another manufacturing company, Y Ltd. For Sh. 8,000,000. Y Ltd. Was unable to use the building and sold it to Z Ltd. , which used the building from 1October 2007 for manufacturing purposes.

Required:

Explain the basis of computing the capital allowances for the building above for the year ended 31 December 2007. (4 marks)

- a) Madini Mining Company Ltd. has been prospecting for gold in Kakamega District since 1995. In year 2005, the company discovered huge deposits of the mineral and commenced mining operations on 1 July 2005.
The following expenditure was incurred on 1 July 2005.

	Sh.
Patent rights paid to the government	4,800,000
Payment of local council licence fees	840,000
Construction of labour quarters at site	1,200,400
Construction of godown in Kakamega town	2,680,000
Construction of godown at site	780,000
Purchase of specialised machinery for mining	1,960,000
Transportation of specialised machinery for mining to site	450,000
Purchase of a ten ton lorry	1,920,000
Purchase of tools and implements for mining	90,000
Purchase of computers	360,000
Purchase of furniture and fittings	1,400,000
Purchase of a Toyota Hilux pick-up	

Additional information:

- The company had incurred exploration expenses amounting to Sh. 1,500,000 as on 1 July 2005
- The administration expenses incurred prior to 1 July 2003 amounted to Sh. 3,000,000

Required:

Compute the capital allowances due to Madini Mining Company Ltd. For the years ended 31 December 2005, 2006 and 2007 (12 marks)

(May 2006 Question 3)

CHAPTER FIVE



STUDY TEXT

ADMINISTRATION OF INCOME TAX



CHAPTER FIVE

ADMINISTRATION OF INCOME TAX

► OBJECTIVES

- Explain the different forms used for filing tax returns
- Explain the different tax assessments
- Evaluate the different modes of tax payment
- Evaluate the tax assessment of different individuals
- Determine tax offences and the penalties applicable

► INTRODUCTION

In the previous chapter we studied capital allowances. In this chapter, we shall concentrate on the compliance requirements under the Income Tax Act. Specifically, we shall look at the types of returns to be submitted, the completion of the returns and the timing requirements for the filing of the same. In addition, we will look at the offences and penalties applicable.

In the next chapter will look at the procedures for resolving any disputes under the Income tax Act.

► DEFINITION OF KEY TERMS

Return: Return of income are forms issued by the Domestic Taxes Department for completing annual details of income or loss

Assessment: Assessment means measurement of income. The commissioner will assess every person who is chargeable to tax after the submission of returns

Advance Tax: An advance tax is payable annually in respect of every Public Service Vehicle (PSV) and Heavy Commercial Vehicle (HCV) at the varying rates depending on the type of vehicle.

► EXAMS CONTEXT

This chapter is mainly examined in short theoretical questions. The student should be conversant with the compliance requirements in the chapter.

► INDUSTRY CONTEXT

This chapter will help the student appreciate the various compliance requirements and the penalties for their non compliance. It is important for tax planning purposes.

5.1 INCOME TAX ACT, FINANCE BILLS AND THEIR PROVISIONS

The constitution of Kenya authorizes the government to levy taxes. The government imposes taxes through statutes and therefore taxes are creatures of statute.

Taxing powers are delegated by the people to the representative legislative bodies which include;

The Central government and local bodies e.g. City councils, Municipals, Corporations, town committees are authorised to impose taxes.

Each June of the year, the Minister for finance makes budget proposals in Parliament which deal with the means of financing public expenditure and changes in taxation. These proposals will then be debated upon by Parliament i.e. the Finance bill goes through the parliamentary procedures and becomes the Finance Act on the day it passes in Parliament. (Doesn't require presidential assent)

No person has got authority to impose taxes except the government or a public authority that has got authority through parliament.

Tax Administration in Kenya

The collection of Public Revenue is administered under the Treasury through various revenue departments operating under the Kenya Revenue Authority, KRA.

The Kenya Revenue Authority was established by an Act of Parliament on July 1st 1995 Cap 469 for the purpose of enhancing the mobilization of Government revenue, while providing effective tax administration and sustainability in revenue collection. The Board and Management of KRA have since its inception spent time and resources setting up systems, procedures and the adoption of new strategies aimed at enhancing the operational efficiency of the Authority's processes.

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KRA VISION AND MISSION

■ Mission Statement

To promote compliance with Kenya's tax, trade and border legislation and regulation by promoting the standards set out in the Taxpayers Charter and responsible enforcement by highly motivated and professional staff thereby maximizing revenue collection at the least possible cost for the socio-economic well being of Kenyans.

■ KRA Vision

"To be the leading Revenue Authority in the world respected for Professionalism Integrity and Fairness."

Professionalism

We are committed to the highest standards of achievement obtainable through dedication and skill.

Integrity

We are committed to treating people fairly and applying the law fairly through honesty and openness.

Fairness

We are committed to applying the law consistently and responsibly as well as administering our requirements reasonably.

Core Values

- Integrity
- Professionalism
- Equity
- Corporate and Social Responsibility

Strategic Theme

Our strategic theme during the plan period (2003/04 – 2005/06) is Enhanced Revenue Collection through Enhanced Quality Service to Stakeholders, Modernization of Internal Processes and Revitalization of our Workforce.

PURPOSE OF KRA

Assessment, Collection, Administration and Enforcement of laws relating to revenue.

■ ORGANIZATION

The **Kenya Revenue Authority** (KRA) is charged with the responsibility of collecting revenue on behalf of the Government of Kenya. In particular, the functions of the Authority are:

- To assess, collect and account for all revenues in accordance with the written laws and the specified provisions of the written laws.
- To advice on matters relating to the administration of and collection of revenue under the written laws or the specified provisions of the written laws.
- To perform such other functions in relation to revenue as the Minister may direct.

A **Board of Directors**, consisting of both public and private sector experts, makes policy decisions to be implemented by KRA Management. The Chairman of the Board is appointed by the President of the Republic of Kenya.

The Chief Executive of the Authority is the Commissioner General who is appointed by the Minister for Finance.

The Authority is a Government agency that runs its operations in the same way as a private enterprise. In order to offer better single-window services to taxpayers, KRA is divided into five regions as follows:

- Rift Valley Region
- Western Region
- Southern Region
- Northern Region
- Central Region

In terms of revenue collection and other support functions, the Authority is divided into the following departments:

- Customs Services Department
- Domestic Taxes Department- headed by the Commissioner of Domestic Taxes
- Road Transport Department
- Support Services Department

Each department is headed by a Commissioner.



In addition to the four divisions, the Authority had seven service Departments that enhance its operational efficiency. These are as follows:

- Investigations and Enforcement Department
- Human Resources Department
- Finance Department
- Board Corporate Services and Administration Department
- Internal Audit Department
- Management Information Services Department
- Research and Corporate Planning Department



Role of KRA in the economy

- To administer and to enforce written laws or specified provisions of written laws pertaining to assessment, collection and accounting for all revenues in accordance with these laws.
- Advise on matters pertaining to the administration or and the collection of revenue under written laws.
- Enhance efficiency and effectiveness of tax administration by eliminating Bureaucracy, Procurement, Promotion, Training and Discipline.
- Eliminate tax evasion by simplifying and streamlining procedures and improving tax payer service and education thereby increasing the rate of compliance.
- Promote professionalism and eradicate corruption amongst KRA employee by paying adequate salaries that enables the institution to attract and retain competent professionals of integrity and sound ethical morals.
- Restore Economic Independence and Sovereign pride of Kenya by eventually eliminating the perennial budget deficits by creating organizational structures that maximize revenue collection.
- Ensure protection of local industries and facilitate economic growth through effective administration of tax laws relating to trade.
- Ensure effective allocation of scarce resources in the economy by effectively enforcing tax policies thereby sending the desired incentives and shift signals throughout the country.
- Facilitate distribution of income in socially acceptable ways by effectively enforcing tax laws affecting income in various ways.
- Facilitate economic stability and moderate cyclic fluctuations in the economy by providing effective tax administration as an implementation instrument of the fiscal and stabilization policies.
- Be a 'watchdog' for the Government agencies (such as Ministries of Health, Finance, etc) by controlling exit and entry points to the country to ensure that prohibited and illegal goods do not pass through Kenyan borders.

■ Legal Structure

In order to realize its mandates, the Authority administers the following written laws relating to revenue:

- The Income Tax Act (Cap. 470)
- The Customs and Excise Act (Cap. 472)
- The East Africa Customs and Management Act
- The Value Added Tax Act (Cap 476)
- The Road Maintenance Levy Fund Act 1993 (No. 9 of 1993)
- The Air Passenger Service Charge Act (Cap. 475)
- The Entertainment Tax Act (Cap. 479)
- The Traffic Act (Cap. 403)
- The Transport Licensing Act (Cap. 404)
- The Second Hand Motor Vehicle Purchase Tax Act (Cap. 484)
- The Widows and Children's Pensions Act (Cap. 195)
- The Parliamentary Pensions Act (Cap. 196)
- The Stamp Duty Act (Cap. 480)
- The Betting, Lotteries and Gaming Act (Cap. 131).
- The Directorate of Civil Aviation Act (Cap. 394).



PROCEDURE

To enable the Domestic Tax Department to carry out the administration of tax, the Legislation contains a series of provisions which enable the tax office to obtain information about tax payers, i.e. persons who are, or may be liable to tax (income tax). This is a very important requirement for any effective system of taxation. This is fulfilled by the requirement of the law that any liable person must submit a return of Income.

It is a fact in Kenya that there are very many liable persons who are not at present within the tax net. In order to identify these persons and often potential taxpayers, the system of Personal Identification Number was introduced in 1992. At the time of its introduction the following transactions with the relevant departments required the production of PIN.

Commissioner of Lands:-

- Registration of title, and stamping of Instruments

Local Authorities:-

- Approval of plans and payment of water deposit

Registrar of Motor Vehicles:-

- Registration, transfer and licensing of motor vehicles

**Registrar of Business Names:-**

- New registration

Registrar of Companies:-

- New registrations

Insurance Companies:-

- Underwriting of policies

Ministry of Commerce:-

- Import and Trade licensing

Commissioner of Domestic Taxes:-

- Application for Registration

Central Bank of Kenya:-

- Licensing and control of activities of financial institutions.

**5.2 IDENTIFICATION OF NEW TAX PAYERS**

Some of the sources of information to the Commissioner of Domestic Taxes regarding chargeable incomes are:

- (a) Self confession.
- (b) Informers e.g. friend, a wife, ex wife.
- (c) Public media (TC, Newspapers, magazines)
- (d) Registrar of companies or business names.
- (e) Large public company e.g. KCC
- (f) Government parastatals.
- (g) Local authorities.
- (h) PIN. Number.

**Who is required to get PIN?**

Employees, employers, businessmen, landlords, farmers, etc

Where is PIN Required

- (a) When registering a motor vehicle.
- (b) When applying for imports and exports licence.
- (c) Applying for water, telephone, electricity connections etc.
- (d) When applying for VAT.
- (e) Applying for insurance covers.
- (f) Applying for land transfers.

Purpose of PINS

- a. To bring more persons to taxation and as such to improve tax compliance.
- b. To assist in the reduction of tax evasion.
- c. To link employee file or return with employers returns.

5.3 TAX ASSESSMENTS AND RETURNS

Returns

There are 3 main returns:

- (a) Instalment tax return.
- (b) Self assessment tax return
- (c) Compensating tax return.

The first two returns will be required from all tax payers whether individual or body cooperate while the compensating return is required only from a body corporate.

■ (A) Instalment tax return

Was introduced **1/1/91** to replace or modify what was called the provision return which was required after year end. Instalment return is required as the year progresses. It shall be submitted by both individual and cooperate liable to tax.

There are 4 instalment returns that require to be submitted by the **20th of the 4th, 6th, 9th, 12th month** as financial year progresses.

**A tax payer won't be required to pay instalment tax if:**

- (a) To the best of his judgement and belief, he will have no income chargeable to tax.
- (b) He has reasonable ground to believe that the whole of the tax he is to pay will be recovered through PAYE.

Since instalment return and the tax are required before year end, the estimate income and tax thereon:

- i. Would be based on last year's performance raised by 10%.
- ii. Current year's performance plus an estimate for the unexpired period of the year.

The amount of instalment tax payable by the person for the current year would be lesser of:

- i. The amount equal to the tax that would be payable by that person if his total income for the current year was an amount equal to the instalment income, or
- ii. The amount specified in the proceeding years assessment multiplied by 110%.

General penalties

- Failure to pay tax by the due date attracts a penalty of 20% of that outstanding tax.
- If that tax isn't paid by the due date then interest at the rate of 2% per month is payable for each month the tax remains outstanding.
- NB. For agricultural tax payers, they are required to pay instalment tax as follows 75% by the 20th of the 9th month, 25% by the 20th of the 12th month.

Advantages of instalment tax

- (a) Early collection of taxes from the government.
- (b) It is convenient to the tax payer to pay tax in bits.
- (c) It reduces tax evasion.

(A) SELF ASSESSMENT RETURN

It is replaced or modified what used to be a final return (w.e.f. 1992).

With a self assessment a tax is required:

- (a) To complete his return fully for the year of income under consideration with respect to all sources of income.
- (b) To complete taxable chargeable income and a tax payable.
- (c) To remit the tax payable or balance after instalment by the due date i.e. by the end of the 4th month after the year end.
- (d) However, the self assessment return itself is to be submitted by the end of the 6th month after year end.
- (e) A self assessment return is to be submitted by employees other individuals not in employment, body corporate, partnership. In the case of partnership, no tax computation is required since tax is payable by individual partners.

Contents of A Return

a. For individuals

- i. Residence status.
- ii. Details of income from various sources.
- iii. Details of expenses allowable.
- iv. Savings up to sh. 48,000 to specified financial institutions under HOSP.
- v. Details of landlord and rent paid.

b. For Bodies Corporate

- i. Principal activity of the body corporate.
- ii. Registered office of the company.
- iii. Share capital and shareholding of the shareholder's details.
- iv. Income details and expenses allowable.
- v. Compensating tax.
- vi. Payments to non-residents
- vii. Payment of non cash benefits, wages, salaries and PAYE tax.

c. Compensating tax Return

It was introduced in 1993 and is applicable to bodies corporate only. Every company liable to tax is required to maintain a dividend tax account so that any tax paid including compensating tax paid is credited to this account. Any dividend received is credited to this account after multiplying it by the factor $t/(1-t)$

Any tax refunded is debited to this account. Any dividend paid out is debited to this account. If debits are more than the credits a compensating tax arises and must be paid.

Income tax department procedure on receipt of self assessment returns

- (a) The returns will be received at the income tax registry.
- (b) Returns are sent to the screening department where checks on arithmetic accuracy will be carried out.
- (c) 15% of the total population of the total cases is selected for AN INDEPTH EXAMINATION.
- (d) Other cases are then filed away after the details have been entered in the computer.

In-depth Examination

- a. Involves a thorough investigation and scrutiny of the tax payer's return and his affairs.
- b. The department will request for all accounting records e.g. check counterfoils, banking slips, payrolls etc.
- c. Income tax department may decide to communicate with 3rd parties, to visit the tax payers premises and interview the tax payer or his agent.



- d. Note that if any undeclared income is identified or expenses claimed erroneously are identified then an additional assessment will be issued plus relevant penalties by the Income Tax department

When a person has substituted a return of income, the commissioner may,

- (a) Accept the return and deem tax assessed as correct and that no further notification is required.
- (b) If he has reasonable cause to believe that the return is not true and correct, he may determine to the best of his judgement, the amount of income of such person and assess him accordingly.
- (c) Institute in-depth examination.

ASSESSMENT

An assessment is the determination or ascertainment of total chargeable income chargeable to tax and computation of tax thereon.

KINDS OF ASSESSMENT

- (a) Instalment assessment.
- (b) Self assessment.
- (c) Normal assessment
- (d) Estimated assessment.
- (e) Additional assessment.
- (f) Amendment assessment.

Instalment assessment

This assessment based on estimate income for the year under consideration for the purpose of ascertaining instalment tax payable in the course of year in equal instalments.

Self assessment

An assessment by a tax payer himself whereby he declares his taxable income and computes tax thereof. The due date for payment of self assessment tax (or balance after instalment taxes) is by the end of the 4th month of the following year.

Self assessment tax return is to be submitted by the end of the 6th month of the year.

Normal assessment

This assessment is issued by CDT on the basis of final return of income submitted. CDT may call for additional information, documents, schedules etc before accepting the income/loss per final return or as adjusted. Note that with effect from year of income ended 31.12.92 the normal assessment will then become a self assessment based on self assessment return.

Estimated assessment

Is an assessment issued by the Income tax Department where:

- a. A tax payer has failed to submit a self assessment return.
- b. When the CDT doesn't agree with the return furnished by the tax payer.

The estimated assessment will contain estimates using the commissioner best of judgement.

Amendment assessment

It is not a new assessment as such rather it is an assessment used to correct an error on earlier assessment and will normally arise after an objection has been made.

Additional assessment

It is used by the Income tax department when they notice additional income not disclosed or the tax payer under assessed himself. This normally follows an in-depth examination into the tax payer's affairs when tax department receives information from another source where tax payer claims relief which he is entitled to.

NB. In case of fraud or willful negligence on the part of the tax payer, penalties could be charged up to **200% on the tax** of such income declared.

Assessment under section 35 of I.T.A

These are raised by I.T.D to charge tax arising on shortfall distribution of dividends.

Reverse charge/ Back duty

Is an assessment to charge tax on 1st years income that were not brought to tax. Heavy penalties will b imposed up **to 200% of that tax**.

RETURN OF INCOME AND NOTICES

In earlier lessons we have looked at taxable income, expenses or deductions that are allowable, and those that are not allowable against taxable income. It is now necessary to discuss how a taxpayer informs the Domestic Tax Department about the details of tax positions on the following matters.

- i) Taxable income or loss;
- ii) Sources of income e.g. business, employment rent, etc.;
- iii) Claims of tax relief in case of individuals only; and
- iv) Payment of tax at source.



A taxpayer informs the Domestic Tax Department about the details of the tax position through the submission of annual returns of income. The returns of income **are forms issued by the Domestic Tax Department for completing annual details of income or loss.**

Taxpayers That Submit Returns of Income:

Three kinds of taxpayers submit returns of income:

- a) Individuals (natural persons)
- b) Legal persons such as companies, trusts, clubs, co-operatives, corporations, etc (persons created by law) generally referred to as company or corporation.
- c) Partnerships.

Types of Returns of Income:

At present, two types of return are in use:

(a) Self-Assessment Return of Income (SAR)

The return was introduced for the year of income 1992. It is required to be submitted by **all companies and individuals with taxable income**. Partnerships also file a Partnership Return. It is due for submission to the Domestic Tax Department by the end of the sixth month after the accounting year end.

The self-assessment tax, if any, is due for payment by the end of the fourth month after the accounting year end.

(b) Compensating Tax Return of Income (CTR)

- The return was introduced with effect from accounting year ended in 1993 and later years. It is required to be submitted by **resident companies only**. It is due for submission to the Domestic Tax Department by the end of the sixth month after the accounting year end.
- The compensating tax, if any, is due and payable by the end of the fourth month after the accounting date.
- The CTR is a form issued by the Domestic Tax Department to enable companies to pay compensating tax. The CTR and the SAR are due at the same date.
- Every company is required to maintain a Dividend Tax Account whose debit balances is the compensating tax payable as follows:

Dividend Tax Account

	<i>Dr</i>	<i>Cr</i>
Income tax paid (excluding dividend w/tax)		XX
Dividends received $\times \frac{t}{1-t}$	XX	XX
Dividends paid $\times \frac{t}{1-t}$	XX	
Compensating tax (if debit side is greater)	—	XX
Balanced account (Dr and Cr equal)	XX	XX
T-current corporation tax rate		

There is a choice of the opening balance of the company's first Dividends Tax Account as either zero or the balance at the end of 1992 year of income created by running a notional Dividend Tax Account from the year of income 1988. The company would choose zero balance if the notional dividend tax account has a debit balance, and would choose the credit balance for carrying forward, if a credit balance was reflected.

A principal officer of the company must sign the CTR.

There is a penalty for failure or lateness in submitting CTR and paying the compensating tax on due date. The details of the penalty are given later in the lesson.

5.4 REMITTANCE OF TAX: INSTALLMENT TAX AND FINAL TAX

Previously, taxpayers were required to submit instalment tax returns. These are no longer in use although instalment tax is still payable; Instalment tax is payable by companies and individuals except where:

- i) The taxpayer is an individual earning employment income only and which has been taxed in full through the PAYE system; or
- ii) The total tax liability of an individual does not exceed Sh 40,000 p.a.; or
- iii) An individual has more than one source of income and employment income constitutes more than two-thirds of his total taxable income.



With effect from 01.01.2003 instalment tax is payable as follows:

Year of Income Commencing or after	Fourth Month by the 20 th day	Sixth Month by the 20 th day	Ninth Month by the 20 th day	Twelfth Month by the 20 th day
	%	%	%	%
1.1..2003 to date.	25	25	25	25

Where a person derives more than two-thirds of his/her income from agriculture, pastoral, horticultural and similar activities, instalment tax is payable in the following proportion by the twentieth day of the months below:

Accounting Year Commencing on or after	Ninth Month 20 th day	Twelfth Month 20 th day
1 January 1995	75%	25%
1 January 1996	75%	25%

The amount of instalment tax payable is the lesser

- 1) The tax payable on total income for the year; or
- 2) The tax assessed, or estimated as assessable for the preceding year of income multiplied by 110%.
- 3) When completed, the partnership's final return contains:
 - a) The total income/loss of the partnership and how it is shared to the partner.
Supporting accounts must be submitted.
 - b) A signed declaration that the return of income contains a full and true statement of the partnership income/loss

5.5 TURNOVER TAX

This is a tax on consumer expenditure introduced in the 2006 and 2007 Finance Acts. The imposition of the turnover tax is contained in Section 12 (c) of the Income Tax Act. TOT came into application on the 1st of January 2008.

According to Section 12C of the Income Tax Act and the Turnover tax regulations, income from business includes **gross receipts, gross earnings, revenue, takings, yield, proceeds or other income.**

The term “person” includes partnership for purposes of turnover tax.

The tax period means every three months commencing 1st January every year;

Application & registration

It applies to any person whose gross sales are more than Sh 500,000 per annum and does not exceed or is not expected to exceed Sh 5 million per annum. It was introduced as a measure to improve tax compliance of small tax payers whose income levels are low.

■ Registration

- A person whose income from business does not exceed or is not expected to exceed Sh 5 M p.a is required to apply for TOT registration.
- A person whose income from business does not exceed Sh 0.5 M p.a shall not apply for TOT registration.
- The commissioner issues a certificate of registration where he is satisfied that a person is required to be registered.
- A person whose income from business falls below Sh 0.5 M p.a is required to apply to the Commissioner for deregistration.
- Where the Commissioner is satisfied that the income of an applicant has fallen below Sh 0.5 M p.a , he shall deregister that person

■ Exemptions

Turnover tax does not apply to:

- i Rental income and management or professional or training fees;
- ii the income of incorporated companies; and
- iii Any income which is subject to a final withholding tax.
- iv any person whose income is exempt from tax under the First Schedule to the Act



Applicable Rate

The applicable rate is **3% of gross sales per annum** as a final tax.

■ Change of Status

- Where the income from the business of a person registered exceeds Sh 5 M during a year of income, that person shall notify the Commissioner of the change of status.
- Where the commissioner is satisfied by the notification above, he shall grant approval of the change.
- This approval granted by the Commissioner becomes effective in the subsequent year of income.

■ Keeping of Records

- A registered person will keep records necessary for the determination and ascertainment of tax, including daily sales summary.
- Where a business is in possession of an Electronic Tax Register records as provided under the Value Added Tax Act (Electronic Tax Register) Regulations, 2004, the records shall be sufficient.

Returns and payments

A person subject to turnover shall:

- Calculate the tax due;
- Remit the tax due to the commissioner by cash or bank guaranteed cheques or electronic fund transfers; and
- Submit a return in the prescribed form, in each tax period, to the commissioner on or before 20th of the month following the end of the tax period.

Offences and Penalties

Any person who fails to submit a tax return is liable to a default penalty of Sh 2,000.

Any person who submits a return within the required period, but fails to pay the tax due is liable to a default penalty of Sh 2,000.

Any person who fails to pay tax due, or part thereof, is liable to pay interest at the rate of two per centum per month, on the unpaid tax.

Inspection of Records

To obtaining any information, the commissioner may by notice require any person to –

- Produce books and records relating to the calculation of turnover tax.
- Appear at such time and place as may be specified in the notice.

Appointment of Agents

The Commissioner may appoint any person under section 96 of the Act to be an agent for purposes of:

- Collection;
- Recovery; and
- Enforcement of tax.

Dispute Resolution

Any dispute arising from the administration of these Rules as regards any assessment to tax shall be dealt with in accordance with the provisions of Section .84 of the Income Tax Act.

>>> Illustration

Mr. Mosota was involved in the business of fish trading. His turnover in 2008 year of income was **Sh.600,000**. He has come to you for advice regarding:

- Whether he should register for TOT.
- The amount of TOT payable.

Solution

- Yes since Mr. Mosota is within the TOT registration threshold.
- The amount payable is **3% of 600,000=Sh.18,000**. This can be paid in four instalments payable on 20th of the month following the tax period.



5.6 OPERATION OF PAYE SYSTEM

PAYE is a method of deducting income tax from salaries and wages and applies to all incomes from any office or employment.

Employer's Duty To Deduct Income Tax

It is the employer's statutory duty to deduct income tax from the pay of his employees whether or not he has been specifically told to do so by the department.

Normal PAYE year runs from 1st Jan to 31st Dec.

The necessary PAYE stationery is issued to employees before commencement of the year.

If any employer fails to comply with the provision of section 37 and with the provision of any rules made under section 130 which deal with the payment over of tax deducted and the accounting for it to the commissioner. The commissioner may by order impose a penalty of 25% of the amount involved or sh.10,000 whichever is greater.

Employer

For PAYE purposes, the term 'employer' is to be taken when it's necessary to include:

- (a) Any person having control of payment of remuneration.
- (b) Any paying officer of government or other public authority.
- (c) Any trust or insurance company or other body or person paying pensions.

Employee

Is any holder of an appointment of office whether public, private or calling for which remuneration is payable. "Employee" will include minister, chief, civil servant, company executive, and secretary, individuals working and religious organizations and other employees.

Also includes an employee who retires in Kenya where pension received from a registered pension fund receives a pension worth sh.180,000 p.a or more.

Paying point

A paying point is the place at which remuneration is paid

If a non resident employer calculates remuneration abroad and remits the remuneration direct to the employee then such remuneration should be notified to the department through the employer's local representative and P.A.Y.E tax operated on the remuneration should be notified to the Department through the employer's local representative and PAYE tax operated on the remuneration accordingly. Any cases of doubt should be referred to the Income Tax Office for advice.

Monthly Pay

“Monthly pay” includes income in respect of any employment or service rendered, accrued in or derived from Kenya. This will include:

- (a) Wages, salary etc
- (b) Cash allowances, e.g. house or rent allowance, telephone allowance, round sum allowance, etc
- (c) Private expenditure of employee paid by employer e.g. grocery bills.
- (d) Non cash benefits when the aggregate value exceeds ksh.2000 per month
- (e) The value of housing, where provided for employer.

Monthly pay slips

Every employer is required to provide each employee on payment of remuneration with a written statement showing:

- (a) Monthly pay
- (b) Income tax deducted

Payment of Tax Deducted

Each employer is supplied with a PAYE credit card slip paying in back (its called form no p.11). The law requires that the employer pays the income tax deducted from his employees pay on or before the 9th day of the month following the payroll month.

Cheques must be drawn payable to the Pay Master General Kenya. Three copies for each month must be completed and signed by the employer using carbon paper.

Special arrangements can be made with the CIT in case the employer finds he is unable to make his monthly payments by the due date (before the 10th day of the following month.)

The amount of tax on a lump sum or penalties, interest should be shown separately from the normal PAYE deductions and the nature of that payment must be explained.

WHAT EMPLOYERS SHOULD DO BEFORE 1ST JANUARY EACH YEAR

(a) P.A.Y.E DOCUMENT

Before commencement of each year, every known employer will be expected to collect sufficient quantity of P.A.Y.E stationery which are necessary for the operation of **P.A.Y.E scheme**.



(b) CHECK OF DOCUMENT RECEIVED

The P.A.Y.E documents received from the Income Tax Office should be checked properly to ensure that the quantity supplied is adequate and none is missing. If any of the forms are missing or additional supplies are required, then the Income tax office should be notified immediately.

(c) WHO IS LIABLE FOR P.A.Y.E?

Any employee whose gross pay plus benefits including housing provided by the employer exceeds **Sh 11,135 per month** is liable to pay **P.A.Y.E**. However, if the employer is aware that the employee has income from main employment elsewhere, then PAYE should be deducted even though the earnings are less than Sh 11,135 per month.

TAX DEDUCTION CARDS

There are three types of Tax Deduction Cards:

(a) Form P.9A

- ◆ All employees whose earnings in cash exceed Sh 11,135 per month and employees in receipt of non- cash benefits, valued at Sh 2,000 or more per month, which together with cash pay, the monthly emoluments exceed Sh 11,135.
- ◆ All company directors whether receiving benefits or not (if not receiving benefits a “NIL” certificate is required on the reverse side of the card at the end of the year)

(b) Form P.9A (HOSP)

This card is used where employee is eligible for a deduction in respect of funds deposited in approved institution, under “Registered Home Ownership Savings Plan”, in addition to the conditions for **P9A (No. (i) above)**.

(c) Form P9B

This card is used in circumstances where the employer bears the tax burden on behalf of the employee (tax free remuneration).

EMPLOYER’S CERTIFICATE OF PAY AND TAX (P9A, P9A (HOSP) & P9B)

At the end of the year, the employer should give the employee a certified copy of the Tax Deduction Card-**P99A, P9A (HOSP) & P9B** which will serve as a “Certificate of Pay and Tax deducted”. When a liable employee leaves employment the employer should prepare and hand over to the employee a certificate of pay and tax showing details of pay and tax deducted up to the date of cessation.

REMITTANCE OF TAX



A. How To Pay-In The Tax Deducted

The Law requires an employer to pay in the PAYE tax deducted from his employees pay on or **before the 9th day of the month following the pay roll month.**

Failure and/or late **P.A.Y.E** payments will incur penalties of 20% of the amount paid as per Section **72D** and interest at the rate of 2% per month of unpaid tax.

Each employer is supplied with **P.A.Y.E credit slip paying in book** (called form no. p 11).

Cheques must be drawn payable to the **pay master General Kenya**. Three copies for each month must be completed and signed by the employer using carbon paper.



B. Special arrangements for remote areas

If an employer finds that he is unable to make his monthly payments by due date- i.e. before the tenth day of the month following the month of deduction- for reasons of remoteness or distance from a bank, he should make full representations setting out all the relevant facts to the appropriate Income Tax Office.



C. Payment of Tax Deducted from Lump sum, PAYE, Audit Tax, Interest and Penalty

Employers are required to make payments of tax recovered from Lump sum amounts, tax established through P.A.Y.E. Audits, penalties or interest imposed for P.A Y.E offences to the paymaster general using pay in credit slip (P11) in the usual way as for the monthly P.A.Y.E payments.

The amount of tax on a lumpsum or penalties, interest should be shown separately from one normal P.A.Y.E deductions and the nature of that payment must be explained.

EXTENT OF PENALTIES AND INTEREST



(a) PAYE OFFENCES-SECTION 37(2)

The Commissioner may impose a penalty under Section 37(2) of the Income Tax Act if an employer fails.-



- a. To deduct tax upon payment of emoluments to an employee.
- b. To account for tax deducted.
- c. To supply the Commissioner with a certificate prescribed under PAYE Rules.

The Penalty is at the rate of **25% of the amount of tax** involved or **Sh 10,000, whichever is greater**.



~~(b) PENALTY ON UNPAID TAX SECTION 94(1)~~

A penalty of **20% will** be levied on **PAYE** tax remaining unpaid after due date.



~~(c) INTEREST ON UNPAID TAX SECTION 94(1)~~

A late payment interest at **2% per month** or part thereof shall be charged on amount of PAYE tax including the penalty remaining unpaid for more than one month after the due date until the full amount is paid.

~~APPEAL BY EMPLOYERS AGAINST PAYE PENALTIES~~

An employer may appeal to the Income Tax local committee against imposition of PAYE penalty by the **CIT** within 30 days after the date of service of the notice; provided that:-

- Employer shall first pay all the tax due plus the penalty imposed prior to lodging the appeal.
- The determination of the appeal shall be limited to the question of whether or not the employer had complied with the provisions of Section 37 of the Income tax Act and the PAYE Rules relating to the deduction of tax from employee's emoluments.

~~END OF MONTH PROCEDURE~~



~~1. List of employee~~

Employer should at each month-end **list** the names of employees from whose pay he has deducted tax together with the respective amount of tax. The total of this list **must agree** with the amount remitted by the employer as recorder on his copy of **form. P. 11**.



~~2. Arithmetical or other errors~~

Entries made on the Tax Deduction Card **cannot be altered** on any manner. Corrections can be made in the following months in the same year.

If the employer discovers the error **after the end of the year** or if for any other reason he cannot correct the mistake, then the attention of the Income Tax Office should be specifically drawn to the error.

Spoiled cards should not be destroyed but should be attached to the new card.

3. Objection By The Employee

If an employee isn't satisfied that the amount of tax deducted by his employer isn't correct he is supposed to seek advice from income tax department otherwise the employer will continue to deduct tax on the basis of the calculations until the commissioner rules on that objection.

END OF YEAR PROCEDURE

1. Completion of PAYE Documents

■ a. Tax Deduction Cards - (P9A, P9A (HOSP) & P9B)

At the end of each year employers should fully complete the questionnaire on every Tax Deduction Card Showing:-

- Dates of commencement and leaving of employment.
- Names and address of old and / or new employer; if known.
- Details of the benefits provided, if any, at the back of the Tax Deduction Cards.
- The amounts and details of any pay from which tax was deducted which relate to an earlier or later period e.g. gratuities, Bonuses, compensation for Loss of office e.t.c
- Details of rent paid by employee towards housing.

■ b. Employers Certificate - Form P10

Employers should give details of normal monthly PAYE remittances separately from other payments made to the Pay Master General relating to tax on lumpsum payments, Audit tax, interest and penalty. Dates on which the relevant payments were made to the bank must also be shown in the space provided.

■ c. Supporting list - Form 10A

Employers are required to show total tax pay in respect of tax on lumpsum payments, tax determined through PAYE audit, interest and penalties.



d. Form P10B (Fringe benefit tax Return)

Since fringe benefit tax is payable by the employer, the details of the fringe benefit and also the tax paid thereon should be reflected in the return to the department using form P10B to show names of employees involved, the loan amounts, rate of interest charged by employer, taxable fringe benefit and amount of tax paid.

The fringe benefit tax return (P10B) should be submitted by the employer together with other PAYE end of year documents.

The relevant end of year documents fully completed should be submitted to the relevant income tax office before **the 28th February the next year.**

2. Audit Procedure

The income Tax department may send officers to employer's paying points during the year to check that they are operating PAYE scheme correctly and to give guidance to employers if they are in difficulties.

Any such officer must produce a signed authority and the employer will be expected to make available all the records connected s to PAYE for inspection.

The audit process will check that:

- (a) The employer has brought into the payroll all the employees, emoluments, cash allowances and benefits.
- (b) The employer has deducted the correct PAYE tax.
- (c) The tax deducted has been paid over to the bank.
- (d) The pay shown in the employer's salary records has correctly been transferred to tax deduction cards.
- (e) The tax deduction card has been fully and correctly completed.

SPECIAL CASES

(a) ARRIVAL, DEPARTURE OR DEATH DURING THE YEAR

- ◆ Where a person becomes resident in Kenya during the year he is given a proportion to the year's personal relief to which he is entitled commencing on the 1st day of the month to which he becomes resident e.g. if an employee arrives in Kenya on 15th August, and enters employment, he will be entitled to a whole month's relief against any emoluments paid August.
- ◆ A resident individual who dies, leaves Kenya permanently or proceeds on leave pending permanent departure from Kenya will, during the year of income in which death occurs or departs, be deemed to have been resident in Kenya only for the number of months up to and including the month of death, departure or expiration of leave.

(b) CHANGE OF PERSONAL CIRCUMSTANCE DURING THE YEAR

The amount of personal Relief to an individual is entitled for any year will remain the same regardless of employees' state of marital status since personal relief is uniform to all employees with taxable income.

(c) MULTIPLE PAYE SOURCES OF INCOME

There are employees who have two or more source of income which fall under PAYE provisions e.g. a person with several directorships or a person with several part-time employments which don't fall under the definition of causal employment. Such employees should be granted personal relief by the employer at their entire main source of employment.

(d) IRREGULARLY PAID EMPLOYEES

PAYE tax basically is deductible from all payments made, the entry or pay on deduction card for in any month. This means that if an employee is paid fortnightly or at any other interval the PAYE for the month will be the total of payment in the month to be made on the occasion of the last payment.



5.7 OBJECTION, APPEALS AND RELIEF OF MISTAKE

Notice of Objection

A taxpayer who disputes or who does not agree with an assessment for any year of income has a right to lodge an objection (or to object) against such an assessment. Such an objection is referred to as a "notice of objection". For the objection to be "a valid notice of objection" it must:

- a) Be in writing
- b) State the grounds of objection (or the reasons why the objection is lodged).
- c) Be made within 30 days after the date of service of the notice of assessment i.e. within 40 days.(30 days of notice + 10 days of service within Kenya = 40 days)
- d) The return of income and any supporting schedules must be submitted before the appeal is accepted. A taxpayer will dispute or will not agree with a notice of assessment because of mistakes or errors relating to:
 - 1) Amount of income/loss assessed
 - 2) Amount of tax payable
 - 3) Allowance or deduction made or omitted to be made in computing chargeable income/loss.
 - 4) Imposition of interest penalties under S.72. There is no right to object against S.95 interest. A tax payer applies for remission of the interest under S.95.
 - 5) Relief granted or omitted to be granted for individuals.
 - 6) Rates of tax used.
 - 7) Assessment being time barred. An assessment is time barred if issued 7 years after the year of income to which it relates.

Late Notice of Objection

Where a taxpayer who disputes an assessment fails to object against the assessment within the time allowed 30 days of notice plus 10 days of service of the notice of assessment in Kenya) the taxpayer can lodge a notice of late objection. The late notice of objection must:

- a) Be in writing
- b) State the grounds or reasons for objecting, and
- c) State the reasons for objecting late.

■ The CDT can accept a late notice of objection on the following conditions:

1. Return of income for the year, and accounts where applicable have been submitted to CDT.
2. If the lateness is due to the taxpayer being absent from Kenya, being sick, or other reasonable cause e.g. death in a family sickness in the family etc. proof of this would be required by CDT.
3. There is no unreasonable delay on the part of the taxpayer in lodging the late objection e.g. the notice was lost at post office.
4. Tax due is paid together with any late payment interest. CDT can waive this condition if he is satisfied that the tax due is excessive.

If the late objection is accepted by CDT, it becomes a **valid notice of objection**.

If the late objection is not accepted, the notice of assessment objected against remains in force. The taxpayer however has a right to appeal to the local committee (an appeal body) against CDT refusal to accept a late objection, and the decision of the local committee is final on the matter.

Dealing With a Valid Notice of Objection

Where a taxpayer has lodged a valid notice of objection against an assessment for any year of income the objection would be dealt with by CDT in any of the following ways:

- a) Amend (change) the assessment to be in accordance with the objection i.e. CDT agreeing with the grounds of the objection.
- b) Amend the assessment in the light of the objection (with some adjustments) and taxpayer or the person objecting agreeing to the adjustments. An agreed amended assessment would be issued by CDT i.e. an assessment agreed by both parties.
- c) Amend (change) the assessment in the light of the objection (with some adjustments) and the taxpayer or the person objecting not agreeing to the adjustments. A non-agreed amended assessment would be issued by CDT. The taxpayer is notified of the right to appeal to the local committee if he disputes the non-agreed amended assessment.
- d) Refuse to amend (change) the assessment and issue a notice to the taxpayer confirming the disputed assessment. The taxpayer has a right to appeal to the local committee against the confirming notice.
- e) Take no action where the taxpayer withdraws the notice of objection.
- f) Take no action where, with effect from 13.6.91, an objection becomes invalid and the assessment objected against final and conclusive. Where the return and accounts for the year have not been submitted within 30 days from the date of objection.

Note

A taxpayer who is aggrieved by the manner in which an objection against an assessment has been cleared by CDT may lodge an appeal to the local committee, tribunal and finally to high court and court of appeal in the manner described below.



5.8 APPELLANT BODIES

A taxpayer has a right to appeal against some decisions made by CDT regarding assessment which the taxpayer does not agree with. The appeal is made to appeal bodies established under the Act.

Local Committee

- a) The local committee is an appeal body. It is an independent body and not part of the Domestic Taxes Department.
- b) The Minister in charge of Finance, by a notice in the gazette appoints a local committee for any given area eg Kisumu Local Committee, Mombasa local Committee, Nyeri Local Committee etc
- c) The duties of a local committee are to hear and determine appeals lodged by taxpayers on matters of tax dispute. Note that only a taxpayer can appeal to the local committee.

■ Composition of the Local Committee

The members of the local committee are appointed by the minister in charge of Finance and consist of:

- a) The chairman and
- b) Not more than eight other members—the quorum for a meeting of the Local Committee is the chairman and two other members.

■ Period of Office

A member of the local committee holds office for a period of two years unless:

- a) The member tenders a resignation, or
- b) The minister revokes the appointment:
 - i) For failure to attend three consecutive local committee meetings; or
 - ii) For being unfit to perform the duties of his office by reason of mental or physical disability.

Local Committee Rules

The minister has made and can make rules under the income tax act referred to as the Income Tax (Local Committees) Rules for the Local Committees to follow relating to:

- a) The manner in which an appeal may be made to the Local Committee.
- b) The procedure for hearing an appeal and the records to be kept by the Local Committee.
- c) The manner to convene, the place, date and time to hold a Local Committee meeting.
- d) Scale of costs that may be awarded by the Local Committee.
- e) General matters for the better carrying out of Local Committee appeal.

Procedure for Appeal to the Local Committee

A taxpayer has a right to appeal to the local committee against some decisions made by CDT affecting tax such as:

- a) CDT refusing to amend an assessment after the taxpayer has lodged a valid notice of objection. The CDT would issue a notice confirming such an assessment and the taxpayer would have a right to appeal to the local committee against such confirming notice.
- b) CDT issuing a non-agreed amended assessment. This arises where CDT has adjusted taxable income in the light of the objection, but the taxpayer does not accept the adjusted income/loss and the subsequent assessment.
- c) CDT refusing to accept a late notice of objection. This is an objection which is lodged after the period allowed for submission of a normal objection. The taxpayer has a right to appeal to the local committee against the decision of CDT to refuse to accept a late notice of objection.
- d) CDT issuing a notice requiring books records and accounts to be kept in a specific language. The taxpayer has a right to appeal to the local committee against such a notice.
- e) CDT refusing to make a repayment of tax overpaid. The taxpayer has a right to appeal to local committee to enforce repayment of overpaid tax.

When considering any appeal procedure, one must bear in mind the three parties involved in any appeal namely, the taxpayer, the CDT and the appeal body. The appeal documents must be filed to the three parties in the procedure for appeals as follows:



1. To CDT

- a) The taxpayer is required to notify the CDT of his intention to appeal to the local committee against any of the above notices or decision within 30 days from the date of service of the notices or decision.
- b) The notice of intention to appeal must be copied to the clerk of the local committee.
- c) Copies of memorandum of appeal and statement of facts must be sent to CIT.

2. To Clerk of Local Committee

The appeal is to the local committee and the following documents must be submitted to the clerk of the local committee:

- a) Memorandum of Appeal—document stating the grounds of appeal—(original + 9 copies for the members of the local committee).
- b) Statement of Facts—a document giving sequence of events on the assessment before appeal to the local committee i.e date assessment issued objected to, confirmed, non-agreed amended assessment issued, etc. (original plus 9 copies for the members of the Local Committee).
- c) A copy of the letter (notice) of intention to appeal to the local committee which was sent to CIT.
- d) A copy of CDT decision against which an appeal is being lodged to the local committee e.g. copy of non-agreed amended assessment or a copy of the confirming notice.

■ Registering an Appeal for Hearing by the Local Committee

Where proper appeal documents have been filed in time to the clerk of the local committee the clerk will register the appeal for hearing by the local committee. The clerk of the local committee will not register an appeal for hearing by the local committee unless the return of income, and the accounts where applicable for the year of income under appeal, are submitted to the CDT.

■ Late Appeal to the Local Committee

Where a taxpayer is prevented from lodging an appeal, in time, to the local committee by either absence from Kenya, sickness, or other reasonable causes; the taxpayer can appeal to the local committee for extension of time within which to lodge an appeal. Such an appeal is referred to as a late appeal. Appeal documents as for normal appeal will also be filed i.e. memorandum of appeal and statement of facts. The application for extension of time within which to appeal must state the reasons why the appeal was not lodged within the time allowed.



Valid Appeal

- 1) Where all the appeal documents have been filed in time, there is a valid appeal to the Local Committee.
- 2) The clerk of the local committee will register any valid appeal for hearing by the Local Committee.
- 3) The date and place of hearing of the appeal is notified to both the taxpayer (appellant) and the CDT (respondent).
- 4) The local committee will then meet and hear the appeal and make a decision on the matters disputed. The decision of the local committee is communicated to both the taxpayer (the appellant) and the CDT (respondent).

■ Appeal to Courts of Law

If the taxpayer or CDT disputes the decision of the local committee, they can appeal to the high court and then to the court of appeal. The appeal to courts must be only on question of law or mixed law and fact.

For the appeal to the courts, the appellant (taxpayer or CDT) must serve the respondent with a notice of intention to appeal to the court within 30 days from the date of service of the decision of the local committee. The appellant must also file in court the following:

- a) Memorandum of appeal listing the grounds of appeal.
- b) Statement of facts giving a sequence of events leading to the decision or notice under appeal.
- c) Copy of the decision or notice appealed against.
- d) Copy of notice of intention to appeal served on the respondent.

■ Tribunal

- a) A tribunal is an appeal body established by the Minister in charge of Finance by a notice in the gazette.
- b) The tribunal consists of:
 - i) The chairman, and
 - ii) not less than two and not more than 4 other members (minimum 3 members and maximum 5 members)
- c) The duties of the tribunal are to hear appeals on assessment based on CDT direction under s.23 and s.24 of the income tax act.



5.9 COLLECTION AND RECOVERY OF TAXES

Where tax assessed is not paid on due date, the collector of income tax has power to collect the tax due as a debt owed to the government in any of the following ways:

- a) Sue for the recovery of the amount in a court of law.
- b) Collect the tax through agents. Here the organisations or individuals known to be making some payments to a defaulting taxpayer are appointed as tax collecting agents. As agents, they are legally required to pay to the collector any moneys due to the defaulting taxpayer and the obligation for paying to the taxpayer is taken as legally satisfied. If the agent defaults in making payments to the collector after appointment as agent, the tax can be collected from such an agent. Bankers, employers, marketing organisations etc. are often appointed as tax agents.
- c) Di-straining defaulting taxpayers, that is, seizing their properties and auctioning them to satisfy the tax debts.
- d) Collection from a guarantor.

CHAPTER SUMMARY

The type of returns are:-

- Self assessment return and
- Compensating tax return.
 - Instalment tax is paid by companies and individuals on 4th, 6th, 9th and 12th of the year by the 20th day
 - Failure by taxable person to file returns will lead to penalties.



CHAPTER QUIZ

Question One

Explain the various types of returns of income.

Question Two

Explain instalment Tax

Question Three

Explain the taxation of income of a deceased person.

ANSWERS TO QUIZ

Question one

- 1) Types of returns of income **Self-Assessment Return of Income (SAR)**
It is required to be submitted by **all companies and individuals with taxable income**. It is due for submission to the Domestic Taxes Department by the end of the sixth month after the accounting year end.

The self-assessment tax, if any, is due for payment by the end of the fourth month after the accounting year end.

2) **Compensating Tax Return of Income (CTR)**

- It is required to be submitted by **resident companies only**. It is due for submission to the Domestic Taxes Department by the end of the sixth month after the accounting year end.
- The compensating tax, if any, is due and payable by the end of the fourth month after the accounting date.
- The CTR is a form issued by the Domestic Taxes Department to enable companies to pay compensating tax. The CTR and the SAR are due at the same date.
- Every company is required to maintain a Dividend Tax Account whose debit balances is the compensating tax payable.

Question Two

Meaning of instalment tax

The instalment tax system is a form of paying tax by the business concerns including individuals and corporations

This system involves all incomes except the employment income which are subject to P.A.Y.E

Under the system businesses are required to pay a specific part of their income tax during the current year of income.

Instalment tax is not payable by individuals.

The amount of instalment tax payable is the lesser

- i. the tax payable on total income for the year; or
- ii. the tax assessed, or estimated as assessable for the preceding year of income multiplied by 110



Question Three

Taxation of income of a deceased person.

The Income of a deceased person may be income that accrue prior to his death or income accrued after his death.

- i) The income accrued to or received prior to the date of the death of a deceased person shall be assessed on, and the tax charged on his executors or administrators for that year of income.
- ii) Any amount received by the executors or administrators of a deceased person shall be deemed to be income of his executors or administrators and shall be assessed on, and the tax charged on them for that year of income.

PAST PAPER QUESTIONS ANALYSIS

The following is an analysis on how the chapter has been examined in the past. The questions are listed in this format: Month/year e.g. 6/01 represents June or May 2001.

12/04, 12/03, 12/02, 6/02, 12/01, 6/00.

REVISION QUESTIONS

QUESTION 1

- (a) Briefly explain the responsibility of partners with respect to:
- (i) Filing of the partnership tax returns. (2 marks)
 - (ii) Penalties for late payment of tax (2 marks)
- (Nov 2004 Question 2)**

QUESTION TWO

- (b) With reference to the provisions of the Income Tax Act, identify four methods which the Commissioner of Domestic Taxes is empowered to use in order to collect overdue tax from a taxpayer. (4 marks)
- (c) With the introduction of the self-assessment system in 1992, the Commissioner of Domestic Taxes does not raise assessments or send notices to taxpayers except in two circumstances.
Explain these two circumstances. (4 marks)
- (d) List six matters that are contained in a notice of assessment. (6 marks)
(Dec 2002 Question 1)

QUESTION THREE

The revenue authority may send its officers to employer's paying points to check the operations of PAYE system. Outline the key areas that the tax officers should include in the audit procedure on the operations of the PAYE systems

(10 marks)

(Dec 2008 Q.3)

QUESTION FOUR

With respect to payment of instalment tax, distinguish between agricultural and non agricultural entities.

(5 marks)

(Dec 2008 Q.1)

CHAPTER SIX



STUDY TEXT

VALUE ADDED TAX



CHAPTER SIX

VALUE ADDED TAX

► OBJECTIVES

- Describe the process of VAT registration
- Gain an understanding of the VAT regulation
- Explain how VAT tax is accounted for
- Determine the computation of VAT liabilities
- Recognise the point at which VAT is charged.
- Establish how to account for VAT and VAT records

► INTRODUCTION

In the previous chapters, we have been studying the Income Tax Act. In this chapter, we study value added tax (VAT) and Turnover Tax. VAT is a tax on turnover rather than on profits and was introduced in Kenya in January 1990 in replacement of Sales tax which had been in operation since 1973. As the name of the tax suggests, it is charged (usually at 16% on the value added. If someone in a chain of manufacture or distribution buys goods for Sh. 1,000 and sells them for Sh 1,200 he has increased their value by Sh. 200. (He may have painted them, packed them or distributed them to shops to justify his mark-up, or he may simply be good at making deals to buy cheaply and sell dearly.) Because he has added value of Sh. 200, he collects VAT of Sh. $200 \times 16\% = \text{Sh. } 32$ and pays this over to the government. The VAT is collected bit by bit along the chain and finally hits the consumer who does not add value, but uses up the goods.

VAT is a tax with simple computations but many detailed rules to ensure its enforcement. You may find it easier to absorb the detail if you ask yourself, in relation to each rule, exactly how it helps to enforce the tax.

In the next chapter we will look at Customs and Excise Tax.

► DEFINITION OF KEY TERMS

Value Added Tax: VAT is tax on spending which is collected by businesses and passed on to the Government. Value Added Tax is charged on the supply of goods or services in Kenya and on the importation of goods into Kenya

Tax invoice: Is a document which gives the description of goods supplied, their VAT rate, amount of VAT and total value of goods supplied by a supplier

Remission: This refers to the waiver by the Commissioner of Domestic Taxes of any tax payable by a tax payer i.e. the tax payers tax is written off.

Turnover Tax: Turnover tax is a tax on consumer expenditure. The applicable rate is **3%** of gross sales per annum and it is a final tax. It is applicable to any person whose annual turnover from business is more than Sh. 500,000 per annum and does not exceed Sh 5 million.

► EXAM CONTEXT

You may be required to advise on almost any aspect, such as registration, deregistration among others. Questions on this topic rarely miss in examinations.

► INDUSTRY CONTEXT

VAT is a very important tax for businesses as there are very few small enough to avoid it. This chapter will be useful in expounding on the rules that apply and also the requirement to install the electronic tax register.

6.1 INTRODUCTION AND DEVELOPMENT OF VAT IN A COUNTRY

Legal and Theoretical Framework

VAT is tax on spending which is collected by businesses and passed on to the Government.

Charge to Tax (S.5 VAT Act)

Value Added Tax shall be charged on the supply of goods or services in Kenya and on the importation of goods into Kenya.



□ The Preliminary Requirements

Before VAT may become chargeable in respect of the supply of goods or services EACH of the following requirements must be fulfilled:

- a) A supply of goods or services must take place;
- b) The supply must be a **taxable supply**;
- c) the goods or services must be supplied by a **taxable person**;
- d) the supply must be made in the course of furtherance of business carried on by the supplier;
- e) The supply must be made in Kenya. These requirements will be examined at a later stage.

■ Taxable Supply

Definition: A taxable supply is a supply of taxable goods or services made or provided in Kenya. The Act defines taxable goods as electricity and manufactured goods, other than those specified in the second schedule of the Act. The second schedule specifies the exempt supplies. The Act also defines taxable services as any service not specified in the third schedule of the Act.. **Exempt supply** is defined as the supply of goods specified in the second schedule or supply of services specified in the third schedule. Therefore taxable supply briefly can be defined as the supply of any goods or service unless the supply is an exempt supply.

■ Taxable Person

Definition: Taxable person means any person liable to apply for registration under the sixth schedule. Generally any person who makes or intends to make taxable supplies will be treated as a taxable person while he is, or is required to be registered.

■ Commencement of VAT

VAT is chargeable on the supply of goods and services or on the importation of goods taking place on or after January 1 1990. It replaced sales tax and this decision to replace sales tax with VAT was largely due to the perceived deficiencies in the sales tax system. These include:

- Sales tax system applied in Kenya was a single tax system. Sales tax was levied only once at the manufacture level. In a country where tax evasion is rampant, a single tax system would result in a higher revenue loss than would normally be the case if the system is multi-stage.
- Where inputs for manufacturing were subject to sales tax, then the imposition of sales tax on the finished product would result in the imposition of tax on tax (a cascade tax). This problem is worsened if the sales tax system is multi-stage since the imposition of tax on tax will be repeated several times over. It is also worse in a situation where a particular good is subject to more than one tax, e.g. sales tax and excise duty.
- The sales tax system used in Kenya like in many parts of the world has a limited scope. In Kenya, sales tax was levied on certain specific manufactured goods. Services did not fall under/within the scope of tax.

Sales tax therefore had a narrow base as compared to VAT with the result that revenue yield was comparatively low.

VAT is an indirect tax. It is essentially a tax on the domestic consumption in the economy. Under VAT, it is generally the end user that bears the tax. The tax is charged on each transaction in the production and distribution chain.

The system of VAT employed in Kenya and in many Commonwealth countries is the type known as “invoice – from – invoice” system. Under this system, VAT traders’ liability is determined by deducting VAT charged on supplies from output tax. The difference is the tax payable to or recoverable from the government. Different systems of VAT are in use in Asia and in Latin America.

Under the “Invoice-from Invoice” system, VAT is calculated on the basis of invoices issued on the point of sale. The application of the invoice method together with a system of tax credits means that it is necessary to calculate the value added by each transaction in the economic sense.

>>> Illustration

Assume a manufacturer acquires raw materials for Sh.100,000 on which VAT is levied at 16%. At each stage of the chain 25% conversion costs are incurred and a 30% mark up is made. The total VAT paid to the Kenya Revenue Authority will be Sh.68,656 made up as follows:

		Value Sh.	VAT Sh.
Stage 1	Supplier of raw material	100,000	
	VAT @ 16%	<u>16,000</u>	16,000 A
		<u>116,000</u>	
Stage 2	Manufacturer		
	Buying price	100,000	
	Conversion cost @ 25%	<u>25,000</u>	
		125,000	
	Mark up @ 30%	<u>37,500</u>	
	Selling price	162,500	
	VAT @ 16%	<u>26,000</u>	26,000
		<u>188,500</u>	
	Input tax (VAT on materials)		<u>(16,000)</u>
	VAT Payable		<u>10,000 B</u>
Stage 3	Wholesaler		
	Buying price	162,500	
	Additional cost @ 25%	<u>40,625</u>	
		203,125	
	Mark up @ 30%	<u>60,938</u>	
	Selling price	264,063	
	VAT @ 16%	<u>42,250</u>	42,250
	<u>306,313</u>		
Input tax		<u>(26,000)</u>	
VAT payable		<u>16,250 C</u>	

**Stage 4****Retailer**

Buying price	264,063	
Additional cost @ 25%	<u>66,016</u>	
	330,079	
Mark up @ 30%	<u>99,023</u>	
Selling price	429,102	
VAT @ 16%	<u>68,656</u>	68,656
Retail price	<u>497,758</u>	
Input tax		<u>(42,250)</u>
VAT Payable		<u>26,406 D</u>

VAT COLLECTION

Supplier of raw material	16,000	A
Manufacturer	10,000	B
Wholesaler	16,250	C
Retailer	<u>26,406</u>	D
	<u>68,656</u>	

**IMPORTANT TERMS IN VAT**

- Value Added:
It is the increase in worth of a supply when it changes hands in the line of manufacture and distribution.
- Output Tax
This is the VAT charged by a registered person when he makes a supply of taxable supplies in the course of his business.
- Input Tax
This is the VAT charged on a taxable person when he acquires taxable supplies for use in the furtherance of his business.
- Taxable person:
This is a person who is liable to apply for registration under the VAT Act (check registration for VAT).
- VAT payable/refundable
It is the difference between input and output tax. If output tax is more than the input tax the difference is the VAT payable. If input tax is higher than output tax the difference is the VAT refundable.
- Tax period
It means one calendar month. VAT is accounted for on a monthly basis.

Supply

This means transacting in taxable goods or services. Supply includes the following:

- a) The sale, supply or delivery of taxable goods to another person;
- b) The sale or provision of taxable services to another person.

- c) The appropriation by a registered person of taxable goods or services for his own use outside the business.
- d) The making of a gift of any taxable goods or services;
- e) Letting of taxable goods on hire, leasing or other transfers;
- f) Provision of taxable services by a contractor to himself in constructing a building and related civil engineering works for his own use, sale or renting to other persons.
- g) The receipt of a sum of money by a registered person for loss of taxable goods or services.

Any other disposal of taxable goods or provision of taxable services.

- **Taxable goods/ services**
 - Goods/ services on which VAT is chargeable.
- **Exempt goods/ services**
 - Goods/ services on which no VAT is chargeable.
- **Zero Rated Goods/services**
 - Goods/ services on which VAT is chargeable at 0%

(Check Input Tax Deduction).

VAT Rates:

There are two Rates in VAT

- 1) 16%: It is the general rate applied on all taxable goods and services except those in (2) below. (the 14% rate for restaurant and catering services was harmonized to the general rate of 16% w.e.f 1/1/2006)
- 2) 0%: It is the rate applicable to the zero rated goods and services
- 3) 12% for electricity consumption above 200,000KWh with effect from 2008.



OPERATION OF VAT

- Every registered person is required to charge VAT when he makes a supply of taxable goods and services. This VAT is referred to as output VAT. On the other hand, when a registered person is acquiring goods and services for use in the furtherance of his business, he pays VAT. This is known as Input Tax.



- At the end of the tax period, the taxable person is required to deduct the Input Tax from the output Tax and pay any balance thereof to the Commissioner of Domestic Taxes. If the input tax exceeds the output tax he carries the balance forward to offset it against the output tax in the next period

>>> Example

Mr. X, a registered trader had the following transactions in the month of March:

	Sh.
Sales	100,000
Purchases	70,000

Assuming the above figures are VAT exclusive and the VAT rate is 16%, show his VAT position for the month of March.

Output Tax	16% x 100,000	=	16,000
Input Tax	16% x 70,000	=	<u>11,200</u>
VAT payable			<u>4,800</u>

6.2 CLASSIFICATION OF TAXABLE GOODS AND SERVICES

VAT becomes chargeable when a supply is made by a taxable person in Kenya for the furtherance of a business.

The term “supply” is extensively defined in section 2 of the Act and must be studied carefully. However, in addition to providing an understanding of what supply means, this section of the chapter seeks to explain the nature of supplies, the time a supply is deemed to have occurred and the determination of value for tax.

Supplies of goods or services made by registered persons are either:

- standard rated;
- zero-rated; or
- exempt;
- supplies that are treated as neither supplies of goods nor supplies of services such as the Transfer of business as a going concern.

☐ Zero-rated Supplies

Where a taxable person supplies goods or services and the supply is zero-rated there are two significant consequences:

- (a) No tax is chargeable on the supply; but
- (b) The supply will in all other respects be treated as a taxable supply.

Accordingly, the rate at which tax is treated as charged on the supply will be nil, in contrast to the standard rate of 16% . The value of zero-rated supplies will be taken into the computation to determine whether the supplier is a taxable person who is required to be registered.

Zero-rating is the most favourable treatment for any transaction in the VAT system. Registered persons making zero-rated supplies are able to recover their input tax and usually find themselves in a refund position.

The government earns no revenue from zero-rated supplies. Consequently, zero-rating is granted sparingly to essential goods and services. Zero-rated supplies include:

- (a) Goods and services exported from Kenya;
- (b) Seeds, fertilizers, pesticides and hoes;
- (c) Educational materials, etc.
- (d) Maize flour
- (e) Paraffin

With effect from 15 June 2007 the following products have been zero rated. Milk powder, pyrethrum extract, locally assembled bodies of buses with carrying capacity of 25 passengers or more, solar, equipment and accessories, taxable goods and services provided for the construction or expansion of private universities recommended by the Minister of Education, excluding student hostels and staff housing.

In addition, certain people and institutions qualify for zero rating on supplies to them. (See the Eighth Schedule of the Act)

6.3 EXEMPT SUPPLIES

The VAT system only applies to a taxable supply made by a taxable person in the furtherance of his business. Where a person makes an exempt supply he will not be regarded as making a taxable supply. Consequently, no tax is charged on exempt supplies. In addition, the value of exempt supplies will be disregarded in determining whether the value of supplies made by a person exceeds the annual registration threshold. An exempt supply is a supply of goods specified in the Second Schedule or a supply of services specified in the Third Schedule.



A person who makes exempt supplies cannot obtain a refund of VAT suffered on supplies made to him. This is the disadvantage of making exempt supplies. Consequently, the person making the exempt supplies must absorb any VAT suffered on supplies inwards when determining pricing policy.

Like zero-rated supplies, the making of exempt supplies does not yield any revenue to the government (but does not require refunds of input tax) and will usually be restricted. Exempt supplies are listed in the Second Schedule to the VAT Act and include:

- (a) Unprocessed food-stuffs;
- (b) Fuel;
- (c) Plant and animal products;
- (d) Wooden coffins;
- (e) Bank notes, etc

VAT is chargeable if there has been a supply of taxable goods or services in Kenya, by a taxable person in the course of furtherance of a business. This means any supplies taking place outside Kenya will not be within the jurisdiction of the Kenya Revenue Authority, unless such goods or services have been imported into Kenya.

6.4 REGISTRATION AND DE-REGISTRATION OF TAXABLE PERSONS

Registration For VAT

This is the process by which traders who are eligible for registration under the VAT Act are issued with registration certificates. It is an important process because only registered traders are allowed to charge VAT. It is important to note that it is an offence to charge VAT if you are not registered.

Who qualifies for registration?

- a) Any person who in the course of his business has supplied, or expects to supply taxable goods or services or both with a value which is Sh 5 million or more in a period of 12 months should apply for registration. Suppliers with turnover of less than Sh 5 million in a period of 12 months are required to pay Turnover tax.

Types of Registrations

a) Normal Registration:

This occurs when a trader who meets the registration requirements applies for registration and is duly registered and issued with a registration certificate.

b) Voluntary Registration:

Occurs when a trader who is not qualified for registration applies for registration so as to enjoy the benefits of a registered person. It is subject to the approval of the Commissioner.

c) Intending Trader Registration:

It occurs when a trader who expects to deal in taxable goods and services applies for registration before he commences trading.

d) Compulsory Registration:

It occurs when a trader who qualifies to register fails to do so. In such a case, the trader once he is identified is issued with a registration certificate without his application. Tax can also be demanded from him on any sale made in the past.

e) Temporary Registration:

This occurs when a trader who has not been registered applies to be registered so as to undertake certain business transactions. He is issued with a temporary registration number.

Note

1. Any registered trader is required to display his registration certificate in a visible position in his business premises.
2. Any trader who is eligible for registration and fails to apply for registration is liable to a default penalty of Sh. 100,000.
3. In order to register the following documents are required:
 - Personal Identification Number (PIN) of the sole proprietor, partner or director
 - A copy of the certificate of registration of business name:



DEREGISTRATION

It is the process of removing a registered trader from the VAT register. Any trader wishing to be de-registered for any reason may apply to the commissioner of Domestic Taxes.

De-registration may be requested on the following grounds

- i) Closure of business
- ii) Sale/transfer of business
- iii) Death of a trader



- iv) Legal incapacitation (Bankruptcy)
- v) Insolvency
- vi) Change of business status eg. Partnership to limited company
- vii) If the turnover falls below the prescribed limit.

Before de-registration, any tax outstanding must be paid to the commissioner of Domestic Taxes. Once the trader is de-registered he is notified of the effective date of deregistration and from that date he should not charge VAT. The original registration certificate should be surrendered to the Commissioner of Domestic Taxes.

Transfer of a Going Concern (TOGC)

The scope of VAT has been defined earlier in the chapter. VAT is chargeable on the supply of taxable goods and services made by a taxable person in the furtherance of a business. In principle, the transfer of the assets of a business falls within the scope of VAT. A transfer of business assets may take different forms. The following are some examples:

- The assets may be bought by another person and the existing business may cease to trade
- The existing owner may die or retire and the business assets be taken over by another person
- Part of an existing business may be sold to another person
- The assets may be transferred to a new legal entity, e.g. a sole proprietor may take on a partner.

In all these cases the assets are transferred from one person to another and so may be covered by the TOGC provisions. In principle, TOGC provisions serve two purposes:

- (a) to help businesses by improving their cash flow and avoiding the need to separately value assets which may be liable at different rates or are exempt which have been sold as a whole, and
- (b) to protect the revenue by removing a charge to tax and entitlement to input tax where the output tax may not be paid to government.

TOGC provisions therefore seek to “de-supply” the transfer of business assets. Technically, when a TOGC occurs the law does not recognize a supply and VAT is not chargeable.

Paragraph 21 of the Sixth Schedule provides that where a person disposes of a registered business as a going concern to another registered person, both persons must provide the Commissioner with details of:

- (a) the transaction,
- (b) arrangements made to pay any outstanding tax;
- (c) the description, quantities and value of assets and stock of taxable goods on hand at the date of disposal;
- (d) the arrangements made for transferring the responsibility for keeping the records and producing books of the business for the period before disposal.

■ Notification of Changes in Registration Details

Under paragraph 19 of the sixth schedule to the Act, a registered person is required to notify details to the Commissioner within fourteen days of the following changes:

- (a) Change of address of the place of business; or
- (b) Additional premises are, or will be used for the purpose of the business; or
- (c) Premises used for the business cease to be used; or
- (d) Business or trading name is changed; or
- (e) An interest of more than thirty percent of the share capital of a limited company has been acquired by a person or group of persons; or
- (f) The person authorised to sign returns is changed;
- (g) The partners in a partnership are changed;
- (h) A change in the trade classification of the goods or services supplied.



6.5 RIGHTS AND PRIVILEGES OF A VAT REGISTERED PERSON

RIGHTS OF A REGISTERED TRADER

1. To deduct allowable input tax
2. To get refund where input tax exceeds output tax as a result of other dealing with zero-rated supplies or making heavy capital investment.
3. To get relief for stock in trade as at the time of registration.
4. To get relief or refund on capital goods (including buildings) acquired or put up within twelve (12) months prior to the date of registration.
5. To get a refund of bad debts.
6. To defer payments of tax due to a date not later than 20th day of the month succeeding that in which tax is charged.
7. To request for reconsideration of an assessment.
8. To appeal to the tribunal.
9. To demand that every authorized officer identifies himself/herself.
10. Have free access to the Commissioner or any other authorized officer.
11. To expect that information obtained in the course of duty by the VAT officers shall be treated in confidence
12. To expect minimum interference
13. To be treated fairly and with equity.
14. To be given assistance in understanding their obligations.

OBLIGATIONS OF A TAX PAYER (REGISTERED TRADER)

1. To apply for registration.
2. To charge VAT at the right rate on all his taxable supplies
3. to pay tax to his registered suppliers
4. To issue a tax invoice for every supply made by him.
5. To submit monthly returns to the VAT department.
6. To pay to the Commissioner any amount he may have charged on an invoice by error.
7. To keep full and true records written up to date and retain for 5 years.
8. To avail records to authorized officers of the department at any reasonable time for inspection.
9. To produce for examination by the Commissioner or an authorized officer any records, books of account, balance sheets or other documents as may be required.
10. To allow an authorized officer to enter premises upon which he carries on business:
11. To notify details to the commissioner of any changes affecting his business.

OBJECTIONS AND APPEALS:

A taxpayer can object to any decision made by the Commissioner of Domestic Taxes on matters relating to VAT. In objecting, the taxpayer will request the commissioner to reconsider the decision stating reasons thereof:

APPEAL

A taxpayer has the right to appeal to an independent tax tribunal when there is a dispute between him and commissioner on matters relating to the VAT Act.

The independent VAT tribunal is established by the Minister for Finance through the Kenya Gazette. It consists of the chairman and not less than 2 but not more than 5 other members.

Process of Appealing

If the taxpayer wishes to appeal, he should do so in writing within 30 days from the day he is notified of the commissioner's decision (which he is disputing). The appeal is entered by presenting the memorandum of appeal in 10 copies and presenting it to the secretary of the tribunal within 14 days after giving the notice of appeal i.e. he must give a notice of appeal before appealing.

The memorandum of appeal should be accompanied by:

- a) Copy of the commissioner's decision in dispute.
- b) Copy of the notice of appeal
- c) Statement signed by the taxpayer stating the grounds on which he is appealing and any documentary evidence should be attached.

On receiving the appeal documents, the secretary to the tribunal shall furnish a copy to the commissioner within 48 hours. If the commissioner does not accept the facts therein, he may make a statement within 21 days. The commissioner should also give a copy of such a statement to the taxpayer.

For an appeal to be accepted the taxpayer must pay any unpaid tax that is not in dispute and all his tax returns (VAT 3) must be up to date.

Hearing of the appeal

The chairman will determine time, date and place of hearing. The secretary to the tribunal will notify the taxpayer and other parties usually 7 days before the hearing. Any interested party may be represented by an advocate or any other person.



■ Powers of the Tribunal

The tribunal may call witnesses, take evidence and call for the production of books and other documents that it deems necessary.

The tribunal can also award costs in any case. Any person summoned by the tribunal to give evidence or produce any records books, statements or to be interrogated and fails to do so, is liable to an offence. The penalty for such an offence is a fine not exceeding Ksh. 15,000 or 2 year imprisonment or both.

Any person not satisfied by a decision of the tribunal may appeal to the High Court within 14 days of being notified of the decision.

■ ■ ■ ■ 6.6 ACCOUNTING FOR VAT, TAXABLE VALUE, TIME OF SUPPLY

TAXABLE VALUE

It is the value of a supply on which VAT is due. It is the consideration given in exchange for a supply and it may be payment in money or in any other form. The taxable value is important because it is on this value that we calculate VAT.

Rules for determining the Taxable Value.

- a) If a discount is offered on a supply the taxable value is the value of such a supply, less the discount offered.
- b) If the consideration is not in money (Barter Transaction) the taxable value will be the consideration which would have been paid if money was the only consideration (open market value).
- c) For imported services the taxable value shall be the price at which the services are provided.
- d) For imported goods the taxable value shall be the cost of such goods plus any duty or customs payable on such goods.

Note

- Cost of Imported goods = Invoice price (cost) + Insurance + Freight
- Cost of Imported goods is also known as the CIF value.

- e) To determine the taxable value, any amount charged on: packaging, advertising, financing, servicing, warrants, commission and any other liability that the purchaser has to pay in addition to the price, is added to the price of the commodity.

Tax Point

- This is the point in time at which the tax (VAT) becomes due and payable. For VAT to become due and payable a supply must have taken place.
- VAT is accounted for on monthly basis. VAT should be accounted for in the month in which the tax point occurred using the VAT rate that was in force at that time.

Tax Point is determined as follows:

- a) When the goods are supplied or the services provided to the purchaser or;
- b) An Invoice is issued to the purchaser in respect of the supply, or;
- c) Payment is received for all or part of the supply, or
- d) When a certificate is issued, by an architect, surveyor or any person acting as a consultant or in a supervisory capacity, in respect of the service,

Whichever of the four occurs earliest.

Note

- (d) applies to contracts for service like construction, surveying etc.

For VAT purposes, the tax becomes due and payable at the tax point. However, the registered traders have been given an allowance of up to 20th of the following month to make the payment to the Commissioner of Domestic Taxes. For example the VAT charged in the month of January 2006 is payable by 20th February 2006.

>>> Example

X, who is a registered trader delivered goods to Y on 21st January 2006. He issued an Invoice for the goods on 10th February 2006. Y paid for the goods on 3rd March 2006. When should X pay the VAT on those goods to the commissioner?

>>> Answer

- The tax point on such goods is 21st January 2006. The VAT should be paid by 20th February 2006.

**Note**

VAT is payable whether payment has been received or not as long as the tax point has occurred.

6.7 CHARGE TO TAX, DEDUCTIONS OF INPUT TAX, APPORTIONMENT METHOD OF INPUT TAX

INPUT TAX DEDUCTION

Traders registered for VAT are entitled to claim all the VAT they incur on purchase of supplies for use in the furtherance of their businesses. This VAT (Input Tax) is claimed by deducting it from the Output tax.

However for Input Tax to be deducted it must fulfill the following conditions:

1. It must relate to taxable supplies for use in the furtherance of business.
2. The trader must be registered for VAT.
3. It must be claimed within 12 months from the month it is incurred

Note

Input tax on purchase of stock and on the construction of business premises incurred before commencement of business must be claimed within 30 days after registration.

4. The Input Tax must be evidenced by a tax invoice. For imports, Input Tax is evidenced by documents from the customs department.
5. Input Tax claimed must be shown in the monthly VAT payment document (VAT return).

INPUT TAX APPORTIONEMENT

A registered trader may be dealing in supplies taxed at the general rate, zero rated supplies and exempt supplies. Such a trader will also incur Input Tax on purchase of supplies that are related to all the items that he deals in.

For example, an expense like electricity will be used in the business for making all the business supplies.

In such a case, it is important to note that only the Input Tax that relates to the taxable supplies can be claimed. Taxable supplies refer to supplies taxable at 16%, 12% and 0%.

The deductible Input Tax is determined using the following formula.

$$\text{Deductible Input Tax} = \frac{\text{Value of Taxable Supplies}}{\text{Value of Total Sales}} \times \text{Input Tax}$$

Note:

The Input Tax to be apportioned is the Input Tax that relate to both the taxable supplies and the exempt supplies.

>>> Example

Mr. X a registered trader, incurred input tax of Sh.500 on purchase of his stock. Out of this stock, he sold as follows: Goods taxable at 16% worth Sh. 2,000, zero rate goods worth Sh.2,000, and exempt goods worth Sh.2,000. He will claim the following Input Tax.

$$\text{Deductible Input Tax} = \frac{\text{Taxable supplies}}{\text{Total supplies}} \times \text{Input Tax}$$

$$\frac{2,000 + 2,000}{2,000 + 2,000 + 2,000} \times 500 = \text{Sh } 333$$

6.8 VAT RECORDS

Records and accounts

Tax invoices — Taxable persons supplying goods or services to other taxable persons are required to provide with invoices referred to as tax invoices. These provide documentary evidence of goods and services supplied and will be indispensable to the persons acquiring goods or services when claiming relief for input tax suffered.

The tax invoice must be issued at the time of the supply or within 14 days of the completion of that supply. No tax invoice should be issued for any supply if:

- a) The supply is not a supply of taxable goods or services.
- b) The supplier is not a registered person.



If an invoice is issued in contravention of the above regulations any tax shown thereon shall become due and payable to the commissioner within seven days of the date of the invoice.

If payment is received prior to the delivery of goods or the rendering of services, a tax invoice must be issued immediately.

W.e.f 1.1.2007, traders must install Electronic tax registers and their tax invoices should be generated by the machine.



Particulars to be stated on a full tax invoice

- i) The name, address, VAT registration number and PIN of the person making the supply;
- ii) The serial number of the invoice;
- iii) The date of the invoice;
- iv) The date of the supply, if different from (iii) above;
- v) The name, address and VAT registration number, if any, of the person to whom the supply was made, if known to the supplier;
- vi) The description, quantity and price of goods or services being supplied;
- vii) The taxable value of the goods or services, if different from the price charged;
- viii) The rate and amount of tax charged on each of those goods and services;
- ix) Details of whether the supply is a cash or credit sale and details of cash or other discounts, if any;
- x) The total value of the supply and the total amount of VAT charged.

W.e.f 1.1.2007, the requirements of a tax invoice have been widened to include:

- ◆ The company's business logo and
- ◆ The business register identification number.

A tax invoice must be serially numbered and issued in serial number order.

Where cash sales are made from retail premises a registered person may issue simplified tax invoices.

Where cash sales to any one person in any day do not exceed five hundred shillings, the registered person may use other methods of accounting for tax.

A Simplified tax invoice shall include the following information:

- i) The name, address, VAT registration number and PIN of the person making the supply;
- ii) The serial number of the invoice;
- iii) The date of the invoice;
- iv) A brief description of the goods or services being supplied;
- v) The total amount charged to the customer, VAT included;
- vi) The explicit statement that the price includes VAT.

Retailer's issue of tax invoices

The issue of tax invoices by retailers involved in making of numerous supplies would clearly produce an impossible burden. This is recognized by a direction that a taxable person who is a retailer is not generally required to provide a tax invoice. The commissioner has authorised an alternative method of accounting where the supplies to any one person in any day do not exceed Sh 500 as follows:

- a) Record the value and brief detail of each supply as it occurs and before the goods leave the premises.
- b) Keep a cash register book or other suitable record at each point of sale in which should be entered all the details of cash received and cash payments at the time they were made and at the end of the day the record totalled and a balance struck.

At the end of each day record the output tax chargeable on supplies made and the deductible input tax in respect of supplies received. However the retailer must provide such an invoice at the request of a customer who is a taxable person in respect of any supply to him. At the end of the business, records must be kept for at least seven years. Cancelled or damaged tax invoices should be kept in sequence for the inspection of by VAT officers. If records are lost or destroyed the local VAT office should be notified immediately. If tax invoices received are lost, the business should obtain a copy from the supplier, which must be marked **duplicate**.

Other records

- a) A record of all the taxable goods and services received or supplied by the firms, businesses, including zero rated supplies.
- b) A separate record of any exempt supplies made.
- c) A summary of the total of input tax and output tax for each calendar month. This is called VAT account.
- d) Copies of all invoices issued, in serial number order.
- e) Copies of all credit and debit notes issued in chronological order.
- f) All purchase invoices, custom entries, receipts for payment of customs duty or tax, and credit and debit notes received. These should be fitted chronologically by date or under each supplier's name.
- g) Details of goods manufactured and delivered from the factory of the taxable person.
- h) Details of each supply of goods and services from the business premises.
- i) Other business records namely—orders and delivery books relevant business correspondence, appointment and job books purchase and sale books, cash books, petty cash vouchers, annual accounts, import and export documents, balance statements and pay in slips, records of daily takings.
- j) Rate and amount of tax charged on each of those goods and services provided.
- k) Details of cash or other discounts.
- l) Details as to whether the supply is for cash or credit.
- m) Total value of supply and total amount of VAT charged.

**>>> Example of tax invoice**

Invoice No. 22

Date 20.1.2007

From: Accessories (Kenya) Ltd,
P.O. Box 90,000
Kenyatta Avenue, Nairobi.

VAT Reg No.10250
Date of supply 20.1.2007

To: Smart Suits Ltd,
P.O. Box 90,001,
Moi Avenue, Nairobi.

VAT Reg. No. 10597

Quantity	Description and size	Amount Exclusive VAT	VAT rate	VAT net
10 pairs	leather gloves @ Sh 200	2,000	16%	320
50 pairs	Men suits @ Sh 2,000	100,000	16%	16,000
50 pairs	Cuff links plated @ Sh 100	5,000	16%	800
Terms Cash	Totals	Totals 107,000 VAT <u>17,120</u> Total 124,120	— — —	17,120

 The Value Added Tax (VAT) account

The VAT account is posted with month totals. Total input tax for the month is debited to the account and the total output tax credited. A credit balance would represent the tax payable to the commissioner while a debit balance will represent excess input tax which is carried forward and offset against output tax of the following month. In order to obtain monthly totals, the sales ledger control account may carry an extra column to record VAT on credit sales, the purchase ledger control account may also have a column for VAT on purchases. The cashbook may be analyzed to show VAT on cash transactions.

 Value Added Tax (VAT) returns

Registered persons are required to submit a VAT return (form VAT 3) by 20th day or not later than the last working day of the month following the month covered by the return if the 20th day is a weekend or a public holiday. The return should show separately for each rate of tax:

- a) Particulars of the total value of supplies.
- b) The rate of tax to which the supplies are liable.
- c) The amount of tax payable.
- d) The total value of taxable supplies received.
- e) The rate at which tax was paid.
- f) The amount of tax paid in respect of which deductible input tax is claimed.

If no transactions are carried in any month a NIL return is submitted. The taxpayer should keep a copy of returns made for record purposes.

Audit Procedures

When a business is subject to an independent audit, the audit should cover the VAT account and other matters relating to VAT.

6.9 VAT DUE FOR PAYMENT/CREDIT

PAYMENT OF VAT

All registered traders are required to pay any VAT payable by the 20th of the month following the month to which the tax relates. Payment is made together with a document known as the VAT return. This return is also known as VAT 3. It is important to note that whether there is any VAT payable or not, a VAT return must be submitted

Payment of VAT can be made at any VAT regional office or to the Central Bank of Kenya.

6.10 REMISSION, REBATE AND REFUND OF VAT

Special matters relating to payment of VAT

A. REMISSION OF VAT

This refers to the waiver by the Commissioner of Domestic Taxes of any tax payable by a tax payer i.e. the tax payers tax is written off. The commissioner can waive wholly or partly any tax payable if he is satisfied that it is in the public interest to do so. Where a remission is granted under a certain condition, the tax shall become payable in the event of breach of the condition.



W.e.f 11th June, 2004 where a taxpayer voluntarily discloses any unpaid VAT and pays it to the CDT before 31st December 2004 the CDT shall remit any additional taxes in form of interest and penalties that would otherwise accrue to the taxpayer. However, such remission is not applicable where the person:

- (a) Has been assessed by the VAT department.
- (b) Is under audit or investigation by the VAT department.

Section 23 (1) of Cap. 476 states that the minister for finance has power to remit tax if he is satisfied that it is in public interest to do so.

- (a) Remission of tax applies to all taxable persons but shall be granted only in respect of: goods manufactured for exports where the manufacturer is bonded to manufacture for exports only for at least three (3) years.
- (b) Capital goods including motor vehicles and computers donated or purchased for donation to NGO's or other institutions approved by the government. This has been removed with effect from 15/06/2007.
- (c) Goods imported or purchased by a company that has been granted oil exploration licence subject to specified conditions.
- (d) Taxable supplies to projects funded through donations approved by the government for the benefit of the poor and destitute persons.
- (e) Goods for use by the Kenya Armed Forces.
- (f) Goods including motor vehicles imported or purchased by any company granted Geothermal Resource Licence.
- (g) Goods imported for use in official aid funded projects.
- (h) Capital goods excluding motor vehicles imported or purchased for investment subject to the provisions of section 117 of customs and excise Act and section 39 of Cap 470. (Refer to Tax credits set offs available to body corporates).

NB:

Remission of VAT is proactive such that the person applies for waiver of VAT if he deals with the above goods. Refund is reactive since the tax payer is reimbursed V.A.T after payment.



B. REFUND

It is the repaying (paying back) by the commissioner of tax that the taxpayer had paid to the Commissioner.

Refund of tax may occur in the following situations:

1. Where goods have been manufactured in Kenya or imported into Kenya and tax paid thereon, but before being used in Kenya, such goods are exported.

2. Tax paid in Error:

It is important to note that if the commissioner refunds any tax in error or grants a remission in error, then the taxpayer is required to pay such tax on demand by the commissioner.

If a taxpayer pays any tax in error (e.g. due to miscalculation) he is entitled to a refund.

3. Refund of tax on Bad debts:

Where a registered person has supplied goods or services and has accounted for the tax on that supply but has not received any payment from the buyer, he may after a period of 3 years from the date of such supply or where the buyer has become legally insolvent, apply to the commissioner for a refund of tax or remission of the tax.

- 4 . A refund is also given if in the opinion of the Minister for Finance, it is in the public interest to do so eg. in times of drought, floods or other calamities.



C. RELIEF DUE TO DOUBT OR UNCERTAINTY IN RECOVERY OF TAX

If the commissioner is of the opinion that:

- a) There is uncertainty as to any questions of law or fact or,
- b) There is uncertainty or undue difficulty or it proves expensive to recover tax, then he may abstain from recovering such tax and hence such tax is written off.



D. ISSUE OF SAMPLES

Where taxable goods:

- a) Are distributed free as samples by a registered person for the furtherance of his business and
- b) Such goods have a value of less than Sh 200 per sample and
- c) They are freely available and
- d) Are not limited in distribution to fewer than 30 persons in any calendar month.

Then such goods are not liable to VAT.



E. SECURITY FOR UNPAID TAX

The commissioner can apply to the Registrar of Lands, to put any Land and buildings belonging to a defaulting taxpayer as security for tax. Such property can not be sold until all tax is paid. The commissioner may also require that a taxpayer provides security in any form for any tax unpaid.



6.11 COLLECTION AND RECOVERY OF TAX

The Commissioner of Domestic Taxes (CDT) can collect and recover unpaid VAT in a number of ways.

1. Through the use of an agent (Section 19(a))
The CDT may appoint any person who purchases taxable goods and services as a tax withholding agent who is required to withhold the VAT applicable and remit it directly to the CDT.
2. Through distraint (Section 18)
The CDT is empowered to exercise distress upon the goods and chattels of the person from whom tax is recoverable i.e. auctioneering such goods and chattels. All the costs incurred in executing the distress is borne by the taxpayer.
3. Security of land and buildings (section 20)
The CDT may not find the person who fails to pay VAT of his intention to apply to the registrar of land to have the land and buildings to be the subject of security for tax if after 30 days of issuing the notice the taxpayer still fails to pay the tax due.
4. Collection of VAT as a civil debt (section 22)
The CDT may recover any VAT due and payable by suing the taxpayer such that the tax owed to the government is equivalent to a civil debt.
5. Power to collect tax from person(s) owing money to the taxpayer (Section 19(1))
The CDT may recover VAT due and payable from a person who owes money to the taxpayer. Accordingly the CDT may by notice in writing require any person;
 - (a) From whom any money is due or may become due to the taxable person or
 - (b) Who holds or may subsequently hold money on account of the taxable person or
 - (c) Who holds or may hold money on account of some other person for payment to the taxable person or
 - (d) Any person having authority from some other person to pay money to the taxable person.

In the above circumstances the CDT will require such a person to pay to the **CDT** that money as may be sufficient to pay the tax due and payable by the taxpayer.

6.13 REFUND OF TAXES AND WAIVERS

VAT Refunds

If, for any tax period, a person has over-paid tax, i.e. the input tax claimed exceeds the output tax for the period; the excess amount is carried forward to be set-off against output tax for the following period. However, if this position is a regular feature of the business then the Commissioner shall refund the excess amount.

No tax is refundable if the registered person is not up to date in the submission of VAT returns.

The claim for refund must be made on the appropriate form within a period of twelve months.

■ The C-VAT may refund tax under the following circumstances:

- Where payment has been made in error e.g. over payment of VAT, use of wrong rate, miscalculation etc.
- Where input tax persistently exceeds output tax and this is a regular feature of the business.
- Where goods are imported, VAT charged and then exported before being used, VAT paid will be refunded.
- When payment for supply of goods/services have been received (bad debts) under Sec. 24. A refund for bad debt is made within 5 yrs.
- VAT refund for bad debt is claimable if:
 - (i) The debtor had been declared legally insolvent or
 - (ii) The debt has been outstanding for more than 3 years.
- Where input VAT was charged on goods purchased, civil works, building constructed etc. for making/manufacturing taxable supply before an individual became registered. Such claim for refund is made in form VAT 5 within 30 days from the date of approval of registration by C-VAT.
- Where refund is in public interest in the opinion of Minister for Finance. Such a claim is made in for VAT 4 within 12 months of paying VAT.
- Refund of input tax on capital investments incurred where the input tax exceeds Sh. 1,000,000 and investments are used in making taxable supplies.

■ Documents accompanying claim for refund under Sec. 24 (bad debts)

1. Confirmation from liquidator that debtor has become insolvent and proof of debt amount.
2. Copies of relevant tax invoices issued at time of supply to the insolvent debtor,
3. A declaration that he debtor and tax payer are unrelated companies/persons.
4. Records/documents showing input tax paid by the tax payer e.g. VAT account, bank pay-in-slips etc.



□ VAT refund audit procedure

- Under legal notice issued 18/11/99, tax refunds and claims for tax relief exceeding Sh. 1,000,000 shall be accompanied by auditor's certificate.
- The certificate should state that the claim is true and the amount claimed is properly refundable under VAT Act.
- The following audit procedure is followed by auditor before issuing such a VAT refund certificate.

The following is a suggested program of work to be carried out by an auditor certifying a VAT refund. It is not exhaustive and may require tailoring to circumstances.

5. Review and document the adequacy of the system of recording and accounting for VAT.
6. Ensure that the VAT 4 corresponds with the supporting VAT return and that the entries in the return agree to the books of account.
7. Establish why the trader is in refund position (e.g. trader in an exporter, inputs taxed at higher rate than outputs, significant capital expenditure, seasonal trading/purchases, etc). The reason for the refund must be soundly based.
8. Check if the trader is subject to partial exemption rules, and if so, whether the rules have been applied correctly as required by regulation 17, especially the annual adjustment.
9. Select a sample of invoices from VAT 4 and perform the following tests where applicable:
 - a. Input tax has been claimed within 6 months after the issue of the invoice.
 - b. The invoices meet the requirement of Regulation 4.
 - c. Simplified tax invoices have not been used to claim relief.
 - d. The invoices are not photocopies or fax copies.
 - e. Ensure that input tax in respect imported goods is properly supported by a Customs Entry form and contained within an original KRA receipt for payment of duty and VAT.
 - f. Ensure that tax has been properly accounted for in respect of imported services (reverse charge).
 - g. Ensure the input tax does not relate to items scheduled on the blocking order VAT Order, 1994.
 - h. Ensure input tax has not been claimed in advance.
 - i. Trace the invoices to the relevant ledger accounts.
 - j. Confirm that the expenditure is business related and not private.
10. Obtain the workings supporting the output tax on the VAT return, if any, and select a sample and perform the following tests where applicable:
 - a. Check that the correct rate of VAT was applied.
 - b. Ensure that sales were accounted for in the correct tax period.
 - c. Trace the invoices to the relevant ledger accounts.
 - d. In the case of exports, ensure a payment has been received in respect of the goods or services exported and the proper documentation supporting export is in place.
 - e. Ensure that VAT has properly been accounted for in respect of miscellaneous sales.

11. Ensure, where applicable, that VAT on intra-group transactions has been properly accounted for.
12. Ensure all VAT returns were submitted on time. If not, compute the penalties and interest to be deducted from the claim, if the trader has not done so.
13. Prepare a statement analyzing the current claim.



The impact of VAT Audit will focus on:

- Assessment of VAT not correctly charged.
- Disallowance of input tax incorrectly claimed.
- Identification of other offences and errors.
- Levying of penalties and interest for the default and errors.
- Educating tax payers thereby ensuring better compliance in future.

If, for any tax period, a person has over-paid tax, i.e. the input tax claimed exceeds the output tax for the period; the excess amount is carried forward to be set-off against output tax for the following period. However, if this position is a regular feature of the business then the Commissioner shall refund the excess amount.

No tax is refundable if the registered person is not up to date in the submission of VAT returns.

The claim for refund must be made on the appropriate form within a period of twelve months.

6.12 OFFENCES, FINES, PENALTIES AND INTEREST

- (a) Any person who makes false statements, false documents, false returns, a non-registered person, fraudulent evasion of tax:
 - Fine not exceeding Sh.400,000 or double the tax evaded, whichever is the greater and/or imprisonment for a term not exceeding three years.
 - Forfeiture of any goods which have passed with the commission of the offence.
- (b) Failure to submit a return
 - Penalty of Shs.10,000 or 5% of VAT due whichever is higher (Sh. 10,000 if a refund is due).
- (c) Failure to keep proper records
 - penalty of between Shs.10,000 and Shs.200,000
- (d) Failure to supply a tax invoice
 - Penalty of between Sh 10,000 and Sh 200,000. Any goods connected with the offence are liable to forfeiture.



- (e) Later registration
 - Penalty of up to Sh.20,000
- (f) Failure to display registration certificate
 - Penalty of up to Sh.20,000 and a fine of up to Shs.200,000 and/or imprisonment for up to two years.
- (g) Late payment of tax – 2% per month interest penalty compounded.

Liability of employers and officers of companies

Where an offence is committed by an employee or agent, the employer shall be guilty of the offence unless he proves otherwise.

Where an offence is committed by a company every director and officer of the company concerned in the management thereof shall be guilty of an offence unless he proves the offence took place without his knowledge or consent.

Any person who without reasonable excuse fails to produce books, records, or provide information as required by the Commissioner or an authorised officer shall be guilty of an offence and liable to a fine not exceeding Sh 6,000 or twelve months imprisonment or both.

General Penalty

For offences under the VAT Act for which no other penalty is provided; a maximum of Sh. 500,000 and/or three-year imprisonment.

Late payment

Late payment of tax produces additional tax equal to 2% per month of the unpaid tax compounded.

Penalties imposed under the VAT Act include the following:

1. Late payment of tax attracts an additional tax equal to 2% compounded per month or part thereof of the unpaid amount. The additional amount shall be deemed to be tax and shall attract further additional tax if not paid after becoming due and payable.
2. Failure to comply with the Commissioner's notice to pay to the Commissioner, money owed to a taxable person from whom tax is due, or furnish a return showing moneys held for or due to a taxable person from whom tax is due-fine not exceeding Sh 15,000 and/or up to six months imprisonment and liability to pay the amount discharged.
3. Failure to produce books, records or provide information as required by an authorised officer-fine not exceeding Sh 15,000 and/or up to six months imprisonment.

4. Failure to produce books, records, statements or other documents or to attend summons or to answer questions put by the VAT Tribunal –*fine not exceeding Sh 15,000 and/or up to two years imprisonment.*
5. Making false statements, producing false documents providing false information, involvement in fraudulent evasion of tax, a non-registered person who holds himself out as a registered person –*fine of up to Sh 400,000 or double the tax evaded, whichever is the greater. In addition, any taxable goods connected with the commission of the offence may be forfeited.*
6. Failure to display registration certificate in a visible place in the business premises *default penalty of up to Sh 20,000 and a fine of up to Sh 200,000 and/or imprisonment for up to two year.*
7. Late submission of application for registration -*penalty of Sh 20,000*
8. Failure to register – Fine not exceeding Sh. 20,000 or imprisonment for a term not exceeding six months or both. Enforce registration
9. Failure to issue a tax invoice as required -
Penalty of between Sh 10,000 and Sh 200,000. Any goods connected with the offence are liable to forfeiture.
10. Failure to keep proper books or records - penalty of between Sh 10,000 and Sh 200,000.
11. Failure to submit a return - penalty of Sh 10,000 or 5% of tax due whichever is higher.
12. General penalty - offences under the Act for which no other penalty is provided are subject to a maximum fine of Sh 500,000 and/or up to three years imprisonment.
13. Where an employee or agent commits an offence, the employer shall also be guilty of the offence unless he proves his innocence.
14. Where a company commits an offence, every director and officer of the company concerned with the management of the company shall also be guilty of the offence unless he proves his innocence.
15. The Commissioner is empowered, subject to specified conditions, to compound offences under the Act. The order issued by the Commissioner in such a case can be enforced as if it were a decree or order of the High Court. The taxpayer whose offences have been compounded is not liable to prosecution except with the express consent of the Attorney General.
16. Failure to withhold VAT, remit withheld VAT Sh.10,000 or 10% of tax due whichever is higher. Same applies to any person withholding VAT when not appointed to do so.
17. Making fraudulent VAT claims for refund attracts double the amount claimed or imprisonment for a period not exceeding 3 years or both.



POWERS OF THE COMMISSIONER

Legal authority is given to the commissioner in the law to administer to tax and the commissioner's powers are delegated to the authorised officers of the department appointed under the VAT Act.

These include:

- (a) To enter business premises without any warrant during normal working hours or at any time when there is evidence of fraud.
- (b) To examine premises, books, documents and records.



- (c) To have and exercise all the rights, powers, privileges and protection of a police officer.
- (d) To require security for VAT liability.
- (e) To levy distress on goods and chattels
- (f) To take samples
- (g) To have priority of tax in bankruptcy, winding up, receivership and distribution of assets in death.
- (h) To require production of any documents useful for investigations with regard to assessment, refund and offences.
- (i) To apply for an order to charge the VAT debt against land or property owned by a registered person.
- (j) To assess the amount of tax due in case of failure by the taxable person to do so.
- (k) To collect the tax due.



LIABILITY FOR OFFENCES

- i. Where an employee or agent commits an offence, the employer shall also be guilty of the offence unless he proves his innocence.
- ii. Where a company commits an offence, every director, general manager, secretary and officer of the company concerned with management of the company shall be guilty of the offence unless he proves his innocence.
- iii. The Commissioner is empowered, subject to specified conditions, to compound offences under the Act.

CHAPTER SUMMARY

- It is only registered traders who are allowed to charge VAT on Taxable supplies.
- VAT tax becomes due and payable at the tax point. However, the registered traders have been given an allowance of up to 20th of the following month to make the payment to the Commissioner of Domestic Taxes.
- Input tax on purchase of stock and on the construction of business premises incurred before commencement of business must be claimed within 30 days after registration.
- Before de-registration, any tax outstanding must be paid to the commissioner of VAT
- Taxable persons supplying goods or services to other taxable persons are required to provide with invoices referred to as tax invoices



CHAPTER QUIZ

QUESTION ONE

- (a) list the conditions when VAT on bad debts is claimable
- (b) Explain the meaning of the term "tax point" in relation to the value added tax on the sale of goods.

QUESTION TWO

State the circumstances in which a registered person may be de-registered.

QUESTION THREE

State the items, which must be contained in Tax invoice.

QUESTION FOUR

State the benefits of value added tax (VAT) in the context of the principles of a good tax system.

ANSWERS TO CHAPTER QUIZ

QUESTION ONE

- a. The following conditions must be satisfied in order to obtain relief from VAT on bad debts.
 - i) The claimant must have supplied goods or services for a consideration and must have accounted for and paid tax on that supply.
 - ii) The claimant must prove insolvency of the debtor.
 - iii) The debtor must be outstanding for at least 3 years and all reasonable efforts have been made to recover the debt but in vain.
- b. The term "tax point" refers to the time at which a supply of goods or services is deemed to take place; it is the point at which VAT becomes chargeable.

Tax becomes due and payable, in relation to supply of goods, at the time when:

- i) The goods are supplied to the purchaser; or
- ii) An invoice is issued in respect of the supply; or
- iii) Payment is received for all or part of the supply, whichever time shall be the earliest.

Question Two

De-registration may be requested on the following grounds

- i) Closure of business
- ii) Sale/transfer of business
- iii) Death of a trader
- iv) Legal incapacitation (Bankruptcy)
- v) Insolvency
- vi) Change of business status e.g. Partnership to limited company
- vii) If the turnover falls below the prescribed limits

Question Three

Information required on a tax invoice:

- i) Name, address, VAT registration number of person making the supply;
- ii) Serial number and date;
- iii) Date of supply if different from ii) above;
- iv) Name, address, VAT registration number of person to whom the supply is made;
- v) Description, quantity and price of goods or services supplied;
- vi) Taxable value of goods or services if different from price charged;
- vii) Rate and amount of tax charged on each of those goods and services provided.



- viii) Details of cash or other discounts;
- ix) Details of whether supply is for cash or credit;
- x) Total value of supply and total amount of VAT charged.

Question Four

Benefits of VAT in the context of a good tax system

- a) VAT is usually collected by the government through VAT registered traders. The government does not pay the traders to collect VAT on its behalf. Given the wide scope of VAT, each and every person in the economy is affected. The government is able to reach every person who suffers VAT though a relatively small proportion of the entire population comprises VAT traders.
- b) VAT is equitable as the overall liability is determined by a person's expenditure/consumption. Those with a higher expenditure (and therefore more able to pay tax) end up contributing a similarly high proportion of VAT collected.
- c) VAT is also equitable where it does not apply, (either through zero rating or exemption) to basic necessities such as foods, medicine, healthcare, agricultural inputs, education, etc. lower income groups spend a high proportion of their incomes on such goods. Consequently, only a small proportion of their expenditure is affected by VAT.
- d) VAT is based on consumption in the domestic economy. Its wide scope where accompanied by little leakage results in high revenue yields.
- e) VAT is an indirect tax. It is based on a person's expenditure and not income. This minimizes the disincentives associated with direct taxation. Its indirect nature means most people who suffer VAT may not know about it or may not be able to quantify how much is paid. For this reason, there is less likelihood of resentment. Resentment of taxation usually leads to high tax evasion.
- f) The wide scope of VAT accompanied with minimal exceptions does not distort the working of the market mechanism. In other words, VAT ensures neutrality as consumers in the economy cannot switch their preferences/consumption to avoid taxation.

PAST PAPER QUESTIONS ANALYSIS

The following is an analysis on how the chapter has been examined in the past. The questions are listed in this format: Month/year e.g. 6/01 represents June or May 2001.

12/08, 6/08, 12/07, 6/07, 12/05, 6/05, 12/04, 12/03, 6/03, 12/02, 6/02, 12/01, 6/01, 6/00.

REVISION QUESTIONS

Question 1

- (a) Distinguish between exempt and zero-rated supplies for VAT purposes. (4 marks)
- (b) The following information relates to Mikopo Ltd.
1. The company did not file a VAT return for the month of February 2007. The vat payable for the month amounting to Sh2,000,000 was also not remitted to the tax authority.
 2. The management of the company intends to remit the VAT for February 2007 on 30 June 2007.
 3. The company has no other VAT liabilities outstanding.

Required:

Determine the amount of VAT payable by Mikopo Ltd. (Inclusive of penalties and interest) on 30 June 2007 in relation to the above VAT liability.

(4 marks)

(June 2007 Question 4)

Question Two

- (a) Briefly explain the VAT treatment for each of the following items, clearly indicating who has the responsibility of remitting the tax to the tax authorities:
- (i) Hotel and restaurant services (2 marks)
 - (ii) Transportation of raw materials (2 marks)
 - (iii) Medical services (2 marks)
 - (iv) Mobile phone airtime (2 marks)
- (b) The management of Maendeleo Ltd., a registered supplier of vatable goods presented the following information relating to the company's transactions for the six months ended 30 June 2007.

	Purchases	Sales
	Sh.	Sh.
January	1,500,000	2,200,000
February	1,800,000	2,700,000
March	1,700,000	2,000,000
April	1,500,000	900,000
May	400,000	600,000
June	2,000,000	2,600,000

The amounts stated above were inclusive of VAT at a rate of 16%.



Additional information:

1. All purchases were made on cash basis while all sales were on credit basis. The cash due on credit sales was received in the month following the month of sale.
2. Ten per cent of the purchases made by the company in the month of April were returned to the suppliers in the same month.
3. Included in the sales for the month of May was Sh.200,000 for which the debtor defaulted and was subsequently declared bankrupt on 30 June 2007.

Required

Determine the VAT payable or refundable for each of the six months from January to June 2007
(12 marks)

(Dec 2005 Question 3)

Question Three

- (a) Outline the importance of a tax invoice in the administration of VAT. (2 marks)
- (b) Mr. P Kamau is a registered VAT trader dealing in household electronics. On 5 August 2007, he sold the following electronic goods to Mr L Omondi on credit terms:

Item	Quantity sold	Selling price per unit (before VAT)
Radio	2	15,000
Television set	1	30,000
Fridge	1	40,000

The goods were subject to VAT at the standard rate of 16%.

Required:

Prepare a tax invoice in the books of Mr P Kamau relating to the above transactions.(6 marks)

- (c) The following information relates to Mrs G Mwajuma, a registered VAT trader for the six month period ended 30 June 2007:
 1. She was registered for VAT on 2 January 2007.
 2. She filed the first VAT return on 27 February 2007 and paid VAT of Sh.48,000
 3. The VAT for the period from 1 January 2007 to 30 April 2007 was as follows:

Month	Input tax Sh.	Output tax Sh.
January	150,000	48,000
February	219,480	Nil
March	167,640	497,940
April	274,380	308,940

4. A VAT return for the month of May 2007 was not submitted since there was no VAT due.

5. A VAT return form the month of June 2007 was filed by the due date and VAT paid; Input tax was however not claimed.

Required:

Assess the VAT compliance by Mrs G Mwajuma over the six month period ended 30 June 2007.

(12 marks)

Total: 20 marks)

(June 2005 Question 4)

CHAPTER SEVEN



STUDY TEXT

ADMINISTRATION OF CUSTOMS & EXCISE



CHAPTER SEVEN

ADMINISTRATION OF CUSTOMS & EXCISE

► OBJECTIVES

- Recognise the main purposes of customs duties
- Gain an understanding of the key provisions of customs and excise Act
- Identify prohibited and restricted goods

► INTRODUCTION

This deals with the taxation of imports and exports of goods and services. The Customs and Excise Department has been split such that Customs Department is now a separate department on its own while the Excise Department has been brought under the umbrella of the Department of Domestic Taxes. The Customs and Excise Act (CAP 472, laws of Kenya) lays down rules and regulations of controlling imports and exports, enforcing prohibitions and restriction.

► DEFINITION OF KEY TERMS

1. **Customs Duty**
This is the duty on tax paid in goods imported through the port of Kenya or imported and which are specified in the first schedule
2. **Excise Duty**
This is the tax imposed on goods manufactured locally and specified on the 5th schedule
3. **Custom warehouse**
This is a place approved by the Commissioner of Customs and Excise (C C E) for placing deposits.
4. **Duty**
Duty is defined to include: - (Customs duty, excise duty, levy, cess, imposition, tax, surtax) Imposed on goods by the CCE.
5. **Subsidy**
This comes in form of direct or indirect deduction on:
 - a. Production or output by way of grants or loans
 - b. Tax relief relating to the goods themselves or the material used to make goods

6. Bonded security

A bond is a commitment to honour certain terms and conditions and fulfil obligations relating to an agreement. The failure to honour the commitment leads to consequences, which include forfeiting of an asset that may have been given out as a security

7. Direct exporters

Manufacturers who import raw materials, manufacture, then export the finished product.

8. Indirect exporters

A manufacture/producer who imports goods for use in the production of goods for supply to another manufacturer for use in the production of goods for export.

► EXAM CONTENT

The student is expected to demonstrate an understanding of the rules and regulations governing the exporting and importing industry and how to value imports and exports for tax purposes.

► INDUSTRIAL CONTENT

This chapter is important especially to companies that deal with imports and exports. It helps in appreciating the basis of computation of the various duties.

7.1 CUSTOM AND EXCISE DUTIES

Customs duty is tax paid on the importation or exportation of goods. Ad valorem duties are assessed on the value of the goods, that is a percentage of the value of the goods based on the aggregate of the original cost, insurance, freight, and other charges incurred up to the point of entry. There are various rates of duty which generally depend on the classification of goods. For example luxury or substitutable goods would attract a higher rate of duty than essential goods. Some goods may be exempted from duty.

Excise duty is tax imposed on various commodities that are manufactured locally. The duty may be intended to raise revenue and/or discourage the consumption of commodities that are considered to be harmful e.g. alcohol, tobacco etc. Excise duty belongs to the class of indirect taxes which lack announcement effects, and which can therefore be implemented easily without resentments.



Customs Documents

1. Customs Entry:

It is the form used to fill all the details relating to goods being imported or exported. It is commonly known as C.63. It shows the following details.

- a) Owner of the goods and his details.
- b) Clearing and forwarding agent (if any) and his address.
- c) Cost of the goods
- d) Country of origin
- e) Country of destination
- f) Description of goods
- g) Duty payable on the goods
- h) VAT payable on the goods

2. Bill of lading:

It is the ownership certificate of goods being transported from one country to another. It is used to identify who owns the goods on board a ship or plane. For air carriage, the bill is known as an airway bill.

3. Clean Report of Findings (CRF):

It is a certificate issued by a pre-shipment inspection company. It is used to show that the goods are fit for importation and also gives the value of the goods. This value is important because it is used to calculate duty payable on the goods.

4. Purchase Invoice:

It is the purchase transaction document issued by the seller to the importer. It shows the selling price and details of the seller. If the goods are acquired free of charge, the value on the CRF is considered.

5. Port Release Order:

It is issued by the Kenya Ports Authority to allow the release of the goods from the port. This helps in avoidance of theft of goods while at the port.

6. Import Declaration Form (IDF)

It is a form issued to a person who intends to import goods. It is issued on payment of a fee known as the IDF fee or the Government of Kenya (GOK) fee.

7. Customs Receipts:

These are vouchers issued by the customs department on payment of any duties payable, customs charges and VAT on imported goods.

BOND SECURITY

A Bond is a written agreement between a person and the CCE, whereby the person promises to pay an amount equal to the duty on goods in case any condition in the agreement is breached. Once a bond is written it is guaranteed by a financial institution and the bond acts as the security for the duty on goods. Bonds can be used as security in the following cases:

- a) Goods in a Bonded Warehouse
- b) Goods in Transit
- c) Goods for use in Manufacturing Under Bond

WAREHOUSING

A Warehouse is a place or structure used for storage of goods. For purposes of customs, warehousing refers to the storage of imported goods pending the payment of customs duties and VAT on such goods. For any goods to be taken from the warehouse, the necessary duties and warehouse rent must be paid. There are two types of warehouses for the purposes of customs.

- a) **Bonded Warehouse**
This is a warehouse used to store goods whose duties, VAT and other charges are secured by a Bond. These warehouses are owned privately by persons Licenced by the customs and Excise Department. They include Bonded oil installations used to store petroleum products.
- b) **Customs Warehouse**
They are owned by the customs and Excise department and are used to store goods that have not been claimed by the importers.



REASONS FOR WAREHOUSING

a) Marketing:

An importer may decide to warehouse his goods if he does not have ready market for them. This will allow him to market them or find a convenient way of disposing them.

b) Payment of duty in Piecemeal (Bit by bit):

When a person does not have sufficient funds to pay for his duties he may warehouse the goods so as to pay the duties in instalments. In this case, the person will take goods from the warehouse in small quantities and pay duty on the quantities taken.

c) Difficulties in accessing the destination of the goods:

Goods may be warehoused if their destination cannot be accessed e.g. due to war, floods etc.

d) Convenient storage facility:

Goods may be warehoused for storage purposes only. This is usually the case with petroleum products which are stored in Bonded Oil Installations (tanks) after refinery.

e) Price Speculation:

Goods may be warehoused with the hope of price improvement.

7.2 TAX POWERS AND RIGHTS TO REVENUE

The Customs and Excise Department is the largest in terms of revenue contribution and manpower requirement of the four revenue generating departments of Kenya Revenue Authority. The Customs and Excise Act (CAP 472, laws of Kenya) is charged with the responsibility of controlling imports and exports, enforcing prohibitions and restriction and collecting revenue on both imports and excisable goods.

POWERS OF THE CCE

Powers of the **Commissioner of Customs and excise:**

- (a) Sec 9 of Cap 472** states that the commissioner can appoint and fix the limits in the Kenya Gazette of:
- i. Ports
 - ii. Customs import.
 - iii. Customs areas (areas of goods subject to customs control)
 - iv. Routes/ road in Kenya over which goods in transit shall be conveyed.
 - v. Bonding stations i.e. areas appointed by the CCE for air crafts and vessel arriving at or departing from a port may be kept.

- ◆ Places of loading and unloading of goods within a port.
 - ◆ Places of examination.
 - ◆ Places of landing and embarkation of person
- (b) Provision of suitable accommodation for offices.
 - (c) Power to permit roads, area, place, boarding station, rout, entrance and exit etc, on temporary basis to be used as if so appointed.
 - (d) Power to disclose information to a person in the service of the government in revenue department for official duties (statistical or revenue purposes).
 - (e) Power to compound an offence by agreement (sec 214).
 - (f) Power to revoke a licence issued to manufacture excisable goods (sec 93).
 - (g) Power to furnish to a competent authority any information, certificate official, import, document etc to prevent, investigate or suppress offences against rules and regulations of importation and exportation of goods in or from a foreign country.
 - (h) Power to require information from importers concerning dumping of goods (sec219)



Powers of The Customs & Excise Officers

To prevent smuggling and evasion of duty, the Act gives the following powers the officers:

1. Power to require vessels to board, failure to which the master of the ship vessel is liable to a fine of sh. 300,000/= (maximum) and seized of the vessel.
2. Power to require a vessel to depart from Kenya within 12 hours failure to which a maximum fine of Sh 100,000 is imposed and the vessel is liable to forfeiture.
3. Power to patrol freely and move the vessels i.e. he can take the aircraft or vessel to a place convenient for investigation of smuggling or evasion without any legal liability to the officer.
4. Power to board a vessel and make a search. If the master of the ship refuses the officer he is liable to:
 - (a) A fine not exceeding Sh 1,500,000 or
 - (b) 3 years imprisonment.
 - (c) Forfeiture of gods.
5. Power to require person entering or leaving Kenya to answer questions concerning the luggage.
6. Power to search person where he has reasonable grounds to believe that the person has excisable goods or uncustomed goods. However, a female officer only searches a female person.
7. Power to seal and search premises. They can seal lock or secure:
 - (a) Buildings, rooms, place or receptacle of a plant.
 - (b) Seized and detail such books and documents.
 - (c) Required containers or envelope to be opened.



- (d) Open and examine any package or goods or materials.
- (e) Take reasonable samples of goods in packages.

Power to have search warrant may be given by the magistrate to enable the officer to enter, day and night, the premises to seize and carry away uncustomed goods, plant or documents.

7.3 IMPORT AND EXPORT DUTIES

Calculation of Customs Duties

- Free on Board (FOB) Value:
This is the Invoice price of the goods or the price on pre-Shipment Inspection (whichever is higher).
- Freight:
It is the cost of transporting the goods from outside Kenya to Kenya.
- Insurance:
It is the cost of Insurance cover on the goods while being transported to Kenya
- Cost Insurance Freight (CIF) Value:
It is the cost on which duty is calculated. It is calculated as follows:
 $CIF = FOB + Insurance + Freight$
- Duty:
It is calculated as a percentage of the CIF value.
 $Duty = x\% \times CIF$
- VAT (on Imports)
It is calculated on CIF value plus Duty.
 $VAT = 16\% \times (CIF + Duty)$

IMPORTING INTO KENYA

Imports to Kenya can be entered under any of the following categories.

- a. For direct home use
- b. For warehousing
- c. For use in a bonded factory
- d. For transit
- e. For temporary importation
- f. For use in an export processing zone facility.

REQUIREMENTS OF IMPORTATION

Other than Pre-Shipment Inspection and production of a clean report of findings (CRF – See next page) the next requirement for clearance of imports are a declaration to Customs on prescribed forms and payment of duty and VAT or execution of guarantees (bonds). Guarantees covering amounts of duty and VAT payable on consignments is required for imports in a bonded warehouse, bonded factory, for transit, temporary importation into an EPZ facility.

In all these cases, these guarantees are discharged on application and production of proof that the imports have been transited or entered into bonded factory as the case maybe. For temporary importation of vehicles, *Carnets de passage* are accepted as sufficient guarantees for duty and VAT payable on such imports.

Guarantees in the form of bonds are required for temporary importation of vehicles originating from within the East Africa region. This preferential arrangement applies only to vehicles registered within the region.

Pre-Shipment Inspection

The government of Kenya has contracted three companies to conduct pre-shipment inspection on all imports. Only some categories are exempted from this requirement. The table below shows inspection zones and companies responsible for goods originating from those zones.

S.G.S

Africa All Counties, Asia, Afghanistan, India, Malaysia, Sri Lanka, Bangladesh, Indonesia, Maldives, Taiwan, Bhutan, Japan, Mongolia, Thailand, Brunei, Kampuchea, Nepal, Vietnam, Burma, Korea, North Pakistan, China, Korea South, Philippines, Hong Kong, Laos, Singapore.

Bureau Veritas

Europe All counties except Ireland and United Kingdom

Asia, Bahrain, Jordan, Qatar, Yemen, Iran, Kuwait, Saudi Arabia, Iraq, Lebanon, Syria, Israel, Oman, U.A.E.

COTECNA

America All countries, Oceania All countries, Europe, Ireland and United Kingdom.

All imports into Kenya of Motor vehicles, used clothing and apparel are subject to pre-shipment inspection. Also, subject to pre-shipment inspection are all other imports whose F.O.B. value exceeds US\$2,000, except the following:

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- a) Goods destined to approved duty free shops;
- b) Goods destined to approved Export Processing Zones enterprises;
- c) Goods destined to approved enterprises manufacturing goods under bonds;
- d) Unset precious stones or precious metals in bullion form;
- e) Accompanied or unaccompanied used personal effects;
- f) Objects of art;
- g) Explosives and pyrotechnic products;
- h) Ammunition, weapons or implements of war imported by the government;
- i) Live animals,
- j) Current newspapers and periodicals (daily and weekly)
- k) Household and personal effects including motor vehicles, provided such motor vehicles qualify for exempt entry under items 8 (3) or 8 (4) of the Third Schedule to the Act;
- l) Post parcels, excluding goods imported for trade;
- m) Gifts or donations by foreign governments or international organisations, to foundations, charities and recognised humanitarian organizations.
- n) Commercial samples of no commercial value;
- o) Crude or refined petroleum and petroleum products;
- p) Personal gifts sent by foreign residents to their relatives in Kenya for their personal use, but excluding motor vehicles;
- q) Gifts and supplies for use by diplomatic and consular missions and to United Nations Organisations; and
- r) Urgent small shipments whose F.O.B. value does not exceed US\$10,000,000 imported through a licensed courier service company.

Visiting Kenya

Various exemptions from import duty and VAT are allowed on imports of personal and household effects to those who are visiting Kenya or changing their residence from another country to Kenya. These exemptions are covered by the Custom & Excise Act under the third schedule Part B paragraph 8.

Your exemptions

Goods covered by these exemptions must be:

- a) The property of and accompanying the passenger, or are imported within 90 days of the date of arrival.
- b) For the personal or household use of the passenger in Kenya.
- c) Of such kind and in such quantity as the proper officer (Customs Officer) may allow.

Generally, exemptions will be granted on the following items if imported as accompanied baggage:

- a) Spirit (including liquors) not exceeding one litre or wine not exceeding 2 litres.
- b) Perfume and toilet water not exceeding in all one litre, of which not more than a quarter may be perfume.

- c) Cigarette, cigarillos, cigars, cheroot, tobacco and snuff not exceeding in all 250 grammes in weight.

Exemptions do not however, apply to the following items:

- a) Fabrics in the piece.
- b) Any trade goods or goods for sale or disposal to other persons.
- c) Aircrafts or vessels of all kinds.
- d) Motor vehicles under temporary importation or those on transit.

Exemptions for those arriving in Kenya for the first time:

In order to qualify for exemption given under this category:

- a) One must have attained the age of 18 years.
- b) One should not have been granted any of these exemptions before.
- c) One must not have resided in Kenya before arrival other than on temporary resident visa.

Exemptions under this item comprise of the following:

- d) Wearing apparel;
- e) Personal and household effects which were for personal or household use in the former place of residence.
- f) One motor vehicle (excluding buses and minibuses or more than 13 passenger and load carrying vehicles of load carrying capacity exceeding two tonnes) owned and used outside Kenya for at least 90 days (excluding period of voyage). If the engine capacity of the motor vehicle exceeds 2,500cc and the value exceeds Sh.200,000, duty is payable on the difference between the value and Sh .200,000/-.

Exemptions for returning residents

Similar terms of exemptions also apply to returning residents if they have been residing outside Kenya for a period of at least two years and have neither been granted an exemption nor resided in Kenya for an aggregate 90 days within the two years immediately preceding their arrival.

Exemptions for those visiting Kenya:

Those making a temporary visit to Kenya not exceeding 3 months are exempted from duty on the following:

- a) Non-consumable goods for personal use during the visit which are intended to be taken out on departure.
- b) Consumable provisions and non-alcoholic beverages in such quantities and of such kind as are consistent with the visit.



7.4 GOODS SUBJECT TO CUSTOMS CONTROL

A Customs area is a designated place or area under the jurisdiction of the C.C.E (or under customs control) e.g. air [ports, lake ports, sea ports etc.

Goods subject to customs control may/shall

- (a) Be examined by any officer any time.
- (b) Not be interfered with in any way by the officer.

Goods subject to control

Sec 12 of Cap 472 specifies the following goods which are subject to customs control:

- (a) **Imported goods** through post office from time of importation to delivery of goods for home or importation whichever happens first.
- (b) **Dutable goods** (goods subject to customs duty) and **excisable goods**(goods subject to excise duty) or which duty has not been paid.
- (c) Goods which have been **seized and all goods under seizure**.
- (d) Goods **on board an aircraft** or used within a part or place of Kenya.
- (e) Goods on board draw back from time of claim of draw back.
(**Drawback** refers to refund of all or part of import duty paid in respect of exported goods or used in a manner or purpose for granting a draw back or refund.)
- (f) Goods subject to export duty from the time of bringing them to the port for export to the time of exportation.
- (g) Goods subject to restriction on exportation(Restricted export)
- (h) Goods pending exportation and are stored in a customs area with permission of a proper officer.

7.5 VALUATION OF IMPORTS AND EXPORTS

Valuation of exports

The value of export goods whether exempt from duty, liable to specific duty or **ad varoalem** shall include;

- (a) The cost of goods to the buyer outside Kenya.
- (b) Packaging charges.
- (c) Any levy, cess duty, tax or surtax.
- (d) Transport and all charges up to a firm of delivery of goods on board the export aircraft or vessels at the place of exit from Kenya.

Section 127(b) states that where goods for exportation or re- exportation are below the normal price, the CCE or any authorised officer will cause the goods to be re-valuated or appraised in accordance to the rate and price at which goods of similar kind and quality have been exported or imported.

Re- exportation occurs when goods are imported from outside Kenya and then exported outside Kenya without being used in Kenya.

Exchange rate for exports

To determine the value of export goods in Kenya shillings, the exchange rate used shall be the higher of:

- (a) The prevailing current bank rate of sight drafts as last notified by C.B.K.
- (b) The rate applied by banks in the financial institutions.
- (c) The commissioner may use weighted average of prevailing bank exchange rate force in during the previous week subject to any revaluation as notified by the CBK.

Valuation of imports

It is important for the purpose of charging of duty. The value for duty shall be the sum of:

- (a) Value ascertained for purpose of import duty.
- (b) Amount of import duty as well as dumping duty if any.

When determining the value the following assumptions are made:

- a. Imported goods are delivered to the Kenyan buyer at the port of importation.
- b. The seller bears the freight, insurance, commission and other charges, expenses and costs related to the sale of goods.
- c. The buyer/importer shall bear any duty or tax chargeable in Kenya.



- d. The proceeds from resale of imported goods in Kenya shall not accrue directly or indirectly to the seller or a person related to him.
- e. The price of imports is not influenced by commercial, financial or other relationship between the seller and the buyer (importer).

For locally manufactured goods the excise duty is imposed. For this purpose of levying Ad valorem excise duty, the value of locally manufactured goods shall be ex factory selling price. Ex factory selling price is the price, at which goods can be sold from the factory exclusive of VAT and excise duty, it consists of:

- (a) Cost of wrapper, package, box bottle or other container in which excisable goods are packed.
- (b) Cost of any other good contained or attached to the wrapper, package, box, bottle etc.
- (c) Any incidental cost on sale of goods e.g. transportation costs, advertising costs, financing costs, commission given to sellers, or any cost incurred in delivery of goods to the purchaser.

■ (a) WTO CUSTOMS VALUATION METHODS

Kenya adopted the WTO agreement on Customs valuation which came into effect on 1st January 2000. The methods adopted are contained in the Finance Act 1999 under this system following methods may be used.

- (a) **Transaction value** - The Customs value is the transaction value or price paid by the importer including all payments made as conditions of that sale.
- (b) **Transaction value of identical goods** - where the value or price paid by the importer including all payments made as conditions of that sale.
- (c) **Transaction value of similar goods** - in this method similar goods value is used rather than the value of identical goods. Goods are said to be similar if they have similar characteristics, components, similar quantity and reputation.
- (d) **Method 4** - Not strictly a valuation method but a guideline. It provides that where an importer requests a particular method of valuation may be used e.g. the use of method 2 rather than method 3.
- (e) **Deducting method** - The value for duty shall be the unit price of identical or similar imported goods sold in Kenya in the same conditions as they were imported at about the same time of importation.
- (f) **Fallback method** - This method is used when all others have failed. It provides that the value for duty will be determined using any of the previous methods in a specified manner subject to specified conditions.

7.6 REFUND OF DUTY

Duty paid on goods may be refunded under the following circumstances:

- (a) Where goods are **returned** to the seller.
- (b) Where goods are damaged, **destroyed, spillage** during voyage or while under Customs control.
- (c) Where duty has been **paid in error or overpaid** or there is a **cancellation** of a bond given as security.
- (d) Where imports are used in production of exports or specified duty exempt goods.
- (e) **Duty paid by privileged persons and institutions** e.g UN, Armed forces, ILO, UNLP, WB, FAO etc.

7.7 PROHIBITIONS AND RESTRICTION MEASURES

(b) PROHIBITED GOODS

These are goods the importation or exportation of which is prohibited.

>>> Examples of prohibited goods.

Prohibited imports

- (a) False or counter foil money.
- (b) Indecent or obscene prints, books, painting.
- (c) Articles marked with ceremonial ensigns or coat of arms of Kenya.
- (d) Adverts to promote sale of medicine to cure cancer, T.B and Aids etc.
- (e) Distilled beverage with injurious chemical products which can affect health of individuals e.g. methanol hyssop etc.

Prohibited exports

- (a) Fire arms and ammunitions.
- (b) Human bones
- (c) Weed, charcoal and timber.
- (d) Ivory and rhino horns and all other products related to endangered species.



(c) RESTRICTED GOODS

Are goods the importation and exportation of which is prohibited except in accordance with the conditions regulating such importation and exportation under the customs and excise Act or any written law.

Restricted imports

- (a) Tear gas
- (b) Traps for killing or capturing game animals.
- (c) Sound moderators (silencers) to be used in fire arms
- (d) Articles bearing boys scouts or girl guides budes, emblems or tokens.
- (e) Postal franking machines unless permitted by the manager of postal Kenya.

Restricted exports

- i. Medicaments not manufactured in Kenya.
- ii. Motor vehicles and accessories not manufactured in Kenya.

If found in possession of prohibited exports or imports such goods are subject to Seizure or confiscation.



7.8 BOND SECURITIES



A bond is a commitment to honour certain terms and conditions and to fulfil obligations relating to the agreement. The failure to honour the commitment leads to consequences, which include forfeiting of an asset that may have been given out as a security.

The CCE may require a person to give security for the following reasons.

- (a) To ensure due compliance by the person with the provision of Cap 472.
- (b) For protection of customs and excise revenue on imported goods.
- (c) To cover any transaction entered into by the person within a specified period.

Forms of Security

- (a) **Cash deposits**
A tax payer can deposit cash with customs department to ensure compliance with payment of tax.
- (b) **Bond security** - a tax payer may be required to deliver a document indicating the legal ownership of an asset. He will therefore enter into a binding commitment to fulfil his obligation with regard to compliance and payment of the failure to which he will loose the asset.

- (c) **Use of guarantees or sureties:-** This is where a third party gives his guarantees that a taxpayer will comply with terms and conditions of the Act e.g. Financial institutions.
- (d) Partly by bond and partly by cash.

A bond security is required for goods which are:

- (a) In a bonded warehouse.
- (b) On transit
- (c) Manufactured goods for export

Discharge of a Bond or Surety

A bond may be withdrawn if:

- a. The conditions of the bond are fulfilled or performed e.g. duty has been paid.
- b. On expiry of 3 years, **CCE** may discharge the bond and ask for a fresh bond security.

When can the CCE require a fresh bond or security?

- (a) Where the surety or guarantor dies.
- (b) When the guarantor is declared bankrupt or enters into a scheme of composition with the creditors.
- (c) When the surety depart from Kenya without leaving sufficient property to satisfy the whole amount of the bond.
- (d) On expiry of 3 years and the CCE deems it reasonable to ask for fresh security.

7.9 FORFEITURE OF GOODS

The following goods shall be liable forfeiture.

- (a) Prohibited goods.
- (b) Restricted goods which are dealt with contrary to any condition regulating their importation, exportation.
- (c) Uncustomed goods.
- (d) Goods which are imported, exported or carried coastwise concealed in any manner, or packed in a package whether with or without other goods in a manner appearing to be intended to deceive any officer.
- (e) Goods which are imported exported or carried coast wise contained in a package of which the entry, application for shipment or application to unload does not correspond with the goods.
- (f) Goods subject to customs control which are moved, altered or in any way interfered with, except with the authority of an officer.
- (g) Goods in respect of which, in any manner relating to customs, an entry, declaration, certificate application or other document, answer, statement or representations, which is knowingly false or knowingly incorrect in any particular has been delivered made or produced.
- (h) Goods in respect of which drawback, rebate remission or refund of duty has been unlawfully obtained.



7.10 EXCISABLE GOODS

Excise duty is the tax imposed on:

- (a) **Specific goods manufactured and sold locally or exported.**
This is collected on a monthly basis.
- (b) Specific goods imported from outside. (It is collected at the point of importation together with other taxes e.g. VAT.)

These goods are specified in **the 5th Schedule of the Cap 472..**

Examples include: Soda, furniture, wine, shoes, cigarettes, and textile

Previously, excise duty was being collected and administered by Customs and excise department. However, currently excise duty is now administered by the **department of domestic taxes**. This means that excise duty on imported goods shall be charged.

Main Purpose For Imposing Excise Duty

- (a) To raise revenue to the government.
- (b) To discourage the production and use of these goods which are harmful for human health e.g. cigarettes, liquors etc.
- (c) To control the production of some specific commodities.

(Generally these taxes have a regressive effect to low income earners)

7.11 RULES OF ORIGIN AND THEIR ECONOMIC CONSEQUENCES

A rule of origin is a criterion used by customs authorities to determine the nationality of a product or a producer. Rules of origin are necessary when there is a desire to discriminate between sources supply.

The only multilateral convention dealing with Rules of origin is the 1974 international convention on the simplification and harmonization of customs procedures (also known as the Kyoto convention). This convention that should be considered to originate in a country because they are wholly produced or obtained there, that is, contains no imported materials. These are largely natural resource- based products extracted or obtained from the territory of the country concerned. Where two or more countries are involved in the production of a product, the origin of the product is the one which substantial transformation took place, that is, the country in which significant manufacturing or processing occurred most recently. Significant or substantial is defined as sufficient to give the product an essential character.

Various criteria can be used to determine if a substantial transformation occurred. These include a change in tariff heading (CTH), the use of specific processing operations which do (or do not) imply substantial transformation, a test based on the value of additional materials embodied in the transformed product or the country of value added in the last country where the good was transformed. Under CTH value added may be high or low for a given product, so that a value added criterion may or may not lead to the same result as a CTH test. Different rules of origin may therefore vary widely in their economic consequences.

If written in ways that make it difficult to satisfy them, effective protectionist devices. Thus, the setting of the rules may be accompanied with rent seeking activities, as import competing lobbies have an incentive to either try and to make the rules as restrictive as possible, or to influence the way they are applied. Restrictive rules are a potential problem in the context of negotiation and implementation of preferential trade agreements.

The rules may be uncertainly as discretion is given to an authority to determine the rule to be applied. The World Trade Organization (WTO) rules on origin seem to foster a harmonized approach that constitute a substantial transformation.

One of the areas where the rule of origin has become controversial is in the enforcement of antidumping mechanisms. The economic impact of a rule of origin depends on the specific criterion that is used and on the degree of uniformity with which the rule is applied. Rules of origin are a major mechanism for 'fine tuning' the effective scope of preferential liberalization at the product level.

The East Africa Customs Union through its Council of Ministers has adopted Rules of origin to be applied by partner states in relation to imports to the East Africa Community. These are aimed at making the process of application transparent, accountable, fair, predictable and consistent with the provisions of the EAC Protocol.

7.12 EAST AFRICAN COMMUNITY CUSTOMS MANAGEMENT ACT (2004)

This is an Act that came into force in 2005 following the revival of the East Africa Community Customs Union. Customs control is therefore under the East Africa Customs Union and excise duty will be under the control of respective partner states. Under the Union, goods traded within the partner states will be zero rated except for certain specified items from Tanzania and Uganda albeit for transition period only.

Goods are classified under the Harmonized System Convention (HSC) that forms the basis for tariff classification of goods traded in the international market as listed in Annex 1 to the Protocol on the Establishment of the East African Community Customs Union.



☐ Customs duty rates

Duties are charged at varying rates as published by the Council of Ministers under the Common External Tariff. The bases of charge of duties are ad valorem (on price value of the good so declared) and specific units (on quantity, weight, number or measurement). The customs duty rates range from 0 to 25%. Reduced customs duty rates are applicable on some imports from countries in the COMESA region, while “Sensitive” imports attract duty above 25% as prescribed by the Council of Ministers.

With effect from 1 January 2005, the East African Community Partner States (Kenya, Uganda and Tanzania) agreed to charge import duties as follows:

- (a) Common External Tariff (CET) on goods coming into the EAC from third party states. The applicable three-band Common External Tariff rates are as follows:

Category	Rate (%)
Raw materials	0
Intermediate goods	10
Finished goods	25

However, sugar, wheat and milk and a few other products are categorized as “sensitive” and attract surcharges above the 25% maximum, while all goods entered for home use from Export Processing Zone (EPZ) enterprises attract additional duty as follows:

- 2½% of the value of sales, or
- 5% of specific rate specified in the Annex I to the EAC Customs Union Protocol: Common External Tariff.

- (b) The Partner States agreed on a transitional provision to eliminate the internal tariffs under the principle of asymmetry: that with effect from 1 January 2006 the Kenyan exports to Uganda and Tanzania would attract duty at reducing rates as follows:

Year	Uganda Duty rate (%)	Tanzania Duty rate (%)*
1	10	25
2	8	20
3	6	15
4	4	10
5	2	5
6	0	0

* Maximum rates for the year.

CHAPTER SUMMARY

- **Customs duty;** is tax paid on the importation or exportation of goods while **Excise duty;** is tax imposed on various commodities that are manufactured locally
- The types of warehouses are Bonded warehouses and custom warehouses
- Custom duty is calculated as a percentage of the CIF value.
- Prohibited goods are goods, the importation or exportation of which is not allowed:
- Restricted goods are goods the importation or exportation of which is prohibited except in accordance with the condition under any law regulating such importation or exportation.



CHAPTER QUIZ

Question One

Distinguish between Custom Duty and Excise duty.

Question Two

Explain the following terms as used in customs

- I. Import declaration form
- II. Pre shipment inspection

Question Three

Explain dumping of goods as used in customs.

Question Four

Identify reasons for warehousing imported goods.

Question Five

Differentiate between customs warehouse and bonded warehouse.

ANSWERS TO CHAPTER QUIZ

Question One

Custom duty	Excise Duty
Is tax paid on the importation or exportation of goods? There are various rates of duty which generally depend on the classification of goods.	Is tax imposed on various commodities that are manufactured locally? The duty may be intended to raise revenue and/or discourage the consumption of commodities that are considered to be harmful e.g. alcohol, tobacco etc.

Question Two

Import Declaration Form

It is a form issued to a person who intends to import goods. It is issued on payment of a fee known as the IDF fee or the Government of Kenya (GOK) fee.

Pre shipping inspection

This is the process of certification of goods to be imported into Kenya. The Laws of Kenya demand inspection to be done at the country where goods are coming from. The inspection shows the good as are freed from imports and gives the **FOB** prices.

All imports into Kenya of motor vehicles and used clothing are subject to pre-shipment inspection.

Significance of pre-shipment inspection

- To ensure that there is no tax or duty evasion.
- The imported goods which are being shipped inland have been acquired legally.
- The right goods have been shipped as per the orders.

However, pre-shipment inspection doesn't apply to the following goods.

Goods exempt from pre-shipment inspection

- Ammunitions
- Goods to be used for duty free shops.
- Goods for use on manufacture under bond.
- Goods for use in the EPZ
- Current newspapers or magazines.
- Crude or refined oil products.
- Goods for use by diplomatic missions.
- Goods for use by UN organisations.



Privileged institutions exempted from pre-shipment inspection of imports

- (a) The president
- (b) Kenya Armed Forces
- (c) Kenya Airways Ltd
- (d) Kenya Railways
- (e) Kenya ports and telecommunications
- (f) Common wealth
- (g) Diplomatic privileges
- (h) British council
- (i) Charitable institutions.

Religious bodies, youth associations, Scouts, the disabled

Question Three

Meaning of dumping as used in customs

Imported goods shall be regarded as having been dumped in the country if :

- 1) If the export price from the country in which the goods originated is less than the fair market price of the goods in that country
- 2) In case where the country from which the goods were exported to Kenya is different from the country in which they originated
- 3) If the export price from the country in which the goods originated is less than the fair market price of those goods in that country
- 4) If the export price from the country from which the goods were so exported is less than the fair market price of those goods in that country
- 5) If the goods are sold in Kenya at a price below the cost of importing, and the cost of importing shall include the cost of the goods in the country from where the goods were exported, insurance, freight, duties, taxes and any other charge.

Question Four

Reasons for warehousing imported goods

- 1. Marketing
- 2. Payment of duty in Piecemeal
- 3. Difficulties in accessing the destination of the goods
- 4. Convenient storage facility
- 5. Price Speculation

Question five

Custom warehouse	Bonded warehouse
They are owned by the customs and Excise department and are used to store goods that have not been claimed by the importers	Is a warehouse used to store goods whose duties, VAT and other charges are secured by a Bond? These warehouses are owned privately by persons Licenced by the customs and Excise Department. They include Bonded oil installations used to store petroleum products.

PAST PAPER QUESTIONS ANALYSIS

The following is an analysis on how the chapter has been examined in the past. The questions are listed in this format: Month/year e.g. 6/01 represents June or May 2001.

Taxation 1: 6/08, 6/06, 12/04, 6/03. 6/00.

REVISION QUESTIONS

Question 1

- a) With reference to the Customs and Excise Act (Cap.476):
- (i) Define the term 'bonded warehouse' and 'dumping'. **(4 marks)**
 - (ii) Distinguish between 'prohibited goods' and 'restricted goods'. **(4 marks)**
- (May 2006 Question 5)**

Question Two

With reference to the Customs and Excise Act (Cap. 472), outline four circumstances under which the Commissioner may grant a refund for import duty paid. (4 marks)

(Nov 2004 Question 1)



Question Three

- a) In the context of the Customs and Excise Act (Cap. 472) what is meant by the term “dumping”? (4 marks)
- b) Identify the measures that a government may put in place to discourage dumping. (4 marks)
- c) Outline four circumstances under which duty paid on imported goods may be refunded.

(4 marks)

(May 2004 Question 5)

CHAPTER EIGHT



STUDY TEXT

OTHER REVENUE SOURCES



CHAPTER EIGHT

OTHER REVENUE SOURCES

► OBJECTIVES

- Identify the other sources of government revenue
- Identify the new taxes, levies and charges

► INTRODUCTION

This is the last chapter of the syllabus coverage for this paper. You are expected to know the various other ways of raising revenue by the government apart from taxes. In the chapter we have detailed some of the revenue sources. Please note that the sources given are not exhaustive and there would be many other sources and as such you will be expected to do your own research on the others.

► DEFINITION OF KEY TERMS

Stamp duty - Stamp duties are chargeable in respect of certain legal documents as specified in the stamp duties Act

Cess - A charge on agricultural income especially cash crops for maintenance and repair of roads which access those agricultural locations

Road Maintenance Levy - The levy is charged on the motor vehicle owner. It is loaded on to the cost of fuel. The levy is charged by increasing the petrol prices. Petroleum companies are required to pay this amount to the government.

► EXAM CONTEXT

This topic, though important is not very common in the exams compared to other topics.

► INDUSTRY CONTEXT

The topic is beneficial to industry players and the government in identifying alternative sources of revenue.

8.1 MISCELLANEOUS REVENUE SOURCES

Public revenue is all the amounts which are received by the government from different sources. The main sources of public revenue are as follows:

8.1.1 Fees

Fees is an amount which is received for any direct services rendered by the central or local authority e.g. television and radio fees, national park fees, airport departure fee, airport landing and parking fee, port fee by ships, university fee, etc.

8.1.2 Prices

Prices are those amounts which are received by the central or local authority for commercial services e.g. railway fare, postage and revenue stamps, telephone charges, radio and television advertisement etc.

8.1.3 External borrowing

This is done from international financial institutions such as World Bank and IMF. Other foreign governments are also lenders.

8.1.4 Fines and Penalties

If individuals and firms do not obey the laws of the country, fines and penalties are imposed on them. Such fines and penalties are also the income of the government.

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8.1.5 State Property

Some land, forests, mines, national parks, etc. are government property. The income that arises from such property is also another source of public revenue. The income will arise from payment of rents, royalties, or sale of produce.

8.1.6 Internal Borrowing

The government usually raises revenue through issue of treasury bills and treasury bonds in the local market



8.2 OTHER MISCELLANEOUS REVENUE SOURCES

8.2.1 Stamp duty

Stamp duties are chargeable in respect of certain legal documents as specified in the stamp duties Act. In order to enforce the collection of stamp duty legal instruments which have not been duly stamped are inadmissible as evidence in any civil proceeding and may not be registered or legally enforced as evidence of ownership.

Liability for stamp duty arises if the legal instruments relates to property situated in Kenya. Duty is payable within 30 days of the execution of the instrument. Stamp duty is levied on the following instruments:

- a) Partnership deeds
- b) Hire purchase agreements
- c) Lease agreements
- d) Bills of exchange and promissory notes
- e) Mortgage, bond, debenture or covenant
- f) Memorandum and articles of associations
- g) Contract note regarding the purchase or sale of securities
- h) Insurance policies

■ Rates for Stamp Duty

	Details	Rate %
o Conveyance of land	Urban	4%
	Rural	2%
o Assignment of debt		2%
o Registration of share capital (creation and increase)		1%
o Transfer of shares or marketable securities	Not listed	1 %*
	Listed on the stock	Nil
o Debentures and Mortgages	Primary security	0.2%
	Auxiliary security	0.1%
o Leases	up to three years	1% of annual rent
	over three years	2% of annual rent
* Transfer of quoted securities is exempt		

■ Stamp Duty exemptions

1. Listed companies

No stamp duty is payable on the transfer of securities listed in the Stock exchange.

2. Section 95 of the Stamp Duty Act exemption on business amalgamations

To qualify for the exemptions under Section 95:

- There must be either a new company incorporated or an increase of share capital of an existing company with a view to acquiring more than 90% of the share capital of the target company &
- The consideration thereof should consist of more than 90% of the shares issued in the transferee company

3. Section 96 of the Stamp Duty Act exemptions- Associated companies

To qualify for the exemption under Section 96 it must be shown to the satisfaction of the Collector that either

- One of such companies is the owner of not less than 90% of the issued share capital of the other company;
- Or not less than 90% of the issued share capital of each of the companies is in the ownership of a third company with limited liability

4. Land purchased for expansion and development of schools is exempted from stamp duty provided the land does not revert to any other use.

5. Instruments exempt from Stamp duty include:

- Acknowledgement of debt
- Adoption deed



- Affidavit or statutory declaration
- Awards
- Charter party
- Bill of lading
- Delivery order
- Instruments of divorce
- Valuations
- Letter of allotment of shares

8.2.3 Air passenger Service Charge

This is levied on all passengers embarking at an airport on an external journey at the rate of 20 US dollars, and at the rate of Sh.50 for passengers embarking on an internal journey. It is collected by airlines and appointed agents who are required to remit the tax to the Commissioner within 20 days. This service charge is payable in accordance to the Air Passengers Service Act.

Transit passengers and children below the age of 2 are exempted. With effect from 1.7.'93 the charge for external journey made by Kenya citizens can be paid for in the Kenyan currency.

8.2.4 Capital Gains Tax

It was tax on gains of sale of property e.g. land and buildings but it was suspended with effect from 14.6.'85.

8.2.5 Road Maintenance Levy

The levy is charged on the motor vehicle owner. It is loaded on to the cost of fuel. The levy is charged by increasing the petrol prices. Petroleum companies are required to pay this amount to the government.

8.2.6 CESS

A charge on agricultural income especially cash crops for maintenance and repair of roads which access those agricultural locations

8.2.7 Property rates

These are rates charged by local authority on land and building owned by individuals and body corporates. The local authority charge such rates on property located within its jurisdiction.

Valuation of property is necessary for purpose of imposing property rates. In this regard to the provisions of the Valuation of Rating Act and the Ratings Act are applied.



8.2.8 Trade licences

Trade licences fees are charged in accordance with the provisions of the Trade Licensing Act. These fees are charged by the government on annual basis to grant the permission for conducting different types of activities. The licence fees change from year to year depending on the type and location of the business.

CHAPTER SUMMARY

Other sources of revenue to the government include: stamp duty, fines and penalties, air passenger service charge, and road maintenance levy.



CHAPTER QUIZ

Question 1

Write brief notes on the following:

1. Stamp duty
2. Fines and penalties

(10 marks)

Question 2

Discuss three major exemptions available under the Stamp Duty Act

(10 marks)

(Total 20 marks)

ANSWERS TO CHAPTER QUIZ

Question 1

1. Stamp duty

Stamp duties are chargeable in respect of certain legal documents as specified in the stamp duties Act. In order to enforce the collection of stamp duty legal instruments which have not been duly stamped are inadmissible as evidence in any civil proceeding and may not be registered or legally enforced as evidence of ownership.

Liability for stamp duty arises if the legal instruments relates to property situated in Kenya. Duty is payable within 30 days of the execution of the instrument. Stamp duty is levied on the following instruments:

- i) Partnership deeds
- j) Hire purchase agreements
- k) Lease agreements
- l) Bills of exchange and promissory notes
- m) Mortgage, bond, debenture or covenant etc

2. Fines and Penalties

If individuals and firms do not obey the laws of the country, fines and penalties are imposed on them. Such fines and penalties are also the income of the government.

Question 2

The three major Stamp duty exemptions available under the Stamp Duty Act are:

1. **Listed companies**
No stamp duty is payable on the transfer of listed securities.
2. **Section 95 of the Stamp Duty Act exemption on business amalgamations.**

To qualify for the exemptions under Section 95:

- There must be either a new company incorporated or an increase of share capital of an existing company with a view to acquiring more than 90% of the share capital of the target company , and
- The consideration thereof should consist of more than 90% of the shares issued in the transferee company



3. Section 96 of the Stamp Duty Act exemptions- Associated companies
To qualify for the exemption under Section 96 it must be shown to the satisfaction of the Collector of Stamp Duty that either
- One of such companies is the owner of not less than 90% of the issued share capital of the other company;
 - Or not less than 90% of the issued share capital of each of the companies is in the ownership of a third company with limited liability

PAST PAPER QUESTIONS ANALYSIS

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Taxation 1: 12/02, 5/04, 6/05

REVISION QUESTIONS

Question 1

- (a) Identify any four instruments on which stamp duty is chargeable. (4 marks)

Question 2

Define each of the following taxes and state its purpose:

- | | |
|---------------------|-----------|
| (i) Cess | (2 marks) |
| (ii) Property rates | (2 marks) |
| (iii) Stamp duty | (2 marks) |

(June 2005 Question 1)

CHAPTER NINE



STUDY TEXT

KASNEB SYLLABUS FOR
TAXATION 1 - REVISION AID



CHAPTER NINE (REVISION AID)

KASNEB SYLLABUS FOR TAXATION

► SPECIFIC OBJECTIVES

A candidate who passes this paper should be able to:

- Explain the theory of taxation
- Discuss the legal framework governing the tax system
- Apply principles and concepts of taxation
- Compute tax and file tax returns for individuals and incorporated businesses
- Outline taxation administration
- Design tax plans and systems for organisations
- Undertake tax management of organisations
- Discuss current developments relating to taxation

9.1 TAXATION OF INCOME OF PERSONS

- Sources of taxable incomes
- Non taxable incomes
- Taxable and non taxable persons and institutions Tax rates: relief and withholding taxes
- Taxation of individuals, partnerships and body corporates Allowable and non allowable deductions
- Tax deficits
- Tax computations
- Incomplete records
- Application of case law

9.2 CAPITAL DEDUCTIONS

- Investment deduction: ordinary manufacture, manufacture under bond,
- Shipping investment deductions
- Industrial building deductions
- Wear and tear allowances
- Farm works deductions
- Other deductions
- Application of case law

9.3 TAX ADMINISTRATION

9.3.1 ADMINISTRATION OF INCOME TAX (CAP 470)

- Income Tax Act, finance bills and their provisions
- Identification of new taxpayers
- Tax assessments, self-assessment, additional assessments and estimated assessment
- Remittance of tax: installment tax and final tax
- Turnover tax



- Operation of PAYE system
- Tax compliance and tax audit notices
- Objection, appeals and relief of mistake
- Appellant bodies
- Collection and recovery of taxes
- Refund of taxes and waivers
- Offences, fines, penalties and interest
- Application of case law



9.3.2 ADMINISTRATION OF VALUE ADDED TAX (CAP 476)

- Introduction and development of VAT in a country
- Classification of taxable goods and services
- Exempt supplies
- Registration and de-registration of taxable persons
- Rights and privileges of a VAT registered person
- Accounting for VAT, taxable value, time of supply
- Charge to tax, deductions of input tax, apportionment method of input tax
- VAT records
- VAT due for payment/credit
- Remission, rebate and refund of VAT
- Collection and recovery of tax
- Offences, penalties and interest
- Requirements of objections and appeals
- Compliance management; reconciliation of returns and compliance checks
- Tax audits; normal audit, in depth audit



9.3.3 Administration of customs taxes and excise taxes (Cap 472)

Customs procedures

- Tax powers and rights to revenue
- Import and export duties
- Goods subject to customs control Valuation of imports and exports
Prohibitions and restriction measures Transit goods and bond securities
Excisable goods
- Rules of origin and their economic consequences
- East African Community Customs Management Act

9.4 TAXATION OF SPECIFIC SOURCES OF INCOME

- Dividends
- Interest
- Rent
- Royalties
- Pension
- Annuities
- Other gains or profits

9.5 OTHER REVENUE SOURCES

- Miscellaneous revenue sources, inspection charges, trade licenses
- Airport taxes, stamp duties, property rates, petroleum levy, sugar levy, betting and gaming tax.
- New taxes, levies and charges.

CHAPTER TEN



STUDY TEXT

MODEL ANSWERS TO
REVISION/EXAM QUESTIONS



MODEL ANSWERS TO REVISION/EXAM QUESTIONS

□ CHAPTER ONE

Question One

(a) Distinction between a single and multiple tax system

Single tax system	Multiple tax system
A tax system comprising of only one tax for example hut tax during the colonial times. In addition, some countries have got turnover tax that is the only tax which is final.	A tax system comprising of a variety of taxes that are applicable at the same time. For example, in Kenya we have a multiple tax system since there are many taxes applicable. These include: <ul style="list-style-type: none"> • Corporation tax • Withholding tax • Customs & excise • Turnover tax • Compensating tax etc

Reasons why a country might prefer a multiple tax system over a single tax system

- i) **Sufficient Revenue**
A government implementing a multiple tax system is able to collect sufficient revenue due to a wide tax base
- ii) **Desire to regulate externalities**
A country implementing a multiple tax system will be in a position to regulate externalities whenever they arise e.g. a country may impose heavy import duty to protect local industries
- iii) **Minimize incidences of tax evasion**
Since a multiple tax system has a wide tax base it is able to minimize tax evasion by bring every taxable person to the tax blanket

Question Two

Principles of a good tax system

- (a) (i) Economical:
Low cost of collection to the tax body
Low compliance costs by the taxpayer.
- (ii) Equity
Horizontal equity: People with the same economic position should pay equal amount of tax.
Vertical equity: Consideration is taken as to whether tax payable should be proportional to income i.e progressive or regressive.
- (iii) Certainty
Clear to taxpayer what his liability actually is and how it arises
To the tax body it is guaranteed of the amount of revenue its going to collect
- (iv) Convenience.
Taxpayer should pay when he has the ability to pay
There are no administrative difficulties when collecting tax

Question Three

- a) (i) Fiscal Policy
Fiscal policies are measures arrived at achieving desirable economic objectives by the government. Fiscal policy is made up of: Public debt, public expenditure and public revenue as the major instruments. The major source of public revenue is tax hence taxation policy is an important part of fiscal policy.
- (ii) The objectives of fiscal policy in a developing country such as Kenya are:
- Achievement of desirable wealth distribution
 - Encouragement of flow of investment into desirable areas of the society
 - Attract foreign and local investments e.g. through tax incentives
 - Promote import substitution
 - Achievement of desirable level of development
 - Promote accountability in public finance and recourses i.e. good governance of public institutions
 - Increasing the level of employment

Question four

- (a) Forward shifting – shifting the tax imposed on one party to consumers through increase in selling price.
Backward shifting – tax is shifted to the suppliers through reduction in buying price.
- (b) (i) Income tax – this cannot be shifted since it is a form of direct tax. The impact and incidence are on the same person. E.g. employees cannot shift PAYE to another party.



- (ii) Custom duties:- if the imparted good is for personal consumption e.g. imparted vehicle for personal use, the duty cannot be shifted. However, if it's for resale, the duty is shifted to the buyer since the seller mark-ups the cost inclusive of duty paid.

(c) Advantages of progressive taxes

Progressive tax is where the tax rate rises as taxable income increases (the higher the taxable income, the higher the rate).

Advantages

- Equitable – higher income is subject to more tax.
- Productive – yields more revenue to the government compared to proportional tax.
- Economical – collection cost does not increase with increase in tax rate.
- Equal sacrifice – the marginal utility of money decreases with every increase in income hence for higher income individuals to make equal sacrifice, they pay higher taxes.
- Equalities in wealth distributions – the rich with less disposable income will forego their luxuries and the poor will benefit more from the more tax charged on the rich.

Question five

- (a) (i) Impact of a tax
- The point at which a tax is imposed is where the impact is.
 - It is with the person that collects and accounts for the tax to the tax authorities.
- (ii) Incidence of a tax
- The point at which the money burden of a tax is or where the payment of tax is made. this is the resting place of a tax.



CHAPTER TWO

Question one

(a) Tax position of the income of a deceased person

Income accrued to or received prior to date of death of a deceased person which would have been assessed on him for a year of income shall be assessed and tax charged on his executors or administrators for that year of income.

Income received by executors or administrators which would have been taxable on the deceased person is assessable and charged on them. (Section 48 of the Income Tax Act)

Where income relating to the deceased is distributed by executors and administrators before a change in tax rate, they shall not be liable to any increase in tax resulting from the change in tax rate.

w.e.f. 1.1.93 the first Sh 1,400,000 payable to the estate of a deceased employee from a registered fund is tax exempt where the estate is eligible for no benefit other than a lumpsum payment.

(b) Set-off tax

Tax already paid by way of PAYE instalment tax systems, withholding tax (if not final tax), refunds claimable from tax authorities, shall be deducted from tax charged on the tax payer for the year of income in respect of which it was deducted. (Section 39(1) of the Income Tax Act)

**(c) (i) Mr. And Mrs. Ongera
Taxable Income
Year of Income 2007**

	Sh.	Sh.
Salary (120,000 x 12)		1,440,000
Overtime (10,000 x 12)		120,000
Christmas gifts		30,000
Pension Income (240,000 – 180,000)		60,000
Rent income: Gross 50,000 x 12)	600,000	
Less interest	<u>(400,000)</u>	<u>200,000</u>
		1,850,000
Add housing benefit: 15% x 1,850,000	277,500	
(Or 20,000 x 12)	240,000	<u>277,500</u>
		2,127,500
Add husbands income = 250,000 p.a x 12		<u>3,000,000</u>
		<u>5,127,500</u>

Mrs. Ongera owns 20% of the shares of Anga Ltd. Thus she is other director and housing benefit is based on 15% of the total income.

(ii) Tax liability on Ksh. 5,127,500

	Sh.	Sh.
Ksh.121,968 @ 10%		12,196.8
Ksh.114,912 @ (15% + 20% + 25%)		68,947.2
Ksh.(5,127,500 – 466,704) @ 30%		<u>1,398,239.0</u>
Less PAYE:		1,479,383.0
Husband	504,000	
Wife	720,000	
Personal relief	<u>13,944</u>	<u>(1,237,944.0)</u>
Net tax liability		<u>241,439.0</u>

(iii) Penalties for failure to fill self assessment return

Penalty of 5% of tax payable subject to Sh. 10,000 minimum. Late payment interest of 2% p.m of tax liability unpaid plus 20% late payment penalty..



Question Two

(a) Residence for tax purposes for:

(i) Mr. Charles Owino.

He has a permanent home in Kenya and was present in Kenya for at least one day. Thus he is a resident of Kenya.

(ii) Mapato Ltd

The company is not a resident of Kenya since it was neither registered nor is the management based in Kenya.

(iii) Mrs. Frida Aloo

She is a resident of Kenya since she was present in Kenya for periods exceeding 183 days (from January to August 2009). The income for part of the year was accrued in Kenya.

(iv) Zawadi Ltd

The company is a resident company of Kenya since it was registered in Kenya and operated in Kenya. However, it will only be taxed in Kenya for income generated up to 15 July 2006.

(b) (i) Joel Kivu
2007 computation of taxable income

	Ksh
Basic salary (75,000x6) + (82,500x6)	945,000
Furniture: 12% x 200,000	24,000
Telephone: 30% x 21,600 =	6,480
Contributions to Golf club	60,000
Life assurance premiums	48,000
- Car benefit:	
• - GG basis Sh 86,400	360,000
• - 24% x1,500,000 = Sh 360,000	
Housing Benefit:	
• Lease rental: Sh 360,000	360,000
• 15%x 1,443,480 = Sh 216,522	
Less contribution to pension	
Actual 300,000	(240,000)
Set limit 240,000	
30% pensionable pay 541,044	
(30% x 1,803,480)	
Farming Income (W - I)	622,250
Taxable Income	<u>2,185,730</u>
(ii) Tax liability	Sh
First (Sh121,968@10%) + (114,912@60%) =	81,144
Surplus (2,185,730 – 466,704) @30% =	<u>515,707.8</u>
	<u>596,851.8</u>
Less T.A.S - PAYE	(180,000)
Insurance relief - 15% x 48,000 =	(7,200)
P/Relief	<u>(13,944)</u>
Tax payable	<u>395,707.8</u>

**NOTES:**

(i) Farming Income	Sh
Reported revenue	1,800,000
Less salary to farm manager	(300,000)
Wages to farm labourers	(160,000)
Pig feeds	(410,000)
FWD-Pigstys - 50% x 48,000	(24,000)
Renovation - 50% x 130,000	(65,000)
WTA-Plastic tank-12.5% x 22,000	(2,750)
Taxable Income	<u>622,250</u>

Question Three**Mr. Kipkoech****2007 Computation of taxable income**

Basic salary	Sh.	720,000
Commission - 5% (50,000+100,000+20,000+15,000)		9,250
Education fees		200,000
Housing benefit::		
(i) 15% x 929,250 = 139,387.5		
(ii) Mkt rental value = 540,000		
HB is the higher = 540,000		
Less own contribution <u>(96,000)</u>		444,000
Less contribution to Hosp.		
(i) Actual -100,000		
(ii) Set Limit- 48,000		<u>(48,000)</u>
		<u>1,325,250</u>

Notes:

- Interest from Housing Development Bonds - 1st Sh. 300,000 W/T of 10% is final tax
- Farming income- Presumptive tax is final tax.

(iii) Tax Computation

		Sh.
First Sh (121,968@10%)+ (114,912@60%)	=	81,144
Surplus (1,325,250-466,704) @30%	=	<u>257,563.8</u>
		338,707.8
Less: T.A.S-PAYE		(180,000)
P/Relief		(13,944)
Insurance relief		
1. 15% x 45,000 = 6,750		(6,750)
2. Set limit = 60,000		
Tax payable		<u>138,013.8</u>

Question four

- (a) Resident tax payer
- (i) Management fees = 5%
 - (ii) Royalties = 5% W/T of gross income
 - (iii) Insurance commission = 10% W/T on gross paid to agencies or 5% W/T on gross paid to brokers.
 - (iv) Rent = No W/T

(b) MAPATO LTD

	Sh.	Sh.
Reported Net profits		218,600
Add back disallowable expenses		
Depreciation	344,760	
Travelling expenses – directors	400,000	
Pension scheme (directors)	160,000	
Compensation-wrongful termination	220,000	
Audit fees – tax appeal	32,000	
– discontinued business	68,000	
Bad debts – general provision	120,000	
100 year lease	28,000	
X- mass party	24,000	
Ask show	10,000	
		<u>1,406,760</u>
		1,625,360
Add insurance compensation (embezzlement)		12,000
Less: investment income (all non-business income)		<u>(284,636)</u>
Adjusted taxable income		<u>1,352,724</u>



- NB** (i) Embezzlement of staff of Sh. 21,600 is treated as allowable expense but compensation as taxable income. This is the practice for strictly cash and stock embezzlement or loss.
- (ii) Interest paid on borrowings made to generate investment income but not exceeding the amount of investment income is tax allowable expense
- (iii) Donations to charitable organisations are allowable expenses

Question five

(b) (i)

Alisa Enterprise

2007 Computation of adjusted profit (loss)

	Sh	Sh.
Reported profit		2,188,900
Add:		
Goods consumed at cost	80,000	
Insurance	70,000	
Bad-debts-Increase in gen. provisions	20,000	
Interest on loan	200,000	
Legal expenses	98,000	
NHIF	108,750	
NSSF	170,000	
Salaries to partners	800,000	
Household expenses-Ali	96,250	
Donations	20,000	
Income tax	240,000	
Depreciation	<u>19,500</u>	1,922,500
Deduct:		
Goods consumed at selling price	150,000	
Proceeds from sale of fixed assets	190,000	
Refund of VAT	41,250	
Interest on Post Bank savings A/C	8,750	
Dividend	<u>42,800</u>	(432,8000)
Adjusted partnership profit		<u>3,678,600</u>

(i) Allocation to partners

	Ali $\frac{3}{5}$	Salama $\frac{2}{5}$	Total Sh.
Salaries	500,000	300,000	800,000
Share of profit	<u>1,727,106</u>	<u>1,151,440</u>	<u>2,878,600</u>
	<u>2,227,160</u>	<u>1,451,440</u>	<u>3,678,600</u>



CHAPTER THREE

Question one

(a) (i) **Dividend Income**

- If from, outside Kenya, it's tax exempt.
- If received from another company in which the receiving company controls 12.5% or more, it's tax exempt.
- If controlling is less than 12.5%, 5% W/T is final.
- If it's investment income of an insurance company from it's life insurance fund, it's tax exempt.

(ii) **Interest**

- From outside Kenya, it's tax exempt.
- If qualifying interest, gross it up and aggregate with other incomes and tax @ 30%.
- Enjoy a tax credit of 15% of gross against corporate tax liability.

(iii) **Rent:**

Determine net rent income, aggregate it with other incomes and tax @ 30% corporate tax rate.

(b) (i) **MALI LTD ADJUSTED INCOME**

	(Sh. '000')	
Reported net profit	4,200	
Add back		
Bad debts – employee loan	15	
Legal expenses – manager	20	
Insurance premium – penalty	24	
Rent expenses – stamp duty	6	
Depreciation	25	
Purchase of furniture	<u>26</u>	116
Less		
Capital allowances	75	
Dividend and interest (200 + 4)	204	
VAT refund	12	
Gain on sale of M. Vehicle	<u>14</u>	<u>(305)</u>
Adjusted taxable income		<u>4,011</u>

(ii) Tax payable = 30% x 4,011,000 = 1,203,300



Question two

This is income earned by a person for rights granted to others to occupy his property. Rent income is made up of key money or goodwill, normal rent and premium.

Taxation of rental income depends on whether one is a resident individual or a non resident.

(a) Non residents

- i. They are taxed at a flat rate of 30% on gross rent income and this is the final tax.
- ii. No expenses are allowed against gross rent income.

(b) Residents

For residents, rental income will be brought to tax at the graduated scale rates for individuals and at the corporation tax rate for the companies. However the following points are relevant in arriving at the net taxable rental income:



CHAPTER FOUR

Question One

2007 computation of capital allowances

Investment Deduction

<u>Nature of assets</u>	<u>Qualifying cost</u>	<u>ID@100%</u>
Possessing machinery	680,000	680,000
Conveyor belts	180,000	180,000
		<u>860,000</u>

Industrial Building Deduction

<u>Nature of building</u>	<u>Qualifying cost</u>	<u>Residue b/f</u>	<u>IBD @ 2.5%</u>	<u>Residue c/f</u>
Factory Building	1,850,000	1,665,000	46,250	1,618,750
Warehouse	784,000	-	19,600	764,400
Security Wall	160,000	-	4,000	156,000
Borehole	560,000	-	<u>4,667</u>	555,333
			<u>74,517</u>	

NOTES

- (i) Factory Building: Years of use (2003-2006) = 4 years.

$$\text{Cost} = \frac{\text{NBV}}{i - rn} = \frac{1,665,000}{i - 0.05 \times 4} = \frac{1,665,000}{0.9} = 1,850,000$$

Wear and tear allowances

class	I	II	III	IV
	<u>37.5%</u>	<u>30%</u>	<u>25%</u>	<u>12.5%</u>
W.D.V. 1.1.2007				
Computers		390,000		
Plant & Machinery				3,640,000
Tractors	940,000			
Furniture & Fittings				120,000
Motor vehicles			740,000	
<u>Additions</u>				
Computer peripherals		96,000		
Motor vehicles			2,000,000	
Lorry	1,290,000			
Office cabinets				84,000
<u>Disposals</u>				
Motor vehicle			(200,000)	
	<u>2,230,000</u>	<u>486,000</u>	<u>2,540,000</u>	<u>3,844,000</u>
WTA	<u>(836,250)</u>	<u>(145,800)</u>	<u>(635,000)</u>	<u>(480,500)</u>
W.D.V. 31.12.2007	<u>1,393,750</u>	<u>340,200</u>	<u>1,905,000</u>	<u>3,363,500</u>

NOTES

- (i) Motor vehicle purchased in 1997
 $\frac{\text{Sales proceeds} \times \text{restricted value}}{\text{cost}}$

$$\frac{240,000}{600,000} \times 500,000 = 200,000$$

**(ii) Mapa Ltd****2007 computation of adjusted profit (loss)**

	Sh	Sh
Reported profit		4,296,000
Less Investment Deduction	860,000	
Industrial Building Deduction	74,517	
WTA	2,097,550	
Demolition Costs	<u>180,000</u>	<u>(3,212,067)</u>
Adjusted taxable profit		<u>1,083,933</u>

Question Two**Maji Mazuri Ltd****2006-2007 Computation of capital allowances****2006 Investment Deduction**

<u>Nature of Assets</u>	<u>Qualifying Cost</u>	<u>ID @100%</u>
Factory building	2,640,000	2,640,000
Production machinery	3,680,000	3,680,000
Drainage systems	840,000	840,000
Treatment plant	720,000	720,000
Stand-by generator	360,000	<u>360,000</u>
		<u>8,240,000</u>

2007

Factory extension	1,600,000	1,600,000
Conveyor belts	600,000	600,000
Electrical posts	200,000	200,000
Production machinery	180,000	<u>180,000</u>
		<u>2,580,000</u>

2006**Industrial Building Deduction**

<u>Nature of building</u>	<u>Qualifying cost</u>	<u>Residue b/f</u>	<u>IBD @ 2.5%</u>	<u>Residue c/f</u>
Canteen	960,000	-	<u>12,000^R</u>	948,000

2007

Canteen	960,000	948,000	24,000	924,000
Godown	700,000	-	17,500	682,500
Perimeter Wall	150,000	-	1,875 ^R	148,125
Recreation Hall	800,000	-	3,333.3 ^R	796,666.7
			<u>46,708.3</u>	

Wear and tear allowances

Class	I	II	III	IV
	37.5%	30%	25%	12.5%
W.D.N. 1.1.2006	-	-	-	-

Additions

Delivery truck	1,560,000
Tractor	860,000

	I	II	III	IV
Photocopier		300,000		
Partitions				<u>420,000</u>
	<u>2,420,000</u>	<u>300,000</u>		<u>420,000</u>
WTA	(453,750 ^R)	(45,000 ^R)		(26,250 ^R)
W.D.V. 1.1.2007	<u>1,966,250</u>	<u>225,000</u>		<u>393,750</u>

Additions

Surveillance Cameras Computer Systems			90,000	
		300,000		
	<u>1,966,250</u>	<u>555,000</u>	<u>483,750</u>	
WTA	(737,343.75)	(166,500)	(60,468.75)	
W.D.V. 31.12.2007	<u>1,228,906.25</u>	<u>388,500</u>	<u>423,281.25</u>	

**(ii) 2006-2007 computation of adjusted profit (loss)**

	2006	2007
Profit (loss) b/f	-	(11,877,000)
Reported Profit (loss)	(2,500,000)	(1,800,000)
Less ID	(8,240,000)	(2,580,000)
IBD	(12,000)	(46,708.3)
WTA	(525,000)	(964,312.5)
Loan interest	(600,000)	(1,200,000)
Adjusted profit (loss)	<u>(11,877,000)</u>	<u>(4,791,020.8)</u>

Question Three

- (a) (i) Building that qualify for Industrial Building deduction
- Factory Building
 - Buildings used for storage e.g. warehouse
 - Hotel Buildings
 - Prescribed dwelling houses
 - Building used for welfare of workers e.g. clinic, canteen
- (ii) For a building that is constructed but not used, the qualifying cost for purposes of capital allowances shall be the selling price of the last owner of the building.
- Assuming that Y Ltd. sold the building to Z Ltd. At the same price, then the basis of computing of capital allowances shall be Sh. 8,000,000. i.e.

AInvestment Deduction

<u>Nature of building</u>	<u>Qc</u>	<u>ID@ 100%</u>
Industrial building	8,000,000	<u>8,000,000</u>

(b)

Madini Mining Co.Ltd
2005-2007 computation of capital allowances

<u>Mining allowances</u>				
<u>Nature of expenditure</u>	<u>QC</u>	<u>2005 (40%)</u>	<u>2006 (10%)</u>	<u>2007 (10%)</u>
Exploration expenses	1,500,000	600,000	150,000	150,000
Administration Expenses	3,000,000	1,200,000	300,000	300,000
Patent rights	4,800,000	1,920,000	480,000	480,000
Const. of labour Quarters	1,200,400	480,160	120,040	120,040
Godown at site	780,000	312,000	78,000	78,000
Machinery for mining	1,960,000	784,000	196,000	196,000
Transportation of machinery	450,000	180,000	45,000	45,000
Mining allowance claim		<u>5,476,160</u>	<u>1,369,040</u>	<u>1,369,040</u>
<u>Wear and tear allowances</u>				
Class	<u>I</u>	<u>II</u>	<u>III</u>	<u>IV</u>
	<u>37.5%</u>	<u>30%</u>	<u>25%</u>	<u>12.5%</u>
W.D.V. 1.1.2005	-	-	-	-
<u>Additions</u>				
Lorry				
Computers	1,920,000			360,000
Furniture and fittings		900,000		
Pick-up			1,400,000	
	<u>1,920,000</u>	<u>900,000</u>	<u>1,400,000</u>	<u>360,000</u>
WTA	(360,000 ^R)	(136,000 ^R)	175,000 ^R)	(22,500 ^R)
W.D.V. 1.1.2006	1,560,000	764,000	1,225,000	337,500
WTA	<u>(585,000)</u>	<u>(229,200)</u>	<u>(306,250)</u>	<u>(42,188)</u>
W.D.V. 1.1.2007	975,000	534,800	918,750	295,312
WTA	<u>(365,625)</u>	<u>(160,440)</u>	<u>(229,688)</u>	<u>(36,914)</u>
W.D.V 1.12.2007	<u>609,375</u>	<u>374,360</u>	<u>689,062</u>	<u>258,398</u>
<u>Diminution in value (33 1/3%)</u>				
	<u>QC</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>
Tools and implements	900,000	300,000	300,000	300,000

**CHAPTER FIVE****Question one**

- (i) The partners have the responsibility of filing the partnership business returns by the end of the 4th month after the end of the calendar year i.e. 30th April. The returns will form the basis of determining how profit was shared and the taxable income from partnership business
- (ii) Late payment of tax will attract the following penalties
- Late payment penalty of 20% of unpaid tax
 - 2% p.m interest penalty on unpaid tax plus penalty

Question Two

- (b) **Four methods the Commissioner of Domestic Taxes is empowered to use in collecting overdue tax**
- Commissioner of Domestic Taxes can use for the method of recovery of the tax through a court of law.
 - Commissioner of Domestic Taxes can collect the tax through authorized agents under Section 96
 - Can collect under Section 102 by distress i.e. can seize property
 - Commissioner of Domestic Taxes under Section 103 can attach property of a tax payer as security for unpaid tax.
- (c) **Three circumstances under which CDT can send notices or raise assessments:**
- A person has not submitted a return of income and the CDT considers that the person has income chargeable to tax for that years
 - CDT considers that a person has been assessed or has assessed himself at a less amount in relation to income or tax payable.
 - Where CDT issues an agreed amended assessment but later discovers unassessed income.
- (d) **Matters that are contained in a notice of assessment**
- Notice to the taxpayer that he has been assessed under the Income Tax Act (ITA)
 - Information to the taxpayer that he has a right to object to the notice of assessment
 - Amount of tax assessed or loss to be carried forward
 - Amount of relief available (in case of individual)
 - Any amount of tax paid at source
 - Personal identification number (PIN)
 - Interest and penalties where applicable
 - Amount of tax payable, due date, or where tax is overpaid amount of refund
 - Name/and address of taxpayer

Question three

The income Tax department may send officers to employer's paying points during the year to check that they are operating PAYE scheme correctly and to give guidance to employers if they are in difficulties.

Any such officer must produce a signed authority and the employer will be expected to make available all the records connected s to PAYE for inspection.

The audit process will check that:

- (a) The employer has brought into the payroll all the employees, emoluments, cash allowances and benefits.
- (b) The employer has deducted the correct PAYE tax.
- (c) The tax deducted has been paid over to the bank.
- (d) The pay shown in the employer's salary records has correctly been transferred to tax deduction cards.
- (e) The tax deduction card has been fully and correctly completed.

Question four

(A) Payment of instalment tax

	Agricultural entities	Non-agricultural entities
First Instalment	75% 20 th of 9 th month after year end	25% 20 th payable 4 th month after year end
Second Instalment	25% -20 th of the 12 th month after year end	25% payable 6 th month after year end
Third Instalment		25% 9 th month after year end
Fourth Instalment		25% payable 12 th month after year end
Tax balance	Balance (if any) payable 30 th of 4 th month after year end	Balance (if any) payable 30 th of 4 th month after year end



CHAPTER SIX

Question One

Zero-rated supplies	Exempt supplies
<ul style="list-style-type: none"> VAT is charged at the rate of 0% VAT paid on all purchases is refundable Zero-rated suppliers must register for VAT as long as their taxable supplies are above 5 million per annum 	<ul style="list-style-type: none"> No VAT is chargeable VAT paid on purchases is not deductible Exempt suppliers need not register for VAT.

(b)

Non-Filing of VAT return =	Sh 10,000
Interest = $V(I+r)^n - V$	
$2,000,000(1.02)^4 - 2,000,000 =$	164,864.32
VAT due	<u>2,000,000</u>
Total Payment	<u>2,174,864.32</u>

Question Two

- (i) Hotel and restaurant services
 - Taxed V.A.T at a rate of 16%. (Previously, the rate was 14%)
 - V.A.T paid by hotel owner.
 - (ii) Transportation of raw material
 - Exempt from V.A.T.
 - (iii) Medical services
 - Exempt from VAT
 - (iv) Mobile phone airtime
 - Subject to VAT at 16% standard rate.
 - Paid by service provider. It's passed to the consumer through higher charges.
- (b) Since prices are inclusive of VAT, the input or output VAT would be determined as follows:

$$\frac{16\%}{116\%} \times \text{price inclusive of V.A.T}$$

Month		Input VAT		Output VAT
January	Purchases	206,897	Sales	303,448
February	Purchases	248,276	Sales	372,414
March	Purchases	234,483	Sales	275,862
April	Purchases	206,897	Sales	124,138
May	Purchases	55,172	Sales	82,759
June	Purchases	275,862	Sales	358,621
Bad debt relief		27,586	Return out	20,690
V.A.T payable		<u>282,759</u>		<u> </u>
		<u>1,537,932</u>		<u>1,537,932</u>

Question Three

- a) Importance of tax invoice
- Indicates the value, quantity and price of supply.
 - Help in determining the tax point.
 - Indicates all vital details of supplier such as VAT number, PIN etc.
 - Used in claiming input VAT.
 - Used in claiming bad debt relief.

(b) Tax Invoice

P. Kamau
P.O. Box 9999-0066
Nairobi, Kenya
Tel: _____

VAT Reg. No:

00987763R

S. No: 16345

Date of invoice: 20/1/2006

Date of

supply: 20/1/2006

To: L. Omondi

VAT Reg. No. = 00120365R

Qty	Description	Value	VAT rate	VAT (Sh)	Total (Sh)
2	Radio	15,000	16%	2,400	17,400
1	Television set	30,000	16%	4,800	34,800
1	Fridge	40,000	16%	<u>6,400</u>	<u>46,400</u>
				13,600	98,600

Paid: cheque No: 014632

Signed _____

Amount: 98,600

Stamp _____

ETR signature xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx



(c)

- (i) January VAT was due by 20th February 2007. The penalties are (i) failure to file VAT return = Sh. 10,000 no VAT was payable since input VAT > output VAT but return should nevertheless be filed. i.e. 48,000 output – 150,000 input = 102,000 refund.
- (ii) February: refund = 0 – 219,480 = 219,480. Should file VAT return by 20th March otherwise a Sh. 10,000 is imposed.
- (iii) March: VAT due = 497,940 – 167,640 = 330,300 payable. Payable by 20th April otherwise penalty would be as follows:
 * Late filing penalty: Higher of 10,000 or 5% x 330,300 = 16,515.
 * Late interest penalty = 2% p.m x 330,300 = 6,606.
 Total penalty = 16,515 + 6,606 = 23,121
- (iv) April: VAT due = 308,940 – 274,380 = 34,560 by 20th May. Penalties due. (whichever is higher)
- | | | |
|--|---|-----------------|
| * Failure to file return = 10,000 or 5% x 34,560 | = | 10,000 |
| * Interest penalty = 2% x 34,560 | = | <u>691.2</u> |
| Total penalty | | <u>10,691.2</u> |
- (v) Mwajuma should notify the commissioner of the omission of not deducting the input VAT.

**CHAPTER SEVEN****Question One****a) (i) Bonded Warehouse**

This is a warehouse licensed by the commissioner for deposit of dutiable goods on which:

- Duty has not been paid
- Entry has been made in the warehouse for use as ship stores
- For sale to passengers departing to places outside Kenya.

Dumping**Imported goods are deemed to be dumped in Kenya if:**

- Goods are sold in Kenya at a price lower than the cost of importing.
- The export price in the country which is exporting the goods is less than the fair market value or price of the goods in that country.
- If the country exporting the goods to Kenya had imported the goods and the export price of goods in the original country of export is less than fair market price in that country.
- The export price in the country which is exporting is less than the fair market price in that country.

(ii) Prohibited imports

- False or counterfeit money

- Indecent/obscene prints, books, paintings.
- Articles marked with ceremonial ensigns or coat of arms of Kenya.
- Adverts to promote sale of medicine to cure cancer, T.B. and Aids etc.
- Distilled beverages with injurious chemical products which can affect health of individuals e.g. methanol, hyssop etc.

(2) Restricted Imports

- Tear gas
- Traps for killing or capturing game animals
- Silencers or firearms and sound moderators
- Articles bearing boy scouts or girl guides badges, emblems or tokens.
- Postal franking machines unless permitted by the manager of Postal Kenya.

Question Two

c) Refund of import duty paid

- Where goods are returned to seller
- Where duty was paid in error i.e. over paid
- Where goods are lost or destroyed while under customs control
- Where goods are used in production of exports, members of diplomatic missions, Armed forces, NGO's etc

Question Three

(a)

- Dumping means importing goods into Kenyan Market and selling them at a price below the fair market price of the same goods in the country from which goods were imported.
- It does not necessarily mean sub-standard goods.
- It also applies to selling of imported goods at a price below the fair market value of the same goods in the country from which were first imported, then exported to another country before being exported to Kenyan.

(b) The measures to eliminate dumping are:

- High, anti-dumping duty.
- Imposition of a quota on the quantity of goods that can be imported from a given country or foreign institution.
- Pre-shipment inspection of goods
- Adequate documentation of all imports.

(c) Import duty may be refunded if:

- It was paid in error (over-paid)
- Goods are returned to the seller
- Goods are destroyed or damaged while under customs control
- If goods are used to manufacture exports.



CHAPTER EIGHT

Question 1

Instruments on which stamp duty is chargeable:

- Increase of share capital – 1%
- Transfer of securities of unquoted firms - 1%
- Transfer of immovable property within and outside a municipality (4% and 2% respectively)
- Lease agreement of 1 – 2 years – 1% of annual rent any other period - 2%
- Primary debenture/mortgage
- Insurance policies
- Hire purchase agreements
- Agreements such as partnership deeds.

The table below summarizes the information:

	Details	Rate %
o Conveyance of land	Urban	4%
	Rural	2%
o Assignment of debt		2%
o Registration of share capital (creation and increase)		1%
o Transfer of shares or marketable securities	Not listed	1 %*
	Listed on the stock	Nil
o Debentures and Mortgages	Primary security	0.2%
	Auxiliary security	0.1%
o Leases	up to three years	1% of annual rent
	over three years	2% of annual rent
* Transfer of quoted securities is exempt		

Source: Stamp Duty Act

Question 2

(a)

- (i) Cess – a charge on agricultural income especially cash crops for maintenance and repair of roads which access those agricultural locations.
- (ii) Property rates – rates charged local authority on land and building owned by individuals and body corporates. The local authority charge such rates on property located within its jurisdiction.
Valuation of property is necessary for purpose of imposing property rates.

(iii) Stamp duty – duty charged by the government in respect of some documents specified under stamp duties act. Such documents must be stamped and duty paid for them to be legal in executing transactions. The instruments are written documents for transactions such as:

- Transfer of property
- Mortgage of property
- Hire purchase agreements
- Lease agreements
- Insurance policies.
- Memorandums and articles of association
- Marketable securities etc.

REFERENCES



STUDY TEXT



REFERENCES

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GLOSSARY



STUDY TEXT



GLOSSARY

Advance tax: is tax payable annually in respect of every Public Service Vehicle (PSV) and Heavy Commercial Vehicle (HCV)

Back Duty: it means the process whereby the commissioner assesses a taxpayer for any tax unpaid in any year of income in the past

Bond: This is a promise (agreement) by a person to pay to the commissioner of Customs and Excise an amount of money if the conditions of the manufacturing agreement are not met.

Bonded Warehouse: is a warehouse used to store goods whose duties, VAT and other charges are secured by a Bond.

Customs duty: This is tax imposed on import or export of commodities.

Customs Warehouse: They are warehouses owned by the customs and Excise department and are used to store goods that have not been claimed by the importers.

Designated Primary Co-op societies: These are co-op societies whose members are individuals.

Designated Secondary Co-op Societies (Co-op Unions)

These are co-op societies whose members are not individuals but the designated primary co-op societies. Therefore they act as umbrella bodies or unions for primary co-op societies co-op societies

Direct tax: is a tax whose impact and incidence are on the same person.

Duty free shop: it means a room or premises situated in a port and licensed by the commissioner for the deposit of suitable goods on which duty has not been paid and which have been entered to be warehoused for use as ship stores or for sale to passengers departing to places outside the country.

Excise duty: This is tax imposed on commodities produced locally

Exempt goods/services: Goods/services on which no VAT is chargeable

Export processing Zone: is an area within a country which is free of duty or government red tape

Farm works deduction: a capital deduction granted only in respect of capital expenditure on agricultural land

Fees: is an amount which is received for any direct services rendered by the central or local authority.

Goods/services on which VAT is chargeable at 0%

Income tax: This is tax imposed on annual gains or profits earned by individuals, limited companies, business and other organisations.

Indirect tax: is a tax whose impact is on one person, but paid partly or wholly by another. An indirect tax can be shifted or passed on to another person.

Industrial building deduction: is a capital deduction or allowance given in respect of capital expenditure on an industrial building.

Input Tax: This is the VAT charged on a taxable person when he acquires taxable supplies for

use in the furtherance of his business.

Instalment Tax: Is a system of tax payment where businesses are required to pay a specific part of their income tax during the current year of income.

Investment deduction: is capital deduction given on cost of buildings and machinery which are used for manufacture, on cost of a ship, and on cost of a hotel building.

Land, rent and rates: This is tax imposed on property. Rent is paid to the central government on some land leases while rates are paid to the local authority based on the value of property

Mining deductions: This refers to capital allowances granted to a person carrying on the business of mining.

Output Tax: This is the VAT charged by a registered person when he makes a supply of taxable supplies in the course of his business.

Prohibited goods: These are goods, the importation or exportation of which is not allowed:

Rent income: This is income earned by a person for rights granted to others to occupy his property

Restricted goods: These are goods the importation or exportation of which is prohibited except in accordance with the condition under any law regulating such importation or exportation.

Royalty income: This is income earned by a person for rights granted to others to use his intellectual properties.

Savings and Credit Co-op Unions/Societies (SACCOs)

SACCOs are typically primary co-op societies since members are individuals but they carry on the business of savings and credit where the savings are for members or the credit is granted to the same members

Stamp duty: This is tax imposed on the transfer of property.

Tax Amnesty: it means forgiveness from payment of taxes or duties to the extent specified by the terms of amnesty.

Tax Avoidance: is where the tax payer arranges his affairs and finances in such a way that he will be required to pay less tax.

Tax Evasion: is where the taxpayer deliberately tries to avoid paying tax by not declaring his true income.

Tax incidence: The incidence of a tax is the direct money burden of the tax

Tax point: This is the point in time at which the tax (VAT) becomes due and payable.

Tax Refund: It is the repaying (paying back) by the commissioner of tax that the taxpayer had paid to the Commissioner.

Tax returns: it is a statement of all the income that accrued to particular person for a certain year of income.

Tax Shifting: This is the transfer of the burden of a tax from the person on whom it is legally imposed to another person.

Tax: Tax can be defined as an involuntary payment by a taxpayer without involving a direct repayment of goods and services in return.

Taxpayer: The person or entity that pays the tax e.g. individuals, companies, business and other organizations.

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Turnover Tax- This is tax imposed on income from business at the rate of 3% on the gross receipts.

Value added tax (V.A.T.): This is tax imposed on sale of commodities and services.

Or it is a tax on spending which is collected by businesses and passed on to the Government.

Warehouse: is a place or structure used for storage of goods.

Withholding Tax: is a method of deducting income tax on certain payments, by the person making the payment.

Year of Income: is a period of 12 months commencing 1 January and ending on 31 December in each year. It is the same as calendar year.

Zero Rated Goods/services: Goods/services on which VAT is chargeable at 0%

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