PRINCIPLES
OF
PUBLIC FINANCE AND TAXATION

ATD LEVEL III
DCM LEVEL III

STUDY TEXT
CONTENT

1. Introduction to Public Financial Management Legal Framework
   - General overview of Public Financial Management as envisaged by the Constitution (Chapter 12 of the constitution)
   - Financial regulations
   - Treasury Circulars
   - Process of developing county government finance bills

2. Public budget process for public bodies
   - General definition of budgets terms
   - Role of budget officers in budget preparation and execution
   - Responsibilities of The National and County treasury's in relation to budget preparation
   - Budget process for both national, county and Public entities
   - Budgetary and fiscal policy tools

3. Oversight function in public finance management
   - The role of National Assembly
   - The role of senate
   - The role of county assembly
   - The role of auditor general
   - The role of Internal Audit
   - Role of controller of budget in relation to disbursement of public funds as envisaged by the constitution and PFM Act, 2012

4. Introduction to taxation
   - History and purposes of taxation
   - Principles of an optimal tax system
   - Single versus multiple tax systems
   - Classification of taxes and tax rates
   - Impact incidence and tax shifting, Lax shifting theories
   - Taxable capacity
   - Budgetary and fiscal policy tools.: General definition of budgets terms ,Budget surplus and deficits
   - Role of budget officers in budget preparation and execution
   - Responsibilities of the national and county treasury in relation to budget preparation
   - Budget process for both national, county and Public entities
   - Revenue Authority — History, structure and mandate

5. Taxation of income of persons Taxable and non taxable persons
   - Sources of taxable incomes
   - Employment income;
     - Taxable and non taxable benefits
     - Allowable and non allowable deductions
- Tax credits (Withholding tax, personal and insurance relief etc)
- Pension Income

- Business income:
  - Sole proprietorship
  - Partnerships (excluding conversions)
  - incorporated entities (excluding specialised institutions)
  - Turnover tax

- Income from use of property- rent and royalties
- Farming income
- Investment income

6. Capital deductions
   - Rationale for capital deductions
   - Investment deductions: ordinary manufacturers
   - Industrial building deductions
   - Wear and tear allowances
   - Farm works deductions

7. Administration of income tax
   - Overview of the income tax act
   - Identification of new tax payers
   - Assessments and returns
   - Operations of PAYE systems: Preparation of PAYE returns, categories of employees
   - Notices, objections, appeals and relief of mistake A
   - Appellant bodies
   - Collection, recovery and refund of taxes
   - Offences, fines, penalties and interest
   - Application of ICT in taxation: iTax, Simba system

8. Administration of value added tax
   - Introduction and development of VAT
   - Registration and deregistration of businesses for VAT
   - Taxable and non taxable supplies Privileged persons and institutions
   - VAT rates
   - VAT records
   - Value for VAT, tax point
   - Accounting for VAT
   - VAT returns
   - Remission, rebate and refund of VAT
   - Rights and obligations of VAT registered person
   - Offences fines, penalties and interest
   - Enforcement
   - Objection and appeals: Requirements and procedure
9. Customs taxes and excise taxes
   - Customs procedure
   - Import and export duties
   - Prohibitions and restriction measures
   - Transit goods and bond securities
   - Excisable goods and services
   - Purposes of customs and excise duties

10. Emerging issues and trends

<table>
<thead>
<tr>
<th>TOPIC</th>
<th>PAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Topic 1:</td>
<td>5</td>
</tr>
<tr>
<td>Introductions to public financial management Legal Framework</td>
<td></td>
</tr>
<tr>
<td>Topic 2:</td>
<td>39</td>
</tr>
<tr>
<td>Public budget process for public bodies</td>
<td></td>
</tr>
<tr>
<td>Topic 3:</td>
<td>72</td>
</tr>
<tr>
<td>Oversight function in public finance management</td>
<td></td>
</tr>
<tr>
<td>Topic 4:</td>
<td>81</td>
</tr>
<tr>
<td>Introduction to taxation</td>
<td></td>
</tr>
<tr>
<td>Topic 5:</td>
<td>117</td>
</tr>
<tr>
<td>Taxation of income of persons Taxable and non taxable persons</td>
<td></td>
</tr>
<tr>
<td>Topic 6:</td>
<td>197</td>
</tr>
<tr>
<td>Capital deductions</td>
<td></td>
</tr>
<tr>
<td>Topic 7:</td>
<td>241</td>
</tr>
<tr>
<td>Administration of income tax</td>
<td></td>
</tr>
<tr>
<td>Topic 8:</td>
<td>259</td>
</tr>
<tr>
<td>Administration of value added tax</td>
<td></td>
</tr>
<tr>
<td>Topic 9:</td>
<td>284</td>
</tr>
<tr>
<td>Customs taxes and excise taxes</td>
<td></td>
</tr>
</tbody>
</table>

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TOPIC 1

INTRODUCTIONS TO PUBLIC FINANCIAL MANAGEMENT

LEGAL FRAMEWORK

INTRODUCTION TO PUBLIC FINANCE

Meaning of Public Finance

Public finance is related to the financing of the state activities and a narrow definition of the public finance would try to say that public finance is a subject which discusses the financial operation of the fiscal or of the public treasury.

Nature of Public Finance

Public finance has been held as a science which deals with the income and expenditure of the government’s finance. It has been held as a study of principles underlying the spending and raising of funds by the public authorities. The various theories which form the basis of the collection; maintenance and expenditure of the public income constitute the subject and matter of finance.

Scope of Public Finance

The scope of public finance is not just to study the composition of public revenue and public expenditure. It covers a full discussion of the influence of government fiscal operations on the level of overall activity, employment, prices and growth process of the economic system as a whole.

According to Musgrave, the scope of public finance embraces the following three functions of the government’s budgetary policy confined to the fiscal department the:

- allocation branch,
- distribution branch, and
- stabilization branch.

These refer to three objectives of budget policy, i.e., the use of fiscal instruments to secure:

- Adjustments in the allocation of resources
- Adjustments in the distribution of income and wealth, and
- Economic stabilization.
Public finance is composed of the following constituents public:

- Expenditure
- Revenue
- Debt
- (Financial) administration

Private finance is the study of the income, debt and expenditure of the individual or a private company or business venture or an association. It includes the study of their own view regarding earning expenditure and borrowing.

Similarities and Differences between Public Finance and Private Finance

Despite the differences in scope and nature of the public finance and private finance, following are similarities.

Similarities

I. Based on Similar Theories
The basis of public as well as private finance is the same. Both seek the help of various principles of economics in determining various interrelated problems. For example, a person wants to secure maximum utility on count of minimum expenditure and government too wants to secure public utility by spending the least possible amount of public money.

II. Both Face the Problem of Scarcity
Limitation of the resources is the problem before private as well as public finance. Individuals’ resources are limited up to this earnings; past savings and ancestral property similar governments’ resources also depend on taxable capacity of the individuals earnings of the various corporations etc. None of the two is capable of extending its expenditure beyond a certain limit; hence non can afford to go to the infinity in the use of finance.

III. Both Require Efficient Administration
Private as well as public finance require efficient administration to look after the various acts of extravagance. In the event of the failure of an efficient administration both might be compelled to face ‘dire-consequence’ in their financial field, individual never wants any kind of wastage or misuse of his income, so the government if it is alive to the sense of duty.

IV. Both Borrow and Must Repay
To run the administration of finance sometimes money in hand fails to fulfill the requirements especially in the times of emergency, governments borrow money from individuals and also borrow from different sources like relatives, banks, at the same it is obligatory for both the
public finance as well as the private finance to repay the debt. The point here is that none can live without repaying the amount.

V. Both are Based on Rationality of Thought
When an individual spends some money he makes it certain in his mind that money is spent in the best way. He applies his rational faculties. In the same way any irrational step taken by the government may bring wastage and misuse of finance. This irrationality lead them to damages while rationality to prosperity and achievement of goals.

Differences between Public Finance and Private Finance

i. Individual determines his expenditure on the basis of his income but government determines its income on the basis of its expenditure. As far as an individual is concerned he determines his expenditure on the basis of the income, in the sense that he cannot think of spending more than his income. He distributes the amount of income to be spent on various subjects with income at his finger tips. The position is quite contrary in the case of government. The government first decides the amount of expenditures to be done during a period of time, and then frames scheme to secure money to meet the expenditure. Government has the power to increase its income be internal borrowings but this is not possible for an individual.

ii. Government’s source of income is more flexible in comparison to private source. Government has legal power to extend the sources of its income according to the needs of the time. Government has the control over the whole national property but individual has to rely upon his own individual standing. Moreover, government can take the help of the foreignment and this is not possible for a person to secure such supports. The last resort available to the government is the printing of new currency notes to increase its income. But an individual will be definitely but behind the bars for such an office.

iii. It is easy for an individual to base his expenditure on the law of equal marginal utility, but far difficult for governments. Individual is free to measure his expenditure in the sense of utility and spends his money on the certain weighted subjects. These subjects may not be of social need or may not add anything to social advantage. Such expenditures are very prominent in the democratic countries for example building of hospitals, roads, parks.

iv. Private finance is narrow and short lived in comparison to public finance. Private finance faces suspension with the end of the individual’s life or with the closure of the particular business enterprise. But governments are more tenable. It is well said in this context is that ‘king may come and king may go but government is eternal.’ Governments keep on moving form generation to generation interlinking past from present with an eye on future.

v. Public finance is subject to public censor but not the private finance. A complete secrecy may be maintained by an individual regarding his income and savings. But the government
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TOPIC 2

PUBLIC BUDGET PROCESS FOR PUBLIC BODIES

General definition of budgets terms

A budget is an estimate of costs, revenues, and resources over a specified period, reflecting a reading of future financial conditions and goals.

One of the most important administrative tools, a budget serves also as a

1. Plan of action for achieving quantified objectives,
2. Standard for measuring performance, and
3. Device for coping with foreseeable adverse situations.

A budget process refers to the process by which governments create and approve a budget

A government budget is a document presenting the government's proposed revenues, spending and priorities for a financial year. The budget is passed by the legislature, approved by the chief executive and presented by the national or county treasury to the national or county assemblies.

It is also a set of procedures by which the government rations resources and controls spending among the various government agencies. The government budget is used as an instrument for economic policy, management and accountability.

It is an allocation mechanism that aims to maximise the contribution of public expenditure to national welfare.

Budget can be divided into two parts namely
(a) Capital
(b) Revenue.

The first one broadly pertains to one time expenditure, whereas the latter one pertains to recurring expenditure.

Capital Budget:

It consists of capital receipts and payments and also incorporates transactions in the Public
Account.

- **Capital receipts** – Receipts by way of (a) loans raised from the market, (b) borrowing from RBI, (c) external assistance from foreign Govt., (d) recoveries of loans and advances.
- **Capital expenditure** – It is the expenditure incurred on (i) acquisition of assets and investments, (ii) loans and advances to State Govts.

**Revenue Budget:**

- **Revenue receipts** – Receipts by way of (a) direct and indirect taxes, (b) interest, (c) dividends and (d) profits from investments, (e) fees and other receipts from services rendered by the Govt.
- **Revenue expenditure** – These are expenses incurred for the (i) normal running of the Govt. departments, (ii) interest charges on debt and subsidies.

**Central Plan:**

This refers to the government’s budgetary support to the plan and, the internal and extra budgetary resources raised by the public sector undertakings.

- **Plan expenditure** – It is the outlay on schemes and programmes formulated by various Ministries under the 5-years plan
- **Non-plan expenditure** - It is the expenditure outside that incurred in keeping with the programmes formulate under the 5-years plan.

**Types of Deficits:**

- **Revenue deficit** – It is the excess of Govt. revenue expenditure over revenue receipts.
- **Budgetary deficit:** It is excess of total expenditure (capital and revenue) over total receipts, bridged through borrowings from the market and RBI.
- **Fiscal deficit** : It is excess of total expenditure over revenue receipts and capital receipts after excluding borrowing
- **Primary deficit** – it is the fiscal deficit reduced by expenditure on interest payment.
- **Current Account Deficit**: This deficit shows the difference between the nation’s exports and imports
Types of Government Accounts:

- **Consolidated Fund:** It is made up of all revenues received by the government, loans raised by it, and also its receipts from recoveries of loans granted by it. All expenditure of the government is incurred from the Consolidated Fund and no amount can be withdrawn from the Fund without authorisation from Parliament.

- **Public Account:** There are certain receipts and expenditure which are beyond the normal receipts and expenditure of the government relating to the Consolidated Fund. Such transactions come to Government’s account mostly as the government acts more as a banker rather than on a permanent basis, for example, transactions relating to provident funds, small savings collections, other deposits etc. Such money is kept in the Public Account and is disbursed as per rules. Thus, it is an account in which money received through transactions not relating to the Consolidated Fund is kept.

- **Contingency Fund:** This fund is similar to the savings which normally ladies in Indian households keep for emergencies. There are occasions when government may have to meet urgent unforeseen expenditure pending authorization from Parliament. The contingency fund is similar to an imprest account, and the same is available at the disposal of the President to incur such unforeseen expenditure. Parliamentary approval for such expenditure and for withdrawal of an equivalent amount from the fund is subsequently obtained and the amount spent from the fund is recouped to the Fund.

**Zero based Budget (ZBB):** begins with decision units that are the lowest levels in the organization for which a budget is prepared. A set of decision package is prepared for each unit, which basically describes various levels of service that may be rendered by the decision unit. The frequently mentioned benefit of ZBB is the increased participation of managers in the budget-making process.

**Demands for grants:** It is a statement of estimates of expenditure from the Consolidated Fund. It is voted by Lok Sabha. Generally one demand for grant is presented in respect of each ministry of department.

**Appropriation bill:** This is introduced in Parliament for approval after the general discussions on budget proposals and completion of the voting on grants. Its approval is required so that government can withdraw from the Consolidated Fund, the amounts required for meeting the expenditure.
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TOPIC 3

OVERSIGHT FUNCTION IN PUBLIC FINANCE MANAGEMENT

Role of National Assembly

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

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

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

Role of Senate

There is established Committee of the Senate set to deal with budgetary and financial matter's, it has responsibilities for the following matters, in addition to the functions set out in the Standing Orders present to the Senate, subject to the exceptions in the Constitution, the proposal for the basis of allocating revenue among the Counties and consider any bill dealing with county financial matters; review the County Allocation of Revenue Bill and the Division of Revenue
Bill in accordance with the Constitution at least two months before the end of the financial year; examine financial statements and other documents submitted to the, and make recommendations to the Senate for improving the management of government's public finances; and

c) Monitor adherence by the Senate to the principles of public finance set out in the Constitution, and to the fiscal responsibility principles of this Act.
d) In carrying out its functions under the Committee shall consider recommendations from the Commission on Revenue Allocation, County Executive Committee member responsible for finance, the Intergovernmental Budget and Economic Council, the public and any other interested persons or groups.

Parliamentary Budget Office

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

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

Responsibilities of the Parliamentary Budget Office

The Parliamentary Budget Office shall—

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

h) Propose, where necessary, alternative fiscal framework in respect of any financial year.

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

Auditor-General

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

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

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

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

a) the accounts of the national and county governments;

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

c) the accounts of all courts;

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

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

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

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

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

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

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

Within three months after receiving an audit report, Parliament or the county assembly shall debate and consider the report and take appropriate action.
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TOPIC 4

INTRODUCTION TO TAXATION

HISTORY AND PURPOSE OF TAXATION

Before 1897, Kenya was made up of multifarious tribal-based societies each with its own geographical and sociological background. These societies were communist/socialist in the sense that property was communally owned by all the members of a particular social setup. Upon amassing wealth in form of harvests, part of it was required to be submitted to the community leaders in form of tithe. This “tithe” was to be used in future to assist those who didn’t have enough property to sustain them or even to assist those who were hit by calamities. In a sense, this was a form of taxation because the percentage that was submitted to the community leaders was used to help others in future.

The principles and systems of taxation that existed in most African Kingdoms during this period were therefore informal. It was only upon the influx of foreigners that some form of formal taxation started. The Arabs who entered Kenya in the seventh century for example taxed the coastal region on the basis of Islamic Law. Islamic law upholds the right of leaders to tax their subjects within bearable limits and therefore taxation is not forbidden. Capitation of such tax was done by charging a fixed amount for each and every slave that was to be exported from the Sultanate of Oman. Custom duties were also charged on other exports like ivory, cloves and beads.

The Portuguese arrived at the Kenyan coast and were now taking over from the Arabs. The first recorded treaty that involved a form of taxation in this period was in 1502. The then Sultan Ibrahim of Malindi was held against his wishes and forced to accept defeat. While being held hostage during negotiations on Vasco da Gamma’s boat, a treaty of surrender was signed with Portugal for an annual tribute of 1,500 meticals of gold.

However, the Portuguese were violent and thus this led to a complete failure to use equity in the creation and levy of taxes there were riots (you thought riots started the other day?) were punctuated with civil disobedience and widespread cases of tax evasion and avoidance.

By the end of the rule of the Arabs and Portuguese along the East coast of Africa the existing balance of taxation that was inherited by the British included a capitation tax payable per head of slave exported and customs revenue shared equally between the Arabs and Portuguese. The tax base was, however, limited to traders only.
Exit Portuguese and Arabs, Enter The British

Next were the British who ruled what is presently Kenya and Uganda together to form British East Africa Protectorate. British colonial tax policy developed mostly on the grounds that Britain needed to support its own economy by creating foreign markets and sources of raw materials for its industries, thus obtain maximum gains with minimum input. This was done by initially through the Chartered company concept. However, later in order to encourage rule from within the territory to make it viable after the accidental discovery of arable land in Kenya.

British Taxes

**Hut and Poll Tax:** The 1901 Hut Tax Regulation imposed a tax of **one rupee**, payable in kind or through labour, upon every native hut in British East Africa. Hut tax or poll tax was **increased to 5 rupees** in 1915 and again in 1920 to **8 Rupees**.

**Land Tax:** The levying of a graduated land tax on individual holdings was introduced by the British as a sound basis for land policy in East Africa. The protectorate government in East Africa argued in early 1908 for preserving the means of obtaining some share of any future appreciation in the value of the land, particularly because much of the land acquired by settlers was not being developed.

**Graduated Personal Tax:** The Graduated Personal Tax was introduced in 1933. The Act was modeled on the Colonial Income Tax Ordinance which itself was a ‘simplified synthesis’ of the United Kingdom Income Tax Act of 1920. Now graduated taxes on global income would have been considered revolutionary because non-Africans were liable to a flat at poll rate and an Educational Tax. This tax was applied for the first time in 1934 at rates graduated according to the taxpayer’s income with certain amendments.

**Income tax:** It was first introduced in Kenya in **1921**, and in 1954, the rates of personal income tax were set at **20 shillings** for anyone earning less than **£60**, for earnings between **£ 60 - 120** charge of **40 shillings** and for earnings over **£120** a charge of **60 Shillings**. In 1956, a Commission of Enquiry into the Administration of Income was established and was chaired by Sir Erick Coates.

**Kenya’s taxation system and policy after independence**
The first post-independence strategy on matters taxation and policy was set out in Kenya’s earliest planning document entitled Sessional Paper No. 10 of 1965 on African Socialism and its Application to planning in Kenya. The main purpose of the paper was to guarantee all citizens equal political and economic rights. The paper stated that the economic approach of the government was to ensure Africanisation of the economy and also the public service.
government would concentrate investment in places where it was likely to maximize returns which would subsequently be distributed to the rest of the country.

The paper laid down the foundation for the country’s fiscal policy framework. By the year 1972, the economy of the country expanded and this saw the introduction of Sales Tax in 1973 which, coupled with the first oil crisis of 1973, led to an economic shock and an increasing debt problem. The resultant fiscal reforms included 20% withholding tax on nonresident entrepreneurs, capital allowance restricted to rural investment, a new tax on the sale of property, taxes on shares, the sale of land and a custom tariff of 10% on a range of previously duty-free goods.

Kenya later came up with its own income tax department as a department of treasury and also came up with its own income tax legislation known as the Income tax Act which commenced on 1st January 1974 and it was codified as Chapter 470 of the laws of Kenya. The preamble to this Act reads as follows, “An Act of Parliament to make provision for the charge, assessment and collection of income tax: for the ascertainment of the income to be charged; for the administrative and general provisions relating thereto; and for matters incidental to and connected with the foregoing”. The preamble gives us the scheme or the various components with which this law has dealt with.

PURPOSE OF TAXATION

1. **Raising public revenue** to meet public expenditure for a common cause.
2. **Protection of the health of citizens**. Heavy taxes are imposed on goods that are considered to be harmful to the health of citizens if consumed in large quantities such as beer and cigarettes.
3. **Protection of local industries**. Heavy taxes are imposed on imported goods which are substandard or goods that are available locally in plenty.
4. **Encourage exportation** and hence the generation of foreign currency e.g. Exports are zero rated for VAT purposes, i.e. VAT paid on purchases used for processing exports is refundable.
   - **Export processing zones (EPZ)**. These are designated areas where the industries located are granted attractive tax incentives in exchange of exporting manufactured goods e.g.
     - Corporation tax is not payable during the first ten years of operation.
     - Corporation tax is payable at a rate of 25% from the 11th to 20th year of operation.
     - Capital expenditure or machinery and factory building is deductible at 100% cost known as investment deduction.
   - **Manufacturers under bond (MUB)**. These are manufacturers that are licensed by the customs department to manufacture for export purposes for at least three years. Such manufacturers are granted 100% investment deduction on capital expenditure incurred on machinery and factory buildings.
5. **To encourage savings for retirement**.
   - **As a contributor**: contributions to a registered pension scheme are **exempted** from tax up to a maximum of **Sh. 240,000** p.a. (20,000 per month)
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TOPIC 5

TAXATION OF INCOME OF PERSONS

INTRODUCTION

Income tax is charged under the income tax Act (Cap 470) which contains rules and regulations relating to the following:

- Ascertainment of income
- Assessment of tax
- Collection of tax
- Entitlement of personal relief

S.3 (1) of the income tax act states that:
“Subject to, and in accordance with this Act, a tax to be known as income tax shall be charged for each year of income upon all the income of a person, whether resident or non-resident, which accrued in or was derived from Kenya.”

S.3 (2) of the income tax act states
‘Subject to this act, income upon which tax is chargeable is income in respect of
a. Gains or profits from
   i) A business for whatever period of time carried on
   ii) Employment or service rendered
   iii) A right granted to another person for use or occupation of property
b. Dividends or Interest
c. Pension income or withdrawal from a registered provident and provident fund.
d. Any withdrawal from a registered Home Ownership Saving Plan
e. Any deemed income
f. Gains from transfer of property

The income tax Act (Cap 470) was enacted in 1973, and its date of commencement was January 1974. It replaced the East Africa Income Tax Management Act, which had served the countries of the East Africa Community, and which became outdated following the break up of the community. Income tax is charged for each year of income on all income of a person, whether resident or non-resident, which accrues in or is derived from Kenya.
Year of income and accounting year

Year of Income is a period of 12 months commencing 1 January and ending on 31 December in each year. It is the same as calendar year. Income tax is charged for each year of income. The year of income should be distinguished from the accounting year. There is a date to which accounts of a business are prepared each year, and this date would indicate the accounting year end. The accounting year ending on 31 December would coincide with the year of income. Other accounting year-ends would however fall in a given year of income and the profit or loss per the accounts would be for that year of income. For example, an accounting date ended 31 May 2015 would fall to be treated as the year of Income 2015.

TAXABLE AND NON TAXABLE PERSONS

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

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

Resident and non-resident persons

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

a) Resident in relation to an individual means that the individual:
   i) Has a permanent home in Kenya and was present in Kenya for any period during the year of income under consideration; or
   ii) Has no permanent home on Kenya but was present in Kenya for a period or periods amounting in total to 183 days or more during the year of income under consideration; or
   iii) Has no permanent home in Kenya but was present in Kenya for any period during the year of income under consideration and in the two preceding years of income for periods averaging more than 122 days for the three years.
### Residence in relation to a company

A company is considered to be a resident in any year of income if:

1. It is incorporated in Kenya under the laws of Kenya.
2. Management and control of the affairs of the company was exercised in Kenya during the year of income under consideration.
3. The company has been declared by the Minister for finance to be a resident for any year of income through a notice in the Kenya gazette.

### The significance of the concept of residence

The importance of residence is shown in the differences in the tax treatment of income derived by residents and non-residents e.g.

<table>
<thead>
<tr>
<th>Resident</th>
<th>Non-resident</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Employment income arising in Kenya and other sources outside Kenya are taxable.</td>
<td>• Employment income arising only from Kenya is taxable.</td>
</tr>
<tr>
<td>• In case of individuals personal relief is granted as a deduction against tax liability.</td>
<td>• Individuals cannot claim personal relief as a deduction from tax liability.</td>
</tr>
<tr>
<td>• Pension Income - The first Sh.600,000 received in lump sum is tax exempt. In case of Periodic payment, the first Sh.300,000 p.a. is tax exempt.</td>
<td>• The gross pension income received for services rendered in Kenya is subject to withholding tax of 5% as the final tax.</td>
</tr>
<tr>
<td>• Rental Income - The income from property less allowable expenses is taxed using the graduated scale for individuals or corporation tax for a company.</td>
<td>• The gross rental income is subject to withholding tax of 30% as the final tax.</td>
</tr>
</tbody>
</table>
| • Royalty Income –  
  • Gross royalties are subject to withholding of 5%. | • Gross royalties are subject to withholding tax at the rate of 20% as the final tax. |
| • Gross royalties net of allowable expenses are taxed using the corporation tax for a company. | |
| • In case of companies, profits are taxed at the rate of 30%. | • In case of companies the profits are taxed at the rate of 37.5%. |
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TOPIC 6
CAPITAL DEDUCTIONS

INTRODUCTION

Key terms

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

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

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

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

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

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

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

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

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

- Capital Allowances are allowable deductions granted on the capital expenditure incurred to acquire assets that are utilized in the business to generate taxable income.
- Capital allowances are granted for the following reasons:
  - To encourage new industrial enterprises;
  - To allow such deductions as may just and reasonable as representing the diminution in value of fixed assets during a particular year.
  - To encourage exportation
- Capital allowances include the following:
  (i) Investment deduction (ID)
  (ii) Industrial building deduction (IBD)
  (iii) Framework deductions (FWD)
  (iv) Diminution in value of loose tools and implements

The capital deductions are important because:

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

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

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

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

As noted earlier any capital loss, diminution, exhaustion of capital, such as depreciation, amortisation, loss on sale of assets, obsolescence, provision for replacement, are not allowable expenditure against income.
But the Income Tax Act recognises the loss of value of assets used in business through usage, passage of time or obsolescence and so grants the wear tear allowance.
As per paragraph 7 of the Second Schedule to the Income Tax Act ... —where during a year of income machinery owned by a person is used by the person for the purpose of his business, there shall be made in computing the person’s gains or profits ... a deduction ... referred to as a „wear and tear deduction‘.

It should be noted that machinery qualifies for wear and tear deduction where:
  i. Owned by a person, and
  ii. Used by the person for business anytime during the year of income.
INVESTMENT DEDUCTION (ID)

This is a claim granted in the year the asset is first used on the capital expenditure incurred on factory buildings and machinery as an incentive to encourage investments in the manufacturing sector.

Investment deduction is granted to encourage:

- The development of industries in normal manufacture, tourism and shipping.
- Exportation to earn foreign exchange e.g. in the case of Export Processing Zones enterprises.
- To encourage foreign investment in Kenya

The qualifying capital expenditure for purposes of investment deduction includes:

1. Construction of a factory building.
2. Installation of new or imported second hand processing machinery.
3. Construction of a hotel building certified to be an industrial building.
4. Purchase of machinery utilized for ancillary purpose such as:
   - Generation, transformation and distribution of electricity.
   - Machinery for clean up and disposal of effluent and other waste products.
   - Machinery for the reduction of environmental damage
   - Machinery for water supply and disposal
5. From 1 January 1995, specified civil works are eligible for investment deductions.
   Civil works includes:
   a. Roads parking areas.
   b. Railway lines and related structures.
   c. Water, industrial effluent and sewerage works.
   d. Communication and electrical posts and pylons and other electrical supply works.
   e. Security walls and fencing.
6. From 1 July 1999, workshop machinery for the maintenance of machinery used for manufacturing.
7. From 1 January 2010, purchase of filming equipment by a local film producer.

Rates of ID are:

<table>
<thead>
<tr>
<th>Year</th>
<th>Nairobi &amp; Mombasa</th>
<th>Elsewhere</th>
</tr>
</thead>
<tbody>
<tr>
<td>1988</td>
<td>10%</td>
<td>60%</td>
</tr>
<tr>
<td>1989</td>
<td>25%</td>
<td>75%</td>
</tr>
<tr>
<td>1990-94</td>
<td>35%</td>
<td>85%</td>
</tr>
<tr>
<td>1995-00</td>
<td>60%</td>
<td>60%</td>
</tr>
<tr>
<td>2001</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td>2002</td>
<td>85%</td>
<td>85%</td>
</tr>
<tr>
<td>2003</td>
<td>70%</td>
<td>70%</td>
</tr>
<tr>
<td>2004-2012</td>
<td>100%</td>
<td>100%</td>
</tr>
</tbody>
</table>
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TOPIC 7

ADMINISTRATION OF INCOME TAX

OVERVIEW OF INCOME TAX ACT

Income tax in Kenya is charged under the income tax Cap 470. The Act contains provisions relating to:

- Ascertainment of income.
- Assessment of tax.
- Collection of tax
- Entitlement to personal relief

The income tax Act Cap 470 was enacted on 20 December 1973 to replace the former East Africa income tax management Act. It contains:

- 14 parts
- 133 sections
- 13 schedules
- 8 subsidiary legislation

IDENTIFICATION OF NEW TAX PAYERS

The finance Act 1992 introduced the thirteenth Schedule to the income tax Act which took effect from 1st January 1993. A personal identification number (PIN) shall be required for tax purposes for any of the following transactions:

<table>
<thead>
<tr>
<th>Institution</th>
<th>Purpose of transaction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commissioner of lands</td>
<td>Registration of title and stamping of instruments</td>
</tr>
<tr>
<td>Local Authorities</td>
<td>Approval of plans and payment of water deposits</td>
</tr>
<tr>
<td>Registrar of motor vehicles</td>
<td>Registration of motor vehicles and transfer of motor vehicles, licensing under traffic act</td>
</tr>
<tr>
<td>Registrar of Business Names</td>
<td>New registrations</td>
</tr>
<tr>
<td>Registrar of Companies</td>
<td>New registrations</td>
</tr>
<tr>
<td>Insurance companies</td>
<td>Underwriting of policies</td>
</tr>
<tr>
<td>Ministry of Commerce</td>
<td>Importing licenses or trade licensing</td>
</tr>
<tr>
<td>Commissioner of VAT</td>
<td>Applying for registration</td>
</tr>
<tr>
<td>Kenya Power</td>
<td>Payment of deposit for power connection</td>
</tr>
</tbody>
</table>
TAX ASSESSMENT: SELF-ASSESSMENT, ADDITIONAL ASSESSMENTS AND ESTIMATED ASSESSMENTS

ASSESSMENT

- Assessment means computation of tax liability on any income derived in a particular year.
- In case a person has submitted a self assessment return to the tax authority, the commissioner may:
  - Accept the assessment return and consider the amount declared in the return as the correct self assessment, in which case no further notification will be given.
  - If the commissioner has reasonable cause to believe that the self assessment return is not true or correct, he may determine according to the best of his judgment the amount of income of that person and prepare an assessment on that basis.
- In case a person has not submitted a self assessment return for any year and the commissioner considers that he has income chargeable to tax, he may determine the amount of income of that person to the best of his judgment and prepare an assessment on that basis.

The time limits for making assessments.
- An assessment may be made at any time by the commissioner for any year of income before the expiry of 7 years. However, in case fraud or willful negligence has been committed, an assessment may be made at any time.
- In case of an assessment upon the executors or administrators of the estate of a deceased person, an assessment must be made before the expiry of 3 years after the year in which the person died.

REMITTANCE OF TAX: INSTALLMENT TAX, FINAL TAX

- Payment of installment tax serves as an assessment to installment tax. The tax is payable not later than the 20\textsuperscript{th} day of the month of the current accounting year. The commissioner may issue an installment tax assessment in the event of failure to pay tax in time; tax assessed is payable within 30 days of service of the assessment.
- The amount of the installment tax payable is the lesser of:
  - The tax payable by the person on his total income for the year:
  - The tax assessed, or in the absence of an assessment, estimated as assessable for the proceeding year of income, multiplied by 110%.
- Installment tax is not payable in the case of an individual to the extent the total liability to tax for a year of income does not exceed Sh. 40,000.
- Installment tax is payable in four equal installments after the commencement of the accounting period on the 20\textsuperscript{th} day of the fourth, sixth, ninth and twelfth month.
• For agricultural enterprises installment tax is payable on the 20\textsuperscript{th} day of the nineth month while the second installment is due on the 20\textsuperscript{th} day of the twelfth month.

• Adjustment to installment tax payable is required where there are changes in the length of a company’s accounting period, where companies have merged or have been acquired or where substantial transfer of assets between companies have taken place.

**TURNOVER TAX**

Turnover tax with effect from 1 January 2007 for businesses with a turnover of less than Sh. 5 Million p.a. the applicable rate is 3\% of the gross receipt of the business.

Turnover shall apply to:

- Employment income.
- Exempt incomes.
- Incomes subject to final withholding tax.
- Business incomes below Sh.500,000.

Turnover tax is charged at the rate of 3\% on gross sales per annum. No expenditure or capital allowance shall be granted against turnover tax.

For income tax purpose, turnover tax is a final tax.

For turnover tax purposes, the tax period means every 3 calendar months commencing 1st of January of every year that is, turnover tax payers shall submit a quarterly return. Payment shall be made on or before the 20\textsuperscript{th} day of the month immediately following the end of the quarter.

For turnover tax purposes, registered tax payer shall maintain the following records:

- Cashbook
- Sales receipts and invoices (daily sales summary)
- Purchase invoices
- Bank statements

Benefits of Turnover tax

- It simplifies tax procedures.
- It simplifies tax computation.
- Makes filing of returns easier.
- Simplifies record keeping
- Reduces cost of compliance
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TOPIC 8

ADMINISTRATION OF VALUE ADDED TAX

INTRODUCTION AND DEVELOPMENT OF VAT

VAT is a tax on expenditure that is collected by suppliers of goods and services and passed on to the government.
VAT is charged on the supply of goods and services in Kenya by a taxable person in the cause of or in furtherance of any business carried on by that person and on the importation of goods and services into Kenya.
VAT was introduced in Kenya 1990 to replace sales tax. The decision to replace sales tax with VAT was as a result of the perceived deficiencies in the sales tax system which includes:

- The sales tax system was a single stage system - sales tax was levied only once at the manufacture level. However, in a country where tax evasion is widespread, a single stage tax system will result in a higher loss of revenue than would normally be the case if the system was multi stage.
- Where the inputs for manufacturing were subject to sales tax, the imposition of sales tax on the finished product will result in the imposition of tax on another tax i.e. cascading effect.
- The sales tax system had a limited scope - sales tax was levied only on certain specific manufactured Goods. Services were not within the scope of tax. Therefore sales tax had a narrow tax base as compared to VAT, with the result that the revenue yield was comparatively low.
- VAT is an indirect tax, It is essentially a tax on the domestic expenditure or consumption. Under VAT, it the end user or consumer that ultimately bears the tax burden.
- VAT is charged on each transaction in the production and distribution chain.

QUESTION:
A manufacturer purchased raw materials at sh. 1 m on which VAT was charged at 16%. At each stage of the production and distribution chain conversion cost of 25% was incurred and a markup of 30% included to determine the selling price. Calculate the total VAT collected for the government.
**ANSWER:**

<table>
<thead>
<tr>
<th></th>
<th>Value</th>
<th>VAT</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Sh.000</td>
<td>Sh.000</td>
</tr>
<tr>
<td><strong>Supplier</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of materials</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>VAT @ 16%</td>
<td>160</td>
<td>160</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,160</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Manufacturer</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Purchase of materials</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>Conversion cost @ 25%</td>
<td>250</td>
<td>250</td>
</tr>
<tr>
<td>Mark-up @ 30%</td>
<td>375</td>
<td></td>
</tr>
<tr>
<td>Selling price</td>
<td>1,625</td>
<td></td>
</tr>
<tr>
<td>VAT @ 16%</td>
<td>260</td>
<td>260</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,885</strong></td>
<td></td>
</tr>
<tr>
<td>Less input VAT</td>
<td>(160)</td>
<td>100</td>
</tr>
<tr>
<td><strong>Wholesaler</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Purchase of product</td>
<td>1,625</td>
<td></td>
</tr>
<tr>
<td>Additional cost @ 25%</td>
<td>406.25</td>
<td>2,031.25</td>
</tr>
<tr>
<td>Mark-up @ 30%</td>
<td>609.375</td>
<td></td>
</tr>
<tr>
<td>Wholesale price</td>
<td>2,640.625</td>
<td></td>
</tr>
<tr>
<td>VAT @ 16%</td>
<td>422.5</td>
<td>422.5</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>3,063.125</strong></td>
<td></td>
</tr>
<tr>
<td>Less input VAT</td>
<td>(260)</td>
<td>162.5</td>
</tr>
<tr>
<td><strong>Retailer</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Purchase of product</td>
<td>2,640.625</td>
<td></td>
</tr>
<tr>
<td>Additional cost @ 25%</td>
<td>660.156</td>
<td>3,300.181</td>
</tr>
<tr>
<td>Mark-up @ 30%</td>
<td>990.234</td>
<td></td>
</tr>
<tr>
<td>Retail price</td>
<td>4,291.015</td>
<td></td>
</tr>
<tr>
<td>VAT @ 16%</td>
<td>686.562</td>
<td>686.562</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>4,977.577</strong></td>
<td></td>
</tr>
<tr>
<td>Less input VAT</td>
<td>(422.5)</td>
<td>264.0</td>
</tr>
</tbody>
</table>
Total VAT collected for Cost

<table>
<thead>
<tr>
<th></th>
<th>Sh.000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Supplier</td>
<td>160</td>
</tr>
<tr>
<td>Manufacturer</td>
<td>100</td>
</tr>
<tr>
<td>Wholesaler</td>
<td>162.562</td>
</tr>
<tr>
<td>Retailer</td>
<td>264</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>686.562</strong></td>
</tr>
</tbody>
</table>

NB

- The illustration above demonstrates that it is the end user or consumer to bears the burden of tax. The participants in the production and distribution chain are simply the collection agents of the government.
- It also shows that incase there is tax evasion, the loss of revenue by the government is minimized.

REGISTRATION AND DE-REGISTRATION OF TAXABLE PERSONS

REGISTRATION FOR VAT

- Registration, de-registration and changes affecting registration are dealt with in the sixth schedule of the VAT Act.
- Compulsory registration applies to any person who in the course of his business has supplied taxable goods or taxable services or expects to supply taxable goods or taxable services, or both, the value of which is Sh. 5,000,000 or more in a period of twelve months.
- Any person who meets the above conditions is a taxable person and should, within thirty days of becoming a taxable person, apply for registration.
- Voluntary registration is permissible under the law, but is granted at the discretion of the commissioner.
- Where a person qualifies for registration, a registration certificate shall be issued within ten working days after receipt of the application by the commissioner.
- Where an application for registration is made within 30 days of becoming a taxable person, the effective date for registration is deemed to be the 30th day from the date the person became a taxable person. However, the commissioner has the discretion to vary the effective date, and in practice, the date of receipt of the certificate applies.
- Every registered person is required to display the registration certificate in a clearly visible place in his business premises. Where a person has more than one place of business, certified copies (by the commissioner) must be displayed in each of those places.
- A group of companies that is owned or substantially controlled by another person may apply to be registered and treated as one person, subject to the discretion of the commissioner.
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TOPIC 9

CUSTOMS TAXES AND EXCISE TAXES

CUSTOMS PROCEDURE

INTRODUCTION

Customs and Excise duties are charged under the custom and excise Act cap 472. The custom department is charged with the responsibility of controlling imports and exports, enforcing prohibitions and restrictions and collecting revenue on both imports and excisable goods.

- On arrival cargo from an aircraft, vehicle or vessel which unloaded must be declared to customs in a prescribed form within 21 days. The goods should be entered either for home consumption, transit, transshipment, warehousing or to an export processing zone.
- Where there is insufficient information, the declaration maybe made on provisional status subject to approval by the proper officer. Where provisional entry has been allowed, the proper officer will require the owner to deposit an amount estimated as the duty payable.
- Where goods have not been entered for clearance within 21 days, they will be deemed as deposited in a customs warehouse where rent will be charged at the prescribed rates. Where goods are not removed from the customs warehouse within the notice period granted by customs, they may be sold by public auction to recover customs duty and warehouse rent payable on them.

TAX POWERS AND RIGHT TO REVENUE

POWERS OF THE COMMISSIONER OF CUSTOMS AND EXCISE

1. S. 9 of customs and excise Act states that the commissioner can appoint and fix the limits in the Kenya gazette of:
   - Ports
   - Customs airport
   - Customs areas
   - Entrances and exits
   - Routes in Kenya over which goods in transit can be conveyed
   - Bonding stations i.e. area appointed by the commissioner for air crafts and vessels arriving or departing from a port may be kept.
   - Places of loading and unloading of goods within a port.
   - Places of examination of goods.
   - Places for landing and embarkation of persons.
2. Provision of suitable accommodation for offices
3. Power to permit roads, area, place, boarding station, route entrance and exit etc to be used on a temporary basis if so appointed
4. Power to disclose information to a person in the service of the government in the revenue department for official duties.
5. Power to compound an offence by agreement
6. Power to revoke a license issued to manufacture excisable goods
7. Power to furnish to a competent authority any information, certificate or official import document etc of goods in or from a foreign country
8. Power to require information from importers concerning dumping of goods

POWERS OF THE OFFICERS
To prevent smuggling and evasion of duty the Act gives the following powers to officers:
1. Power to require vessels to board failure to which the master of the ship or vessel is liable to a fine of sh. 100,000 and seizure of the vessel.
2. Power to require a vessel to depart from the Kenyan port within 12 hours, failure to which a maximum fine of Sh.100,000 is imposed and the vessel is liable to forfeiture.
3. Power to patrol freely and move the vessels i.e. He can take the aircraft of vessel to a place convenient for investigation of smuggling or evasion without any legal liability to the office.
4. Power to board a vessel and make a search. If the master of the ship refuses he is liable to;
   a) A fine not exceeding Sh. 500,000 or
   b) 3 years imprisonment
   c) Forfeiture of goods
5. Power to require persons entering or leaving Kenya to answer questions concerning their luggage.
6. Power to search persons where he has reasonable grounds to believe that the person has excisable goods or uncustomed goods. However, a female office can only search a female person
7. Power to seal and search premises. They can sea, lock or secure:
   a) Buildings, rooms or receptacle of a plant
   b) Excisable goods or material in a factory
   c) Aircraft, vessels, vehicles or container
8. Power to have a search warrant issued by the magistrates to enable the officer to enter day and night premises to seize and carry away uncustomed goods, plant or documents

IMPORTS AND EXPORT DUTIES

DUTY
- Duty is defined to include:-
  Customs duty, excise duty, levy, cess, imposition of tax, surtax
CUSTOMS DUTY

- This is the duty or tax paid on goods imported through any port of Kenya or goods imported and which are specified in the first schedule of the Customs and Excise Act
- Goods subject to customs duty include:
  - Machinery
  - Textiles
  - Electronics
  - Vehicles
  - Food commodities

- The purposes of customs duty are:
  - To raise revenue for the government.
  - To protect local industries e.g. impose high customs duty to discourage consumption of imports.
  - To prevent dumping of goods into the Kenyan Market e.g. impose high anti-dumping duty
  - To discourage production of harmful goods e.g. excise duty imposed on manufacture of beer and cigarettes.

EXPORT DUTY

- This is tax that is imposed on goods which are exported to foreign countries. The main purposes of excise duties are:
  - To raise revenue for the government.
  - To discourage the exportation of certain goods e.g. scrap metal, hides and skins.
  - To encourage the use of materials locally e.g. scrap metal.

GOODS SUBJECT TO CUSTOMS CONTROL

S.12 of the Custom and Excise act specifies goods which are subject to customs control:
1. Imported goods through the post office from the time of importation to delivery of goods for home or importation whichever happens first.
2. Dutiable goods and excisable goods on which duty has not been paid.
3. Goods which have been seized and all goods under notice of seizure.
4. Goods on board and aircraft or used within a port or place in Kenya
5. Goods under drawback from time of claim of drawback
6. Goods subject to export duty from the time of bringing to the port for export to the time of exportation.
7. Goods subject to restriction on exportation
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