

A CITIZEN'S HANDBOOK ON TAXATION IN KENYA

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Acronyms and Abbreviations

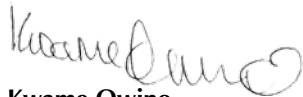
CMA	Capital Market Authority
CIT	Corporate Income Taxes
CIF	Cost Of Insurance
COMESA	Common Market for Eastern and Southern Africa
EAC	East African Community
EPPO	Export Promotion Programme Support
GDP	Gross Domestic Product
ITEP	Institute of Taxation and Economic Policy
KRA	Kenya Revenue Authority
LTU	Large Taxpayers Unit
MUB	Manufacture Under Bond
MSMEs	Micro, Small and Medium Enterprises
NSSF	National Social Security Fund
NTA	National Taxpayers Association
PAYE	Pay As You Earn
PIN	Personal Identification Number
SED	Single Entry Document
TJN-A	Tax Justice Network-Africa
TMP	Tax Modernisation Programme
TOT	Turnover Tax
TREO	Tax Remissions Export Office
VAT	Value Added Tax
WCO	World Customs Organisation
WTO	World Trade Organisation

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Kwame Owino,
Chief Executive Officer

Executive Summary

This handbook attempts to break down Kenya's complex tax system into a user friendly form for consumption by the average person. It among other issues discusses design of various tax heads, their purposes and differences and also how they are administered.

Taxation is the key source of revenue that the government of Kenya uses to provide public services to its citizenry. Over the last decade tax performance in Kenya has significantly improved in nominal terms averaging about 24% of the size of the economy. This has enabled the government to finance 60% of the budget. Due to its importance, tax policy debates and decision making becomes a critical issue to the public, to businesses and the economy at large owing to the varied impact that it will have on each of these entities. Therefore the design and performance of the tax system has implications for inequality and as such it is the role of the government to ensure that it pursues a fair tax system for equitable distribution of income and welfare of the citizens. The other important benchmarks for assessing the tax system include simplicity, adequacy and neutrality.

The tax system will hitherto passing the new Constitution of Kenya 2010 reflects a two tier system of government comprising the national and 47 county governments. According to the Constitution, the national government will retain the powers to impose taxes both direct taxes including income taxes and indirect taxes namely; value added tax, excise duty and customs or import duty. On the other hand the county governments' powers to impose tax will be confined to property taxes, entertainment taxes and other taxes that are feasible at this jurisdiction. Of the total tax revenue collected by the government over the last decade, the largest contributors are income tax, about 40% followed by VAT at 28%. However it is important to note that the burden on income tax and in particular pay as you earn is felt by about 20% of the total productive labour force raising fairness concerns despite income tax being the most progressive tax. Besides the use of tax credits and deductions such as a tax relief, this handbook indicates that to ensure fairness and that income tax is more progressive government reforms towards income tax should consider widening the tax brackets by applying high marginal tax rate for high income earners as well as adjusting income tax bands to ensure that salary increases that are commensurate to inflation rates do not artificially push income taxpayers to a higher tax rate. Unlike personal income tax that follows a graduated rate structure; corporate income tax is charged on profits from registered business entities at a flat rate of 30% for resident companies. However a number of businesses especially in the informal sector are not taxed again raising equity questions. The government has responded by introducing turnover tax which has not been performing well. Further the question on whether it is time to review the tax incentives regime with regard to meeting the key objective of attracting investment vis a vis the revenue loss incurred by the government was posed

As a way of generating more revenue in the wake of 1990, the government introduced the broad based value added tax as a consumption tax. However despite these reforms, VAT structure has faced a number of challenges including high administrative costs, leakages and distortion of the VAT system owing to exemptions and zero rating as well as low productivity. In addressing these challenges the government introduced and consequently tabled a VAT legislation that seeks to make VAT system simpler and rationalise zero rated and exempted supplies. Since VAT is a regressive tax, citizen oversight and contribution to the debate, amendment and final approval of the VAT law by parliamentarians will determine the extent to which it will burden poor.

Despite its moderate performance the composition of total tax revenue, excise duty, a tax applied on selective goods and services is a very important source of revenue to the government. In addition it is also used to discourage the consumption of harmful products such as tobacco and alcohol for public health objectives. To enhance its collection, reforms on excise duty have been characterised by shifting from specific tax rates (charged as per volume or quantity) and *ad valorem* (value based). Generally *ad valorem* is used where the objective is to raise more revenue whereas specific excised duty is used to correct negative externalities for example aforementioned effects of tobacco consumption.

The final tax head discussed are trade taxes applicable when importing or exporting certain goods and services. All imported goods are subject to import duty unless they receive preferential treatment. The current structure of eight tariff bands is determined by the international trade agreements that Kenya is party to, for example the East Africa Community and World Trade Organisation. Similar to the aforementioned three tax type, trade taxes are not only used for generating revenue but to facilitate trade and protect or bolster domestic manufacturing industry. As such reforms in customs have been determined by the objective the government wants to pursue with regard to international trade.

Introduction

Governments in both developed and developing countries collect taxes to fund public services. Marina *et al.* (2002) argue that, “taxation is the only known practical manner for collecting resources in order to finance public expenditure for goods and services consumed by any citizenry”. However, this is not strictly true, as developing countries; in particular, get revenue from other sources besides taxation, including non-tax revenue such as user-fees and licenses charged for services rendered by ministries, department and agencies, as well as income from sale of government assets and privatization. Moreover, many developing countries are dependent on foreign aid as an external source of revenue (Barnett and Grown, 2004).

Kenya’s dependency on foreign aid and borrowing has declined over the last five years, averaging about 11% of the total budget relative to the East Africa Community member states, whose budgets are financed to the tune of 30-40% by development partners. According to Barnett and Grown (2004), tax policy is at the heart of the political debate on the level of public services that should be provided and who should pay for them because taxes are the principal source of recurring revenue under government control. Besides, taxes are used to assist in the redistribution of wealth and incomes and to regulate economic activities. To this end, tax policy decisions have different impacts on different individuals, businesses and the economy at large.

Governments need to develop tax policies and tax systems that are guided by certain tenets. Since taxation affects incomes and prices of goods and services, individuals and businesses react differently in response to changes in income, and in relative prices, emanating from taxation. Therefore, analysis of the effects of tax policy is critical for government decision makers and the public to make informed policy decisions.

Tax issues have for a long time been viewed as a complex subject that should be left largely to tax experts. This perception has contributed to the huge information gaps on issues of tax policy, tax administration and tax performance reaching the public. This handbook, therefore, seeks to fill this gap by using a simplified approach to help the reader to a) understand how the various taxes are designed, b) differentiate the different types of taxes, and c) understand how these taxes are administered and the changes that have occurred in the tax system over the years. We hope that this handbook will be useful to the civil society and the general public looking to be more involved in tax dialogues and debates and in influencing tax and revenue policy decisions.

The next section discusses reasons we pay taxes and basic concepts and principles of taxation. This is followed by a section on division of taxes and the tax structure in Kenya. The final section looks at the four tax heads in Kenya, how they work, how they have changed

and how they relate with the taxation principle of equity or fairness with an emphasis on the two key tax heads in Kenya. A stand alone section on tax incentives and questions about whether they have realized their intended objective concludes this handbook.

1.1 Why do we Pay Taxes?

Governments provide a variety of services to their citizens, including education, health care, water, security, roads, and social security (for example, care for the elderly), among others. In order to provide these goods and services, governments, collectively, use taxes and other sources of revenue as stated earlier. As such, taxes are compulsory payments that do not necessarily bear any relationship to the benefits of government goods and services received (Hyman, 1990). It is important to note that, by paying taxes, we do not receive a direct and immediate service (instantaneously) in return; in other words, by paying tax amounting to, for example Ksh. 5,000 in January, does not mean that you will be able to enjoy health care, education, security services of an equivalent amount in the same month. The reason why we pay taxes is because one person cannot afford to fully pay for a service they use and thus it is the responsibility of governments to collect taxes in order to fund public goods and services for the benefit of the citizens.

The question and debate that follow is on what constitutes a fair system of taxation and a fair allocation of the tax burden; i.e., taxes based on wealth, on income and ability to pay, on economic activity or on perceived benefits (Spitzer, 2003). The answer to this is usually based on legal and statutory framework that governs the design of any country's tax system. Whatever the tax system design, the widely documented common objectives of tax systems include:

- to raise revenue to be used to fund government operations;
- to assist in the redistribution of wealth and income (fairness/equity question); and
- for regulation purposes, with a view to encourage or discourage certain activities such as smoking.

Box 1: What is the Difference between User Fees and Taxes?

Classifications	Basic characteristics	Protections	Accounting
Taxes	Burdens or charges imposed by legislative authority on persons or property to raise money for public purposes. There is no relationship between the person who bears the burden of at tax shilling and who determines how to spend tax revenues. Examples include income taxes, excise taxes, property taxes and so on.	Express statutory authority always required. Subject to limits, uniformity requirements and other controls on tax levels and allocation of burden among taxpayers	May be deposited in any fund the legislative body elects. In the case of Kenya, National Government taxes deposited in the Consolidated Fund whereas at the County Government level is deposited in County Revenue Fund

Classifications	Basic characteristics	Protections	Accounting
User Charges:			
i) Commodity charges	Imposed to pay for the provision of commodities or services of direct benefit to consumers. Examples include water rates, connection charges and so on.	Commodity charges must be uniform within classes of customers and classes of service. May not exceed allocable share of cost.	Must be deposited in special fund. May not be transferred to general fund or other special fund for purposes of the those funds
ii) Burden offset charges	Imposed to offset cost of handling burdens on others and on public resources (externalities) caused by the payer's activities. Example includes but not limited to garbage rates , water utility charges and sewer rates	May not exceed payer's allocable share of cost of programmes or improvements to handle burdens caused by payer's activities. Must be uniform within classes of service and classes of users. Certain impact fees must be used within certain periods for identified facilities	Must be deposited in special fund. May not be transferred to general fund or other special funds. Must be used to pay for program facilities or activities.
iii) Processing and inspection fee (True regulatory fees)	Imposed to pay cost of governmental handling of payer's applications or requests or to pay for inspection and control of payer's activities. Example includes building permit fees, housing inspection fees, and professional licensing fees and so on.	May not exceed allocable share of cost of processing , licensing or inspection and enforcement program	Must be used to pay for processing or program activities.

Source: Adopted from Spitzer (2003)

1.2 Basic Tax Concepts and Principles

To answer the question of whether everyone has to pay the same tax, one needs to understand some basic principles for evaluating a tax system and some of the common concepts used for a better understanding of tax policy issues. The most commonly documented principles or characteristics that guide tax policy include: equity, adequacy, simplicity, and neutrality.¹ Detailed explanations of these principles are given hereunder.

- **Adequacy** – A tax system is said to be adequate if it raises enough funds to pay for public services, and more so, in a sustainable manner. There are two factors that contribute to the adequacy of a tax, namely, stability/predictability and its elasticity. In the preparation of the Budget, policy makers usually match expected spending within a realm of

1. Inferred from the ITEP Guide to Fairs State and Local Taxes

predictable growth of tax revenues. However, in order to achieve adequacy in the long run, they would like to know whether growth of a specific tax keeps up with the pace of the growth of the economy (elasticity).

- **Simplicity** - This ensures that the tax system has simple rules for citizens to understand and at the same time ensure that the cost of tax collection and administration is not higher than the actual tax raised. For example, a tax system is made complex if it has many tax exemptions such as tax credits, tax breaks, and tax holidays, among others. The complexity is likely to increase the cost of collection and administration.
- **Neutrality** - The other similar term for neutrality is efficiency. This principle answers the question of whether the tax system interferes with the investment and spending decisions of individuals and businesses (see Box 2).

Box 2: Tax Efficiency

Marina *et al.* (2000) states that:

“The objective of a good tax system is to distort or alter as little as possible the economic decisions of persons and firms as compared with the decisions they would have made if the taxes were not collected at all (an entirely hypothetical condition). The less a tax affects the decisions of enterprises about production, or the decisions of consumers about purchasing, the more we say it is efficient. But how can a high degree of tax efficiency be ensured in practice? This is achieved in the following ways:

- expanding the taxable base by abolishing tax exemptions and tax incentives for individual taxpayers;
- reducing the number of tax rates; and
- lowering the tax rate levels”.

- **Equity** - The question of equity or fairness in taxation arises in many tax policy debates. Equity in taxation expresses the idea that taxes should be fair as one of the principles that guide tax policy. There are two measures of equity; namely,
 - i) horizontal, and
 - ii) vertical.

A system is horizontally equitable if taxpayers, in similar circumstances, pay similar amounts of tax. This implies that, if you have two families with an equal income level then by paying the same amount of tax they would pass the test of horizontal fairness, otherwise if one of the families pays a higher amount of tax, this amounts to violating the principle of horizontal fairness. In contrast, vertical equity refers to the idea that people with a greater ability to pay, that is individuals earning higher incomes or rich people, should pay higher level of tax compared to poorer people (TJNA, 2011).

The ability to pay is one of the measures for evaluating equity or fairness, whereby those with a higher income pay a higher percentage of tax than the people with a lower income. The alternate measure that is commonly used for user-charges and local taxation is that of benefits received (Barnett and Grown, 2004). It is used to assess taxpayers in proportion to the benefits they receive from public services; implying that those who receive the same benefit should pay the same, and those receiving higher levels of benefits pay more, and vice versa. The extent to which these measures are useful is made complex in a situation where you have a poor population that needs a great deal of public benefits yet it has no ability to pay.

According to the ability to pay criterion, the rich should pay more tax, given their capacity. But just how much more should they be paying? Numerous tax debates have followed this question. Below is an attempt to illustrate the problem with the help of Table 1.

Table 1: Measuring Equity in Taxation

Income (Ksh.)	Proportional tax		Regressive tax		Progressive tax	
	Amount of tax (Ksh.)	Tax as % of income	Amount of tax	Tax as % of income	Amount of tax	Tax as % of income
20,000	5,000	25	6,000	30	4,000	20
40,000	10,000	25	10,000	25	10,000	25
60,000	15,000	25	12,000	20	18,000	30

Source: Adopted from Mankiw (1998).

In all the examples in Table 1, those who have larger incomes also pay the most tax. But the percentages of their incomes set aside for taxation differ a great deal.

- In the first case, the tax is **proportional**, because all the taxpayers pay the same percentage of their income.
- In the second case, the tax is called **regressive** because the rich, although paying larger amounts of tax, actually pay smaller percentages of their income.
- In the third case, the tax is **progressive**, since the rich pay a greater percentage of their income in the form of tax.

Which of these cases is most equitable? The question has many answers, depending on which angle you look at it. ITEP (2011) gives some of the key reasons why tax fairness should be considered as an important goal by policy makers. These reasons are:

- Fair taxes are essential to adequate funding of public services because they tax those who have the most to give.
- Fair taxes help the government in its relations with its citizens, who are likely to support and tolerate tax reforms that will lead to fair tax systems.
- A fair tax system is important on grounds of moral imperative.

Box 3: Basic Terminologies on tax

- The **tax base** is all items or activities subject to a tax. It is important to distinguish between the potential tax base and the actual tax base. Potential tax base constitutes a set of items that would be taxed if there were no special exemptions; whereas the actual base what is used, given exemptions and other benefits and it is often much smaller. Tax base is measured to the shilling amount to which a tax rate is applied.
- The **tax rate** is usually defined as a percentage of a certain value - the tax base. Therefore, multiplying say a VAT tax rate of 16% on a taxable item such as a pair of shoes (tax base) worth Ksh. 2,000, the total amount of tax to be collected from this purchase amounts to Ksh 320.
- **Tax burden** - refers to the amount of tax borne by an individual or a business. Tax burdens vary depending on a number of factors including income level, jurisdiction and current tax rates. It is worth noting that tax burden may not be the same as the tax actually paid because of the possibility of passing a tax on. This distinction helps explain who has the legal liability of a tax-who has the “statutory burden” and who actually bears the ultimate burden of the tax-who has the tax burden i.e. bears the economic incidence of the tax
- The **average tax rate** is calculated by dividing the total income taxes paid by your total income.
- The **marginal tax rate** is the rate of tax applied to the last shilling added to your taxable income

Source: Institute of Taxation and Economic Policy, ITEP (2011) and TJNA (2011)

1.3 Division of Taxes

Following the promulgation of the new Constitution of Kenya in August 2010, the tax system will henceforth reflect a two-tier system of government, national and county government, where some fiscal (government finances) power and responsibilities will be delegated to the county government by the national government.

Within any given structure of tax system, the following need to be considered when designing and assessing taxes:

- basis on which the tax is levied (on income, for example, or on consumption);
- level of government to which the tax revenue is paid (national government taxes, county taxes, for example); and
- extent to which different sections of the population are affected (whether they are progressive or regressive taxes, for example).

The most common division of taxes is into either direct or indirect taxes. Direct taxes are those that we pay personally as taxpayers, or which our employers pay directly to), the agency mandated to collect taxes on behalf of Treasury. These are worked out as a percentage of our income or assets; and as a rule, cannot be shifted to a different party. What this means is that whoever pays the tax is the actual person incurring the cost of the tax. Examples of direct tax are the income tax deducted from salaries, from royalties or trades, and corporate income tax.

Indirect taxes, on the other hand, are not borne by the person who has the responsibility of surrendering to KRA; rather, they are often transferred to a third party, for example end-users or consumers of goods and services. Taxpayers of indirect taxes most commonly shift the burden (see Box 3) of these taxes through the prices of their goods and services, onto the end-user, that is, to the population at large. The classic example of indirect taxes is consumption taxes including: Value Added Tax (VAT); excise duty; trade taxes among others.

The characteristic of the tax system in Kenya is that, tax revenue is spread across various different tax instruments (both direct and indirect). The advantage of this is that it can help the fiscal system to better withstand economic fluctuations and can minimize the tax burden on any particular group of taxpayers or sectors of the economy. Further, tax policy in Kenya has changed over time towards relying more on indirect taxes as a major source of finance for development budget as a deliberate move intended to reduce the burden on income taxation so that savings and investments could be promoted (Karingi *et al.*, 2005).

1.4 Tax Structure in Kenya

Article 209 of the Constitution of Kenya 2010 outlines powers to impose taxes or raise revenue for both the national government and the county government. The assignment of revenue responsibility between these two tiers of government is in keeping with the devolution framework, whose design ensures that the national government has responsibility over most of the taxes with significant tax bases. In particular, the national government will solely be responsible to impose income tax, value added tax, custom duties and excise taxes. The justification for this is that the national government needs to retain the ability to redistribute national resources and stabilize the economy as the key objectives of tax systems.

In so far as the county governments are concerned, Article 209 (3) empowers them to impose property taxes, entertainment taxes, and any other tax as authorized by an Act of parliament (see Table 2). In addition, county government may impose charges on services provided at the local level.

Table 2: National and county Government Taxes

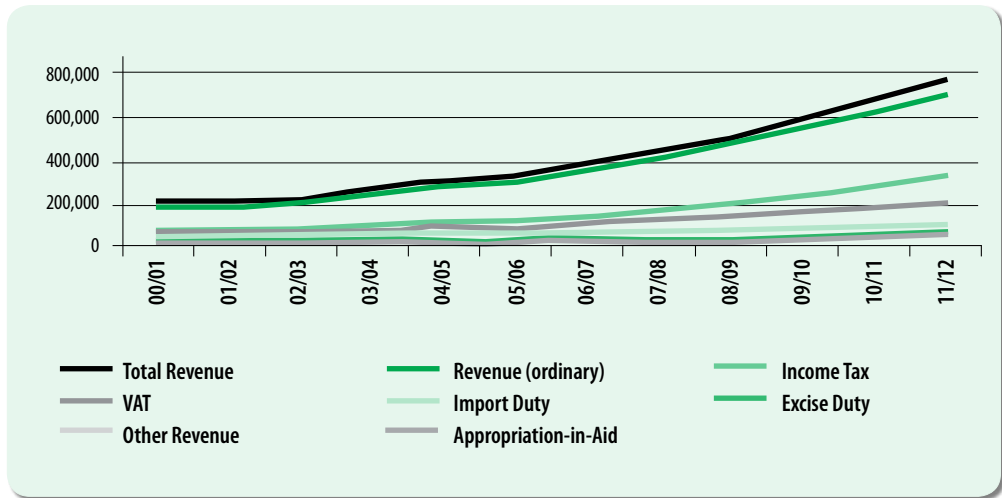
National Government taxes	County Government taxes
• Income tax	• Property tax
• Value added tax (VAT)	• Entertainment tax
• Excise tax	• Other taxes
• Custom duty/import duty	

Source: RoK, Constitution of Kenya 2010

1.4.1 Trends in tax revenue

Other than the redistribution function, taxation in Kenya is also used for allocation and stabilization functions. According to Karingi et al. (2005), Kenya has moved from a low tax yield country during the 1980s, when total tax revenue as a percentage of Gross Domestic Product (GDP) which is measure of the size of the economy, averaged 19.7% to the current average of about 24% following continuous reforms through the Tax Modernization Programme (TMP) after 1994/95 to date. The tax revenue performance over the period 1991/92 - 2010/11 has maintained a consistent growth, in nominal terms (see graph in Figure 1).

Figure 1: Trends in Tax Revenue

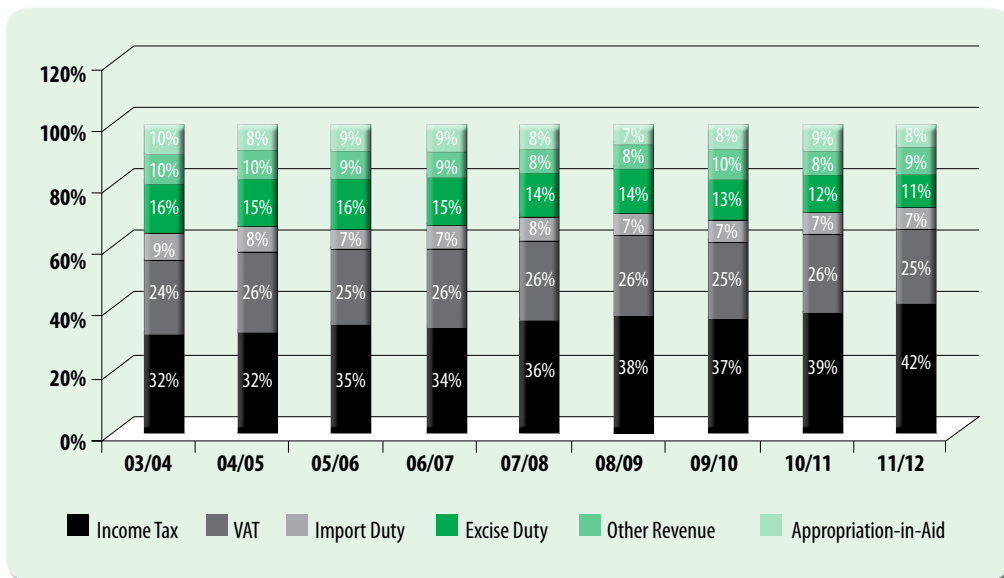


Source: Statistical Annexe to the Budget Speech for FY 2007/08 & 2011/12

It is important to note that tax structure in Kenya is skewed heavily towards income taxes and Value Added Taxes (VAT) as the two largest source of total tax revenue. For example, for the period 2005/06 - 2011/12 income tax accounted for 36.3% of total government revenue (total taxes plus appropriation-in-aid). VAT comes in second, averaging over 25% in the same period, followed by excise duty with import duty and other taxes (for example, stamp duty) accounting for more or less similar proportions. Appropriation-in-aid is a non-

tax source of government revenue constituting user charges collected in form of fines, licenses and other charges when a ministry or government department offers certain goods and services, for example passport application fees. All these fees are, at this juncture, referred to as user-charges but whenever the said ministry that generated the fees applies them to finance a certain operation/expense the amount spend is in turn referred to as appropriation-in-aid.

Figure 2: Composition of Government Revenue



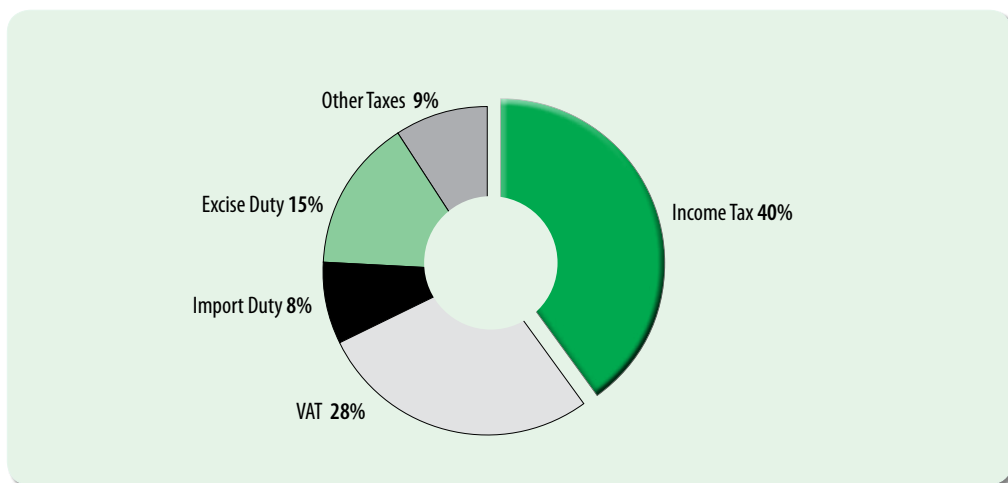
Source: Statistical Annexe to the Budget Speech for FY 2010/11 & 2011/12

This therefore implies that, total taxes on goods and services (VAT, excise duty, and trade taxes), also referred to as indirect taxes, as compared to taxes on income and profits, are more important in Kenya’s tax structure. This is in line with Kenya’s policy to shift reliance from direct taxes to indirect taxes to finance the budget and also as a way of reducing the burden on income taxation in order to stimulate savings and investment.

2. Types of Taxes in Kenya²

2.1 Income Tax

As a taxpayer, the month of June could mean many things but one of the things that surely come to mind for many is the mandatory requirement from Kenya Revenue Authority (KRA) to adhere to filing tax returns before 30th June, so long as you have an income. This income could be from a salary as an employee, you run a registered business which brings you income, obtain rental income, invested in shares and earn dividends, do consultancy and earn consultancy fees, are a registered company or you could even be a retiree dependent on pension. The deductions are withheld from either personal income or corporate income and surrendered to KRA.



2.1.1 What it is?

Income tax is a direct tax charged on incomes of individuals from

- employment,
- self-employment,
- profits from business entities,
- income taxes such as rent incomes, dividends, interests, pensions, royalties, income from management or professional fees, and
- others.

Income tax can thus be broadly grouped into individual, corporate, withholding and other income taxes. Indeed, income from individually-owned businesses is referred to as

² It is important to note that tax rates, tax bases or administrative issues for the various taxes and duties may change from year to year dependent on the approved Finance Bill that is tabled in parliament every financial with various tax or revenue mobilization measures or proposals.

personal income tax and that from employment is subject to Pay As You Earn (PAYE). Further, tax withheld from the other incomes as aforementioned is referred to as withholding tax whereas corporate income tax is charged on profits of limited liability companies.

Income tax is governed by the Income Tax Act, Cap 470 Laws of Kenya, which is the principal legislation with schedules and subsidiary legislations. The principle law of the Income Tax Act has 14 parts, 133 sections and 13 schedules. In fact, the administration of various direct taxes, which have different rates, is undertaken by the Income Tax Department at KRA. The Minister for Finance, when reading Budget Statement 2012/13 in Parliament, mentioned that his Ministry is committed to review Income Tax Act following tabling of the VAT Bill, 2012 for debate and approval in Parliament.

2.1.2 Purpose of income tax

Generally, income tax in Kenya is used for revenue mobilization and income redistribution purposes. Income tax is used to achieve equity objectives through rationalization of tax brackets and rates; in other words, tax brackets could be broadened or the number of brackets increased and the tax rates could be increased or reduced depending on the objective. The redistribution and equity purposes are more evident with personal income tax than with the other types of income tax. Evidently, the rationalization of tax brackets and rates is done so as to reduce tax burden on those with lower and fixed incomes and make the tax more equitable.

2.1.3 How income tax works

First, income tax is charged on the income earned by any person resident in Kenya. A resident is defined as an individual who has permanent residence in Kenya, and has spent any part of the working year(s) in the country; or, one without permanent residence in Kenya but who has spent 183 days or more, working in the country during the period of assessment. A foreign employee in a non-Kenyan firm who is resident in Kenya is subject to tax on all emoluments.

Income from Employment

The income from employment that is taxable includes salaries, wages, commission, bonus, allowances and compensation for termination of employment or self-employment. The method of collecting tax at source from individuals in formal employment is called Pay As You Earn (PAYE). The employer deducts a certain amount of tax from the employee's salary or wages on each payday then remits the deductions to the KRA. This relieves the employee from paying taxes at the end of the year and shifts the responsibility to the employers.

Individual income (both PAYE and personal income tax) is taxable at the same graduated rates from 10% up to 30%. The first taxable band is for an annual income of Ksh 121,968 at the rate of 10% and the top tax bracket is for an annual income over 466,704 at 30%. It is important to note that tax rates and tax brackets are subject to change from time to time and the prevailing tax brackets and tax rates since 2005 is what is captured in Table 3.

Table 3: Personal Income Tax Structure (2005 - 2012)

Annual Taxable Income (Ksh.)	Bands of Taxable Income p.a. (a)	Taxable Income	Tax Rate (b)	Tax on Bands {(a)*(b)}	Cumulative tax on Income
0 - 121,968	121,968	121,968	10%	12,197	12,197
121,969 - 236,880	114,911	236,880	15%	17,237	29,434
236,881 - 351,792	114,911	351,792	20%	22,982	52,416
351,793 - 466,704	114,911	466,704	25%	28,728	81,144
Over 466,704	Over 466,704		30%		

Source: KRA

Furthermore, tax allowances are provided for all individual taxpayers. Kenyan residents working abroad are given credit of foreign tax paid on the salaries earned in the respective countries.

Every individual who receives an income is granted a tax credit or a tax relief - this is known as personal tax relief which is Ksh. 13,944 per annum. Insurance relief of 15% of premiums paid to a minimum of Ksh. 60,000 per annum and mortgage relief are also available for eligible persons. The total tax credit is spread evenly during the charge year. At the end of the year, an individual will submit his self-assessment on total income received from various sources. Should the tax credit be lower than actual tax charged during the year, the balance of tax due will be payable.

Below is an illustration of how PAYE is calculated for Ms X who earns Ksh. 50,000 per month over and above the tax relief, and since Ms X pays education insurance premium for her son Y, she is eligible for insurance relief.

CALCULATIONS		Pay Slip	
Basic earnings	50,000.00	EARNINGS	
Less: Pension	2,500.00	Basic pay	50,000.00
Gross pay	47,500.00	Gross pay	47,500.00
Less: NSSF	200.00	TAX CALCULATION	
Taxable pay (i)	47,300.00	Less: N.S.S.F	(200.00)
Tax thereon		Taxable pay (i)	47,300.00
First 10,164 @10%	1,016.40	Tax charged (ii)	9,284.40
		Relief (iii + iv)	1,912.00

Next 9576 @15%	1,436.40	DEDUCTIONS		
Next 9576 @20%	1,915.20			
Next 9576 @25%	2,394.00		P.A.Y.E (v)	7,372.40
Balance of 8408 @30%	2,522.40		N.S.S.F	200.00
Total tax liability (ii)	9,284.40		Pension	2,500.00
Less: Personal relief (iii)	1,162.00			
Less: Insurance relief (iv)	750.00	SUMMARY		
Net tax liability (v)	7,372.40	Gross pay	47,500.00	
NET SALARY	39,927.60	Less: Deductions	7,572.40	
		NET SALARY	39,927.60	

Assumptions:

Ms X contributes 5% of basic earnings towards a pension fund.

Ms X gets an insurance relief of 15% of total premiums paid. She contributes

Ksh. 5,000 towards the insurance scheme per month.

Steps in calculation of net tax liability and the net salary

- Gross pay is obtained by deducting pension Ksh 2,500 (5% of Basic pay Ksh 50,000) to get Ksh Ksh 47,500
- To obtain taxable pay, another statutory deduction of National Social Security Fund (NSSF) of Ksh 200/month is deducted from the basic pay to obtain Ksh 47,300
- Taxable pay is subjected to tax rates (10%) up to the 30% for balance of Ksh 8,408 to obtain a total tax liability of Ksh 9,284.40
- Furthermore, the net tax liability of Ksh 7,372.40 by subtracting tax credit/relief of personal relief Ksh 1,162 (Ksh 13, 944 per annum divided by 12 months) and insurance relief of Ks 750 (15% of Ksh 500)
- Finally the net salary is obtained deducting Ksh 7,372.40 from the taxable pay of Ksh 47,300 amounting to Ksh 39,927.60

What is considered for income tax?

- Insurance premium paid by an employer for the benefit of an employee or their dependants is taxable on the employee.
- Allowance given to an employee while on duty.
- Employment benefits in kind, whose total value exceeds Ksh. 36,000 per annum are taxable at the higher[something missing here] of cost to the employer of providing the benefit. For example, if an employer provides a house to an employee it is taxed to this employee at varying rates for directors, whole time service directors, agricultural employee, and for other employees. The other benefits include motor vehicles provided by an employer, taxed dependent on the engine capacity, whether leased or hired and sometimes at the prescribed rate by the Commissioner.

What is not considered for income tax?

There are some employment benefits that are tax free, including:

- Employer contribution to an employee's insurance premium that is paid to a pension or provident fund or even to an individual retirement fund.
- Medical benefits provided to a full time employees and a whole-time service director (holding less than 5% shares).
- Education fees of an employee's dependants or relatives, if taxed on the employer.
- Education fees paid by an educational institution for low-income employee's dependants attending the institution.
- Meals served to low-income employees in canteens operated or established by an employer within their premises for the benefit of the employees.
- The cost of international passage paid for by an employer for an employee who is not a Kenyan citizen, recruited outside Kenya and is in Kenya specifically to discharge his/her official employment duties.

Box 4: Understanding Marginal Rates

Tax policy debate sometimes confuse the distinction between effective tax rates, which tells us what fraction of a taxpayer's income goes to income tax overall and marginal tax rates which tell us the tax rate that applied to the last shilling of income. For example someone earning Ksh 130,000 per year may conclude that they will have to pay 15% of their income in tax according to the PAYE graduated tax structure. However, tax rate in this structure is based on taxable income, not total income. Supposing there are no deductions, the taxable income remains Ksh 130,000 per year taxable at a rate of 10% for the first part of Ksh 121,968 and the remaining Ksh 8,032 will be taxed at a rate of 15%. On the other hand if total deductions are Ksh 20,000, then the taxable income reduces to Ksh 110,000 and the applicable tax rate is 10%.

Source: ITEP (2011)

(b) Corporation Tax

Corporation tax is similar to the individual income tax, only that it is levied on companies and it does not have a graduated rate structure. Resident companies are taxable at a rate of 30% while non-resident companies are taxable at a rate of 37.5% (see Table 4).

Table 4: Corporate Tax Structure

Type of business	Resident
Corporate tax rate	30%
Export processing zones enterprises	
First 10 years	0%
Next 10 years	25%

Newly listed companies at the Nairobi Securities Exchange (NSE) over 20% capital listed (3 years)	27%
Newly listed companies at the NSE over 30% capital listed (5 years)	25%
Newly listed companies at the NSE over 40% capital listed (5 years)	20%

Source: Kenya Revenue Authority

From Table 4, enterprises in the export processing zones operating for the first ten year are exempt from paying any corporate tax, which is zero, but for those operating for the next ten years are taxed at 25% of their profits (tax incentives topic is discussed further later in this handbook). The table also contains information on the corporate income tax rate for new listed companies at Nairobi Securities Exchange by proportion of capital base and period.

(c) Withholding Tax

Withholding taxes are deducted at source from the following sources of income: interest from bank at 15%, interest on housing bonds at 10%, dividends at 5%, royalties at 5%, insurance commission at 5%, and insurance brokerage at 10%. Further, other services payments, including management or professional fees, consultancy and training fees exceeding Ksh. 24,000 per month are charged at 5% as per the Finance Act 2011.

(d) Taxing the micro, small and medium enterprises (MSMEs)

Literature shows that MSMEs in Kenya operate largely in the informal sector. This sector constitutes 80.8% of total employment in Kenya by 2011 (Economic Survey 2012). A **Turnover Tax (TOT)** was introduced by the Finance Act, 2007 through the provision of the Income Tax Act, Cap 47 as one of the approaches of taxing the informal sector. It came into effect on 1st January 2008. According to KRA, Turnover Tax is applicable to any resident person whose turnover from business does not exceed Ksh. 5 million at the rate of 3% of turnover. TOT is applicable to the following businesses, namely: trade, profession or vocation and every manufacture, adventure and concern in the nature of trade. However, it excludes turnover from the following:

- i) persons whose business income has an annual turnover below Ksh. 500,000,
- ii) employment income,
- iii) exempt incomes falling under the 1st Schedule of in the Income Tax Act,
- iv) business incomes, subject to a final withholding tax,
- v) limited companies,
- vi) rental income, and
- vii) professional or management fees.

Furthermore KRA introduced advance tax as further attempt to net MSMEs and also as a way of formalising the informal sector businesses. This tax is applicable to owners of commercial and public service vehicles. It is not a final tax, but a tax partly paid in advance before a public service vehicle or commercial vehicles are registered or licensed and the objective is to ensure compliance. The current rates are:

- For vans, pickups, trucks and lorries Ksh.1,500 per ton of load capacity per year or Ksh.2, 400, whichever is higher.
- For saloons, station wagons, mini-buses, buses and coaches, Ksh.60 per passenger capacity per month or Ksh.2, 400, whichever is higher.

Tax Returns

To transact business with KRA, any person above 18 years of age should have a computer generated Personal Identification Number (PIN). As such a person chargeable to tax must complete and submit to the Commissioner a self-assessment annual tax return on dates specified below:

- Individuals (employees and sole proprietors) on or before 30th June every year.
- Corporate bodies (limited companies, trusts, among others) on or before the last day of the sixth month after the end of the accounting period.
- A Turnover Tax (TOT) taxpayer must submit quarterly returns on or before the 20th day after the quarter.

2.1.4 How income tax has changed over time/income tax reforms

Income tax in Kenya has undergone a number of changes since independence period of 1963/64, and more during the implementation of the Tax Modernization Programme that was started in the 1980s. These changes are evident in the design, structure, administration, and performance of income tax system.

First, the legislation that governs income tax, the Income Tax Act, was effected on 1st January 1974 after the dissolution of the East African Community (EAC) Management Act, where one income tax law governed all the member countries of EAC. Further, upon formation of the Kenya Revenue Authority on 1st July 1995, income tax was absorbed as a department of the Authority. The Commissioner of Income Tax who is appointed by the Minister for Finance heads the department.

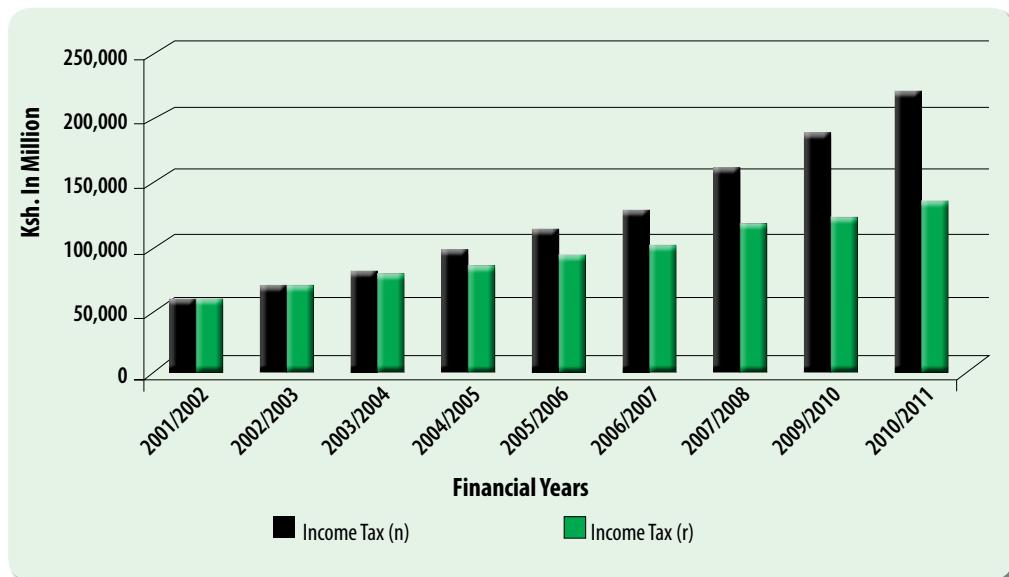
Performance of income tax in Kenya

The collection of income tax has increased over time from Ksh.7 billion in 1991/92 financial year to Ksh. 216 billion in 2009/10 as shown in Figure 3. Much of the growth has been attributed to the various reforms that have been undertaken by KRA as well as improved economic performance brought about by increased economic activity. Improved tax performance has further enabled the government to finance a significant proportion of the national budget from local resources. For example, the proportion of the budget financed from income taxes improved to an average of 33% of the budget in the period 1991/92 to 2009/10. However, on factoring inflation³, the graph on Figure 2 shows, for the period 2001/02 to 2009/10, that real income tax increased from Ksh. 55,562 million in 2001/02 to Ksh.132,785 million in 2009/10 compared to nominal income tax increase of Ksh. 55,562 million to Ksh. 216, 760 million over the same period. It is always important

3. Inflation is defined as the persistent increase in prices of goods and services over a given period of time. Inflation normally erodes one's purchasing power in that Ksh 100 in 2007 when the annual inflation rate was below 10% will not buy the same amount of goods and services when inflation rate is now over 10%.

to factor inflation rate when considering the growth of anything that has a monetary value so as to get the real or true picture of the actual growth over time. Overall, the government has heavily relied on this tax head in its day to day financing explained by the fact that PAYE comprises the largest share of total income tax (over 60%) and it is easy to collect and administer.

Figure 3: Performance of income Tax in Kenya



Source: Various issues of Statistical Annexes to the Budget and KRA Statistical Bulletin

It is also important to point out that since the total number of employees in the formal sector paid wage or salary has not been increasing much as by 2010 it was 2.06 million out of a total labour force (15-64 years) of slightly over 10 million (Statistical Abstract, 2011). The implications of this is that a small proportion of the population, about 20% is bearing the burden of paying PAYE and this raises tax equity concerns.

From a reform perspective, KRA has undertaken key reforms to modernize its tax administration systems, geared towards lowering the cost of collection. Some of the reforms include establishment of the Large Taxpayers Unit (LTU) in 2000. According to KRA, this department was established with the objective of strengthening tax administration in order to a) achieve increased control over large taxpayers, b) improve the audit of large taxpayers, and c) improve and increase compliance among large taxpayers. LTU targeted income tax taxpayers with an annual turnover in excess of Kshs.500 million, all banks, insurance companies, and loss making companies with turnover in excess of Ksh.250 million. The top 200 VAT taxpayers over a two-year period were also selected into the LTU for purposes of VAT; while for excise duty, any person paying amounts in excess of Kshs.1.2 million was recruited into the LTU. In addition, the introduction of instalment tax for corporation tax

in 1990 was another key milestone in the transition phase. With instalment tax, it meant that corporate taxes would be paid in 4 instalments based on the lower of the previous year's profits or the current years expected profits. It was very instrumental in smoothing the flow of revenues by ensuring that tax liability for taxpayers and revenues for government was evenly distributed throughout the year. This had major implications in government financing by ensuring that funding was steady and fairly predictable which is a necessary component for good planning. Box 5 gives a summary of the various reforms.

Box 5: Features of Revenue Administration Reforms

- Implementing appropriate, simple, and transparent tax and trade legislation, to provide the best environment for compliance and support international agreements;
- Implementing simple, up-to-date procedures to reduce burden on taxpayers and traders, improve the effectiveness of controls, and promote integrity and transparency in processes;
- Rationalizing organizational and management structures (e.g., organization design, layers of management, spans of control);
- Promoting voluntary compliance and use of risk management techniques to provide the most cost-effective outcome;
- Developing “holistic” approaches to taxpayer services (e.g., understanding all of their tax obligations) and responding to their behaviours in an integrated manner. This requires examining all taxes together;
- Employing post clearance controls in customs to identify and correct inconsistencies in the application of legislation and procedures at the time of release and to assist in the identification of potential fraud;
- Ensuring effective protection and surveillance functions in customs;
- Effective use of automated systems to: gather, collate and share information using reliable databases and a common identification number; undertake selective checking based on risk analysis; standardize payment processes and accounting requirements; provide assurance that the legislation and procedures are being applied uniformly; and provide adequate, timely information to support management decision making and tax policy formulation; and
- Increasing autonomy to recruit, train, retain, and motivate high calibre staff; measure performance and remove ineffective and corrupt officials; control budgets, pay competitive salaries, and operate flexibility (e.g., moving staff to meet workload needs).

Source: KRA

2.1.5 Income tax in relation to the principle of equity

The way the tax rates of country works can determine the extent of fairness of the income tax system. Kenya's design of income tax especially personal income tax takes the graduated tax rate schedule which means that higher tax rates and in turn tax burden are applied to those people with higher income levels. Literature shows that the design of Kenya tax policy uses income taxes redistribution purposes. This has been achieved through a structure combining income brackets with marginal tax rates., For example, in the period before tax reforms were initiated (before 1983), Kenya personal income tax schedule had eight income tax brackets and high marginal tax rates, with the lowest being about 10% and the highest being 65%. However, the post-reforms period witnessed the rationalization of income tax brackets and marginal tax rates by widening (reducing the number of brackets) and lowering the marginal tax rate from 65% to the current 30% rate.

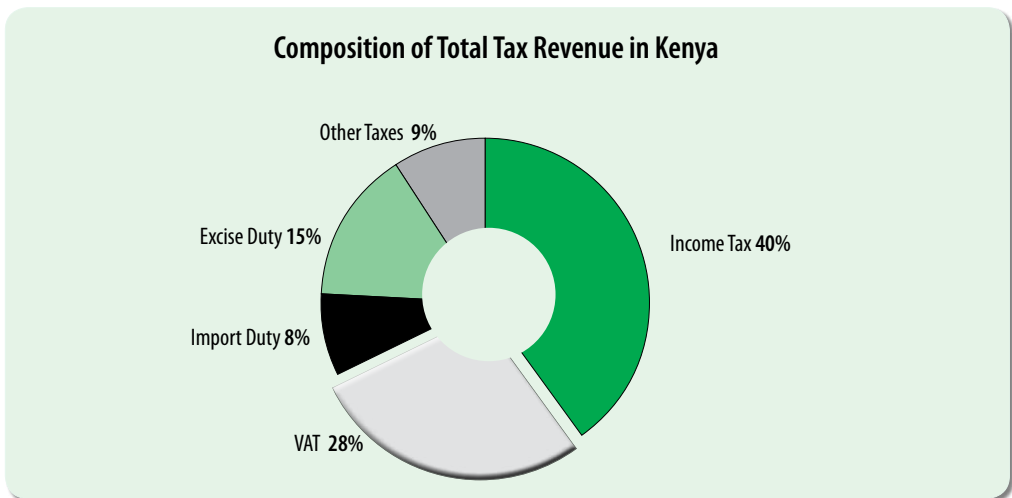
The current marginal tax rate of 30% for tax band of over Ksh. 38,892 per month is a low progressivity tax system.. It seems unfair to charge someone earning over Ksh. 1,000,000 per month at the same rates of 30% marginal tax rate with someone earning Ksh. 38,892. Therefore for improved and true progressivity the top marginal tax needs to be reviewed and increased upwards.

Furthermore, review of income tax bands should be accompanied by adjusting them for inflation. Supposing that one had a salary of Ksh. 10,164 implying that they fall within the first income bracket Ksh 0-10,164 per month taxed at a rate of 10% in PAYE graduated tax structure. Assuming that over time their salary grows at the same rate as the prevailing rate of inflation, means that the person may find themselves paying income tax at a higher rate because the rise in salary may push them partly or fully into the second bracket of Ksh. 10,164 -19,740 to pay tax at a rate of 15% or even to the third bracket, giving an illusion that they are richer and hence paying at a higher rate yet in real terms they are not. This whole phenomenon is referred to as "bracket creep" and is often addressed by indexing or adjusting tax brackets for inflation so that if salaries rise at the same rate as inflation, then the person still pays their income tax at the same marginal tax rate, which is the level of tax threshold that reduces the tax burdens of the poor.

The second instrument that governments use to achieve equity and fairness in income tax is through personal income tax credits and deductions. In Kenya, for every registered income taxpayer, their income notwithstanding is provided with a tax relief. Currently the annual level of relief is Ksh. 13,944, a unification of both the single tax and the married (family) relief into one. With regard to corporations, corporate income taxes (CIT) were lowered from 45% in 1989/90 period to the current 30% in order to compete favourably with other countries for investment funds. Secondly, CIT rates were lowered to make it equal to the top marginal personal income tax rate (30%) for purposes of horizontal equity.

2.2 Value Added Tax (VAT)

Whenever you go to the supermarket to shop for household items after paying for the items at the teller you are issued with a receipt. A closer look at the receipt shows the items bought and their respective prices and below the receipt, in what will comprise the total price, is a section showing the VAT rate 16%, the VATable amount (for items that are levied VAT on purchase) and the VAT amount as a calculation of 16% of the VATable amount. Similarly, on receipt of electricity bill, the billing details show the VAT rate for electricity which is 12%. Therefore, whenever you purchase something or pay for a service that is not exempt from VAT you will pay according to the applicable VAT rates.



2.2.1 What it is?

VAT is an indirect tax levied on the consumption of goods and services, and it is charged at each stage of production and distribution chain up to the retail stage. VAT is also levied on imported taxable goods and services. Therefore, it is a tax on the difference between what a producer pays for inputs (raw materials, and services such as advertising) and what the producer charges for finished/final goods and services and hence the word “value added.”

From the perspective of the seller, it is a tax only on the value added to a material, product, or a service but from the buyer’s perspective, it is a tax on the purchase price. Some of its key characteristics are as follows:

- a) it has wide coverage, including manufactured goods, services, and imported goods,
- b) it is charged on selling prices,
- c) it is charged where value is added,
- d) it is easily separable from other costs,
- e) VAT avoids the cascading effect of a tax, that is, VAT is not charged on another tax, and
- f) the input tax is claimable immediately by offsetting from the output tax.

2.2.2 Purpose of VAT

Alan (1990) explains three key reasons why a number of countries have adopted VAT:

- *Revenue generation:* The adoption of VAT by a number of countries has arisen out of their dissatisfaction with their existing tax structure. Income tax, for example, has been either unreliable or volatile for countries that have a limited income tax base or those that rely on revenue from primary commodities such as oil, minerals, coffee, sugar and cocoa. In addition, before the adoption of VAT, most countries relied on sales tax as the main consumption tax which is seen to be narrow-based (levied on goods only) and difficult to administer especially at high rates. To this effect VAT is seen as the valuable alternative tax source that is broad-based (levied on goods and services).

VAT was introduced in Kenya in 1990 as a broad-based tax levied on the consumption of, not only locally manufactured and imported goods, but also on services with a view of generating substantial revenue (Karingi et al., 2005) Although Kenya experienced revenue shortfall at the initial introduction period, VAT performance has subsequently contributed to improved revenue collection at lower administrative and compliance cost. Indeed, the importance of VAT is evidenced by the fact that it accounts, on average, for 28% of total tax revenue, coming second after income tax (see pie chart above).

- *Neutrality:* This is one of the principles of taxation that answers the question of whether the tax system interferes with the investment and spending decisions of individuals and businesses. VAT is non-distortionary (Alan, 1990) and is reported as one of the best ways of, not only promoting neutrality and uniformity of tax burden, but also as a way of providing incentives for increasing productivity and industrialization through few exemptions, for example on exports and targeted zero rating.
- *Efficiency:* It is related to neutrality and involves the promotion of uniformity and simplicity in the administration and management of a tax system. The popularity of VAT in many countries is seen as an alternative of replacing inefficient consumption taxes that use many tax rates, tax capital goods and exports, and erode tax base, among other issues (Alan, 1990).

Rationale for the review of VAT legislation

The VAT law is contained in the Value Added Act, Cap 476 Laws of Kenya. Following the replacement of sales tax with VAT on 1st January 1990, further reforms and rationalization were continued involving the lowering of top rate from 150% to the standard rates of 16% and reduction of the number of tax rates from 15 in 1990 to 3 currently. It was expected that these changes would lead to reduction in tax evasion, stimulate saving and investment by simplifying the system and make the system more efficient as large dispersion of tax rate impose heavy costs. The ultimate aim is to shift the structure of VAT towards a single rate. Other specific VAT reforms are as outlined below:

Surveillance on the tax registers: Administration of VAT relies heavily on proper recording of transactions as the product moves toward final market. Transparency is, therefore, key in

ensuring that proper recording is done and trailing the invoices is clear at an institutional level. This should be done through monitoring of the tax registers thus addressing the poor recording of the business transactions.

Reduce VAT tax rate to some manageable levels and widen the base: There has been a considerable increase in the number of taxpayers over the last two decades. This has mainly been in the PAYE and VAT categories. Despite this increase in tax registration, there has been little improvement in compliance. There is therefore a high potential in increasing tax revenue through the expansion of the tax base and improving compliance without necessarily increasing the tax burden on individuals.

Enhance awareness among the taxpayers on VAT: Increased sensitization and education of taxpayers can go a long way in improving tax revenue. For example, the introduction of the electronic tax registers and sensitizing the public on obtaining official and legal receipts for their purchases will reduce the leakages in tax revenue and increase compliance. Emphasis on the use of self-assessment systems can also lead to increased tax revenue collection and compliance. Together with computerization of systems at the KRA, this can also reduce the cost of compliance borne by the taxpayers.

Despite these reforms that have led to numerous amendments to the VAT legislation, Treasury indicates that after two decades, the VAT structure has become complex, inefficient and unproductive⁴, contrary to some of the reasons why Kenya adopted VAT in the first place. According to Treasury, what has led to these challenges include:

- High procedural and administrative costs in regard to managing high frequency tax filing, processing refund claims, for example, among other issues;
- Distortions of the VAT system and tax leakages caused by exemptions and zero rating of certain goods and services;
- Huge backlog of refund claims which has not only been difficult to administer but also affects cash flow for businesses;
- Lack of clarity due to several amendments of various sections of the VAT Act, for example on the treatment of cross-border services; and
- Trend analysis shows that productivity levels of VAT, as a proportion of GDP and as a proportion of total tax revenue, have been largely static over the last two decades.

It is for the above reasons that the Minister for Finance, in his Budget Statement 2011/12 undertook, through a constituted task force, to review the VAT Act with a view to “making it simpler and easy to administer.” To this end, the minister presented the draft VAT Bill legislation to parliament and consequently availed it through the Treasury website for public review and comments. Upon completion of review and revision, the Minister for Finance, during his Budget Statement 2012/13 in June 2012 tabled the VAT Bill, 2012 for parliamentary debate and approval.

4. Drawn from Director of Economic Affairs - Ministry of Finance (31st January 2012) presentation on the draft VAT Bill, 2012.

2.2.3 How VAT works

The design of Kenya's VAT is one that adopted consumption-type VAT based on destination principle as is the case with most countries. The method used to compute VAT liability is called invoice/credit-based method. Using this method, any person registered for VAT is required to charge, collect and account for VAT on taxable goods and services and remit the tax to the Commissioner of VAT using the invoice. With regard to imported goods and services, the liability lies with the person receiving these goods and services. VAT on imported goods is payable at the point of entry by the importer and this tax is collected by the Commissioner of Custom Services Department. On the importation of services, the Commissioner may appoint a resident person to collect tax to be paid for the imported services, especially if the supplier is non-resident. The collected amount is paid to the Commissioner of Domestic Taxes.

Box 6: What is VATable?

According to sections 5 and 6 of the VAT Act, 2010, the following are subject to VAT:

- Supply of goods or services, and on importation of goods and services into Kenya.
- The supply is a taxable supply and is made by a taxable person.
- The supply is made or provided in Kenya.
- The supply is made or provided in the course of furtherance of a business carried on by any of the taxable person.

Who registers for VAT?

- Any person who in the course of their business supplied taxable goods or taxable services or expects to supply taxable goods or taxable services, or both, of the value Ksh. 5 million or more in a period of 12 months becomes a taxable person and should within 30 days apply for registration.
- Upon registration, a certificate is duly issued as stipulated in the law, currently within 10 working days and it is a requirement that the certificate is displayed in a clearly visible place in the business of the registered person.
- A registered person is required to file a monthly VAT return by the 20th day of the month following the tax period. Where the 20th day falls on a weekend or a public holiday, the return must be submitted on the last working day prior to the weekend or public holiday.
- The return must always be submitted whether there is tax payable or not as failure to submit attracts penalties of Ksh. 10,000 or 5% of tax due, whichever is higher.
- All registered taxpayers are obliged to install and operate an electronic tax register.
- A VAT registered person should issue his or her clients with a tax invoice which should have specific details as stipulated in the VAT law.

Tax Refunds

Any registered person is legally required to submit monthly returns with details of tax on goods and services charged to their customer (output tax) and tax on goods and services charged to their suppliers (input tax).⁵

KRA defines **input tax** as the tax a registered person charges on goods and services that they have purchased or procured to be used further as inputs into their business and upon adding value to these inputs and supplying/selling them as new products or service (output) the tax charged is called **output tax**. In cases where the difference between the amount of VAT charged on the suppliers' invoice for inputs purchased is larger than the amount of output tax, this excess amount is allowed to the registered persons as credit/advance payment to be carried forward to the forthcoming tax period. However, in certain circumstance this amount can be paid as tax refund.

The other circumstances that lead to the commissioner refunding tax include:

- Where tax has been paid in error. The VAT Bill, 2012 proposes to reduce the time for one to apply for refunds where tax has been paid in error from the current 12 months to 3 months.
- Where in the opinion of the Minister it is in the public interest.
- Where taxable goods have been manufactured in or imported into Kenya and tax has been paid in respect to those goods and before being used, those goods have been subsequently exported under customs control.

Tax Rates of VAT

There are three classifications of VAT rates as specified in the VAT Act, 2010 whereas Section 5 (2) of the VAT Bill, 2012 proposes two classifications as shown in Table 5.

Table 5: Tax Rates of VAT

As per the VAT Act, 2010	As per the proposed VAT Bill, 2012
Standard rate of 16% applicable on taxable goods and services	Standard rate of 16% applicable on taxable goods and services
Petroleum products and electricity - 12%	12% on petroleum products has been removed
Zero rated goods and services and all exports - charged at the rate of 0%	Zero rated goods and services and all exports - charged at the rate of 0%

In the current VAT law, the standard rate of 16% is applicable to all the goods and services that are not exempt or zero rated, as well as for petroleum and electricity services that attracts a lower rate of 12%. It is important to note that, under the current VAT Act, 2010, hotel and restaurant services attract a slightly lower rate of 14%. This applies specifically to restaurant services (including bar & beverage services) offered by a restaurant owner

5. KRA via <http://www.kra.go.ke/index.php/domestic-taxes/vat/about-vat/how-vat-works>

or operator. In addition, it also applies to accommodation and all other services provided by hotel owner or operator, including telecommunication, entertainment, laundry, dry cleaning, storage, safety deposits, conference, and business services. The tax rate of 14%, however, does not apply to designated goods such as matches, gift items, confectionaries, and other articles sold over the counter or in mini-shops within the hotels and restaurant; they will be taxed at the standard rate of 16%.

VAT Bill, 2012 proposes to rationalize tax rates to only two, by retaining a standard rate of 16% and zero per cent to apply only to goods and services listed in the zero rated schedule. This, therefore, means that if the Bill is enacted as proposed, the price of electricity and hotel and restaurant services will proportionately go up 4% and 2%, respectively. The Bill goes on to propose discretionary powers, but with approval from the National Assembly, for the Cabinet Secretary to amend and vary the standard rate of 16% upwards or downwards by an amount not exceeding 25%. This implies that, with approved amendments, the range of the standard VAT tax rate will vary from 12% (lowest) to 20% (highest).

Zero rating and tax exemptions

Zero rated goods and services - charged at the rate of 0%: Zero rating is a term that is used in the VAT law to refer to supplies of goods and services that are subject to tax of zero per cent but deemed to be taxable supplies. Therefore, since the rate of tax is zero per cent, a taxpayer dealing with these goods and services does not charge the customers any tax (output tax). However, whoever is dealing with these goods and services is entitled to recover tax charged on these goods and services by your supplier (input tax).

The purpose of zero rating is to make the supplies cheaper as the dealers, such as manufacturers, exporters and suppliers of zero rated goods and services can claim refund of tax on inputs incurred in dealing with zero rated supplies (claim back the input tax amount) in the course of their businesses. Table 6 shows the list of zero rated goods and services according to the current Act and the proposed changes as per the VAT Bill, 2012.

Table 6: Summary List of Zero Rates and Exempted Goods and Services

Area	VAT Act 2010	Proposed changes in the VAT Bill 2012
Zero rated goods and services	<ul style="list-style-type: none"> Essential basic food items such as maize and wheat flour, kerosene, exercise books among other items as indicated in the 5th Schedule. All goods and services for export. Agricultural inputs. Pharmaceutical products, Educational materials. Supplies to privileged persons. 	<ul style="list-style-type: none"> Reflected in the 2nd Schedule and limited to exports and institutions with diplomatic privileges. Part C provides for certain supplies including medicaments, vaccines and medical equipment proposed to remain zero rated for a period of 3 years.

Area	VAT Act 2010	Proposed changes in the VAT Bill 2012
Exempted supplies	<ul style="list-style-type: none"> • 2nd Schedule - some items include some agricultural produce such as tomatoes and onions, animal products such as live goat, cell phone, among other items. • The list of exempt services is covered in the 3rd Schedule, and this includes insurance, medical, and veterinary. 	Covered in the 1 st Schedule - list of exempt supplies reduced to: <ul style="list-style-type: none"> • Unprocessed agricultural produce. • Financial services. • Education, medical, agricultural, accommodation and restaurant services at designated premises, betting, gaming and lotteries, among others. • Kerosene, fuels and other fuel oils to be exempt for a transitional period of 3 years.
VAT remissions	Remission of tax in the public interest for capital goods (excluding motor vehicles), goods for emergency aid, goods for use by Kenya Armed Forces, among others.	Remissions scheme abolished.

Source: VAT Act, 2010 and VAT Bill, 2012.

During the Budget Speech for 2005/06, the Finance Minister proposed that milk and maize flour be VAT zero rated. This was meant to allow the input tax deduction thus making these essential basic food items more affordable at retail prices, especially to the poor. Sanitary pads were zero rated, which was a welcome move in response to calls by various women's right organizations that this was a necessity for ensuring the girl child does not miss school and would also impact positively to the household budget; more so to those who were already buyers of sanitary towels before VAT was zero rated. To date, sanitary pads have since then remained zero rated.

Exempt supplies

Exempt supplies are business transactions on which the VAT is not chargeable at either the zero rate or other rates. This means that, under this category, goods and services are not taxable. Persons dealing with such supplies are not required to register for VAT. However, if a trader deals with both exempt (non-taxable) and taxable supplies, the trader should be registered for VAT if eligible on taxable supplies. Therefore, any persons dealing exclusively in exempt supplies cannot claim input tax on these supplies.

From the 2nd Schedule of VAT Act, 2010, some items are exempt from VAT, including some agricultural produce such as tomatoes and onions; animal products such as live goat, cell phone, among other items. The list of exempt services is reflected in the 3rd Schedule of the VAT Act and this includes: insurance, medical and veterinary services, among others. Any service that is outside this list is treated as a taxable service. Interestingly, kerosene which is currently zero rated, is proposed to be re-listed in the exemption list of goods in the VAT Bill, 2012.

VAT, being a consumption tax, is considered to be generally regressive especially if levied on essential items because they take a greater share of the income of low-income households than that of the high-income households. That is, the poor spend more of their income on consumption than the rich. One of the ways of dealing with VAT regressivity is through exemptions and zero ratings.

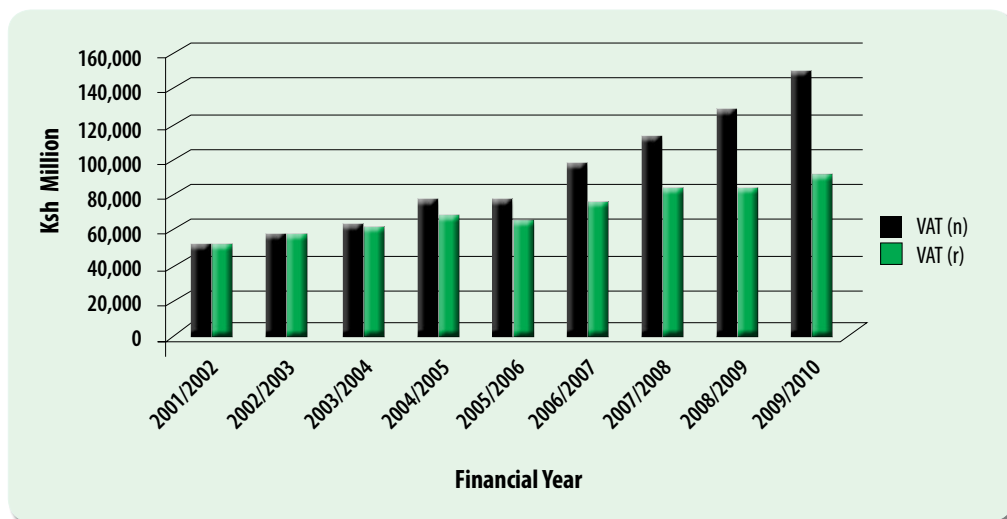
However, the VAT Bill, 2012 has proposed to rationalize and reduce the list of both exempt and zero rated goods and services as shown in the Table 6. For example, prices of essential basic items such as maize, bread, wheat flour that are currently zero rated will be subject to VAT of 16% and since businesses will transfer this to customers it implies that the prices for these basic commodities are likely to increase in the same proportion. In addition, the Bill also proposes to remove other items such as agricultural inputs and education materials from the list of zero rated goods. Some items such as medicaments will be zero rated for a transition period of 3 years; and after the lapse of this period, they will be subjected to 16% tax.

It therefore means that, the Bill will have implications on the cost of living with regard to its treatment of basic food items, farmers and health care. Understandably, the Bill seeks to limit exemptions and zero ratings so as to expand the tax base and address the refund claims challenges.

VAT performance

Like income tax, nominal VAT in the 10-year period specified in the graph on Figure 4 increased consistently with 2004/05 and 2005/06 period registering minimal increase. A comparison of nominal VAT performance with the real VAT performance, however, shows that there was a considerable decline in 2005/06 from 2004/05 by Ksh. 2,863 million.

Figure 4: Nominal vs Real VAT Performance



Achievement of an increased VAT revenue collection can be expanded through increased economic activities but, essentially, these should occur in the key sectors that attract VAT. Administratively, the costs associated with VAT are barely limited and less inconveniencing because it is elastic, thus generate adequate revenue.

2.2.5 VAT in relation to the principle of equity

Criticism has been placed on VAT burden as it relies on the personal end–consumer. It is thus considered as a regressive tax, meaning that the poor pay more as a percentage of their income compared to the rich. The effective progressiveness and regressiveness nature of VAT can be affected when different classes of goods or services are taxed at different rates. Governments, including Kenya, explore various ways of reducing the impact this tax has, especially on the low-income earners including the common targeted exemptions and zero rating on essential items such as food and social necessities.

What are the other alternatives?

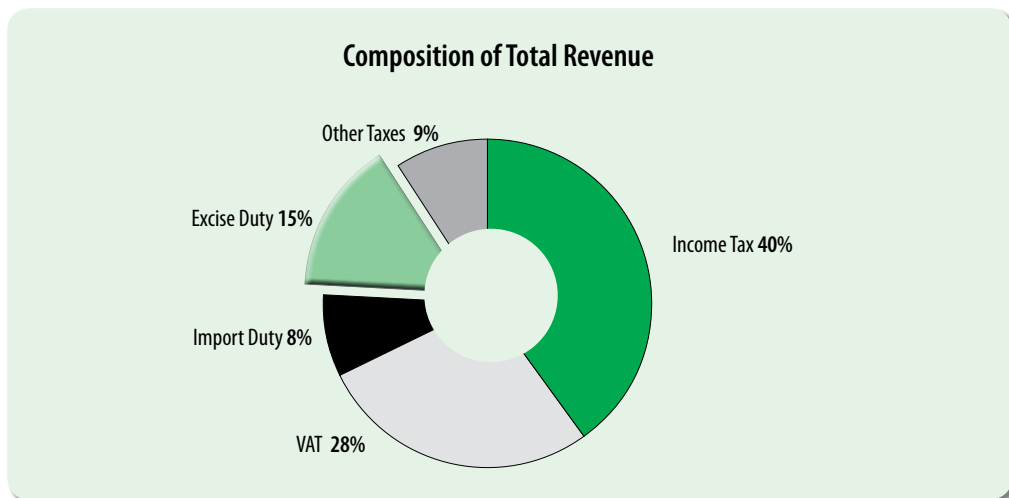
1. Employing low rates for goods and services purchased primarily by the poor.
2. Special taxes or high rates on luxury consumption items purchased mostly by the rich such as wines, cars, etc.
3. Consideration of government expenditure on safety nets such as transfers to people with special needs, the marginalized, the elderly, for example.

The consumer is the person who bears fully the VAT as producers only collect the taxes on behalf of the government. The burden of an indirect tax is very important, and will vary according to the elasticity of demand and supply for the product imposed on. If the demand for the good is responsive to price, then the price will not increase very much when the tax is imposed, but the quantity will fall significantly.

2.3 Excise Duty

Over the years, whenever the Minister for Finance presents the Budget Speech in parliament the public is usually waiting with bated breath to know whether there will be price increases on some products. Cigarettes and tobacco products are seen as the usual target for price increases. What the public may not know is that the Minister often proposes to increase excise duty on these two products and since it is an indirect tax the producers and sellers pass on this cost to consumers through increased prices.

Excise tax can be defined as a levy that is applied selectively on particular goods and services. The tax may be applied to either production or sale, to domestic output or imported. The tax is directly paid by the manufacturers, but the tax burden is passed to the consumers through an increase in prices (Karing'i *et al.*, 2005).



2.3.1 Purpose of excise tax

Excise taxes are levied for a variety of reasons as outlined below:

- To raise substantial revenue for the government at relatively low administrative and compliance costs.
- To discourage consumption of those goods deemed to be socially undesirable. This, in economic terms, is referred to as correcting negative externalities. For example, this tax is levied on cigarettes and alcohol to deter excessive consumption of these products which are, not only harmful to the individual consuming them, but also to the society at large. These taxes are also levied to internalise the cost of externalities caused by use of petroleum product.
- To improve vertical equity of the tax system or largely promote fairness in the system. For example, levying excise tax on luxurious goods that are consumed by the rich does this. On the other hand, revenue collected from excise tax is used to promote equity by spending on job creation and pro-poor programmes to benefit the low-income groups (Okello, 2001).

2.3.2 How excise tax works/what is the tax rate?

Excise duty is levied on specified schedule goods and services and charged at either specific or ad valorem (value based) depending on type of goods. An *ad valorem* is a rate charged in accordance with the value of goods, whereas specific rates are charged as per volume or quantity.

In the late 1980s, Kenya initiated a Tax Modernization Programme (TMP) which was meant to reform the tax system affecting excise tax policy. In this respect, there was a switch between specific rate and *ad valorem* regimes, in order to ensure that revenue maximization was maintained. For example, although Kenya maintained specific rate regime during the implementation of TMP, in 1991/2, there was a switch from specific to *ad valorem*, where

there were discretionary annual changes to excise duty for beer and tobacco to keep in line with inflation. Further, in 1997/98 there was rationalization of multiple excise rates on cigarettes to uniform rate in order to simplify collection and curb mis-declaration of imported cigarettes. In 2003/04, the government reverted back to specific tax regime from *ad valorem*; and more recently, excise tax policy is currently influenced by the East African Community integration and harmonization policies of which Kenya is a member.

Generally, *ad valorem* is used where the objective is to raise revenue, whereas specific excise duty is imposed to correct for externalities. Table 7 shows the main current excisable products in Kenya:

Table 7: Current Excisable Products in Kenya

Commodity description	Specific rates	Ad valorem
Spirits	Kshs 120 per litre or 35% whichever is higher	
Wines	Kshs 80 per litre or 40% of RSP* whichever is higher	
Minerals and aerated water	Kshs 3per litre 5% whichever is higher	
Malted Beefs	Kshs 70 per litre or 40% of RSP whichever is higher	
Beer not made from malt	Kshs 70 per litre of RSP whichever is higher	
Stout and porter	Kshs 70 per litre or 40% RSP whichever is higher	
Other fermented beverages, mixture of fermented & non-alcoholic beverages not elsewhere specified or included	Kshs 70 per litre or 40% of RSP whichever is higher	
Opaque beer (e.g Chibuku)	Kshs 70 per litre or 40% of RSP whichever is higher	
Cider	Kshs 70 per litre or 40% of RSP whichever is higher	
Undenatured ethyl alcohol strength by volume 80% or higher	Kshs 120 per litre or 35% whichever is higher	
Ready to drink alcoholic beverages of strength not exceeding 10% by volume of alcohol	Kshs 70 per litre or 40% of RSP whichever is higher	
Motor spirit (gasoline) regular	Per 1000L @200 °C shs 19,505	
Motor spirit (gasoline) premium	Per 1000L @200 °C shs 19,895	
Aviation Spirit	Per 1000L @200 °C Shs 19,895	
Spirit type jet fuel	Per 1000L @200 °C Shs 19,895	
Special boiling point spirit and white spirit	Per 1000L @ 200 °C Shs 8,500	
Other light oils and preparations	Per 1000L @ 200 °C Shs 8,500	
Partly refined	Per 1000L @ 200 °C Shs 1,450	
Medium oils and preparations	Per 1000L @ 200 °C Shs 1,450	
Other medium oils and preparations	Per 1000L @ 200 °C Shs 5,300	
Gas oil	Per 1000L @ 200 °C Shs 10,305	

Diesel oil	Per 1000L @ 200 °C Shs 3,700	
Other gas oil	Per 1000L @ 200 °C Shs 6,300	
Residual fuel oils	Per 1000L @200 °C Shs 600	
Perfumes, Cosmetics and beauty products		5%
Petroleum Jelly		5%
Other non – alcoholic beverages		7%
Juices and carbonated soft drinks		7%
Mobile Cellular phone services		10%
Other wireless telephone services		10%
Plastic Shopping bags		50%
Processed Tobacco		130%
Imported motor vehicles		20%
Used computers		25%

Source: KRA

***RSP** means Retail Selling Price

Kenya's main excisable commodities at the moment are soft drinks, alcoholic beverages, tobacco, fuel and motor vehicles. Other excisable commodities are plastic bags and importation of second hand computers. Excisable services mainly include mobile telephone services and gambling. Other than on motor vehicles, excise taxes on beer, cigarettes and petroleum are currently charged on a specific basis, i.e., per volume or quantity.

Characteristic of these commodities is that they have a low own-price elasticity of demand implying that their responsiveness to price change is low and hence minimum shifting of consumer purchases. It is these characteristics that make high tax rates applicable.

2.3.3 How excise tax has changed overtime

Reforms in excise tax are characterised by shifting between specific and *ad valorem* tax regimes. A review of the excise tax policy indicates that, at the time of implementing the tax modernization programme, Kenya maintained a specific excise tax regime. For the better part of the mid to late 1980s, excise duty on cigarette and tobacco products was raised annually to ensure that they kept pace with domestic inflation and, in turn, maintain the level of real excise duty. This presented a challenge of balancing between revenue maximization and pursuing a specific tax regime. As part of the TMP, and to support the still valid objective of revenue maximization, there was a change in the excise tax regime in 1991/92. A number of excise tax rates were converted from specific to *ad valorem* to help the government achieve its multiple objectives of:

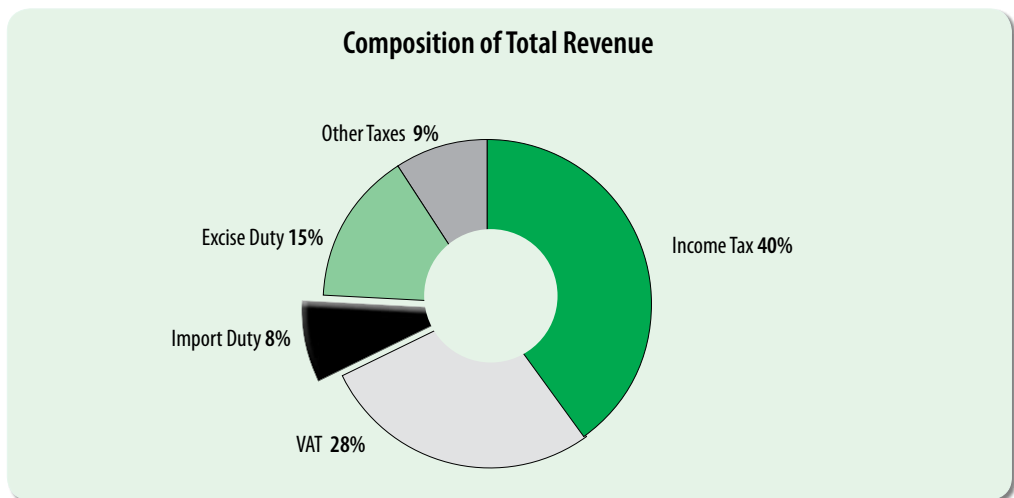
- ensuring that excise tax revenue increased in parallel with inflation, thus eliminating the need for discretionary measures. This automatic inflation adjustment was intended to offset the anticipated revenue loss from reduced import duty rates;

- allowing for the rationalization of VAT rates and increasing control over high tax rate goods; and
- giving equal tax treatment to all types of beer, and closing the gap between malt and non-malt beer.

Since the regime switch to *ad valorem* excise taxes in 1991/92 did not yield as much as was expected in terms of eliminating discretion, the ensuing period up to 1997/98 witnessed moves to rationalize the number of rates and standardize rates where, for example, excise duty on cigarettes in 1997/98 was changed to a uniform 135% rate for the purposes of simplification in order to ease administration and collection. Besides, these reforms were intended to curb mis-declaration of imported tobacco products. Regarding alcoholic products, similar measures were undertaken but the multiple rates on malt, non-malt and other local alcoholic products was retained.

There was a reversal of excise policy regime from *ad valorem* back to specific taxation for tobacco and alcoholic products in 2003/04. However, it is important to mention that the country's excise tax policy has recently been influenced by the regional integration initiatives that Kenya is party to. Harmonization of policies has been one of the key issues in the treaty of the East African Community (EAC), comprising Kenya, Uganda and Tanzania. However, excise tax for petroleum products continued to remain within the specific tax regime. The current regime on excise duty is as shown earlier.

2.4 Trade Taxes



Trade taxes are applicable when importing or exporting goods and services. These taxes are either import duties or export duties. Certain domestic goods that are exported are subject to export duty. The individual is required to pay the import duties before the goods are released, for example, from the Port of Mombasa. The tax burden is borne by the importer if

the goods being imported are for personal use. However, the tax burden can be transferred to consumers if the importer is a trader/manufacturer. For example, if the individual imports goods that are used to manufacture other goods to be supplied in Kenya, then the import duties will be included in the total cost of production, which translates into higher prices. (National Tax Payers Association (NTA) via <http://www.nta.or.ke/about-taxes/types-of-taxes/excise-duty>).

2.4.1 Purpose of the tax

Custom duties have three key functions:

1. raise revenue, although most African countries have experienced lower revenues from trade taxes as a result of regional integration, and this has necessitated a shift to domestic taxes such as excise or VAT to mitigate against revenue loss.
2. To protect and/or bolster domestic manufacturing industry, for example by making imported goods more expensive hence protection from import competition.
3. To facilitate trade.

2.4.2 How the tax works?

All imported goods are subject to import duty unless they receive preferential tax treatment. The import duties are usually computed as a percentage of the value of imports - usually includes cost of insurance and freight (CIF) value. Similar to other countries, custom duty liability, governed largely by the international trade agreements that Kenya enters into with entities such as the World Trade Organisation (WTO), World Customs Organisation (WCO), Common Market for Eastern and Southern Africa (COMESA) and the East Africa Community (EAC), are used to determine the tariff classification, valuation and Rules of Origin. The current structure of the tariff bands is 0%, 5%, 15%, 20%, 25%, 30%, 35% and sugar at 100%.

2.4.3 Reforms in customs

Literature reveals that changes in custom duty since independence and during the tax modernization programme have been guided by the type of trade policy regime that Kenya has pursued. For example, after independence, Kenya adopted protectionism of its local industries using the trade taxes as it pursued more inward looking trade policy. In the 1970s, the strategy shifted from import substitution, where an import duty on raw materials was increased, to export-led industrialization geared towards earning foreign exchange. During the tax modernization programme in the 1980s, there was a move towards enhancing openness and simplification of import duty administration by rationalization of tariffs and rates. However, the 1990s witnessed a policy reversal towards part protectionism of some sectors outside the agriculture sector.

From a revenue administration point of view, most customs and excise duty transactions are entry-based. Taxpayers interacting with the KRA with respect to these taxes were required to prepare various paper-based entries depending on the transaction type. There were a total of 19 different forms to be filled for various transactions. As a result, the business

processes in these two taxes were characterized with duplication, and a lot of time was spent on preparation of documents. To address this, and to benchmark Customs services to international best practice, various options were considered to address the problem of diverse Customs entries. A solution had been implemented in other countries with the introduction of the single entry document, commonly referred to as C63. It was imperative that the KRA began the implementation of the Customs Single Entry Document (SED) from 1999/2000. The system was aimed at facilitating international trade through reduction of time and costs in filling the Customs' 19 different transaction entries. The various types of transaction entries that were mainly used included: import, warehousing, export, and transit entries. The SED put into consideration all the fields in the Customs entries and ensured that the SED had captured all the required fields for the transactions.

The declaring agent/importer/exporter was to declare goods and ensure that the correct fields in the entry are correctly filled depending on the type of transaction. This reduced the amount of paperwork and also the cost of clearance, which was as a result of buying the different coloured entries for different transactions, as well as reducing time and thus facilitate trade.

3. Tax Incentives

Governments undertake tax reforms for a number of reasons; namely, a) to simplify the tax system; b) to address the equity question in the distribution of tax burden; c) to strengthen tax administration and d) to ensure revenue adequacy. Indeed, the drivers and emphasis of tax reforms will vary from country to country. Karingi *et al.* (2005) show that Kenya tax reforms emphasis has always been towards introduction of new taxes or new rates of existing bases, the need to widen tax bases and reduce exemptions, as well as introducing more stringent administrative changes to seal loopholes and appropriate sanction measures.

The outcome of tax reforms is usually expected to realize the three common objectives of a good tax system, including: i) to raise tax revenue for funding government operations without excessive government borrowing; ii) to contribute to equitable distribution of income, and iii) to encourage or discourage certain activities. However, implementing tax reforms to meet this ultimate goal of an ideal tax system is a challenge. Indeed, it has been documented that there has always been heated discussion on whether, and to what extent, a government can and should use the tax system for policy goals other than raising tax revenue. In the case of Kenya's tax system, raising tax revenue is a key objective; nonetheless, striking the balance in meeting the ever increasing competing needs vis-à-vis enhancing a competitive investment that calls for lower taxes is not easy. It is the latter side of the weighing scale that has seen the Government of Kenya, like other governments, introduce tax incentives in the belief that taxes are an appropriate policy instrument to use in attracting investments. This is contrary to some schools of thought that are of the opinion that policy goals, such as stimulation of employment or economic growth, financial incentives among others, should be given through direct expenditure and not through the tax system.

Definition of tax incentive

A tax incentive can be defined variously as a deduction, exclusion or exemption from a tax liability offered as an enticement to engage in a specified activity such as investment in capital goods for a specified period.⁶ Kenya Revenue Authority (KRA) defines it as a provision that grant to any person or activity favourable conditions that deviate from the normal provisions of the tax code/legislation in a positive manner for that person or activity.⁷ Tax incentives may take a number of forms. In Kenya, the following are some of the tax incentives applied: a) tax holidays; b) investment allowances and tax credits; c) accelerated depreciation; d) investment subsidies, and e) indirect tax incentives (visit link for details on

⁶ via <http://www.businessdictionary.com/definition/tax-incentive.html>

⁷ Other commonly agreed definitions of tax incentives according to KRA include:

- Any measure that provides for a more favourable tax treatment of certain activities or sectors compared to what is available to general industry.
- A motivational offer intended to persuade a potential economic investor to choose one tax jurisdiction over another.
- A financial inducement offered in the form of an abatement of taxes.

tax incentives http://www.ieakenya.or.ke/publications/doc_details/246-tax-incentives-and-exemption-regime-in-kenya-is-it-working)

As earlier mentioned, tax incentives are used to achieve certain economic goals such as attracting investment and social goals such as exemption and zero rating of goods and services for the benefit of the poor; there is need to assess both positive and negative aspects as briefly mentioned below.

Advantages of tax incentives

- A policy tool to attract increased foreign direct investment through lower tax burdens;
- Encourage private sector participation in economic and social programs where government plays a main role; and
- Economically, tax incentives may be justified to address some form of market failure especially those involving externalities such as investment in research and development or to promote high technology industries that have a positive externality.

Tax Incentive Issues

The foregoing notwithstanding, tax incentives are associated with various negative aspects. According to Tanzi and Zee (2000), tax incentives make the tax system less transparent, less predictable and potential investors are likely to perceive taxation as less stable (i.e., they introduce a governance problem). Further, tax incentives for foreign investors shift the burden of taxation to immobile factors of production such as labour. Besides, not only are tax incentives seen as favouring new producers over existing businesses, surveys show that investors rate them rather low among the factors they decisively consider in influencing business decisions. In contrast, socioeconomic and political factors, such as basic infrastructure, stable government, sound fiscal conditions, and labour availability, among others, are considered key. Most of these disadvantages of tax incentives are related to their potential ineffectiveness, inefficiency and inequity. Moreover, tax incentives are seen to erode revenue bases, complicate tax laws and may contribute to bloated government.

Further, Parliamentary Budget Office (2010) study indicated that, over the period 2003/04 - 2005/06 the total amount of revenue forgone over the three-year period was Ksh.109.2 billion, of which investment-related incentives accounted for 84% while export related incentives accounted for 16%. On average, Ksh.30.4 billion was forgone annually in the three-year period. Trade-related incentives accounted for Ksh.18 billion forgone. In this category, Tax Remissions Export Office TREO-related exemptions accounted for 53% followed by Export Processing Zones Authority EPZA, which accounted for 40%, and Manufacture Under Bond (MUB) 7%.

The Policy question that emerges from the foregoing is whether it is time to review and rationalize tax incentives and the exemption regime with regard to the amount of revenue

forgone/lost and whether money is well spent. The other questions that need answers are a) targeting of the right group; b) transparency around tax incentives, and c) the extent to which government objectives of attracting investment is being realized.

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