

ADVANCED TAXATION

STUDY TEXT

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CHAPTER ONE



TAXATION OF SPECIALISED ACTIVITIES



CHAPTER ONE

ADVANCED ASPECTS OF THE TAXATION OF BUSINESS INCOME

► 1.1 Objectives

In this chapter, the student should be able to understand tax aspects of partnerships and Limited companies. To enhance their understanding, various relevant case law examples have been discussed.

► 1.2 Introduction

In the first taxation paper you were introduced with aspects of taxation of business income. In this chapter, you will be introduced with concepts on advanced aspects of the taxation of business income. Some of the issues to be discussed in this chapter are tax implications of various sources of income for partnerships, and taxation of group of companies. In the next chapter you will cover the taxation of specialized institutions.

► 1.3 Key Definitions

- **Partnership:** The relationship that subsists between persons carrying on a business in common with a view to profit.
- **Company:** it's an association of persons who contribute capital towards common stocks for a common aim. Companies are incorporated under the Companies Act and are legal persons.

► 1.4 Exam Context

This topic is highly examined. Students will be required to not only remember the content learnt in their first taxation paper but also apply the knowledge learnt, in answering questions in this paper.

► 1.5 Industrial Context

This topic will help businesses be able to deal with complicated and advanced aspects of taxation of their businesses. The major beneficiary of the topic will be the finance manager, tax practitioners and accountant who will apply the information in making key management decisions.

1.6 Partnerships

■ Provisions of the Income Tax Act Cap 470 Laws of Kenya

For purposes of imposing tax a "person" does not include a partnership. The income of a partnership is assessed on the partners.

Under Section 4(b) of the Act, "the gain or profits of a partner from a partnership shall be the sum of -

- i. remuneration payable to him by the partnership together with interest on capital so payable, less interest on capital payable by him to the partnership; and
- ii. his share of the total income of the partnership calculated after deducting the total of any remuneration and interest on capital payable to any partner by the partnership and after adding any interest on capital payable by any partner to the partnership".

Where a partnership makes a loss as calculated in (ii) above, the gains or profits shall be the excess, if any of the amount set out in (i) over his share of that loss.

Determining the existence of a Partnership

Under English and Kenya law a partnership is not a person but "**the relationship that subsists between persons carrying on a business in common with a view to profit**".

Whether a partnership exists or not is a question of fact. The basic criterion is whether two or more persons carry on a business in common with a view to profits.

This suggests that the persons involved bear the attribute of a proprietor and have a profit motive.

Other useful guidelines include the following:

- Usually a partnership deed or written agreement will be drawn up
- There is a joint tenancy or tenancy in common
- There is sharing of gross receipts or profits

None of these circumstances of itself would constitute conclusive evidence of the existence of a partnership.

Common situations which pose difficulties in proving a partnership are:

1. Whether joint transactions may constitute a partnership; and
2. Whether the parties concerned are partners or merely employees.

1. Joint transactions - JOHN GARDNER & BOWRING & CO V CIR

G arranged during a coal strike to buy imported coal from B. The coal was invoiced to G at cost and the net excess of his sales were shared with B.



Judgement "whereas these cargoes of coal generally had been formally the simple transaction of purchase and sale between the parties, they immediately became the subject of a transaction in which both parties were interested, and in which when one of them had sold the coal, the sale was not on his behalf but on behalf of the two together the net profit, so obtained was equally divisible between them".

Held: The relation between these two parties constituted a partnership.

2. Employee or partner

The Deed of partnership does not necessarily constitute partners for income tax purposes.

Dickenson V Gross (Hmit)

A farmer named Dickenson, entered into a Deed of Partnership with his three sons with the admitted intention of reducing income tax liability in respect of the profits. The deed provided inter alia that two farms owned by D should be let to D and his sons at stated rentals, that accounts should be made up annually, that the net profits should be divided equally between the partners, and that the partners shall have the right to sign and endorse cheques on behalf of the firm. No rent was paid and no accounts or books had been kept. No distribution of profits was made. Cheques were signed by D and some business receipts were paid to his private bank account.

Held: That as a partnership did not exist **in fact**, and that there was no partnership for purposes of income tax.

E v CIT

E carried on business as a sole trader. In June 1942 he admitted his three daughters and son as partners. A Deed was executed stating the partnership commenced on 1 June 1942. The provision of the deed gave E sole and exclusive management and control of the business. Neither the son nor any of the daughters contributed property, labour or skill to the partnership.

A Deed of covenant was executed whereby each of the daughters was to pay a fraction of her partnership profits to her mother and other infant children of E.

Held: Both the local committee and the High Court ruled that there was no evidence that a partnership in fact existed.

Sinclair J stated:

"The terms of the Deed of Partnership and the facts as a whole are, in my view, inconsistent with the relation of a partnership. The other partners contributed neither property nor labour, nor skill. The whole of the capital was provided by the appellant. The partners in fact drew no profit. It was evident that the appellant intended to retain control, not only of the management of the business but also of the share which he gave to the children.

CIT V Williamson

A farmer and his sons for several years leased and worked in a farm jointly, but without any deed of partnership. He supplied the capital, conducted all buying and selling and controlled the bank account which was in his name.

He made no regular payments to his sons but supplied them, on request, with such monies as were necessary for their requirements. No record of these disbursements or the financial results of the farm was kept.

The respondent appealed against additional assessment to income tax in respect of the farm, raised on the basis that he alone was assessable.

Held: That the facts did not justify the inference that a partnership had existed.

Opinions

The Lord President (Clyde)

"My Lords the question before us is whether there was a partnership between the father and his three sons in whose joint names the lease ... was taken ... No doubt the lease was in joint names ... That it is in vain to constitute a partnership and the whole capital belonged to the respondent ... There is no record of any kind to show the existence of any contractual relation of any sort. The bank account was the respondent's bank account and his alone. It was never operated by anybody but him ... The sons got no wages ... You do not constitute or create or prove a partnership by saying that there is one. The only proof is proof of the relations of agency and of loss and profits and of the sharing in one form or another of the capital".

Lord Sands

"Stated all the facts and circumstances of the case otherwise, except the matter of the lease, appear to be against and, indeed almost exclusive of the idea of a partnership".

Pratt V Strick

P agreed to purchase a medical practice. A Deed of assignment was exercised on 15 July 1929 whereby the vendor agreed to stay on in the practice for three months to introduce P to his patients, with a view to maintaining the connection of the practice and generally to aid and assist him in the practice. It was agreed that the earnings and expenses of the practice during the three months be borne by the vendor and purchaser in equal shares.

P contended that the practice was sold outright to him on 15 July 1929 and that his income tax liability should be computed on the basis the practice was commenced anew by him on that date.

Held: That there was an out-and-on sale of the practice on the 15th July, 1929, and that there has been no partnership. The practice was assessable as a new business in the name of the purchaser only, and the vendor was in receipt of remuneration for services rendered.

Waddington V O'callaghan (Hmit)

The appellant, who had for many years carried on, solely, a practice as solicitor, informed his son on 31 December, 1928, that it was his intention to take him into partnership as from that date.

On 1 January, 1929, he instructed another firm of solicitors, by letter, to draft a partnership deed. The deed was executed on 11 May 1929 to have effect from 1 January 1929.

No formal notice of the partnership was at any time given by advertisement, circular or otherwise. No alteration of the name under which the practice was carried on, or in the business bank account, was made until after the date of the partnership deed. From 31 December 1928 the son was credited with the share of profits to which he was entitled under the partnership deed.

Held: The Partnership constituted by deed commenced on the date of the deed and that there was no knowledge of the existence of a partnership before.



Steps in Computing tax on 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.

Format of Income Tax Computation of a Partnership

	Shs	Shs
Net profit as per A/C		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	XX	XX
Less		
Non taxable income	X	
Capital deductions allowed	X	(XX)
Adjusted partnership profits		<u>XXX</u>

Income Allocation to Partners

	Total Shs	Partner A Shs	Partner B Shs
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.

Computing taxable income of a partnership where the partner has no proper books of account

Jimna and Mwala are in partnership trading as Jimna Enterprises and sharing profits and losses in the ratio of 2:1 respectively. The partnership has however not been maintaining proper books of account.

The following information relates to the financial year ended 31 December 2007:

1. The firm's assets and liabilities as at 1 January 2007 comprised:

	Shs
Office equipment (net book value)	180,000
Motor vehicle (net book value)	480,000
Stock (cost)	95,000
Trade debtors	600,000
Trade creditors	480,000
Shop premises at cost (year of construction 2002)	1,200,000
Bank balance	100,000

2. The following transactions were reflected in the bank statement of the partnership for the year ended 31 December 2007:

	Debit	Credit	Balance
	Shs.	Shs.	Shs
Balance brought forward (1 January 2007)			100,000
Additional capital from partners		800,000	900,000
Cash sales		965,000	1,865,000
Cash received from trade debtors		114,000	1,979,000
Cash purchases	705,000		1,274,000
Purchase of delivery van	620,000		654,000
Miscellaneous expenses	90,200		563,800
Electricity expenses	19,400		544,400
Sales assistant's wages	58,000		486,400
Motor car running expenses	39,620		446,780
Drawings by partners	40,000		406,780
Interest on partners' drawings		4,000	410,780
Sale of land		460,000	870,000
Salaries and wages	840,000		30,780
Advertisement	24,000		6,780
Farming revenue		360,000	366,780
Ledger fees	5,600		361,180
Insurance	36,000		325,180
Payment to trade creditors	448,000		(122,820)
Legal expenses	20,000		(142,820)
Closing balance on 31 December 2006:			(142,820)Dr



3. The cash sales deposited are after deducting Sh.3,000 per month taken as imprest by each partner in order to pay for goods drawn from the firm. No entries have been made to record the imprest or drawings of goods.
4. Trade debtors and creditors balances as at 31 December 2007 were Sh.1,200,000 and Sh.160,000 respectively.
5. Salaries and wages include salaries to partners paid during the year amounting to Sh.165,000 and Sh.160,000 to Jimna and Mwala respectively.
6. Legal expenses comprise:

	Shs
Conveyance fee for shop premises	5,000
Breach of trade agreement	3,600
Preparation of partnership deed	5,400

1. Miscellaneous expenses include estate valuation fee of Shs.4,000 in relation to insurance of the shop premises.
2. Five percent of the trade debtors outstanding as at 1 January 2007 were uncollectible during the year and were written off.
3. Stock as at 31 December 2007 amounted to Sh.128,000

Required:

- i) Adjusted partnership profit or loss for the year ended 31 December 2006 (**Hint:** start with sales) (12 marks)
 - ii) Allocation of the profit or loss in (b) (i) above to the partners. (2 marks)
- (Total: 20 marks)**

Attempted solution

Step 1: Compute the figures not provided. In this case, ascertain the sales and purchases figure by drawing the relevant accounts.

JIMNA PARTNERSHIP

TOTAL DEBTORS ACCOUNT

	Shs. '000'		Shs. '000'
Bal b/d	600	C/B	114
Credit Sales	744	Bad debts	30
		Bal c/d	<u>1,200</u>
	<u>1,344</u>		<u>1,344</u>

Total Sales: Cash Sales + Credit Sales

$$[(965,000 + 72,000) + 744,000] = 1,781,000$$

Goods drawn (6,000 x 12) = Shs.72,000

72,000

1,853,000

TOTAL CREDITORS

	Shs. '000'		Shs. '000'
C/B	448	BAL B/D	480
		Credit Purchases	128
BAL C/D	<u>160</u>		
	608		608

Step 2: Having obtained the total sales and total purchases figures, we can now use them to compute the adjusted profit or loss for the partnership for the year 31 December 2006. The applicable capital allowances must be deducted from the profit before arriving at the net taxable profit.



ADJUSTED PARTNERSHIP PROFIT OR LOSS FOR THE YEAR TO 31 DECEMBER 2006

	Shs. '000'	Shs '000'	Shs. '000'
Sales: Cash			1,037.00
Credit			744.00
Receipts for goods drawn (6,000 x 12 months)			72.00
			1,853.00
<u>Cost of Sales</u>			
Opening stock		95.00	
Purchases – Cash	705.00		
- Credit	<u>128.00</u>	833.00	
Closing stock		<u>(128.00)</u>	<u>(800.00)</u>
Gross profit			1,053.00
Farming revenue			360.00
			<u>1,413.00</u>
<u>Allowable expenses:</u>			
Miscellaneous expenses		90.20	
Electricity expenses		19.40	
Sales assistants wages		58.00	
Car running		39.62	
Salaries and wages (840,000 – 325,000)		515.00	
Advertisement		24.00	
Ledger fees		5.60	
Insurance		36.00	
Legal expenses (20,000 – 14,000)		6.00	
Bad debts written off		30.00	
Wear and tear allowance		297.50	(1,121.32)
Net profit			291.68
	Shs. '000'	Shs '000'	Shs. '000'
Sales: Cash			1,037.00
Credit			744.00
Receipts for goods drawn (6,000 x 12 months)			72.00
			1,853.00
Cost of Sales			
Opening stock		95.00	
Purchases – Cash	705.00		
- Credit	128.00	833.00	
Closing stock		(128.00)	(800.00)
Gross profit			1,053.00
Farming revenue			360.00
			1,413.00
<u>Allowable expenses:</u>			
Miscellaneous expenses		90.20	
Electricity expenses		19.40	
Sales assistants wages		58.00	
Car running		39.62	
Salaries and wages (840,000 – 325,000)		515.00	
Advertisement		24.00	
Ledger fees		5.60	
Insurance		36.00	
Legal expenses (20,000 – 14,000)		6.00	
Bad debts written off		30.00	
Wear and tear allowance		297.50	(1,121.32)
Net profit			291.68

WEAR AND TEAR ALLOWANCE

	III @ 25%	IV @ 12½%
	SHS '000'	SHS '000'
CLASS		
Brought forward:		
Office equipment (net)		180
Motor vehicle (net)	480	
Addition: Delivery van	620	
Sub-total	1,100	180
Wear and tear allowance	(275)	(22.5)
	825	157.5

Total wear and tear allowance $(275 + 22.5) = \underline{297.5}$

Note:

No written down values have been provided for wear and tear assets as at 1/1/2006. The net book value has been used instead as representative of written down values at the beginning of the year.

Step 2: Allocate the profits or losses to the partners according to the profit and loss sharing losses taking into considerations the provisions of Section 4 (b) of the Income Tax Act..

iii) ALLOCATION OF PROFIT IN (b) (i) ABOVE

PARTNER	JIMNA	MWALA	TOTAL
	SHS '000'	SHS '000'	SHS '000'
Salary	165.00	160.00	325.00
Share of loss	(22.21)	(11.11)	(33.32)
	<u>142.79</u>	<u>148.89</u>	<u>291.68</u>

1.7 Limited companies

Limited companies in Kenya can either be private or public. There are no fundamental differences in the taxation of either private or public companies.

Companies 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 lesser 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.



1 st instalment	25% of tax due by 20 th day of the 4 th month during the year of income.
2nd instalment	25% of tax due by 20 th day of the 6 th month during the year of income.
3rd instalment	25% of tax due by 20 th day of the 9 th month during the year of income.
4th instalment	25% of tax due by 20 th day of the 12 th 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:

1 st instalment	75% of tax due by 20 th day of the 9 th month during the year of income.
2nd instalment	25% of tax due by 20 th day of the 12 th 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.

■ 1.7.1 Corporation Tax Rates.

In Kenya, the corporate tax rate for a resident company is 30% whilst the tax rate for a permanent establishment of non resident company is 37.5%. A non resident company can have a permanent establishment in Kenya by opening a branch. However, different rates of taxes apply for the following:

i. Newly 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.

ii. Export Processing Zone Companies

Companies 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 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.

iii. Resident companies mining specified minerals

Resident companies mining specified minerals under the Income Tax Act – for the first 4 years of mining operations income is taxed 27.5% per year, while normal rates shall apply from the fifth year of operations.

1.7.2 Tax Effects of Shortfall Distribution of Company Profits (Section 24)

The profits of a company after taxation may be distributed to the shareholders in full as dividends or retained to provide finance, or be partly distributed and partly retained. If a company fails to distribute as dividends that part of its income which in the opinion of the Commissioner is in excess of its requirements within a period of twelve months after the accounting period, the Commissioner may direct that that income be deemed to have been distributed to the shareholders as dividends.

The Act requires that a company paying dividends to deduct tax at source and remit it to the Commissioner. The company is entitled to recover such from the shareholder. When the profits are subsequently distributed, they will not be taxed on the shareholders.

In practice, the Commissioner usually allows for the retention of 60% of the profits after tax derived from trading income. Profits after tax from investment income are distributed in full. Non-taxable dividends are also distributed in full.

Illustration

Limited made a pre-tax profit of Kshs.100m comprising of:

- a. Trading profits Shs.60m
- b. Investment income Shs.10m
- c. Dividends from B. Limited (a subsidiary) Shs.30m



State how much the company should distribute as dividends in order to comply with the Section 24 proviso (Assume corporation tax is 40%)

	<i>Trading</i>	<i>Investment</i>	<i>Non-taxable</i>	<i>Total</i>
	Profits	Income	dividends	
	Kshs.—m	Kshs—m	Kshs—m	Kshs—m
Pre-tax profits	60	10	30	100
Corporation tax (40%)	<u>(24)</u>	<u>(4)</u>	—	<u>(28)</u>
Profits after tax	36	6	30	72
Maximum retention (60%)	<u>(21.6)</u>	<u>NIL</u>	<u>NIL</u>	<u>(21.6)</u>
distributable profits	<u>14.4</u>	<u>6</u>	<u>30</u>	<u>50.4</u>

■ 1.7.3 Taxation of Branches of foreign companies.

Non-resident companies with branches in Kenya are liable to pay corporation tax at a comparatively higher rate of 37½% on incomes generated by their local branches. Like for resident companies, such branches shall be allowed to deduct expenditure incurred in generation of income. In the case of export processing zones enterprises. There is a tax holiday during the first 10 years of their operations, followed by a lower tax rate of 25% during the next ten year period. For mining companies a lower tax rate of 27½% is applicable over the first five years of production. Special withholding tax rates exist for certain specified income sources.

For the purpose of ascertaining the gains or profits of a business carried on in Kenya no deductions shall be allowed in respect of expenditure incurred outside Kenya by a non-resident person other than expenditure in respect of which the commissioner determines that adequate consideration has been given and in particular no deduction shall be made in respect of expenditure on remuneration for services rendered by the non resident director who is not full time director of a non-resident company.

On executive and general administrative expenses except to extent the commissioner may determine to be just and reasonable. No deduction shall be allowed in respect of interest, royalties or management or professional fees paid or purported to be paid by the permanent establishment to the non-resident person. Sales abroad by a branch of goods produced in Kenya will be deemed to generate income derived in Kenya and such income is taxable in Kenya. A branch does not suffer any withholding tax on remittances of profits to head office

■ 1.7.4 A Group Comprising the Holding Company and Subsidiary Companies

Under the Income Tax Act, companies are treated as legal persons independently. There is no lifting of the veil to consider them as part of one group for tax purposes. As such, the law does not permit any form of consolidated return combining the profits and losses of affiliated companies or the transfer of losses from loss making to profit making members of the same group of companies.

Where assets qualifying for wear and tear allowances are transferred between companies under common control, the sale consideration is deemed for tax purposes to be the open market value of those assets. However, if this treatment would give rise to a taxable balancing adjustment in the computations of the transferor company, the two companies may jointly elect for tax written down value to be substituted as the sale considerations. This election is possible only if both companies are resident in Kenya.

Dividends paid by one resident company to another one exempted from tax in the recipients company's hands if it controls 12½% or more of the voting power of the paying company.

Real estate maybe transferred free of stamp duty where the beneficial ownership does not change.

■ 1.7.5 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 arise 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	Kshs	Kshs
	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

The following information was obtained from the books of Nyawira Ltd, for the year ended 31 Dec. 2008

Details	Kshs.
Profit after Tax	4,200,000
Dividend paid	6,400,000
Dividend received	1,500,000

Additional information:

A tax refund of Kshs 360,000 was received by the company for the year ended 31 dec 2008

Required: Compensating tax, if any payable by Nyawira Ltd for the year ended 31 dec 2008.

Attempted solution

Computation of compensating tax

	DR	CR
Income tax paid (0.3 x 4,200,000) (excluding dividend w/tax)		1,260,000
Dividend received (1,500,000 x 0.3/1-0.3)		642,857
Dividend paid (6,400,000 x 0.3/1- 0.3)	2,742,857	
Tax refund	360,000	
Compensating tax		1,200,000
	3,102,857	<u>3,102,857</u>

Definition

Compensating tax as per section 7A of the Income Tax Act is an additional tax imposed on companies arising where tax paid plus tax on dividends received is less than tax on dividends paid and tax refunds by the company.

Tax paid excludes withholding tax on qualifying dividends but includes compensating tax.

■ **1.7.6 Capital Deductions**

Section 16 of the Income Tax Act expressly provides that in calculating the gains or profits of a person no deduction can be made for expenditure of a capital nature. The same principle is applied in disallowing capital losses, exhaustion of capital e.g. depreciation of fixed assets.

The substance of this principle is that on the other hand a disposal of a fixed asset is not a revenue receipt and therefore excluded from the computation of taxable profits.

The distinction between capital expenditure and revenue expenditure is quite essential in the study of capital allowances.

The scheme of capital allowances serves three main purposes:

1. To encourage new industrial enterprises;
2. To allow such deduction as may be just and reasonable as representing the diminution in the value of fixed assets by reason of wear and tear during a particular year, of any plant or machinery used for the purpose of a business; and
3. To encourage exportation.

The capital allowances available in Kenya are:-

- a. Investment Deduction Allowance
- b. Wear and Tear Allowance
- c. Industrial Building Allowance
- d. Farmworks Deduction Allowance
- e. Mining Deduction

We provide a summary of the capital allowances on the assumption that the same were covered in detail in the taxation 1 level.

(a) Investment Deduction

Based on eligible cost:

	Rate %
Building and machinery used for manufacturing purposes and hotel buildings	100
Civil works and structures forming part of an industrial building used for purposes of manufacturing	100
Ships	40
Filming Equipment (W.E.F 12 th June 2009)	100
Satellite Towns Investments (W.E.F 12 th June 2009)	150

'Manufacturing' for the purposes of investment deduction includes generation of electrical power supply to the national grid. Investment deduction is granted to lessors on machinery that is subsequently leased and used for the purpose of manufacture.

With effect from 12th June 2009,

- For any expenditure to qualify for investment Deduction on machinery and buildings, there must be a minimum expenditure of Kshs.200 million.
- Filming equipment qualify for Investment Deduction of 100%
- An incentive was introduced for an Investment in the Satellite towns adjoining Nairobi, Mombasa or Kisumu at 150%



(b) Wear and tear allowance

Based on cost net of any investment deduction and computed on declining balance basis:

	Rate %
Heavy self-propelling machinery such as tractors and combine harvesters	37.5
Computer and peripheral computer hardware, calculators, copiers and duplicating machines	30
Other self propelling vehicles and aircrafts (cost of non-commercial motor vehicles is restricted to KShs 2 million)	25
All other machinery including ships	12.5
Computer software (W.E.F 12 th June 2009)	5
Telecommunication Equipment (W.E.F 12 th June 2009)	20

With effect from 12th June 2009,

- The Wear and Tear allowance for computer software is 5%.
- The wear and Tear Allowance rate for telecommunication equipment is 20%

(c) Industrial buildings allowance

Based on cost net of any investment deduction and computed on a straight line basis:

	Rate %
Industrial buildings	2.5
Hotel buildings	10
Hostels and buildings used for educational purposes	10
Hostels, Training and educational buildings (W.E.F 12 th June 2009)	50
Rental residential buildings constructed in a planned developed area approved by Minister for Housing	5
Rental residential buildings constructed in a planned developed area approved by Minister for Housing(W.E.F 12 th June 2009)	25
Commercial Buildings (W.E.F 12 th June 2009)	25

With effect from 12th June 2009,

- The IBD for commercial buildings is 25%
- The IBD for hostels educational and training buildings was increased from 10% to 50%
- The IBD for rental residential buildings in a planned development area increased from 5% to 25%

(d) Farm works allowance

	Rate %
Computed on a straight-line basis	2006 – 33.3%
	2007 to date 50%

(e) Mining allowance

Based on capital expenditure incurred in mining specified minerals:

	Rate %
Year 1	40
Year 2 – 7	10

Illustration Question

a) The following is the summarised balance sheet of Faraja Ltd. as at 1 January 2006:

	Shs.	Shs.
Non-current assets:		
Factory building (net book value)	5,680,000	
Processing machinery (net book value)	2,420,000	
Motor vehicles (net book value)	1,500,000	
Furniture and fittings (net book value)	840,000	
Office equipment (net book value)	<u>670,000</u>	11,110,000
Current assets:		
Stock	1,240,000	
Trade debtors	760,000	
Prepaid insurance	360,000	
Bank balance	<u>540,000</u>	<u>2,900,000</u>
		14,010,000
Financed by:		
Share capital (ordinary shares of Sh.20 each)	9,000,000	
10% debenture stocks	2,400,000	
15% bank loan	<u>1,500,000</u>	12,900,000
Current liabilities:		
Creditors	1,000,000	
Accrued general expenses	<u>110,000</u>	<u>1,110,000</u>
Total capital liabilities		14,010,000

Additional information:

- All the non-current assets were acquired on 1 January 2004 when the company commenced operations. The net book value of these assets as at 1 January 2007 were the same as their written down values for capital allowance purposes.
- Included in the processing machinery are machinery with a net book value of Shs.420,000 as at 1 January 2007. This machinery are used in designing and moulding products during the manufacturing process.
- Office equipment as at 1 January 2007 comprised the following assets at net book value:



	Shs.
Computers	240,000
Telephone switchboard	96,000
Fax machines	120,000
Neon sign	36,000
Other office equipment	178,000

- 4 One of the motor vehicles purchased on 1 January 2004 was a saloon car acquired at a cost of Sh.1,200,000.
- 5 The reported profit of the company for the year ended 31 December 2007 was Sh.1,840,000 before accounting for capital allowances due for the year and interest expense. The reported profit was based on cash sales.
- 6 The following transactions included in the bank statement for the year had also not been accounted for in arriving at the reported profit:

	Shs.
Receipts from trade debtors	2,800,000
Payments to trade creditors	1,400,000
Refund from trade creditors for purchases returned	360,000
General expenses	346,400
Insurance	550,800
Cash sales deposited directly to bank account	140,000

Insurance paid includes a pre-payment of Sh.50,800 for year 2008.

7. There were no closing balances of trade debtors and creditors as at 31 December 2007. All payments from/to trade debtors and creditors were made through the bank account.

Required:

For the year ended 31 December 2007, determine for Faraja Ltd:

- i) Capital allowances (8 marks)
- ii) Adjusted taxable profit or loss (4 marks)

(Total: 12 marks)

Attempted Solution.

FARAJA LTD

- i) CAPITAL ALLOWANCES FOR YEAR TO 31 DECEMBER 2006

- a) INDUSTRIAL BUILDING DEDUCTION

Nature of building	Qualifying Cost	Residue b/f	IBD @ 2½%	Residue c/f
	Shs. '000'	Shs. '000'	Shs. '000'	Shs. '000'
Factory building	6,140.541	5,680	153.514	5,526.486

b) WEAR AND TEAR ALLOWANCE

CLASS	I @ 37½%	II @ 30%	III @ 25%	IV @ 12½%
	S. '000'	SHS. '000'	SHS. '000'	SHS. '000'
W.D.V b/f:				
Computers		240		
Telephone switchboard		96		
Fax machine		120		
Neon sign				36
Other office equipment				178
Motor vehicles			1,500	
Furniture and fittings				840
Processing machinery				<u>2,420</u>
Sub total		456	1,500	3,474
WTA		<u>(136.8)</u>	<u>(375)</u>	<u>(434.25)</u>
		319.2	1,125	<u>3,039.75</u>

SUMMARY OF CAPITAL ALLOWANCES

	SHS. '000'
IBD	153.514
WTA II	136.8
III	375
V	434.25
Total Capital allowances	1,099.564

ii) ADJUSTED TAXABLE PROFIT OR LOSS FOR YEAR TO 31 DECEMBER 2006

	SHS. '000'	SHS. '000'
Reported profit		1,840.00
Add: Credit sales omitted	2,040.00	
Cash sales omitted	140.00	2,180.00
		4,020.00
Deduct		
Purchases	400.00	
General expense	346.40	
Insurance (550.8 – 50.8)	500.00	
Capital allowances	1,099.56	(2,345.96)
Adjusted taxable profit		1,674.04

DEBTORS ACCOUNT

	SHS. '000'		SHS. '000'
Bal b/d	760	Bank	2,800
Credit Sales	<u>2,040</u>		
	2,800		<u>2,800</u>



CREDITORS ACCOUNT

	SHS. '000'		SHS. '000'
Bank	1,400	Bal b/d	1,000
Balance carried down		Credit Purchases	400
	<u>1,400</u>		<u>1,400</u>

1.8 CHAPTER SUMMARY

- Partnerships are not legal persons. Their incomes are taxed on the respective partners at their graduated scale rates
- Resident and non resident companies with permanent establishments are taxed at the rates of 30% and 37.5% respectively.
- There are special incentives available for newly listed companies, companies operating in the EPZ and companies involved in mining specified minerals.
- There are differences in the taxation of a branch of a foreign company compared to a resident company.
- Companies declaring dividend from untaxed profits are subject to compensating tax.
- There are five major types of capital allowances in Kenya, applicable to expenditure of a capital nature incurred in the generation of income.

1.9 QUIZ

QUESTIONS ONE

Name the five capital allowances in Kenya

QUESTION TWO

Distinguish between taxation of partnerships and private limited companies.

QUESTION THREE

List the incentives if companies operating in the EPZ zone.

QUESTION FOUR

Explain the dates for instalment tax payment for companies.

QUESTION FIVE

What is compensating tax?

**1.10 ANSWERS TO THE QUIZ****QUESTIONS ONE**

Name the five capital allowances in Kenya

- a. Investment Deduction Allowance
- b. Wear and Tear Allowance
- c. Industrial Building Allowance
- d. Farmworks Deduction Allowance
- e. Mining Deduction

QUESTION TWO

Distinguish between taxation of partnerships and private limited companies.

- i) A partnership is not considered as a separate taxable entity as a company, therefore, the taxable income of a partnership is allocated among the partners according to the profit/loss sharing ratio. A company is considered to be a separate taxable entity and as such it will bear its taxes.
- ii) The partners in a partnership are taxed at the graduated scale rates which are lower than the corporate tax rates. The taxable income or loss of a limited company is taxable on the company at a flat rate of 30% for resident and 37.5 % for nonresident companies.
- iii) Partner's salaries are not tax deductible while director's salaries in a limited company are tax deductible.
- iv) Very important also to consider is that the losses made under a partnership are carried forward by the Partners individually but not the firm while losses in a limited company are carried forward by the company.
- v) The company will be required to pay withholding tax when its declaring dividends to its share holders while a partnership does not declare dividends. The partners may withdraw and any such withdrawal will be taxed on the individual partner.
- vi) Companies have compensating tax while partnerships are not subject to the same.
- vii) Currently partnership can pay turnover tax at 3% on gross income if the company has turnover of between Kshs.500,000 and Kshs.5m within one year. However, companies are not subject to turnover tax.

QUESTION THREE

List the incentives if companies operating in the EPZ zone.

Companies operating within EPZ have the following benefits:

- A ten year tax holiday –This is an exemption from corporation tax for the first ten years of trading.

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

QUESTION FOUR

Explain the dates for installment tax payment for companies.

Instalment tax is payable as follows.

1 st instalment	25% of tax due by 20 th day of the 4 th month during the year of income.
2nd instalment	25% of tax due by 20 th day of the 6 th month during the year of income.
3rd instalment	25% of tax due by 20 th day of the 9 th month during the year of income.
4th instalment	25% of tax due by 20 th day of the 12 th 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:

1 st instalment	75% of tax due by 20 th day of the 9 th month during the year of income.
2nd instalment	25% of tax due by 20 th day of the 12 th 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.

QUESTION FIVE

Compensating tax was introduced in 1993 under Section 7 A of the Income Tax Act. It is an additional tax imposed on companies and arise 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.



1.11 PAST PAPER QUESTIONS ANALYSIS.

The topic has been tested very frequently in the previous years. The student is advised to practice the questions so as to enhance understanding of the topic. 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.

06/00 Q. 1, 06/00 Q.2, 12/00 Q.1, 2, 3, 06/01 Q. 1, 06/01 Q. 5, 12/01 Q. 2(b), 12/01 Q. 5, 06/02 Q. 2, 06/02 Q. 5, 12/02 Q. 3, 06/03 Q. 2, 06/03 Q. 4 & 5, 12/03 Q.1 & 2, 06/04 Q.3, 06/04 Q.5, 12/04 Q.1, 12/04 Q.3, 06/05 Q.2 (b), 06/05 Q.3, 06/05 Q.4, 12/05 Q.1(a), 12/05 Q.2(a), 12/05 Q.3, 12/05 Q.5 (b), 06/06 Q.1, 06/06 Q.5(b), 12/06 Q.2, 12/06 Q. 4(b), 12/07 Q.2, 06/07 Q.3(a & b), 06/07 Q.4(b), 12/07 Q.3(a & b), 12/07 Q.4(a), 12/07 Q.5(a), 06/08 Q.1, 06/08 Q.2, 06/08 Q.4, 12/08 Q.3, 12/08 Q.5(b).

1.12 REVISION QUESTIONS.

Tax Rates

VALUE OF TAXABLE BENEFITS PRESCRIBED BY CIT (YEAR 2008)

Taxable Employment Benefits - Year 2008

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

Year of income 2008

Taxable Employment Benefits - Year 2008

Monthly taxable pay (shillings)		Annual taxable pay (shillings)		Rates of tax % in each shilling
1	- 10,164	1	- 121,968	10%
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 Shs. 1,162 per month (Shs. 13,944 per annum)

		Prescribed benefit rates of motor vehicles provided by employer		Monthly rates	Annual rates
				(Sh.)	(Sh.)
Capital allowances:		(i)	Saloon, Hatch Backs and Estates		
Wear and tear allowances			Upto - 1200 cc	3,600	43,200
Class I	37.5%		1201 - 1500 cc	4,200	50,400
Class II	30%		1501 - 1750 cc	5,800	69,600
Class III	25%		1751 - 2000 cc	7,200	86,400
Class IV	12.5%		2001 - 3000 cc	8,600	103,200
Industrial building allowance:			Over - 3000 cc	14,400	172,800
Industrial buildings	2.5%	(ii)	Pick-ups, Panel Van (Unconverted)		
Hotels					
2006	4.0%				
2007 to date	10%				
Farm works allowance			Upto 1750 cc	3,600	43,200
2006	33%				
2007 to date	50%				
Investment deduction allowance:			Over 1750 cc	4,200	50,400
2003	- 70%	(iii)	Land Rovers/Cruisers	7,200	86,400
2004	- 100%		OR 2% of the initial capital cost of the vehicle for each month, whichever is higher.		
2006 to date	100%				
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.

QUESTION ONE

- a. Briefly discuss the tax implication of the taxation of branches of foreign companies and companies registered in Kenya.

(Dec 2008 4(a) adopted)

- b. The management of Mazuri Limited has presented the following trading and profit and loss account for the year ended 31 December 2007:

	Ksh. '000'	Ksh. '000'
Sales		18,500
Less cost of sales:		
Opening Stock	4,200	
Purchases	5,600	
Cost of goods available for sale	9,800	
Closing stock	<u>(2,400)</u>	<u>(7,400)</u>
Gross profit		11,100
Other incomes:		
Gain on sale of equipment		120
Interest on savings account		40
Refund of import duty		80
Gain on foreign exchange transactions		100
		11,440
Expenditure:		
Goodwill amortisation	25	
Legal expenses	420	
Salaries	2,000	
Bad debts	500	
NSSF contribution	60	
General expenses	600	
Advertising	300	
Staff meals	190	
Travelling expenses	180	
Donations to a trade association	40	
Property rates	45	
Depreciation	150	
Interest on long term	300	
Interest on bank overdraft	80	
Insurance	124	
Cost of stolen stock	20	
Branch closure costs	<u>100</u>	<u>(5,134)</u>
Net profit		6,306

Additional information:

1. The closing stock on 31 December 2007 was valued at a cost plus a mark up of twenty per cent.
2. Legal expenses related to:

	Ksh.
Preparation of the Memorandum of Association	150,000
Conveyance fees on purchase of land	60,000
Acquisition of leasehold property	90,000
Settling customer disputes	100,000
Acquisition of a bank loan	<u>20,000</u>
	420,000

3. The directors had withdrawn goods costing Ksh.600,000 (selling price Ksh.720,000) for their personal use. These goods have been included in both purchases and sales for the year ended 31 December 2007.
4. Sales (expense) includes:

	Ksh.
Directors allowances	720,000
Christmas gifts to staff	600,000
Golden handshake to a retiring director	400,000

5. Bad debts include:

	Ksh.
Loan to director	200,000
Estimated defaults by trade debtors	120,000

1. Advertising expense includes Ksh.100,000 for a neon sign
2. Twenty per cent of the travelling expenses relate to the private usage of company motor vehicles.
3. Capital allowances were agreed with the revenue authority at Ksh.200,000.

Required:

- i) Adjusted taxable profit or loss for Mazuri Limited for the year ended 31 December 2007. (12 marks)
- ii) The tax payable by Mazuri Limited (if any) for the year ended 31 December 2007 (2 marks)

(Total: 14 marks)

(June 2005 Q.4)



QUESTION TWO

Christine, Atieno and Rose Njeri started a law firm as partners on 1 January 2007. They named the firm Atieno Njeri and associates. The partners opened a joint account where Njeri deposited Kshs. 3,000,000 and Atieno Kshs.2,000,000 as initial capital. They also agreed that profits and losses would be shared in the ratio of their initial capital contributions. Further, they agreed that interest on capital would be paid at the rate of 5% per annum based on the initial capital contributions.

On 5th January 2007, the firm signed a six-year lease for an office at an annual lease payment of Kshs. 200,000. The lease contract required the partners to deposit a lump sum to cover the lease payment for the first two years of the lease term.

On 11th January 2007, the firm purchased the following assets for use in the business:

Asset	Cost (Shs)
Motor vehicle (double-cabin pick-up)	2,500,000
Other Assets:	
Furniture and fittings	280,000
Computers and printers	120,000
Telephone and fax machines	40,000
Reference books	16,000
Kitchen utensils (for office tea)	3,000
Television Set	12,000
Fans	6,000
Carpets	22,000
Safe (Metallic)	25,000

The firm did not maintain all the necessary books of account as required under the Income Tax Act (CAP 470). However, the partners were able to obtain the following details of the transactions for the year ended 31st December 2007:

- Professional fees earned amounted to Shs. 8,200,000. Of this amount, Shs 3,700,000 was received in cash while the balance was directly deposited by clients to the firm's bank account.
- The following monthly payments were made from fees received in cash before banking the balance at each month end:

		Shs.
Business mileage allowance to partners:	Atieno	30,000
	Njeri	25,000
Mobile phone airtime(for official use):	Atieno	3,000
	Njeri	3,000
	Staff	2,000
Office tea and snacks		5,000

- Analysis of the firms bank statement for the year showed the following summary of payments:

	Shs
Lease payment	400,000
Purchase of motor vehicle(double cabin pick up)	2,500,000
Purchase of other assets	524,000
Office expenses	2,921,000
Advertisement Commission	200,000

4. The office expenses amount shown in note 3 above was further analysed as follows:

	Shs
Partner's salaries	
Atieno	600,000
Njeri	400,000
Salaries to staff	436,000
Contributions to retirement benefit plans	
Partners	180,000
Staff	120,000
Contributions to medical Scheme	
Partners	280,000
Staff	150,000
Premium on partners' life insurance policies	210,000
Golf club membership for partners	50,000
Donations: Political Party	10,000
Red cross Society of Kenya	60,000
Tax consultancy fees	35,000
Subscriptions to Law Society of Kenya	40,000
Training fees	
Partner's Children school fees	140,000
Staff	80,000
Motor vehicle Insurance	30,000
Other office expenses	100,000

Required

- Taxable profit(loss) of the firm for the year ended 31st December 2007. (14 marks)
 - Allocation of profit or loss obtained in (a) above to the partners. (4 marks)
 - Tax payable (if any) by each partner for the year ended 31st December 2007.(2 marks)
- (June 2008 1)**

QUESTION THREE

Starlit company Ltd. has been operating in Kenya since 1 January 2003. The company is a subsidiary of Mega Holdings Ltd. which is based in the United Kingdom.

The financial statements of Starlit Company Ltd. for the year ended 31 December 2005 are presented below.



Profit and loss account for the year ended 31 December 2005

	Sh '000'	Sh '000'
Sales		97,440
Less cost		<u>44,940</u>
Gross profit		<u>52,500</u>
Less expense		
Wages	30,000	
Depreciation	7,500	
Interest	1,500	
General expenses	9,000	48,000
Net profit		4,500
Proposed dividend		600
Retained profit for the year		3,900

Balance sheet as at 31 December 2005

	Sh '000'	Sh '000'
Fixed assets (net)		92,350
Current assets		
Stock	6,000	
Trade creditors	2,250	
Bank balance	<u>15,000</u>	<u>23,250</u>
Total assets		<u>115,600</u>
Capital and liabilities		
Ordinary share capital		87,000
Debentures		13,500
Retained profits		10,000
Current liabilities		
Trade creditors	4,125	
Accrued wages	375	
Proposed dividend	<u>600</u>	<u>5,100</u>
Total capital and liabilities		<u>115,600</u>

Bank account for the year ended 31 December 2005:

Sh '000'		Sh '000'	
Balance brought forward	1,500	Wages	30,375
Receipts from customers	98,250	General expenses	9,000
Payments to suppliers			43,125
Interest			1,500
Dividend			750
Balance carried down			<u>15,000</u>
	<u>99,750</u>		<u>99,750</u>

Additional information

- Included in sales was Sh.2,100,000 representing goods sold to the parent company. All sales to the parent company are made at 10% below the normal selling price.
- General expenses include:

	Sh. '000'
Flotation cost on issue of debentures	1,400
Stamp duty on issue of debentures	800
Conveyance fees on purchase of land	2,000
Foreign exchange losses relating to the parent company's transactions.	560

- The written down values of fixed assets extracted as at 1 January 2005 were as follows:

	Sh.
Industrial building	17,100,000
Computers	900,000
Processing machinery (imported from United Kingdom)	19,906,250
Office partitions	400,000
Lorries (each 3 tonnes)	4,500,000
Delivery vans	3,600,000
Pick-ups	2,500,000
Furniture and fittings	600,000
Office equipment	800,000

The company did not claim investment (ID) allowance on industrial building and processing machinery in year 2003. However, the company claimed industrial building reduction (IBD) and wear and tear allowances on the industrial building and processing machinery respectively from years 2005 and 2006.



Included in the cost of processing machinery was import duty of Sh.1,200,000 and freight charges of sh.400,000.

Required:

- (a) (i) Compute the investment deduction allowance that was due to the company in year 2003. (4 marks)
- (ii) Calculate the total over or under-claimed wear and tear allowance in relation to the processing machinery as at 31 December 2004. (4 marks)
- (iii) Compute the industrial building deduction allowance due to the company in years 2003, 2004 and 2005. (2 marks)
- (b) Determine the company's adjusted taxable profit or loss for the year ended 31 December 2005. (10 marks)

(Hint: Start your computation with the reported profit) (Total: 20 Marks)

(June 2006 1)

QUESTION FOUR

- a. Discuss the Provisions of the Income Tax Act (Cap.470) relating to shortfall tax on non-distribution of dividend. (10 marks)
- b. Samia Ltd reported the following income during the year ended 31 December 2007.

	Shs.
Operating Income (before tax)	12,000,000
Investment income	650,000
Rental income(gross)	1,600,000

Additional information:

- 1. Investment income comprised

	Shs.
Dividend from a company in which Samia Ltd Holds 20% of the share capital	100,000
Interest from fixed deposit accounts(net)	50,000
Interest from treasury bills(net)	500,000
	<u>650,000</u>

- 2. Samia Ltd. declared a dividend of Kshs. 1,300,000 for the year ended 31 December 2007.

Required:

Determine the shortfall tax (if any) payable by Samia Ltd for the year ended 31 December 2007. (6 Marks)

(June 2008 2 (b))

QUESTION FIVE

- a) With reference to Section 7A of the Income Tax Act (Cap.470), define the term “compensating tax” (2 marks)
- b) The following information relates to ABC Ltd for the year ended 31 December 2007:

• Profit before tax	Sh.4,000,000
• Import duty refunded by tax authority	Sh400,000
• Dividend distributed by ABC Ltd	Sh8,800,000
• Dividend received by ABC Ltd	Sh.3,000,000
• Corporation tax rate	30%

Required

Compensating tax payable by ABC Ltd. for the year ended 31 December 2007 (4 marks)

- c) The Commissioner for Customs has powers to appoint and fix limits of customs areas for the control of movement of persons and goods.
Identify four areas which may constitute a custom’s area (4 marks)

- d) D. Mkasana is a director with Sabasaba Industries Ltd. where he controls 15% of the voting capital. He also owns residential houses in addition to being a partner with his wife in a flower business.

The following information relates to his income for the year ended 31 December 2007.

- Employment
 - Basic pay Sh.250,000 per month (PAYE Shs50,000)
 - He was admitted to hospital in March 2006 and the employer paid the medical bill which amounted to Shs.1,300,000
 - He was issued with additional 1,000 shares in the company at a price of Shs.50 per share when the prevailing market price was Shs.80per share.
 - He enjoys free lunch and tea valued at Sh.8,000 per month.
- Rental income

		Shs	Shs
Gross rent			1,960,000
Less:	Structural alterations	600,000	
	Land rent and rates	48,000	
	Loan interest	200,000	
	Valuation of rental buildings	140,000	
	Commission to estate agents	28,000	
	Purchase of furniture and fittings for tenants	100,000	
	Painting before letting	96,000	
	Legal fees	<u>24,000</u>	<u>(1,236,000)</u>
	Net rental income		724,000

Land rent and rates include Sh8,000 paid as deposit for water connection. Structural alterations enhanced the value of the buildings. Legal fees relate to collection of rent arrears.



3. Flower business

This is a partnership with his wife where they share profits and losses equally. The wife runs the business on a full time basis. Sales proceeds for the year to 31 December 2007 amounted to Sh.8,000,000. The following expenses have not been deducted from the sales proceeds:

	Shs
Salary to wife (arm's length)	600,000
Construction of flower sheds	240,000
Purchase of pesticides	180,000
Foreign exchange losses	64,000
Other farm expenses	1,200,000

Required:

Total taxable income of D. Mkasana for the year ended 31 December 2007 (10 marks)

(Total: 20 marks)



CHAPTER TWO

TAXATION OF SPECIALISED ACTIVITIES

► 2.1 Objectives

At the end of this chapter, the student is expected to be able to compute tax liability under the following institutions. She/he should also be able to distinguish between any of these institutions for tax purposes.

- Leasing entities
- Co-operative societies
- Trade associations and clubs
- Charitable institutions
- Trust bodies, settlements and estates under administration
- Petroleum, banking, insurance, sea and air transport undertakings
- Unit trusts
- Property developers and contractors
- Application of relevant case law

► 2.2 Introduction

In the previous chapter, we studied advanced aspects of taxation of partnerships and companies. In this chapter, you will be introduced to the taxation of other specialized activities or institutions which include: leasing, banking, insurance, petroleum, trust, co-operative societies among others. The tax concepts learnt in this topic will help you to be better equipped in answering exam questions.

In the next topic we shall study concepts in tax investigation.

► 2.3 Key Definitions

- **Leasing entity:** This is a firm or a company involved in the business of leasing
- **Lease:** This is a contract by which a person owning assets grants to a leasee the right to possess, use and enjoy such assets for a specified period of time, in exchange for periodic payments. There may be finance or operating lease.
- **Co-operative society:** A Cooperative Society is taken to be a body corporate having its own existence separate from that of its members. It is, therefore, deemed to have its own income even though some of the income is from transactions with its members. It

comprises a group of people who come together and pull resources for a common goal. It is formed under the Co-operative Societies Act.

- **Trade Associations:** A trade association is a body of persons which is an association of persons separately engaged in any business with the main object of safeguarding or promoting the business interests of such persons.
- **Club:** A members club means a **club or similar institution** with all its assets owned by, or held in trust for the members thereof. The income of clubs is made up of the **gross receipts**, including entrance fees, and subscriptions and such receipts are taxed in the name of the club at the corporation tax rate.
- **Charitable Institutions:** This is a non profit making organization established in Kenya which
 - Is of public character and
 - Has been established for purposes of the relief of poverty or distress of the public or advancement of education.
- **Trust:** Its an arrangement under which a person, the settler transfers property to another person, the trustee or trustees, who is required to deal with the trust property on behalf of certain specified persons, the beneficiaries.
- **Unit trust:-** A Unit Trust or a mutual fund organization is one registered under the Unit Trust Act. It sells units (equivalent to shares) to the public and invests the funds for a return. The unit holder gets a return (interest) from the Unit Trust tax free.

► 2.4 Exam Context

Concepts explained in this topic are highly examinable. The student advised to master the content and be able to apply the same in exam questions

► 2.5 Industrial Context

This topic is very practical. It will be helpful to tax or finance managers in various industries or sectors. With the emergence of such institutions, the students will be able to apply the knowledge learnt in this topic in computing taxable income.

2.6 Lease Hire Arrangements

A lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership from lessor to lessee. All other leases are classified as operating leases. Classification is made at the inception of the lease.

Any income derived from leasing activities is taxable at the corporate tax rate.



2.6.1 Corporation tax on lease hire arrangements

Whereas the leasing rules have defined the operating and finance leases, there is no distinction between the two categories of leasing for corporate tax purposes. However, this distinction exists for Value Added Tax (VAT) purposes.

Lease rentals are allowable expenses for corporate tax purposes. if the Commissioner is satisfied that:

- a. The sole consideration for the payment is the use of or the right to use the asset; and
- b. The entire payment is income in the hands of the recipient.

However, lease-hire payments in respect of a non-commercial vehicle are not tax deductible.

Related costs such as maintenance are allowable expenses for tax purposes.

The lessee is entitled to claim VAT on expenses incurred on the leased asset.

The lessor enjoys wear and tear allowance deductions as long as the equipment was utilized wholly and exclusively for generation of taxable income.

The lessor enjoys investment allowance and which is deducted from his profits in the same tax year in which investment is made. The deduction is made at a rate of 100% of the cost of investing in machinery and buildings provided these are used for the purpose of manufacturing.

2.6.2 Withholding tax of lease hire arrangements

The lessee should withhold tax at a rate of 3% on any payment made to the lessor in relation to payment of lease rentals. In case the lessor is a non-resident with no branch in Kenya, tax is withheld at a rate of 15% which is a final tax.

Effective 1 July 2003, lease rental payment in relation to aircrafts is exempted from withholding taxes

2.6.3 Taxation of lease rentals

Finance Lease: Eventual ownership of the leased asset passes to lessee upon payment of 75% of cost.

Operating Lease: Ownership remains with lessor throughout the entire lease agreement.

Leasing is included in the definition of **supply** as “*The letting of taxable goods on hire, leasing or other transfers*”, which supply is taxable.

Leasing is considered as a service, and lease instalments, being payments for this service, are subject to VAT. If equipment that is the subject of a lease is either exempted from VAT or attracts zero VAT, then the lease payments are similarly exempted from VAT.

Leasing of land, residential buildings, and non-residential buildings are exempted from VAT. This exemption does not apply with respect to car park services, conference or exhibition services.

Illustration

You are provided with the following information for Anne lease hire Ltd, a company in the business of leasing vehicles for the year ended 31 December 2008.

	Kshs'000
Lease payments	10,000
Leased vehicle repairs	1,000
Salaries for lease staff	400
Business license	20

Required:

- Compute corporation tax payable.
- Compute Withholding tax deductible.

Attempted solution

(a) Corporation tax payable

Anne Lease hire Ltd**Computation of corporation tax payable**

	KShs'000	KShs'000
Taxable Income		10,000
Allowable expenses		
Leased vehicle repairs	1,000	
Salaries for lease staff	400	
Business license	20	(1,420)
Taxable income	<u> </u>	<u>8,580</u>
Tax payable*30%		<u><u>2574</u></u>

(b) Withholding Tax payable

A company should withhold 3% of the payments and remit the tax by the **20th of the month** following the deduction. In this case, Kshs. 300, 000 should have been deducted in total and remitted.

2.7 Co-operative societies (Section 19A of the Income Tax Act)

Cooperative Societies are formed under the Cooperative Societies Act (Cap 490, Laws of Kenya). A Cooperative Society is taken to be a body corporate having its own existence separate from that of its members. It is, therefore, deemed to have its own income even though some of the income is from transactions with its members. The accounts of Cooperative Societies must be audited by a professional accountant.

2.7.1 Mutual Transactions

These are transactions engaged in by a Cooperative Society with its members and not outsiders.



Mutuality is recognised in general law that a person cannot make a profit from himself. This means that any profit and income arising from a cooperative society's transactions with its members **is tax exempt**, e.g. In the case of a SACCO, interest from members loans is purely mutual and is **not taxable**.

When a cooperative society gets involved in activities which are **not its primary objectives**, then income derived thereof is taxable and the society become liable to tax, i.e

- When the society acquires property and buildings etc, and receives rental income from it.
- When it acquires a farm from which the main produce is the product is the product of the society as a farm owner.
- When it deals with non members in the form of sale of stores, hire of transport, etc.
- When it has investment income such as dividends and interests.

2.7.2 Taxation of cooperative Societies

The income of cooperative societies became taxable **from Jan, 1st 1985**. For tax purpose, cooperatives are broadly classified into:

- Those **registered under the Companies Act** i.e KFA, KCC 2000, KPCU, COOP Bank.
- Those Registered under **the Cooperative Societies Act** referred to as Designated Cooperative Societies.

Cooperative Societies registered under the Companies Act are taxed just like any other company.

Those registered under the Cooperative Societies Act (Designated Cooperative Societies) are further classified as follows:-

i. Designated Cooperative Society other than designated Primary Society. (Secondary societies)

These are **Apex** and **Union Cooperative Societies**.

ii. Designated Primary Societies.

A primary society is a cooperative society registered under the Cooperative Societies Act. The membership of which is restricted to individual persons.

Designated primary societies may be:-

- Those carrying on the business of a savings and credit cooperative society. (SACCO)
- Those not carrying on the business of a SACCO.

Secondary societies comprise of Apex and Unions. Apex societies have membership of union societies whilst unions members are primary societies

iii. Primary Societies- Members are individuals

2.7.3 Taxation of Apex and Union Cooperative Societies (Designated Secondary Societies)

Compute taxable income in the same manner just like for any other business i.e. Gross income less allowable expenses. However, **dividends and bonuses are allowable expenses against adjusted income up to a maximum of 100% of adjusted profit and must not exceed adjusted profit.** Therefore the carrying forward of losses is not allowed.

Illustration

Kilimo Union Co-Op Society Ltd

Year 2001 Profit And Loss Account

		<u>SH'000'</u>	<u>SH'000'</u>
<u>Gross profit</u>			32,000
<u>Less expenses</u>			
	Salaries and wages	4,400	
	Director's fees	1,000	
	Rent and rates	1,200	
	Travel and entertainment	400	
	Donations	1000	
	Legal fees-bank overdraft	1,600	
	Income tax paid	2,400	
	Bad debts reserve	800	
	Provision for leave passages	500	
	Loss on sale of investment	300	
	Furniture and fittings	1,000	
	General expenses	2,200	
	Tax Consultation fees	140	
	Depreciation	<u>2,000</u>	(18,940)
Surplus income			13,060

Required

Compute the **adjusted surplus**. Note that the company has **declared 90% of adjusted surplus** as dividends and bonus. Compute the tax payable by the cooperative.

**Solution****Kilimo Union Co-Op Society Ltd****Adjusted Surplus In Year 2001 And Tax Payable**

	<u>SH'000'</u>	<u>SH'000'</u>
Surplus as per the accounts		13,060.00
ADD-		
Deductions not allowable		
Furniture and fittings	1,000.00	
Depreciation	2,000.00	
Legal fees-bank overdraft	1,600.00	
Income tax paid	2,400.00	
Bad debts reserve	800.00	
Provision for leave passages	500.00	
Donations (Note 1)	1,000.00	
Loss on investment	300.00	
	<u>9,600.00</u>	
		22,660.00
Less: <u>Deductions allowable</u>		
Wear and tear on Furniture and fittings(12.5% x 1,000)		(125.00)
Adjusted surplus		<u>22,535.00</u>
Less-Dividends and bonus @ 90%		(20,281.50)
Taxable surplus		<u>2,253.50</u>
Tax thereon@ 30%		676.05

Note 1: I have assumed that the donations are to charitable organizations.

2.7.4 Taxation of a Primary Society Other Than a SACCO

Taxable income for a primary society which is not a SACCO is computed in the same manner as in the case of Apes and Union Societies except that dividends and bonuses are allowable as declared for that year and distribute to its members (**w.e.f.** 1.1.2004).

Note

For dividends and bonuses to be allowable:

- Dividends and bonuses must have approved by the AGM and the CIT.
- They must have been authorised by the Commissioner of Cooperative development.
- They must have been actually paid out in cash, cheque, dividend, and warrants or credited to member's accounts. If not paid out then the auditors should guarantee that the amount will be paid.
- Dividends paid out by designated cooperative Societies other than SACCO is non qualifying hence are subjected to further taxation.

■ 2.7.5 Taxation of a SACCO

- (a) The income of a SACCO is made up of:
- (b) Interest from the member's loans.
- (c) Interest income from third parties e.g banks, insurance companies and other financial institutions.
- (d) Rental income.
- (e) Other gains chargeable to tax in the Act.
- Interest income from members is fully exempt from taxation.
 - Administrative expenses to the SACCO are not allowable.
 - Other incomes of a SACCO apart from interest from members is taxable after allowing a prescribed percentage to cater for expenses relating to such income as follows:
 - Interest from third parties is taxable up to 50% of Gross interest.
 - Its gross rental income.
 - Gains chargeable to tax under sec 3(2)(f) of the Income Tax Act.
 - Any other income chargeable to tax excluding royalties.

ILLUSTRATION

JARIBU SACCO

2001 PROFIT AND LOSS ACCOUNT

		SH'000'
INCOME		
Interest from members loans		6,000
Interest from KCB (net)		255
Rental income		2,500
Dividends from xyz Ltd (Gross)		300
Dividends from Wananchi Co-op Society Ltd (net)		800
		9,855
EXPENSES		
Salaries and wages	2,450	
Donations	300	
Depreciation	600	
Travel and entertainment	80	
AGM and training	35	
Insurances	100	
Rent	200	
Interest	140	
Repairs and maintenance	120	
General expenses	50	
Bad debts written off	25	(4,100)
Surplus income		5,755

Required:- Compute the taxable surplus and tax liability.



Attempted Solution

Jaribu Sacco

Year 2001 Taxable Surplus and Tax Liability

		SH'000'
TAXABLE INCOME		
Interest income from KCB	(300x50%)	150
Rental income		2500
Dividends from Wananchi	800 x 100/85 x 50%	<u>470.588</u>
Total taxable surplus		<u>3120.588</u>
Tax thereon @ 30%		<u>936.176</u>
Less set off taxes		

Notes

- Withholding tax on KCB interest is not final tax.
- Dividends from Wananchi cooperative Society is the non qualifying type hence taxed further.
- Dividends from XYZ Ltd (Gross) suffers withholding tax at source which is Final tax.

2.8 Taxation of Trade associations

A trade association is a body of persons which is an association of persons separately engaged in any business with the main object of safeguarding or promoting the business interests of such persons. However, members of taxable trade associations are allowed to deduct the subscriptions in their income tax computation.

Generally trade associations are not considered to be carrying out trading activities. However, they may engage in trade. Under section **21(2) of the Income Tax Act**, such an association can choose or elect by notice in writing to the CDT to be considered to be carrying out **business chargeable to tax** in respect to any year of income. In which case, it's **gross receipts from the transactions with members** (including entrance fees and subscription fees) and with other persons is deemed to be income from the business for that year of income at the **corporate tax rate**.

2.9 Taxation of Clubs

Under Section 21 of the Income Tax Act, a members club means a **club or similar institution** with all its assets owned by, or held in trust for the members thereof. The income of clubs is made up of the **gross receipts**, including entrance fees, and subscriptions and such receipts **are taxed** in the name of the club **at the corporation tax rate**.

However, **when ¾ or more of such investment** is derived from **members**, the body will not be taken to be carrying on business and no part of such non investment income will be taxed i.e income from members is not taxable.

Investment income of a club such as dividends, interest, rents, capital gains etc are to be **excluded in the ¾ test mentioned above.**-(sec 21(1))

2.10 Taxation of amateur sporting association

Under Paragraph 6 of the first schedule to the Income Tax Act, income other than income from investment of an Amateur sporting association is not taxable. For this to be the case, the amateur sporting association must be one:

- Whose sole aim or object is to foster outdoor sports and control any outdoor sports.
- Whose members consist of amateurs or affiliated associations the members of which are amateurs.
- Whose memorandum of association or by laws have provisions defining an amateur or a professional and providing that no person other than an amateur shall be a member of that association.

2.11 Taxation of venture capital enterprises

The term ‘venture company’ refers to a company incorporated in Kenya in which a venture company has invested and which at the time of the first investment by the venture company has assets with a market value or annual turnover of less than five hundred million in Kenya shillings.

A **venture capital company** is a company incorporated in Kenya for the purpose of investing in new and expanded business.

Venture capital companies enjoy certain tax exemptions as follows:

- Dividends received by a registered venture capital company is tax exempt. (A registered venture capital company is a venture capital company registered by the CDT as such)
- Gains arising from trade in shares of a venture company earned by a registered venture capital company within the first ten years from the date of first investment in that venture company by the venture capital company are **tax exempt.**: Provided that the venture company has not been listed in any securities Exchange operating in Kenya for a period of more than two years

2.11.1 Registration of a venture capital company

Under the Income Tax Venture Capital rules, a ‘venture capital company’ shall, upon application for registration, be registered by the Commissioner for the purposes of this Act if the Commissioner is satisfied that –

- (a) It is incorporated in Kenya; and
- (b) It is incorporated for the purpose of investing in new or expanding venture companies; and
- (c) It is approved by Capital Markets Authority; and
- (d) It is managed by a fund manager; and
- (e) Seventy-five percent or more of its portfolio of investable funds is invested in the equity shares of venture companies; and
- (f) The primary activities of the venture company in which it has invested are approved activities.



2.11.2 Prohibited services

The primary activities of a Venture Capital Enterprise shall not include -

- (a) trading in real property;
- (b) banking and financial services; or
- (c) retail and wholesale trading services

2.12 Taxation of Charitable trusts

A Charitable Institutions is defined as non profit making organization established in Kenya which

- Is of public character and
- Has been established for purposes of the relief of poverty or distress of the public or advancement of education.

The income of charitable trusts is exempt under paragraph 10 of the First Schedule to the Income Tax Act. Under this section, the income of an institution, body of persons, or irrevocable trust, of a public character established: solely for the purposes of:

- The relief of the poverty or
- Distress of the public, or
- For the advancement of religion or education established in Kenya

For the income to be exempt, any of the following conditions must also be met:

- (i) the business is carried on in the course of the actual execution of those purposes; or
- (ii) the work in connection with the business is mainly carried on by beneficiaries under those purposes; or
- (iii) the gains or profits consist of rents (including premiums or similar consideration in the nature of rent) received from the leasing or letting of land and chattels leased or let therewith.

In summary, therefore, the income of a charitable trust is exempted from tax if:

- (i) It is public in character
- (ii) If it is established for relief of distress or poverty to the public.
- (iii) If it is established to advance religion or education.
- (iv) Its total income is used or spent for charitable purposes.

If a charitable trust runs a business then profits thereof is not taxed if proceeds are used for purposes 2 and 3 above.

2.13 Taxation of Trust bodies, settlements and estates under administration

The term 'settlement' includes a disposition, trust, covenant, agreement, arrangement, or transfer of assets, other than -(a) a settlement made for valuable and sufficient consideration;(b) an agreement made by an employer to confer a pension upon an employee in respect of a period after the cessation of employment with that employer, or to provide an annual payment for the benefit of the widow or any relative or dependant of that employee after his death, or to provide a lump sum to an employee on the cessation of that employment. It also does not include a disposition, trust, covenant, agreement, arrangement, or transfer of assets, resulting from an order of a court unless that order is made in contemplation of this provision;

The term "child" means a child under the age of nineteen years and includes a step-child, an adopted child and an illegitimate child;

The term "settlor", in relation to a settlement, includes a person by whom the settlement was made or entered into directly or indirectly, and a person who has provided or undertaken to provide funds directly or indirectly for the purpose of the settlement, or has made with another person a reciprocal arrangement for that person to make or enter into the settlement;

2.13.1 Income Settled on Children

Under section 25. of the Income Tax Act, where, under a settlement, income is paid during the life of the settlor to or for the benefit of a child of the settlor in a year of income, that income shall be deemed to be income of the settlor for that year of income and not income of any other person. Provided that it shall not apply to any year of income in which -

- (i) the income so paid does not exceed one hundred shillings; or
- (ii) the child attains the age of nineteen years.

The income which is dealt with under a settlement so that it, or assets representing it, will or may become payable or applicable to or for the benefit of a child of the settlor in the future (whether on the fulfilment of a condition, or the happening of a contingency, or as the result of the exercise of a power of discretion, or otherwise) shall be deemed to be paid to or for the benefit of that child;

income so dealt with which is not required by the settlement to be allocated, at the time when it is so dealt with, to any particular child or children of the settlor shall be deemed to be paid in equal shares to or for the benefit of each of the children to or for the benefit of whom or any of whom the income or assets representing it will or may become payable or applicable;

in relation to a settlor, only income originating from that settlor shall be taken into account as income paid under the settlement to or for the benefit of a child of the settlor.

Where tax is charged on and is paid by the person by whom the settlement was made, that person shall be entitled to recover from a trustee or other person to whom the income is payable under the settlement the amount of the tax so paid, and for that purpose to require the Commissioner to furnish to him a certificate specifying the amount of the tax so paid, and a certificate so furnished shall be conclusive evidence of the facts appearing therein.



Where the amount of the tax chargeable upon a person for a year of income is affected by withholding tax deducted from the income, the amount by which the tax is affected shall, if the amount of tax is thereby reduced, be paid by him to the trustee or other person to whom the income is payable under the settlement or, where there are two or more of them, shall be apportioned among those persons as the case may require; and if any question arises as to the amount of a payment or as to an apportionment to be made under this subsection, that question shall be decided by the Commissioner whose decision thereon shall be final.

2.13.2 Income deemed to be income of settlor

The income of certain settlements may be deemed to be income of settlor. Under Section 26.(1) of the Income Tax Act, all income which in a year of income accrued to or was received by a person under a settlement from assets remaining the property of the settlor shall, unless that income is deemed under section 25 to be income of the settlor for an earlier year of income, be deemed to be income of the settlor for the year of income in which it so accrued to or was received by that person and not income of another person whether or not the settlement is revocable and whether it was made or entered into before or after the commencement of this Act.

Further, all income, which in a year of income accrued to or was received by a person under a revocable settlement shall be deemed to be income of the settlor for that year of income and not income of another person.

Where in a year of income the settlor, or a relative of the settlor, or any other person, under the direct or indirect control of the settlor or any of his relatives or the settlor and any of his relatives, by agreement with the trustees of a settlement in any way, whether by borrowing or otherwise, makes use of income arising, or of accumulated income which has arisen, under the settlement to which he is not entitled thereunder, then the amount of that income or accumulated income so made use of shall be deemed to be income of the settlor for that year of income and not income of any other person.

A settlement is deemed to be revocable if under its terms the settlor -

- (a) has a right to reassume control, directly or indirectly, over the whole or any part of the income arising under the settlement or of the assets comprised therein; or
- (b) is able to have access, by borrowing or otherwise, to the whole or any part of the income arising under the settlement or of the assets comprised therein; or
- (c) has power, whether immediately or in the future and whether with or without the consent of any other person, to revoke or otherwise determine the settlement and in the event of the exercise of that power, the settlor or the wife or husband of the settlor will or may become beneficially entitled to the whole or any part of the property comprised in the settlement or to the income from the whole or any part of that property:
 - Provided that a settlement shall not be deemed to be revocable by reason only that under its terms the settlor has a right to reassume control, directly or indirectly, over income or assets relating to the interest of a beneficiary under the settlement in the event that the beneficiary should predecease him.
 - Where, under this section, tax is charged on and is paid by the settlor, the settlor shall be entitled to recover from the trustees or other person to whom the income is payable under the settlement the amount of the tax so paid, and for that purpose to require the Commissioner to furnish to him a certificate specifying the amount of the tax so paid, and a certificate so furnished shall be conclusive evidence of the facts appearing therein.

- Where, under this section, income is deemed to be income of the settlor, it shall be deemed to be income received by him as a person beneficially entitled thereto under the settlement.

2.14 Taxation of Petroleum companies

2.14.1 Introduction

In Kenya, petroleum companies are regulated by the Petroleum (Exploration and production) Act, (Cap 308, Laws of Kenya). A "petroleum company" means a corporate body that carries out, in addition to any other activities, operations under a petroleum agreement entered into under the Petroleum (Exploration and Production) Act. A "contractor" means the person with whom the Government concludes a petroleum agreement. A "petroleum service subcontractor" means a non-resident person who provides services in Kenya to a petroleum company.

Under the Act, the Minister for Energy has power to authorise any person to commence exploration activities in Kenya. Under Section 4 of the Petroleum Act, no person shall engage in any petroleum operations in Kenya without having previously obtained the permission of the Minister. All petroleum operations shall be conducted in accordance with the provisions of this Act, the regulations made thereunder and the terms and conditions of a petroleum agreement. "petroleum operations" means all or any of the operations related to the exploration for, development, extraction, production, separation and treatment, storage, transportation and sale or disposal of, petroleum up to the point of export, or the agreed delivery point in Kenya or the point of entry into a refinery, and includes natural gas processing operations but does not include petroleum refining operations. The term "petroleum" means mineral oil and includes crude oil, natural gas and hydrocarbons produced or capable of being produced from oil shales or tar sands;

The Government may conduct petroleum operations either—

- (a) Through an oil company established by the Government to conduct those operations; or
- (b) Through contractors in accordance with petroleum agreements. A "petroleum agreement" means the agreement, contract, or other arrangement between the Government and a contractor to conduct operations in accordance with the provisions of this Act; or
- (c) In such other manner as may be necessary or appropriate.

The Government may authorize a contractor to engage in petroleum operations within a specified area, in accordance with the terms and conditions set out in the petroleum agreement.

Notwithstanding the provisions of this section, the Government may grant to any person, other than the contractor, a permit for the prospecting and mining of minerals or other natural resources other than petroleum or the conduct of operations other than petroleum operations within an area which is the subject of a petroleum agreement, provided that the prospecting, mining and the other operations shall not interfere with petroleum operations.



2.14.2 Income tax provisions on taxation of petroleum companies

Part 2 of the 9th schedule to the Income Tax Act provides guidance on the taxation of petroleum companies.

Determination of income

- (1) Under the section, in determining the gains or profits of a petroleum company for a year of income for the purposes of this Act there shall be brought into account the value of the production to which a petroleum company is entitled under a petroleum agreement in that year of income.
- (2) For the purposes of subparagraph (1), the value of production shall be the total of-
 - (a) The price receivable for that production disposed of by a petroleum company in sales at arm's length; and
 - (b) The market value, calculated in accordance of production not disposed of by a petroleum company in sales at arm's length.

Sales of petroleum at arms length

- (1) A sale of petroleum is a sale at arm's length if the following conditions are satisfied -
 - (a) The price is the sole consideration for the sale;
 - (b) The terms of the sale are not affected by any commercial relationship, other than that created by the contract of sale itself, between the seller or an affiliate and the buyer or an affiliate; and
 - (c) The seller or an affiliate do not have, directly or indirectly, an interest in the subsequent resale or disposal of the petroleum or any product derived therefrom.
- (2) For the purposes of this Schedule, the market value of petroleum shall be determined in accordance with the petroleum agreement entered into with the petroleum company but where the terms of the petroleum agreement do not in any case provide a valuation, the market value shall be -
 - (a) where petroleum is disposed of to third parties at arm's length, the amount actually receivable for that sale, at the FOB point of export, or at the point that title and risk pass to the buyer;
 - (b) in any other case-
 - (i) If there have been sales to third parties at arm's length during the current calendar quarter, the weighted average per unit price paid in those sales, at the FOB point of export, or at the point that title and risk pass to the buyer, adjusted for quality, grade and gravity, and any special circumstances;
 - (ii) If there have been no sales to third parties at arm's length during the current calendar quarter, the weighted average per unit price at the FOB point of export, or at the point that title and risk pass to the buyer, paid elsewhere in arm's length sales of petroleum of a similar quality, grade and quantity, adjusted for any special circumstances of those sales.

Disposal of petroleum

Where a person disposes of petroleum and, for the purposes of ascertaining the gains or profits of that person, the market value of the petroleum is calculated at arm's length, the consideration for the acquisition of that petroleum, for the purposes of ascertaining the gains, profits or losses of the person acquiring that petroleum, shall be that market value.

Allowable deductions

- (1) For the purposes of ascertaining the gains or profits for a petroleum company for a year of income, there shall be deducted the expenditure referred to in subparagraph (2) incurred in that year, but this shall not prevent other deductions authorized by the Income Tax Act, and where an item of expenditure is specifically deductible under a provision of this Schedule, that item shall not be deductible under another provision of the Income Tax Act.
- (2) For the purposes of subparagraph (1), there shall be deducted –
 - (a) intangible drilling costs;
 - (b) Geological and geophysical costs;
 - (c) Payments to the Government, or any agency thereof, pursuant to the provisions of the petroleum agreement entered into with the petroleum company;
 - (d) Production expenditure;
 - (e) Executive and general administrative expenses wholly and exclusively incurred in Kenya by a petroleum company;
 - (f) Where a non-resident petroleum company operates in Kenya through a permanent establishment in Kenya, only those reasonable executive and general administrative expenses incurred outside Kenya by that person, including management or professional fees, but limited to the amount that is attributable to the permanent establishment in Kenya and is fairly and reasonably allocated thereto;
 - (g) Management or professional fees, including those paid to persons outside Kenya limited to the amount that is attributable to the petroleum company and is fairly and reasonably payable thereby; and
 - (h) Interest paid, including interest paid by a non-resident petroleum company and fairly and reasonably allocated to a permanent establishment maintained in Kenya by that company, but no interest paid shall be deductible unless –
 - (i) The payment does not exceed the amount that would have been payable on a loan concluded at arm's length where the loan, repayment thereof, and the interest payable constitute the only consideration for the making of the loan;
 - (j) the loan, in respect of which interest is paid, is applied for operations by the petroleum company in Kenya, but where only part of the loan is applied in accordance with this paragraph only the interest payable in respect of that part shall be deductible;
 - (k) Withholding tax on interest has been deducted and paid to the Commissioner.
- (3) Where expenditure is incurred on an asset representing qualifying expenditure, there shall be made, in ascertaining the gain or profits for the year of income in which that asset is first brought into use in Kenya, or in which production commences, whichever is the later, and the four following years of income, a deduction equal to one-fifty of the expenditure.
- (4) Where a well which fails to discover petroleum is drilled and abandoned, the expenditure incurred in drilling the well, which has not been deducted under another provision of this Act, shall be deducted in the year of income in which the well is abandoned.
- (5) Where in ascertaining the gains or profits of a petroleum company in a year of income, there results a deficit, the amount of that deficit shall be an allowable deduction in ascertaining the gains or profits of the previous year of income but the deficit may only be carried back –
 - (a) from a year of income which the petroleum company has ceased permanently to produce petroleum; and
 - (b) for not more than three years of income from the year in which the deficit occurred



Transactions with affiliates

Where a transaction takes place between a petroleum company and an affiliate, the income chargeable, or the deduction allowable to that company, shall be deemed to be the amount that might have been expected to accrue if that transaction had been conducted by independent persons dealing at arm's length.

Assignment of petroleum agreement and disposal of assets

An assignment of a right under a petroleum agreement shall not give rise to Capital gains tax but, subject to this paragraph, the consideration for the assignment shall be treated as a **receipt of the petroleum company**, and tax shall be charged accordingly.

Further, where an assignment of a right under a petroleum agreement involves the disposal of assets which represent qualifying expenditure, there will be deducted from the consideration for the assignment the amount of the qualifying expenditure not yet allowed against income.

The assignment is of part only of the rights held by a petroleum company, or where not all the assets which represent qualifying expenditure are included in the assignment, the amount of qualifying expenditure not yet allowed against income which is to be deducted from the consideration for the assignment shall be apportioned by the Commissioner.

The amount to be treated as a receipt shall be, in the case of an assignment at arm's length, the consideration therefore and in any other case, the market value of that which is assigned, but where part of the consideration consists of the undertaking by the assignee of a work obligation, no amount in respect thereof shall be taken into account under this paragraph.

Where a right under a petroleum agreement is assigned, the Assignee shall be treated as having incurred, at the date of the assignment, qualifying expenditure equal to the lesser of the total amount of the consideration paid for the assignment and the market value of rights and assets representing qualifying expenditure assigned.

Where a petroleum company sells, disposes or removes from Kenya an asset which represents qualifying expenditure, otherwise than on an assignment of a right under a petroleum agreement, and the net proceeds of the sale are –

- (a) Less than the qualifying expenditure not yet allowed against income, a deduction, in this Schedule referred to as a "balancing deduction", shall be made to the company, in the year of income in which the sale or disposal takes place, equal to the difference;
- (b) More than the qualifying expenditure not yet allowed against income, a charge, in this Schedule referred to as a "balancing charge", shall be made to the company, in the year of income in which the sale or disposal takes place, equal to the difference.

Where an asset representing qualifying expenditure is brought into use without being purchased, or, without being sold, ceases permanently to be used, by a petroleum company, it shall be deemed to have been purchased or sold at market value.

Taxation of petroleum service subcontractors

The profits or gains of a petroleum service subcontractor (PSS) in respect of services rendered in Kenya to the petroleum company is specifically taxed in accordance with Part III of the 9th Schedule regardless of any other provision of the Act. Some of the salient provisions of the Schedule are *inter alia*:

“Paragraph 9: PSS shall be deemed to have made a taxable profit equal to 15%, assumed profit rate, of all the moneys paid by a Petroleum company (taxable service fee), which profits shall be taxed at the rates set out in the Third Schedule applicable to non-resident companies which have a permanent establishment in Kenya.

The taxable service fee does not include moneys paid as reimbursement to PSS for the cost of mobilization and demobilization and reimbursement of expenses.

Paragraph 10: when paying a taxable service fee, the petroleum company (PC) shall:-

- Deduct an amount of tax equal to the sum produced by applying the income tax rate referred to in paragraph 9 to the assumed profit;

Paragraph 11: the tax collected by the PC under this paragraph in a month shall be remitted within 30 days to the Commissioner with a return of amounts paid and tax deducted, hereinafter referred to as the “subcontractors return” showing...

- The total taxable service fee paid;
- The total tax deducted and remitted;
- The total amount paid for mobilization and demobilization; and
- The total amount paid for reimbursement of expenses.”

In line with the above provisions, where for instance the Petroleum Company is required to pay Kshs 100 to the Petroleum service subcontractor the assumed profits which are subject to taxation for services deemed to have been rendered in Kenya shall be Kshs 15 (being 15% of Kshs 100). The taxes payable on this amount and for which the petroleum company is subject to withhold and remit to the revenue authorities is Kshs. 5.625 (37.5% of Kshs 15).

The aforesaid taxes ought to be remitted to the tax authorities within 30 days by the PC with a return referred in the Schedule as *“the subcontractor’s return”* in respect of that month amounts as outlined above

■ 2.14.3 Value Added Tax Rules on Taxation of petroleum companies

Some of the goods and supplies used by a petroleum companies to carry out its exploration activities either by itself or by an subcontractor attract VAT at 16%. Under Section 23 of the VAT Act, a petroleum company can apply for VAT remission on imports for exploration activities.

■ 2.14.4 Customs & excise rules on taxation of petroleum companies

Under the Customs & excise rules, a petroleum company can make an application for duty remission on its imports.

Illustration

Titanic Limited, a company incorporated in Kenya has recently concluded a petroleum agreement with the government of Kenya. Under the terms of the petroleum agreement, the company has been allowed to explore along the Kenyan waters and share the proceeds with the government on a 50: 50 basis. The company has subcontracted TNM Ltd to carry out exploration surveys along waters for a period of 3 months. You are provided with the following information with regard to Titanic limited.

**Titanic Limited****Draft Income statement**

	Kshs'000	Kshs'000
Production sales receipts		1,000,000
Geological and geophysical costs	20,000	
Intangible drilling costs	10,000	
Production expenditure	5,000	
Salaries and wages to production staff	2,000	
Entertainment of director's children	4,000	
Payment to government (50:50 basis)	1,000	
Executive and general admin expenses	1,000	
Management fees to KLM consultancy	3,000	
Professional fees to Ernst & Young for consultancy services	2,000	
Service fee paid to TNM Ltd	200,000	
Interest on loan at arm's length from Uganda Commercial Bank	10,000	
Exploration Machinery purchased	10,000	<u>(268,000)</u>
		<u>732,000</u>

Required;

- Compute the taxable profit for Titanic Limited
- Compute the amount of tax payable by TNM Ltd and the dates for the payment

Attempted solution**Part 1****Titanic Limited****Computation of taxable profit**

	Kshs	Kshs
Net profit as per the income statement		732,000
Add back disallowable expenditure		
Entertainment of director's children	4,000	
Exploration machinery purchased	10,000	<u>14,000</u>
		746,000
Less		
Capital allowance on machinery (12.5% of 10000)		<u>(1,250)</u>
Adjusted taxable profit		<u>744,750</u>
Corporation tax payable at 30%		223,425

Part 2**TNM Ltd**

Service fee paid	200,000
Assumed profit (15%)	30000
Corporation tax at 37.5%	11250

Titanic Ltd has got an obligation to withhold tax of the subcontractor of Kshs.11,250 and remit the same within 30 days of such withholding to the CDT.

2.15 Taxation of Banks

The Banking industry is a very dynamic and competitive industry. It involves the provision of financial services. It is regulated by the Central Bank of Kenya Act (Cap 491, Laws of Kenya) and regulations and the Banking Act (Cap 488, Laws of Kenya).

The taxation of the Banking industry as a company is provided for mainly under the Income Tax Act, the Customs and Excise Act the East African Community Customs Management Act 2004, the Value Added Tax Act and the Stamp Duty Act. There is no fundamental difference between the taxation of Banks and other companies. The allowable deductions and disallowable deductions are the same. Some unique features are:

- Thin capitalization provisions do not apply to the Banking sector.
- Where a bank which is a permanent establishment of a non-resident person holds outside Kenya any deposits, assets or property acquired from its operations in Kenya, the gains or profits accruing from such deposits, assets or other property held outside Kenya shall be deemed to be income accrued in or derived from Kenya.

Illustration

The management of Shamrock Bank Ltd. has sought your professional guidance in determining the Bank's tax liability for the year ended 31 December 2007.

The income statement of Shamrock Bank Ltd. for the year ended 31 December 2007 is given below:



	Kshs. 000	Kshs. 000
Income		
Interest on loans and advances to customers		540,800
Interest on government securities		120,600
Interest on placements with other banks and institutions		40,650
Fees and commissions income		39,360
Rental income		2,190
Income from foreign exchange dealings		31,980
Gain on disposal of property and equipment		12,300
Other operating income		42,950
Total income		830,830
Expenses:		
Salaries and employee benefits		360,400
Occupancy expenses		20,350
Deposit protection fund contributions		12,360
Depreciation expense		43,700
Interest on customers' deposits		202,450
Interest on deposits from other banks and institutions		80,200
Director's emoluments:		
Fees		
Other	11,200	
Auditors' remuneration:	3,600	14,800
Current year		
Under provision for the previous year (2006)	2,100	
Operating lease rental	300	2,400
Loss on disposal of equipment		16,300
Other administrative expenses		7,250
Provision for bad and doubtful debts		20,620
Provision for interest suspense		80,500
Total expenses		20,950
Loss for the year		882,280

Additional information:

1. Salaries and employee benefits comprise:

	Sh. 000
Leave benefits	720
Pension contributions	1,460
Termination costs	2,860
Provision for staff leave accruals	4,920
	9,960

2. Included in the Directors' "other" emoluments are:

	Sh. '000'
School fees for the Chairman's children	1,200
Entertainment allowance (used on clients)	1,800
Travelling costs for a newly recruited expatriate director	600

3. The movement in provisions for bad and doubtful debts during the year was as follows:

	Specific provisions	General provisions	Total Sh. '000'
	Sh. '000'	Sh. '000'	Sh. '000'
	Sh. '000'	Sh. '000'	Sh. '000'
At 1 January 2007	630,500	630	631,130
Charge for the year	83,800	15,300	99,100
Released during the year	<u>(18,600)</u>	—	<u>(18,600)</u>
At 31 December 2007	<u>695,700</u>	<u>15,930</u>	<u>711,630</u>

4. Provision for interest suspense represents non-performing loans and advances on which interest has been suspended. The management has confirmed that the loans and advances are fully secured.
5. Capital allowances for the year ended 31 December 2007 amounted to Sh. 18,900,000.
6. Lease rental charges relate to office equipment leased from AB office solutions for use in the entire bank network.

Required:

- (a) (i) Taxable income of Shamrock Bank Ltd. for the year ended 31 December 2007. (11 marks)
- (ii) Tax payable (if any), on the taxable income computed in (i) above. (2 marks)
- (b) Given the Shamrock Bank Ltd's taxable income for the year ended 31 December 2006, was assessed at Sh. 2,400,000, show how the tax computed in (a) (ii) above is to be paid, inclusive of the due dates. (5 marks)



- (c) Explain the implication of Income Tax Act – section 15(7) (e) (specified sources of income) on Shamrock Bank Ltd's income. (2 marks)

(Total: 20 marks)

Attempted solution

- (a) (i)

Shamrock Bank Ltd			
Computation of Taxable income			
	Sh '000'	Sh '000'	Sh '000'
Reported net loss			(51,450)
Add back disallowable expenses			
Salaries – provision for staff leave accruals		4,920	
School fees for chairman children		1,200	
Traveling cost for expatriate		600	
General bad debt provisions		15,300	
Provision for interest expense		20,950	
Depreciation		43,700	
Loss on disposal of equipment		7,250	93,920
			42,470
Less capital allowances	18,900		
Gain on disposal of property	12,300		
Rental income	2,190		(33,390)
Adjusted taxable income			9,080
Other incomes			
Taxable Rental income			2190

- NB** - Assumed that income from forex dealing is realized hence taxable
 - Assumed the pension fund is registered hence contributions allowable

- (ii) Tax payable = $10,270,000 \times 30\% = 3,381,000$

	Kshs'000	Tax @30%
Business income	9,080	2,724
Rental income	2,190	657
	11,270	3,381

(b) Year 2006 tax liability	=	2,400,000 x 30%	=	720,000
Year 2007 instalment tax	=	110% x 720,000	=	792,000
Year 2007 actual tax	=	10,510,000 x 30%	=	3,153,000

20/4/2006 = 1 st instalment = 25% x 792,000	198,000
20/6/2007 = 2 nd instalment = 25% x 792,000	198,000
20/9/2007 = 3 rd instalment = 25% x 792,000	198,000
20/12/207 = 4 th instalment = 25% x 792,000	<u>198,000</u>
Total paid	792,000

30/4/2008 = final 15th instalment = 3,153,000 – 792,000 = 2,361,000

- (c) Section 15(7) (e) of the Income Tax Act provides for the specified sources of income. The income of the specified sources should be taxed separately. In the present case. Rental income has been taxed separately. A loss from one source of income should not be offset against the gains of another source of income.

2.16 Taxation of insurance companies

2.16.1 Ascertainment of Income of Insurance Companies

1. Life insurance business of an insurance company is treated as a separate business from any other class of business.
2. The gains or profits of a resident insurance business other than life insurance business comprise of:
 - a. Gross premium less any premium returned to the insured and premium paid on reinsurance.
 - b. Other income including commission or expenses allowance received or receivable from reinsurers and investment income.
 - c. A deduction in respect of a reserve for unexpired risk, at the end of the previous year.
 - d. Addition of reserve deducted for unexpired risks at the end of the previous year.
 - e. A deduction of claims admitted net of any claim recovered from reinsurance companies.
 - f. A deduction of agency expenses.
 - g. Other deductions allowable under the Income Tax Act.

Non-resident insurance companies

Gains or profits include:

- a. Gross premium receivable in Kenya less premiums returned to the insured and premiums paid on reinsurance other than to the Head Office of the company.
- b. Other income including commission and expense allowances received or receivable from reinsurance other than from the Head Office of the company in relation to risks accepted in Kenya.



- c. Income from investments representing reserves created for or from the business done in Kenya.

Deductions

- a. Reserve for unexpired risk at the end of that year of income in respect of policies whose premiums are received or receivable in Kenya but after adding the reserve deducted in the previous year.
- b. Claims admitted in that year of income less any amount recovered from reinsurance companies.
- c. Agency expenses.
- d. Head Office expenses which would have been allowable if the company had been a resident company.

■ 2.16.2 Life Insurance Business

The income from life insurance business comprises

1. Investment income of the life insurance fund except that part of the life fund which relates to an annuity fund, less management expenses including commissions. The investment income is defined as dividends and interest income but does not include qualifying dividends.
2. The amount of interest received by the company on surrender of policies or on the return of premiums other than premiums in relation to a registered annuity contract, registered trust scheme or a registered pension fund.

■ 2.16.3 Amendment in the Taxation of Insurance Companies

The taxation framework of insurance companies was amended as shown herein below. These amendments will come to effect from 1.1.2009.

Section 19 of the Income Tax Act states as follows:

- (5) The gains or profits for a year of income from the long term insurance business of a resident insurance company, whether mutual or proprietary, shall be the sum of the following -
 - (a) The amount of the actuarial surplus recommended by the actuary to be transferable from the life fund for the benefit of the shareholders, whether or not it is actually transferred; and
 - (b) Any other amounts transferred from the life fund for the benefit of shareholders; and
 - (c) 30% of management expenses and commissions that are in excess of the maximum amounts allowed by the Insurance Act.

Where the actuarial valuation of the life fund results in a deficit for a year of income and the shareholders are required to inject money into the life fund, the amount of money so transferred shall be treated as a negative transfer for the purposes of subsection (5) (a):

Provided that the amount of the negative transfer shall be limited to the amount of actuarial surplus recommended by the actuary to be transferable from the life fund for the benefit of shareholders in previous years of income, whether or not it was actually transferred.

- (6) The gains or profits for a year of income from the long term insurance business of a non-resident insurance company, whether mutual or proprietary, shall be the sum of the following:-
- (a) The same proportion of the amount of actuarial surplus recommended by the actuary to be transferable from the life fund for the benefit of the shareholders, whether or not it is actually transferred, as the actuarial liability in respect of its long term insurance business in Kenya bears to actuarial liability in respect of its total long term insurance business; and
 - (b) The same proportion of any other amounts transferred from the life fund for the benefit of shareholders as the actuarial liability in respect of its long term insurance business in Kenya bears to the actuarial liability in respect of its total long term insurance business; and
 - (c) The same proportion of thirty per cent of management expenses and commissions that are in excess of the maximum amounts allowed by the Insurance Act as the actuarial liability in respect of its long term insurance business in Kenya bears to the actuarial liability in respect of its total long term insurance business.

(6A) Where the actuarial valuation of the life fund results in a deficit for a year of income and the shareholders are required to inject money into the life fund, the proportionate amount of the money so transferred shall be treated as a negative transfer for the purposes of subsection (6) (a):

Provided that the amount of the negative transfer shall be limited to the amount of actuarial surplus recommended by the actuary to be transferable from the life fund for the benefit of shareholders in previous years of income, whether or not it was actually transferred.

**Illustration**

Afro Insurance Ltd. underwrites three classes of insurance. The management has provided you with the details shown below on their operations for the year ended 31 December 2007:

Class of insurance	Fire	Motor vehicle	Theft
	Sh.'000'	Sh.'000'	Sh.'000'
Gross premium written	23,088	24,664	9,780
Reinsurance ceded	14,747	15,007	4,822
Unearned premium brought forward	4,205	6,293	1,466
Unearned premium carried forward	2,035	9,259	668
Claims paid	2,216	5,538	1,215
Claims outstanding brought forward	2,781	10,325	4,532
Claims outstanding carried forward	2,755	9,416	8,756
Legal expenses on claims	645	420	125
Depreciation	60	125	65
Gain on sale of motor vehicles previously written off	-	50	-
Specific bad debts	80	35	62
Management expenses	1,606	2,350	876
Commissions (net)	255	1,546	890

Additional information:

1. Wear and tear deductions have been agreed with the Income Tax Department at sh.454,000.
2. The company invested surplus funds and earned investment income as follows:

	Sh.
Interest from Treasury bills (net)	2,040,000
Interest from fixed deposits in local bank (net)	762,450
Gross dividends from Zim-Re of Zimbabwe (a foreign company)	450,000
Dividends from KELP Ltd.	912,000

3. The company paid Sh.745,000 to ABC Investment Management Services, their fund managers for professional services for the year ended 31 December 2007.
4. The company owns Afro House which houses its offices. Part of the office space is rented out to other tenants. In the year to 31 December 2007, the company received sh.2,200,000 net rental income from their estate agents. Property management fees amounting to sh.2,400,000 for the year to 31 December 2007 had been deducted.
5. Afro Insurance Ltd. owns 80% of the ordinary share sin KELP Ltd. a locally incorporated company.

Required:

- (a) Compute the taxable profit or loss for Afro Insurance Ltd. for the year ended 31 December 2007. (16 marks)
 - (b) Compute the tax payable in (a) above. (2 marks)
 - (c) Comment on any information you have not used in your computations. (2 marks)
- (Total: 20 marks)**

**Attempted solution**

(a)

Afro Insurance Ltd.**Computation of taxable profit for year ended 31 December 2007**

	Fire	Motor Vehicle	Theft	Total
	Sh.'000'	Sh.'000'	Sh.'000'	Sh.'000'
Gross premium written	23,088	24,664	9,780	57,532
Reinsurance ceded	14,747	15,007	4,822	34,576
Unearned premium b/f	4,205	6,293	1,466	11,964
Unearned premium c/f	(2,035)	(9,259)	(668)	(11,962)
Gross income earned	40,005	36,705	15,400	92,110
Less allowable expenses				
Claims paid	2,216	5,538	1,215	8,969
Claims outstanding b/f	(2,781)	(10,325)	(4,532)	(17,638)
Claims outstanding c/f	2,755	9,416	8,756	20,927
Claims incurred	2,190	4,629	5,439	12,258
Commissions (net) paid	255	1,546	890	2,691
Management expenses	1,606	2,350	876	1,832
Legal expenses	645	420	125	1,190
Specific bad debts	80	35	62	177
Total Expenses	4,776	8,980	7,392	18,148
Underwriting profit/loss	35,229	27,725	8,008	70,962
Total underwriting profit	70,962,000			
Less wear and tear	<u>(454,000)</u>	70,508,000		
Investment income				
Interest from Treasury bills	2,400,000			
Interest from Fixed deposits	897,000			
Less: investment mgt. Fees	<u>(745,000)</u>	2,552,000		
Rental income	2,200,000			
Less mgt. Fees	(2,400,000)			
		(200,000)		
Total taxable profit		72,860,000		

2.17 Taxation of sea and air transport undertakings

Firms or enterprises involved in sea or air transport undertakings are taxed in the ordinary way. It is important to point out the following unique features:

- **Income of certain non resident persons deemed derived from Kenya-**When one is on the business of shipowner, charterer or air transport operator and a ship or aircraft owned or chartered by him calls at any port or airport in Kenya, the gains or profits from that business from the carriage of passengers who embark, or cargo or mail which is embarked, in Kenya shall be the gross amount received on account of the carriage; and those gains or profits shall be deemed to be income derived from Kenya; but this subsection shall not apply to gains or profits from the carriage of passengers who embark, or cargo or mail which is embarked, in Kenya solely as a result of transshipment.
- **Collection of tax from ship owner-** In addition to any other powers of collection of tax provided in this Act, the Commissioner may, in a case where tax recoverable by suit charged on the income of a person who carries on the business of shipowner, charterer or air transport operator, issue to the proper officer of Customs by whom clearance may be granted a certificate containing the name of that person and the amount of the tax due and payable and on receipt of that certificate the proper officer of Customs shall refuse clearance from any port or airport in Kenya to any ship or aircraft owned by that person until the tax has been paid.
- **Exemptions-** The income of a non-resident person who carries on the business of aircraft owner, charterer or air transport operator, from such business where the country in which such non-resident person is resident extends a similar exemption to aircraft owners, charterers or air transport operators who are not resident in such country but who are resident in Kenya.

Shipping Investment Deduction (SID)- SID is granted where a resident ship owner incurs capital expenditure:

- a. On purchase of new, unused power-driven ship of more than 495 tons; or
- b. On purchase of and subsequent refitting for the purpose of shipping business of a used power-driven ship of more than 495 tons.

The rate of shipping investment deduction is 40% (2/5) of Qualifying cost granted in the first year of use.

Limitations

- A ship only gets one SID
- If ship is sold before 5 years of use, the SID earlier granted will be withdrawn and the deduction will be treated as taxable income for year the withdrawal of SID takes place.
- Compensation by way of wear and tear allowance will be granted.

Illustration:

A ship of 500 tons was acquired on 1.1.2004 at Ksh.40, 000,000. It was sold in Year 2007 for Kshs.36,000,000. Required: Compute capital allowances to claim for the years 2004 to 2007.

**Solution:****Capital Deductions Computation****1) SID Yr. 2004**

Qualifying Cost	SID @40%	Residue of W.T.A
Sh.	Sh.	Sh.
40,000,000	16,000,000	24,000,000

2) W.T.A**Class IV @ 12.5%****SH.**

Residue after SID	24,000,000
YR 2004 W.T.A	<u>(3,000,000)</u>
	21,000,000
YR 2005 W.T.A	<u>(2,625,000)</u>
	18,375,000
YR 2006 W.T.A	<u>(2,296,8705)</u>
	<u>16,078,140</u>

Since ship was sold before 5 years had elapsed, SID earlier granted of Sh.16,000,000 will be reclaimed and compensation granted for wear and tear allowance, i.e.

Wear And Tear Allowance Compensation

	Sh.	<u>Alternatively</u>		
Reclaimed SID		16,000,000	S.I.D withdrawn	16,000,000
Yr. 2004 W.T.A		<u>(2,000,000)</u>	less WTA for	
		14,000,000	2004, 2005 and 2006	<u>5,281,250</u>
Yr. 2005 W.T.A		<u>(1,750,000)</u>	Taxable S.I.D	<u>10,718,750</u>
		12,250,000		
Yr. 2006 W.T.A		<u>(1,531,250)</u>		
Taxable S.I.D balance in year 2007		<u>10,718,750</u>		

2.18 Taxation of Unit trusts or collective investment schemes

A Unit Trust or a mutual fund organization is one registered under the Unit Trust Act. It sells units (equivalent to shares) to the public and invests the funds for a return. The unit holder gets a return (interest) from the Unit Trust tax free.

The sale purpose of the unit trust or collective investment scheme is to carry on investments on behalf of the unit holders or shareholders, where contributions are invested in shares traded in any securities, operated in Kenya, the income of schemes will be exempted. The scheme will pay withholding tax on dividends and interest received on behalf of employees at rates of 5% and 15% respectively.

The Unit Trusts are supposed to invest in shares and the government hopes this will help develop the capital market (buying and selling of shares mainly in the Nairobi Stock Exchange).

The withholding tax paid by a Unit Trust on interest and dividend is final tax, which means that the Unit Trust is not taxed further on the income.

Where unit holders or shareholders in any unit trust or collective investment scheme are exempt persons under the first schedule to the Act, the manager or trustee of the unit trust or collective investment scheme shall maintain separate but identifiable account of the funds of such persons. Business incomes of such bodies will also be exempt so long as the business income is applied to investments in securities as mentioned above, income is from rental properties of the scheme and that such business is carried on by the beneficiaries.

1.19 Property developers and contractors

In Kenya, there are no specific guidelines governing the taxation of property developers and contractors. We note that while there is no Capital gains tax, if a firm or a company has been formed for purposes of property development. The adjusted profits therefrom will be taxed as business income of the company.

Tax is imposed under Section 3(2)(a)(iii). The word "property" is not defined in the Income Tax Act. The Interpretation and General Provision Act defines property as:

"Property" includes money, goods, chosen in action, land and every description of property, whether recoverable or immovable, and also obligations, easements and every description of estate, interest and profit, present or future, vested or contingent, arising out of or incident to property as herein defined".

Section 6 provides that "gains or profits from the use or occupation of property includes a royalty, rent, premium or similar consideration received for the use or occupation of property.

"Royalty" means a payment made as a consideration for the use of or the right to use:

- (a) A copyright of a literary, artistic or scientific work; or
- (b) A cinematographic film, including film or tape for radio or television broadcasting; or
- (c) A patent, trade mark, design or model, plan, formula or process; or
- (d) Any industrial, commercial or scientific equipment.

Rent is not defined and is therefore assigned its normal and usual meaning.

Premium is not defined but usually refers to a reward or something extra above par. Another expression used is "Key Money".

In *A.C v C.I.T* the decision by the Income Tax Department to charge key money was upheld by the courts on the basis that it was received for the use of an asset.

The court ruled that it was revenue receipt and should be assessed in full in the year in which it is received without spreading it over the lease term.



Allowable deductions

Section 15 (i): All the expenditure incurred wholly and exclusively in the production of rental income. This refers to the usual expenses of a revenue nature.

- (a) Bad debts and specific provision for bad debts.
- (b) Capital allowances under the second schedule, where appropriate e.g. Property let furnished, the furniture qualifies for wear and tear.
- (c) Expenditure incurred in the maintenance of the property.
- (d) Expenditure of a capital nature on legal costs and stamp duty in connection with the acquisition of a lease of premises to be used for business (letting out premises). The lease should be for 99 years or less and should not be capable of extension beyond 99 years.
- (e) Municipal rent and rates.
- (f) Expenditure incurred on structural alteration to premises in order to maintain existing rent.
- (g) A reasonable amount representing the diminution in value of any implement, utensil or similar article not being plant and machinery e.g. Crockery, cutlery, utensils, blankets, sheets, towels etc.
- (h) Caretaker wages and salaries.

The Overland Case

CIT v Overland Company Ltd. This case established the principle that all the expenditure incurred, including rates and interest, throughout the construction period up to the date the property is first used should be regarded as capital outlay for which no deduction can be allowed.

Such expenditure is treated as a preliminary expense of a capital nature.

The Low Shipping Company Case

(Low Shipping Company Ltd v CIR)

The Appellant company purchased a second hand ship when her Lloyd's survey was overdue. The survey was deferred pending the completion of a voyage. On her return six months later the survey was made and the company was obliged to spend large sums in repairs. The company claimed that the whole cost of the repairs should be deducted.

Held: that except for such part of the cost of repairs as was attributable to the period during which the ship was employed in the Appellant's trade, the expenditure in question was in the nature of capital expenditure.

Partial Occupation by Owner

Where a portion of the property is occupied by the owner an apportionment of the relevant expenses is made. The portion attributable to the owner is disallowed.

Temporary Vacancy

Where a let property remains temporarily vacant no adjustments of expenses is made. The property should not remain vacant for more than six months.

Travelling costs

The cost of travel by the owner from his home to the property is not allowable.

Non-resident owners

No deductions are allowable from the gross rent received if the owner is non-resident. The rent is taxed at source at the appropriate rate i.e. 30% of gross rent.



2.20 CHAPTER SUMMARY

- The taxation of Petroleum companies and petroleum subcontractors is spelt out under the 9th Schedule of the Income Tax Act. In addition to paying their taxes, petroleum companies have an obligation of withholding tax to payments made to the sub contractors.
- The income of a charitable trust is exempted from tax if:
 - (a) It is public in character
 - (b) If it is established for relief of distress or poverty to the public.
 - (c) If it is established to advance religion or education.
 - (d) Its total income is used or spent for charitable purposes.
- Cooperative Societies are considered to be body corporates and are taxed at the rate of **30%**.
- The income of clubs is made up of the **gross receipts**, including entrance fees, and subscriptions and such receipts **are taxed** in the name of the club **at the corporation tax rate**.



2.21 QUIZ

QUESTION ONE

Distinguish between the taxation of trade association and clubs

QUESTION TWO

Briefly discuss the taxation of armateur sporting associations.

QUESTION THREE

List the allowable expenditure of a petroleum company while arriving at the taxable profit

QUESTION FOUR

List the applicable tax exemptions to venture capital enterprises



2.22 ANSWERS TO QUIZ

QUESTION ONE

Distinguish between the taxation of trade association and clubs

Taxation of Trade associations

A trade association is a body of persons which is an association of persons separately engaged in any business with the main object of safeguarding or promoting the business interests of such persons.

Generally trade associations are not considered to be carrying out trading activities. However, they may engage in trade. Under sec **21(2) of the Income Tax Act**, such an association can choose or elect by notice in writing to the CDT to be considered to be carrying out **business chargeable to tax** in respect to any year of income. In which case, it's **gross receipts from the transactions with members** (including entrance fees and subscription fees) and with other persons is deemed to be income from the business for that year of income at the **corporate tax rate**.

Taxation of Clubs

Under Section 21 of the Income Tax Act, a members club means **a club or similar institution** with all its assets owned by, or held in trust for the members thereof. The income of clubs is made up of the **gross receipts**, including entrance fees, and subscriptions and such receipts **are taxed** in the name of the club **at the corporation tax rate**.

However, **when $\frac{3}{4}$ or more of such investment** is derived from **members**, the body will not be taken to be carrying on business and no part of such non investment income will be taxed i.e income from members is not taxable.

Investment income of a club such as dividends, interest, rents, capital gains etc are to be **excluded in the $\frac{3}{4}$ test mentioned** above.-(sec 21(1))

QUESTION TWO

Under Paragraph 6 of the first schedule to the Income Tax Act, income other than income from investment of an Amateur sporting association is not taxable. For this to be the case, the amateur sporting association must be one:

- Whose sole aim or object is to foster outdoor sports and control any outdoor sports.
- Whose members consist of amateurs or affiliated associations the members of which are amateurs.
- Whose memorandum of association or by laws have provisions defining an amateur or a professional and providing that no person other than an amateur shall be a member of that association.

QUESTION THREE

Under the 9th schedule of the Income Tax Act, the following are the allowable expenditure for a petroleum company:

- intangible drilling costs;
- geological and geophysical costs;
- payments to the Government, or any agency thereof, pursuant to the provisions of the petroleum agreement
- executive and general administrative expenses wholly and exclusively incurred in Kenya by a petroleum company;
- management or professional fees, including those paid to persons outside Kenya limited to the amount that is attributable to the petroleum company and is fairly and reasonably payable thereby; and
- interest paid, including interest paid by a non-resident petroleum company and fairly and reasonably allocated to a permanent establishment maintained in Kenya by that company,

QUESTION FOUR

Venture capital companies enjoy certain tax exemptions as follows:

- Dividends received by a registered venture capital company is tax exempt. (A registered venture capital company is a venture capital company registered by the CDT as such)
- Gains arising from trade in shares of a venture company earned by a registered venture capital company within the first ten years from the date of first investment in that venture company by the venture capital company are **tax exempt.**: Provided that the venture company has not been listed in any securities Exchange operating in Kenya for a period of more than two years



2.23

PAST PAPER ANALYSIS

This topic covers a wide range of concepts. The student should be able to understand each concept and be able to answer questions as they come. 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.

12/02 Q. 4, 12/03 Q. 3(d), 06/04 Q.2, 12/04 Q.2, 12/06 Q.1(b), 12/06 Q.5(c), 12/07 Q.2(b), 12/08 Q.2(b),



2.24 REVISION QUESTIONS

QUESTION ONE- LEASE HIRE ARRANGEMENTS

Discuss the tax implications of lease hire arrangements

QUESTION TWO- PETROLEUM COMPANIES AND EPZS

Write short notes on the taxation of:

- (i) Petroleum companies and their sub-contractors. (4 marks)
- (ii) Enterprises situated in export processing zones (EPZs). (4 marks)

(Tax 1 Dec 2003 Q 3)

QUESTION THREE- INSURANCE COMPANIES

Linda Insurance Company Ltd. is a resident insurance company carrying out both general and life assurance businesses. The following information relates to the insurance company's financial year ended 31 December 2007:

	General insurance business	Life assurance business
	Shs. '000'	Shs. '000'
Investment income	13,780	16,400
Insurance premiums received	15,450	86,900
Commission and management fees	-	13,600
Premiums returned on surrendered policies	374	-
Re-insurance commission	1,360	3,450
Interest paid out of Annuity Fund on surrender of policies	-	23,670
Premiums paid to re-insurance company	4,680	12,000
Agency expenses	1,350	1,960
Management expenses	1,934	2,456
Travelling expenses	1,800	2,400
Advertising expenses	364	820
General expenses	8,490	4,640
Bad debts (specific)	368	240
Income from exercise of subrogation rights	1,250	1,800
Interest on premiums returned	396	-
Recoveries on re-insurance	150	180

Additional Information:

Management expenses for Life assurance business include Sh.400,000 being salaries to pension department employees and Sh.456,000 for trust scheme rent.

Investment income comprise:

	General insurance business	Life assurance business
	Shs. '000'	Shs. '000'
Interest on fixed deposit accounts (net)	780	400
Dividend received (net)	3,000	4,800
Rental income	<u>10,000</u>	<u>11,200</u>
	13,780	<u>16,400</u>

3. General expenses include the purchase of:

	General insurance business	Life assurance business
	Shs. '000'	Shs. '000'
Computers	800	720
Furniture and fittings	1,260	860

4. Reserves for unexpired risk were as follows:

	General insurance business	Life assurance business
	Shs. '000'	Shs. '000'
1 January 2007	3,240	4,340
31 December 2007	1,760	5,370

5. Claims outstanding were as follows:

	General insurance business	Life assurance business
	Shs. '000'	Shs. '000'
1 January 2007	5,640	3,460
31 December 2007	6,200	2,880

Claims paid during the year ended 31 December 2007 amounted to Sh.7,600,000 for General insurance business and Sh.6,900,000 for Life assurance business.

Required:

- i) Determine the taxable income or loss of Linda Insurance Company Ltd. for the year of income 2007 (14 marks)
 - ii) Tax payable (if any) by the insurance company (2 marks)
- (Total: 20 marks)**



QUESTION FOUR - TRADE ASSOCIATIONS, CLUBS, AMATEUR SPORTING ASSOCIATIONS

Write brief notes on the taxation of the incomes received by the following institutions:

- (i) Charitable trusts (4 marks)
 (ii) Amateur sporting associations. (4 marks)

(Dec 2005 Q 1)

Question five-Cooperative societies

- (a) Ukulima Savings and Credit Co-operative Society Ltd. has presented you with the following income and expenditure account for the year ended 31 December 2007:

	Sh.	Sh.
Income		2,252,500
Rental income		424,000
Investment income – dividends		5,750,500
Interest from loans to members		<u>747,300</u>
Interest from Savings and Loans Kenya Ltd.		9,174,300
Expenses		
Traveling	443,875	
Printing and stationery	236,910	
Legal expenses	132,500	
Medical expenses for staff	271,625	
Salaries and wages	4,253,350	
General office expenses	<u>100,000</u>	<u>5,438,260</u>
Net income		<u>3,736,040</u>

Required:

- (i) The taxable income for the year and tax payable. (8 marks)
 (ii) Comment on any information not used in (i) above. (2 marks)

(Tax 1 Dec 2001 Q 2)

- (b) Explain the basic principles followed in the taxation of the income of cooperative societies. (4 marks)

(Dec 2007 Q 2)

CHAPTER THREE



STUDY X

TAX INVESTIGATIONS



CHAPTER THREE

TAX INVESTIGATIONS

► 3.1 Objectives

At the end of this chapter, the student should know the procedure for tax investigation under the following headings:

- Tax evasion, tax avoidance and fraud
- Events which may trigger an investigation
- Back duty and indepth examinations
- Methods of computing omitted and understated income
- VAT refunds, false claims and accountant's certificate
- Capital statements and ascertainment of income omitted or understated
- Customs and excise investigations
- Negotiation for settlement
- Tax audit
- Application of relevant case law

► 3.2 Key definitions

Tax avoidance is the use of existing law to reduce tax payable. It is legal and may be achieved through taking advantage of the knowledge about tax to reduce the tax burden or liability.

Tax evasion is the use of fraudulent and dishonest means to reduce tax payable. Generally speaking tax evasion is illegal.

► 3.3 Introduction

In the previous chapter, we studied concepts on taxation of specialised institutions. In this chapter, we shall study the various approaches that can be used either by the enterprises or by the revenue authority to investigate tax compliance of a company. The tax concepts learnt in this topic will provide a practical basis in taxation. In the next topic we shall study concepts in cross-border transactions.

► 3.4 Exam Context

The procedure of tax investigation learnt in this topic will be tested in the application questions in the examinations. As such, a deep understanding of the same will be essential.

► 3.5 Industrial Context

This topic is designed to not only help the students tackle related exam questions, but also to help tax experts, revenue authority experts and finance managers conduct any tax investigation. With the aggressive nature of the revenue authority, different and more sophisticated approaches are being adopted while undertaking the audits. As such, the content in this text may not be exhaustive.

3.6 Tax evasion, tax avoidance and fraud

Tax avoidance is the use of existing law to reduce the tax payable. Tax avoidance is legal and may be achieved through taking advantage of the knowledge about tax to reduce the tax burden or liability. Some modes of tax avoidance include:

- Investment decisions: Do you buy an asset of capital nature and claim capital allowances or incur revenue expenditure?
- Personal investment decisions: Do you invest in debentures or ordinary shares?
- Employment income: Take light loans to build a house or buy a house?
- Do you buy your own car and claim mileage or rely on the company car?
- Production for domestic or international: EPZ for exports are zero rated for VAT, they have a tax holiday of 10 years, import duty refund on raw materials imported, 25% corporate tax rate for years from 11 to 20, ID of 100%
- Financing decisions: Debt capital interest is allowable unlike equity where dividends are disallowable.
- Business ownership: Should it be a sole proprietorship, a partnership or a limited company?
- A limited company is a going concern, salary to directors is allowable, tax liability is on the company, tax 30% for company, personal relief for individuals, interest on debt capital is allowable unlike on partners capital which is disallowable.

Tax evasion is the use of fraudulent and dishonest means to reduce tax payable. Tax evasion is illegal. It can also be defined as the reduction of tax liabilities by illegal means such as concealing information or supplying false information. Tax evasion may be achieved through:

- corrupt deals with tax officials,
- willful negligence in furnishing tax information (e.g. false returns),
- Non declaration of incomes.
- Alarming expenses, allowances and relief that one is not entitled to or
- Engaging in smuggling or black markets.
- Money laundering
- Barter trade transactions
- Lighting i.e. not declaring income related to extra employment
- Manipulation of accounts (creative accounting)



3.6.1 Anti-avoidance provision (Sec 23 of the Income Tax Act)

Under **S.23**, the Commissioner of Income Tax is empowered to reject certain business transactions when he is of the opinion that the main purpose or one of the main purposes for effecting a transaction is evasion or reduction of tax liability. He can direct for necessary adjustment on taxable income and issue an assessment accordingly. If the taxpayer disputes the adjustment and the resulting assessment, the taxpayer can appeal to the Tribunal e.g.

- A Director buying a car from the company at a throw away price. He would be taxed on the difference between the low price he pays for the car and the market price for the car.
- A child paid very high salary for minor duties. The salary helps to spread tax payable but the parent controls the child's income. The Commissioner of Income Tax would disallow the salary and tax it.

S.24-Anti-avoidance provision

Under S.24, the Commissioner of Income Tax is empowered to direct a company to distribute dividends to its shareholders i.e. when there is dividend distribution shortfall e.g. Fair Ltd had adjusted income for tax in 2005 of Kshs 10 million and dividend provided/declared was Kshs 1 million. Dividend distribution shortfall would then be calculated as follows:

	Kshs '000
Adjusted income for tax	10,000
Less tax thereof @ 30%	
(tax rate for the year)	<u>3,000</u>
	7,000
Less: Allowable retention @60%	<u>4,200</u>
	2,800
Less: dividend declared	<u>1,000</u>
Dividend distribution shortfall	<u>1,800</u>
Shortfall distribution tax = 1,800 x 5% =	90

The Commissioner of Income Tax can direct the company to distribute Kshs 1,800 to the shareholders and deduct withholding tax accordingly. If a taxpayer disputes an assessment resulting from forced distribution, the taxpayer can appeal to the Tribunal.

Tax avoidance: Principles emerging from case law

Section 23 of the Kenya Income Tax Act empowers the Commissioner to order the adjustment of transactions which in his opinion are effected with the main aim of avoiding or reducing liability to tax.

Such a direction can only be challenged by appealing to the Income Tax Tribunal. This decision of the Tribunal is final and there is no right to further appeal.

However, the Commissioner rarely, if ever, does use such powers. Consequently, there is no such litigation in respect of tax avoidance schemes in Kenyan courts.

However, the following principles have emerged from UK Case Law and which may well be applied in Kenya:

1. The “Duke of Westminster” Principle.

Lord Tomlin stated: “Every man is entitled, if he can, to order his affairs so that the tax attaching ... is less than it would otherwise be.

2. The “Ramsay” Principle:

This was established in a Capital Gains Tax Case in relation to composite transactions. At the time, the most prevalent scheme to avoid tax (especially Capital Gains Tax) was to enter into a series of transactions, which would facilitate the following:

- (a) Conceal the sale of property subject to Capital Gains Tax (CGT)
- (b) The exchange of shares for shares, which would not have CGT implications.

This interdependent series of transactions would normally be “circular and self- cancelling”.

The Ramsay doctrine provides that whether a series of transactions is genuine or artificial would be dependent on the end result. Transactions which have no commercial purpose are treated as a fiscal nullity. The preordained series of transactions are disregarded if they have no business purpose other than achieving the preordained end.

The same principle was extended in CIR vs *Burmah Oil Co. Ltd.*

3. Francis Vs Dawson

Facts of the Case

George Dawson and family owned two private companies which they wanted to sell. If they were sold in UK at a gain, it would be subject to Capital Gains Tax.

Dawson wanted to sell to W Ltd a UK company. He was advised to sell by an exchange of shares for shares with an offshore company, G Ltd.

G Ltd then sold its shares in the two companies to W Ltd. The scheme succeeded on the grounds that the end result led to “enduring legal consequences” and therefore the individual transactions had a business purpose and not artificial as in the Ramsay Case.

3.7 Events which may trigger an investigation

The following are some of the circumstances that trigger audits by the Kenya Revenue Authority:

- (a) Self confession.
- (b) Third party information
- (c) Informers e.g. friend, a spouse, former spouse.
- (d) Information from related company audits.
- (e) Non compliance in the industry.
- (f) Cessation of business or a large part of the business.
- (g) Non compliance detected via compliance check
- (h) Staff of the entity
- (i) Public media (TV, Newspapers, magazines)
- (j) Registrar of companies or business names.
- (k) Large public company e.g. KCC



- (l) Government parastatals.
- (m) Local authorities.
- (n) Investigation using the PIN number.

3.8 Back duty and indepth examinations

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.

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 Domestic Taxes Department records though 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 wilful negligence on the part of the taxpayer and his accountant, or;
- ii) Fraud on the part of the taxpayer

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

- Taxpayer himself
- Informers
- Public media
- Income tax departments
- Farming organisations
- 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.

Capital statements must appear reasonable to be acceptable by the Income Tax Department and must

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.

Procedure:

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?

3.9 VAT refunds, false claims and accountant's certificate

Refund of tax

If, for any tax period, a person has overpaid 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 12 months.

The Commissioner VAT may refund tax under the following circumstances:

- Where payment has been made in error e.g. overpayment 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 the Commissioner VAT.
- Where refund is in public interest in the opinion of the 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 Kshs1,000,000 and investments are used in making taxable supplies.

Documents accompanying claim for refund under Sec. 24 (bad debts)

- Confirmation from liquidator that debtor has become insolvent and proof of debt amount.

- Copies of relevant tax invoices issued at the time of supply to the insolvent debtor,
- A declaration that the debtor and taxpayer are unrelated companies/persons.
- Records/documents showing input tax paid by the taxpayer 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 Kshs 1,000,000 shall be accompanied by the **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 the auditor before issuing such a VAT refund certificate.

(It is not exhaustive and may require tailoring to suit circumstances).

1. Review and document the adequacy of the system of recording and accounting for VAT.
2. Ensure that the VAT 4 corresponds with the supporting VAT return and that the entries in the return agree with the books of account.
3. 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.
4. 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.
5. Select a sample of invoices from VAT 4 and perform the following tests where applicable:
 - Input tax has been claimed within 6 months after the issue of the invoice.
 - The invoices meet the requirement of Regulation 4.
 - Simplified tax invoices have not been used to claim relief.
 - The invoices are not photocopies or fax copies.
 - Ensure that input tax in respect of imported goods is properly supported by a Customs Entry form and contained within an original KRA receipt for payment of duty and VAT.
 - Ensure that tax has been properly accounted for in respect of imported services (reverse charge).
 - Ensure the input tax does not relate to items scheduled on the blocking order VAT Order, 1994.
 - Ensure input tax has not been claimed in advance.
 - Trace the invoices to the relevant ledger accounts.
 - Confirm that the expenditure is business related and not private.
6. Obtain the workings supporting the output tax on the VAT return, if any, and select a sample and perform the following tests where applicable:
 - Check that the correct rate of VAT was applied.
 - Ensure that sales were accounted for in the correct tax period.
 - Trace the invoices to the relevant ledger accounts.
 - 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.
 - Ensure that VAT has properly been accounted for in respect of miscellaneous sales.
7. Ensure, where applicable, that VAT on intra-group transactions has been properly accounted for.
8. 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.
9. Prepare a statement analysing 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 taxpayers thereby ensuring better compliance in future.

3.10 Capital statements and ascertainment of income omitted or understated

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.

Capital statements must appear reasonable to be acceptable by the Income Tax Department and must

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**.

A capital statement may be required where:

- no accounting records are kept by the taxpayer
- taxpayer maintains incomplete records
- when a self assessment has been filed but indepth assessment has to be carried out.

3.11 Customs and excise investigations

Under Customs & excise, the revenue authority can carry out a post clearance audit.

■ Post clearance audits

According to the taxpayer's charter, a taxpayer may be selected for a post clearance audit on all Customs related transactions. The scope of audits may include visits to the taxpayer's premises. The taxpayer will be notified in advance of the intention to carry out an audit before its commencement. However, under certain circumstances depending on the factors surrounding the case, it may be necessary to conduct a surprise audit. The audit may be completed within 14 days from the date of commencement of audit.

- A post clearance audit is mostly conducted where fraud is suspected.
- This examination is carried out after the completion of import clearance.
- The audit inquiry is carried out at the importer's offices, and is made not only of the importer but also of other people concerned.
- The audit is done in order to:
 - Check whether the importer's own initiative declaration was true and correct.
 - See whether the basis of assessment and other matters contained in the declaration of imported goods were correctly established.
 - Confirm whether the declared value of the imported goods was correct

Customs audits verify:-

- Tariff classification,
- Valuation,
- Country of origin,
- Financial information and
- Documentation the importer is required to maintain.

3.12 Tax audit

The Kenya Revenue Authority may carry out either a compliance check or a comprehensive audit. A compliance check is like a spot check to confirm summaries from the ledger/ returns with the taxpayer's sales and purchases journal. A comprehensive audit is an audit covering many types of taxes and multiple issues in the accounts of a taxpayer.

KRA may select a taxpayer for audit on Income Tax, Pay As You Earn (PAYE), Value Added Tax (VAT), Excise or Customs duty or any other tax administered by the Authority. Sometimes the taxpayer may be selected for audit in respect of multiple taxes. In most cases, the audits will be field audits i.e. they will be carried out in your premises. In the majority of cases, the taxpayer will be notified in advance of the intention to carry out an audit before the commencement of the audit. However, under certain circumstances depending on the factors surrounding the case, it may be necessary to conduct a surprise audit. In order not to inconvenience the taxpayer, and subject to the taxpayer's co-operation with KRA officers, KRA shall endeavour to complete the audit within:

- 10 days from the date of commencement of single issue audits.
- 30 days from the date of commencement of comprehensive audits.



- One day for a general inspection of an excise factory.
- 7 days for any other tax administered by the authority.

If the taxpayer has been selected for audit by the Large Taxpayer Office or the Investigations Department all the multiple taxes will invariably be audited. It is expected that the audit by the Large Taxpayer Office will take no more than two months to complete. Cases under investigation will be completed within a period of between two to six months. Complex cases may take a longer period to complete.

The taxpayer may also be subjected to a **compliance check** (e.g. computation and intelligence information) to verify certain information. A visit by a KRA official to check on the taxpayer's compliance does not amount to a comprehensive audit.

An audit is considered complete when the findings have been fully explained in writing to the taxpayer giving specific details on how additional tax liability if any, has been arrived at. The taxpayer will also be informed in writing if the audit results in no additional tax.

The commissioner general, a departmental commissioner or headquarters tax programmes will require that the taxpayer be re-audited if it is discovered that the taxpayer's case was settled irregularly, or is dissatisfied with the manner in which the case was completed.

Objections

The taxpayer is entitled to object to an assessment (Income Tax, VAT, Customs and Excise Duty, or other assessment issued under KRA) if you believe you have been assessed wrongly or unfairly. You must exercise your right to object within a specific period and comply with the requirements, which include submission of returns together with all supporting documents for the objection to be valid. You may also attach your own workings accompanied by new evidence, which can be taken into consideration in reviewing the objection.

Once you have filed a valid notice of objection KRA shall conduct an impartial review of your case. KRA shall acknowledge your objection within 7 days and endeavour to resolve the objection within 30 consecutive days.

Complex cases may take more than 30 days to resolve.



3.13 CHAPTER SUMMARY

- Tax avoidance is the arrangement of a person's financial affairs so as to legitimately reduce a tax liability.
- Tax evasion is the illegal arrangement of financial affairs so as to minimise a tax burden.
- The revenue authority has powers to carry out a comprehensive audit and a compliance audit across all types of taxes.
- The taxpayer has an avenue to object, or appeal against an assessment.

3.14 QUIZ

QUESTION ONE: TAX AVOIDANCE AND EVASION

Distinguish between tax avoidance and tax evasion.

QUESTION TWO: AUDIT

What are the two types of audits that can be carried out by **KRA**?

QUESTION THREE: VAT REFUND

Describe the procedure for a VAT refund audit.

QUESTION FOUR: CUSTOMS INVESTIGATION

Describe how a customs and excise investigation is carried out.

QUESTION FIVE

List the circumstances that may trigger an audit.



3.15 QUIZ ANSWERS

QUESTION ONE: TAX AVOIDANCE AND EVASION

Tax avoidance is the arrangement of a person's financial affairs so as to legitimately reduce a tax liability.

Tax evasion is the illegal arrangement of financial affairs so as to minimise a tax burden.

QUESTION TWO: AUDIT

KRA may carry out either a compliance check or a comprehensive audit. A compliance check is like a spot check to confirm summaries from the ledger/ returns with the taxpayer's sales and purchases journal. A comprehensive audit is an audit covering many types of taxes and multiple issues in the accounts of a taxpayer.

QUESTION THREE: VAT REFUND AUDIT

VAT refund audit procedure

- Under legal notice issued 18/11/99, tax refunds and claims for tax relief exceeding Kshs1,000,000 shall be accompanied by the **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. (It is not exhaustive and may require tailoring to suit circumstances).
- Review and document the adequacy of the system of recording and accounting for VAT.
- Ensure that the VAT 4 corresponds with the supporting VAT return and that the entries in the return agree with the books of account.
- Establish why the trader is in refund position (e.g. if trader is 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.
- 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.
- 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 of 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).
- Ensure the input tax does not relate to items scheduled on the blocking order VAT Order, 1994.
- Ensure input tax has not been claimed in advance.
- Trace the invoices to the relevant ledger accounts.
- Confirm that the expenditure is business related and not private.
- Obtain the workings supporting the output tax on the VAT return, if any, and select a sample and perform the following tests where applicable:
 - Check that the correct rate of VAT was applied.
 - Ensure that sales were accounted for in the correct tax period.
 - Trace the invoices to the relevant ledger accounts.
 - 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.
 - Ensure that VAT has properly been accounted for in respect of miscellaneous sales.
 - Ensure, where applicable, that VAT on intra-group transactions has been properly accounted for.
 - 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.
- Prepare a statement analysing 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.

QUESTION FOUR: CUSTOMS INVESTIGATION

According to the taxpayer's charter, a taxpayer may be selected for post clearance audit on all Customs related transactions. The scope of audits may include visits to the taxpayer's premises. The taxpayer will be notified in advance of the intention to carry out an audit before its commencement. However, under certain circumstances and depending on the factors surrounding the case, it may be necessary to conduct a surprise audit. The audit may be completed within 14 days from the date of commencement..

- Post clearance audit is mostly conducted where fraud is suspected.
- This examination is carried out after the completion of import clearance.
- The audit inquiry is carried out at the importer's offices, and is made not only of the importer but also of other people concerned.
- The audit is done in order to:
 - Check whether the importer's own initiative declaration was true and correct.
 - See whether or not the basis of assessment and other matters contained in the declaration of imported goods were correctly established.
 - Confirm whether the declared value of the imported goods was correct.

**Customs audits verify:**

- tariff classification,
- valuation,
- country of origin,
- financial information and
- documentation the importer is required to maintain.

QUESTION FIVE

- (a) The following are some of the circumstances that trigger audits by the KRA:
- (b) Self confession.
- (c) Third party information
- (d) Informers e.g. a friend, a spouse, or former spouse.
- (e) Information from related company audits.
- (f) Non-compliance in the industry.
- (g) Cessation of business or a large part of the business.
- (h) Non compliance detected via compliance check
- (i) Staff of the entity
- (j) Public media (TV, newspapers, magazines)
- (k) Registrar of companies or business names.
- (l) Large public company e.g. KCC
- (m) Government parastatals.
- (n) Local authorities.
- (o) Investigation using the PIN number.

**3.16 PAST PAPER ANALYSIS**

The following is a list of past exams and questions in which the topic was featured. The questions are listed in this format: Month/year e.g. 6/01 represents June or May 2001.

06/00 Q.4, 12/04 Q.5 (d), 12/06 Q.2. 06/06 Q.3 (b) 12/06 Q.4(a), 12/06 Q.5(a), 06/07 Q.3(c), 06/07 Q.5(b), 12/07 Q.1(b).

3.17 REVISION QUESTIONS**QUESTION ONE**

- (a) You have recently been appointed by an individual running his own business to act on his behalf in a back duty investigation. Following preparation of a capital statement for a number of years you have agreed with the District Assessor handling the case, the additional amounts to be assessed and calculations showing the amount of tax interest on overdue tax and penalties arising on the additional amounts assessable.
- Your client is puzzled as to how the back duty investigation began. He has also asked whether the Income Tax Department will accept a settlement of less than the full amount.

Required:

Write a letter to your client advising him:

- (i) Of the information the assessor might have received which resulted in an investigation into his affairs. (3 marks)
- (ii) Of the circumstances of the case which the Income Tax Department might take into consideration in deciding whether to accept a payment of less than the full amount due. (2 marks)
- (b) Your client, Sophia Town, has owned a general retail store since 1 April 2003. The Tax Assessor has recently begun an investigation into her affairs as he is not satisfied that she has been making full declaration of income in recent, years. On your advice, Sophia decided to co-operate fully with the Income Tax Department and after discussing the matter with her and investigating her records you have managed to prepare the following statements:



Year ended:	31 March 2004	31 March 2005	31 March 2006	31 March 2007
	Kshs	Kshs	Kshs	Kshs
Sales (recorded)	40,000	50,000	60,000	65,000
Cost of sales	<u>34,000</u>	<u>42,500</u>	<u>45,000</u>	<u>58,000</u>
Gross profit	6,000	7,500	15,000	7,000
Bank deposit interest (undeclared)	<u>300</u>	<u>700</u>	<u>800</u>	<u>1,200</u>
	6,300	8,200	15,800	8,200
Expenditure:				
Items for which receipts are available	3,510	3,820	4,840	5,120
Other items	<u>1,490</u>	<u>1,680</u>	<u>1,760</u>	<u>2,080</u>
	<u>5,000</u>	<u>5,500</u>	<u>6,600</u>	<u>7,200</u>
Net profits (assessed to tax)	<u>1,300</u>	<u>2,700</u>	<u>9,200</u>	<u>1,000</u>

You ascertain that the bank deposit account was opened in May 2003. Your calculations reveal her gross profit percentage should be 33% on cost. Sophia informs you that she banked 1/11 of her takings in a National Savings Bank ordinary account which earned interest at 5% per annum throughout the period under review. The National Savings Bank account which had not been declared on her tax return form was opened on 31 December 2003 and undeclared takings were banked annually on 31 December each year. Sophia's turnover fluctuates very little from month to month. Of the expenditure for which no receipts are available you have satisfied yourself that 60% is genuine business expenditure, while the other 40% is of a doubtful nature. Sophia also has casual dealings in antiques which have not been declared to the Income Tax Department. Her antique dealings also commenced in April 2003.

Preparation of capital statements reveals the following:

	1 April 2003 Kshs	31 March 2004 Kshs	31 March 2005 Kshs	31 March 2006 Kshs	31 March 2007 Kshs
Assets at cost:					
Shop premises fittings and stock	25,000	30,000	32,000	36,500	40,000
Debtors and cash	500	2,500	4,500	6,000	7,000
Bank deposit account	-	2,800	7,620	9,040	13,150
National Savings Bank Account	-	3,000	7,900	14,045	21,122
Investments (legacy from deceased aunt)	-	-	7,000	7,000	7,000
	<u>-</u>	<u>-</u>	<u>7,000</u>	<u>7,000</u>	<u>7,000</u>
Liabilities	25,500	38,300	59,020	72,585	88,272
Loan from friend to purchase shop					
Creditors	(20,000)	(20,000)	(20,000)	(20,000)	(20,000)
	<u>-</u>	(2,000)	(6,000)	(8,000)	(11,000)
	(20,000)	<u>(22,000)</u>	(26,000)	<u>28,000</u>	<u>(31,000)</u>
	<u>5,500</u>	<u>16,300</u>	<u>33,020</u>	<u>33,020</u>	<u>57,272</u>

Close questioning of Sophia reveals that no stock of antiques is held on the above dates and she has no other assets of significance for investigation.

Sophia's outgoings in the year concerned may be deducted from the following information:

Year ended	31 March 2004 Kshs	31 March 2005 Kshs	31 March 2006 Kshs	31 March 2007 Kshs
Personal drawings	3,140	5,200	6,240	9,800
Tax and national insurance	105	120	525	2,420
	-			
Cash gifts to enable her mother to buy a house		2,000	12,000	-

Sophia inherited Kshs 10,000 of 10% debentures in Akamba Limited on the death of her aunt on 1 July 2004. The debentures were valued at 70% for probate purposes and interest is paid half-yearly on 30 June and 31 December. Sophia is a widow and living with her mother.



Required:

- (i) Prepare schedules which will form the basis of your negotiations with the Income Tax Department on the question of undeclared income. (13 marks)
- (ii) Suggest what factors the Assessor will take into account in negotiating penalties and interest on the lost tax. (7 marks)

July 2000 Q 3

QUESTION TWO

Mr. Dickson Maelfu is a businessman with interest in the manufacturing sector. He is facing a back-duty investigation by the revenue authority which suspects that he has been under-declaring income for four years from year 2004 to year 2007.

You are the head of the team from the revenue authority conducting this investigation. Mr. Maelfu has submitted to you records of his private and business assets and liabilities from 1 January 2004 to 31 December 2007 as shown below:

	1 January	31	31	31	31
	2004	December	December	December	December
	Kshs	2004	2005	2006	2007
	'000'	Kshs	Kshs	Kshs '000'	Kshs
		'000'	'000'		'000'
Assets and Liabilities					
Factory building	36,000	48,000	48,000	52,000	54,000
Plant and machinery	24,000	28,000	36,000	36,000	38,000
Commercial vehicles	9,000	12,000	12,000	15,000	18,000
Stock in trade	3,600	4,200	8,000	9,000	7,000
Trade debtors	2,960	3,540	2,640	2,530	2,980
Private residence	9,240	13,600	13,600	13,600	13,600
Trade creditors	7,280	8,640	9,420	8,360	7,890
Bank loan	10,900	10,000	9,870	7,640	9,840
Loan from an uncle	800	700	600	870	640
Mortgage loan	3,780	3,780	3,780	3,780	3,780
Bank balance	3,400	5,400	3,600	3,760	4,670

Additional information:

1. There were no disposals of fixed assets during the period under investigation.
2. The bank balance on 31 December 2005 included Kshs 400,000 inherited from a relative on 31 October 2005.
3. His living expenses for each of the four years were as follows:

Year ended 31 December:				
	2004	2005	2006	2007
Living expenses (Kshs)	70,000	120,000	90,000	150,000

4. Interest on the mortgage is at a rate of 15% per annum.

Required:

- i) The taxable income of Mr. Maelfu for each of the four years ended 31 December 2004, 2005, 2006 and 2007. **Ignore capital allowances.** (8 marks)
- ii) Comment on any four areas on which you would seek further clarification from Mr. Maelfu before concluding your investigation. (4 marks)

(Dec 2007 Q 5)

QUESTION THREE

Mr. Pesa provided the following accounts with his returns for 2007:

Mr Pesa Trading and profit and loss account for the year ended 31 December 2007

	Kshs	Kshs
Sales		12,040,000
Less: Cost of goods sold		<u>11,530,000</u>
Gross profit		510,000
Less: Salaries expense	1,200,000	
Office rent	220,000	
Advertising	97,500	
General expenses	60,000	
Motor upkeep	137,500	
Printing and stationery	94,500	
Travelling expenses	100,000	
Provision for bad debts	175,000	
Depreciation expense	30,000	
Interest on capital	265,000	
Net discounts	<u>10,000</u>	<u>2,389,500</u>
Net loss		<u>1,879,500</u>

**Mr. Pesa****Balance sheet as at 31 December 2007**

Assets:		Sh.
Cash at bank		1,910,000
Cash in hand		85,000
Sundry debtors (less provisions)		1,298,800
Stocks		2,500,000
Fixtures and fittings (depreciation Sh.10,000)		190,000
Office car (depreciation Sh.20,000)		<u>80,000</u>
		<u>6,063,800</u>
Equity and liabilities	Sh.	Sh.
Capital	6,200,000	
Add: Addition	200,000	
Interest on capital	265,000	
Less: Loss for the year	<u>(1,879,500)</u>	
	4,785,500	
Less: Drawings	<u>660,000</u>	4,125,500
Outstanding liabilities		14,500
Salaries outstanding		100,000
Rent payable		20,000
Sundry creditors (less discount sh.46,200)		<u>1,803,800</u>
		<u>6,063,800</u>

An indepth investigation has been commenced and you, as the assessor in charge, has been provided with the following information in support of the above accounts.

1. **Balances as at 31 December:**

	2006	2007
	Sh.	Sh.
Cash at bank	300,000	1,910,000
Cash in hand	40,000	85,000
Stock-in-trade	2,200,000	2,500,000
Sundry debtors	-	3,500,000
Sundry creditors	2,340,000	1,850,000
Fixtures and fittings	200,000	-
Office car	100,000	-

2. From past financial statements, the line of business of Mr. Pesa maintains a steady gross profit rate of 25% on sales.
3. The bills outstanding as at 31 December 2007 were:

	Sh.
Petrol	2,500
Advertising	7,500
Printing	4,500

4. The motor car and fixtures are depreciated by 20% and 5% respectively. Capital allowances have been agreed at Sh.32,000.
5. 5% interest is allowed on capital.
6. Provision was made at 5% for doubtful debts and 2½% on creditors for discounts.
7. The cash book analysis shows the following figures among others:

	Kshs		Kshs
Receipts from customers	13,500,000	Motor upkeep	135,000
Discounts allowed on them	140,000	Printing and stationery	80,000
Further capital introduced	200,000	Drawings	660,000
Salaries to 30 November 2007	1,100,000	Payments to creditors	11,200,000
Office rent to 30 November 2007	220,000	Discounts allowed by them	120,000
Advertising	90,000	Travelling expenses	100,000
General expenses	60,000		

8. Specific bad debts were Sh.215,000.

Required:

- (a) Using the information provided, validate the accuracy or otherwise of the figures in the accounts and prepare a computation of adjusted taxable income.



Provide all supporting details. (16 marks)

- (b) Specify the tax consequences of incorrect returns of income. (4 marks)

(Total: 20 marks)

QUESTION FOUR

- (a) It may be advantageous for a trader whose turnover is below the legislated turnover limits under the sixth schedule to the VAT Act to register for VAT voluntarily. Under what circumstances could this be beneficial? (3 marks)
- (b) Under what circumstances is a VAT refund properly due? (6 marks)
- (c) What is the procedure for obtaining the refund in (b) above? (3 marks)
- (d) The management of Kasuku Rolling Mills Ltd. appointed your firm their auditor with effect from 1 January 2007. The senior partner of your firm assigned you the responsibility of dealing with the company's tax affairs. You have just completed performing the audit of the company's VAT refund claim. You have also confirmed that the VAT refund is properly due under the VAT regulations.

Prepare a draft VAT audit refund certificate for your senior partner's review. (6 marks)

- (e) After your firm issued the VAT refund certificate in (d) above, the VAT department made their own independent investigations and established that the company's refund claim was grossly misstated.

What are the consequences of this error to the management of Kasuku Rolling Mills Ltd. and to your audit firm? (2 marks)

(Total: 20 marks)

(May 2002 Q.3)

QUESTION FIVE

- (a) Explain the circumstances under which a tax authority may conduct a PAYE audit on a business. (8 marks)

(December 2006 Q 5)

- (b) What circumstances may trigger a Pay As You Earn (PAYE) audit? (5 marks)

(December 2002 Q 1)

CHAPTER FOUR



TAXATION OF CROSS BORDER ACTIVITIES



CHAPTER FOUR

TAXATION OF CROSS BORDER ACTIVITIES

► 4.2 Objectives

- Distinction between trading in and trading with a country
- Double taxation agreements; theory, design and application
- Regional perspective with reference to the East African Community (EAC) and the Common Market for Eastern and Southern Africa (COMESA)
- Most favoured nation status
- Withholding tax provisions
- Transfer pricing
- Application of relevant case law

► 4.1 Introduction

In the previous chapter, we studied tax investigations. In this topic, we will discuss the various issues arising from the taxation of cross border activities. The world is slowly becoming a global village and as such there is an increase of cross border transactions that need to be regulated.

Further, the concept of double taxation is crucial in the overall economic policy of a country. It refers to the imposition of comparable taxes in two or more states on the same income/same subject matter for identical periods of a named taxpayer. Income tax is imposed in Kenya on any person, whether resident or non-resident if the income accrued in or was derived from Kenya. This means that expatriates working in Kenya will be taxed in Kenya and also in their countries of origin. Where rates of tax are high, double taxation can be a serious obstacle to growth in international trade.

In the next topic, we will cover concepts of tax planning.

► 4.5 Key definitions

Off shore taxation (Tax havens)

Refers to the principle of harmonising Company law, Trust law, Banking and Tax regulations with a view to attract investors. The measures put in place have to be tax effective as compared to those established in the average countries in the world.

► 4.3 Exam Context

The student is expected to demonstrate an understanding of the various taxation issues affecting cross border transactions. Further, the student should be able to identify any tax charged in excess of the expected amount where double taxation is evident. Questions on this topic have been preferred by the examiner in recent exam sittings.

► 4.4 Industrial Context

In the recent past, we have had many companies and individuals complaining of double taxation of their taxable gains. The student is expected to identify this problem and perform computations to solve it.

4.6 Taxation of cross border activities

These are the various transactions or activities that are exercised by a Kenyan resident in another country and vice versa. The issue here is: How is the income earned or derived from such transactions brought to charge?

The taxation of income of a person is based on the concept of residence.

■ 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 in 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.
- 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 Kenya 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.

■ Significance of the concept of residence

Residential status of an individual and body corporate is important in the following ways:

- Kenya resident individuals pay Kenya income taxes on their incomes from Kenya and worldwide employment, but Kenya non residents pay Kenya income taxes only on their income from Kenya.
- Residents pay income taxes at graduated scale rates but non residents pay income taxes at special rates on certain specified incomes or sources.
- Resident companies are taxed at the rate of 30% on their taxable income while non resident companies with a branch in Kenya are taxed at a higher rate of 37.5%.
- Withholding taxes are deducted at source on all income of Kenyan non-residents but residents have withholding tax deducted on only some of their incomes.
- Non residents companies with no branch in Kenya have withholding tax deducted at source on all their incomes while resident and non resident companies with branches in Kenya have withholding tax deducted from only their dividend and interest income.

4.7 Distinction between trading in and trading with a country

Trading in a country is where a person conducts their business within the domestic jurisdiction of a country. For example, a foreign company establishing a business in Kenya as a branch and then conducting its business activities in Kenya.

Trading with a country happens in situations where a person or the government enters into trading relations with another country.

4.8 Double taxation agreements; theory, design and application

Double taxation arrangements may take the form of:

- a) Bilateral conventions or agreements relief
- b) Unilateral relief

a) Conventions and agreements

These are bilateral agreements for relief from double taxation. This involves countries affected negotiating an agreement with a view to minimise or eradicate effects of double taxation. Most double taxation agreements are based on the Organisations for Economic Cooperation and Development (OECD) recommended models articles. Each agreement is peculiar to itself depending on how it was negotiated.

A double taxation agreement/treaty would have articles addressing the following:

1. Persons to which the convention applies
2. Taxes covered
3. Definition of terms
4. Rules for determining tax residence (fiscal domicile)
5. Incomes affected by the agreement
6. Tax on capital
7. Diplomatic and consular officials
8. Termination of the agreements, etc.

Most countries usually give the country in which the income arises prior right of levying tax.

b) Unilateral relief

Due to the difficulty involving double taxation negotiations, it is possible for an individual country to remove the burden of double taxation from international trade by opting to give relief for foreign taxation on a unilateral basis i.e. without regard to whether the other taxing country extended relief or not. This may be triggered by a representation by the business community.

A unilateral approach is usually a last resort where negotiations have proved difficult due to political and other reasons. It is possible to have both arrangements in place to take care of different income sources and persons. Up to 1972, there existed the commonwealth income tax relief confined to member countries. The authority was contained in the East African Income tax Management Act and is not available in the Kenya Income Tax Act.

Double taxation agreements are reached with the following in mind:

1. Attraction of foreign investors through tax incentives
2. Encouragement of mobility of labour to attract expertise
3. Tax incentives as loss of revenue to government
4. Level and areas of economic interaction between states concerned
5. Overall cost and benefit principle
6. Political climate/relations

■ Authority to grant double taxation in Kenya

The Income Tax Act section 41-43 gives authority to grant double taxation itself.

S41:

Authorises the Minister for Finance to make arrangements with other countries for relief from double taxation.

S42 (3):

Double tax relief shall be granted provided that “the tax chargeable upon the income of a person in respect of which a credit is to be allowed ... shall be the amount by which the tax chargeable ... in respect of his total income”

S42 (4):

“The amount of credit allowed shall not exceed the tax chargeable”. For example, if the foreign tax is equivalent to Kshs160,000 and the tax chargeable in Kenya is Kshs100,000, the amount of relief from the foreign tax shall be limited to Kshs100,000.

**S42 (5):**

Relates to the treatment of foreign tax on dividends not specifically covered under special arrangements with another country. In such a case if the dividend is paid to a company, which controls 0% or more of the voting power of the company paying the dividend, a credit shall be obtained in the same way as if a special arrangement existed.

S43:

Any claims for allowance by way of credit should be made to the commissioner within six years from the end of the year of income to which it relates.

Kenya has tax treaties for relief from double taxation on income arising in Kenya with the following countries: United Kingdom, Germany, Denmark, Norway, Sweden, Zambia, Canada and India.

Withholding tax on payments to countries with which Kenya has double tax treaty are as follows:

Non-resident rates where no specific rate exists		United Kingdom	Germany & Canada	Denmark, Norway, Sweden, Zambia	India
20%	Management & Professional fees	12.50%	15%	20%	17.50%
20%	Royalties	15	15	20	20
30%	Rent: - Immovable property	30	30	30	30
15%	- other than immovable	15	15	15	15
10%	Dividends	10	10	10	10
15%	Interest	15	15	15	15
5%	Pension and retirement annuities	5	5	5	5
20%	Entertainment and sporting event		20	20	20
20%	Promoting entertainment or sporting events	20	20	20	20

Note:

Credit will be given after such taxpayer proves:

- That tax was actually deducted in that other country.
- The tax so deducted is not more than the tax he would have paid in Kenya if he had been wholly charged in Kenya, i.e. tax credit is limited to the amount by which his tax increases because of inclusion of the income from foreign country.
- The time limit for claims is six years since the occurrence of the tax liability.
- With effect from 1 January 2002, a taxpayer with foreign employment income shall be granted double taxation relief whether Kenya has an agreement with that other country.

Illustration 1:

Chris Ouma, a married Kenyan resident, had income of Kshs360,000 for year of income 2007 and also received income from Zambia net of tax Kshs180,000. The tax deducted in Zambia was Kshs 60,000. Kenya has a double taxation relief treaty with Zambia.

Required:

- a) The double taxation relief in Kenya
- b) The tax payable by Ouma in Kenya.

Solution

(a) Kenyan and foreign income

$$= 360,000 + 240,000 = \text{Kshs}600,000$$

Tax liability thereon

121,968 @ 10%	12,196.8	
114,912 @ (15%+ 20%+25%)	68,947.2	
(600,000 – 466,704) @ 30%	<u>39,988.8</u>	108,935.2

Less tax on Kenyan income of Kshs360,000

Kshs 121,968 @10%	12,196.8
Kshs 114,912 @(15% + 20%)	40,219.2
(Ksh360,000 – 351,792) @ 25%	<u>2,052</u>
	<u>(54,468)</u>

Kenyan tax on foreign income 54,467Foreign tax on foreign income 60,000

Double taxation relief is Kshs 54,467 (the lower of the two)

(b)

Gross tax liability	108,935
Less personal relief	(13,944)
Double taxation relief	<u>(54,467)</u>
Net tax liability	40,524

Double taxation relief shall be the Kshs 54,467, i.e. the lower of foreign tax and increase in Kenyan tax by inclusion of foreign income in tax computation – (Kshs 60,000 or KShs 54,467)

Double tax treaties are important to multinational corporations, which have international trade spread across several countries. These corporations derive benefits by exploiting national law so as to maximise their results. Negotiating tax treaties internationally facilitate an enabling trade environment for companies operating in these countries.



4.9 Regional perspective with reference to the East African Community (EAC) and the Common Market for Eastern and Southern Africa (COMESA)

4.9.1 East Africa Community (EAC)

The East African Community (EAC) is the regional intergovernmental organisation of the republics of Kenya, Uganda, the United Republic of Tanzania, Republic of Rwanda and Republic of Burundi with its headquarters in Arusha, Tanzania

The first major step in establishing the East African Federation was the East African Customs union signed in March 2004 and commenced on 1 January 2005. Under the terms of the treaty, Kenya, the region's largest exporter, will continue to pay duties on its goods entering the other four countries until 2010, based on a declining scale. A common system of tariffs will apply to goods imported from third-party countries.

The EAC was originally founded in 1967, but collapsed in 1977. It was officially revived on 7 July 2000. EAC is one of the pillars of the African Economic Community. In 2008, the EAC, after negotiations with the South African Development Community (SADC), and the Common Market For East and Central Africa (COMESA) agreed to an expanded Free Trade Area covering the member states of all three.

At the moment, the member states of the EAC have negotiated the East African Community Customs Management Act (2004) agreeing on common tariffs.

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 a transition period only.

Goods are classified under the Harmonised 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.

4.9.2 Common Market for Eastern and Southern Africa (COMESA)

The Common Market for Eastern and Southern Africa, is a preferential trading area with 19 member states stretching from Libya to Zimbabwe. COMESA was formed in December 1994, replacing the Preferential Trade Area which had existed since 1981. Nine of the member states formed a Free Trade Area in 2000 (Djibouti, Egypt, Kenya, Madagascar, Malawi, Mauritius, Sudan, Zambia and Zimbabwe), with Rwanda and Burundi joining the FTA in 2004 and the Comoros and Libya in 2006.

COMESA is one of the pillars of the African Economic Community.

In 2008, COMESA agreed to an expanded free-trade zone including members of two other African trade blocs, the East African Community (EAC) and the Southern Africa Development Community (SADC).

4.10 Most favoured nation status

Tax policy is used to promote international trade by grouping countries into trade blocs. Countries belonging to trading blocs enter into treaties harmonising the customs and excise duty rates in order to make exports and imports price within the bloc attractive as compared with the same commodities outside the particular trade bloc. The inter-state transactions will be governed/facilitated by terms of agreements in their particular area to the exclusion of outsiders. Uniform customs tariffs would be geared towards increased welfare, economies of scale obtained, increased competition results in higher production and improved quality of products, flow of investments in the region. It provides good ground for emergence of customs union, common market and economic union. Trade blocs include the European Union, The East African Community, COMESA, ECOWAS (West Africa), The North American Free Trade Area (USA, Mexico & Canada), Southern Africa Development Community (South Africa, Botswana, Lesotho, Swaziland).

Most favoured nation status

Trade agreement legislation can be based on the most-favoured nation principle. This is non-discriminate principle extended to all trade partners such that any reciprocal tariff reductions are negotiated. Member countries who are signatories of the most-favoured nation status benefit from negotiations to boost international trade. The problem with this arrangement is that tariff negotiations may be on certain few commodities only. Also benefits may leak to other non-member countries hence diluting the real purpose of the arrangement.

Off shore taxation (Tax havens)

Refers to the principle of harmonising Company law, Trust law, Banking and Tax regulations with a view to attract investors. The measures put into place have to be tax effective as compared to those established in the average countries in the world.

Some of the benefits extended to investors include:

- Tax free bank interest
- Tax free dividends paid by companies domiciled in these countries.
- Fixed corporate tax based on level of capital investment.
- Attractive corporate tax rates including nil tax for specified periods
- No capital gains tax
- Tax free profit repatriations etc



The countries most involved in utilising the principle of tax haven are those with resources requirement and depend on the financial investment attracted:

Examples of tax havens:

- Seychelles
- Gibraltar
- Bahamas
- Cyprus
- Panama

Other tax havens:

- Netherlands
- British Virgin Islands
- Isle of Man (UK)
- Channel Islands (UK)
- Liechtenstein

4.11 Withholding tax provisions

Income subject to withholding tax or tax at source for non-resident persons

Certain incomes derived from Kenya and paid to non-residents with no permanent establishment in Kenya are taxed at source at special non-resident tax rates 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	(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:

- Qualifying interest in respect of Housing Bonds is limited to Kshs 300,000 per year.
- 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.
- Commissions payable to non-resident agents for purposes of auctioning horticultural produce outside Kenya are exempt from withholding tax.
- Tax deducted at source on withdrawals from provident and pension schemes in excess of the tax-free amounts made after the expiry of 15 years or on the attainment of the age of 50 years, or upon earlier retirement on health grounds is final.
- Withholding tax on payments to resident persons for management and professional fees applies to payments of Kshs 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%.
- 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 our country is concerned.

4.12 Transfer pricing

Transfer pricing for goods or services is important in international taxation and will be subject to specific laws. Transfer pricing is widely in use by multinational entities, which are involved, in international trade in several countries.

Laws guiding multinational corporations ensure that transfer pricing is not abused because several nations have a tax interest in their operations. There is a pending bill in parliament regarding Transfer pricing and the tax implications for multinational companies.

Transfer pricing is a problem of apportioning taxable income among various jurisdictions where an enterprise engages in more than one country or it belongs to a group of companies that are located in more than one country and have relations with one another. This phenomenon is as old as international trade and as old as the existence of tax boundaries. It is an issue that may arise in relation to any type of income, such as the purchase or sale of goods, the provision of services, the payment of royalty fees and of interest on loans for instance.

The real culprit is transfer pricing manipulation; a phenomenon discouraged by governments. The fixing of prices based on non-market criteria results in saving company tax by shifting accounting profits from high tax to low tax jurisdictions. This amounts to moving one nation's tax revenue to another.

Transfer pricing also leads to balance of payments distortions between the host country and home country bordering on undermining sovereignty of the host nation.

Transfer pricing has become a critical consideration in location of production as well as employment because multinational corporations tend to open subsidiaries in countries where production is most profitable and the tax burden is less. Therefore, a country with no transfer pricing controls would be most attractive to foreign investors. It is for this reason that the Asiatic locations of Hong Kong and Singapore have succeeded in attracting foreign direct investments.

Most countries enforce tax laws based on the arms length principle as defined in the Organisation for Economic Co-operation and Development (OECD) model. The following methods or definitions are based on the OECD guidelines:

i) Uncontrolled price method (CUP)

This method compares the price at which a controlled transaction is conducted to the price at which a comparable uncontrolled transaction is conducted.

ii) Cost plus method (CP)

Is a method generally used for the trade of finished goods and determined by adding an appropriate mark-up to the costs incurred by the selling party in manufacturing/purchasing goods and services provided with the appropriate mark-up being based on the profits of other companies comparable to the tested party.

The method is generally accepted by the tax customs authorities, since it provides some indication that the transfer price approximates the real cost of item.

iii) Resale price method (RP)

This method is similar to cost plus method except it is found by working backwards from transactions taking place at the next stage in the supply chain, and is determined by subtracting an appropriate gross mark-up from the sale price to an unrelated third party with the appropriate gross margin being determined by examining the conditions under which the goods or services are sold and comparing said transactions to other third party transactions.

iv) Profit split method (PS)

Is the method applied when the businesses involved in the examined transaction are too integrated to allow for separate evaluation and so the ultimate profit derived from the endeavour is split based on the level of contribution of each of the participants in the project.

If, for example, Company A sent three researchers to its subsidiary to aid in the development of a product designed for use in country X market while the subsidiary allocated six identically compensated researchers to aid in the development of the product, then we would expect that the subsidiary pays 3/6 that is 50% of the ultimate profits as a royalty fee for the technical knowledge provided by Company A's researchers.

v) Transactional net margin method (TNMM)

Is a method that uses arm's length operating profit – that is earnings after all operating expenses, including overhead, but before interests and taxes earned by one of the entities in the transaction. Relative operating profit relative to sales, costs or assets allows comparisons between different transactions and is a more robust measure of an arms length result.

Other available methods include advance pricing agreement between the tax authorities and the tax payer and also mutual agreement procedure for purposes of relief from international tax grievances.



4.13 CHAPTER SUMMARY

- A resident individual is taxed on worldwide employment income while a non-resident individual will be taxed on the income accrued in or derived from Kenya.
- Countries are encouraged to negotiate double taxation agreements to be able to agree on preferential tax rates and as such help to improve trading relations.
- Transfer pricing is a concept that regulates the prices between related entities or transactions. The transfer pricing rules were introduced in Kenya in 2005.



4.14 QUIZ

QUESTION ONE

Discuss the significance of residence in cross-border transactions.

QUESTION TWO

Discuss the concept of the 'Most Favoured Nation'

QUESTION THREE

What is withholding tax?

QUESTION FOUR

List the various transfer pricing methods that can be adopted.

QUESTION FIVE

Discuss the meaning of double taxation unilateral relief.

4.15 QUIZ ANSWERS

QUESTION ONE

Residential status of an individual and body corporate is important in the following ways:

- Kenya resident individuals pay Kenya income taxes on their incomes from Kenya and worldwide employment, but Kenya non residents pay Kenya income taxes only on their income from Kenya.
- Residents pay income taxes at graduated scale rates but non-residents pay income taxes at special rates on certain specified incomes or sources
- Resident companies are taxed at the rate of 30% on their taxable income while non residents companies with a branch in Kenya are taxed at a higher rate of 37.5%.
- Withholding taxes are deducted at source on all income of Kenyan non-residents but residents have withholding tax deducted on only some of their incomes.
- Non resident companies with no branch in Kenya have withholding tax deducted at source on all their incomes while resident and non-resident companies with branches in Kenya have withholding tax deducted from only their dividend and interest income.

QUESTION TWO

Most Favoured Nation Status

Trade agreement legislation can be based on the most-favoured nation principle. This is non-discriminate principle extended to all trade partners such that any reciprocal tariff reductions are negotiated. Member countries who are signatories of the most-favoured nation status benefit from negotiations to boost international trade. The problem with this arrangement is that tariff negotiations may be on certain few commodities only. Also benefits may leak to other non-member countries hence diluting the real purpose of the arrangement.

QUESTION THREE

The Income Tax Act requires that withholding tax or tax at source be deducted at the point when payment is made in respect of interest, dividend, insurance commission, employment income, pension and farming income subject to Presumptive Income Tax (PIT), etc. The income subject to withholding tax may be received by a resident or non resident person.

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:

- a) Remit the tax so deducted to the Domestic Taxes Department;
- b) 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.

QUESTION FOUR

Most countries enforce tax laws based on the arms length principle as defined in the Organisation for Economic Co-operation and Development (OECD) model. The following methods or definitions are based on the OECD guidelines:

i) **Uncontrolled price method (CUP)**

This method compares the price at which a controlled transaction is conducted to the price at which a comparable uncontrolled transaction is conducted.

ii) **Cost plus method (CP)**

Is a method generally used for the trade of finished goods and determined by adding an appropriate mark-up to the costs incurred by the selling party in manufacturing/purchasing goods and services provided with the appropriate mark-up being based on the profits of other companies comparable to the tested party.

The method is generally accepted by the tax customs authorities, since it provides some indication that the transfer price approximates the real cost of item.

iii) **Resale price method (RP)**

This method is similar to cost plus method except it is found by working backwards from transactions taking place at the next stage in the supply chain, and is determined by subtracting an appropriate gross mark-up from the sale price to an unrelated third party with the appropriate gross margin being determined by examining the conditions under which the goods or services are sold and comparing said transactions to other third party transactions.

iv) **Profit split method (PS)**

Is the method applied when the businesses involved in the examined transaction are too integrated to allow for separate evaluation and so the ultimate profit derived from the endeavour is split based on the level of contribution of each of the participants in the project.

If, for example, Company A sent three researchers to its subsidiary to aid in the development of a product designed for use in country X market while the subsidiary allocated six identically compensated researchers to aid in the development of the product, then we would expect that the subsidiary pays 3/6 that is 50% of the ultimate profits as a royalty fee for the technical knowledge provided by Company A's researchers.

v) **Transactional net margin method (TNMM)**

Is a method that uses arm's length operating profit – that is earnings after all operating expenses, including overhead, but before interests and taxes earned by one of the entities in the transaction. Relative operating profit relative to sales, costs or assets allows comparisons between different transactions and is a more robust measure of an arms length result.

Other available methods include advance pricing agreement between the tax authorities and the tax payer and also mutual agreement procedure for purposes of relief from international tax grievances.

QUESTION FIVE

Due to the difficulty involving double taxation negotiations, it is possible for an individual country to remove the burden of double taxation from international trade by opting to give relief for foreign taxation on a unilateral basis i.e. without regard to whether the other taxing country extended relief or not. This may be triggered by a representation by the business community.

A unilateral approach is usually a last resort where negotiations have proved difficult due to political and other reasons. It is possible to have both arrangements in place to take care of different income sources and persons. Up to 1972, there existed the commonwealth income tax relief confined to member countries. The authority was contained in the East African Income tax Management Act and is not available in the Kenya Income tax Act.

4.16 PAST PAPER ANALYSIS

The following is a list of questions in which the topic was tested in past examinations. The questions are listed in this format: Month/year e.g. 6/01 represents June or May 2001.

12/00 Q.4, 12/01 Q.1, 12/02 Q. 2 (a), 06/05 Q2(a), 06/06 Q.4(a & b), 06/06 Q.5(a), 06/07 Q.1(a & b), 12/07 Q.1,(a), 12/07 Q.3(c), 12/08 Q.1, 12/08 Q.2(a).

4.17 REVISION QUESTIONS

QUESTION ONE

Outline the benefits which may accrue to a country from being a signatory to the most favoured nations status agreement (4 marks)

(June 2005 Q 2)

QUESTION TWO

Kenya has entered into double taxation agreements with a number of countries. Explain the meaning and implications of a double taxation relief. (4 marks)

(Dec 2003Q 3)



QUESTION THREE

- a) With reference to Sections 46 and 47 of the Income Tax Act (Cap 470), explain how the incomes of the following persons are assessed for tax.
- Incapacitated persons
 - Non resident persons
- b) Mr. Dan Mbazo, a citizen of Zambia is employed by Southnet International Ltd, a company based in Lusaka Zambia. Southnet International Ltd opened a branch in Nairobi Kenya on 1 January 2007 and posted Mr. Mbazo as the branch operation manager on the same date. The following information relates to Mr. Mbazo's employment for the year ended 31 December 2007 (All amounts are stated in Kenya Shillings (Kshs))
- His basic pay commencing 1 January 2007 was Kshs 200,000 per month
 - He was booked by the employer in a hotel for the month of January pending the availability of a suitable residential house. The employer paid Kshs 50,000 to the hotel for his accommodation and meals.
 - On 1 February, he rented a house in a Nairobi suburb for a monthly rent of Kshs35,000. It is the employer's policy to reimburse half of the rent paid by an employee.
 - In March, he relocated his family from Lusaka to Nairobi. The employer paid Kshs25,000 for the air tickets used by the family.
 - Commencing 1 July, he received a monthly entertainment allowance of Kshs12,000 from the employer which he spent on visiting local tourist sites.
 - In August, passages of Kshs110,000 were paid by the employer for Mr. Mbazo to attend a two week seminar in Cape Town, South Africa. While in South, he purchased a motor vehicle costing Kshs 2,000,000 for his use in Kenya. The total fuel and maintenance costs of the motor vehicle to 31 December 2007 amounted to Kshs 120,000. Three quarters of the vehicle usage related to official duties.
 - On 1 October the employer effected the following changes on Mr. Mbazo's basic pay and benefits with effect from 1 October 2007:
 - His basic pay was increased by 25 per cent
 - A comprehensive insurance cover for his motor vehicles for an annual premium of Kshs 80,000 payable on 1 October each year
 - A medical cover for self and family to a maximum of Kshs 2,000,000. Monthly contributions by the employer to the scheme amounted to Kshs 8,000
 - On 30 December he received a cheque of Kshs150,000 from the employer for being the best foreign-based employee for the year ended 31 December 2007
 - The PAYE remitted from his pay for the year ended 31 December 2007 amounted to Kshs 200,000.

Required:

- Comment on the residence of Mr. Mbazo (for tax purposes) for the year ended 31 December 2007 (2 marks)
- Calculate the taxable income of Mr. Mbazo for the year ended 31 December 2007 (12 marks)
- Compute the tax payable (if any) from the income calculated in (ii) above (2 marks)

(Total: 20 marks)
(June 2005 Q 1)

QUESTION FOUR

- a) Discuss the concept of double taxation treaties with specific reference to its application in your country (8 marks)
- b) Daniel Otworl, a resident of Kenya, earned income from the countries listed below during the year ended 31 December 2007:
- Income from Kenya: Kshs1,765,000
 - Income from United Kingdom (UK): UK£4,800 net. Tax deducted amounted to UK£960.
 - The average exchange rate during the year was 1 UK£ = Kshs 140. A double taxation agreement exists between Kenya and United Kingdom.

Required:

The double taxation relief (in Kenya Shillings) due to Daniel Otworl for the year ended 31 December 2007 (4 marks)

- c) J.Karimi has been operating a wholesale business in Nairobi. The following details related to the business for the month of April 2007:

	Kshs
Sales at standard rate	24,000,000
Purchases at zero rate	6,000,000
Purchases at standard rate	20,000,000
Electricity bill paid	16,000
Water bill paid	4,000
Export sales	10,000,000
Exempt sales	14,000,000
Salaries and wages	4,800,000
Purchases of electronic tax register	150,000
Legal fees	60,000

Additional Information:

1. Sales at standard rate include goods sold to the Ministry of Health for Kshs4,000,000
2. The wholesaler issued debit notes amounting to Kshs800,000 in respect of sales at standard rate.
3. Goods at standard rate valued at Kshs600,000 were returned during the month to the wholesaler.
4. Purchases at standard rate include a photocopier acquired at a cost of Kshs100,000.
5. One of the debtors of the business was declared bankrupt and the business wrote off Kshs500,000 which was outstanding from the debtor at the end of the month.
6. Legal fees include Kshs10,000 relating to VAT appeals.

Required:

The VAT payable (or refundable) by the business for the month of April 2007

Note: The amounts above are stated exclusive of VAT at the rate of 16% where appropriate (8 marks)

(Total: 20 marks)

(June 2007 Q 1)



QUESTION FIVE

Related companies may understate their taxable profits by engaging in transfer pricing. With reference to Section 18 (3) of the Income Tax Act (Cap. 470), briefly explain three transactions that may constitute transfer pricing.

(June 2006 Q 5)

CHAPTER FIVE



TAX PLANNING



CHAPTER FIVE

TAX PLANNING

► 5.1 Objectives

At the end of this chapter, students should be able to discuss the following concepts:

- Tax planning for individuals and companies
- Employment versus self-employment
- Identifying opportunities to alleviate, mitigate or defer the impact of direct or indirect taxation
- Remuneration packages
- Corporate structure and dividend flows
- Anti - avoidance provisions
- Transfer of real properties
- Pricing policy
- Uses of tax incentives
- Disposal of business operations and restructuring of activities

► 5.2 Introduction

In the last chapter, we studied the various tax issues affecting cross border transactions. In this chapter, we will cover tax planning aspects. Tax planning is the arrangement of the affairs of a taxpayer in such a way as to minimise tax liability at lowest cost without contravening any tax law or regulations. It is determination, in advance, of the tax effect of proposed business actions and requires a deeper understanding of the tax legislation and sound knowledge of case law in taxation. Among the many advantages, tax planning helps organisations to fully comply with applicable tax laws. In the next topic, we will study the various tax systems and policies.

► 5.3 Key definitions

Tax planning - Tax planning is the arrangement of the affairs of a taxpayer in such a way as to minimise tax liability at lowest cost without contravening any tax law or regulation

Tax avoidance - The reduction of tax liabilities by legal, although possibly artificial means.

Tax evasion - The reduction of tax liabilities by illegal means such as concealing information or supplying false information.

► 5.4 Exam Context

The student is expected to demonstrate an understanding of the taxation laws. This paper mainly tests the application of the concepts discussed here. Questions on this topic rarely miss in examinations.

► 5.5 Industrial Content

The student is expected to use his knowledge in taxation to effectively implement tax control measures to ensure adherence to tax law. This helps an organisation to control costs hence ensuring profitability.

5.6 Tax planning concept

Tax planning is the arrangement of the affairs of a taxpayer in such a way as to minimise tax liability at lowest cost without contravening any tax law or regulations. It is determination, in advance, of the tax effect of proposed business actions.

Tax planning requires:

- A deeper understanding of the tax legislation; and
- A sound knowledge of case law in taxation.

Tax consultancy is therefore basically tax planning involving offering tax advice to clients in various situations. Tax revenue departments have to ensure the following through proper tax planning: -

- Taxpayers comply fully with tax laws and regulations; and
- Revenue collection is maximised.

A careful study of decided cases is important in:

- i) Highlighting tax planning schemes;
- ii) Provision of judicial interpretation of the legislation;
- iii) The judgement in a particular case will show strengths and weaknesses of a particular scheme.

Aims of tax planning

1. To achieve compliance with tax laws since non-compliance with tax laws is costly due to penalties and interest charges.
2. To ease administration as in working out arrangements, methods of accounting, records to be kept, reports to be prepared etc.
3. To achieve the most advantageous financial position out of a business transaction to be measured in terms of direct tax savings from planning and financial benefits by way of cash flow effects.



5.6.1 Tax planning for individuals

The tax planning measures of an individual would depend on whether they are employed or unemployed. The following tax planning measures are allowable for employees.

Owner Occupier Relief

According to Section 15 (3) (b) of the Income Tax Act, interest paid by a person on amount borrowed from specified financial institution (includes a bank, insurance company or building society) for the purchase of or improvement of premises that he occupies for residential purpose shall be deductible against total taxable income of the person. The maximum allowable interest is Kshs 150,000 per annum (Kshs 12,500 per month).

An employer should ensure that mortgage interest paid by the employees is allowed for deduction in the payroll of all eligible employees.

Insurance Relief

An employer should notify employees who have taken individual life assurance covers or education policies with a maturity of 10 years (with effect from 1 January 2003) and maybe paying out of payroll premiums on the same that they are eligible to claim insurance relief and effect the same through the payroll. The deductible amount paid is subject to a maximum of Kshs. 60,000 per annum (Kshs. 5,000 per month).

Non-cash Benefits

Increasing the non-taxable benefits may reduce tax on employees especially where such benefits are allowable for corporate tax purposes. Examples of benefits that the company could consider introducing or expanding include the following:-

Medical services

This entails the reimbursement to staff of medical expenses incurred for self and dependants or access to designated hospital facilities where the company holds an account. There is no maximum limit of the same under the law.

Staff development and training

Training costs directly paid to a training institution for an employee in relation to the employees' responsibilities at the work place and for the benefit of the company's business are allowable for corporate and PAYE purposes.

Mileage reimbursement for use of personal car on the company business

This benefit is tax efficient in comparison to the car benefit and provision of staff transport which are taxable on the employees.

Meals for low income employees

Meals provided to low income employees on employers premises are a non taxable benefit on the employees. A low income employee is a person earning not more than Kshs. 29,316 per month.

School fees

Generally, where the employer pays school fees for the employee's child, dependant or relative, such payment becomes a taxable benefit on the employee if not already taxed on the employer. However, 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 Kshs. 29,316 per month, i.e. employees at income tax bracket of 20% and below. (Effective date: 13 June 2008)

■ 5.6.2 Tax planning for companies

Companies may lay strategies for tax planning. Some of the reasons companies or entities should plan for their taxes are:

- Tax is a major expense in company's P&L;
- To take advantage of the available tax incentives.
- To minimise tax penalties and interest;
- The KRA aggressiveness in collecting taxes;
- To improve cash management and forecast;

There are many strategies that companies can adopt in tax planning. Some of the tax planning opportunities are:

a) Tax compliance

One of the best strategies for tax planning for companies is tax compliance. The company should ensure that it complies with its obligation to pay corporate taxes, to deduct advance taxes, to pay withholding taxes and to file returns. This will avoid unnecessary penalties and interest being levied on the company for non-compliance in case of an audit by the revenue authority.

b) Use of Capital allowances;

The company should explore the provisions of the Income Tax Act on capital allowances. As such, the company should always claim the proper capital allowances on the qualifying costs of the assets. This will reduce taxable profits of the company and as such lead to a good tax planning measure. The company may seek consultancy advice to help utilize the capital allowances.

c) Tax losses used to reduce taxable income

Tax losses or tax deficits of a company can be carried forward to be offset against future income from the same source. Following an amendment in the 2009 Finance Bill, the carry forward of tax losses is only allowed for the year of income it arose and four subsequent years. The company should be able to use tax losses to plan their taxes.

d) Tax refunds used to reduce tax payable;

The company should utilise tax refunds to reduce tax payable. Tax refunds arise from overpayment of taxes. It can be overpayment of VAT, corporation tax among others. The refund is allowed upon application and approval by the CDT. One can apply to offset a recoverable or a refund from one form of tax against tax payable in another form.

e) Lower tax rate on listing at NSE.

Companies can list their shares to make use of preferential tax rates. Companies newly listed on any securities exchange approved under the Capital Markets Act enjoy favourable corporation tax rates as follows:

- If the company lists at least 20% of its issued share capital, 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, 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, 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.

f) Instalment tax payment

Under the Income Tax Act, companies are required to pay instalment taxes when they expect to receive taxable income in that year of income. The payment of instalment tax is a good means of cash management since it helps avoid a situation where a company pays a huge tax balance. Further, the company can opt to use either the previous year basis or the current year basis while estimating instalment tax payable. Whichever method is selected, the company should adopt a good approach to the management of cash flows.

g) Application for tax exemptions or remissions

The company can explore the avenue of applying for tax exemptions or tax remissions.

h) Applications for waiver of penalties and interest

The Income Tax allows the taxpayer to apply for waiver of any penalties and interests charged. The commissioner can waive up to Kshs 1,500,000 while the Minister of Finance can waive any amount upon application. The taxpayer should therefore pay the principal tax and make the application for waiver of penalties of interest - it will be upon the commissioner to grant.

5.7 VAT planning

VAT legislation tends to be complex thus making compliance difficult. Penalties resulting from non-compliance with VAT law are punitive. Tax losses may result by failure to plan vatable transactions. Some of the VAT planning options are:

1. VAT should be loaded on the taxable goods and services and passed on to the customer.
2. VAT compliance- payment of VAT by 20th of the following month.
3. Use of VAT set off where the company is in refund situation and has taxes payable.
4. Use of tax remission scheme such as Tax Remission for Exports Office (TREO)
5. VAT remission on capital investments.
6. Whilst VAT is supposed to be paid even on unpaid invoices, the company may, as a cash flow management tool, reduce its debt collection period.
7. VAT is not a cost to the company. The company should ensure that input tax is claimed on a timely basis.
8. Claiming for refund of VAT on bad debts. These are debts over three years but not more than five years. Evidence of recovery efforts is however required.

5.8 Customs duty planning

■ Duty planning

Deals with import duty and excise duty. The amount of duty on imports will have a significant effect on cost of goods finally exported to say nothing of competitiveness and profitability of the business. Excise duty adds to cost of a locally manufactured good ultimately affecting price and profit margins.

Customs planning can give opportunities in the following areas:

- Duty Remission
- Customs valuation
- Duty Suspension
- Classification of goods
- Duty deferral
- Origin of goods

Duty Remission

Investors can apply to the Minister for duty waiver or exemption under special duty rates. Duty remissions are also available under the Tax Remission for Exports Office (TREO) programme.

Customs valuation

This involves ensuring that the best valuation method is used. It would be advisable to import from a manufacturer rather than a middleman. In practice, the value of the second transaction is used to calculate Customs value on import. As such, if one has prior information of first transaction and bought directly from the importer or manufacturer, it will result in duty saving. Thus applying “first sale” principle can minimise duty by eliminating “middleman markup.”

Duty suspension

The bonded warehouse arrangement can be used to minimise Customs value. A trader in Tanzania approaches a Kenyan trader for the first time in order to purchase sports shoes. Had the trader imported the sports shoes under a bonded warehouse arrangement they could have avoided unnecessary import duties and VAT on the import (enter as transit goods).

Classification of goods

The taxpayer should ensure goods are correctly classified. Incorrect classification of goods may lead to payment of either higher or lower duty. If lower duty is paid, there are risks of paying the difference after a post clearance inspection. If higher duties are paid, it will result in the pursuit of the duties outstanding (Customs duty and VAT) and even fines or interest in arrears on the duties and VAT.

Duty deferral

This planning opportunity involves importing goods, storing or further manufacturing the goods, then exporting the goods to another country or releasing them to the Kenyan market (pay 2.5% surcharge)



Origin of goods

There may be varying amounts of import duty payable depending on the origin of the goods. Some imports from certain countries enjoy a preferential import duty. As such, the importer should be well versed with rules of origin to make use of the preferential import duty rates. One would need to produce a valid Certificate of Origin.

5.9 Employment versus self-employment

There is a distinction between employment (receipts taxable as earnings) and self-employment (receipts taxable as trading income). Employment involves a contract of service, whereas self employment involves a contract for services.

Taxpayers tend to prefer self-employment, because:

- The rules on deductions for expenses are more generous.
- Under self-employment, the person would be subject to withholding tax which is usually at a lower rate than the graduated scale rates.

Factors which may be of importance include:

- The degree of control exercised over the person doing the work: The higher the degree of control, the more likely that the contract of service as opposed to a contract for service where there is minimal control from the entity.
- Whether he must accept or provide further work: If the person must accept any further work delegated to them, and then the same is a contract of services and not a contract for services.
- Whether he provides his own equipment: A person on self employment is expected to have his own equipment while providing services. If most of the equipment are provided by the employer then it can be construed to be a contract of services.
- Whether he hires his own helpers: If he has the authority and powers to hire his own helpers then he is in self-employment as opposed to employment.
- What degree of financial risk he takes: The more the degree of financial independence, the more likely that he is in a contract for services.
- What degree of responsibility for investment and management he has: The more such responsibilities, the more likely that it is a contract for services.
- Whether he can work when he chooses: If so, then it could be a contract for services.
- The wording used in any agreement between the parties: the agreement can state categorically what it is.

Relevant cases include:

(a) **Edwards v Clinch 1981**

A civil engineer acted occasionally as an inspector on temporary ad hoc appointments.

Held: There was no ongoing office which could be vacated by one person and held by another so the fees received were from self-employment not employment.

(b) Hall v Lorimer 1994

A vision mixer was engaged under a series of short-term contracts.

Held: The vision mixer was self-employed, not because of any one detail of the case but because the overall picture was one of self-employment.

(c) Carmichael and Anor v National Power Plc 1999

Individuals engaged as visitor guides on a casual 'as required' basis were not employees. An exchange of correspondence between the company and the individuals was not a contract of employment as there was no provision as to the frequency of work and there was flexibility to accept work or turn it down as it arose. Sickness, holiday and pension arrangements did not apply and neither did grievance and disciplinary procedures.

A worker's status also affects national insurance. The self-employed generally pay less than employees.

5.10 Remuneration packages

Staff costs are significant operational costs. The employer needs to reward labour in the highest possible way at lowest cost possible while at the same time observing full compliance with the law. Consider lumpsum payments, benefits, expenses etc.

An employee will usually be rewarded largely by salary, but several other elements can be included in a remuneration package. Some of them bring tax benefits to the employee only, and some will also benefit the employer.

Bonuses are treated like salary, except that if a bonus is accrued in the employer's accounts but is paid more than nine months after the end of the period of account, its deductibility for tax purposes will be delayed.

The general position for benefits is that they are subject to income tax. The cost of providing benefits is generally deductible in computing trading profit for the employer

However, there are a large number of tax free benefits and there is a great deal of planning that can be done to ensure a tax efficient benefits package for directors and employees. The optimum is to ensure that the company receives a tax deduction for the expenditure while creating tax free benefits.

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, notably:

1. Pension or gratuities earned or granted in respect to disability
2. Monthly or lumpsum pension granted to a person who is 65 years of age or more.
3. 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
4. Allowances to the Speaker, Deputy Speaker and Members of Parliament payable to them under the National Assembly remuneration



5. Interest up to Kshs 100,000 per individual on housing bonds, account with Housing Finance (formerly 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 Kshs 300,000 is qualifying while the excess is non qualifying.)
6. Cost of passage to and from Kenya of a non-citizen employee borne by the employer.
7. Employer's contribution to pension funds or provident funds.
8. Benefits, advantages/facilities of an aggregate value of less than Kshs 36,000 p.a. in respect of employment or services rendered.(W.e.f.1.1.2006, non cash benefits are taxed if their aggregate value is more than Kshs 36,000 p.a or Kshs 3,000 p.m.)
9. The first Kshs 150,000 per month for persons with disabilities exempt from taxation. (w.e.f. 12.June 2009).
10. Expenditure on amenities by the physically disabled tax allowable up to a maximum of Kshs 50,000 per month. (w.e.f. 12. June 2009)

Illustration

Mr Jared Masai, a human resource manager is currently out of employment. However, he has received two offers of employment which require him to report on duty on 1st July.. One of the job offer is from Mapato Ltd. The company owns a large scale farm in Kitale on which it grows maize and rares dairy cows. The other offer is from Watalii Tourist Hotel located in Nanyuki. Mr. Masai has approached you as a tax expert, to advise him on which of the two job offers to accept. He has provided you with the following additional information.

JOB OFFER A: MAPATO LTD

Terms of employment

1. A basic salary of Kshs 140,000 per month
2. Free housing for him and his family within the farm , with free water and electricity. The water is from a borehole sunk in the farm. The electricity is also generated within the farm.
3. Free supply of farm produce subject to a maximum of Kshs 600,00 per month.
4. Reimbursement of medical expenses incurred on self and family subject to a maximum of Kshs 1,500,000 per annum. The reimbursement policy applies only to senior managers.
5. Payment of his children's school fees amounting to Kshs 180,000 per month by the employer. The employer would bear the tax on this benefit
6. His annual membership fee to the local golf club amounting to Kshs 50,000 would be paid for by the employer
7. He would be required to register as a member of the Institute of Human Resources Managers and pay the initial registration fee of sh. 10,000. The employer would pay the annual subscription fee of Kshs 18,000.

JOB OFFER B: WATALII TOURIST HOTEL

1. Terms of Employment
2. A basic salary of Kshs 180,000 per month.
Free housing and meals but only for self.
3. Monthly entertainment allowance of Kshs 15,000
4. Payment by the employer of his medical expenses subject to a maximum of Kshs 800,000 per annum. The medical scheme covers all hotel employees.

5. Payment by employer of his life assurance premiums amounting to Kshs 60,000 per annum.
6. Reimbursement by the employer of annual subscription for the *Journal of Human Resources Managers* amounting to Kshs 2,500 per annum.
7. A one-week fully paid holiday package worth Kshs 150,000 for his wife and children to visit him and reside at the hotel once per year. The package will also include visits by the family to neighbouring tourist attractions.

Mr. Masai has further provided the following information:

- His average annual medical expenses are as follows.

	Kshs
Self	150,000
Wife and children	<u>300,000</u>
Total average medical expenses	<u>450,000</u>

- His consumption of the farm produce under job Offer A would average to about Kshs. 300,000 per annum.

Required

Evaluate the two job offers and advise Mr. Masai on which offer to accept based on expected net annual income. Your evaluation should include both taxable and non taxable benefits.

Attempted solution

JOB OFFER A

Mapato Ltd

Expected net annual income statement

(Taxable/ non-taxable benefits)

	Sh.	Sh.
Employment income		
Basic salary (140,000 x 12)		1,680,000
Benefits		
Medical benefits (Reimbursement)	450,000	
Consumption of farm produce	300,000	
School fees	180,000	
Annual membership – golf club	50,000	
Registration (Institute of Human Resource Managers)	10,000	
Annual subscription fees	18,000	
Electricity	10,800	
Water	2,400	
Housing benefit		
Higher of 10% x 2,701,200	270,120	
Actual payment		
Annual taxable income		<u>2,971,320</u>



JOB OFFER B: Watalii Tourist Hotel

	KSh.	Sh.
Employment income		
Basic salary (180,000 x 12)		2,160,000
Allowances		
Entertainment allowance (15,000 x 12)	180,000	
Benefits		
Life assurance premiums	60,000	
Reimbursement of annual subscriptions	2,500	
Holiday package	<u>150,000</u>	<u>392,500</u>
		2,552,500
Housing benefit		
Higher of 15% x 3,002,500	450,375	450,375
Actual payment	-	
Annual taxable income		<u>3,002,875</u>

Computation of tax liability

			JOB OFFER A	JOB OFFER B
			SHS	SHS
Taxable profit			2,971,320	3,002,875
Tax thereon				
121,968	121,968	10%	12,197	12,197
236,880	114,912	15%	17,237	17,237
351,792	114,912	20%	22,982	22,982
466,704	114,912	25%	28,728	28,728
Excess over	2,504,616	30%	<u>751,385</u>	<u>760,851</u>
Gross Tax Liability			832,529	841,995
Less	Personal Relief		<u>(13,944)</u>	<u>(13,944)</u>
Net Tax Liability			<u>818,585</u>	<u>828,051</u>
Income after tax			2,152,735	2,174,824

Advise:

Job offer B has higher annual income after tax hence accept it.

b) (i) Responsibility of employers for the collection of PAYE due from retirees receiving monthly pension income.

Pensions or retirement annuities (periodic payments) up to **KShs 180,000 p.a** received by a resident individual are tax exempt so long as the scheme or fund is registered. As such the employer will deduct tax on monthly withdrawals in excess of Kshs 180,000. However, if the employee is above **65 years** of age then the whole withdrawal from a pension fund is tax exempt.

NB. Lumpsum withdrawals from a pension or retirement scheme of up to K.shs 480,000 p.a received by a resident individual are tax exempt so long as the scheme or fund is registered.

5.11 Identifying opportunities to alleviate, mitigate or defer the impact of direct or indirect taxation

The student should be able to identify opportunities to alleviate, mitigate or defer the impact of direct or indirect taxation. Questions on this area will be practical and the student will be expected to apply the content learnt in taxation in general.

5.12 Corporate structure and dividend flows

The topic focuses on chargeable income, deductible expenses, capital allowances, available tax incentives, treatment of tax losses, dividend policy, transfer pricing, etc.

Forms of decision problem

1. Whether to lease an industrial building or construct one.
2. Whether to invest in office buildings or rent.
3. Whether to operate a partnership or a limited company
4. Determining expenditure tax deductible or non-tax deductible.

1. Capital structure and taxation

By capital structure of a company, we mean the long-term financing normally made up of ordinary share capital., preference share capital, reserves (revenue and capital) and debt finance (long term, medium and short term loans and debentures).

Capital structure explains the relationship (proportion) between the various sources of finance.

Optimum capital structure is the most ideal capital structure to be maintained and any changes to it must affect amounts and not proportions. Optimum capital structure is achieved where, among other considerations, the cost of finance is lowest. The capital structure has great impact on cost of finance because some finances are cheaper to use than others. Taxation discriminates between equity and debt capital. Debt finance is cheaper since interest on debt is tax allowable expense and cost is less by the amount of such tax interest. Dividends on equity is not tax deductible.

Illustration

Company ABC Ltd. is to pay interest on debt capital of 15% where corporation tax rate of 30%



Required

Compute the true/effective cost of debt capital.

Solution

$$\begin{aligned}
 \text{Effective cost of debt} &= 15\% \text{ less (30\% of 15\%)} \\
 &= 15\% - 4.5\% \\
 &= \underline{10.5\%}
 \end{aligned}$$

The following details relate to two companies for year ending 31/12/2005:

Company	ABC Ltd.	XYZ Ltd
Number of shares 10%	50,000 each Kshs. 5	50,000 each Shs. 5
Preference shares	25,000 each Kshs	10% debentures Shs. 125,000
Gross income Kshs.	250,000	Gross income

Required

- a) Earnings per ordinary share for each company.
- b) Corporate tax rate and cost of debt.

Solution

a) Earnings per ordinary share

ABC Ltd.		XYZ Ltd.	
<i>K Kshs '000</i>		<i>K Kshs '000</i>	
Gross income	250,000	Gross income	250,000
Less loan interest	<u>Nil</u>	Less loan interest	<u>(12,500)</u>
Before tax	250,000	Before tax	237,500
Corporation tax @30%	<u>(75,000)</u>	Corporation tax @30%	<u>(71,250)</u>
Income after tax	175,000	Income after tax	166,250
Less Pref- dividend @	<u>(12,500)</u>	Pref. Dividend	<u>Nil</u>
Amount available to ordinary shareholders	<u>162,500</u>	Amount available to ordinary shareholders	<u>166,250</u>
Earnings per share	3.25	Earnings per share	3.325
Effective tax rate $\frac{75000}{250000} \times 100 = 30\%$		Effective tax rate $\frac{71250}{250000} \times 100 = 28.5\%$	

b) Effective cost of debt (XYZ Ltd.)

$$\begin{aligned}
 \text{Effective cost of debt} &= 10\% \text{ less (30\% x 10\%)} \\
 &= 10\% - 3\% \\
 &= \underline{7\%}
 \end{aligned}$$

Note in the case of XYZ Ltd. tax savings = (75,000 – 71,250) = Sh.3, 750

2. Income taxes and project appraisal

XYZ Company Ltd, a manufacturing company in industrial area, Nairobi requires 2,500 units a year of a component over a period of 3 years. There are three possible plans of action to be considered namely:

Plan A:

To buy the component from a supplier who quotes Kshs 10 per component.

Plan B

To manufacture the component themselves. Equipment needed would cost Kshs 20,000 initially. Incremental costs are estimated at Kshs 5 per component. The equipment would be expected to have a sale value of Kshs 8,000 after two years; repair costs during the period of use are forecast at Kshs 200, Kshs 500 and Kshs 800 for each of the three years respectively.

Plan C:

To manufacture the component using hired equipment which would be maintained by the owner without additional charge. The rent of the equipment would be Kshs 5,000 per annum payable annually in advance.

The company uses a discount rate of 5% per half year. A wear and tear deduction of 12½% would be available on purchased equipment.

Required

Which alternative maximises tax cash inflow? (*Take corporation tax rate to be 30%*).



Solution

Incremental cost analysis	Plan A			Kshs	Option ranking
	Kshs	KShs	Kshs		
Component cost	25,000	25,000	25,000		
Tax shield on the component cost (cost x 30%)	7,500.0	7,500.0	7,500.0		
Discounted figures	7,500.0	7,143	6,803	21,445.6	3
	17,500.0	17,500.0	17,500.0		
Tax effect	17,500.0	16,667	15,873	50,039.7	
Plan B					
Initial cost	(20,000)				
W & T	2,500	2,813	-		
Depn	(3,000)	(3,000)	(3,000)		
Repairs	200	500	800		
	12,500	12,500	12,500		
	12,200	12,813	10,300		
	8,540	8,969	7,210		
Release on disposal			<u>-8000</u>		
	<u>28,540</u>	<u>8,969</u>	<u>(790)</u>		
Tax effect	<u>28,540</u>	<u>8,541.67</u>	<u>(717)</u>	36,365	2
Plan C					
Hire charges	5000	5000	5000		
	1500	1500	1500		
	3500	3500	3500		
Discount rate	<u>5%</u>	<u>5%</u>	<u>5%</u>		
Tax effect	3500	<u>3,333</u>	<u>3,175</u>	10,008	1

The option that maximises tax cash inflows is Option 3.

Illustration

The directors of Tycom Limited have identified Kenya as one of its most probable overseas investment locations. One issue nevertheless arise and the directors would wish to obtain tax advice before making a decision. These issues are:

- a) They have two options:
 - Option one: To build a factory from scratch at the following costs:

Factory building	Kshs 10,000,000
New machinery fixed	Kshs 30,000,000
Executive office furniture	Kshs 2,000,000
Three-phase power supply (paid to Kenya Power)	Kshs 4,000,000

- Option two: To lease a factory, fully built and ready for use. The lease will be for 10 years. The lease charges will be based on Kshs 46,000,000 on an 18 per cent per annum cost of capital.
(Present value of annuity 18%, 10yrs = 4.4941)

Solution

Tycom Ltd (assume Yr.2007)

Option 1

Investment deduction (first year of use of assets)	Kshs '000'		
	ID @ 100% Residue for IBD or WTA		
	Kshs '000'	Kshs '000'	
Factory building	10,000	10,000	-
New machinery fixed	30,000	30,000	-
Power supply	<u>4,000</u>	<u>4,000</u>	-
	44,000	<u>44,000</u>	

WTA	Kshs '000'
Class	IV @ 12½%
Furniture	<u>2,000</u>
	2,000
WTA (Yr. 1)	<u>(250)</u>
	<u>1,750</u>

Summary of capital allowances Yr. 1

	Kshs '000'
ID	44,000
WTA	<u>250</u>
Tax allowable capital allowance (1 year only)	<u>44,250</u>

Option 2

Leasing the factory would mean lease hire payments of:

$$\text{Shs'000'} \frac{46,000}{PVF_{18,10\text{years}}} = \frac{46,000}{4.491} \quad \text{Kshs.10, 235,640 tax allowable expense against income before taxation per annum.}$$

In 10 years lease, hire payment would be Kshs102, 356, 400 but allowable against profits.

Therefore acquiring the assets from 1st year allowance would be better.



5.13 Form of business ownership

There are many tax implications involved in deciding the form of business:

- Company or Business
- Branch or subsidiary

■ Opening a company or a partnership

- The following are the major tax considerations to take into account in deciding whether to operate a partnership or a limited company.
- A partnership is not considered as a separate taxable entity as a company, therefore, the taxable income of a partnership is allocated among the partners according to the profit/loss sharing ratio. A company is considered to be a separate taxable entity and as such it will bear its taxes.
- The partners in a partnership are taxed at the graduated scale rates which are lower than the corporate tax rates. The taxable income or loss of a limited company is taxable on the company at a flat rate of 30% for resident and 37.5 % for non-resident companies.
- Partner's salaries are not tax deductible while director's salaries in a limited company are tax deductible.
- The losses made under a partnership are carried forward by the partners individually but not the firm while losses in a limited company are carried forward by the company.
- The company will be required to pay withholding tax when it is declaring dividends to its shareholders while a partnership does not declare dividends. The partners may withdraw and any such withdrawal will be taxed on the individual partner.
- Companies have compensating tax while partnerships are not subject to the same.
- Currently partnership can pay turnover tax at 3% on gross income if the company has turnover of between Kshs500,000 and Kshs5 million within one year. However, companies are not subject to turnover tax.

■ Opening a branch or subsidiary

The following considerations should be made in case of a branch or a subsidiary:

	Branch	Subsidiary
Residency	Non resident for tax purposes	Resident for tax purposes
Tax rate	37.5%	30%
Deductibility of expenses	Expenses of interest, royalties and management or professional fees paid to head office in India are not allowable expenses in deriving taxable income. Expenditure incurred by the branch outside Kenya is only allowable/ deductible to the extent the Commissioner of Domestic Taxes (CDT) may consider	Expenses incurred wholly and exclusively in generation of income are allowable except for those specifically disallowable.
Withholding tax rates	No WHT tax applies	WHT tax will apply to payments to both residents and non residents

The implications of debt or equity as modes of raising additional capital is as follows:

Corporate form of ownership enjoys legal personality and income is subject to corporate income tax rates. Sole proprietorship/partnerships are not separate entities from those forming it for tax purposes.

For a corporation, reasonable salaries paid to officers/directors who are also shareholders are tax deductible. For sole proprietorships/partnerships no deduction is allowed for owner's salaries or for interest expense on invested ownership capital.

Corporate profits are subject to double taxation: first corporation tax and secondly dividends withholding tax on recipients.

Other considerations:

- Ease of transfer of ownership
- Tax brackets are high or low for owners
- Expected life of business.

Illustration:

2.1.1 Mr. Kamau has two offers for employment in two engineering firms. The details of the two offers are as follows:

	Firm A	Firm B
Basic pay per month	Sh.	Sh.
Benefits:	65,000	61,000
Housing (market rate) p.m		
Car 2000 cc (cost)	20,000	30,000
	600,000	600,000

Pension scheme, which is registered by commissioner of income, and both employer and employee contribute 5% of the basic salary for pension scheme.

Required

What offer would you recommend to Mr. Kamau? Explain reasons for your recommendation.

**Solution:**

Firm	A		B
Basic salary 65000pm x 12	780,000	61,000 x 12	732,000
Car benefit: Higher of			
(i) 24% of Sh. 600,000 = 144,000	144,000		144,000
(ii) Benefit on 2000cc = 86,400	<u>924,000</u>		<u>876,000</u>
Housing benefit: higher of			
(i) Mkt value 240,000		360,000	
(ii) 15% x 924,000 138,600	<u>240,000</u>	15% x 876,000 = 131,400	<u>360,000</u>
Pensionable pay	1,164,000		1,236,000
Less pension contribution			
By employee: lower of			
(i) Set limit 240,000		240,000	
(ii) 30% x 1,164,000 349,200		30% x 1,236,000 =	
		370,800	
(iii) 5% x 780,000 39,000	<u>(39,000)</u>	5% x 732,000 = 36,600	<u>(36,600)</u>
Net taxable income	<u>1,125,000</u>		1,199,400

Tax liabilities**Firm A on Kshs 1,125,000**

First Kshs. 466,704 = (121,968 x 10%) + (114,912 x 60%)	= 81,144
Surplus Kshs (1,125,000 – 466,704) @ 30%	= <u>197,488.8</u>
	278,632.8
Less: personal relief	<u>13,944.0</u>
Net tax liabilities	<u>264,688.8</u>

Firm B on Kshs 1,199,400

First Kshs 466,704 = (121,968 x 10%) + (114,912 x 60%)	= 81,144
Surplus Kshs (1,199,400 – 466,704) @ 30%	= <u>219,808.8</u>
	300,952.8
Less personal relief	<u>(13,944.0)</u>
Net tax liability	<u>287,008.8</u>

Recommendation: Accept Job offer A where net tax liability is lower and net take home amount is higher

5.14 Anti-avoidance provisions S.23

Under S.23, the Commissioner of Income Tax is empowered to reject certain business transactions when he is of the opinion that the main purpose or one of the main purposes for effecting a transaction is evasion or reduction of tax liability. He can direct for necessary adjustment on taxable income and issue an assessment accordingly. If the taxpayer disputes the adjustment and the resulting assessment, the taxpayer can appeal to the Tribunal e.g.

- A director buying a car from the company at a throw away price. He would be taxed on the difference between the low price he pays for the car and the market price for the car.
- A child paid very high salary for minor duties. The salary helps to spread tax payable but the parent controls the child's income. The Commissioner of Income Tax would disallow the salary and tax it.

Tax Avoidance: Principles emerging from case law

Section 23 of the Kenya Income Tax Act empowers the Commissioner to order the adjustment of transactions which in his opinion are effected with the main aim of avoiding or reducing liability to tax.

Such a direction can only be challenged by appealing to the Income Tax Tribunal. This decision of the Tribunal is final and there is no right to further appeal.

However, the Commissioner rarely, if ever, does use such powers. Consequently, there is no such litigation in respect of tax avoidance schemes in Kenyan courts.

However, the following principles have emerged from UK Case Law and which may well be applied in Kenya:

1. The “Duke of Westminster” Principle.

Lord Tomlin stated: “every man is entitled, if he can, to order his affairs so that the tax attaching ... is less than it would otherwise be.

2. The “Ramsay” Principle: This was established in a Capital Gains Tax Case in relation to composite transactions.

At the time, the most prevalent scheme to avoid tax (especially Capital Gains Tax) was to enter into a series of transactions, which would facilitate the following:

- (a) Conceal the sale of property subject to Capital Gains Tax (CGT)
- (b) The exchange of shares for shares, which would not have CGT implications.

This interdependent series of transactions would normally be “circular and self cancelling”. The Ramsay doctrine provides that whether a series of transactions is genuine or artificial would be dependent on the end result. Transactions which have no commercial purpose are treated as a fiscal nullity. The preordained series of transactions are disregarded if they have no business purpose other than achieving the preordained end. The same principle was extended in CIR vs BURMAH OIL CO. LTD.

3. Francis vs Dawson

Facts of the Case

George Dawson and family owned two private companies which they wanted to sell. If they were sold in UK at a gain, it would be subject to Capital Gains Tax.



Dawson wanted to sell to W Ltd a UK company. He was advised to sell by an exchange of shares for shares with an offshore company, G Ltd.

G Ltd then sold its shares in the two companies to W Ltd. The scheme succeeded on the grounds that the end result led to “enduring legal consequences” and therefore the individual transactions had a business purpose and not artificial as in the Ramsay Case.

5.15 Transfer of real properties

Income from ‘sale of land and buildings’ in Kenya is non-taxable income. It used to be tax on gains of sale of property e.g. land and buildings but was suspended with effect from 14.6.1985.

- (a) A taxpayer (or a partnership) with Kenya rental income is treated as running a business, his Kenya property business'. All the rents and expenses for all properties are pooled, to give a single profit or loss. Profits and losses are computed in the same way as trading profits are computed for tax purposes, on an accrual basis.
- (b) Expenses will often include rent payable where a landlord is himself renting the land which he in turn lets to others.

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.

Non residents

They are taxed at a **flat rate of 30% on gross rent income** and this is the final tax.

No expenses are allowed against gross rent income.

Residents

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

Some of the tax planning measures include:

- Claim the expenses allowable on the rental income.
- If you obtain a mortgage to acquire rental houses, the entire interest will be allowable against the rental income for that year of income. As such the mortgage option is recommended.
- Compute capital allowances and claim the same accordingly on the capital expenditure incurred in the rental premises.
- With the introduction of VAT on commercial rental property, it is important to charge VAT on any such properties and issue a valid tax invoice.

5.16 Pricing policy

The firm or entity should have a tax efficient pricing policy. A tax efficient pricing policy should be informed by all considerations including the prices of commodities and the taxes payable for the commodities. Further, the taxpayer should consider the risk of transfer pricing.

■ Transfer pricing

The introduction of transfer pricing documentation requirements in Kenya in June 2006 has contributed to increased tax audits by the tax authorities in regard to the same.

Transfer pricing is important when structuring transactions. Due, in part, to their often complex nature and specific characteristics, the transfer pricing aspects of intercompany financing activities have had a relatively low profile so far. However, in view of the tax administration's increasing interest in this subject and the pre-eminently 'affiliated' nature of shareholder financing, this subject cannot be avoided in an M&A transaction.

Documentation requirements

Transfer pricing involves transactions among associated entities at arm's length conditions, the "arm's length principle". The fact of not meeting such transfer pricing documentation requirements might result in severe penalties in said countries. In addition, discussions about transfer pricing might lead to substantial taxation adjustments for both the present and past years which could lead to double taxation. In addition to specific, local transfer pricing rules, many countries also apply the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations for consistent application of the arm's length principle at an international level.

Intercompany financing transactions and Mergers & Acquisitions (M &A)

If shareholder loans are granted or other financing transactions are made during an M&A transaction or even within the target group, the applied conditions should be at arm's length and sufficiently substantiated. Examples are the substantiation of the (often high) interest charged by the investor on shareholder financing; the spread in a back-to-back situation; charging or not charging a fee if a group company stands as guarantor for another group company within the scope of an overdraft facility; the allocation of the advantage in case of cash pooling; or the situation in which external bank financing within the group is on lent at a 'blended' rate to all group companies, without involving the stand-alone creditworthiness of the various companies in the analyses. In principle, a substantiation should be available for each transaction, based on its specific characteristics and taking into account the position of the parties involved.

■ Loan pricing policy

As said, the arm's length nature of each loan should be substantiated based on the arm's length principle, transfer pricing legislation and local documentation requirements. Depending on the scale and the complexity of the intercompany loans, this may constitute a considerable administrative burden. In practice, therefore, substantial loans and high-interest loans in particular have only been documented so far.

In order to ensure that the documentation requirements are nevertheless somewhat met and that interest on intercompany loans is determined in a consistent manner, a loan pricing policy can be drafted within the scope of (post-deal) structuring. In such loan pricing policy, the credit rating of the group companies and the currency and term of the loans must be taken into account. Based on this, and on a database with external comparables, a matrix of credit spreads can be prepared, to be used to determine the interest and spread on intercompany loans.



5.17 Uses of tax incentives

The taxpayer can make use of the various tax incentives as a form of tax planning. Some of the tax incentives include:

■ Capital allowances

The capital allowances available in Kenya are Farm works, Industrial Building, Investment and Wear and Tear allowances. These allowances are deductions from taxable income based on a percentage of the qualifying cost of investment. They tend to lower the effective price of acquiring capital since the initial cost is recovered.

■ Export Processing Zone incentives

Enterprises operating in the Export Processing Zones (EPZ enterprises) have got a number of incentives. These incentives were provided on the enactment of the Export Processing Zone Authority Act “EPZA Act” in 1990 which established the EPZ Authority (EPZA) as a “one-stop” centre for facilitating export-oriented investment and administering a number of incentives. The incentives offered by the Authority cover trade as well as income taxes.

The EPZA is also an executing agency since it manages the government-owned free zone parks. Most of the parks are, however, owned by private firms. The number of industrial parks that were administered by the Authority rose from 7 to 16 between 1993 and 1998. Similarly, the number of EPZ firms increased from 13 to 22 within the same period.

Enterprises operating within EPZ have the following benefits:

- There is a 10- year tax holiday. This is an exemption from corporation tax for the first 10 years of trading.
- There is a lower corporation tax rate of 25% for the subsequent years after the 10- year tax holiday.
- There is an exemption from withholding tax on dividends and other payments to non residents during the first 10 years.
- Investment deductions are 100% of the capital expenditure claimable in the 11th year after commencement of production.
- Supplies from an EPZ enterprise are zero rated for purposes of VAT
- There is a refund of import duty on raw materials to manufacture exports.

The EPZ companies are allowed to sell up to 20% of their products to the domestic market. However, these rules were not rigidly applied during the early years of the scheme, with the domestic firms sometimes exceeding 50%. To prevent the EPZ benefits from giving undue disadvantage to domestic firms, an additional 2.5% import duty is charged on EPZ sales made to the domestic market.

Another constraint for EPZ operations in Kenya is that because EPZ firms operate outside Kenya’s Customs territory, the preferential tariff regime they would have enjoyed in marketing to the COMESA countries is blocked. This is considered to be a major disincentive for expansion of the scheme since many Kenyan firms target the COMESA market. The EPZ incentives encourage the participation of the private sector in the development of the processing zones. Up to now, EPZA has gazetted 16 zones but only half of these zones are in operation.

■ VAT Remission

The Kenyan tax regime incorporates a remission scheme, including VAT targeted at either attracting investments or promoting exports. They include the following:

A duty / VAT remission scheme for firms that import inputs under the Manufacturing Under Bond (MUB) and Export Promotion Programmes Office (EPPO); the Minister may also remit the tax in the public interest under specific circumstances.

Under the original VAT law introduced in 1990 imports made by **MUB** are zero rated to avoid the payment of VAT up front. The zero rating incentive has since been extended to domestic supplies made to **MUBs** to encourage local firms to sell to those enterprises.

Export processing zone enterprises are exempt from registration under VAT Act because they are not considered as local firms. They are also exempt from the payment of excise duties as specified in the Customs and Excise Act. The main trade tax incentive schemes include export compensation, duty drawback, manufacturing under bond (**MUB**), and export processing zones.

■ Export compensation schemes

Duty Remission Facility

These are a form of Export Compensation schemes. Materials imported for use in manufacturing for export; the production of raw materials for export; or the production of duty free items for sale domestically, are eligible for duty remission. Applications for this facility should be made to the Tax Remission for **Export Office (TREO)** administered by the Ministry of Finance.

Manufacture under Bond

The **Manufacturing under Bond (MUB)** scheme. MUB was established in 1988 to boost exports as part of the Structural Adjustments Programmes introduced earlier in 1987. It is a duty or tariff deferral scheme under which eligible firms were licensed, placed under bond and allowed to import capital items, spares and raw materials without payment of duty. The bonds may be established on behalf of the firms by commercial banks or insurance companies. The amount of the bond is predetermined for each import, with the Customs authorities, canceling when the firms make exports, using the input on which the tax was waived.

A firm must invest up to **Kshs 10 million** and employ a minimum of 100 people to qualify for MUB status. The goods produced can only be sold on the domestic market with the permission of the Commissioner of Income Tax. When goods are sold on the domestic market, the firm becomes liable for the equivalent import duties waived on the inputs used to manufacture the goods. The physical controls that exist for monitoring their inputs and output are similar to those used under the excise regimes. By 1993, there were over 70 MUBs that were operating in Kenya, exporting mainly garments to the US market. Though the scheme continues, the number of firms has declined drastically to about 12 when, in 1994, the US trade authorities revoked Kenya's export quota to that market. They cited the abuse that involved transshipment of cargo from India through Kenya as the reason for the revocation order.



Kenya also offers Duty and **VAT** remission scheme as a tax incentive. The scheme was introduced in 1990 to provide relief for the payment of these taxes on imports on raw materials and other inputs that physically form part of the goods exported. Unlike the MUB and EPZ schemes, the remission mechanism does not cover taxes paid on capital inputs such as equipment and machinery. firms that wish to use the scheme are required to apply to the **EPPO** of the Ministry of Finance.

Double taxation treaties

Kenya has double tax treaties with various governments. In fact, Kenya has signed double tax treaties with United Kingdom, Germany, Canada, India, Norway and Zambia. The agreements are aimed at eliminating double taxation of income earned by the residents of the respective countries. The treaty rates are as shown below:

	Dividends	Interest	Royalty, management and professional fees
Resident in	%	%	%
Canada	15	15	15
Denmark	20	(a) 20	20
Germany	15	(a) 15	15
India	15	15	(d) 20
Norway	15	(a) 20	20
Sweden	15	15	20
U.K	15	(a) 15	(b) 15
Zambia	(c) 0	15	20

- (a) Interest paid by the government and the Central Bank of Kenya is tax-exempt.
- (b) The rate is 12.5% for management and professional fees.
- (c) No Kenya tax is due if the dividend is subject to tax in Zambia.
- (d) The rate is 17.5% for management and professional fees.

Where the treaty rate is higher than the non-treaty rate, the lower rate applies.

Turnover tax

This is a tax on consumer expenditure introduced in the 2006 Finance Act. It was introduced as a measure to improve compliance of small tax payers. It also acts as a tax incentive for the medium size businesses with a turnover of less than Kshs 5 million. The imposition of the turnover tax is contained in section 12 (c) of the Income Tax Act. It applies to any person whose gross sales is more than Kshs 500,000 per annum and does not exceed or is not expected to exceed Kshs 5 million per annum

The applicable rate as per the 2006 Finance Bill was 3% of gross sales per annum and it was to be a final tax. However, the 2006 Finance Act was not clear on the rate which is applicable and also had deleted the charging section. This made it difficult for it to be imposed by 1 January 2007.

The situation was clarified in the 2007 Finance Bill and the rate was clarified as the resident rate for any year of income. Following this amendment, the turnover tax is expected to be effective with effect from 1 January 2008.

5.18 Disposal of business operations and restructuring of activities

The various tax planning opportunities in the disposal of business operations and restructuring activities are as follows:

- **Application to transfer assets of a going concern without charging VAT**

Under paragraph 21 of the 6th Schedule to the VAT Act, where any person disposes of a registered business as a going concern to another registered person, both registered persons can apply to the Commissioner to transfer the taxable goods without charging VAT. For the application to be granted, both registered persons must within 30 days furnish the Commissioner with the following information:

- Details of the transaction,
- Details of the arrangements made for payment of tax due on supplies already made
- Description of the transaction
- Quantities and value of stocks of taxable goods on hand at the date of disposal,
- Details of arrangements made for transferring the responsibility for keeping and producing books and records relating to the business before disposal;

Unless the Commissioner has reason to believe that there would be undue risk to the revenue, and notifies the registered persons accordingly within 14 days of receipt of the notification, the stocks of taxable goods on hand may be transferred without payment of the tax otherwise due and payable; and

Further, notwithstanding that the business is being disposed of by the registered person as a going concern, that registered person shall remain registered and be responsible for all matters under the VAT Act in relation to the business prior to its disposal, up to the time of its disposal, until such time as the requirements of this Act have been properly complied with.

- **Transfer of assets at the WDV**

Under paragraph 13(3) of the 2nd Schedule to the Income Tax Act, in the case of a transfer where one of the parties (body of person) exercises control over the other, the body of persons can apply to transfer assets at the written down value if the sale would have given rise to a balancing charge. In this case, no election will be made in cases where either the buyer or the seller is at the time of the sale a non resident person.

- **Stamp duty incentives**

- **Section 95 of the Stamp Duty Act**

Section 95 provides some exemptions on stamp duty and a reduction on stamp duty on increase of capital. In order for a company to qualify for the tax incentive, the following conditions must be met:

- There must be a new company to be incorporated in Kenya or an increase of share capital of an existing company. In our interpretation, the company must be incorporated under the laws of Kenya.
- That the absorbing company is either registered or increases its capital with a view to acquiring more than 90% of the share capital of the target company.
- The consideration of the transfer consists of more than 90% of the shares issued in the transferee company.



Section 96 exempts from tax instruments in respect to which it is shown to the satisfaction of the collector.

- (a) That the effect thereof is to convey or transfer a beneficial interest in property from one company with limited liability (hereinafter called the transferor) to another such company (hereinafter called the transferee); and
- (b) That either—
 - (i) One of such companies is beneficial owner of not less **than ninety per centum** of the issued share capital of the other company; or
 - (ii) Not less than ninety per centum of the issued share capital of each of the companies is in the beneficial ownership of a third company with limited liability;
- (c) That the instrument was not executed in pursuance of or in connection with an arrangement where under—
 - (i) The consideration for the conveyance or transfer was to be provided directly or indirectly by a person other than a company which at the time of the execution of the instrument was associated with either the transferor or the transferee; or
 - (ii) The beneficial interest in the property was previously conveyed or transferred directly or indirectly by such a person.



5.19 CHAPTER SUMMARY

- Adequate tax planning requires a deeper understanding of the tax legislation and a sound knowledge of case law in taxation principles.
- Tax planning for the case of an organisation may involve the following areas remuneration, duty, VAT or corporation tax.
- Planning is meant to achieve compliance with tax laws, ease tax administration and advantageous financial position.



5.20 QUIZ

QUESTION ONE

Identify some of the opportunities for Customs planning.

QUESTION TWO

Discuss the tax planning opportunities with regard to employee taxes.

QUESTION THREE

Discuss some of the tax planning opportunities for individuals.

QUESTION FOUR

Discuss some of the tax planning opportunities with regard to Disposal of business operations and restructuring of activities

QUESTION FIVE

With the aid of case law, discuss the anti avoidance provisions as provided under Section 23 of the Income Tax Act.



5.21 QUIZ ANSWERS

QUESTION ONE

Customs planning can give opportunities in the following areas:

1. **Duty remission:** Investors can apply to the Minister for duty waiver or exemption under special duty rates. Duty remissions are also available under the Tax Remission for Exports Office (TREO) programme.
2. **Customs valuation:** This involves ensuring that the best valuation method is used. It would be advisable to import from a manufacturer rather than a middleman. In practice, the value of the second transaction is used to calculate customs value on import. As such, if one has prior information of first transaction and bought directly from the importer or manufacturer, it would result in duty saving. Thus applying “first sale” principle can minimise duty by eliminating “middleman” markup.
3. **Duty suspension:** The bonded warehouse arrangement can be used to minimise Customs value. A trader in Tanzania approaches a Kenyan trader for the first time in order to purchase sports shoes. Had the trader imported the sports shoes under a bonded warehouse arrangement they could have avoided unnecessary import duties and VAT on the import (enter as transit goods).
4. **Classification of goods:** The taxpayer should ensure goods are correctly classified. Incorrect classification of goods may lead to payment of either higher or lower duty. If lower duty is paid, there are risks of paying the difference after a post clearance inspection. If higher duties are paid, it will result in the pursuit of the duties outstanding (customs duty and VAT) and even fines or interest in arrears on the duties and VAT.
5. **Duty deferral:** This planning opportunity involves importing goods, storing or further manufacturing the goods, then exporting the goods to another country or releasing them to Kenyan market (pay 2.5% surcharge).
6. **Origin of goods:** There may be varying amounts of import duty payable depending on the origin of the goods. Some imports from certain countries enjoying a preferential import duty. As such, the importer should be well-versed with rules of origin to make use of the preferential import duty rates. One would need to produce a valid Certificate of Origin.

QUESTION TWO

Staff costs are significant operational costs. The employer needs to reward labour in the highest possible way at lowest cost possible while at the same time observing full compliance with the law. Consider lumpsum payments, benefits, expenses etc.

An employee will usually be rewarded largely by salary, but several other elements can be included in a remuneration package. Some of them bring tax benefits to the employee only, some will benefit the employer.

Bonuses are treated like salary, except that if a bonus is accrued in the employer's accounts but is paid more than nine months after the end of the period of account, its deductibility for tax purposes will be delayed.

The general position for benefits is that they are subject to income tax. The cost of providing benefits is generally deductible in computing trading profit for the employer.

However, there are a large number of tax free benefits and there is a great deal of planning that can be done to ensure a tax efficient benefits package for directors and employees. The optimum is to ensure that the company receives a tax deduction for the expenditure while creating tax.

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. Pension or gratuities earned or granted in respect to disability.
2. Monthly or lumpsum pension granted to a person who is 65 years of age or more.
3. 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.
4. Allowances to the Speaker, Deputy Speaker and MP payable to them under the National Assembly remuneration.
5. Interest up to Kshs 100,000 per individual on housing bonds, account with Housing Finance (formerly 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 Kshs 300,000 is qualifying while the excess is non qualifying.)
6. Cost of passage to and from Kenya of a non-citizen employee borne by the employer.
7. Employer's contribution to pension funds or provident funds
8. Benefits, advantages/facilities of an aggregate value of less than Kshs 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 Kshs 36,000 p.a or Kshs 3,000 p.m.)
9. The first Kshs 150,000 per month for persons with disabilities exempt from taxation. (w.e.f. 12.June 2009).
10. Expenditure on amenities by the physically disabled tax allowable up to a maximum of Kshs 50,000 per month. (w.e.f. 12. June 2009)

QUESTION THREE

Tax planning is the arrangement of the affairs of a taxpayer in such a way as to minimise tax liability at lowest cost without contravening any tax law or regulations. It is determination, in advance, of the tax effect of proposed business actions.

Tax planning requires:

- A deeper understanding of the tax legislation; and
- A sound knowledge of case law in taxation.

Tax consultancy is therefore basically tax planning involving offering tax advice to clients in various situations. Tax revenue departments have to ensure the following through proper tax planning: -

- Taxpayers comply fully with tax laws and regulations; and
- Revenue collection is maximised.



A careful study of decided cases is important in:

- i) Highlighting tax planning schemes;
- ii) Provision of judicial interpretation of the legislation;
- iii) The judgement in a particular case will show strengths and weaknesses of a particular scheme.

Aims of tax planning

1. To achieve compliance with tax laws since non-compliance is costly as it will result in penalties and interest charges.
2. To ease administration as in working out arrangements, methods of accounting, records to be kept, reports to be prepared etc.
3. To achieve the most advantageous financial position out of a business transaction to be measured in terms of direct tax savings from planning and financial benefits by way of cash flow effects.

Tax planning for individuals

The tax planning measures of an individual would depend on whether they are employed or unemployed. The following tax planning measures are allowable for employees.

Owner-occupier Relief

According to Section 15 (3) (b) of the Income Tax Act, interest paid by a person on amount borrowed from specified financial institution (includes a bank, insurance company or building society) for the purchase of or improvement of premises that he occupies for residential purpose shall be deductible against total taxable income of the person. The maximum allowable interest is Kshs 150,000 per annum (Kshs 12,500 per month).

An employer should ensure that mortgage interest paid by the employees is allowed for deduction in the payroll of all eligible employees.

Insurance relief

An employer should notify employees who have taken individual life assurance covers or education policies with a maturity of 10 years (with effect from 1 January 2003) and maybe paying out of payroll premiums on the same that they are eligible to claim insurance relief and effect the same through the payroll. The deductible amount paid is subject to a maximum of Kshs 60,000 per annum (Kshs 5,000 per month).

Non-cash benefits

Increasing the non-taxable benefits may reduce tax on employees especially where such benefits are allowable for corporation tax purposes. Examples of benefits that the company could consider introducing or expanding include the following:-

Medical services

This entails the reimbursement to staff of medical expenses incurred for self and dependants or access to designated hospital facilities where the company holds an account. There is no maximum limit of the same under the law.

Staff development and training

Training costs directly paid to a training institution for an employee in relation to the employees' responsibilities at the work place and for the benefit of the company's business are allowable for corporate and PAYE purposes.

Mileage Reimbursement for use of personal car on the company business

This benefit is tax efficient in comparison to the car benefit and provision of staff transport which are taxable on the employees.

Meals for low income employees

Meals provided to low income employees on employer's premises are a non taxable benefit on the employees. A low income employee is defined as one earning not more than Kshs. 29, 316 per month, i.e. employees at income tax bracket of 20% and below. (Effective date: 13 June 2008)

School fees

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

QUESTION FOUR

The various tax planning opportunities in the disposal of business operations and restructuring activities are as follows:

- **Application to transfer assets of a going concern without charging VAT**

Under paragraph 21 of the 6th Schedule to the Income Tax Act, where any person disposes of a registered business as a going concern to another registered person, both registered persons can apply to the Commissioner to transfer the taxable goods without charging VAT. For the application to be granted, both registered persons must within 30 days furnish the Commissioner with the following information:

- Details of the transaction;
- Details of the arrangements made for payment of tax due on supplies already made;
- Description of the transaction;
- Quantities and value of stocks of taxable goods on hand at the date of disposal;
- Details of arrangements made for transferring the responsibility for keeping and producing books and records relating to the business before disposal;

Unless the Commissioner has reason to believe that there would be undue risk to the revenue, and notifies the registered persons accordingly within 14 days of receipt of the notification, the stocks of taxable goods on hand may be transferred without payment of the tax otherwise due and payable; and, further, notwithstanding that the business is being disposed of by the registered person as a going concern that registered person shall remain registered and be responsible for all matters under the VAT Act in relation to the business prior to its disposal, up to the time of its disposal, until such time as the requirements of this Act have been properly complied with.

- **Transfer of assets at the WDV**

Under paragraph 13(3) of the Income Tax Act, in the case of a transfer where one of the parties (body of person) exercises control over the other, the body of persons can apply to transfer assets at the written down value if the sale would have given rise to a balancing charge. In this case, no election will be made in cases where either the buyer or the seller is at the time of the sale a non resident person.



- **Stamp duty incentives**

- **Section 95 of the Stamp Duty Act**

Section 95 provides some exemptions on stamp duty and a reduction on stamp duty on increase of capital. In order for a company to qualify for the tax incentive, the following conditions must be met:

- There must be a new company to be incorporated in Kenya or an increase of share capital of an existing company. In our interpretation, the company must be incorporated under the laws of Kenya.
- That the absorbing company is either registered or increases its capital with a view to acquiring more than 90% of the share capital of the target company.
- The consideration of the transfer consists of more than 90% of the shares issued in the transferee company.

Section 96 exempts from tax instruments in respect to which it is shown to the satisfaction of the Collector.

- (a) that the effect thereof is to convey or transfer a beneficial interest in property from one company with limited liability (hereinafter called the transferor) to another such company (hereinafter called the transferee); and
- (b) that either—
 - (i) One of such companies is beneficial owner of not less **than ninety per centum** of the issued share capital of the other company; or
 - (ii) Not less than ninety per centum of the issued share capital of each of the companies is in the beneficial ownership of a third company with limited liability;
- (c) that the instrument was not executed in pursuance of or in connection with an arrangement where under—
 - The consideration for the conveyance or transfer was to be provided directly or indirectly by a person other than a company which at the time of the execution of the instrument was associated with either the transferor or the transferee; or
 - The beneficial interest in the property was previously conveyed or transferred directly or indirectly by such a person.

- **Section 96 of the Stamp duty Act**

Section 96 exempts from tax instruments in respect to which it is shown to the satisfaction of the Collector.

- (a) That the effect thereof is to convey or transfer a beneficial interest in property from one company with limited liability (hereinafter called the transferor) to another such company (hereinafter called the transferee); and
- (b) That either—
 - (i) One of such companies is beneficial owner of not less **than ninety per centum** of the issued share capital of the other company; or
 - (ii) Not less than ninety per centum of the issued share capital of each of the companies is in the beneficial ownership of a third company with limited liability;
- (c) that the instrument was not executed in pursuance of or in connection with an arrangement where under—
 - The consideration for the conveyance or transfer was to be provided directly or indirectly by a person other than a company which at the time of the execution of the instrument was associated with either the transferor or the transferee; or
 - The beneficial interest in the property was previously conveyed or transferred directly or indirectly by such a person.

QUESTION FIVE

Anti-avoidance provisions S.23

Under S.23, the Commissioner of Income Tax is empowered to reject certain business transactions when he is of the opinion that the main purpose or one of the main purposes for effecting a transaction is evasion or reduction of tax liability. He can direct for necessary adjustment on taxable income and issue an assessment accordingly. If the taxpayer disputes the adjustment and the resulting assessment, the taxpayer can appeal to the Tribunal e.g.

- A director buying a car from the company at a throw away price. He would be taxed on the difference between the low price he pays for the car and the market price for the car.
- A child paid very high salary for minor duties. The salary helps to spread tax payable but the parent controls the child's income. The Commissioner of Income Tax would disallow the salary and tax it.

Tax Avoidance: Principles emerging from case law

Section 23 of the Kenya Income Tax Act empowers the Commissioner to order the adjustment of transactions which in his opinion are effected with the main aim of avoiding or reducing liability to tax.

Such a direction can only be challenged by appealing to the Income Tax Tribunal. This decision of the Tribunal is final and there is no right to further appeal.

However, the Commissioner rarely, if ever, does use such powers. Consequently, there is no such litigation in respect of tax avoidance schemes in Kenyan courts.

However, the following principles have emerged from UK Case Law and which may well be applied in Kenya:

1. The "Duke of Westminster" Principle.
Lord Tomlin stated: "every man is entitled, if he can, to order his affairs so that the tax attaching ... is less than it would otherwise be.
2. The "Ramsay" Principle: This was established in a Capital Gains Tax Case in relation to composite transactions.

At the time, the most prevalent scheme to avoid tax (especially Capital Gains Tax) was to enter into a series of transactions, which would facilitate the following:

- a. Conceal the sale of property subject to Capital Gains Tax (CGT)
- b. The exchange of shares for shares, which would not have CGT implications.

This interdependent series of transactions would normally be "circular and self cancelling".

The Ramsay doctrine provides that whether a series of transactions is genuine or artificial would be dependent on the end result. Transactions which have no commercial purpose are treated as a fiscal nullity. The preordained series of transactions are disregarded if they have no business purpose other than achieving the preordained end.

The same principle was extended in CIR vs BURMAH OIL CO. LTD.



5.21 PAST PAPER ANALYSIS

The following is a list of questions covering the topic that were tested in previous exams. The questions are listed in this format: Month/year e.g. 6/01 represents June or May 2001.

6/00 Q.5 (a) 12/05 Q.5 (a), 06/06 Q.5 (a), 06/08 Q.2, 12/08 Q.5 (a),

Taxation 1- 12/08,

5.22 REVISION QUESTIONS

QUESTION ONE

- a) i) Define the term 'tax planning' (2 marks)
ii) Briefly explain two instances in which a business may apply the concept of tax planning (4 marks)
(Dec 2005 Q 5)

QUESTION TWO

Discuss the concept of corporate tax planning

QUESTION THREE

- a) Explain the main tax incentives provided to newly listed companies in your country. (4 marks)
b) Under what circumstances are imported goods considered to have been dumped in your country? (6 marks)
c) Write brief notes on the following:
i) Tax-free employment benefits (6 marks)
ii) Set off of import duty (4 marks)
(Total: 20 marks)

QUESTION FOUR

“In my judgement, not every payment made to an employee is necessarily made to him as a profit arising from his employment. Indeed, in my judgement, the authorities show that to be a profit arising from employment the payment must be in reference to the services the employee renders by virtue of his office, and it must be something in the nature of a reward for services past, present or future”. Justice Upjohn in *Hochstrasser v – Mayes* (1960) 38 TC 673.

Required:

In the light of the above judgement and the relevant provisions of Income Tax Act (Cap 470) of the laws of Kenya, explain the tax benefits arising out of the use of the following in the design of an “Executive Remuneration Package”.

Expense reimbursement.	(4 marks)
Benefits in kind	(4 marks)
Pension entitlement	(4 marks)
Bonus Schemes	(4 marks)
Share Purchase arrangements for employees.	(4 marks)

QUESTION FIVE

- a) “Multinational corporations may adopt certain pricing structures for their Kenyan subsidiaries that shift profits out of Kenya to countries where profits are taxed less and thus divert part of Kenya’s revenue abroad”. (Deloitte and Touche: 2006 East Africa Budget Insight).

Required:

With reference to the statement above and section 18(3) of the Income Tax Act (Cap.470):

- i) Outline the characteristics of transactions that may constitute transfer pricing. (4 marks)
- ii) Identify four methods of determining an appropriate transfer price as provided in the Organisation for Economic Co-operation and Development (OECD) model. (4 marks)



CHAPTER SIX



TAX SYSTEMS AND POLICIES



CHAPTER SIX

TAX SYSTEMS AND POLICIES

► 6.0 TAX SYSTEMS AND POLICIES

6.1 Introduction

In the previous chapter we covered tax planning. In this chapter we will lay emphasis on developing tax systems and policies. Tax systems are the frames on which a country's revenue collection is built. The chapter will assist the student understand the various types of tax systems and be able to recommend a viable tax system based on International best practices.

In the next chapter we shall look at professional ethics in taxation.

6.2 Objectives

After this chapter the students should have understood the following concepts:

- Types of tax systems
- Role of taxation in economic development
- Design of a tax policy
- Criteria for evaluation of a tax system
- Tax reforms and modernisation of tax systems

6.3 Exam Context

This is a new topic introduced with the review of the syllabus. Questions in this topic are likely to be theoretical and could test a candidates' understanding of tax systems, reforms, modernisation of the tax systems and design of a tax policy.

6.4 Industrial Context

This topic will enable economic experts understand the various tax systems and be in a position to advise accordingly. It will also help students understand the role of taxation in economic development.

6.5 Key definitions

Tax system: This is an organised way in which the government collects tax from its citizens. It involves the various approaches, structures and policies adopted over time and relating to taxation and revenue generation.

Tax policy: is the government's approach to taxation, both from the practical and normative side of the equation. Policymakers debate the nature of the tax structure they plan to implement (i.e., how progressive or regressive) and how it might affect individuals and businesses (i.e., tax incidence).

Tax reforms: These are changes or amendments of the tax system with the general objective of revenue adequacy, economic efficiency, equity and fairness and simplicity.

Tax Modernisation: These are reforms implemented to ensure that tax systems are kept abreast with technological advances. This improves tax collection and ensures efficiency in the tax system.

6.6 Types of tax systems

Generally, there are two major types of tax systems.

- Single or unified tax system
- Multiple tax system.

■ Unified tax system

A unified tax system has only one form of tax. For example, in some countries, turnover tax is the only tax upon income of a person. A unified tax is a fixed tax that is paid for a given period of time, usually one year, to guarantee business entity of all legal protection for the period.

It caters for tax liabilities that a business entity is required to pay in order to acquire the legal protection for a specified period of time usually one year. The regime is usually graduated into tax schedules defined on the basis of either profitability or employment levels of business entities such that the higher the level of employment or profitability, the higher the amount of unified tax payable.

■ Multiple tax system

It comprises a variety of taxes that are applicable at the same time on the income of a person. In Kenya, for example, we have a multiple tax system since there are many taxes applicable including personal tax, corporation tax, withholding tax, compensating tax, turnover tax, Value Added Tax, Customs and Excise tax ..

A multiple tax system may be preferred to a single tax system for the following reasons:

- 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) **Minimise incidences of tax evasion**
Since a multiple tax system has a wide tax base it is able to minimise tax evasion by bringing every taxable person into the tax blanket



6.7 Role of taxation in economic development

The role of taxation and fiscal policy in the development strategy of a country has to be viewed in the background of the functions a taxation system performs. The main functions of taxation in relation to economic are as follows.

a. Economic stability

Taxes 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 of tax helps to check the big fluctuations in the prices and maintain economic stability.

b. 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 defense 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 subsidise their production. 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 subsidised because the market does not take account of all the costs and benefits of the public transport system.

c. Pay interest on national debt

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

d. 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.

e. 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.

h. 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.

i. Optimum allocation of resources

Taxes are also imposed to allocate resources of the country for their optimum use. 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.

6.8 Design of a tax policy

■ Tax policy challenges facing developing countries

Taxation is the only practical means of raising the revenue to finance government spending on the goods and services that the citizens of a country demand. Setting up an efficient and fair tax system is not easy, particularly for developing countries that want to become integrated in the international economy. The ideal tax system in developing countries like Kenya, should raise essential revenue without excessive government borrowing, and should do so without discouraging economic activity and without deviating too much from tax systems in other countries.

Developing countries face formidable challenges when they attempt to establish efficient tax systems:

- i. Most workers in developing countries are typically employed in agriculture or in small, informal enterprises. As they are seldom paid a regular, fixed wage, their earnings fluctuate, and many are paid in cash, "off the books." The base for an income tax is therefore hard to calculate. Nor do workers in these countries typically spend their earnings in large stores that keep accurate records of sales and inventories. As a result, modern means of raising revenue, such as income taxes and consumer taxes, play a diminished role in these economies, and the possibility that the government will achieve high tax levels is virtually excluded.
- ii. It is difficult to create an efficient tax administration without a well-educated and well-trained staff, when money is lacking to pay good wages to tax officials and to computerise the operation (or even to provide efficient telephone and mail services), and when taxpayers have limited ability to keep accounts. As a result, governments often take the path of least resistance, developing tax systems that allow them to exploit whatever options are available rather than establishing rational, modern, and efficient tax systems.
- iii. Informal structure and financial limitations of the economy in many developing countries hinder the statistical and tax offices from generating reliable statistics. This lack of data prevents policymakers from assessing the potential impact of major changes to the tax system. As a result, marginal changes are often preferred over major structural changes, even when the latter are clearly preferable. This perpetuates inefficient tax structures.
- iv. Income tends to be unevenly distributed within developing countries. Although raising high tax revenues in this situation ideally calls for the rich to be taxed more heavily than the poor, the economic and political power of rich taxpayers often allows them to prevent fiscal reforms that would increase their tax burdens. This explains in part why many developing countries have not fully exploited personal income and property taxes and why their tax systems rarely achieve satisfactory progressivity (in other words, where the rich pay proportionately more taxes).



- v. Developing countries attempting to become fully integrated in the world economy will probably need a higher tax level if they are to pursue a government role closer to that of industrial countries, which, on average, enjoy twice the tax revenue. Developing countries will need to reduce sharply their reliance on foreign trade taxes, without at the same time creating economic disincentives, especially in raising more revenue from personal income tax. To meet these challenges, policymakers in these countries will have to get their policy priorities right and have the political will to implement the necessary reforms. Tax administrations must be strengthened to accompany the needed policy changes.
- vi. As trade barriers come down and capital becomes more mobile, the formulation of sound tax policy poses significant challenges for developing countries. The need to replace foreign trade taxes with domestic taxes will be accompanied by growing concerns about profit diversion by foreign investors, which weak provisions against tax abuse in the tax laws as well as inadequate technical training of tax auditors in many developing countries are currently unable to deter. A concerted effort to eliminate these deficiencies is therefore of the utmost urgency.
- vii. Tax competition is another policy challenge in a world of liberalised capital movement. The effectiveness of tax incentives— in the absence of other necessary fundamentals — is highly questionable. A tax system that is riddled with such incentives will inevitably provide fertile grounds for rent-seeking activities. To allow their emerging markets to take proper root, developing countries would be well advised to refrain from reliance on poorly targeted tax incentives as the main vehicle for investment promotion.
- viii. Finally, personal income taxes have been contributing very little to total tax revenue in many developing countries. Apart from structural, policy, and administrative considerations, the ease with which income received by individuals can be invested abroad significantly contributes to this outcome. Taxing this income is therefore a daunting challenge for developing countries. This has been particularly problematic in several Latin American countries that have largely stopped taxing financial income to encourage financial capital to remain in the country.

6.9 Criteria for the evaluation of a tax system

Principles of an optimal tax system

The principles of an optimal tax system, what are known as Canons of taxation, some of which were laid down by Adam Smith include:

1. Simplicity

A tax system should be simple enough to enable a taxpayer 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 taxpayer's willingness to declare income. It may also create administrative difficulties leading to inefficiency. The simplest tax system is one with only 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 taxpayers 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 taxpayers 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 taxpayer e.g. PAYE. This may discourage tax evasion. For example, it may be difficult for many taxpayers to make a lumpsum 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 taxpayer.

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 taxpayer 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 taxpayer 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 taxpayer'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 step with the circumstances in the economy, e.g. if the 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 taxpayers. 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

6.10 Tax reforms and modernisation of tax systems

The Kenya Revenue Authority was established in 1995 as a semi-autonomous government agency responsible for revenue administration. The overall objective was to provide operational autonomy in revenue administration and enable its evolution into a modern, flexible and integrated revenue collection agency.

Since the inception of KRA, revenue collection has continued to grow while professionalism in revenue administration has been enhanced. However, a number of processes remain manual and KRA is yet to operate as a fully integrated organisation. Thus the KRA Second Corporate Plan while acknowledging these challenges recommended appropriate strategies to address the same. This actuated the Revenue Administration Reform and Modernisation Programme (RARMP) which commenced in 2004/05 with the objective of transforming KRA into a modern, fully integrated and client-focused organisation.

The RARMP process has adopted project management and business analysis techniques in accordance with international best practice with the creation of the Programme Management and Business Analysis Office (PMBO) under the Office of the Commissioner General. This has led to the development of an institutionalised administrative framework for the RARMP making it easier to track progress in the reform initiatives and enhance project ownership and acceptance to change from both internal and external stakeholders.

The RARMP has now entered its Second Phase which will run until 2008/09 and will see the reforms entrenched at the operational levels to achieve operational efficiencies and enhance service delivery. This will be achieved through the implementation of the following seven key projects:

1. Customs Reforms & Modernisation Project
2. Domestic Taxes Reform & Modernisation Project
3. Road Transport Reform & Modernisation Project
4. Investigation & Enforcement Reform & Modernisation Project
5. KRA Infrastructure Development Project
6. KRA Business Automation Project
7. Human Resource Revitalisation Project

Achievements:

Many positive developments in revenue administration were achieved during the implementation of the First Phase of the Revenue Administration Reform and Modernisation Programme. Overall,

- Revenue collection has increased by 1% of the Gross Domestic Product from **Kshs 202 billion** in 2002/03 to **Kshs 297 billion** in the 2005/06 financial year.
- Income Tax, Value Added Tax and Domestic Excise were merged to form Domestic Taxes Department (DTD) while the mandate and taxpayer population of LTO was clearly defined with LTO being elevated to department status.
- The Simba system was implemented to facilitate self-assessment and Post Clearance Audit (PCA) function was strengthened.
- Support Service Department was created to consolidate support functions and enhance taxpayer services while the Office of Regional Heads was formed to bring services and decision making closer to taxpayers.
- The KRA Information Communication & Technology (ICT) strategy was developed to act as the blue print for all future automation programmes.
- Employee development programmes were undertaken and staff terms of service improved.

Challenges:

Despite the achievements enumerated above, significant challenges still remain. These include:

- Lack of sufficient funding.



- Implementation hiccups in Simba 2005 towards the attainment of a complete self assessment regime while faster progress is needed in the implementation of an Integrated Tax Management System.
- Stakeholders' resistance to reform initiatives.
- Need for sustained efforts in fighting corruption and tax fraud.
- Timeliness of legislative changes.
- Human resource issues like remuneration, skills and integrity.

The above challenges are recognised and adequately addressed in the Third Corporate Plan whose theme is '**Develop a dedicated professional team embracing modern processes and technologies to deliver customer focused services that enhance compliance and revenue collection**'.

■ Key performance indicators

Below are the Key Performance Indicators on the basis of which we not only will KRA evaluate itself but invite its stakeholders to evaluate it on the performance of the reform programme

- Improve tax compliance by 5% per annum (assuming an overall compliance level of 60%).
- Enhance revenue collection by an additional Kshs 15 billion per annum on account of improved compliance
- Maintain cost of collection at below 2% of printed estimates.
- Improved quality of service to stakeholders.
- Improved public perception of KRA.
- Competitive terms and conditions of service for employees.
- Reduction in corruption/bribery index.
- Number of KRA functions fully integrated.
- Number of IT business solutions successfully implemented.
- Quality and timeliness of production of statistics.

Customs Services Department Reform and Modernisation Project (CRM)

This project aims to transform Customs into a modern Customs administration by 2008/09 in accordance with internationally accepted conventional standards and best practice as outlined in WTO agreements and the WCO Revised Kyoto Convention on Simplification and Harmonisation of Customs Procedures. This will be done through:

- Implementation of a fully function-based Customs structure and reengineering of Customs procedures from physically controlled checks to risk based and post release controls through strengthening of Post Clearance Audit.
- Taking the lead in implementing an inter-agency review of border processing and clearance time to enhance service delivery at the borders.
- Taking the lead at the regional level Customs in addressing deficiencies in the East African Management Act to streamline the import/export process.
- Enhancement of the Simba 2005 system functionality in critical areas of manifest acquittal, management reporting and risk based selection.
- Enhancement of staff competencies in critical areas such as risk-based approaches to cargo management and the adoption of post release verification and audit.

Domestic Taxes Department Reform and Modernisation Project

This project seeks to create a Domestic Taxes Department that is structured along the key tax administration functions of taxpayer education and services, returns and payments processing, audit, enforced collection and tax operations policy. This will be achieved through:

- Implementation of an Integrated Tax Management System (ITMS) that integrates both income tax and value added tax operations and takes a single view of the taxpayer.
- Enhance service delivery by achieving complete taxpayer segmentation through building capacity in the Large Taxpayer Office and developing specific programmes targeting the Middle and Small taxpayers.

Road Transport Department Reform and Modernisation Project

Considerable progress has been made in automating RTD processes. This project aims at automating all remaining manual processes and simplifying administrative procedures through record keeping and file tracking features that support front office operations. The project also aims to achieve full connectivity of the RTD with all other KRA departments in order to ensure seamless flow of information. Indeed this is already being achieved through the interconnection between Simba 2005 system and the RTD system KOVIS.

Investigation & Enforcements Reform and Modernisation Project

The project seeks to create a modern Business Intelligence unit that will analyse data to assess the risks inherent in transaction and ownership relationships which constitute the basis for evasion schemes. The project also seeks to strengthen the prosecution unit and implement a KRA-wide enforcement strategy to discourage tax malpractices by imposing maximum penalties and publicise recurrent evaders to deter future tax evasion.

Infrastructure Development Reform and Modernisation Project

This project aims at ensuring that projects in the reform programme are given adequate support through timely acquisition and provision of needed utilities, upgrading of KRA infrastructure and enhancement of asset and security management systems. It also seeks to boost the capacity of KRA to respond to the various needs of stakeholders through the implementation of modern KRA-wide taxpayer education, integrity and accountability programmes

KRA Business Automation Project

This project seeks to develop and implement an enterprise-wide IT strategy for KRA which promotes integration of domestic tax administration and the exchange of information between DTD, Customs and RTD. The project will enable a 'single view of the taxpayer' across all KRA functions, ensure efficient and effective revenue collection and attain operational excellence. The project will undertake to provide seamless sharing of information across KRA and interconnectivity with external systems of stakeholders to enable integrated e-processing of tax returns and efficient enforcement.

Human Resources Revitalisation Project

This project seeks to upgrade and diversify the skill base at KRA to international best practice standards with emphasis being placed on competency based management, recruitment and retention policy, establishment review and clearly defined career path progression.

For any reform programme to be successful, it needs to be hinged on a strong administrative structure that creates ownership and enhances ownership. KRA has put in place an elaborate governance structure for the RARMP.



6.11 CHAPTER SUMMARY

- A tax system is an organised way in which the government collects tax from its citizens. It involves the various approaches, structures and policies adopted over time and relating to taxation and revenue generation.
- **Tax policy:** is the government's approach to taxation, both from the practical and normative side of the equation. Policymakers debate the nature of the tax structure they plan to implement (i.e., how progressive or regressive) and how they might affect individuals and businesses (i.e., tax incidence).
- There are two types of tax systems:
 - Unified Tax system
 - Multiple tax system
- Role of taxation in economic development
 - a. Raising revenue
 - b. Economic stability
 - c. Protection policy
 - d. Social welfare
 - e. Fair distribution of income
 - f. Allocation of resources
 - g. Increase in employment
- Principles of an optimal tax system
 - a. Simplicity
 - b. Certainty
 - c. Convenience
 - d. Economic/administrative efficiency
 - e. Taxable capacity
 - f. Neutrality
 - g. Productivity
 - h. Elasticity or buoyancy
 - i. Flexibility
 - j. Diversity
 - k. Equity

6.12 QUIZ

QUESTION ONE

- a. What is a tax system?
- b. What is a tax policy?
- c. What are tax reforms?

QUESTION TWO

List and explain the role of taxation in economic development.

QUESTION THREE

List and explain the principles of an optimal tax system

QUESTION FOUR

Discuss the challenges faced by tax authorities like the KRA in the process of modernising tax collection and administration procedures



6.13 ANSWERS TO QUIZ

QUESTION ONE

Tax system: A tax system is an organised way in which the government collects tax from its citizens. It involves the various approaches, structures and policies adopted over time and relating to taxation and revenue generation.

Tax policy: is the government's approach to taxation, both from the practical and normative side of the equation. Policymakers debate the nature of the tax structure they plan to implement (i.e., how progressive or regressive) and how they might affect individuals and businesses (i.e., tax incidence).

Tax reforms: These are changes or amendments of the tax system with the general objective of revenue adequacy, economic efficiency, equity and fairness and simplicity

QUESTION TWO

- a. Raising revenue
- b. Economic stability
- c. Protection policy
- d. Social welfare
- e. Fair distribution of income
- f. Allocation of resources
- g. Increase in employment

QUESTION THREE

The principles of an optimal tax system, what are known as Canons of taxation, some of which were laid down by Adam Smith include:

Simplicity

A tax system should be simple enough to enable a taxpayer 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 taxpayer's willingness to declare income. It may also create administrative difficulties leading to inefficiency. The simplest tax system is one with only a single tax. However, this may not be equitable as some people will not pay tax.

Certainty

The tax should be formulated so that taxpayers 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 taxpayers 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.

Convenience

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

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 taxpayer.

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

Taxable capacity

This refers to the maximum tax which may be collected from a taxpayer 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.

- Absolute taxable capacity
- 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 taxpayer 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.

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 taxpayer's choice of goods or services to be consumed.

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.



Elasticity or buoyancy

By elasticity we mean that the government should be capable of varying (increasing or reducing) rates of taxation in step with the circumstances in the economy, e.g. if the 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.

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.

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 taxpayers. A single tax or a few taxes may not meet revenue requirements of the state. There should be both direct and indirect taxes.

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.

QUESTION FOUR

- Challenges faced by tax authorities in the process of modernising tax collection and administration procedures
- Technological limitations: The fact that many of the taxpayers do not have access to Internet nor able to use new may hamper the tax authority's attempts to modernise the KRA administrative systems, for example, the electronic filing system
- Complicated tax regime: Many taxpayers do not understand the tax system. They find the taxes available in Kenya very complicated. This makes them not be able to comply as required.
- Financial constraints: Some of the systems involve substantial financial outlay.
- Inadequate support from other government agencies.
- Scope of the reforms: Some of the reforms have a very wide scope and as such they may take a longer period before their impact is felt.
- Political interference: Some of the proposed tax reforms have been affected by politics of the day e.g the proposed taxation of Members of Parliament among others.
- Evolving tax avoidance strategies: Some taxpayers have adopted well calculated and complicated mechanisms of tax evasion. This has made the revenue authority ensure that they under go continuous training to be on top of their game.
- Lack of enough assessors (personnel) to ensure compliance: The revenue authority does not have enough personnel to enforce the taxation laws and collect taxes.

- Non tax paying culture: The payment of some taxes is dependent on the culture of the taxpayers. For example, the payment of turnover tax will depend on the integrity of the taxpayers to disclose the sales as required by law. If the taxpayers do not develop a good tax paying culture, the attempts by the revenue authority to ensure high revenue collection may not succeed.
- Cumbersome dispute resolution mechanisms: It has been argued that the dispute resolution mechanism available under the Kenyan tax laws has flaws which need to be redressed.

6.14 PAST PAPER ANALYSIS

The following is a list of questions in which the topic was tested in past exams. The questions are listed in this format: Month/year e.g. 6/01 represents June or May 2001.

12/07 Q.4(b),

6.15 REVISION QUESTIONS

QUESTION ONE

- Distinguish between single and multiple tax system
- Explain four reasons why a country may prefer a multiple tax system over a single tax system

(June 2008 Q. 1)

QUESTION TWO

Discuss why taxation policies of developing countries should be different from those of developed countries.

(June 2008 Q. 5)

QUESTION THREE

- Highlight the benefits of an effective tax policy to a developing country
- As part of institutional reforms, of tax systems, governments usually establish advisory units within tax departments such as Tax Policy Units (TPUs). What role do such TPU's play in Kenya.

(May 2002 Q.1(d))



QUESTION FOUR

Revenue production of a tax system is measured through as buoyancy and elasticity.

- (a) Distinguish buoyancy from elasticity of a tax. (4 marks)
- (b) State and explain two methods that can be used to estimate tax elasticities. (6 marks)
- (c) Explain the elasticity of taxes with reference to:
 - (i) Value Added Tax (VAT) (2 marks)
 - (ii) Income tax (2 marks)
 - (iii) Customs and excise duty. (2 marks)

(May 2002 Q. 1)

QUESTION FIVE

List and briefly explain the various types of taxes that can comprise a multiple tax system in Kenya. (10 marks)

CHAPTER SEVEN



PROFESSIONAL ETHICS IN TAXATION



CHAPTER SEVEN

PROFESSIONAL ETHICS IN TAXATION

► 7.1 Introduction

In the previous chapter we covered tax systems and policies in Kenya. In this topic we shall lay emphasis on professional ethics in taxation. Tax systems are the background of a country's revenue collection basis. The chapter will assist the student understand the various types of tax systems and be able to recommend a viable tax system based on International best practices. In the next chapter we shall study professional ethics in taxation.

► 7.2 Objectives

The objective of this topic is to equip the student with ethical principles that will assist them in their work place. The chapter discusses the form of tax practice and matters relating to the accountant's obligations to their clients and how to handle client work. The chapter discusses the various ethical regulations by the applicable accountancy bodies that go a long way in assisting the accountants at work. After this chapter the students should have understood the following concepts:

- Form of tax practice and matters relating thereto
- Obligations to clients
- Confidentiality
- Matters relating to new clients
- Handling of client work
- Charging for services
- Matters giving rise to conflict of interest
- Disclosures in tax returns, computations and correspondence with the Revenue Authority
- Dealing with the Revenue Authority
- Moral and social issues in taxation

► 7.3 Exam Context

This is a new topic introduced during the review of the syllabus. Questions in this topic are likely to be both theoretical and practical in nature. The examiner could test on candidates' understanding of the practical ethical issues at the work place as a tax consultant.

► 7.4 Industrial Context

This chapter will enable accountants and tax consultants acquire skills on how to manage their tax practices, how to manage client work and charging for services. Further, they will understand the ethical issues affecting their businesses and how to deal with the ever aggressive revenue

authority. There is an increasing focus in the industry on adherence to the professional ethical standards hence the need for the importance of this topic.

► 7.5 Key Definitions

Ethics- Ethics may be defined as the science of the moral rectitude of human acts in accordance with the first principles of natural reason. It is the moral standards by which people judge behaviour.

Integrity- Is defined as:

- the quality or state of being complete; unbroken condition; wholeness; entirety
- the quality or state of being unimpaired; perfect condition; soundness
- the quality or state of being of sound moral principle; uprightness, honesty, and sincerity

7.6 Regulation

The Institute of Certified Public Accountants (ICPAK), like any other professional body, requires its members to observe the highest professional standards in all aspects of their work. This chapter discusses how these standards can be maintained, with particular reference to taxation. Members are also required to comply with statutory and regulatory requirements imposed by the government.

ICPAK publishes a **Code of Ethics and Conduct** covering the standards and ethical requirements which they expect. It details the **fundamental principles and sets out a framework for applying those principles**. Members must apply this framework to particular situations to identify instances where compliance with the ethical standards may be compromised so that safeguards may be put in place to avoid threats, or to reduce them to below the minimum level that can be regarded as acceptable.

Normally a member's responsibility will be to a client, or to an employer, but there may be instances where a member may need to act in the public interest.

7.7 Fundamental principles of Ethics

The fundamental principles that govern the ethical issues should be well observed by ICPAK members as well as students. These include:

Integrity:

Requires all members to be straightforward and honest in professional and business relationships. A member should not be associated with information if he believes that the information contains a materially false or misleading statement, statements or information furnished recklessly, or omits or obscures information required to be included where such omission or obscurity would be misleading.

Objectivity:

Imposes an obligation on members not to compromise their professional or business judgement



because of bias, conflict of interest or the undue influence of others. Relationships that bias or unduly influence the professional judgment of the member should be avoided.

Professional competence and due care:

Requires members to maintain professional knowledge and skill at the level required to ensure that clients or employers receive competent professional service based on current developments in practice, legislation and techniques; and act diligently in accordance with applicable technical and professional standards when providing professional services

Any limitations relating to the service being provided must be made clear to clients and other users to ensure that misinterpretation of facts or opinions does not take place.

Confidentiality

It imposes an obligation on members to refrain from:

- 7.7.1 Disclosing outside the firm confidential information acquired as a result of professional and business relationships without proper and specific authority or unless there is a legal or professional right or duty to disclose; and
- 7.7.23 Using confidential information acquired as a result of professional and business relationships to their personal advantage or the advantage of third parties

A member should consider the need to maintain confidentiality of information within the firm. A member should also maintain confidentiality of information disclosed by a prospective client or employer

The need to maintain confidentiality continues even after the end of relationships between a member and a client or employer. When a member changes employment or acquires a new client, the member is entitled to use prior experience, but not confidential information obtained from the previous relationship

Professional behaviour

Imposes an obligation on a member to comply with relevant laws and regulations and avoid any action that may bring discredit to the profession.

This includes actions which a reasonable and informed third party, having knowledge of all relevant information, would conclude negatively affects the good reputation of the profession.

Members should be honest and truthful and should not

- i. Make exaggerated claims for the services they are able to offer, the qualifications they possess, or experience they have gained
- ii. Make disparaging references or unsubstantiated comparisons to the work of others.

7.7 Form of tax practice and matters relating thereto

In Kenya, to form a tax practice, one has to have the requisite qualifications. It can be a company or a partnership. In most cases, firms that offer tax services also offer audit services under a partnership.

Once the firm has been set up, the firm will hire qualified personnel and proceed with business. The firm will take up clients in a professional way.

7.8 Obligations to clients

It is advisable that the tax practice enters into a written contract with clients that provide specific duties and rights under the contract. Some of the obligations that tax practices have to clients include:

- Agents for all tax matters
- Agent for tax compliance matters
- Agent for corporate tax matters

The firm should ensure that it meets its part of the bargain to avoid misunderstanding and unnecessary litigation.

7.9 Confidentiality

Confidentiality as a principle does not only affect the members in provision of tax services. It also affects the tax officers. The Income Tax Act provides that:

An officer and any other person in carrying out the provisions of this Act shall regard and deal with all documents and information relating to the income of a person and all confidential instructions in respect of the administration of the Income Tax Department which may come into possession or to his knowledge in the course of his duties as secret.

In the light of this statement, any tax officer or member of ICPAK should not disclose any information regarding income of a person unless:

- The recipient is an officer or person so employed in the course of his duties, or to a person authorised in that behalf by the Minister in relation to a person resident in Kenya, or to a court or person for the purposes of this Act;
- The recipient is in the service of the government, in the revenue and statistical department and the information will be used solely for revenue or statistical purposes (official purposes). The recipient should also have made a declaration of secrecy in relation to information coming to his knowledge in the course of his official duties;
- The recipient is an officer under the Higher Education Loans Board and he requires the name and address of any person granted education loan where such information is required for the performance of the Board's official duties in recovery of the education loans.

7.10 Matters relating to new clients

7.10.1 Acceptance of new clients

Members invited to act as tax advisers by clients must contact the existing tax advisers to ascertain if there are any matters they should be aware of when deciding whether to accept the appointment.

Before accepting a new client, members should consider whether acceptance of the client or the particular engagement would create any threats to compliance with the fundamental principles.



Potential threats to integrity or professional behaviour may be created from, for example, questionable issues associated with the client, or a threat to professional competence and due care may be created if the engagement team does not possess the necessary skills to carry out the engagement.

Where it is not possible to implement safeguards to reduce the threats to an acceptable level, members should decline to enter into the relationship.

■ Changes in Professional Appointment

It is required that members who are asked to replace another accountant to ascertain whether there are any professional or other reasons for not accepting the engagement. This may require direct communication with the existing accountant to establish the facts and circumstances behind the proposed change so that members can decide whether it is appropriate to accept the engagement.

The main purpose of communication is to enable members to ensure that there has been no action by the client which would on ethical grounds, prevent members from accepting the appointment and that, after considering all the facts, the client is someone for whom members would wish to act. Thus, members must always communicate with the existing accountant on being asked to accept appointment for any recurring work.

The extent to which a client's affairs may be discussed with a prospective accountant will depend on the nature of the engagement and on whether the client's permission has been obtained. If the client refuses permission, the existing accountant should inform the prospective accountant, who should then inform the client that he is unable to accept the appointment.

If the existing accountant fails to communicate with the prospective accountant despite the client's permission, the prospective accountant will need to make other enquiries to ensure there are no reasons not to accept the appointment. This could be through communications with third parties, such as banks.

Where the member is the existing accountant then, subject to obtaining the client's permission, he should disclose all information requested without delay.

7.11 Handling of client work

Clients' work should be handled with care. This is to ensure quality in output and delivery of the assignment.

7.12 Charging for services

The firm should have a policy for charging its clients. The fee would be dependent on time taken, on the output or deliverables, on a contingency basis or any other basis. The fee charged should be fair and uniform for its clients. ICPAK does not regulate its fees.

■ Matters giving rise to conflict of interest

One should take reasonable steps to identify circumstances that could pose a conflict of interest. These may give rise to threats to compliance with the fundamental principles. A conflict may arise between the firm and the client or between two conflicting clients being managed by the same firm. For example if the firm acts for its directors in their personal capacity.

A member may evaluate the threats by considering whether he has any business interests or relationships with the client or a third party that could give rise to threats. When the evaluation reveals some conflict of interest, some safeguard measures should be looked into.

The safeguards ordinarily include the member in public practice:

- (a) Notifying the client of the firm's business interest or activities that may represent a conflict of interest
- (b) Notifying all known relevant parties that the member is acting for two or more parties in respect of a matter where their respective interests are in conflict
- (c) Notifying the client that the member does not act exclusively for any one client in the provision of proposed services

The member should obtain the consent of the relevant parties to act in ways to avoid conflict of interest.

Where a member has requested consent from a client to act for another party (which may or may not be an existing client) and that consent has been refused, then he must not continue to act for one of the parties in the matter giving rise to the conflict of interest.

The following additional safeguards should also be considered:

- (a) The use of separate engagement teams
- (b) Procedures to prevent access to information (e.g. strict physical separation of such teams, confidential and secure data filing)
- (c) Clear guidelines for members of the engagement team on issues of security and confidentiality
- (d) The use of confidentiality agreements signed by employees and partners of the firm
- (e) Regular review of the application of safeguards by a senior individual not involved with relevant client engagements.

Where a conflict of interest poses a threat to one or more of the fundamental principles that cannot be eliminated or reduced to an acceptable level through the application of safeguards, the member should conclude that it is not appropriate to accept a specific engagement or that resignation from one or more conflicting engagements is required.

7.13 Disclosures in tax returns, computations and correspondence with the Revenue Authority

When a taxpayer or a tax practice is completing returns or making a declaration for any goods or remittance of revenue collected on behalf of the departments, she or he has an obligation to ensure that the return and declarations represent full and true disclosure of the transactions for the period covered. KRA may cross-check the information you provide.



The law provides for penalty for an incorrect return and/or prosecution in case of gross negligence or fraud.

Taxpayers have an obligation to disclose and produce all relevant information, records and documents required by KRA officials when carrying out their lawful duties. It is an offence to refuse to give or to withhold information, records or documents. Penalties for this offence have been prescribed under the various revenue Acts.

7.14 Dealing with the Revenue Authority

The work of a tax practice involves frequent correspondence with the Kenya Revenue Authority officials. These may include requests to carry out audits or demand taxes from your clients. It is important that you fully co-operate with the KRA.

You have an obligation to accord KRA officials co-operation, due respect and freedom to carry out their lawful duties. You should not intimidate, abuse, threaten or influence them in any manner, whether financial or otherwise.

7.15 Moral and social issues in taxation

During the conduct of the tax practice many moral and ethical issues will arise, for example;

- Should I advise my client to evade tax?
- Should I overcharge my client?
- Should I collude with the revenue authority officials to defraud my client?
- Should I engage in s to get favours from the KRA on behalf of my clients?
- To the government; is it ethical for the government to collect revenue without using the resources for development?

The tax practitioner should exhibit high standards of moral, ethical and social uprightness in the discharge of his or her duties.



7.16 CHAPTER SUMMARY

- Principles governing ethical issues in taxation include: integrity, objectivity, professional competence and due care, confidentiality, professional behaviour.
- Members asked to take up new clients should consider communicating with existing accountants so as to learn of any pending issues regarding tax and other relevant matters.
- Conflict of interest is also an ethical issue. An accountant should evaluate whether his appointment gives rise to any threats of conflict of interest. If it does, he should take necessary measures to minimise the threats.

7.17 QUIZ**QUESTION ONE**

You have acted for Mr. X. but have discovered a serious tax irregularity which Mr. X has refused to correct and you have advised Mr. X that you can no longer act for him. You receive a letter from another ICPAK member advising you that he has been asked to act for Mr. X. Mr. X has forbidden you from divulging any information to him. What should you do?

QUESTION TWO

You have acted for Maria Rosella Ltd for several years, and also for the three director shareholders, Maria, Rose and Ella. During this year, Maria has a disagreement with Rose and Ella over the direction of the company.

What should you do?



7.18 ANSWERS TO THE QUIZ

QUESTION ONE

You should advise the new accountant that Mr. X has not given you permission to divulge any information. The new accountant should then refuse to act for Mr. X.

QUESTION TWO

When you commenced acting for both the company and Maria, Rose and Ella, you should have advised each that you were acting for the others, and asked their permission to act. Providing there were no areas where the interests of the clients conflicted, there is no reason why you should not have acted for all the clients, although it may be advisable to have ensured that, for example, a different tax manager was responsible for each client.

However, now that there has been a disagreement between Maria and the other clients the situation has changed and there is a conflict of interest. It is most likely that it would be inappropriate to continue to act for all the clients, and you will need to cease to act, either for Maria, or for Rose, Ella and the company.

7.19 REVISION QUESTIONS

QUESTION ONE

Can a member act for both a husband and wife?

QUESTION TWO

What should you do if you suspect that a client may have taken a bribe from a customer?

CHAPTER EIGHT



EMERGING TRENDS IN TAXATION



CHAPTER EIGHT

EMERGING TRENDS IN TAXATION

► 8.1 Objectives

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

appreciate the emerging trends in the Kenyan taxation system

understand the various changes that have taken place in the Kenyan taxation system

► 8.2 Introduction

In the previous chapter, we dealt with professional ethics in taxation. In this chapter, we look at emerging trends in the Kenyan taxation system. We will also look at various changes that have taken place in the current budget that warrant to be mentioned. These changes may have been pointed out in earlier chapters.

► 8.3 Exam Context

This area is new and has not been tested before. However, the students are expected to keep abreast with changes in the taxation system. They can do this by ensuring that they know the current year's budget and be able to interpret various changes in the budget.

► 8.4 Industrial Context

Every year, the Finance Minister presents a budget as part of executing his obligation. The budget normally includes some changes in taxation and allowances that are important in businesses. The finance manager, tax consultant and owners of small businesses should be aware of these changes to avoid applicable penalties.

► 8.5 Information, Communication and Technology

ETR: The first attempt by the Kenya Revenue Authority to incorporate technology in tax administration is the introduction of the Electronic Tax Register (ETR). The main role of an ETR is to improve VAT compliance and administration. Every person chargeable to VAT is supposed to install an ETR machine and issue an ETR generated tax invoice.

KRA Website: The Kenya Revenue Authority has now gone electronic. The authority's website has many portals for access by the common citizen. For example, the authority gives employers an option of filing returns online when the employees do not exceed 10,000. Taxpayers can also download various forms that are needed to enable them to pay tax. Citizens can also apply online for PIN numbers; file VAT returns, register for turnover tax among others.

Simba system: The Simba System is a Customs automated system that the Kenya Revenue Authority introduced in an attempt to modernise customs operations. It enhances efficiency and tax collection in the Customs and Excise department. Under the Simba System, Customs authorities require one to be registered as a clearing agent in order to lodge documents electronically. The system was introduced in 2005.

8.6 Taxes:

- **Personal taxes of the physically challenged persons:** The minimum taxable income for the physically challenged persons introduced and pegged at Kshs 150,000 per month. Expenditure on healthcare services and facilities for physically challenged allowable deduction up to Kshs. 50,000 per month.
- **Reduction of tax burden on senior citizens:** The Minister of Finance reduced the tax burden on senior citizens by increasing the exemption gap of monthly pension income from Kshs. 15,000 to Kshs. 25,000 of monthly, i.e. the first Kshs 25,000 of monthly pension income is exempted from tax, from Kshs. 15,000 that was previously exempted.
- For lumpsum withdrawals, the first Kshs. 600,000, up from Kshs. 480,000 withdrawals from a registered pension or individual retirement fund is exempted from tax.
- **VAT:** To fasten the withholding VAT claiming process, withholding agents are required to issue withholding VAT certificate at the point of payment. Previously, the agent was obligated to furnish the supplier with "acknowledgement of the payment."
- **Turnover Tax:** Turnover tax of 3% has been introduced. It targets businesses with an annual turnover of between Kshs. 500,000 and Kshs. 5,000,000. These include individuals and partnerships. Turnover tax returns shall be submitted quarterly using a pay-in slip. The regulations also say that the payments shall be made by the 20th day of the month immediately following the end of the tax quarter.

8.7 Allowances:

- Capital expenditure incurred in acquisition of an indefeasible right to use a fibre optic cable by a telecommunication operator granted deduction of 5% per annum.
- Allowance is granted at 25% per annum on cost of commercial buildings.
- Telecommunication equipment has been granted specific allowance at 20% per annum on cost.
- Qualifying cost of machinery and buildings on investment deduction has been capped to Kshs. 200 million. i.e. for buildings or machinery to qualify for investment deduction, their cost must be Kshs. 200 million or more.
- An investment deduction has been introduced on filming equipment. It has been granted at 100%.
- A special incentive has been introduced for investment in the satellite towns adjoining Nairobi, Mombasa or Kisumu at 150%. This is to decongest the three cities. It is also an incentive to encourage regional growth.
- Expenditure on computer software is allowable at 5% per annum.



8.8 Taxpayer Education

The Kenya Revenue Authority (KRA), in its quest to modernise the Kenyan tax system, is holding seminars to sensitise the taxpayers on the importance of paying tax. The Kenya Revenue Authority also creates awareness to the taxpayers on their rights and obligations, regarding tax issues. The seminars are being held on a monthly basis.



8.9 CHAPTER SUMMARY

- The Kenya Revenue Authority is embracing information technology in its bid to improve tax collection and to increase operational efficiency. Some of the ideas introduced include use of an ETR, online filing of returns, the Simba system among others.
- The 2009 Finance Bill introduced many changes in regard to capital allowances.



8.10 QUIZ



QUESTION ONE

Discuss the role of information technology development in taxation.

QUESTION TWO

Discuss Turnover Tax as an emerging tax in the Kenyan tax system.

8.11 QUIZ ANSWERS

QUESTION ONE

- The first attempt by the Kenya Revenue Authority to incorporate information technology in tax administration is the introduction of the Electronic Tax Register (ETR). The main role of an ETR is to improve VAT compliance and administration. Every person chargeable to VAT is supposed to install an ETR machine and issue an ETR generated tax invoice.
- **KRA Website:** The Kenya Revenue Authority has gone electronic. The authority's website has many portals for access by the common citizen. For example, the authority gives employers an option of filing returns online when the employees do not exceed 10,000. Taxpayers can also download various forms that are needed to enable them to pay tax. Citizens can also apply online for PIN numbers; file VAT returns, register for turnover tax among others.
- **Simba System:** The Simba System is a Customs automated system that the Kenya Revenue Authority introduced in an attempt to modernise customs operations. It enhances efficiency and tax collection in the Customs and Excise department.
- Under the Simba System, Customs authorities require one to be registered as a clearing agent in order to lodge documents electronically. The system was introduced in 2005

QUESTION TWO

Turnover tax of 3% has been introduced. It targets businesses with an annual turnover of between Kshs. 500,000 and Kshs. 5,000,000. These include individuals, partnerships, limited companies and other legal persons. Turnover tax returns shall be submitted quarterly using a pay-in slip. The regulations also say that the payments shall be made by the 20th day of the month immediately following the end of the tax quarter.

8.12 REVISION QUESTIONS

QUESTION ONE

What are the factors that contribute to failure by revenue authority to achieve its tax targets

Dec 2008 Q 4

QUESTION TWO

Discuss the objectives of the Customs Union.

Dec 2008 Q 2



QUESTION THREE

Discuss the significance of the East African Community Customs Management Act (2004) in the Kenyan context.

SELECTED CASES IN TAXATION

KEY TO CASES

LUMPSUMS

Beak v. Robson	£7,000 not to compete with his company if he ever left them	NOT TAXABLE.
Duff v. Barlow	£4,000 paid for relinquishing right to future remuneration	NOT TAXABLE.
Davis v. Harrison	Professional footballers benefit	TAXABLE.
Dale v. de Soissons	£1,000 compensation for early termination of post: it in the contract	TAXABLE.
Henry v. Foster	company's articles provided for lump sum when a director ceased to hold office. Foster resigned and got it.	TAXABLE.
Hunter v. Dewhurst	Dewhurst, about to retire agreed to remain on a lower salary and also waived his right to the Lump sum. He then received £10,000.	NOT TAXABLE.
Hose v. Warwick	£30,000 paid to relinquish old terms and a personal connection on accepting managing directorship	NOT TAXABLE.
Pudd v. Collins	Secretary got £1,000 negotiating the sale of a branch.	TAXABLE.
Prendergast v Cameron	£45,000 to stay on but with less time and smaller salary.	TAXABLE.
Radcliffe v Holt	£2,000 gift voted by the shareholders because profit high	TAXABLE.
Reed v. Seymour	Professional cricketer-benefit match.	NOT TAXABLE.
Wales & Tilley	£4,000 paid to (a) release company from a pension obligation and (b)Tilley to continue at a reduced salary	(a) NOT (b) - TAXABLE.
Weston v. Hearn	Voluntary payment after 25 years faithful service	TAXABLE.
Cowan v. Seymour	Shareholders voted a sum to the liquidator who was formerly unpaid secretary.	NOT TAXABLE.

BENEFITS



Parker v. Chapman	Remuneration paid in the form of shares.	TAXABLE.
Hartland v. Diggins	Employer paid the tax on Hartland's salary.	TAXABLE.
Richardson v Lyon	Employer paid the annual insurance premium.	TAXABLE.
Ede v. Wilson	Shares sold to manager at par market value higher.	TAXABLE.
Weight v. Salmon	Shares allotted to Managing Director at par market value higher.	TAXABLE.
Nicoll v. Austin Coy	Paid upkeep of managing director's residence.	TAXABLE.
Smyth v. Stretton	Sum placed on credit under a provident scheme.	TAXABLE.

EXPENSES

Friedson v. Glyn Tom	Faversham curate up Edmonton curacy. Removal expenses	NOT TAXABLE.
Ricketts v Colquhoun	House to office London barrister and Recorder of Portsmouth.	N.A.
Eagles v. Levy	Court costs of suit to recover remuneration due to Managing Director of Ardath Ltd	NA Airline pilot (a) cost of the Car upkeep for "house to airport" running (b) cost of telephone. (a) + (b)- N.A. (c) – ALLOWABLE.
Nolder v. Walter (c)	Excess hotel etc expenses as subsistence allowance not enough.	
Dingley v. McNulty	Director of a Benefit fund received one guinea per meeting,	N.A.
Blackwell v. Mills	Lab research student must attend certain classes. Travelling and textbooks.	N.A.
Short v. McIgorm	Fee paid to an employment agency for getting a job.	NA.
Simpson v. Tate	Country Managing Director's subscription to medical societies membership not obligatory.	N.A.

BEAK v. ROBSON

Robson entered into an agreement with his company to continue as director and manager for five years at a fixed salary plus bonuses. By the last two clauses he covenanted for £7,000 not to compete with the company if he left it.

Lawrence: The £7,000 comes not from having or exercising an office but from absence from employment after the cessation of the office.

Lord Greene MR: Robson is selling to the company the benefit of a covenant which only come into effect when the service is concluded. The £7,000 is not paid for performing the service in respect of which he is chargeable under schedule E.

COWAN v. SEYMOUR

Cowan acted as unpaid secretary of a company, and later as liquidator. After liquidation, there remained a sum on hand which the shareholders (NB: Not the employer) voted unanimously to the secretary and chairman. The resolution stated "... the late secretary be asked to accept a moiety of such balance..." M.R. (It is)... more in the nature of a testimonial to him for what he had done in the past whilst in office, which had then terminated.

Younger L.J: ... this was not a profit by reason of the office...but was really a gift by persons in the position of beneficiaries who had appreciated and it may be, had benefited by, the personal exertions of the holder of the office while he held it.

Held: That the sum voted by the shareholder did not accrue to him by reason of an officer or employment of profit and was not chargeable.

DUFF v. BARLOW

Barlow was a director of a company manufacturing metal goods. A subsidiary company was formed which supplied the parent with tinsplate at cost. The responsibility for the venture fell largely on Barlow, who was to be remunerated with a percentage of profits. These were much larger than expected, so it was agreed that Barlow would receive, £500 remuneration for his services, the agreement to be cancelled and £4,000 compensation paid for the loss of his right to future remuneration. He continued to be the Managing Director of the parent company.

Lawrence J: The question whether the sum was paid as compensation for loss of Barlow's office which, being a source of income was a capital asset or was a payment for future services in that office. As the agreement was determined there could rest upon him thereafter, no obligation to perform his services and such services could not be any part of the consideration for payment of that sum.

Held: That the sum was compensation for giving up a right to remuneration.

DAVIS v. HARRISON

Harrison was a professional with Everton F.C. The club agreed to pay £650 benefit if he was still employed in 1925 i.e. the season following 10 completed seasons. In 1923, he was transferred, but the football association agreed to Everton's application to pay £650 accrued benefit.

Rowlatt J: The benefit seems to be ... simply a payment. It is not the result of direct subscription by the public and indirect support to the fund by the public attending a match the gate money of which goes to the professional (it is) ... simply a payment not only in view of his services but for his services.

Held: That the payment was remuneration for services rendered.

DALE v. de SOISSONS

de Soissons was assistant to the MD of ballahers Ltd. His service contract was for, £3,000 salary p.a. for 3 years. It provided however for the company to terminate it, if it wished after one year on payment of "compensation for loss of office" of £10,000. This actually happened.

Raxburgh J: He got exactly what he was entitled to get under his contract of employment.



Sir R Evershed MR: The remuneration for the services took the form of ... (salary) ... plus a further sum which he was contractually entitled to ...

Held: That the £10,000 was a compensation for losses of office. It was assessable.

HENRY v. FOSTER

Foster was a Company director. There was no contract of service but an article of the Company provided that a lumpsum be paid to any director who ceased to hold office after at least five years service. The so-called “compensation for loss of office” equalled the last 5 years salary. Foster resigned and got the lumpsum.

Howarth MR: In substance ... this payment ... was made for services rendered. If related to services rendered, it comes back to being a sum which is a profit...arising from the office.

Held: The payment constituted a profit of the office of director.

HUNTER & DEWHURST

Hunter was on the same terms in the same company. He wanted to retire but agreed to stay on at a reduced salary and waiving his rights under the article. He received £10,000 as compensation in lieu of the rights he waived.

Lord Atkin: The £10,000 was not paid for past remuneration for the condition of it to become payable never was performed. It was not paid for future remuneration for that was expressed to be £250 p.a. It seems to me that a sum of money paid to obtain a release from a contingent liability under a contract of employment, cannot be said to be received “under” the contract... and is not received “from” the contract...

Held: In the circumstances of the case (House of Lords 3-2) the sum was not income assessable to tax.

HOSE v. MARWICK

Hose was an insurance broker who had built up an expensive personal connection. His company received the benefit of this connection - though it remained his property - and his remuneration was fixed partly by reference to it under an oral service agreement. He became the managing director of the company. The terms included:

- (a) That he sell his personal connection to the company.
- (b) He surrender his old rights to remuneration.
- (c) Not to engage in business on his own account.
- (d) Not to compete when he finally left the company.

He received a lumpsum of £30,000.

Artkinson J: The £30,000 (was) a payment for giving up something. He gave up working on and developing his personal connection and he gave up that connection to the company. The £30,000 has nothing to do with his remuneration as managing director. I can see no conceivable reason for not giving effect to what everybody must have known was the plain intention of the parties.

Held: That the £30,000 was not remuneration for services rendered or to be rendered, but compensation for the relinquishment by the appellant of his rights under his previous agreement for service and his personal connection.

MUDD v. COLLINS

Mudd was the paid secretary of a company. He negotiated the sale of a branch for which he was given £1,000. He argued unsuccessfully that the negotiation was outside his duties and that payment was a voluntary gift.

Row Catt: If an officer is willing to do something outside the duties of office... and his employer gives him something in that respect, that is a profit, it becomes a profit of his office which is enlarged a little so as to receive it.

Held: That the sum paid is chargeable to tax.

PRENDERGAST v. CAMERON

Cameron, a director, intimated that he wished to resign. The company wanted to continue using his services. He agreed to carry on, but to devote less time to the business at a reduced salary, on payment of £45,000.

Caldecote L.C: I can see no difference between a promise not to resign and a promise to continue to serve the company.

Maugham: The sum was paid to induce him to continue to serve the company.

Raner: In consideration of the payment, the appellant agreed to continue to serve as a director.

Held: That the sum is assessable as a profit from the office of director.

RADCLIFFE v. HOLT

Holt was a company director. Because the years' profits greatly exceeded that of the past years, they voted "a gift of £2,000 tax free... to the directors" in addition to their ordinary remuneration.

Held: That the payment was remuneration arising from Holt's office and was assessable.

REED v. SEYMOUR

A cricket club, in the exercise of their absolute discretion, granted a benefit match to Seymour. The proceeds together with certain public subscriptions were invested in the names of the trustees of the club and the income therefore paid to Seymour. Subsequently, the investments were released and paid over to Seymour.

Sargant L: We have to consider whether this (sum) comes to Seymour merely as a member of the Kent County Eleven, or ...by way of a personal gift in recognition of the brilliance of his performance in the past.

Viscount Care L.C: The terms of his employment did not entitle him to a benefit, though they provide that if a benefit were granted, the club should have a voice in the application of the proceeds, a benefit...is to express the gratitude of his employers and of the cricket loving public for what he has already done, and their appreciation of his personal qualities. Just as those (public) subscriptions which are the spontaneous gift of members of the public are plainly not income or taxable as such, so the gate moneys taken at the benefit match which may be taken as the contribution of the club to the subscription list are in the same category.

Held: That the proceeds of the benefit match was a personal gift and not assessable.

WALES v. TILLEY

A company agreed to pay Tilley £6,000 p.a. salary and when he ceased to be a managing director,



a pension of £4,000 p.a. for 10 years after cessation. A new agreement cancelled the obligation to pay the pension, and reduced the salary to £2,000 p.a. for a consideration of £40,000.

Viscount Simon L.C: The £40,000 is paid in part as the price of compounding the pension, and in part in consideration of the reduction of the salary. The ordinary way of remunerating ... a person employed is to make payment to him periodically but I cannot think that such payment... escape the quality of income ...because an arrangement is made to reduce for the future the annual payments, while paying a lumpsum...to represent the difference. Whatever part of the £40,000 is the equivalent of a drop in salary... of £4,000 p.a. is within the charge on profits from the office of director.

Lord Porter: (The balance)...is a sum paid for the release of an obligation to provide a pension. If so, it is admittedly not subject to tax.

Held: The portion paid in compromise of reduction if salary was assessable. (Prendegast v Cameron followed); the portion representing capitalisation of pension was not assessable (Hunter v Dewhurst followed).

WESTON v. HEARN

On completion of 25 years service, Weston was given £250, which he contended was a voluntary payment of a voluntary nature.

McNaughton: (This sum) ...was a gratuity by way of a bonus after 25 years service.

Held: That the sum was remuneration for services rendered.

PARKER v. CHARMAN

Parker was a director of a company on a salary and commission basis. His commission was credited to his account. In 1920 a dividend was proposed, together with an announcement of a new share issue. Later, the price of the company's trading commodity (sugar) fell from \$125 to £15 per ton. The company was reluctant to pay the dividend. They also realised that the share issue would not be taken up. To support the credit of the company, Parker utilised his dividend and his commission towards purchasing a large portion of the new issue.

Rowcatt: A company pays its debts in shares, (it is) ...applying the money which it owes its creditor by the consent of the creditor in buying the company.

Lord Hanworth MR: This commission was a sum which Mr. Parker received and subsequently appropriated to the benefit of the company.

Held: That the appellant was assessable on the full amount of remuneration credited to him.

HARTLAND v. DIGGINES

The company paid the tax charged on standard salary, though it entered into no agreement verbal or written to do so.

Pollock MR: The salary paid to Hartland is not all he has received. He has received moneys worth to the extent of the sum which has been paid in respect of that salary to the revenue.

Samtton L.J: Because the appellant is an employer of the company the company pays his tax and that is clearly an employment relating to his office as accountant in the company.

Held: Tax liability, paid by the employer is assessable.

RICHARDSON v. LYON

By agreement the company agreed to pay the annual premium on a policy on the life of the employee.

Held: That the payments are part of the emoluments of his office.

EDE v. WILSON

Wilson was employed in a managerial capacity in a subsidiary company. He was given the privilege of acquiring shares in the parent company at par value. He gave a verbal undertaking that he would not sell such shares without the permission of the directors of the parent company as long as he remained in the employment of the subsidiary.

Woottesley: He has received an advantage...that can be turned into money (the shares could be sold).

Held: That Wilson was assessable on the privilege.

WEIGHT v. SALMON

Salmon was a managing director of a company and was entitled to a fixed salary under a service agreement. By resolution, his "eminent and special services" were rewarded by giving him the right to take up shares at par value. The market price was considerably higher.

Finlay J: The privilege was granted to a person exercising an office of profit and in respect of his successful exercise of that office of profit he has got a thing which...by ...selling can be turned into money. It is a privilege, which in itself is not indeed, money, but moneys worth.

Held: that the privilege represented money's worth and was assessable.

NICOLSS v. AUSTIN

Austin who was a life governing director of a company entered into an agreement which provided, inter alia, that the company should bear the cost of upkeep of his residence. Austin had previously intimated that due to the cost of upkeep, he might have to vacate his residence. The company wished him to continue to reside there for the convenience and prestige of the business.

Finlay J: These sums... were moneys worth and therefore income of the respondent.

Held: That the sums paid are assessable as profit of his office as managing director.

SMYTH v. STRETTON

Stretton's terms of service were altered. His salary was increased but the increase was placed to his credit under the provident scheme. Of the sum due, no part was payable until Stratton left his employment, and the moiety was contingent on length of service and good conduct.

Bhannel J: A sum receivable by way of salary or wages is not the less taxable because ...the person who receives it has not got the full right to apply it just as he likes. (it is) ...a sum which really has been added to the salary.

Held: That the sum is assessable.

CALVERT v. WAINWRIGHT

Wainwright was employed by a taxi hire company at a definite wage. The bargain made no reference to tips.



Atkinson J: Tips received by a man as a reward for services rendered ...are assessable to tax. Personal gifts, gifts to a man on personal grounds, irrespectively of and without regard to the question of whether services have been rendered or not, are not assessable.

Held: That the tips having been given in ordinary way as remunerating for service rendered are assessable.

COOPER v. BLAKISTON

An appeal was made by the Bishop and supported by the church wardens stating that it was the privilege and the duty of the laity to augment the poor stipends of the clergy by personal freewill gifts which an offer would be collected on Easter Sunday.

Lord Chancellor: Where a sum of money is given to an incumbent substantially in respect of his services as an incumbent, it accrues to him by reason of his office. There was a continuity of annual payments from any special occasion or purpose.

Lord Ashbourne: The whole machinery was, ecclesiastical-bishop, church wardens, church collections-and I am able to see room for doubt that they are made for the vicar because he was the vicar and became part of the profits which accrued to him by reason of his office.

Held: That the Easter offerings were assessable.

HERBERT v. McQUADE

Herbert was a person of a large parish, on a stipend of under £200 p.a. The Queen Victoria Clergy Sustentation Fund made grants to him to augment his income.

M.R.: (This sum) ...comes to him only because he is the incumbent for the time being of inadequately provided for parish.

Held: That the sums paid were assessable.

Re: STRONG

Strong received (a) Xmas £100 as a gift from his congregation. There was no obligation to make or repeat the gift. Marshall (Lord of the Exchequer) it is a voluntary contribution ...made to the appellat payment (is) either a (Sch E) emolument ...or ...a gain

Held: That the sum was assessable.

TURNER v. CUXSON

A curate received a grant from a religious society, receivable annually on certain conditions, at discretion. The grant is in recognition of faithful service as a clergyman but not the employer.

Colefidge (C.J.): The payment comes to him at the mere will of a charitable society which at its own pleasure, pays him. The payment is made not for services in the parish, not by the persons whom he serves, and not in respect of the particular services which he renders.

Held: That the sum is not assessable.

TRIVEDI v. C.I.T.

Trivedi, a Chartered Accountant, sold on commission a sisal estate for a client. A single and solitary transaction - he had never sold property before, which is usually the business of an estate agent.

Bacon J of a:...the word ‘business’-and especially when regarded in juxtaposition with the expression “for whatever period of time ...carried on...” plainly covers a transaction such as the appellants procurement of the sale of an industrial concern...

Held: That the commission received was gains or profits from a business associate.

FRIEDSON v. GLYTOM

Glyn Tom was a curate at Faversham. He left there to take up a curacy at Edmonton. He claimed the expenses of removal.

Samkey J: There is all the difference in the world between an expense which you have to incur in order to go to a place in order to take up your duties and an expense incurred in the performance of your duties.

Held: That the deduction is not an allowable deduction.

RICKETTS v. COLQUHOUN

Ricketts was a barrister living and practising in London. He also held the office of Recorder of Portsmouth. He claimed as a deduction from his emoluments as Recorder the travelling expenses to Portsmouth and the hotel expenses whilst there.

Viscount Cave LC: (The expenses) ... are incurred not because the appellant holds the office of Recorder, but because, living and practising away from Portsmouth, he must travel to that place before he can begin to perform his duties. They (the expenses) are incurred, partly before he enters upon (the duties) and partly after he has fulfilled them.

Held: The expenses are not an allowable deduction.

EAGLES v. LEVY

Levy had been chairman and managing director of a company. He started a high court action for the recovery of the balance of remuneration which he claimed was due to him. On the second day of the hearing, the action was settled without a court order. Counsel for the company stated in court that “the sum is a comprehensive sum; there are no costs on either side in the matter”. Levy claimed his expenses over £6,000 in making the action as a deduction from the emoluments recovered.

Finlay J: This £45,000 p.a. did not, to any extent represent costs but on the contrary, was a sum from which costs were excluded (following Ricketts v. Colquhoun) ...this was not a sum which can be deductible.

Held: That the costs of the action were not necessarily incurred in the performance of his duties.

NOLDER v. WALTERS

Walter was an airline pilot. He claimed as a deduction expenditure in respect of

- a) The cost of upkeep of a car to convey him from his home to the aerodrome.
- b) The cost of telephone.
- c) The expense, over the subsistence allowance granted him when away from home to duty.



Rowlatt J: In getting there, he is not doing the duties or doing the work of the office. (The telephone) ...is a mere question of communicating with him with a view to him coming to the office to do his duties, which begin when he gets there. He would be entitled to charge something for the extra expense he is put to by having to spend...all of the day and often the night, away from home, because that is part of his duty.

Held: (a) and (b) not allowable, (c) allowable.

DINGLEY v. McNULTY

Dingley was a director of a Benevolent Fund. He received one guinea per meeting and attended 74 meetings. An allowance of 25% was made for expenses and the rest assessed. Dingley contended that the entire 74 guineas was an allowance for sums expended wholly exclusively and necessarily in the performance of his duties. He provided the evidence of expenditure.

Held: That the sum paid was assessable as remuneration and that in the absence of detailed evidence, the allowance made for expenses was adequate.

BLACKWELL v. MILLS

Mills was a student assistant in a research lab. As a condition of his employment, he was required to attend classes to study for a Bsc. He was allowed time off without deduction of pay. He claimed the cost of travelling to and from Chelsea Polytechnic and the cost of text books.

MacNaughton J: It seems to me impossible to say that when he was listening to the lecturer ...he was performing the duties of a student assistant. The expenses permitted to be deducted must be expenses incurred in the performance of the duties of the office.

Held: that the expenses claimed are not an allowable deduction.

SHORT v. McILGORM

Short obtained employment through an employment agency to whom he paid a fee. He claimed the fee was an expense incurred in performing the duties of the office.

Wrottesley J: ...the money expended in order to get the job was in no sense money spent in the performance of the duties attached to the job.

Held: That the deductions claimed are not allowable.

SIMPSON v. TATE

Tate was a bounty Medical Officer. He belonged to certain professional societies, membership of which was not a condition of his employment. He claimed the subscription as a deduction from earnings.

Rowlatt J: He is qualifying himself so that he may continue to hold his office, just as he did qualify himself before he got the office to enable him to perform it.

Held: That the deductions claimed are not allowable.

CHAPTER NINE



STUDY X

REVISION AID



CHAPTER NINE

REVISION AID

KASNEB SYLLABUS FOR ADVANCED TAXATION

SECTION 6

PAPER NO. 16 ADVANCED TAXATION

GENERAL OBJECTIVE

To equip the candidate with advanced knowledge of current taxation practices as well as the ability to solve practical taxation problems using relevant legislation

SPECIFIC OBJECTIVES

1. A candidate who passes this paper should be able to:
2. Compute the tax liability of leasing entities, co-operative societies, trade associations, trust bodies and other specialised entities
3. Explain the procedure for conducting a tax investigation
4. Explain the tax implications of cross border business activities
5. Identify the broad components of tax planning
6. Analyse various tax systems and policies
7. Identify ethical issues in the practice of taxation

CONTENT

Advanced aspects of the taxation of business income

- Partnerships
- Limited companies
- Application of relevant case law

■ Taxation of specialised activities

- Leasing entities
- Co-operative societies
- Trade associations and clubs
- Charitable institutions
- Trust bodies, settlements and estates under administration
- Petroleum, banking, insurance, sea and air transport undertakings
- Unit trusts
- Property developers and contractors
- Application of relevant case law

■ Tax investigation

- Tax evasion, tax avoidance and fraud
- Events which may trigger an investigation
- Back duty and in-depth examinations
- Methods of computing omitted and understated income
- VAT refunds, false claims and accountant's certificate
- Capital statements and ascertainment of income omitted or understated
- Customs and excise investigations
- Negotiation for settlement
- Tax audit
- Application of relevant case law

■ Taxation of cross border activities

- Distinction between trading in and trading with a country
- Double taxation agreements; theory, design and application
- Regional perspective with reference to the East African Community (EAC) and the Common Market for Eastern and Southern Africa (COMESA)
- Most favoured nation status
- Withholding tax provisions
- Transfer pricing
- Application of relevant case law

■ Tax Planning

- Tax planning for individuals and companies
- Employment versus self-employment
- Identifying opportunities to alleviate, mitigate or defer the impact of direct or indirect taxation
- Remuneration packages
- Corporate structure and dividend flows
- Anti-avoidance provisions
- Transfer of real properties
- Pricing policy
- Uses of tax incentives
- Disposal of business operations and restructuring of activities



■ Tax systems and policies

- Types of tax systems
- Role of taxation in economic development
- Design of a tax policy
- Criteria for evaluation of a tax system
- Tax reforms and modernization of tax systems

■ Professional ethics in taxation

- Form of tax practice and matters relating thereto
- Obligations to clients
- Confidentiality
- Matters relating to new clients
- Handling of client work
- Charging for services
- Matters giving rise to conflict of interest
- Disclosures in tax returns, computations and correspondence with the Revenue Authority
- Dealing with the Revenue Authority
- Moral and social issues in taxation

■ Emerging trends in taxation

TAX RATES

INDIVIDUAL RATES

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 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%
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 Shs. 1,162 per month (Shs. 13,944 per annum)

Prescribed benefit rates of motor vehicles provided by employer

			Monthly rates (Sh.)	Annual rates (Sh.)
Capital allowances:		(i) Saloon, Hatch Backs and Estates		
Wear and tear allowances		Upto - 1200 cc	3,600	43,200
Class I	37.5%	1201 - 1500 cc	4,200	50,400
Class II	30%	1501 - 1750 cc	5,800	69,600
Class III	25%	1751 - 2000 cc	7,200	86,400
Class IV	12.5%	2001 - 3000 cc	8,600	103,200
Industrial building allowance:		Over - 3000 cc	14,400	172,800
Industrial buildings	2.5%	(ii) Pick-ups, Panel Van (Unconverted)		
Hotels				
2006	4.0%			
2007 to date	10%			
Farm works allowance		Upto 1750 cc	3,600	43,200
2006	33%			
2007 to date	50%			
Investment deduction allowance:		Over 1750 cc	4,200	50,400
2003 -	70%	(iii) Land Rovers/ Cruisers	7,200	86,400
2004 -	100%	OR 2% of the initial capital cost of the vehicle for each month, whichever is higher.		
2006 to date	100%			
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.





SUGGESTED SOULTIONS



MODEL ANSWERS TO REVISION/ EXAM QUESTIONS

■ CHAPTER ONE

QUESTION ONE

- a. The following considerations should be made in case of a branch or a subsidiary:

	Branch	Subsidiary
Residency	Non resident for tax purposes	Resident for tax purposes
Tax rate	37.5%	30%
Deductibility of expenses	Expenses of interest, royalties and management or professional fees paid to head office are not allowable expenses in deriving taxable income. Expenditure incurred by the branch outside Kenya is only allowable/deductible to the extent the Commissioner of Domestic Taxes (CDT) may consider	Expenses incurred wholly and exclusively in generation of income are allowable except for those specifically disallowable.
Withholding tax rates	No WHT tax applies	WHT tax will apply to payments to both residents and non residents

b.

Mazuri Ltd**Adjusted taxable income for year ended 31/12/07**

	Kshs.	Kshs	Kshs
Reported accounting Net Profits			6,306
Add back disallowable expenses – preparing M.O.A		150	
- Fees for land purchase		60	
- Bank loans		20	
Bad debts – Loan to director		200	
- General bad debts		120	
Advertising – Neon sign		100	
Travelling expenses private = 20% x 180		36	
Goodwill amortisation		25	
Donations to trade association		40	
Cost of goods withdrawn		600	
Depreciation		150	1,501
Less allowable/deductible items			
Capital allowances	200		
Sales to directors	720		
	400		
Overstated closing stock = $2400 - \frac{2400}{1.20}$			
Gain on sale of equipments	120		
Interest on savings account	40		
Refund of import duty	80		(1,569)
			6,238

- Assumed foreign exchange gain realised hence taxable
- Golden handshake is for services rendered in the past, present or could have rendered in future hence allowable



ii) Tax payable – $6,238,000 \times 30\% = \underline{1,871,100}$

QUESTION TWO

(a) Christine Atieno and Rose Njeri Partnership

Taxable profit (loss)

For the year ended 31.12.2007

	Kshs.	Kshs
Income		
Professional fees		8,200,000
Allowable deductions/expenses		
Business mileage allowance Atieno		
Njeri	360,000	
Mobile airtime official Atieno	300,000	
Njeri	36,000	
Staff	36,000	
Office tea and snacks	24,000	
Advertisement commission	60,000	
Salaries to staff	200,000	
Contribution to staff retirement benefit plan	436,000	
Contribution to medical scheme staff	120,000	
Red cross society of Kenya	150,000	
Tax consultancy fees	60,000	
Subscriptions to law society of Kenya	35,000	
Training fee staff	40,000	
Motor vehicle insurance	80,000	
Office expenses	30,000	
Capital allowance (Note 1)	100,000	
Class II	51,600	
III	625,000	
IV	44,000	
Taxable profit		<u>5,412,400</u>
		<u>(2,787,600)</u>

Note 1: Wear and Tear Allowance Schedule

	Class I (37.5%)	Class II (30%)	Class III (25%)	Class IV (12.5%)
WDV b/f				
Additions				
Motor vehicle			2,500,000	
Furniture and fittings				280,000
Computer and printers		120,000		
Telephone and fax		40,000		
Reference books				16,000
Kitchen utensils				3,000
Television set		12,000		
Fans				6,000
Carpets				22,000
Safe				<u>25,000</u>
	-	172,000	2,500,000	352,000
WTA		<u>(51,600)</u>	<u>(625,000)</u>	<u>(44,000)</u>
WDV c/f		120,400	1,875,000	<u>308,000</u>

Allocation/ division of the partnership profit/loss to partners

	ATIENO Kshs	ROSE Kshs	TOTAL Kshs
Partner's salaries	600,000	400,000	1,000,000
Contribution to pension fund	108,000	72,000	180,000
Contribution to medical scheme	168,000	112,000	280,000
Premium on insurance policies	84,000	126,000	210,000
Golf club membership	30,000	20,000	50,000
Interest on capital	100,000	150,000	250,000
Training; partner's children's fees	56,000	84,000	140,000
Share of Profit (3:2)	<u>2,430,240</u>	<u>1,620,160</u>	<u>4,050,400</u>
	<u>3,576,240</u>	<u>2,584,160</u>	<u>6,160,400</u>



(c)

**Computation of tax payable by each partner
For the year ended 31 December 2007**

			ATIENO	ROSE
			Kshs	Kshs
Taxable profit			3,576,240	2,584,160
Less: pension contribution			<u>(108,000)</u>	<u>(72,000)</u>
			3,468,240	2,512,160
Tax thereon				
121,968	121,968	10%	12,197	12,197
236,880	114,912	15%	17,237	17,237
351,792	114,912	20%	22,982	22,982
466,704	114,912	25%	28,728	28,728
Excess over		30%	<u>900,461</u>	<u>613,637</u>
Gross Tax Liability			981,605	694,781
Less	Personal Relief		<u>(13,944)</u>	<u>(13,944)</u>
	Insurance relief		<u>(18,900)</u>	<u>(12,600)</u>
Net Tax Liability			<u>948,761</u>	<u>668,237</u>

QUESTION THREE

Starlit Company Ltd.

2005 Computation of Investment deduction

part a (i)

Investment Deduction Allowance

Item	Qualifying cost	Workings	ID @70%	Residue
IB	17,988,166	W1a	12,591,716	5,396,449.70
Processing machinery	26,000,000	W1b	18,200,000	7,800,000.00
			<u>30,791,716</u>	<u>13,196,449.70</u>

ID for 2003=Kshs 43,988,165.65

Working 1a

To determine the cost of IB as at 1 Jan 2003

	Item	Cost	IBD @2.5%	WDV
2003	Industrial Building	17,988,166	449,704	17,538,462
2004	Industrial Building	17,538,462	438,462	17,100,000
			<u>888,166</u>	

Working 1b

Wear and Tear allowance

		Cost	Class 4 @12.5%	WDV
2003	Processing machinery	26,000,000	3,250,000	22,750,000
2004		22,750,000	2,843,750	19,906,250

Part a(ii)

6,093,750



(b) 2005 Computation of adjusted profit (loss)

Starlit Company Limited
Computation of Adjusted Taxable profit/loss
For 2005 year of income

	Kshs'000	Kshs'000
Net profit before tax per the accounts		4,500
Add		
Add back disallowable expenses		
Depreciation	7500	
Conveyance fees on purchase of land	2,000	
Understated sales $(100/90 \times 2100) - 21000$	233	9,733
		<u>14,233</u>
Less		
Capital allowances	Notes	<u>(2,696)</u>
Adjusted Taxable Profit		<u>11,537</u>

Notes

- Flotation costs and stamp duty costs on issue of debentures is allowable by virtue of Section 15(s) as expenditure incurred in relation to issue of shares to the general public.
- Foreign exchange losses have been assumed to be realised. Further the company is not thinly capitalised and as such, the exchange losses will not be deferred as per Section 4A of the Income Tax Act.
- The sales to the parent company at 10% below the normal selling price has a transfer pricing exposure. The sales figure has been adjusted accordingly

NB: (3) Wear and tear allowances

Wear and Tear Allowance schedule

2003	Class 1	Class 2	Class 3	Class 4	Total
	37.50%	30%	25%	12.50%	
Computers		900,000			900,000
Processing machinery				7,800,000	7,800,000
Office partitions				400,000	400,000
Lorries	4,500,000				4,500,000
Delivery Van			3,600,000		3,600,000
Pick ups			2,500,000		2,500,000
Furniture & fittings				600,000	600,000
Office equipment				800,000	800,000
WDV as at 1.1.2003	4,500,000	900,000	6,100,000	9,600,000	21,100,000
WTA	(1,687,500)	(270,000)	(1,525,000)	(1,200,000)	(4,682,500)
WDV as at 1.1.2004	2,812,500	630,000	4,575,000	8,400,000	16,417,500
WTA	(1,054,688)	(189,000)	(1,143,750)	(1,050,000)	(3,437,438)
WDV as at 1.1.2005	1,757,813	441,000	3,431,250	7,350,000	12,980,063
WTA	(659,180)	(132,300)	(857,813)	(918,750)	(2,568,042)
					0
WDV as at 31 Dec 2005	1,098,633	308,700	2,573,438	6,431,250	10,412,020

Wear and Tear allowance- **Kshs 2,568,042**

QUESTION FOUR

a. Provisions of the Income Tax Act (cap 470) relating to shortfall tax on non-distribution of dividends

Where the commissioner is of the opinion that a company has not distributed to its shareholders as dividends within a reasonable period, not exceeding twelve months, after the end of its accounting period that part of its income for that period which could be so distributed without prejudice to the requirements of the company's business, he may direct that, that part of the income of the company shall be treated for the purposes of this Act as having been distributed as a dividend to the shareholders in accordance with their respective interests and shall be deemed to have been paid on a date twelve months after the end of that accounting period – Section 24(1).



For example if the adjusted income for tax for Jitahidi Company Ltd for year of income 2005 was Kshs.20 million and dividend declared was Kshs.2 million then the shortfall distribution would be arrived at as follows:

JITAHIDI COMPANY LTD

DIVIDEND DISTRIBUTION SHORTFALL

	Kshs '000
Adjusted income for tax	20,000
Corporation tax @ 30%	(6,000)
Profit after tax	14,000
Allowable retention @ 60%	(8,400)
Distributable as dividend	5,600
Less actual distribution	(2,000)
Shortfall distribution of dividends	3,600

The commissioner can direct Jitahidi Company Ltd to distribute the Kshs 3.6 million dividend shortfall to the shareholders and deduct withholding tax thereof accordingly.

Note that a company is allowed to retain 60% of its after tax profits and to distribute 40% as dividend from which the commissioner receives a withholding tax. Note also that a company may be allowed to retain more than 60% of after tax profits where it proves the following:-

Company's liquidity position is poor;

Company has entered into heavy capital and development commitments requiring payments of huge sums;

That the directors do not owe any monies to the company; and

That the shareholders have paid up their Share Capital

b.

SHORTFALL CALCULATION

Types of income	Operating income Kshs.	Investment inc. Kshs.	Rental income Kshs.	Total Kshs.
NET INCOME	12,000,000	550,000	1,600,000	14,250,000
Less corporation tax @ 30%	<u>(3,600,000)</u>	<u>(195,000)</u>	<u>(480,000)</u>	<u>(4,275,000)</u>
Income after tax	8,400,000	355,000	1,120,000	9,975,000
Less allowable retention 60%	<u>(5,040,000)</u>	-		5,040,000
	3,360,000	355,000	1,120,000	4,835,000
Less dividend distributed				(1,300,000)
SHORTFALL				3,535,000

QUESTION FIVE

a. "Compensating tax" as per section 7A of the Income Tax Act is an additional tax imposed on companies arising where tax paid plus tax on dividends received is less than tax on dividends paid and tax refunds by the company. Tax paid excludes withholding tax on qualifying dividends but includes compensating tax paid.

b.

ABC LTD

COMPENSATING TAX PAYABLE FOR YEAR TO 31 DECEMBER 2007

DIVIDEND TAX ACCOUNT

	Kshs '000		Kshs '000
Import duty refunds	400	Dividend received (.3/.7 x 3,000)	1,285.714
Dividend paid (.3/.7 x 8,800)	3,771.429	Tax paid	NIL
	-	Compensating tax	2,885.715
	4,171.429		4,171.429

Note

Tax for year 2007 has not yet been paid by year end. Neither is there a tax payment relating to year 2006 tax liability.

c) Four areas which may constitute a customs area are:

- Airport
- Seaport
- Customs bonded warehouse
- Internal Inland Container depot etc



d)

D. MKASANA

TOTAL TAXABLE INCOME FOR THE YEAR TO 31 DECEMBER 2006

				Tax at source
		Kshs '000'		Kshs '000'
<u>Employment</u>				
Basic pay (250,000 x 12)		3,000	(50,000 x 12)	600
Medical bill (Director other than whole time service)		1,300		
Share issue (80 – 50) 1,000		30		
Free lunch & tea		96		
Rental income:	Kshs '000			
Net rental income reported	724			
Add back:				
Purchase of furniture & fittings	100			
Painting before letting	96			
	920			
Less WTA on furniture (12½% x 100)	(12.5)	907.5		
Business income:	Kshs '000			
Sales	8,000			
Less: Pesticides	(180)			
Forex losses	(64)			
Other farm expenses	(1,200)			
Farmworks (240 x 33 1/3%) (sheds)	(80)	6,476		
		11,809.5		

Notes

Structural alterations to premises has been allowed since no rent increase resulted therefrom.

Deposit for water connection is part of overall water expenses hence allowable.

Legal fees on collection of rent in arrears is normal revenue expense in a continuous process of rent collection hence allowable.

CHAPTER TWO**QUESTION ONE - LEASE HIRE ARRANGEMENTS**

A lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership. All other leases are classified as operating leases. Classification is made at the inception of the lease.

Any income derived from leasing activities is taxable at the corporate tax rate for companies while individuals are taxed at the graduated scale rates.

Corporation tax on lease hire arrangements

Whereas the leasing rules have defined the operating and finance leases, there is no distinction between the two categories of leasing for corporate tax purposes. However, this distinction exists for Value Added Tax (VAT) purposes.

Lease rentals are allowable expenses for corporate tax purposes. if the Commissioner is satisfied that:

- a. The sole consideration for the payment is the use of or the right to use the asset; and
- b. The entire payment is income in the hands of the recipient.

However, lease-hire payments in respect of a non-commercial vehicle are not deductible

Related costs such as maintenance are allowable expenses for tax purposes.

The lessee is entitled to claim VAT on expenses incurred on the leased asset.

The lessor enjoys wear and tear allowance deductions as long as the equipment was utilized wholly and exclusively for generation of taxable income

The lessor enjoys investment allowance and which is deducted from his profits in the same tax year in which the investment is made. The deduction is made at a rate of 100% of the cost of investing in machinery and buildings provided these are used for the purpose of manufacturing.

Withholding tax of lease hire arrangements

The lessee should withhold tax at a rate of 3% on any payment made to the lessor in relation to payment of lease rentals. In case the lessor is a non-resident, tax is withheld at a rate of 15%.

Effective 1 July 2003, lease rental payment in relation to aircrafts is exempted from withholding taxes



Taxation of lease rentals

Finance Lease: Eventual ownership of the leased asset passes to lessee upon payment of 75% of cost.

Operating Lease: Ownership remains with lessor throughout the entire lease agreement.

Leasing is included in the definition of **supply** as “**The letting of taxable goods on hire, leasing or other transfers**”, which supply is taxable. It is worth noting that it is only leasing of taxable goods.

Leasing is considered as a service, and lease instalments, being payments for this service, are subject to VAT. If equipment that is the subject of a lease is either exempted from VAT or attracts zero VAT, then the lease payments are similarly exempted from VAT.

Leasing of land, residential buildings, and non-residential buildings are exempted from VAT. This exemption does not apply with respect to car park services, conference or exhibition services.

QUESTION TWO

- (a) (i) Taxation of petroleum companies and their sub-contractors. (Ninth Schedule Income Tax Act)
- Favourable rates of tax on management or professional fees and interest paid to non-residents by such companies.
 - Generous terms with regard to allowable deductions for tax purposes.
 - Non-resident contractors will be deemed to have made a taxable profit of 15% of the sum paid to them by a petroleum company (exclusive of certain defined expenses, and the tax on this is deducted when payment is made.
 - The firms are taxed at 30% corporate tax rate.
- (ii) Enterprises situated in export processing zones (EPZs)
- For the first 10 years, from the date of commencement of business:
 - (a) Payments to the EPZ will be subject to withholding tax at non-resident rate
 - (b) Payment by the EPZ to non-resident persons will be exempt from tax
 - (c) The EPZ will be exempt from corporate tax.
 - For the period of 10 years commencing immediately after its initial 10-year commencing immediately after its initial 10-year period the EPZ will be subject to corporation tax at the rate of 25%.
 - Thereafter 20 year, CT is 30%.
 - Employees and directors of EPZ if resident are liable to tax and deduction of PAYE in the normal way.
 - Exports are zero rated for V.A.T purposes.
 - Investment allowance is granted at 100% on cost of qualifying building and machinery and is claimed on the 11th year after commencement.

QUESTION THREE

a) LINDA INSURANCE COMPANY LTD

i) TAXABLE INCOME OR LOSS FOR YEAR OF INCOME 2006

Nature of business:	General		Life	
	Kshs '000	Kshs '000	Kshs '000	Kshs '000 Kshs '000
Premiums received		15,450		
Commission and management fees		-		13,600
Premiums returned and interest charged on returns		(770)		(-)
Net premiums received		14,680		13,600
Add: Re-insurance Commission		1,360		3,450
Income from subrogation rights		1,250		1,800
Recoveries from re-insurance		150		180
Income from insurance business		17,440		19,030
Less allowable expenses:				
Premiums paid to re-insurance	4,680		12,000	
Agency expenses	1,350		1,960	
Management expense (1,934 – 456)	1,478		2,456	
Travel	1,800		2,400	
Advertising	364		820	
General expenses (8,490 – 2,060)	6,430	(4,640 – 1,580)		
		3,060		
Bad debts (Specific)	368		240	
Interest paid out of				
Annuity paid on surrender of policies	-		23,670	
Wear & Tear allowances	397.5		323.5	
		GENERAL		LIFE
Claims paid	7,600		6,900	
Less outstanding at beginning	(5,640)		(3,460)	
Add outstanding at end	6,200		2,880	
Reserves at year end	1,760		5,370	
Less at beginning	(3,240)	(23,547.5)	(4,340)	(54,279.5)
Profit for insurance business		(6,107.5)		51,650.5
Rent income (13,780 – 3,780)		10,000		(16,400 - 5,200) 11,200
		3,892.5		62,850.5
	Kshs '000			
Total income for the year (3,892.5 + 62,850.5)	66,743			

ii) Tax payable @ 30% = (66,743,000 x .3) = Kshs. 20,022,900



QUESTION FOUR

Taxation of charitable trusts

Income of a charitable trust is exempted from tax if:

- It is public in character
- It is established for relief of distress or poverty to the public.
- It is established to advance religion or education.
- Its total income is used or spent on charitable purposes.

If a charitable trust runs a business then profits thereof are not taxed if proceeds are used for purposes 2 and 3 above.

Taxation of amateur sporting associations

The income other than income from investment of an amateur sporting association is not taxable.

The conditions for the associations income to be exempted from tax include:

- Its sole or main objective is to foster or control outdoor sporting activities;
- Its members consist of amateurs and non professionals;
- Its memorandum of association and articles state that should any member turn professional he shall be discontinued from membership.

(3 marks)

QUESTION FIVE

(a) (i) **Ukulima Sacco**

Taxable Income for the year 2007

	Sh.
Rental Income (100% of 2,252,500)	2,252,500
Dividend Income (50% of 424,000)	212,000
Interest Income (50% of 747,300)	<u>373,650</u>
Taxable income	<u>2,838,150</u>

Tax payable

30% of 2,838,150 = Sh. 851,445

(ii) Information not used

Interest from loans to members – This is not taxable

Expenses – These are ignored since income is assessed gross.

(b) Basic principles of taxing co-operatives

- Taxed on incomes from independent activities e.g rent
- The basic notion underlying the new code of taxation is that a co-operative society is a body corporate having its own existence, separate from that of its members. A

co-operative society is, therefore, deemed to have its own income, regardless of the consideration that some of that income may be derived from transactions with its own members. The current law sanctions the deduction from the income of the co-operative society appropriations to profit made by it from its members. (only 50% of interest is taxed)

- Corporate rate = 30%
- Tax on gross investment income
- A different basis of taxation has been laid down for credit and savings societies. These societies will be liable to tax generally on only their gross investment income that is on interest and dividends derived from normal investment of surpluses.
- Expenses not from incomes deducted.

Interest income deducted from members loans not taxable.



■ CHAPTER THREE

QUESTION ONE

(a)

Saambaya & Associates
Certified Public Accountants
P.O. Box X2222
Nairobi

December 5th, 2007

Client
P O Box 59857
Nairobi

Dear Sir,

Re: Back Duty Investigation

The following write-up is in response to queries raised by you with respect to the above subject matter.

- (i) The obligation to declare all incomes for tax purposes rests with the person liable to pay tax (taxpayer) whether or not he has been specifically told to do so by the Income Tax Department. Yours is a case of under declaration of income for a number of years and the following information may have been received by the assessor regarding your affairs:
Reference was made to your PIN (personal Identification Number) records and this may have revealed discontinued disclosure of incomes from certain sources;
You may have consistently done business promotions through the public media regarding a business line but have consistently not declared any income from such source;
You did register a business at the Registrar General's office but have not made return of such income.
You may have been in receipt of farming income from a farming organization and such information has landed in the assessors hands through informers.
- (ii) The Income Tax department may take into consideration the following circumstances of your case in accepting a payment of less than the full amount due:
The assistance (co-operation) you give to the revenue officials in arriving at the income under-declared;
The degree of deliberation in carrying out the fraud or omission/motive for false declarations.
Whether or not payment of additional tax arrived at in the back duty investigation will cripple your business financial position.
Defaulters circumstances during period of omissions such as age and health and whether or not a voluntary declaration had been made by the tax payer.

Yours faithfully,

Michael Odutu
Partner

(b) Sophia (client)

(i) Capital Statements

Year of income	2004	2005	2006	2007
	Kshs '000'	Kshs '000'	Kshs '000'	Kshs '000'
Net assets:		16.3	33.02	44.585
Beginning	5.5	33.02	44.585	57.272
End year	16.3	16.72	11.565	12.687
	10.8	5.2	6.24	9.8
Add: Personal drawings	3.14	0.12	0.525	2.42
	0.105	2.00	12	-
Tax & National Insurance	—	(7)	(7)	(7)
Cash gifts	7.555	17.04	23.33	17.907
Deduct: Legacy				

(ii) Factors the assessor will take into account in negotiating penalties and interest charges

- Gross or willful negligence on the part of the tax payer or his accountant;
- Fraud on part of taxpayer
- Number of years involved (year of non/under declaration)
- Level of co-operation from the taxpayer under investigation
- Whether or not a quasi voluntary declaration was made by the taxpayer.
- Motive of non-declaration of income
- Whether such payment of additional tax plus penalties and interest charges will affect adversely the taxpayers financial position.

**QUESTION TWO**

b) i)

Mr. DICKSON MAELFU**TAXABLE INCOME FOR EACH OF THE FOUR YEARS TO 31 DECEMBER****2004, 2005, 2006 AND 2007**

YEAR	2004	2005	2006	2007
	Kshs	Kshs	Kshs	Kshs '000
	'000'	'000	'000	
ASSETS				
Factory building	48,000	48,000	52,000	54,000
Plant & Machinery	28,000	36,000	36,000	38,000
Commercial Vehicles	12,000	12,000	15,000	18,000
Stock in trade	4,200	8,000	9,000	7,000
Trade debtors	3,540	2,640	2,530	2,980
Private residence	13,600	13,600	13,600	13,600
Bank balance	5,400	3,600	<u>3,760</u>	<u>4,670</u>
Total Assets	114,740	123,840	131,890	138,250
LIABILITIES				
Trade Creditors	8,640	9,420	8,360	7,890
Bank loan	10,000	9,870	7,640	9,840
Loan from Uncle	700	600	870	640
Mortgage loan	3,780	3,780	3,780	3,780
	<u>(23,120)</u>	<u>(23,670)</u>	<u>(20,650)</u>	<u>(22,150)</u>
Net worth	91,620	100,170	111,240	116,100
Less: Net Assets at beginning of Year	<u>(65,440)</u>	<u>(96,720)</u>	<u>(106,950)</u>	<u>(117,070)</u>
Increase in Networth	26,180	3,450	4,290	(970)
Increase in Networth b/d	26,180	3,450	4,290	(970)
Adjustments				
Inheritance from relative	-	(400)	-	-
Living expenses	70	120	90	150
Interest on mortgages	<u>(150)</u>	<u>(150)</u>	<u>(150)</u>	<u>(150)</u>
Estimate taxable income	26,100	3,020	4,230	<u>(970)</u>

iii) Four areas for further clarification from Mr. Maelfu

Bank loan – The purpose for the bank loan whether for business or private purposes and what is the interest rate to determine its allowability.

Loan from uncle – Was the loan used in business or private purposes and what is the interest rate if any. This would determine whether it is a business loan and deductibility of the interest thereof.

Fixed Assets - Whether or not any capital allowances had been claimed and the written down valuers for the respective capital alloances tables.

Other sources of income - Whether or not he was in receipt of any other incomes such as dividends, interest, rent, consultancy fees and others which should be included in taxable income.

QUESTION THREE

(a) Alternative 1

	Sh.	Sh.
Net Loss as per accounts		(1,879,500)
Add: understated sales		2,000,000
Overstated cost of sales		1,000,000
Overstated printing and stationery		10,000
Net discount as per accounts		<u>10,000</u>
		1,140,500
		<u>20,000</u>
Less: office rent understated		1,120,500
Add: correct discount net		<u>26,200</u>
Adjusted accounting profit		1,146,700
Add back: depreciation	30,000	
Provision for bad debts	175,000	
Interest on capital	<u>265,000</u>	<u>470,000</u>
		1,616,700
Less: tax allowances	32,000	
Specific Bad debts provision	<u>215,000</u>	<u>(247,000)</u>
		<u>1,369,700</u>

From the workings:

- i. Sales are understated by Sh.2,000,000
- ii. Cost of goods sold are overstated by Sh.1,000,000
- iii. Office rent is understated by Sh.20,000
- iv. Printing and stationery is overstated by Sh.10,000
- v. Net discounts should be credit of Sh.26,200 (income)
- vi. Opening capital is overstated by Sh.1,000,000

**Alternative 2**

	Sh.	Sh.
Gross profit (see workings)		3,510,000
Less: Allowable expenses		
Salaries	1,200,000	
Office rent	240,000	
Advertising	97,500	
General expenses	60,000	
Motor upkeep	137,500	
Printing & Stationery	84,500	
Travelling expenses	100,000	
Bad debts (specific)	215,000	
Wear and Tear	32,000	
Allowance		(2,069,000)
		1,441,000
Add: Discount net		26,200
Taxable income		1,467,200

Workings:**DEBTORS ACCOUNT**

Balance b/d (**)	4,700,000	Cash	13,500,000
Credit Sales	12,440,000	Discount	140,000
	<u> </u>	Balance c/d	<u>3,500,000</u>
	<u>17,140,000</u>		<u>17,140,000</u>

CREDITORS ACCOUNT

Cash	11,200,000	Balance b/d	2,340,000
Discount	120,000	Purchases (**)	10,830,000
Balance c/d	<u>1,850,000</u>		<u> </u>
	<u>13,170,000</u>		<u>13,170,000</u>

Sales:

	Sh.
Opening stock	2,200,000
Purchases	<u>10,830,000</u>
	13,030,000
Closing stock	<u>(2,500,000)</u>
Cost of goods sold	10,530,000
Add: $33\frac{1}{3}\%$ mark-up	<u>3,510,000</u>
Total sales	14,040,000

(**) – Balancing figures

Tax consequences on incorrect returns of income:

(b) In the case of the tax payers:

Additional tax of an amount twice the tax conceded, plus a maximum of Kshs.200,000 fine and or up to 2 years imprisonment.

QUESTION FOUR

(a) When sales are predominantly to businesses registered for VAT. This will enable the trader claim VAT paid on purchases.

- When sales are zero-rated items and the trader wishes to reclaim input VAT (exports)
- When the trader wishes to conceal the small size of business from customers.

(b) Refund

VAT refund is properly due under the following circumstances:

- Where input tax exceeds output tax continually and it is a regular feature of the business
- Where goods are imported and then re-exported without being used in Kenya. VAT on import is refundable.
- Where newly registered persons have goods in stock which are intended for use in the manufacture of taxable supplies.
- Refund for credit sales which became bad debt as long as 3 years have lapsed and supplier have taken all necessary legal actions in an attempt to recover the bad debt.
- Where tax has been paid in error.
- Where the registered person has incurred major capital costs in construction of building to manufacture taxable supplies.
- Where taxable goods have been imported into Kenya and tax has been paid in respect of those goods and before being used, the goods are exported under customs control
- Where in the opinion of the Minister, a refund is due in the public interest.



(c) Procedure

Fill in VAT 4 (Refund Claim Form)

If claim is for an amount of Ksh. 1M and above attach audit certificate

Lodge the claim with the VAT department

Trader must have filled a VAT 3 (return form) which must correspond to VAT 4.

(d) VAT Audit Refund Certificate

Kasuku Rolling Mills Ltd (KRM)

VAT Refund Audit Certificate for January 2007.

We have examined the attached claim for refund of VAT amounting to Ksh (...) made by KRM Ltd. for the period from 1st January 2007 to 31st January 2007 to ensure compliance with the VAT Act and regulations, and have obtained all the information and explanations necessary for the purposes of our examination.

Our examination was designed to enable us to obtain reasonable assurance that the claim is free from material misstatement, and included verification, on a test basis, of evidence supporting the amount claimed. It also included an assessment of the adequacy of KRM's system of recording and accounting for VAT.

In our opinion the attached VAT claim gives a true and fair view of the amount claimed and is properly refundable under the VAT Act and regulations.

c) Implications of the error

- Input VAT was understated
- The company did not avail the invoices in respect to some of the purchases made.
- The company's record keeping may not be accurate.
- The company would be losing a lot of cash flows

Input tax can still be claimed in a subsequent month as long as its not more **that 12 months old**. If it's more than 12 months old, you apply to the Commissioner to be able to claim the same.

QUESTION FIVE

(a)

- i. Non-remittance of PAYE which has been deducted.
- ii. Fluctuating and late payment of PAYE by the employer.
- iii. Irregularities detected through examination of PAYE end year returns.
- iv. Employers whose final accounts submitted to the department are suspect i.e. they arouse suspicion.
- v. When director's fees and bonuses are claimed in the accounts with no corresponding PAYE remittances.
- vi. When proper books of accounts are not kept by the organisation. (8 marks)

(b) Circumstances that trigger off PAYE Audit

- Salaries and wages figure per the audited accounts is higher or lower than the amounts reflected in the PAYE returns.
- PAYE is usually not paid on time
- Material fluctuations over the months on PAYE payments
- Third party information or complaints
- Non-compliance noted/detected during a normal tax examination be it VAT or Corporate tax examination.
- Of late KRA is offering rewards to anybody who divulges information that leads to a tax recovery by authorised persons only.
- Newspaper reports
- Court cases
- Construction sites sign boards – This affects mainly contractors and professionals in the construction industry.
- Information emanating from related companies audited
- Cessation of business on a large part of a business
- Higher salaries awarded to middle level managers compared to those awarded to their seniors.

■ CHAPTER FOUR**QUESTION ONE**

This is a reciprocated economic and tax “favour” granted to a member country if a trading or economic bloc first as the receiving member has granted other members of the bloc. It generally involves agreement on tax/tariff concessions on particular goods. The benefits are

- It enhances international trade among member countries due to lower tariffs on imports and exports.
- Facilitates comparative advantage as countries specialise in production of what they produce at lowest cost
- Promotes free trade as member countries remove any restrictions on trade barriers on imports/exports of member countries.
- It accords equal commercial opportunities on import duties and freedom of investment
- Enable member countries to enjoy trading benefits accorded to third states by member countries

QUESTION TWO

Double taxation relief:

- A relief allowed for income tax in two different counties, one of which must be Kenya.
- The foreign tax will be compared with the increase in the Kenyan tax liability and the lower of the two taxes is allowed as the double taxation relief.
- Time limit for claims is six years.
- The double taxation agreement must be gazetted in the Kenya Gazette.
- Encourage cross boarder investments.

**QUESTION THREE**

a) Taxation of

i) Incapacitated person

- According to Section 46 of Cap 470 (Income Tax Act) the income of incapacitated person shall be assessed on and tax thereon charged on that person in the name of his trustee, guardian, curator, committee or receiver appointed by the court.
- It shall be assessed on such a name in the same manner and to the same amount as that incapacitated person would have been assessed and charged if he were not an incapacitated person.

ii) Non-resident persons (Section 47 of Cap 470)

- The income shall be assessed on and tax thereon charged on that person either in his name or the name of his trustee, guardian, curator or committee or of attorney, factor, agent, receiver or manager.
- For tax purposes a normal agent maybe deemed to be the master of a ship or the captain of an aircraft owned by a non-resident person chargeable to tax shall does not exclude any other agent.
- Non-resident persons are taxed at a specified withholding tax rates.
- Individuals don't enjoy personal relief.

- b) i) Mr. Mbazo was an individual resident in Kenya for tax purposes because he was present in Kenya for a period exceeding 183 days during year of income under consideration although he does not have a permanent home in Kenya

Mr. Mbazo taxable income for year ending 31/12/2007

Basic pay Jan – Sep (200,000 p.m x 9)	1,800,000
Oct – Dec (200 x 1.25 x 3 months)	750,000
	2,550,000
Add other benefits	
	192,500
Rent reimbursed (35,000 p.m. x $\frac{1}{2}$ x 11)	
Air tickets (not an expatriate)	25,000
Entertainment allowance (12,000p.m x 6)	72,000
	20,000
Motor vehicle insurance (80,000 x $\frac{3}{2}$)	
Medical cover/allowance (8,000 p.m x 3)	24,000
Performance bonus	150,000
Net taxable income	3,033,500

Tax liability (using year 2007 rates)

1 st Ksh.121,968	@10%		12,196.8
Next 114,912	@15%		
Next 114,912	@20%	= 114,912 x 60% =	68,947.2
Next <u>114,912</u>	@25%		81,144.0
466,704			
Surplus (3,033,500 – 466,704) @ 30%			770,039
Less personal relief 1162p.m x 12			(13,944.0)
P.A.Y.E. deducted			(200,000.0)
Net tax liability			637,239

QUESTION FOUR

a) Concept of the double taxation treaties

Double taxation treaties are agreements drawn between one country such as Kenya and other states for two main reasons:

- i. To encourage technological transfers and capital transfers in commerce and industry without overburdening investors with taxation in both countries on same income
- ii. To encourage exchanges of technical personnel without overburdening them with taxation in both countries on same income.

In terms of the Kenyan taxation laws, Section 41 of the Income Tax Act authorises for double taxation relief to be granted while Section 42 details on the determination of such relief where there exists, a double taxation treaty entered into by Kenya with another country.

It is worth noting, at this point, that Kenya non-residents are taxed on income derived from Kenya only. Kenya residents, on the other hand may be liable to tax on income derived from outside Kenya in addition to tax on income derived from Kenya. Kenya residents may suffer double taxation as a result.

With a view to reduce the tax burden suffered by Kenya residents relating to tax already paid in other countries, Kenya has signed double taxation treaties, with countries such as Denmark, Italy, Switzerland, Zambia, UK, Sweden, Norway, Malawi, Uganda, Tanzania, Germany, Canada and all COMESA countries.

The tax treaties adhere to the following principles:

- The agreements get the approval of the parliament,
- Are gazetted by the Minister For Finance,
- The foreign tax shall be compared with the increase in the Kenya tax liability and the lower of the two will be allowed as a set off tax,
- Time limit for double taxation relief claim is 6 years.



b)

DANIEL OTWORI**DOUBLE TAXATION RELIEF DUE FOR THE YEAR TO 31 DECEMBER 2006**

Income from UK in Ksh.	=	[140 x (£960 + £4,800)]
	=	140 x 5,760
	=	Ksh.806,400
Tax charged in the UK in Kshs.	=	(£960 x 140)
	=	Ksh.134,000
Total income for year Ksh (806,400 + 1,765,000)	=	Ksh.2,571,400

Kenya Tax charged on total income

	Kshs.
First Kshs = 121,968 @ 10% =	12,196.8
Next Kshs. 114,912 (1% + 20% + 25%) =	68,947.2
Balance Ksh.2,104,696 @ 30% =	631,408.8
Gross tax liability in Kenya on combined income	712,552.8

Tax on Kenya income alone

Income from Kenya Kshs.	<u>1,765,000</u>
Tax thereof:	Kshs
First Kshs.121,968 @ 10% =	12,196.8
Next Kshs.114,912 (15% + 20% + 25%) =	68,947.2
Balance Kshs.1,298,296 @ 30% =	389,488.8
Gross tax on Kenya income alone	470,632.8

Difference between tax on combined income and tax on Kenya income alone

i.e. Kshs. (712,552.8 – 470,632.8) = Kshs.241,920

Double taxation relief shall be the lesser of increase in tax liability due to addition of foreign income and actual tax deducted in the foreign country.

Kshs.241,920 Or Kshs.134,400

That is relief is Kshs.134,400 the tax charged in the UK.

c)

J. Karimi

VAT PAYABLE (OR REFUNDABLE) FOR THE MONTH OF APRIL 2007**VAT ACCOUNT MONTH OF APRIL 2007**

	Kshs '000		Kshs '000
Std rate Purchases (.16 x 19,900)	3184.00	Standard rate sales (.16 x 20,000)	3200.00
Photocopier (.12 x 100)	12.00	Ministry of Health	1280.00
Electricity (.16 x 16)	2.56	Debit notes (.16 x 800)	128.00
Electronic tax register (.16 x 150)	24.00		
Electronic tax register (cost recovery)	150.00		
Legal fees (.16 x 50)	80.00		
Bad debt relief (.16 x 500)	80.00		
Returns in (.16 x 600)	96.00		
VAT payable	<u>979.44</u>		
	<u>4608.00</u>		<u>4608.00</u>

Notes:

1. VAT relating to VAT appeals is not deductible.
2. Purchase of a photocopier is not part of purchases at standard rate, however VAT suffered is deductible.
3. Water is assumed to be for a public source hence no VAT charged.
4. Suppliers to Ministry of Health exempt from VAT.
5. Cost of Electronic tax register is deductible with prior approval from the commissioner, provided that ETR was acquired from the Commissioner, provided that the ETR was acquired and installed before 31.12.06

QUESTION FIVE

(a) Transactions that constitute transfer pricing include:

- Sale of goods to a subsidiary or branch by the head office at a price that is not at arm's length i.e. prices that are not granted on sale of goods to third parties.
- Purchase of goods to another company in which one or more of the directors are also directors in the selling company and the goods are not sold at the open market.
- Inflating cost of goods which are subsequently sold in a low tax location at lower prices so as to reflect lowered profits or nil profits for tax purposes in the country of export.



CHAPTER FIVE

QUESTION ONE

- a) i) Tax planning
- The arrangement of affairs of a taxpayer in such a way as to minimise tax liability at the lowest cost without contradicting any tax laws and regulations. It involves determining in advance the tax effect of any proposed business action and decision.
 - It requires a deep understanding of tax legislations and decided case law of taxation. The aims of tax planning are to:
 - i. Achieve the most advantageous financial position from business transactions measured in terms of direct tax savings and improved cash inflows.
 - ii. Ease tax administration (internally) in terms of methods of accounting for tax, records to be maintained and tax reports to be prepared.
 - iii. Achieve the highest level of compliance with the tax laws.
- ii) The planning areas in business decisions may include
- Lease or buy decisions: do we lease assets and pay lease charges (allowable) or buy assets and enjoy capital allowances?
 - Financing decisions: do we use debt capital (interest charges are allowable) or equity capital (dividends not allowable)?
 - Form of business ownership: do we operate as a partnership, sole proprietorship or a limited company?
 - Trading decisions – do we produce and sell locally or export (exports are zero rated for VAT purposes)?

QUESTION TWO

Corporate Tax Planning

Tax Planning

Defined as the arrangement of affairs of tax in such a way as to minimise tax liability at the lowest cost without contradicting any tax laws and regulations. It involves determining in advance the tax effect of any proposed business action and decision. It requires a deep understanding of existing tax legislation and decided case law of taxation. The aims of tax planning are to:

- Achieve the most advantageous financial position from business transactions measured in terms of direct tax savings and improved cash inflows
- Ease tax administration (intensity) in terms of methods of accounting for tax, records to be maintained and tax reports to be prepared
- Achieve the highest level of compliance with the tax laws

The following are various ways in which corporate entities may engage in tax planning

- i. Lease or buy decisions: Do we lease assets and pay lease charges (allowable) or buy assets and enjoy capital allowances

- ii. Financing decision: Do we use debt capital (interest charges are allowable) or equity (dividends not allowable)
- iii. Trading decisions: Do we produce and sell locally or export (exports are zero rated for VAT purposes)

QUESTION THREE

- a) Tax incentives to newly listed companies:-
 - Flotation costs e.g. Legal expenses are allowable
 - Reduced corporate tax rate of 20% p.a. for the first 5 years if listed any time after 1/1/2006. Any issues at least 40% of shares to the public with effect from 1/1/2003. The rate applies for first five years of listing.
 - A tax amnesty for past tax evasion activities.
 - A reduced corporate tax rate of 27% p.a. for the first 3 years for any company that get listed after 1/1/2002.
- b) Imported goods are deemed to have been dumped in Kenya if:-
 - Goods are sold in Kenya at a price lower than the cost of importing (cost of insurance, freight, duties and cost of goods to the exporter)
 - The export price by the foreign exporter to Kenya is less than the fair market price in the exporting country.
 - If the country exporting goods to Kenya had imported such goods and either
 - i. The export price of the original country less than fair market price in that country
 - ii Export price of the country re-exporting the goods is less than fair market price in that re-exporting country.
- c) i) Tax free (exempt) employment benefits
 - Fringe benefits
 - Benefits in kind not exceeding Kshs. 36,000 p.a (Kshs 3,000p.m)
 - Education fees paid by employer for employee and his dependents if such fees are taxed on the employer.
 - Medical benefits if scheme is non-discriminative.
 - Passages/translocation costs for non-citizen expatriates.
 - Contribution by employer for employees to registered and unregistered pension and provident funds.

QUESTION FOUR

(i) Expense Reimbursement

Reimbursement of personal expenses constitutes a taxable benefit. The assessed benefit will be equivalent to the cost of the employer. Consequently, this scheme does not have any benefits if the reimbursement is for personal expenses. The reimbursement of expenses incurred in the course of carrying out the business of the employer does not constitute a taxable benefit. Here, it is assumed the reimbursement is for the actual cost incurred by the employee. If the amount reimbursed exceeds the cost to the employee, the difference will be subject to tax.



The personal expenses reimbursed will be tax deductible by the employer if the employee has been taxed. Reimbursement of business expenses is tax deductible if the employee has been taxed. Reimbursement of business expenses is tax deductible if the expenditure is incurred wholly and exclusively for the purpose of the business.

(ii) Benefits in kind

Benefits in kind are taxable, unless the aggregate value does not exceed Kshs.36,000 p.a (Kshs. 3,000 pm). This amount is not significant enough to be included in an “Executive Remuneration Package”. Other benefits not subject to tax include:

- Medical services to full time employees;
- Employer’s contribution to a pension or provident fund (whether registered or not);
- Education fees of an employee’s dependents, where treated as a non-deductible expense by the employer;
- Passages between Kenya and any place outside Kenya for expatriates.

(iii) Pension Entitlement

Contributions by an employer to a pension or provident fund, whether registered or not are not taxable on the employees. However, the employer is not allowed to deduct contributions to non-registered schemes. The employees can benefit from these schemes but may not be tax efficient because the employer will be taxed on the contributions.

The employer is tax exempt (e.g. NGO), contributions to unregistered schemes are fully taxable on the employees.

(iv) Bonus Schemes

Bonuses constitute cash payments to employees. All cash payments received as a gain or profit from employment are taxable in full. This item will not be tax effective to be included in a remuneration package.

(v) Share Purchase Arrangements

- (a) 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 the shares are given free, the taxable benefit is based on the prevailing market price per share (MPS). Where the shares are issued at price lower than the market price per share, the taxable benefit shall be (MPS – issue price) number of shares issued.

Where the difference between MPS and issue price is 5% or less of the MPS, the benefit is not taxable. Example.

Assume	1	2
MPS	Sh.100	Sh.100
Issue price to employee	Sh. 96	Sh. 91
Different/discount	Sh. 4	Sh. 91
% of MPS	$\frac{4}{100} \times 100 = 4\%$	$\frac{9}{100} \times 100 = 9\%$

Where the shares are redeemable, the taxable benefit shall be the higher of the difference between:

- Issue price and nominal value; or
- Issue price and redemption value.

QUESTION FIVE

- i) Characteristics of transactions that constitute transfer pricing
- Fixing of prices based on non-market criteria resulting in saving company tax;
 - Apportioning taxable income among various jurisdictions in a way to transfer a larger portion of overall income to low tax jurisdictions
 - Selling of goods from a division in one country to another division in yet another country;
 - Absence of the arms length relationship.
- ii) Four methods of determining appropriate transfer price provided in the Organisation for Economic Co-operation and Development (OECD) model
- a) Uncontrolled price method
This method compares the price at which a controlled transaction is conducted to the price at which a comparable uncontrolled transaction is conducted.
 - b) Cost plus method
Is a method generally used for the trade of finished goods, and is determined by adding an appropriate mark-up to the costs incurred by the selling party in manufacturing/purchasing the goods or services provided, with the appropriate mark-up being based on the profits of other companies comparable to the tested party.
 - c) Resale price method
Is similar to the cost plus method but is arrived at by working backwards from transactions taking place at the next stage working backwards from transactions taking place at the next stage in the supply chain and is determined by subtracting an appropriate gross. Mark-up from the sale price to an unrelated, third party with the appropriate gross margin being determined by examining the conditions under which the goods or services are sold and comparing the transaction to other, third party transactions.
 - d) Profit split method
Is a method applied when businesses involved in the transaction are too integrated to allow for separate evaluation and so the ultimate profit derived from the endeavour is split based on the level of contribution of each of the participants in the project.

**CHAPTER SIX****QUESTION ONE****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: 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**Sufficient revenue**

A government implementing a multiple tax system is able to collect sufficient revenue due to a wide tax base

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

Minimise 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

QUESTIONS TWO

- i. Most workers in developing countries are typically employed in agriculture or in small, informal enterprises. As they are seldom paid a regular, fixed wage, their earnings fluctuate, and many are paid in cash, "off the books." The base for an income tax is therefore hard to calculate. Nor do workers in these countries typically spend their earnings in large stores that keep accurate records of sales and inventories. As a result, modern means of raising revenue, such as income taxes and consumer taxes, play a diminished role in these economies, and the possibility that the government will achieve high tax levels is virtually excluded.
- ii. It is difficult to create an efficient tax administration without a well-educated and well-trained staff, when money is lacking to pay good wages to tax officials and to computerize the operation (or even to provide efficient telephone and mail services), and when taxpayers have limited ability to keep accounts. As a result, governments often take the path of least resistance, developing tax systems that allow them to exploit whatever options are available rather than establishing rational, modern, and efficient tax systems.
- iii. Informal structure and financial limitations of the economy in many developing countries hinder the statistical and tax offices from generating reliable statistics. This lack of data prevents policymakers from assessing the potential impact of major changes to the tax system. As a result, marginal changes are often preferred over major structural changes, even when the latter are clearly preferable. This perpetuates inefficient tax structures.
- iv. Income tends to be unevenly distributed within developing countries. Although raising high tax revenues in this situation ideally calls for the rich to be taxed more heavily than the poor, the economic and political power of rich taxpayers often allows them to prevent fiscal reforms that would increase their tax burdens. This explains in part why many developing countries have not fully exploited personal income and property taxes and why their tax systems rarely achieve satisfactory progressivity (in other words, where the rich pay proportionately more taxes).
- v. Developing countries attempting to become fully integrated in the world economy will probably need a higher tax level if they are to pursue a government role closer to that of industrial countries, which, on average, enjoy twice the tax revenue. Developing countries will need to reduce sharply their reliance on foreign trade taxes, without at the same time creating economic disincentives, especially in raising more revenue from personal income tax. To meet these challenges, policymakers in these countries will have to get their policy priorities right and have the political will to implement the necessary reforms. Tax administrations must be strengthened to accompany the needed policy changes.
- vi. As trade barriers come down and capital becomes more mobile, the formulation of sound tax policy poses significant challenges for developing countries. The need to replace foreign trade taxes with domestic taxes will be accompanied by growing concerns about profit diversion by foreign investors, which weak provisions against tax abuse in the tax laws as well as inadequate technical training of tax auditors in many developing countries are currently unable to deter. A concerted effort to eliminate these deficiencies is therefore of the utmost urgency.



- vii. Tax competition is another policy challenge in a world of liberalised capital movement. The effectiveness of tax incentives—in the absence of other necessary fundamentals—is highly questionable. A tax system that is riddled with such incentives will inevitably provide fertile grounds for rent-seeking activities. To allow their emerging markets to take proper root, developing countries would be well advised to refrain from reliance on poorly targeted tax incentives as the main vehicle for investment promotion.
- viii. Finally, personal income taxes have been contributing very little to total tax revenue in many developing countries. Apart from structural, policy, and administrative considerations, the ease with which income received by individuals can be invested abroad significantly contributes to this outcome. Taxing this income is therefore a daunting challenge for developing countries. This has been particularly problematic in several Latin American countries that have largely stopped taxing financial income to encourage financial capital to remain in the country.

QUESTION THREE

TPU's role is to make policies relating to Kenyan taxes specifically issues relating to:

- Harmonisation and rationaliation of Kenya's tax rates.
- Widening or narrowing tax brackets
- Narrowing or widening the tax net as all the above have implications on tax revenue
- Long term tax objectives.

QUESTION FOUR

- (a) (i) Buoyancy
Buoyancy of a tax is the responsiveness of tax revenue to changes in national income and to discretionary changes.
- (ii) Elasticity of a tax is the responsiveness of the tax revenue to changes in national income adjusted for discretionary changes.
Where discretionary changes are the changes in tax rates and rules governing the tax system.
- (b) (i) Historical time series tax data (HTSTD) attempts to eliminate discretionary tax changes to estimate elasticity by using a single equatica model.

$$\text{Log}(T_i) = \text{Log } a + \text{Log } b_i + \log(\square_i) + e_i$$

Where: T = adjusted HTSTD to discretionary tax changes
 \square = tax base (or GDP aggregate level)
 e = disturbance term
 bi = tax elasticity

- (ii) Adjusted HTSTD with time trends or dummy variables as proxies for discretionary tax measures.
 Adjustments could be done using.
 The proportional adjustment method
 The constant rate structure method
 The dummy variable approach

- (c) (i) Value Added Tax (VAT)
This is tax elastic because a slight change in VAT rate leads to a significant fall in revenue. This applies for taxable goods.
However, for zero-rated and exempt goods, VAT is tax inelastic.
- (ii) Income Tax
Income tax is tax inelastic since the amount of tax tends to be proportional to tax rate in case of proportional corporate taxes.
For individual taxes reduction or increase in tax rates does not significantly change tax collectible but works to encourage or discourage tax evasion or tax avoidance.
- (iii) Customs and Excise Duty
Excise taxes tend to be tax inelastic as consumers tend to reorganize their spending in the case of excise tax.
Customs tax however is tax elastic and increase in import tax discourages imports leading to low customs tax collected.

QUESTION FIVE

Employee Taxes (PAYE)- This is tax on the income of an employee. An employer has an obligation to deduct tax on graduated scale rates. 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.

Fringe benefit Tax- 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.

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**.

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.

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. The current VAT rate is 16% and the taxable turnover is Kshs. 5 million.

Compensating tax- Compensating tax was introduced in 1993 under Section 7 A of the Income Tax Act. It is an additional tax imposed on companies and arise 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.



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.

Customs and Excise Tax-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. Excise Duty is the tax imposed on goods manufactured locally and specified on the 5th schedule

Corporation Tax- is tax on a company at the corporation tax rate of 30% for resident companies while 37.5% for non resident companies.

■ CHAPTER SEVEN

QUESTION ONE

It depends on whether there are any relationships between the two that could give rise to a conflict of interest. For example they may be business partners, or one may employ the other. Even so, it may be sufficient to ensure that each is aware that you act for both, provided you keep the position under review.

In other cases the conflict of interest might be such that you should not; for example if they are in the course of a divorce.

QUESTION TWO

This is likely to be a criminal offence and you should report your suspicions to the police.

■ CHAPTER EIGHT

QUESTION ONE

- Tax avoidance measures implemented by tax payers
- Good set targets but bad measures to meet the targets
- Technological limitations- The fact that many of the taxpayers have no access to nor understand technology, hampers the tax authority's attempts to achieve its target.
- Complicated Tax regime- Many tax payable do not understand the tax system. They find the taxes available in Kenya very complicated. This makes them not be able to comply as required.
- Evolving tax avoidance strategies- Some tax payers have adopted well calculated and complicated mechanisms of tax evasion. This has made the revenue authority ensure that they undergo continuous training to be on top of their game.
- Lack of enough assessors (personnel) to ensure compliance- The revenue authority does not have enough personnel to be able to enforce the taxation laws and such

- collect taxes.
- Non-tax paying culture- The payment of some taxes is dependent on the culture of the tax payers. For example, the payment of turnover tax will depend on the integrity of the tax payers to disclose the sales as required by law. If the tax payers do not develop a good tax paying culture, the attempts by the revenue authority to ensure high revenue collection may not succeed.

QUESTION TWO

- Objectives of the Customs Union:
- To raise revenue for the government
- To protect local industries from multinational or foreign based industries by imposing high customs duty to discourage consumption of imports
- Prevention of dumping of goods into the Kenyan market
- Discourage production of harmful goods e.g. beer and cigarettes

QUESTION THREE

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 Harmonised 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
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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.

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.

GLOSSARY





GLOSSARY

Business - Business includes any trade, profession or vocation, and every manufacture, adventure and concern in the nature of trade, but does not include employment.

Deductions Allowed - For expenditure to be deductible it must be wholly and exclusively incurred in the production of income.

Farmer - Farmer means a person who carries on pastoral, agricultural or other similar operations

The setting test - This test distinguishes plant as part of the apparatus with which the trade is carried on from assets forming part of the setting in which a trade is carried on.

The functional test - A structure will be regarded as plant if it fulfills the function of plant in the trader's operations.

Trading receipt and trading loss - Where a business is a going concern and the entire class of assets qualifying for WTA is disposed of at a value greater than the written down value the gains or profits arising therefrom are called trading receipt which is taxable business income; in case of a loss, it's a trading loss

Balancing charge and balancing deduction - In case a firm is being liquidated trading receipt is called balancing charge which is a taxable income while the trading loss is called balancing deduction which is an allowable expense.

Off shore taxation (Tax havens) - Refers to the principle of harmonising Company law, Trust law, Banking and Tax regulations with a view to attract investors. The measures put into place have to be tax effective as compared to those established in the average countries in the world.

Back-duty - Back-duty refers to collection of all kinds of tax in arrears which arise due to Under declaration of income (incomplete and incorrect returns), Non-declaration of income, Taxpayer claims expenses, allowances, reliefs he is not entitled to

Tax evasion - The reduction of tax liabilities by illegal means such as concealing information or supplying false information.

Tax avoidance - The reduction of tax liabilities by legal, although possibly artificial means.

Group Registration - Where a group of companies is owned or substantially controlled by another person it may apply to the Commissioner to be treated as one person.

Zero-rated Supplies - Where a supply is not charged to taxation and the supply will in all other respects be treated as a taxable supply.

Partial Exemption - This arises where only part of the taxable person's supplies are taxable.

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.

Excise Duty - This is the tax imposed on goods manufactured locally and specified on the 5th schedule.

Custom warehouse - This is a place approved in CCE for deposits.

Duty- Defined to include Customs duty, excise duty, levy, cess, imposition, tax, surtax imposed on goods by CCE.

Subsidy - This comes in form of direct or indirect deduction on production or output by way of grants or loans and tax relief relating to the goods themselves or the material used to make goods

Bonded security - A bond is a commitment to honour certain terms and conditions and fulfill 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.

Direct exporters - Manufacturers who import raw materials, manufacture, then export the finished product.

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.



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STUDY X



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