

# Higher National Diploma in Taxation

## Tax Accounting

*Contact hours: 45hrs*

*Prerequisite – Income Tax Practice*

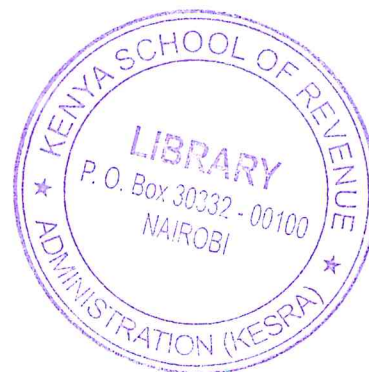
### **General Objective**

This unit is intended to equip the learner with adequate knowledge and skills to analyze and prepare tax accounting records for all forms of business organization.

### **Expected Learning Outcomes**

At the end of the course the learners should be able to:

1. Prepare financial statements of taxation and tax assessment of different business entities.
2. Analyze business activities and tax planning opportunities and back duty.
3. Apply various Kenyan taxation statutory provisions for purposes of ensuring tax compliance.
4. Compute tax for complex aspects of companies and specialized entities
5. Evaluate emerging issues on incidence and impact of taxation in Kenya.



## Contents

Higher National Diploma in Taxation.....	1
Tax Accounting.....	1
<b>Chapter 1.....</b>	<b>6</b>
<b>1.1 Capital Deductions.....</b>	<b>6</b>
<b>1.1.1 Introduction .....</b>	<b>6</b>
<b>1.1.2 Capital Expenditure .....</b>	<b>6</b>
<b>1.2 Capital Deductions under Second Schedule to the Income Tax Act Cap 470 .....</b>	<b>7</b>
<b>1.2.1 Types of Capital Deductions.....</b>	<b>7</b>
<b>1.2.2.1 Wear And Tear Deduction (Allowance).....</b>	<b>7</b>
<b>1.2.2.2 Industrial Building Deductions (IBD).....</b>	<b>16</b>
<b>1.2.2.3 TYPES OF INVESTMENT DEDUCTIONS.....</b>	<b>19</b>
<b>1.2.2.4 Summary of Investment Deduction Rates.....</b>	<b>21</b>
<b>1.2.2.5 Investment Deduction Bonded Manufacturers (IDBM).....</b>	<b>24</b>
<b>1.2.2.6 Shipping Investment Deduction (S.I.D).....</b>	<b>32</b>
<b>1.2.2.7 Deductions In Respect of Capital Expenditure on Agricultural Land.....</b>	<b>33</b>
<b>Chapter 2.....</b>	<b>37</b>
<b>2.1 Taxation of Partnerships.....</b>	<b>37</b>
<b>2.1.1 Introduction .....</b>	<b>37</b>
<b>2.1.2 Partnership Computation .....</b>	<b>37</b>
<b>Chapter 3.....</b>	<b>42</b>
<b>3.1 Taxation of Related Parties.....</b>	<b>42</b>
<b>3.1.1 Introduction .....</b>	<b>42</b>
<b>3.1.2 Transfer Pricing.....</b>	<b>42</b>
<b>3.1.3 Importance of Transfer Pricing (TP).....</b>	<b>42</b>
<b>3.1.4 Transfer Pricing Provisions in Kenya.....</b>	<b>43</b>
<b>3.1.5 Cross Border Transactions.....</b>	<b>43</b>
<b>3.1.6 Arm's Length Price .....</b>	<b>43</b>

3.1.7	Transfer Pricing Methods.....	43
3.1.7.1	Comparable Uncontrolled Price Method (CUP).....	44
3.1.7.2	Resale Price Method.....	44
3.1.7.3	Cost Plus Method.....	46
3.1.7.4	Profit Split Method.....	46
3.1.7.5	Transactional Net Margin Method (TNMM).....	47
3.1.8	Selection of Transfer Pricing Method.....	47
Chapter 4.....		49
4.1	Taxation of Extractive Industries.....	49
4.1.1	Introduction.....	49
4.1.2	Taxable Income.....	51
4.1.3	Nature and Classification of Income.....	51
Chapter 5.....		56
5.1	Taxation of Insurance Companies.....	56
5.1.1	Legal Provisions on Taxation of insurance Companies.....	56
5.1.2	Ascertainment of Income of Insurance Companies.....	56
5.1.3	Life Insurance Business.....	57
Chapter 6.....		60
6.1	Taxation of Cooperatives.....	60
6.1.1	Taxation of Co-Operative Societies.....	60
6.1.2	Designated Co-Operative Societies.....	60
Chapter 7.....		66
7.1	Back Duty and In Depth Examinations.....	66
7.1.1	Introduction.....	66
7.1.2	Sources of information to the Domestic tax department.....	66
7.1.3	Determination of income in back duty cases.....	66
7.1.4	Capital statement.....	67
7.1.4.1	Steps in the computation of income chargeable to tax – under capital statement.....	67
Chapter 8.....		71

<b>8.1 Capital Gains Tax</b> .....	71
<b>8.1.1 Introduction</b> .....	71
<b>8.1.2 Definition of Capital Gains Tax (CGT)</b> .....	71
<b>8.1.3 Reasons for Reintroduction of CGT</b> .....	71
<b>8.1.4 Challenges in implementation of taxation of capital gains</b> .....	72
<b>8.1.5 What constitutes a transfer?</b> .....	72
<b>8.1.6 Determination of Net gain</b> .....	72
<b>8.1.7 CGT Declaration Forms</b> .....	74
<b>8.1.8 Exemptions from capital gains tax</b> .....	74
<b>8.1.9 Treatment of Capita Gain on Extractive Industry</b> .....	75
<b>8.1.10 Transfer Value Computation</b> .....	75
<b>Chapter 9</b> .....	76
<b>9.1 Tax Planning for Individuals and Companies</b> .....	76
<b>9.1.1 Tax Planning, Tax Avoidance and Tax Evasion</b> .....	76
<b>9.1.1.1 Tax Avoidance</b> .....	76
<b>9.1.1.2 Tax planning</b> .....	76
<b>9.1.1.3 Tax Evasion</b> .....	77
<b>9.1.2 Distinguishing Between Tax Planning, Tax Avoidance and Tax Evasion</b> .....	77
<b>9.1.3 Objectives of Tax Planning</b> .....	78
<b>9.1.4 Importance of Tax Planning</b> .....	79
<b>9.1.5 Essentials of Tax Planning</b> .....	79
<b>9.1.6 Areas of Tax Planning In the Context of the Income-Tax Act, 470</b> .....	80
<b>9.1.7 Tax Planning Relating to Corporate Restructuring</b> .....	80
<b>9.1.8 Tax Planning Relating to Financial Management Decisions</b> .....	81
<b>Chapter 10</b> .....	83
<b>10.1 Current Developments in Taxation.</b> .....	83
<b>10.1.1 Why modernization of taxation</b> .....	83
<b>10.1.2 Role played technology in taxation</b> .....	83
<b>10.1.3 Impact of Technology on Revenue Collection</b> .....	84

10.1.4 Technology impact on Taxpayers ..... 84

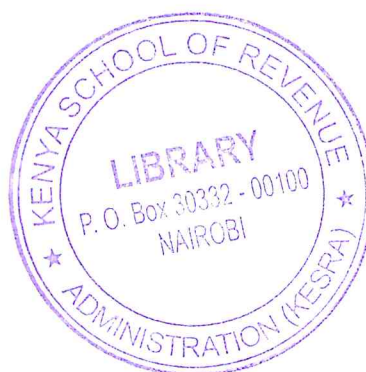
10.1.5 Technology and compliance..... 84

10.1.6 Taxation challenges in a digital economy ..... 84

10.1.7 New Regulations ..... 85

10.1.8 Strategic priorities in respect to Enhancing revenue collection ..... 85

10.1.9 Strategic priorities in respect to Enabling business by leveraging on technology ..... 85



## **Chapter 1**

### **1.1 Capital Deductions**

#### **Expected Learning Outcomes**

After studying this chapter, the learner should be able to:

1. Explain the purpose of granting capital deductions.
2. Identify qualifying costs for capital deductions.
3. Describe industrial buildings, qualifying costs for investment deductions and industrial building deductions.
4. Compute different types of capital deductions.
5. prepare the adjusted statement of profit for tax purposes by including capital deductions.

#### **1.1.1 Introduction**

The second schedule of the income tax Act provides for capital deductions. Capital deductions are tax deductions granted to investors who incur qualifying capital expenditure for purposes of carrying on business activity. Capital expenditure is any expenditure which gives a “long-term benefit” to the business and incurred “wholly and exclusively” for the trade. Ordinarily, depreciation is not allowable for tax purpose because businesses use different accounting policies when accounting for depreciation. Therefore uniform rate is provided to ensure equity in taxation. This is because the traders may be motivated to choose depreciation rates which maximize tax benefits thus negating the canons of taxation. Therefore section 16 of the Income Tax Act disallows depreciation for tax purposes and instead provide for capital allowance. Capital deductions are business costs claimable against taxable profits. Capital deductions computations are prepared for each accounting periods for instance for the year ended 31 December 2019, and classified as a trading expense for a business and should be deducted from adjusted profits for the accounting period.

#### **1.1.2 Capital Expenditure**

The purchase of capital asset should be included in the statement of financial position as non-current assets of the business. For example, capital items would include:

- Motor vehicles;
- Buildings;
- Furniture and fittings, photocopiers, computers, etc.

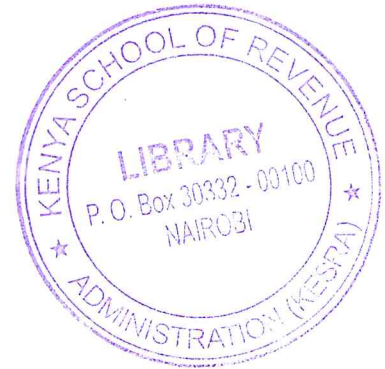
If the entity has included any capital additions in the statement of profit and loss and other comprehensive income, they should be disallowed for tax purposes. Therefore, they should be added back in arriving at the taxable profits under the income tax Act. In other words, any form of the capital item including losses on the sale of assets are disallowed and therefore added back. Likewise, profits on sales of non-current assets are not chargeable to tax and should, therefore, be deducted in

arriving at trading profits. Further, the entity may incur legal fees on the acquisition of capital assets. These are disallowed as they relate to a capital item. However, legal fees incurred on the renewal of a short lease that is a lease of not more than 99 years are specifically allowed.

## **1.2 Capital Deductions under Second Schedule to the Income Tax Act Cap 470**

### **1.2.1 Types of Capital Deductions**

1. Wear and tear allowances
2. Industrial building deduction
3. Investment deductions
  - Normal investment deduction- for normal industries
  - Shipping investment deduction
  - Investment deduction bonded manufacturer
4. Farmworks deductions
5. Mining allowances
6. Petroleum allowances



The Second Schedule to the Income Tax Act lists deductions or allowances at standard rates for all taxpayers depending on the nature of the capital expenditure incurred. The capital deductions are important because:

- a) Some offer an 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. Thus compensate for the loss of value of assets used in generating income.

Various capital deductions/allowances are computed as given below.

#### **1.2.2.1 Wear And Tear Deduction (Allowance)**

The Income Tax Act recognises the loss of value of assets used in business through usage, the passage of time or obsolescence and so grants the wear tear allowance. The wear and tear deduction is a capital deduction on machinery and equipment used for business, where the deduction is made against income in arriving at the taxable income or loss for the year and after disallowing any depreciation and similar charges against taxable income. Further, any capital loss, diminution, exhaustion of capital, such as depreciation, amortisation, loss on the sale of assets, obsolescence, provision for replacement, are not allowable expenditure against income.

Paragraph 7 of the Second Schedule to the Income Tax Act states that where during a year of income machinery owned by a person is used by the person for his business, there shall be made in computing the person's gains or profits ... a deduction ... referred to as a 'wear and tear deduction. For an entity to qualify for wear and tear allowance, the machinery and equipment should be:

- (a) Owned by a person, and
- (b) 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. however, implements, utensils, tools and similar articles, qualify for diminution (reduction) in value.
2. The machinery which qualifies for wear and tear are classified as follows:

#### **Class I (37.5%)**

This is a class for heavy earth moving equipment and heavy self-propelling (producing 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 1.1.1992 e.g. computers, printers, electronic Calculators, adding machines, photocopiers, and duplicating machines.

#### **Class III (25 %)**

This is a class for other self-propelling machinery including aircraft, pick-ups, motor cars, motorcycles, Lorries of less than 3 tons load capacity, vans, tuk-tuk, lawnmowers, etc

#### **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, Signboards, fridges, freezers, advertisement stands etc.

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

## Computing the wear and tear deduction

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

- a) Start with the written down value (WDV) for each class at the commencement of the accounting year (period), but if it's a newly established business there could be no balance WDV's brought forward from previous accounting period.
- b) Add to the balance brought forward for each class the amounts of any additional machinery (assets) purchased or made, new or old during the year.
- 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.
- d) Finally, the appropriate percentage rate is applied to the sub-total in (c) above for each class thus resulting to Wear and Tear Allowance for the year.

See the format below:

### Wear and tear computation — format

	Class I	Class II	Class III	Class IV
	37½%	30%	25%	12½%
	Sh.	Sh.	Sh.	Sh.
Written Down Value (WDV) b/d	XX	XX	XX	XX
Additions during the year	<u>XX</u>	<u>XX</u>	<u>XX</u>	<u>XX</u>
Sub—totals	XX	XX	XX	XX
Disposal/sales	<u>(XX)</u>	<u>(XX)</u>	<u>(XX)</u>	<u>(XX)</u>
Sub-totals	XX	XX	XX	XX
Wear and Tear Deduction	<u>(XX)</u>	<u>(XX)</u>	<u>(XX)</u>	<u>(XX)</u>
Written down Value (WDV) - end of period	<u>XX</u>	<u>XX</u>	<u>XX</u>	<u>XX</u>

#### Points to note

1. It is very important to give notes showing details of how the figures of addition or disposal for each class are made up.
2. The amount of wear and tear deduction calculated is summed up and deduction against taxable income or loss.

#### Commercial and non-commercial vehicles for wear and tear deduction

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

The Income Tax Act defines a commercial vehicle<sup>27</sup> as a road vehicle which the Commissioner is satisfied is—

1. Manufactured for the carriage of goods and so used in connection with a trade or business eg Lorry, pick-up, van etc or

2. A motor omnibus within the meaning of that term in the Traffic Act (Cap. 403); e.g. public service (PSV) vehicles for instance buses and matatus, or
3. Used for the carriage of members of the public for hire or reward e.g taxi and tour operator vehicles.

NB. Any vehicle not fitting the definition of a commercial vehicle is referred to as a non-commercial vehicle. In this case, any addition of non-commercial vehicle will have its value restricted to Sh.2 million w.e.f 1/1/2006. And 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:

$$\frac{\text{Sales Proceeds}}{\text{Cost}} \times \text{Restriction value applicable in the year of purchase.}$$

The following issues are considered when determining wear and tear allowances

1. The WDV at the close of the accounting year becomes the opening WDV for the coming accounting year.
2. The cost of assets which qualify for wear and tear additions are:
  - a) The historical cost of the asset is the qualifying cost for WTA, whether the asset is new or old.
  - b) The pre-operating expenses/costs that are costs incurred before the asset becomes operational e.g. customs duty, transport, installation expenses, alterations to buildings incidental to installation like widening room or building a stand for machinery are capitalized.
  - c) The trade-in value plus cash paid in purchasing the asset is the qualifying cost for wear and tear allowance.
  - d) In case of hire purchase, the cash price is the qualifying cost for WTA while the hire purchase interest is expensed in the profit and loss account.
  - e) Donations and proprietors private assets brought into the business, the market price of such assets is considered for WTA.
  - f) The non-commercial vehicles in Class III are restricted if the cost of such vehicle exceeds the restriction amount. The restricted amount is as follows:
    - With effect from 1.1.1998 – 31/12/2005 sh.1, 000,000
    - With effect from 1/1/2006 to date sh.2, 000,000
  - g) With effect from 1.1.1987 for machinery qualifying for both wear and tear allowance and investment deduction, the qualifying cost for WTA is the residual/net amount after investment deduction.
3. The sales proceeds upon disposal of an asset are:
  - a. The amount of cash proceeds or cash equivalent is taken as the sale amount for wear and tear.
  - b. The restricted amount of sale proceeds for non-commercial vehicles  $\frac{\text{Sale Proceeds}}{\text{cost}} \times$  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. Similarly, the amount of insurance compensation received is taken as sales proceeds.
- i. When sale proceeds in any class of wear and tear exceed the written down value the difference is called trading receipt or balancing charge when the business is continuing or ceasing respectively. These amounts are chargeable to tax.
  - ii. But when the sale proceeds are less than the written down value, the difference is called trading loss or balancing deduction when the business is continuing or ceasing respectively. These amounts are allowable against taxable income.
4. The amount calculated as wear and tear deduction is deducted in the income tax computation.
  5. The annual rate of wear and tear is applied on the reducing balance in each class.
  6. Where the operation of the business was carried on for a full year, the full amount of wear and tear is allowed irrespective of the date the qualifying assets were first brought into use.
  7. But if the business is operated for less than 12 months, the annual wear and tear deduction is restricted to the period the business operated.
  8. 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.
  9. Where an asset is partly used for business and partly private, the wear and tear deductible is restricted to the proportion related to the business.
  10. In the case of business succession, the new owner inherits the residue from the previous owner

**Example**

Mataa Co. Ltd deals in hardware where the final statement year-end is usually 31 December. The following information relates to the company for the year ended 31 December 2019.

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

	Class I	Class III	Class IV
	37½%	25%	12½%
	sh.	sh.	sh.
Written Down Value 1.1.2018	175,000	180,000	87,000

ii) Disposals during the year:

	Cost	Net Book Value	Sales proceeds
	sh.	sh.	sh.
Isuzu Lorry	280,000	175,000	260,000
Motor car (purchased in 1.9.2018)	1,160,000	1,015,000	800,000

iii) additions during the year

	sh.
Saloon car for office manager	4,000,000
Tractor	80,000
Trailer for the tractor	80,000
Fixtures and fittings	60,000
Computer bought 1.9.2019	250,000
Switchboard bought 1.9.2018	72,000

- iv) The office cabinet purchased in 2016 for sh.30,000 was traded-in for a modern cabinet of sh. 40,000. The old cabinet was valued at Sh. 20,000 and the company paid the balance of sh. 20,000 by cash. The netbook value of the old cabinet was Sh. 22,968 at the time of disposal.

**Required**

Prepare a wear and tear schedule for the company for the year 2019.

**Solution**

Mataa Co. Ltd				
Wear and tear computation for the year ended 31 December,2019				
	Class I 37.5% Sh.	Class II 30% Sh.	Class III 25% Sh.	Class IV 12.5% Sh.
WDV as at 1.1.2019	175,000	—	180,000	87,000
Additions:				
Saloon car (restriction)—Note 1			2,000,000	
Tractor	80,000			
Trailer—Note 2				80,000
Fixtures and fitting				60,000
Computer—Note 3		250,000		
Switchboard—Note 3				72,000
Cabinet (cash + trade-in) Note 4				<u>40,000</u>
	<u>255,000</u>	<u>250,000</u>	<u>2,180,000</u>	<u>339,000</u>
Disposal (Sales):				
Cabinet (trade-in-value)				(20,000)
Isuzu Lorry	(260,000)			
Saloon car—Note 5			(1,379,310)	
	(5,000)		800,690	490,000
Trading Receipt—Note 6	5,000	—	—	—
Wear and tear deduction/allowance	<u>NIL</u>	<u>(75,000)</u>	<u>(200,172.5)</u>	<u>(39,875)</u>
WDV as at 31.12.2019	<u>—</u>	<u>175,000</u>	<u>600,517.5</u>	<u>279,125</u>

**Wear and tear deduction:**

	<i>Sh.</i>
Class I	—
Class II	75,000
Class III	200,172.5
Class IV	<u>39,875</u>
Total amount to be deducted in the Income Tax Computation	<u>315,047.5</u>

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

**Notes**

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

Note that a trailer attached to the 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 1.1.2019 fall under Class II (30%) of wear and tear.
4. The purchase price of the safe is Sh. 40,000 arrived at as follows:

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

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

5. The car sold is not a commercial vehicle which means that it was restricted to Sh. 2,000,000 as addition in 2018. The sale proceeds of Sh. 800,000 must, therefore, be restricted by a factor of 1,000,000 costs as follows:

$$\frac{800,000}{1,160,000} \times 2,000,000 = Sh .1,379,310$$

6. Trading receipt arises in a continuing business where the sale proceeds in a class of wear and tear machinery exceed 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 recognized.

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 a 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.

### Exercise

Mawe Ltd commenced operation on 1 January 2017. The following are the written down value of the assets as at 1.1.2018:

Class I	Sh. 800, 000
Class II	Sh. 600, 000
Class III	Sh. 1,000, 000
Class IV	Sh. 500, 000

During the year the following assets were acquired or disposed of:

- Purchased a lorry of 4 tons in January 2018 for Sh.800,000, a tractor from insurance Co. without an engine at a cost Sh.700 000 and a pick-up of 3.5 tons at Sh.300 000.

In March 2018 the proprietor transferred his saloon car valued at sh.840,000 to the business for use in transporting workers.

He traded in a computer purchased in 2017 at Sh.80 000 with a new type of computer valued at Sh.140 000 in 2018 where the trade-in value was Sh.38,000.

On 1 April 2018 the company purchase a Mercedes Benz for Sh.1 200 000 which was used as a tax during the year.

On 1 October 2018, the company purchased dysfunctional forklift for Sh.1,200,000 and a motorbike for Sh.240,000.

1 December 2018 the company disposed of a pick-up with a book value of sh. 300 000 for sh Sh.280 000.

During the year 2019, the following transactions took place:

On 1 January 2019, an engine for the tractor for Sh. 200 000 was bought and the tractor put into operational use immediately.

A computer purchased in 2017 for Sh.70,000 was stolen and the insurance company compensated for Sh.64,000 was paid in the year 2019. The same period the company purchased another computer from the auction at sh 55,000.

In June 2019 a Toyota Corolla purchased in 2017 at Sh. 800 000 was disposed of for 600,000.

In July 2019 the company purchased a land cruiser costing Sh.500 000 for use by the general manager.

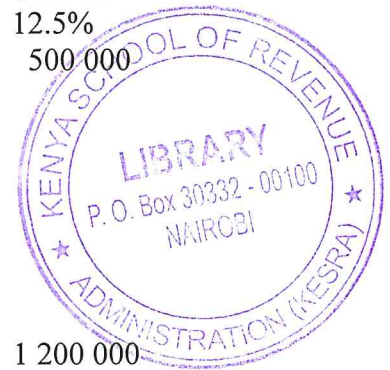
During the year 2019, the firm imported machines for Sh.2,000,000, where other related costs incurred included; storage cost of machines at the container inland depot, Sh.50,000, customs duty paid sh.200,000, installation costs by own staff sh.100,000, demolished the room to create space for one of the machines sh.50,000, constructed a pillar for a machine sh.30,000, Testing of the machine before installation sh.60,000, maintenance cost after installation sh.200,000.

Required:

Prepare a schedule of wear and tear allowance for the years 2018 & 2019.

**Mawe Ltd Wear & Tear computation**

	CLASS I 37.5%	CLASS II 30%	CLASS III 25%	CLASS IV 12.5%
WDV 1.1.2018	800 000	600 000	1 000 000	500 000
<i>Additions</i>				
Lorry	800 000			
Tractor	Nil			
Pick-up	300 000			
Car			100 000	
Computer		140 000		
Mercedes Benz			1 200 000	
Forklift				1 200 000
Motorbike			240 000	
	<u>1 900 000</u>	<u>740 000</u>	<u>2 540 000</u>	<u>1 700 000</u>
<i>Disposals</i>				
Old computer		38 000		
Pick-up			280 000	
	<u>1 900 000</u>	<u>702 000</u>	<u>2 260 000</u>	<u>1 580 000</u>
Wear & Tear	<u>712 500</u>	<u>210 600</u>	<u>565 000</u>	<u>197 500</u>
WDV 31.12.18	<u>1 187 500</u>	<u>491 400</u>	<u>1 695 000</u>	<u>1 382 500</u>



Cost of machinery	2 000 000
Storage cost	50 0000
Custom duty	200 000
Installation cost	100 000
Demolition cost- create space	50 000
Construction of pillar	30 000
Testing before installation of machinery	60 000
Qualifying cost	<u>2 490 000</u>

2019	CLASS I 37.5%	CLASS II 30%	CLASS III 25%	CLASS IV 12.5%
WDV 1.1.19	1 187 500	491 400	1 695 000	1 382 500
<i>Additions</i>				
Tractor	900 000			
Computer		250 000		
Land cruiser			500 000	
Machinery				2 490 000
<i>Disposals</i>				
Toyota corolla			(600 000)	
Computer		(180 000)		
	<u>2 087 500</u>	<u>561 400</u>	<u>1 595 000</u>	<u>3 872 500</u>
W& T	<u>782 813</u>	<u>168 420</u>	<u>398 750</u>	<u>484 063</u>
	<u>1 304 687</u>	<u>392 980</u>	<u>1 196 250</u>	<u>3 388 437</u>

### 1.2.2.2 Industrial Building Deductions (IBD)

IBD are deductions in respect of capital expenditure on certain buildings, where a person incurs capital expenditure on the construction of an industrial building to be used in a business carried on by him or his lessee.

NB. Construction of an industrial building” includes the expansion or substantial renovation or rehabilitation of an industrial building, but does not include routine maintenance or repair.

Definition of an industrial building: An Industrial building means;

- a) building in use—
  - (i) for a business carried on in a mill, factory or other similar premises; or
  - (ii) for a transport, dock, bridge, tunnel, inland navigation, water, electricity or hydraulic power undertaking; or
  - (iii) for a business which consists of the manufacture of goods or materials or the subjecting of goods or materials to any process; or
  - (iv) for a business which consists of the storage of goods or materials—
    - (a) Which are to be used in the manufacture of other goods or materials; or
    - (b) Which are to be subjected, in the course of business to any process; or
    - (c) which, having been manufactured or produced or subjected, in the course of a business, to any process, have not yet been delivered to any purchaser; or
    - (d) On their arrival by sea or air into any part of Kenya; or
- (v) For a business consisting of ploughing or cultivating agricultural land (other than land in the occupation of the person carrying on the business) or doing any other operation on such land, or threshing the crops of another person; or
- (vi) For a business which may be declared by the Minister by notice in the Gazette.
- b) A prescribed dwelling-house, that is to say, a dwelling-house constructed for and occupied by employees of a business carried on by the person owning such dwelling-house, and which conforms to conditions as may be prescribed.
- c) A building which is in use as a hotel or part of a hotel and which the Commissioner has certified to be an industrial building 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.
- d) A building in use for the welfare of workers employed in any business used for the purposes specified (a) in the first section of the definition of an industrial building.
- e) A building in use as a hostel or an educational building, or a building in use for training, the building should be certified by the Commissioner.

(f) A building in use as a rental residential building where such building is constructed in a planned development area approved by the Minister for the time being responsible for matters relating to housing.

(g) The commercial building where the person has provided roads, power, water, sewers and other social infrastructure.

In claiming Industrial Building Deductions, a deduction equal to the following rates shall be granted:

- Ordinary Industrial building: Upto 2009; was 2.5%, and 10% with effect from 1.1.2010,
- Hotels WEF from 2010 the rate changed to 10% before it was 4%.
- Hostels/educational buildings are at 50%.
- Building in use for the training of film producers, actors or crew, the rate of deduction shall be 100%.
- Commercial building to be used in a business carried on by him or his lessee on or after the 1st January 2013, and the person has provided roads, power, water, sewers and other social infrastructure, a deduction 25% p.a

NB; WEF 1 January 2010, IBD is at 25% on the cost of roads, power, water, sewers and other social infrastructure is provided to the person incurring the capital expenditure. Social infrastructure expenditure” means capital expenditure incurred by a licensee or contractor on the construction of a public school, hospital, road etc.

A capital deduction equivalent to the rate specified of the qualifying expenditure shall be made in computing the gains or profits of such person for any year of income in which the building is so used.

**Points to note:**

- a) Industrial Building is computed on a straight-line basis.
- b) Where the building was so used for part only of such year of income, the deduction shall be proportionately reduced. For example, if the building was used for only 3 months a deductible amount for IBD is appropriated for only 3 months. The practice of the Domestic taxes Department is to have a minimum apportionment of one full month where days are involved.
- c) where the building is sold and continues to be an industrial building used by the purchaser or his lessee, the deduction shall thereafter be made in computing the profits or gains of such person for any year of income in which such building is so used.
- d) In case the industrial building is abandoned before exhaustion of IBD, the notional IBD will continue to accumulate, although going to waste. That it will not be claimed against any taxable profit.
- e) 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 new owner of the building shall inherit the residual and claim IBD for the remainder of the economic life of the building.

- f) The following civil works or structures on the premises of an industrial 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) water, industrial effluent and sewage works;
  - (iv) communications and electrical posts and pylons and other electricity supply works; and
  - (v) security walls and fencing
- g) In case the economic life of the industrial building is substantially less than expected life, the investor may apply to the commissioner for an increase in the amount (rate) of the deduction.
- h) If an investor sold the building before use, the qualifying cost for IBD for the new owner is the lower of the actual cost incurred on the construction of the building and the purchase price. 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 like an industrial building. The cost qualifying for industrial building deduction is the lower of construction cost to (A) and the amount/price paid by (D).
- i) Where the cost of constructing an industrial building is incurred by a person carrying on the business of constructing buildings (a builder) to sell it 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.
- j) Industrial building” does not include a retail shop, showroom, office or dwelling-house, or for any purpose ancillary to the purposes of a retail shop, showroom or office. However, where the capital expenditure not more than 10% of the total capital expenditure which has been incurred on the construction of the building, the whole building shall be treated as an industrial building.
- k) 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 do not qualify.
- l) The costs of items treated as machinery for wear and tear e.g. partitioning, shelves, counters etc. do not qualify for IBD
- m) The cost of a 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.), the total cost qualifies for IBD.

### **Example**

A factory closed down for two years in 2014 and 2015 and the residue value on 31.12.2016 was Sh. 420,000 with an annual IBD of Sh. 14,000.

2014 notional IBD Sh. 14,000

2015 notional IBD Sh. 14,000

Assuming the building was put into use again in 2016 the Sh. 14,000 is claimed as Industrial building deduction in the income tax computation or in arriving at the taxable income/loss for the year 2016.

The residue of expenditure as at 31.12.2016 which is Sh. 378,000, that is, Sh. 420,000 — (14,000 x 3) = Sh. 378,000.

### 1.2.2.3 TYPES OF INVESTMENT DEDUCTIONS

- (1) Investment deduction – normal manufactures
- (2) Investment deduction – bonded manufactures (Sec 291) of the Customs and Excise, Act 472
- (3) Shipping investment deductions

#### **Investment Deduction**

The investment deduction is another capital deduction given on the cost of buildings and machinery which are used for manufacture, on the cost of a ship, and the 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 in 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, however different investment rates are granted ranging from 100% to 150%. The investment deduction is granted only once during the assets useful economic life, usually during the assets first year of use.

#### **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 the purchase and installation therein of new machinery, and the owner or lessee of that building uses that machinery in that building for manufacture. (New building + new/old machinery qualify for ID).

With effect from 1.1.1992, a building used for manufacture qualifies for investment deduction on its own, provided that it had not been used for other purposes before being used for manufacture; or

- b. On the purchase and installation of new/old machinery used for manufacture in any part of a building other than a building previously used for manufacture (new/old machinery installed in old building qualifies for investment deduction).

With effect from 1.1.1992 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 1.1.1993 machinery does not need to be installed to qualify for the allowance.

- c. on the construction of a hotel building which is certified as an industrial building by the Commissioner of Domestic taxes; or
- d. On the construction of a building and the purchase and installation therein of new machinery, and the owner of that building uses that machinery in that building for manufacture under bond; that is, manufacture for export only.
- "building" includes any building structure and if used for manufacture, then with effect from 1.1.1995 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 the 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 1.1.1995, 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 the machinery qualifies for investment deduction.

2. In a bid to encourage investment in industrial building machinery and equipment, the level of investment deduction was increased to 100% with effect from 1.7.2000. Thereafter it reduced to 85% during the year 2002, 70% in 2003, finally reverted to 100% in the year 2004 to date (2020).

#### **1.2.2.4 Summary of Investment Deduction Rates**

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.

Rates of investment deduction for building and machinery used for ordinary manufacture and hotel building.

<b>Year of Income</b>	<b>ID rate</b>
1995 – 30.6.2000	60%
1.7.2000 – 31.12.2001	100%
1.1.2002 – 31.12.2002	85%
1.1.2003 – 31.12.2003	70%
1.1.2004- to date	100%

#### **The 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 the acquisition of land.
- Cost of items or activity which are supplementary to manufacture such as design, storage, transport, administration, security, etc.
- Replacement machinery.

#### **Things to remember when calculating investment deduction**

1. Non-qualifying capital expenditure of the building such as office, showroom, retail shop, store and dwelling house if it is not more than 10% of the total cost of the building (qualifying and non-qualifying), 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 the qualifying cost for investment deduction.
  - c) 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.

**Exercise:**

Kiambu manufacturers Plc started a factory in Thika industrial area for processing fruit juice. The company incurred the following capital expenditure before the start of manufacturing on 1.1.2018

	Sh.
• cost of land	2,000,000
• factory building	6,000,000
• processing machinery	3,080,000
• computer installed to the processing machinery	400,000
• weighing scale	100,000
• reconditioned boiler	600,000
• fork lift	500,000
• Furniture	100,000

The company bought:

2 station wagon cars use in delivery of products @1 600 000 each= 3,200,000

3 Toyota saloons @ 1 200 000 =3,600,000

1 lorry of 3 tonnes @ 800,000

July 1<sup>st</sup> 2018 the firm started another factory in Ruiru due to increasing demand for the product, the capital expenditure included:

- Purchase of an old building for sh.10,000,000, the building was previously used as a shop. The building was constructed in 2000 at a cost of sh. 4,000,000. The company installed therein machinery for manufacturing costing sh. 3,000,000.
- Purchased a computer and a typewriter for sh. 60,000 & sh.40,000 respectively.
- Acquired furniture during the year of sh. 40,000 while disposing old fixtures at sh. 70,000.
- One of the Toyota corolla purchased during the year was involved in an accident and the insurance co. compensated for sh. 720,000 was given. The money was used to purchase Datsun pick-up for sh. 1,100,000.

Suppose the current rate of investment changes to a rate lower than 100% as it is currently the case. In this example assume investment deduction granted was 60%.

Required:

Capital allowance due to the company in 2018.

(w1)

Kiambu building 4,000,000

$$\text{IBD } 4,000,000 \times 10\% \times \frac{6}{12} = 200,000$$

(w2)

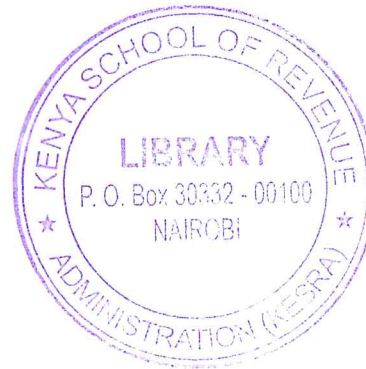
1.1. 2000----- 4,000,000

1.1. 2000----- 31. 12. 80----- 1 yr

1.1. 2001----- 31. 12. 81 ----- 2 times

$$18 \times 100,000 = 1,800,000$$

$$30.6.2000 \quad 200,000$$



2, 000,000

$$4,000,000 - 2,000,000 = 2,000,000$$

(w3)

$$\text{Toyota Corolla} \quad \frac{720,000}{1,200,000} \times 2,000,000$$

Thika  
1998 Capital Allowance Computation:

Investment Deduction:

<u>Nature of asset</u>	<u>qualifying cost</u>	<u>I.D @ 60%</u>	<u>Residue for WTA \$ IBD</u>
Factory building	6,000,000	3,600,000	2,400,000
Processing machinery	3,000,000	1,800,000	1,200,000
Recond. Boiler	600,000	360,000	240,000
Machinery	<u>3,000,000</u>	<u>1,800,000</u>	<u>1,200,000</u>
	<u>12,600,000</u>	<u>7,560,000</u>	

Industrial Building Deduction:

<u>Nature of the building</u>	<u>qualifying cos</u>	<u>residue b/fwd</u>	<u>IBD@ 10%</u>	<u>residue c/fwd</u>
Factory building	2,400,000	-	240,000	2,160,000
Ruiru building	4,000,000	(w2) 2,000,000	<u>200,000</u>	1,800,000
			<u>440,000</u>	

Wear & Tear Allowance:

	<u>class1 [37 <math>\frac{1}{2}</math> %]</u>	<u>class 2 [30%]</u>	<u>class3[25%]</u>	<u>class4[12 <math>\frac{1}{2}</math> %]</u>
WDV as at				
1. 1. 2018	NIL	NIL	NIL	NIL
Additions:				
Processing machine				1,200,000
Efficiency computer		400,000		
Weighing scale				100,000
Recond. Boiler				240,000
Mobile fork lift	500,000			
Furniture				100,000
2 Peugeot 504			2,000,000R	
2 Toyota corolla			3,000,000	
Lorry	800,000			
Machinery				1,200,000
Computer		60,000		
Typewriter				40,000
Furniture				2,000,000
1200 pick up			<u>1,100,000</u>	
	<u>1,300,000</u>	<u>460,000</u>	<u>6,100,000</u>	<u>4,810,000</u>

Disposals:

Furniture				[70,000]
Toyota corolla			[w3] [1,200,000]	
	<u>1,300,000</u>	<u>460,000</u>	<u>4,900,000</u>	<u>4,740,000</u>
WTA	<u>[487,500]</u>	<u>[138,000]</u>	<u>[1,225,000]</u>	<u>[376,250]</u>
W.D.V 31. 12. 2018	<u>812,500</u>	<u>322,000</u>	<u>3,675,000</u>	<u>2333,750</u>

### 1.2.2.5 Investment Deduction Bonded Manufacturers (IDBM)

IDBM was introduced on 1<sup>st</sup> January 1988, as an additional incentive to manufacture for export to:

- (a) Generated and building up foreign currency reserves.
- (b) Encourage both local and foreign investors to manufacture for foreign markets.

#### 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. A bond is a promise (agreement) by a person to pay to the 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.

#### Conditions to Qualify for IDBM

For an investor (manufacturer) to be granted IDBM, the following conditions must be fulfilled:

1. Must 1<sup>st</sup> qualify for the normal/ordinary investment deduction i.e. the investor must have incurred capital expenditure on the construction/purchase of an industrial building and installation of machinery therein.
2. Must obtain a license from customs and border control and excise dept. indicating that he wishes to manufacture for exports.
3. One must manufacture for export for at least three years.
4. However, 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 will be granted wear and tear deductions and IBD for the years he had operated.
5. 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 ID 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 to date 2020	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 1.1.1989, 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 years 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.

	Sh.	Sh.
IDBM claimed first year of use (100% of cost)		XX
Less: deductions that would have been claimed if not an investment deduction bonded manufacturer case:		
ID ordinary manufacture	(XX)	
Industrial Building Deduction	(XX)	
Wear and Tear Deduction	(XX)	(XX)
Claw back (added back) as taxable income		<u>XX</u>

#### Rates

(a) Outside the municipalities of Nairobi or Mombasa.

	1988	1989	1990-1994
Normal ID	60%	75%	85%
IDBM	25%	25%	15%
	<u>85%</u>	<u>100%</u>	<u>100%</u>

(b) Within the Municipalities of NRBI & MSA

	1988	1989	1990-1994
Normal ID	10%	25%	35%
IDBM	75%	75%	65%

From the above information, the investors were not encouraged through tax incentives to invest for export outside NRBI & MBS. In the case of NRBI & MSA, the rates for IDBM were high.

(c) WEF 1995, Regional tax rates disparities were removed and instead uniform rates came into effect.

**Applicable to all regions**

	1995 – 30 JUNE 2000	1 JULY 2003 – DEC. 2001	2002	2003	2004
Normal ID	60%	100%	85%	70%	100%
IDBM	40%	NIL	15%	30%	NIL

Note:

If a manufacturer fails or ceases to be eligible to engage in manufacture under bond before the expiry of the mandatory 3 years after the date of commencement of manufacturing an amount equivalent/equal to the deductions allowed under IDBM will be withdrawn and taxed in the year of income the company ceased to be eligible to engage in the manufacture under bond.

- (i) The portion of capital allowance which related to IDBM in respect to IBD and WTA will be spread forward as though the business was operating under normal manufacturing.
- (ii) The difference between the amount withdrawn as IDMB and the compensation for IBD & WTA will be treated as a trading receipt for the year of income in which he ceases to be eligible to engage in the MUB. The amount withdrawn and taxed will be net off compensation for WTA and IBD and will be treated as a trading receipt.

**Example**

ABC Limited constructed a building and installed new machinery for the manufacture of animal feeds for export. The building cost Sh. 15,000,000 and the machinery Sh. 10,000,000. Manufacturing commenced on 1.1.2016 and ceased on 1.1.2018. Compute the capital allowances for the year 2016, 2017 and 2018. Assume Investment Deductions was @ 70% so that the Example helps in understanding the calculation of manufacture under bond.

2016

Assets	Qualifying Cost	I.D (70%)	ID (MUB) (30%)	WDV
Building	15,000,000	10,500,000	4,500,000	-
Machinery	10,000,000	<u>7,000,000</u>	<u>3,000,000</u>	-
		<u>17,500,000</u>	<u>7,500,000</u>	

2017

No capital allowances

2018

The IDMUB is treated as income. However, IBD and WTD in respect of this amount is granted as follows:-

IBD

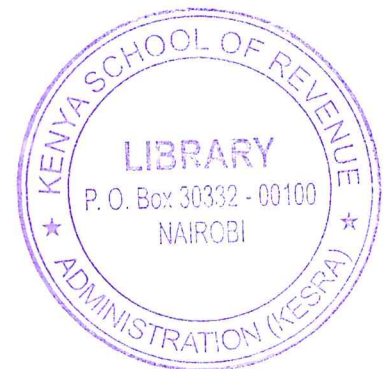
	Qualifying Cost	Residual Value b/f	IBD (2.5%)	Residual value c/f
2016	4,500,000	4,500,000	112,500	4,387,500
2017	4,500,000	4,387,500	112,500	4,275,000
2018	4,500,000	4,275,000	<u>112,500</u>	4,162,500
			<u>337,500</u>	

#### Wear & Tear Deduction

	WDV	Wear & Tear Deduction (12.5%)	WDV c/f
2003	3,000,000	375,000	2,625,000
2004	2,625,000	328,125	2,296,875
2005	2,296,875	<u>287,109</u>	2,009,766
		<u>990,234</u>	

The taxable trading receipt will be as follows:

	Sh.	Sh.
Trading receipt		7,500,000
Less: IBD	337,500	
WTD	<u>990,234</u>	<u>(1,327,734)</u>
Net Trading Receipt		<u>6,172,266</u>



#### Note

For the year 2004 and thereafter, the I.D (MUB) is 100% just like the I.D

#### Assignment

1. Explain why your government provide tax incentives for manufacture under bond
2. Matunda plc. applied and obtained a license from custom and border control dept to manufacture the herbal medicine for the export market only. The operation commenced in 2016 after having incurred the following capital expenditure:
  - ✓ Factory construction sh. 10 000 000 (which included the cost of land sh. 2 000 000 and administration bock sh. 750 000)
  - ✓ Processing machine sh. 4 000 000
  - ✓ Other machinery purchased: lorry sh. 600 000, furniture [made by staff] sh. 100 000, typing machine sh. 80 000
  - ✓ In 2017 he bought another engine of the lorry sh. 200 000 and brought for use for the first time.

✓ Computer acquired at a cost of sh.80 000

On 31<sup>st</sup> Dec 2017 due to unfavourable business environment in the foreign market, the company was forced to abandon the exportation business and reverted to production for the local market.

Assume Investment Deductions was @ 60% so that the Example helps in understanding the calculation of manufacture under bond.

Required:

Compute capital allowance due to him in 2016, 2017, & 2018.

Matunda plc.  
1996, 1997 & 1998 Capital Allowance Computation

Investment deduction:

Nature of asset	Qualifying cost	ID@ 60%	IDBM @ 40%
Factory building	8 000 000	4 800 000	3 200 000
Processing machine	4 000 000	<u>2 400 000</u>	<u>1 600 000</u>
		<u>7 200 000</u>	<u>4 800 000</u>

Wear &tear allowances:

	Class I [37.5%]	Class II [30%]	Class III [25%]	Class IV [12.5%]
WDV 1. 1.2016	nil	nil	nil	nil
Additions:				
Processing machinery				nil
furniture				100 000
Typing machine				<u>80 000</u>
				180 000
WTA				<u>[ 22 500]</u>
WDV 31.12.2016				<u>157 500</u>
WDV 1.1 2017				157 500
lorry	800 000			
computer		80 000		
WDV on IDBM withdrawn				nil
WTA				<u>19 680</u>
WDV 1.1.2018				137 812
Add WDV on withdrawn IDBM				<u>1 225 000</u>
				<u>1 362 812</u>

[W1]

Wear and tear on IDBM withdrawn:

amount	Sh. 1 600 000
2016WTA	<u>W2 200 000</u>
WDV as at 31.12.2016	1 400 000
WTA	<u>W2 175 000</u>
WDV as at 31.12.2016	<u>1 225 000</u>

Industrial building deduction:

Nature of asset	Qualifying cost	Residue b/fwd	IBD @ 2.5%	Residue c/fwd
1996 factory building	3 200 000	-	320 000	2880 000
1997 factory building	3 200 000	-	320 000	3 040 000
1998 factory building	3 200 000	-	320 000	2 960 000

### Assignment

Athi Plc. is a listed company at Nairobi securities exchange. The company obtained a license from the customs and border control department to manufacture clothes for export to the USA market. The license was granted on 1 January 2017 and commenced operation immediately after incurring the following expenditure:-

• Factory building (including office sh. 40,0000)	Sh.12 million
• Processing machinery	Sh.2,400,000
• Generator	Sh.600,000
• Workshop maintenance machinery	Sh.360,000
• Furniture	Sh.120,000
• Computers	Sh.30,000
• Lorry (3.5 tones)	Sh.1,800,000
• Train coaches	Sh.3,000,000
• Mercedes car	Sh.1,800,000

On 31 December 2018, the company was involved in a legal dispute and as a result, stopped sewing the clothes for USA market. As a result, the customs and border control department cancelled the export license, however, the company continued producing for the local market.

During the year of income, 2018, the company made a profit of sh.2,400,000.

Assume Investment Deductions was @ 70% so that the Example helps in understanding the calculation of manufacture under bond.

Required:

- (1) Compute capital allowances due to the company for the years 2017 and 2018
- (2) Adjusted taxable profit for the year 2018
- (3) Tax payable
- (4) Due date of paying final tax

On 1 July 2018, the company constructed an extension at a cost sh.6,000,000 after demolishing a wall at a cost sh.200,00. Installed machinery at a cost sh.1,200,000.

### Solution

2017 Investment deduction bonded manufacture

Value of asset	Qualifying Cost (sh.)	ID 70 % (sh.)	IDBM 30% (sh.)
F. Building	12,000,000	8,400,000	3,600,000
Processing M.	2,400,000	168,000	720,000
Generator	600,000	420,000	180,000
Workshop Machine	360,000	252,000	108,000
			<u>4,608,000</u>

Wear & Tear Allowance

	Class I 37 ½	Class II 30%	Class III 25%	Class IV 12 ½%
Furniture				120,000
Computers		30,000		
Lorry	1,800,000			
Train coaches				3,000,000
Mercedez @			1,000,000	
	<u>1,800,000</u>	<u>300,000</u>	<u>1,000,000</u>	<u>3,120,000</u>
WTA 2003	<u>675,000</u>	<u>90,000</u>	<u>250,000</u>	<u>390,000</u>
	1,125,000	210,000	750,000	2,730,000
	1,125,000	210,000	750,000	2,730,000
WAV 1.1.2004				882,000
Add: wdv (Withdrawn)	<u>1,125,000</u>	<u>210,000</u>	<u>750,000</u>	<u>3,612,000</u>
	412,875	63,000	187,500	451,500
WTA	<u>703,125</u>	<u>147,000</u>	<u>562,500</u>	<u>3,160,500</u>

IDBM – Withdraw – Compensation provided

Amount withdrawn Sh.4,608,000

Compensation for IBD & WTA

	WTA (sh).
Processing machinery	720,000
Generator	180,000
Workshop machinery	108,000
	1,008,000
WTA 2017 (12 /12 % x 1008000)	126,000
WTA 1.1.2018	882,000

Industrial Building deduction

Qualifying cost 3,600,000 x 2½% = 90,000 = 3510000

W1

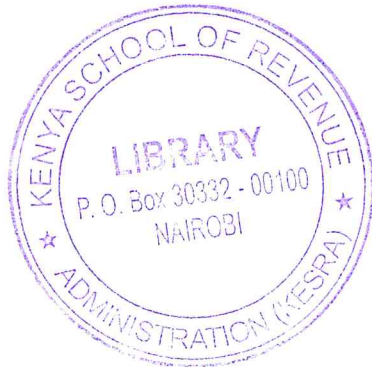
Total amount withdrawn ad taxed:

Sh..

Total amount withdrawn		4,608,000
Less compensation for: WTA	126,000	
	IBD	<u>90,000</u>
		<u>216,000</u>
Trading receipt		4,392,000

Athi Ltd  
Adjusted taxable profit for the year 2018

		sh.
Report Profit		2,400,000
Add back IDBM withdraw (WI)		4,392,000
		6,792,000
Less capital allowance: WTA	1,123,875	
	ID	<u>90,000</u>
		1,213,875
Adjusted taxable profit		5,578,125
Tax 25% x 5578125 =		1,394,531.25



### **1.2.2.6 Shipping Investment Deduction (S.I.D)**

The shipping investment deduction is given where a resident ship-owner incurs capital expenditure:

- a) on the purchase of new, power-driven ship of more than 295 tons tare weight; or
- b) on the purchase and subsequent refitting for shipping business of a used power-driven ship of more than 295 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 1.1.1987, 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 Sh. 2.5 million in 1985. If the ship is sold in 1990. The shipping investment deduction of Sh. 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 the Year 1985 to 1989, and the balance of the shipping investment deduction is taxed in 1990.

#### **Assignment**

1. Outline the procedure followed in the taxation of calculation of capital deductions for shipping investment in Kenya.
2. Explain two limitations for investment deduction for firms in marine businesses
3. Highlight conditions to be met by a marine investor to qualify for shipping investment deduction.

### 1.2.2.7 Deductions In Respect of Capital Expenditure on Agricultural Land

Agricultural land means land occupied wholly or mainly for a trade of husbandry.e.g.

- ✓ Crop farming—tea, coffee, horticultural, pyrethrum, maize, wheat, sugar cane etc. or
- ✓ Animal farming—dairy cattle, ranching, pigs, chicken, fish, snakes for venom etc.

“farm works” means farmhouses, labour quarters and any other immovable buildings necessary for the proper operation of the farm, it also includes fences, dips, drains, water and electricity supply works (other than machinery), windbreaks, dams, cowsheds, paddocks, fish ponds, mangers, coffee factory, pigsty, roads, stores, irrigation network and other works necessary for the proper operation of the farm.

In the case of a farmhouse, only one-third of the initial cost of the farmhouse qualifies for farm works deduction. The cost of a farmhouse extension is Sh. 270,000, but only one third, i.e. Sh. 90,000, qualifies for farm works deduction. Note that a company does not have any farmhouse as directors and other employees would occupy any house on the farm as employees in which case the house would be labour quarters.

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

#### Farm Works Deductions

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.

Farmworks deductions are allowances granted to the owner or tenant of agricultural land who incurs capital expenditure on construction of farm works used by him or his tenant in the farm. Only farmers can claim farm works deduction which shall be made when computing the gains or profits from the farm.

Where the owner or tenant of any agricultural land incurs capital expenditure on the construction of farm works, a farm works deduction shall be deducted in the income tax computation or in arriving at the taxable income/loss.

#### Rates

- (i) Up to 31.12.1984 FWD was granted 20% of the qualifying cost i.e. (1/5) of qualifying cost per year for five years
- (ii) WEF 1.1.1985 – 33 1/3 or 1/3 of the qualifying cost per year for three years
- (iii) WEF 1.1.2007 – 50% of the qualifying cost
- (iv) Currently, the rate for farm works deduction is 100% of the qualifying cost of farm works.

#### Points to note:

- (i) Farmworks deduction is granted on a straight-line basis.
- (ii) Period a farm work is used during the year is not considered in computing annual farm works deduction to claim

- (iii) For a farmhouse only 1/3 of the expenditure (cost) qualifies for farm works deduction
  - (iv) Only one farmhouse qualifies for FWD
  - (v) In case of a transfer of a farm
    - (a) Annual FWD is apportioned between the transferor and transfer (if it is done within the year)
    - (b) The new owner inherits the residue of farm works left by the previous owner in case the transfer is done at the end of the year. The purchase process is not considered.
  - (vi) For FW to qualify for FWD it must be for husbandry.
  - (vii) Where a FarmWorks is used partly for husbandry and partly other purposes, F Works education should be apportioned accordingly.
  - (viii) If a Farm work has been subsidized by the government subsidies do not qualify for FWD.
  - (ix) Cost of construction of a gabion to prevent soil erosion is expensed whether capital or revenue (section 15)
- Machinery qualifying for WTA, do not qualify for FWD.

**Example**

Mahindi farmers incurred the following capital expenditure in his farm for the year ended 31.12.2015

	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 2015 of Sh. 25,000

**Required**

Compute the capital deductions for the year 2015.

Solution

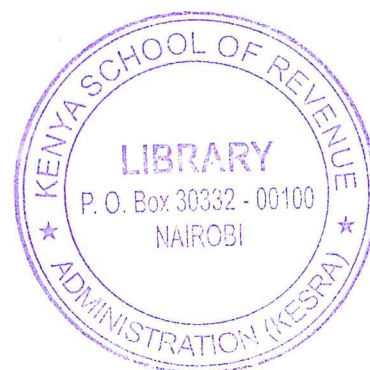
Farm Works Deduction:

Item	Cost Sh.	2015 Sh.	2016 Sh.
Extension to labour lines	30,000		
Fenced paddock	15,000		
1/3 of farm house extension	<u>90,000</u>		
	135,000	67,500	67,500
FWD brought forward	<u>25,000</u>	<u>25,000</u>	<u>—</u>
	160,000	92,500	67,500
FWD for 2015	<u>(92,500)</u>	<u>(92,500)</u>	<u>—</u>
FWD unclaimed carried forward	<u>67,500</u>	<u>—</u>	<u>67,500</u>

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

### Wear and Tear Deduction

	Class IV
	12½ %
	Sh.
WDV as at 1.1.2015	—
Addition: Electric generator	<u>32,000</u>
	32,000
Wear and Tear Deduction	<u>(4,000)</u>
WDV as at 31.12.2015	<u>28,000</u>



### Assignment 1

On 1 January 2018, Muimi Ltd. acquired a piece of land for Sh. 3,000,000 to carry out farming business.

In the same year, he incurred the following expenditure

- Cost of clearing business
- Fenced the farm at a cost of sh.200,000
- Constructed livestock shed for Sh.120,000
- Constructed labour quarter sh.360,000
- Constructed padlocks sh.180,000
- Tarmacked all the road on the farm for sh. 300,000
- Constructed irrigation systems (including a water pump for sh.. 200,000) for sh.560,000
- Installed a neon sign for sh.60,000
- Bought a tractor for sh.900,000
- Construction of gabions to prevent soil erosion for sh.40,000
- Farmhouse for sh. 960,000

On the 1 January 2019 the farmer, sold the farm to Maina including all structure for sh. 8,000,000

The farmer made a profit of sh.1,400,000 for 2019 compute farm works deduction for the years 2019.

### Assignment 2

Coffee milling factory Ltd is located in Limuru commenced operations on 1 January 2019. The written down values of the factory assets as at 1 January 2019 were as follows:

	Sh.
Coffee milling machinery	2,400,000
2 lorries (each 3 tonnes)	900,000
Tractors	1,200,000
Factory building	3,420,000
3 saloon cars	1,890,000
Land	5,000,000
Computers	450,000

Furniture	480,000
Fax machine	90,000
Electronic typewriters	36,000

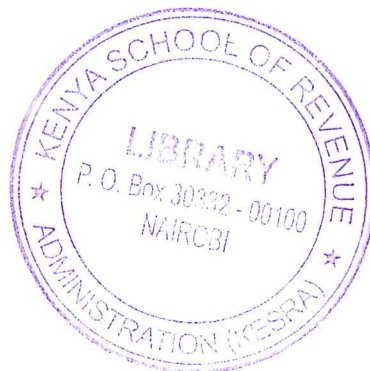
All the assets above were acquired on commencement of operations.

Additional information for the year ended 31 December 2019:

1. The company constructed a dam and a factory extension for Sh.1,200,000 and sh.3,600,000 respectively. Included in factory extension costs were offices constructed at a cost of Sh.1,400,000.
2. New milling machinery costing Sh.800,000 were installed in the factory extension.
3. In June 2019, all assets qualifying for wear and tear deduction under class II were stolen. The insurance compensation amounting to Sh.800,000 was received in August 2019.
4. The company cleared all the old coffee trees at a cost of Sh.300,000. These were disposed of as firewood to a local school for Sh.100,000.
5. The company constructed a farmhouse and labour quarters at Sh.630,000 and Sh.480,000 respectively.
6. Other income earned by the company during the year comprised:
  - Rental income sh. 600,000
  - Dividends from shares sh. 20,000 (net)

**Required:**

- (i) Compute the capital allowances due to the company for the year ended 31 December 2019.
- (ii) Determine the taxable income of the company for the year ended 31 December 2019.



## Chapter 2

### 2.1 Taxation of Partnerships

#### Expected Learning Outcomes

After studying this chapter, the learner should be able to:

1. Prepare a statement of adjusted taxable profit/loss after incorporating incoming or retiring partners during the year.
2. Prepare a statement of adjusted taxable profit/loss for converted partnerships into liability companies
3. Evaluate the tax implications after conversion of the businesses

#### 2.1.1 Introduction

##### 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 to be 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.

#### 2.1.2 Partnership Computation

A partnership does not pay tax. It is the partners who are taxed separately on their income from the partnership and income from other sources. The income of a partner from a partnership includes:

- ✓ Salaries
- ✓ Interest received from a partnership
- ✓ Share of profits from a partnership less interest paid to the partnership by the partners.

The computation of income for a partnership is similar to businesses apart from the following:

- ✓ Salaries paid to partners is not allowable
- ✓ Interest paid to the partners is not allowable
- ✓ Interest charged to the partners is not an income
- ✓ Deduct it from taxable income

#### Example

Kimani and Wachira are partnership sharing profits and losses in the ratio 3:2 respectively. The following is the statement of profit and loss account for the year ended 31 December 2019:

Statement of profit or loss Account and other comprehensive income for the year 2019			
	Sh.		Sh.
Interest on Capital			
Kimani	20,000	Gross profit from trading	380,000
Wachira	10,000	Net dividends received	17,000
Goodwill written off	4,000	Sub-letting rent income	6,000
Bad debts (1)	20,000		
Professional expenses (2)	20,000		
Motor vehicle expenses	30,000		

Depreciation	60,000	
Special expenses (3)	8,000	
Withholding tax on dividends	3,000	
Partnership salaries		
Wachira	60,000	
Loss on sale of investment (4)	10,000	
Repairs and Renewals (5)	6,000	
Salaries and Wages	100,000	
Utilities (light, water etc.)	20,000	
Net profit	<u>32,000</u>	
	<u>403,000</u>	<u>403,000</u>

Additional information

- Bad Debts Account

Write-offs	10,000	Bal b/d:	
Bal c/d		General	60,000
General	80,000	Specific	30,000
Specific	22,000	Recovered	2,000
		Profit and Loss	<u>20,000</u>
	<u>112,000</u>		<u>112,000</u>
- Professional Expenses: sh.

Audit fee	10,000
Partners Insurance	2,000
Legal fees for debt collector	500
Partnership deed	<u>7,500</u>
	<u>20,000</u>
- General Expenses: sh.

Penalty for breach of VAT regulations	4,000
Redundancy pay to an employee	3,000
Christmas gift to the partners spouses	<u>1,000</u>
	<u>8,000</u>
- Loss on sale of investment relates to the sale of a parcel of land which had cost Sh. 60,000 and sold for sh.50,000. There were no incidental expenses.
- Repairs and Renewals: sh.

Office partitions	2,000
Office carpet	1,000
Replacement of adding machine	1,000
General repairs	<u>1,500</u>
	<u>6,000</u>
- Wear and Tear allowances schedule:

	Class II	Class III
	sh.	sh.
Written down value	90,000	56,000
- One-third of motor-vehicle expenses is used on private motoring by partners.

**Required:**

Prepare a statement of adjusted taxable profit for the partnership and allocation of taxable income for each partner for the year of income 2019

## Solution

### Kimani & Wachira 2019 Partnership Income & Tax Computation

	Sh.	Sh.
Net profit as per A/Cs		32 000
Add: Increase in general provisions	20 000	
Partners Insurance	2 000	
Partnership deed	7 500	
Penalty VAT regulation	4 000	
Christmas gift- spouses	1 000	
Loss on sale of shares	10 000	
Office partitions	2 000	
Office carpet	1 500	
Replacement of adding machinery	1 000	
Interest- Kimani & Wachira	30 000	
Motor vehicle( $\frac{1}{4} \times 14\ 000$ )	10 000	
Depreciation	60 000	
Dividends withstanding tax	3 000	
Partnership salary	60 000	
Goodwill w/o	<u>4 000</u>	
 Deduct: WAT	 17 000	
Sub-letting	6 000	
Tear	<u>37 071</u>	
Adjusted business income		<u>187 929</u>

#### Bad debt A/C analysis

Bad debts w/o	10 000
Increase in general provisions	20 000
A decrease in general provisions	18 000
Recovery	<u>(2 000)</u>
	<u>20 000</u>

#### Wear and tear allowance

	Class I 37.5%	Class II 30%	Class III 25%	Class IV 12.5%
WDV 1.1.98	-	90 000	<u>56 000</u>	-
Additions				
Partitions	-			2 000
Carpets	-			<u>1 500</u>
Add	-	<u>1 000</u>		
machinery		91 000	56 000	35 000
WTA		<u>27 300</u>	<u>14 000</u>	<u>438</u>
		63 700	42 000	3 068

#### Summary

Class I – 27 300
Class II – 9 333
Class III – <u>438</u>
Total WTA to claim <u>37 071</u>
Class III ( $\frac{3}{4} \times 14\ 000$ ) = 9 333

<u>Partners' allocation of taxable income</u>			
	Kimani	Wachira	Total
	<u>sh.</u>	<u>sh.</u>	<u>sh.</u>
Interest:	20 000	10 000	30 000
Salary:		60 000	60 000
Profit:	<u>58 757</u>	<u>39 172</u>	<u>97 927</u>
	<u>70 757</u>	<u>109 172</u>	<u>187 929</u>
Rental income	<u>3 600</u>	<u>2 400</u>	<u>6 000</u>
Total taxable income	<u>82 357</u>	<u>111 572</u>	

### Assignment

1. Explain under what conditions partners' income may be exempted from income tax (4 marks)
2. State tax benefits accruing to partnership intending to convert into a cooperative society (4 marks)
3. State the major tax considerations you would take into account while advising your client regarding doing business either as a partnership or a private company. (5 marks)
4. Abdi and Saidi are operating as Saba enterprises. They share profits and losses in the ratio of 1:2 respectively. The following is a statement of profit and loss account for the year ended 31 December 2019:

Income:	Sh.
Turnover (inclusive of VAT @16%)	5,568,000
Capital gain on sale of a parcel of land	156,000
Import duty refund	89,200
Interest from government bond	64,000
Dividend from Kiambu Cooperative society (net of tax)	<u>51,000</u>
	<u>5,928,200</u>
Expenditure:	
Purchases	1,176,000
Motor vehicle running expenses	64,200
Salaries to partners	640,000
Personal expenses-Abdi	23,400
Renovations of business premises	48,200
Advertising billboards	89,700
Insurance premiums	75,000
Interest on bank overdraft	124,500
Subscriptions to the chamber of commerce and trade	48,000
Donations to a political party	150,000
Audit fee	45,000
Legal expenses	180,000
General expenses	100,600
Bad debts written off	38,000
Utility expenses	56,000
Provision for depreciation	<u>76,200</u>
	<u>2,934,800</u>
Net profit	<u>2,993,400</u>

Additional information:

1. Turnover includes goods consumed by Saidi family valued at Sh. 75,000.
2. Purchases include 20% of stocks which had not been sold by the end of the year.
3. Bad debts include

	Sh.
Increase in general provisions	14,000
Increase in specific provisions	28,700

4. Interest on bank overdraft includes legal fees of sh. 8,200 paid to a lawyer to legal advice about the loan
5. Partners' salaries comprise

	Sh.
Abdi	270,000
Saidi	<u>390,000</u>
	<u>640,000</u>

Required:

- a) Prepare a statement of adjusted partnership profit or loss for the year of income 2019.
- b) A schedule of allocation of the adjusted profit or loss between the partners.

## Chapter 3

### 3.1 Taxation of Related Parties

#### Expected Learning Outcomes

After studying this chapter, the learner should be able to:

1. Explain the term related party
2. Describe what constitutes related parties
3. Outline provisions of Transfer Pricing
4. Identify taxation issues of related parties including transfer pricing mechanisms
5. Explain the different ways the government could mitigate tax losses from related parties.

#### 3.1.1 Introduction

The income tax Act cap 470, section 18 (6) states that a person is related to another if:

- a) Either person participates directly or indirectly in the management, control or capital of the business of the other;
- b) A third person participates directly or indirectly in the management, control or capital of the business of both; or
- c) An individual, who participates in the management, control or capital of the business of one, is associated by marriage, consanguinity or affinity to an individual who participates in the management, control or capital of the business of the other.

NB. In the eleventh schedule, two companies are related when one company owns whether directly or indirectly twelve and one-half per cent or more of the voting shares of the other company.

#### 3.1.2 Transfer Pricing

Due to globalization and expansion, companies are working as a group engaged in varied sectors leading to a large number of transactions from related parties. This has contributed to a loss of domestic tax revenue. In this context, the mechanism for accounting for the pricing for related transactions has elicited interest by revenue authority. The ministry of finance made amendments in the income tax act by providing guidelines in 2006 for Transfer Pricing.

Transfer Price denotes to the price of goods or services used in accounting for the transfer of goods or services from one responsibility centre to another or from one company to another associated company. Transfer price affects the revenue of transferring division and the cost of receiving division. As a result, transfer pricing affects the financial performance and Performance Evaluation of both divisions.

#### 3.1.3 Importance of Transfer Pricing (TP)

The transfer pricing mechanism is Significant because of:

1. Supports determination of correct pricing of Product or Services. Since the transaction is frequent between associated parties it is prudent to value all transaction correctly to price correctly all product or services.

2. Helps in performance evaluation of an entity. Calculation of correct transfer price assists in the accounting of interrelated transaction between two related enterprises.
3. Assists in complying Statutory Legislations because an effective transfer pricing mechanism is very necessary especially when related party transaction has a direct bearing on the profitability or cost of a company.

### **3.1.4 Transfer Pricing Provisions in Kenya**

Growing numbers of multinational companies carrying out economic activities in Kenya has led to new and complex issues emerging from transactions entered into between two or more enterprises which are related. Therefore, the need for transfer pricing mechanism which introduces a uniform and internationally accepted mechanism of determining reasonable, fair and equitable profits and taxes in Kenya.

### **3.1.5 Cross Border Transactions**

- ✓ TP Documentation
- ✓ Taxpayers need to maintain TP documentation.
- ✓ A penalty of 2% of the transaction value imposed if TP documentation is not maintained.
- ✓ Country by country reporting
- ✓ to be filed by a parent company or a constituent company
- ✓ To be filed not later than twelve months after the last day of reporting of the MNE

### **3.1.6 Arm's Length Price**

First, we describe a related Party transaction. This refers to transaction between or among the parties which are related by common control, common ownership or other mutual interest

Arm's length price is the fair price of goods/services, where the transfer price should represent the price which could be charged by an independent party. If the price is not at arm's length, the price calculation is very important for a company because it may have following consequences: wrong performance evaluation, wrong pricing of the final product in a manufacturing set up, or non-compliances of applicable laws thus attracting penalties.

### **3.1.7 Transfer Pricing Methods**

The transfer pricing methods which determine Arm's Length prices for International Transaction and specified domestic transaction are:

1. Comparable Uncontrolled Price Method (CUP)
2. Resale Price Method (RPM)

3. Cost Plus Method (CPM)
4. Profit Split Method (PSM)
5. Transactional Net Margin Method (TNMM)

#### **3.1.7.1 Comparable Uncontrolled Price Method (CUP)**

This is the most direct method for the determination of the Arms' length price. Where Comparable Uncontrolled Price ("CUP") method compares the price charged for products/services transferred in a controlled transaction to the price charged for products/services transferred in a comparable uncontrolled transaction in comparable circumstances. An Uncontrolled price is the price agreed between the unrelated parties for the transfer of goods or services. If this uncontrolled price is comparable with the price charged for transfer of goods or services between the Associated Enterprises, then that price is Comparable Uncontrolled Price (CUP).

Comparable Uncontrolled Price Method can be either internal or external:

Internal CUP arises when the taxpayer enters into a similar transaction with unrelated parties and as it is done with a related party. Since functions performed, processes involved, risks undertaken and assets employed are all easily comparable.

The external CUP is available if a transaction between two independent enterprises takes place under comparable conditions relating to equivalent goods or services. External CUP arises when for instance an independent enterprise buys or sells a comparable product of similar quantities under comparable term from/to another independent enterprise in a similar market will be termed as external CUP.

#### **3.1.7.2 Resale Price Method**

Resale Price method for determining transfer price is described as:

- (a) The price at which property purchased or services obtained by the enterprise from an associated enterprise is resold or are provided to an unrelated enterprise is identified;
- (b) Such resale price is reduced by the amount of a normal gross profit margin accruing to the enterprise or to an unrelated enterprise from the purchase and resale of the same or similar property or from obtaining and providing the same or similar services, in a comparable uncontrolled transaction, or several such transactions;

- (c) The price so arrived at is further reduced by the expenses incurred by the enterprise in connection with the purchase of property or obtaining of services;
- (d) The price so arrived at is adjusted to take into account the functional and other differences, including differences in accounting practices, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of gross profit margin in the open market;
- (e) The adjusted price arrived at under sub-clause (d) is taken to be an arm's length price in respect of the purchase of the property or obtaining of the services by the enterprise from the associated enterprise.

**Example**

A sold a machine to B (Associated enterprise) and in turn, B sold the same machinery to C (an independent party) at sale margin of 30% for Sh. 210,000 but without incurring any additional expenses and change.

Calculate the Arm's length price

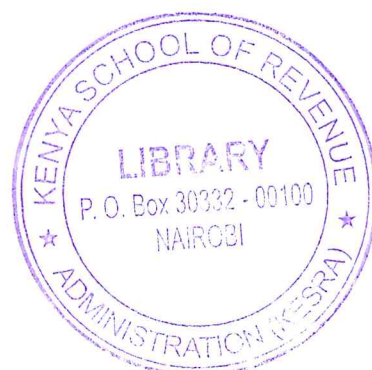
Sales price to B = sh. 210,000: Gross Margin sh. 210,000 × 30% = sh. 63,000  
 Transfer price = sh. 147,000 {210,000-63,000}

**Example 2**

A sold a machine to B (Associated enterprise) and in turn, B sold the same machinery to C (an independent party) at sale margin of 30% for Sh. 400,000 but B has incurred Sh. 4,000 in sending the machine to C.

Calculate the Arm's length price

Sales price to B	=	Sh.400,000	
Gross Margin	=	<u>Sh.120,000</u>	{4,00,000 × 30%}
		2, 80,000	
Less: Expenses (incurred by B )		<u>4,000</u>	
Arm's length price		2,76,000	



### 3.1.7.3 Cost Plus Method

The direct and indirect costs of production incurred by the enterprise in respect of property transferred or services provided to an associated enterprise are determined.

Under the Cost Plus Method, an arm's-length price equals the controlled party's cost of producing the tangible property plus an appropriate gross profit mark-up, defined as the ratio of gross profit to cost of goods sold (excluding operating expenses) for a comparable uncontrolled transaction.

The formulas for the transfer price in inter-company transactions of products are as follows:

$$TP = COGS \times (1 + \text{mark-up})$$

Where:

- ✓ TP = Transfer Price of a product sold between a manufacturing company and a related company;
- ✓ COGS = Cost of goods sold by the manufacturing company
- ✓ Cost-plus mark-up = gross profit mark-up defined as the ratio of gross profit to cost of goods sold

Gross profit is defined as sales minus cost of goods sold

Example

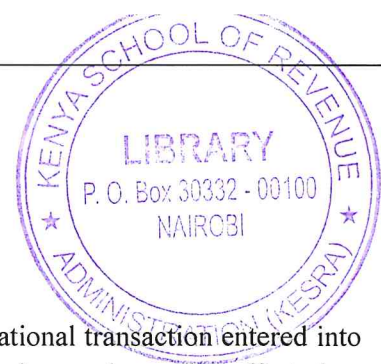
Assume Cost of goods sold in a transaction between two associated enterprises is sh. 5,000, and that an arm's length gross profit mark-up that Associated Enterprise X should earn is 50%. The resulting transfer price between Associated Enterprise X and Associated Enterprise is sh 7,500 [i.e. sh. 5,000 × (1 + 0.50)].

In this method, the calculation of the cost of goods sold and gross margin is the most important factor.

### 3.1.7.4 Profit Split Method

This mainly applies in international transactions involving the transfer of unique intangibles or in multiple international transactions which are so interrelated that they cannot be evaluated separately to determine the arm's length price of any one transaction, by which:

- (i) The combined net profit of the associated enterprises arising from the international transaction in which they are engaged is determined;
- (ii) The relative contribution made by each of the associated enterprises to the earning of such combined net profit, is then evaluated based on the functions performed, assets employed or to be employed and risks assumed by each enterprise and based on reliable external market data which indicates how such contribution would be evaluated by unrelated enterprises performing comparable functions in similar circumstances;
- (iii) The combined net profit is then split amongst the enterprises in proportion to their relative contributions, as computed above;
- (iv) The profit thus apportioned to the assessee is taken into account to arrive at an arm's length price in relation to the international transaction.



### **3.1.7.5 Transactional Net Margin Method (TNMM)**

Transactional net margin method is prescribed, by which;

- (i) The net profit margin realized by the enterprise from an international transaction entered into with an associated enterprise is computed in relation to costs incurred or sales effected or assets employed or to be employed by the enterprise or having regard to any other relevant base;
- (ii) The net profit margin realized by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same base;
- (iii) The net profit margin referred to in (ii) arising in comparable uncontrolled transactions is adjusted to take into account the differences, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of net profit margin in the open market;
- (iv) The net profit margin realized by the enterprise and referred to in (i) is established to be the same as the net profit margin referred to in (iii);
- (v) The net profit margin thus established is then taken into account to arrive at an arm's length price in relation to the international transaction.

### **3.1.8 Selection of Transfer Pricing Method**

In selecting a most appropriate method, the following factors shall be taken into account namely,

1. The nature and class of the international transaction.
2. The class or classes of Associated Enterprises entering into the transaction and the functions performed by them taking into account assets employed or to be employed and risks assumed by such enterprises.
3. The availability, coverage and reliability of data necessary for the application of the method.
4. The degree of comparability existing between the international transaction and the uncontrolled transaction and between the enterprises entering into such transactions.
5. The extent to which reliable and accurate adjustments can be made to account for differences, if any, between the international transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions.
6. The nature, extent and reliability of assumptions required to be made in the application of a method.

#### **Assignment**

1. Explain the criterion used in determining the method to be applied for the transfer pricing of related enterprises.
2. Describe any four transfer pricing methods

3. Amigo plc. sold furniture to Baringo ltd a subsidiary company and in turn, Baringo sold the same furniture to Cables Ltd (an independent party) at sale margin of 30% for Sh. 800,000 but Baringo has incurred Sh. 8,000 in sending the machine to Cables Ltd. Required: Using resale price method calculate the Arm's length price
4. Explain using decided cases what may constitute transfer pricing.

## Chapter 4

### 4.1 Taxation of Extractive Industries

#### Expected Learning Outcomes

After studying this chapter, the learner should be able to:

1. Explain the terminology used in extractive industries
2. Identify allowable expenses under petroleum companies for tax purposes.
3. Prepare a statement of adjusted taxable profit/loss for petroleum companies.

#### 4.1.1 Introduction

The ninth schedule of the income tax outlines the taxation of extractive industries among them petroleum mining. The schedule highlights the definitions of the following terms as used in the taxation of the petroleum industry.

The Petroleum (Exploration and Production) Act (Cap 308) is the principal law governing upstream activities in Kenya. The Act envisages upstream activities being conducted via a state oil company established for that purpose or through contractors under a petroleum agreement.

- (i) Consideration means the total amount received or receivable for the disposal, including the fair market value of any amount in kind determined at the time of the disposal of a petroleum company.
- (ii) Contract area means the area that is the subject of a petroleum agreement
- (iii) A contractor is a person with whom the Government has concluded a petroleum agreement and includes any successor or assignee of the person.
- (iv) Cost means the total consideration given for the acquisition of the interest, right, or information, including the fair market value of any amount given in-kind determined at the time the amount is given.
- (v) De-commissioning plan means a plan for the decommissioning, abandonment, relocating or removal and or redeployment of wells, flowlines, pipelines, facilities, infrastructure and assets related to upstream petroleum operations.
- (vi) Social infrastructure expenditure means capital expenditure incurred by a licensee or contractor on the construction of a public school, hospital, road, or any similar social infrastructure.
- (vii) Development expenditure means capital expenditure incurred by a contractor when undertaking operations authorized under a development plan, other than social infrastructure or to capital expenditure in the Second Schedule.

The development expenditure includes:

- (a) An interest in a petroleum agreement other than interest on costs incurred on the exploration expenditure or

- (b) Petroleum information other than information on costs incurred on the exploration expenditure.

Exploration expenditure means expenditure incurred by a contractor in undertaking exploration operations authorized under a petroleum agreement, other than social infrastructure expenditure or expenditure in the Second Schedule. It includes expenditure incurred in acquiring — (a) an interest in a petroleum agreement from the Government or under a farm-out agreement; or (b) petroleum information relating to exploration operations from the Government or under a farm-out agreement.

Farmout agreement is an agreement entered into by the owner of one or more mineral leases, called the "farmor", and another company who wishes to obtain a percentage of ownership of that lease or leases in exchange for providing services, called the "farmee." The typical services described in farmout agreements is the drilling of one or more oil and/or gas wells.

Development plan means a development plan prepared and adopted under a petroleum agreement.

Exploration operations mean work authorised under a petroleum agreement in the search for petroleum prior to the approval of a development plan and includes—

- a) Geological, geophysical, and geochemical surveys and analyses;
- b) Aerial mapping;
- c) Investigations of subsurface geology;
- d) Stratigraphic tests;
- e) The drilling of wells to test a geological feature that has not already been determined to contain producible petroleum sufficient for commercial production;
- f) Any other work that is necessarily connected with activities described in paragraphs (a) to (e).

Extraction expenditure means capital expenditure incurred by a licensee when undertaking operations authorised under an extraction right, other than social infrastructure expenditure or expenditure to deductions in respect of capital expenditure on machinery in the Second Schedule.

Extraction expenditure includes:

- a) An interest in a mining right other than interest on petroleum agreement from the Government or under a farm-out agreement
- b) Mining information other than information on petroleum agreement from the Government or under a farm-out agreement
- c) A right to extract minerals issued or granted under the Mining Act (Cap. 306).
- d) A right to extract geothermal resources issued or granted under the Geothermal Resources Act (Cap. 314A).

The Income Tax Act sets out general rules governing the taxation of oil and gas companies in Kenya. The Ninth Schedule to the Act, cap 470 provides for specific rules applicable to the taxation of upstream oil and gas sector.

#### **4.1.2 Taxable Income**

Taxable income in Kenya generally comprises gross income less deductions provided for in the income tax Act. The Act does provide detailed rules on the deductibility of expenses incurred in the exploration, development and production phases.

Kenya introduced new rules governing the taxation (Effective 1 January 2015) of gains on the direct and indirect disposal of petroleum license interests. Net gains on the direct and indirect disposal of an interest in Kenya are taxable at corporate tax rates of 30% for resident persons and 37.5% for non-residents. The disposal of interest can be by way of sale, transfer, assignment or exchange and the standard corporate tax rates would apply.

#### **4.1.3 Nature and Classification of Income**

Oil and gas industry is characterised by peculiar factors such as the duration between the time an investment is made and the time the oil and gas is produced in commercial quantities and sold to generate income.

The main sources of income petroleum producing companies are

1. Sale of crude oil: export and domestic market
2. Sale of gas: export and domestic market

Interest income earned from incidental to petroleum operations, such incomes include;

- (i) Ullage fees,
- (ii) Rentals,
- (iii) Management fees,
- (iv) Mineral property conveyance, and
- (v) Interest on fixed deposits, and
- (vi) Balancing charge on the disposal of items of qualifying expenditure

NB In determining income in the oil and gas, the oil produced is deemed sold when produced. Therefore the sale value of crude oil produced is considered as income immediately without waiting for the time the actual sale takes place.

Special deductions for oil and gas companies

The Ninth Schedule to the income tax Act provides for specific deductions against oil and gas income in determining the taxable income in the year in which they were incurred. The allowable deductions must have been incurred for the petroleum operations. These deductions relating to the upstream sector are:

- a) Mineral rights acquisition costs are costs incurred in the acquisition of concession rights in a lease area. They include legal fees, land acquisition fees/levies, valuation fees etc. Costs incurred to purchase, lease are initially capitalised when incurred. They include costs of Oil prospecting licence (search for oil), Oil exploration licence (explore for petroleum) and Oil mining lease (to win, work, and dispose of petroleum), and legal fees in acquiring properties.

\*prospecting means search for mineral deposits, especially by drilling and excavation \*  
Exploration search by petroleum geologist and geophysicists for deposits of petroleum and natural gas.

- b) Exploration and drilling costs including capital expenditure incurred in undertaking exploration operations. Exploration costs include:
- (i) Costs of geological and geophysical studies, rights to access to properties to conduct those studies, and salaries and other expenses of geologists, geophysical staff.
  - (ii) Costs of carrying and retaining undeveloped properties, such as rentals, legal costs for title deeds, stamp duties, costs relating to the keeping of lease records.
  - (iii) Dry hole contributions (A contributions in exchange for geological or drilling information if the well-drilled is unproductive) and bottom hole contributions.
  - (iv) Costs of drilling and equipping exploratory wells.
  - (v) Costs relating to the resettlement of local communities, compensation for crops, surface rights and road building.
  - (vi) Appraisal costs to determine the size and characteristics of a reservoir discovered, as well as to assess its commercial potentials.
- c) Development Costs are incurred to obtain access to reserves and provide facilities for extracting, gathering treating and storing the oil and gas. These costs include:
- (i) Drilling, equipping and testing development and production wells,
  - (ii) Production platforms, downhole and wellhead equipment, pipelines, production and initial treatment and storage facilities and waste disposal systems.
  - (iii) Improved recovery systems and equipment.
- These expenditures (excluding plant and machinery and social infrastructure) are depreciated for tax purposes at a rate of 20% per annum (straight-line) commencing the year after the asset is brought into use and the year in which production commences.
- d) Production costs- These are revenue costs incurred in oil and gas production, which include costs for the maintenance of wells, equipment and storage facilities. Examples of production costs are:
- (i) Costs of personnel engaged in the operation of wells and related equipment and facilities
  - (ii) Repairs and maintenance of production facilities
  - (iii) Materials, supplies, fuel consumed and services utilised in the production operations
  - (iv) Royalties
- e) General costs- These are costs which are not capitalized and relating to the provision of amenities for the communities where they operate. They include corporate affairs, staff training, and staff development.

- f) Losses from oil and gas companies (to carry forward losses which are incurred in their operations indefinitely. They can also carry back losses arising in the final year of production for up to three years. This is an exceptional rule since no carryback of losses is permitted under general tax rules.
- g) Capital allowances for example petroleum allowances, wear and tear etc.

**Note**

1. Operating costs (including geological and geophysical and intangible drilling costs) are fully deductible in the year incurred.
2. All items except motor vehicles imported by oil and gas companies for direct use in oil and gas exploration and development are exempt from customs duty upon recommendation by the Ministry of Energy and Petroleum.
3. While Value Added Tax provides for both remission and exemption from VAT with respect to services and goods procured by oil and gas companies for their exploration activities in Kenya.
4. The same principles relating to deduction for expenditure to businesses in mining operations during a year of income shall be allowed against the income derived by the licensee from the mining operations during the accounting year.
5. The amount of the losses suffered is carried forward and allowed as a deduction against the income of mining operator in the following year of income. However, if the losses are carried forward until they are fully exhausted. This implies there is no time frame for offsetting losses of mining companies.

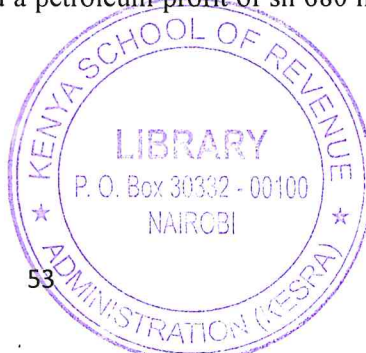
**Format**

XYZ Petroleum Plc			
2019 Petroleum Profit Tax Computation		Sh.M	Sh.M
Value of chargeable oil			XXXX
Other income incidental to petroleum operations e.g:			
Ullage fees, Rentals, Management fees, Mineral property conveyance			<u>XX</u>
Profit for the year			XXXXX
Less			
Loss b/d	XXX		
Capital allowances	XXX		
Operating expenses	XXX		
General costs	<u>XXX</u>		<u>XXX</u>
Chargeable profit			<u>XXXX</u>

**Exercise**

Mauta Petroleum Ltd is a petroleum company in the business of exploration and production of oil and gas in Kenya. The petroleum company reported a petroleum profit of sh 680 million in the year 2019 after the deduction of the following costs:

	Sh.million
Royalties on domestic sales	100
Customs tax on plant and equipment	160



Capital allowances not utilized in the past year	40
Capital deductions for the year	90
Losses b/f from previous year	100

The following additional information was available

- (i) Tangible drilling costs sh.120 million capitalized and intangible expenses sh.100 million
- (ii) Non-productive rent sh.10 million
- (iii) Additional assets for offshore operations sh. 30 million
- (iv) Royalties on export sales sh. 200 million
- (v) Memorandum of understanding credit sh. 46 million
- (vi) Incidental incomes sh.26 million including sh 4 million for transportation of crude oil and sh 2 million for disposed of fixed assets

Required:

Prepare a statement of computation of petroleum profit for the accounting period ended 31 December 2019.

Mauta Petroleum Plc  
2019 Petroleum Profit Tax Computation

	Sh.M	Sh.M
Value of chargeable oil		680
Add back:		
Royalties on domestic sales	100	
Customs tax on plant and equipment	160	
Capital allowances not utilized in the past year	40	
Capital deductions for the year	90	
Losses b/f from previous year	<u>100</u>	<u>490</u>
Incidental incomes		<u>1170</u>
Petroleum profit for the year		<u>20</u> <u>1190</u>

**Assignment**

1. Outline four examples of exploration costs relating to petroleum companies
2. Explain each of the following terms
  - (i) Petroleum agreement
  - (ii) Downstream
  - (iii) Upstream
  - (iv) Production costs
3. Oiler Petroleum Company limited presented the following information from the financial records for the year ended 31 December 2019.

	Sh. 000
Sale of natural gas	20,230
Export of crude oil	346,800

Incidental income	2,048
Production expenses	95,200
Administration expenses	139,500
Intangible drilling costs	28,240
Non-productive rentals	8,700
Royalties on domestic sales	2,280
Royalties on export	2,020
Custom duties on equipment	16,160
Provision for restoration of wells	84,600

Additional information:

- (i) Petroleum agreement provides for a tax credit of sh.9,400,000
- (ii) Petroleum investment allowance was agreed at sh.6,864,000
- (iii) Production expenses included depreciation of equipment of sh.356,000
- (iv) Capital allowances agreed with the commissioner was sh.4,856,000

Required:

- a) Prepare a statement of chargeable income to tax for the year ended 31 December 2019
- b) Tax payable by the company

## Chapter 5

### 5.1 Taxation of Insurance Companies

#### Expected Learning Outcomes

After studying this chapter, the learner should be able to:

1. Identify challenges in the taxation of insurance companies
2. Describe different types of insurance businesses
3. Prepare a statement of adjusted taxable profit/loss for insurance companies.

#### 5.1.1 Legal Provisions on Taxation of Insurance Companies

Types of insurance businesses: General and Life insurance businesses.

Life insurance business of an insurance company is treated as a separate business from any other class of business.

The gains or profits of resident insurance business (General insurance business) other than life insurance business comprise of:

- (a) Gross premium less any premium returned to the insured and premium paid on reinsurance.
- (b) Other income including commission or expenses allowance received or receivable from reinsurers and investment income.
- (c) A deduction in respect of a reserve for unexpired risk, at the end of the previous year.
- (d) Addition of reserve deducted for unexpired risks at the end of the previous year.
- (e) A deduction of claims admitted net of any claim recovered from reinsurance companies.
- (f) A deduction of agency expenses.
- (g) Other deductions that are allowable under the Income Tax Act.

#### 5.1.2 Ascertainment of Income of 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.

### 5.1.3 Life Insurance Business

The income from the life insurance business comprises

Investment income of the life insurance fund except for 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.

The amount of interest received by the company on surrender of policies or the return of premiums other than premiums in relation to a registered annuity contract, registered trust scheme or a registered pension fund.

#### Example

Americana Insurance Ltd. underwrites two classes of insurance. The management has provided you with the details shown below on their operations for the year ended 31 December 2019:

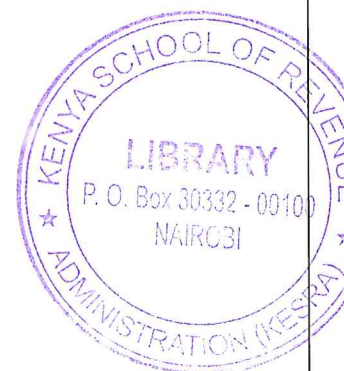
	<b>Fire</b>	<b>Motor vehicle</b>
	<b>Sh.'000'</b>	<b>Sh.'000'</b>
Gross premium written	45,000	26,600
Reinsurance commission received	12,700	18,000
Unearned premium 1.1.2019	3,200	6,200
Unearned premium 31.12.2019	2,500	9,200
Claims paid	4,280	7,500
Claims outstanding 1.1.2019	4,700	17,300
Claims outstanding 31.12.2019	4,600	16,400
Legal expenses on claims	940	680
Provision for depreciation	120	240
Capital Gain on sale of motor vehicles	-	50
Bad debt written off	80	35
Management expenses	1,850	2,500

Additional information:

1. Wear and tear deductions have been agreed with the Income Tax Department at sh.385,000.
2. The company paid Sh.842,000 an Investment Management Services, fund managers for professional services for the year ended 31 December 2019.
3. The company rented office space where it earned a rent income of sh.480,000 b estate agents fees of sh 42,000.

Required:

- (a) Prepare a statement of taxable profit or loss for Americana Insurance Ltd. for the year ended 31 December 2019.
- (b) Compute the tax payable



## Solution

### Americana Insurance Ltd.

A statement of computation of taxable profit for the year ended 31 December 2019

	Fire	Motor Vehicle	Total
	Sh.'000'	Sh.'000'	Sh.'000'
Gross premium written	45,000	26,600	71,600
Reinsurance commission received	<u>12,700</u>	<u>18,000</u>	<u>31,700</u>
	57,700	44,600	102,100
Unearned premium b/d	3,200	6,200	9,400
Unearned premium c/d	<u>(2,500)</u>	<u>(9,200)</u>	<u>(11,700)</u>
Gross income earned (A)	58,400	41,600	100,000
Less allowable expenses			
Claims paid			
Claims outstanding b/f	4,280	7,500	11,780
Claims outstanding c/f	<u>(4,700)</u>	<u>(17,300)</u>	<u>(22,000)</u>
Claims incurred	<u>4,600</u>	<u>16,400</u>	<u>21,000</u>
	4,180	6,600	10,780
Management expenses	1,850	2,500	4,350
Legal expenses	940	680	1620
bad debts	<u>80</u>	<u>35</u>	<u>115</u>
Total Expenses (B)	7,050	9,815	16,865
Underwriting profit (A - B)			83,135
Total underwriting profit	83,135		
Less wear and tear	<u>(385)</u>	82,750	
Rental income 480			
Less Estate Fees <u>42</u>		<u>438</u>	
Total taxable profit		<u>83,188</u>	

Tax payable  
sh.83,188,000 \* 0.3  
=24,956,400

## Assignment

1. Outline four aspects that distinguish the taxation of insurance businesses from other forms of business organizations
2. Briefly describe what constitutes taxable income for life insurance businesses.
3. Waita and Baraka are in partnership selling merchandise goods in Nairobi. They share profit and losses in the ratio of 2:3 for Waita and Baraka, respectively. The following details were extracted from the books of the firm for the year ended 31 December 2019.

<b>Receipts and payments account</b>			
	sh.		sh.
Balance brought forward	480,000	Payments to trade creditors	3,280,000
Payments received from trade		Partners' commission	120,000
Debtors	5,600,000	Travelling expense	30,000
Cash sales	360,000	Rent and Rates expense	72,000
Interest received on drawings	10,000	Packaging expense	184,000
		office Furniture	150,000
		Drawings by Waita	100,000
		Motor vehicle oil expense	432,000
		Partners Salaries	840,000
		Balance carried down	<u>1,242,000</u>
			<u>6,450,000</u>
	<u>6,450,000</u>		

### Additional information:

1. The following balances were also obtained from the business records:

	1 January 2007	31 December 2007
	Sh.	Sh.
• Trade creditors	240,000	420,000
• Trade debtors	360,000	520,000
• Shop fittings	380,000	460,000
• Office furniture	397,000	280,000

2. Travelling expense includes Sh. 8,000 incurred in relation to private travel by Baraka
3. During the year, the firm purchased office furniture on credit for Sh. 260,000
4. Rent expense included sh. 9,800 spent on replacing a wooden door in the shop with a metallic door.
5. Closing stock as at 31 December 2019 amounted to Sh. 95,000.

### Required:

- a) Prepare a statement showing the taxable profit or loss for Waita and Baraka traders for the year ended 31 December 2019
- b) A schedule of allocation of taxable income for each partner for the year of income 2019

## Chapter 6

### 6.1 Taxation of Cooperatives

#### Expected Learning Outcomes

After studying this chapter, the learner should be able to:

1. Identify different types of designated cooperatives registered under the Cooperative Societies Act, cap 490.
2. Describe the steps for taxation of cooperative societies
3. Prepare a statement of adjusted taxable profit/loss for cooperatives registered under the Companies Act and Cooperative societies Act.

#### 6.1.1 Taxation of Co-Operative Societies

Corporate societies become taxable entities with effect from 1<sup>st</sup> 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.”

#### 6.1.2 Designated Co-Operative Societies

Types of Designated co-operative societies can be broadly classified into 3:

##### 1. 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 therefrom 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	<u>xx</u>

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.

## 2. 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 therefrom 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	<u>xx</u>

Should the co-op society pay all adjusted income like bonuses and dividends, then no tax liability shall arise otherwise the adjusted taxable income shall be subjected to a 30% corporate tax rate.

## 3. 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 of 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 royalty incomes).
- (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 under 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 a 30% corporate tax rate when determining the tax liability.
- No allowable expense shall be deducted in determining the gross rental income. However, a society shall be granted to wear and tear allowance just like any other ordinary business.
- In the 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%. Besides, dividends paid by co-operative societies will no longer be considered as qualifying dividends, i.e. the withholding tax is NOT final.

**Example:**

The profit and loss account of Kiambu cooperative society for the year 2019 was as follows:

<u>Kiambu Cooperative Societies</u>			
<u>Profit &amp; Loss Account For Year Ended 31/12/19</u>			
	Sh.		Sh.
Salaries & wages	1,200,000	Gross profit	10,000,000
Directors fees	200,000	Sales of fixed assets	1,500,000
Rent & rates	80,000	Bad debts recorded previously w/cf	20,000
Travelling & entertainment	20,000	Income tax refund	1,000,000
Donations	80,000	Release of liability	200,000
Repairs & maintenance	1,000,000		
Bad debts reserves	600,000		
General expenditure	1,500,000		
Income tax paid	400,000		
Net profit	2,820,000		
	12,900,000		12,900,000

**Additional Information:**

1. Included in directors fees sh.60,000 paid to the director's daughter studying in the USA.
2. Repairs & maintenance include depreciation of sh.400,000
3. General expenditure included the cost of a delivery van purchased at sh.900,000
4. Agreed WTA allowance was sh.600,000
5. The cooperative society would like to pay 90% of adjusted profits as dividends and bonuses

**Required:**

- a) Compute taxable income & tax liability for a cooperative society
- b) Suppose it was a primary society, what would be the taxable income & tax payable

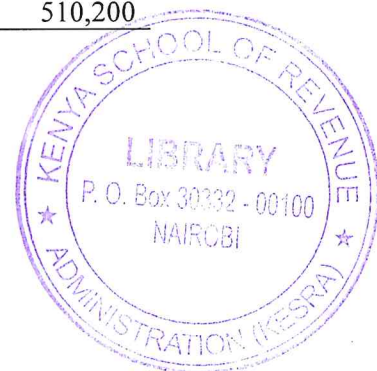
**Solution**

**Kiambu Cooperative Society  
2019 Taxable Income Computation**

	Sh.	Sh.
Reported profit		7,820,000
<u>Add:</u>		
Directors fees	60,000	
Depreciation	400,000	
Delivery van	900,000	
Donations	80,000	
Bad debts reserves	600,000	
Income tax paid	400,000	2,440,000
 <u>Deduct:</u>		
WTA	600,000	
Sale of fixed assets	1,500,000	
Income tax refund	1,000,000	(3,100,000)
Adjusted income		7,160,000
Less dividends & bonuses = 90%		6,444,000
Taxable income		716,00
Corporate Tax @ 30% x 716		(214,800)
		510,200

c) Primary Society

	Sh.
Adjusted Income	7,160,000
Less: Dividends & Onuses @ 80%	(5,728,000)
Taxable Income	1,432,000
Less Corporation Tax @ 30%	429,600
	1,002,400



**Savings & Credit Cooperative Societies Saccos**

Are classified as primary societies i.e. the membership is made up of individuals whose income has already been subjected to tax.

Since most of the income of SACCOs is from members loans, this is exempted from taxation.

The only taxable income is the ones arriving from 3<sup>rd</sup> parties:

1. Rental Income: Take the gross rental income and deduct expenses directly incurred to earn it.

2. Investment income:
3. (a) Dividends – They are generally exempted from taxation
  - (c) Interest Income – Any other interest apart from that from members loans is taxable (50% gross interest income is the taxable amount but remember to effect the withholding tax in such interest income).

**Example:**

Jamii Sacco presented the following income statement for the year ended 31<sup>st</sup> December 2019.

<u>Income:</u>	Sh.	Sh.
Interest on members loans	17,000,000	
Interest from commercial banks	400,000	
Interest from treasury bills	180,000	
Dividends from Bidii Kenya Ltd	42,000	
Rental Income	440,000	
Total Income	2,272,000	
 <u>Expenditure:</u>		
Administration expense	235,000	
Depreciation	130,000	
Purchase of furniture for a rental property	180,000	
Printing & stationery	19,000	
Caretaker wages	12,000	
Mortgage interest on rental premises	20,000	
Miscellaneous expenses	16,000	(612,000)
Net profit		2,150,000

The Sacco intends to distribute sh.400,000 as dividends and bonuses to members for the year.

NB: All the investment incomes have been stated gross of withholding tax.

Required:

Determine the taxable profit/loss for the Sacco and the tax liability for the year ended 31 December 2019

Jamii Sacco		
2019 Taxable Income & Tax Computation		
	Sh.	Sh.
Interest on members loans – Exempted	-	-
Interest – commercial banks (50% x 400,000)		200,000
- Treasury bill (50%x 180,000)		90,000
Dividend – Bidii (K) Ltd – WT is final		-
 <u>Less: Allowable Expenses</u>		
Caretakers wages	(12,000)	
Mortgage interest	(20,000)	
Furniture WTA @ (12.5% x180,000)	(22,500)	
Adjusted Income	385,500	675,000
 <u>Less: Dividends &amp; Bonuses – proposed 400,000</u>		
Restricted (80/100 x 675,500) 540,400		(400,000)
Taxable income		275,500
<u>Less: Corporation Tax @ 30%</u>		(82,650)
		192,850

**Assignment**

1. Highlight distinguishing features of taxation of cooperatives from other forms of business organizations.
2. Meka Savings and Credit Cooperative Society (Sacco) Ltd. reported the following incomes and expenditure for the year ended 31 December 2019

Income:	sh.
Interest on loans to members	1,500,000
Interest on savings accounts	400,000
Interest on fixed deposit accounts	200,000
Rental income	<u>600,000</u>
Total income	<u>2,700,000</u>
Expenditure	
Administration expenses	<u>300,000</u>
Surplus	<u>2400,000</u>

Required:

The taxable profit of Meka Sacco Ltd. for the year ended 31 December 2019.

## **Chapter 7**

### **7.1 Back Duty and In-Depth Examinations**

#### **Expected Learning Outcomes**

After studying this chapter, the learner should be able to:

1. Identify different sources of information for tax investigation
2. Document the procedure for determining tax arrears for enterprises not keeping complete records.
3. Compute tax arrears using capital statement

#### **7.1.1 Introduction**

Back duty means the process of assessment and collection of tax arrears in any year of income in the past. The tax arrears arising from:

1. Under the declaration of income
2. False claim of reliefs' or expenses or allowance
3. Failing altogether to notify the commissioner of his chargeability to tax.

In the above case, the omission may be due to fraudulence or negligence on the part of the taxpayer. Tax arrears will attract interests and penalties; if the arrears are as a result of gross negligence or fraudulent accounting.

It is the responsibility of the tax-payer to declare whether he has income chargeable to tax and notify the DTD before the end of the 4<sup>th</sup> month after the year-end if it is a company.

#### **7.1.2 Sources of information to the Domestic tax department**

- (i) The taxpayer disclosing taxable income e.g. as in the recent case of tax amnesty where you voluntarily disclosed taxable income.
- (ii) Informers from domestic tax investigation section
- (iii) Public media – raid, newspaper etc
- (iv) Exchange of information between tax districts and local knowledge of officers

#### **7.1.3 Determination of Taxable income for cases of back duty**

The tax in arrears may be determined by:

- Declaration of income to the dept which must be supported by accounts – example as was reflected in the year 2004 – i.e. from June 2004 – 31 Dec 2004 – when taxpayers were given tax amnesty to pay all tax in arrears.

- Through a capital statement, if sufficient information cannot proceed i.e. more of available accounting records.

#### **7.1.4 Capital statement**

A capital statement consists of details of assets and liabilities at a given date(s) showing an increase or decrease of the total worth of taxpayer. The resulting increase in a person's net worth is taken to be income chargeable to tax for the year.

circumstance capital statement is used are

- (i) Where reliable and sufficient account cannot be produced
- (ii) Where there is suspicion of under declaration of income
- (iii) Where there is non-declaration resulting from neglect or fraud
- (iv) Where the taxpayer is believed to be claiming false reliefs and allowances.

#### **7.1.4.1 Steps in the computation of income chargeable to tax – under capital statement.**

1. Add all the assets of the taxpayer both personal and business each year.
2. Deduct all liabilities both personal and business form (i) above
3. Calculate the growth/ loss in net assets each period by taking the net assets of one period and comparing it with the net assets of the previous period. This represents an increase or decrease in assets (Net worth)
4. Deduct any non-taxable income that was used finance the above growth net assets e.g. income & assets obtained through; legacy, inheritance, capital gain, friends, relatives etc.
5. Deduct also non-trading business income from the net assets
6. Add living expenses, such as utility bills (water, electricity), income tax paid, interest on loans, insurance premium, rent and rates, food, house servant, private motoring, theft of cash shop, Harambee contribution and other donations.
  - (i) Adjust for tax purposes
    - (i) Goods for own use adds
    - (ii) Trading receipts in case of disposal
    - (iii) Trading loss – deduct
    - (iv) We are and tear



### Example

Mr Makosa has been operating as a sole proprietor for the last few years. He has been accused of tax evasion, and you have gathered the following information from the books of the business for the year ended 31 December,

	31 December 2015 Sh.000	31 December 2016 Sh.000	31 December 2017 Sh.000	31 December 2018 Sh.000	31 December 2019 Sh.000
Shop premises	2,500	3,000	3,000	3,500	4,000
Debtors	500	250	450	600	700
Bank balance	-	2,800	620	940	110
Investments		300	790	1,445	2,122
Loan from friend	-		700	700	700
Creditors	2,000	2,000	2,000	2,000	2,000
Motor vehicle (Cost)	450	450	450	450	450

The proprietor also provided the following details with respect to his business activities for the years of operations.

Year ended	31 Dec 2016 Sh.000	31 Dec 2017 Sh.000	31 Dec 2018 Sh.000	31 Dec 2019 Sh.000
Personal consumption of stock in trade	3,140	5,200	6,240	9,800
Donation to a local church	105	120	525	2,420
Dowry paid for his sons	-	200	189	-
Inheritance from her Mother	360	-	-	-

- Prepare a capital statement to determine tax arrears for the years 2016-2019
- Advise the proprietor the course action he should take to comply with tax laws.

## Assignment

1. Outline sources of information for computation of tax arrears
2. State reasons why tax authorities may institute back duty investigations
3. Outline the steps involved in preparing a capital statement
4. Mr A. Waki started a retail business on 1 January 2013. He has not been filing tax returns on income for the five years to 31 December 2017. An investigation of his affairs revealed the following:

1. The balance sheet of the retail business as at 31 December 2017 was as shown below:

	Sh. '000'	Sh. '000'
Non-current assets		
Premises		2,000
Furniture and fittings		1,000
Motor vehicle		<u>500</u>
		<u>35,000</u>
Current assets:		
Stock	250	
Debtors	160	
Bank balance	81	
Cash in hand	<u>9</u>	<u>500</u>
		<u>4,000</u>
Total assets		
Capital: 1 January 2017	3,000	
Net profit for the year	<u>300</u>	
	1,300	
Drawings	<u>(500)</u>	
Mortgages loan		2,800
Creditors		1,000
Total capital an liabilities		<u>200</u>
		<u>4,000</u>

2. He constructed an extension to the premises in the year 2013 for Sh.625,000.

3. The following account balances were outstanding for the year shown below:

	2013	2014	2015	2016	2017
	Sh.	Sh.	Sh.	Sh.	Sh
Trade debtors	173,000	190,000	208,000	232,500	253,000
Bank balance	109,000	194,000	281,000	409,500	(32,000)
Trade creditors	230,000	241,000	253,000	272,000	291,500
Cash in hand	10,000	10,000	10,000	10,000	10,000
Stock	255,000	302,500	332,500	366,000	402,500

4. He withdrew goods worth Sh.5,000 per annum from the business for his personal use.
5. The principal repayments on each mortgage loan amounted to Sh. 250,000 per annum from 31 December 2013. The mortgage interest paid in each of the four

years ended 31 December 2013, 2014, 2015 and 2016 amounted to Sh.100,000, Sh.75,000, Sh.50,000 and 25,000 respectively.

6. His living expenses and wear and tear allowances were agreed with the authorities as follows:

	2013	2014	2015	2016	2017
	Sh.	Sh.	Sh.	Sh.	Sh
Living expenses	300,000	400,000	450,000	500,000	600,000
Wear and tear	155,500	130,500	109,000	73,000	157,000

**Required:**

- a) Compute the annual taxable income of Mr A. Waki from the year 2013 to 2017
- b) Factors an assessor may consider when negotiating penalties and interest charges.

## **Chapter 8**

### **8.1 Capital Gains Tax**

#### **Expected Learning Outcomes**

After studying this chapter, the learner should be able to:

1. Explain how capital gain tax arises.
2. Describe how capital gain on disposal of securities and property is determined.
3. Calculate the capital gain on disposal of securities and property

#### **8.1.1 Introduction**

Capital Gains Tax is not a new tax since it was first introduced in 1975 but later on, suspended mid in 1985. Suspension intended to attract investment in both real estate and the stock market and consequently facilitate growth in the property market. The first attempt to lift the suspension was in 2006, but the proposed law was not passed by the parliament.

#### **8.1.2 Definition of Capital Gains Tax (CGT)**

This is a tax chargeable on the whole of a gain which accrues to a company or an individual on or after 1st January 2015 on the transfer of property situated in Kenya, whether or not the property was acquired before 1st January 2015. Where the Property includes land, buildings and marketable securities.

#### **8.1.3 Reasons for Reintroduction of CGT**

Given the constitutional provisions, CGT was reintroduced through the Finance Act, 2014 for the following reasons:

1. Promote horizontal and vertical equity in taxation by ensuring fair sharing of the tax burden
2. Enhance market efficiency by minimizing speculation
3. Minimize tax avoidance and evasion because CGT eliminates tax advantage from those who may shift from other income-generating investments to property expecting untaxed gains on transfer.
4. Internationally, including all other EAC countries, CGT has generally been embraced.

The reintroduction came through amendments to the Income Tax Act: i. Section 34(1) of the by insertion of a new paragraph (j) which introduced a rate of 5% on capital gains; and ii. Paragraph 2 of the 8th Schedule to the Act (on taxation of gain) as read together with Section 3(2) (f) of the Act.

#### **8.1.4 Challenges in implementation of taxation of capital gains**

- 1) Records on acquisition costs and other allowable expenses on properties subject to CGT were not preserved to enable taxpayers to support their claims
- 2) The re-introduction after 30 years required a lot of time to sensitize stakeholders
- 3) Relevant Sections and Schedules of the Income Tax Act required amendments to be in harmony with the changes which have taken place since 1985.

#### **8.1.5 What constitutes a transfer?**

Para 6 (1) of 8th Schedule states that transfer includes;

- 1) Where a property is sold, exchanged, conveyed or disposed of in any manner (including by way of a gift whether or not for consideration); or
- 2) On the occasion of loss, destruction or extinction of property whether or not compensation is received or not; or
- 3) On the abandonment, surrender, cancellation or forfeiture of, or the expiration of rights to the property.

**However, Para 6 (2) outlines situations that do not constitute a transfer for CGT purposes:**

- a. Transfer only as security to secure a debt or a loan; or
- b. Issuance by a company of its shares or debentures; or
- c. Vesting of property of a deceased person in the personal representative by operation of law; or
- d. Transfer of property by a personal representative to a person as a legatee in the course of the administration of the estate of a deceased person; or
- e. Vesting in the liquidator by an order of a court of the property of a company under section 240 of the Companies Act; or
- f. Vesting in the official receiver or other trustees in a bankruptcy of a bankrupt under section 57 of the Bankruptcy Act; or
- g. Transfer by a trustee of the property, to a beneficiary on his becoming entitled thereto; or
- h. Refer to 2016 FA amendments to paragraph 6 as discussed above. On transfer between spouses and immediate family members

NB:

What is the rate of tax? Section 34(1) (j) indicates a rate of 5% of the net gain is imposed which is a final tax.

#### **8.1.6 Determination of Net gain**

The net gain is the excess of the transfer value (Para 7) over the adjusted cost (Para 8) of the property that has been transferred. It is this excess that is subjected to tax at 5%.

Transfer value; Adjusted Cost & Incidental Costs....

Transfer Value (Para 7):

1. Computed in reference to amounts outlined in Para 7 depending on the manner of the transfer.
2. Incidental costs to the transferor in making the transfer shall be deducted when computing the transfer value.
3. Where no amount is ascertainable as the transfer value, the transfer value shall be the market value as determined by the Commissioner.

Adjusted Cost (Para 8):

1. Constitutes the amounts listed in Para 8.
2. The adjusted cost computed shall be reduced by amounts allowed as deductions under Section 15(2)

Incidental Costs (Para 10)

1. Constitutes expenditure wholly & exclusively incurred by the person acquiring the property or the transferor for purposes of the acquisition or transfer.
2. Para 11 – Costs already allowed as deductions in the determination of other incomes, are not allowable for CGT.
3. Proof of the incidental costs must be provided.

Capital Loss- This arises when the adjusted cost exceeds the transfer value, a capital loss is incurred, This loss can only be offset against a gain from a similar source i.e, another capital gain – Section 15(3)(f).

Market Value (Para 9)...

1. Where property is acquired or transferred, and is not at arm's length or • by way of a gift in whole or in part or • for a consideration that cannot be valued or • as a result of a transaction between persons who are related, then:
  - Consideration for the transfer = the market value of the property at the time of the transfer
  - consideration for the acquisition = market value of the property at the time of the acquisition or to the amount of consideration used in computing stamp duty payable on the transfer by which the property was acquired, whichever is the lesser.

Due date, Declaration & Payment...

- Due date for tax payable upon disposal of property under Part 1 of the 8th Schedule= on or before the date of application for transfer of the property is made at Lands Office (par 11(A) of the 8th Schedule but currently under dispute) wef 1st January 2016
- Taxpayer to do a self-assessment to determine the gain upon which tax is computed.
- For investment shares, stockbrokers are required to collect and account on behalf of individual investors (Par.18 of 8th Sch). Note: This paragraph is also applicable to shares transferred under Part 1 of the 8th Schedules).

- Upon transfer of property the transferor shall complete the relevant CGT declaration form and compute and pay the tax thereon.

#### **8.1.7 CGT Declaration Forms**

- ✓CGT 1 – Transfer of land and buildings by individuals & corporate bodies
- ✓CGT1P – Transfer of land and buildings by partnerships
- ✓CGT2 – Transfer of marketable securities by individuals & corporate bodies
- ✓CGT2P – Transfer of marketable securities by partnerships
- ✓CGT3 – Declaration for transactions that are exempt from CGT

NB: Forms can be downloaded from the KRA website

#### **Exclusions**

Income that is taxed elsewhere as in the case of property dealers-Para 3 (3) of 8th Schedule; • gain on transfer of machinery including motor vehicles para 3 (2);

#### **8.1.8 Exemptions from the capital gains tax**

- ✓ Income that is taxed elsewhere as in the case of property dealers;
- ✓ Issuance by a company of its shares and debentures;
- ✓ Transfer of machinery including motor vehicles;
- ✓ Disposal of property for purpose of administering the estate of a deceased person; e) the vesting of property in the hands of a liquidator or receiver;
- ✓ Transfer of individual residence occupied by the transferor for at least three years before the transfer;
- ✓ Compensation by Government for property acquired for infrastructure development;
- ✓ Transfer of asset between spouses as part of a divorce settlement;
- ✓ Sale of land by an individual where the proceeds are less than Ksh.. 30,000;
- ✓ Sale of agricultural land by individuals outside gazetted townships where the property is less than 100 acres
- ✓ Exchange of property necessitated by incorporation, recapitalization, acquisition, amalgamation, separation, dissolution or similar restructuring involving one or more companies which are certified by the Cabinet Secretary to have been done in the public interest
- ✓ Transfer of investment shares by a body exempted under Paragraph 10 of the First Schedule
- ✓ Transfer of investment shares by retirement benefits scheme registered with Commissioner (this does not include foreign-registered retirement schemes)

### 8.1.9 Treatment of Capital Gain on Extractive Industry

The net gain on disposal of an interest in a person owning immovable property in the mining and petroleum industry is taxable. The applicable rate of tax is as per the Ninth Schedule to the Income Tax Act – 30% for residents and 37.5% for non-residents with permanent establishments. The taxable gain is the net gain derived on the disposal of an interest in a person if the interest derives its value from immovable property in Kenya. Immovable property means a mining right, an interest in a petroleum agreement, mining information or petroleum information.

### 8.1.10 Transfer Value Computation

#### Example:

The sale proceed of the property was sh. 2,000,000 where the incidental costs included: Legal fees sh. 100,000; Advertisement sh. 50,000; Agent's commission sh. 200,000 and Valuation fees as sh. 150,000.

Sales proceeds		Sh. 2,000,000
Less Incidental Costs (Sh.)		
Legal fees	100,000	
Advertisement	50,000	
Agents commission	200,000	
Valuation fees	150,000	<u>500,000</u>
Transfer Value		<u>1,500,000</u>

#### Adjusted Cost computation

The cost of acquisition/construction was sh. 1,500,000 and the other relevant/incidental costs were as follows: legal cost on acquisition sh. 60,000; valuation sh. 70,000; costs of repairing the roof of property sh. 130,000; legal cost for defending title sh. 50,000; IBD allowed was sh. 450,000 over the years.

Cost of acquisition		Sh.1, 500,000
Add:		
Legal cost on acquisition	Sh. 60,000	
Repair of roof	Sh. 130,000	
Valuation	Sh. 70,000	
Defending title	Sh. 50,000	<u>310,000</u>
		1,810,000
Less: IBD		<u>450,000</u>
Adjusted cost		<u>1,360,000</u>

#### Computation of Gain & Tax thereon:

Transfer Value less Adjusted Cost (1,500,000 – 1,360,000) = 140,000

Tax at 5% of Gain: 5% x 140,000 = 7,000

## **Chapter 9**

### **9.1 Tax Planning for Individuals and Companies**

#### **Expected Learning Outcomes**

After studying this chapter, the learner should be able to:

1. Describe different ways of mitigating tax costs among taxpayers
2. Identify tax planning opportunities under the income tax Act cap 470
3. Describe different income tax planning opportunities for individuals and body corporate

#### **9.1.1 Tax Planning, Tax Avoidance and Tax Evasion**

In the perspective of saving tax, three practices are commonly used; the tax planning, tax avoidance and tax evasion.

Tax planning cannot be equated to tax evasion nor tax avoidance. It is the scientific planning of the taxpayer's operations in such a way to attract-least liability to tax or postponement of the tax liability for the subsequent period by availing various incentives, concessions, allowances, rebates and reliefs as provided for in the tax laws. The incentives provided are meant for achieving certain clear objectives, for instance, re-directing resources/investment to a particular sector of the economy.

##### **9.1.1.1 Tax Avoidance**

In Kenya the tax laws are complex. This is because of numerous deductions, exemptions, relief and rebates. This makes it difficult for taxpayers to mitigate tax costs without failing to comply with tax laws. Thus, it is reasonable for taxpayers to plan their activities so that they maximize tax savings without violating the laws. Nonetheless, avoidance practice worldwide is a common phenomenon and the taxman is battling it out with the taxpayer.

##### **9.1.1.2 Tax planning**

Tax planning is an arrangement of one's financial and business affairs by taking legally in full benefit of all deductions, exemptions, and allowances and reliefs so that tax liability minimized.

The line of demarcation between tax planning and tax avoidance is very thin and unclear. Tax planning is done strictly according to legal requirements and strictly within the spirit of the law while tax avoidance is legal although not within the spirit of the law. It involves the adjustment of the affairs of a taxpayer in a manner that does not infringe tax laws and by capitalizing on tax loopholes with a view of bearing least incidence of tax.

In Kenya, tax avoidance has been considered as terrible as tax evasion and a crime against society. The amendments in section 23- transactions designed to avoid liability to tax, aimed at restricting the

practice of tax avoidance. The Commissioner directs that such adjustments be made in respect to liability to tax as he considers appropriate to counteract the avoidance or reduction of liability to tax which could otherwise be affected by the transaction.

The types of cases that come under 'Tax avoidance' are those where:

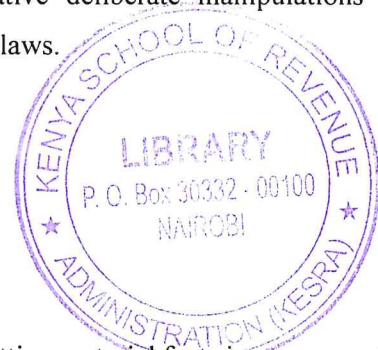
- 1) The taxpayer has circumvented the law, without giving rise to an offence for instance by the use of a scheme, arrangement or device though of a complex nature,
- 2) The main or sole purpose is to defer, reduce or completely avoid the tax payable under the law or
- 3) Shifting the liability for tax to another person, not at arm's length in whose hands the tax payable is reduced or eliminated.

### 9.1.1.3 Tax Evasion

Tax evasion is a method of evading tax liability by dishonest mean. It arises from a person attempting to reduce his tax liability by intentionally suppressing the income or by inflating expenses to indicate income lower than the genuine income and engage in alternative deliberate manipulations of accounting records. Tax evasion is illegal and punishable under tax laws.

Tax evasion may involve:

- ✓ Stating false statement knowingly,
- ✓ Submitting misleading documents,
- ✓ Suppression of facts,
- ✓ Not maintaining proper accounts of income earned and omitting material facts in assessments.



### 9.1.2 Distinguishing Between Tax Planning, Tax Avoidance and Tax Evasion

Basis	Tax planning	Tax avoidance	Tax evasion
Meaning.	Avails maximum benefit of deductions, exemptions, rebates etc. to minimize tax liability	Reduces the tax liability through capitalizing on loopholes in the law.	Reduces tax liability by dishonest means
Legality	It is within the framework of tax law and it makes use of the beneficial provisions in the law.	It complies with the legal framework of the law but not the spirit of the law.	It is a violation of tax law and unethical and constitutes an element of deceit

Penalties and Prosecution	No penalties and prosecution are imposed. It is within the law and the spirit of the law.	It may result in disregarding the transaction done to avoid tax and it may/may not result in penalties and prosecution, but adjustments could be made in the accounting records if the transaction was intended to avoid tax	Heavy penalties and prosecution are imposed against the person engaged in it including imprisonment
Period	It is futuristic and aims at minimizing the tax liability of the future years.	It is also futuristic.	Aims at evading the payment of tax after the liability to tax have occurred.
Acceptance	The concept is acceptable in tax law in Kenya.	The concept is heinous to tax evasion. Section 23 was amended to curb such practices and to seal the weaknesses in the Acts	It is prohibited and illegal.

### 9.1.3 Objectives of Tax Planning

Through tax planning the taxpayer could achieve the following:

1. Reduction of tax liability
  - ✓ By arranging the business affairs per the requirements of the tax law, one will derive the maximum tax savings. Therefore it would be to his benefit to plan his tax affairs properly and avail the deductions and exemptions under the tax Acts.
  - ✓ This can be achieved by keeping an awareness of the implications of the various business/other transactions as well as keeping up to date various concessions for which he is eligible.
2. Minimization of litigation
  - ✓ With proper tax planning by the taxpayer which conforms to the provisions of the taxation laws, the incidence of tax litigation is minimized.
  - ✓ This could save taxpayer's money and time caused by the unnecessary litigations, which at times may end up at Court of Appeal or Supreme Court.
3. Productive Investment: Through proper tax planning one would invest money in investment schemes aimed at attaining the following objectives:
  - ✓ Harness the resources for socially productive projects, and
  - ✓ Relieve the taxpayer not only from the initial effect of taxation but also to convert the earnings so made into means of future earnings.
4. Healthy growth of the economy

- ✓ Saving of earnings by legally approved plans nurtures the growth of the economy and the taxpayer. This is because savings by suspicious means would lead to a development black money market which is disastrous to the economy.
  - ✓ Tax planning measures ensure free flow and generation of clean money through allowances, rebates and reliefs without reservations for the overall growth of the economy.
5. Economic stability: Tax planning will contribute to economic stability by:
- ✓ Attracting investors/ taxpayers by availing of avenues for productive investments.
  - ✓ Harnessing of resources for national projects aimed at general prosperity of the national economy.

#### **9.1.4 Importance of Tax Planning**

1. Reducing tax liability.
2. Enable a taxpayer to make proper planning claiming deductions so that he does not miss out claims for deductions and relief before the final assessment.
3. Tax planning exercise is more reliable since the tax laws provide specific tax incentives available to taxpayers.
4. Acts as incentives by the Government to promote activities of public interest: This makes planners aware of the laws concerning incentives.
5. Adequate time for tax planning, this enables the taxpayer to devote most of his time on tax planning.
6. Enables to bear the burden of taxes during inflation: It enables companies to make proper expense planning especially during inflation because company tend to bear the burden of both direct and indirect taxation on the capital budget, sales promotion planning etc.
7. Capital formation attracts huge deduction: Through proper tax planning a taxpayer would make decisions involving huge capital expenditure generally financed by ploughing back the profits or utilization of reserves to undertake modernization, replacement, repairs and renewal of plant and machinery etc.: Therefore claiming of such expenditure are possible through proper implementation of tax planning techniques.
8. Money saved is money earned: Money saved through tax planning is considered free money received from the government which an assessee will not repay.

#### **9.1.5 Essentials of Tax Planning**

Many tax planning techniques are applied by taxpayers, however, these techniques to be successful, a taxpayer should take into account the following:

1. Have a thorough knowledge of tax laws: He should keep track of the amendments of the tax laws, circulars, notifications, clarifications and administrative instructions issued by the tax authority from time to time.

2. Disclose and furnish all information to domestic taxes department: Disclosing such information is a precondition of tax planning as disguising in any form of information would attract heavy penalties.
3. Planning should be within the framework of tax law: That is whatever is planned should comply with legal provisions as stated and meet the tax obligations as well as be within the framework of the law. Therefore avoid fraudulent transactions which could circumvent the legal provisions, must be avoided.
4. Capability to achieve desired objectives and open to changes: A planning model must be capable of attainment of the desired objectives of a business and be agreeable to its possible future changes. NB all the important areas of corporate planning involving tax considerations for long term or short term management objectives and policies should be strictly scrutinized in relative situations. Foresight is the essence of a business.

#### **9.1.6 Areas of Tax Planning in the Context of the Income-Tax Act, 470**

1. When setting up of new business entity:
  - ✓ Form of organization/ownership pattern;
  - ✓ Locational aspects;
  - ✓ Nature of business
2. For the business entities already in existence:
  - ✓ Tax planning in respect of corporate restructuring;
  - ✓ Tax planning in respect of financial management;
  - ✓ Tax planning in respect of employees' remuneration;
  - ✓ Tax planning in respect of specific managerial decisions;
  - ✓ Tax planning in respect of foreign collaborations and Joint Venture Agreements;
  - ✓ Tax planning in the light of various Double Taxation Agreements.

#### **9.1.7 Tax Planning Relating to Corporate Restructuring**

Suggestions useful for tax planning in respect of business combination include:

1. Planning for carrying forward and set off of unabsorbed losses and unabsorbed capital deductions: The unabsorbed losses and unabsorbed capital deductions cannot be allowed to be carried forward and set off in the hands of the amalgamated company.
2. That the scheme of the amalgamation can be put off till such time the full benefit of set-off is availed of by the amalgamating company; and
3. That the loss carrying company should absorb or take over the business of a profit-making company. In other words, the profit-making company should merge itself with the loss incurring company. This would help in carrying to carry forward the benefits of all unabsorbed losses and unabsorbed capital deductions to be set off against the profits derived from the business of the profit-making company.

4. Allowability of bad debts in amalgamation scenario: The amalgamated company should plan to make suitable provision for the expected losses on account of bad debts at the time of fixing the consideration while taking over the business of the amalgamated company.
5. An amalgamation of an unlisted company with a listed company: A company whose shares are not quoted on a recognized stock exchange may avail the benefit of amalgamation by amalgamating itself with another company whose shares are quoted on a recognized stock exchange. This would help its shareholders to take advantage of the quoted price of their shares in the stock exchange thus benefiting from capital gain on shares.
6. An amalgamation of loss incurring company and profit-making company to reduce tax incidence: A loss incurring company and a profit-making company may merge to reduce the overall incidence of liabilities to tax under the Income-tax Act, 470.

### **9.1.8 Tax Planning Relating to Financial Management Decisions**

To maximize tax benefits arising from financing decisions corporate entities should adopt a suitable capital structure and selecting the appropriate financing sources by providing an optimal capital mix for the organization.

Following points need to be considered while planning financial management decisions:

1. When a company raises long term loans from financial institutions or by way of public issue of debentures or inviting deposits from the public, it should plan in such a way that the expenses incurred on issues of debentures or expenses towards stamp duty, registration fees and legal fees be incurred only after the date of the setting up of the business.
2. The interest paid before the commencement of production but after setting up of the business on loans taken by the company for the acquisitions of its plant and machinery and other assets, forms part of the actual cost of the asset and it should be capitalized in the actual cost of the asset. Thus, the company would be allowed to capitalize expenditure and claim a higher capital deduction.
3. The company should also plan the optimum use of the share capital and the borrowed funds by using such funds to as far as possible for the acquisition and installation of assets like buildings, plant and machinery so that interest can be capitalized for the period after setting up of the acquired assets like buildings, plant and machinery but before the commencement of production. The interest and higher amount of capital allowances may be claimed as revenue expenditure on the business of the company.
4. The company should plan to purchase the depreciable assets on credit terms and an agreed amount of interest can be paid on such credit purchases or the company may purchase these company assets based on the hire purchase agreement enabling the company to claim the amount of interest paid as revenue business expenditure. The company would also be entitled to claim either the capital allowances for use of the asset or may treat the hire charges as the rent for the asset in the normal course of business and claim deduction on revenue account.
5. Taking the source of finances i.e. Equity capital or borrowings, the comparison between the pre-commencement period and post-commencement period is as follows:

- ✓ A dividend is not deductible either for a pre-commencement period or in the post-commencement period in Kenya;
- ✓ Interest is capitalized for the pre-commencement period is included in the cost of non-current assets and its capital allowance is calculated on capitalized value of assets. While in post-commencement period interest is fully deductible.
- ✓ Cost of raising finance in case of capital is not deductible as revenue expenditure but disallowed under the Act.
- ✓ Cost of borrowing funds in case of a pre-commencement period is capitalized and in case of a post-commencement period, it is tax-deductible in the year of income.

### **Assignment**

1. Describe some of the important tax planning available to a company over the other forms of organizations.
2. Tax planning is relevant from the location point of view. Explain five tax benefits an entity may derive from setting up a business in certain locations which are given special tax treatment.
3. Tax planning is also relevant while deciding upon the nature of business. What are some of certain businesses which are granted special tax treatment in your Kenya.
4. Describe some of the tax planning opportunities available to employees.
5. Specify whether the following actions amount to; Tax management; Tax planning or Tax evasion:
  - i) Wambui deposits sh.72,000 in provident fund scheme account to reduce tax payable.
  - ii) Mamba Ltd. installed an air conditioner costing sh. 60,000 at the residence of a director as per terms of his appointment; but treats it as fitted in quality control section in the factory.
  - iii) Tata Ltd. issues a credit note for sh. 36,000 for brokerage payable to Abdi, who is a son of the managing director of the company. The purpose is to increase his income from sh.18,000 to sh.54,000 and reduce its income accordingly.
  - iv) Musa is a partner in Tanka Ltd where he is entitled to a salary of sh. 7,500 per month. He treats this as a salary instead of business income.
  - v) Wasabi uses his motor car for his private purposes, but charges as business expenditure.

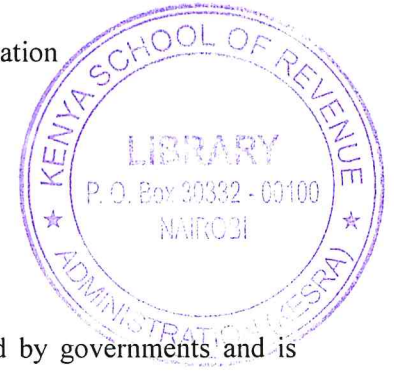
## Chapter 10

### 10.1 Current Developments in Taxation.

#### Expected Learning Outcomes

After studying this chapter, the learner should be able to:

1. Identify modern challenges the government is facing in tax administration
2. Describe the challenges faced in the taxation of the digital economy
3. Tax reforms and bridging of the tax gap among taxpayers.



#### 10.1.1 Why modernization of taxation

Modernization of taxation is a contemporary approach to taxation adopted by governments and is largely driven by:

- a) Globalization;
- b) Technological development;
- c) Administrative challenges;
- d) Presence of customized & diverse tax laws in countries; and
- e) Emerging business structures

Major reorganizations and strengthening of the fiscal and tax management function in the Treasury occurred, as a result;

- i) Led to the introduction of Personal Identification Numbers (PINs)
- ii) All taxpayers had to have PINs which had to be produced to make transactions.
- iii) The government declared a tax amnesty to all taxpayers who declared their true income or sources which they had hidden in the past.

To achieve efficiency, the Government through an Act of parliament established KRA on 1st July 1995, where this was the culmination of the reforms and reorganizations that the government had taken in the tax management sector, the authority is charged with the responsibility of collecting revenue on behalf of the government

With manual tax system posing various administrative challenges, KRA drafted its 2nd corporate plan bringing about reforms among them: Revenue Administration Reform and Modernization Programme (RARMP) in 2004/05 to advocate for three drastic changes and systems:

- 1) Integrated Tax Management Systems (ITMS)
- 2) Electronic Tax Registers (ETR's) – VAT
- 3) 2005 Simba System- to sort the challenges in customs

#### 10.1.2 Role played technology in taxation

With iTax everything is connected for instance: Registrar of Motor Vehicles; Commissioner of Lands; Registrar of Companies; County Government – building approval; Department of immigration; Registrar of Births; Intelligence gathering.

### **10.1.3 Impact of Technology on Revenue Collection**

- 1) Increased revenue collection in the latter years attributable to
- 2) Ease in filling and improved compliance amongst citizens
- 3) Blocking of loopholes of revenue loss present in manual systems
- 4) Wider tax base
- 5) Assisted to detect and curb tax evaders by establishing taxpayers database
- 6) Improved accountability of revenue collected

### **10.1.4 Technology impact on Taxpayers**

- 1) Service delivery-Taxpayers can access tax ledgers conveniently
- 2) Timeliness-Shortened the duration to file taxes & objection and generation of tax payment slips
- 3) Effectiveness- From customers feedback it's easier and faster to follow up and address tax challenges online
- 4) Enhanced accountability-Presence of ledgers of taxpayers account and trail of activity in the account
- 5) Improved transparency-Noted as people feel confident when they can track their issues with the taxman

### **10.1.5 Technology and compliance**

1. Compliance management via
  - ✓ Ease and facilitation to file amended tax records
  - ✓ Helps taxpayers and their agents via online advisory
2. Debt and Enforcement
  - ✓ Assessment and notification of tax liability via emails
  - ✓ Improves consistency on the follow-up of debts
  - ✓ Has eased application of waiver and tax amnesty
3. Acting as a tax policy advisor on Itax & KRA website encloses with its tax Acts, FAQ, support videos which are helpful to tax agents, taxpayers & revenue officers

### **10.1.6 Taxation challenges in a digital economy**

Revenue authority may be facing the following challenges:

1. Mismatch in assessments: Suppliers experiencing inconsistencies with VAT input taxes calculated by the VAA
2. Tax base: Compared to the population statistics and number of registered taxpayers, a huge variance is visible thus the system does little to bridge the principle of equity.
3. Mismanagement and fraud by officers denying Kenya its revenue
4. System failures: Time outs and bugs during taxpayers end the year at times has discouraged all parties involved
5. Customer feedback that is the feedback at times is delayed and inconsistent

### 10.1.7 New Regulations

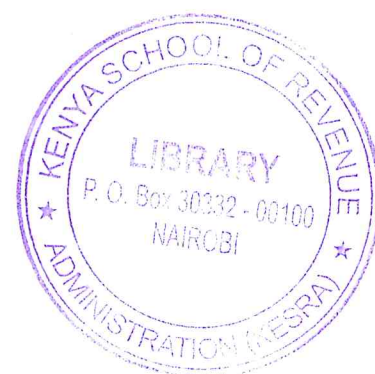
1. Alternative Dispute Resolution Regulations
  - ✓ Aims for win-win amicable resolutions on tax disputes.
  - ✓ Will help tax man recover shortfall taxes and still enable continuity of businesses.
2. VAT Regulations 2019
  - ✓ Places emphasis on electronic registers
  - ✓ Bound to improve on VAT
  - ✓ Seeks to improve VAT collections

Strategic priorities as per KRA's 6th corporate Plan

- 1) Enhance revenue collection and strengthen enforcement
- 2) Strengthening the revenue administrative capacity & enhancing transparency & fairness;
- 3) Creating a staff establishment that is professional, courteous, accessible and pro-active in solving customer problems;
- 4) Enabling business by leveraging on technology.

### 10.1.8 Strategic priorities for Enhancing revenue collection

- 1) Broadening the tax base through enhanced taxpayer recruitment;
- 2) Revamped debt programme;
- 3) Enhanced efficiency of the audit programme;
- 4) Implementation of ADR;
- 5) Becoming the lead border agency;
- 6) KRA becoming a fully automated single collector;
- 7) Fully implementing the enterprise risk management framework;
- 8) Reforming the organizational structure to meet the challenges of implementation.



### 10.1.9 Strategic priorities to Enabling business by leveraging on technology

- 1) Implementation of enhanced business systems to ensure accountability;
- 2) Implementation of full electronic customer service to enhance service delivery;
- 3) Exploit technological advances such as cloud computing and mobile platforms to improve

### Assignment

- (i) Explain the significance of technology in tax modernization
- (ii) Outline five challenges tax authorities are facing in curbing tax crimes in e-commerce businesses.
- (iii) Explain four benefits accruing to tax authority through the use of information technology

*END*

