PUBLIC FINANCE

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CHAPTER ONE

INTRODUCTION TO PUBLIC FINANCIAL MANAGEMENT LEGAL FRAME WORK

Public Finance Management in Kenya is covered in the constitution of Kenya 2010, Chapter 12 and Public Finance Management Act, 2012. This Act of parliament provides effective management of public finances by the national and county governments; the oversight responsibility of Parliament and county assemblies; the different responsibilities of government entities and other bodies, and for connected purposes

Interpretation of terms

"Accounting officer" means—

(a) an accounting officer of a national government entity referred to in section 67;
(b) an accounting officer of a county government entity referred to in section 148;
(c) in the case of the Judiciary, the Chief Registrar of the Judiciary; or
(d) in the case of the Parliamentary Service Commission, the Clerk of the Senate;

"Accounting Standards Board" means the Public Sector Accounting Standards Board

"Appropriation" means—

(a) Authority granted by Parliament to pay money out of the Consolidated Fund or out of any other public fund; or
(b) authority granted by a county assembly to pay, money out of the relevant County Revenue Fund or out of any other county public fund;

"Appropriation Act" means an Act of Parliament or of a county assembly that provides for the provision of money to pay for the supply of services;

"Authorized officer"—

(a) in relation to the National Treasury, means any of its members or officers authorised by the National Treasury in accordance with section 13; or
(b) in relation to a County Treasury, means any of its officers authorised by the County Treasury in accordance with section 105;

"Borrower" means a person to whom a loan has been or is to be made;

"Budget Policy Statement", in relation to a financial year, means the Budget Policy

Statement referred to in section 25;

"Cabinet Secretary" means the Cabinet Secretary responsible for matters relating to finance;

"chart of account" means a structured list of accounts used to classify and record budget revenue and expenditure transactions as well as government assets and liabilities on a standard budget classifications system;

"Chief Officer" means the person appointed by the County Governor to administer the County department responsible for financial affairs;

"commitment" means entering into a contract or other binding arrangement under which expenses or liabilities may be incurred;

"collector of revenue"—

(a) in relation to the national government, means a person authorised under section 76 to be a collector of revenue for the national government;

(b) in relation to a county government, means a person authorised under section 158 to be a collector of revenue for that county government;

"Contingencies Fund" means the Contingencies Fund established by Article 208(1) of the Constitution;

"county corporation" means a public corporation within a county established by an Act of Parliathent or county legislation;

"County Emergency Fund" means a Fund established under section 110;

"County Exchequer Account" means a County Exchequer Account referred to in section 109;

"County Executive Committee member for finance" means the member of a County Executive Committee responsible for the financial affairs of the County and for the County Treasury;

"County Fiscal Strategy Paper", in relation to a county government, means the County Fiscal Strategy Paper referred to in section 117;

"county government entity" means any department or agency of a county government, and any authority, body or other entity declared to be a county government entity under section 5(1);

"county government revenue" means all money derived by or on behalf of a county rates, government from levies, fees, charges or any other source authorised by the Constitution or an Act of Parliament;

"county government security" means a security issued by the county government under section 144 and includes a treasury bill, treasury bond, treasury note, government stock and any other debt instrument issued by the county government;

"County Public Debt" means all financial obligations attendant to loans raised and securities issued by the county government;

"County Treasury" means a County Treasury established under section 103;

"development expenditure" means the expenditure for the creation or renewal of assets;

"development partner" means a foreign government, an international organisation of states or any other organization prescribed by regulations for the purpose of this Act;

"financial statements", in relation to a financial year or other accounting period of the national government, county government, or a national government or county government entity, means—

(a) the financial statements referred to in Part III and Part IV of this Act; and

(b) the financial statements prescribed by the Accounting Standards Board;

"fiscal responsibility principles" means the principles of public finance specified in Article 201 of the Constitution, together with—

(a) the principles of fiscal responsibility referred to in section 15, in relation to national government; and

(b) the principles of fiscal responsibility referred to in section 107, in relation to a county government;

"financial objectives" means the financial objectives set out in a Budget Policy Statement of the national government or in the County Fiscal Strategy Paper of the county governments;

"Intergovernmental Budget and Economic Council" means the Council established under section 187;

"internal auditing" means an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations, which helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes;

"Medium term" means a period of not less than three years but not more than five years;

"National government entity" includes any department or agency of the national government and any authority, body or other entity declared to be a national government entity

"National government revenue" Means all taxes imposed by the national government under the Constitution, excluding county government revenue;

"national government security" includes a security issued by the national government and a treasury bill, treasury bond, treasury note, government stock and any other debt instrument issued by the national government;

"Principal Secretary", in relation to the National Treasury, means the person responsible for the administration of the National Treasury;

"Public money" includes—

(a) all money that comes into possession of, or is distributed by, a national government entity and money raised by a private body where it is doing so under statutory authority; and

(b) money held by national government entities in trust for third parties and any money that can generate liability for the Government;

"publicise", in relation to a document, means to make known to the public, through the national or local media—

(a) The general nature of the document; and

(b) How and where it may be accessed and read by members of the public;

"Publish", in relation to a document, includes—

(a) Publishing the document in a newspaper, Government Gazette or other publication of general circulation in Kenya; or

(b) Publication of an abridged or summary versions of the documents without loosing the core content of the document; or

(c) Making the document available for reference at public libraries or offices of national government entities or in archives of those institutions; or

(d) Posting the document on the internet on a Government website; or

(e) If the document relates only to a county government or any of its entities—

(i) Publishing the document in a newspaper or other publication of general circulation in the County;

(ii) Making the document available for reference at public libraries or offices of the county government or those entities; or

(iii) Posting the document on the Internet on a county government website;

"Receiver of revenue"—

(a) In relation to the National government, means a person designated to be a receiver of revenue under section 75;

(b) In relation to the county government, means a person designated to be a receiver of revenue under section 157;

"Recurrent expenditure"—

(a) In relation to the national government, means the expenditure that is incurred in operating the services provided by the national government; and

(b) in relation to a county government, means the expenditure that is incurred in operating the services provided by that county government, but does not include expenditure incurred in creating or renewing assets belonging to or managed by that government;

"Short term borrowing" means borrowing by a government by way of Treasury Bills, bank-overdraft or other instrument to cover temporary cash shortfalls and is repayable within twelve months;

"State Corporation" means a state corporation within the meaning of the State Corporations Act;

"Treasury Single Account"—

(a) In relation to the national government, means a centralised bank account system where all deposits and payment transactions are processed for State Departments, Commigsions and Independent Offices, and any national government entity which draws directly from the Consolidated Fund;

(b) in relation to the county government, means a centralised bank account system established in each county where all deposits and payment transactions are processed for county departments and any other county entity which draws directly from the County Revenue Fund;

"Urban Board" means a city or municipal board within the meaning of the Urban Areas and Cities Act, 2011;

"Vote" means money authorised by an appropriation Act for withdrawal from the Consolidated Fund or a County Revenue Fund; and

"Wasteful expenditure" means any expenditure that was incurred which could have been avoided had due care and diligence been exercised.

Overview of public financial management Act

The Public Financial Management (PFM) Act is an Act of Parliament meant to provide for effective management of public finances by the national and county governments. In developing the PFM Act, Parliament was keenly aware of the importance of having a good PFM system in determining the success or failure of devolution. To ensure a good PFM system, two objectives were taken into account:

i. That the PFM was consistent with the Constitution and in particular provide for safe-guarding autonomy in financial management at both levels of government but within a unitary system of devolution. This autonomy is supported by articles 6 and 189 of the Constitution. Article 6(2): The governments at the national and County levels are distinct and inter-dependent and shall conduct their mutual relations on the basis of consultation and cooperation; article 189(1)(a): Government at either level shall per-form its functions, and exercise its powers, in a manner that respects the functional and institutional integrity of government at the other level, and respects the Constitu-tional status and institutions of government at the other level.

The spirit of these articles is that both levels of government should not interfere in the day-to-day management of finances and other affairs in the other level of government. Specifically, each level of government should be able to formulate, plan, implement and report on their budgets and plans without the interference of the other government. To operationalize this concept and to avoid favouring one level of government over the other, the Act has mirrored many of the institutional structures for financial management of the national government at the county government level as shown below:

NATIONAL ASSEMBLY		COUNTY ASSEMBLY
Reviews the Budget Policy Statement and makes recommendations to National Treasury Approves the Budget Estimates for National Government, Parliament and Judiciary Provides overall oversight at National Government level Approves the establishment of other National Government public funds Monitors budgets and public finances and related matters Approves the Budget Policy Statement (BPS) and the Budget Review and Outlook Paper (BROP) Reviews the Annual Budget Estimates for National Government	National Assembly	Reviews the Fiscal Strategy Paper and makes recommendations to County Executive Committee Approves the budget estimates for County Government, Urban areas and Cities Provides overall oversight over public finances at the County Government level Approves the establishment of other County public funds Monitors budgets and public finances and related matters Approves the Fiscal Strategy Paper (FSP) and the County Budget Review and Outlook paper (C- BROP; Reviews and approves the Annual Budget Estimates for the County Government Has powers to establish a County Emergency Fund but with approval of County Assembly
CABINET		COUNTY EXECUTIVE COMMITTEE
Approves the Budget Policy Statement (BPS) and the Budget Review and Outlook Paper (BROP) Reviews the Annual Budget Estimates for National Government	Cabinet Secretary	Approves the Fiscal Strategy Paper(FSP) and the County Budget Review and Outlook paper(C- BROP; Reviews and approves the Annual Budget Estimates for the County Government Has powers to establish a County Emergency Fund but with approval of County Assembly.

NATIONAL TREASURY		COUNTRY TREASURIES
Has overall responsibility for macroeconomic formulation and management Prepares annual budget estimates of revenues and expenditure of National Government and coordinates the preparation and implementation of the National Government budget Prepares the BPS for the National Government.		Head of County Treasury and oversees formulation of economic policies Manages the County Government budget process May at the request of Cabinet Secretary stop transfers of funds to a County Government entity for serious material breach or persistent material breaches Has power to raise loan on behalf of County Government in accordance with the law Has overall responsibility for economic affairs at the County Government Prepares annual budget estimates for County Government and coordinates the preparation and implementation of the CG budget Prepares Fiscal Strategy Paper, as the integrated Development Plan for County Government Enforces the Fiscal responsibility principles at the County Government

NATIONAL GOVERNMENT		COUNTY GOVERNMENT
Accounting Officers are responsible for accounting for money appropriated by Parliament		Accounting Officers are to be responsible for money appropriated by County Government
Accounting Officers for National Government entities, Parliament and the Judiciary are accountable to the National Government for financial management		Accounting Officers for County Government entities are accountable to the County Assembly for financial management
Accounting officers for National Government entities are to be designated by Cabinet Secretary for Finance		Accounting Officers for County Government entities are to be designated by County Executive Member responsible for Finance
Accounting Officers to ensure that public resources are used lawfully, effectively and efficiently		Accounting Officers to ensure that public resources are used lawfully, effectively and efficiently
Receivers of National Government revenue are to be designated by the Cabinet Secretary– Finance		Receivers of County revenue are to be designated by County Executive Committee member –Finance
Receivers of National Government revenue are to be responsible for receiving and accounting for National Government revenue		Receivers of County Government revenue are to be responsible for receiving and accounting for County Government revenue
Kenya Revenue Authority has been retained in the PFM Act as collector of National Government revenue		County Executive Committee member–Finance has to appoint KRA as collector of County Government revenue

ii. To ensure that the PFM Act is firmly anchored in article 201 of the Constitution that deals with the principles of public finance. In particular, this Act provides for openness, accountability, public participation, equitable sharing of revenue and tax burden, promote equitable development, promote equitable sharing of debt burden/ benefits between current and future generations, and ensure prudent and respon-sible use of public resources and responsible financial management and clear fiscal reporting.

This Act has also other links to other sections of the Constitution: article 206 spells out the principles of management of consolidated funds and other public funds; article 207 establishes the County Revenue Funds and provides for setting up of other funds at the county level; article 208 provides for the setting up of contingencies fund; articles 211 to 214 spell out on the borrowing and guarantees; article 220 requires national legislation to prescribe the form, content and timing of budgets; article 225 provides for financial controls at the national and county level; and article 226 requires an Act of Parliament to provide for financial records and audit of all accounts of governments, and article 227 on public procurement.

iii. A third objective was to consolidate the many public financial management laws into one integrated PFM law. With the enactment of the PFM, the following acts have been repealed:
  - The Government Financial Management Act, 2004;

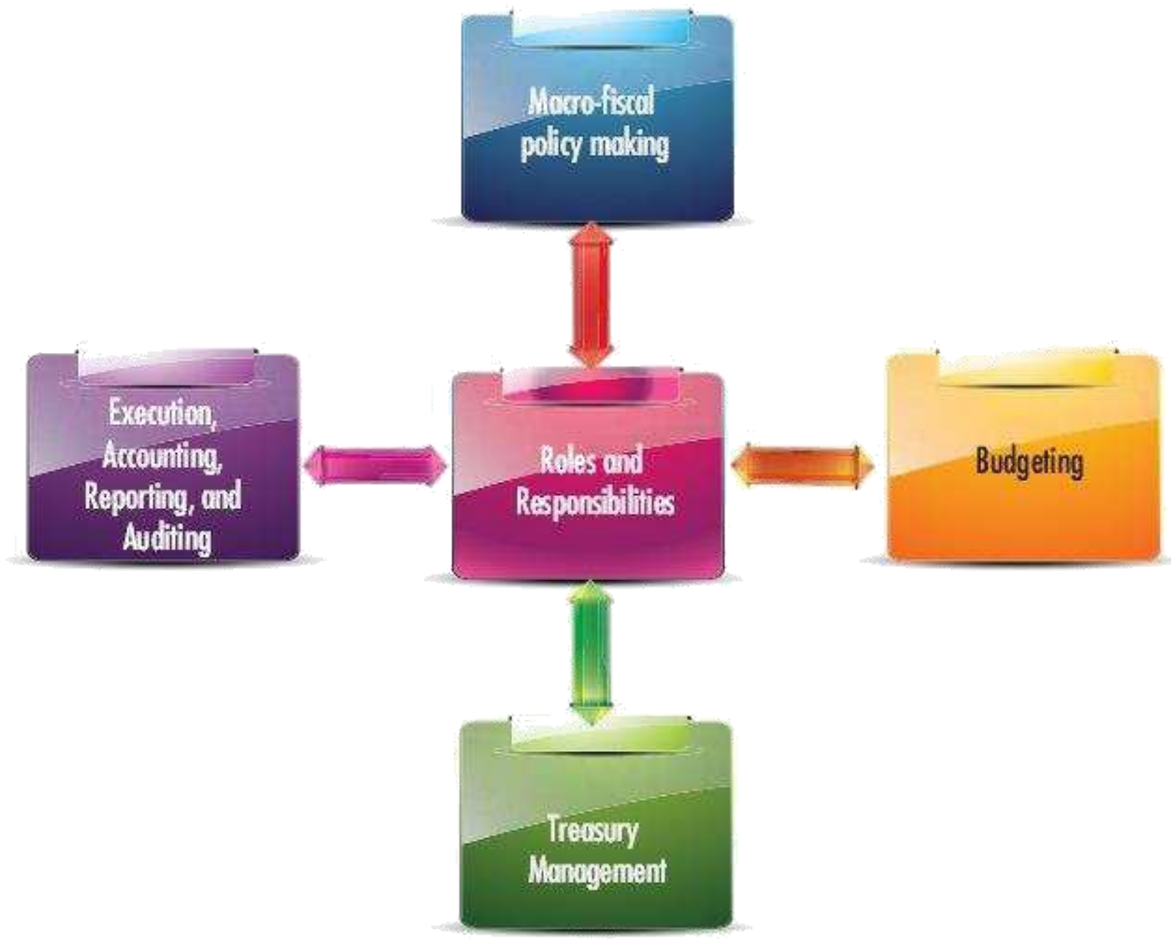
- The Fiscal Management Act, 2009;
- The Internal Loans Act;
- The External Loans Act;
- The National Government Loans Guarantee Act, 2011; and
- The Contingencies Fund and County Emergency Funds Act, 2011.

The Act also caters for all legislations required under the Fifth Schedule of the Constitution, except for the procurement law, which will be separate.

iv. The final objective was to ensure that the Act incorporated best international practices. The Act did this by:

- Holding extensive public consultations within/outside government, counties, get-ting more comments from international/local experts on public financial management;
- Ensuring the PFM as a single law at the county and national government; and
- Basing the policy framework on the five core areas of a good system of public finances, as shown in the diagram below.

Figure 1: Five core areas of a good PFM system



The main objective of the Act is to ensure that national and county governments manage public finances in accordance with the principles spelt out in Article 201 of the Constitution, and that public officer's account to the public through Parliament and county assemblies. The PFM Act outlines a new budget calendar with clear deadlines, and clarifies the roles and responsibilities of the various stakeholders. The Act also introduces new PFM reforms, such as a Single Treasury Account, which will have far reaching implications on public finance management.

Initially, the PFM Act was divided into two: a National Act and the County Act. Due to obvious overlaps, it was found necessary to merge the two. Amendments to the Act were therefore necessary because the previous drafts did not clearly promote accountability at both the national and the county level. For instance, previous drafts of the Act only indicated how resources would be disbursed but did not indicate which institutions were involved and how and when this should have been done.

PRINCIPLES OF PUBLIC FINANCE

The following principles shall guide all aspects of public finance in the Republic—

1. There shall be openness and accountability, including public participation in financial matters;
2. The public finance system shall promote an equitable society, and in particular—

   i. the burden of taxation shall be shared fairly;
   ii. revenue raised nationally shall be shared equitably among national and county governments; and
   iii. expenditure shall promote the equitable development of the country, including by making special provision for marginalised groups and areas;
3. the burdens and benefits of the use of resources and public borrowing shall be shared equitably between present and future generations;
4. public money shall be used in a prudent and responsible way; and
5. financial management shall be responsible, and fiscal reporting shall be clear

Equitable sharing of national revenue

Revenue raised nationally shall be shared equitably among the national and county governments.

County governments may be given additional allocations from the national government's share of the revenue, either conditionally or unconditionally.

Equitable share and other financial laws

The following criteria shall be taken into account in determining the equitable shares provided for under Article 202 and in all national legislation concerning county government enacted in terms of this Chapter—

i. the national interest;
ii. any provision that must be made in respect of the public debt and other national obligations;
iii. the needs of the national government, determined by objective criteria;
iv. the need to ensure that county governments are able to perform the functions allocated to them;
v. the fiscal capacity and efficiency of county governments;
vi. developmental and other needs of counties;
vii. economic disparities within and among counties and the need to remedy them;

viii. the need for affirmative action in respect of disadvantaged areas and groups;
ix. the need for economic optimisation of each county and to provide incentives for each county to optimise its capacity to raise revenue;
x. the desirability of stable and predictable allocations of revenue; and
xi. the need for flexibility in responding to emergencies and other temporary needs, based on similar objective criteria.

For every financial year, the equitable share of the revenue raised nationally that is allocated to county governments shall be not less than fifteen per cent of all revenue collected by the national government.

The amount referred to in clause (2) shall be calculated on the basis of the most recent audited accounts of revenue received, as approved by the National Assembly.

Consultation on financial legislation affecting counties

When a Bill that includes provisions dealing with the sharing of revenue, or any financial matter concerning county governments is published, the Commission on Revenue Allocation shall consider those provisions and may make recommendations to the National Assembly and the Senate.

Any recommendations made by the Commission shall be tabled in Parliament, and each House shall consider the recommendations before voting on the Bill.

PROCESS OF DEVELOPING COUNTY GOVERNMENT FINANCE BILL

County Treasury to prepare County Fiscal Strategy Paper

The County Treasury shall prepare and submit to the County Executive Committee the County Fiscal Strategy Paper for approval and the County Treasury shall submit the approved Fiscal Strategy Paper to the county assembly, by the 28th February of each year.

The County Treasury shall align its County Fiscal Strategy Paper with the national objectives in the Budget Policy Statement.

In preparing the County Fiscal Strategy Paper, the County Treasury shall specify the broad strategic priorities and policy goals that will guide the county government in preparing its budget for the coming financial year and over the medium term.

The County Treasury shall include in its County Fiscal Strategy Paper the financial outlook with respect to county government revenues, expenditures and borrowing for the coming financial year and over the medium term.

In preparing the County Fiscal Strategy Paper, the County Treasury shall seek and take into account the views of—

a) the Commission on Revenue Allocation;
b) the public;
c) any interested persons or groups; and
d) any other forum that is established by legislation.

Not later than fourteen days after submitting the County Fiscal Strategy Paper to the county assembly, the county assembly shall consider and may adopt it with or without amendments.

The County Treasury shall consider any recommendations made by the county assembly when finalising the budget proposal for the financial year concerned.

The County Treasury shall publish and publicise the County Fiscal Strategy Paper within seven days after it has been submitted to the county assembly.

County Treasury to prepare a County Budget Review and Outlook Paper

A County Treasury shall—

a) prepare a County Budget Review and Outlook Paper in respect of the county for each financial year; and
b) Submit the paper to the County Executive Committee by the 30th September of that year.

In preparing its county Budget Review and Outlook Paper, the County Treasury shall specify—

a) the details of the actual fiscal performance in the previous year compared to the budget appropriation for that year;
b) the updated economic and financial forecasts with sufficient information to show changes from the forecasts in the most recent County Fiscal Strategy Paper;
c) information on—

i. any changes in the forecasts compared with the County Fiscal Strategy Paper; or

ii. how actual financial performance for the previous financial year may have affected compliance with the fiscal responsibility principles, or the financial objectives in the County Fiscal Strategy Paper for that financial year; and

d) Reasons for any deviation from the financial objectives in the County Fiscal Strategy Paper together with proposals to address the deviation and the time estimated for doing so.

The County Executive Committee shall consider the County Budget Review and Outlook Paper with a view to approving it, with or without amendments, within fourteen days after its submission.

Not later than seven days after the County Budget Review and Outlook Paper is approved by the County Executive Committee, the County Treasury shall—

a) arrange for the Paper to be laid before the County Assembly; and
b) as soon as practicable after having done so, publish and publicise the Paper.

Banking arrangements for county government and its entities

The County Treasury is responsible for authorising the opening, operating and closing of bank accounts for the county government and its entities, except as otherwise provided by other legislation and in accordance with regulations made under this Act.

As soon as practicable, each County Treasury shall establish a Treasury Single Account at the Central Bank of Kenya or a bank approved by the County Treasury through which payments of money to and by the various county government entities are to be made.

The Treasury Single Account shall not be operated in a manner that prejudices any entity to which funds have been disbursed.

An accounting officer for a county government entity shall not cause a bank account of the entity to be overdrawn beyond the limit authorised by the County Treasury or a Board of a county government entity, if any.

A County Treasury shall keep complete and current records of all bank accounts for which it is responsible under the Constitution, this Act or any other legislation.

Accounting officer who authorises the bank account of a county government entity to be overdrawn is liable for the full cost of the overdrawn amount, in addition to any other disciplinary measures that—

a. the County Executive Committee member for finance may impose; or
b. Any other relevant authority may impose under the provisions of any other legislation.

Management of cash at the county government level

A County Treasury shall manage its cash within a framework established by the county assembly and by regulations.

Every county government entity shall submit an annual cash flow plan and forecasts to the County Treasury in a form and manner directed by County Treasury, and shall send a copy to the Controller of Budget.

The County Treasury may invest subject to any regulations that may be prescribed, any money kept in a bank account of the county government.

Except as otherwise provided by other legislation, the following are payable into the County Exchequer Account—

a. all interest received from investments;
b. All money received from the redemption or maturity of the investments, and from the sale or conversion of securities relating to the investments.

The County Treasury may incur costs, charges and expenses in connection with negotiating, placing, managing, servicing, or converting any investment entered into under subsection (3).

Any costs, charges or expenses incurred above are payable from the County Exchequer Account.

County Treasury to maintain records of county government loans.

The County Treasury shall maintain a record of all loans made to the county government and make the record available to the county assembly within seven days of request.

The County Treasury shall include in the record under subsection (1), the following information—

a. the principal of the loan and the terms and conditions of the loan, including interest and other charges payable and the terms of repayment;

b. the amount of the loan advanced at any particular time;
c. the principal amount, interest and other charges paid at any particular time; and
d. the balance of principal, interest and other charges outstanding at any particular time.

The county treasury shall maintain the following additional information with respect to every such loan—

a. the names of the parties to the loan;
b. the amount of the loan and the currency in which it is expressed and in which it is repayable;
c. the terms and conditions of the loan, including interest and other charges payable and the terms of repayment;
d. the amount of the loan advanced at the time the report under subsection (3) is submitted;
e. the purpose for which the loan was used and the perceived benefits of the loan; and
f. any other information that the county assembly requests.

The County Treasury shall submit both quarterly and annual reports of all loans made to the county government to the county assembly.

County Treasury to submit county government debt management strategy to county assembly

On or before the 28th February in each year, the County Treasury shall submit to the county assembly a statement setting out the debt management strategy of the county government over the medium term with regard to its actual liability and potential liability in respect of loans and its plans for dealing with those liabilities.

The County Treasury shall include the following information in the statement—

a. the total stock of debt as at the date of the statement;
b. the sources of loans made to the county government;
c. the principal risks associated with those loans;
d. the assumptions underlying the debt management strategy; and
e. An analysis of the sustainability of the amount of debt, both actual and potential.

As soon as practicable after the statement has been submitted to the county assembly under this section, the County Executive Committee member for finance shall publish and publicise the statement and submit a copy to the Commission on Revenue Allocation and the Intergovernmental Budget and Economic Council.

County Treasury to provide county assembly with additional reports when required

On being requested to do so by the county assembly, the County Treasury shall prepare and submit to the county assembly a report on any matter relating to its responsibilities within fourteen days of the request.

Stages in county government budget process

The budget process for county governments in any financial year shall consist of the following stages—

a. integrated development planning process which shall include both long term and medium term planning;
b. planning and establishing financial and economic priorities for the county over the medium term;
c. making an overall estimation of the county government's revenues and expenditures;
d. adoption of County Fiscal Strategy Paper;
e. preparing budget estimates for the county government and submitting estimates to the county assembly;
f. approving of the estimates by the county assembly;
g. enacting an appropriation law and any other laws required to implement the county government's budget;
h. implementing the county government's budget; and
i. accounting for, and evaluating, the county government's budgeted revenues and expenditures;

The County Executive Committee member for finance shall ensure that there is public participation in the budget process.

County government to prepare development plan

Every county government shall prepare a development plan in accordance with Article 220(2) of the Constitution, that includes—

a. strategic priorities for the medium term that reflect the county government's priorities and plans;
b. a description of how the county government is responding to changes in the financial and economic environment;
c. programmes to be delivered with details for each programme of—
   i. the strategic priorities to which the programme will contribute;

ii. the services or goods to be provided;
iii. measurable indicators of performance where feasible; and
iv. the budget allocated to the programme;

d. payments to be made on behalf of the county government, including details of any grants, benefits and subsidies that are to be paid;
e. a description of significant capital developments;
f. a detailed description of proposals with respect to the development of physical, intellectual, human and other resources of the county, including measurable indicators where those are feasible;
g. a summary budget in the format required by regulations; and (h) such other matters as may be required by the Constitution or this Act.

The County Executive Committee member responsible for planning shall prepare the development plan in accordance with the format prescribed by regulations.

The County Executive Committee member responsible for planning shall, not later than the 1st September in each year, submit the development plan to the county assembly for its approval, and send a copy to the Commission on Revenue Allocation and the National Treasury.

The County Executive Committee member responsible for planning shall publish and publicise the annual development plan within seven days after its submission to the county assembly.

County government to prepare cash flow projections

Not later than the 15th June of each financial year, every county government shall prepare an annual cash flow projection for the county for the next financial year, and submit the cash flow projection to the Controller of Budget with copies to the Intergovernmental Budget and Economic Council and the National Treasury.

Regulations shall prescribe the format and content of the annual cash flow projections.

County Executive Committee member for finance to manage budget process at county government level

The County Executive Committee member for finance shall manage the budget process for the county.

Not later than the 30th August in each year, the County Executive Committee member for finance shall issue a circular setting out guidelines to be followed by all of the county government's entities in the budget process.

The County Executive Committee member for finance shall include in the circular—

a. a schedule for preparation of the budget, specifying the key dates by which the various processes are to be completed;
b. the methodology for the review and projection of revenues and expenditures;
c. key policy areas and issues to be taken into consideration when preparing the budget;
d. the procedures to be followed by members of the public who wish to participate in the budget process;
e. the format in which information and documents relating to the budget are to be submitted;
f. the information to be in conformity with standard budget classification systems as prescribed by regulations; and
g. any other information relevant to the budget process.

A county government entity shall comply with the guidelines and, in particular, shall adhere to the key dates specified in the schedule referred to in the above

County Executive Committee member to submit budget estimates and other documents to County Executive Committee for approval

A County Executive Committee member for finance shall submit to the County Executive Committee for its approval—

a. the budget estimates and other documents supporting the budget of the county government, excluding the county assembly; and
b. the draft Bills at county level required to implement the county government budget, in sufficient time to meet the deadlines prescribed by this section.

Following approval by the County Executive Committee, the County Executive Committee member for finance shall—

a. submit to the county assembly the budget estimates, supporting documents, and any other Bills required to implement the budget, except the Finance Bill, by the 30th April in that year; and
b. Ensure that the estimates submitted are in accordance with the resolutions adopted by county assembly on the County Fiscal Strategy Paper.

Each county assembly clerk shall prepare and submit to the county assembly the budget estimates for the county assembly and a copy shall be submitted to the Count Executive Committee member for finance.

The County Executive Committee member for finance shall prepare and present his or her comments on the budget estimates presented by the county assembly clerk.

The County Executive Committee member for finance shall ensure that the budget process is conducted in a manner and within a timeframe sufficient to permit the participants in the process to meet the requirements of the Constitution and this Act.

As soon as is practicable after the budget estimates and other documents have been submitted to the County Assembly under this section, the County Executive Committee member for finance shall publish and publicise the documents.

Upon approval of the budget estimates by the county assembly, the County Executive Committee member for finance shall prepare and submit a County Appropriation Bill to the county assembly of the approved estimates.

County Executive Committee member for finance to submit budget documents to county assembly

The County Executive Committee member for finance shall submit to the county assembly the following documents in respect of the budget for every financial year—

A budget summary that includes—

i. a summary of budget policies including revenue, expenditure, debt and deficit financing; and
ii. an explanation of how the budget relates to the fiscal responsibility principles and the financial objectives;
iii. a memorandum by the County Executive Committee member for finance explaining how the resolutions adopted by the county assembly on the budget estimates have been taken into account;

Budget estimates that include—

i. a list of all county government entities that are to receive funds appropriated from the budget of the county government;
ii. estimates of revenue projected from the Equalisation Fund over the medium term;
iii. all revenue allocations from the national government over the medium term, including conditional and unconditional grants;
iv. all other estimated revenue by broad economic classification;
v. all estimated expenditure, by Vote, and by programme, clearly identifying both recurrent and development expenditures;
vi. information regarding loans made to the county government, including an estimate of principal, interest and other charges to be paid by that county government in the financial year in respect of those loans;

information relating to any payments and liabilities to be made or incurred by the county government for which an appropriation is not included in an Appropriation Act, together with the constitutional or national legislative authority for any such payments or liabilities; and

a statement by the County Executive Committee member for finance specifying the measures taken by the county government to implement any recommendations made by the county assembly with respect to the budget for the previous financial year.

In preparing the annual Appropriation Bill to put before the County Assembly, the County Executive Committee member for finance shall ensure that the expenditure appropriations in the Bill are in a form that—

a. is accurate, precise, informative and pertinent to budget issues; and
b. Clearly identifies the appropriations by Vote and programme.

County Assembly to consider budget estimates

The county assembly shall consider the county government budget estimates with a view to approving them, with or without amendments, in time for the relevant appropriation law and any other laws required to implement the budget to be passed by the 30th June in each year.

Before the county assembly considers the estimates of revenue and expenditure, the relevant committee of the county assembly shall discuss and review the estimates and make recommendations to the county assembly, and in finalising the recommendations to county assembly, the committee shall take into account the views of the County Executive Committee member for finance and the public on the proposed recommendations.

An amendment to the budget estimates may be made by the county assembly only if it is in accordance with the resolutions adopted regarding the County Fiscal Strategy Paper and if—

a. any increase in expenditure in a proposed appropriation, is balanced by a reduction in expenditure in another proposed appropriation; and
b. Any proposed reduction in expenditure is used to reduce the deficit.

Where a Bill originating from a member of a county assembly proposes amendments after the passing of budget estimates and the Appropriations Bill by the county assembly, the county assembly may proceed in accordance with the resolutions adopted regarding the County Fiscal Strategy Paper and ensure—

a. an increase in expenditure in a proposed appropriation is balanced by a reduction in expenditure in another proposed appropriation; or
b. a proposed reduction in expenditure is used to reduce the deficit.

Not later than twenty-one days after the county assembly has approved the budget estimates, the County Treasury shall consolidate the estimates and publish and publicise them.

The County Executive Committee member for finance shall take all reasonably practicable steps to ensure that the approved budget estimates are prepared and published in a form that is clear and easily understood by, and readily accessible to, members of the public.

Submission and consideration of the revenue raising measures in the county assembly

Each financial year, the County Executive member for finance shall, with the approval of the County Executive Committee, make a pronouncement of the revenue raising measures for the county government.

The County Executive Committee member for finance shall, on the same date that the revenue raising measures are pronounced, submit to the county assembly the County Finance Bill, setting out the revenue raising measures for the county government, together with a policy statement expounding on those measures.

Any recommendations made by the relevant committee or adopted by the county assembly on revenue matters shall—

a. ensure that the total amount of revenue raised is consistent with the approved fiscal framework and the County Allocation of Revenue Act;
b. take into account the principles of equity, certainty and ease of collection;

c. consider the impact of the proposed changes on the composition of tax revenue with reference to direct and indirect taxes;
d. consider domestic, regional and international tax trends;
e. consider the impact on development, investment, employment and economic growth; and
f. Take into account the taxation and other tariff agreements and obligations that Kenya has ratified, including taxation and tariff agreements under the East African Community Treaty.

The recommendation of the County Executive Committee member for finance shall be included in a report and tabled in the county assembly.

Approval of the Finance Bill

133. Not later than ninety days after passing the Appropriation Bill, the county assembly shall consider and approve the Finance Bill with or without amendments.

Action to be taken in case of delay in enacting County Appropriation Bill

if the County Appropriation Bill for a financial year has not been assented to, or is not likely to be assented to by the beginning of that financial year, a county assembly may authorise the withdrawal of money from the County Revenue Fund.

Money withdrawn under the above condition,

a. may be used only for the purpose of meeting expenditure necessary to carry on the services of the county government during the financial year concerned until such time as the relevant appropriation law is passed; and
b. may not exceed, in total, one-half of the amount included in the estimates of expenditure submitted to the county assembly for that year.

The Speaker of the county assembly shall, within seven days, communicate the authorisationto the County Executive Committee member for finance.

The money withdrawn shall be included in the appropriation law, under separate rotes, for the services for which it is withdrawn.

County government to submit to county assembly supplementary budget in certain circumstances

A county government may spend money that has not been appropriated if the amount appropriated for any purpose under the County Appropriation Act is insufficient or a need has arisen for expenditure for a purpose for which no amount has been appropriated by that Act, or money has been withdrawn from the county government Emergency Fund.

A county government shall submit a supplementary budget in support of the additional expenditure for authority for spending
In complying with the above rule, a county government shall describe how the additional expenditure relates to the fiscal responsibility principles and financial objectives.

Except as provided the approval of the county assembly for any spending under this section shall be sought within two months after the first withdrawal of the money.

If the county assembly is not sitting during the time contemplated, or is sitting but adjourns before approval has been sought, approval shall be sought within fourteen days after it next sits.

When the county assembly has approved spending, a supplementary Appropriation Bill shall be introduced for the appropriation of the money spent.

In any financial year, the county government may not spend under this section more than ten percent of the amount appropriated by the county assembly for that year unless that county assembly has, in special circumstances, approved a higher percentage.

Appropriation of money for county government purpose to lapse if unspent.

Subject to any other legislation, an appropriation that has not been spent at the end of the financial year for which it was appropriated lapses immediately at the end of that financial year.

If, at the end of a financial year, a county government entity is holding appropriated money that was withdrawn from the County Exchequer Account but has not been spent, it shall repay the unspent money to the County Exchequer Account and prepare a refund statement which shall be forwarded to the Controller of Budget.

Establishment of county budget and economic forum for county budget consultation process

As soon as practicable after the commencement of this Act, a county government shall establish a forum to be known as the (Name of the County) County Budget and Economic Forum.

The County Budget and Economic Forum shall consist of—

a. the Governor of the county who shall be the chairperson;
b. other members of the county executive committee;
c. a number of representatives, not being county public officers, equal to the number of executive committee members appointed by the Governor from persons nominated by organisations representing professionals, business, labour issues, women, persons with disabilities, the elderly and faith based groups at the county level.

The purpose of the Forum is to provide a means for consultation by the county government on—

a. preparation of county plans, the County Fiscal Strategy Paper and the Budget Review and Outlook Paper for the county; and
b. Matters relating to budgeting, the economy and financial management at the county level.

In addition to the above, consultations shall be in accordance with the consultation process provided in the law relating to county governments.

CHAPTHER TWO

THE OPERATIONS OF THE NATIONAL AND COUNTY GOVERNMENTS ON MANAGEMENT AND CONTROL OF PUBLIC FINANCE

Establishment of the National Treasury

There is established, pursuant to Article 225 of the Constitution, an entity of the national government to be known as the National Treasury.

The National Treasury shall comprise of—

a) the Cabinet Secretary;
b) the Principal Secretary; and
c) The department or departments, office or offices of the National Treasury responsible for economic and financial matters.

The Cabinet Secretary shall be the head of the National Treasury.

General responsibilities of the National Treasury

1. formulate, implement and monitor macro-economic policies involving expenditure and revenue;
2. manage the level and composition of national public debt, national guarantees and other financial obligations of national government within the framework of this Act and develop a framework for sustainable debt control;
3. formulate, evaluate and promote economic and financial policies that facilitate social and economic development in conjunction with other national government entities;
4. mobilize domestic and external resources for financing national and county government budgetary requirements;
5. design and prescribe an efficient financial management system for the national and county governments to ensure transparent financial management and standard financial reporting as contemplated by Article 226 of the Constitution:
6. Provided that the National Treasury shall prescribe regulations that ensure that operations of a system under this paragraph respect and promote the distinctiveness of the national and county levels of government;
7. in consultation with the Accounting Standards Board, ensure that uniform accounting standards are applied by the national government and its entities;
8. develop policy for the establishment, management, operation and winding up of public funds;

9. within the framework of this Act and taking into consideration the recommendations of the Commission on Revenue Allocation and the Intergovernmental Budget and Economic Council, prepare the annual Division of Revenue Bill and the County Allocation of Revenue Bill;
10. strengthen financial and fiscal relations between the national government and county governments and encourage support for county governments in terms of Article 190(1) of the Constitution in performing their functions; and
11. Assist county governments to develop their capacity for efficient, effective and transparent financial management in consultation with the Cabinet Secretary responsible for matters relating to intergovernmental relations.

The National Treasury shall have the following functions, in addition:-

1. promote transparency, effective management and accountability with regard to public finances in the national government;
2. ensure proper management and control of, and accounting for the finances of the national government and its entities in order to promote the efficient and effective use of budgetary resources at the national level;
3. co-ordinate the preparation of annual appropriation accounts and other statutory financial reports by the national government and its entities;
4. prepare annual estimates of revenue of the national government, and co-ordinate the preparation of the budget of the national government;
5. consolidate reports of annual appropriation accounts and other financial statements of the national government and county governments and their entities;
6. report every four months to the National Assembly on the implementation of the annual national budget on areas not reported on by the Controller of Budget;
7. be the custodian of an inventory of national government assets except as may be provided by other legislation or the Constitution;
8. monitor the management of the finances of public enterprises and investments by the national government and its entities;
9. monitor the financial aspects of risk management strategies and governance structures for the national government and national government entities;
10. monitor the financial performance of state corporations; and
11. Issue guidelines to national government entities with respect to financial matters and monitoring their implementation and compliance.

The National Treasury shall take such other action, not inconsistent with the Constitution, as will further the implementation of this Act.

Powers of the National Treasury

The Cabinet Secretary may generally give to the National Treasury such powers as are necessary to facilitate the Cabinet Secretary and national government to exercise their powers in the Constitution, and in particular, the National Treasury may do all or any of the following—

1. With prior notification to the entity, access any system of public financial management and control of national government entity;
2. where reasonably necessary in the execution of its functions, access the premises of any national State Organ or other public entity and inspect the entity's records and other documents relating to financial matters after giving notice;
3. require national government entities to comply with any specified applicable norms or standards regarding accounting practices and budget classification systems;
4. require any public officer in the national government to provide information and if necessary, explanations with respect to matters concerning public finance:
   Provided that a person providing information shall not be liable if at the time of providing the information that person, in writing, objected to providing such information on grounds that the information may incriminate him or her;
5. Provide any County Treasury with any information as it may require to carry out its responsibilities under the Constitution; and
6. Perform any other act as the Cabinet Secretary may consider necessary including power to intervene where a state entity or state organ fails to operate a financial system that complies with requirements provided for in accordance with Constitution.

The National Treasury may authorise any of its officers in writing to carry out a responsibility or exercise a power specified in the authorisation on behalf of the National Treasury.

When acting, an authorized officer, if requested by the person in relation to whom the responsibility or power is being carried out or exercised, shall produce the authorisation for inspection and failure to comply with that request invalidates any subsequent action purporting to be taken in terms of the authorisation.

An authorization given above remains in force for a period specified in it or, if no period is specified, until it is revoked by the National Treasury

The National Treasury may, in writing, revoke or vary an authorisation given above

Secondment of public officers by National Treasury to County Treasury

National Treasury may, upon request by the County Treasury, and for a period that shall be agreed, second to a County Treasury for purposes of capacity building, such number of officers as may be necessary for the County Treasury to better carry out its functions under this Act.

A public officer seconded to a County Treasury under above, shall be deemed to be an officer of the County Treasury and shall be subject only to the direction and control of the County Treasury.

The National Treasury to enforce fiscal responsibility principles

The National Treasury manages the national government's public finances in accordance with the Constitution, and the principles of fiscal responsibility set out

In managing the national government's public finances, the National Treasury enforces the following fiscal responsibility principles—

a. Over the medium term a minimum of thirty percent of the national and county government's budget shall be allocated to the development expenditure.
b. the national government's expenditure on wages and benefits for its public officers shall not exceed a percentage of the national government revenue as prescribed by regulations;
c. over the medium term, the national government's borrowings shall be used only for the purpose of financing development expenditure and not for recurrent expenditure;
d. public debt and obligations shall be maintained at a sustainable level as approved by Parliament for the national government and the county assembly for county government;
e. fiscal risks shall be managed prudently; and
f. a reasonable degree of predictability with respect to the level of tax rates and tax bases shall be maintained, taking into account any tax reforms that may be made in the future.

Short term borrowing shall be restricted to management of cash flows and in case of a bank overdraft facility it shall not exceed five per cent of the most recent audited national government revenue.

National Treasury ensures that the level of National Debt does not exceed the level specified annually in the medium term national government debt management strategy submitted to Parliament.

Regulations made under this Act may add to the list of fiscal principles set out

National government deviation from financial objectives

The national government may, with the approval of Parliament, deviate from the financial objectives in a Budget Policy Statement on a temporary basis where such deviation is necessitated by a major natural disaster or other significant unforeseen event.

If there is a change of national government, the new government may, with the approval of Parliament, deviate from the financial objectives in a Budget Policy Statement but shall not deviate from the fiscal responsibility principles.

The National Treasury shall provide a report to Parliament regarding the deviation, and shall include in the report—

a. The reasons for and the implications of the deviation;
b. proposals to address the deviation;
c. the period the deviation is estimated to last; and
d. The status of development projects initiated by the national government and if any project has been stopped, the reasons for doing so.

The National Treasury shall publish and publicize the report made above within fifteen days after its submission to Parliament.

National Treasury to prepare annual Budget Policy Statement

The National Treasury shall prepare and submit to Cabinet the Budget Policy Statement for approval.

The National Treasury shall submit the Budget Policy Statement approved in terms of subsection (1) to Parliament, by the 15th February in each year.

In preparing the Budget Policy Statement, the National Treasury shall set out the broad strategic priorities and policy goals that will guide the national government and county governments in preparing their budgets both for the following financial year and over the medium term.

The National Treasury shall include in the Budget Policy Statement—

a. an assessment of the current state of the economy and the financial outlook over the medium term, including macro-economic forecasts;
b. the financial outlook with respect to Government revenues, expenditures and borrowing for the next financial year and over the medium term;
c. the proposed expenditure limits for the national government, including those of Parliament and the Judiciary and indicative transfers to county governments; and
d. The fiscal responsibility principles and financial objectives over the medium term including limits on total annual debt.

In preparing the Budget Policy Statement, the National Treasury shall seek and take into account the views of—

a. the Commission on Revenue Allocation;
b. county governments;
c. Controller of Budget;
d. the Parliamentary Service Commission;
e. the judicial Service Commission;
f. the public; and
g. any other interested persons or groups;

Regulations made under this Act shall prescribe circumstances and the manner in which persons or groups may make written or oral representations about the contents of the statement.

Parliament shall, not later than fourteen days after the Budget Policy Statement is submitted to Parliament, table and discuss a report containing its recommendations and pass a resolution to adopt it with or without amendments.

The Cabinet Secretary shall take into account resolutions passed by Parliament in finalising the budget for the relevant financial year.

The National Treasury shall publish and publicise the Budget Policy Statement not later than fifteen days after submission of the Statement to Parliament.

National Treasury to prepare Budget Review and Outlook Paper
The National Treasury shall prepare and submit to Cabinet for approval, by the 30th September in each financial year, a Budget Review and Outlook Paper which shall include—

a. actual fiscal performance in the previous financial year compared to the budget appropriation for that year;
b. updated macro-economic and financial forecasts with sufficient information to show changes from the forecasts in the most recent Budget Policy Statement;
c. information on how actual financial performance for the previous financial year may have affected compliance with the fiscal responsibility principles or the financial objectives in the latest Budget Policy Statement; and
d. The reasons for any deviation from the financial objectives together with proposals to address the deviation and the time estimated to do so.

Cabinet shall consider the Budget Review and Outlook Paper with a view to approving it, with or without amendments, not later than fourteen days after its submission.

Not later than seven days after the Budget Review and Outlook Paper has been approved by Cabinet, the National Treasury shall—

a. submit the Paper to the Budget Committee of the National Assembly to be laid before each House of Parliament; and
b. Publish and publicise the Paper not later than fifteen days after laying the Paper before Parliament.

Publication of pre and post- election economic and fiscal reports by National Treasury

The National Treasury shall arrange to be published—

a. a pre-election economic and fiscal update not earlier than four months before the polling day for any general election; and
b. a post-election economic and fiscal update not later than four months after the polling day of any general election.

The pre-election and post-election economic and fiscal update shall—

Detail all election related spending including—

i. direct election expenses such as those for the Independent Electoral and Boundaries Commission for costs of elections and election materials;
ii. indirect election expenses such as allocations to police and security forces for the election year; and
iii. any other expenses related to the election specified in regulations or instructions; and

Be accompanied by a statement signed by the Principal Secretary stating that the economic and fiscal updates include—

a. all policy decisions with material economic or fiscal implications that the national government made before the day on which the contents of the economic and fiscal updates were finalised;
b. all other circumstances with material economic or fiscal implications of which the National Treasury was aware before those days; and
c. a confirmation that the economic and fiscal updates were prepared using the best professional judgment and information available before the economic and fiscal updates were finalised.

If the day of dissolution of Parliament is less than two months before the day appointed as polling day for the general election, the Cabinet Secretary shall arrange for the pre-election economic and fiscal update required under this section to be published not later than fourteen days after the day of the dissolution of Parliament.

Banking arrangements for national government entities

The National Treasury shall authorise the opening, operating and closing of bank accounts and sub accounts for all national government entities in accordance with regulations made under this Act.

The National Treasury shall establish a Treasury Single Account into which all revenues received by national government entities shall be deposited and from which all payments of money to or on behalf of national government entities shall be made.

The Treasury Single Account shall not be operated in any manner that prejudices any entity to which funds have been disbursed.

An accounting officer for a national government entity shall not cause a bank account of the entity to be overdrawn beyond the limit authorised by the National Treasury or a board of a national government entity, if any.

Subject to subsection (3), an accounting officer who authorises the bank account of a national government entity to be overdrawn is liable for the full cost of the overdrawn amount, in addition to any other disciplinary measures that—

a. the Cabinet Secretary may impose by regulations; or
b. Any other relevant authority may impose under the provisions of any other legislation.

The National Treasury shall keep complete and current records of all bank accounts for which it is responsible under the Constitution, this Act or any other legislation.

The National Treasury shall give monthly statements on actual revenue collected in the accounts relating to Article 206 of the Constitution to the Commission on Revenue Allocation.

Management of cash at the national government level

The National Treasury shall establish a framework within which the national government shall manage its cash transactions.

Every national government entity, other than a state corporation, shall submit an annual cash plan and forecast to—

a. the National Treasury in a form and manner and relating to such periods directed by that Treasury; and
b. The Controller of Budget.

Subject to the Constitution, the Cabinet Secretary may, notwithstanding any previous authority given, limit or suspend national government expenditure, if in the Cabinet Secretary's opinion, the exigencies of the financial situation render such a limitation or suspension necessary.

The approval of the National Assembly for any limitation or suspension under subsection (3) shall be sought within two months of the decision being made.

The National Treasury may invest, subject to any regulations that may be prescribed, any money kept in a bank account of the national government.

Except as otherwise provided by legislation—

a. interest received from investments made under subsection (5); and
b. money received from the redemption or maturity of those investments, and from the sale or conversion of securities relating to them, is payable into the National Exchequer Account.

The National Treasury may incur costs, charges and expenses in connection with negotiating, placing, managing, servicing, or converting any investment entered into under subsection (5).

Costs, charges or expenses referred to under subsection (7) shall be paid from the Consolidated Fund in accordance with Article 228 of the Constitution.

Procurement of goods and services

For the purposes of this Act, all procurement of goods and services required for the purposes of the national government or a national government entity is to be carried out in accordance with Article 227 of the Constitution and the relevant legislation on procurement and disposal of assets.

Cabinet Secretary to report all loans

The Cabinet Secretary shall submit to Parliament, every four months, a report of all loans made to the national government, national government entities and county governments, in accordance with Article 211(2) of the Constitution.

Where either House of Parliament is canvassing a matter relating to the national debt, the Cabinet Secretary shall submit to Parliament, a report of all loans made to the national government, national government entities, and county governments, not later than seven days after receiving a request to do so from either House of Parliament.

At the end of every four months, the Cabinet Secretary shall submit a report to Parliament stating the loan balances brought forward, carried down, drawings and amortizations on new loans obtained from outside Kenya or denominated in foreign currency, and such other information as may be prescribed by regulations, specifying—

a. the names of the parties to the loan;
b. the amount of the loan and the currency in which it is expressed and in which it is repayable;
c. the terms and conditions of the loan, including interest and other charges payable and the terms of repayment;
d. the amount of the loan advanced at the time the report is submitted;
e. the purpose for which the loan was used and the perceived benefits of the loan; and such other information as the Cabinet Secretary may consider appropriate.

Cabinet Secretary to report on national government guarantees

The Cabinet Secretary shall submit to Parliament, a record of all guarantees given by the national government, not later than seven days after receiving a request to do so from either House of Parliament.

The Cabinet Secretary shall, with respect to every such guarantee, specify the following information in the record—

(a) names of the parties to the loan that is guaranteed;
(b) principal amount of that loan;
(c) terms and conditions applicable to that loan, including—
    (i) interest and other charges that are payable in respect of that loan; and
    (ii) terms of its repayment.

Not later than two months after the end of each financial year, the Cabinet Secretary shall publish and publicise a report giving details of the guarantees given by the national government during that year.

Cabinet Secretary to submit national government debt management strategy to Parliament annually

On or before the 15th February in each year, the Cabinet Secretary shall submit to Parliament a statement setting out the debt management strategy of the national government over the medium term with respect to its actual liability and potential liability in respect of loans and guarantees and its plans for dealing with those liabilities.

The Cabinet Secretary shall ensure that the medium-term debt management strategy is aligned to the broad strategic priorities and policy goals set out in the Budget Policy Statement.

The Cabinet Secretary shall include in the statement the following information—

a. the total stock of debt as at the date of the statement;
b. the sources of loans made to the national government and the nature of guarantees given by the national government;
c. the principal risks associated with those loans and guarantees;
d. the assumptions underlying the debt management strategy; and
e. an analysis of the sustainability of the amount of debt, both actual and potential.

Within fourteen days after the debt strategy paper is submitted to Parliament Under this section, the Cabinet Secretary shall submit the statement to the Commission on Revenue Allocation and the Intergovernmental Budget and Economic Council and publish and publicise the statement.

The National Treasury to provide Parliament with additional reports when required

Either House of Parliament may request the Cabinet Secretary or the National Treasury to prepare and submit to that House a report on any matter relating to the Cabinet Secretary or National Treasury's responsibilities as the House of Parliament may specify.

Stages in the budget process

The budget process for the national government in any financial year shall comprise the following stages—

a. integrated development planning process which shall include both long term and medium term planning;
b. planning and determining financial and economic policies and priorities at the national level over the medium term;
c. preparing overall estimates in the form of the Budget Policy Statement of national government revenues and expenditures;
d. adoption of Budget Policy Statement by Parliament as a basis for future deliberations;
e. preparing budget estimates for the national government;
f. submitting those estimates to the National Assembly for approval;
g. enacting the appropriation Bill and any other Bills required to implement the National government's budgetary proposals;
h. implementing the approved budget;
i. evaluating and accounting for, the national government's budgeted revenues and expenditures; and
j. reviewing and reporting on those budgeted revenues and expenditures every three months.

The Cabinet Secretary shall ensure public participation in the budget process provided for under subsection (1).

Cabinet secretary to manage budget process at national level

The Cabinet Secretary shall manage the budget process at the national level.

Not later than the 30th August in each year, the Cabinet Secretary shall issue to all national government entities a circular setting out guidelines on the budget process to be followed by them.

The circular shall include—

- a schedule for preparation of the budget indicating key dates by which various exercises are to be completed;
- the procedures for the review and projection of revenues and expenditures;
- key policy areas and issues that are to be taken into consideration when preparing the budget;
- procedures setting out the manner, in which members of the public shall participate in the budget process;
- the format in which budget information and documents shall be submitted; and
- any other information that, in the opinion of the Cabinet Secretary, may assist the budget process.

Every national government entity shall comply with the guidelines, and in particular, such dates as are specified in the schedule referred to in subsection (3)(a).

The Cabinet Secretary shall by regulations, prescribe procedures specifying how, when and where members of the public shall participate in the budget process at the national level.

The Cabinet Secretary shall notify the members of the Intergovernmental Budget and Economic Council of the commencement of the budget process.

Submission of budget estimates and related documents for approval

The Cabinet Secretary shall, within a period allowing time to meet the deadlines specified in this section, submit to the Cabinet for its approval—

(a) the budget estimates and other documents supporting the budget; and
(b) the draft Bills required to implement the national budget.

The Cabinet Secretary shall submit to the National Assembly, by the 30th April in that year, the following documents—

(a) the budget estimates excluding those for Parliament and the Judiciary;
(b) documents supporting the submitted estimates; and
(c) any other Bills required to implement the national government budget.

The accounting officer for the Parliamentary Services Commission shall, not later than the 30th April in each financial year—

Submit to the National Assembly the budget estimates for Parliament, including proposed appropriations; and

provide the National Treasury with a copy of those documents.

The Chief Registrar of the Judiciary shall, not later than the 30th April in each financial year—

a. submit to the National Assembly the budget estimates for the Judiciary, including proposed appropriations; and
b. provide the National Treasury with a copy of those documents.

In preparing the documents referred to in subsections (3) and (4), the accounting officer for the Parliamentary Service Commission and the Chief Registrar of the Judiciary—

a. shall ensure that members of the public are given an opportunity to participate in the preparation process; and
b. may make and publish rules to be complied with by those who may wish to participate in the process.

The Cabinet Secretary shall submit to the National Assembly not later than the 15th May any comments of the National Treasury on the budgets proposed by the Parliamentary Service Commission and the Chief Registrar for the Judiciary.

The Cabinet Secretary shall ensure that the budget process is conducted in a manner and within a timeframe sufficient to permit the various participants in the process to comply with the requirements of the Constitution and this Act.

As soon as practicable after the budget estimates and other documents have been submitted to the National Assembly under this section, the Cabinet Secretary shall publicise those documents.

Upon approval of the budget estimates by the National Assembly, the Cabinet Secretary shall prepare and submit an Appropriation Bill of the approved estimates to the National Assembly.

Submission of other budget documents to the National Assembly

The Cabinet Secretary shall submit to the National Assembly the following other budget documents for each financial year—

(a) a budget summary that includes—

i. a summary of budget policies including policies on revenue, expenditure, debt and deficit financing;

ii. an explanation of how the budget relates to the fiscal responsibility principles and to the financial objectives; and
iii. a memorandum by the Cabinet Secretary explaining how the resolutions adopted by the National Assembly on the Budget Policy Statement under section 25(7) have been taken into account.

(b) the format of the budget estimates shall include—

i. a list of all entities that are to receive funds appropriated from the budget of the national government;
ii. estimates of revenue allocated to, and expenditures projected from, the Equalisation Fund over the medium term, with an explanation of the reasons for those revenue allocations and expenditures and how these estimates comply with the policy developed by the Commission on Revenue Allocation under Article 216(4) of the Constitution;
iii. all revenue allocations to county governments from the national government's share in terms of Article 202 (2) of the Constitution, including conditional and unconditional grants;
iv. all estimated revenue by broad economic classification;
v. all estimated expenditure, by vote and by programme, clearly identifying both recurrent and development expenditures; and
vi. an estimate of any budget deficit or surplus for the financial year and medium term and the proposed sources of financing;

(c) information regarding loans made by the national government, including an estimate of principal, interest and other charges to be received by the national government in the financial year in respect of those loans;

(d) information regarding loans and guarantees made to and by the national government, including an estimate of principal, interest and other charges to be paid by the national government in the financial year in respect of those loans;

(e) information regarding any payments to be made and liabilities to be incurred by the national government for which an appropriation Act is not required which shall include the constitutional or national legislative authority for any such payments or liabilities; and

(f) a statement by the National Treasury specifying the measures taken by the national government to implement any recommendations made by the National Assembly with respect to the budget for the previous financial year or years.

The nature of information that is to be presented in the budget estimates and the form of its presentation shall be prescribed in regulations and the regulations shall be tabled in Parliament for approval.

The Cabinet Secretary shall ensure that the expenditure appropriations and the budget estimates in an appropriation Bill are presented in a way that—

a. is accurate, precise, informative and pertinent to budget issues; and
b. clearly identifies the appropriations by vote and programme.

National Assembly to consider budget estimates

The National Assembly shall consider the budget estimates of the national government, including those of Parliament and the Judiciary, with a view to approving them, with or without amendments, in time for the Appropriation Bill and any other relevant Bills, except the Finance Bill, required to implement the budget to be assented to by the 30th June each year.

Before the National Assembly considers the estimates of revenue and expenditure, the relevant committee of the National Assembly shall discuss and review the estimates and make recommendations to the National Assembly, taking into account the views of the Cabinet Secretary and the public on the proposed recommendations.

The National Assembly may amend the budget estimates of the national government only in accordance with the Division of Revenue Act and the resolutions adopted with regard to the Budget Policy Statement ensuring that —

a. an increase in expenditure in a proposed appropriation is balanced by a reduction in expenditure in another proposed appropriation; or
b. a proposed reduction in expenditure is used to reduce the deficit.

Where a Bill originating from a member of the National Assembly proposes amendments after passing the budget estimates and the appropriations Bill by Parliament, the National Assembly may only proceed in accordance with—

a. the Division of Revenue Act;
b. Article 114 of the Constitution; and
c. any increase in expenditure in a proposed appropriation is balanced by a reduction in expenditure in another proposed appropriation or any proposed reduction in expenditure is used to reduce the deficit.

Not later than twenty-one days after the National Assembly has approved the budget estimates, the National Treasury shall consolidate, publish and publicise the budget estimates.

The National Treasury shall take all reasonably practicable steps to ensure that the approved budget estimates are prepared and publicised in a form that is clear and easily understood by, and readily accessible to, members of the public.

Following approval of the budget estimates under this section, and before the Appropriation Act is assented to, the National Assembly may authorise withdrawals in accordance with Article 222 of the Constitution, and such authority shall be communicated to the Cabinet Secretary responsible for finance by the Speaker of the National Assembly within seven days of that authority being granted by the National Assembly.

The Controller of Budget shall ensure that members of the public are given information on budget implementation both at the national and county government level in accordance with Article 228 of the Constitution.

Submission and consideration of budget policy highlights and the Finance Bill in the National Assembly

Each financial year, the Cabinet Secretary shall, with the approval of Cabinet, make a public pronouncement of the budget policy highlights and revenue raising measures for the national government.

In making the pronouncement under subsection (1), the Cabinet Secretary shall take into account any regional or international agreements that Kenya has ratified, including the East African Community Treaty and where such agreements prescribe the date when the budget policy highlights and revenue raising measures are to be pronounced, the Cabinet Secretary shall ensure that the measures are pronounced on the appointed date.

On the same date that the budget policy highlights and revenue raising measures are pronounced, the Cabinet Secretary shall submit to Parliament the Finance Bill, setting out the revenue raising measures for the national government, together with a policy statement expounding on those measures.

Following the submission of the Finance Bill by the Cabinet Secretary, the relevant committee of the National Assembly shall introduce the Bill in the National Assembly, together with the report of the committee on the Bill.

Any of the recommendations made by the relevant committee of the National Assembly or adopted by the National Assembly on revenue matters shall—

a. ensure that the total amount of revenue raised is consistent with the approved fiscal framework and the Division of Revenue Act;
b. take into account the principles of equity, certainty and ease of collection;
c. consider the impact of the proposed changes on the composition of the tax revenue with reference to the direct and indirect taxes;
d. consider domestic, regional and international tax trends;
e. consider the impact on development, investment, employment and economic growth;
f. take into account the recommendations of the Cabinet Secretary as provided under Article 114 of the Constitution; and
g. take into account the taxation and other tariff agreements and obligations that Kenya has ratified, including taxation and tariff agreements under the East African Community Treaty.

(The recommendations of the Cabinet Secretary in subsection (5) (f) shall be included in the report and tabled in the National Assembly.

Passing of the Finance Bill

Not later than ninety days after passing the Appropriation Bill, the National Assembly shall consider and approve the Finance Bill with or without amendments.

Consideration by Parliament of Division of Revenue and County Allocation of Revenue Bills

Parliament shall consider the Division of Revenue and County Allocation of Revenue Bills not later than thirty days after the Bills have been introduced with a view to approving them, with or without amendments.

Limited powers of accounting officer of national government entity to reallocate appropriate funds

An accounting officer may reallocate funds from the authorised use but may not reallocate funds where—

a. the funds are appropriated for transfer to another government entity or person;
b. the funds are appropriated for capital expenditure except to defray other capital expenditure;
c. the reallocation of funds is from wages to non-wages expenditure; or
d. the transfer of funds may result in contravention of fiscal responsibility principles.

An accounting officer for a national government entity, other than a state corporation, may reallocate funds between programs, or between Sub-Votes, in the budget for a financial year if—

a. there are provisions in the budget of a program or Sub-Vote which are unlikely to be utilised;
b. a request for the reallocation has been made to the National Treasury explaining the reasons for the reallocation and the National Treasury has approved the request; and
c. the total sum of all reallocations made to or from a program or Sub-Vote does not exceed ten percent of the total expenditure approved for that program or Sub-Vote for that financial year.

Regulations made under this Act may provide for the reallocation of funds within Sub-votes or programs.

National government to submit supplementary budget to Parliament

The national government shall submit to Parliament for approval, a supplementary budget in support of money spent under Article 223 of the Constitution.

After Parliament has approved spending under subsection (1), an Appropriation Bill shall be introduced for the appropriation of the money spent.

The supplementary budget shall include a statement showing how the additional expenditure relates to the fiscal responsibility principles and financial objectives.

Appropriations to lapse if unspent at the end of the financial year.

An appropriation that has not been spent at the end of the financial year for which it was appropriated shall lapse immediately at the end of that financial year.

Subject to any other legislation, where, at the end of a financial year, a national government entity is holding appropriated money that was withdrawn from the National Exchequer Account but has not been spent, it shall repay the unspent money into the National Exchequer Account and shall prepare and submit a statement of the same to the Controller of Budget.

COUNTY GOVERNMENT RESPONSIBILITIES IN PUBLIC FINANCE

Each county government shall ensure adherence to—

a) the principles of public finance set out in Chapter Twelve of the Constitution;
b) the fiscal responsibility principles provided in section 107 under this Act;
c) national values set out in the Constitution; and
d) any other requirements of this Act.

The County Executive Committee shall observe principles of collective responsibility in exercising their functions under this Act.

In making decisions a county assembly shall take cognisance of Article 216 (2) of the Constitution.

Establishment of county treasuries

There is established for each county government, an entity to be known as County Treasury.

The County Treasury shall comprise—

a) the County Executive Committee member for finance;
b) the Chief Officer; and
c) The department or departments of the County Treasury responsible for financial and fiscal matters.

The County Executive Committee member for finance shall be the head of the County Treasury.

General responsibilities of a County Treasury

Subject to the Constitution, a County Treasury shall monitor, evaluate and oversee the management of public finances and economic affairs of the county government including—

1. developing and implementing financial and economic policies in the county;
2. preparing the annual budget for the county and co- ordinating the preparation of estimates of revenue and expenditure of the county government;
3. co-ordinating the implementation of the budget of the county government;
4. mobilising resources for funding the budgetary requirements of the county government and putting in place mechanisms to raise revenue and resources;

5. managing the county government's public debt and other obligations and developing a framework of debt control for the county;
6. consolidating the annual appropriation accounts and other financial statements of the county government in a format determined by the Accounting Standards Board;
7. acting as custodian of the inventory of the county government's assets except where provided otherwise by other legislation or the Constitution;
8. ensuring compliance with accounting standards prescribed and published by the Accounting Standards Board from time to time;
9. ensuring proper management and control of, and accounting for the finances of the county government and its entities in order to promote efficient and effective use of the county's budgetary resources;
10. maintaining proper accounts and other records in respect of the County Revenue Fund, the County Emergencies Fund and other public funds administered by the county government;
11. monitoring the county government's entities to ensure compliance with this Act and effective management of their funds, efficiency and transparency and, in particular, proper accountability for the expenditure of those funds;
12. assisting county government entities in developing their capacity for efficient, effective and transparent financial management, upon request;
13. providing the National Treasury with information which it may require to carry out its responsibilities under the Constitution and this Act;
14. issuing circulars with respect to financial matters relating to county government entities;
15. advising the county government entities, the County Executive Committee and the county assembly on financial matters;
16. strengthening financial and fiscal relations between the national government and county governments in performing their functions;
17. reporting regularly to the county assembly on the implementation of the annual county budget; and
18. Taking any other action to further the implementation of this Act in relation to the county.

Powers of a County Treasury

A County Treasury has such powers as are necessary to enable it to carry out its functions and responsibilities under this Act including—

a) with prior notice, access any system of public financial management used by any of the county government entities and the internal controls used to monitor the system;
b) taking appropriate measures, including the stoppage of funds, to deal with any failure of a county government entity to comply with this Act;

c) with prior notice, accessing the premises of a county government entity and inspecting all records and other documents relating to the financial affairs of that county government entity, kept by that entity;
d) requiring county government entities to comply with all applicable norms or standards regarding accounting practices, budget classification systems and other public financial management systems as prescribed by the Accounting Standards Board;
e) requiring any public officer employed by a county government or county government entity to provide explanations, information and assistance in respect to matters relating to the county government's public finances:
f) Provided that a person providing the information shall not be liable if at the time of providing the information, that person, in writing, objected to providing such information on grounds that the information may incriminate him or her;
g) issuing guidelines to accounting officers for the county government entities, or public officers employed by those entities, with respect to the financial affairs of that Government or those entities, and monitoring compliance with those guidelines; and
h) Ensuring that county government entities operate a financial management system that complies with national standards as prescribed by the Accounting Standards Board.

A County Treasury may, in writing, authorise any of its officers to carry out a specified responsibility, or exercise a specified power, on its behalf.

When carrying out a responsibility, or exercising a power, on behalf of a County Treasury, an authorised officer shall, if requested to do so by the person in relation to whom the responsibility or power is being carried out or exercised, produce the officer's authorisation for inspection and failure to comply with such a request invalidates any subsequent action purporting to be taken under the authority of the authorisation.

An authorisation given under subsection (3) remains in force for such period as is specified in it or, if no such period is specified, until it is revoked by the County Treasury concerned.

A County Treasury may, in writing, revoke or vary an authorisation given under subsection (3).

Secondment of public officers by a County Treasury to the National Treasury

A County Treasury may, upon the request of the National Treasury, second to the National Treasury such number of officers as may be necessary for the National Treasury to better carry out its responsibilities under this Act.

A public officer seconded to the National Treasury under subsection (1), shall be deemed to be an officer of the National Treasury and shall be subject only to the direction and control of the National Treasury.

County Treasury to enforce fiscal responsibility principles

A County Treasury shall manage its public finances in accordance with the principles of fiscal responsibility set out in subsection (2), and shall not exceed the limits stated in the regulations.

In managing the county government's public finances, the County Treasury shall enforce the following fiscal responsibility principles—

a) the county government's recurrent expenditure shall not exceed the county government's total revenue;
b) over the medium term a minimum of thirty percent of the county government's budget shall be allocated to the development expenditure;
c) the county government's expenditure on wages and benefits for its public officers shall not exceed a percentage of the county government's total revenue as prescribed by the County Executive member for finance in regulations and approved by the County Assembly;
d) over the medium term, the government's borrowings shall be used only for the purpose of financing development expenditure and not for recurrent expenditure;
e) the county debt shall be maintained at a sustainable level as approved by county assembly;
f) the fiscal risks shall be managed prudently; and
g) a reasonable degree of predictability with respect to the level of tax rates and tax bases shall be maintained, taking into account any tax reforms that may be made in the future.

For the purposes of subsection (2) (d), short term borrowing shall be restricted to management of cash flows and shall not exceed five percent of the most recent audited county government revenue.

Every county government shall ensure that its level of debt at any particular time does not exceed a percentage of its annual revenue specified in respect of each financial year by a resolution of the county assembly.

The regulations may add to the list of fiscal responsibility principles set out in subsection (2).

County government deviation from financial objectives

A county government may, with the approval of its county assembly, deviate from the financial objectives in the relevant County Fiscal Strategy Paper, but only on a temporary basis and only if the deviation is required because of a major natural disaster or some other significant unforeseen event.

If there is a change of county government, the new county government may deviate from the financial objectives in a County Fiscal Strategy Paper, but may not deviate from the fiscal responsibility objectives.

The County Treasury shall also provide a report to the county assembly regarding the deviation and its implication and shall include in the report—

a) information on the reasons and implication for the deviation;
b) proposals to address the deviation;
c) the time the deviation is estimated to last; and
d) The status of development projects initiated by the county government and if any projects have been stopped, the reasons for doing so.

The County Treasury shall publish and publicise the report not later than fifteen days after it has been submitted to the county assembly.

Establishment of a County Revenue Fund for each county government

There is established, for each county a County Revenue Fund in accordance with Article 207 of the Constitution.

The County Treasury for each county government shall ensure that all money raised or received by or on behalf of the county government is paid into the County Revenue Fund, except money that—

a) is excluded from payment into that Fund because of a provision of this Act or another Act of Parliament, and is payable into another county public fund established for a specific purpose;
b) may, in accordance with other legislation, this Act or County legislation, be retained by the county government entity which received it for the purposes of defraying its expenses; or
c) is reasonably excluded by an Act of Parliament as provided in Article 207 of the Constitution.

The County Treasury shall administer the County Revenue Fund and ensure that the county government complies with the provisions of Article 207 of the Constitution.

The County Treasury shall—

a) arrange for the County Revenue Fund to be kept in the Central Bank of Kenya or a bank approved by the County Executive Committee member responsible for finance and shall be kept in an account to be known as the "County Exchequer Account; and
b) ensure that all money authorised to be paid by the county government or any of its entities for a public purpose is paid from that account without undue delay.

The County Treasury shall ensure that at no time is the County Exchequer Account overdrawn.

The County Treasury shall obtain the written approval of the Controller of Budget before withdrawing money from the County Revenue Fund under the authority of—

a) an Act of the county assembly that appropriates money for a public purpose;
b) an Act of Parliament or county legislation that imposes a charge on that Fund; or
c) This Act in accordance with sections 134 and 135.

The approval of the Controller of Budget to withdraw money from the County Revenue Fund, together with written instructions from the County Treasury requesting for the withdrawal, is sufficient authority for the approved bank where the County Exchequer Account is held to pay amounts from this account in accordance with the approval and the instructions.

Any unutilised balances in the County Revenue Fund shall not lapse at the end of the financial year but shall be retained for the purposes for which it was established.

Financial reports shall be submitted to the Commission on Revenue Allocation with a copy to the Controller of Budget.

County Government Executive Committee may establish county government Emergency Fund

A County Executive Committee may, with the approval of the county assembly, establish an emergency fund for the county government under the name "…………………… County Emergency Fund" and the fund shall consist of money from time to time appropriated by the county assembly to the Fund by an appropriation law.

The purpose of an Emergency Fund is to enable payments to be made in respect of a county when an urgent and unforeseen need for expenditure for which there is no specific legislative authority arises.

County Executive Committee member for finance to administer the Emergency Fund

The County Executive Committee member for finance shall administer the county government Emergency Fund for the county government in accordance with a framework and criteria approved by the county assembly.

The County Executive Committee member for finance shall establish and maintain a separate account into which all money appropriated to the Emergency Fund shall be paid.

Power of County Executive Committee member to make payments from Emergency Fund

Subject to section 113, the County Executive Committee member for finance may make payments from the county government's Emergency Fund only if he or she is satisfied that there is an urgent and unforeseen need for expenditure for which there is no legislative authority and shall be in accordance with operational guidelines made under regulations approved by Parliament and the law relating to disaster management.

(For the purposes of subsection (1), there is an urgent and unforeseen event for expenditure if the County Executive Committee member for finance, guided by regulations and relevant laws, establishes that—

a) payment not budgeted for cannot be delayed until a later financial year without harming the general public interest;
b) payment is meant to alleviate the damage, loss, hardship or suffering which may be caused directly by the event; and
c) The damage caused by the event is on a small scale and limited to the county.

For the purposes of subsection (1), the unforeseen event is one which—

a) threatens damage to human life or welfare; or
b) Threatens damage to the environment.

Limitation on power of County Executive Committee member for finance to make payments from Emergency Fund

The County Executive Committee member for finance may not, during a financial year, make a payment from the Emergency Fund under section 112 exceeding two per cent of the total county government revenue as shown in that county government's audited financial statements for the previous financial year, except for the first year.

ESTABLISHMENT, PURPOSE AND COMPOSITION OF THE INTERGOVERNMENTAL BUDGET AND ECONOMIC COUNCIL

There is established a council known as the Intergovernmental Budget and Economic Council comprising—

1. the Deputy President who shall be the Chairperson;
2. the Cabinet Secretary;
3. a representative of the Parliamentary Service Commission;
4. a representative of the Judicial Service Commission;
5. the Chairperson of the Commission on Reveille Allocation or a person designated by the Chairperson;
6. the Chairperson of the Council of County Governors;
7. every County Executive Committee member for finance; and
8. The Cabinet Secretary responsible for intergovernmental relations.

(The purpose of the Council is to provide a forum for consultation and cooperation between the national government and county governments on—

a. the contents of the Budget Policy Statement, the Budget Review and Outlook Paper and the Medium-Term Debt Management Strategy;
b. matters relating to budgeting, the economy and financial management and integrated development at the national and county level;
c. matters relating to borrowing and the framework for national government loan guarantees, criteria for guarantees and eligibility for guarantees;
d. agree on the schedule for the disbursement of available cash from the Consolidated Fund on the basis of cash flow projections;
e. any proposed legislation or policy which has a financial implication for the counties, or for any specific county or counties;
f. any proposed regulations to this Act; and
g. recommendations on the equitable distribution of revenue between the national and county governments and amongst the county governments as provided in section 190; and

h. Any other matter which the Deputy President in consultation with other Council members may decide.

An appointed member of the Council holds office for 2 years and is eligible for re-nomination and re-appointment at the end of a term of office for another term not exceeding two years.

The National Treasury shall provide secretariat services to the Council and assign or appoint such support staff as may be necessary for the Council to effectively perform its functions.

The Council shall meet at least twice a year and the Deputy President shall decide the time and agenda for meetings of the Council in consultation with the other members of the Council.

In the absence of the Chairperson from any meeting of the Council, the Cabinet Secretary shall chair the meeting.

The Council may determine its own rules and procedures in such manner as it considers appropriate.

The Council may invite other persons to attend any of its meetings.

Vacation of office by a member

A member of the Intergovernmental Budget and Economic Council shall cease to be a member if that person ceases to hold office by virtue of which he or she became a member to the Council.

THE PROCESS OF SHARING REVENUE

The process of sharing revenue raised by the national government between the national and county governments, and among the county governments, shall be in accordance with the Constitution and this Act.

Recommendations of the Commission on Revenue Allocation

At least six months before the beginning of the financial year, or at a later date agreed between the Cabinet Secretary and the Commission on Revenue Allocation, the Commission shall submit to the Senate, the National Assembly, the County Assembly, the National Executive and the County Executives, recommendations for the following financial year regarding—

a. an equitable division of revenue raised nationally, among the national and county levels of government; and
b. The determination of each county's equitable share in the county share of that revenue.

When making its recommendations, the Commission takes into account the criteria listed in the Constitution.

Division of Revenue Bill and County Allocation of Revenue Bill

Each year when the Budget Policy Statement is introduced, the Cabinet Secretary submits to Parliament a Division of Revenue Bill and County Allocation of Revenue Bill prepared by the National Treasury as provided in this Act for the financial year to which that Budget relates.

The Division of Revenue Bill shall specify the share of each level of government of the revenue raised nationally for the relevant financial year.

The County Allocation of Revenue Bill shall specify—

a. each county's share of that revenue under subsection (2); and
b. Any other allocations to the counties, from the national government's share of that revenue, and any conditions on which those allocations shall be made.

Before the submission of the Division of Revenue Bill and County Allocation of Revenue Bill, the Cabinet Secretary notifies —

a. the Intergovernmental Budget and Economic Council; and
b. The Commission on Revenue Allocation.

When the Division of Revenue Bill or County Allocation of Revenue Bill is submitted, it shall be accompanied by a memorandum which explains—

a. how the Bill takes into account the criteria listed in Article 203 (1) of the Constitution;
b. the extent of the deviation from the Commission on Revenue Allocation's recommendations;
c. the extent, if any, of deviation from the recommendations of the Intergovernmental Budget and Economic Council; and
d. any assumptions and formulae used in arriving at the respective shares above

THE ROLE OF THE COMMISSION ON REVENUE ON ALLOCATION (COR)

There is an established commission of revenue allocation; the Commission consists of the following persons appointed by the President—

a) a chairperson, who shall be nominated by the President and approved by the National Assembly;

b) two persons nominated by the political parties represented in the National Assembly according to their proportion of members in the Assembly;

c) five persons nominated by the political parties represented in the Senate according to their proportion of members in the Senate; and

d) The Principal Secretary in the Ministry responsible for finance.

The persons nominated are not be members of Parliament.

To be qualified to be a member of the Commission a person shall have extensive professional experience in financial and economic matters.

The principal function of the Commission on Revenue Allocation is to make recommendations concerning the basis for the equitable sharing of revenue raised by the national government—

a) between the national and county governments; and
b) Among the county governments.

The Commission also makes recommendations on other matters concerning the financing of, and financial management by, county governments, as required by this Constitution and national legislation.

In formulating recommendations, the Commission seeks—

a) To promote and give effect to the criteria mentioned the article relating to Equitable share and other financial laws.
b) when appropriate, to define and enhance the revenue sources of the national and county governments; and

c) to encourage fiscal responsibility.

The Comission shall determine, publish and regularly review a policy in which it sets out the criteria by which to identify the marginalised areas for purposes of Article 204 (2).

The Commission shall submit its recommendations to the Senate, the National Assembly, the national executive, county assemblies and county executives.

CHAPTER THREE

ESTABLISHMENT OF PUBLIC FUNDS IN THE PUBLIC SECTOR

ESTABLISHMENT OF A COUNTY REVENUE FUND FOR EACH COUNTY GOVERNMENT

There is established, for each county a County Revenue Fund in accordance with the Constitution.

The County Treasury for each county government shall ensure that all money raised or received by or on behalf of the county government is paid into the County Revenue Fund, except money that—

a) is excluded from payment into that Fund because of a provision of this Act or another Act of Parliament, and is payable into another county public fund established for a specific purpose;

b) may, in accordance with other legislation, this Act or County legislation, be retained by the county government entity which received it for the purposes of defraying its expenses; or

c) is reasonably excluded by an Act of Parliament as provided in Article 207 of the Constitution.

The County Treasury shall administer the County Revenue Fund and ensure that the county government complies with the provisions of the Constitution.

The County Treasury shall—

a) arrange for the County Revenue Fund to be kept in the Central Bank of Kenya or a bank approved by the County Executive Committee member responsible for finance and shall be kept in an account to be known as the "County Exchequer Account; and

b) ensure that all money authorised to be paid by the county government or any of its entities for a public purpose is paid from that account without undue delay.

The County Treasury shall ensure that at no time is the County Exchequer Account overdrawn.

The County Treasury shall obtain the written approval of the Controller of Budget before withdrawing money from the County Revenue Fund under the authority of—

(a) an Act of the county assembly that appropriates money for a public purpose;

(b) an Act of Parliament or county legislation that imposes a charge on that Fund; or

The approval of the Controller of Budget to withdraw money from the County Revenue Fund, together with written instructions from the County Treasury requesting for the withdrawal, is sufficient authority for the approved bank where the County Exchequer Account is held to pay amounts from this account in accordance with the approval and the instructions.

Any unutilised balances in the County Revenue Fund shall not lapse at the end of the financial year but shall be retained for the purposes for which it was established.

Financial reports shall be submitted to the Commission on Revenue Allocation with a copy to the Controller of Budget.

County Government Executive Committee may establish county government Emergency Fund.

A County Executive Committee may, with the approval of the county assembly, establish an emergency fund for the county government under the name "…………………… County Emergency Fund" and the fund shall consist of money from time to time appropriated by the county assembly to the Fund by an appropriation law.

The purpose of an Emergency Fund is to enable payments to be made in respect of a county when an urgent and unforeseen need for expenditure for which there is no specific legislative authority arises.

County Executive Committee member for finance to administer the Emergency Fund

The County Executive Committee member for finance shall administer the county government Emergency Fund for the county government in accordance with a framework and criteria approved by the county assembly.

The County Executive Committee member for finance shall establish and maintain a separate account into which all money appropriated to the Emergency Fund shall be paid.

Power of County Executive Committee member to make payments from Emergency Fund

The County Executive Committee member for finance may make payments from the county government's Emergency Fund only if he or she is satisfied that there is an urgent and unforeseen need for expenditure for which there is no legislative authority and shall be in accordance with operational guidelines made under regulations approved by Parliament and the law relating to disaster management.

There is an urgent and unforeseen event for expenditure if the County Executive Committee member for finance, guided by regulations and relevant laws, establishes that—

a) payment not budgeted for cannot be delayed until a later financial year without harming the general public interest;

b) payment is meant to alleviate the damage, loss, hardship or suffering which may be caused directly by the event; and

c) the damage caused by the event is on a small scale and limited to the county.

The unforeseen event is one which—

a) threatens damage to human life or welfare; or

b) threatens damage to the environment.

Limitation on power of County Executive Committee member for finance to make payments from Emergency Fund

The County Executive Committee member for finance may not, during a financial year, make a payment from the Emergency Fund exceeding two per cent of the total county government revenue as shown in that county government's audited financial statements for the previous financial year, except for the first year.

County Executive Committee member for finance to seek approval for payments from Emergency Fund

The County Executive Committee member for finance shall seek approval of the county assembly within two months after payment is made from the Emergency Fund.

If the county assembly is not sitting during the period, or soon thereafter, the County Executive Committee member for finance shall seek the approval for the payment within fourteen days after the County Assembly next sits.

As soon as practicable after the county assembly has approved the payment, the County Executive Committee member for finance shall cause a draft of the appropriation Bill to be introduced in the county assembly for the appropriation of the money paid and for the replenishment of the county government's Emergency Fund to the extent of the amount of the payment.

County Treasury to submit a report to Auditor-General in respect to Emergency Fund

Where an Emergency Fund has been established for a county government, the County Treasury shall, not later than three months after the end of each financial year, prepare and submit to the Auditor-General, financial statements in respect of the Emergency Fund for that year.

The County Treasury shall include in the financial statements—

a. the date and amount of each payment made from that Fund;

b. the person to whom the payment was made;

c. the purpose for which the payment was made;

d. whether the person to whom the payment was made has spent the money for that purpose, and a statement made to that effect;

e. if the person to whom the payment has been made has not yet spent the money for that purpose, a statement specifying the reasons for not having done so; and

f. a statement indicating how the payment conforms to the set guidelines

Power to establish other county public funds

A County Executive Committee member for finance may establish other public funds with the approval of the County Executive Committee and the county assembly.

For every county public fund established, the County Executive Committee member for finance shall designate a person responsible for administering that fund.

The administrator of a county public fund shall ensure that the earnings of, or accruals to a county public fund are retained in the fund, unless the County Executive Committee member for finance directs otherwise.

The administrator of a county public fund shall ensure that money held in the fund, including any earnings or accruals is spent only for the purposes for which the fund is established.

The County Executive Committee member for finance may wind up a county public fund with the approval of the county assembly.

On the winding up of a county public fund—

a. the administrator of the fund shall pay any amount remaining in the fund into the County Exchequer Account; and

b. The County Executive Committee member for finance shall, with the approval of the county assembly, pay any deficit in the fund from the County Exchequer Account.

The administrator of a county public fund shall—

a. prepare accounts for the fund for each financial year;

b. not later than three months after the end of each financial year, submit financial statements relating to those accounts to the Auditor-General; and

c. Present the financial statements to the county assembly.

The administrator of a county public fund shall ensure that the accounts for the fund and the annual financial statements relating to those accounts comply with the accounting standards prescribed and published by the Accounting Standards Board from time to time.

Regulations may provide for the establishment, management, operation or winding-up of county public funds under this section.

The funds and usage of money through the funds shall be published and publicised.

CONSOLIDATED FUND

There is established Consolidated Fund into which all monies raised or received by or on behalf of the national government, except money that—

a) is reasonably excluded from the Fund by an Act of Parliament and payable into another public fund established for a specific purpose; or
b) May, under an Act of Parliament, be retained by the State organ that received it for the purpose of defraying the expenses of the State organ.

Money may be withdrawn from the Consolidated Fund only—

a) in accordance with an appropriation by an Act of Parliament;
b) in accordance with the constitution
c) As a charge against the Fund as authorised by this Constitution or an Act of Parliament.

Money is not withdrawn from any national public fund other than the Consolidated Fund, unless the withdrawal of the money has been authorised by an Act of Parliament.

Money is not withdrawn from the Consolidated Fund unless the Controller of Budget approves the withdrawal.

Revenue Funds for county governments

There is also established Revenue Fund for each county government, into which payment of all money raised or received by or on behalf of the county government, except money reasonably excluded by an Act of Parliament is kept

Money may be withdrawn from the Revenue Fund of a county government only—

a) as a charge against the Revenue Fund that is provided for by an Act of Parliament or by legislation of the county; or
b) As authorised by an appropriation by legislation of the county.

Money cannot be withdrawn from a Revenue Fund unless the Controller of Budget has approved the withdrawal

An Act of Parliament may—

a) make further provision for the withdrawal of funds from a county Revenue Fund; and
b) Provide for the establishment of other funds by counties and the management of those funds.

Administration of the Consolidated Fund

The National Treasury administers the Consolidated Fund in accordance with the Constitution.

The National Treasury also maintains the Consolidated Fund in an account known as the National Exchequer Account, kept at the Central Bank of Kenya and shall, subject to Constitution—

a. facilitate payment into that account all money raised or received by or on behalf of the national government; and
b. Pay from that National Exchequer Account without undue delay all amounts that are payable for public services.

The National Treasury ensures that the National Exchequer Account is not overdrawn at any time.

Where a withdrawal from the Consolidated Fund is authorised under the Constitution or an Act of Parliament for the appropriation of money, the National Treasury makes a requisition for the withdrawal and submits it to the Controller of Budget for approval.

The approval of a withdrawal from the Consolidated Fund by the Controller of Budget, together with written instructions from the National Treasury requesting for the withdrawal, is sufficient authority for the Central Bank of Kenya to pay amounts from the National Exchequer Account in accordance with the approval and instructions provided.

The National Treasury at the beginning of every quarter, and in any event not later than the fifteenth day from the commencement of the quarter, disburses monies to county governments.

The disbursement referred to here is done in accordance with a schedule prepared by the National Treasury in consultation with the Intergovernmental Budget and Economic Council, with the approval of the Senate, and published in the Gazette, as approved, not later than the 30th May in every year.

CONTINGENCIES FUND

There is established a Contingencies Fund, the operation of which is in accordance with an Act of Parliament.

An Act of Parliament provides for advances from the Contingencies Fund if the Cabinet Secretary responsible for finance is satisfied that there is an urgent and unforeseen need for expenditure for which there is no other authority

Source of the Contingencies Fund

The Contingencies Fund consists of monies appropriated from the Consolidated Fund by an appropriation Act in any financial year.

Cabinet Secretary to administer the Contingencies Fund

The Cabinet Secretary administers the Contingencies Fund.

The permanent capital of the Contingencies Fund is not to exceed ten billion shillings or such other amount as may be prescribed by the Cabinet Secretary with the approval of Parliament.

The Cabinet Secretary keeps the Contingencies Fund in a separate account, maintained at the Central Bank of Kenya and shall pay—

a. into that account all monies appropriated to the Contingencies Fund by an appropriation Act; and
b. From the Contingencies Fund, without undue delay, all advances made under section 21.

Advances from the Contingencies Fund

The Cabinet Secretary may make advances from the Contingencies Fund if, on the basis of the set criteria and the process and operational guidelines as prescribed in regulations approved by Parliament and the laws relating to disaster management, the Cabinet Secretary is satisfied that an urgent and unforeseen need for expenditure has arisen for which there is no specific legislative authority.

For the purposes of the above section, there is an urgent need for expenditure if the Cabinet Secretary, guided by regulations and relevant laws, establishes that—

a. the payment which was not budgeted for because it was unforeseen and cannot be delayed until a later financial year without harming the general public interest; and
b. The event was unforeseen.

In addition to regulations and relevant laws, and for the purposes of this section, an unforeseen event is one which—

a. threatens serious damage to human life or welfare;
b. threatens serious damage to the environment; and
c. Is meant to alleviate the damage, loss, hardship or suffering caused directly by the event.

An event threatens damage to human life or welfare under subsection (3)(a) only if it involves, causes or may cause —

a. loss of life, human illness or injury;
b. homelessness or damage to property;
c. disruption of food, water or shelter; or
d. Disruption to services, including health services.

The Cabinet Secretary, by regulations and with Parliament approval, prescribes the criteria for making advance under the above power

Cabinet Secretary seeks Parliamentary approval for payments made from Contingencies Fund.

Not later than two months after a payment from the Contingencies Fund, the Cabinet Secretary submit to Parliament a detailed report in respect of the payment setting out the information specified and seek Parliament to approve the payment.

If Parliament does not sit during that period of 2 months or is not sitting at the end of that period and the Cabinet Secretary has not sought' the approval of Parliament before the end of that period, the Cabinet Secretary should seek the approval for the payment not later than fourteen days after Parliament next sits.

As soon as practicable after the Parliament has approved the payment, the Cabinet Secretary causes an appropriation Bill to be introduced in Parliament for the appropriation of the money paid and for the replenishment of the Contingencies Fund to the extent of the amount of the payment.

Financial statements in respect of the Contingencies Fund

Not later than 3 months after the end of each financial year, the National Treasury should prepare and submit to the Auditor-General financial statements for that year in respect of the Contingencies Fund.

The National Treasury should include the following information in the financial statements:-

a. the date and amount of each payment made from that Contingencies Fund;
b. the person to whom the payment was made;
c. the purpose for which the payment was made;
d. if the person to whom the payment was made has spent the money for that purpose, a statement to that effect;
e. if the person to whom the payment was made has not yet spent the money for that purpose, a statement specifying the reasons for not having done so; and
f. a statement indicating how the payment conforms to section 21.

Establishment of Parliamentary Fund and other national government public funds

There is established a fund to be known as the Parliamentary Fund.
The Secretary to the Parliamentary Service Commission shall, on the directions of the Commission, open and operate such bank accounts as may be necessary for the purposes of the Parliamentary Fund.

Notwithstanding any other provisions of this Act, where a Fund is established under any other law for the purposes of Parliament or a House of Parliament, the Parliamentary Service Commission shall—

a. establish procedures and systems for proper and effective management of the monies and property of the Fund;
b. establish accounting procedures and systems for the Commission to properly account for the monies and property;
c. superintend the expenditure of the monies of the Fund to ensure that the monies are properly accounted for;
d. prepare and submit accounts for each financial year in accordance with the written law for the time being relating to audit for audit by the Auditor-General; and
e. Ensure that accounts prepared under paragraph (d) comply with the provisions of this Act.

The Cabinet Secretary may establish a national government public fund with the approval of the National Assembly.

The Cabinet Secretary shall designate a person to administer every national public fund
The administrator of a national public fund shall ensure that the earnings of, or accruals to a national public fund are retained in the fund unless the Cabinet Secretary directs otherwise.

The administrator of a national public fund shall ensure that money held in the fund, including any earnings or accruals referred to above, is spent only for the purposes for which the fund is established.

The Cabinet Secretary may wind up a national public fund with the approval of the National Assembly.

On the winding up of a national public fund—

a. the administrator of the national public fund shall pay any amount remaining in the fund into the National Exchequer Account for the credit of the national government; or
b. the Cabinet Secretary shall pay any deficit in the fund from funds of the national government in the National Exchequer Account with the approval of the National Assembly; and
c. The Cabinet Secretary shall submit a final statement of accounts to Parliament.

The administrator of a national public fund—

a. prepares financial statements for the fund for each financial year in a form specified by the Accounting Standards Board; and
b. Not later than three months after the end of each financial year, submit those statements to the Auditor-General and deliver a copy of the statements to the National Treasury, Commission on Revenue Allocation and the Controller of Budget.

The regulations provides for the establishment, management, operation or winding-up of national public funds.

This section applies to all other national public funds including funds earmarked for specific purposes established by an Act of Parliament but does not apply to a public fund established by the Constitution.
In this section—
"administrator", in relation to a national public fund, means a person designated by the Cabinet Secretary to administer the fund; and
"national public fund" means a public fund

EQUALISATION FUND

There is established an Equalisation Fund into which shall be paid one half per cent of all the revenue collected by the national government each year calculated on the basis of the most recent audited accounts of revenue received, as approved by the National Assembly.

The national government shall use the Equalisation Fund only to provide basic services including water, roads, health facilities and electricity to marginalised areas to the extent necessary to bring the quality of those services in those areas to the level generally enjoyed by the rest of the nation, so far as possible.

The national government may use the Equalisation Fund—

a. only to the extent that the expenditure of those funds has been approved in an Appropriation Bill enacted by Parliament; and
b. Either directly**,** or indirectly through conditional grants to counties in which marginalised communities exist.

The Commission on Revenue Allocation is consulted and its recommendations considered before Parliament passes any Bill appropriating money out of the Equalisation Fund.

Any unexpended money in the Equalisation Fund at the end of a particular financial year shall remain in that Fund for use during any subsequent financial year.

Money shall not be withdrawn from the Equalisation Fund unless the Controller of Budget has approved the withdrawal.

CHAPTER FOUR

SUPPLY CHAIN MANAGEMENT IN PUBLIC ENTITIES

Procurement of public goods and services

When a State organ or any other public entity contracts for goods or services, it shall do so in accordance with a system that is fair, equitable, transparent, competitive and cost-effective.

The public procurement and disposal act prescribe a framework within which policies relating to procurement and asset disposal are to be implemented and provides the following—

a) categories of preference in the allocation of contracts;
b) the protection or advancement of persons, categories of persons or groups previously disadvantaged by unfair competition or discrimination;
c) sanctions against contractors that have not performed according to professionally regulated procedures, contractual agreements or legislation; and

Sanctions against persons who have defaulted on their tax obligations, or have been guilty of corrupt practices or serious violations of fair employment laws and practices

Definitions and terminologies

―accounting officer‖ means—

(*a*) for a public entity other than a local authority, the person appointed by the Permanent Secretary to the Treasury as the accounting officer or, if there is no such person, the chief executive of the public entity; or

(*b*) for a local authority, the town or county clerk of the local authority;
―Advisory Board‖ means the Public Procurement Oversight Advisory Board established under section 21;
―Authority‖ means the Public Procurement Oversight Authority established under section 8; ―candidate‖ means a person who has submitted a tender to a procuring entity;
―citizen contractor‖ means a natural person or an incorporated company wholly owned and controlled by persons who are citizens of Kenya;
―contractor‖ means a person who enters into a procurement contract with a procuring entity;
―corruption‖ has the meaning assigned to it in the Anti Corruption and Economic Crimes Act, 2003 and includes the offering, giving, receiving or soliciting of anything of value to influence the action of a public official in the procurement or disposal process or in contract execution.

―Director-General‖ means the Director-General of the Authority provided for under section 10;

―disposal‖ means the divestiture of public assets, including intellectual and proprietary rights and goodwill and other rights of a procuring entity by any means including sale, rental, lease, franchise, auction or any combination however classified, other than those regulated by any other written law;

―fraudulent practice‖ includes a misrepresentation of fact in order to influence a procurement or disposal process or the exercise of a contract to the detriment of the procuring entity, and includes collusive practices amongst bidders prior to or after bid submission designed to establish bid prices at artificial non competitive levels and to deprive the procuring entity of the benefits of free and open competition;

―goods‖ includes raw materials, things in liquid or gas form, electricity and services that are incidental to the supply of the goods;

―local contractor‖ means a contractor who is registered in Kenya under the Companies Act and whose operation is based in Kenya;

―Minister‖ means the Minister responsible for matters relating to finance;

―prescribed‖ means prescribed by regulation under this Act;

―procurement‖ means the acquisition by purchase, rental, lease, hire purchase, license, tenancy, franchise, or by any other contractual means of any type of works, assets, services or goods including livestock or any combination;

―procuring entity‖ means a public entity making a procurement to which this Act applies;

―public entity‖ means—

a) the Government or any department of the Government;
b) the courts;
c) the commissions established under the Constitution;
d) a local authority under the Local Government Act;
e) a state corporation within the meaning of the State Corporations Act;
f) the Central Bank of Kenya established under the Central Bank of Kenya Act;
g) a co-operative society established under the Co-operative Societies Act;
h) a public school within the meaning of the Education Act;
i) a public university within the meaning of the Universities Act;
j) a college or other educational institution maintained or assisted out of public funds; or

k) an entity prescribed as a public entity for the purpose of this paragraph;
l) ―public funds‖ has the meaning assigned to it in the Exchequer and

Audit Act and includes monetary resources appropriated to procuring entities through the budgetary process, as well as extra budgetary funds, including aid grants and credits, put at the disposal of procuring entities by foreign donors, and revenues of procuring entities;

―Review Board‖ means the Public Procurement Administrative Review Board established under section 25;

―services‖ means any objects of procurement or disposal other than works and goods and includes professional, non professional and commercial types of services as well as goods and works which are incidental to but not exceeding the value of those services;

―the regulations‖ means regulations made under this Act;

―urgent need‖ means the need for goods, works or services in circumstances where there is an imminent or actual threat to public health, welfare, safety, or of damage to property, such that engaging in tendering proceedings or other procurement methods would not be practicable;

―Works‖ means the construction, repair, renovation or demolition of buildings, roads or other structures and includes—

a) the installation of equipment and materials;
b) site preparation; and
c) Other incidental services.

GENERAL OVERVIEW OF PUBLIC PROCUREMENT AND DISPOSAL (PPD) ACT

The purpose of this Act is to establish procedures for procurement and the disposal of unserviceable, obsolete or surplus stores and equipment by public entities to achieve the following objectives—

a) To maximise economy and efficiency;

b) To promote competition and ensure that competitors are treated fairly;

c) To promote the integrity and fairness of those procedures;

d) To increase transparency and accountability in those procedures; and

e) To increase public confidence in those procedures;

f) To facilitate the promotion of local industry and economic development.

Application of Act

This Act applies with respect to—

a) procurement by a public entity;
b) contract management;
c) supply chain management, including inventory and distribution; and
d) Disposal by a public entity of stores and equipment that is unserviceable, obsolete or surplus.

For greater certainty, the following are not procurements with respect to which this Act applies—

a) the retaining of the services of an individual for a limited term if, in providing those services, the individual works primarily as though he were an employee;
b) the acquiring of stores or equipment if the stores or equipment are being disposed of by a public entity in accordance with the procedures set.
c) The acquiring of services provided by the Government or a department of the Government.

For greater certainty, the following are procurements with respect to which this Act applies—

a. the renting of premises, except as described under above;
b. the appointing, other than under the authority of an Act, of an individual to a committee, task force or other body if the individual will be paid an amount other than for expenses;
c. The acquiring of real property.

Conflicts with other Acts

If there is a conflict between this Act or the regulations made under this Act and any other Act or regulations, in matters relating to procurement and disposal, this Act or the regulations made under this Act shall prevail.

For greater certainty, a provision of an Act that provides for a person or body to approve any work or expenditure shall not be construed as giving that person or body any power with respect to procurement proceedings.

Conflict with international agreements

Where any provision of this Act conflicts with any obligations of the Republic of Kenya arising from a treaty or other agreement to which Kenya is a party, this Act shall prevail except in instances of negotiated grants or loans.

Where a treaty or agreement referred to above contains provisions favourable to citizens and local contractors, full advantage shall be taken of these in the interest of promoting domestic capacity development.

Where the Republic of Kenya is required under the terms of any treaty or agreement to which she is a party, to contribute from her resources, in any form, to any procurement activities within Kenya, either in part or wholly, jointly or separately, procurement through such contributions shall be–

a. in discrete activities where possible; and
b. subject to the applicable provisions of this Act.

The disposal of any or all of the goods or public assets accruing to Kenya as a result of procurement activities subject to the provisions of this Act.

Where procurement to which conflict with any obligations of the Republic of Kenya arising from a treaty or other agreement to which Kenya is a party favours an external beneficiary–

a. the procurement through contributions made by Kenya, shall be undertaken in Kenya through contractors registered in Kenya; and
b. all relevant insurances shall be placed with companies registered in Kenya and goods shall be transported in carriages registered in Kenya.

Conflict with conditions on donated funds.

If there is a conflict between this Act, the regulations or any directions of the Authority and a condition imposed by the donor of funds, the condition shall prevail with respect to a procurement that uses those funds and no others.

This does not apply if the donor of funds is a public entity.

The Public Procurement Oversight Authority is hereby established as a body corporate.

The Authority shall have all the powers necessary or expedient for the performance of its functions.

Without limiting the generality of the above power the Authority shall have perpetual succession and a common seal and shall be capable of–

a. suing and being sued in its corporate name; and
b. Holding and alienating moveable and immovable property.

Functions of Authority

1. to ensure that the procurement procedures established under this Act are complied with;
2. to monitor the public procurement system and report on the overall functioning of it and present to the Minister such other reports and recommendations for improvements as the Director-General considers advisable;
3. to assist in the implementation and operation of the public procurement system and in doing so-

   i. to prepare and distribute manuals and standard documents to be used in connection with procurement by public entities;
   ii. to provide advice and assistance to procuring entities;
   iii. to develop, promote and support the training and professional development of persons involved in procurement; and
   iv. to issue written directions to public entities with respect to procurement including the conduct of procurement proceedings and the dissemination of information on procurements; and
   v. To ensure that procuring entities engage procurement professionals in their procurement units.

4. To initiate public procurement policy and propose amendments to this Act or to the regulations; and
5. To perform such other functions and duties as are provided for under this Act.

PROCUREMENT GUIDELINES AS ENVISAGED BY PPD ACT GENERAL PROCUREMENT RULES

Choice of procurement procedure

For each procurement being done, the procuring entity should use open tendering under or an alternative procurement procedure and the, procuring entity can use an alternative procurement procedure only if that procedure is allowed.

A procuring entity can also use restricted tendering or direct procurement as an alternative procurement procedure only if, before using that procedure, the procuring entity—

(*a*) Obtains the written approval of its tender committee; and
(*b*) Records in writing the reasons for using the alternative procurement procedure.
A procuring entity can use such standard tender documents as may be prescribed

Procurement not to be split or inflated

No procuring entity may structure procurement as two or more procurements for the purpose of avoiding the use of a procurement procedure.

Any person who contravenes the provisions of this section shall be guilty of an offence.

Standard goods, services and works with known market prices shall be procured at the prevailing real market price.

Public officials involved in transactions in which standard goods, services and works are procured at unreasonably inflated prices shall, in addition to any other sanctions prescribed in this Act or the regulations, be required to pay the procuring entity for the loss resulting from their actions.

Qualifications to be awarded contract

A person is qualified to be awarded a contract for a procurement only if the person satisfies the following criteria—

a) the person has the necessary qualifications, capability, experience, resources, equipment and facilities to provide what is being procured;
b) the person has the legal capacity to enter into a contract for the procurement;
c) the person is not insolvent, in receivership, bankrupt or in the process of being wound up and is not the subject of legal proceedings relating to the foregoing;
d) the procuring entity is not precluded from entering into the contract with the person under section on Limitation on contracts with employees,

e) the person is not debarred from participating in procurement proceedings under Limitation on contracts with employees,

The procuring entity may require a person to provide evidence or information to establish that the criteria above are satisfied.

The criteria above) and any requirements shall be set out in the tender documents or the request for proposals or quotations or, if a procedure is used to pre-qualify persons, in the documents used in that procedure.

The procuring entity shall determine whether a person is qualified and that determination shall be done using the criteria and requirements set out in the documents or requests described above

The procuring entity may disqualify a person for submitting false, inaccurate or incomplete information about his qualifications.

No person shall be excluded from submitting a tender, proposal or quotation in procurement proceedings except under this section and under section on Participation in procurement .
Procuring entities shall use creative approaches, such as design and build in order to enhance efficiency of the procurement process and project implementation.

Pre-qualification procedures
To identify qualified persons a procuring entity may use a pre-qualification procedure or may use the results of a pre-qualification procedure used by another public entity

Limitation on contracts with employees, etc
Except as expressly allowed under the regulations, a procuring entity shall not enter into a contract for procurement with—

a) an employee of the procuring entity or a member of a board or committee of the procuring entity;
b) a Minister, public servant or a member of a board or committee of the Government or any department of the Government or a person appointed to any position by the President or a Minister; or
c) a person, including a corporation, who is related to a person described above

Whether a person is related to another person for the purpose of above rule shall be determined in accordance with the regulations.

Specific requirements

The procuring entity shall prepare specific requirements relating to the goods, works or services being procured that are clear, that give a correct and complete description of what is to be procured and that allow for fair and open competition among those who may wish to participate in the procurement proceedings.

The specific requirements shall include all the procuring entity's technical requirements with respect to the goods, works or services being procured. The technical requirements shall, where appropriate—

a) relate to performance rather than to design or descriptive characteristics; and
b) Be based on national or international standards.

The technical requirements shall not refer to a particular trademark, name, patent, design, type, producer or service provider or to a specific origin unless—

a) there is no other sufficiently precise or intelligible way of describing the requirements; and
b) The requirements allow equivalents to what is referred to.

Verification that not debarred

A tender, proposal or quotation submitted by a person shall include a statement verifying that the person is not debarred from participating in procurement proceedings under Part IX and a declaration that the person will not engage in any corrupt practice.

Termination of procurement proceedings

The procuring entity shall give prompt notice of a termination to each person who submitted a tender, proposal or quotation or, if direct procurement was being used, to each person with whom the procuring entity was negotiating.

On the request of a person described above the procuring entity shall give its reasons for terminating the procurement proceedings within fourteen days of the request.

If the procurement proceedings involved tenders and the proceedings are terminated before the tenders are opened, the procuring entity shall return the tenders unopened.

The procuring entity shall not be liable to any person for a termination under this section. A termination under this section shall not be reviewed by the Review Board or a court.

A public entity that terminates procurement proceedings shall give the Authority a written report on the termination.

A report under subsection (7) shall include the reasons for the termination and shall be made in accordance with any directions of the Authority with respect to the contents of the report and when it is due.

Form of communications

If the procurement procedure used is open or restricted tendering or a request for proposals, communications between the procuring entity and a person seeking a contract for the procurement shall be in writing.

If the procurement procedure used is direct procurement or a request for quotations, communications between the procuring entity and a person seeking a contract for the procurement shall either be—

a. in writing; or
b. Referred to and confirmed in writing.

To the extent allowed under written directions of the Authority, electronic communications may be used instead of written communications.

Inappropriate influence on evaluations, etc

After the deadline for the submission of tenders, proposals or quotations—

a. no person who submitted a tender, proposal or quotation shall make any unsolicited communications to the procuring entity or any person involved in the procurement proceedings that might reasonably be construed as an attempt to influence the evaluation and comparison of tenders, proposals or quotations; and
b. No person who is not officially involved in the evaluation and comparison of tenders, proposals or quotations shall attempt, in any way, to influence that evaluation and comparison.

A person who contravenes the above rule is guilty of an offence and is liable on conviction—

a. if the person is an individual, to a fine not exceeding four million shillings or to imprisonment for a term not exceeding three years or to both; or
b. if the person is a corporation, to a fine not exceeding ten million shillings.

Participation in procurement

Candidates shall participate in procurement proceedings without discrimination except where participation is limited in accordance with this Act and the regulations.

The Minister shall, in consideration of economic and social development factors, prescribe preferences and or reservations in public procurement and disposal. The preferences and reservations referred to in the above shall—

a. be non-discriminatory in respect of the targeted groups;
b. allow competition amongst the eligible;
c. Be monitored and evaluated by the Authority.

The preferences and reservations shall apply to—

a. candidates such as disadvantaged groups, micro, small and medium enterprises;
b. works, services and goods, or any combination thereof;
c. identified regions; and
d. such other categories as may be prescribed.

A procuring entity shall, when processing procurement, comply with the provisions of this Act and the regulations in respect of preferences and reservations.
To qualify for a specific preference or reservation, a candidate shall provide evidence of eligibility.

The Authority shall maintain an up-to-date register of contractors in works, goods and services, or any combination thereof, in order to be cognizant at all times of the workload and performance record.

In applying the preferences and reservations under this section—

(*a*) Exclusive preference shall be given to citizens of Kenya where—

i. the funding is 100% from the Government of Kenya or a Kenyan body; and
ii. the amounts are below the prescribed threshold.

(*b*) A prescribed margin of preference shall be given—

i. in the evaluation of bids to candidates offering goods manufactured, mined, extracted and grown in Kenya; or
ii. works, goods and services where a preference shall be applied depending on the percentage of shareholding of the locals on a graduating scale as prescribed.

Corrupt practice

No person, agent or employee shall be involved in any corrupt practice in any procurement proceeding.

If a person or an employee or agent of a person contravenes the above rule the following shall apply—

a. the person shall be disqualified from entering into a contract for the procurement; or
b. if a contract has already been entered into with the person, the contract shall be voidable at the option of the procuring entity.

The voiding of a contract by the procuring entity does not limit any other legal remedy the procuring entity may have.

A person, employee or agent who contravenes the above rules shall be guilty of an offence

Fraudulent practice
No person shall be involved in a fraudulent practice in any procurement proceeding.

If a person contravenes the above rule the following shall apply—

a. the person shall be disqualified from entering into a contract for the procurement; or
b. if a contract has already been entered into with the person, the contract shall be voidable at the option of the procuring entity.

The voiding of a contract by the procuring entity does not limit any other legal remedy the procuring entity may have.

Collusion
No person shall collude or attempt to collude with any other person

(a) to make any proposed price higher than would otherwise have been the case;
(b) to have that other person refrain from submitting a tender, proposal or quotation or withdraw or change a tender, proposal or quotation; or
(c) to submit a tender, proposal or quotation with a specified price or with any specified inclusions or exclusions.
If a person contravenes the above rule the following shall apply —

(a) both persons shall be disqualified from entering into a contract for the procurement; or

(b) if a contract has already been entered into with either persons referred above, the contract shall be voidable at the option of the procuring entity.

The voiding of a contract by the procuring entity, does not limit any other legal remedy the procuring entity may have.
A person who contravenes subsection (1) shall be guilty of an offence.

Conflicts of interest

a) An employee or agent of the procuring entity or a member of a board or committee of the procuring entity who has a conflict of interest with respect to a procurement —

(a) shall not take part in the procurement proceedings; and

(b) shall not, after a procurement contract has been entered into, take part in any decision relating to the procurement or contract.

An employee, agent or member described above who refrains from doing anything prohibited under that subsection that, but for that subsection, would have been within his duties shall disclose the conflict of interest to the procuring entity.

If a person contravenes the above rule with respect to a conflict of interest and the contract is awarded to the person or his relative or to another person in whom one of them had a direct or indirect pecuniary interest, the contract shall be voidable at the option of the procuring entity.

The voiding of a contract by the procuring entity under subsection (3) does not limit any other legal remedy the procuring entity may have.

For the purpose of this section, a person has a conflict of interest with respect to a procurement if the person or a relative of the person —

(a) seeks, or has a direct or indirect pecuniary interest in another person who seeks, a contract for the procurement; or

(b) owns or has a right in any property or has a direct or indirect pecuniary interest that results in the private interest of the person conflicting with his duties with respect to the procurement.

Confidentiality

During or after procurement proceedings, no procuring entity and no employee or agent of the procuring entity or member of a board or committee of the procuring entity shall disclose the following—

a. information relating to a procurement whose disclosure would impede law enforcement or whose disclosure would not be in the public interest;

b. information relating to a procurement whose disclosure would prejudice legitimate commercial interests or inhibit fair competition;
c. information relating to the evaluation, comparison or clarification of tenders, proposals or quotations; or
d. the contents of tenders, proposals or quotations.

This section does not prevent the disclosure of information if any of the following apply—

a. the disclosure is to an employee or agent of the procuring entity or a member of a board or committee of the procuring entity involved in the procurement proceedings;
b. the disclosure is for the purpose of law enforcement;
c. the disclosure is for the purpose of a review under Part VII or an investigation under Part VIII or as required under section 105;
d. the disclosure is pursuant to a court order; or
e. the disclosure is allowed under the regulations.

Notwithstanding the provisions of subsection (2), the disclosure to an applicant seeking a review under Part VII shall constitute only the summary referred to in section 45 (2) (*e*).

Any person who contravenes the provisions of this section shall be guilty of an offence.

Procurement records
A procuring entity shall keep records for each procurement for at least six years after the resulting contract was entered into or, if no contract resulted, after the procurement proceedings were terminated.

The records for procurement must include—

a. a brief description of the goods, works or services being procured;
b. if a procedure other than open tendering was used, the reasons for doing so;
c. if, as part of the procurement procedure, anything was advertised in a newspaper or other publication, a copy of that advertisement as it appeared in that newspaper or publication;
d. for each tender, proposal or quotation that was submitted—

    i. the name and address of the person making the submission; and
    ii. the price, or basis of determining the price, and a summary of the other principal terms and conditions of the tender, proposal or quotation;

e) ea summary of the evaluation and comparison of the tenders, proposals or quotations, including the evaluation criteria used;
f) (if the procurement proceedings were terminated without resulting in a contract, an explanation of why they were terminated;
g) a copy of every document that this Act requires the procuring entity to prepare; and
h) such other information or documents as are prescribed.

After a contract has been awarded or the procurement proceedings have been terminated, the procuring entity shall, on request, make the records for the procurement available to a person who submitted a tender, proposal or quotation or, if direct procurement was used, a person with whom the procuring entity was negotiating.

The procuring entity may charge a fee for making the records available but the fee shall not exceed the costs of making the records available.

A procuring entity shall maintain a proper filing system with clear links between procurement and expenditure files.

COMMITTEES RESPONSIBLE FOR PROCUREMENT

Establishment of Committees

For the purpose of ensuring that procurement and asset disposal decisions are made in a systematic, corporate and structured manner, a county procuring entity shall establish the following standing committees from within its members of staff—

iv. tender committees specified in the Schedule to these Regulations;

v. disposal committee; and

vi. Such other bodies as prescribed under the Act.

For greater certainty, a county procuring entity shall establish

- tender opening committee;
- tender evaluation committee;
- negotiation committee; and

- inspection and acceptance committee.

Where a county public entity lacks capacity to comply with paragraph (2), the accounting officer shall seek advice from the Authority.

Composition of tender committees
The membership of the tender committees shall be as set out in the Schedule.

The accounting officer shall inform the Authority on the composition of the county public entity's tender committee and respective alternates within fourteen days from the date of appointment in a format as prescribed under these Regulations.

The accounting officer or head of the procuring entity shall appoint an alternate member for each member of the county and designated tender committee and only the alternate shall attend any meeting of the county and designated tender committee whenever the member is unable to attend.

compliance
A county procuring entity shall ensure that it complies with the provisions of the Act, all the Public Procurement and Disposal Regulations, 2006, these Regulations, the directions of the Authority and the Administrative Review Board in respect of its procurement and disposal activities.

County preference and reservations

County governments shall apply preference and reservations to small and micro enterprises and other disadvantaged groups that are located and operate within the counties as specified in the Public Procurement (Preference and Reservations) Regulations, 2011

Transfer of procurement and contractual records and responsibilities
All existing procurement and contractual records and responsibilities by—

(a) local authorities under the repealed Local Government Act; or

(b) district commissioners under the Districts and Provinces Act, shall be transferred to the respective county service delivery coordinating unit.

Termination of procurement and disposal proceedings
Any procurement and disposal proceedings commenced but not finalized by any local authority, district, any health unit other than a referral hospital, the roads development fund, or any

constituency development fund committee, before the coming into operation of
these Regulations are terminated.
Deployment of supply chain management staff

For the purposes of this regulation, a procurement and disposal proceeding is finalized when a contract has been entered into between the parties in accordance with section 67 and 68 of the Act.

Any procurement officer or supply chain management staff currently employed by the Public Service Commission and who is currently deployed in a local authority, district, a health unit other than a referral hospital, the roads development fund, or any constituency development fund committee shall report to the Interim County Head of Supply Chain Management for deployment upon commencement of these Regulations.

TENDER COMMITTEES AND THEIR COMPOSITION

1. *County Government Tender Committee*

Chairperson-An officer appointed in writing by the Secretary of the county.
Deputy Chairperson-County Chief Officer (head of department) appointed in writing by the chief secretary of the county;
Member- Five county chief officers (heads of departments) appointed in writing by the chief secretary of the county; and
Secretary-The procurement professional heading the procurement unit of the county Government

2. *County Government Entities Tender Committee*

Chairperson-An officer appointed in writing by the accounting officer of the county government entity;
Deputy Chairperson-County government entity chief officer (head of department) appointed in writing by the accounting officer;
Member- Five county government entity chief officers (heads of departments) appointed in writing by the accounting officer; and
Secretary-The procurement professional heading the procurement unit of the county government entity

3. *County Assembly Tender Committee*

Chairperson-An officer appointed in writing by the county assembly clerk;
Deputy Chairperson-Head of department of the county assembly appointed in writing by the county assembly clerk;
Member- Five heads of departments appointed in writing by the county assembly clerk;
Secretary-The procurement professional heading the procurement unit of the county assembly

4. City Tender Committee

Chairperson-An officer appointed in writing by the city manager;
Deputy Chairperson-Head of department of the city appointed in writing by the city manager;
Member- Five heads of departments appointed in writing by the city manager; and
Secretary-The procurement professional heading the procurement unit of the city

5. ***Urban Area Tender Committee***

Chairperson-An officer appointed in writing by the municipal or town manager;
Deputy Chairperson-Head of department of the urban area appointed in writing by the municipal or town manager;
Member- Five heads of departments appointed in writing by the municipal or town manager;
Secretary-The procurement professional heading the procurement unit of the urban area

6. ***County Service Delivery Co-ordinating Unit Tender Committee***

Chairperson-An officer appointed in writing by the county commissioner;
Deputy Chairperson-Head of department of the service delivery co-ordinating unit of the county appointed in writing by the county commissioner;
Member- Five heads of departments appointed in writing by the county commissioner; and
Secretary-The procurement professional heading the procurement unit of the service delivery co-ordinating unit of the county;

CONCEPT OF E-PROCUREMENT

E-Procurement is an automated business process which includes procurement planning, management of suppliers, requisitions, quotations, contracts and receipts will be shifted to a more effective and cost efficient online transaction.

Categories for E-procurement:

According to Baily (2008), the following are the types of E-procurement

1. **Web-based ERP (Enterprise Resource Planning).**

This deals with creating and approving purchasing requisitions, placing purchase orders and receiving goods and services by using a software system based on Internet technology.

2. **E-MRO (Maintenance, Repair and Operations)**

This deals with creating and approving purchasing requisitions, placing purchase orders and receiving non-product related MRO supplies

3. **The third type is E-sourcing.**

This involves Identifying new suppliers for a specific category of purchasing requirements using Internet technology.

4. E-tendering

This involves sending requests for information and prices to suppliers and receiving the responses of suppliers using Internet technology

5. E-reverse auctioning

This is another type of e-procurement. This uses Internet technology to buy goods and services from a number of known or unknown suppliers.

6. E-informing

This involves gathering and distributing purchasing information both from and to internal and external parties using Internet technology

7. E-market sites.

Here, buying communities can access preferred suppliers' products and services, add to shopping carts, create requisition, seek approval, receipt purchase orders and process electronic invoices with integration to suppliers' supply chains and buyers' financial systems.

Benefits of E-Procurement

An organisation which uses E-procurement has the following advantages:

1. Price reduction in tendering:

In this method, there is no paperwork, postage fee and other costs associated with preparation and sending tender documents. It is also faster to send a document electronically as compared to the traditional method of sending tender documents through post office. It results to improved order tracking and tracing, for it is much easier to trace the orders and make necessary corrections in case an error is observed in the previous order.

2. There is reduction in time to source materials:

A lot of time is spend on paper invoicing in terms of writing, filing and postal communication but while in e-procurement, staff have sufficient time to engage on strategic issues of procurement The time wasted in moving from one town or country to another to look for a potential supplier or buyer is greatly reduced since with a click of a button, you can readily get the information in the internet. By extension, E-procurement leads to reduction in maverick buying. Maverick buying is when staff buys from suppliers than those with whom a purchasing agreement has been negotiated.

3. Lower Administration costs

Reduction in paperwork and this leads to lower administration costs.

4. Reduction in procurement staff

Since most of the procurement process is done electronically, the number of staff needed to facilitate the process reduces. Reduction in staff is an important way of producing competitive advantage through reduced costs.

5. e-procurement gives an organization competitive advantage over its competitors.

As a centralized department can oversee all procurement activities and different offices worldwide can access the same documentation when required, this gives a distinct advantage over the much slower process of having to post documentation between offices. This extends the supply chain beyond geographical boundaries to a much wider group. Suppliers can be monitored on timely delivery, quality delivery of products and services hence performing suppliers can be contacted in future. This implies that with e-procurement, every prospective supplier and buyer is always accessible to his/her convenience. The result is not only greater market access but also increased productivity.

6. e-procurement is improvement of communication

E-procurement allows sections of electronic documentation to flow through the supply chain; it improves the speed of returns and subcontractor price visibility.

7. Enhanced inventory management

8. Increased accuracy of production capacity

9. Negotiated unit cost reduction

Perceived challenges with E-Procurement

Despite its benefits, e-procurement is also faced with some problems that hinder its adoption in various departments.

The following are some of the challenges:

1. Company culture and upper management support:

There is resistance to change, lack of a widely accepted solution and lack of leadership, which are cultural, are some of the biggest barriers to the introduction of e-procurement within the public sector. To counter this problem a cultural change needs to take place prior to adoption of an e-procurement system. People need to be appointed and backed with full senior management support in order to effect this change. Adequate sensitization on the system will greatly reduce the resistance to the change.

it is the cultural change brought about by senior management support which can enable e-procurement is to be successfully implemented.

2. Uncertainty as to the legal position of e-procurement

Some organizations doubt whether electronically sent documents can be recognized by a third party as valid or legal.

3. Lack of IT infrastructure, is also another challenge of e-procurement

Some companies lack relevant technology to carry out e-procurement.
Technological integration, data quality, system-to-system integration, and ICT/technical issues is also as major challenges for many organizations when implementing e-procurement

4. Cost implications of the system.

Some organizations perceive the system is too expensive to implement. Budgeting and costs, change management, as well as need of training and resources Harrigan (2008). Therefore in their opinion, they would rather stick to their system. Furthermore, engaging suppliers in the process - especially smaller organizations - is also proving to be difficult given the level of investment expected in terms of providing catalogue information to buyers, and marketplaces using different technologies, platforms and business languages (OGC, 2002). As noted by Heywood (2002), sometimes e-Procurement results in large investments of time and money, without absolute certainty that it's full potential will be achieved every time. Besides, there is also lack of technical expertise. Most organizations lack the expertise to operate the system if initiated. In their view, embracing e-procurement technology implies employing the necessary manpower to operate it. Lack of e-procurement knowledge / skilled personnel is another barrier hindering smooth implementation of e-procurement. The older generation that has not kept up to the advances in IT related issues. This makes them rely heavily on traditional forms and means of procurement. In fact, this forms the majority of those against change, especially when the change requires anything more that the training they already have. Therefore, as e-Procurement includes new technologies and changes in traditional procurement approaches, the need to train staff in procurement practices and the use of e-Procurement tools are critical to the success of an e-Procurement initiative (World Bank, 2003).

The seventh challenge stated by Eadie (2007) is lack of a business relationship with suppliers capable of e-procurement. Hawking et al (2004) argues that lack of business relationships with suppliers showing the need for an e-procurement enabled supply chain as another barrier for the implementation of e-procurement. The eighth challenge is Security of transactions. Working on the internet has become risky due to hacking of information. This has made organizations fear using it. Banks have lost money. Data which is transmitted on the World Wide Web can be garbled, can reassemble wrongly at the other end, or can display only partially because of incompatible software (Jennings, 2001). There are also interoperability concerns: Providing procurement information over the internet produces interoperability concerns. This is due to the fact that software companies have sought to make their product unique. In doing so, they have endeavoured to stop migration of data between systems. Rankin (2006) further shows that compatibility, interfacing with other systems and stability, are technical issues which have become barriers to e-procurement implementation. Lastly, organizations are of the view that there is no business benefit realized.

E-procurement in the Government of Kenya

In Kenyan E-procurement was launched on august year 2014, the system was meant for submitting and evaluating procurement applications as a way of becoming more efficient. The government’s goal was also to weed corruption while also speeding up the procurement process. The shift from manual to e-procurement enhanced transparency and credibility in the management of public finances and tendering process through the Integrated Financial Management Information System (IFMIS). The system which enables monitoring of all transactions during the procurement process provides functionalities such as the approval hierarchy, which is an end to end process that facilitates the procurement process from planning to payment.

Among the e-procurement functions is the item master responsible for standardizing the use of items within all Government Ministries, Department and Agencies (MDA's) and counties. This is set to manage the price inflation of commonly used items in Government offices.

Another function of the e-procurement system is the Kenya Supplier portal that is set to enable suppliers to access the status of their purchase or service order issued and payments. This means all government suppliers must be duly registered with the Registrar of Companies and own a tax compliance certificate among other details such as business contacts, IFMIS number to access the Kenya Supplier portal.

CHAPTER FIVE

OVERSIGHT FUNCTION IN PUBLIC FINANCE MANAGEMENT

Role of National Assembly

National assembly has established budget committee in public finance matters meant to oversee public finance management.

The committee is established to deal with budgetary matters and has responsibility for the following matters, in addition to the functions set out in the Standing Orders—

a) discuss and review the Budget Policy Statement and budget estimates and make recommendations to the National Assembly;
b) provide general direction on budgetary matters;
c) monitor all budgetary matters falling within the competence of the National Assembly under this Act and report on those matters to the National Assembly;
d) monitor adherence by Parliament, the Judiciary and the national government and its entities to the principles of public finance and others set out in the Constitution, and to the fiscal responsibility principles of this Act;
e) review the Division of Revenue Bill presented to Parliament and ensure that it reflects the principles of the Constitution;
f) examine financial statements and other documents submitted to the National Assembly and make recommendations to the National Assembly for improving the management of Kenya's public finances;
g) make recommendations to the National Assembly on "money Bills", after taking into account the views of the Cabinet Secretary; and
h) table in the National Assembly a report containing the views of the Cabinet Secretary
i) Introduce the Appropriations Bill in the National Assembly.

Role of Senate

There is established Committee of the Senate set to deal with budgetary and financial matter's, it has responsibilities for the following matters, in addition to the functions set out in the Standing Orders—

a) present to the Senate, subject to the exceptions in the Constitution, the proposal for the basis of allocating revenue among the Counties and consider any bill dealing with county financial matters;
b) review the County Allocation of Revenue Bill and the Division of Revenue Bill in accordance with the Constitution at least two months before the end of the financial year;

c) examine financial statements and other documents submitted to the, and make recommendations to the Senate for improving the management of government's public finances; and
d) Monitor adherence by the Senate to the principles of public finance set out in the Constitution, and to the fiscal responsibility principles of this Act.

e) In carrying out its functions under the Committee shall consider recommendations from the Commission on Revenue Allocation, County Executive Committee member responsible for finance, the Intergovernmental Budget and Economic Council, the public and any other interested persons or groups.

Parliamentary Budget Office.

The office known as the Parliamentary Budget Office shall continue to exist as an office of the Parliamentary Service.

In addition to any other criteria established by the Parliamentary Service Commission, the Budget Office shall consist of persons appointed on merit by virtue of their experience in finance, economics and public policy matters.

Responsibilities of the Parliamentary Budget Office

The Parliamentary Budget Office shall—

a) provide professional services in respect of budget, finance, and economic information to the committees of Parliament;
b) prepare reports on budgetary projections and economic forecasts and make proposals to Committees of Parliament responsible for budgetary matters;
c) prepare analyses of specific issues, including financial risks posed by Government policies and activities to guide Parliament;
d) consider budget proposals and economic trends and make recommendations to the relevant committee of Parliament with respect to those proposals and trends;
e) establish and foster relationships with the National Treasury, county treasuries and other national and international organisations, with an interest in budgetary and socio-economic matters as it considers appropriate for the efficient and effective performance of its functions;
f) subject to Article 35 of the Constitution, ensure that all reports and other documents produced by the Parliamentary Budget Office are prepared, published and publicised not later than fourteen days after production; and

g) report to the relevant committees of Parliament on any Bill that is submitted to Parliament that has an economic and financial impact, making reference to the fiscal responsibility principles and to the financial objectives set out in the relevant Budget Policy Statement; and
h) Propose, where necessary, alternative fiscal framework in respect of any financial year.

i) In carrying out its functions the Parliamentary Budget Office shall observe the principle of public participation in budgetary matters.

Auditor-General

An Auditor-General is nominated by the President and, with the approval of the National Assembly.

To be qualified to be the Auditor-General, a person is required to have extensive knowledge of public finance or at least ten years experience in auditing or public finance management

The Auditor-General holds office, for a term of eight years and is not eligible for re-appointment.

Within six months after the end of each financial year, the Auditor-General shall audit and report, in respect of that financial year, on—

a) the accounts of the national and county governments;

b) the accounts of all funds and authorities of the national and county governments;

c) the accounts of all courts;

d) the accounts of every commission and independent office established by this Constitution;

e) the accounts of the National Assembly, the Senate and the county assemblies;

f) the accounts of political parties funded from public funds; (*g*) the public debt; and

g) The accounts of any other entity that legislation requires the Auditor-General to audit.

The Auditor-General may audit and report on the accounts of any entity that is funded from public funds.

An audit report confirms whether or not public money has been applied lawfully and in an effective way.

Audit reports shall be submitted to Parliament or the relevant county assembly.

Within three months after receiving an audit report, Parliament or the county assembly shall debate and consider the report and take appropriate action.

The role of Internal Auditor

The Internal Auditor-General Department of the National Treasury ensures that its arrangements for conducting internal auditing include—

(a) Reviewing the governance mechanisms of the entity and mechanisms for transparency and accountability with regard to the finances and assets of the entity;

(b) Conducting risk-based, value-for-money and systems audits aimed at strengthening internal control mechanisms that could have an impact on achievement of the strategic objectives of the entity;

(c) Verifying the existence of assets administered by the entity and ensuring that there are proper safeguards for their protection;

(d) Providing assurance that appropriate institutional policies and procedures and good business practices are followed by the entity; and

(e) Evaluating the adequacy and reliability of information available to management for making decisions with regard to the entity and its operations.

Controller of Budget

Controller of Budget is nominated by the President and, with the approval of the National Assembly. To be qualified to be the Controller, a person needs have extensive knowledge of public finance or at least ten years experience in auditing public finance management.

The Controller, hold office for a term of eight years and is not eligible for re-appointment.

His roles:

1. To oversees the implementation of the budgets of the national and county governments by authorising withdrawals from public funds
2. Not approve any withdrawal from a public fund unless satisfied that the withdrawal is authorised by law.
3. In every four months, to submits to each House of Parliament a report on the implementation of the budgets of the national and county governments.

Taxation I

SUBJECT NO. 4

Distance Learning Study Pack

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INSTRUCTIONS FOR STUDENTS

This study guide is intended to assist distance-learning students in their independent studies. In addition, it is only for the personal use of the purchaser, see copyright clause. The course has been broken down into eight lessons each of which should be considered as approximately one week of study for a full time student. Solve the reinforcement problems verifying your answer with the suggested solution contained at the back of the distance learning pack. When the lesson is completed, repeat the same procedure for each of the following lessons.

At the end of lessons 2, 4, 6 and 8 there is a comprehensive assignment that you should complete and submit for marking to the distance learning administrator.

SUBMISSION PROCEDURE

1. After you have completed a comprehensive assignment clearly identify each question and number your pages.
2. If you do not understand a portion of the course content or an assignment question indicate this in your answer so that your marker can respond to your problem areas. Be as specific as possible.
3. Arrange the order of your pages by question number and fix them securely to the data sheet provided. Adequate postage must be affixed to the envelope.
4. While waiting for your assignment to be marked and returned to you, continue to work through the next two lessons and the corresponding reinforcement problems and comprehensive assignment.

On the completion of the last comprehensive assignment a two-week period of revision should be carried out of the whole course using the material in the revision section of the study pack. At the completion of this period the final Mock Examination paper should be completed under examination conditions. This should be sent to the distance-learning administrator to arrive in Nairobi at least five weeks before the date of your sitting the KASNEB Examinations. This paper will be marked and posted back to you within two weeks of receipt by the Distance Learning Administrator.

Contents

TAXATION I COURSE DESCRIPTION

The Taxation 1 paper covers the theoretical and legal framework of taxation. Firstly, the Study Pack introduces students to the theory of Public Finance. Students should understand the need for taxation, and government intervention in the economic system. Students will be expected to have a comprehensive knowledge of elementary economics.

Secondly, having obtained the theoretical background of taxation, students will be introduced to the basic mechanics of taxation with reference to the Kenyan law and practice. Here, students will be expected to be knowledgeable in book-keeping and basic financial accounting.

Students should be aware that there are regular changes in the Income Tax Law and must refrain from using old textbooks or study materials. Students are advised to keep abreast with these changes. This pack contains the relevant amendments to the Income Tax Act which take effect in the 1993 year of income.

Lastly, other minor taxes will be covered, and Value Added Tax examined in detail.

Taxation I Index

CONTENTS

REVISION AID

FINAL ASSIGMENT

LESSON ONE

BASIC CONCEPTS AND PURPOSES OF TAXATION

INSTRUCTIONS

1. Assigned Reading. Read study text given below.
2. Complete the Reinforcing Questions at the end of the lesson.
3. Compare your answers to the models given in the revision section of the study pack.
4. Study text

BASIC CONCEPTS AND PURPOSES OF TAXATION

This first lesson is on the general theory of taxation. From your general knowledge, you are aware that the government (central or local government) provides some goods and services to the public. The goods and services provided to the public cost money which means that the government must incur expenditure in providing them. This is referred to as the government expenditure. On the other hand, the government cannot incur any expenditure unless it first obtains money in form of government revenue or income. The major source of government income is taxation. Taxation may be referred to as the revenue raising activity of the government.

Taxation is part of public finance. Public finance is the study of the spending and revenue raising activities of the government.

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

ACTIVITIES OF THE GOVERNMENT

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

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

2. To provide infrastructure and communication such as:
    - Cost of constructing roads, railways, airports and harbours.
    - Cost of constructing electricity and telephone networks, television and radio systems etc.

3. To provide basic social services such as the cost of:
    - Medical services and medicine in hospitals.
    - Education in schools, colleges and universities.
    - Water supply and sewerage.
    - Sports and cultural activities.
    - Entertainment and information on radio and television.

4. To participate in the production and marketing of commercial goods and services:
    - Cost of establishing public enterprises such as parastatals.
    - Combining with private business through purchase of shares in commercial enterprises. There is pressure all over the world for government to divest or privatise business enterprises. The kenya government in the 1991 budget announced its plans to divest in 139 business enterprises.
    - Providing in form of easy loans not obtainable in financial institutions, and providing cheap business premises such as the kenya industrial estates , export processing zones etc.
    - Guaranteeing markets through protection from competition and preferential purchases.

5. Influencing and guiding the level and direction of economic activities through various regulations:
    - Monetary policy (relating to interest and money supply);
    - Fiscal policy (deliberate manipulation of government income and expenditure so as to achieve desired economic and social goals).

6. Redistributing income and wealth through taxation and public spending:
    - Taxing the rich and those able to afford tax.
    - Cost of providing basic needs to the poor such as free education, medical care and housing.
    - Cost of relief of famine and poverty which may arise from unemployment, sickness, old age, crop failure, drought, floods, earthquakes etc.

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

PUBLIC REVENUE

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

1. TAXES

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

The following features are common in any tax system:

Taxing authority—This is the authority with the power to impose tax e.g. the central government or a local authority. The taxes are received as public revenue. The taxing authority has power to enforce payment of tax.

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

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

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

a. A compulsory contribution to a public authority, irrespective of the exact amount of service rendered to the taxpayer in return.

b. A compulsory contribution from a person to the government to defray the expenses incurred in the common interest of all.

c. A compulsory contribution of wealth by a person or body of persons for the service of the public. There is a portion of the produce of the land and labour of country that is placed at the disposal of the government for the common good of all.

THERE ARE DIFFERENT KINDS OF TAXES:

i. **Income tax**—this is tax imposed on annual gains or profits earned by individuals, limited companies, business and other organisations. The income tax will be explained in lessons 2 to 6.

ii. **Value added tax (V.A.T.)**—This is tax imposed on sale of commodities and services introduced in Kenya with effect from 1.1.90. The V.A.T. is explained in lesson 7 in detail.

iii. **Sales tax**—This is tax imposed on sale of commodities which was abolished in Kenya on 31.12.89 and replaced with value added tax. There is a brief review of the tax in lesson 8.

iv. **Excise duty—**This is tax imposed on commodities produced locally. The details of this are in lesson 8.

v. **Customs duty**—This is tax imposed on import or export of commodities. The details of this tax are in lesson 8.

vi. **Stamp duty**—This is tax imposed on the transfer of property. The details of this tax are in lesson 8.

vii. **Land, rent and rates—**This is tax imposed on property. Rent is paid to the central government on some land leases while rates are paid to the local authority based on the value of property.

2. **FEES**

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

3. **PRICES**

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

4. **EXTERNAL BORROWING**

This is done from international financial institutions such as World Bank and IMF. Other foreign government are also lenders.

5. **FINES AND PENALTIES**

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

6. **STATE PROPERTY**

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

7. **INTERNAL BORROWING**

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

THE PURPOSES OF TAX

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

a. **Raising Revenue**

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

b. **Economic Stability**

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

c. **Protection Policy**

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

d. **Social Welfare**

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

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

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

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

POWER TO TAX

The laws of a country will authorise the government (central or local authority) to levy taxes. The taxes imposed are legally enforceable and must be paid by all those individuals and organisations that come within the jurisdiction of the taxing authority. There are fines and penalties for failure to pay taxes.
The parliament and local councils have the power to pass laws and by-laws, respectively, that govern taxes. As people's representatives sit in parliament and councils, the final power to tax rests with the people.

In our country, the Central Government and the Local Authorities (municipal, town, urban, and county councils) are authorised to impose taxes. Every year in June, the Minister for Finance presents the budget before Parliament (National Assembly). Briefly, the budget is a statement of the government expenditure and the sources of funds to finance the expenditure. The Local Authorities must also present their annual budgets. The purpose of presenting budgets which have to be approved by the relevant authorities is that all taxes that are imposed must be approved and authorised.

The main taxes of the Central Government are usually value -added tax, income tax, custom duty, excise duty, stamp duty, etc. The main taxes of a local authority are usually rates, poll tax, fees, service charge, etc.

PRINCIPLES OF AN OPTIMAL TAX SYSTEM

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

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 most simple tax system is where there is a single tax. However, this may not be equitable as some people will not pay tax.

2. **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.

3. **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.

4. **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.

5. **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.

6. **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 lump-sum payment of tax at the year-end. For such taxes, the evasion ratio is quite high.

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

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

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

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

The Benefit Principle

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

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

The Ability to Pay Principle

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

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

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

The Cost of Service Principle

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

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

THE INCIDENCE OF TAX AND TAX SHIFTING

Tax Shifting

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

Illustration

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

1. If K Creameries Ltd. bears the whole tax i.e. it does change the buying price or the selling price, there will be no tax shifting.
2. If K Creameries Ltd. transfers the whole tax to the consumers by raising the selling price by Shs 2 to Shs 12 i.e. 20% of Shs 10, it is referred to as forward shifting.
3. K Creameries Ltd. could transfer the whole burden to dairy farmers so that the buying price of milk is lowered by Shs 2 to Shs 3. This is referred to as backward shifting.
4. The tax could be shifted partly forward to the consumers and partly backwards to the farmers.
5. K.Creameries Ltd. could bear part of the tax shift forward partly and shift backwards partly.

Tax Burden

There are four aspects of tax burden, namely:

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

1. The total direct money burden of a tax is its yield to the government. For every shilling of tax received by the treasury there corresponds a shilling of **direct money burden** upon someone.

2. The payment of tax constitutes a sacrifice of economic welfare or utility to the taxpayer. The sacrifice is relatively greater, for example, to a poor man who parts with a shilling than to a rich man paying the same amount. This is referred to as the **direct real burden** of tax.

3. A tax on commodity which is shifted forward to the consumers has the effect of raising its price. This may force the consumers to partake less of that commodity. The reduced consumption is the **indirect real burden** of the tax.

4. In the illustration above, the dealer would pay the tax to the government even before the commodity is sold and the tax recovered from the consumers. Some time will elapse, occasioning an opportunity cost to the dealer equivalent to the interest he could have earned on the money paid to the tax authorities. This constitutes the **indirect money burden** of the tax. Other examples of indirect money burden of tax would include tax consultancy fees, and the cost of remitting tax.

Tax Incidence

The incidence of a tax is the direct money burden of the tax. It deals with who ultimately pays the tax.
From the illustration given above the incidence of the tax collected from the dealer is:

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

The Importance of Tax Incidence

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

CLASSIFICATION OF TAXES

1. **Direct Taxes**
   A direct tax is one whose impact and incidence are on the same person. The impact of a tax is its money burden. A tax has impact on the person on whom it is legally imposed. The incidence of a tax is on the person who ultimately pays the tax whether or not it was legally imposed on him. Therefore a direct tax is one which is paid (incidence) by the person on whom it is legally imposed (impact). Examples are income tax and corporation tax.

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

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

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

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

   Individual income tax rates for Kenya in 2005

Annual taxable pay (Shs.)	**Rates of tax** % in each Shilling
1 – 121,968	10%
121,969 – 236,880	15%
236,881 – 351,792	20%
351,793 – 466,704	25%
Over - 466,704	30%

Personal relief Sh. l, 162 per month (Sh.13,944 per annum)

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

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

Illustration: Tax versus base of tax

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

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

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

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

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

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

Advantages of Direct Taxes As Opposed To Indirect Taxes

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

Disadvantages of Direct Taxes As Compared To Indirect Taxes

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

5. Some forms of direct taxes are paid annually as a lump sum. It may be difficult for the taxpayer to find a lump sum and it gives opportunities for evasion by the submission of fraudulent returns of income.

THE ECONOMIC EFFECTS OF TAXATION

The quality of a tax system will depend on the effects produced. The best tax system is one which produces the least undesirable effects.

The effects of taxation can be examined under two headings:
1. Effects on production
2. Effects on distribution

Effects on Production

There are two aspects of the effects on production

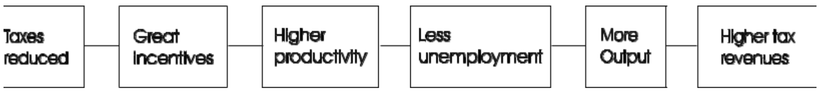
a. Ability to work and save
b. Desire to work and save

(a) **Ability to work and save**

Taxes have adverse effects on the ability to work if they lower efficiency of the workers. Any person's ability to work will be reduced by taxation which reduces efficiency. This argument applies to the taxation of small incomes and necessities. It also applies to taxes on commodities. Some commodities, which are not strictly necessities, but their consumption contributes to efficiency. These will be treated by the workers concerned as "conventional necessities" whose demand is comparatively inelastic. If a tax is imposed on such commodities, and hence an increase in their price will cause an increase in the expenditure upon them. Little income will be left for real necessities leading to lower consumption as if it were the real necessities taxed.

The ability to save is reduced by all taxes on those who have any margin of income out of which saving is possible. This happens when a person maintains the same standard of living after the imposition or increase in taxes and does not reduce his expenditure on goods accordingly.

(b) **Desire to work and save**
Taxes, especially direct taxes are argued to be a disincentive to work. It is argued that if taxes are cut this will increase incentives because people will receive more from their efforts. The process can be illustrated as follows:



Greater incentives will lead to hard work and higher productivity and as the economy expands, create more employment. This will lead to a rise in the level of real national income and a higher yield from taxation. On the other hand, it may be argued that an increase in taxes will induce people to work harder to raise their disposable incomes. After all, at the end of the month they have to find the money to pay rent, debts, school fees, buy food and so on and are thus forced to work harder.

It follows that increase in taxation may or may not be a disincentive to work. The effect upon the taxpayer's desire to work and save would depend partly on the nature of the tax and partly on the individual's reaction to taxation. These factors are examined below.

a) **Nature of taxes**
An unexpected tax or a temporary tax may not have any effect at all. For example a tax on windfall gains, (unexpected gains), which is unexpected, and will not continue in future may not produce any effects on the desire to work.

b) **Nature of individual's reaction to taxation**
The individual's reaction to taxation is largely governed by the elasticity of his/her demand for income, in terms of the efforts and sacrifices which he/she makes in order to obtain his/her net income. Increased taxation lowers the net income earned although the efforts and sacrifice remain the same. If the elasticity of his/her demand for income is small, he/she will desire to work harder.

Effects on Distribution

A person who owns resources, or by himself/herself embodies resources which in their actual employment are subject to taxation may seek to escape taxation by diverting these resources to other employment in which they will either be untaxed or taxed less heavily.

A tax is considered to have adverse effect if it diverts resources from their "natural channels". Conversely, a tax is considered to produce desirable effects on distribution if it helps encourage the flow of resources along their "natural channels".

The resources therefore tend to flow in the tax-free direction or where there is less punitive taxation or where generous tax concessions are available. For example, steeply progressive taxation on income may lead to an outflow of high achievers to other countries with lower marginal tax rates at high levels of income. This leads to a loss of their contributions to the economy and such a "brain drain" hinders economic growth and their tax contribution to the exchequer are also lost.

REINFORCING QUESTIONS

QUESTION ONE

What factors should a country take into account in designing its tax policy. Is it possible to accommodate all the factors?

QUESTION TWO

Argue the case for and against the principle of progression in a system of direct taxation.

QUESTION THREE

Discuss the advantages and disadvantages of direct as opposed to indirect taxation, explaining and illustrating the various terms used in your answer.

QUESTION FOUR

a) Explain the role of parliament in the budgetary process. (5 marks)
b) How does a budget deficit arise and what are its consequences? (5 marks)
c) Faced with a budget deficit:
   i. State how to finance the deficit. (5 marks)
   ii. Give two effects of each alternative method of financing. (5 marks)

(Total: 20 marks)

CHECK YOUR ANSWERS WITH THOSE GIVEN IN LESSON 9 OF THE STUDY PACK

LESSON TWO

TAXABLE PERSONS, INCOME, RATES OF TAX AND RELIEFS

In Lesson One you have learnt about the general theory of taxation including the public finance, Government's fiscal measures, raising of public revenue, and the principles and concepts of taxation.

You will now learn about a specific tax "The Income Tax" or the tax on income in Lessons Two to Six of our course. The income tax is an example of a direct tax charged on income that a person (individual or a legal person) earns every year.

INSTRUCTIONS

1. Assigned Reading: Read study text given below.
2. Complete the reinforcing questions at the end of the lesson.
3. Compare your answers to models given in Lesson 9 of the Study Pack.
4. Study text

DEFINITIONS

Imposition (charging) of income tax

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

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

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

Year of income

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

Income tax is charged for each year of income.

The year of income should be distinguished from the accounting year. There is a date to which accounts of a business are prepared each year, and this date would indicate the accounting year end. The accounting year ending on 31 December would coincide with the year of income. Other accounting year-ends would however fall in a given year of income and the profit or loss per the accounts would be for that year of income. For example, an accounting date ended 30 May 1999 would fall to be treated as the year of Income 1999.

(Taxable) income

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

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

(Taxable) person

A person whose income is taxed is either:

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

A taxable person does not include a partnership. A partnership is not taxed on its income, but the partners are taxed on their share of profit or loss from the partnership.

Resident and non-resident persons

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

a) Resident in relation to an individual means that the individual:
i) has a permanent home in Kenya and was present in Kenya for **any** period during the year of income under consideration; or
ii) has no permanent home on Kenya but was present in Kenya for a period or periods amounting in total to 183 days or more during the year of income under consideration; or

iii) has no permanent home in Kenya but was present in Kenya for any period during the year of income under consideration and in the two preceding years of income for periods averaging **more than** 122 days for the three years.

Example

Mondo and Titi visited Kenya between 2003 and 2005 as follows.

	Days in Kenya	
Year	**Mondo**	**Titi**
2003	365	364
2004	1	1
2005	3	1
Total days	369	366
	divide by 3	divide by 3
Average for the three years	123 days	122 days

Mondo was a resident in 2002 as the average days for the three years is more than 122 days. Titi was not a resident in 2002 as the average days for the three years at 122 is not more than 122 days. Kenya includes the air space which is a distance up in the sky considered to be part of Kenya. It also includes the Territorial waters which is a distance into the sea considered to be part of Kenya.

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

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

c) Non-Resident:

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

Note

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

(Income) Accrued In or Derived From Kenya

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

TAXABLE INCOME

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

a) gains or profits from business;
b) gains or profits from employment or service rendered;
c) gains or profit from rights granted to other persons for use or occupation of property e.g. rent;
d) dividend and interest;
e) pension, charge or annuity, and withdrawals from registered pension and provident funds;

f) an amount deemed to be income of a person under the Act or rules made under the Act;

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

There are items which are commonly referred to as income but are not included in the above list of taxable income. A number of such non-taxable incomes come to mind such as dowry, lottery winning, post office premium bond winning, gifts, horse race winning, harambee collections, donations received, foreign income, bettings winning, inheritance, and profit on sale of isolated assets unless dealing in them as a business. This list is not exhaustive.

We will now look at the items of taxable income in more detail.

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

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

Trade means buying and selling for gain;
Profession means professional practice such as by a doctor, lawyer, accountant etc;
Vocation means a calling or career;
Adventure would include smuggling and poaching;
Concern would mean any commercial enterprise.
Business may be carried on for a short time or a full year. The period a business is carried on is irrelevant in taxing the income (gains or profits) and so the use of the phrase "for whatever period" of time (business is) carried on.

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

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

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

Wear and tear computation

	Class III
	Shs
Sale proceeds (business ceased)	35,000
Written down Value	30,000
Balancing Charge(taxable income)	5,000

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

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

Wear and tear computation

	Class III
	Shs
Sale proceeds (business continuing)	35,000
Written down Value	30,000
Trading receipts (taxable income)	(5,000)

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

Gains or Profits from Employment or Service Rendered

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

An employer will include:

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

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

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

1) Cash payments to employees will include:

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

    ii) an amount paid for employment or service rendered to an employer who is resident in Kenya or with a permanent establishment in Kenya. A non-resident person is therefore taxed on income from service rendered to a resident person.

2) Non-cash Employment Income will include:

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

The benefits that are taxed are:

(i) Facilities e.g. free lunch, transport, gift by employer etc.

(ii) Servants provided by employer, for example house servants, cooks, watchman (day and/or night), ayah, and gardener. The Commissioner of Income Tax has quantified the value of the benefits as shown below. An employee is taxed on the cost of providing the benefit or the quantified value of the benefit, whichever is higher.

(iii) Services provided by employer, for example, water, telephone, electricity, furniture, and radio and electronic alarm system. The Commissioner of Income Tax has quantified the value of some benefits as shown below. The employee is taxed on the market value or the cost of providing the service, whichever is the higher, except in the cases of telephone, furniture, and electricity from a generator to agricultural employees.

(iv) Motor car provided by employer. The Commissioner of Income Tax (CIT) has quantified the value of the benefit on the basis of the engine capacity rating. Employees are taxed at the quantified value or 24%p.a. of the initial expenditure on the motor vehicle, whichever is higher. If the motor vehicle is leased/hired by the employer, the taxable benefit on the employee shall be the higher of:

1) 24% p.a. of cost or
2) Hire charges paid.

VALUE OF TAXABLE BENEFITS PRESCRIBED BY CIT (YEAR 2005)

Taxable Employment Benefits - Year 2005

RATES OF TAX (Including wife's employment, self employment and professional income rates of tax). Year of income 2005.

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)

Capital allowances:

Wear and tear allowances

Class I	37.5%
Class II	30%
Class III	25%
Class IV	12.5%

Industrial building allowance:

Industrial buildings	2.5%
Hotels	4.0%

Farm works allowance 33.3%

Investment deduction allowance:

2003	-	70%
2004	-	100%
2005	-	100%

Shipping investment deduction 40%

Mining allowance:

Year 1	40%
Year 2 - 7	10%

Prescribed benefit rates of motor vehicles provided by employer

		Monthly rates (Sh.)	Annual rates (Sh.)
(i)	Saloon, Hatch Backs and Estates		
	Upto - 1200 cc	3,600	43,200
	1201 - 1500 cc	4,200	50,400
	1501 - 1750 cc	5,800	69,600
	1751 - 2000 cc	7,200	86,400
	2001 - 3000 cc	8,600	103,200
	Over - 3000 cc	14,400	172,800
(ii)	Pick-ups, Panel Van (Unconverted)		
	Upto 1750 cc	3,600	43,200
	Over 1750 cc	4,200	50,400
(iii)	Land Rovers/Cruisers	7,200	86,400

OR 2% of the initial capital cost of the vehicle for each month, whichever is higher.

Commissioner's prescribed benefit rates

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

Agricultural employees: Reduced rates of benefits

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

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

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

Note

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

b) **Housing Benefit. – Section 5 (3)**
A housing benefit arises where an employee is housed by the employer. The employer may own the house or lease it from other parties.

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

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

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

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

This is subject to employer obtaining prior approval from Income Tax Office – Note also reduced rates of benefits for agricultural employees – (Page 6).

(iii) **Director**
Fifteen per cent (15%) of his total income; excluding the value of those premises minus amount of rent charged to the director; PROVIDED THAT: -

(a) If employer pays rent under an agreement not made at arm's length with a third party; the value of quarters shall be; the fair market rental value of the premises in that year or rent paid by employer, whichever is higher, OR

(b) Where premises are owned by the employer, the fair market rental value in that year is to be taken.

(iv) **Whole-time Service Director**
15 per cent of gains or profits from his employment, excluding the value of those premises, minus amount of rent charged to the director, PROVIDED THAT: -

(a) If employer pays rent under an agreement not made at arm's length with a third party, the value of the quarters shall be; the fair market rental value of the premises in that year or rent paid by the employer; whichever is higher, OR

(b) Where the premises are owned by employer; the fair market rental value of the premises in that year is to be taken.

This means therefore that directors and whole-time service directors will be subject to the new provisions irrespective of their level of earnings.

The new provisions are effective from 11th June, 1998.

Notes:

- In calculating the housing benefits the employer is required to deduct rental charges recovered from the employee or director. The amount remaining is the chargeable value to be included in the total taxable amount.

- If the premises are occupied for part of the year only, the value is 15% of employment income relative to the period of occupation less any rental charges paid by employee/director.

- Any employee who provides other than normal housing to an employee should consult his local Income Tax office regarding the value of such housing.

- Whole-time service director is a director who is required to: -
  (a) devote substantially the whole of his time to the service of the company in a managerial or technical capacity; and
  (b) does not own or control, directly or indirectly, more than 5% of the share capital or voting power of such a company. Shares owned by spouse or own shares in the company are included in computing the 5% control.

(v) **Accommodation and Meals Provided**

If an employee is accommodated within the employer's premises and is also provided meals, the value of the benefits shall be 10 per cent of the gains or profits from employment for accommodation and 10 per cent representing meals making a total charge of 20%.

In situations other than where accommodation and meals are provided to employee, the taxable value of the benefit should be determined as is explained in paragraph 5 (e) of the Guide Book.

Note

The value of housing in this case will only apply where an employee's gains or profits from employment do not exceed Kshs.50,000 per month (i.e. Kshs.600,000 per annum)

(vi) **Valuation of Quarters – Section 5 (3) Proviso**

Where gains or profit from employment of an individual exceed Kshs.50,000 per month (i.e. Kshs.600,000 per annum) excluding the value of the premises; the value of the quarters shall be: -

(a) Rent paid by the employer to a third party under an agreement made at arm's length.

(b) Fair market rental value of the premises in that year or rent paid by the employer to a third party under an agreement not made at arm's length; whichever is higher, OR

(c) Fair market rental value of the premises in that year is to be taken in case the premises are owned by the employer.

Note

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

Example – Section 5 (3) (C)

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

Calculation for Quarters

Basic Salary	-	Kshs.56,000
Add:		
Benefits	-	Ksh.9, 900
Total	-	Kshs.65, 900

65900 ×15

15% of value of Quarters————— = Ksh.9, 885

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

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

LOAN TO EMPLOYEES

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

i) Low Interest Rate Benefit:

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

Example:

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

Low Interest Benefit:

= (10% - 2%) x 500,000 = Kshs. 40,000 p.a

ii) Fringe Benefit

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

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

Example

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

Fringe Benefit

(12% - 2%) x 800,000 = Kshs. 80,000 p.a.

Fringe Benefit Tax
= 80,000 x 30% = Kshs. 24,000 p.a. or Sh. 2,000 p.m.

COMPENSATION FOR TERMINATION OF EMPLOYMENT

This refers to payment, whether voluntary or obligatory made to a person to compensate him for termination of employment or services. Such a contract could be written or verbal. Such payment is taxable on the person receiving it with effect from 1st july 2004, these compensation is taxable in full

a) Where the contract is for a specified term:

The amount to be taxed in this case shall spread evenly over the un-expired period using the employee's rate of earning at the ate of termination until it is exhausted.

Example
A contract for four years is terminated on 31.12.2005 after it has ran for 2 years. A compensation of ksh.1, 000,000 is received. The employee was earning ksh. 400,000 per annum at the time of termination.

The compensation will be spread as follows:

Year	Taxable Amount (Kshs)
2006	400,000
2007	400,000
2008	200,000
Total	1000,000

b) Where the contract does not specify the term (period) but it provides for a compensation, the compensation received shall be spread using the employee's rate of earning at the time of termination until the whole amount is taxed.

A contract for an unspecified term provides for a payment of Sh. 900,000 on termination. The contract is terminated on 31.12.2005 when the employee was earning Ksh. 400,000 per annum. The compensation will be spread as follows:

Year	Taxable Amount (Kshs.)
2006	400,000
2007	400,000
2008	400,000
2009	100000
	1300,000

c) Where the contract does not specify the term and does not provide for terminal payments the compensation shall be spread forward but it should not exceed the employees 3 years earnings.

Example:

A contract for an unspecified term and which provides for no terminal payments is terminated on 31.12.2005. A compensation Kshs. 1,300,000 is paid. The employee was earning Ksh. 400,000 at the time to termination.

The compensation will be spread as follows:

Year	Taxable Amount (Kshs.)
2006	400,000
2007	400,000
2008	500,000
	1,300,000

Note:
The above treatment of compensation for the termination of contracts apply to all employees and whole time service directors.

LIMITING OF BENEFITS

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

Taxable benefit=12% x 800,000 x3/12 = 24,000

Benefits excluded from Employment Income (Tax free employment benefits):

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

   Conditions for qualifying for passage:

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

   Where cash is paid for passage and the employee may not travel and could in fact use the money for personal expenses, then the cash sum is taxable on the employee.

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

3. Fringe benefit
4. Benefits in kind whose value does not exceed Kshs. 36,000 p.a. (3000 p.m).

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

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

Expenses those are deductible against employment income:

a) Mortgage interest (owner occupier interest) paid on loan to buy or improve a residential house to the maximum of Shs.100,000. Where the mortgage interest paid is less than the maximum, the actual interest paid is claimed. Where the mortgage interest paid is more than the maximum, only the maximum can be claimed. The mortgage interest is also deductible against other incomes and will appear later on in the list of specific expenses deductible against taxable income. The maximum amount has been increased to Kshs. 150,000 p.a. w.e.f 1/1/2006.

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

	1998 Shs	**1999 Shs**	**2000 Shs**	**2001 Shs**	**2006**
Pension: the lower of					
- actual contribution and					
- 30% of pensionable income					
or – Set limit p.m.	10,000	12,500	15,000	17,500	20,000

(c)Annual subscriptions to professional associations such as LSK, ICPAK, KMA etc

(d) Contribution to a Registered Home Ownership Savings Plan Hospital up to Sh.48,000 p.a. (Sh. 4,000 p.m)

(e) Amount of NSSF contributions to a maximum of Kshs. 2,400 p.a. (200p.m)

Employment Income which is exempted from Taxation.

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

i) Employment income of foreign embassy staff excluding locally recruited staff.
ii) Employment income of Organization of African Unity(OAU) staff, foreign and locally recruited.
iii) Employment income of United Nations Organization(UNO) staff, foreign and locally recruited.
iv) Allowances payable to the Speaker, Deputy Speaker, Vice-President, Ministers, Assistant Ministers, and Members of Parliament. The salaries are however taxed.
v) Salaries, allowances, and benefits paid from public funds to the President of Kenya.
vi) Foreign allowances paid from public funds to Kenya officers serving abroad.

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

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

- Royalty for copyrights, patents, trademarks etc.
- Rent which is the tenant's periodic payment for the use of land, building or part of the building etc.

- Rent premium or key money being inducement to lease out a property.

Income In Respect of Dividend and Interest

Dividend:

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

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

a) In a voluntary winding up of a company, amounts distributed as profits whether earned before or during winding up, whether paid in cash or otherwise.

b) Issue of debentures or redeemable preference shares for no payment. The dividend is taken to be the greater of nominal or redeemable value e.g.

- nominal value Kshs. 100
- redeemable value Kshs. 110

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

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

95/100 x Kshs. 110 = Kshs. 104.5. The payment of Kshs. 70 is less than 95% of Kshs. 110 which is Kshs. 104.5. The difference Kshs. 40 is taxable dividend income i.e. Kshs. 110 – Kshs. 70 = Kshs. 40

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

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

2) Dividend received as business income by specified financial institutions, subject to a pro-rata disallowance of relevant expenses.

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

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

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

Interest income exempted from taxation:

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

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

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

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

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

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

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

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

(i) Pension is received for past service and after retirement.
(ii) Pension of up to Kshs. 180,000 p.a is exempted from taxation where received by a resident individual.
(iii) Lump sum payments from registered pension fund and registered provident fund by resident individuals are exempted from taxation as follows: First Kshs. 480,000.

(iv) Any amount received in excess of exempt amounts is taxed as follows above Kshs. 480,000 tax exempt.

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

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

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

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

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

Presumptive Income

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

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

(ii) PIT is re-introduced with effect from 1.1.2000 at 2%.

(iii) PIT is deducted at source by authorised agents appointed by the Commissioner of Income Tax. These are normally the respective marketing organizations, for example, Kenya Seed Company, National Cereal and Produce Board, Farmers Association, Kenya Breweries Ltd, National Irrigation Board for grains:

Sugar Mills for cut sugar cane;
Pyrethrum Board of Kenya for pyrethrum;
BAT(K) Ltd and Mastermind Tobacco(K) Ltd for tobacco Leaf;
Tea Factories for tea leaf;
Ginneries for raw cotton;
Tanneries for hides and skins;
Coffee Board of Kenya for coffee;
Farmers Choice Ltd and Uplands Bacon Factory Ltd for Pigs;
Kenya Cashewnuts Ltd and National Cereal and Produce Board for raw cashewnut;
KCC, Kitinda Dairy Co-operative society, and Meru Central Farmers Co-operative Society for fresh milk.

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

(v) The PIT deducted must be remitted to Commissioner of Income Tax by the 20th day of the month following the deduction and the agent must:

a) provide the Commissioner of Income Tax with a return showing amount of gross payment, PIT deducted, name of payee, and the type of agricultural produce; and
b) Provide taxpayer with a certificate showing gross sale proceeds and PIT deducted.

(vi) In cases where an authorized agent produces specified produce subject to PIT, the gross sale proceed is deemed to be the price that would be paid to farmers for similar purchases.

(vii) For individuals, partnerships and co-operatives, PIT is final tax which means that the income from specified produce does not attract any more income tax. They are, therefore, not required to compute farming income if their income is only from specified produce subject to PIT.

(viii) For companies, PIT is a tax at source and reduces any tax which is finally calculated as payable.

Income of a Married Woman

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

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

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

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

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

Wife's Employment Income and self-employment income.

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

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

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

d) a trustee or manager of a trust created by her husband.

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

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

Wife's Professional Income.

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

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

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

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

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

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

Specified (Separate) Sources Of Income

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

Example:

MR. MALIMOTO INCOME (LOSS)

Source	Income/(loss) Shs.
Employment income	3,000
Business Loss	(1,000)
Farming Loss	(4,000)
Loss carried forward/ tax	(2,000)

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

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

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

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

Specified Sources of Income are:

1) The right granted to other persons for use or occupation of property e.g. rent and royalty. Employment remuneration, e.g. salary, wages, benefits etc.
Professional income from practicing profession e.g. lawyer, doctor, engineer etc.

A loss from professional practice can be offset against employment income.
Professionals rarely make losses.

2) Employment and any self-employed professional vocation.
3) Farming including agricultural, pastoral, horticultural, forestry, fishing and similar farming activities.
4) Business e.g. shop, hotel, butchery etc and any other source of income chargeable to tax as gains or profits but not included in (1) to (3) above.
5) Dividend and interest with effect from 1.1.87.
6) Unspecified sources. These are sources of income that do not fit into any of the above e.g. pension, annuity or charge and withdrawals or payments from registered pension and provident funds.

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

RATES OF TAX

After determining the taxable income, also referred to as assessable or chargeable income/loss of a person, the person is taxed. The tax is always expressed in KShs and the income is always expressed in K£.

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

b) Income is taxed at the prescribed rates of taxation.
There are Corporation rates of tax applicable to companies (legal persons) and there are individual rates of tax applicable to individuals (natural persons)

Corporation Rates of Tax

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

1) Corporate rate of tax from years 2000 to date is 30% for resident corporations.

2) From year 2000 to date, a non-resident company with a permanent establishment in Kenya is taxed at 37½%.

Individual Rates of Tax

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

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

Providing certain conditions are satisfied, the above rates also apply to a wife's employment, wife's professional and wife's self employment income. The liability on wife's employment income, wife's professional and wife's self employment income is calculated separately but assessed together with that of the husband's income.

Withholding Tax or Tax at Source

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 Income Tax Department;
b) pay the payee the amount net of tax; and
c) 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.

   With effect from 1.1.95 where a person pays consultancy, agency or contractual fees in excess of KShs.24,000 per month to an individual, he must deduct withholding tax at 10% except where the individual works under a registered business name or one whose PIN has been supplied to the payer and notified by the payer to the Commissioner. Currently, for consultancy, contractual and agency fees the rate applicable is 5% for payments over Ksh.24,000 per month. Non-resident rate is 20%.

Income Subject To Withholding Tax or Tax at Source for Resident Persons

Interest

Withholding tax on interest carried from financial institutions and government bearer bonds of more than 2 years duration is 15%. Interest on bearer certificates attracts withholding tax at 25%.

Those paying interest, except where interest is exempted from deduction of withholding tax, must deduct the withholding tax. If they fail to deduct the withholding tax, the Income Tax Department has power to collect such tax from the person making the payment.

Interest exempted from withholding tax for resident persons:

a) The interest paid to banks, financial institutions, insurance companies, building societies, Agricultural Finance Corporation, and hire purchase companies.
b) Where the interest is exempted from taxation e.g. Post Office Savings Bank interest.
c) The interest paid to a unit holder from a 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.

   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.

Dividend

The withholding tax on dividend is charged at the rate of 5%.

Those paying dividend, except where dividend is exempted from deduction of withholding tax, must deduct the withholding tax.

If they fail to deduct the withholding tax, the Income Tax Department has power to collect such tax from the person paying.

Dividend exempted from withholding tax for resident persons.

a) Dividends received by a company which owns 12½% or more of the voting power of the paying company. The dividends are also finally exempted from any tax.
b) Dividends received by an exempt person e.g. registered pension and provident funds.

   As mentioned earlier, the withholding tax on qualifying dividend for residents is final tax. This means that there is no further tax charged on dividend once the withholding tax has been paid. Dividends received by insurance companies are not qualifying dividends and are taxed at corporation rate.

Insurance commission

The rate of withholding tax is 5% from amounts paid to insurance brokers, and 10% from amounts paid to any other person.

Employment income

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

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

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

  a) the tax deduction cards (form P9) for all employees;
  b) personal relief claim forms duly signed (forms P1, 2 and 4) for all employees concerned;
  c) certificate showing total monthly PAYE tax deducted for the year (form P10);
  d) List of employees and total PAYE tax deducted from each for the year of income (form P10A).

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

Presumptive income from some agricultural produce

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

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

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

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

Remitting of tax deducted at source to the income tax department

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

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:

Type of Income	Non-resident TaxRates %
Management or Professional fee	20
Sporting or entertainment fee	20
Royalties	20
Management fees paid by petroleum company (exploring for oil)	12½
Rent	30
Dividend	10
Interest including interest on government bearer bonds of more than two years duration	15
Interest on bearer certificates	25
Interest paid by the petroleum company (exploring for oil)	10
Pension	5

Note: Various reduced rates of withholding tax apply to treaty countries.

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 Income Tax 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.

PERSONAL RELIEFS

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

General Application:

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

RENT INCOME

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

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

Note

1) Any cost incurred with the intention to increase rent will be disallowed.
2) Any cost in respect of extension or replacement of the building or part thereof is not allowable.
3) All costs of a capital nature are not allowed.

4) For non-residents the income is taxed at a rate of 30% with-holding tax which is a final tax. No expenses are allowed.

ROYALTY INCOME:

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

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

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

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

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

REINFORCING QUESTIONS

Assume ALL Questions relate to year of income 2004 rates

QUESTION ONE

Explain briefly the following income tax terms:

a) Year of Income.
b) Business.
c) "Resident" when applied to an individual.

QUESTION TWO

(a) State FIVE items of income which are totally excluded in computing total income of a resident individual under the Income Tax Act.
(b) In respect of certain incomes the Income Tax Act, requires that tax be deducted at source. State briefly the provisions of the Act regarding deduction of tax at source.

QUESTION THREE

Write brief notes on the following:

a) Specified sources of income.
b) Income subject to tax at source for resident persons.
c) Wife's employment income.

QUESTION FOUR

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

	Firm A	Firm B
	Shs.	***Shs.***
Basic pay per month	45,000	41,000
Benefits: Housing		
Car 1600cc (cost)	600,000	600,000

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

Required:

(a) What offer would you recommend to Mr. Shoma? Explain the reasons for your recommendation (16 marks)
(b) What is the treatment of school fees? (4 marks)

(Total: 20 marks)

QUESTION FIVE

With reference to Pay As You Earn (PAYE) system;

d) Write explanatory notes on:
   (i) Taxation of pension income for a retired employee; (4 marks)
   (ii) Allowable deductions for contributions to a registered pension scheme; (2 marks)
   (iii) Procedure for the end of year return; (6 marks)

e) Give a list of statutory deductions from employment income. (4 marks)

f) Give a list of three omissions which amount to failure to comply with PAYE regulations and indicate penalty thereon. (4 marks)

(Total: 20 marks)CPA Adapted

Check your answers with those given in Lesson 9 of the Study Pack

COMPREHENSIVE ASSIGNMENT No.1

TO BE SUBMITTED AFTER LESSON 2

To be carried out under examination conditions and sent to the Distance Learning Administrator for marking by the University.

EXAMINATION PAPER. **TIME ALLOWED: THREE HOURS.**
ANSWER ALL QUESTIONS

QUESTION ONE

Makundi, a Tanzanian National came to Kenya for the first time in 2002……………. For the period from that date to 31 May 2005, he stayed in Kenya as follows:

- 1 January 2002 to 31 October 2002;
- 1 January 2003 to 31 May 2003;
- 1 January 2004 to 31 October 2004;
- 1 January 2005 to 31 May 2005.

Mr. Makundi left Kenya permanently on 1 June 2005.

During the year ending 31 December 2004 and 31 December 2005, Makundi's income consisted of:

	2004 Ksh	2005 Ksh
Business in Kenya	40,000	-
Dividend from Kenya companies	24,000	24,000
Dividend from Tanzania companies	30,000	30,000
Business in Kenya (partly exercised in Kenya)	24,000	36,000
Rent income from property in Tanzania	20,000	20,000
Pension received in respect of services rendered to the defunct East African Railways and Harbours -		
- Paid from Kenya	100,000	130,000
- Profit from a business carried on in London	20,000	20,000

Required

Determine, giving reasons, the total income chargeable to Income Tax of Mr Makundi for 2004 and 2005 after ascertaining his residence for the purposes of the Income Tax Act. **(20 marks)**
(CPA Adapted)

QUESTION TWO

Write short notes on
i. Insurance relief
ii. Specified sources of income

QUESTION THREE

Distinguish between direct and indirect taxation, giving examples of each. What do you think would be the consequences of a shift from direct taxation to indirect taxation?

QUESTION FOUR

Explain how a country may use its tax system to influence the general level of productivity.

QUESTION FIVE

(a) The income of a married woman living with her husband is deemed to be the income of the husband for the purposes of ascertaining his total income chargeable to tax. However, under certain circumstances, employment income of a married woman may be assessed separately.

State the circumstances under which tax assessed on the husband may be collected from the wife. *(5 marks)*

(b) Mr F is a director of FG Limited a manufacturing company in which he owns 15% of the issued and fully paid up share capital. He earns a fixed salary of Ksh 160,000 p.a. The company is considering various additional means of remunerating Mr. F for the financial year starting on 1.7.2005. The proposals under consideration are as follows:

(i) Giving Mr. F a housing loan of Shs.1,000,000 at an interest of 3% p.a. repayable over a period of 15 years. Interest for the year will be calculated on the loan balance due on 1 July each year. Mr. F would be required to occupy his own house from the date of granting the loan. He is currently housed by the company.

(ii) Employing his wife at an enhanced salary of Ksh 480,000 p.a. instead of her continuing with her civil service salary of Ksh 300,000 p.a.

(iii) Issuing 1000 redeemable preference shares of Shs.5 nominal value, in consideration of his dedicated and loyal service to the company. The market price of these shares is currently estimated at Shs.20.

(iv) Providing a fully maintained company car of cc. rating 1799 instead of the current mileage allowance of Shs.6,000 per month.

(v) Increasing the company's contribution to the unregistered Executive Provident Fund from 5% of his basic salary to 10% per annum.

(vi) Paying his medical bills and those of family directly to the doctor instead of the current system where he has to pay the doctor and then claim reimbursement from the company. He is also entitled to claim a maximum of Shs.30,000 per annum. His normal medical bills are approximately Shs.40,000 per annum. The company has a medical scheme for directors and executive staff.

Required

Explain the income tax implication for Mr. F for each of the above proposals. Show under which proposals tax due would be collected under the P.A.Y.E. system. (15 marks)

(Total: 20 marks)

CPA Adapted

END OF COMPREHENSIVE ASSIGNMENT No.1

NOW SEND TO THE DISTANCE LEARNING CENTRE FOR MARKING

LESSON THREE

EXPENSES OR DEDUCTIONS ALLOWED AND NOT ALLOWED AGAINST INCOME

INSTRUCTIONS

1. Assigned Reading. Read study text given below.
2. Complete the Reinforcing Questions at the end of the lesson.
3. Compare your answers to the models given in the revision section of the study pack.
4. Study text

EXPENSES OR DEDUCTIONS ALLOWED AGAINST INCOME UNDER SECTION 15, SECOND SCHEDULE, AND NINTH SCHEDULE OF THE INCOME TAX ACT

Expenses or Deductions Not Allowed Against Income (Section 16)

Introduction

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

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

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

EXPENSES OR DEDUCTIONS ALLOWED AGAINST INCOME

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

Expenses or deductions generally allowed against income

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

Section 15(1)
For the purpose of ascertaining the total income of a person there shall be deducted all expenditure which is expenditure wholly and exclusively incurred (by the person) in the production of that income.

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

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

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

butchery	-	purchase of meat, purchase of beef livestock.
coffee farmer	-	picking, fertilizer, mulching, wages for farm labourers
transport	-	fuel and oils, tyres, salaries of drivers.
hotel	-	purchase of food, soft drinks, beer and salaries of workers.
clinic	-	purchase of medicine, detergents and salary of a nurse.

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

Expenses specifically allowed against taxable income

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

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

   The following are allowable against taxable income:

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

   The following are not allowable against taxable income:

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

   Arising from the above, the following should be noted:

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

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

   Two examples of pre-trading expenses are:

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

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

e) The legal costs and stamp duty for registration of a lease of business premises. The lease period must not be in excess of or capable of extension beyond 99 years.
f) The legal costs and other expenditure including capital expenses related to the issue of shares, debentures or similar securities offered to purchase to the general public. This is the expenditure for turning a company public and thus enabling it to be quoted on the Nairobi Stock Exchange. The allowing of these expenses is

intended to boost the capital market (buying and selling of shares). This also includes expenditure incurred in increasing the authorized share capital in order to sell shares to the public.

g) The expenditure on structural alterations to enable premises to be let e.g. subdivision of open rooms in a house which is necessary to maintain existing rent. The expenses relating to extension or replacement of premises are not part of structural alterations and are therefore not allowed against rent income.

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

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

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

A typical case of diminution would be as follows:

	Shs
Opening value of loose tools	1,000
Closing value-per owner	(600)
Diminution (decrease in value) charged in P & L account and allowed	400

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

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

j) The expenditure incurred for scientific research whether capital or revenue expenditure.
k) The amount of contribution to a scientific research association which undertakes research related to the class of business of the contributor. The research association must be approved by the CIT e.g. Ruiru Coffee research, Fresian Cattle Society etc.
l) The amount of contribution to university, college or research institution approved by CIT for scientific research e.g. Nairobi University, Kenya Polytechnic, AMREF, Kenya Medical Research Institute (KEMRI), Kenya Agricultural Research Institute (KARI) etc.

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

m) The contribution by employer on behalf of employees to National Social Security Fund (NSSF).
n) The expenditure on advertising. This includes expenditure intended to advertise or promote directly or indirectly, the sale of goods or services provided by a given business e.g. advertisement in television, radio, press, calendars, sponsoring sports like football clubs, golf tournament, rally cars, horse races, olympic teams etc.

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

o) Mortgage interest (also called owner occupier interest) to the maximum of Ksh.100,000. This is the interest on loan obtained for purchase or improvement of a residential house. For the interest to be allowed the loan must be obtained from any of the following institutions:

- Banks and financial institutions licensed under the Banking Act;
- Insurance companies licensed under the Insurance Companies Act;
- Building society licensed under the Building Societies Act;
- Kenya Re-insurance Corporation.

The following points should be noted:

i) Where the mortgage interest paid is less than the maximum of Shs.100,000, the actual interest paid is the amount allowed against income.
ii) Where the mortgage interest paid is more than Ksh.100,000 in year 2001, then only the maximum is allowed against taxable income.
iii) Only individuals can claim mortgage interest and on only one residential house.
iv) If the house is occupied for less than a year, the mortgage interest allowable is restricted to the period of occupation.
v) The maximum amount has been increased to Kshs. 150,000 p.a. w.e.f 1/1/2006.

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

	Wear & Tear Class
Written down value	50,000
Sale of all assets (business continuing)	40,000
Trading loss-allowable against income	10,000

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

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

	Wear & Tear Class
Written down value	50,000
Sale of all assets (business has ceased)	40,000
Balancing deduction-allowable against income	10,000

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

s) The amount of interest on money borrowed and used in the production of income e.g. interest on loan, overdraft, debentures etc.
t) The amount of realised foreign exchange loss (capital or revenue) with effect 1.1.'89. If the foreign exchange loss is not realised or incurred, it is not allowed against taxable income.
u) Capital deductions under the second schedule of the Act, namely:

i) The amount of wear and tear deduction (allowance) on machinery used for business.
ii) The amount of industrial building deduction (allowance) on industrial buildings used for business.
iii) The amount of farm works deduction (allowance) given to farmers only on construction of farm works used for farming.

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

EXPENSES OR DEDUCTIONS NOT ALLOWED AGAINST TAXABLE INCOME

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

Expenditure generally not allowed against taxable income

S.16(1) of the Income Tax Act generally disallows expenditure which is not incurred in the production of taxable income. The section reads as follows:
S.16(1) "..... for the purpose of ascertaining the total income of the person ..... no deduction shall be allowed in respect of expenditure ..... which is ***not*** wholly and exclusively incurred by the person in the production of income."

This is a general provision for disallowing:

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

Specific items of expenditure not allowable against income

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

a) The amount of capital expenditure, loss, diminution or exhaustion of capital e.g. depreciation, amortisation, write-off of all assets, loss on sale of asset etc. These are disallowed unless specifically allowed in the Income Tax Act.
b) The amount of personal expenditure incurred by any individual in the maintenance of himself, his family, or for domestic purpose. With effect from 1.6.'91, the disallowed expenditure includes:

    i) entertainment expenses for personal purposes;
    ii) hotel, restaurant, or catering expenses except:

        a) on business trip;
        b) during training or work related conventions or conferences; and
        c) meals provided to low income employees on employers premises.

    iii) vacational trips except those provided to expatriates;
    iv) education fees, if not taxed on the employee(s):
    v) club fees including entrance and subscription fee.

c) The amount of expenditure or loss recoverable under insurance contract or indemnity.
d) The amount of income tax paid, or any tax on income. Other taxes may be allowed.
e) The amount of premium paid under an annuity contract, that is, paid to an insurance company for the purpose of receiving annuities (regular amounts annually) in future.
f) The amount of expenditure in the production of income by a non-resident person with no permanent establishment in Kenya. The income is taxed gross at source at non-resident rates of tax. The expression

"permanent establishment" is defined in the Act as a fixed place of business in which that person carries on business. A fixed place of business means a building site, or a construction or assembling project, which has existed for six months or more in relation to a person.

g) The amount of loss from hobby business. This is business not carried on with a view to making profit e.g. keeping of three cows at the estates of Karen in Nairobi. The issue of losses from hobby business has been weakened by the concept of specified sources of income.

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

h) The amounts of lease hire rentals for assets relating to lease hire agreements entered into with effect from 17.6.'88. The lease hire agreement entered into before the above date were allowable.

i) The amount of reserves and provisions. These are not business expenditure incurred. It should be noted that the provision for specific trade bad debts is specifically stated to be allowable expenditure.

INCOME AND EXPENDITURE AFTER CESSATION OF BUSINESS

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

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

REINFORCING QUESTIONS

QUESTION ONE

Paul Otieno, is employed by PO Advocates, a firm of practicing lawyer. He made the following payments during the year 2005.

i) Mortgage interest of shs 120,000 on a shs 850,000 mortgage provided by Housing Finance Company of Kenya Ltd. for his residential premises in Kiambu.
ii) A subscription to Muthaiga Golf Club. He joined the Club in the hope of meeting potential clients.
iii) Shs 10,000 to the company's retirement scheme.The scheme was registered with the Commissioner in the prescribed manner.
iv) Alimony of shs 75,000 to his former wife for her maintenance and their two children.
v) Donated shs 10,000 to the National Bursary Fund, and shs 25,000 to the Kenya Medical Research Institute.

Required
State, giving reasons,whether each of the above payments are deductible by Otieno in computing his total income and show the amount deductible in 2005. **(20 marks)**

QUESTION TWO

An individual's total income for tax purposes may not be the same as the income which he actually receives during a year of income. Discuss. **(20 marks)**

QUESTION THREE

Section 15 of the Income Tax Act sets out deductions allowed in arriving at profits. One of the allowed deductions is bad debts.

a) Under what circumstances would these be deducted?
b) State whether or not the following would qualify for deduction against income and giving reasons:

i) A trading company's loan to an employee, which the employee, following termination of his employment refuses to pay.
ii) A trading company's loan to a retailer to purchase equipment for use in retailing the products of the lender and which the retailer, on disposing of his business refuses to pay. **(20 marks)**

QUESTION FOUR

Depending on the nature of the business, expenses are allowable against taxable income if they are wholly and exclusively incurred in the production of income. List FIVE types of business, and against each indicate an example of expenditure that would not be wholly and exclusively incurred in the production of income. **(20 marks)**

QUESTION FIVE

Mr. Hesabu has recently opened an Income Tax Consultancy office in Nairobi. He has been approached by his clients on the following matters.

i. M/S Watu; Wote; Wao; are three partners operating WWW Enterprise. In 2005, they made profits of Sh. 1,800,000. They share profits in terms of 3:3:4. Wao had overdrawn on his account and was charged Sh. 300,000 interest. Watu and Wote received interest of Sh. 250,000 each from the partnership. The interest is included in the above profits. Mr. Wote wishes to know how much tax he would pay. He has no other source of income. (6 marks)

ii. Live Well Foundation is a Non-Governmental organization formed for the purpose of addressing people's spiritual needs. It will derive its income from donors of all kinds, charitable walks and sale of religious literature. They wish to know if they will be required to pay any tax. *(4 marks)*

iii. Mrs. Mjini is a happily married housewife residing in Kilimani Estate, Nairobi. Since her compound is big she engages in backyard gardening during her spare time and she derive a lot of satisfaction from it. She also maintains very accurate records of the performance of her garden. Details for the three years ending 31 December are as shown below:

	Sh.
Year ended 31 December 2003 Profit	200,000
Year ended 31 December 2004 Loss	40,000
Year ended 31 December 2005 Profit	50,000

Garden produce consumed by Mrs. Mjini's family during the year of income 2005 was Sh. 60,000 (not included in the above results).
She wishes to know how much tax she should pay from this activity in 2005. (4 marks)

iv. New Plastic Limited, manufacturers of plastic products wishes to sponsor research into plans that may produce plastics related materials. They have set aside Sh. 20,000,000 which will be awarded to the Department of Biochemistry, Ubora Science University. They wish to know if there is any tax advantage which may arise. (4 marks)

Required
As Mr. Hesabu's tax manager, write a memorandum on each of the points for his consideration.

(Total: 18 marks)

CHECK YOUR ANSWERS WITH THOSE GIVEN IN LESSON 9 OF THE STUDY PACK

LESSON FOUR

CAPITAL DEDUCTIONS/ALLOWANCES

INSTRUCTIONS

1. Assigned Reading. Read study text given below.
2. Complete the Reinforcing Questions at the end of the lesson.
3. Compare your answers to the models given in the revision section of the study pack.
4. Study text

COMPUTATION OF CAPITAL DEDUCTIONS (ALLOWANCES) (DEDUCTIONS UNDER SECOND SCHEDULE TO THE INCOME TAX ACT)

While discussing allowable expenses above, the deductions or allowances on some machinery and buildings used for business were stated to be some of the expenses specifically allowed against taxable income. The deductions or allowances are at standard rates for all taxpayers depending on the nature of the capital expenditure incurred.

The capital deductions are important because:

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

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

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

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

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

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

   Wear and Tear Deduction (Allowance)
   As per paragraph 7 of the Second Schedule to the Income Tax Act ... "where during a year of income machinery owned by a person is used by the person for the purpose of his business, there shall be made in computing the person's gains or profits ... a deduction ... referred to as a 'wear and tear deduction'."

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

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

   Procedure for Wear and Tear Deduction

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

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

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

      Class I This is a class for heavy earth moving equipment and heavy self-propelling (producing

(37.5%)	own power to move) machinery e.g. tractors, combined harvesters, lorries of load capacity of 3 tons and over, tippers, buses, loaders, graders, bulldozers, mounted cranes etc.
Class II ***(30%)***	This is a class for office equipment bought on or after 1.1.'92 e.g. computers, printers, electronic calculators, adding machines, photocopiers, and duplicating machines.
Class III ***(25.0%)***	This is a class for other self-propelling vehicles including aircrafts, examples include pick-ups motor cars, aircraft, motor cycles, lorries of less than 3 tons load capacity, vans.
Class IV ***(12.5%)***	This is a class for other machinery including ship e.g. factory plant and machinery, fixtures and fittings, bicycles, partitions (temporary or movable), shop counters and shelves, safes, typewriters, sign boards, fridges, freezers, advertisement stands etc.

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

Wear and tear computation — format

	Class IV	Class I	Class II	Class III
	37½%	***30 %***	***25%***	***12½%***
	Sh	Sh	Sh	Sh
Written Down Value (WDV) at the beginning of the period/year (a)	XX	XX	XX	XX
Additions (give details of each class) (b)	XX	XX	XX	XX
Sub—totals	XX	XX	XX	XX
Disposal/sales (give details of each class) (c)	(XX)(XX)	(XX)	(XX)	
Sub-totals	XX	XX	XX	XX
Wear and Tear Deduction (d)	(XX)	(XX)	(XX)	(XX)
Written Down Value (WDV) at the end of period/year	XX	XX	XX	XX

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

Computing the wear and tear deduction

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

a) Take the balance brought forward at the commencement of the accounting year (period) referred to as the Written Down Value (WDV) for each class. Sometimes there is no balance brought forward from previous accounting period.
b) Add to the balance brought forward for each class, the value of any additional machinery (assets) purchased or made, new or old during the year. There would be a sub-total for each class.

c) Then deduct from the sub-total in (b) above the amount of cash or cash equivalent on sale of machinery (assets) purchased for each class. There would again be a sub-total for each class involved.
d) Finally, the appropriate percentage rate is applied on the sub-total in (c) above for each class and the result is the amount of Wear and Tear Deduction (Allowance) for the year.

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

Commercial and non-commercial vehicles for wear and tear deduction

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

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

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

Any vehicle which does not fit the definition of a commercial vehicle is referred to as a non-commercial vehicle.
For the purpose of wear and tear, the value of addition of any non-commercial vehicle is restricted to Sh.1million w.e.f 1/1/2006, the restricted value will be Sh. 2 million.

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

$$\frac{\text{Sales Proceeds}}{\text{Cost}} \times \text{Restriction value applicable in the year of purchase.}$$

Example of Wear and Tear Computation

Molo Co. Ltd., a company dealing in hardware, prepares its accounts to 30 June each year. The following information relates to the year ended 30 June 2005.

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

	Class I	Class III	Class IV
	37½%	25%	12½%
	Shs	***Shs***	***Shs***
Written Down Value 30.6.2004	175,000	180,000	87,000

ii) **Disposals during the year:**

	Cost	**Net Book Value**	**Sales proceeds**
	Shs	**Shs**	**Shs**

Isuzu Lorry	280,000	175,000	260,000
Motor car (purchased in 1.3.2004)	1,160,000	1,015,000	800,000

iii) **Additions during the year**

	Shs
Mercedes Benz sports car for director	4,000,000
Second-hand Tractor	80,000
Trailer occasionally used by tractor	80,000
Shop fittings	60,000
Computer bought 1.3.2005	250,000
Telephone system bought 1.9.2004	72,000

iv) the office safe which cost Shs 30,000, in 2002 was traded-in for a more modern safe costing Shs 40,000. The old safe was valued at Shs 20,000 and the company paid the balance of Sh,20,000 to acquire the new safe. The net book value of the old safe was Shs 22,968 at 30.6.2004.

Required
Calculate the wear and tear deductions due to the company for the year 2005.

Solution
MOLO Co. LTD

Wear and tear computation for the year ended 30.6.'99

	Class I 37.5% Shs	**Class II 30% Shs**	**Class III 25% Shs**	**Class IV 12.5% Shs**
WDV as at 1.7.2004	175,000	—	180,000	87,000
Additions:				
Mercedes Benz car (restriction)—Note 1			1,000,000	
Second-hand Tractor	80,000			
Trailer—Note 2				80,000
Shop fitting				60,000
Computer—Note 3		250,000		
Telephone system—Note 3				72,000
New Safe (cash + trade-in) Note 4				40,000
	255,000	250,000	1,180,000	339,000
Disposal (Sales):				
Safe (trade-in-value)				(20,000)
Isuzu car	(260,000)			
Motor car—Note 5			(690,000)	
	(5,000)		250,000	490,000
Trading Receipt—Note 6	5,000	—	—	—
Wear and tear deduction/allowance	NIL	(75,000)	(122,500)	(39,875)
WDV as at 30.6.2005	—	175,000	367,500	279,125

Wear and tear deduction:

	Shs
Class I	—
Class II	75,000
Class III	122,500
Class IV	39,875
Total amount to be deducted in the Income Tax Computation	237,375

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

Notes

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

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

3. Computers and computer hardware, calculators, copiers and duplicating machines bought on or after 1.1.2005 fall under Class II (30%) of wear and tear.
4. The purchase price of the safe is Shs. 40,000 arrived at as follows:

	Shs
Trade in value of old safe	20,000
Cash paid	20,000
Total purchase price	40,000

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

5. a. The car sold is not a commercial vehicle which means that it was restricted to Shs 1,000,000 as addition in 2004. The sale proceeds of Shs 800,000 must therefore be restricted by a factor of 1,000,000 cost as follows:

$$\frac{800{,}000}{1{,}160{,}000} \times 1{,}000{,}000 = Shs.690{,}000$$

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

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

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

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

Things to remember in computing wear and tear allowance

1. **Written Down Value (WDV)**
   The WDV at the close of the accounting year/period is the opening WDV for the following accounting year/period.

2. **Addition for Wear and Tear**
   The cost of assets which qualify for wear and tear additions are:

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

      To Shs 1,000,000 with effect from 1.1.1998 – 31/12/2005
      To Shs. 2,000,000 with effect from 1/1/2006

   Note that for persons in the business of hire or sale of motor vehicles, the non-commercial vehicle are restricted.

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

3. **Disposal or Sales for Wear and Tear.**
   Some details of sale proceeds which qualify as sales for wear and tear:

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

   $$\frac{\text{SaleProceeds}}{} \times \text{restricted cost in the year of purchase.}$$

   c. The trade-in amount or part-exchange value is taken as sale proceeds for wear and tear.

   d. The amount of insurance claim received for wear and tear machinery lost in theft, fire or accident is taken as sale proceeds for wear and tear.

   e. In a continuing business:

i. If the amount of sale proceeds in any class of wear and tear is more than the written down value, there is a trading receipt. The amount of trading receipt is taxable income and is added back in the tax computation. It is in a way, wear and tear over-provided.
ii. If all the items in a class of wear and tear are sold, and the amount of sale is less than the written down value, there is a trading loss. The amount of trading loss is allowable against income and is deducted in the income tax computation. It is Wear and Tear Deduction under-provided.

f. In case of business which has ceased to operate:

i) If the amount of sale proceeds is more than the balance (WDV) in any class of wear and tear, the excess is called balancing charge. The balancing charge is taxable income and is added back in the income tax computation. It is wear and tear deduction over-provided.
ii) If all the items in a class of wear and tear are sold for less than the written down value the difference is a balancing deduction. The amount of balancing deduction is allowable against income. It is wear and tear deduction under-provided.

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

4. **Wear and Tear Deduction.**

a. The amount calculated as wear and tear deduction is deducted in the income tax computation.

b. The annual rate of wear and tear is applied on the reducing balance in each class.

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

Annual wear and tear deduction X 6/12 = wear and tear deduction claimable.

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

Annual wear and tear deduction X 18/12 = wear and tear deduction claimable.

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

h. Where a person owns machinery which is leased to another person who uses the machinery for his business, wear and tear deduction is claimed by the lessor (owner).

2. **Farm Works Deduction (Allowance)—F.W.D.**

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

The rate for Farm Works Deduction with effect from 1.1.'85 is 33 1/3 % (1/3) of qualifying cost per year for three years. Previously, the rate was 20% (1/5) of qualifying cost per year for five years.

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

Farm Works means:

a. Farmhouses, labour quarters, any other immovable building necessary for the proper operation of the farm, fence dips, drains, water and electricity supply works other than machinery and other works necessary for the proper operation of the farm such as—fish pond, coffee factory, horse stable, cow shed, drains, windbreak, roads, stores, irrigation network etc.
b. In case of farm house, only one third of the initial cost of the farm house qualifies for farm works deduction.

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

Only one farm house qualifies for the deduction.

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

Example
Mr Tononoka, a farmer, incurred the following capital expenditure in his farm for the year ended 31.12.2005

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

There is a balance of unclaimed Farm Work Deduction brought forward in 2005 of Shs 25,000

Required
Compute the capital deductions for the year 2005.

Solution

Farm Works Deduction:

Item	Cost Shs	2005 Shs	2006 Shs	2007 Shs
Extension to labour lines	30,000			
Fenced paddock	15,000			
1/3 of farm house extension	90,000			
	135,000	45,000	45,000	45,000
FWD brought forward	25,000	25,000	—	—
	160,000	70,000	45,000	45, 000
FWD for 2005	(70,000)	(70,000)	—	—
FWD unclaimed carried forward	90,000	—	45,000	45,000

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

Wear and tear deduction

	CLASS IV *12½ % Shs*
WDV as at 1.1.2005	—
Addition : Electric generator	32,000
	32,000
Wear and Tear Deduction	(4,000)
WDV as at 31.12.2005	28,000

Notes

1. The cost of construction of a gabion of Shs 20,000 for the prevention of soil erosion is a capital expenditure which the Income Tax Act allows against income.

2. The cost of farm house extension is Shs 270,000, but only one third, i.e. Shs 90,000, qualifies for farm works deduction.

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

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

3. **Investment Deduction/Allowance**
PARAGRAPH 24 - 26 OF THE SECOND SCHEDULE TO THE INCOME TAX ACT

The investment deduction is another capital deduction given on cost of buildings and machinery which are used for manufacture, on cost of a ship, and on cost of a hotel building.

There are four types of investment deduction:

a. Investment deduction in respect of buildings and machinery used for ordinary manufacture.

b. Investment deduction in respect of building and machinery used for manufacture under bond, that is, goods manufactured for export only. It was introduced 1988. It is commonly referred to as Investment Deduction Bonded Manufacture (IDBM).
c. Investment Deduction in respect of a hotel building certified by the Commissioner of Income Tax to be an industrial building.
d. Shipping Investment Deduction (S.I.D) in respect of a ship.

The investment deduction on buildings and machinery is intended to encourage new investments in the manufacturing sector. Previously, the government wished to attract investments outside Nairobi and Mombasa by offering higher rates of allowance. With effect from 1.1.'95 there is a uniform rate of 60%.

The investment deduction is deducted in the income tax computation, or in arriving at the taxable income/loss and is given once and for all when the building and machinery are used, that is, in the "year of first use" of building or machinery.

Cost of building and machinery qualifying for investment deduction.

The cost which qualifies for Investment Deduction is capital expenditure incurred:

a. on the construction of a building and on the purchase and installation therein of new machinery, and the owner or lessee of that building uses that machinery in that building for the purpose of manufacture. (New building + new machinery qualify for ID).

   With effect from 1.1.'92 a building used for manufacture qualifies for investment deduction on its own, provided that it had not been used for other purpose prior to being used for manufacture; or
b. on the purchase and installation of new machinery used for manufacture in any part of a building other than a building previously used for the purpose of manufacture (new machinery installed in old building qualifies for investment deduction).

   With effect from 1.1.'92 either new or old machinery qualifies for investment deduction if installed and used for manufacture. This now allows investors to invest in phases without losing investment deduction as was the case previously. With effect from 1.1.'93 machinery does not need to be installed to qualify for the allowance.

c. on the construction of a hotel building which is certified as an industrial building by the Commissioner of Income Tax; or
d. on the construction of a building and on the purchase and installation therein of **new** machinery, and the owner of that building uses that machinery in that building for the purpose of manufacture under bond; that is, manufacture for export only.

- "building" includes any building structure and if used for manufacture, then with effect from 1.1.'95 the qualifying cost of the building includes major renovations and civil works such as roads, parking areas, drainage systems, etc.
- "manufacture" means making (including packaging) of goods or raw materials from raw or partly manufactured materials to other goods.
- "new" means not having previously been used by any person, or acquired or held by any other person except the dealer (supplier) in normal course of business.
- "installation" means affixed (fixed) to the fabric (wall or floor) of the building in a manner necessary for and appropriate to the proper operation of the machinery concerned.
- "Machinery" means machinery and equipment used directly in the process of manufacture, and includes, with effect from 1.1.'95, machinery used for the following ancillary purposes:
  - generation, transformation and distribution of electricity;
  - clean-up and disposal of effluents and other waste products;

- reduction of environmental damage; and
- water supply or disposal.

- With effect from 1.7.1999, Workshop Machinery used for the maintenance of machinery used for manufacture qualify for investment deduction.
- With effect from 1.7.2000, power generation equipment also qualifies for investment deduction.

Note

1. In case a building is converted into a factory and new machinery installed for manufacture then only machinery qualify for investment deduction.
2. In a bid to encourage investment in industrial building machinery and equipment, the level of investment deduction has been increased to 100% for 18 month period with effect from 1.7.2000. Thereafter it will reduce to 85% during year 2002, 70%in 2003, finally reverting back to 100% in year 2004 and thereafter.

Cost which does not qualify for investment deduction:

- cost of land on which the building is constructed.
- stamp duty, legal costs and other incidental expenses on acquisition of land.
- cost of items or activity which are supplementary to manufacture such as design, storage, transport, administration, security, etc.
- replacement machinery.

Rates of Investment Deduction on Building and Machinery

Once the qualifying cost for investment deduction is determined, the appropriate rate of investment deduction is applied to obtain the amount of investment deduction that can be claimed.

1. Rates of investment deduction for building and machinery used for ordinary manufacture and for hotel building.

Year of Income	**% ID RATE**
1995 – 30.6.2000	60
1.7.2000 – 31.12.2001	100%
1.1.2002 – 31.12.2002	85%
1.1.2003 – 31.12.2003	70%
1.1.2004 to 2008	100%

Note the favourably high rates for locating building and machinery outside Nairobi and Mombasa municipalities, that applied up to 1994.

2. Rates for investment deduction for building and machinery for manufacture under bond (for export only) with effect from 1988 (IDBM) would be as follows:-

Year Commencing	**Investment deductions rate**	**Additional I.D for MUB**	**Total Investment deductions**
1.1.1995	60%	40%	100%
1.7.2000	100%	-	100%
1.1.2002	85%	15%	100%
1.1.2003	70%	30%	100%
1.1.2004	100%	-	100%

The investment deduction for building and machinery for bonded manufacture (IDBM) is given in addition to the investment deduction for ordinary manufacture. Where investment deduction is claimed with effect from 1.1.'89, other capital deductions are NIL as total capital expenditure is claimed in the year of first use, irrespective of the location of the manufacturing concern.

If the investment deduction for bonded manufacture is granted and the manufacture under bond ceases to be carried on before three year are over, the investment deduction for Bonded Manufacture is withdrawn and the difference between the investment deduction claimed and the capital deductions which would have been claimed (wear and tear deduction, and industrial building deduction) if not a bonded manufacturer is added back in the income tax computation or in arriving at the taxable income/loss for the year in which manufacturing under bond ceases. The amount is taxable income similar to trading receipt e.g.

	Shs	Shs
IDBM claimed first year of use (100% of cost)		XX
Less: deductions that would have been claimed		
if not an investment deduction bonded manufacturer case:		
ID ordinary manufacture	(XX)	
Industrial Building Deduction	(XX)	
Wear and Tear Deduction	(XX)	(XX)
Claw back (added back) as taxable income		XX

Things to remember in calculating investment deduction

1. Where non-qualifying capital expenditure of the building such as office, showroom, shop is not more than 10% of the total cost of the building (qualifying and non-qualifying), then it is included in the calculation of investment deduction.
2. Where an existing building is extended by further construction, the extension is treated as a separate building for the calculation of investment deduction.
3. Where a building is sold before use:

   a. take the cost of construction or the purchase price paid whichever is lower; and
   b. where sold by a person carrying on the business of constructing and selling buildings as a trade (a builder) take the price paid as qualifying cost for investment deduction. If sold more than once before use, take the last price paid by the person who uses the building, or the construction cost, whichever is the lowest.

4. A building qualifying for investment deduction automatically qualifies for industrial building deduction. Industrial building deduction is dealt with later in this lesson.

5. a. Up to 31.12.'86, investment deduction was granted over and above other capital deductions (Industrial
   Building Deduction and Wear and Tear Deduction). An investment deduction of 20% or 50% on cost as applicable was granted on the qualifying cost and such cost also qualified for industrial building deduction and wear tear deduction.

4. **Shipping Investment Deduction—S.I.D.**

The shipping investment deduction is given where a resident shipowner incurs capital expenditure:

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

The rate of shipping investment deduction is 40% (2/5) of qualifying cost. The deduction is made in computing the taxable income/loss of a person for the year of income in which the ship is first used for business, that is, the year of "first use of the ship".

With effect from 1.1.'87, the wear and tear deduction for a ship is calculated on the qualifying amount net of shipping investment deduction.

Limitations on shipping investment deduction.

1. A given ship can only get one shipping investment deduction in its life.
2. If a ship is sold within 5 years after the year of income in which shipping investment deduction is given, the shipping investment deduction is withdrawn and the deduction treated as income of the year of income in which the sale takes place e.g.

Shipping investment deduction given Shs 2.5. million in 1985

Ship sold in 1990. The shipping investment deduction of Shs 2.5 million is withdrawn in 1990*. The ship would have to be sold in 1991 and after for shipping investment deduction to hold.

*In its place Wear & Tear Team allowance Class IV would be granted for Year '85 to '89. the balance of the shipping investment deduction is taxed in 1990.

5. **Industrial Building Deduction (Allowance)—I.B.D.**

This is a capital deduction or allowance given in respect of capital expenditure on an industrial building as per paragraph 1 to 6 of the Second Schedule to the Income Tax Act.

".... where a person incurs capital expenditure on the construction of an industrial building, and the industrial building is used for business carried on (by the person) or a lessee .... a deduction called industrial building deduction shall be made in computing (the person's) gains or profits from the business."

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

The rates for industrial building deduction are:

a. The standard rate of 2.5% (1/40) of the qualifying cost per year for 40 years, except in two cases below. The life of an industrial building is deemed to be 40 years.
b. A rate agreed with the Commissioner of Income Tax. Where a taxpayer considers that the life of an industrial building is less than 40 years, the taxpayer can apply for a greater rate than 1/40 and if the Commissioner of Income Tax agrees, that will be the agreed rate of industrial building deduction. The life of an industrial building may be shorter than 40 years due to the type of construction or the use to which the industrial building is put.
c. In the case of a hotel building which is certified by the Commissioner of Income Tax to be an industrial building, the industrial building deduction rate is 4% (1/25) of qualifying cost per year for 25 years.

It is important at this point to know what is an industrial building which qualifies for the industrial building deduction.

Industrial Building means

a) A building in use:
   i) For the purpose of a business carried on in a mill, factory or other similar premises e.g. bakery, saw mill, soap factory, posho mill, etc.
   ii) For the purpose of a commercial undertaking of transport, dock, bridge, tunnel, inland navigation, water, electricity, or hydraulic power e.g. old Nyali bridge, old Karen water supply, repair dock in Mombasa, Kenya Bus Depot at Eastleigh etc.
   iii) For the purpose of a business of manufacture of goods or materials, or the subjection of goods or materials to any process e.g. East African Industries, Kenya Breweries, BAT Kenya Ltd etc.
   iv) For the purpose of a business which consists in the storage of goods or materials which are raw materials for manufacture of other goods or materials, finished goods, or on their arrival by sea or air into any part of Kenya.
   v) For the purpose of agricultural services e.g. ploughing, cultivation, threshing of crops etc. on agricultural land but not owned by the farmer. This is normally buildings used by agricultural contractors.
   vi) For the purpose of a business declared by the Minister for Finance by a notice in the Gazette as qualifying for industrial building deduction.

b) A prescribed dwelling-house e.g. dwelling-house constructed for and occupied by employees e.g. Tusker Village for Kenya Breweries employees and BAT Shauri Moyo houses.
c) A hotel building or part of a hotel building which the Commissioner of Income Tax has certified to be an industrial building, including any building directly related to the operations of the hotel such as kitchens, staff quarters and entertainment and sporting facilities.
d) A building used for the welfare of workers employed in any business or undertaking referred to in (a) above e.g. canteen, sports-house etc.
e) With effect from 1.1.'95 where a building is an industrial building, the following civil works or structures on the premises of the building shall be deemed to be part of the building where they relate or contribute to the use of the building:
   i) roads and parking areas;
   ii) railway lines and related structures;
   iii) communications and electrical posts and pylons and other electricity supply works;
   iv) water, industrial effluent and sewage works; and
   v) security walls and fencing.

The following costs do not qualify for industrial building deduction:

1. The cost of acquisition of land on which the industrial building is constructed, and other incidental costs on acquisition such as stamp duty and legal fees.
2. The costs of items treated as machinery for wear and tear e.g. partitioning, shelves, counters etc.
3. The cost of retail shop, showroom, office, dwelling house etc. **EXCEPT** where the cost is not more than 10% of the total capital expenditure (the industrial building plus shop, office etc.)

Things to remember in the calculation of industrial building deduction.

1. Where an industrial building is used for part of the accounting year, the annual industrial building deduction is proportionately reduced to the period of the year that the building is used e.g. if used for 6 months during the accounting year, 6/12 of the annual industrial building deduction would be claimed. The annual industrial building deduction would be extended if accounting period exceeded 12 months. The practice of the Income Tax Department is to have a minimum apportionment of one full month where days are involved.

2. Where an industrial building in use is sold and continues to be an industrial building used by the purchaser or his lessee, the industrial building deduction continues to be given to purchaser as

before and the purchase price is not considered for any capital deduction. In other words the buyer takes over the residue of expenditure as at the date of purchase.

3. Where capital expenditure is incurred on the construction of an industrial building and the industrial building is sold before it is used, then the purchaser is deemed to have incurred capital expenditure for the purpose of industrial building deduction equal to the **lower** of construction cost and the purchase price paid.
   If the building is sold more than once before being used as an industrial building, the last purchase price is compared with the construction cost e.g. A → sells to B → C → D, and D uses the building as an industrial building. The cost qualifying for industrial building deduction is the lower of construction cost to (A) and the price paid by (D).
4. Where the cost of constructing an industrial building is incurred by a person carrying on the business of constructing buildings with a view to selling them (a builder) and he sells the industrial building before use, then the capital expenditure which qualifies for IBD is equal to the price paid for such a sale. The construction cost is ignored in this case.
5. Where a building is not used as an industrial building for a period, a notional industrial building deduction is calculated for the purpose of determining the residue of expenditure to be carried forward.

   Example
   A factory closed down for two years in 2004 and 2005 and the residue on 31.12.'96 was Shs 420,000 and the annual IBD of Shs 14,000.
   2004 notional IBD Shs 14,000
   2005 notional IBD Shs 14,000
   2006 when it operates again, the Shs 14,000 is claimed as industrial building deduction in the income tax computation or in arriving at the taxable income/loss for 2006. The residue of expenditure as at 31.12.06 is Shs 378,000, that is, Shs 420,000 — (14,000 x 3) = Shs 378,000.

6. With effect from 1.1.'87, for an industrial building which qualifies for investment deduction the amount qualifying for industrial building deduction is the cost net of investment deduction.

MANUFACTURE UNDER BOND: (MUB)

This is a programme by the government to encourage the production of goods for exports. In this programme, the Manufacturer of the goods writes a Bond to cover the goods being manufactured.

Bond: This is a promise (agreement) by a person to pay to the commissioner of Customs and Excise an amount of money if the conditions of the manufacturing agreement are not met.

Goods manufactured and exported will not be charged any duty. However, if such goods are not exported, then duty must be paid. Such duty is secured by the Bond.

INVESTMENT DEDUCTIONS FOR MUB

This is granted to firms operating in the MUB programme. It is granted in the first year the building and machinery are brought to use. It is based on capital expenditure incurred in building and installation there in of new machinery. Such building and machinery must be used for MUB.

However, the cost of land is not included.
The investment deduction for MUB operations for MUB is 100% as shown below:

Where 1st year of use is any year commencing on or after	Investment Deductions	Additional Investment Deductions for MUB	Total Investment Deductions
1.1.1996	60%	40%	100%
1.7.2000	100%	-	100%
1.1.2002	85%	15%	100%
1.1.2003	70%	30%	100%
1.1.2004	100%	-	100%

MUB Conditions:

Where a person who has been granted Investment deductions for MUB ceases to manufacture under Bond within 3 years from the date of commencement, then the investment deduction for MUB is withdrawn and treated as income in the year of income in which he ceases to manufacture under Bond. However, he is granted Wear and Tear Deductions and IBD for the years he has operated.

Example
ABC Limitd constructed a building and installed new machinery for the manufacture of spoons for export. The building cost Sh. 15,000,000 and the machinery cost Sh. 10,000,000. Manufacturing commenced on 1.1.2003 and ceased on 1.1.2005. Compute the capital allowances for the year 2003, 2004 and 2005.

Investment Deductions @ 70%:

2003

Assets	Qualifying Cost	I.D (70%)	ID (MUB) (30%)	WDV
Building	15,000,000	10,500,000	4,500,000	-
Machinery	10,000,000	7,000,000	3,000,000	-
		17,500,000	7,500,000	

2004
No capital allowances

2005
The IDMUB is treated as income. However, IBD and WTD in respect of this amount is granted as follows:-

IBD

	Qualifying Cost	Residual Value b/f	IBD (2.5%	Residual value C/f
2003	4,500,000	4,500,000	112,500	4,387,500
2004	4,500,000	4,387,500	112,500	4,275,000
2005	4,500,000	4,275,000	112,500	4,162,500
			337,500	

WTD

	WDV	WTD (12.5%)	WDV C/f
2003	3,000,000	375,000	2,625,000
2004	2,625,000	328,125	2,296,875
2005	2,296,875	287,109	2,009,766
		990,234	

The taxable trading receipt will be as follows:

	Sh.	Sh.
Trading receipt		7,500,000
Less: IBD	337,500	
WTD	990,234	(1,327,734)
Net Trading Receipt		6,172,266

Note
For the year 2004 and thereafter, the I.D (MUB) is 100% just like the I.D

MINING DEDUCTIONS
This refers to capital allowances granted to a person carrying on the business of mining.

Qualifying Costs:

1) Cost of exploring and prospecting the mine.
2) Cost of acquiring rights over the mine and minerals but does not include cost of land/site.
3) Cost of buildings and machinery (mining equipments) which will have little or no value if mining ceased,
4) Cost of development and general administration and management incurred prior to commencement of production or during a period of non-production (temporary stoppage).

NB

1) If a mining operation is transferred during a year of income, then the deduction will be apportioned between the new and old owner on time basis.
2) If someone operates many mining operations that are not related then each mining operation is treated separately and granted its own deductions.
3) When a person incurs qualifying expenditure in relations to a mine and without having used such assets for mining he sells such assets to a person who will be entitled to such deductions and the qualifying cost will be the price paid by him for such assets (purchase price).

Mining Deductions Rates:

Mining operation is usually expected to last for 7 years. The deductions are granted as follows:

Year	Rate (%)
1	40%
2	10%
3	10%
4	10%
5	10%
6	10%
7	10%

Taxation Rate

Corporation tax rate for mining concerns is 27.5% for the first 4 years and thereafter the normal rate of 30%

Example 1

Mr Jackson Tele manufactures animal feeds at Thika with effect from 1.1.2005. He constructed the factory building at a cost of Shs 800,000 and installed machinery costing Shs 500,000. He prepares accounts to 31 December each year.

Required

1. Calculate the investment deduction for 2005

Solution

1. Investment deduction—2005

Item	**Cost Sh**	**ID at 100% Sh**
Building for manufacture	800,000	800,000
Machinery for Manufacture	500,000	500,000
	1,300,000	1,300,000

With effect from 1.1.'87, the investment deduction is deducted from the qualifying cost after which other capital deductions of Industrial Building Deduction, and Wear and Tear Deduction are calculated. If I.D rate is 100%,the residual for IBD and WTA would be Nil hence no IBD and WTA is applicable in the Example 1 above .

Examples

1. Mr Metameta who prepares his accounts to 31 December every year constructed a soap factory and related buildings in Industrial area Thika and used them with effect from 1.1.2005 at a cost of Shs 1 million (factory, including land Shs 400,000), canteen for workers Shs 80,000, showroom Shs 20,000, office Shs 44,800, stone wall round the factory Shs 100,000, and gate Shs 30,000. He installed factory plant and machinery costing Shs 800,000.

2. Mr Metameta constructed a store at a cost of Shs 120,000 and labour quarters at a cost of Shs 100,000 and used them with effect from 1.7.2005.

Required

Calculate the capital deductions in each case.

Solution
As with the calculation of other capital deductions, it is important to recognise the capital cost which qualifies for industrial building deduction. Then the appropriate rate of industrial building deduction is applied to the cost to obtain the amount of industrial building deduction. This will be done in the solution to the above examples.

In tackling questions of capital deductions, always start with calculation of investment deduction where applicable particularly so with effect from 1.1.'87 where industrial building deduction and wear and tear deduction are calculated on amounts net of investment deduction.

1.

a. **Investment Deduction (ID) (using year 2005 rates)**

	Cost	*investment deduction*	*Balance for WTD or IBD*
		At 100%	
	Shs	*Shs*	*Shs*
Factory (Note iv)	794,800	794,800	Nil
Plant and machinery	800,000	800,000	Nil
Total	1,594,800	1,594,800	Nil

The amount of investment deduction of Shs 1,594,800 is deducted in the income tax computation, (or in arriving at the taxable income/loss for the year).

b. **Industrial Building Deduction (IBD)**

Building	**Q. Cost**	**Residual b/f**	**IBD @ 2.5%**	**Residual c/f**
Canteen	80,000	-	2,000	78,000
Labour quarter	100,000	-	1,250	98,750
Store	120,000	-	1,500	118,500
			4,750	

$$100{,}000 \times 2.5\% \times \frac{6}{12} = 1{,}250$$

$$120{,}000 \times 2.5\% \times \frac{6}{12} = 1{,}500$$

Note and workings:

i) The Qualifying cost for factory is determined as follows

		Shs
a)	Factory cost	1,000,000
b)	Less cost of land	(400,000)
		600,000
c)	Add – Stone wall	100,000
	- gate	30,000
		730,000

ii) A staff canteen is a building used for the welfare of workers, it therefore automatically qualifies for IBD. However, it is not used for manufacture. Therefore, it does not qualify for I.D.

iii) The cost of showroom and office qualify for I.D as it is not more than 10% of the total cost of buildings e.g.

iv)

$$\frac{20{,}000 + 44{,}800}{600{,}000 + 20{,}000 + 44{,}800 + 100{,}000 + 30{,}000} = \frac{64{,}800}{794{,}800} \times 100$$

$$= \underline{\underline{8.1\%}}$$

v) The IBD of Shs. 4,750 will be deducted in arriving at the taxable income/loss for each year for 40 years, or be deducted in the income tax computation per year for 40 years.

vi) Residue of expenditure is the capital expenditure qualifying for IBD but the residual or balance after deducting 100% I.D IS Nil

Concluding Remarks On Capital Deduction

1. Tackling examination questions on capital deductions
   When tackling questions involving capital deductions, it is advisable to follow the following steps:

a. identify the capital costs incurred for a year/period.
b. list the capital cost under the respective capital deduction headings including those not qualifying e.g.

	Cost	ID	IBD	FWD	WTD	Non-Qualifying
Item	Shs	Shs	Shs	Shs	Shs	Shs

b. apply the appropriate rates of capital deduction where applicable to obtain the capital deduction for the year/period.
c. always start with the calculation of investment deduction whenever it applies as this will affect figures for industrial building deduction, and wear and tear deduction with effect from 1.1.'87.

2. The topics of Mining Deduction and Petroleum Company Deduction are complicated and are left out on the belief that they are appropriate topics for the Taxation II syllabus.

THE INCOME TAX COMPUTATION

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

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

The income tax computation involves:

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

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

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

Income

Income is either:

a. taxable (chargeable, assessable) to tax, that is, it is included in the definition of taxable income as per the Income Tax Act e.g. salary, rent, business profit etc; or

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

Expenses

An item of expenditure is either:

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

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

Rules for adjusting income items in the income tax computation

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

Rules for adjusting expenditure items in the income tax computation:

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

Income Tax Computation - Format

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

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

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

Example

The profit and loss account of Mambo Walia, a trader at Eastleigh, Nairobi, show the following for the year ended 31.12.2005

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

The following information is given:

i) An amount of Shs 8,000 received from Kenya National Assurance Company as compensation for trading stock destroyed by fire has been included in drawings.

ii) Owing to new found friendship, a creditor Mrs. Matata wrote-off amounts payable to her by Mr. Walia of Shs 4,000. The amount is included in drawings.

iii) The sundry expenses in the Profit and Loss Account include:

a. cost of a bicycle used in the shop bought in May 2005 for Shs 3,500.
b. alimony paid to a former wife he divorced Shs 2,400.
c. subscription of Shs 1,000 to Matumbo Welfare Association of which he is a member.
d. Depreciation of assets Shs 2,200

iv) He paid with amounts drawn and included in his drawings accounts:
a. insurance premium of Shs 2,500 against fire in respect of trading stock.
b. painting of business premises Shs 800.
c. stationery Shs 500.

v) Wear and tear deduction of Shs 1,500 has been agreed with the Income Tax Department .

Required
Compute the taxable income for the year ended 31.12.2005

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

Mambo Walia
Taxable Income for the year ended 31.12.2005

	Shs	Shs
Net profit/(loss) as per the accounts		35,000
Add back: Disallowable expenses (Note 1)		
Bicycle - capital expenditure	3,500	
Alimony - personal expenditure	2,400	
Subscription to MWA - personal expenditure	1,000	
Depreciation - not allowable given WTD	2,200	9,100
Add back omitted taxable income		
Insurance compensation	8,000	
Written off liability	4,000	12,000
		56,100
Less non taxable income		
P.O.S.B. interest		(15,000)
Tax Reserve Certificate interest	(3,000)	
Bank interest (tax at source Shs 300)	(2,000)	
Sweepstake winning	(5,000)	(25,000)
Less allowable expenses not deducted		
Insurance premium	(2,500)	
Painting of business	(800)	
Stationery	(500)	(3,800)
Wear and Tear Deduction (Note 2)		(1,500)
Total taxable income for 2005		25,800

Notes

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

SUNDRY TOPICS

Lease Hire Arrangements

Payments for hire or rent of an asset are allowable deductions only 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.

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%)

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

Relief From Double Taxation

The government of Kenya may make arrangements with the government of another country for the relief for double taxation of similar taxes in that other country. Currently Kenya has arrangement for double taxation relief with the following countries

Denmark	U.K.
Zambia	Germany
Norway	Italy
Sweden	Canada
India	

In order to qualify for the relief, the taxpayer must fulfill the following conditions:

a. Prove the deduction of tax from that other country;
b. The foreign tax that qualifies for the relief should not exceed the local tax payable;
c. The relief must be claimed within six years after the date when the tax liability was incurred.

Taxation of Partnership Profits

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

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

	Shs	Shs
Partnership salary	XX	
Interest on capital receivable	XX	
		XX
Interest on capital payable		(X)
		XX
Share of profits/(loss)		X
		XX

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

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

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

Steps in Computing Partnership Income

1) Determine or compute the adjusted income or loss for the partnership in the normal way, except that: -
   (a) Salary to partners is not allowable expense
   (b) Interest paid to partners is not allowable
   (c) Interest paid by partners is not taxable
   (d) Wife's salary is not allowable
   (e) Drawings of commodities dealt with in the partnership is added back at cost. Note that no profit is to be made from another partner.

2) Allocate the income adjusted to the partner by first isolating salaries to partners, interest on capital (net) to partners, bonus to partners, commissions, etc. The balance is either profit or loss to be shared out among partners according to profit sharing ratio or as per partnership agreement. Income Tax Computation of a Partnership

	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		XXX

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	XX	XX	XX
	XXX	XX	XX

Note

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

Example

A, B and C are in partnership, trading as X enterprises. They share profits and losses in the ratio of 2:2:1. In the year 2004, they reported a loss of Sh. 200,000 after charging the following items.

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

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

X enterprises adjusted Business Income.

	Sh.	Sh.
Loss as per account		(200,000)
Add back: Depreciation	100,000	
Salaries A	400,000	
B	300,000	
C	200,000	
Interest on Capital A	100,000	
C	100,000	

Commission	B	200,000	1,400,000
Partnership income			1,200,000

Distribution of Adjusted Profit to Partners

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

Partners' Taxable Income from Partnership

A	460,000
B	460,000
C	280,000
	1,200,000

Taxation of Export Processing Zone Enterprises

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

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

Legal provisions

1. An E.P.Z. is required to maintain its accounts in a convertible foreign currency of its choice.
2. An E.P.Z. enterprise will be exempted from paying any corporation tax for a period of 10 years commencing with the year in which production, sales or receipts from its activities commence.
3. After the first 10 years an E.P.Z. enterprise will be subject to corporation tax at the rate of 25% for a period of 10 years commencing immediately thereafter.
4. Not withstanding that an E.P.Z. enterprise will be exempted from corporation tax for the first 10 years of operation, it will be expected to submit an annual return of income and its business accounts (section 52 & 54).
5. An E.P.Z shall be a non-resident company.
   a. Payments to the enterprise will be subject to withholding tax at the non-resident rates. The withholding tax will be final tax if the payment is made by a person:
   i) who is of an E.P.Z. enterprise (Finance Bill 1990)
   ii) who is not of an E.P.Z. enterprise (Finance Bill 1991).
   b. Payment by an E.P.Z. enterprise i.e. any non-resident person shall be deemed to be exempted from tax.

6. Resident employees and directors of an E.P.Z. enterprise are liable to tax and deduction of PAYE. The E.P.Z. is required to comply with the rules and regulations concerning the deduction of tax from their employment income.

Ascertainment of Income of Insurance Companies

Legal Provisions

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 compromise 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.

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.

Taxation of Co-Operative Societies

Corporative societies become taxable entities with effect from 1st Jan 1985. This was with the introduction of sect 19(a) of cap 470. This section states that, "designated co-operative societies shall be required to pay tax on their incomes."

Designated co-operative societies can be broadly classified into 3:

(i) **Designated Primary Co-op societies:** These are co-op societies whose members are individuals. Many of the farmers co-op societies fall under this category. Such societies usually deal with tea, coffee, milk, sugarcane etc.

Section 19 (a) (iii) states "In the case of every designated primary society the income on which tax should be charged shall be its total income for the year of income, deducting there from an amount equal to the aggregate of bonuses and dividends declared for that year and distributed by it to its members in money or an order to pay money."

Total income	xx
Less: Allowable Expenses	(xx)
Adjusted income	xx
Less: Bonus and dividends	(xx)
Taxable income	xx

If a primary co-op society pays all the adjusted incomes as bonuses and dividends, then it shall not pay any tax liability. However, if this is not the case, any income that remains after distribution of business and dividends shall be taxed at 30% corporate tax rate.

(ii) **Designated Secondary Co-op Societies (Co-op Unions)**

These are co-op societies whose members are not individuals but the designated primary co-op societies. Therefore they act as umbrella bodies of unions for primary co-op societies. Examples are KPCU, KFA, Meru Farmers Union (MFU). For tax purposes, sect 19(a)(ii) states, "in the case of every designated secondary co-op society, the income on which tax shall be charged shall be the total income for the year of income deducting there from an amount equal to the aggregate of bonuses and dividends declared for that year and distributed by it to its members in money or an order to pay money but the deduction shall in no case exceed that the total income of the society for that year of income."

This implies that a designated secondary co-op society can only pay bonuses and dividends from the current year of income profits but not from any profits retained in the past years.

Total Income	xx
Less: Allowable Expenses	(xx)
Adjusted income	xx
Less: bonuses and dividends	(xx)
Adjusted taxable business income	xx

Should the co-op society pay all adjusted income as bonuses and dividends, then no tax liability shall arise otherwise the adjusted taxable income shall be subjected to 30% corporate tax rate.

(iii) **Savings and Credit Co-op Unions/Societies (SACCOs)**

SACCOs are typically primary co-op societies since members are individuals but they carry on the business of savings and credit where the savings are for members or the credit is granted to the same members. Therefore this constitutes a mutual transaction where the saver is the same as the borrower.

Section 19(a)(iv) states, "in the case of a designated primary society which is registered and carries on business as a credit and savings co-op society its total income for any year of income shall be deemed to be the aggregate of;

(a) 50% of its gross income from interest other than interest from its members.
(b) Its gross income from any right granted for the use or occupation of any property (rent income and not royalties income).
(c) The gains chargeable to tax under sec 3(2)(f) i.e. deemed income.
(d) Any other income excluding royalties chargeable to tax under this Act not falling within a, b and c above ascertained in accordance with the provisions of this Act."

NB: If a SACCO or any other type of co-op society makes a loss in any year of income that loss cannot be carried forward to be offset against the future profits of the society.

- The total income of a SACCO shall be subject to 30% corporate tax rate when determining the tax liability.
- No allowable expense shall be deducted in determining the gross rent income. However, a society shall be granted wear and tear allowance just like any other ordinary business.
- In case of designated primary co-op societies, dividends and bonuses shall be treated as deductible expenses (deducted from adjusted income) under the following conditions;
  (i) They must be paid in cash or by cheque to the members.

(ii) The payment must be approved at the AGM by the members of the primary co-op society.
(iii) The payment must be approved by the commissioner of co-op societies.

Primary Co-op societies are considered as home-based societies and the dividend income received by the members is called non-qualifying dividend income.

With effect from 1st January 1993, a bonus paid by a co-operative society to its members is deemed to be a dividend payment subject to withholding tax at the rate of 15%. In addition, dividends paid by co-operative societies will no longer be considered as qualifying dividends, i.e. the withholding tax is NOT a final tax.

REINFORCING QUESTIONS

QUESTION ONE

Mr. Handa who is the owner of a supermarket in Nairobi has given you the following profit and loss account for the year ending 31.12.2005.

	Shs		*Shs*
Opening stock	3,600,000	Sales	46,000,000
Purchases	40,000,000	Closing Stock	460,000
Salaries and wages	1,250,000	Profit on sale of	
Rent rates and taxes	46,000	residential hose	250,000
Fire insurance	6,200	Bad debts recovered	
Household expenses	42,000	not allowed	
Income tax for 2004	130,000	in the previous year	
Advertisement	69,500	for lack of proof	15,000
Legal and professional fees	45,500	Dividends (gross)	18,000
Stationery and postage	13,800		
Reserve for bad debts	23,000		
Depreciation	151,600		
Purchase of machinery	10,500		
Interest on loan to			
purchase shares	20,800		
Gifts and present	8,400		
Medicine expenses of the			
proprietor	12,000		
VAT	103,000		
Net profit	1,210,700		
	46,743,000		46,743,000

Notes

i) Stock of goods at the opening as well as the closing day of the accounting year had consistently been undervalued at 10% below cost price.

ii) Sales include a sum of Shs 50,000 representing the value of goods withdrawn for use by family members. These goods were purchased during the year 2004 at a cost of Shs 40,000.

iii) Rates rents and taxes include Shs 8,500 for customs duty and VAT for purchase of machinery. VAT represents non-deductible input tax on business expenses.

iv) Advertisement expenses include Shs 10,000 for erecting a signboard at the shop front.

v) Analysis of legal and professional fees:

Shs	
10,500	Renewal of a five year lease.
15,000	Defending a suit for alleged breach of trading contract.
10,000	Appeal to a local committee against tax assessment.
8,500	Defending a criminal proceedings against the proprietor for dealing in smuggled goods. The proprietor made a profit of Shs 16,000 from such activities.
1,500	Miscellaneous and allowable.
45,500	

vi) Wear and tear has been agreed with the Tax Assessor at Shs 108,000.

Required

Compute Mr. Handa's chargeable profit for the year of assessment 2005. **(20 marks)**

1.

QUESTION TWO

Dr. Bidi and Dr. (Mrs) Bidi are husband and wife who manage a joint medicine practice. They have given you the following statement of income and expenditure for the year 2005.

Income	Notes	Shs	Shs
Professional fees			1,900,000
Other income:			
Rental income—Bidi			30,000
Net income on milk sales (Mrs Bidi)	(1)		6,000
Post office bank interest—Mrs Bidi			10,000
Dividends—Mrs Bidi (net)			8,500
			1,954,500
Expenditure			
Locum		48,880	
Salaries and wages		169,000	
Drugs purchases		60,000	
Rent and services		90,000	
Subscription and licenses		11,500	
Repairs and maintenance	(2)	185,000	
Income tax paid		58,000	
Stationery and postage		63,550	
Telephone and utilities		54,600	
Donations to heart fund		6,660	
NSSF contributions—staff		34,440	
Bank charges and interest	(3)	16,500	
Newspapers and periodicals		18,960	
Motor vehicles running expenses	(4)	87,600	
Security expenses		31,400	
Travelling and subsistence	(5)	162,000	
Professional fees	(6)	45,000	
Miscellaneous expenses		5,665	
Bad debts	(7)	166,000	
Depreciation		190,700	
			1,474,455
Net Profit			480,045

Notes

1. Milk sales:

Dr. (Mrs.) Bidi has a zero grazing cows project at their Karen Farm Nairobi and the net income had been arrived at as follows

	Sh	Sh
Sale of milk		15,000
Deduct: Animal feeds	12,000	
Veterinary and drugs	3,000	(15,000)
Profit/Loss		NIL

NB

Value of milk consumed by the family Sh 6,000

2. Repairs and Maintenance account:

	Sh		Sh
To repairs to E.C.C. equipment	17,800	By sale of surplus furniture	90,100
To addition to surgery room	126,900	By P & L Account	185,000
To electrical wiring			
- new surgery room	16,980		
To repairs to other machinery	113,420		
	275,100		275,100

3. Bank charges and interest account:

To mortgage interest (residence)	65,000	By Fixed deposit interest (net)	126,900
To bank charges	13,600	By P & L Account	16,500
To bank interest	46,200		
To interest on loan to purchase shares	18,600		
	143,400		143,400

4. Motor vehicle running:
   One quarter of motor vehicle running expenses relates to private motoring.

5. Travelling and subsistence:
   Dr. (Mrs.) Bidi accompanied two of her patients to a London hospital for specialised treatment. She spent Shs 60,000 on air fare and Shs 80,000 on boarding and lodging. The balance of the expenditure represents staff travel and subsistence. The amounts were billed to the patient.

6. Professional fees

	Sh
Audit and accountancy	30,000
Drawing of three year lease—legal fees	7,500
Tax appeal against 2004 assessment	7,500
	45,000

7. **Bad debts account**

	Shs		**Shs**
Bad debts written off:		By balance b/d	
To Fixed deposit with a		Specific	42,000
collapsed bank	100,000	General	46,000
To loan to a machinery		By P & L Account	166,000
supplier who died insolvent	20,000		
To Book debts taken over when			
clinic was purchased	18,000		
To Balance c/d:			
Specific	40,000		
General	76,000		
	254,000		254,000

8. Wear and Tear deductions in respect of furniture of furniture and fittings equipment and motor vehicles had been agreed with the Principle Assessor as follows:

	Sh
Furniture and fittings and equipment	84,100
Motor vehicles	48,200
	132,300

9. Dr Bidi and Dr. (Mrs.) Bidi live in their own house which they purchased with the help of a loan from Savings and Loan Kenya Limited. Interest on mortgage charged for the year 2005 Shs 72,000.

Required
Calculate the practice income of Dr. Bidi and Mrs. (Dr.) Bidi for the year 2005 and show their total income as well. (**20 marks)**
(CPA Adapted)

QUESTION THREE

a) Distinguish between farm-work deductions and capital deductions.
b) John Moturi, a farmer, constructed a farmhouse on 2 January 2005 for Sh.6,000,000 and incurred the following additional expenditure:

		Shs
2.1.2005	Cattle dip	1,000,000
30.6.2005	Irrigation system	1,500,000
30.9.2005	Labour quarters	1,200,000
30.10.2005	Milking machinery	1,120,000

John Moturi sold the farm on 2.1.2006 to his brother, Peter Muturi, who is also a farmer. Their sale agreement contained the following particulars:

	Shs
Cattle dip	1,200,000
Farmhouse	6,700,000
Irrigation system	1,200,000
Milking machinery	980,000
Labour quarters	2,800,000

Required
Calculate the capital deductions to:
a) John Muturi (8 marks)
b) Peter Muturi (2 marks)
(Total: 15 marks)

QUESTION FOUR

Rai, Sai and Tai are former schoolmates who are doing business together. The business is not registered but they regard themselves as equals in it. They keep proper books of account and have been able to provide the following profit and loss account for the year ended 31 December 2005.

Profit and Loss Account

	Shs		
Operation expenses	800,000	Gross Profit	1,908,000
Rent of business premises owned		Sundry receipts	80,000
by all of them jointly	180,000	Interest income	72,000
Interest expense	80,000	Profit on sale of shares	200,000
Stationery and printing	120,000	Gross income from farming	340,000
Lighting and heating	40,000	Lottery winnings	
General farm expenses	294,000	Dividend (Gross)	800,000
Repair of premises	40,000		
Depreciation	300,000		
Interest on partner's capital:			120,000
Rai	80,000		
Tai	120,000		
Salary to Sai	160,000		
Commission to partners:			
Rai	96,000		
Sai	96,000		
Tai	96,000		
Bad debts	240,000		
Gifts, present and charity	40,000		
Donation to child welfare	200,000		
Interest on loan taken to pay income tax	20,000		
Legal charges	120,000		
Net Profit	398,000		
	3,520,000		3,520,000

Additional information

1. Capital allowances have been agreed as follows: Wear and Tear allowance Sh.180,000; Farm works deduction Sh.120,000
2. The partners had borrowed Sh.400,000 with a hope of investing it on fixed securities to earn more income. Interest rates nevertheless declined. Interest expense of Sh.80,000 and interest income of Sh.72,000 relate to this loan.
3. Legal charges include Sh.40,000 paid to finish a case in the customs department.
4. In 2004, the partners brought forward losses amounting to Sh.800,000 from this business.

Required:

(a) Compute taxable income derived from the partnership. (16 marks)

(b) Show allocation among partners. (3 marks)

(Total: 19 marks)

CHECK YOURS ANSWERS WITH THOSE GIVEN IN LESSON 9 OF THE STUDY PACK

COMPREHENSIVE ASSIGNMENT No.2

TO SUBMITTED AFTER LESSON 4

To be carried out under examination conditions and sent to the Distance Learning Administrator for marking by the University.

EXAMINATION PAPER. **TIME ALLOWED: THREE HOURS.**
ANSWER ALL QUESTIONS

QUESTION ONE

a) With reference to wear and tear allowances, what is meant by the "pooling method"?
b) The following is given to you from the books of Kilimo Holdings Ltd., a farming and manufacturing company as at 31 December 2004.

Written down values as at 31 December 2004	**Shs.**
Motor vehicles	655,000
Tractors	2,755,000
Plant and machinery	530,000
Furniture and fittings	225,000
Combine harvester	1,012,500
Spares for tractors	510,000
Land rovers	1,135,000
Office curtains	22,000
Computers	77,000
Fax machine	40,000
Telephones	80,000
Farm works (original cost Sh.21,000)	7,000
Industrial building (original cost net of investment deductions Sh.1,000,000)	950,000

Additions in 2005

	Shs		**Shs**
Library books	25,000	Saloon car	1,500,000
Loose tools	10,000	Pick-up	850,000
Engine head for trailer	500,000	Farmhouse	200,000
New building	750,000		
Old machinery installed in new building	350,000		

Disposals in 2005:	**Sh.**
Saloon car (cost in 2004 – Sh.1,200,000)	850,000
Furniture	25,000
Computers	200,000
Tractors	100,000

Required

(i) Compute total capital allowances for the year 2005. State why you have not used any information and why you think it is not relevant. (14 marks)
(ii) Show balances carried forward to 2006. (2 marks)
(iii) Comment on the tax treatment of class II balance (2 marks)

(Total: 20 marks)
CPA Adapted

QUESTION TWO

a) Define the term 'capital allowances'. (4 marks)

b) Cindera Enterprises is a partnership manufacturing timber pallets. The partners are L, M and N. The business has an account in the balance sheet entitled "Property". The account had been used to record a variety of expenditure. At the end of the year, the property account contained the following entries:

Debit entries	**Shs**	**Shs**
Purchase by cash of building site		2,000,000
Cost of removing old building from site to build factory		80,000
Paid contract price for new factory building completed on 1 January 2005		5,600,000
Insurance inspection fees and other costs directly related to construction of new building		180,000
New machinery brought to use on I January 2005		4,000,000
Cost of fixing machinery and testing		400,000
		12,260,000
Credit entries		
Proceeds from sale of salvaged material from Demolition of old building	30,000	
Depreciation for the year computed at 4% of Shs12,260,000	490,400	
Total credits		(520,000)
		11,739,600

Required

(i) Determine the correct balance for each account (4 marks)

(ii) Show the capital allowances due to the partnership in 2005. (9 marks)

(iii) If the profits before capital allowances and salaries made by the partnership was Shs 2,860,000, show its allocation among partners if each receives a salary of Shs 120,000 p.a. The adjusted profit is after adjusting for these salaries. (3 marks)

(Total: 20 marks)

QUESTION THREE

(a) Miss Nyakio's contract of employment for five years was terminated on 31 December 2005 after it had run for three years. Compensation for Sh.300,000 was paid. Her salary at the date of termination was Sh.90,000 per year. If the contract had run its full term, a total of Sh.180,000 would have been paid as salary for both 2006 and 2007.

Required

(i) What income is assessable on Miss Nyakio, and in which years?

(ii) Assume that Nyakio's contract, was not specific, what income is assessable on Miss Nyakio and in which years?

(iii) Assume Miss Nyakio was a director in the company paying compensation. Her shareholding in the company was 5% of the share capital. What will be the tax treatment in (i) and (ii) above. Explain. (12 marks)

(b) State and explain from tax perspective whether each of the following items are capital or revenue

(i) Legal and professional fees on computerisation.

(ii) Structural alterations to premises to maintain existing rent.

(iii) Legal costs and stamp duty for acquisition of lease of business premises.

(iv) Expenditure on advertising to promote sale of goods or services provided by a business.

(v) Income tax

(vi) Reserves and provisions (3 marks)

(c) Give five examples of non-taxable income. (5 marks)

(Total: 20 marks)

QUESTION FOUR

Richex limited has provided the following profit and loss account for the year ended 31 December 2005:

Profit and Loss Account for the year ended 31 December 2005

	Shs		**Shs**
Opening stock	524,000	Sales	10,584,000
Purchases	4,692,000	Closing stock	761,000
Manufacturing expenses	2,563,000		
Salaries and wages	252,000		
Supplies consumed	466,000		
General expense	85,000		
Interest on loan	364,000		
Commission and brokerage	0		
Director's fees	90,000		
Auditor's fees	55,000		
Taxes	70,000		
Bad debts reserve	43,000		
Depreciation	296,000		
Managing directors' remuneration	648,000		
Reserves	126,000		
Provision for dividends	750,000		
Profit for the year	300,000		
	21,000		
	11,345,000		11,345,000

The following additional information is provided:

1) Salaries and wages include Sh.20,000 contributed by the company to unregistered pension scheme.
2) General expenses include Sh.15,000 for donations, Sh.10,000 for contributions to a business pressure group that protects traders of the same kind.
3) Taxes represent VAT paid
4) Bad debts (specific) are Sh.180,000.
5) The fixed asset schedule is as follows:

Asset	**Year**	**Cost (Shs)**
Factory building	2000	4,000,000 (net of I.D)
Additional plant building	2005	2,000,000 – brought to use 1 July 2005
Machinery	2000	4,800,000 (net of I.D)
New machinery	2005	6,000,000 – fixed in new building
Computers	2004	1,000,000
Other machinery and furniture	2000	640,000

Required

a) Compute the capital allowances due to the company. (8 marks)
b) Show the adjusted profit (loss) for tax purposes for the year 2005. (7 marks)
c) State if any tax is payable. (1 mark)
d) State the intervals relating to payment of tax instalments (4 marks)

(Total: 20 marks)

QUESTION FIVE

a) Explain the circumstances under which a company could pay dividends and interest to another company and/or person without deducting withholding tax. (6 marks)

b) In relation to industrial buildings deductions, what is the residual of expenditure and why is it important for the purchasers of industrial buildings to obtain details of it?

c) Write brief notes on:
   i) deficit of total income of a married woman.
   ii) Income and expenditure after the cessation of business. (5 marks)

d) State six alternative purposes for which a may be in use in order to qualify for building deductions as an industrial building. capital (6 marks)

(Total: 17 marks)

(CPA adapted)

END OF COMPREHENSIVE ASSIGNMENT No. 2

NOW SEND TO THE DISTANCE LEARNING CENTRE FOR MARKING

LESSON FIVE

RETURN OF INCOME AND NOTICES

INSTRUCTIONS

1. Assigned Reading. Read study text given below.
2. Complete the Reinforcing Questions at the end of the lesson.
3. Compare your answers to the models given in the revision section of the study pack.
4. Study text

RETURN OF INCOME AND NOTICES

In earlier lessons we have looked at taxable income, expenses or deductions that are allowable, and those that are not allowable against taxable income. It is now necessary to discuss how a taxpayer informs the Income Tax Department about the details of tax positions on the following matters.

i) Taxable income or loss;
ii) Sources of income e.g. business, employment rent, etc.;
iii) Claims of tax relief in case of individuals only; and
iv) payment of tax at source.

A taxpayer informs the Income Tax Department about the details of the tax position through the submission of annual returns of income. The returns of income ***are forms issued by the Income Tax Department for***
completing annuals details of income or loss.

Taxpayers That Submit Returns of Income:
Three kinds of taxpayers submit returns of income:

a) Individuals (natural persons)
b) Legal persons such as companies, trusts, clubs, co-operatives, corporations, etc (persons created by law) generally referred to as company or corporation.
c) Partnerships.

Types of Returns of Income:
At present, two types of return are in use:

(a) Self-Assessment Return of Income (SAR)
The return was introduced for the year of income 1992. It is required to be submitted by **all companies and individuals with taxable income**. It is due for submission to the Income Tax Department by the end of the sixth month after the accounting year end.
The self-assessment tax, if any, is due for payment by the end of the fourth month after the accounting year end.

(b) Compensating Tax Return of Income (CTR)
- The return was introduced with effect from accounting year ended in 1993 and later years. It is required to be submitted by **resident companies only**. It is due for submission to the Income Tax Department by the end of the sixth month after the accounting year end.
- The compensating tax, if any, is due and payable by the end of the fourth month after the accounting date.
- The CTR is a form issued by the Income Tax Department to enable companies to pay compensating tax. The CTR and the SAR are due at the same date.
- Every company is required to maintain a Dividend Tax Account whose debit balances is the compensating tax payable as follows:

Dividend Tax Account

	Dr	***Cr***
Income tax paid (excluding dividend w/tax)		XX
Dividends received x $\frac{t}{1-t}$	XX	XX
Dividends paid x $\frac{t}{1-t}$	XX	
Compensating tax (if debit side is greater		XX
Balanced account (Dr and Cr equal)	XX	XX

t-current corporation tax rate

There is a choice of the opening balance of the company's first Dividends Tax Account as either zero or the balance at the end of 1992 year of income created by running a notional Dividend Tax Account from the year of income 1988. The company would choose zero balance if the notional dividend tax account has a debit balance, and would choose the credit balance for carrying forward, if a credit balance was reflected.

A principal officer of the company must sign the CTR.
There is a penalty for failure or lateness in submitting CTR and paying the compensating tax on due date. The details of the penalty are given later in the lesson.

a) **Instalment Tax**

Previously, taxpayers were required to submit instalment tax returns. These are no longer in use although instalment tax is still payable; Instalment tax is payable by companies and individuals except where:

i) the taxpayer is an individual earning employment income only and which has been taxed in full through the PAYE system; or
ii) the total tax liability of an individual does not exceed Sh 40,000 p.a.; or
iii) an individual has more than one source of income and employment income constitutes more than two-thirds of his total taxable income.

With effect from 01.01.2003 instalment tax is payable as follows:

Year of Income Commencing or after	Fourth Month by the 20th day	Sixth Month by the 20th day	Ninth Month by the 20th day	Twelfth Month by the 20th day
	%	%	%	%
1.1..2003 to date.	25	25	25	25

Where a person derives more than two-thirds of his/her income from agriculture, pastoral, horticultural and similar activities, instalment tax is payable in the following proportion by the twentieth day of the months below:

Accounting Year Commencing on or after	Ninth Month 20th day	Twelfth Month 20th day
1 January 1995	75%	25%
1 January 1996	75%	25%

The amount of instalment tax payable is the lesser

1) the tax payable on total income for the year; or
2) the tax assessed, or estimated as assessable for the preceding year of income multiplied by 110%.
3) when completed, the partnership's final return contains:
    a) the total income/loss of the partnership and how it is shared to the partner. Supporting accounts must be submitted.
    b) A signed declaration that the return of income contains a full and true statement of the partnership income/loss

c) Advance Tax

An advance tax is payable annually in respect of every Public Service Vehicle (PSV) and Heavy Commercial Vehicle (HCV) and the following rates:

1) for vans, pick ups, trucks and lorries: Ksh.1,500 per ton of load capacity p.a. or Kshs.2,400 p.a., whichever is higher;

2) for saloon, station wagons, minibuses, buses and coaches: Ksh. 60 per passenger capacity p.a. or Ksh.2,400 p.a., whichever is higher.

With effect from 1st July 1999, the above tax also applies to all commercial vehicles.

d) **Import Duty Set-off**

Import duty paid with respect to qualifying capital goods for qualifying projects may be set off against tax. Qualifying projects must be worth not less than US$ 70,000 over a two-year period and must have prior approval by Minister for Finance for duty set-off. The qualifying expenditure is expenditure on capital goods that qualify for wear and tear (excluding passenger cars) and buildings that qualify for capital deductions. The capital goods must be used wholly and exclusively in the production of taxable income.

INCOME OF A DECEASED PERSON:

The Income of a deceased person may be income that accrue prior to his death or income accrued after his death.

i) The income accrued to or received prior to the date of the death of a deceased person shall be assessed on, and the tax charged on his executors or administrators for that year of income.
ii) Any amount receive by the executors or administrators of a deceased person shall be deemed to be income of his executors or administrators and shall be assessed on, and the tax charged on them for that year of income.

INCOME OF INCAPACITATED PERSON

The income of an incapacitated person shall be assessed on and the tax thereon charged on, that person in the name of his trustee, guardian, committee or receiver appointed by a court.

Penalties on Returns and Tax

Whenever a person (individual or legal person) has not submitted a return on income or return of tax by the due date, the CIT has power under the Income Tax Act to estimate the person’s income to the beset of his judgement and tax the person accordingly. He has also to impose prescribed interest penalty or additional tax as appropriate for failure or lateness to submit returns or pay tax on due dates.

OFFENCE	PENALTY
Failure to furnish a return on time	5% of tax due (minimum Ksh10,000 for companies and individuals.
Penalty on unpaid tax	20% of unpaid tax
Interest on unpaid tax	2% per month of unpaid tax and penalty.
Under-payment of tax	20% of difference
Under-estimation of instalment tax	20% of difference
Fraud or wilful omission in a return	- Double the amount of tax underpaid - Fine not exceeding Ksh.200,000 - Imprisonment not exceeding 2 years
Failure to deduct or remit P.A.Y.E tax	- 25% of amount involved or Ksh.10,000 whichever is higher. - and or/imprisonment of a term not exceeding six months
Failure to kept adequate books of account	Ksh.20,000

Compensating Tax Return and Tax

a) Only resident companies submit compensating return and the return is due for submission to the Income Tax department by the end of the fourth; month after the accounting year end.
b) The CIT imposes a penalty or additional tax of 5% on tax due.
c) If compensating tax is not paid by the due date, a penalty of 20% would be imposed on the tax unpaid on due date, and thereafter, a penalty of 2% would be imposed on tax which remains unpaid at the end of every month.

REINFORCING QUESTIONS

QUESTION ONE

Instalment tax returns were introduced with effect from 1 January 1990.

(a) State the advantages and the disadvantages of this requirement.

(b) Comment on the contention that the current rules regarding submission of returns and payment of tax discriminate against employees as compared to companies.

QUESTION TWO

Compare and contrast the self-assessment system with the old system it replaced.

QUESTION THREE

The imposition of compensating tax effectively raises a company's tax bill beyond the corporation rate of tax. Comment.

CHECK YOUR ANSWERS WITH THOSE GIVEN IN LESSON 9 OF THE STUDY PACK

LESSON SIX

ASSESSMENTS, OBJECTIONS AND APPEALS

INSTRUCTIONS

1. Assigned Reading. Read study text given below.
2. Complete the Reinforcing Questions at the end of the lesson.
3. Compare your answers to the models given in the revision section of the study pack.
4. Study text

COLLECTION AND RECOVERY OF TAX

Where tax assessed is not paid on due date, the collector of income tax has power to collect the tax due as a debt owed to the government in any of the following ways:

a) Sue for the recovery of the amount in a court of law.
b) Collect the tax through agents. Here the organisations or individuals known to be making some payments to a defaulting taxpayer are appointed as tax collecting agents. As agents, they are legally required to pay to the collector any moneys due to the defaulting taxpayer and the obligation for paying to the taxpayer is taken as legally satisfied. If the agent defaults in making payments to the collector after appointment as agent, the tax can be collected from such an agent. Bankers, employers, marketing organisations etc. are often appointed as tax agents.
c) Distraining defaulting taxpayers, that is, seizing their properties and auctioning them to satisfy the tax debts.
d) Collection from a guarantor.

TYPES OF NOTICES OF ASSESSMENT

a. **Estimated assessment**—This assessment is issued by CIT on income that he estimates to the best of his judgement where:
i) Taxpayer has failed to submit a provisional return for accounting year ending earlier than 31.12.92
ii) Taxpayers has failed to submit an instalment return.
iii) Taxpayer has failed to submit a final return (self assessment return w.e.f year ended 31.12.92)
iv) CIT does not agree with the final return or self-assessment return submitted.
v) The taxpayer has submitted a self assessment return without accounts etc.

b. **Normal assessment**—This assessment is issued by CIT on the basis of final return of income submitted. CIT may call for additional information, documents, schedules etc before accepting the income/loss per final return or as adjusted. Note that with effect from year of income ended 31.12.92 the normal assessment will then become a self assessment based on self assessment return.

c. **Additional Assessment**—This assessment is issued by CIT after he has received the self assessment return and he has further information to suggest that the person is under-assessed.

d. **Amended assessment**—This assessment is issued by CIT after a taxpayer has lodged a notice of objection to CIT against the assessment, applied for relief of error or appeal to the local committee, tribunal or court of law against any of the above assessment. An assessment can be amended upwards (on more income) or downwards (on less income)

e. **A self assessment**—For accounting year ended 31.12.92 and after, a taxpayer will determine the tax liability on the basis of the final return and such bill is referred to as self assessment and the final return self assessment return.

Note

The above types of notices of assessments are not all mentioned in the act but arise out of the ITD practice and serve to highlight circumstances under which an assessment can be issued.

Notice of Objection

A taxpayer who disputes or who does not agree with an assessment for any year of income has a right to lodge an objection (or to object) against such an assessment. Such an objection is referred to as a "notice of objection". For the objection to be "a valid notice of objection" it must:

a) be in writing
b) state the grounds of objection (or the reasons why the objection is lodged).
c) be made within 30 days after the date of service of the notice of assessment i.e. within 40 days.(30 days of notice + 10 days of service within Kenya = 40 days)
d) the return of income and any supporting schedules must be submitted before the appeal is accepted. A taxpayer will dispute or will not agree with a notice of assessment because of mistakes or errors relating to:

1) amount of income/loss assessed
2) Amount of tax payable
3) Allowance or deduction made or omitted to be made in computing chargeable income/loss.
4) Imposition of interest penalties under S.72. There is no right to object against S.95 interest. A tax payer applies for remission of the interest under S.95.
5) Relief granted or omitted to be granted for individuals.
6) Rates of tax used.
7) Assessment being time barred. An assessment is time barred if issued 7 years after the year of income to which it relates.

Late Notice of Objection
Where a taxpayer who disputes an assessment fails to object against the assessment within the time allowed 30 days of notice plus 10 days of service of the notice of assessment in Kenya) the taxpayer can lodge a notice of late objection. The late notice of objection must:

a) be in writing
b) state the grounds or reasons for objecting, and
c) State the reasons for objecting late.

The CIT can accept a late notice of objection on the following conditions:

1. Return of income for the year, and accounts where applicable have been submitted to CIT.
2. If the lateness is due to the taxpayer being absent from Kenya, being sick, or other reasonable cause e.g death in a family sickness in the family etc. proof of this would be required by CIT.
3. There is no unreasonable delay on the part of the taxpayer in lodging the late objection e.g. the notice was lost at post office.
4. Tax due is paid together with any late payment interest. CIT can waive this condition if he is satisfied that the tax due is excessive.

If the late objection is accepted by CIT, it becomes a **valid notice of objection**.

If the late objection is not accepted, the notice of assessment objected against remains in force. The taxpayer however has a right to appeal to the local committee (an appeal body) against CIT refusal to accept a late objection, and the decision of the local committee is final on the matter.

Dealing With a Valid Notice of Objection
Where a taxpayer has lodged a valid notice of objection against an assessment for any year of income the objection would be dealt with by CIT in any of the following ways:

a) Amend (change) the assessment to be in accordance with the objection i.e. CIT agreeing with the grounds of the objection.
b) Amend the assessment in the light of the objection (with some adjustments) and taxpayer or the person objecting agreeing to the adjustments. An agreed amended assessment would be issued by CIT i.e. an assessment agreed by both parties.
c) Amend (change) the assessment in the light of the objection (with some adjustments) and the taxpayer or the person objecting not agreeing to the adjustments. A non-agreed amended assessment would be issued by CIT. The taxpayer is notified of the right to appeal to the local committee if he disputes the non-agreed amended assessment.
d) Refuse to amend (change) the assessment and issue a notice to the taxpayer confirming the disputed assessment. The taxpayer has a right to appeal to the local committee against the confirming notice.
e) Take no action where the taxpayer withdraws the notice of objection.

f) Take no action where, with effect from 13.6.91, an objection becomes invalid and the assessment objected against final and conclusive. Where the return and accounts for the year have not been submitted within 30 days from the date of objection.

Note

A taxpayer who is aggrieved by the manner in which an objection against an assessment has been cleared by CIT may lodge an appeal to the local committee, tribunal and finally to high court and court of appeal in the manner described below.

APPEAL BODIES

A taxpayer has a right to appeal against some decisions made by CIT regarding assessment which the taxpayer does not agree with. The appeal is made to appeal bodies established under the Act.

Local Committee

a) The local committee is an appeal body. It is an independent body and not part of the ITD.
b) The Minister in charge of Finance, by a notice in the gazette appoints a local committee for any given area eg Kisumu Local Committee, Mombasa local Committee, Nyeri Local Committee etc
c) The duties of a local committee are to hear and determine appeals lodged by taxpayers on matters of tax dispute. Note that only a taxpayer can appeal to the local committee.

Composition of the Local Committee

The members of the local committee are appointed by the minister in charge of Finance and consist of:

a) The chairman and
b) Not more than eight other members— the quorum for a meeting of the Local Committee. The quorum for a meeting of the Local Committee is the chairman and two other members.

Period of Office

A member of the local committee holds office for a period of two years unless:

a) the member tenders a resignation, or
b) the minister revokes the appointment:

i) for failure to attend three consecutive local committee meetings; or
ii) For being unfit to perform the duties of his office by reason of mental or physical disability.

Local Committee Rules

The minister has made and can make rules under the income tax act referred to as the Income Tax (Local Committees) Rules for the Local Committees to follow relating to:

a) The manner in which an appeal may be made to the Local Committee.
b) The procedure for hearing an appeal and the records to be kept by the Local Committee.
c) The manner to convene, the place, date and time to hold a Local Committee meeting.
d) Scale of costs that may be awarded by the Local Committee.
e) General matters for the better carrying out of Local Committee appeal.

Procedure for Appeal to the Local Committee

A taxpayer has a right to appeal to the local committee against some decisions made by CIT affecting tax such as:

a) CIT refusing to amend an assessment after the taxpayer has lodged a valid notice of objection. The CIT would issue a notice confirming such an assessment and the taxpayer would have a right to appeal to the local committee against such confirming notice.
b) CIT issuing a non-agreed amended assessment. This arises where CIT has adjusted taxable income in the light of the objection, but the taxpayer does not accept the adjusted income/loss and the subsequent assessment.
c) CIT refusing to accept a late notice of objection. This is an objection which is lodged after the period allowed for submission of a normal objection. The taxpayer has a right to appeal to the local committee against the decision of CIT to refuse to accept a late notice of objection.
d) CIT issuing a notice requiring books records and accounts to be kept in a specific language. The taxpayer has a right to appeal to the local committee against such a notice.
e) CIT refusing to make a repayment of tax overpaid. The taxpayer has a right to appeal to local committee to enforce repayment of overpaid tax.

When considering any appeal procedure, one must bear in mind the three parties involved in any appeal namely, the taxpayer, the CIT and the appeal body. The appeal documents must be filed to the three parties in the procedure for appeals as follows:

1. **To CIT**

   a) The taxpayer is required to notify the CIT of his intention to appeal to the local committee against any of the above notices or decision within 30 days from the date of service of the notices or decision.
   b) The notice of intention to appeal must be copied to the clerk of the local committee.
   c) Copies of memorandum of appeal and statement of facts must be sent to CIT.

2. **To Clerk of Local Committee**

   The appeal is to the local committee and the following documents must be submitted to the clerk of the local committee:

   a) Memorandum of Appeal—document stating the grounds of appeal—(original + 9 copies for the members of the local committee).
   b) Statement of Facts—a document giving sequence of events on the assessment before appeal to the local committee i.e date assessment issued objected to, confirmed, non-agreed amended assessment issued, etc. (original + 9 copies for the members of the Local Committee).
   c) A copy of the letter (notice) of intention to appeal to the local committee which was sent to CIT.
   d) A copy of CIT decision against which an appeal is being lodged to the local committee e.g copy of non-agreed amended assessment or a copy of the confirming notice.

Registering an Appeal for Hearing by the Local Committee

Where proper appeal documents have been filed in time to the clerk of the local committee the clerk will register the appeal for hearing by the local committee. The clerk of the local committee will not register an appeal for hearing by the local committee unless the return of income, and the accounts where applicable for the year of income under appeal, are submitted to the CIT.

Late Appeal to the Local Committee

Where a taxpayer is prevented from lodging an appeal, in time, to the local committee by either absence from Kenya, sickness, or other reasonable causes; the taxpayer can appeal to the local committee for extension of time within which to lodge an appeal. Such an appeal is referred to as a late appeal. Appeal documents as for normal appeal will also be filed i.e. memorandum of appeal and statement of facts. The application for extension of time within which to appeal must state the reasons why the appeal was not lodged within the time allowed.

Valid Appeal

1) Where all the appeal documents have been filed in time, there is a valid appeal to the Local Committee.
2) The clerk of the local committee will register any valid appeal for hearing by the Local Committee.
3) The date and place of hearing of the appeal is notified to both the taxpayer (appellant) and the CIT (respondent).
4) The local committee will then meet and hear the appeal and make a decision on the matters disputed. The decision of the local committee is communicated to both the taxpayer (the appellant) and the CIT (respondent).

Appeal to Courts of Law

If the taxpayer or CIT disputes the decision of the local committee, they can appeal to the high court and then to the court of appeal. The appeal to courts must be only on question of law or mixed law and fact.

For the appeal to the courts, the appellant (taxpayer or CIT) must serve the respondent with a notice of intention to appeal to the court within 30 days from the date of service of the decision of the local committee. The appellant must also file in court the following:

a) Memorandum of appeal listing the grounds of appeal.
b) Statement of facts giving a sequence of events leading to the decision or notice under appeal.
c) Copy of the decision or notice appealed against.
d) Copy of notice of intention to appeal served on the respondent.

Tribunal

a) A tribunal is an appeal body established by the Minister in charge of Finance by a notice in the gazette.

b) The tribunal consists of:

   i) The chairman, and
   ii) not less than two and not more than 4 other members (minimum 3 members and maximum 5 members)

c) The duties of the tribunal is to hear appeals on assessment based on CIT direction under s.23 and s.24 of the income tax act.

S.23 ANTI-AVOIDANCE PROVISION

Under S.23, CIT is empowered to reject certain business transactions when he is of the opinion that the main purpose or one of the main purpose for effecting a transaction is avoidance 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. CIT would disallow the salary and tax it.

S.24 ANTI-AVOIDANCE PROVISION

Under S.24, CIT is empowered to direct for a company to distribute dividends to its share holders i.e when there is dividend distribution shortfall e.g. Fair ltd had adjusted income for tax in 2002 of £10,000 and dividend provided/declared of £1,000. Dividend distribution shortfall would then be calculated as follows:

	Shs.
Adjusted income for tax	10,000
Less tax thereof @ 30% (tax rate for the year)	3,000
	7,000
Less: Allowable retention @ 60%	4,200
	2,800
Less: dividend declared	1,000
Dividend distribution shortfall	1,800

CIT can direct the company to distribute £1,800 to the shareholders and deduct withholding tax accordingly. If taxpayer disputes an assessment resulting from forced distribution taxpayer can appeal to tribunal.

APPLICATION FOR RELIEF OF ERROR OR MISTAKE IN A RETURN OF INCOME - S.90 APPLICATION

1) Where CIT has issued an assessment in accordance with the return of income submitted by a taxpayer, the taxpayer has no right to object against such an assessment. The assessment is raised in accordance with the information provided by the taxpayer.
2) A taxpayer can make an error or mistake when completing a return of income e.g wrong figure of income etc resulting in the assessment being excessive.
3) A taxpayer can make an application to CIT under s.90 of the act for the error or mistake to be rectified. The application is referred to as the application for 'relief of error or mistake' in the return. If the application is accepted the assessment is amended accordingly to rectify the error. The time limit for making such an application is 7 years after the year of income with the error

REINFORCING QUESTIONS

QUESTION ONE

Miss Cecilia Nyemura received a notice of additional assessment dated 4.1.99, which she does not agree with as the income assessed is wrong. He would like to know:

a) The conditions for lodging a normal notice of objection.
b) The conditions for CIT accepting a late notice of objection.

QUESTION TWO

(a) An aggrieved taxpayer may appeal against the Commissioner's decision either to the Local Committee in his Income Tax District or to the Tribunal in Nairobi.

i) Under what circumstances may an appeal be made to the Tribunal.
ii) What are the requirements of a valid memorandum of appeal to the Local Committee?
iii) State the rules governing the payment of tax assessed pending the determination of the appeal.

(b) You are the Chief Accountant of Mountain Trout Ltd. and have received the following letter from the Income Tax Department:

The accounts of the above company for the year ended 31 March 2006 have been examined and the total income is Ksh. 30,000 Million. The position on the shortfall is as follows:

	Ksh Million
Income	30.0
Corporation Tax	13.5
Residual Income	16.5
Permissible retention	9.9
Distributable amount	6.6
Proposed dividends	Nil
Shortfall	6.6

The distributable amount will need to be cleared by 31 March 2006 to avoid shortfall provisions unless the company considers itself entitled to greater relief than the permissible retention. In such a case a claim for relief supported by all relevant information will need to be made on or before 31 March 2006".

Required

i) Calculate the tax payable by the company if it decides to clear the shortfall by way of dividends and indicate the date that the tax will be due.
ii) Calculate the tax payable if the company decides not to clear the shortfall by way of dividends and consequently the Commissioner directs that a charge be made upon the company in respect of adjustments to the liability to tax of the shareholders.
iii) Discuss the circumstances under which the company may be entitled to greater relief than the permissible retention.

QUESTION THREE

(a) Now that there is self-assessment under the Income Tax Act, does the Commissioner of Income Tax have to issue any assessment? Explain. (3 marks)
(b) Does an individual have to raise an objection for tax assessed under the Income Tax Act now that there is self-assessment? Explain. (3 marks)
(c) Mr. Banu Shah provided the following information for the year ended 31 December 2005:

- He was employed as a director of Letex Limited at a salary of Shs.80,000 per month (PAYE) – Shs.31,200 per month was deducted).
- Free goods worth Shs.30,000 were received from the company in the year for personal use.
- He owns 6% of the share capital of Letex Limited.
- He enjoyed free medical treatment under a medical scheme operated by the company which was assessed at Shs.200,000.
- Letex Limited provided him with free housing from 1 August 2005 prior to which he lived in his own house.
- His wife works as a nurse in a private hospital and earned Shs.20,000 per month, (PAYE Shs.4,000) with fringe benefits of Shs.4,500.
- Rent from property owned was Shs.30,000 per month from August 2005. Repair and painting cost was Shs.11,500 before letting. The house had a mortgage of Shs.2,000,000. He paid Shs.600,000 of which Shs. 330,000 was capital.

Required

i) Total taxable income of Mr. And Mrs. Banu Shah for 2005. (9 marks)
ii) Tax payable/repayable on the income computed above. (3 marks)
iii) Comment on the importance of P9 in income tax returns (2 marks)

CHECK YOUR ANSWERS WITH THOSE GIVEN IN LESSON 9 OF THE STUDY PACK

COMPREHENSIVE ASSIGNMENT No.3

TO SUBMITTED AFTER LESSON 6

To be carried out under examination conditions and sent to the Distance Learning Administrator for marking by the University.

EXAMINATION PAPER. TIME ALLOWED: THREE HOURS. ANSWER ALL QUESTIONS

QUESTION ONE

With reference to Income Tax, write short notes on the following:

a) Self-assessment; (4 marks)
b) Notice of objection; (4 marks)
c) NSSF; (4 marks)
d) PIN Advantages; (4 marks)
e) Valuation of housing for employees. (4 marks)

(Total: 20 marks)

QUESTION TWO

Explain the different alternative ways in which the CIT may deal with a notice of objection against an assessment. Which ones give rise to an appeal to the Local Committee?

QUESTION THREE

With regard to the Local Committee write brief notes on the following:

i) Its function;
ii) Its composition;
iii) Appointment and tenure of office of the members;
iv) Persons who may appeal to the local committee;
v) Appeals to it that constitute a valid appeal.

QUESTION FOUR

Write brief notes on self-assessment return.

QUESTION FIVE

Mr. Kuweka received a revised assessment from the Commissioner of Income Tax under Section 77 of the Income Tax Act. The assessment revised his tax payable from Sh.250,000 to 620,000 for the year of income 2005. The income shown in his self-assessment for 2005 was Sh.851,566. The grounds of revision were:

i) He had sold shares in the following companies and made profits as shown:

	Profit (Shs.)
Kenya Commercial Bank	160,000
National Bank of Kenya	40,000
Credit Finance Bank of Kenya	20,000

ii) Interest of Shs.70,000 due to him and shown in the accounts of Thika Limited had not been included in the returns. He loaned shs.1,000,000 at 7% to the company. The interest has not been received by him.

iii) He earned Shs.50,000 in South Africa. He was paid a honoraria in Johannesburg when he gave advisory services to a women group. He was there on a private visit.
iv) He was a partner in a coffee farm with two other people. Presumptive tax was deducted as required. His share of profit omitted from the returns was Sh.80,000.
v) His wife, an employee of Kuweka Limited, a family company, had employment income of Shs.300,000. This was taxed separately in accordance with PAYE rules and excluded from the returns.

Mr. Kuweka objected to the assessment in light of the requirements of Section 85 of the Income Tax Act. The Commissioner of Income Tax has responded and given the ruling as provided by Section 85 (1) (c).

Required

f) Specify the rulings provided for under Section 85 of the Income Tax Act. (6 marks)
g) Write a memorandum of appeal on behalf of Mr. Kuweka as provided for under the income tax local committee rules. (14 marks)

(Total: 20 marks)

END OF COMPREHENSIVE ASSIGNMENT No.3

NOW SEND YOUR ANSWERS TO THE DISTANCE LEARNING CENTRE FOR MARKING

LESSON SEVEN

VALUE ADDED TAX

INSTRUCTIONS

1. Assigned Reading. Read study text given below.
2. Complete the Reinforcing Questions at the end of the lesson.
3. Compare your answers to the models given in the revision section of the study pack.
4. Study text

LEGAL AND THEORETICAL FRAMEWORK

VAT is tax on spending which is collected by businesses and passed on to the Government.

CHARGE TO TAX (S.5 VAT ACT)

Value Added Tax shall be charged on the supply of goods or services in Kenya and on the importation of goods into Kenya.

THE PRELIMINARY REQUIREMENTS

Before VAT may become chargeable in respect of the supply of goods or services EACH of the following requirements must be fulfilled:

a) A supply of goods or services must take place;
b) The supply must be a **taxable supply;**
c) the goods or services must be supplied by a **taxable person**;
d) the supply must be made in the course of further business carried on by the supplier;
e) The supply must be made in Kenya. These requirements will be examined at a later stage.

TAXABLE SUPPLY

Definition: A taxable supply is a supply of taxable goods or services made or provided in Kenya. The Act defines taxable goods as electricity and manufactured goods, other than those specified in the second schedule of the Act. The second schedule specifies the exempt supplies. The Act also defines taxable services as any service specified in the third schedule of the Act. **Exempt supplies** is defined as the supply of goods specified in the second schedule or supply of services not specified in the third schedule. Therefore taxable supply, briefly can be defined as the supply of any goods or service unless the supply is an exempt supply.

TAXABLE PERSON

Definition: Taxable person means any person liable to apply for registration under the sixth schedule. Generally any person who makes or intends to make taxable supplies will be treated as a taxable person while he is, or is required to be registered.

COMMENCEMENT OF VAT

VAT is chargeable on the supply of goods and services or on the importation of goods taking place on or after January 1 1990. It replaced sales tax and this decision to replace sales tax with VAT was largely due to the perceived deficiencies in the sales tax system. These include:

- Sales tax system applied in Kenya was a single tax system. Sales tax was levied only once at the manufacture level. In a country where tax evasion is rampant, a single tax system would result in a higher revenue loss than would normally be the case if the system is multi-stage.
- Where inputs for manufacturing were subject to sales tax, then the imposition of sales tax on the finished product would result in the imposition of tax on tax (a cascade tax). This problem is worsened if the sales tax system is multi-stage since the imposition of tax on tax will be repeated several times over. It is also worse in a situation where a particular good is subject to more than one tax, e.g. sales tax and excise duty.
- The sales tax system used in Kenya like in many parts of the world has a limited scope. In Kenya, sales tax was levied on certain specific manufactured goods. Services did not fall under/within the scope of tax.

Sales tax therefore had a narrow base as compared to VAT with the result that revenue yield was comparatively low.
VAT is an indirect tax. It is essentially a tax on the domestic consumption in the economy. Under VAT, it is generally the end user that bears the tax. The tax is charged on each transaction in the production and distribution chain.
The system of VAT employed in Kenya and in many Commonwealth countries is the type known as "invoice – from – invoice" system. Under this system, VAT traders' liability is determined by deducting VAT charged on

supplies from output tax. The difference is the tax payable to or recoverable from the government. Different systems of VAT are in use in Asia and in Latin America.
Under the "Invoice-from Invoice" system, VAT is calculated on the basis of invoices issued on the point of sale. The application of the invoice method together with a system of tax credits means that it is necessary to calculate the value added by e.ach transaction in the economic sense.

Illustration
Assume a manufacturer acquires raw materials for Kshs.100,000 on which VAT is levied at 16%. At each stage of the chain 25% conversion costs are incurred and a 30% mark up is made. The total VAT paid to the Kenya Revenue Authority will be Kshs.68,656 made up as follows:

		Value Kshs.	VAT Kshs.	
Stage 1	**Supplier of raw material**	100,000		
	VAT @ 16%	16,000	16,000	**A**
		16,000		
	Stage 2	**Manufacturer**		
	Buying price	100,000		
	Conversion cost @ 25%	25,000		
		125,000		
	Mark up @ 30%	37,500		
	Selling price	162,500		
	VAT @ 16%	26,000	26,000	
		188,500		
	Input tax (VAT on materials		(16,000)	
	VAT Payable		**10,000**	**B**
Stage 3	**Wholesaler**			
	Buying price	162,500		
	Additional cost @ 25%	40,625		
		203,125		
	Mark up @ 30%	60,938		
	Selling price	264,063		
	VAT @ 16%	42,250	42,250	
		306,313		
	Input tax		(26,000)	
	VAT payable		**16,250**	**C**
Stage 4	**Retailer**			
	Buying price	264,063		
	Additional cost @ 25%	66,016		
		330,079		
	Mark up @ 30%	99,023		
	Selling price	429,102		
	VAT @ 16%	68,656	68,656	
	Retail price	497,758		
	Input tax		(42,250)	
	VAT Payable		**26,406**	**D**

VAT COLLECTION

Supplier of raw material		16,000	A
Manufacturer		10,000	B
Wholesaler		16,250	C

Retailer	26,406	D
	68,656	

IMPORTANT TERMS IN VAT

- Value Added:
  It is the increase in worth of a supply when it changes hands in the line of manufacture and distribution.
- Output Tax
  This is the VAT charged by a registered person when he makes a supply of taxable supplies in the course of his business.
- Input Tax
  This is the VAT charged on a taxable person when he acquires taxable supplies for use in the furtherance of his business.
- Taxable person:
  This is a person who is liable to apply for registration under the VAT Act (check registration for VAT).
- VAT payable/refundable
  It is the difference between input and output tax. If output tax is more than the input tax the difference is the VAT payable. If input tax is higher than output tax the difference is the VAT refundable.
- Tax period
  It means one calender month. VAT is accounted for on a monthly basis.

Supply
This means transacting in taxable goods or services. Supply includes the following:

a) The sale, supply or delivery of taxable goods to another person;
b) The sale or provision of taxable services to another person.
c) The appropriation by a registered person of taxable goods or services for his own use outside the business.
d) The making of a gift of any taxable goods or services;
e) Letting of taxable goods on hire, leasing or other transfers;
f) Provision of taxable services by a contractor to himself in constructing a building and related civil engineering works for his own use, sale or renting to other persons.
g) The receipt of a sum of money by a registered person for loss of taxable goods or services.
h) Any other disposal of taxable goods or provision of taxable services.

Taxable goods/services
- Goods/services on which VAT is chargeable.

Exempt goods/services
Goods/services on which no VAT is chargeable.

Zero Rated Goods/services
Goods/services on which VAT is chargeable at 0%
(Check Input Tax Deduction).

VAT Rates:
There are 3 Rates in VAT

i) - 16%: It is the general rate applied on all taxable goods and services except those in (ii) and (iii) below.
ii) - 14%: It is the rate applicable to the hotel and restaurant services.
iii) - 0%: It is the rate applicable to the zero rated goods and services

OPERATION OF VAT

- Every registered person is required to charge VAT when he makes a supply of taxable goods and services. This VAT is referred. To as output VAT. On the other hand, when a registered person is acquiring goods and services for use in the furtherance of his business, he pays VAT. This is known as Input Tax.
- At the end of the tax period, the taxable person is required to deduct the Input Tax from the output Tax and pay any balance thereof to the commissioner of VAT. If the input tax exceeds the output tax he carries the balance forward to offset it against the output tax in the next period.

Example

Mr. X, a registered trader had the following transactions in the month of March:

	Sh.
Sales	100,000
Purchases	70,000

Assuming the above figures are VAT exclusive and the VAT rate is 16%, show his VAT position for the month of March.

Output Tax	16% x 100,000	=	16,000
Input Tax	16% x 70,000	=	11,200
VAT payable			4,800

TAXABLE VALUE

It is the value of a supply on which VAT is due. It is the consideration given in exchange for a supply and it may be payment in money or in any other form. The taxable value is important because it is on this value that we calculate VAT.

Rules for determining the Taxable Value.

a) If a discount is offered on a supply the taxable value is the value of such a supply, less the discount offered.
b) If the consideration is not in money (Barter Transaction) the taxable value will be the consideration which would have been paid if money was the only consideration (open market value).
c) For imported services the taxable value shall be the price at which the services are provided.
d) For imported goods the taxable value shall be the cost of such goods plus any duty of customs payable on such goods.

   Note
   - Cost of Imported goods = Invoice price (cost) + Insurance + Freight
   - Cost of Imported goods is also known as the CIF value.

e) To determine the taxable value, any amount charged on: packaging, advertising, financing, servicing , warrants, commission and any other liability that the purchaser has to pay in addition to the price, is added to the price of the commodity.

Tax Point

- This is the point in time at which the tax (VAT) becomes due and payable. For VAT to become due and payable a supply must have taken place.
- VAT is accounted for on monthly basis. VAT should be accounted for in the month in which the tax point occurred using the VAT rate that was in force at that time.

Tax Point is determined as follows:

a) When the goods are supplied or the services provided to the purchaser or;

b) An Invoice is issued to the purchaser in respect of the supply, or;
c) Payment is received for all or part of the supply, or
d) When a certificate is issued, by an architect, surveyor or any person acting as a consultant or in a supervisory capacity, in respect of the service,

Whichever of the four occurs earliest.

Note
- (d) applies to contracts for service like construction, surveying etc.

For VAT purposes, the tax becomes due and payable at the tax point. However, the registered traders have been given an allowance of up to 20th of the following month to make the payment to the commissioner of VAT. For example the VAT charged in the month of January 2006 is payable by 20th February 2006.

Example

X, who is a registered trader delivered goods to Y on 21st January 2006. He issued an Invoice for the goods on 10th February 2006. Y paid for the goods on 3rd March 2006. When should X pay the VAT on those goods to the commissioner?

Answer

- The tax point on such goods is 21st January 2006. The VAT should be paid by 20th February 2006.

Note
VAT is payable whether payment has been received or not as long as the tax point has occurred.

REGISTRATION FOR VAT

This is the process by which traders who are eligible for registration under the VAT Act are issued with registration certificates. It is an important process because only registered traders are allowed to charge VAT. It is important to note that it is an offence to charge VAT if you are not registered.

- Who qualifies for registration?

a) Any person including a sole-proprietor, partnership and Limited company who is already in business and has supplied or expects to supply taxable goods or services or both exceeding Sh. 3,000,000 p.a. or Sh. 2.4m for 9 months or Sh. 1.8m for 6 months or Sh. 1.2m for 3 months.
b) Any person who has manufactured or is about to commence manufacturing taxable goods which exceed the above amount.
c) Suppliers of zero rated goods and services.
d) The following should register irrespective of whether their turnover reaches the above limits:

 i) Persons dealing in jewellery, timber, motor vehicle parts and accessories, household or domestic electric apparatus (appliances).
 ii) All saw millers.
 iii) Any person who in any year sells four or more motor vehicles.
 iv) Any person dealing in pre-recorded music.
 v) Any person dealing in the following designated services:

 - Accounting and relate services
 - Legal and Arbitration services
 - Auctioneers
 - Estate Agents
 - Valuers
 - Clearing and Forwarding services

TYPES OF REGISTRATIONS

a) Normal Registration:
This occurs when a trader who meets the registration requirements applies for registration and is duly registered and issued with a registration certificate.

b) Voluntary Registration:
Occurs when a trader who is not qualified for registration applies for registration so as to enjoy the benefits of a registered person.

c) Intending Trader Registration
It occurs when a trader who expects to deal in taxable goods and services applies for registration before he commences trading.

d) Compulsory Registration:
It occurs when a trader who qualifies to register fails to do so. In such a case, the trader once he is identified is issued with a registration certificate without his application. Tax can also be demanded from him on any sale made in the past.

e) Temporary Registration:
This occurs when a trader who has not been registered applies to be registered so as to undertake certain business transactions. He is issue with a temporary registration number.

Note

1. Any registered trader is required to display his registration certificate in a visible position in his business premises.
2. Any trader who is eligible for registration and fails to apply for registration is liable to a default penalty of Kshs. 100,000.
3. In order to register the following documents are required:
   - Personal Identification Number (PIN) of the sole proprietor, partner or director
   - A copy of the certificate of registration of business name:

DEREGISTRATION:

It is the process of removing a registered trader from the VAT register. Any trader wishing to be de-registered for any reason may apply to the commissioner of VAT. De-registration may be requested on the following grounds

i) Closure of business
ii) Sale/transfer of business
iii) Death of a trader
iv) legal incapacitation (Bankruptcy)
v) Insolvency
vi) Change of business status eg. Partnership to limited company
vii) If the turnover falls below the prescribed limits.

Before de-registration, any tax outstanding must be paid to the commissioner of VAT. Once the trader is de-registered he is notified of the effective date of deregistration and from that date he should not charge VAT. The original registration certificate should be surrendered to the commissioner of VAT.

INPUT TAX DEDUCTION

Traders registered for VAT are entitled to claim all the VAT they incur on purchase of suppliers for use in the furtherance of their businesses. This VAT (Input Tax) is claimed by deducting it from the Output tax.

However for Input Tax to be deducted it must fulfill the following conditions:

1. It must relate to taxable supplies for use in the furtherance of business.
2. The trader must be registered for VAT.
3. It must be claimed within 12 months from the month it is incurred

Note

Input tax on purchase of stock and on the construction of business premises incurred before commencement of business must be claimed within 30 days after registration.

4. The Input Tax must be evidenced by a tax invoice. For imports, Input Tax is evidenced by documents from the customs department.
5. Input Tax claimed must be shown in the monthly VAT payment document (VAT return).

INPUT TAX APPROTIONEMENT

A registered trader, may be dealing in supplies taxed at the general rate, zero rated supplies and exempt supplies. Such a trader will also incur Input Tax on purchase of supplies that are related to all the items that he deals in.

For example, an expense like electricity will be used in the business for making all the business supplies.

In such a case, it is important to note that only the Input Tax that relates to the taxable supplies can be claimed. Taxable supplies refers to supplies taxable at 16%, 14% and 0%.

The deductible Input Tax is determine using the following formula.

$$\text{Deductible Input Tax} = \frac{\text{Value of Taxable Supplies}}{\text{Value of Total Sales}} \times \text{Input Tax}$$

Note:

The Input Tax to be apportioned is the Input Tax that relate to both the taxable supplies and the exempt supplies.

Example

Mr. X a registered trader, incurred input tax of Sh.500 on purchase of his stock. Out of this stock, he sold as follows: Goods taxable at 16% worth Sh. 2,000, zero rate goods worth Sh.2,000, and exempt goods worth Sh.2,000. He will claim the following Input Tax.

$$\text{Deductible Input Tax} = \frac{\text{Taxable supplies}}{\text{Total supplies}} \times \text{Input Tax}$$

$$\frac{2{,}000 + 2{,}000}{2{,}000 + 2{,}000 + 2{,}000} \times 500 = \text{Shs. } 333$$

PAYMENT OF VAT

All registered traders are required to pay any VAT payable by the 20th of the month following the month to which the tax relates. Payment is made together with a document known as the VAT return. This return is also known as VAT 3. It is important to note that whether there is any VAT payable or not, a VAT return must be submitted

Payment of VAT can be made at any VAT regional office or to the Central Bank of Kenya.

Special matters relating to payment of VAT

A. REMMISSION OF VAT

This refers to the waiver by the commissioner of VAT of any tax payable by a tax payer i.e. the tax payers tax is written off. The commissioner can waive wholly or partly any tax payable if he is satisfied that it is in the public interest to do so. Where a remission is granted under a certain condition, the tax shall become payable in the event of breach of the condition. Remission can be given in the following situations.

1. Purchase of goods for government approved projects.
2. Purchase of goods for use in new investments aimed at net foreign exchange earnings.
3. Goods purchased for use in refugee camps in Kenya.
4. Goods purchased for use in petroleum exploration in Kenya
5. Capital equipments for use in manufacture under Bond.
6. Good purchased for use by the Kenya Armed Forces.
7. Polythene materials for use in Agricultural/Horticultural activities.

B. REFUND

It is the repaying (paying back) by the commissioner of tax that the taxpayer had paid to the Commissioner.

Refund of tax may occur in the following situations:

1. Where goods have been manufactured in Kenya or imported into Kenya and tax paid thereon, but before being used inn Kenya, such goods are exported.

2. Tax paid in Error:

   It is important to note that if the commissioner refunds any tax in error or grants a remission in error, then the taxpayer is required to pay such tax on demand by the commissioner.

   If a taxpayer pay any tax in error (eg due to miscalculation) he is entitled to a refund.

3. Refund of tax on Bad debts:

   Where a registered person has supplied goods or services and has accounted for the tax on that supply but has not received any payment form the buyer, he may after a period of 3 years from the date of such supply or where the buyer has become legally insolvent, apply to the commissioner for a refund of tax or remission of the tax.

4. A refund is also given if in the opinion of the Minister for Finance, it is in the public interest to do so eg. in times of drought, floods or other calamities.

C. RELIEF DUE TO DOUBT OR UNCERTAINITY IN RECOVERY OF

TAX: If the commissioner is of the opinion that:

a) There is uncertainty as to any questions of law or fact or,
b) There is uncertainty or undue difficulty or it proves expensive to recover tax, then he may abstain from recovering such tax and hence such tax is written off.

D. ISSUE OF SAMPLES:

Where taxable goods:

a) Are distribute free as samples by a registered person for the furtherance of his business and
b) Such goods have a value of less than Ksh. 200 per sample and
c) They are freely available and
d) Are not Limited in distribution to fewer than 30 persons in any calendar month.

Then such goods are not liable to VAT.

E. SECURITY FOR UNPAID TAX:

The commissioner can apply to the Registrar of Lands, to put any Land and buildings belonging to a defaulting taxpayer as security for tax. Such property can not be sold until all tax is paid. The commissioner may also require that a taxpayer provides security in any form for any tax unpaid.

OBJECTIONS AND APPEALS:

A taxpayer can object to any decision made by the commissioner of VAT on matters relating to VAT. In objecting, the taxpayer will request the commissioner to reconsider the decision stating reasons thereof:

APPEAL

A taxpayer has the right to appeal to an independent tax tribunal when there is a dispute between him and commissioner on matters relating to the VAT Act.

The independent VAT tribunal is established by the Minister for Finance through the Kenya Gazette. It consists of the chairman and not less than 2 but not more than 5 other members.

Process of Appealing

If the taxpayer wishes to appeal, he should do so in writing within 30 days from the day he is notified of the commissioners decision (which he is disputing). The appeal is entered by presenting the memorandum of appeal in 10 copies and presenting it to the secretary of the tribunal within 14 days after giving the notice of appeal i.e. he must give a notice of appeal before appealing.

The memorandum of appeal should be accompanied by:

a) Copy of the commissioner’s decision in dispute.
b) Copy of the notice of appeal
c) Statement signed by the taxpayer stating the grounds on which he is appealing and any documentary evidence should be attached.

On receiving the appeal documents, the secretary to the tribunal shall furnish a copy to the commissioner within 48 hours. If the commissioner does not accept the facts therein, he may make a statement within 21 days. The commissioner should also give a copy of such a statement to the taxpayer.

For an appeal to be accepted the taxpayer must pay any unpaid tax that is not in dispute and all his tax returns (VAT 3) must be up to date.

Hearing of the appeal

The chairman will determine time, date and place of hearing. The secretary to the tribunal will notify the taxpayer and other parties usually 7 days before the hearing. Any interested party may be represented by an advocate or any other person.

Powers of the Tribunal

The tribunal may call witnesses, take evidence and call for the production of books and other documents that it deems necessary.

The tribunal can also award costs in any case. Any person summoned by the tribunal to give evidence or produce any records books, statements or to be interrogated and fails to do so, is liable to an offence. The penalty for such an offence is a fine not exceeding Ksh. 15,000 or 2 year imprisonment or both.

Any person not satisfied by a decision of the tribunal may appeal to the High Court within 14 days of being notified of the decision.

Records and accounts

Tax invoices—Taxable persons supplying goods or services to other taxable persons are required to provide with invoices referred to as tax invoices. These provide documentary evidence of goods and services supplied and will be indispensable to the persons acquiring goods or services when claiming relief for input tax suffered.

The tax invoice must be issued at the time of the supply or within 14 days of the completion of that supply. No tax invoice should be issued for any supply if:

a) The supply is not a supply of taxable goods or services.
b) The supplier is not a registered person.

If an invoice is issued in contravention of the above regulations any tax shown thereon shall become due and payable to the commissioner within seven days of the date of the invoice.

If payment is received prior to the delivery of goods or the rendering of services, a tax invoice must be issued immediately.

Particulars to be stated on a full tax invoice

i) the name, address, VAT registration number and PIN of the person making the supply;
ii) the serial number of the invoice;
iii) the date of the invoice;
iv) the date of the supply, if different from (c) above;
v) the name, address and VAT registration number, if any, of the person to whom the supply was made, if known to the supplier;
vi) the description, quantity and price of goods or services being supplied;
vii) the taxable value of the goods or services, if different from the price charged;
viii) the rate and amount of tax charged on each of those goods and services;
ix) details of whether the supply is a cash or credit sale and details of cash or other discounts, if any;
x) the total value of the supply and the total amount of VAT charged.

A tax invoice must be serially numbered and issued in serial number order.

Where cash sales are made from retail premises a registered person may issue simplified tax invoices.

Where cash sales to any one person in any day do not exceed five hundred shillings, the registered person may use other methods of accounting for tax.

A Simplified tax invoice shall include the following information:

i) The name, address, VAT registration number and PIN of the person making the supply;
ii) The serial number of the invoice;
iii) The date of the invoice;
iv) A brief description of the goods or services being supplied;
v) The total amount charged to the customer, VAT included;
vi) The explicit statement that the price includes VAT.

Retailer's issue of tax invoices

The issue of tax invoices by retailers involved in making of numerous supplies would clearly produce an impossible burden. This is recognized by a direction that a taxable person who is a retailer is not generally required to provide a tax invoice. The commissioner has authorised an alternative method of accounting where the supplies to any one person in any day do not exceed Shs 500 as follows:

a) Record the value and brief detail of each supply as it occurs and before the goods leave the premises.

b) Keep a cash register book or other suitable record at each point of sale in which should be entered all the details of cash received and cash payments at the time they were made and at the end of the day the record totalled and a balance struck.

At the end of each day record the output tax chargeable on supplies made and the deductible input tax in respect of supplies received. However the retailer must provide such an invoice at the request of a customer who is a taxable person in respect of any supply to him. At the end of the business must be kept for at least seven years. Cancelled or damaged tax invoices should be keep in sequence for the inspection of by VAT officers. If records are lost of destroyed the local VAT office should be notified immediately. If tax invoices received are lost, the business should obtain a copy from the supplier, which must be marked **duplicate.**

Other records

a) A record of all the taxable goods and services received or supplied by the firms, businesses, including zero rated supplies.
b) A separate record of any exempt supplies made.
c) A summary of the total of input tax and output tax for each calendar month. This is called VAT account.
d) Copies of all invoices issued, in serial number order.
e) Copies of all credit and debit notes issued in chronological order.
f) All purchase invoices, custom entries, receipts for payment of customs duty or tax, and credit and debit notes received. These should be fitted chronologically by date or under each supplier's name.
g) Details of goods manufactured and delivered from the factory of the taxable person.
h) Details of each supply of goods and services from the business premises.
i) Other business records namely—orders and delivery books relevant business correspondence, appointment and job books purchase and sale books, cash books, petty cash vouchers, annual accounts, import and export documents, balance statements and pay in slips, records of daily takings.
j) Rate and amount of tax charged on each of those goods and services provided.
k) Details of cash or other discounts.
l) Details as to whether the supply is for cash or credit.
m) Total value of supply and total amount of VAT charged.

Example of tax invoice

Invoice No. 22 Date 20.1.2005

From: Accessories (Kenya)ltd,
P.O. Box 90,000 VAT Reg No.10250
Kenyatta Avenue,Nairobi. Date of supply 20.1.2005

To: Smart Suits Ltd,
P.O. Box 90,001, VAT Reg. No. 10597
Moi Avenue, Nairobi.

Quantity	Description and size	Amount Exclusive VAT	VAT rate	VAT net
10 pairs	leather gloves @ KShs 200	2,000	16%	320
50 pairs	Men suits @ KShs 2,000	100,000	16%	16,000
50 pairs	Cuff links plated @ Shs 100	5,000	16%	800
Terms Cash	Totals	Totals 107,000 VAT 17,120 Total 124,120	— — —	17,120

The Value Added Tax (VAT) account

The VAT account is posted with month totals. Total input tax for the month is debited to the account and the total output tax credited. A credit balance would represent the tax payable to the commissioner while a debit balance will represent excess input tax which is carried forward and offset against output tax of the following month. In order to obtain monthly totals, the sales ledger control account may carry an extra column to record VAT on credit sales, the purchase ledger control account may also have a column for VAT on purchase. The cashbook may be analyzed to show VAT on cash transactions.

Value Added Tax (VAT) returns

Registered persons are required to submit a VAT return (form VAT 3) by 20th day or not later than the last working day of the month following the month covered by the return if the 20th day is a weekend or a public holiday. The return should show separately for each rate of tax:

a) Particulars of the total value of supplies.
b) The rate of tax to which the supplies are liable.
c) The amount of tax payable.
d) The total value of taxable supplies received.
e) The rate at which tax was paid.
f) The amount of tax paid in respect of which deductible input tax is claimed.

If no transactions are carried in any month a NIL return is submitted. The taxpayer should keep a copy of returns made for record purposes.

Audit Procedures

When a business is subject to an independent audit, the audit should cover the VAT account and other matters relating to VAT.

OFFENCES AND PENALTIES

(a) Any person who makes false statements, false documents, false returns, a non-registered person, fraudulent evasion of tax:

- Fine not exceeding Sh.400,000 or double the tax evaded, whichever is the greater and/or imprisonment for a term not exceeding three years.
- Forfeiture of any goods which have passed with the commission of the offence.

(b) Failure to submit a return
- penalty of Shs.10,000 or 5% of VAT due whichever is higher (Kshs. 10,000 if a refund is due).

(c) Failure to keep proper records
- penalty of between Shs.10,000 and Shs.200,000

(d) Failure to supply a tax invoice
- penalty of between Shs.10,000 and Shs.200,000. Any goods connected with the offence are liable to forfeiture.

(e) Later registration
- penalty of up to Sh.20,000

(f) Failure to display registration certificate
- penalty of up to Sh.20,000 and a fine of up to Shs.200,000 and/or imprisonment for up to two years.

(g) - Late payment of tax – 2% per month interest penalty compounded.

Liability of employers and officers of companies

Where an offence is committed by an employee or agent, the employer shall be guilty of the offence unless he proves otherwise.

Where an offence is committed by a company every director and officer of the company concerned in the management thereof shall be guilty of an offence unless he proves the offence took place without his knowledge or consent.

Any person who without reasonable excuse fails to produce books, records, or provide information as required by the Commissioner or an authorised officer shall be guilty of an offence and liable to a fine not exceeding Shs 6,000 or twelve months imprisonment or both.

General Penalty

For offences under the VAT Act for which no other penalty is provided; a maximum of Shs. 500,000 and/or three-year imprisonment.

Late payment

Late payment of tax produces additional tax equal to 2% per month of the unpaid tax compounded.

Appeals

A taxpayer who is aggrieved by the commissioner decision in a dispute can within thirty days appeal to an appeal tribunal, provided the tribunal is established by the Minister For Finance by an order of the Kenya gazette. It consists of:

i) A chairman

ii) 2 other members

These officials are appointed by the Minister, the decision of the tribunal on any appeal shall be final.

REINFORCING QUESTIONS

QUESTION ONE

(a) Relief from VAT on bad debts is claimable under certain conditions; you are required to list the conditions.
(b) Explain the expression "prescribed accounting period for value added tax".
(c) Explain the meaning of the term "tax point" in relation to the value added tax on the sale of goods.

QUESTION TWO

You are required to state the circumstances in which a registered person may be de-registered.

QUESTION THREE

With regard to Value Added Tax,

a) Outline the different effects where a person makes supplies which are:

(i) zero rated only
(ii) exempt only
(iii) a mixture of zero rated and exempt.

b) A tax invoice is often regarded as one of the important documents in the operation of VAT. State the items, which must be contained in such an invoice.

QUESTION FOUR

i) State the benefits of value added tax (VAT) in the context of the principles of a good tax system.
(10 marks)

ii) Given below were the purchases and sales made by Tough Limited during the month of December 2005. The prices were inclusive of VAT at the standard rate of 16%.

December 1st	Purchased 400 units at Shs.5,600 per unit
1st	Sold 40 units at Shs.7,200 per unit.
5th	Sold 80 units at Shs.7,200 per unit.
10th	Sold 200 units at Shs.7,200 per unit.
20th	Purchased 300 units at Shs.6,400 per unit.
25th	Sold 80 units at Shs.7,200 per unit.
31st	Sold 200 units at Shs.8,000 per unit.

There was no inventory at the beginning of the month but 100 units were in stock at the end of the month.

Required

a) The VAT account for the month of December 2005. (8 marks)
b) On what date is VAT due payable? (2 marks)

(Total: 20 marks)

QUESTION FIVE

a. Explain any FOUR effects of Value Added Tax on business. (8 marks)

b. Specify the rules relating to appeal against the Commissioner's decision under the Value Added Tax Act. (4 marks)

c. A company had VAT due amounting to Shs.300,000. It was late in making the payment for six weeks. What late payment penalty will be charged? (4 marks)

d. Inland Limited imported goods whose landed value is Shs.400,000. The duty chargeable on them is at the rate of 35%. There is to be made a provision for transport to the interior amounting to Shs.50,000. A commission is to be paid of 2% of dutiable value. Value Added Tax is charged on those goods at 16%. Determine the amount of VAT payable. (4 marks)

(Total: 20 marks)

QUESTION SIX

(a) Outline the circumstances under which a taxable person might incur non-deductible input tax (4 marks)

(b) Explain briefly the offences and related penalties under VAT Act. (6 marks)

(c) Jitegemee had the following purchases and sales for the month of March 2006 for a commodity taxable at the standard rate. The prices shown are inclusive VAT.

March	
1	Purchased 200 units at Sh.2,800 per unit
2	Sold 20 units at Sh.3,600 per unit.
6	Purchased 150 units at Sh.3,200 per unit
10	Sold 40 units at Sh.3,600 per unit
15	Sold 100 units at Sh.3,600 per unit.
18	Sold 40 units at Sh.3,600 per unit.
23	Sold 100 units at Sh.4,000 per unit.

Opening stock at the beginning of the month was 15 units valued at Sh.2,600 per unit. A physical count Confirmed that.

Required:

(i) Units in stock on 24 march 2006 assuming the last transaction occurred on 23 March 2006.
(ii) Purchases account
(iii) Sales account
(iv) Bank account
(v) VAT account (10 marks)

(Total: 20 marks)

QUESTION SEVEN

(a) Explain the VAT position on imported goods and warehoused goods (4 marks)

(b) On 31 March 2006, VG Company had VAT due amounting to Sh.120,000 relating to sales for the month of March 2006. The company made the payment on 30 May. State the penalty chargeable for the late payment and the total amount to be paid by the company. (5 marks)

(c) On 10 July 2006, Dubai Merchants imported goods valued at Sh.1,200,000. The customs duty chargeable on these goods was at 35% clearing charges paid amounted to Sh.20,000 and transport from Mombassa to Nairobi amounted to Sh.70,000. A commission on the dutable value of the goods was paid at 5%

Required

(i) Determine the amount of VAT payable on the goods (8 marks)
(ii) If the goods were sold on arrival in Nairobi at a mark-up of 20% determine the selling price (3 marks)

(Total: 20 marks)

QUESTION EIGHT

(a) Recently, traders opposed a move by Kenya Revenue Authority requiring them to keep stock records on a daily basis arguing that it would result in increased cost of compliance. However, upon review of the VAT Act, one realizes that record keeping in general has all along been part of the VAT regulations.

List down ten examples of records that must be kept for purposes of accounting for VAT (10 marks)

(b) Under the VAT regulations, taxable value of supplies is the price at which the goods are provided.

Required:
Calculate the value for VAT and the amount of VAT under each of the following circumstances

(i) Kucheza Limited imported computers valued at Sh.1,500,000. A duty of 20% was charged by the customs department. (2 marks)

(ii) ART (K) Ltd. Sold a fridge by hire purchase. The cash price was Sh. 96,000 while the hire purchase price was Sh.165,000 with a 20% down payment plus 20 monthly instalments of Sh.6,600 (2 marks)

(iii) The price of a motor car was Sh.2,500,000. A cash discount of 20% was allowed to Peter when he bought the vehicle. (2 marks)

(iv) Ern.est and Kamau, a professional accounting firm provided free accountancy and auditing services to the bomb blast project. This project a charitable undertaking was initiated to help victims of the 1998 bomb blast. The value of the services provided is estimated at Sh.2,400,000. (2 marks)

(v) ABC Ltd purchased goods worth Sh.1,200,000 from Colour Packaging Ltd. This excluded cost of packaging and transportation charged by Colour Packaging Ltd. Amounting to Sh.96,000 (2 marks)

(Total: 20 marks)

QUESTION NINE

c) Lusweti Kamau operates an electronics shop along Luthuli Avenue in Nairobi. He undertook the following transactions for the month of March 2006.

1 March 2006	Purchased 10 cameras for a total of Sh. 500,000.
4 March 2006	Purchased flashbulbs for a total of Sh.200,000
4 March 2006	Purchased 5 slide projectors for a total of Sh. 1,000,000
5 March 2006	Sold 5 cameras each at 25% above cost price.
6 March 2006	Purchased 200 wrist-watches at Sh.1,500 each
8 March 2006	Sold 2 slide projectors for a total of Sh. 500,000
9 March 2006	Sold flashbulbs that cost Sh. 100,000 for Sh.150,000
12 March 2006	Purchased 50 stop watches for a total of Sh.50,000
15 March 2006	Purchased 100 alarm clocks at a total value of Sh.80,000
18 March 2006	Sold the remaining 5 cameras each at 25% above cost price
20 March 2006	Sold 3 slide projectors for a total of Sh.750,000
22 March 2006	Sold 100 wrist-watches at Sh.2,000 per watch
25 March 2006	Sold 70 alarm clocks each at 30% above cost.
27 March 2006	Sold 50 stop watches for a total of Sh. 75,000

Required

(i) Given that the prices are inclusive of VAT, calculate Mr. Lusweti Kamau's:
- Input Tax (5 marks)
- Output Tax (5 marks)

(ii) Prepare the VAT account for Mr. Lusweti Kamau clearly showing the VAT payable (refundable). (2 marks)

(iii) State when the above tax is due, and the penalties payable if the tax is not paid on the due date. (2 marks)

(Total: 20 marks)

CHECK YOUR ANSWERS WITH THOSE GIVEN IN LESSON 9 OF THE STUDY PACK

LESSON EIGHT

MISCELLANEOUS TAXES

INSTRUCTIONS

- Assigned Reading. Read study text given below.
- Complete the Reinforcing Questions at the end of the lesson.
- Compare your answers to the models given in the revision section of the study pack.
- Study text

OTHER TAXES

In lesson 1 we discussed the importance of taxation as a means of raising revenue for the government to finance public expenditure. We also discussed the two criteria of distributing the tax burden of a country, namely the ability to pay approach and the benefit approach. Under the ability to pay approach people should pay taxes according to their stated taxable capacities. Under the benefit principle, the state was regarded as a market for public goods and services, and those who benefit from the consumption of such goods and services should be made to pay for them.

In order to collect enough revenue and in the application of the benefit principle, many tax systems are made up of many different taxes. This ensures that the system has a wide base or a wide net which covers almost all the citizens of the country. In that way almost everyone is made to contribute to meet the country's revenue needs. Apart from the major taxes such as income tax and value added tax the government imposes other taxes, which are examined below.

Custom and Excise Duties

Customs duty is tax paid on the importation or exportation of goods. Ad valorem duties are assessed on the c.i.f. value of the goods, that is a percentage of the value of the goods based on the aggregate of the original cost, insurance, freight, and other charges incurred up to the point of entry. There are various rates of duty which generally depend on the classification of goods. For example luxury or substitutable goods would attract a higher rate of duty than essential goods. Some goods may be exempted from duty.

Excise duty is tax imposed on various commodities that are manufactured locally. The duty may be intended to raise revenue and/or discourage the consumption of commodities that are considered to be harmful e.g. alcohol, tobacco etc. Excise duty belongs to the class of indirect taxes which lack announcement effects, and which can therefore be implemented easily without resentments.

CUSTOMS DOCUMENTS

1. Customs Entry:

   It is the form used to fill all the details relating to goods being imported or exported. It is commonly known as C.63. It shows the following details.

   a) Owner of the goods and his details.
   b) Clearing and forwarding agent (if any) and his address.
   c) Cost of the goods
   d) Country of origin
   e) Country of destination
   f) Description of goods
   g) Duty payable on the goods
   h) VAT payable on the goods

2. Bill of lading:

   It is the ownership certificate of goods being transported from one country to another. It is used to identify who owns the goods on board a ship or plane. For air carriage, the bill is known as an airway bill.

3. Clean Report of Findings (CRF)

   It is a certificate issued by a pre-shipment inspection company. It is used to show that the goods are fit for importation and also gives the value of the goods. This value is important because it is used to calculate duty payable on the goods.

4. Purchase Invoice:

It is the purchase transaction document issued by the seller to the importer. It shows the selling price and details of the seller. If the goods are acquired free of charge, the value on the CRF is considered.

5. Port Release Order:
   It is issued by the Kenya Ports Authority to allow the release of the goods from the port. This helps in avoidance of theft of goods while at the port.

6. Import Declaration Form (IDF)

   It is a form issued to a person who intends to import goods. It is issued on payment of a fee known as the IDF fee or the Government of Kenya (GOK) fee.

7. Customs Receipts:

   These are vouchers issued by the customs department on payment of any duties payable, customs charges and VAT on imported goods.

BOND SECURITY

A Bond is a written agreement between a person and the commissioner of customs and Excise, whereby the person promises to pay an amount equal to the duty on goods in case any condition in the agreement is breached. Once a bond is written it is guaranteed by a financial institution and the bond acts as the security for he duty on goods. Bonds can be used as security in the following cases:

a) Goods in a Bonded Warehouse
b) Goods in Transit
c) Goods for use in Manufacturing Under Bond

WAREHOUSING

A Warehouse is a place or structure use for storage of goods. For purposes of customs, warehousing refers to the storage of imported goods pending the payment of customs duties and VAT on such goods. For any goods to be taken from the warehouse, the necessary duties and warehouse rent must be paid. There are two types of warehouses for the purposes of customs.

a) Bonded Warehouse
   This is a warehouse used to store goods whose duties, VAT and other charges are secured by a Bond. These warehouses are owned privately by persons Licenced by the customs and Excise Department. They include Bonded oil installations used to store petroleum products.

b) Customs Warehouse
   They are owned by the customs and Excise department and are used to store goods that have not been claimed by the importers.

REASONS FOR WAREHOUSING

a) Marketing:
   An importer may decide to warehouse his goods if he does not have ready market for them. This will allow him to market them or find a convenient way of disposing them.

b) Payment of duty in Piecemeal (Bit by bit):
   When a person does not have sufficient funds to pay for his duties he may warehouse the goods so as to pay the duties in instalments. In this case, the person will take goods from the warehouse in small quantities and pay duty on the quantities taken.

c) Difficulties in accessing the destination of the goods:
   Goods may be warehoused if their destination cannot be accessed eg. due to war, floods etc.

d) Convenient storage facility:
Goods may be warehoused for storage purposed only. This is usually the case with petroleum products which are stored in Bonded Oil Installations (tanks) after refinery.

e) Price Speculation:
Goods may be warehoused with the hope of price improvement.

CALCULATION OF CUSTOMS DUTIES

- Free on Board (FOB) Value:
  This is the Invoice price of the goods or the price on pre-Shipment Inspection (whichever is higher).

- Freight:
  It is the cost of transporting the goods from outside Kenya to Kenya.

- Insurance:
  It is the cost of Insurance cover on the goods while being transported to Kenya

- Cost Insurance Freight (CIF) Value:
  It is the cost on which duty is calculated. It is calculated as follows: CIF = FOB + Insurance + Freight

- Duty:
  It is calculated as a percentage of the CIF value. Duty = x% x CIF

- VAT (on Imports)
  It is calculated on CIF value plus Duty. VAT = 16% x (CIF + Duty)

RESTRICTIONS AND PROHIBITIONS OF GOODS PROHIBITED GOODS

These are goods, the importation or exportation of which is not allowed:

Examples of prohibited goods.

Prohibited imports:

a) Obscene or indecent prints, paintings, books or cards include electronic media.
b) False or counterfeit money.
c) Articles marked with the following:
   - Armorial ensigns (coat of arms) without authority
   - Manufactured articles bearing the name, address or trademark of any manufacturer or dealer in Kenya i.e. contrabands.
   - Firearms or ammunitions imported by post.

PROHIBITED EXPORTS

a) Firearms and ammunitions exported by post
b) Human bones
c) Wood, charcoal and timber
d) Ivory and rhino horns
e) Products related to endangered species.

RESTRICTED GOODS

These are goods the importation or exportation of which is prohibited except in accordance with the condition under any law regulating such importation or exportation. They include the following:

Restricted Imports

a) Traps to kill or trap game animals.
b) Tear gas and any device designed to expand tear gas.
c) Postal franking machines.
d) Sound moderators (silencers) to be used in fire arms.
e) Articles bearing boy scouts/girl guides badges.

4 .Restricted Exports

a) Medicaments not manufactured in Kenya.
b) Motor vehicle parts and accessories not manufactured in Kenya.

Stamp Duty

Stamp duties are chargeable in respect of certain legal documents as specified in the stamp duties Act. In order to enforce the collection of stamp duty legal instruments which have not been duly stamped are inadmissible as evidence in any civil proceeding and may not be registered or legally enforced as evidence of ownership.

Liability for stamp duty arises if the legal instruments relates to property situated in Kenya. Duty is payable within 30 days of the execution of the instrument. Stamp duty is levied on the following instruments:

a) Partnership deeds
b) Hire purchase agreements
c) Lease agreements
d) Bills of exchange and promissory notes
e) Mortgage, bond, debenture or covenant etc

Air passenger Service Charge

This is levied on all passengers embarking at an airport on an external journey at the rate of 20 US dollars, and at the rate of Kshs.50 for passengers embarking on an internal journey. Transit passengers and children below the age of 2 are exempted. With effect from 1.7.'93 the charge for external journey made by Kenya citizens can be paid for in the Kenyan currency.

Capital Gains Tax

This was suspended with effect from 14.6.'85.

Estate and Death Duties

No taxes or duties arising on property passing on the death of an individual to a beneficiary.

Road Toll Tax

This is levied on motor vehicle owners or operators for the use of roads. The rate of tax varies according to the size of the motor vehicle. This tax has now been replaced by Road Maintenance Levy which is loaded on to the cost of fuel.

REINFORCING QUESTIONS

QUESTION ONE

Explain why it may be necessary for a good tax system to have a wide base.

QUESTION TWO

Argue the case for and against a single tax system.

(December 1996 Question 5)

QUESTION THREE

a) Write brief notes on the following:

i. Stamp duty; (6 marks)

ii. Tax matters relating to Export Processing Zones. (6 marks)

(Total: 12 marks)

CHECK YOUR ANSWERS WITH THOSE GIVEN IN LESSON 9 OF THE STUDY PACK

COMPREHENSIVE ASSIGNMENT No.4
TO SUBMITTED AFTER LESSON 8

To be carried out under examination conditions and sent to the Distance Learning Administrator for marking by the University.

EXAMINATION PAPER. **TIME ALLOWED: THREE HOURS.**
ANSWER ALL QUESTIONS

QUESTION ONE

(a) A person who registers for VAT must maintain certain records to satisfy the VAT regulations. Give ten examples of such records that must be kept. (10 marks)

(b) A trader who is registered for VAT purposes has made the following supplies to Lulai Ltd.

Date	Rate Goods		VAT Gross	
		Ksh	**Ksh**	**Ksh**
25.1.2006	Zero rated	3,000	-	3,000
3.2.2006	Standard rate	1,200	216	1,416
5.3.2006	Exempt	450	-	450
22.3.2006	Standard rate	1,600	288	1,888
2.4.2006	Standard rate	2,500	450	2,950
10.4.2006	Standard rate	2,000	360	2,360
		10,750	1,314	12,064

The trader has received the following payments on account of these invoices from Lulai Ltd.

	Ksh
15.4.2006	1,276
11.5.2006	1,000
20.5.2006	1,000

Lulai Limited was the subject of a **creditor voluntary winding up** and the appropriate resolution was passed on 29.5.2006. Assume that all the creditors for bad debt were paid.

Required
Calculate the amount of bad debts relief claimable by the trader for VAT purposes. (10 marks)
(Total: 20 marks)

QUESTION TWO

(a) State the advantages and disadvantages of VAT.
(b) Would it be possible for the Government to increase revenue by lowering the rate of VAT?

QUESTION THREE

(a) Otieno has a market stall in Village Market selling fruits, vegetables and other foodstuffs as well as a high class butchery. He started trading on 1st December 2005 and anticipates that his turnover will be as follows:

	Shs.
One month ended 31st December 2005	224,000
Quarter ended 31st March 2006	942,000
Quarter ended 30th June 2006	845,000
Quarter ended 30th September 2006	1,048,000

Assume that the amounts accrue evenly.

Required

Advise Otieno if he should register for VAT and if so, when the Commissioner should be notified. (10 marks)

(c) Lillian Wanjiru's input tax and supplies made in the quarter to 31st December 2006 are analysed as follows:

i)	Input tax on taxable supplies	180,000
ii)	Input tax on exempt supplies	165,000
iii)	Non-attributable input tax	192,000
iv)	Value of taxable supplies	1,250,000
v)	Value of exempt supplies	540,000

Required

Calculate the deductible input tax that Lillian should have attributed to her. (10 marks)

(Total: 20 marks)

QUESTION FOUR

Explain the meaning of the following terms as appearing in the respective tax legislation:

a) Excise duty; (2 marks)
b) Local committee; (2 marks)
c) Designated primary society; (2 marks)
d) Bonded warehouse; (2 marks)
e) Taxable person; (2 marks)
f) Zero-rated; (2 marks)
g) Non-resident; (2 marks)
h) Exempt income; (2 marks)
i) Registered home ownership savings plan; (2 marks)
j) Commercial vehicle; (2 marks)

Explain the meaning of the following terms as used in respective tax legislation:

i. Bond Security
ii. Single business Permit
iii. Customs bonded warehouse
iv. Stamp Duty
v. Tax free Remuneration

END OF COMPREHENSIVE ASSIGNMENT No.4

NOW SEND YOUR ANSWERS TO THE DISTANCE LEARNING CENTRE FOR MARKING

CUSTOMS & EXCISE TAX

a) Assigned reading.
b) Complete the reinforcing questions at the end of the lesson.
c) Compare your answers to model answers given in Lesson 9 of the Study Pack.
d) Study Text

CONTENTS

Introduction

The Customs and Excise Department is the largest in terms of revenue contribution and manpower requirement of the four revenue generating departments of Kenya Revenue Authority. The Customs and Excise Act (CAP 472, laws of Kenya) is charged with the responsibility of controlling imports and exports, enforcing prohibitions and restriction and collecting revenue on both imports and excisable goods.

IMPORTING INTO KENYA

Imports to Kenya can be entered under any of the following categories.

a. For direct home use
b. For warehousing
c. For use in a bonded factory
d. For transit
e. For temporary importation
f. For use in an export processing zone facility.

REQUIREMENTS OF IMPORTATION

Other than Pre-Shipment Inspection and production of a clean report of findings (CRF – See next page) the next requirement for clearance of imports are a declaration to Customs on prescribed forms and payment of duty and VAT or execution of guarantees (bonds). Guarantees covering amounts of duty and VAT payable on consignments is required for imports in a bonded warehouse, bonded factory, for transit, temporary importation into an EPZ facility.

In all these cases, these guarantees are discharged on application and production of proof that the imports have been transited or entered into bonded factory as the case maybe. For temporary importation of vehicles, *Carnets de passage* are accepted as sufficient guarantees for duty and VAT payable on such imports.

Guarantees in the form of bonds are required for temporary importation of vehicles originating from within the East Africa region. This preferential arrangement applies only to vehicles registered within the region.

Pre-Shipment Inspection

The government of Kenya has contracted three companies to conduct pre-shipment inspection on all imports. Only some categories are exempted from this requirement. The table below shows inspection zones and companies responsible for goods originating from those zones.

S.G.S

Africa All Counties, Asia, Afghanistan, India, Malaysia, Sri Lanka, Bangladesh, Indonesia, Maldives, Taiwan, Bhutan, Japan, Mongolia, Thailand, Brunei, Kampuchea, Nepal, Vietnam, Burma, Korea, North Pakistan, China, Korea South, Philippines, Hong Kong, Laos, Singapore.

Bureau Veritas

Europe All counties except Ireland and United Kingdom
Asia, Bahrain, Jordan, Qatar, Yemen, Iran, Kuwait, Saudi Arabia, Iraq, Lebanon, Syria, Israel, Oman, U.A.E.

COTECNA

America All countries, Oceania All countries, Europe, Ireland and United Kingdom.

All imports into Kenya of Motor vehicles, used clothing and apparel are subject to pre-shipment inspection. Also, subject to pre-shipment inspection are all other imports whose F.O.B. value exceeds US$2,000, except the following:

a) Goods destined to approved duty free shops;
b) Goods destined to approved Export Processing Zones enterprises;
c) Goods destined to approved enterprises manufacturing goods under bonds;
d) Unset precious stones or precious metals in bullion form;
e) Accompanied or unaccompanied used personal effects;
f) Objects of art;
g) Explosives and pyrotechnic products;
h) Ammunition, weapons or implements of war imported by the government;
i) Live animals,
j) Current newspapers and periodicals (daily and weekly)
k) Household and personal effects including motor vehicles, provided such motor vehicles qualify for exempt entry under items 8 (3) or 8 (4) of the Third Schedule to the Act;
l) Post parcels, excluding goods imported for trade;
m) Gifts or donations by foreign governments or international organisations, to foundations, charities and recognised humanitarian organizations.
n) Commercial samples of no commercial value;
o) Crude or refined petroleum and petroleum products;
p) Personal gifts sent by foreign residents to their relatives in Kenya for their personal use, but excluding motor vehicles;
q) Gifts and supplies for use by diplomatic and consular missions and to United Nations Organisations; and
r) Urgent small shipments whose F.O.B. value does not exceed US$10,000,000 imported through a licensed courier service company.

Visiting Kenya

Various exemptions from import duty and VAT are allowed on imports of personal and household effects to those who are visiting Kenya or changing their residence from another country to Kenya. These exemptions are covered by the Custom & Excise Act under the third schedule Part B paragraph 8.

Your exemptions

Goods covered by these exemptions must be: -

a) The property of and accompany the passenger, or are imported within 90 days of the date of arrival.
b) For the personal or household use of the passenger in Kenya.
c) Of such kind and in such quantity as the proper officer (Customs Officer) may allow.

Generally, exemptions will be granted on the following items if imported as accompanied baggage:

a) Spirit (including liquors) not exceeding one litre or wine not exceeding 2 litres.
b) Perfume and toilet water not exceeding in all one litre, of which not more than a quarter may be perfume.
c) Cigarette, cigarillos, cigars, cheroot, tobacco and snuff not exceeding in all 25o grammes in weight.
Exemptions do not however, apply to the following items:
a) Fabrics in the piece.
b) Any trade goods, or goods for sale or disposal to other persons.
c) Aircrafts or vessels of all kinds.
d) Motor vehicles under temporary importation or those on transit. *Exemptions for those arriving in Kenya for the first time:*

In order to qualify for exemption given under this category:

e) One must have attained the age of 18 years.
f) One should not have been granted any of these exemptions before.
g) One must not have resided in Kenya before arrival other than on temporary resident visa. *Exemptions under this item comprise of the following:*
h) Wearing apparel;
i) Personal and household effects which were for personal or household use in the former place of residence.
j) One motor vehicle (excluding buses and minibuses or more than 13 passenger and load carrying vehicles of load carrying capacity exceeding two tonnes) owned and used outside Kenya for at least 90 days (excluding period of voyage). If the engine capacity of the motor vehicle exceeds 2,5000cc and the value exceeds Kshs.200,000, duty is payable on the difference between the value and Ksh.200,000/-.

Exemptions for returning residents

Similar terms of exemptions also apply to returning residents if they have been residing outside Kenya for a period of at least two years and have neither been granted an exemption nor resided in Kenya for an aggregate 90 days within the two years immediately proceeding their arrival.

Exemptions for those visiting Kenya:

Those making a temporary visit to Kenya not exceeding 3 months are exempted from duty on the following:

k) Non-consumable goods for personal use during the visit which are intended to be taken out on departure.
l) Consumable provisions and non-alcoholic beverages in such quantities and of such kind as are consistent with the visit.

Prohibited and restricted goods

A list of goods, which are prohibited or restricted, can be found in the eighth schedule of the Customs and Excise Act (CAP 472). Restricted goods in this case refers to goods whose importation, carriage or exportation is subject to certain specified conditions.

The eighth schedule is reproduced here below.

Eighth Schedule

Prohibited and Restricted Goods.

Part A – Prohibited Imports

1. All goods the importation of which is prohibited under this Act or any law for the time being in force in Kenya.
2. False money or counterfeit currency notes or coins, and any money not being of the established standard and weight of fitness.
3. Indecent or obscene prints, paintings, books, cards, lithographs or other engravings, and any indecent or obscene articles.
4. Matches in the manufacture of which white phosphorous has been employed.
5. Any article marked, without proper authority, with the Armorial Ensigns or Coat of Arms of Kenya, or having ensigns or arms so closely resembling them as to be calculated or deceive.
6.

   a) any advertisement or statement intended to promote sale of medicine, appliance or article for the alleviation or cure of tuberculosis, or of cancer or of any venereal disease affecting the generative organs or functions, or of sexual impotence, or of any complaint or infirmity arising from or relating to sexual intercourse in or of humans;

      Provided nothing herein shall apply to a book, document or paper published for the advancement of medical science and intended for use of a government department or registered medical practitioner.

   b) Any medicine, appliance or article to which is affixed an advertisement or statement referred to in paragraph one (i) or to which such an advertisement or statement relates.

7. Distilled beverages containing essential oils or chemical products which are injurious to health, including thujone, star anise, benzoic aldehyne, salicylic esters, hyssop and absinthe: Provided that nothing herein contained shall apply "Anise" and "Anisette" liqueurs containing not more than 0.1 per centum of oil of "Anise" and distilled from either Pimpinella anisum or the star of Anise allium verum.
8. Manufactured articles bearing the name, address or trade mark of any manufacturer or dealer, or the name of any place in Kenya, calculated to impact to those articles a special character of Kenya manufacture and which are not of that manufacturer.
9. fire arms and ammunition of all types and other articles having the appearance of lethal weapons imported by post.

Part B – Restricted Imports

1. All goods the importation of which is for the time being regulated under this Act or any law for the time being in force in Kenya.
2. Tear gas and any other similar lachrymatory substance (whether in liquid or gaseous form), except under and in accordance with the term of a written permit granted by the Minister responsible for Home affairs.
3. Portable spirits unless in respect of each consignment of spirits there is produced a certificate of age use in the country of production or shipment by such official authority as may be acceptable to commissioner showing that the spirits have been stored in wood for a period of not less than four years. Provided that: -
   a) the commissioner may accept in place of a certificate of age a sworn declaration to the same effect that the blender or exporter o the spirit in respect of all shipments made within a period of twelve months from the date of such declaration;
   b) no certificate of age or declaration shall be necessary in respect of portable spirits which the commissioner is satisfied are: -
      a. Alcoholic bitters, liqueurs, cordials and similar alcoholic mixtures
      b. Gin, Geneva, Holland's schnapps, rum or nay other similar portable spirits.

c. Spirits imported for medical, industrial or specific purposes

1. Postal franking machines, except under and in accordance with the terms of written permit granted by the Managing Director of the Kenya Post and Telecommunication Corporation.
2. Traps capable of killing or capturing any game animal except under and in accordance with the terms of a written permit granted by the Chief Game Warden.
3. Articles bearing Boy Scout or Girl Guides badges, tokens or emblems, except in accordance with the terms of a written permit granted by the Boy Scout or Girl Guide Commissioner.
4. Sound moderators or silencers capable of being fitted to a firearm as defined in the Firearms Act, except under and in accordance with the terms of a written permit granted by the Chief Fame Warden.
5. Unwrought precious metals, and precious metals which are not manufactured or made into any article of commerce, from Zaire, Rwanda or Burundi whether to be imported in transit or for transhipment or otherwise except under an in accordance with a written permit granted by the Minister.

Part C – Prohibited Exports

1. All goods the exportation of which is prohibited under this Act or any law for the time being in force in Kenya.
2. Firearms and ammunition of all types and other articles having the appearance of lethal weapons exported by post.

Part D – Restricted Exports

1. All goods the exportation of which is regulated under this Act or any law for the time being in force in Kenya.
2. The following goods shall not be exported in vessels of less than ten tons registered –
   i. warehoused goods;
   ii. goods under drawback;
   iii. goods for transhipment
1. The following goods shall be exported only after the written consent thereto of the Permanent Secretary to the Treasury has been obtained:
   a. Medicaments (including veterinary medicaments) not manufactured in Kenya;
   b. Motor vehicle components, parts or accessories not manufactured in Kenya.

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LESSON NINE

REVISION AID

KASNEB SYALLBUS

OBJECTIVES

To examine candidates' knowledge of the theory of public finance, the Government's fiscal measures, the raising of public revenues, and principles, law and practice of taxation and elementary knowledge of the principles and law of taxation.

CONTENT

Theory of Taxation. Why governments levy taxes. Principles of an optimal tax system. Comparative tax systems.

Classification of Taxes. Direct taxes, indirect taxes, progressive taxes, regressive taxes.

Different types of taxes: Taxes on income, taxes on capital,taxes on wealth taxes on consumption/expenditure.

Budgetary and Fiscal measures: Revenue motive, other wider objectives and implications, social aspects of taxation.

Effects of taxes on business decisions, household decisions, savings and investments decisions, risk-taking decisions, debt decisions.

Incidence of taxation.
Taxable capacity.
Tax Powers and Rights to Revenue; central government, local government.

Elements of Income and Corporation Taxes; Income liable to tax. Taxation of individuals, Partnerships, Corporations, Co-operatives, other business units.

Determination of taxable income, tax computations, deductions allowed. Deductions not allowed, capital and annual allowances.

Taxation at source, withholding taxes, the PAYE system, allowances and reliefs Returns, Notices, assessments, objections, Appeals, Reliefs for mistake, Collection, recovery and repayment of tax, offenses and Penalties.

Other Revenue Sources, Import Duties, Excise Duties, Sales Taxes, Value Added Tax, Export Taxes, Stamp Duties, Royalties, Property Rates, Taxes on Motor Vehicle Transport, Poll Taxes, Community Charges, Taxes on other outlays and services, licenses and duties, Local Authority Service Charges.

MODEL ANSWERS TO REINFORCING QUESTIONS

LESSON 1

QUESTION ONE

This question requires one to aknowledge whether or not the various attributes of a good tax system are compatible with each other. Briefly the principles are:

a. Simplicity.
b. Taxable capacity
c. Administrative efficiency
d. Neutrality.
e. Convenience
f. Equity. (Details apparent in the text).

It may not be possible to accommodate all the attributes. For this reason, most tax regimes would have a wide base i.e. would comprise various forms of taxation. A single tax system is the simplest, but it may not have all the attributes mentioned above. With many taxes, the merits and demerits of each tax, and in certain of their effects, correct and balance one another. A single tax system will not bring in enough revenue, and will lead to a very bad distribution of the burden of taxation.

There may not be objective parameters to measure some attributes like equity and taxable capacity, and whether a tax is equitable or not would greatly depend on individual circumstances.

For example, it may be argued for the sake of equity, for people earning the same income to pay equal tax. But should a married person with a family of 10 and earning shs 20,000 per month pay the same tax as a bachelor earning shs 20,000? Do they have the same taxable capacity? If they paid equal tax equity would have been achieved at the expense of taxable capacity.

People should be taxed according to their taxable capacities. This would entail carrying out surveys by the government, and imposing different rates of taxation according to different levels of taxable capacities. This can be costly and time consuming, leading to high administration cost and inefficiency.

The solution to the above problem is to design a progressive system of taxation, where people with relatively high incomes pay more taxes and greater proportion of their incomes as tax. Strongly progressive income tax system will create disincentive for hard work, and misallocation of resources. The effective yield would be lower as the system encourages tax avoidance and tax evasion.

It is clear now that a single tax, viewed independently will not possess all the attributes of a good tax system. We should not look at the individual taxes. Any tax system should be looked at as a whole, and the comparative merits and demerits of each tax in the end would offset each other.

QUESTION TWO

A progressive tax is one which takes a larger proportion of an individual's gross income and wealth in taxation. The rate of taxation rises with the increase in income, with the marginal rate exceeding the average rate of taxation.

One of the key objectives of any public finance system is the redistribution of income and wealth. Different individuals of a country will be endowed with varying degrees of resources resulting to an imbalance in the distribution of the national income. Yet another objective would be to clear market imperfections or modify the price system. The movement of price is one factor that determines the actions of consumers and producers. Prices act as a guide to the producers as to the commodities and quantities that they should produce in order to optimise output. However, the pricing system has the following imperfections.

a. It only takes account of effective demand, i.e. demand backed by money. That means that individuals without money or purchasing power cannot satisfy even their basic wants. In a civilised society, all citizens should be capable of fulfilling their basic needs.
b. The production or consumption of some goods or services confer benefits not only to the purchaser but on other people too. These are known as external effects of production or consumption. They are also known as externalities, or neighbourhood effects. e.g. pollution (negative externalities).

In order to enable the relatively less affluent citizens fulfil their basic needs, there must be a redistribution of purchasing power. This is achieved via progressive taxes. These take more from the relatively affluent citizens' income and wealth, and the funds employed in financing social welfare, to subsidise necessities or provide essential goods and services at zero prices to all citizens. This will benefit the low income earners as they will have a greater command for goods and services than would be possible from their incomes and wealth. It follows that a progressive system of tax is beneficial, and the benefit would be more, the steeper the progression.

However, a steeply progressive tax system creates other problems:

a. It may discourage enterprise especially with the wealthy taxpayers, and the sense of responsibility to the less wealthy. In all, it may be a disincentive for hard work. The wealthy taxpayers will be reluctant to work harder, if any addition to gross income earned is taxes punitively.

On the other hand, it may be argued that the low income group who benefit more from subsidised goods and services may not see the need to work harder and improve their lot. This is evident in our country, from the widely held notion that the state has unlimited resources.

The discouragement of hard work result to slow economic growth. Workers will not be motivated to seek higher training and promotion if pay differentials between groups of workers are negligible. This may lead to an exodus of higher achievers out of the country to other countries with less punitive taxes. The state suffers a "brain drain" and loses their contribution.

A further problem would be the high incidence of tax avoidance (exploitation of the loopholes in the tax system to pay little or no tax) and tax evasion (the illegal act of not declaring true income for tax purposes). This leads to a lower yield from taxation.

QUESTION THREE

A direct tax is one where the impact and the incidence of the tax is on one person. The taxpayer pays the tax due direct to the state and cannot shift the burden of the tax. Examples of direct taxes are income tax and corporation tax. An indirect tax is one where the impact is on one person and the incidence on another. The tax is paid to the state by the person on whom it is legally imposed, but is shifted onto another person, say the consumers—when they purchase the commodities taxed.

Examples of indirect taxes are customs and excise duties, and value added tax.

Direct taxes have the following advantages over indirect taxes:

i. They are generally economical in collection. For example with income tax, all employers are bound to collect the tax at source and remit it without delay to the state. The state does not pay the employers for such a service.
ii. They are certain in amount; the taxpayer can easily ascertain the amount to be paid as tax and the state is certain of the yield from direct taxes. On the other hand, indirect taxes on commodities can be avoided, and the yield would depend on the elasticity of demand of the commodities.

iii. Direct taxes ensure equity; if the tax is on a progressive scale, it can be made to fall equitably, on all taxpayers, thereby achieving the redistribution of income and wealth. Further, the progressive scales may have regard to the taxpayers' ability to pay. indirect taxes especially on small incomes and on some commodities tend to be regressive in nature. If indirect taxes are imposed on necessaries, a greater proportion of poor people's incomes will be taken through taxation because they spend a greater proportion of their incomes on these necessaries. The rich will have a relatively lighter burden as they spend a small proportion of their incomes on necessaries. For this reason, although all citizens pay equal taxes the burden is heavier on the poor than on the rich thus making indirect taxes regressive.

iv. Direct taxes are less inflationary. In fact they can be used to curb inflation. Indirect taxes on commodities have the effect of raising the cost of producing the commodities, leading to higher prices. This leads to higher cost of living setting into motion the wage-price spiral. Direct taxes on income reduce the disposable income of the taxpayers thus lowering the effective aggregate demand.

Compared with indirect taxes, direct taxes have the following disadvantages.

i. They are costly to administer; there are many collection points, for example income tax, each individual is assessed separately depending on his taxable capacity. Indirect taxes have fewer collection points leading to administrative efficiency.
ii. They are inflexible and cannot be varied so quickly as indirect taxes. Changes take long to be felt in the economy.
iii. They have a direct effect on income and may therefore discourage effort and enterprise, especially if they are steeply progressive. Indirect taxes lack announcement effect, i.e. people are often unaware that they are paying tax or even how much they are paying.
iv. High levels of income tax reduce the incentive to save. With high indirect taxes, people postpone present consumption in the hope that prices will fall in the future, thus encouraging saving.
v. Direct taxes other than income tax are paid annually as a lump-sum. It may be difficult for the taxpayer to find a lump-sum and gives opportunity for evasion by the submission of fraudulent returns of income.
vi. Direct taxes are not quite useful in effect economic changes, especially the allocation of resources. For example, the government can stimulate and dampen the demand for the goods of a particular industry by varying the level of indirect taxation of such goods. This cannot be possible with direct taxes.

QUESTION FOUR

(a) Role of parliament in the Budgetary process: Parliament participates in the budgetary process through the members of parliament. It is important to note that the Minister for Finance who is also a Member of Parliament heads the budgetary process. The role of parliament may be analysed as follows:

i. Budget Committee
The budget is proposed by a committee, which comprises of professionals and other stakeholders. There is also a parliamentary representation through the minister and his assistant.

ii. Reading of the budget
The budget is presented to the parliament and read by the Finance Minister before the house. This is an important session because it is the point at which the budgetary information is made public. It is important to note that before the budget is read in the house, it is meant to remain confidential.

iii. Budget Debate
The budget is presented as a Financial Bill. The Members of Parliament are then required to critically debate on it. This is a session of discussion on each and every item in the budget.

iv. Budget Voting
The budget is then passed by the parliament. Once it is passed, it becomes a Financial Act. The provisions there-in are then incorporated as amendments in the various Acts affected by the Finance Act. E.g. Income Tax Act, VAT Act etc.

v. Implementation control
It is the role of the Members of Parliament to see to it that the budget provisions are implemented rightfully. This is in line with avoidance of misuse of public funds.

a) **BUDGET DEFICIT**

A deficit arises as a result of the government expenditure being in excess of the government income. It is the reverse of a budget surplus.
The consequences of a budget deficit may be discussed as follows:

i. Lack of Development Projects
In the event of a budget deficit, the government will give priority to the recurrent expenditure as opposed to the Development Projects.

ii. Deflation
The government may result to public borrowing in order to finance the budget. This may cause deflation if not checked.

iii. Industrial Unrest
In some cases, lack of funds may render it impossible for the government to pay its workers well. This may lead to strikes and go slows. E.g. Teacher's strike, Doctor's strike etc.

iv. Low living standards
In the event of a budget deficit, the government may not be in a position to provide essential amenities like water, food, medical care etc.

v. Insecurity
Due to lack of development projects employment level will fall. This may lead to insecurity as most people will result to crime.

b) **SOURCES OF FNANCING**

- Public Borrowing
- Printing of money
- Borrowing from International lenders
- Borrowing from other governments
- Cost sharing
- Increase taxes

c) **EFFECTS**

i. Public Borrowing
This may lead to deflation. Also, the interest on money borrowed is an additional cost to the government.

ii. Printing of money
This can only be used in extreme case, as it is highly inflationary.
Printing of money will also lead to devaluation of Local currency against other currencies.

iii. Borrowing from International lenders
These are bodies like IMF and World Bank.
Their lending is usually subject to conditions. Some of these conditions may not be beneficial to the country as they affect the running of the government and policy implementations.
Repay may also be expensive especially if any interest is charged.

iv. Borrowing from other governments
The government that is giving the fund will usually ask for favours especially in trade. E.g. they may force the other government to buy their products.

v. Cost sharing
It will increase the burden on the tax payers who are already heavily taxed.
The people who cannot afford may be unable to enjoy the facilities like education, medical etc.

vi. Increase taxes
It may lead to over-taxing of the people.
It may encourage tax evasion.
It may not be effective especially if the collection costs also rises.

LESSON 2

QUESTION ONE

a. Year of income means the period of twelve months commencing on 1st January in any year and ending 31st December in that year. Where the accounting period of a person does not coincide with the year of income as defined, then, for the purposes of ascertaining his total income for a year of income, the income of an accounting period ending on that other date,(say 30.6.99) shall be taken to be income of the year of income in which the accounting period ends, i.e. 1999 year of income. This will not apply to individuals earning employment income only.

b. Business includes any trade, profession, or vocation and every manufacture, adventure and concern in the nature of trade, but does not include employment. This will include business carried on partly in Kenya and partly outside Kenya by a **resident person.**

QUESTION TWO

a. Apparent from the text.
b. Apparent from the text.

QUESTION THREE

Answers apparent from the text.

QUESTION FOUR

a)Mr. SHOMA

		Firm A		Firm A
Basic pay p.a. 45000 x 12		540,000	41,000 x 12	492,000
Car benefit – Higher of				
(i) 2% p.m x 600,000 x 12 = 144,000		144,000		144,000
(ii) 1600 cc rating = 69,600				
Total income before H. B		684,000		636,000
add housing benefit @ 15%		102,600		95,400
		786,600		731,400
Less pension contribution				
Lower of				
(i) Actual amount = 5% x 540,000 =	27,000	(27,000)	5% x 492,000 = 24,600	(24,600)
(ii) Set Limit by C.I.T =	210,000		210,000	
Taxable income		759,600		706,800

Tax payable using year 2005 graduated scale

Firm A on Kshs. 759,600

First	121,968	@ 10%	=	12,196.8
Next	114,912	@ 15%	=	17,236.8
Next	114,912	@ 20%	=	22,982.4
Next	114,912	@ 25%	=	28,728.0
	466,704			81,144.0

Or (121,968 x 10%) + (114,912 x 60%)	=	81,144
Surplus (759,600 – 466,704) @ 30%	=	87,868.8
Gross tax		169,012.8
Less: personal relief		(13,944.0)
Net tax		155,068.8

Firm B on Kshs. 706,800

1st	121,968	@ 10%	=	12,196.8
Next	114,912	@ 15%	=	17,236.8
Next	114,912	@ 20%	=	22,982.4
next	114,912	@ 25%	=	28,728.0
	466,708			81,144.0

OR

(121,968 x 10%) + (114,912 x 60%)	=	81,144
Surplus (706,800 – 466,708) @ 30%	=	72,028.8
Gross tax		153,172.8
Less personal relief		(13,944.0)
Net tax		139,228.8

b. According to Sec 16(2)(a)(iv), no deduction shall be allowed in respect of educational fees of employee(s) dependants or relatives.

QUESTION FIVE

a. i. Taxation of pension income for a retired employee.
A retiring employee may be paid his/her pension income as follows:

- A one time lump sum
- Regular payments for a specified period
- A combination of the above.

For periodic income, the first Kshs 180,000 paid out of a registered pension fund or the NSSF will be exempted from tax. Any payment in excess of the tax-free limit will be subject to tax as if it were and employment income. For lumpsum pension income the first Kshs. 480,000 is tax exempt.

ii. Allowable deductions for contributions to a registered scheme. This is the lower of:
(a) Set limit of Kshs. 240,000 p.a.
(b) 30% of pensionable pay
(c) Actual amount contributed.

iii. Procedure for end of year return. See text on Lesson 5.

b. Statutory deductions (required by law)
- Pay As You Earn (PAYE)
- NSSF contribution
- NHIF contribution

c. Omissions constituting PAYE offences
- Failure to deduct tax
- Failure to remit PAYE deducted
- Failure to remit PAYE deducted by due date
- Failure to submit end of year PAYE returns to the Commissioner.

The general penalty for not observing PAYE rules is a fine of 25% tax due with a minimum of Sh 10,000.

In addition, where an employee fails to deduct tax from employees, he will be liable to pay the outstanding tax.

Late payment of tax attracts a penalty of 20 of tax due. In addition, interest at 2% per month or part thereof is charged on late payment of tax.

Tax Implications

QUESTION FIVE

a.

Proposal 1:

1. The director will pay the loan Interest which is not tax deductible. However, at the end of repayment, he will be able to enjoy the house ownership.
2. The house loan will amount to a fringe benefit which will be taxed on the employer.
3. There will be a tax reduction he occupies his house, he will not be enjoying a housing benefit from the company's house hence he will not be taxed on it.

Proposal 2:

1. Issue of preference share for no payment is deemed to be a payment of dividend. (Section 7(i) d of the Income Tax Act). This amount is taxable in accordance with the withholding Tax rates. (Section 35(i) d of the Income Tax Act).

   Dividend Amount
   (10 – 0) × 1,000 = Ksh. 10,000

2. Any dividend that will be payable to Mr. Lewis on the share held will be taxable.

Proposal 3:

The provision of a car will amount to a car benefit. The taxable amount in this case will be the higher of:
2% × the cost of the car (per month)
The prescribed rate based on the engine capacity (cc)

The car benefit Amount will be:

i. Value of 1799cc = Sh. 86,400

ii. Car benefit = Sh. 144,000 = 2% x 600,000 x

12 Proposal 4:

1. Contributions to an unregistered provident fund is not tax deductible.
2. Payment received from an unregistered provident fund is not taxable.

Proposal 5:

1. Payment of medical bills by the employer is a benefit taxable on the employee.
2. Provision of medical service to ALL employees including whole-time service directors is a benefit that is not taxable on the employee.
3. Any benefit that is enjoyed from a medical scheme for directors and executive staff is taxable on the recipient.

Medical benefit:

	Sh.
Claim	30,000
Bills	40,000
	70,000

SUMMARY

1. Proposal 1 reduces his taxable income through the elimination of housing benefit. It also gives him a chance to own property.
2. Proposal 2 increases his taxable income through inclusion of dividend.
3. Proposal 3 highly increases his taxable income by inclusion of the car benefit.
4. Proposal 4 does not change the taxable income. However, it increases his provident fund savings.
5. Proposal 5 increases his taxable income through the inclusion of medical benefit.

b)
1. Proposal 1 seems to be the best option. The Director will be able to own a house at a low cost. The tax on the benefit is payable by the employer through the Fringe benefit Tax.
2. If Mr.Lewis is not interested in owning a house, the Board may consider proposal 4. In this option the company contributes a high amount on his behalf. The amount will be tax free when received by Mr. Lewis.

QUESTION SEVEN

a)
i. Income Tax

Sole Proprietorship:

1. The owner of the business pay tax on his Income which is inclusive of the profit from the business so the business profit is assessed and taxed on the proprietor.
2. Business profit taxed on the proprietor is taxed on graduated tax scales.
3. The proprietor is entitled to a person relief
4. His personal salary is not tax deductible.
5. Audited accounts are not required.

Limited liability form of business

1. The income of the company is assessed and taxed in the name of the company.
2. The income of the company is taxed at the corporation tax rate.
3. There is no relief for limited company.
4. Director's salary and fees will be tax deductible
5. Audited accounts must be submitted.

ii. PAYE for the owners of the business:

Sole Proprietor:
The proprietor income is the business Profit. Since there is no monthly payment, PAYE need not be operated.

Limited Liability form of business:
The directors of the company are employees of the company. The payment will be subject to PAYE.

b)
In this question, the expected profit is Sh 2,000,000 before the payment of Tax and before the payment of Salary to the owner.

Sole Proprietorship:

Taxable income Ksh, 2,000,000
Tax computation:

Ksh.	%		Tax
121,968	10		12,196.8
114,912	15		
114,912	20	(114,912 x 60%)	68,947.2
114,912	25		
(2,000,000 – 466,704)	30		459,988.8
			541,132.8
Less Personal Relief			(13,944)
Tax Payable			527,188.8

Limited Liability Company

	Sh.
Profit as per A/C	2,000,000
Less: Director's salary	
10% × 5,000,000	(500,000)
Taxable Income	1,500,000

Corporation Tax 30% × 1,500,000 = 450,000

Note
The director's salary is subject to PAYE.
Any income the director gets from the company inform of dividends will also be subject to withholding Tax at 5%.

LESSON 3

QUESTION ONE

i. Mortgage interest is deductible subject to an upper limit of Shs.100,000, upon fulfilling the following conditions.

a. The mortgage is provided by any of the prescribed institutions.
b. The mortgage is wholly applied to purchase, or improve a residential house.
c. The house must be occupied by the owner for the whole or a portion of the year.

Shs.100,000 out of the Shs.120,000 would be deductible. W.e.f 1/1/2006, the maximum allowable interest is Kshs. 150,000 p.a (12,500p.m)

ii. The subscription paid to Muthaiga Sports Club is a personal expense which, if paid, for by the employer, produces a taxable benefit. It does not matter whether there are spin-off benefits to the business of the taxpayer. The subscription is now a business expense hence allowable.

iii. Contributions to a pension fund made on behalf of the employee by the employer are not taxable benefit. They are deductible (with effect from 1.1.'90) upto a maximum of KShs.240,000 p.a.

iv. Alimony paid is a non-deductible expense of the person paying it; it is not taxable income of the recipient..

v. Donations are generally disallowed except to research institution undertaking research related to the class of business of the taxpayer. In this case donation to KEMRI would be allowable.

QUESTION TWO

The income of a person is usually measured on a cash basis. For tax purposes income includes non-cash benefits received.

For example, in measuring the income received one does not take into account housing as part of gains or profits arising from employment. This and other non-cash benefits are assigned quantified rates or values and form part of the taxable income.

On the other hand, it may be argued that the receipt of non-cash benefits can be regarded as income received equivalent to the monetary sacrifice one would have to undertake if he had to procure such goods or services in the open market. Following this argument, there will be no difference between an individuals income for tax purposes and income actually received.

QUESTION THREE

a. Only trade bad debts are deductible. Trade debts are those arising from the sale of goods or provision of services on credit in the ordinary course of business. They do not arise from the sale of or provision of services not related to the principal activities of the firm. Specific provisions for bad debts are deductible. General provisions are not deductible.

b. i. A trading company's principal activity is not to lend money. The loan facilities granted to the employee is not a trade debt and any loss arising therefrom is not deductible.

ii. It can be argued the loan was made as a means of boosting sales and the non-recovery regarded as a trade bad debt, which is deductible. The loan was made for the furtherance of business and the default can regarded as a business loss.

QUESTION FOUR

a. Educational Institution—subscription to a golf club for the principal.
b. Bus transport company—Donation to a medical research institute.
c. Consultancy firm—stamp duty on the purchase of share.
d. Hotel—Interest on loan to purchase shares.
e. Supermarket—traffic fines

QUESTION FIVE

i.
W.W.W. Enterprises:

Adjusted Partnership Profit for the year 2005

	Shs	***Shs***
Profit as per A\Cs		1,800,000
Add back:		
Interest: Watu	250,000	
Wote	250,000	500,000
		2,300,000
Less:		
Interest: Wao		(300,000)
Adjusted Taxable Profit		2,000,000

Profit Distribution

	Watu	Wote	Wao	Total
Interest	250,000	250,000	(300,000)	200,000
Profit Share	540,000	540,000	720,000	1,800,000
Total Income	790,000	790,000	420,000	2,000,000

Mr Wote **(Kshs. 790,000)**

Tax Computation: on Kshs. 790,000

First 466,704 (121,968 x 10%) + 114,912(15%+20%+25%)	=	81,144.0
Surplus (790,000 – 466,704) @ 30%	=	96,988.8
Gross tax		178,132.8
Less p/relief		13,944.0
Net tax		164,188.8

ii.
The income of Livewell Foundation shall be exempted from tax. Incomes earned by religious and charitable organisations and educational Institutions approved by the provisions in the Act are not chargable to tax. This is subject to the following conditions:

a) The institutions should be solely for the purposes of aiding or relieving distress to the society or for the purpose of advancement of religion of education.
b) The income there from is expended in Kenya.
c) The institution is in service of the public.

iii. Answer apparent from the text (iii) Mrs Mjini

	Sh.
Profits – year 2003	200,000
Profits – year 2005	50,000
	250,000
Add back consumption	60,000
	310,000
Less year 2004 loss	(40,000)
Net income	270,000

	1st Kshs. 121,968 @ 10%	12,196.8
Tax liability on Kshs. 270,000	next Kshs. 114,912 @ 15%	17,236.8
	236,880	
	(270,000 – 236,880) @ 20%	6,624.0
	Gross tax	36,057.6
	Less: p/relief	(13,944.0)
	Net tax	22,113.6

iv.
New Plastic Ltd:
According to s. 15.2 (n) of the Income Tax Act Cap 470:
"Expenditure incurred by a person for the purposes of a business carried on by him being

i. expenditure of a capital nature on scientific research; or
ii. expenditure not of a capital nature on scientific research; or
iii. a sum paid to a scientific research association approved by the commissioner; or
iv. a sum paid by the university, college research institute or other similar institution approved by the commissioner for purposes of research."

Then such a expenditure shall be allowable against business income.

Note
This question requires that the answer to be given as a memorandum. In this case, the student should write an official letter and the content should be the matters above. It should be addressed to the tax payer in question. It should also have the letter head Hesabu Tax Consultancy and should be signed at the end.

LESSON 4

QUESTION ONE

MR HANDA

CHARGEABLE PROFITS FOR 2005 YEAR OF INCOME

	Shs	Shs
Net profit as per accounts		1,210,700
Add back:		
Under-valuation of closing stocks	51,111	
Household goods at cost	40,000	
Rent, rates and taxes—Customs duty (note 1)	8,500	
Household expenses (note 2)	42,000	
Income tax (note 2)	130,000	
Advertisement—signboard	10,000	
Legal and professional fees		
— Tax appeal (note 4)	10,000	
— Criminal (note 4)	8,500	
Reserve for bad debts (note 5)	23,000	
Depreciation	151,600	
Purchase of machinery (note 7)	10,500	
Interest on loan to purchase shares (note 9)	20,800	
Gifts and presents	8,400	
Medicine and expenses of proprietor (note 9)	12,000	526,411
		1,737,111
Less Non-Taxable incomes:		
Profit on sale of house	(250,000)	
Bad debt recovered (note 5)	(15,000)	
Gross dividends (note 10)	(18,000)	
	(283,000)	
Less under-valuation of opening stock	(400,000)	
Selling price of goods drawn	(50,000)	(733,000)
		1,019,111
Less Wear and Tear deductions		(108,000)
Taxable income		896,111

Notes

1. The purchase of goods used by family members is a private expense thus should be added back to the net profit as disallowable deduction.
2. Customs duty and sales tax are regarded as part of the capital expenditure related to the purchase of the machinery; capital expenditure is non-allowable against income as set out in Section 16 of the Income Tax Act.
3. The signboard advertisement is subject to wear and tear deduction. It is expense of capital nature.
4. The expenses are not wholly and exclusively for the business thus are not allowable. The suit and criminal case are legal expenses incurred in defending a breach of law whereas the appeals relates to income tax which is not allowable.

5. (a)The reserve for bad debts is like a general provision for bad debts and only specific provisions are deductible.

   (b) Bad debts, previously non-allowable, are not liable to taxation when recovered.

6. Wear and tear deductions replace depreciation when computing taxable income.
7. Purchase of machinery is considered a capital expenditure
8. Personal expenses are not chargeable against business income.
9. The total income of a taxpayer is ascertained according to a specified source of income. Expenses related to a particular source are charged against its revenue. The interest on loan to purchase shares should be deducted from investment income.
10. Withholding tax is a final tax for individuals.

QUESTION TWO

DR AND DR (Mrs) BIDI

PRACTICE INCOME FOR 2005 YEAR OF INCOME

	Shs	Shs
Net income as per account		480,045
Addback:		
Repairs and maintenance:		
Addition to surgery room	126,900	
Electrical wiring	16,980	
Income tax paid	58,000	
Donations to heart fund	6,660	
Interest on loan to purchase shares	18,600	
Travelling and subsistence:		
Air fare	60,000	
Boarding	80,000	
Private motoring expenses	21,900	
Professional fees - tax appeal	7,500	
Bad debts: Fixed deposit account	100,000	
Loan to insolvent supplier	20,000	
Book debts take over	18,000	
General provision for bad debts	30,000	
Bank charges: mortgage interest	65,000	
Depreciation	190,700	820,240
Less:		1,300,285
Rental income	30,000	
Net income from milk sales	6,000	
P.O.S.B. interest	8,500	
Dividends	10,000	
Sale of furniture proceeds	90,100	
Fixed deposit interest	126,900	
Capital deductions	132,300	403,800
Adjusted practice income		896,485

TOTAL INCOME

Practice income	896,485
Rent income	30,000
Total	926,485
Less: mortgage interest (lower of 100,000 and 72,000)	72,000
Net taxable income	854,485

NB: dividends and interests are subject to 5% and 15% final w/T respectively.

QUESTION THREE

(a) Strictly speaking, it is not possible to distinguish between farm works deductions and capital deductions.

Capital Deductions refers to allowances granted under the Income Tax Act in respect of capital Investments incurred by a person in the course of business. Farm works refers to such allowances which are granted to a person in the trade of husbandry in respect of capital investments incurred in the construction of Farmworks. It's granted to encourage capital expenditure in agriculture sector. It's a portion of capital deductions.

(b) JOHN MOTURI

Farm-works deductions

Expenditure	**Total cost**	**Sh. '000'** **2005**	**2006**	**2007**
Farmhouse (⅓ x 6m)	2,000	667.667	667.667	666.666
Cattle dip	1,000	333.333	333.333	333.333
Irrigation systems	1,500	500	500	500
Labour quarters	2,400	800	800	800
Milking machinery (Given wear and tear)	NIL	NIL	NIL	NIL

When a farmer takes over farm works (in this case Peter Muturi) from another farmer (John Moturi) he will continue to claim the remaining deductions regardless of the price paid for the farm works

Where farm works are transferred during the year, the deductions for that year in respect of the transferred farm works will be apportioned to the farmer on a time basis.

Wear and Tear Allowance

	Class IV
	12½%
	Shs '000'
Written down value 1.1.2005	Nil
Additions in the year	1,120
	1,120
Wear and Tear	(140)
WDV at 31.12.2005	980

Summary (John Moturi)

	2005	**2006**	**2007**
	Shs '000'	Shs '000'	Shs '000'
Farm works	2,300	-	-
Wear and Tear	140	-	-
	2,440	-	-

Summary (Peter Muturi)

	2005	**2006**	**2007**
	Shs '000'	**Shs '000'**	**Shs '000'**
Farm works	-	2,300	2,300
Wear and tear	-	123	107
	-	2,423	2,407

WDV at 31.12.2005	980
Wear and tear - 2006	(123)
WDV 31.12.2006	857
WTA 2007	(107)
WDV 31.12.2007	750

QUESTION FOUR

(a) **RAI, SAI AND TAI**

ADJUSTED TAXABLE INCOME 2005 YEAR OF INCOME

	Shs.	***Shs***
Net profit as per accounts		398,000
Add back disallowable deductions		
Depreciation	300,000	
Interest on partners' capital:Rai	80,000	
Sai	120,000	
Salary to Sai	160,000	
Commission to partners: Rai	96,000	
Sai	96,000	
Tai	96,000	
Interest expense	80,000	
Gifts, presents and charity	40,000	
Donations to child welfare	200,000	
Interest on loan to pay income tax	20,000	
Legal charges	40,000	1,328,000
		1,726,000
Deduct non-taxable income		
Profit on sale of shares	200,000	
Lottery winnings	340,000	
Dividends (tax at source is final tax)	120,000	(732,000)
Interest income	72,000	994,000
Less: - Loss brought forward	800,000	
- WTD	180,000	
- FWD	120,000	
		(1,100,000)
Adjusted business loss		(106,000)

Notes:

1. Legal charges to Shs. 40,000 to finish the case in the Customs Department is disallowable as we assume the case was for failure to comply with regulations of the Customs Department.
2. We assume that the partners engage in farming thus the gross income from farming is taxable.
3. The profit on sale of shares is non-taxable as this is a capital gain and capital gains tax is currently suspended.
4. We assume that the loss in 2004 has not been offset to date.

(b) **ALLOCATION AMONG PARTNERS**

	Rai	**Sai**	**Tai**	**Total**
	Shs	**Shs**	**Shs**	**Shs**
Interest on capital	80,000	-	120,000	200,000
Salary	-	160,000		160,000
Commission	96,000	96,000	96,000	288,000
Profit (loss) share	(251,333)	(251,333)	(251,333)	(754,000)
	(75,333)	4,667	(35,333)	(106,000)

LESSON 5

QUESTION ONE

(a) **Advantages**

Government

- Improved cash flow as taxpayers make regular payments;
- Less evasion of tax as taxpayers would no longer need to raise a lump sum to pay taxes at the year end;
- Ensures government collects tax before year end.
- Enhances cash flow planning for tax payers as it is paid on piece-meal and determined at beginning of each year.

Advantages:

Taxpayers

- Equity: most individual taxpayers suffer tax through the PAYE system. Corporate tax payers were, prior to the introduction of instalment, only required to make one payment after year end. Instalment tax system has led to corporate taxpayers paying taxes regularly like most individual taxpayers.

- The monetary burden to pay tax is spread out thereby making it easy to observe compliance.

Disadvantages

Government

- Increased administrative work

Taxpayers

- Increased cost of compliance
- Negative impact on cashflows
- Higher risk of non-compliance

(b) - Employees pay taxes on a monthly basis whereas companies pay on a quarterly basis;

- employees are usually not allowed to charge expenses they incur in the course of their employment, whereas companies are allowed to do so. For example, an employee would not be allowed to deduct his training costs but a company would be allowed to do so;
- employees may not have the resources to ensure maximum compliance with the Tax regulations.
- Employees enjoy personal relief unlike body corporate.

QUESTION TWO

The accounting cycle i.e. the period of time taken from the time when income is earned to the time when final payment of tax is due is shorter with the self assessment system.

- As a result of the above the old system entailed a lot of administrative work than the self assessment system.

- Under the self assessment system, a taxpayer would assess and pay his tax liability, whereas under the old system the taxpayer has to be issued with an assessment from the Income Tax Department.

- Both systems entail the completion of a Final Return of Income. However, under the self assessment system, the return incorporates an assessment. No further assessment is issued by the authorities. In the old system a taxpayer would file a Final Return of Income and wait for an assessment to be issued by the authorities.

QUESTION THREE

Compensating tax liability is determined by completing a Dividend Tax Account (see Lesson 5 for details).

Compensating tax effectively increases the tax bill of a company as illustrated below:

	Shs m
Profit before Tax	100
Tax (at 30%)	30
Profit after Tax	70

If the profits after tax are distributed in full the Dividend Tax Account would be as follows:
Assuming a tax refund of Sh 7 Million

DTA

DR			**CR**	
Tax refund		7	b/f	NIL
			Tax paid	30
Dividends	70 x 30/70	30	Compensating Tax	7
		37		37
Total tax = 30m + 7m =		37		

Effective rate = $\frac{37\text{ m}}{100\text{ m}} \times 100\% = 37\%$

LESSON 6

QUESTION ONE

The information that Miss Cecilia Nyemura would like to know regarding notices of objection:

a. Conditions for lodging a normal notice of objection:
   i. The notice of objection must be in writing

   ii. The notice of objection must state the grounds or reasons for objecting against the assessment.

   iii. With effect from 1.1.05, the notice of assessment must be lodged with CIT within 40 days (30 days of notice + 10 days of service = 40 days) together with the return of income and the supporting documents.

b. Conditions for CIT to accept a late notice of objection

   i. The return of income for the year together with the relevant supporting documents have been supported.

   ii. If the lateness is due to taxpayer being absent from Kenya, being sick, or other reasonable cause.

   iii. There is no unreasonable delay on the part of the taxpayer in lodging the late objection.

   iv. Tax due is paid including any late payment interest. The CIT can waive this condition if he is satisfied that the tax due is excessive.

QUESTION TWO

(a)

i. The Income Tax Tribunal is appointed to deal with appeals concerning decisions made by the Commissioner under Section 23 and 24 of the Act.

   Section 23 of the Income Tax Act empowers the Commissioner to direct a taxpayer to disregard those transactions which, in the opinion of the commissioner were designed with a sole objective of avoiding or minimizing tax.

   Section 24 of the Act deals with shortfall distribution of profits. If in the opinion of the Commissioner a company has not distributed as dividends, he may direct that such profit be deemed to have been distributed.

ii. Requirement of a Valid Memorandum of Appeal. Answer apparent from Lesson 6 text.

iii. Payment of tax assessed pending the determination of appeal. Where an assessment is issued and a taxpayer raises an objection, the amount of tax in dispute is stood-over (frozen) pending the determination of the objection. The tax not in dispute is payable immediately or within the period specified in the assessment.

(b) **Mountain Trout Limited**

i. The tax payable on clearing the shortfall is the with holding tax that would be chargeable, had the shortfall been distributed as a dividend.

   Applying a withholding tax rate of 5%, the tax payable by Mountain Trout Limited is
   5% 5% x 6.6 Million=0.33 Million
   20th day of the following month after the month of deducting withholding

   Tax The due date will be 30 days from the date the shortfall is cleared.

ii. If the company fails to clear the shortfall and the Commissioner directs charge to be made to the company, the amount of tax payable will still be 30% of the shortfall. However, the due date for the tax will be deemed to be 12 months after the accounting year-end. The tax will attract the late penalty of 10% of Tax due with a maximum of Sh 1 Million (effective from 1/12004)

iii. As a rule of thumb, the Commissioner permits the retention of 60% of the after tax profits (excluding investment income, which must be distributed in full). However, the Commissioner may allow greater retention in the following circumstances;
- The company intends to incur significant capital expenditure.
- The company is facing liquidity problems and does not have the money to pay dividends.
- The Directors or shareholders do not owe any money to the company
- The company has commitments to repay long term loans.

QUESTION THREE

(a) Section 52(B) of the Income Tax Act requires that every individual chargeable to tax with effect from the year of income 1992 shall furnish to the Commissioner a return of income including a self assessment of his/her tax from all sources not later than the last day of the sixth month.

The return of income together with the declared self-assessment of tax on the declared income shall be prescribed on such a form or forms as shall be prescribed by the Commissioner.

The Commissioner may, where he considers appropriate send to any person to whom Section 52(B) applies (i.e. persons meant to submit self assessment returns) in respect of any year of income, a form or forms to enable that person to furnish the required return; and failure by the Commissioner to send the return form or forms shall not affect the obligation of that person to furnish the required return by the due date.

(b) An individual person assess his/her own income in self assessment thus they can only raise an objection for tax assessed where the CIT intervenes in the following instances:

i. Estimated assessment; Issued by the CIT where:
- He does not agree with the self assessment return submitted
- The taxpayer has submitted a self assessment return without accounts

ii. Additional assessment: CIT receives further information to suggest the person is under-assessed.

Mr. Banu Shah

(i) Total taxable income for 1999

Self	Shs	Shs	Shs (PAYE)
Salary (80,000 for 12 months)		960,000	374,400
Free goods (note 1)		30,000	
Property income			
Rent income (30,000 for 5 months)	150,000		
Less repairs	(11,500)		
Less interest on mortgage (note)	(112,500)	26,000	
		1,016,000	
Housing benefit 15% (5/12)		63,500	
Taxable income		1,079,500	374,400
Wife			
Salary (20,000 for 12 months)		240,000	48,000
Taxable income		240,000	48,000

Notes

1. The free goods of Shs 30,000 to Mr. Banu Shah and the fringe benefits of Shs 4,500 exceed the maximum tax free amount of Shs 240,000 per annum therefore are taxable (Kshs. 36,000 w.e.f 1/1/2006)
2. The medical scheme operated by the company is assumed to be for all employees thus the medical treatment is not taxable.
3. Since Mr. Shah owns more than 5% of the share capital of Letex Limited, he is not a whole time service director and the housing benefit is calculated on 15% of the taxable income i.e. employment income and income from other sources.
4. Mrs. Shah's employment income is separated from the husband and taxed on her.
5. The interest component was Sh 600,000 – 330,000 = 270,000 The allowable interest charges = 5/12 x 270,000.
6. Fringe benefits less than Sh. 24,000 hence not taxable.

(ii) Tax payable

Mr. Banu Shah on Kshs. 1,679,500

	Rate	Shs
1 - 121,968	10%	12,196.8
Next 114,912	15%	17,236.8
Next 114,912	20%	22,982.4
Next 114,912	25%	28,728.0
Balance (1,079,500 – 466,704)	30%	183,838.8
		264,982.8
Less – PAYE		(374,400.0)
- Personal relief		(13,944.0)
Tax refundable		(123,401.2)

Mrs Banu Shah on Kshs. 240,000

	Rate	Shs
1 – 121,968	10%	12,196.8
114,912	15%	17,236.8
Balance (240,000 – 121,968 – 114,912)	20%	624.0
Less – PAYE		(48,000.0)
- Personal relief		(13,944.0
Tax refundable		(31,886.4)

(iii) Form P9 is a Pay As You Earn tax deduction that is maintained for each employee showing monthly gross pay benefits, allowed deductions, PAYE deducted, personal relief and net pay.

LESSON 7

QUESTION ONE

a. The following conditions must be satisfied in order to obtain relief from VAT on bad debts.

i) The claimant must have supplied goods or services for a consideration and must have accounted for and paid tax on that supply.
ii) The claimant must prove insolvency of the debtor.
iv) The debtor must be outstanding for at least 3 years and all reasonable efforts have been made to recover the debt but in vain.

b. Prescribed accounting periods, frequently referred to as tax periods, refer to the period or time interval after which VAT returns must be submitted.

Returns recording VAT payable or carried forward or refundable together with other information will be made with reference to the prescribed accounting period, which in Kenya is one month. The return, duly completed and with the tax due, if any, must be submitted to the Commissioner of VAT by the last working day of the month following the month covered by the return.

c. The term "tax point" refers to the time at which a supply of goods or services is deemed to take place; it is the point at which VAT becomes chargeable.

Tax becomes due and payable, in relation to supply of goods, at the time when:

i) the goods are supplied to the purchaser; or
ii) an invoice is issued in respect of the supply ; or
iii) payment is received for all or part of the supply, whichever time shall be the earliest.

QUESTION TWO

a. i. Zero rated supplies are still treated as taxable supplies, but the rate of tax charged is zero. A registered person making zero rated supplies is therefore fully within the VAT system. This means that he can reclaim any input tax suffered.

ii. An exempt supply is not a taxable supply. A person making exempt supplies only, may not need to register for VAT. Consequently, the supplier will not charge output tax on supplies made and will not be able to reclaim input tax suffered.

iii. Where a person makes both zero rated and exempt supplies he must register for VAT if the supply of zero-rated goods attains the threshold turnover. The input tax suffered on exempt supplies may not be reclaimed. However, the taxable person may claim all input tax if the input tax related to exempt supplies is always less than 5 percent of the total input tax.

b. When a registered taxable person makes a supply (other than a zero rated supply) to another taxable person, he must furnish the purchaser with a tax invoice in order for the purchaser to reclaim input tax.

Information required on a tax invoice:

i) Name, address, VAT registration number of person making the supply;
ii) Serial number and date;
iii) Date of supply if different from ii) above;
iv) Name, address, VAT registration number of person to whom the supply is made;
v) Description, quantity and price of goods or services supplied;
vi) Taxable value of goods or services if different from price charged;
vii) Rate and amount of tax charged on each of those goods and services provided.
viii) Details of cash or other discounts;
ix) Details of whether supply is for cash or credit;
x) Total value of supply and total amount of VAT charged.

QUESTION THREE

(i) Benefits of VAT in the context of a good tax system

a) VAT is usually collected by the government through VAT registered traders. The government does not pay the traders to collect VAT on its behalf. Given the wide scope of VAT, each and every person in the economy is affected. The government is able to reach every person who suffers VAT though a relatively small proportion of the entire population comprises VAT traders.
b) VAT is equitable as the overall liability is determined by a person's expenditure/consumption. Those with a higher expenditure (and therefore more able to pay tax) end up contributing a similarly high proportion of VAT collected.
c) VAT is also equitable where it does not apply, (either through zero rating or exemption) to basic necessities such as foods, medicine, healthcare, agricultural inputs, education, etc. lower income groups spend a high proportion of their incomes on such goods. Consequently, only a small proportion of their expenditure is affected by VAT.
d) VAT is based on consumption in the domestic economy. It's wide scope where accompanied by little leakage results in high revenue yields.
e) VAT is an indirect tax. It is based on a person's expenditure and not income. This minimises the disincentives associated with direct taxation. Its indirect nature means most people who suffer VAT may not know about it or may not be able to quantify how much is paid. For this reason, there is less likelihood of resentment. Resentment of taxation usually leads to high tax evasion.
f) The wide scope of VAT accompanied with minimal exceptions does not distort the working of the market mechanism. In other words, VAT ensures neutrality as consumers in the economy cannot switch their preferences/consumption to avoid taxation.

(ii) **TOUGH LIMITED**

(a) **Vat Account For The Month Of December 2005**

		Shs			***Shs***
Dec	Purchases		Dec	Sales	
1st	16/116(400)(5,600)	308,966	1st	16/116(40)(7,200)	39,724
20th	Purchases		5th	Sales	
	16/116(300)(6,400)	264,828		16/116(80)(7,200)	79,448
			10th	Sales	
				16/116(200)(7,200)	198,621
			25th	Sales	
				16/116(80)(7,200)	79,448
31st	Net VAT payable	43,137	31st	Sales	
				16/116(2,00)(8,000)	220,690
		616,931			616,931

(b) Net VAT is payable on or before the twentieth day of the following month. In this case, Shs 41,717 will be payable to the Commissioner of VAT on 20th January; if 20th January 2006 falls on a weekend or public holiday, the payment should be made on the last working day before that date.

QUESTION FIVE

(a) **4 effects of VAT on business**

i) On registered business - required to keep elaborate records and ensure returns are submitted promptly. Involves some administration costs.

ii) On non-registered business – are not able to deduct VAT charged as input tax meaning that their overheads or production costs will be relatively higher making them less competitive.

iii) Business that buy on credit and sell on cash such as supermarkets enjoy some cash flow benefit as they collect VAT from consumers but need to pay it to the government for a period of up to 7 weeks.

iv) Consumer resistance – Many consumers usually avoid businesses that charge VAT in the belief that their goods and services are made costly by VAT thus the consumers "run away".

(b) Rules relating to Appeals (Answer apparent from Lesson 7 text)

(c) Late payment interest of 2% per month compounded.

		Shs
Penalty – failure to file VAT return	=	10,000
Interest Month 1 = 2% x (300,000)	=	6,000
Interest Month 2 = 2% (300,000 + 6,000)	=	6,120
Total penalty for 6 weeks	=	22,120

(d) **INLAND LIMITED**

Value for duty (landed value	400,000
Import duty @ 35%	140,000
	540,000
VAT @ 16%	86,400
	626,400

Amount of VAT = Shs 86,400

Note

The value for tax in respect of imported goods is the value for duty plus the duty.

QUESTION SIX

(a) and (b) – Answers apparent from the text.

(c) (i)

			Units	Units
March	1:	Opening Stock		15
	1:	Purchases		200
	6:	Purchases		150
				365
	2:	Sales	20	
	10:	Sales	40	
	15:	Sales	100	
	18:	Sales	40	
	23:	Sales	100	(300)
				65

Purchases a/c (exclusive 16% VAT)

(ii)

Date		Sh.	Date		Sh.
March	1 Bank	482,759	March 31	Profit and Loss	896,552
	6 Bank	413,793			
		896,552			896,552

(iii)

Sales a/c
(Exclusive 16% VAT)

Date	Sh.	Date		Sh.
March		March 2	Bank	62,069
		March 10	Bank	124,138
		March 15	Bank	310,345
		March 18	Bank	124,138
March 31 Profit & Loss	965,518	March 23	Bank	344,828
	965,518			965,518

(iv) Bank a/c

Date	Sh.	Date	Sh.
March			
2. Bank	62,069	1. Purchases	482,759
2. VAT	9,931	1. VAT	77,241
10. Bank	124,138	6. Purchases	413,793
10. VAT	19,862	6. VAT	66,207
15. Bank	310,345		
15. VAT	49,655		
18. Bank	124,138		
18. VAT	19,862		
23. Bank	344,828		
23 VAT	55,172		
		Balance	80,000
	1,120,000		1,120,000

(iv) VAT a/c

Date	Sh.	Date	Sh.
March	Input VAT	March	Output VAT
1 Bank	77,241	2 Bank	9,931
6 Bank	66,207	10 Bank	19,862
		15 Bank	49,655
		18 Bank	19,862
VAT Payable	11,034	23 Bank	55,172
	154,482		154,482

NB: input/output VAT = $\frac{16}{116}$ x value inclusive of V.A.T

QUESTION SEVEN

a) VAT position on imported goods and warehoused goods:

Imported Goods:

Goods imported into Kenya are subject to VAT. VAT on such goods is payable when the goods are cleared (allowed) to be used in the local market.

Warehoused Goods:

Goods in the warehouse will be subjected to VAT at the time they are taken out of the warehouse for used in the local market. However, if the goods are taken from the warehouse and then exported then there is no VAT collectable.

b (i)

Dutable value	Sh. 1,200,000
Customs duty (35%)	Sh. 420,000
Taxable value	Sh. 1,620,000

VAT = 16% x Taxable value
VAT 16% x 1,620,000 = Sh. 259,200

(ii)

	Sh.
Dutable value	1,200,000
Customs Duty	420,000
Clearing charges	20,000
Transportation	70,000
Commission (5% x 1,200,000)	60,000
	1,770,000
Mark-up (20%)	354,000
	2,124,000
VAT (16%)	339,840
Selling price	2,463,840

QUESTION EIGHT

a) **Answer Apparent from the text**

b) (i)

Cost of Goods	1,500,000
Customs Duty (20%)	300,000
Dutable value	1,800,000

VAT = 16% x 1,800,0000 = Sh. 288,000

(ii) Cash Price Sh. 96,000
VAT = 16% x 96,000 = Sh. 15,360.

Note: Hire Purchase Interest is a business expense.

(iii)

Cost of vehicle	Sh. 2,500,000
Cash Discount (20%)	Sh. (500,000)
	Sh. 2,000,000

VAT = 16% x 2,000,000 = Sh. 320,000

(iv) Value of Services = Sh. 2,400,000
VAT = 16% x 2,400,000 = Sh. 384,000

Note: For charitable organizations, the Tax may be waived if it is in the public interest to do so.

(v)

Cost of goods	Sh. 1,200,000
Packaging and Transportation	Sh. 96,000
	1,296,000

VAT = 16% x 1,296,000 = Sh. 207,360

QUESTION NINE

Use 16% VAT rate

March 5th :

$$500{,}000 \times \frac{5}{10} = 250{,}000$$

$$\text{VAT Exclusive} = \left[250{,}000 \times \frac{100}{116}\right] \times 1.25 = 269{,}397$$

VAT = 269,397 x 16% = Sh. 43,104

March 8th :

$$\text{VAT} = \frac{16}{116} \times 500{,}000 = \text{Sh.}68{,}966$$

March 9th

$$\text{VAT} = \frac{16}{116} \times 150{,}000 = 20{,}690$$

March 18th :

$$500{,}000 \times \frac{5}{10} = 250{,}000$$

$$\text{VAT Exclusive} = \left[250{,}000 \times \frac{100}{116}\right] \times 1.25 = 269{,}397$$

VAT = 269,397 x 16% =

Sh.43,104 March 20th :

$$\text{VAT} = 750{,}000 \times \frac{16}{116} = \text{Sh.}103{,}448$$

March 22nd

$$\text{VAT} = (2{,}000 \times 100) \times \frac{16}{116} = \text{Sh. } 27{,}586$$

March 25th

$$\text{VAT exclusive} = \left[\frac{80{,}000}{100} \times 70\right] \times \frac{100}{116}$$

$$= \text{Sh. } 48{,}276$$

$$\text{VAT} = \left[48{,}276 \times \frac{130}{100}\right] \times \frac{16}{100}$$

$$= \text{Sh. } 10{,}041$$

March 27th

$$VAT = 75{,}000 \times \frac{16}{116} = Sh.\ 10{,}345$$

PURCHASES

March 1st

$$VAT = 500{,}000 \times \frac{16}{116} = Sh.\ 68{,}966$$

March 4th

$$VAT = 200{,}000 \times \frac{16}{116} = Sh.\ 27{,}586$$

March 4th :

$$VAT = 1{,}000{,}000 \times \frac{16}{116} = Sh.\ 137{,}931$$

March 6th

$$VAT = (200 \times 1{,}500) \times \frac{16}{116} = Sh.\ 41{,}379$$

March 12th

$$VAT - 50{,}000 \times \frac{16}{116} = Sh.\ 6{,}897$$

March 15th

$$VAT = 80{,}000 \times \frac{16}{116} = Sh.11{,}035$$

VAT ACCOUNT

Date			Date		
March 1	Bank	68,966	March 5	Bank	43,104
March 4	Bank	27,586	March 8	Bank	68,966
March 4	Bank	137,931	March 9	Bank	20,690
March 6	Bank	41,379	March 18	Bank	43,104
March 12	Bank	6,897	March 20	Bank	103,448
March 15	Bank	11,035	March 22	Bank	27,586
			March 25	Bank	10,041
			March 27	Bank	10,345
VAT payable		33,490			
		327,284			327,284

ii) The VAT is due and payable on or before 20th April 2002.

LESSON 8

QUESTION ONE

When a tax system has a wide base, it means there are a wide variety of objects of taxation. A tax base is the object of taxation. For example, taxes may be imposed on income, expenditure, wealth, etc.

The principal objective of any tax is to raise revenue. A wide tax base insures a substantial amount of revenue is collected. This is because a wide base of taxation provides many sources of revenue.

In designing a tax system, it is important to adhere to the concept of equity. One way of achieving equitable distribution of the tax burden is to involve as far as possible all the citizens of a country in taking the burden of tax. A wide base provides the wide net that ensures that almost all the citizens contribute towards the tax burden.

The other objective is to use taxation as a fiscal tool to achieve the government's macroeconomic objectives in order to toe an effective fiscal tool, a tax must be directed to the appropriate economic parameters in order to achieve the desired goals.

QUESTION TWO

A single tax system, is a tax system comprising of only one tax. For example, in the colonial times there was the "Hut tax" for all "natives". Such a tax has the following benefits:

a. It is simple to understand and taxpayers are certain of the amount to pay as tax.
b. It is flexible and can be altered to suite the needs of the government.
c. It does not have any adverse allocation effects.
d. It ensures that all citizens contribute towards public expenditure.
e. Because of its simplicity, certainty and a wide net it provides for responsible and honest citizenry.

The drawbacks of a single tax system:

a. It may not be effective as a fiscal tool. It cannot be used to bring about changes in economic parameters such as employment, inflation, allocation of resources, etc.
b. Some aims of taxation, such as regulating externalities cannot be achieved without special purpose taxes. A single tax system will not regulate strong externalities.
c. a single tax system may be regressive in nature because all people may (as in pole tax) be required to pay the same amount of tax regardless of their incomes, or wealth. Furthermore, it may be useful in achieving the redistribution of income and wealth.
d. The application of the benefit approach to equity in taxation, may not be achieved in a single tax regime.
e. A single tax by itself cannot raise sufficient revenue.

QUESTION THREE

i. Stamp Duty

Payment and operation in relation to Stamp Duty is governed by the Stamp Duty Act. Under this Act;

1. Every instrument relating to property ownership is chargeable to Stamp Duty.
2. Every such instrument should be stamped and duty thereof paid within 30 days after it is first executed.

Such Instruments include:

a) Agreement deeds.
b) Title deeds.
c) Bills of exchange and promissory notes.

ii. EPZ

1. The EPZ enterprises are exempt from corporation Tax for the first 10 years.
2. Thereafter, they pay corporation Tax at the rate of 25% for the next 10 years.
3. They are entitled to 100% capital deductions.
4. They are also exempted from paying VAT in their inputs.
5. Exports are zero rated and can claim all input VAT suffered.

MODEL PAST PAPERS

KENYA ACCOUNTANTS AND SECRETARIES NATIONAL EXAMINATION BOARD

CPA PART I

TAXATION I

THURSDAY: 4 December 2000. **Time allowed: 3 hours**

QUESTION ONE

(a) Explain the tax position of the income of a deceased person. (2 marks)

(b) What is 'set-off' tax?

(c) Mrs Ongera works with Anga Ltd. and has provided you with the following information for the year ended 31 December 1999.

1. Pension from previous employment Sh.20,000 per month.
2. Salary Sh.120,000 per month (PAYE Shs.42,000 per month
3. Mrs Ongera and her husband own a company whose taxable income was agreed at Sh.500,000 after charging husband's salary of Sh.250,000 per month (PAYE Sh.60,000 per month).
4. Anga Ltd. Provided a company house to Mrs Ongera in South B, where rent of similar houses was Sh.20,000 per month.
5. Mrs Ongera works over time and her overtime income averages Sh.10,000 per month.
6. Mrs Ongera enjoyed medical benefit of Sh.160,000 during the year. She is a senior manager and the company has medical cover for all its employees.
7. She obtained free consumables from the company as a Christmas gift worth Sh.30,000 during the year
8. Mrs Ongera owns rental property at Komarock Estate and receives Sh.50,000 as rental income per month. During the year, she incurred Sh.60,000 in renovations, repairs and painting before letting the property. She had obtained a mortgage loan from Housing Finance Company amounting to Sh.3,000,000. She paid Sh.900,000 during the year of which Sh.500,000 was principal.
9. Mrs Ongera owns 20% of the shares of Anga Ltd.

Required

i) The taxable income for Mr and Mrs Ongera for year of income 1999 (10 marks)
ii) Tax payable on the income computed above. (4 marks)
iii) Mrs Ongera did not fill her self assessment return form for 1999. State the penalties due, if any. (2 marks)

(Total: 20 marks)

QUESTION TWO

(a) Explain the tax treatment of a farmhouse for purposes of capital deductions. (2 marks)

(b) Sweet Tooth, a grape farmer completed construction of a farmhouse on 2 January 1998 for Sh.12,000,000. Additional expenditure incurred on the same date was as follows:

	Shs
Milking machinery	2,240,000
Irrigation system	3,000,000
Labour quarters	4,800,000
Cattle dip	2,000,000
Sewerage system	1,200,000
Digging terraces	500,000
Farm implements	600,000

On 6 April 1998, Sweet Tooth incurred additional Sh.3,500,000 as expenditure for uprooting old plants and planting others. The uprooted plants were infected by pests. The cost of treating the soil before replacing the old plants amounted to Sh.200,000.

Sweet Tooth sold his farm to Toothache on 1 May 1999 for the following amounts:

	Sh.
Milking machinery	1,960,000
Irrigation system	2,400,000
Labour quarters	5,600,000
Farmhouse	13,400,000
Cattle dip	2,400,000
Sewerage system	1,600,000

The farm implements were considered to be of marginal value and were given to Toothache free of charge. An expert valuer however estimated their value at Sh.50,000. Terraces which had cost Sh.500,000 to dig were destroyed by heavy rains and therefore their value was reduced to zero.

Required

i) Calculate the farm work deduction due to Sweet Toothache for the years 1998 and 1999 (14 marks)

ii) Comment on the treatment of the cost incurred to replace the old plants and the cost of treating the soil. (2 marks)

iii) Comment on any other information not used above. (2 marks)

(Total: 20 marks)

QUESTION THREE

K. Kinyenje Co. Ltd. is a manufacturing cum wholesale business. The accountant of the company has provided you with the following profit and loss account for the year of income 1999.

	Sh.		***Sh.***
Opening stock	1,048,000	Sales	31,752,000
Purchases	14,076,000	Closing stock	2,283,000
Depreciation	2,052,000	Profit on sale of shares ex-dividend	760,000
Directors' remuneration	543,000	Bad debts recovered (specific)	120,000
Salaries and wages	756,000		
General expenses	255,000		
Auditor's fees	210,000		
Reserves	2,250,000		
Bad debts reserve	888,000		
Taxes	129,000		
Interest on loan	1,038,000		
Manufacturing expenses	7,689,000		
Supplies used	1,338,000		
Commissions paid	270,000		
Provisions for dividends	900,000		
Audit fees for tax appeal	100,000		
Preliminary expenses	700,000		
Fire insurance	122,000		
Rental loss	10,000		
Net profit	541,000		
	34,915,000		34,915,000

Additional information provided is as follows:

1. Stock of goods both at beginning and at the end of the year were overstated by 20%.
2. Rental loss analysis

	Sh.	**Sh.**
Gross rent		820,000
Less: Sweeper wages	60,000	
Extension (servant quarter)	400,000	
Painting	80,000	
Mortgage interest	170,000	
Land rates and rent	20,000	
Stone wall fencing	100,000	830,000
Loss		(10,000)

3. Preliminary expenses relate to company formation.
4. Bad debts (specific) are Sh.540,000.
5. Taxes represent VAT paid
6. General expenses include Sh.45,000 for donations and Sh.30,000 contributions to a trade union.
7. The company owned the following fixed assets purchased during the years indicated:

	Year	**Cost Shs.**
Machinery (old) fixed in old building	1998	14,400,000
Computers	1999	3,000,000
Furniture and fittings	1998	1,920,000
New machinery fixed in building	1999	18,000,000
Factory building	1998	12,000,000
Extension to factory building (Brought to use on 1 August 1999)	1999	6,000,000

Required

(a) The adjusted income loss for K. Kinyenje Co. Ltd. for the year of income (17 marks)
(b) The tax payable (if any), indicating when it is due. (3 marks)

(Total: 20 marks)

QUESTION FOUR

(a) Explain the Vat position on imported goods and warehoused goods. (4 marks)

(b) On 31 March 2002, VG Company had VAT due amounting to Sh.120,000 relating to sales for the month of March 2000. The company made the payment on 30 May. State the penalty chargeable for the late payment and the total amount to be paid by the company. (15 marks)

(c) On 10 July 2002. Dubai Merchants imported goods valued at Sh.1,200,000. The customs duty chargeable on these goods was at 35%, clearing paid amounted to Sh.20,000 and transport from Mombasa to Nairobi amounted to Sh.70,000. A commission on the dutable value of the goods paid at 5%.

Required:

i) Determine the amount of VAT payable on the goods. (8 marks)
ii) If the goods were sold on arrival in Nairobi at a mark-up of 20% determine the selling price. (3 marks)

(Total: 20 marks)

QUESTION FIVE

(a) Briefly explain the position regarding hotel accommodation tax? (4 marks)
(b) State and briefly explain the factors that influence tax shifting. (6 marks)
(c) Explain the tax position on "recovery of tax from persons intending to leave Kenya or who have left Kenya? (3 marks)
(d) Time limit to making tax assessments. (7 marks)

(Total: 20 marks)

KENYA ACCOUNTANTS AND SECRETARIES NATIONAL EXAMINATION BOARD CPA PART I
TAXATION I

THURSDAY : 29 May 2001. **Time allowed: 3 hours**

Answer ALL questions. Marks allocated to each question are shown at the end of the question. Show ALL your workings. Any assumptions made must be clearly and concisely stated.

Taxable Employment Benefits - Year 2005

RATES OF TAX (Including wife's employment, self employment and professional income rates of tax). Year of income 2005.

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)

Capital allowances:

Wear and tear allowances

Class I	37.5%
Class II	30%
Class III	25%
Class IV	12.5%

Industrial building allowance:

Industrial buildings	2.5%
Hotels	4.0%

Farm works allowance 33.3%

Investment deduction allowance:

2003 -	70%
2004 -	100%
2005 -	100%

Shipping investment deduction 40%

Mining allowance:

Year 1	40%
Year 2 - 7	10%

Prescribed benefit rates of motor vehicles provided by employer

		Monthly rates (Sh.)	Annual rates (Sh.)
(i)	Saloon, Hatch Backs and Estates		
	Upto - 1200 cc	3,600	43,200
	1201 - 1500 cc	4,200	50,400
	1501 - 1750 cc	5,800	69,600
	1751 - 2000 cc	7,200	86,400
	2001 - 3000 cc	8,600	103,200
	Over - 3000 cc	14,400	172,800
(ii)	Pick-ups, Panel Van (Unconverted)		
	Upto 1750 cc	3,600	43,200
	Over 1750 cc	4,200	50,400
(iii)	Land Rovers/Cruisers	7,200	86,400

OR 2% of the initial capital cost of the vehicle for each month, whichever is higher.

Commissioner's prescribed benefit rates

Services		**Monthly rates Sh.**	**Annual rates 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.

Vat RATE = 16%

QUESTION ONE

Write short notes on the following:

(a) Taxable turnover in relation to VAT;	(6 marks)
(b) Deregistration for VAT;	(2 marks)
(c) Assessment for VAT;	(3 marks)
(d) Appeals under VAT Act;	(3 marks)
(e) Tax invoice;	(3 marks)
(f) Rules regarding payment of VAT.	(3 marks)
	(Total: 20 marks)

QUESTION TWO

The partners of Mehta Brothers reported a loss of Sh.250,000 for the year ended 31 August 2000 after deducting the following expenses:

	Sh.
Salaries and wages	450,000
Partners drawings	360,000
Loss on sale of investment	15,000
Professional fees	120,000
Travelling expenses	650,000
Purchases	5,250,000
Repairs and maintenance	320,000
Depreciation	650,000
Rent and rates	240,000
Telephone	60,000
Postage and stationery	175,000
Bank charges and interest	24,000
Salaries to partners:	
S. Mehta	50,000
M. Mehta	50,000
N. Mehta	100,000
Donations	20,000
Purchase of a computer	200,000
Bad debts written off	65,000
Interest on capital:	
S. Mehta	20,000
M. Mehta	20,000

Notes:

1. Agreed written down values of the assets as at 31 August 1999
   Class I – Sh.1,250,000; Class III – Sh.250,000; Class IV – Sh.375,000

2. The partners share profits and losses equally after salaries and interest
3. The wife of S. Mehta is a full time employee of the company and was paid a salary of Sh.120,000 during the year.
4. The partners have no other source of income other than from the partnership.

Required

(a) Calculate the taxable profit(loss) of the partnership for the year ended 31 August 2000 and taxable income of each partner. (13 marks)

(b) The partners' self assessment returns and the partnership self assessment are to be submitted to the Tax Department by 31 December 2000. What advice would you give the partners on filing tax returns? (4 marks)

(c) State the tax position of S. Mehta and wife, if the wife runs a part time curio shop where she earns Sh.40,000 per month and incurs an expenditure of Sh.10,000 in the same month. (3 marks)

(Total: 20 marks)

QUESTION THREE

Mrs Jimmy Ondemo is a professional medical doctor, practicing in Nairobi. Given below are the financial details of her clinic for the year ended 31 December 2000.

		Sh.
I.	Gross professional fees received	3,000,000
II.	Directors' fees received (deductions at source)	360,000
III.	Interest income from AB Bank Ltd. – Gross	72,000
IV.	Dividend income (net	102,000
V.	Subscriptions to professional association and publications	60,000
VI.	Donations to destitute children's home	30,000
VII.	Subscriptions to Wildlife Magazine	6,000
VIII.	Debt collection (patients) expenses	18,000
IX.	Wages for clinic assistant	360,000
X.	Replacement of clinic instruments	120,000
XI.	Rent for the clinic premises	420,000
XII.	Electricity and water – clinic	120,000
XIII.	General expenses – clinic	210,000
XIV.	Car hire expenses – for use in practice	150,000
XV.	Uniform for staff	115,000
XVI.	Payment of school fees for own children	120,000
XVII.	Contribution to Registered Provident Fund – self	180,000
XVIII.	Payment of life insurance premium – self	60,000
XIX.	Terminal benefits paid to retired receptionist	150,000
Depreciation on furniture – clinic		36,000
Rents received from sub-rentals		42,000
Rent collection expenses		6,000
Wages paid to cleaners an watchman – clinic		150,000
Tarmacking of drive-way – personal residence		240,000
Additional servant quarters – personal residence		420,000

Required

(a) Taxable income of Mrs Jimmy Ondemo for the year ended 31 December 2000. (10 marks)

(b) Tax payable by Mrs. J. Ondemo (3 marks)

(c) Indicate the date when the tax, if any, is payable to the Income Tax Department. (2 marks)

(d) What is the tax position on a wife's income? (5 marks)

(Total: 20 marks)

QUESTION FOUR

The Gitoro Food Processing Industries Ltd. commenced business on 1 January 1999 and the following are the fixed assets of the company which it acquired prior to the commencement of the business:

	Sh.
Conveyer and sorter (installed in the building)	3,120,000
Packaging machine	2,325,000
Milling machine	2,580,000
Crashing machine	2,760,000
Fork lifts	1,290,000
Farm tractors	5,850,000
Lorry	1,8000,000
Saloon car	585,0003
Delivery van	1,350,000
Furniture, fittings and partitions	408,000
Land at cost	15,000,000

The building in use was constructed at a cost of Sh.10,200,000 but its value after construction was estimated at Sh.12,600,000 by a professional valuer. In year 2000, the company bought the following assets:

	Sh.
Tractor	2,655,000
Lorry	3,900,000
Toyota – Land Cruiser	2,025,000
Furniture	210,000
Partitions	408,000
Land	4,680,000
3 computers – year 2000 compliant	450,000

The following assets were disposed off in Year 2000:

	Sh.
Land	4,290,000
Fork lifts	360,000
Saloon car	690,000

Further enquiry revealed that under repairs and maintenance Sh.276,000 was paid for office partitions done in year 2000.

Required

(a) Compute the capital allowances for the company for the years 1999 and 2000 (18 marks)

(b) Comment on any information not used in (a) above. (2 marks)

(Total: 20 marks)

QUESTION FIVE

(a) Name and briefly explain four major principles of a good tax system. (16 marks)

(b) Write brief notes on housing benefit (4 marks)

(Total: 20 marks)

MODEL ANSWERS TO PAST CPA PAPER SET IN DECEMBER 2000

QUESTION ONE

(a) **Income of a deceased person**

The tax position of the income of a deceased person is as follows:
The income accrued or received prior to date of death of a deceased person and not already assessed on him shall be assessed and charged on the executors, administrators of his estate – Sec. 48 (1). Note that such assessment must be made within 3 years after the year in which death occurs.

The income accruing to the estate of a deceased person is deemed to be the income of the executor or administrator of such estate.

(b) Set-off tax refers to any tax paid/deducted at source which is allowed as a deduction against gross tax liability – e.g.

- Pay as you earn tax (PAYE tax)
- Withholding tax on non-qualifying dividends.
- Personal relief.
- Tax refund b/f

Note that set-off tax must be made in the same year in which the deduction took place.

(c)

(i) MR AND MRS ONGERA
DETERMINATION OF TAXABLE INCOME FOR YR. 2000

				Tax at source
MR ONGERA		Shs '000'		Shs '000'
Employment income – Salary (Sh. 250,000 x 12 mths)		3,000	(Sh 60000 x 12)	720
WIFE				
Employment income: - Salary (Sh120,000 x 12 mths)		1,440	(Sh 42000 x 12)	502
- Overtime (Sh10,000 x 12 mths)		120		
- Medical benefit (director othan than WTSD)		160		
- Free consumables		30		
- Housing benefit (Take market rental since house is owned by employer – Sh 20,000 x 12 mths)		240		
	Shs '000'			
Pension from previous employment	240			
Less: tax exempt amount	180	60		
Other incomes: -				
Rental income – Gross (50,000 x 12 mths)	600			
Less: Interest on mortgage (900000 – 50000)	400	200		
Total taxable income		5,250		

(ii) Tax payable on income above

Tax payable on	=	5,250,000
121,968 @ 10%	=	12,196.8
114,912 (15% + 20% + 25%)	=	68,947.2
(5,250,000 – 466,704)30%	=	1,434,988.8
		1,516,132.8
Less tax at source (720,000 + 504,000)	=	(1,224,000.0)
Personal relief		(13,944.0))
Net tax liability		278,188.8

Notes

1. Mrs Ongera is a director other than whole time service director. Housing benefit is 15% of total income subject to limit of market rent since house is owned by the employer.

2. Mrs Ongera's employment income will not qualify for separate taxation since she owns 20% of the shares of Anga Ltd.

3. Medical benefit is taxable on a director other than whole time service director.

a) No penalties are due for payment by Mrs. Ongera since the assessment is on her husband. Note that Mrs. Ongera has the option to file a separate return on employment, professional and self-employment income assessable on her, if any applicable from year of income 1999 to date.

QUESTION TWO

(a) A farmhouse is a farmwork (construction on a farm), for the better performance of farm activities on a farm. A third of the cost of the farmhouse qualifies for farmwork deduction ccomputation. Only one farmhouse qualifies and where the size of the farmhouse is out of proportion to the nature and extent of the farm activity then the commissioner may reduce further the qualifying cost of such house for computation of farmworks deduction.

(b)

(i) CALCULATION OF FARMWORKS DEDUCTIONS DUE TO SWEET TOOTH AND TOOTH ACHE FOR YRS. 1998 AND 1999

Farmer		SWEET TOOTH	TOOTH ACHE	
Year		JAN – DEC 1999	JAN – APR 1999	1 MAY – 31 DEC 1999
		FWD @ 33⅓%	FWD @ 33⅓%	FWD @ 33⅓%
	Shs '000'	Shs '000'	Shs '000'	Shs '000'
Farmworks qualifying cost	Shs '000'			
Farmhouse (⅓ x 12 million)	4,000	1,333,333	444.444	888.889
Irrigation system	3,000	1,000	333.333	666.667
Labour quarters	4,800	1,600	533.333	1,066.667
Cattle dip	2,000	666.666	222.222	444.444
Sewerage system	1,200	400	133.333	266.667
Totals	15,000	4,999.999	1,666.665	3,333.334

Summary of Farm-work deductions

Farmer		Sweet Tooth	Tooth Ache
		Shs '000'	Shs '000'
Year	1998	4,999.999	NIL
	1999	1,666.665	3,333.334
Total FWD		6,666.664	3,333.334

(ii) Cost incurred to replace the old plants and the cost of treating the oil are allowable expenditure on a farm as costs incurred in clearing land for plantation or semi-permanent or permanent crops (e.g. grapes)

(iii) Information not used

(a) Digging terraces cost is specifically allowed by the Income Tax Act since it is for soil erosion prevention on a farm.

(b) Farm implements, milking machinery are not farm works. However, they qualify for wear and tear allowance. Value of farm implements as per expert valuer will be used for computing wear and tear allowance

QUESTION THREE

(a) KINYENJE CO. LTD.
ADJUSTED INCOME (LOSS) FOR YR. 1999

	Shs '000'	Shs '000'
Net profit as per account		541
Add back disallowable expenditure:		
Overstatement of opening stock (Sh. 1,048,000x 20/120)		174.667
Depreciation		2,052
General expenses: - Donations		45
Reserves		2,250
Bad debts reserve less specific provision		348
Taxes – VAT paid		129
Provision for dividends		900
Audit fees for tax appeal		100
Preliminary expenses		700
		6,698.667
		7,239.667
Deduct: -		
Overstatement of closing stock (Sh 2,283,000 x 20/120)	380.5	
Profit on sale of shares ex-dividend	760	1,140.5
Business income		6,099.667
Other income:		
Rent income : Gross		820
Less: Sweepers wages	(60)	
- Mortgage interest	(170)	
- Land rates and rent	(20)	570
		6,669.667
Less capital allowance		(19,425.75)
Adjusted profits		(12,756.083)

Workings:

Capital deductions for Yr. 1999 (using year 2004 rates)

		Shs '000 '	Residue Shs '000'
(i)	Investment deduction @ 100%		
	Extension to factory building (Sh 6,000,000 x100%)	6,000	-
	New Machinery fixed (Sh 18,000,000 x 70%)	18000	-
		24000	7200

(ii) Industrial building deduction:

Nil because of 100% I.D rate

(iii) Wear and Tear Allocance

Class	II @ 30%		IV @ 12½%
	Shs '000'		Shs '000'
WDV 1/1/1998	NIL		NIL
Year 1998			
Machinery (old) fixed			5,760
Furniture and fittings			1,920
	NIL		7,680
WTA	NIL	(960)	
WDV 31/12/98	NIL		6,720

Year 1999

Additions:		
Computers	3,000	
	3,000	6720
WTA	(900)	(840)
WDV	2,100	5880

SUMMARY OF CAPITAL ALLOWANCE YR. 1999

	Shs '000'
Investment deduction	24000.00
Industrial building deduction	Nil
Wear and Tear allowance: - Class II	900.00
Class IV	840.00
Total Allowance	25,740.00

(b) No tax is payable since a loss arises from assessment. A tax refund is expected from the Income Tax department. Any instalment tax earlier paid during the year is also refundable.

Notes

1. Supplies consumed are deemed consumed in the manufacture of manufactured goods hence allowable.
2. Commissions paid are taken to be business expenses and allowed.
3. Profit on sale of shares is a capital gain not taxable.
4. General expenses are deemed for business and allowed.
5. Preliminary expenses write off is a capital expenditure not allowable after all no analysis of the expenditure is given.

QUESTION FOUR

(a) - For imported goods, VAT is payable when goods are cleared for use in the local market.

- For warehoused goods, VAT is payable when the goods are removed from the warehouse and cleared for use in the local market.

- Clearing means the realising of the goods by the customs department to the owner to dispose them as he wishes in the local market. The local market means Kenya.

(b) VAT is payable on 20th of the following month.

20th April:

	Sh.
VAT outstanding	120,000
Interest (2%)	2,400
Total VAT outstanding	122,400
Default penalty	10,000
	132,400

20th May:

	Sh.
VAT outstanding	122,400
Interest(2%)	2,448
	124,848

Default penalty	10,000
	134,848

Note

The default penalty of Sh.10,000 is payable only in the first month of default. Interest is also not charged on this amount.

(c) ..

(i) VAT on importation

	Sh.	
Cost of goods	1,200,000	
Duty (35%)	420,000	
Taxable value	1,620,000	
VAT: 16%	259,200	(Input VAT)

VAT on sale.

(ii)

	Sh.	
Taxable value	1,620,000	
Clearing charge	20,000	
Transport	70,000	
Commission (5% x 1,200,000)	60,000	
	1,770,000	
Mark-up	354,000	
	2,124,000	
VAT (16%)	339,840	(Output VAT)
Selling Price	2,463,840	

N.B. VAT payable to commissioner

	Sh.
Output VAT	382,320
Input VAT	291,600
VAT payable	90,720

QUESTION FIVE

(a) HOTEL ACCOMMODATION TAX

This is tax charged in accordance with the provisions of Hotel Accommodation Tax Act (Cap. 487). The quest of hotels and clubs are charged with an accommodation tax of 12.5% (Full board) or 17.5% (Bed and breakfast) and a hotel training levy of 2% based on the hotel or club charges.

(b) TAX SHIFTING

Tax shifting is the process by which the money burden of a tax is transferred from one person to another as brought about by changes in price of goods and services. Factors influencing tax shifting are: -

- elasticity of demand and supply
- time available for adjustment
- type of tax (direct or indirect)
- government price control

- nature of markets (oligopoly, monopoly etc).
- rate of tax
- geographical location

(b) Factors determining tax shifting:

(i) Elasticity of demand and supply – The more the elasticity, the lower the incidence on the sales. The higher the incidence on supply.

(ii) Nature of markets
In an oligopolistic market (i.e. sellers and many buyers) tax shifting to buyers is high since few sellers can team up to determine the market price.
In a situation where there are many buyers and sellers, a large portion of tax will be borne by sellers. For a monopolistic market, the entire tax burden falls on the shoulders of the buyer.

(iii) Government policy on pricing
In the case of government price control, the supplier cannot increase prices hence cannot shift tax burden to buyers and vice versa.

(iv) Geographical location
If taxes are imposed on certain regions, it is hard to shift them to consumers because consumers will move to regions with low taxes.

(v) Nature of tax (direct or indirect tax)
Direct tax e.g. PAYE cannot be shifted whatsoever while indirect taxes can be shiften through increase in prices.

(vi) Rate of tax
If too high, shifting can occur backwards or forwards, it too low, it may be absorbed by the manufacturer.

(vii) Time available for adjustment
The person who can adjust faster (buyer or seller) will be able to shift tax e.g. if the buyer cash shift to substitute goods, the seller will bear the tax burden

(c) RECOVERY OF TAX FROM PERSONS INTENDING TO LEAVE OR WHO HAVE LEFT KENYA.

Section 98 states "Notwithstanding anything to the contrary in this ACT", where an estimated assessment has been issued to a person who has left, or is about to leave Kenya, the commissioner may, by notice in writing, require such a person to pay any tax unpaid or give security to his satisfaction, by the time stated in the notice. If already assessed then a notice by the commissioner requiring the person to pay any tax unpaid. If the tax remain unpaid, then the commissioner is entitled to proceed to recover tax by suit, or distress.

If tax is still not paid, the commissioner is entitled to apply to a magistrate for the person's arrest. Committal to prison is a last resort

(d) THE LIMIT TO MAKING ASSESSMENTS

The following are assessments and time limits; -

(i) Instalment assessment based on estimate income for the year under consideration will be required by end of fourth month during the year under consideration and tax estimated payable in four equal instalments in the case of tax payers other than agricultural tax payers, i.e.

- 20th of 4th month during year – 1st instalment
- 20th of sixth month during year – 2nd instalment
- 20th of ninth month during year – 3rd instalment
- 20th of twelfth month during year – 4th and last instalment

For agricultural tax payers, instalment assessment and tax will be required by 9th and 12th months during year under consideration as follows:

1st instalment	75% of tax due by 20th of 9th month
2nd instalment	25% of tax due by 20th of 12th month

(ii) Self Assessment

Assessment return required by end of sixth month after year end while self-assessment tax is payable by end of the 4th month after year end.

(iii) Additional assessment

This is raised by the tax department when they notice additional income not declared by the tax payer following and in-depth examination into the tax payers' affairs.

MODEL ANSWERS TO PAST CPA EXAMINATION PAPER SET IN MAY

2001 QUESTION ONE

(a) TAXABLE TURNOVER IN RELATION TO VAT

For a person to qualify for registration he must have attained or expect to attain a taxable turnover of Sh. 3 million p.a, 2.4m for 9 months, 1.8m for 6 months and 1.2m for 3 months.

Such a person must apply for registration voluntarily, but if he fails to do so, the Commissioner will register him compulsorily retrogressively from the date he became registrable in which case he loses his right to claim input tax relief besides being subjected to a hefty penalty of Ksh.100,000.

The re are other cases of registration without turnover limits. These include: -

1. Designated persons who deal in designated jewellery, pre-recorded music and timber.
2. Saw millers.
3. Persons who sell four or more motor vehicles in any one year.
4. Persons who deal in motor vehicles parts and accessories.
5. Persons who deal in Household or domestic electric or electronic appliances and apparatus.
6. Designated services contained in part II of the Fourth Schedule of the VAT Act which include: -

    (i) Accounting services including any type of auditing, bookkeeping and similar services.
    (ii) Legal and arbitration services including any services supplied in connection therewith.
    (iii) Services supplied by auctioneers, estate agents and valuers
    (iv) Clearing and forwarding services.

Designated goods are those goods which are taxed at all levels of distribution chains.

(b) DEREGISTRATION FOR VAT

- If you cease to make taxable supplies you should without delay notify the commissioner of the date of cessation and furnish him with a return showing details of all goods in stock within thirty (30) days from the date you ceased to make taxable supplies.
- If the value of the taxable supplies in any twelve (12) months does not exceed Ksh.3 million and you do not expect any increase in such supplies in the next twelve (12) months, you may also notify the Commissioner for deregistration.
- Other causes of deregistration include – death, insolvency goods becoming non-taxable, change of trading names, and legal incapacitation. Where such changes occur the registered person, the liquidator or the executor or any other person must notify details to the Commissioner without delay.

(c) ASSESSMENT FOR VAT

There are various rates to charge VAT based on nature of supplies as specified in the 1st and 5th Schedules to the VAT Act. Currently, we have: -

(i) General rate at 16%
(ii) 14% rate as specified in part II of the first schedule
(iii) 0% rate specified in the 5th schedule.

The term zero-rating is used in the VAT law to denote supplies of goods and services which are subject to tax but taxable at the rate of (0%) zero percent. Zero-rated supplies are deemed to be taxable supplies. In this case a person who supplies zero-rated goods does not have to charge output tax to his customers because the tax is nil but can recover any input tax that has been charged by his own suppliers

The Zero-rating concept was introduced in the VAT system to enable exporters and manufacturers of zero-rated goods to claim refund of tax paid on inputs used in exportation and manufacture of zero-rated goods. It was also meant to ensure that funds used by exporters and manufacturers are not unnecessarily tied down in taxation. Examples of zero-rated supplies include all export agricultural inputs, pharmaceuticals and educational materials just to mention a few.

For traders who supply both taxable and exempt supplies, Zero rated supplies are included in the taxable supplies. While zero rated supplies are chargeable at the tax rate of zero (0%), exempt supplies are business transaction on which VAT is not chargeable at either zero rate or other rates. Exempt supplies are not taxable and do not form part of the taxable turnover. Persons exclusively dealing in exempt supplies are not liable to register and can not claim input tax on these supplies.

From time to time, VAT inspector carry out control verification visits to check on compliance and where it is found to be lacking, the necessary assessments are raised established and appropriate demands for payment made. These assessments are supposed to be discussed between the asserting officers and the taxpayer, but should a dispute arise, the taxpayer is at liberty to discuss the matter with the District Head. If he is still unsatisfied and he has new evidence in support of his objection he can make a formal objection to the assessment.

(d) APPEALS UNDER VAT

If the Commissioner makes a decision which still leaves him aggrieved, he can appeal to the VAT Appeals Tribunal within thirty days for an independent decision. However, such a person must pay to the commissioner the assessed tax no in dispute or such part thereof as the commissioner may require before the appeal is registered. If further aggrieved by the rulings of the tribunal, he can seek redress from the High Court on payment of the tax disputed. Likewise, the Commissioner is also allowed to appeal to the High Court against the decision of the Tribunal.

(e) TAX INVOICE

A tax invoice is the most important instrument of VAT control. It is a requirement that every registered trader must issue tax invoices for supplies of all taxable goods or services to their customers and clients which must show the mounts of tax charged. You must therefore furnish the purchaser with a tax invoice at the time of supply or within fourteen (14) days of the completion of that supply.

The following are the prescribed details of a tax invoice:

- Name, address, VAT/PIN number of supplier
- Serial number
- Date of supply
- Name and address of purchaser
- Description and quantity of supply
- Taxable value of goods if different from price charged
- VAT rate
- Tax charged
- Details for whether the supply is cash or credit and any discounts

Where cash sales are made from retail premises and subject to conditions prescribed by the Commissioner, a registered person may issue a simplified tax invoice. A simplified tax invoice quotes that the price is VAT inclusive.

Note: Possession of a suppliers' tax invoice is sufficient authority for input tax deduction irrespective of whether the supply has been paid for.

(f) RULES REGARDING PAYMENT OF VAT

Where the VAT 3 Return form is a payment return, you are required to submit the return and the cheque not later than the 20th day prescribed in the VAT Act. This return should show separately, particulars of the total value of supplies, the rate of tax which the supplies are liable and the amount of tax payable.

VAT must be accompanied by a banker's cheque made payable to the "Commissioner of VAT". Payment returns should be submitted to any of the commercial banks or Central Bank nearest to your business. The due date of submission of these returns is not later than the 20th day of each month. Where the 20th day for submission of returns falls on a public holiday, a Saturday or a Sunday, then the returns must be submitted on the last working day prior to that day.

QUESTION TWO

MEHTA BROTHERS

(a) TAXABLE PROFIT (LOSS) OF THE PARTNERSHIP FOR THE YEAR ENDED 31 AUGUST 2000

		Shs '000'	Shs '000'
Reported loss			(250)
Add back disallowable expenditure:			
Salary to Mrs. S. Mehta		120	
Partners drawings		360	
Loss on Sale of investment		15	
Depreciation		650	
Salaries to partners:	S Mehta	50	
	M Mehta	50	
	N Mehta	100	
Donations		20	
Purchase of computer		200	
Interest on capital:	S Mehta	20	
	M Mehta	20	1,605
Deduct: Wear and tear allowance			(263.125)
Adjusted partnership profit			1,091.875

TAXABLE INCOME OF EACH PARTNER

Partner	S. Mehta	M. Mehta	N. Mehta	Total
	Shs '000'	Shs '000'	Shs '000'	Shs '000'
Salary	50	50	100	200
Salary to Mrs Mehta	120	-	-	120
Interest on capital	20	20	-	40
	243.958	243.458	243.959	731.875
Taxable income	450.625	310.625	360.625	

Workings:

(i) Wear and tear allowance

Class	I @ 37½%	II @ 30%	III@ 25%	IV @12 ½%
	Shs '000'	Shs '000'	Shs'000'	Shs '000'
W.D.V 1.9.1999	250	Nil	250	375
Add: Computer	-	200	-	-
	250	200	250	375
W.T.A	(93.75)	(60)	(62.5)	(46.875)
	156.25	140	187.5	328.125

(b) TAX APPLICABLE BY MRS. ONDEMO

Taxable income b/d	Shs. 947,000
Tax thereon:	Shs.
121,968 @ 10%	12,196.8
114,912 (15% + 20% + 25%)	68,947.2
(947,000 – 466,704) @ 30%	144,088.8
	225,232.8
Less: Personal relief	(13,944.0)
Net tax payable	211,288.8

(c) Tax is payable to the Income Tax Department (self-assessment tax) by the end of the fourth month after year end, i.e. 30th April 2001.

(d) Tax position on a wife's income

Wife's income as per Section 45 of Income Tax Act, is considered as the income of the husband and her income is aggregated with her husbands income in order to ascertain his total income. However, the following incomes of the wife will qualify for separate taxations: -

(i) Wife's income from employment or services rendered at arm's length taxed separately at wife's employment or wife's professional income tax rates (same as individual graduated scale rates).
(ii) Wife's professional income is also assessed separately on her if from the following professions: - medical, dental, legal, surveyors, architects, veterinary surgeons, engineers, accountants.
(iii) Wife's self-employment income is also assessed on her separately, i.e. gains or profits arising from a business of a married woman living with her husband and does not include any income derived from the provision of goods or services by her to a business, partnership or a company owned by or the voting power of which is held to the extent of 12½% or more at any one time during the year of income by her or her husband either directly or through a nominee.
(iv) Each partner is responsible for filing his self-assessment return on income accruing to him from partnership and other income sources. Partners are jointly and severally liable in the case of failure to file partnership return. Self-assessment returns are required to be submitted by end of sixth month after year end, i.e. in this case by end of February 2001. Failure to file self-assessment returns will attract a penalty of 5% per month on normal tax payable while such failure continues subject to a minimum of Kshs. 10,000.
(v) For income tax assessment purposes, the income of a married woman living with her husband is deemed income of her husband – Section 45 of Income Tax Act. This means that Mrs S Mehta's business income arising from curio shop will be aggregated with her husband's income and assessed to tax in his name. However, such business income in her own names will qualify for separate taxation using the individual tax rates after allowing for expenditure if incurred wholly and exclusively to generate the business income.

QUESTION THREE
MRS JINNY ONDEMO
(a) Taxable income for year ended 31 December 2000

Clinic Income	**Shs '000'**	**Shs '000'**
Gross professional fees received		3,000
Less allowable deductions: -		
Subscriptions to professional associations and publications	60	
Debt collection (patients) expenses	18	
Wages for clinic assistant	360	
Replacement of clinic instruments	120	
Rent for clinic premises	420	
Electricity and water – clinic	120	
General expenses – clinic	210	
Car hire expenses – for use in practice (see notes	150	
Uniforms for staff	115	
Terminal benefits paid to retired receptionist	150	
Wages paid to cleaners and watchman – clinic	150	
Wear and tear on furniture – clinic (see note 2)	36	1,909
Total clinic income		1,901

Other incomes

Director's fees received (tax at source) (see note 3)	Nil	
Interest income from AB Bank Ltd - Gross – taxed separately	Nil	
Dividend income (net) (See note 5)	Nil	
Rent income (Sh. 42,000 – 6,000)	36	36
Taxable income		1,127
Deduct:		
Contribution to registered provident fund – self		(180)
Taxable income		947

Notes

(1) Car hire expenses are for clinic and assumed commercial vehicles for hire purposes used hence allowed.
(2) Depreciation amount is not allowable, however, tax depreciation figure and allowed.
(3) Director's fees assumed received from clinic and as such not allowable and the tax paid at source may be allowed as a set off tax.
(4) Donations, payment of life insurance premiums for self, subscriptions to wildlife magazine and other expenditure not used are not for clinic business hence not allowed against income.
(5) Dividend income assumed qualifying hence withholding tax is final tax. Interest income from financial institution, AB Bank is taxable at source hence can not be aggregated with other incomes for further taxation. However, withholding tax at rate of 15% on Gross interest is still payable since received gross.

QUESTION FOUR
GITORO FOOD PROCESSING INDUSTRIES LTD.

(a) Capital allowances for Years 1999 and 2000(using year 2004

rates) Year 1999

(i) Investment deduction

ASSET	Qualifying cost	Investment deduction @100%	Residue for IBD and W.T.A
	Shs '000'	Shs '000'	Shs '000'
Building	10,200	10,200	-
Conveyor and sorter	3,120	3,120	-
Packaging machine	2,625	2625	-
Milling machine	2,580	2580	-
Crashing machine	2,760	2760	-
Total I.D.		21285	

Industrial Building Deduction

Cannot be computed since with 100% I.D rate, residual for IBD and WTA is Nil

(ii) Wear and Tear allowance

Class	I @ 37½%	II @ 30%	III@ 25%	IV @12 ½%
	Shs '000'	Shs '000'	Shs'000'	Shs '000'
W.D.V 1.1.1999	Nil	Nil	Nil	Nil
Conveyor and sorter	-	-	-	-
Packaging machine	-	-	-	-
Milling machinery	-	-	-	-
Crashing machine	-	-	-	-
Fork lifts	1,290	-	-	-
Farm tractors	5,850	-	-	-

Lorry	1,800	-	-	-
Saloon car	-	-	585	-
Furn., fittings & partitions	-	-	-	408
				408
	8,940	Nil	585	
Wear and tear allowance	(332.75)	Nil	(146.25)	(51)
W.D.V 31 Dec 1999	5,587.5	Nil	438.75	357

SUMMARY OF YEAR 1999 CAPITAL ALLOWANCES

		Shs '000'
Investment deductions		21285
Industrial building deduction		Nil
Wear and tear allowances: -	Class I	3,352.5
	II	–
	III	146.25
	IV	51
Total capital allowance		24834

Year 2000

		Shs '000'
(i)	Investment deduction	Nil
(ii)	Industrial building deduction (straight-line method)	-
(iii)	Wear and Tear allowance	

Class	I @ 37½%	II @ 30%	III@ 25%	IV @12 ½%
	Shs '000'	Shs '000'	Shs'000'	Shs '000'
W.D.V 1.1.2000	5,587.5	Nil	438.75	327
Additions:				
Tractors	2,655			
Lorry	3,900			
Toyota Land Cruiser			1,000	
Furniture				210
Partitions (408 + 276)				683
Computers		450		
Disposals:				
Fork lifts	4,290			
Saloon car	-	-	690	-
	16,432.5	450	2,128.75	4,159.8
Wear and tear allowance	(6,170.404)	(135)	(532.188)	(519.9)
W.D.V 31 Dec 2000	10,262.096	315	1,596.562	3,639.9

SUMMARY OF CAPITAL ALLOWANCES YEAR 2000

		Shs '000'
Investment deduction		Nil
Industrial building deduction		-
Wear and Tear allowance:	Class I	6,170.404
	II	135
	III	532.188
	IV	130
		7044.092

Note: Toyota land cruiser is deemed non-commercial vehicle hence qualifying cost for wear and tear allowance is restricted to Kshs. 1 million

(b) Information not used in (a) above:

(i) Professional valuation for building is not taken as qualifying cost for investment deduction since not incurred.

(ii) Cost of land does not qualify for any capital allowance.

QUESTION FIVE

(a) Four major principles of a good tax system are:

(i) Equity
(ii) Economy
(iii) Certainty
(iv) Convenient

(i) Equity principle

The burden of a tax should be equitably distributed among taxpayers to ensure that the rich contribute more than the poor. The rate of tax should be progressive such that as a person's income increases, the rate of income tax also increases. All direct taxes fall heavily on the people whose income and wealth increase. Examples of direct tax are income tax, corporation tax, wealth tax, gift tax, expenditure tax.

(ii) Canon of economy

Means that cost of collection of tax should not be more than the amount finally collected and remitted to the treasury. Cost of collection of direct taxes is low since in the case of income tax, it is deducted at the source from salaried persons. Indirect taxes may also be claimed to be economical since the producers and sellers deposit tax with government as agents to government.

(iii) Canon of certainty

Certainty of a tax is the assurance to the taxpayer regarding the time and manner of payment which must be clear to him. To the government, the amount to be paid (collected) in taxes should be known with reasonable accuracy. Certainty must relate to who is required to pay the tax, who collects, fiscal marksmanship, etc.

(iv) Canon of convenience

A tax should not inconvenience the taxpayer. This means that the time and manner of payment should be known and to coincide with time of earning income or incurring expenditure. The tax should not take away from taxpayer as to leave him with an amount that does not enable him to sustain himself, (i.e. below subsistence level). Indirect taxes are less inconvenient and less burdensome since they are paid only when a commodity or a service is bought. Since indirect taxes are included in prices of commodities, the buyers do not feel the burden of these taxes. Direct taxes may be said to be inconvenient because traders, businessmen, producers etc., have to comply with a number of formalities relating to their sources of income and expenditure incurred in earning that income. Sometimes services of tax experts has to be sought at a fee.

(b) Housing benefit

This arises where housing has been provided to the employee by his employer. Housing benefit excluding the value of any furniture or other contents so provided is taxable benefit to be computed as follows: -

(i) A director other than W.T.S.D an amount equal to 15% of his total income excluding value of those premises and income chargeable to tax under section 3 (2) (f):
(ii) For agricultural employee required by the terms of employment to reside on a farm or plantation, an amount equal to 10% of the gains or profits from his employment. Agricultural employee excludes director other than W.T.S.D.

(iii) Other employees, an amount equal to 15% of the gains or profits from his employment, excluding the value of those premises, subject to a limit of the rent paid by the employment that is paid under an agreement made at arm's length with a third party.

Provided that: -

1. Housing benefit is restricted to period of use during year;
2. Housing benefit shall be reduced by any amount employee pays to employer for those premises;
3. Housing benefit shall be reduced where part only of the premises is so provided;
4. Where gains or profits from a person's employment excluding the value of the premises provided by the employer, exceed six hundred thousand shillings in the year, the value of the premises determined will be subject to the limit of:
   (a) the fair market rental of the premises in the year or the rent paid by the employer under an agreement with a third party where that agreement is not at arms length, whichever is then higher, or
   (b) the fair market rental value of the premises that year where the premises are owned by the employer.

MOCK EXAMINATION

KENYA ACCOUNTANTS AND SECRETARIES NATIONAL EXAMINATION BOARD

CPA PART I & CPS PART 1

TAXATION 1 (PRINCIPLES AND CONCEPTS)

Time Allowed: 3 hours

Answer ALL questions. Marks allocated to each question are shown at the end of the question. Show ALL your workings. Any assumptions made must be stated.

MOCK ONE

Answer ALL Questions. Marks allocated to each question are shown at the end of the question. Show ALL your workings. Any assumptions made must be clearly and concisely stated.

Taxable Employment Benefits - Year 2005

RATES OF TAX (Including wife's employment, self employment and professional income rates of tax). Year of income 2005.

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)

Capital allowances:

Wear and tear allowances

Class I	37.5%
Class II	30%
Class III	25%
Class IV	12.5%

Industrial building allowance:

Industrial buildings	2.5%
Hotels	4.0%

Farm works allowance 33.3%

Investment deduction allowance:

2003	-	70%
2004	-	100%
2005	-	100%

Shipping investment deduction 40%

Mining allowance:

Year 1	40%
Year 2 - 7	10%

Prescribed benefit rates of motor vehicles provided by employer

			Monthly rates (Sh.)	**Annual rates (Sh.)**
(i)	Saloon, Hatch Backs and Estates			
	Upto	- 1200 cc	3,600	43,200
	1201	- 1500 cc	4,200	50,400
	1501	- 1750 cc	5,800	69,600
	1751	- 2000 cc	7,200	86,400
	2001	- 3000 cc	8,600	103,200
	Over	- 3000 cc	14,400	172,800
(ii)	Pick-ups, Panel Van (Unconverted)			
	Upto	1750 cc	3,600	43,200
	Over	1750 cc	4,200	50,400
(iii)	Land Rovers/Cruisers		7,200	86,400

OR 2% of the initial capital cost of the vehicle for each month, whichever is higher.

Commissioner's prescribed benefit rates

Services		**Monthly rates Sh.**	**Annual rates 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
Richex Limited has provided the following profit and loss account for the year ended 31 December

Profit and Loss Account for the year ended 31 December 2005

	Sh.		Sh.
Opening stock	524,000	Sales	10,584,000
Purchases	4,692,000	Closing stock	761,000
Manufacturing expenses	2,563,000		
Salaries and wages	252,000		
Supplies consumed	466,000		
General expenses	85,000		
Interest on loan	364,000		
Commission and brokerage	90,000		
Director's fee	55,000		
Auditor's fee	70,000		
Taxes	43,000		
Bad debts reserve	296,000		
Depreciation	648,000		
Managing directors remuneration	126,000		
Reserves	750,000		
Provision for dividends	300,000		
Profit for the year	21,000		
	11,345,000		11,345,000

The following additional information is provided:
1. Salaries and wages include Sh. 20,000 contributed by the company to unregistered pension scheme.
2. General expenses include Sh. 15,000 for donation, Sh. 10,000 for contribution to a business pressure group that protects traders of the same kind.
3. Taxes represent VAT paid.
4. Bad debts (specific) are Sh. 180,000.
5. The fixed asset schedule is as follows:

Assets	**Year**	**Cost** Sh.
Factory building	2001	4,000,000 (net of I.D)
Additional plant building	2005	2,000,000 – brought to use on 1.1.2005
Factory Machinery	2002	4,800,000
New Factory Machinery	2005	6,000,000 – fixed in new building
Computers	2004	1,000,000
Furniture	2004	640,000

Required
a) Compute the capital allowances due to the company. (10 marks)
b) Show the adjusted profit (loss) for tax purposes for the year. (7 marks)
c) Calculate the tax payable thereon. (3 marks)
(Total: 20 marks)

QUESTION TWO
a) Discuss the capital allowances available to hotel owners and the capital expenditures that qualify for such allowances. (6 marks)
b) Wageni tourist hotel ltd. Is a five star hotel in Mombasa. The hotel provided the following information,

1) Written down values as at 31.12.2004

Class I	Class II	Class III	Class IV
Sh.	Sh.	Sh.	Sh.
875,000	2,500,000	1,750,000	3,725,000

Disposals during the year.

Class I	Class II	Class III	Class IV
900,000	125,000	-	90,000

2) Additions during the year

1.	Computer	350,000.00
2.	Fax Machine	40,000.00
3.	Photocopier	160,000.00
4.	Beds	500,000.00
5.	New hotel building	5,000,000.00

The new hotel building was brought to use on 1.9.2005

3) The old hotel building was first brought in to use on 1.1.2000 at a cost of Sh. 8,000,000.00 (I.D = 60%)

4) A saloon car which cost sh. 1,200,000 in 2000 was traded in for a new car costing Sh. 900,000.00. The old car was valued at Shs. 600,000 and the company paid a balance of shs. 300,000.00

Required

1) Compute capital allowances due to the company for the year ended 31.12.2005. (10 marks)
2) Show the written down value of all the assets as at 31.12.2005. Comment on Class I balance. (4 marks)

(Total: 20 marks)

QUESTION THREE

a) Many flower growers and exporters are unaware of the benefits accruing from registering for VAT and claiming capital allowances available to them under the income tax Act. Write brief notes on the benefits arising in the two areas. (6 marks)

b) You have been approached by the director of flower export ltd. To help them in their tax return for the year 2005. The following information is available.

1. Written down value as at 31.11.2004

Motor vehicle	
Lorries	250,000.00
Tractors	375,000.00
Saloons	1,250,000.00
Equipment	275,000.00
Computers	300,000.00
Furniture	725,000.00

2. Greenhouses at cost	1,200,000.00
Farmhouse at cost	1,500,000.00

Additional information.

I. A Mercedes Benz was purchased for the director at shs. 2,500,000.00

II. Four cars were traded in for four new ones. The value of the new cars was shs. 750,000 each. The company made a cash payment of shs. 600,000.00 for each of the four cars acquired.

III. An irrigation system was installed at a cost of sh. 900,000.00

IV. A new water pump was acquired at a cost of sh. 200,000.00

Required

1. Compute the capital allowances for flower export ltd, as at 31.12.2005. (12 marks)

2. Comment on the motor vehicle benefit for the car used by the director. (2 marks)

(Total: 20 marks)

ANSWERS TO MOCK ONE

QUESTION ONE

(a)

A. INVESTMENT DEDUCTIONS (I.D.) (2005)

Asset	Q.C.	I.D @100%	Residual
Additional Building	2,000,000	2,000,000	-
New machine	6,000,000	6,000,000	-
		8,000,000	

B. INDUSTRIAL BUILDING DEDUCTION (IBD)

Year 2001 F. Building IBD = 4,000,000 x 2.5% = 100,000

p.a. C. WTA

Class	II (30%)	IV (12.5%)
WDV 1/1/04	-	-
Add: computers	1,000,000	-
Furniture	-	640,000
	1,000,000	640,000
WTA – 2004	300,000	80,000
WDV 31.12.04	700,000	560,000
WTA – 2005	210,000	70,000
WDV 31.12.05	490,000	490,000

SUMMARY (2005)

	Sh.
Investment Deductions:	8,000,000
Building Deduction:	100,000
Wear and Tear Deduction: II	210,000
IV	70,000
	8,380,000

1(b)

Note

The answer should be used with clear consideration of the notes that follows:

RICHEX LIMITED:

Adjusted Profit /(Loss) for the year 2005:

	Sh.	Sh.
Profit as per A/Cs		21,000
Add Back:		
Contribution (unregistered scheme)	20,000	
Donation	15,000	
Taxes	43,000	
Bad debts (296,000 – 180,000)	116,000	
Depreciation	648,000	
Reserves	750,000	
Provision for Dividends	300,000	
Supplies consumed (Note 1)	466,000	2,358,000

	2,379,000
Less:	
Capital Allowances:	(8,380,000)
Loss c/f:	(6,001,000)

Note:

1. Supplies Consumed: In manufacturing industries, we have consummated supplies that are used up in course of production e.g. lubrication. Supplies consumed can also be taken to mean products by employees. In this case, we took the latter. The forms is allowable.
2. Contribution to pressure groups can only be allowed if the group is recognised and registered e.g. Kenya Association of Manufacturers (KAM). In this case, we assumed that the group is registered.
3. It is always important that the student clearly state his assumptions on any issue that is not clear.

1(c)

- The company has reported a loss. Therefore, no tax is payable. The loss will be carried forward to the next period.
- However, the company must file its returns on or before 30th June 2006. A loss does not exempt a company from filing returns.

QUESTION TWO

a)
i. Investment Deductions:
The hotel building will qualify for investment Deductions if it has been approves to be an Industrial Building. The cost that qualify will be the building in use as a hotel and any building directly related to the operations of the hotel contained within the grounds of the hotel complex, including staff quarters, kitchens, and entertainment and sporting facilities.

ii. Industrial Building Deduction
It is an annual deduction granted to a building that has been approved to be an industrial building.
The cost that qualify will be that in (i) above.
However, the cost to be taken shall be not of investment deductions.

iii. Wear and Tear Deductions.
This will be granted in respect of the machinery used in the business.
The cost that qualify shall be the purchase price of such machinery. If the machinery is acquired free of charge, the open market value is taken.

b) **(1)**
Investment Deductions:

	Cost	I.D(100%)	Net Value
New Building	5,000,000	5,000,000	-

Industrial Building Deduction:
Old Building:

Cost	I.D(60%)	Residual for IBD
8,000,000	5,600,000	2,400,000

IBD = 4% x 2,400,000 = Sh. 96,000

Wear and Tear Deductions

	I(37.5%)	II(30%)	III(25%)	IV(12.5%)
W.D.V. b/f	875,000	2,500,000	1,750,000	3,725,000
Additions: Computers		350,000		
Fax		40,000		
Photocopier		160,000		
Beds				500,000
Saloon Car			900,000	
	875,000	3,050,000	2,650,000	4,225,000
Disposal (WK: 1)	(900,000)	(125,000)	(500,000)	(90,000)
	(25,000)	2,925,000	2,150,000	4,135,000
	-	(877,500)	(537,500)	(516,875)
	(25,000)	2,047,500	1,612,500	3,618,125

WK: 1

Saloon Car (Class III)

$$= 600{,}000 \times \frac{1{,}000{,}000}{1{,}200{,}000} = \text{Sh. } 500{,}000$$

b) (2)

Machine:	Sh.
Class I	(25,000)
Class II	2,047,500
Class III	1,612,500
Class IV	3,618,125

The balance in Class I is a trading Receipt and it is taxable together with other incomes.

QUESTION THREE

a) VAT:

1. The flower growers will be able to claim input VAT on the taxable purchases just like other traders.
2. The flower growers will also claim input VAT on the polythene materials they use for their green houses in the farm.
3. Exporters of goods are dealers of Zero-rated goods. Such dealers are required to register for VAT. Farmers who export should therefore register to avoid fines and penalties on non-registration.

Capital Allowances:

(b) (i) The farmer who claim capital allowance will be an allowance against their profits. In so doing, they will be able to reduce their profit hence reducing their tax liability.

Flower Export ltd:

Farm work deductions

	Sh.
Green houses	1,200,000
Farm house (1/3)	500,000
Irrigation system	900,000
	2,600,000
Farm Work Deductions	(866,667)
Net Value	1,733,333

Wear and Tear Deductions:

	I(37.5%)	II(30%)	III(25%)	IV(12.5%)
Lorries	250,000			
Tractors	375,000			
Saloon Cars			1,250,000	
Equipment				275,000
Computers		300,000		
Furniture				725,000
	625,000	300,000	1,250,000	1,000,000
Addittion:				
Mercedes Benz			1,000,000	
Saloon Cars			3,000,000	
Water Pump				200,000
	625,000	300,000	5,250,000	1,200,000
Disposals: Saloon Car			(600,000)	
	625,000	300,000	4,650,000	1,200,000
W.T.D	(234,375)	(90,000)	(1,162,500)	(150,000)
W.D.V c/f	390,625	390,625	3,487,500	1,050,000

(2) The motor car benefit to director will be taxed as a benefit at the higher of:
(i) Fixed benefit based on CC rating.
(ii) 24% p.a. of cost of car.

MOCK TWO

To be carried out under examination conditions and sent to the Distance Learning Administrator for marking by the University.

EXAMINATION PAPER **TIME ALLOWED: THREE HOURS**
ANSWER ALL QUESTIONS

Taxable Employment Benefits - Year 2005

RATES OF TAX (Including wife's employment, self employment and professional income rates of tax).
Year of income 2005.

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)

Capital allowances:

Wear and tear allowances

Class I	37.5%
Class II	30%
Class III	25%
Class IV	12.5%

Industrial building allowance:

Industrial buildings	2.5%
Hotels	4.0%

Farm works allowance 33.3%

Investment deduction allowance:

2003	-	70%
2004	-	100%
2005	-	100%

Shipping investment deduction 40%

Mining allowance:

Year 1	40%
Year 2 - 7	10%

Prescribed benefit rates of motor vehicles provided by employer

					Monthly rates (Sh.)	**Annual rates (Sh.)**
(i)	Saloon, Hatch Backs and Estates					
	Upto	-	1200 cc		3,600	43,200
	1201	-	1500 cc		4,200	50,400
	1501	-	1750 cc		5,800	69,600
	1751	-	2000 cc		7,200	86,400
	2001	-	3000 cc		8,600	103,200
	Over	-	3000 cc		14,400	172,800
(ii)	Pick-ups, Panel Van (Unconverted)					
	Upto		1750 cc		3,600	43,200
	Over		1750 cc		4,200	50,400
(iii)	Land Rovers/Cruisers				7,200	86,400

OR 2% of the initial capital cost of the vehicle for each month, whichever is higher.

Commissioner's prescribed benefit rates

	Services	**Monthly rates Sh.**	**Annual rates 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.

VAT @ 16%.

QUESTION ONE

a) What does the term employer include for PAYE purposes? (4 marks)

b) J. Selina is an accountant with Kamau Enterprises Ltd. Details of employment income for the year ended 31st December 2005 are as follows:

1. Salary per month Shs 250,000 [PAYE Shs 84,000 per month
2. She contributes 5% of her monthly salary to the company's pension scheme which is registered with the Commissioner of Income Tax.
3. She is provided with a company house.

The financial controller has informed you that Kamau Enterprises has leased the house which J. Selina is occupying at the monthly rent of shs 50,000.

Required

1. Compute chargeable income for J. Selina in the year. (6 marks)
2. Compute J. Selina's tax liability for the year. (6 marks)
3. Would the chargeable income and the tax liability in 1 and 2 above change if the house that J. Selina occupies was rented from her? Explain. (Calculations not required) (4 marks)

(Total :20 marks)

(CPA adapted)

QUESTION TWO

a) Explain the meaning of the following terms and state their effects on taxable income.

i) Trading receipts (2 marks)
ii) Balancing charge (2 marks)
iii) Trading loss (2 marks)
iv) Balancing deduction (2 marks)

b) The Meru Forest Tree Fellers Ltd. commenced business on 1st January 2004. The following fixed assets of the company which it acquired prior to the commencement of the business were stated at their written down values as at 1st January 2005.

	Shs
Milling machine	3,440,000
Fork lifts	1,720,000
Tractors	7,800,000
Lorries-200 tonnes	2,400,000
Packaging machine	3,500,000
Crushing machine	3,680,000
Conveyor and sorter	6,240,000
Two pick-ups	1,800,000
One lorry	2,400,000
Saloon cars	780,000
Furniture and fittings	544,000
Land	20,000,000

The building in which the processing was to be carried out was constructed in 2003 but was first used for manufacture in 2005. The building cost Shs 13,600,000 in 2003 and the estimated value in January 2005 was Shs 11,400,000. In 2005, the company bought the following assets:

	Shs
Toyota saloon car	2,700,000
Lorry	5,200,000
Tractor	3,540,000
Furniture	280,000
Land	6,240,000
Pick-up	4,000,000
Computers	500,000
Computer scanner	400,000
Printers	200,000
Milling machine	5,550,000

The following assets were also disposed in 2005.

	Shs
Fork lift	480,000
Saloon car	920,000
Printer	50,000
Land	2,240,000
Packaging Machines	4,500,000

A tractor was damaged through a road accident during the year and the insurance company paid Shs 3,200,000 as compensation.

Required
Capital allowances for the company in 2005. (12 marks)

(Total: 20 marks)
(**CPA adapted**)

QUESTION THREE
Gatwiri, Kiende and Kanyiri are partners operating a supermarket in Meru town. They share profits and losses in the ratio 2:2:1 respectively. During the year ended 31st December 2005, the partners reported a loss of Shs 4,425,000 after deducting the following;

	Shs
Interest on capital -Gatwiri	232,000
-Kiende	232,000
-Kanyiri	348,000
Salaries to partners -Gatwiri	400,000
-Kiende	420,000
-Kanyiri	576,000
Motor vehicle running expenses	304,000
Repairs and maintenance	96,000
Office expenses	240,000
Goodwill	400,000
Loss on investment	600,000
Postage and telephone	170,000
Water and electricity	136,000

Subscriptions to Kenya National Chamber of Commerce	128,000
Salaries and wages	712,000
Donations	300,000
Bad debts written off	346,000
Rent, rates and licences	160,000
Professional fees	960,000
Depreciation	1,760,000
Purchase of lorry	1,331,000
Dividends received (net)	264,000
Insurance recovery on motor vehicle	520,000

Notes
1. Office expenses included cost of office cabinet of Shs 110,000
2. Travelling expenses amounted to Shs 12,000 per month related to personal.
3. Provision for bad and doubtful debts account

	Shs		Shs
Bad debts	246,000	General c/f	330,000
Specific c/f	192,000	Specific c/f	152,000
General c/f	390,000	Profit and loss a/c.	346,000
	828,000		828,000

4. Kiende had taken goods worth Shs 70,000 for her own use.
5. Wear and tear allowances agreed with the Commissioner amounted to Shs 706,000.
6. Included in repairs and maintenance is Shs 80,000 paid for office partitions in 2005.

Required:
The taxable profit(loss) from the partnership business and show the distribution among the partners as at 31st December 2005. **(Total : 20 marks)**
(CPA adapted)

QUESTION FOUR
Explain the meaning of the following terms as appearing in the respective tax legislation.

a) Excise duty (2 marks)
b) Local committee (2 marks)
c) Designated primary society (2 marks)
d) Bonded warehouse (2 marks)
e) Taxable person (2 marks)
f) Zero rated (2 marks)
g) Non-resident (2 marks)
h) Exempt income (2 marks)
i) Registered home ownership savings plan (2 marks)
j) Commercial vehicle (2 marks)

(Total : 20 marks)
(CPA adapted)

QUESTION FIVE

a) Explain any FOUR effects of Value Added Tax on business. (4 marks)

b) Define a tax invoice. List six particulars of a tax invoice. (8 marks)

c) Inland Limited imported goods whose landed value is Shs 400,000. The duty payable on them is at the rate of 35%. There is to be made a provision for transport to the interior amounting to Shs 50,000. A commission is to be paid of 2% of dutable value. Value Added Tax is charged on those goods at 15%.

Determine the amount of VAT payable. (4 marks)

d) Write short notes on VAT Tribunal. (4 marks)

(Total: 20 marks)

(CPA adapted)

END OF MOCK EXAMINATION

NOW SEND TO THE DISTANCE LEARNING FOR MARKING