

**THE TAXATION OF COMPANIES IN KENYA
WITH PARTICULAR REFERENCE
TO THE INCOME TAX ACT, CHAPTER 470
LAWS OF KENYA**

**BY
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ABBREVIATIONS

A.C.	Appeal Cases
All E.R.	All England Reports
All N.L.R.	All Nigeria Law Reports
B.T.R.	British Tax Review
C.A.	Court of Appeal
Ch.	Chancery
C.I.T.	Commissioner of Income Tax
E.A.L.R.	East Africa Law Reports
E.A.T.C.	East Africa Tax Cases
Ex.D.	Exchequer Division Reports
H.L.	House of Lords
K.B.	Kings Bench
L.R. Ind. App.	Law Reports Indian Appeals
S.C.	Session Cases
T.C.	Tax Cases
T.L.R.	Times Law Reports

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35. Todd V. Egyptian Delta Ltd and Investment Co. Ltd (1929) 14.T.C. 119.
36. Whitney V. I.R.C. 107 T.C. 88.

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1. The Bills of Exchange Act, Chapter 27, Laws of Kenya.
2. The Companies Act, Chapter 486, Laws of Kenya.
3. The East African Income Tax (Management) Act, Chapter 24 (1970 Rev. edn),
Laws of the Community.
4. The Exchange Control Act, Chapter 113, Laws of Kenya.
5. The Export Processing Zone Act, Chapter 517, Laws of Kenya.
6. The Finance Act, 1985.
7. The Finance Act, 1986.
8. The Finance Act, 1987.
9. The Finance Act, 1989.
10. The Finance Act, 1990.
11. The Finance Act, 1991.
12. The Finance Act, 1992
13. The Finance Act, 1993.
14. The Income Tax Act, Chapter 470, Laws of Kenya.
15. The Provisional Collection of Taxes and Duties Act. Chapter 415, Laws of
Kenya.
16. The Traffic Act, Chapter 403, Laws of Kenya.
17. The Unit Trusts Act, Chapter 521, Laws of Kenya.

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Source: The Income Tax Report for the period 1 July, 1975 to 30 June, 1976 (*Ministry of Finance and Planning, Nairobi*)

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Source: Deloitte and Touche, "Income Tax in Kenya" December, 1994.

INTRODUCTION

Tax law is the body of rules under which the public authority has a claim on tax payers requiring them to transfer to the public authority part of their income or property. Tax law is concerned only with the legal aspects of taxation, not with its financial, economic or other aspects.¹

Tax law falls within the domain of public law, that is, the rules that determine and limit the activities and reciprocal interests of the political community and the members comprising it. This is distinguished from the sphere of private law which deals with the relationships between individuals. The specific purpose of the relationship between the individuals and the community regulated by tax law is the imposition on individuals and corporations of a contribution to cover public expenditure.

The codification of tax law is a recent phenomenon. No general codified system of taxation existed in any country before the middle of the 19th Century. In traditional, essentially Agrarian societies, government revenue was drawn either from non-tax sources², or to a lesser extent, from taxes on various objects³. Levies on income or capital were not considered as an ordinary means for financing a government. These first appeared as emergency measures. Indeed, the British system of tax was first codified in the 1744 *Act*⁴ as a temporary means for meeting the increasing financial burden of the Napoleonic wars.

As the years passed by, taxation became one of the means of raising sufficient revenue to finance all of a country's activities. The progress of the twentieth century indicated that tax can be used as an instrument for the redistribution of wealth.⁵ The burdens of taxation and the problem of defining limits to the taxing power of the public authority led to an elaborate tax law. This became substantial with the broadening of the concept of the proper sphere of government which has accompanied the growing intervention of modern states in economic, social, cultural and other matters.

The introduction of a tax on income was not accompanied by a definition of "income".⁶ The problem therefore fell to the judges to decide this as and when required. In *London County Council V.A.G.*⁷, Lord Macnaghten, with his native wit begged to remind the Lords that income tax is a tax on income and not on anything else. It is important to distinguish between income and capital mainly because in Kenya a capital receipt cannot be taxed as income and is tax free. Sankey J's judgement in *Pool V. Guardian Investment Trust Company Ltd*⁸ graphically illustrated this distinction where he used the analogy of the tree and the fruit. He said that in the case of a company, if a person receives dividends from his shares in a company, his shares are the tree which produces the fruit of dividends. The shares are his capital and his dividends are his income, liable to income tax.⁹

In Kenya, taxation on income firmly began in 1937. However, both before and even after then, a "crude" direct taxation was put in force. In 1900, the African had been subjected to the Hut Tax whose base was the hut. In the African context, the hut was the most permanent structure by which the African could be identified. It assisted the tax authority in locating the tax payer. The hut was also a symbol of wealth because the number of huts denoted the number of wives a man had. This meant that he had capacity to pay dowry, and therefore, tax. Later a twin tax was introduced. The poll tax of 1910 was based on the identification system. The base was the poll or the human being. Finally, after various unsuccessful attempts in 1921 and 1932¹⁰, the income tax was introduced in Kenya in 1937.

At present, the law providing for the taxation of incomes in Kenya is *The Income Tax Act*¹¹. This *Act* was enacted in 1973 as Act No. 16 of that year. However, it never came into effect until 1st January, 1979. Prior thereto, the applicable law was *The East African Income Tax (Management) Act of 1958*¹². This *Act* provided the basic principles of income taxation in the East African states and left such matters as tax rates, allowances, deductions and exemptions to territorial legislations.¹³ From 1st January, 1974, each of the partner states enacted its own income tax legislations.¹⁴ Nevertheless, the basic principles of the income tax law remained the same. In general, the tax system is focused on the taxation of the income of both individuals and corporations.

The concepts of income and of tax under Kenyan law is a wholly foreign concept. It has not to date been based on a conscious effort depicting the social, and perhaps the political engineering of this country. Indeed, the Coates Report¹⁵ says that:

"The East African (now Kenyan) Income Tax Code....has its roots in the income tax system of the United Kingdom".

It can therefore safely be said that the Kenya taxation system is in many respects based upon the British system of taxation as it existed at the time of Kenyan independence. However, over the past three decades, and in particular during the last few years, a number of major changes have occurred to the Kenyan tax system.

The important thing to note is that throughout this rather tangled development of income tax legislation, it is not far to see that effort was always made to bring the East African law as close as possible to the English position. Most of the preparatory Reports in East Africa, drew heavily from similar previous inquiries of the United Kingdom.¹⁶ A perusal of all these reports¹⁷ shows no attempt on their part to inquire into and make local circumstances the basis for income taxation. No attempt was made to tax dowry although this was a guaranteed source of wealth. Resultantly, the concept being foreign, it introduced in Kenya the taxation of incomes quite appreciable in England but not so much obtaining here.¹⁸

In this system, incomes subject to taxation were largely in the domain of the English community in Kenya and to a lesser extent, the Asians. Africans were incapable of

producing the scientific form of income that was taxed. They were therefore subjected to a different system. Taken haphazardly and without detail, income continued throughout to be regarded to be salaries (and receipts incidental thereto), alimony, pensions, dividends and interest, income from sources such as business, employment and property. In terms of tax payers, a conversion of the above receipts or sources amounts to a position where income taxes are broadly paid and collected from companies and individuals.

Company tax is a tax imposed on the profits and gains of companies. A company is a distinct legal person, but yet it is an artificial person and can act only through the agency of natural persons-its owners (the shareholders), or its managers (the directors). By its very nature, the company poses taxation problems.¹⁹

Like income tax, companies are a foreign concept in Kenya. Company law was not codified either in England or in Kenya. Instead, a body of case-law which was more or less common to all the countries involved, was accompanied by the local Companies Acts. This in some fields made detailed regulations independently of the case-law, and in others, provided a basis for or a supplement to the rules developed in the case-law. The result was a complex amalgam of statute and case-law.²⁰

The Companies Act 1948 was reenacted by the *Kenyan Companies Act 1961*²¹ which came into force on 1st January, 1962. In Kenya, previous company law had been derived first from the *Indian Companies Act, 1882* (through the process of application) and then from earlier United Kingdom Acts. The United Kingdom 1948 *Act* had been significantly modified in Kenya²². Thus, Kenyan company law, just like tax law, is a colonial concept brought in by the colonialists.

Ever since Kenya became responsible for administering her own taxes, companies have continued to raise more taxes than individuals. During the 1973/74 fiscal year, immediately after the *Income Tax Act* came into force, companies raised about 46% of the gross total. In 1974/75, this figure rose to 56%, but in 1975/76, it dropped to 50%. On average, this indicates a very substantial contribution of about 51%.²³

The following tables graphically illustrate the importance of company taxation to the revenue of Kenya. Table one shows company taxes collected in 1961, just before independence. Table Two relates to the years 1973-76, the period immediately after The Income Tax Act was introduced.

Table One²⁴
Company Tax Payable as a Percentage of Total Income Tax Payable and G.D.P. 1961 - Kenya

Company Tax Payable (£ '000s)	Total Income Tax (Personal and Company Payable (£ '000s))	Company Tax Payable as % of Total Tax Payable	G.D.P. (1961) (£ '000S)	Company Tax Payable as % of G.D.P.
5,932	12,169	49	224,700	2.64

Source: 1962-63 Report of the East African Income Tax Dept. (Nairobi, 1963)

Table Two²⁵
Tax Collected

Year	Companies	Individuals (including PAYE)	Others (shipping & withholding tax)	Gross Total
1973/74	26,335,649	26,636,832	4,409,508	56,838,774
1974/75	42,956,301	29,336,535	4,409,508	76,702,344
1975/76	44,402,484	36,867,797	6,806,091	88,075,112

Source: The Income Tax Report for the Period 1st July, 1975 to 30th June, 1976 (Ministry of Finance and Planning) Nairobi

SOURCES OF TAX LAW

There are various sources of tax law, the most important of which is statutes. The law relating to taxation is based on Acts of Parliament. In Kenya, the statutory authority for company taxation is found in *The Income Tax Act* (hereinafter referred

to as *the Act*) which was enacted in 1973, and its date of commencement was 1 January 1974. It replaced the *East African Income Tax Management Act*, which had served the countries of the East African Community, and which became outdated following the breakup of the community.

The most up to date printed edition of the Kenya *Income Tax Act* is the Revised Edition 1989, which contains amendments to the *Act* upto 31 December 1989. This *Act* is a comprehensive statute with self-contained provisions on income tax law. No other statutes deal with company tax law. This raises problems because the *Act* deals jointly with individual and company tax law. This dissertation incorporates the amendments to the *Act* enacted upto and including the provisions of *The Finance Act, 1994*.

Income tax is an annual tax and must be re-imposed by Parliament every year. Each July, the Minister of Finance makes his Budget Speech to Parliament. *The Finance Bill* is later introduced to provide the statutory authority to continue income tax and to give effect to changes in taxation proposed by the Minister. The Budget Speech is always followed immediately by Parliament's resolutions to give temporary continuance to taxation pending the enactment of the Finance Act. During this period, they are invested with statutory authority "as if contained in an Act of Parliament" by *The Provisional Collection of Taxes and Duties Act*.²⁶ The annual

Finance Acts therefore incorporate provisions and measures made by the Minister of Finance in his Budget Speech.

Caselaw has an immense bearing on company tax law. This source of tax law is gradually building up in Kenya. The courts enrich the sources of law by their decisions. The construction of the tax statutes by the courts help throw light on statute law. Caselaw, therefore, enables the discovery of certain principles of company taxation. The most distinctive feature about caselaw in East Africa is the East African Tax Cases Law Reports. These are a tribute to B.C.W. Lutta who was an expert judge on taxation. The reporting ended in 1973.

The general principle of the construction of tax statutes is that they must be strictly construed.²⁷ However, the special position of fiscal legislation has led to the development of some special rules.²⁸ This is mainly because at the time of introduction of income tax, some of the key concepts used by Parliament (such as income, residence, trade) were left undefined and have had to be interpreted by judges. As the rates of income tax became higher and progressive, and as the ingenuity of taxpayers and their professional advisers achieved heights of sophistication undreamt of, Parliament responded with language and provisions of increasing complexity. Thus, there are the older and more general provisions, the

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extent of which have to be determined, and the modern complex provisions with complicated definitions. All these required to be interpreted.

Lord Donovan in *Mangin V. IRC*²⁹ outlined the rules of statutory interpretation as applied to tax legislations as follows:

"First, the words are to be given their ordinary meaning. They are not to be given some other meaning, simply because their object is to frustrate legitimate tax avoidance devices.... Secondly, one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used (per Rowlatt J. in *Cape Brandy Syndicate v. IRC*³⁰). Thirdly, the object of construction of a statute being to ascertain the will of the legislature, it may be presumed that neither injustice, nor absurdity was intended. If therefore, a literal interpretation would produce such a result, and the language admits of an interpretation which would avoid it, then such an interpretation may be adopted. Fourthly, the history of an enactment and the reasons which led to its being passed may be used as an aid to construction".

In construing the provisions of our tax statutes, there is often a temptation to rely on English decisions, or even sometimes on the decision of some other common law

countries. However, in the Kenyan case, the local statute is not in *pari materia* with the present English Act, therefore, "little can be gained by attempting to reason from one to the other".³¹ Thus, when a statute or law in Kenya has to be interpreted, little purpose is served by making references to English decisions, unless the English counterpart which is being interpreted or certain vital word(s) is or are more or less identical with our own statute or law.³²

An important issue which cannot be overlooked in company tax law is tax planning or tax avoidance. A taxpayer is "entitled to be astute to prevent so far as he honestly can the depletion of his means by the Revenue."³³ A distinction is drawn between tax avoidance and tax evasion. The former refers to the legitimate exploitation of the tax legislation, whereas the latter refers to the deliberate dishonesty on the part of a taxpayer. Tax avoidance will probably always exist in one form or another. Indeed, some countries have a substantial tax planning industry. In *IRC V. Duke of Westminster*³⁴ it was said that every man is entitled, if he can, to order his affairs so that the tax attaching under the appropriate Acts is less than that it otherwise would be.

GENERAL OUTLINE OF THE STUDY

We shall firstly deal with the basic mechanics of company taxation with reference to the Kenyan law and practice. The manner in which the tax is imposed, the charge,

the computation of assessable profits, items included in income, ascertainment of total income and the rates of tax will be carefully studied. The aim here will be to illustrate that any item of income is either taxable as defined in the Act, or not taxable if left out of the list of taxable incomes.

In dealing with company tax, the international aspect is very important. These are special considerations that are made. The residence and non-residence of a company is extremely important in taxation. The foreign companies in Kenya and foreign operations of resident Kenyan corporations will be looked into. Certain companies and industries are taxed differently which will also be studied.

Any discussion on tax law is incomplete without looking at the administrative and procedural aspects of that tax system. Thus, it is necessary to study the manner in which a taxpayer informs the Income Tax Department about the details of his tax position on matters such as taxable income, loss or sources of income. The returns made by companies will therefore be discussed.

Assessments, objections and dispute settlement will be laid out mainly because it is very important in taxation for the law to lay down clear machinery for dispute resolution. As justice to the taxpayers, institutions for dispute resolution must be

provided for. This aspect of company tax law will be examined closely before concluding our study.

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INTRODUCTION

ENDNOTES

1. The New Encyclopaedia Britannica, Macropaedia, Vol. 16, 15th edn.
2. Such as tribute, income from royal domains and land rent.
3. Such as land taxes, tolls, customs and exercises.
4. It was introduced by the younger Pitt.
5. For a review of the history of taxation before the "modern" system emerged, see Carson. *"The Development of Taxation Upto the 18th Century"* (1984) B.T.R. 237.
6. Eshiwani A.A., *"What is income? A definitive Study into the Income Tax Law in Kenya"*, LL.M. Thesis, University of Nairobi, 1978.
7. (1901) A.C. 26, 35/36 (H.L.); 4 T.C. 265, 293.
8. (1921)8 T.C. 167.
9. As Mr. Justice Pitney pointed out in giving the judgement of the Supreme Court of the United States [in *Eiswer V. Macomber* (1919) 252, U.S. 189...] the fundamental relation of capital to income has been much discussed by economists, the former being likened to the tree or the land, the latter being likened the fruit or the crop, the former depicted as a reservoir supplied from springs, the latter as the outlet stream to be measured by its flow during a period of time. He cites various definitions, one of which was that income may be defined as the gain derived from capital from labour, or from both

- combined, and points out that the essential matter is that income is not a gain accruing to capital but a gain derived from capital.
10. For a full history of income tax in East Africa see *The Coates Report*. Report of the East African Commission of Inquiry on Income Tax (High Commission Printer, Nairobi, as it then was in 1956-57) pg. 3 para 13-31. The reasons for earlier failure are not clearly documented. There however appears to be a suggestion that the white farmers and the white community in general, objected to an imposition upon them of a tax whose benefits, enjoyed by their United Kingdom counterparts, were not going to be conferred upon them (*The Pim's Report*). A resistance, which if true, appears to be a specie of "no taxation without representation".
 11. Chapter 470, Laws of Kenya.
 12. Chapter 24 (1970 Revised Edition), Laws of the Community, as it then was.
 13. The 1958 Act succeeded *The East African Income Tax (Management) Act* of 1952.
 14. For Kenya Chapter 470, Laws of Kenya; for Uganda *The Income Tax Decree* No. 10/1974; for Tanzania *The Income Tax Act* No. 33/1973.
 15. Supra note 10, pg. 3, para 11.
 16. *The Coates Report*, for example, makes copious reference to the First Tucker Committee Report, U.K. 1951, Comd. 8189, and the Second Tucker Committee Report, U.K. 1952, Comd. 9063.

17. *The Pim's Report*: Report on the Commission Appointed to Inquire into and Report on the Financial Position and System of Taxation in Kenya - 1936 (His Majesty's Stationery Office - Colonial No. 116) pg. 35, para. 69 *The Gill Report*: The report of the Income Tax Committee; Kenya (Govt. Printer, Nairobi, 1954) para. 41. *The Coates Report*, see Supra note 10.
18. Supra, note 6.
19. Mayson, S.W. and Blake S., "*Mayson on Revenue Law*", 11th edn, London Blackstone Press Limited (1990-91).
20. Katende et. al., "*The Law of Business Organisations in East and Central Africa*," East African Literature Bureau (1976).
21. Chapter 486, Laws of Kenya.
22. In the Kenya Legislative Council Debates in 1959 (Vol. 81, pg. 20), the Acting Solicitor - General, Mr. A.M.F. Webb, is reported as saying, "Company Law in Kenya has for obvious and cogent reasons followed English Law".
23. Supra, note 6.
24. Jetha N., "*Company Taxation in East Africa*", B.T.R. (1965) 42.
25. Supra, note 6.
26. Chapter 415, Laws of Kenya at section 2.
27. This principle was stated by Rowlatt J. in *Cape Brandy Syndicate v. IRC* (1921) 1KB at pg. 71 as follows.

"it is urged... that in a taxing Act, clear words are necessary in order to tax the subject. Too wide and fanciful a construction is often sought to be given to that maxim, which does not mean that words are to be unduly restricted against the Crown, or that there is to be any discrimination against the Crown in those Acts. It simply means that in a taxing Act one has to look merely at what is clearly said. There is no reason for any intendment. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used".

Also in *Ormond Investment Co. Ltd. V. Betts* (1928) A.C. 143, Lord Atkinson at pg. 162 and *Canadian Eagle Oil Co. Ltd V.R.* (1946) A.C. 119 per Viscount Simon L.C. at pp. 134, 135.

28. Rawlinson, "Tax Legislation and the Hansard Rule" (1983) B.T.R. 294.
29. (1971) A.C. 739.
30. (1921) 1 KB. 64.
31. *C.I.T. V. Shaw Wallace & Co.* (1931) L.R. Ind. App. 206, a Privy Council decision on the interpretation of a section of the Indian Income Tax Law.
32. Orojo. J. Ola., "*Company Tax Law in Nigeria*", London, Sweet and Maxwell (1979).
33. As per Lord Clyde in *Ayshire Pullman Motor Service V. IRC* (1929) 14 T.C. 745.
34. (1936) AC. 1.

CHAPTER ONE

1.0.0 THE NATURE OF CORPORATION TAX

A company is an association of persons formed for the purpose of some business or undertaking carried on in the name of the association, each member having the right of assigning his shares to any other person, subject to the regulations of the company.

Companies are either incorporated or unincorporated. An unincorporated company is an entity distinct from its members. Companies are incorporated either by charter, by special Act of Parliament, or by registration under one of the public general Acts relating to companies.¹ By its very nature of being a distinct legal person, the company poses taxation problems.²

Corporation tax is the special separate income tax of companies and other legal entities in commercial and industrial life. The tax in its classical and other forms has the effect that the distributed profit of a company - the dividend, is taxed twice. It is firstly taxed in the hands of the company, and secondly, in the hands of the shareholders. Reform must relate chiefly to this so called double taxation. The problem is to find a reasonable interrelationship between corporation tax and personal income tax.

Corporation tax concerns the interests of the company itself, its management, employees, shareholders and creditors on the one side, and the government and the general public on the other side. Members of the first group plead for low taxation though their views may diverge as to which part of the company's profit should be most favoured - the distributed or the undistributed. However, the government may use taxes to influence the economy in boom and slump periods.³

1.1.0 THE CHARGE OF INCOME TAX

In *London Country Council V.A.G.*⁴, Lord Macnaghten said that income tax is the tax on income. He said:

"Income tax, if I may be pardoned for saying so is a tax on income. It is not meant to be a tax on anything else. It is one tax, not a collection of taxes essentially distinct".

Income tax is charged on the income of a person for each year in accordance with section 3(1) of *The Income Tax Act*¹⁵ (hereinafter referred to as the Act). This section, known as the "charging section" provides that:

"s.3(1)...[A] tax to be known as income tax shall be charged for each *year of income* upon all the income of a person, whether resident or non-resident: which *accrued in* or was *derived from Kenya*" (emphasis mine).

It is important to understand certain words and phrases as emphasised above. Section 2 of the Act defines these as follows:

"Taxable person" is a person whose income is taxed. This includes:

- (a) an individual i.e. a natural person; or,
- (b) a legal person e.g. a company.

The act specifically subjects corporations to a special rate of tax. Individuals are to be taxed at progressive individual rates while all other "persons" are to be taxed at corporate rates. Section 34(1)(d) provides that:

"[T]ax upon the total income of a person other than an individual shall be charged at the corporation rate for that year of income".

Section 34(4) provides that for the purposes of that section, the term "person" will not include a partnership. Hence, the income of a partner will not be subject to tax at the partnership level. Instead, the partners are taxed on their share of profit or loss from the partnership. The term, however, does include unincorporated associations, joint ventures and other business entities, including unit trusts or mutual funds, co-operative societies, estates, clubs, trade associations, etc.

A "Company" means a company incorporated or registered under any law in force in Kenya or elsewhere. Judicial opinion reiterated this definition in *Conservative and Unionist Central Office V. Burrell*⁶ where it was said that a company means any body, corporate or unincorporated association but does not include a partnership, a local authority or a local authority association.

"Year of income" is the period of twelve months commencing on 1 January and ending on 31 December in each year. It is the same as the calendar year. Income tax is charged for each year of income. The year of income must be distinguished from the accounting year. This is a date to which accounts of a business are prepared each year and it indicates the accounting year end. Normally, the accounting year ending on 31 December would coincide with the year of income.

"Taxable income" includes gains or profits from various sources. The *Act* has specifically listed the incomes upon which tax is charged. This includes income in respect of business profits⁷; employment salary, wages, bonus, commission, etc⁸; rent⁹; investment interest and dividends¹⁰; pensions and annuities¹¹; deemed income¹² and presumptive income.¹³ Presumptive income is gross sale proceeds of some agricultural produce which are presumed to be income and taxed accordingly. A company receiving all or some of the above income in a given year of income is taxed on the income.

A number of incomes are untaxable. These include dowry, income from gambling, harambee collections, donations received, profit on sale of isolated assets unless dealing in them as a business, betting winnings, foreign income and inheritance. This is not an exhaustive list. A company receiving any of the above incomes will not be taxed on them.¹⁴

The income which is taxable is income arising from or earned in Kenya. Under certain conditions, some business and employment income derived outside Kenya are taxable in Kenya. These will be discussed in Chapter Two.

1.2.0 COMPUTATION OF ASSESSABLE PROFITS

The income tax computation is a process in which an effort is made to reconcile the financial statements or accounts with the requirements of the *Income Tax Act* as regards taxable or non-taxable income and expenses that are allowable or not allowable against income. Simply, it is the process of arriving at the taxable income or loss of a company for any year of income.

The *Act* does not specify in great detail how "taxable income" is to be calculated. Generally, a corporation's taxable income will be its net profits for a taxable year.¹⁵ "Profits" comprise of income and chargeable gains. Net profit is an entity's gross income from the carrying on of a business.

The profits of a company are computed broadly by applying Generally Accepted Accounting Principles. This means that normal commercial and accountancy principles and practice are adopted subject to the provisions of the *Act*¹⁶ unless there is good reason to depart from such practice. An example would be where a particular accountancy principle disregards factors which should be considered relevant.¹⁷

In *Morgan V. Tate & Lyle Ltd*,¹⁸ Jenkins L.J, in dealing with the relevant provisions of the English Tax *Acts*, observed on this point that the balance of profits and gains of a trade must be ascertained in accordance with the ordinary principles of commercial trading by deducting from the gross profits all expenditure properly deductible from them on those principles, save in so far as any amount deducted falls within any of the statutory prohibitions contained in the relevant rules. In this case, it must be added back for the purpose of arriving at the balance of profits and gains assessable to tax. In case of a conflict between accountancy principles and tax law, the latter will prevail.¹⁹

The amount of any income for the purposes of corporation tax is computed in accordance with income tax principles. All questions as to the amounts which are or are not to be taken into account as income, or in computing income, or as to the time when any such amount is to be treated as arising, are determined in accordance with income tax law and practice as if accounting periods were years of assessment. For

this purpose, "income tax law" means the law applying for the year of assessment in which the accounting period ends, to the charge on individuals of income tax other than rules which make special provisions for individuals.²⁰

A company is not entitled to any personal reliefs since, it is not an individual. Reliefs only apply to individuals and not to companies.

As a preliminary matter, income is deemed to have a number of separate specified sources.²¹ These are determined by the sourcing rules which have been outlined under section 15(7)(e). These "sources" include:

- (i) rental income from immovable property
- (ii) employment or professional income
- (iii) wife's employment and professional income
- (iv) agricultural income not included in (i) and (ii) above
- (v) all other unspecified income²²

Losses arising in one source category cannot be offset against profits arising in another category. Furthermore, they cannot be carried back and may only be carried forward against profits from the same source.²³ However, they can be carried back if the business is ceasing operations.

Accounts of companies will need to be adjusted in order to arrive at the taxable profit. Certain income is not assessable to income tax and certain expenses are not allowable. Computation of profits, therefore, includes analysing terms included in income, description allowed against income and deductions not allowed against income. Following is a deduction of how to compute such taxable income.

1.3.0 ITEMS INCLUDED IN INCOME

The Act sets out the types of income considered to be gains or profits to be included in taxable income. However, not all items set out in the Act are related to the company tax law. The following items are included in the taxable income of companies.

1.3.1 DIVIDENDS

A dividend is "a share of profits, whether at a fixed rate or otherwise, allocated to the holders of shares in a company".²⁴ It is the amount of profit of a company which it pays to its shareholders in proportion to their shareholding in any particular year.

A person receiving any one of the following is deemed to receive a payment of dividend.²⁵

- (i) In a voluntary winding up of a company, amounts distributed as profits whether earned before or during winding up, whether paid in cash or otherwise.
- (ii) Issue of debentures or redeemable preference shares for no payment. The dividend is taken to be the greater of nominal or redeemable value.
- (iii) Payment for debentures or redeemable preference shares for less than 95% of the nominal value and redeemable value, whichever is greater.

Sums deemed dividends under the second and third heads above will be taxable in the hands of the recipient, regardless of whether the recipient is an owner of 12½% or more of the company making the dividend. If dividends form part of the investment income of a resident life insurance company, they will be taxable.

Dividends received by one resident corporation from another resident corporation will be taxable unless the recipient resident corporation holds a 12½% or greater voting interest (directly or indirectly) in the subsidiary declaring the dividend.²⁶ Any such taxable dividends will be subject to a withholding at the rate of 15%. This will be allowed as credit against tax subsequently owing.²⁷ Dividend distributions to non-resident shareholders are also subject to a 15% withholding.

Withholding tax is simply a tax at source.²⁸ It is deducted at the point when payment is made in respect of interest, dividend, etc. It makes tax collection easy and ensures that some incomes do not escape taxation. A person making payment of incomes subject to withholding tax is legally required to deduct the withholding tax, or tax at source, at appropriate rates before effecting payment. The tax so deducted is remitted to the Income Tax Department. The payee is paid the net amount of tax. He is issued with a certificate of withholding tax. In the present case, a dividend voucher will be issued.²⁹

With effect from 1 January 1993,³⁰ the withholding tax on dividends is 10%. With effect from 1 January 1991,³¹ dividends referred to as qualifying dividends are taxed at 15% paid at source. This was intended to boost the capital market, that is, the buying and selling of shares in the stock exchange. For this reason, dividends, being the return on shares held, are favourably taxed as compared with other income which is taxed at a higher rate than 15%.

If a company fails to distribute "that part of its income.....which could be so distributed without prejudice to the requirements of the company's business.....", then the Commissioner may deem the corporation nevertheless to have distributed a dividend to the shareholders in proportion to their interest in the corporation.³²

The Commissioner may collect the tax owing by the shareholder from the corporation. But the corporation has the right to recoup such sums from the shareholders. Any subsequent actual distribution of such (taxed) sums to the shareholders will not be included in their income. There is a hardship exception to this rule. More importantly, these provisions do not generally apply if more than 50% of the shares of the corporation are held by non-residents.

1.3.2 INTEREST

An interest is a reward or consideration or recompense for the actual or notional use of one person's money by another person.³³ It also means interest payable in any manner in respect of any loan, deposit, debt, claim or other rights or obligations e.g. loans by banks and financial institutions, deposits to banks and financial institutions, etc. Interest is income on accrual basis, which means that it is taxed when earned even if not paid.

Interest earned by a corporation, whether resident or non-resident, from sources within Kenya is subject to tax.³⁴ For the purposes of the sourcing rule, the income is deemed to have an "unspecified source".³⁵

Any interest payment, whether to a resident or to the permanent establishment of a non-resident, is subject to a withholding of 10%. Payment to non-residents not

having a permanent establishment in Kenya (including payments by a Kenyan subsidiary to its overseas parents) is subject to withholding at 12½%, unless payment is made to a financial institution registered under *The Bills of Exchange Act*³⁶, which is resident or has a permanent establishment in Kenya.³⁷

Those paying interest, except where interest is exempted from deduction of withholding tax, must deduct the withholding tax. If they fail to do so, the Income Tax Department has power to collect such tax from the person making the payment.³⁸

The interest paid to a unit holder from a Unit Trust is exempted from withholding tax. A unit trust or a mutual fund organisation is one registered under *The Unit Trust Act*.³⁹ It sells units (equivalent to shares) to the public and invests the funds for a return. The unit holder gets a return (interest) from the unit trust tax free. The unit trusts are supposed to invest in shares and the government hopes this will help develop the capital market. The withholding tax paid by a unit trust on interest and dividend is a final tax. This means that the unit trust is not taxed further on the income.

1.3.3 ROYALTIES

This refers to income from a right granted to another to use industrial property such as patents, trademarks, copyright and goodwill. Royalties received from sources

within Kenya are taxable both to resident and non-resident corporations.⁴⁰ However, there is a withholding tax of 20% paid by a non-resident individual on royalty received.

In *Jones V. I.R.C.*⁴¹, the inventions, letters patent and other rights and goodwill of a company were sold to another company in consideration of a certain sum together with a "further royalty" of 10% on the invoice price of machines made under the invention during a period of 10 years. It was held that the lumpsum paid was capital receipt, but the "further royalty" was a trading receipt and therefore taxable.

1.3.4 MANAGEMENT FEES ~~XXXXXXXXXXXXXXXXXXXX~~

There is no definition of "Management Fees".⁴² However, in *Capital and National Trust Ltd V. Golder*⁴³ it was said that the term will include administrative expenses, including salaries and wages. Such fees will normally be included in taxable income of the recipient corporation.⁴⁴ There is a withholding of 20% of the gross amount of payments on non-residents.

1.3.5 INCREASE OR DECREASE IN VALUE OF INVENTORY

The Income Tax Act does not contain any specific requirements on stock (inventory) valuation.⁴⁵ Stock is generally valued at the lower cost or net realizable value. A corporation may change its method of inventory valuation. But if it does so, then the

Government may require that the closing inventory be valued using the same methods as the opening inventory and that the change is deemed to take place at the beginning of the next taxable year.

The above illustrate the items included in evaluating a company's taxable income. A conclusion is drawn that any item of income is taxable if defined in the *Act*, or not taxable if it is left out from the list of taxable incomes.

1.4.0 ASCERTAINMENT OF TOTAL INCOME

In ascertaining the total income, an item of expenditure is either allowable or not allowable against taxable income as provided in the *Act*. In order to earn income, expenses must be incurred. The *Act*, under section 15, the Second Schedule and the Ninth Schedule has listed the expenses which can be deducted against taxable income. Under section 16, it provides the expenses which are not allowed against taxable income.

Under section 15, expenses are either generally or specifically allowed against taxable income.

1.4.1 EXPENSES GENERALLY ALLOWED AGAINST INCOME

The *Act* under section 15(1) generally allows expenditure which is "wholly and exclusively" incurred in the production of taxable income. This section provides that:

"For the purpose of ascertaining the total income of a person there shall be deducted all expenditure which is expenditure wholly and exclusively incurred in the production of that income".

This general provision allows deductions of such expenses of a business from gross income unless expressly restricted by the *Act*. However, capital expenses may not be deducted from gross income, but must be amortized according to the relevant depreciation allowance, if any.⁴⁶

Generally,⁴⁷ all monies paid to employees for services performed by them, whether the employees are resident or non-resident, will be deductible as business expenses. However, "management fees" paid by a branch to its head office will not be deductible.

1.4.2 EXPENSES SPECIFICALLY ALLOWED AGAINST TAXABLE INCOME

Section 15(2) allows certain specific amounts to be deducted in computing for a year of income the gains or profits chargeable to tax under section 3(2)(a). These include the following:

- (a) The amount of trade bad debts written off and the amount of provision for specific doubtful trade debts are allowable against taxable income.

In the normal course of a trade or business, debts are owed to the company. While some of these debts are paid, in others, there is a good chance of recovery. The latter are good debts. While yet in others, the chances are doubtful or so poor that in the opinion of the company there is little or no chance of recovering them. These are bad debts.⁴⁸

In *Anderton & Halstead Ltd V. Birrell*⁴⁹, Rowlatt J. said that what is required is:

"[A]n estimate to what extent the debt is bad, and this is for the purpose of a profit and loss account. Such an estimate is not a prophecy to be judged as to its truth by events; but a valuation of an asset de present; upon an uncertain future to be judged as to its soundness as an estimate upon the facts and probabilities".

When a debt is bad, it is written off. It is credited in the account of the debtor and debited in the bad debts account. These are normally deductible so long as the taxpayer can prove that either debtor is incapable of making payment (generally through bankruptcy), or that the taxpayer has made a genuine effort to recover the debt (generally by action in the courts)⁵⁰. In the case of *Dinshaw V. Bombay*

*Commissioner*⁵¹ it was said that specific debts are allowable provided that the taxpayer discharges the onus of proving that the debts are bad.

If a trade debt was previously written off and is recovered, it is taxable income for the year in which it is recovered. However, a debt previously not allowed as a write off is not taxed when recovered. The amount of general provision for bad debts e.g. a provision of 5% on all debts, and the amount of any bad debts on sale of capital item and on other non-trade activities like friendly loans are not allowable against taxable income.⁵²

In *Robson and another V. Commissioner of Income Tax*⁵³, it was held that certain sum of money paid by and representing losses borne by the appellants, and which were written off by them in their partnership accounts as bad debts were properly deductible in arriving at their total income and were not precluded from being deductible.

In *B.O. Ltd V. The Commissioner of Income Tax*⁵⁴ the appellant company was incorporated in Kenya in December 1953, taking over the business of an individual who was a moneylender and an insurance agent. The Memorandum of Association contained powers both to lend money and to acquire and hold investments of all descriptions. In 1956, the appellant lent Shs 600,000/= on the security of a second

mortgage on land at Mombasa. The mortgagor died insolvent and the appellant incurred a loss of Shs 539,272/= on the loan. The appellant claimed a deduction of the amount lost as a bad debt incurred in the production of income but the Commissioner disallowed the deduction upon the grounds that the loss was a loss of capital. The appellant appealed to the Supreme Court of Kenya and it was held that it was an essential part of the appellant's business to make loans and that the loss was a loss of circulating capital.

(b) Capital expenditure incurred for the prevention of soil erosion incurred by the owner or occupier of farmland will be deducted.⁵⁶ This includes expenditure for the construction of dams, terraces, wind breaks, etc. A company owning such farmland is entitled to this deduction.

Capital expenditure by a company on cleaning agricultural land or on cleaning and planting permanent or semi-permanent crops by a company will be allowed.

(c) Expenditure incurred before the commencement of business which would be allowable if the business was operating.⁵⁶ Such pre-trading expenses are allowable when business commences.

(d) The legal costs and stamp duty for registration of a lease of business premises.⁵⁷ The lease period must not be in excess of or capable of extension beyond 99 years.

With effect from 7 June 1990,⁵⁸ the legal costs and other expenditures including capital expenses related to the issue of shares, debentures or similar securities offered for purchase to the general public. This is expenditure for turning a company public (and thus enabling it to be quoted on the Nairobi Stock Exchange). The allowing of these expenses is intended to boost the capital market.

From 1 January 1994,⁵⁹ legal expenses and stamp duty incurred in increasing the authorised share capital of a company prior to a public issue are deductible.

(e) The expenditure on structural alterations to enable premises to be let.⁶⁰ This is deducted only if the expenditure is necessary to maintain the existing rent. However, no deduction is made for the cost of an extension to, or replacement of those premises.

(f) The diminution or decrease in value of implements, utensils or similar articles e.g. loose tools in workshop or factory; crockery, cutlery, kitchen utensils in hotels or restaurants, etc. Such amount must be considered just and reasonable by the

Commissioner.⁶¹ These are not machinery or plants for which wear and tear deductions are given. In practice, the Income Tax Department accepts the taxpayer's valuation of tools and implements and generally most taxpayers take the life of loose tools to be about three years, thus writing off their cost over the three years.⁶²

(g) The entrance fee or annual subscription paid to a trade association e.g. Kenya Chamber of Commerce and Industry and Kenya Association of Manufacturers.⁶³ The trade association must have elected to be treated as trading by giving notice to the Commissioner of Income Tax.⁶⁴

(h) Expenditure of a capital or revenue nature incurred in scientific research is fully deductible in the year it is incurred.⁶⁵ The research must be for the purpose of the company's business. Also included is the amount of contribution to a scientific research association which undertakes research related to the class of business of the contributor. The research association must be approved by the Commissioner of Income Tax.⁶⁶

(i) The contribution by an employer on behalf of employees to the National Social Security Fund (N.S.S.F) is also deductible.

- (j) The expenditure on advertising, including any expenditure used by a company, intended to advertise or promote directly or indirectly the sale of goods or services provided by a given business.⁶⁷
- (k) The amount of loss brought forward from previous years of income are deductible. These losses shall be on the basis of specified sources.⁶⁸
- (l) The amount of trading loss which arises when business is continuing and all the assets in a class of wear and tear are sold for less than the written down value.
- (m) The amount of balancing deduction. This arises where business has ceased and all the assets of a class of wear and tear are sold for less than the written down value.
- (n) The amount of interest borrowed and used in the production of income e.g. interest on loan, overdraft, debentures, etc. Under section 15(3), interest is deductible on loans where the proceeds are used wholly and exclusively for the production of income.

Kenya has recently introduced provisions regarding thin capitalization⁶⁹, with the result that if indebtedness to a related corporation exceeds by more than three times that corporation's equity, then the excess interest will not be allowed as a deduction.

Any payments made by a branch of a foreign corporation to its head office will not be deductible. Interest on arms length loans to overseas lenders will be deductible although subject to withholding.

(o) Royalty payments are also deductible. If a company uses patents, trademarks and other proprietary information wholly and exclusively for the production of income, any royalty payments for such use will be deductible. The government has the ability to determine royalty rates under Kenya's transfer pricing legislations.⁷⁰ Any royalties paid to non-residents are deductible but subject to a withholding of 20%.

1.4.3 CAPITAL DEDUCTIONS UNDER THE SECOND SCHEDULE OF THE ACT

These deductions are allowed on some machinery and buildings used for business. They are at a standard rate for all taxpayers depending on the nature of the capital expenditure incurred. The importance of these capital deductions is that some offer incentives to business by allowing capital expenditure otherwise not claimable. Others direct investment away from the major urban centres of Nairobi and Mombasa, while others act as standard depreciation for income tax purposes.⁷²

The capital deductions under the Second Schedule applicable to corporation tax law include:

- (i) The amount of wear and tear deduction on machinery used for business.
- (ii) The amount of investment deduction given only once to an investor of some industrial buildings and machinery used for business.

1.4.3.1 WEAR AND TEAR DEDUCTION

This is a capital deduction on machinery used for business. "Machinery" is not defined, but in practice includes vehicles, ships, aircraft, equipment, tools, furniture, fixtures and fitting. It is all owed on the net costs of the assets after taking into account the investment deduction. This deduction is made against income. The Act therefore recognises the loss of value of assets used in business through usage, passage of time or obsolescence, and so guarantees the wear and tear allowance, capital deduction or allowances.⁷³

Paragraph 7 of the second schedule provides that:

".....[W]here 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 gain or profits.....a deduction.....referred to as a wear and tear deduction".

Wear and tear allowances are calculated annually.

The deductions allowed on machinery and equipment fall into four classes. The allowance in each of the four classes is calculated on a reducing (declining) balance

basis. Depreciation on machinery is not calculated on a reducing balance basis, but is aggregated or "pooled" in respect of each category of machinery. The four classes are:

- (a) Certain vehicles such as tractors, combine harvesters and heavy trucks for which the depreciation allowance is $37\frac{1}{2}\%$ per year on a reducing balance basis.
- (b) Computers and "peripheral computer hardware" e.g. printers, fax machines, photocopiers, etc. This is a new class for office machinery bought on or after 1 January 1992 for which the allowance is 30%.
- (c) Certain other self-propelling vehicles such as air planes, on which the allowance is 25% per year on a reducing balance basis.
- (d) All other machinery (including ships) for which a reducing basis depreciation allowance of $12\frac{1}{2}\%$ is available.

Unused allowances on machinery may be carried back six years upon the cessation of a business. Balancing charges (i.e. additional income) will apply if, on the sale of machinery from any particular category, the sale proceeds exceed the written down

value of the pool. Sale of machinery not at arm's length or at an under-value to artificially create allowances will be recalculated.⁷⁴

With effect from 1 January 1992⁷⁵, motor vehicles as machinery for wear and tear deduction may fall under class (a) or (c) above depending on the nature of the motor vehicle. For class (c) vehicles, the value of wear and tear deduction as well as value for wear and tear sale is restricted if the vehicle is a non-commercial vehicle.

The *Act* defines a "commercial vehicle"⁷⁶ as a vehicle which the Commissioner of Income Tax is satisfied:

- (a) is manufactured for the carrying of goods and is so used in connection with trade or business e.g. lorry, pick-up, van, etc. or;
- (b) is a motor omnibus within the meaning of that term in *The Traffic Act*⁷⁷ such as all public service vehicles e.g. buses and matatus, or;
- (c) is used for the carrying of members of the public for hire or reward e.g. taxi and tour operator vehicles.

Any vehicle not fitting the definition of a commercial vehicle is referred to as a non-commercial vehicle.

The Kenyan case of *A Company Ltd V. The Commissioner of Income Tax*⁷⁸ clearly illustrates the above. The appellant company used a motor car in its business and an allowance for wear and tear thereon was granted. The car was subsequently sold for a sum in excess of the written down value. The appellant company was assessed to income tax on the excess of the sale price of the car over its written down value. On appeal, the Supreme Court held that a motor-car used in a business comes within the meaning of plant or machinery used or employed in a business.

For the purpose of wear and tear, the value of addition of any non-commercial vehicle was restricted to Shs 75,000/= (£3,750) upto 31 December 1989⁷⁹ where the cost of the vehicle this rose to Shs 100,000/= where the cost of the non-commercial vehicle exceeds Shs 100,000/=. Where a non-commercial vehicle which was restricted as an addition for wear and tear is sold, the amount of sale proceeds is also restricted by a factor of 75,000/cost (£3750/cost) if it was brought prior to 1 January 1992 and by a factor of 100,000/cost (£5,000/cost) if brought on or after 1 January 1990⁸¹.

1.4.3.2 INVESTMENT DEDUCTION

This deduction is given on the cost of buildings and machinery which are used for manufacture, on cost of a ship, and on cost of a hotel building. It is intended as an incentive to encourage investment, primarily in the rural areas.⁸³

It was introduced in the 1975 Budget Speech to encourage rural industrialization. This deduction was and still is mainly given as a bonus to those making investments outside Nairobi and Mombasa municipalities. With effect from 1 January 1988⁸⁴, investment deduction at a lower rate of 10% was given in respect of investments made within Nairobi and Mombasa municipalities.

There are four main types of investment deductions as follows:

- (a) Investment deduction in respect of building and machinery used for ordinary manufacture.
- (b) Investment deduction in respect of building and machinery used for manufacture under bond i.e. goods manufactured by export only. It was introduced in 1988 and is commonly referred to as an 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 is deducted in the income tax computation, or in arriving at the taxable income or loss and is given once and for all when the building and machinery are used i.e. in the "year of first use". The deduction is allowed on the cost of construction or purchase of buildings and new machinery used for manufacturing purposes.

The general deduction is 85% (but a lower rate of 65% applies in the case of construction and equipment purchased for manufacture under bond). A smaller investment deduction of 35% is allowed for the construction or purchase of buildings and purchase of new machinery (and 15% for construction or purchase of buildings or machinery for manufacture under bond) used in the Nairobi and Mombasa areas. Taking an investment deduction does not preclude taking the standard building and machinery deductions, although they do reduce the basis of the assets upon which the building and machinery allowance is taken.⁸⁵

1.4.4 DEDUCTIONS NOT ALLOWED AGAINST TAXABLE INCOME

Section 16 of the Act lists expenses generally not allowable against taxable income, or specifically stated to be not allowable against taxable income.

Generally, section 16(1) disallows expenditure which is not incurred in the production of taxable income.

"S. 16(1).....[F]or the purpose of ascertaining the total income of the person..... no deduction shall be allowed in respect of expenditure..... which is not wholly and exclusively incurred by the person in the production of income".

Section 16(2) disallows specific items of expenditure if charged against taxable income. In the case of companies, the following items of expenditure must be disallowed:

- (a) The amount of capital expenditure, loss, diminution or exhaustion of capital e.g. depreciation, amortisation, write-off of all assets, loss on sale of assets, etc.
- (b) The amount of expenditure or loss recoverable under insurance contracts or indemnity.
- (c) Any expenditure on the production of income deemed to derive or accrue from Kenya by a non-resident not having a permanent establishment in Kenya.

1.5 THE CAPITAL GAINS TAX⁸⁶

This was introduced in Kenya in 1975, applying to transfer of all property owned by companies, and of land, buildings and marketable securities owned by individuals. Its impact was progressively softened by a series of amendments reducing the

proportion of gains subject to tax. It was finally suspended with effect from 14 June 1995.⁸⁷

1.6 CORPORATION RATES OF TAX

These apply to legal persons such as companies, trusts, clubs, estates, cooperatives, associations, etc. Tax on the total income of a person other than an individual is charged at the corporation rate tax.⁸⁸ Standing at 45% in the year of income 1989, it had been reduced in steps of 2.5% since then. In the year of income 1994, it stood at 35%. For accounting periods ending between 1 July 1994 and 30 June 1995, the rate has been temporarily increased to 37.5%.⁸⁹

Separate rates of tax apply to the income for non-resident persons in respect of management or other fees - 20%; royalties - 20%; rents - 30%; dividends - 15%; interest - 12½%.⁹⁰

From 1 January 1991, the "qualifying dividend rate of tax" applies to dividends paid to resident persons, excluding insurance companies. This is set at the resident dividend withholding tax rate from 1 January 1993 at 10%.⁹¹

Kenyan law does not provide for the filing of consolidated returns by members of a group. Therefore, each corporation must file a separate return. Accordingly, there is no ability to allocate income or losses among members of a group.⁹²

Below is a table giving a summary of the tax rates payable by companies for the years of income 1994 and 1995.

TABLE THREE
SUMMARY OF TAX RATES
(VALID 1994 AND 1995)
COMPANIES

	Resident		Non-Resident with Kenya Branch		Non-Resident no Kenya Branch	
	Income Tax	Withholding Tax	Income Tax	Withholding Tax	Income Tax	Withholding Tax
Business/Trade	35%	N/A	42.5%	N/A	N/A	N/A
Employment/Services Rendered	N/A	N/A	N/A	N/A	N/A	N/A
Management/Professional, Entertainment, Sporting Fees and Royalties	35%	N/A	42.5%	N/A	20%	20%
Rents	35%	N/A	42.5%	N/A	30%	30%
Dividends	10%	10%	10%	10%	10%	10%
Interest	35%	10%	42.5%	10%	12.5%	12.5%
Pension/Retirement Annuities	N/A	N/A	N/A	N/A	N/A	N/A
Interest from Housing Bonds	35%	10%	42.5%	10%	12.5%	12.5%
Insurance Commissions	35%	N/A	42.5%	N/A	20%	20%

Source: Deloitte and Touche, "Income Tax in Kenya" December 1994

CHAPTER ONE

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CHAPTER TWO

2.0.0 SOME SPECIAL CONSIDERATION IN COMPANY TAX LAW

The income tax is charged for each year of income upon all the income of a person (including legal person), whether resident or non-resident, which accrued in or was derived from Kenya.¹ This means that a Kenyan resident company is taxable in respect of all income no matter where it arises; a non-resident company is taxable on income arising from sources within Kenya. The former is taxed because, whether he be a Kenyan subject or not, he enjoys the benefit of our laws for the protection of his property; the latter because in respect of his property in Kenya, he enjoys the benefit of our law for the protection of that property.²

To clearly understand the extent and meaning of this provision, it is essential to expound on the concept of the resident of the company.

2.1.0 RESIDENTS AND NON-RESIDENTS³

A company is a distinct legal entity. Thus, its residence is of utmost importance in company taxation.⁴ There is no statutory definition of residence. However, the

Income Tax Act sets out the conditions which must be fulfilled for a company to be considered resident.⁵

The Act provides that "resident"⁶ in relation to a body of persons-including legal person, means that:

- (i) the body is a company incorporated under the Laws of Kenya; or,
- (ii) the management and control of the affairs of the body was exercised in Kenya in the year of income under consideration; or,
- (iii) The body has been declared by the Minister for Finance by a notice in the Gazette, to be resident in Kenya for any year of income.

The Act does not define a "non-resident". However, it must be taken to mean any person (individual or body of person) not covered by the above conditions for resident. Obviously residents have some tax advantages over non-residents which relate to tax-reliefs, rates of tax and expenses allowable against some income.

Non-resident companies are only taxed on income derived from or deemed to derive from the operation of a business in Kenya carried on through a permanent establishment.⁷ A "permanent establishment" has been defined as a fixed place of business from which a business is carried on, including building sites established for longer than six months.⁸ All its Kenyan source income, whether or not derived

directly through the permanent establishment, is subject to company tax. Kenyan withholding taxes deducted at source from such income are creditable against the company's corporate tax liability. However, an exception is provided for interest received on government securities.⁹ Here, the income from such securities will be exempt in the hands of non-residents. This may be important in relation to exchange controls.

If a company has no permanent establishment in Kenya, final (definitive) withholding taxes deducted from its Kenyan source income normally discharge its tax liability. A non-resident company pays corporate tax at a higher rate than a resident company.¹⁰ These rules may be modified by the provisions of a relevant double taxation agreement or treaty.

The Act makes provision for the income of certain non-resident persons deemed derived from Kenya.¹¹ The government may tax income arising to non-residents carrying on a shipping, chartering or air transport business to the extent that passengers or goods are taken on board at a Kenyan port or airport, except in the case of transshipment. The tax will be that percentage of the amount received for the transportation as the Commissioner "may determine to be just and reasonable"¹² The

same formula applies to cable or radio messages transmitted into Kenya by non-residents.¹³

To make the above position clear, caselaw has attempted to indicate what will constitute the residence of a company. Since income tax originally applied both to individuals and companies, it was perhaps inevitable that residence would be taken as the basis of taxation of companies. Indeed, in *De Beers Consolidated Mines Ltd V. Howe*¹⁴, Lord Loreburn said that:

"In applying the conception of residence to a company, we ought, I think, to proceed as nearly as we can upon the analogy of an individual. A company cannot eat or sleep, but it can keep house and do business. We ought, therefore, to see where it really keeps house and does business".

The House of Lords, therefore, held that a company is resident where its real business is carried on. Lord Loreburn adds.

"[T]he real business is carried on where the central management and control actually abides."¹⁵

The control and management of a business is situated at the place where "the head and the brain of the trading adventure" is situated.¹⁶ The place of control may be different from the place where the corporeal subjects of trading are to be found. In law, a company may have more than one residence.¹⁷ In Tanzanian case of *The*

*Commissioners of Income Tax V. P. Co. Ltd*¹⁸ it was held that residence continues though only occasional.

The powers of management and control are normally vested in the directors of an unincorporated company.¹⁹ In such a case, the company is controlled by the directors and not the shareholders.²⁰ The central management and control of a company would therefore, normally abide at the place where the directors hold their meetings. It was usually irrelevant to consider the residence of individual directors or shareholders or the place of the company's general meeting. It does not matter where the company's assets are situated. A company with assets in India would be resident in the United Kingdom²¹, conversely, a company with assets in Egypt could be resident there if the directors met there.²²

2.1.1 THE IMPORTANCE OF RESIDENCE²³

Residence is an important factor in determining liability to income tax, including surtax, in as much as a resident in Kenya is assessable in respect of income arising from all sources, whether the source is suitable in Kenya or abroad; whereas a non-resident is generally assessable only in respect of income arising from sources in Kenya. The charging enactments and schedules exclude from the charge to tax the income arising abroad to a non-resident; but, in addition, a non-resident enjoys specific exemptions from tax in certain circumstances.

The text, therefore, in determining whether or not a company is resident is not necessarily the place of registration, but the place where the company does its real business, that is, where the central management and control is found.²⁴ This raises important questions in the international aspects of company taxation, which is discussed next.

2.2.0 THE INTERNATIONAL ASPECTS OF KENYAN COMPANY TAXATION

2.2.1 TAXATION OF FOREIGN CORPORATIONS IN KENYA

As illustrated above, a corporation will be deemed resident in Kenya if its central management and control is undertaken there, or if the government deems it to be resident there.²⁵ "Central management and control" depends upon factual issues such as where important management decisions are taken, the location of meetings of the Board, the day-to-day decision making discretion of employees in certain locations, etc.²⁶

While a corporation may not be resident in Kenya, and thus not subject to Kenyan tax on its worldwide business income, it may be considered to be doing business in Kenya and thus to be subject to tax on its income accrued in or derived from Kenya. Furthermore, certain income earned outside of Kenya, will not be deemed to have been earned in Kenya and thus subject to tax.²⁷

Anything manufactured, grown or extracted in Kenya, but sold, or sold for delivery, outside of Kenya, or used in a business outside of Kenya will be "deemed to be income derived from Kenya and to be gains or profits of such amount as would have accrued if that product or products had been sold wholesale to best advantage."²⁸

Profits from businesses carried on in Kenya by resident persons and derived from transactions with related non-resident persons are assessed for tax purposes on the basis of the profits that would have ensued if the relevant transactions had been between independent persons at arm's length.²⁹

In computing the income deemed to arise in Kenya in general, expenses incurred overseas are not deductible. Specifically mentioned are payments to non-resident directors and executive and general administrative expenses, unless the Commissioner deems them reasonable.³⁰

Generally, if a foreign corporation has a branch or office in Kenya that constitutes a permanent establishment, then it will be considered to be carrying on business there. Income of the branch of the foreign corporation is calculated in the same manner as for resident corporations, with the exception that payments of interest, royalties and management fees paid by the branch to its overseas parent corporation are not deductible from the branch's Kenyan income.³¹

The branch is subject to tax at a rate of 45% which is higher than the normal corporate rate tax. There is no withholding on payments of such taxed income by the branch to its overseas head office, and such payments will not constitute income arising in Kenya in the hands of the foreign parent.³²

2.2.2 FOREIGN OPERATIONS OF RESIDENT KENYAN COMPANIES

Generally, resident corporations are taxable on their world-wide business income. All income from the operations of overseas branch of a resident corporation will be taxable in Kenya. This is subject to a deduction or a credit for foreign tax paid.

Income earned by overseas subsidiaries of resident corporations is not taxable if such income is returned to the Kenyan corporation by way of dividend or interest payment. However, management fees received from the overseas subsidiaries are likely to be taxable.

More importantly, the *Act* provides for the application of certain transfer pricing principles.³³ If it appears to the Commissioner that a transaction was effected for "the avoidance or reduction of liability to tax" in the year of income, or would have an effect within 3 years thereafter, then he can adjust the tax of any person and charge more tax than was due before the adjustments. Where a transaction is not at arm's length, that is, not between an independent willing buyer and seller, or between

related parties, or for consideration that cannot be valued, the Commissioner may substitute market value (or in certain cases, the value for stamp duty purposes) at the time of the transfer or acquisition.

2.2.3 TAX TREATIES AND DOUBLE TAXATION RELIEF

The problem of doubt and concurrent taxation by overlapping governmental authorities has become increasingly important, particularly in international tax. The growth of international contacts has multiplied the possibility of a corporation being taxed in several countries.³⁴ Kenya's *Income Tax Act* also deals with these provisions under sections 41 and 42.

The Kenyan government can enter into Double Taxation Treaties which override any conflicting provisions of the Kenyan tax laws. Kenya does not, however, have a wide tax treaty network. Treaties signed between Kenya and other states include Uganda, Tanzania, Canada, United Kingdom, Sweden, Zambia, Denmark, Norway, Federal Republic of Germany and India.³⁵ A number of these treaties, for example, those with United Kingdom, Germany and Zambia also contain tax sparing agreements whereby the overseas country will not tax income spared from taxation under the investment incentives provided under Kenyan law.

Most questions, therefore, regarding the taxation of overseas corporations and individuals will be resolved under general Kenya law. The tax treaties that Kenya has entered into follow the OECD model draft treaty.³⁶ Generally, the tax treaties entered into by Kenya only operate in relation to the income tax, and therefore do not cover Kenya advalorem taxes such as value added, stamp duty and local property taxes.

Double taxation agreements are drawn between Kenya and other states for two main reasons:

- (i) to facilitate exchange of qualified technical personnel without the personnel being burdened with heavier taxation due to double taxes;
- (ii) to facilitate the exchange of technology in commerce and industry without the investors feeling that they are overburdened with the tax in both countries.³⁷

The *Act* details out the determinants of the relief where Kenya has entered into Double Taxation Agreements with other countries.³⁸ The Kenyan Government may tax income arising through the operation of a permanent establishment. Credit will be given for this tax in the country of residence.³⁹

In order to qualify for the relief, the taxpayer must fulfil the following conditions.⁴⁰

- (a) Prove the deduction of tax from that other country.

- (b) The foreign tax that qualifies for the relief should not exceed the local tax payable.
- (c) The relief must be claimed within six (6) years after the date when the tax liability was incurred.

Income from independent personal services will only be taxable to a non-resident if that non-resident has a fixed base available to him in Kenya, or is present in the country for a period of 183 days or more in the tax year concerned.⁴¹ There are restrictions on the amount of discriminatory tax which can be assessed against a corporation of one country which operates through a branch in another. There are also information exchange provisions. Kenya's tax treaties do not however, appear susceptible to anti-treaty shopping provisions.

Non-residents are taxed on income derived in Kenya only. But residents may be liable to tax on income derived from outside Kenya also. Therefore, resident persons are subjected to double taxation. It is to reduce the tax burden on resident that the double taxation agreements are signed.

The agreements are to be gazetted in the Kenya Gazette by the Minister for Finance. The treaties must get the approval of Parliament.

Dividends of associated companies, that is, dividends from a parent company to an uncontrolled subsidiary, are given double taxation relief even where special arrangements have been stated that the particular class of dividends shall enjoy the relief. The Minister for Finance, Hon. W. Musalia Mudavadi, in the 1994/95 Budget Speech, introduced proposals that prevent double taxation of company income where dividends are received as trading income by financial institutions. Such dividend income will become tax exempt to the financial institutions when received as trading income, but the expenses related to earning such dividend income will no longer be deductible.⁴²

2.3.0 SPECIAL TAXATION OF PARTICULAR INDUSTRIES

Certain industries are taxed differently and specially from the normal tax system. It is essential to point out these industries to illustrate the differences.

2.3.1 STATE-OWNED INDUSTRIES

The income of certain state-owned industries and boards set out in the First Schedule, paragraph 4, are exempt. These include the Tea Board of Kenya and The Kenya Dairy Board, to name but a few.

2.3.2 INDUSTRY IN AN EXPORT - PROCESSING ZONE (EPZ)

An export processing zone (E.P.Z.) is an area within a country which is free of duty or government red tape. The main objectives of an E.P.Z. is:

- (i) to create employment;
- (ii) to attract foreign investment;
- (iii) export promotion - as a means to boosting foreign exchange earnings;
- (iv) technological transfer.

The *Act* sets out the provisions relating to the taxation of enterprises situated in the E.P.Z⁴³. For any enterprise registered under *The Export Processing Zone Act*⁴⁴, any capital expenditure on buildings constructed or machinery purchased for use in the zone made in the first twenty years of operation, is deductible in full in the first year of use. The chances are that machinery and buildings constructed within the first ten years will not be claimed by such an enterprise because there could be no tax advantage. However, such machinery and buildings will qualify for normal wear and tear deduction⁴⁵ and the Industrial Building Deductions⁴⁵. In the next ten years when the enterprise becomes assessable a claim for investment deduction is prudent.⁴⁷

Any income earned by an enterprise registered in an E.P.Z is exempted from tax for ten years starting with the year that production, sales or receipts commence, and will be taxed at a reduced rate of 25% for ten years thereafter.⁴⁸

Certain legal provisions attach to an E.P.Z. An E.P.Z. is required to maintain its accounts in a convertible foreign currency of its choice. Notwithstanding that an E.P.Z will be exempted from corporation tax for the first ten years of operation, it will be expected to submit an annual return of income and its business accounts.⁴⁹

An E.P.Z. shall be a non-resident company. Payments to the enterprise will be subject to a withholding tax at the non-resident rates. The withholding tax will be final tax if the payment is made by a person who is of an E.P.Z. enterprise⁵⁰, or who is not an E.P.Z. enterprise.⁵¹ Payment by an E.P.Z. enterprise, that is, by any non-resident person is deemed to be exempted from tax.

In the 1994/95 Budget Speech⁵², it was said that the ten-year tax holiday available to new E.P.Z. enterprises provided an all too attractive opportunity for a related resident company to set up transfer pricing arrangements to evade income tax. To help control tax evasion behaviour through transfer pricing it was proposed to introduce special rules where manufacturing or other services are being provided by a resident company to an E.P.Z. enterprise.

2.3.3 AGRICULTURE

Agriculture is the most important component of the Kenyan economy and has been designated as a "special trade". For this reason, a special tax regime applies.⁵³

Taxable income is computed by adding to or deducting from gains or losses made from farming any decrease or increase in "farming stock" at the end of each taxable year.⁵⁴ "Stock" includes all livestock and agricultural produce.⁵⁵ In certain cases, an election not to be assessed on the value of stock, if made before December 31, 1961, may still be in effect.

The following special deductions are also available to farmers.⁵⁶

- (i) Expenditure on farm works made after January 1, 1985 maybe deducted on a straight line basis at the rate of 33 $\frac{1}{3}$ % per year. No provision is made for balancing charges (recapture) on resale, but unused allowances will pass to the purchaser.⁵⁷
- (ii) Any capital expenses incurred in clearing and planting permanent or semi-permanent crops⁵⁸ are deductible in full in the year in which such expenses are incurred.
- (iii) Any capital expenses incurred in preventing soil erosion are also deductible in full in the year in which such expenses are incurred.⁵⁹

Certain large corporations which purchase significant amounts of agricultural products are "authorised agents" for tax purposes. This means that they must deduct presumptive income tax from any payments for crops or livestock made to farmers, and account for it to the government. Any purchaser who is not an authorised agent must report the purchase of crops or livestock to the government within 30 days of that purchase. If a purchaser does not report a purchase, that person will become responsible for the payment of the presumptive income tax. The farmer need not include the gains or profits in his taxable income from which presumptive tax has been deducted.⁶⁰

2.3.4 INSURANCE COMPANIES

Insurance companies is another class which is subject to a special tax regime.⁶¹ Resident insurance companies are taxed at a rate of 40% on their life insurance business income.⁶² The general corporate rate applies to other insurance business of a resident insurance company. Life insurance business of an insurance company is treated as a separate business from any other class of business.⁶³

The gains or profits of a resident insurance business other than life insurance business comprise of⁶⁴:

- (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 risk at the end of the previous year.
- (e) a deduction in respect of a reserve for unexpired risk, at the end of the previous year.
- (f) a deduction of agency expenses.
- (g) other deductions allowable under the *Act*.

In the case of non-resident insurance companies, tax is assessed only on a proportion of investment income determined by reference to the proportion that premiums from business in Kenya bear to total worldwide income. The gains and profits of a non-resident insurance business comprise of⁶⁵:

- (i) gross premium receivable in Kenya less premium returned to the insured and premiums paid on reinsurance other than to the Head Office of the company.
- (ii) other income including commissions and expenses allowances received or receivable from reinsurance other than from the Head Office of the company in relation to risks accepted in Kenya.
- (iii) Income from investments representing reserves created for or from business done in Kenya.

Certain deductions are specifically allowed and these include:

- (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.⁶⁶
- (b) Claims admitted in that year of income less any amount recovered from reinsurance companies.⁶⁷
- (c) Agency expenses.⁶⁸
- (d) Head Office expenses which would have been allowable if the company had been a resident company.⁶⁹

In the case of life insurance business, the income comprises of the investment income of the life insurance fund except that part of the life fund which relates to an annuity fund, less management expenses including commissions.⁷⁰ The investment income is defined as dividends and interest income but does not include qualifying dividends. It also includes the amount of interest received by the company on surrender of policies or on the return of premiums other than premiums in relation to a registered annuity contract, registered trust scheme or a registered pension fund.¹⁷

2.3.5 MINING OPERATIONS

Mining is another "special trade" to which a special tax regime applies. This is attributed to various reasons. For example the life of a mine is more difficult to

predict than the life of a single asset. It depends on two things - the extent of the ore, and the maintenance of world prices at a level which makes extraction from the particular mine economic. A fall in prices may put a high cost mine out of production, though it may contain substantial reserves of ore. The little mining in Kenya is of the marginal type and could be brought to an end by a drop in the price obtainable for the ore. These special considerations must be borne in mind when capital deductions proper to mining are under consideration.

Indeed, the Coates Commission Report⁷² provided that:

"Special considerations apply to mining concerns. The working life of an asset used by a mining concern depends not merely on its own life, but also on the life of the particular mine in which it is installed. When a mine doses down, the expenditure that has incurred. For example, on the pit shaft will be valueless. Even things which are physically detachable such as winding gear are likely to be unsaleable in practice; they will probably be adapted to the conditions of the particular mine and will be useless elsewhere; in any event they are unlikely to be in a remote place from which it would be impracticable to convey them to some other place where they might be useful."

Generally, mining business are treated like any other business in the computation of taxable income. However, mining companies are given two concessions:

- (i) For the first four years of a mining operation beginning in the year in which the corporation shows a profit (i.e. is obligated to pay corporate tax), it will

be subject to a reduced tax rate of 27½% on that income derived from mining. From the fifth year and thereafter, the normal derived from mining. From the fifth year and thereafter, the normal corporate rate of 45% will apply.⁷³

- (ii) Mining deductions are given to any person who carries on the business of mining due to the riskiness of the mining investment so as to encourage mining activities in the country. The mining deduction is given at 40% in the first year and 10% in each of the succeeding six years on qualifying investment in mining activities. However, the Commissioner may allow depreciation over a shorter period if it appears that the mine will become worked out in less than seven years.⁷⁴

While this depreciation allowance applies to expenditures on geological research, testing, acquiring rights over new mineral deposits, mining, machinery, buildings and general expenses, it does not include the expense of acquiring the mine site itself, any pre-existing buildings thereon or of processing the mined product. The legislation does not provide any balancing charges and unused allowances that may be passed onto purchasers.⁷⁵

Where expenditure is incurred by a person about to carry on a business of mining, it shall be treated as having been incurred by him on the first day on which he does carry it on. This provision puts such a person in the same position as a person who

is actually carrying on a business of mining when he incurs the expenditure. Where a person who does not carry on a business of mining incurs expenditure, sells any asset representing such expenditure, then the purchaser, if he carries on a business of mining, shall be deemed to have incurred, for the purposes of that business, expenditure equal to the price paid by him for such assets.

The Commissioner is given powers to increase or decrease the amount of the deductions for any year if this is deemed necessary having regard to the estimated reserves of the ore. Where assets representing qualifying expenditure change hands during the period when deductions are being given, the *Act* empowers the Commissioner to make such apportionments between vendor and purchaser as he considers just and reasonable. Normally, apportionment will be made on a line basis.

Where there are distinct mining operations carried on by the same person in mines that are not contiguous, they shall be treated as separate traders. The provision now appears to be relevant only in relation to increased deductions.⁷⁶

The depreciation allowance is not applicable to certain materials, such as common clay, sand, kaolin, bauxite, sodium or potassium compounds. Expenses for mining certain "specified minerals", designated by notice in the Gazette, may be deducted in full in the tax year in which they are incurred.⁷⁷

2.3.6 PETROLEUM PRODUCERS

The Act in its Ninth Schedule, which was effective from 28 December, 1984, makes provision for the taxation of companies involved in petroleum exploration and production in Kenya. The provisions include favourable rates of tax on management or professional fees and interest paid to non-residents by such companies and generous terms in regard to allowable deductions for tax purposes.⁷⁸

A petroleum company must pay tax on the value of production to which it is entitled under a "Petroleum Agreement" less any allowable expenses. Petroleum agreements are those entered into under *The Petroleum (Exploration and Production) Act 1984*. Non-resident sub-contractors will be deemed to have made a taxable profit of 15% of the sums paid to them by a petroleum company, exclusive of certain defined expenses, and the tax on this is deducted when payment is made.⁷⁹

2.3.7 SHIPPING

A Kenyan resident engaged in the business of shipping who purchases or refits a power driven ship over 495 tons gross is allowed a one time deduction at 40% of the expense in the year in which the ship is first used.⁸⁰ The allowance may only be taken once for each vessel. If, however, the ship is sold in less than 5 years from the time it is first used, then the allowance will be recaptured as income in the year of sale.

The shipping investment deduction is given where a resident shipowner incurs capital expenditure either on the purchase of new, power-driven ship of more than 495 tons tare weight, or, on the purchase and subsequent refitting for the purpose of shipping business of a used power-driven ship of more than 495 tons tare weight.

With effect from 1 January 1987⁸¹, the wear and tear deduction for a ship is calculated on the qualifying amount net of the shipping investment deduction.

CHAPTER TWO

ENDNOTES

1. S.3(1)
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3. Sumption, "*Taxation of Overseas Income*", Chapter 1, also printed in (1973) B.T.R. 155.
4. Fornsworth, "*The Residence and Domicile of Corporations*", (1978) B.T.R.
5. S.2.
6. Ibid.
7. S.9(1)
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9. First schedule, part 2, paragraph 1.
10. Third schedule, Head B, paragraph 2.
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20. *Automatic Self-Cleansing Filter Syndicate Co. V. Cuninghame* (1906) 2 ch. 34.
21. *Calcutta Jute Mills V. Nicholson* (1878) 1 Ex.D. 428.
22. *Egyptian Delta Land and Investment Co. Ltd V. Todd* (1929) A.C.I. Here, it was also stated that the place of the.....company's incorporation - the decisive factor, for domicile was just one of the factors which may determine residence.
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44. Chapter 517, Laws of Kenya.
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49. S.52 and S.54.
50. *Finance Bill* 1990.
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52. Supra, note 42.
53. Jetha N., "*Company Taxation in East Africa*", B.T.R. (1965) 42.
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56. Second Schedule, paragraph 22-23.
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CHAPTER THREE

3.0.0 THE ADMINISTRATIVE PROVISIONS OF COMPANY TAX LAW

The chapter deals with the machinery by which company tax is levied and collected. This includes provisions regarding the returns which companies have to submit, the assessment on the tax and the penalties which apply in case of default by the company.

3.1 RETURNS

There are a number of provisions which require a taxpayer to make returns to the revenue so as to provide information necessary to set in motion assessments to tax.¹

A taxpayer informs the income tax department about the details of the tax position through the submission of annual returns of income.² Thus, every company must, whenever required to do so by the Commissioner, prepare and deliver to the Commissioner a true and correct statement of the amount of its profits from each source for the year of assessment and of such other particulars as may be specified on the notice.³ The returns of income are forms issued by the income tax department for completing annual details of income or loss.⁴

Returns are required of a company's total income for a year of income. Where a person makes up annual accounts, then the income for the year ending on the accounting date will constitute the income for the year of income in which the accounting date falls.⁵

The Commissioner has power to make adjustments in respect of accounting periods for other than twelve months. The year of income, for income not the subject of accounts, is the calendar year.⁶

Legal persons such as companies, trusts, clubs, co-operatives and corporations, generally referred to as companies or corporations, submit various returns or income. Initially, five current and proposed returns of income used to be submitted. These were the instalment, provisional⁷, final, self-assessment and compensating returns. Presenting, only three types of returns are in use—instalment, self-assessment and compensating.⁸ It must be noted that the *Income Tax Act* has recently introduced far reaching changes in the types of returns to be submitted, the due dates for submitting them and the due dates for payment of taxes thereon.

Penalties⁹ are exigible from companies which fail to make returns, when liable to do so within the prescribed time limits, and from persons who make fraudulent¹⁰ or negligent returns.

The importance of the demand of the return as a pre-requisite for assessment was emphasised in the case of *F.B.I.R. V. Joseph Rezcallah & Sons Ltd*¹¹ where it was said that:

"[T]he request to render a return is a condition precedent to assessment; the waiting for the time allowed in the request to pass is also a condition precedent; both conditions are intended to protect a person by according him an opportunity of stating his income and other relevant matters; and an assessment which does not fulfil either of those conditions is made without jurisdiction and is null and void."¹²

Similarly, an assessment made before the expiration of the time for making a return of profits is invalid, as was shown in the case of *Mandavia V. Commissioners of Income Tax*¹³.

Discussed below are the various types of returns which a company may have to submit. This includes the returns which have been abolished, as they still have an impact on the taxation of companies.

3.1.1 THE INSTALMENT RETURN OF INCOME

This is submitted by all companies not exempted from submitting it. It is a form issued by the income tax department for completion by companies. It was introduced with effect from the 1990 year of income.

The instalment return is due for submission to the collector of income tax by the end of the ninth month of the current accounting year. This return declares the instalment tax which is calculated using either the preceding year actual tax or using the current year tax estimate whichever has lower tax.¹⁴ The instalment return must indicate the choice made and either the tax payable for the preceding year, when the preceding year basis is used, or the estimated taxable income and tax payable for the current year, where the current year basis is used.¹⁵

When completed, the instalment return contains the following vital details, that is, the year of income for which it is submitted, the instalment tax payable, the basis of calculating instalment tax and the signature of one of the principle officers of the company who is making the return.

Instalment returns are supplied by the Commissioner, but failure to do so does not relieve a person of the responsibility to furnish such a return by the due date.¹⁶

Whenever a legal person has not submitted a return of income or return of tax by the due date, the Commissioner has power under the *Act* to estimate the legal person's income to the best of his judgement and tax the company accordingly. The minimum penalty for a company Shs 500/=.

The Commissioner has power to issue an instalment assessment on estimate basis where a taxpayer has failed to submit an instalment return on due date.¹⁷ The Commissioner can further impose a penalty on any underpayment of instalment tax. The penalty is 15% of the underpaid tax multiplied by 110%.¹⁸

3.1.2 THE PROVISIONAL RETURN OF INCOME

The provisional return was a form issued by the Income Tax Department to enable companies declare their provisional or estimated income and tax thereon for a given year of income. All companies were required to submit a provisional return for years of income ending earlier than 31 December 1992¹⁹, after which it was abolished.

The provisional return was due for submission to the income tax department by the end of the third month after the accounting year end. Provisional tax, if any, was payable by the same date that the provisional return was due. The tax payable was computed using the relevant corporation rates of tax for the year of income and offsetting any withholding tax or tax paid at source, and the instalment paid.²⁰

A declaration in the provisional return that it continued a full and considered estimate of the income liable to tax had to be signed by the principal officer of the company making the return. After signing the company's copy of the provisional return, it became a notice of provisional assessment or a bill for provisional tax payable.²¹

To force companies to make proper estimates of provisional income and tax, there was a penalty for underestimation of the provisional tax as compare with final tax. Where a company submitted a provisional return by the due date, then the final return of income was due for submission to the income tax department by the end of the ninth month after the accounting year end. Provisional tax paid reduced any final tax payable.

The Commissioner of income tax had the power to issue a provisional assessment on estimated basis where a taxpayer had failed to submit a provisional return on the due date. The Commissioner was required to issue such provisional assessment as quickly as possible after the expiry of the time allowed for submission of the provisional return. The tax thereon was payable within 30 days from the date of issue of assessment.

The Commissioner could impose a penalty or additional tax of 3% per month or part of the month that the provisional return was not submitted. The period of the penalty ran from the date of the failure to submit a provisional return to the date that the Commissioner issued an assessment on estimated basis for failure to submit the return.²²

Where a taxpayer had submitted a provisional return but the difference between this and the final return was more than 10% of the provisional tax, a penalty was imposed. This was referred to as an underestimation of provisional tax.²³ The Commissioner imposed a penalty on the underestimation tax of 2% per month.²⁴ If the provisional tax declared was not paid, the Commissioner imposed a penalty of 15% on tax unpaid on due date. However, this return has been abolished.

3.1.3 THE FINAL RETURN OF INCOME

This was a form issued by the income tax department to enable a company to declare a final income.²⁵ It was abolished for the years of income ending 31 December 1992²⁶ and later years of income. Instead, the self-assessment return was introduced.

For a company which had submitted a provisional return by the due date, the final return was due for submission to the income tax department by the end of the ninth month after the year end. A declaration had to be signed by one of the principal officers of the company making the return that the final return contains a full and true statement of the income liable to tax. The final return for companies had facilities for a company to declare the amount and sources of income or loss and to claim for tax paid at source or withholding tax.

Where the taxpayer failed to submit a final return on the due date, the Commissioner of income tax had power under the *Act* to issue a final assessment on the estimated income. The tax thereon was payable within 30 days from the date when the assessment was issued. Where the final assessment was submitted late, the Commissioner imposed a penalty of 5% for each year or part of the year that the return was late.²⁷

3.1.4 THE SELF-ASSESSMENT OF INCOME

This return for companies is a relatively new return introduced in 1992.²⁸ It is submitted by all companies in respect of the year of income ending on 31 December 1992 and later years. It is a detailed return and combines the declaration of income and the assessment to tax. Thus, every legal person chargeable to tax must submit a return of income incorporating a self-assessment of tax on such income.

Persons, other than individuals, are required for accounting period commencing on or after 1 January 1992 to submit a self-assessment return not later than the last day of the fourth month following the end of their accounting period.²⁹ By concession, extensions of upto five months will be granted for submission of accounts forming part of the return, provided that the return itself has been submitted and any self-assessed tax paid by the fourth month from the due date.³⁰

The self-assessment return for companies is also a self-assessment to tax and has the facility for the company to declare the amount and sources of income or losses on the basis of the specified sources of income; to compute the tax payable for the year; to claim the tax paid at source or the withholding tax; to show the net tax payable and to declare residence. A principle officer of the company must sign the declaration in the self-assessment return that it contains a full and true statement of the income liable to tax.

The Commissioner imposes a penalty or additional tax of 5% for each year or part of the year that the return is late. If the tax is not paid on the due date, a penalty of 15% on the tax unpaid is payable. Thereafter, a penalty of 2% is imposed every month on any tax unpaid.³¹

Following recent changes in procedure, the Commissioner may respond to the self-assessment return in one of the following ways. He can accept the return, correct computational errors in the return, or institute an in-depth examination.³²

3.1.5 THE COMPENSATING TAX RETURN

This is a new return for companies introduced in 1993.³³ It is submitted by resident companies only for accounting years ending in 1993 and later years. Thus, every company liable to tax submits a return of any compensating tax payable by it.

The return is submitted with the company's self-assessment return. It also constitutes an assessment of the compensating tax payable. The first compensating tax returns were submitted in respect of accounting periods ending in 1993.³⁴

The compensating tax return states the balance on a company's dividend tax account as at the due date for the filing of the self-assessment return. A dividend tax account must be kept for all accounting periods beginning 1 February 1992³⁵ and after, and is debited with dividends paid and received and compensating tax paid. Both dividends paid and received are reduced by reference to a formula.

A net debit balance on a company's dividend tax account represents compensating tax payable. Credit balances are carried forward. The opening balance on a company's first dividend tax account will either be zero, or the balance at the end of the year of income 1992 created by running a notional dividend tax account from year of income 1988, whichever ever is to the company's advantage.³⁶

The Commissioner imposes a penalty of 5% for every month or part of the month that the return is late.³⁷ If compensating tax is not paid by the due date, a penalty of 15% would be imposed on the tax unpaid on due date. Thereafter, a penalty of 2% would be imposed on tax which remains unpaid at the end of every month with effect from 1 January 1993.³⁸

3.2.0 ASSESSMENT

A notice of assessment is the tax bill issued by the Commissioner of income tax to all taxpayers for each year of income. Where income has been declared, the appropriate rate of tax is used to arrive at the tax payable by the company for any year of income. In case of loss, a notice of assessment is still issued to show loss carried forward for the year on the basis of the specified sources of income.³⁹

A furnished instalment return serves as an assessment to instalment tax. The tax is payable not later than the last day of the month of the current accounting year, or of the calendar year for calendar year taxpayers.⁴⁰ The Commissioner may issue an instalment tax assessment in the event of failure to submit a return in time; tax assessed is payable within 30 days of service of the notice of assessment.⁴¹

The amount of instalment tax payable is the lesser of the tax payable by that person on his total income for the year; or, the tax assessed, or in the absence of an assessment, estimated as assessable for the preceding year of income.⁴²

Adjustments to instalment 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 transfers of assets between companies have taken place.⁴³

A completed self-assessment return constitutes an assessment for payment of the relevant tax and this tax is payable on the last date specified for submission of the self-assessment return. Although the *Act* does not say so, instalment tax should be deducted from the self-assessment tax payable.

Although final returns are being superseded by self-assessment returns, final assessments or their equivalent will still be issued for earlier years of income still unassessed and where, for example, self-assessment returns are not accepted by the Commissioner as a complete statement of income. For this reason, the law in relation to final assessments remains in place.

Where the final assessment is agreed, payment of the balance of the tax assessed not already paid is generally required within 30 days of receipt of the assessment, although in practice 30 days from the end of the month in which the assessment is issued are allowed. Companies do not in any case have to pay tax charged on a final assessment before 30 June in the year following the year of income.⁴⁴

3.3.0 OBJECTIONS AND APPEALS

A taxpayer who disputes or does not agree with an assessment for any year of income has a right to lodge an objection against such an assessment. Such an objection is referred to as a "notice of objection". For the objection to be a "valid notice of

objection", it must be in writing⁴⁵, state the grounds of objection⁴⁶ and it must be made within 30 days after the date of service of the notice of assessment.⁴⁷

Thus, within 60 days from the date of service of an assessment, objection to disputed income may be made in a formal letter of objection. Such an objection will be invalid unless accompanied or preceded by a return of income, together with all supporting documents. Date of service is 10 days from the date of an assessment.⁴⁸

The income tax department may respond to an objection by:

- (a) agreeing to amend the assessment in a manner agreed by the taxpayer;
- (b) amending the assessment in a manner not agreed by the taxpayer;
- (c) issuing a notice confirming the original assessment.⁴⁹

In the case of (b) and (c), a taxpayer still disputing the original or amending assessment must appeal to the local committee or tribunal. The local committee is made up of laymen, and is equivalent to the General Commissioners in the United Kingdom.⁵⁰ The tribunal deals with assessments resulting from anti-avoidance directions made by the Commissioner.⁵¹ These are extremely rare and currently there is no tribunal in being.

Either party may appeal to the High Court against the decision of the local committee or tribunal, but only on a question of law or mixed law and fact. A further right of appeal against a High Court decision exists to the Court of Appeal.⁵²

Tax in dispute only becomes payable when either it is confirmed by the Court of Appeal or by a lower court or where no further appeal is made.⁵³ From 13 June 1986, tax declared payable by a decision of the local committee must be paid within 30 days of the notice of that decision, notwithstanding any appeal to the High Court.

In general, tax in dispute is not payable until the relevant dispute has been resolved. However, where an appeal is decided against the taxpayer by the local committee, tax in dispute is then payable notwithstanding that the taxpayer appeals to the High Court. If the appeal is ultimately successful, tax already paid but not in the extent due will be refunded with interest.⁵⁴

Where an appeal fails, interest on unpaid tax will be calculated by reference to the date of payment on the original assessment, notwithstanding that tax in dispute has been stood over pending determination of the objection or appeal.⁵⁵

3.4.0 PROCEDURAL ASPECTS OF THE TAX SYSTEM

The Income Tax Act (cap 470), Laws of Kenya, establishes a Department of Income

Tax under the Finance Ministry. The head of the department is the Commissioner of income tax.⁵⁶ His senior officers are the principal assessors and the senior assessors.

The department is divided into two division - the loan assessment and collections. The department has its headquarters in Nairobi. It has nine district offices around the country, four of which are also in Nairobi.

Under the Tax Modernisation Programme⁵⁷, the income tax has undergone fundamental changes over the last few years. Significant amendments have been introduced to make the administration more efficient and effective. One such make has been the recent move to a system of self-assessment⁵⁸ from the former system where tax returns were filed by corporations and assessments then issued by the tax department.⁵⁹ Furthermore, under the old system, a provisional amount of taxes was due three months after the end of the tax period, and the final amount nine months after the end of the tax period.⁶⁰ This system has also changed and Kenya is converting to a method of instalment payments under which 75% of all tax due at the end of the year will already have been paid.⁶¹

Under the old system, and the same result presumably prevails, the Commissioner has seven years from the year of income in which to raise a valid assessment against a

person (including a legal person). In *D.A. Pritam V. The Commissioner of Income Tax*⁶² an assessment was made seven years after the year of income and the question was whether the assessment statute was barred. It was held that if the Commissioner of income tax seeks to maintain any particular assessment, which on the face of it is expressed to have been more than seven years after the end of the year of income to which it relates, it is not statute barred. He must call evidence of such a nature as to establish that there was a preponderance of probability that the taxpayer, in relation to his income tax for the relevant year of assessment either acted fraudulently, or was in gross or wilful default.

If there has been fraud or gross or wilful neglect, then the Commissioner may raise an assessment at any time.⁶³ Assessments cannot be voided simply on the grounds of technicalities.⁶⁴

Kenya has an apparently rigorously enforced system of penalties and interest. If a payment of a tax is made after the due date, which under the new self-assessment system is four months from the end of the year of income for corporations⁶⁵, irrespective of whether an objection or appeal has been made, then interest of 15% immediately becomes payable. Thereafter, another 15% is payable every twelve months. If a person is about to leave Kenya, without having paid taxes, rigorous steps, including arrest and detention may be taken.⁶⁶

There are three offenses in increasing levels of severity:

- (a) failing to keep proper books and records.⁶⁷
- (b) negligent misstatement on tax returns.⁶⁸
- (c) fraudulent misstatement.⁶⁹

In the last instance, the penalty can be a fine of the greater of upto Shs 10,000 or double all the tax owing for the year in which the offence was committed and/or two years in jail.

In the case of *Rattan Singh V. The Commissioner of Income Tax*⁷⁰ additional assessments and penalties were imposed by the Commissioner upon the taxpayer for fraudulent returns for the years 1946/53.

False returns were dealt with in *Alfred Granville Ross V.R.*⁷¹. The appellant, a partner in a firm of commission agents carrying on business in East Africa and England, had been convicted on a retrial on 35 counts charging the making of false returns to evade tax, and sentenced to one year's imprisonment and fines totalling £50,000. The substance of his appeal against conviction was that the firm's undeclared income was commission from overseas suppliers paid to and retained by his United Kingdom office, and therefore, was not income derived from East Africa. It was held that the firm procured its income from obtaining orders and it was open

to the jury to find as a fact that the income in question was largely earned in and therefore derived from East Africa within the mean of the Income Tax Ordinance. His appeal was dismissed. This principle is also applicable in respect of false returns made by companies.

The Commissioner has extensive powers to accept settlement proposals made by taxpayers to avoid prosecution. Likewise, the Commissioner has wide powers to compound, that is, suggest to and made a deal with the taxpayers the offence.⁷² He also has the authority unilaterally to remit tax owing.⁷³ In *The Commissioner of Income Tax V. Lakhani*⁷⁴, judgement was given for the plaintiff for a reduced penalty by 5%.

The Commissioner has extensive powers to collect taxes owing. He may either proceed through the court system or *distrain* upon goods and chattels⁷⁵ or enter tax liens against property with the Land Registrar.⁷⁶

Under section 99 of the *Act*, coordination is required with *the Exchange Control Act*⁷⁷ so that any person emigrating from Kenya must, in addition to fulfilling the exchange control requirements, also apply to the Commissioner for an Exchange Control Income Tax Certificate.

Tax audits by the department were infrequent under the old system of assessment. The more informal methods of setting taxpayer disputes are generally employed by the department. If the taxpayer and the department cannot reach an agreement over the tax due on a return, the Department will issue a confirming notice.⁷⁸ The taxpayer may appeal this notice to the local committee of his tax district.⁷⁹

The local committee is made up of lay persons. In certain circumstances, an appeal of the Commissioner's decision may be taken to a more specialised tribunal.⁸⁰ Hearings before the local committee are not so formal as court proceedings and either side may appeal from a decision of the local committee to the High Court.

If a taxpayer wishes to appeal a decision to the local committee or from the local committee to the court, and his appeal is late, he must first pay the amount of tax in dispute. This is subject to a refund if he is successful. Appeals may be taken from the Commissioner's decision within 30 days of the service of a confirming notice of assessment. Costs may be awarded against the losing party.⁸¹

Other decisions of the Commissioner may also be appealed to the local committee.⁸² A taxpayer has seven years from the end of the year of income in question to claim relief from an assessment made by error or mistake of fact.⁸³

In the case of corporations, the person liable for any offence are all the directors and officers, unless they can prove that they did not consent to and had no knowledge of the commission of the offence and that they exercised diligence in the performance of their duties to ensure that offences would not take place.

The tax authorities have extensive search and seizure powers exercisable upon the issue of a warrant by a magistrate.⁸⁴ In addition to those powers, assessors have an unfettered right to enter onto land and buildings, interview persons and take copies of all books and records related to tax matters.⁸⁵

Any document seized or copied can be used in civil or criminal proceedings. This right overrides any other principles of law. The tax authorities are meant to treat such information in confidence⁸⁶, but even this obligation is severely circumscribed. There are also provisions for the exchange of information with other tax authorities.

Finally, the *Income Tax Act* provides very stiff penalties for any employee of the department who accepts a bribe, and for any person who offers a bribe.

CHAPTER THREE

ENDNOTES

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12. Orojo, J.O., "*Company Tax Law in Nigeria*", London, Sweet & Maxwell, 1979.
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22. *Supra*, note 20.
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54. S.93(1)(2).
55. S.94(3).
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70. (1967) E.A.L.R.; 434.
71. (1957) E.A.L.R.; 507.
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74. (1961) E.A.L.R.;136.
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- 82. S.89.
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CONCLUSION

Company tax law is the discipline which relates to the place of the law in the taxation of companies and to the manner in which this tax is applied and administered. By its very nature of being a distinct legal person, the company poses taxation problems.

The Income Tax Act includes a "legal person" as a taxable person. The *Act* specifically lists taxable incomes. These are reconciled with allowable and non-allowable expenses so as to derive an income tax computation. Items included in income are dividends, interests, royalties, management fees and any increase or decrease in the value of the inventory. A conclusion is drawn that any item of income is taxable if defined in the *Act*, or not taxable if left out from the list of taxable incomes.

Certain company expenses are deducted against taxable income. These include expenses generally or specifically allowed against taxable income. Certain capital deductions are also allowed e.g. wear and tear deductions and investment deductions.

Since a company is a distinct legal entity, its residence is of utmost importance in tax imposition. A Kenyan resident company is taxable in respect of all income no matter where it arises; a non-resident company is taxable on income arising from sources

within Kenya. The test of residence of a company is the place where the company does its real business and where the central management and control is found.

Some industries and companies are taxed differently and specially from the normal tax system, e.g. state-owned industries, industries in the Export Processing Zone, insurance companies, mining operations, etc. This is due to their peculiar natures and characteristics.

The taxpayer is required to make returns to the revenue so as to provide information necessary to set in motion assessments to tax. A company too must make a return of its total income for a year of income. It does this by making various returns which include the instalment return, the provisional return, the final return, the compensating return and the self-assessment return of income. A taxpayer who does not agree with the assessment for any year of income has the right to object and appeal against such assessment. It is important to understand the system within which this company taxation works and so the procedural aspects of the tax system must be explored.

The nature of tax law is that it is very dynamic. Since there are regular changes in the income tax law, it is essential to keep abreast with these changes. This

dissertation has attempted to cover the relevant amendments, in relation to company taxation, to the *Income Tax Act* upto the 1995 year of income.

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