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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 Shs.	Credit Shs.	Balance 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



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	<u>128.00</u>	833.00	
Closing stock		<u>(128.00)</u>	(800.00)
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Farming revenue			360.00
			1,413.00
<u>Allowable expenses:</u>			
Miscellaneous expenses		90.20	
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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



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%



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>

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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.

1. 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.80 per share.
- He enjoys free lunch and tea valued at Sh.8,000 per month.

2. 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	24,000	(1,236,000)
	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.



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 learned 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



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 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.

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 computation fees	140	
	Depreciation	<u>2,000</u>	<u>(18,940)</u>
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.



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.

(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.

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 owned 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.

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),

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**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.

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:



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 2004 Kshs '000'	31 December 2004 Kshs '000'	31 December 2005 Kshs '000'	31 December 2006 Kshs '000'	31 December 2007 Kshs '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:



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:

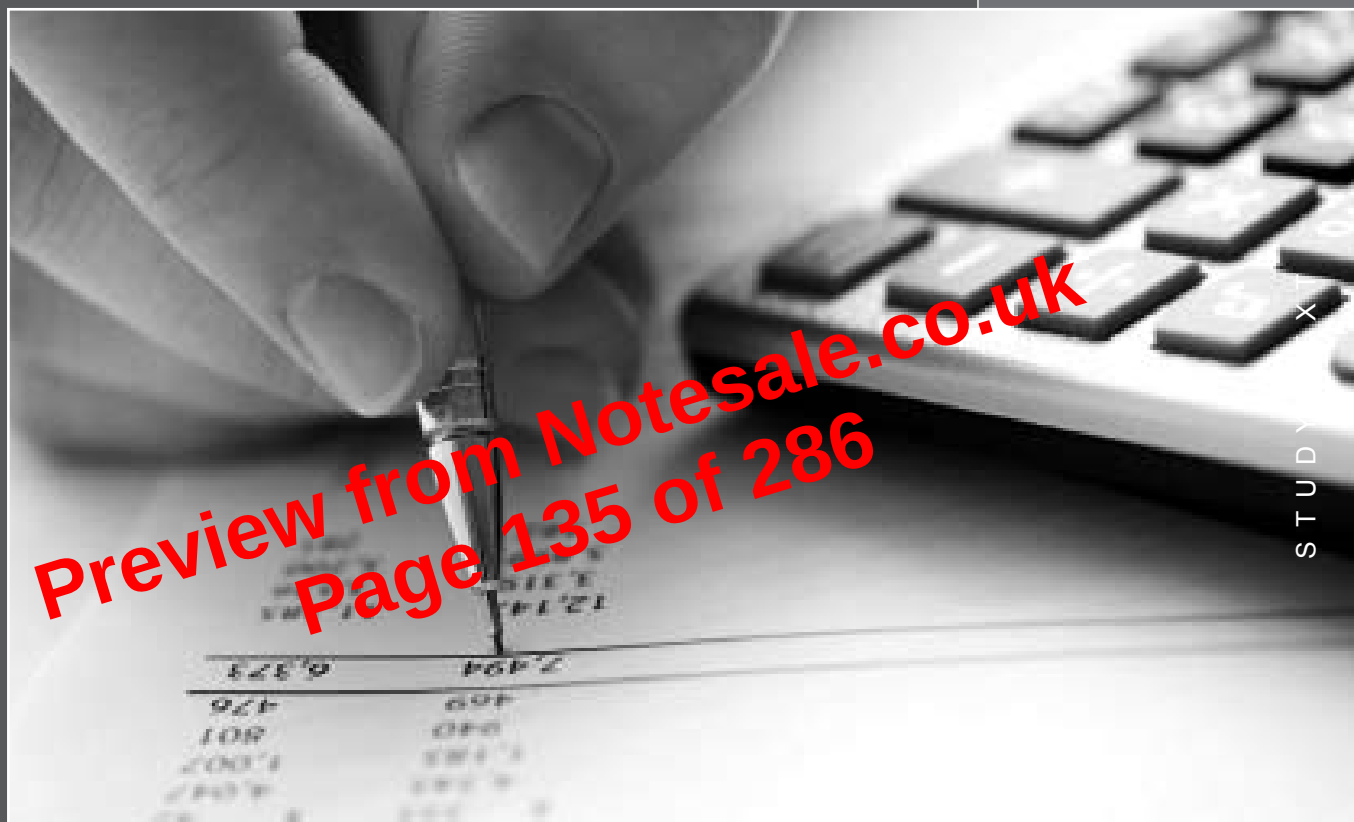
Credit will be given after such taxpayer proves:

- 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.

CHAPTER FIVE



TAX PLANNING

► 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 of all 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)



- 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 interest 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 up to 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)

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	300,000
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

Mapat 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 SHS	JOB OFFER B 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
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Advise:

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

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
	Sh.	Sh.
Basic pay per month		
Benefits:		
Housing (market rate) p.m	51,000	61,000
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>		<u>1,199,400</u>

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



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

Insurance relief

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Non-cash benefits

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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.

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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.



- 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/ribe v 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.



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))

■ 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.



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

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	5%
10,165	-	19,740	121,969	-	236,860	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%

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.

STUDY X

SUGGESTED SOLUTIONS



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%	(3,600,000)	(195,000)	(480,000)	(4,275,000)
Income after tax	8,400,000	355,000	1,120,000	9,975,000
Less allowable retention 60%	(5,040,000)	-		5,040,000
	3,360,000	355,000	1,120,000	4,835,000
Less dividend distributed				(1,300,000)
SHORTFALL				3,535,000

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	176,000	
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:

- Sales are understated by Sh.2,000,000
- Cost of goods sold are overstated by Sh.1,000,000
- Office rent is understated by Sh.20,000
- Printing and stationery is overstated by Sh.10,000
- Net discounts should be credit of Sh.26,200 (income)
- Opening capital is overstated by Sh.1,000,000

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:

- To encourage technological transfers and capital transfers in commerce and industry without overburdening investors with taxation in both countries on same income
- 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.

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

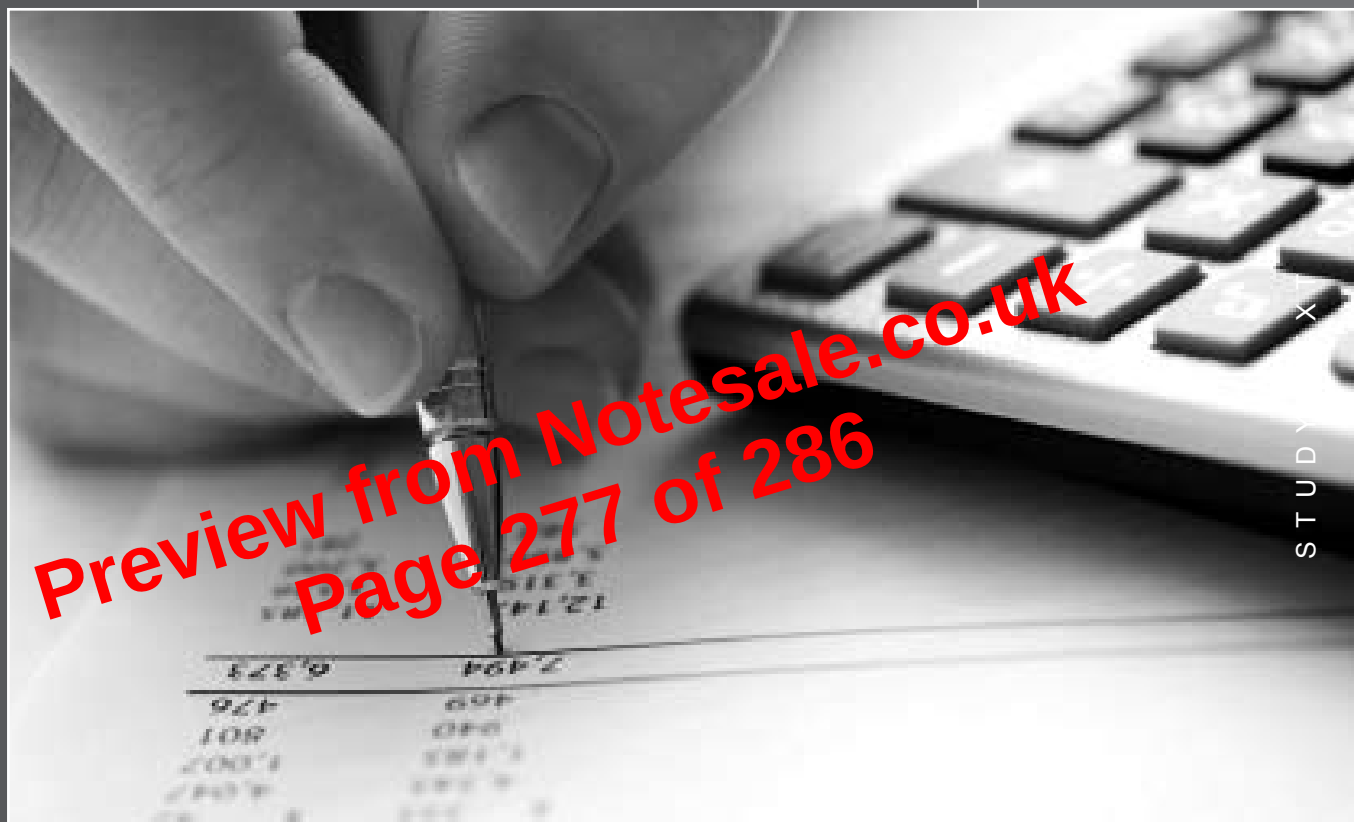
Defined as the arrangement of affairs of tax in such a way as to minimise tax liability at the lowest cost without contradicting any tax laws and regulations. It involves determining in advance the tax effect of any proposed business action and decision. It requires a deep understanding of existing tax 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

GLOSSARY



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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