

TAX COMPLIANCE: AN EXAMINATION OF KENYAN LAW AND POLICY



BY

MWANGI RAPHAEL CHEGE


LLB/10044/81/DF

**A DISSERTATION SUBMITTED TO THE SCHOOL OF LAW AS A PARTIAL
FULFILMENT FOR THE AWARD OF BACHELOR DEGREE OF LAW
OF KAMPALA INTERNATIONAL
UNIVERSITY**

JUNE 2012

DECLARATION


“ I declare that this research is the work of Mwangi Raphael alone, except where due acknowledgement is made in the text. It does not include materials for which any other university degree or diploma has been awarded”.

Signature:..........Date: 21st JUNE 2012.....

Name :Mwangi Raphael Chege

APPROVAL

"I certify that I have supervised and read this study and that in my opinion, it conform to acceptable standards of scholarly presentation and is fully adequate in scope and quality as a dissertation in partial fulfillment for the award of Degree of Bachelor of law of Kampala International University."

Signature:  Date: 21/6/2022

Madam Proscovia Yaweh.

DEDICATION

I dedicate this dissertation to my beloved parents Mr. Solomon Mwangi and Mrs. Jennifer Mwangi and to my siblings for their unwavering support in my life and specifically in my studies. I am greatly indebted to you.

ACKNOWLEDGEMENTS

I thank the almighty God for enabling me reach this far in my academic life. I also acknowledge the understanding, patience and professional guidance of Madam Proscovia Yaweh, who was my supervisor. I acknowledge the support and good spirit of everyone who has assisted me through out my studies and in the writing of this dissertation

LIST OF ACRONYMS

CET	:	Common External Tariff
CIT	:	Corporate Income Tax
COMESA	:	Common Market For East And South Africa
DTD	:	Domestic Tax Department
ETR	:	Electronic Tax Register
FBT	:	Fridge Benefit Tax
GFI	:	Global Finance Integrity
ITA	:	Income Tax Act
KIPPRA	:	Kenya Institute of Public Policy Research and Analysis
KRA	:	Kenya Revenue Authority
LTO	:	Large Taxpayer Office
MNE	:	Multinational Enterprises
PAYE	:	Pay As You Earn
PIN	:	Personal Identity Number
PIT	:	Presumptive Income Tax
SME	:	Small and Medium Sized Enterprises
TMP	:	Tax Modernization Programme
VAT	:	Value Added Tax

LIST OF STATUTES

Custom and exercise duty Act

Constitution of Kenya 2010

Income Tax Act

Stamp Duty Act

Value Added Tax Act

LIST OF CASES

Camad Investment Property Ltd v Federal Commissioner of Tax,
Commissioner of Income Tax v Jaffer Bros. Ltd EA U MA NO 9 OF 1956
Custom and Exercise Commissioner v British Railways Board (1976)1 WLR 1036
Eisner v Macomber 252 US 189
Ericsson v Last (1881)8 QB 416
Esso Standard Eastern Inc.v Income Tax (1971)Ea 127
Glantre Engineering Ltd v Goodhand (1983)1 ALL E.R 542
Hamblett v Godfrey (1987)ALL E.R 916
IRC v Maxse (1919)1 KB 647
John Smith and sons v Moore (1921)AC 13
Lindsey v IR Commrs (1933)18 TC 43
London County Council v Attorney General (1901)AC 36
Machon v McLoughlin (1926)11TC 83
Minister of Finance v Smith (1972)ac 193
O'Brien v Bension Hosiery (1980)AC 562
Ramson v Higgs(1971)3 ALL E.R 94

TABLE OF CONTENT

DECLARATION.....	i
APPROVAL	ii
DEDICATION	iii
ACKNOWLEDGEMENTS	iv
LIST OF ACRONYMS.....	v
LIST OF STATUTES.....	vi
TABLE OF CONTENT	viii
ABSTRACT	xii
CHAPTER ONE.....	1
1.0 INTRODUCTION.....	1
1.1 Background of the study.....	1
1.2 Statement of Problem	7
1.3 Objectives of the study	9
1.4 Hypothesis	9
1.5 Research question.....	9
1.6 Research methodology	10
1.7 Literature Review	10
1.8 Chapterization.....	11
CHAPTER TWO.....	13
2.0 Introduction	13
2.1 Improper keeping of records	14
2.2 Filing of tax returns;	14

2.3 Lack of proper auditing	16
2.4 Tax Refunds.....	17
2.5 Domestic resistance	17
2.6 Political influence	18
2.7 Bargaining for tax incentives.....	19
2.7.1 VAT fraud	20
2.7.2 Misclassification of commodities and smuggle of goods.....	20
2.7.3 Bribery of tax officials.....	20
2.7.4 Profit shifting.....	21
2.8 Tax incentives / tax expenditures	22
 CHAPTER THREE	 24
3.0 Introduction	24
3.1 Functions of KRA.....	24
3.1.1 Composition of the Board	25
3.1.2 The Commissioner General.....	25
3.1.3 Tax Commissioners	25
3.2 Legal Framework.....	26
3.3 Income Taxes.....	26
3.3.1 Charge of the Income Tax	29
3.3.2 Gains or profits from Business	31
3.3.3 Capital gains v Revenue	32
3.3.4 Rental income.....	34
3.3.5 Dividend and interest income.....	35
3.3.6 Interest Income	35

3.3.7 Employment income and PAYE Tax law	36
3.4 Fringe Benefit Tax (FBT).....	38
3.5 Exercise laws	39
3.6 Value Added Tax.....	39
3.6.1 Charge of VAT	40
3.6.2 Canons of VAT.....	40
3.6.3 VAT is payable by	41
 CHAPTER FOUR	 42
4.0 Introduction	42
4.1 Tax Evasion and Avoidance.....	42
4.1.1 Tax evasion.....	42
4.1.2 Tax avoidance.....	43
4.2 Low tax morale.....	43
4.3 Low quality of the service in return for taxes.....	44
4.4 Tax system and perception of fairness	44
4.5 Low transparency and accountability of public institutions.....	45
4.6 High level of corruption	45
4.7 Weak enforcement of tax laws	45
4.8 Insufficiencies in tax collection.....	46
4.9 Weak capacity in detecting and prosecuting inappropriate tax practices.....	48

CHAPTER FIVE	49
CONCLUSION AND RECOMMENDATIONS	49
5.0 Introduction	49
5.1 Measures improving tax compliance.....	50
5.2 Taxpayer education and taxpayer service.....	50
5.3 Addressing tax compliance costs and administrative costs.....	51
5.4. Measures improving the ability to enforce tax laws.....	51
5.5 Change the perception of the society with regard to payment of tax	51
5.6. Reforming Tax enforcement laws	52
5.7 Large Tax Payer Unit	53
5.8 Complex and often changing tax laws.....	54
5.9 International endeavours to strengthen national tax law enforcement	54
5.9.1. Summary and Conclusions	55
BIBLIOGRAPHY	57

ABSTRACT

This study was an attempt to examine the extent to which tax administration affects tax payer's compliance. The study was guided by the following objectives; to show the need for co-existence between tax enforcement and demonstrate that enforcement undermines voluntary tax compliance, to show how taxpayers compliance is complex and therefore the need to put in place measures orchestrated at achieving tax compliance, to reveal suggestions which may influence and bring forth tax compliance. This research entailed secondary mode of data collection and in addition literature review were applied in order to collect data. The study mainly focused on the effectiveness of tax administration in Kenya and how the whole process affects the level of tax payer's compliance. The study thus revealed that tax administration in Kenya is not effective as it is subjected to complex and opaque laws, lack of enough resources by the authority, lack of necessary professionalism, lack of clear, simple and user friendly administrative systems and procedures and above all lack of public support for set priorities. On the other hand, it was found out that tax payer's compliance is determined by the government fiscal policy, tax enforcement systems, perceptions of tax payers, fairness of the tax system services provided by the government in return.

The study further revealed that the mode of tax administration greatly determines how compliant and responsive tax payers will be. Issues such as routine training of Kenya Revenue Authority staff, fair assessment of tax payers in which they are consulted as well as frequently seeking responses and suggestions from tax payers are crucial factors that need not to be under estimated while administering taxes.

CHAPTER ONE

1.0 Introduction

1.1 Background of the study

Tax has been defined in Oxford concise English dictionary as a compulsory contribution to support of government levied on person's property, income, commodities, transactions etc at a fixed rate mostly proportionate to the amount on which the contribution is levied. Taxes can also be defined as enforced contribution from persons and property levied by the state by virtue of its sovereignty power for the support of government and for all public needs. Black's law dictionary also underlines the compulsory nature of taxation saying that tax is a compulsory contribution to the state's fund.¹In *Camad Investment Property Ltd v Federal Commissioner of Tax*,² Dawson J identified the characteristics of tax to include:

- a) A compulsory payment;
- b) The moneys are raised for government purposes;
- c) The extractions do not constitute payment for services rendered;
- d) The extractions aren't arbitrary;
- e) The payment are not penalties;
- f) The extraction should not be incontestable.

Even though taxes are compulsory, they are readily justified by public services provided by the government such as education, health and security. All these functions are funded largely by revenues from taxation. Therefore, there is inherent good in the existence of government and taxation is seen as a necessary consequence. The imperative of

¹ Blacks Dictionary 9th Edition 2009 page 1594

² (1931) AC 352

government and the resulting need for taxation gives rise to a duty for the public to comply with tax payment. The obligation to pay taxes is not only evident but should be readily accepted. However, voluntary payment of taxes remain a myth. Most people hate to honour their tax obligations Taxpayers' behavior towards tax system has evoked great attention among many Revenue Authorities in the World especially in Developed Countries.

However, it is debatable on what has been done towards the study of taxpayers behavior towards tax system in developing countries as they concentrate more in studies which would increase their budgets "bottom-line" in terms of huge revenue collection and enforcement efforts at the expense of studies on taxpayers compliance which would make increase in this tax revenue to be realized and enforcement efforts work! Perhaps the less developed countries are not to blame as they run on "budget deficits" hence, scarce resources to see through such studies which are perceived as adding no direct value to revenue collection. Empirical evidence on the ground shows there has been hostility between the taxpayers and tax collectors on issue relating to tax compliance- how about tax evasion cases reported daily in our local newspaper³ and outward resistance from taxpayers for example the recent protest by taxpayers over implementation of Electronic Tax Registers. Hostility towards tax compliance date back to the History of Taxation. "Taxes are considered a problem by everyone. Not surprising, taxation problems date back to the earliest recorded history" According to Director, Tax world Organization, during⁴ the Roman empire, in 60A.D, Boadecia queen of East Anglia led a revolt that can be attributed to corrupt tax; in Great Britain, the 100 years war (1337-1453) between England

³ Daily Nation, July 7, 2006, pg 3

⁴ Director, Taxworld Organization, 7th April 1999

and France was renewed in 1369 by among other key factors, the rebellion of the nobles of Aquitaine over the oppressive tax policies of Edward, The Black Prince and in Post-Revolution America, Tax Act of 1864 was challenged several times.

Hostile taxpayers behavior implies that given a chance taxpayers would not comply with tax laws. Perhaps, understanding the taxpayers' behavior in terms of factors which influence their attitude towards tax compliance and how to influence the very factors would be a solution to this "jigsaw puzzle". Hence, one of the purpose of this research is to bring attitudes and these factors to light in relation to the Kenyan taxpayers and show how they affect tax compliance. In explaining taxpayers' compliance behaviour, that is, the reasons why some taxpayers comply and others do not comply; there are broadly two classes of theories – economic based theories, which emphasize incentives, and psychology-based theories.

Economic theories of tax compliance are also referred to as deterrence theory. According to Trivedi⁵, economic theories suggest that taxpayers "play the audit lottery," i.e. they make calculations of the economic consequences of different compliant alternative, such as whether or not to evade tax; the probability of detection and consequences thereof, and choose the alternative which maximizes their expected after tax return/ profit (possibly after adjustment for the desired level of risk). The theories suggest that taxpayers are amoral utility maximizers hence, economic theories emphasize increased audits and penalties as a solution to compliance problems. Economic based studies suggest that taxpayers' compliance influenced by economic motives such as profit maximization and probability of detection. Psychology theories of tax compliance assume that psychological

⁵) Trivedi & Shehata . Attitudes, Incentives, And Tax Compliance.

factors – including moral and ethical concerns are also important to taxpayers and so taxpayers may comply even where the risk of audit is low. Psychology theories de-emphasize audits and penalties and instead focus on changing individual behaviours towards tax system. Trivedi and Shehata⁶ concluded that some taxpayers' behaviour may follow economic theories while others may follow the psychological theories and a mixture of the two is also possible. Tax compliance is a complex term to define.

According to Brown and Mazur⁷ compliance is multi-faceted measure and theoretically, it can be defined by considering three distinct types of compliance such as payment compliance, filing compliance, and reporting compliance. These categories are administrative compliance and technical compliance where the former refers to complying with administrative rules of lodging and paying otherwise referred to as reporting compliance, procedural compliance or regulatory compliance and the latter refer to complying with technical requirements of the tax laws in calculating taxes or provisions of the tax laws in paying the share of the tax. Theoretically, views of the taxpayers and tax collectors are that tax compliance means adhering to the tax laws, which are different from one country to another. According to Silvani⁸ the goal of tax administration is to foster voluntary tax compliance. In and hence reduce tax gap (difference between taxes paid and owed for all taxes and all taxpayers) and “compliance gap.” Tax compliance, according to Cobham,⁹ Tax Evasion, Tax Avoidance and low tax compliance are problems to many countries as measured by tax to GDP ratio although it has been improving for many

⁶ *ibid*

⁷ Brown, R.E & Mazur, M.J. IRS's Comprehensive Approach to Compliance. Paper presented at National Tax Association Spring Symposium in May 2003, Washington D.C.s, tax

⁸ Silvani, Silvani, C.A; Improving Tax Compliance . Washington D.C. International Monetary Fund ,Publication Service.

⁹ Cobham As. Tax Evasion , Tax Avoidance and Development Finance : 2005

countries. For example, its one-third of GDP in rich countries; Latin America and the Caribbean - 17% of GDP and low-income countries (in Sub Saharan Africa) showed less than 15% to GDP (the recommended rate). It remains a big challenge to low income countries. This has promoted radical tax reforms in countries like Bolivia, Uruguay, Colombia, Jamaica and Spain with notable success.

According to Ajzen's¹⁰ Theory of Planned Behaviour, attitude relates to one's own personal views about a behaviour. Attitude may also be defined as positive or negative views of an "attitude object"; for example a person, behaviour or event. In relation to taxation, taxpayers' attitudes may be defined as positive or negative views of a tax compliance behaviour. The outcome of positive views is tax compliance and negative views is tax non compliance. These views may be explained by Psychology-based theories which reveal that taxpayers' attitude may be influenced by the following factors which eventually influence tax payers behavior. Kenya is ranked among low-income countries or low compliance countries with hard task of ensuring efficient and effective tax administration. In order to ensure tax compliance, hence raising more revenue. Administration of tax in Kenya is by Kenya Revenue Authority established through an Act of Parliament on July 1st 1995 (Cap 469). "Kenya Revenue Authority is supposed to promote compliance with Kenya's tax ensure responsible enforcement by highly motivated and professional staff thereby maximizing revenue collection at least possible cost for the social economic well being of Kenyans".

¹⁰ Ajzen, I & Fishbein (1991.) "Theory of Planned Behavior," Vol 50, No 2 Organization Behaviour and Human Decision Processes. 179-211

The purpose of Kenya Revenue Authority is assessment, collection, administration and enforcement of tax laws with professionalism governed by integrity and fairness . To achieve this purpose, KRA is divided into regions such as North Region, Rift Valley Region, Western Region, Southern Region and Central Region and departments such as Customs Services Department, Domestic Services Department, Road Transport Department and Support Services Department. KRA administers different types of taxes under different Laws (Acts) such as Income Tax, Value Added Tax, Custom duties and Excise Tax among many others. Hence, KRA is supposed to ensure taxpayers comply with the respective tax laws.

Nonetheless tax compliance an important component in designing tax systems and administering tax legislations. The need to have enforce compliance is imperative thing to the government her is need for the government to streamline the tax laws which will be more effective in enforcement of tax compliance. Tax should be based on existing laws. The constitution of Kenya prohibits taxation by the legislative authority. No tax or licensing fee may be imposed, waived or varied except as provided by legislation¹¹. Tax laws are always enacted with assumption that there is sufficiently, high legal literacy amongst the population to understand the taxation laws and the obligation which tax laws impose; there is high sense of civic duty among tax payers to easily and rapidly appreciate the need for the tax laws; the high sense of civic duty will drive taxpayers to accept tax laws and willingly bear tax obligations and; the few errant taxpayers will find the enforcement measures in the laws as sufficient deterrence to guide them back into the fold.

¹¹ Article 210 (1) of the constitution of Kenya 2010

1.2 Statement of Problem

The problem under investigation is why tax compliance level in Kenya is poor even though there are numerous legislations regulating tax in Kenya. The proposition put forward is that the coexistence relationship which must exist between enforcement of tax and voluntary tax compliance is not adequately appreciated. There are evident factors which already show that Kenya has not succeeded in securing fully tax compliance. Such factors include narrow tax base and the existence of dissatisfaction with taxation and the prevailing perception that administration of tax in Kenya is highly tainted with corruption and lack of accountability on the part of the government.

In Kenya tax administration is solely monitored by the Kenya Revenue Authority which is established by an Act of parliament which is an autonomous government agency. The Kenya Revenue Authority is acutely aware of the tax problems and has taken several steps in ensuring that tax laws are adhered to the letter. However, the Kenya Revenue Authority is encountered by general dissatisfaction with taxation and low levels of voluntary tax compliance. Kenya Revenue Authority has tended to rely on detection and punishment underpinning tax administration strategies. Audits and inspections have become a regular rather than random feature of tax administration. There is also a tendency of criminal prosecution and fiscal penalties which characterize the response of tax administration to non compliance.

It is important to note that though Kenya Revenue Authority has tried as much as possible to enforce tax compliance it is costly. A more efficient tax enforcement agency needs large team of tax administrators and tax auditors who need to be well equipped to do their jobs. It as well needs a lot of money and the same money is derived from the revenue generated

from the tax[payers which at the end results to a low revenue collection turnover. The enforcement is also limited by the capacity of the country to allocate tax enforcement resources.

The study will demonstrate that undue reliance on tax enforcement can be counter productive and may reduce taxpayer compliance. It also demonstrates that if the problems that undermine voluntary tax compliance will significantly improve. The study attempts to disapprove the perception that voluntary tax compliance is a myth rather than a reality by helping to show the means by which this problem can be addressed. In Kenya, taxpayers exhibit varying levels of tax compliance. Apart from unpublished study by Simiyu,¹² whose objective was to identify factors influencing taxpayers' voluntary compliance among local authorities, the researcher was not aware of any other study that has been carried out to establish how taxpayers' attitudes influence tax compliance behavior. The challenge of lack of knowledge of tax Compliance behaviour towards a tax system is serious on the grounds that it may have played part in the KShs. 3.4 billion short fall in 2005/2006 according to Daily Nation.¹³ Even after aggressive marketing by KRA in the print and electronic media the extent of the impact of attitudes and attitude change on tax compliance behaviour was not well understood and studies in this area have not been carried in Kenya. Therefore addressing this knowledge gap was the primary purpose of this study. It was for this reason that this study attempted to find out how taxpayers' attitudes influence tax compliance behavior in Kenya.

¹²Simiyu , N.T.T (2003); Taxation in Kenya. Nairobi :

¹³ Daily Nation. August 5, 2006

1.3 Objectives of the study

The fundamental objective of this study is to reveal why the level of tax compliance in Kenya is low and poor. The following are the objectives;

- i) To show the need for co-existence between tax enforcement and demonstrate that enforcement undermines voluntary tax compliance.
- ii) To show how taxpayers compliance is complex and therefore the need to put in place measures orchestrated at achieving tax compliance
- iii) To reveal suggestions which may influence and bring forth tax compliance.

1.4 Hypothesis

- i) The following hypotheses have guided the preparation of this research:
- ii) There is no involvement of the public in making tax legislations which has an adverse effect on tax compliance in Kenya.
- iii) The current laws are inconsistent with voluntary tax compliance
- iv) The public perception that tax systems are unjust and marred with corruption affects tax compliance in Kenya.
- v) Mismanagement of revenue has a negative attitude on taxpayers when it comes to tax compliance.

1.5 Research question

- i) Whether there is need for co-existence between tax enforcement and voluntary tax compliance?
- ii) What are the necessary measures that need to be put in place in order to achieve tax compliance?
- iii) What are the suggestions which may influence and bring forth tax compliance?

1.6 Research methodology

Research conducted entails secondary data which includes collection and review of policy documents, legislations, text books relevant to the subject under the study. The sources of literature and documents include institution libraries, the internet for electronic and government offices. The research method relied on also include examination and analysis of Kenya Revenue Authority Regulations and practice notes and tax policy documents.

1.7 Literature Review

This study attempts to explore the existing knowledge on tax payer compliance. Though there is ample literature on tax compliance there are some gaps specifically on voluntary tax compliance which this study intends to cover. In Kenya, taxpayers exhibit varying levels of tax compliance. Apart from unpublished study by Simiyu ¹⁴ whose objective was to identify factors influencing taxpayers' voluntary compliance among local authorities, the researcher was not aware of any other study that has been carried out to establish how taxpayers' attitudes influence tax compliance behavior. The challenge of lack of knowledge of tax Compliance behaviour towards a tax system is serious on the grounds that it may have played part in the KShs. 3.4 billion short fall in 2005/2006 even after aggressive marketing by KRA in the print and electronic media.

In order to achieve a high level of tax compliance in Kenya the issue of the co-existence between tax compliance and enforcement of tax must be reconciled. It is important to come up with strategies that will pave the way for high tax compliance.

The study tend to suggest that the legislations that regulate tax compliance must be recognized among the taxpayers and there need to be a way to change the long existence

¹⁴ ibid

of the perception that taxation is unjust and marred with corruption. Just tax system should be put in place which must be reflected in the administrative principles.

The lack of enough literature on the subject under the study and the predominance of writings examining the subject from a developed country perspective is a challenge for this study. Notwithstanding a critical examination of the subject is still possible, and is undertaken here to assist in developing tax administration on principles that will foster voluntary tax payer compliance in Kenya.

1.8 Chapterization

Tax compliance level in Kenya is low and as the problem is addressed in chapter one it is suggested that there are little or no incentives that can promote and cultivate the culture of voluntary tax compliance without enforcement from government agencies. Further it is suggested in this chapter that balance should be struck between enforcement and persuasion as means of ensuring tax compliance.

Chapter two involves the tax administration in Kenya though tax regimes, the responsibilities of KRA in conjunction with the ministry of finance, powers of the commissioner general of tax and how the above influences tax compliance in Kenya. This chapter also pays attention to the tax laws which govern the taxation of income. Imposition of custom duties and the administration of value added tax. These legislations are important because they govern the tax regime in Kenya and it is imperative to talk about them.

Chapter three entails use of already existing data to show tax compliances a myth and it goes further to demonstrate that the taxpayers do whatever is in their power to resist

payment of taxes. This chapter contains a thorough discussion of how taxpayers undermine the efforts of the Kenya Revenue Authority in if legal obligation in the enforcement of tax compliance.

Chapter four encompasses the challenges that are faced by the Kenya Revenue Authority in the enforcement of tax and ensure tax compliance in Kenya.

Chapter five includes recommendations and conclusion. The chapter suggests the steps to be taken to improve tax compliance which has not been achieved in Kenya so far .

CHAPTER TWO

2.0 Introduction

This chapter outlines different modes of tax flight strategies that are employed by private individuals or corporations with the purpose to minimize or circumvent their tax liability. The chapter intends to give a broad overview on the most prevalent instruments that are constraining revenue mobilization efforts in Kenya.

In Kenya the tax compliance requirements according to the income tax laws relating to businesses are: Keeping of up to date books of account by businessmen, acquiring of Personal Identification Numbers (PIN) by all potential taxpayers, determining the taxable income according to the stipulated rules and regulation, accurate determination of tax liability, filing of returns on income by the prescribed date, paying of tax dues by the prescribed date, payment of fines and penalties for overdue taxes and allowing of audit by tax collectors if deemed necessary. The respondents were asked to give information relating to the above compliance requirements to enable and facilitate the determination of the levels of tax compliance and how taxpayers' attitude influence tax compliance in Kenya. On the possession of a personal identification number (PIN) majority of the Kenyan taxpayers do not have it (PIN), and from the research data 47% of the Tax payers indicated that they have this requirement, as 53% indicated they don't have¹⁵. This distribution may be because of the lack of understanding of the Kenyan tax law, which the taxpayers perceive to be very unfair and thus why a vast majority do not comply with .

¹⁵ Daily Nation, 13th July 2008

2.1 Improper keeping of records

On keeping up to date transaction records and books of accounts, the taxpayers do not keep up to date transaction records and books of accounts i.e. cash receipts, invoices, journals, ledgers cash books, trial balances, profit and loss accounts, and balance sheet. From the research data, it was ¹⁶ indicated that they have partially complied in terms of keeping up to date records and books of accounts. This is because most of them (more than 40%) keep Cash receipts, Cashbook, Balance sheet, Invoices, and Profit and Loss accounts. But other records like the trial balance, Journals and Ledgers as requirements for tax compliance are not up to date. Generally, there is some sort of non-compliance in keeping up to date records and books of accounts.

2.2 Filing of tax returns;

Filing of tax returns is one of the requirements on tax compliance. However, on the question whether taxpayers do regularly file tax returns, when and who files them and from the research data, 51% of the taxpayers comply which means .In the year 2005, the research data indicated that 26% of the taxpayers had filed their tax returns on or before 30th June, as 74% did it after 30th June.¹⁷ This shows that tax compliance is still low despite the efforts of KRA to make sure that there is maximum tax compliance.

¹⁶Moyi, E. D and Muriithi M.K. 2003. "Tax Reforms and Revenue Mobilization in Kenya", Research Paper No 131, African Economic Research Consortium (AERC), Nairobi, Kenya.

³ KRA. 2004. Staff Quarterly Newsletter, Kenya Revenue Authority, Edition No 22, December 2004

Paying taxes

Paying taxes is also one of the requirements of tax compliance in Kenya. In Kenya, taxation is the single largest source of government budgetary resources. Between 1995 and 2004, tax revenue constituted 80.4% of total government revenue (including grants). Relatively, the importance of non-tax revenue is also significant in sustaining the public budget, although its importance is much less than the role of taxation given that its share over the same period was 15.1%. Foreign grants play a minimal role as they have averaged only 4.5%. Given its central role, taxation has been applied to meet two objectives.

First, taxation is used to raise sufficient revenue to fund public spending without recourse to excessive public sector borrowing. Second, it is used to mobilize revenue in ways that are equitable and that minimize its disincentive effects on economic activities. Over time, Kenya has moved from being a low tax burden country to a high tax burden country, yet the country faces the obvious need for more tax revenues to maintain public services. Given the high tax burden, prospects to raise additional revenue seem bleak. In addition, Kenyans are yet to accept a tax paying “culture”. On one hand, those with political power and economic ability are few and do not want to pay tax. On the other hand, those without political power are many, have almost nothing to tax, and do also resist paying taxes. Since no one enjoys paying taxes, there is mistrust between those collecting taxes and taxpayers. This mistrust generates a game theoretic coexistence between tax agents and tax payers, with agents perceiving taxpayers as criminals unwilling to pay their taxes, and tax payers wary of government agencies’ high-handedness in collection of taxes.¹⁸ This creates the need for the tax agents to improve their image by building trust and public confidence. Even though the tax system has continuously changed, in pursuit of the

¹⁸ Supra note,33

objectives of the Tax Modernization Programmed (TMP) that came into force in 1986, the challenges that confront the tax authorities today are not much different from the pre-reform challenges. With Kenyan firms reporting that about 68.2% of profit is taken away in taxes, tax competitiveness is low and the country remains among the most tax unfriendly countries in the world. Tax evasion remains high, with a tax gap of about 35% and 33.1% in 2000/1 and 2001/2 respectively¹⁹.

2.3 Lack of proper auditing

In principle, the tax system is moving in the direction of self-assessment, whereby individuals and firms calculate their tax liability directly and submit returns and payments. Administrative assessment, on the other hand, requires that each taxpayer's liability is calculated by a revenue official, using data supplied by the taxpayer. In practice, there is a continuum of systems between these two, distinguished by the probability of being audited. Auditing activities have recently been streamlined with the merger of the Income and VAT departments under the DTD. This consolidation has allowed joint audits of VAT and income taxes, including PAYE taxes that are the responsibility of the employer (who is often a VAT payer). In 2004-05, two thousand audits were undertaken, raising KSh 5.5 billion.²⁰ To improve compliance among taxpayers, the KRA has developed an audit handbook, and is engaged in continuing taxpayer education activities.

The KRA, the Treasury, and KIPPRA recently fielded a survey to assess tax compliance issues in Kenya. Preliminary results show that 74 percent and 72 percent of respondents had been subject to a VAT and (corporate) income tax audit, respectively. Roughly one-

¹⁹KIPPRA. 2004a. "Tax Compliance Study", Tax Policy Unit, Macroeconomics Division, Kenya
²⁰KRA (2005b). "Statistical Bulletin (July 2004-June 2005)." Nairobi, Kenya: KRA

third and one-quarter of respondents reported being audited annually for VAT and income tax purposes. These audit rates appear high, but as participation in the survey was voluntary, they may well be overestimates of actual audit rates.

2.4 Tax Refunds

It is revealing that while most taxpayers surveyed reported being satisfied with the procedures for tax registration and payment, they also assessed the procedures for appeals, exemptions, remissions, and refunds as 'very poor' and 'unfair'. Typically, at least sixty days elapse before a refund is processed, and this delay can be as long as 120 days. All refunds, including those for VAT collected on imports, are processed by the DTD.

All requests for refunds e.g., for excess VAT paid must be audited, which may delay, and certainly adds to the cost, of receiving compensation for overpayment of net taxes. A further impediment to the speedy refund of excess payments is that such transfers are treated under the budget as expenditures, not as negative revenues. This distinction is important in practice (although of course not in theory) because it means parliament must pass an appropriation bill with funds earmarked for refunding. This leads to backlogs which are intermittently cleared, only to start growing again immediately. In addition there appears to be disagreement between the KRA and the Treasury over the size of refunds required, which again leads to delays. Refund policy should clearly be much more automatic, unless there are serious concerns over fraud that would be determined on a basis of risk assessment.

2.5 Domestic resistance

Vast majority of Kenyans resist to pay taxes including the opposition by local sugar producers to the liberalization of the sugar sub-sector to COMESA imports and the



opening up of the cereals sector under the Free Trade Area agreements. In 1998, the Minister of Finance proposed to increase the tax levied on subsidized loans to bank employees as a way of broadening tax base through taxing employer provided benefits. In response, around 12,000 bank employees began a nation-wide strike. As the strike entered its sixth day, paralyzing businesses, their employers announced that the striking workers would be sacked. In response, Kenya's trade union federation threatened to call a national strike and, recognizing the difficulty of the situation, the Minister was forced to reverse the decision. The KRA introduced Electronic Tax Registers (ETRs) in 2005 to ensure full remittance of VAT by retailers. This was resisted openly through strikes and street demonstrations in major towns in the country. Currently, ETRs are the subject of court battles between KRA and Traders (under the United Business Association).

The introduction of *Simba* 2005 system, an online value declaration customs system, has been strongly resisted, especially after it became evident that some imported vehicles had escaped the net following collusion between importers and customs officials.

2.6 Political influence

An unfriendly political economy that is not amenable to rational tax policy may prevent significant tax compliance. The political elite, who possess high personal income, wealth and property, may use their political influence to oppose the imposition of wealth and property taxes. This is what happened in November 2006, when Parliament rejected some of the June 8, 2006 budget proposals by the Minister of Finance. The proposals rejected included a tax on entertainment and house allowances for holders of constitutional offices, a tax on yearly donations to political parties exceeding KShs 1 million, tax on sale of houses by individuals (capital gains tax), an increase in tax on fortified wines from 45% to

65%, a proposal to tax cigarettes differently, and the proposal to shift the 7% sugar cane development levy from consumers to farmers.

2.7 Bargaining for tax incentives

These include misreporting and non-declaration of personal income or corporate profits to circumvent direct income taxation or tax obligations resulting from sales of goods and services. In this context, holding offshore financial accounts to conceal taxable income from tax authorities in the country of residence allows tax evaders to benefit from low or zero taxes abroad, exploiting bank secrecy and poor financial regulation abroad. The resulting tax revenue loss for developing countries is substantial: According to estimates reported by Global Finance Integrity (GFI), developing countries have lost \$858.6 billion – \$1.06 trillion in illicit financial outflows in 2006.

Along these lines, trade mispricing through faked invoices between colluding exporters and importers serves as a commonly used way to illegally transfer money from developing countries to financial accounts abroad usually with the purpose to evade taxes. In the past, developing countries like Cote d'Ivoire, Kenya or Nigeria fell prey to substantial illegal capital outflows that were based on deliberate over-invoicing of imports or under-invoicing of exports.²¹

²¹TJN – Tax Justice Network (2006), Newsletter 2006, Vol. 2(3).

2.7.1 VAT fraud

False statements of business transactions subject to VAT represents a type of tax evasion that has attracted increased attention in the course of broader adoption and rising rates of VAT or goods and services taxes (GST).

Fraudulent exploitation of the VAT system thereby takes a number of different forms and is carried out within as well as across national borders. All different forms of VAT fraud rely on the principle that all registered businesses are able to credit VAT expenses from purchasing input goods against VAT due on their sales.

In the simplest case, missing trader fraud includes under-reporting of sales by falsifying records and accounts allowing the fraudster to collect taxes without remitting them to the tax authority. Similarly, overstating purchases and forging invoices to increase the amount of VAT refunds are methods applied especially by new businesses where corresponding levels of sales are not expected immediately by illegitimately claiming a tax refund for the good that is export.

2.7.2 Misclassification of commodities and smuggle of goods

Another source of tax Non-compliance stems from the misclassification of commodities subject to different VAT rates with the purpose to reduce tax liabilities or increase claims for tax refunds. Related to revenue losses stemming from the above activities is the smuggling of goods across borders as a way of evading not only VAT liabilities but also other forms of indirect taxes such as customs and excise duties.

2.7.3 Bribery of tax officials

Developing countries that suffer from inefficiencies in the administration and enforcement of taxes are exposed to bribing activities.

All in all, it is important to note that the above described activity is not mutually exclusive but may also result as a consequence of one another. For instance, illicit financial flows that are directed to offshore accounts may result from proceeds that are realized through criminal activities such as the smuggling of goods or fraudulent manipulation of VAT records or bribery.

2.7.4 Profit shifting

Typically, subsidiaries of Multinational Enterprises (MNE) are treated as separate entities by tax authorities, i.e. they are liable to taxes in the country where they operate and reside. The separate entity approach is considered as a viable option to avoid double taxation as profits of the MNE are taxed only once in the residence country of the subsidiary. However, the approach can also be applied by the MNE to minimize the overall corporate tax burden. To this end, the MNE can engage in tax planning activities to shift profits within the affiliated group from high tax to low tax countries. Profit shifting can be achieved by manipulating transfer prices that is pricing of goods and services traded within the group, exploiting intra group loans and deliberately choosing the allocation of profitable intangible assets.

Transfer prices are intra-group prices for inter-company transactions of goods, services, (in)tangible and financial assets that are traded between affiliated companies. They constitute a necessary and legitimate tool for a corporate group to deal with intra-group transactions, assigning profits correctly to the relevant affiliate. This allows not only to identify profitable parts within the group, but also to avoid double taxation.

Apart from that, MNEs can distort transfer prices to reduce the group's overall tax burden manipulating the allocation of profits in particular high- and low-tax jurisdictions. The

possibility to manipulate transfer prices arises as there usually exists no commonly observable market prices that normally result from market transactions among independent economic agents to which the intra-group prices could be compared to. As inter-company transactions are often unique in their nature this offers a MNE considerable power of discretion in setting intra-firm transfer prices violating the arm's length principle. Consequently, to reduce its overall tax burden the MNE can try to set higher transfer prices for products and services that are transferred to divisions located in high-tax countries whereas low transfer prices are used for transactions with low tax countries. That way, costs for inputs are overstated and taxable profits generated in high-tax countries can be artificially minimized.

From the international perspective, barter trade and transfer pricing are closely related mechanisms of profit shifting. If goods and services are directly bartered instead of being sold and bought the firms involved in the exchange are mainly interested in receiving fair value in return for their barter goods. Prices are only fixed for purposes of taxation. As a consequence, artificially reducing these prices may help all parties involved to reduce their liabilities for taxes related to sales (VAT, excise duties, energy taxes etc.).

2.8 Tax incentives / tax expenditures

Tax incentives which also go by the names tax exemptions or tax subsidies are intentional exceptions from the general rules guiding the tax code. They present a frequently used instrument of governments to reach a specific economic, social or other political goal, e.g. they are often used to promote foreign investment. Governments promote certain activities by lowering tax rates, by postponing tax liabilities; by exempting activities from taxation or by giving them some other kind of favourable tax treatment.

Not all tax exemptions are implemented for some legitimate societal goal. Under certain circumstances nepotism, corruption, and low transparency they may just appear to be “tax evasion with an official stamp on it.” Certain individuals, firms, or groups receive favourable tax treatment – for instance, due to lobbying which is formally legal, but nevertheless illegitimate.

Furthermore, such favourable treatment evokes negative governance effects. In the Kenyan context, tax incentives to attract Foreign Direct Investment (FDI) can be the outcome of preceding lobbying activities by multinational companies which possess high bargaining power towards government officials of developing countries. Their bargaining power has additionally been aggravated in the course of increased global competition for mobile capital. As a matter of fact, tax incentives for foreign investments not only enable foreign firms to avoid taxation but in turn give rise to illegal tax evasion activities of domestic companies e.g. by re-labeling domestic investments as FDI or selling businesses to subsidiaries disguised as new investors as a means to become eligible for tax holidays that are exclusively granted to new investors.²²

²²Wanda Tseng and Harm Zebregs (2002), Foreign direct investment in China: Some Lessons for Other Countries, IMF Policy Discussion Paper PDP 02/3.

CHAPTER THREE

3.0 Introduction

In Kenya tax is administered by the Kenya Revenue Authority. The Authority was established by an Act of parliament on 1st July 1995 Chapter 469 for the purpose of enhancing the mobilization of the government revenue, while providing effective tax administration and sustainability in revenue collection²³. The KRA is a body corporate with perpetual succession to borrow, dispose of property and does anything that a body corporate can do. It is government agency for the collection of all revenues. The board and management of KRA have since its inception spent time and resources setting up procedures and the Adoption of new strategies aimed at enhancing the operational efficiency of the authority's process.

3.1 Functions of KRA

They include the following as provided for in the KRA Act²⁴

- a) To administer and enforce the written laws or the specified provisions of the written laws relating to revenue collection.
- b) To asses, collect and account for all revenues in accordance with written laws and specified provisions of the written laws.
- c) To advise on matters relating to the administration of and collection of revenue under the written laws or the specified provisions of the written laws.
- d) To perform such other functions in relation to revenue as the minister may direct.

²³ Section 3 of the KRA Act

²⁴ Section 5 of the KRA Act

3.1.1 Composition of the Board

The board has the following composition as provided for in the KRA Act.²⁵ It is the governing body of the KRA and it consists of the following directors

- i) A chairman appointed by the president.
- ii) The commissioner General.
- iii) The permanent secretary, ministry of finance.
- iv) The financial secretary, ministry of finance.
- v) The attorney general.
- vi) The governor central bank.
- vii) Four persons appointed by the minister of finance.

3.1.2 The Commissioner General

The office of the commissioner general is established as provided for in the Act who is appointed by the minister on the recommendation of the board and who is the chief executive officer of the Authority.²⁶

3.1.3 Tax Commissioners

The KRA Act provides that there shall be commissioners of customs and exercise, commissioner of the income tax and any other commissioner as is deemed necessary.²⁷ The commissioners are appointed by the Commissioner General with the approval of the finance minister.

²⁵ Section 6 of the KRA Act

²⁶ Section 4 of KRA Act

²⁷ Section 13 of KRA Act

3.2 Legal Framework

KRA administers taxation in Kenya through numerous written laws relating to revenue but in my research I will restrict myself to four Acts which are;

- The income Tax Act Cap 476
- The Customs and Exercise Act Cap 472
- The value Added Tax Act Cap 476
- The Stamp Duty Act Cap 480

3.3 Income Taxes

Income has been defined by different people. Many economists have different views of what constitutes income. Also, the way income is defined for tax purposes differ in several jurisdictions. Adam Smith stated that revenue is drawn from either labour, stock or land. That derived from labour is wages; that derived from stock by the person who employs or manages it is called profit; that derived from it by the person who does not employ it himself but lends it to another is interest on the use of money. Revenue from land is rent. He further distinguished stock into two folds. First, the part which a person expects to afford revenue is capital and secondly, that which is reserved for the purposes of revenue is reserve.²⁸ Therefore, stock in trade is circulating capital while investment in improvement of land, purchases of useful machineries and investment of trade or things which yield revenue or profit without changing masters is capital. In *John Smith and sons v Moore*²⁹ Viscount Haldane stated that the assets of a business including its goodwill and inherited contract by which to employ circulating capital constituted fixed capital.

²⁸ Adam Smith, (1776) The Wealth of Nations.

²⁹ (1921)AC 13

In *Eisner v Macomber*³⁰ Pitney J. stated that, in order to define income one need to distinguish between capital and income. He stated that, “ the fundamental relation of capital to income has been much discussed by economists the former being likened to a tree and the latter to a fruit or the crop the former being depicted as a reservoir supplied from the springs, the latter as the outlet stream to be measured by its flow during a period of time. Income may be defined as gain derived from capital, from labour, or from both combined, provided it being understood to include profit gained through the sale or conversion of capital assets.”

The characterization of income is not affected by the fact that the receipt is illegal, immoral or ultra vires. In *Lindsey v IR Commrs*,³¹ a whisky smuggler was taxed on the gains from smuggling. In *Minister of Finance v Smith*,³² it was held that even though the proceeds of respondent arose from illegal trafficking of liquor they were still assessable to tax since they came within the ambit of income.

Lord Macnaghten in the *London County Council v Attorney General*³³ defined tax as, “income tax if I may say so is a tax on income, it is not meant to be a tax on anything else. It is one tax not a collection of taxes in every case the tax on income whatever may be the standards.”

On the advent of colonialism, the failure of the imperial British East Africa Company to become a viable venture and the scramble for Africa led to the elevation of Kenya to the level of a British Colony. On what is now called the reception date (1887) the British government adopted Kenya as a colony of Britain. This meant that a number of administrative measures applicable in Britain were also to be applied in Kenya. One of

³⁰ 252 US 189

³¹ (1933)18 TC 43

³² (1972)AC 193

³³ (1901)AC 26 at 36

these measures was the importation of laws applicable in Britain then, and of these imported laws was the introduction of a government and laws of governance the new colonial government needed to raise funds to finance the government and reduce the strain on the colonizers. Thus in 1900 the colonial government introduced the hut tax through the hut tax Ordinance of 1900.³⁴

In 1952, the East Africa Income Tax Act was passed and a department of income tax was established to administer the collection of income tax in East Africa. After the break up of the East African Community in 1972, each country passed its own Income Tax Act. In Kenya the Income Tax Act cap 470 was born.

In Kenya, income tax has been designed to target corporate profits (Corporate Income Tax -CIT) and employment (personal income tax, PIT, and Pay As You Earn, PAYE). Income tax is charged directly on business income, employment income, rent income, pension earnings, investment income (dividends, royalties), commission and so on. Income from self-employment is subject to the PIT while employment income is subject to PAYE. The PIT and PAYE are charged at the same graduated scale while CIT is charged on profits on limited liability companies. Other income taxes include fringe benefits tax, advance tax, taxes under Widows and Orphans Act and Parliamentary Pensions Act.

At the theoretical level, income taxation is applied to achieve broad objectives of income Redistribution and revenue mobilization. In practice, Kenya has relied heavily on income Taxation on the basis of ease of collection rather than on the basis of abstract principles of equity. This explains why the pre-reform period was characterized by high top marginal rates, very wide brackets between the lowest and highest brackets, discrepancy between

³⁴ G. Kitenga,(2010) Introduction to tax law.

CIT and PIT rates, too many income tax brackets, and low levels of compliance. Given these features, the main challenges of income tax reforms were to reduce the maximum rates, reduce the dispersion between the minimum and maximum rates, and rationalize the income tax brackets.

3.3.1 Charge of the Income Tax

Income tax in Kenya is charged under the provision of the Income Tax Act cap 470 laws of Kenya. It is charged on all the income of a person, whether resident or non-resident, provided that accrues in or is deriving from Kenya. The term income is not defined in the law. However, there are different thoughts for instance the accountants, legal and economic school of thoughts which have attempted to define income.

The accountant school of thought defines income as assets which have been acquired and have been accrued within the accrual period, less the cost of acquisition. The accrual concept refers to that which has been earned but not received.

The economic school was of two categories: classical and neo classical. The classical economic argue that income comes from; labour out of which came wages, property out of which came income called rent. On the other hand neoclassical economists argue that income is all the material acquisition of a person earned during a period from which an economic activity and which a money value has been given less all the costs of production and depreciation allowance.

Income tax is imposed on business income, employment income including benefits, rent income, and pensions.³⁵

- a) Business income.³⁶
- b) Income from employment or services rendered.
- c) Rental income.
- d) Dividends and interest.³⁷
- e) A pension charged or annuity.³⁸
- f) An amount deemed to be an income of a person under the income tax Act.
- g) Royalties.
- h) Management and professional fees.³⁹
- i) Employment income while non-residents are taxed income from employment with a Kenyan resident employer or a non-resident employer with a permanent establishment in Kenya.⁴⁰
- j) Payment to sportsmen and entertainers.
- k) Any gains accruing in the circumstances listed in the 8th schedule.

Income tax is charged for each year of income which is a period of 12 months. This has to be distinguished from the accounting year, which in the case of a company but not an individual, need not coincide with the year of income.

Income tax is charged on all the income of a person, whether resident or non-resident, which accrues in or is derived from Kenya. In *Esso Standards Eastern Inc. v Income*

³⁵ Section 3(2) income tax Act

³⁶ Section 4 of Income tax Act

³⁷ Section 10 of the income tax Act

³⁸ Section 8 of the income tax Act

³⁹ Supra note 10

⁴⁰ Section 5 of the income tax Act

*Tax*⁴¹ the commissioner of income tax confirmed an assessment on the appellant of income tax interest received by it in respect of a loan. The agreement of the loan was made with a Kenyan company for a construction of a refinery in Kenya and for working capital. The agreement was made in New York in dollars. The question was whether the interest on the loan accrued in or was derived from Kenya. It was held inter alia that;

- i) The source of income is the place which it is derived and was a question of fact.
- ii) The source of interest was the contract made in New York, the location of that source was New York and the interest neither accrued nor was derived from Kenya.

3.3.2 Gains or profits from Business

The taxation of business income is governed by the income tax Act ⁴². Business is defined as including any trade, profession, vocation or adventure in the nature of trade but does not include employment.⁴³ In *IRC v Maxse*⁴⁴ it was stated that a profession involves the idea of an occupation requiring either purely intellectual skills or manual skills to control it for example, painting, sculpture, surgery or law.

A vocation is a calling to serve or a way of life with no care to the payment for instance priests. Vocations are independent activities one undertakes thus they amount to business.

The determination of whether a business exists is like all questions of fact, a matter of judgment impression and degree. In *Ericsson v Last*⁴⁵ Jessel MR said, "There is not I think any principle of law which lays down what carrying on trade is. There are multitude of things which together makeup the carrying on of trade, profit motive scale activity, whether ordinary commercial principles are applied, characteristics of the line of business

⁴¹ (1971)EA 127

⁴² Section 4 of the income tax Act

⁴³ Section 2 of the income tax Act

⁴⁴ (1919)1 KB 647

⁴⁵ (1881)8 QB 416

in which the venture is carried on, repetition and a permanent character, continuity and systems, are all indicia to be considered as a whole although the absence of any one would not necessarily result in the conclusion that no business is carried on.” In *Ramson v Higgs*⁴⁶ Lord Wilberforce defined trade as “involving normally the exchange of goods and services, for reward not all services, since some qualify as a profession or employment or vocation, but there must be something which the trade offers by way of business.”

In *customs and exercise Commissioners v British Railways Board*⁴⁷ the operation of pension fund for the benefit of its employees was held to be part of business carried on by the British Railways Board, even though its statutory duty was to provide railway services. In *Smith v Anderson*⁴⁸ It was held that the expression “ carrying on business” implies a repetition of act and excludes in the case of an association for doing one particular act which is never to be repeated. Business refers to any income derived by a person in carrying on a business and includes gains and losses on disposal of assets, derived by a person on the disposal a business assets or on the satisfaction or cancellation of a business debt whether or not the assets or debt was on revenue or capital account, any amount derived by a person as consideration for accepting a restriction on the person’s capacity to carryon business.⁴⁹

3.3.3 Capital gains v Revenue

Income tax charges tax on the amount of any gain derived by a person on the disposal of a business asset or on the satisfaction or cancellation of business debt, whether or not the

⁴⁶ (1974)3 ALL ER 94

⁴⁷ 1976)1 WLR 1036

⁴⁸ (1880)15 Ch.D 247

⁴⁹ Section 19 of the income tax Act

asset is defined as an asset used or held ready for use in a business and includes any asset held for sale in a business and any asset of partnership or company.

The definition of business asset has not been judiciously in Kenya. However it would arguably include payment of a release from an agreement made by a director to a company. Thus in *O'Brien v Benson Hosiery Ltd*⁵⁰. The taxpayer company received GBP 50000 from one of its directors in furtherance of an agreement to release that director from obligations under his service contract with the company. The taxpayer company was assessed to tax on the basis that its rights under the service of contract were assets and that the release of these rights in return for the capital sum was a disposal of assets. It was held that the rights released by the company were assets and that the capital sum received by the company in the return for their release was chargeable to tax.

In *Commissioner of Income tax v Jaffer Bros. Ltd*⁵¹ the assessment of the respondents for the year 1953 included among their taxable income the sum of Shs 6000 shown in the accounts of the respondents as being rent restriction ordinance and the payment was made to induce them to vacate. The respondents contended that the sum paid by them was an outgoing property deductible. The Jinja income tax committee allowed the appeal by the respondents but the commissioner appealed contending that the sum paid was expenditure for a capital purpose and therefore not deductible. The question was whether the amount was incurred wholly and exclusively during the year of income in the production of income and as such deductible. It was held that the payment to the tenant secured for the respondents the use of additional premises in which to carry on their expanding business

⁵⁰ (1980)AC562

⁵¹ EA U MA NO 9 OF 1956

thereby an enduring benefit and there were no special reasons why the payment should be treated otherwise than expenditure for a capital purpose.

3.3.4 Rental income

This refers to gains or profits from a right granted to another person for the use or occupation of property. It includes a royalty rent, premium or similar consideration.⁵² The Act does not define property but the interpretation and general provisions Act defines property as...money goods choses in action, land and every description of property, whether movable or immovable and also obligations, easement and every description of estates interest and profit, present or future, vested or contingent, arising out of or incident to property however defined.

Royalty means a payment made as a consideration for the use of or the right to use;

- a) A copyright of a literary, artistic or scientific work or
- b) A cinematographic film, including film or tape for radio or television broadcasting; or
- c) A patent, trade mark, design or model, plan, formula or process ;or
- d) Any industrial commercial or scientific equipment.

Rent and premiums are amount taxable in full in the year in which it was received without spreading it over the lease term. However, the expenditures incurred in generating rent or premium are deductible. It is also an established principle that all expenditure incurred, including rates and interest, throughout the construction period up to the date when the property is first used should be regarded as capital outlay for which no deduction can be allowed.

⁵² Section 15 of the income tax Act

3.3.5 Divided and interest income

Divided is defined as ... any distribution (whether in cash or property, and whether made before or during a winding up) by a company to its shareholders with respect to their equity interest in the company, other than distribution made in complete liquidation of the company.⁵³ Dividends include any distribution by a company to its shareholders, including in a winding-up except for reimbursement of sums paid as a share capital.

Dividends paid by Kenya resident companies are deemed to be income of the year which they were payable. For example if dividends are declared in the respect of the year 1997 but are paid in the year 1998 such dividends will be deemed to be the income of the recipient for the year of income 1998. Accordingly, the rate of tax redundant by the fact that taxation of the dividends other than dividends paid by a cooperative society paid to Kenya residents is limited to the withholding tax deductible at source. Dividends received from sources outside Kenya are deemed to have accrued in or derived from Kenya and are not subject to Kenyan tax.

3.3.6 Interest Income

Interest is defined as ... interest payable in any manner in respect of a loan, deposit, debt, claim or other right or obligation, and includes a premium or discount by way of interest and a commitment or service free paid in respect of any loans or credit.⁵⁴ Tax on qualifying interest paid to a resident individual is limited to the withholding tax deducted at source.

⁵³ Section 2 of the income tax Act

⁵⁴ *ibid*

3.3.7 Employment income and PAYE Tax law

The income derived by an employee from any employment is taxable.⁵⁵

Employment income is taxable for the year of income in respect of which it is received or accrued. Taxable employment income include:

- a) All cash payment however described;
- b) The value of any non cash benefits exceeding Ksh.200 per month and;
- c) Compensation for termination of an employment contract.⁵⁶

Employment income include any wages, salaries, leave pays, payment in lieu of leave, fees commission, bonus, gratuity, or any subsistence, travelling, entertainment utilities, cost of living, housing, medical or other allowances. In *Hamblett v Godfrey*⁵⁷ the right to belong to a trade union and certain other rights under the employment protection legislation were withdrawn from civil servants working with the Government Communications Headquarters (G.C H.Q) including the taxpayer Hamblett. A payment of 1000 pounds was made to those employees who wished to continue to be employed at GCHQ In recognition of the withdrawal of these rights. Hamblett received the 1000 pounds but appealed against assessment under income Tax Act contending that the payment made was neither an emolument nor chargeable under the British Income and Corporation Taxes Act 1970 but a solatium. It was held that the payment was an emolument within the Act and taxable since it was made for the loss of rights within the employment protection legislation and was thus recognition of changes in the contract of services. The source of payment was the employment and was referable to employment

⁵⁵ Section 5 of the Income Tax Act

⁵⁶ Section 5 ITA

⁵⁷ (1987)ALL E.R 916

and nothing else. In *Glanre Engineering Ltd v Goodhand* ⁵⁸the taxpayer company offered a lump sum payment of 10000 pounds to Wells as an inducement to him to leave the firm which he was then working and take up employment with the taxpayer company. Wells accepted the offer, and was paid the 10000 on taking employment with the company. Wells was assessed to tax on this inducement. The issue arose as to whether this payment was an emolument within the Income and Corporations Taxes Act. It was held that the payment was an emolument.

Allowances are also considered as part of employment benefits and hence are taxable. It is possible for an employee to receive a stated sum less some deduction or a stated sum plus some benefit received in a form other than cash. The allowances currently cover travelling, lunch and entertainment, accommodation and provision of an official car. In *Machon v McLoughlin* ⁵⁹the taxpayer was a male attendant at an asylum. He received a weekly salary subject to fixed deductions, before payment for board and lodging and for laundry. He contended that only the amount of salary was assessable. It was held that he was assessable in respect of the gross amount. Rowlatt J thus stated "... if a person is paid a wage with some advantage thrown in, you cannot add the advantage to the wages for purposes of taxation unless the advantage can be turned into money. That is one proposition. But when you have a person paid a wage with the necessity if you like to expend that wage in a particular way, then he must pay tax upon the gross wage and no question of alienability or inalienability.

⁵⁸ (1983) 1 ALL E.R. 542

⁵⁹ (1926) 11 T.C. 83

PAYE tax is that payable on employment income through monthly deduction and remittance by an employer. The basis of taxation for an employee is the same as that for any person subject to taxation in Kenya for example income tax is chargeable on all the income of a person, whether resident or non-resident, which accrues in or derived from Kenya⁶⁰. An employer for this purpose will include anyone through whom an employee of a non-resident employer gets his pay. The procedures for accounting for and remitting PAYE tax are contained in the income tax PAYE Rules under subsidiary legislation provisions of the income Tax Act. The rates of tax Act are set out in the third schedule of the ITA.

3.4 Fridge Benefit Tax (FBT)

The 1998 Finance bill introduced two amendments to the taxation of employment income as it relates to soft loans the impact which is as follows; with regards to existing loans employees will continue to be taxed under the provisions of subsection 2A of section 5 and in addition employers will be subject to fridge benefit tax on the greater of;

- a) The difference between the prescribed rate of interest and the market interest rate.

The latter is defined as the average rate of interest for the 91 days treasury bills issued in the month prior to the month in which FBT is charged; and

- b) Zero.

The FBT is to be computed and paid monthly with effect from 1st July 1998. However the tax for July to December 1998 may be deferred to 1st July 1999.

⁶⁰ Section 3 ITA

3.5 Exercise laws

The main sources of exercise laws in Kenya is the custom and exercise Act Cap 473, Regulations. The Domestic Taxes Department is responsible for the management of exercise laws. In Kenya, exercisable are classified in accordance with harmonized commodity coding Treaty of the World. Customs organization is also a source of exercise law in Kenya

Before 2005, the customs and exercise Act chapter 472 was administered by the customs department. However in an effort to separate and consolidate domestic from non-domestic taxes, exercise functions was transferred to Domestic Taxes Department. This department is headed by a commissioner who is appointed in accordance with section 11(4) of the KRA Act.

3.6 Value Added Tax

Value added tax is a multi-stage consumption tax based on the destination principle. It is charged on both local sales and importation of taxable goods. It is an indirect tax collected on various stages of the supply chain. Value added is the value that a producer adds to an input before selling the new improved goods and services at all stages of the production and distribution chain.

VAT has been operationalized in Kenya since 1989 when it replaced sales tax. The tax is ultimately paid by the consumers of taxable goods and taxable services. Players in the supply chain merely acts as collection agents who collect the tax and then remit it to the government. Those in the intermediary stages in the supply chain usually collect the tax and pass it on to the next stage. The amount of VAT passed down in the supply chain however, depends on the elasticity of demand for the supply or service. Often, some of the tax burden is born by the agent where he cannot pass the whole burden down stream.

3.6.1 Charge of VAT

VAT is charged on the supply on the supply of taxable goods or services made or provided in Kenya by a taxable person in the course of or in furtherance of any business carried on by that person and on the importation of goods and services into Kenya.⁶¹ VAT is levied on;

- a) Every taxable supply made by a taxable person;
- b) Every supply of taxable goods other than an exempt goods and;
- c) The supply of any taxable services by any person.

3.6.2 Cannons of VAT

- i) There must be a supply.
- ii) VAT is a tax on supplies not on income. The profit motive test is therefore immaterial in so far as VAT is concerned. A charitable organization that run a restaurant to supplement its grants will be expected to register and account for the VAT supplies.
- iii) Supply must be taxable.
- iv) Not all supplies are subject to VAT. One needs to determine whether one's supplies are taxable or exempt from VAT.
- v) The supply must be in the country where the supply is made. A trading in a foreign country is not expected to account VAT in another country. In the case of imported services, where the supplier of the services is normally resident outside Kenya, the commissioner may appoint person to collect the tax payable on the services and remit it to the department.⁶²

⁶¹ Section 6 of VAT Act

⁶² Section 6 of VAT Act

vi) The supplier must be a taxable person.

If one does not fall under the definition of VAT purposes, then there will be no need to account for VAT.

3.6.3 VAT is payable by

- a) The taxable person making the taxable supply in case of the taxable supply;
- b) The importer in case of an import of goods;
- c) The recipient of taxable services in case of an import of services.⁶³

⁶³ Section 6(4) VAT Act

CHAPTER FOUR

4.0 Introduction

This chapter deals with the challenges that are faced by the KRA and other government authorities in the implementation of tax legislation and collection of taxes. These challenges include the following:

4.1 Tax Evasion and Avoidance

The issue of tax evasion and avoidance is a complex multidimensional problem. There are many different reasons why individuals and corporations try to avoid or reduce the amount of tax they have to pay either by semi-legal or illegal practices.

The subject of tax evasion and avoidance embraces many dimensions and problems. As there exists no clear-cut distinction between tax evasion and tax avoidance, one firstly needs to define which practices can be considered as violation or abuse of tax codes.

4.1.1 Tax evasion

In general refers to illegal practices to escape from taxation. To this end, taxable income, profits liable to tax or other taxable activities are concealed, the amount and/or the source of income are misrepresented, or tax reducing factors such as deductions, exemptions or credits are deliberately overstated.⁶⁴ Tax evasion can occur as an isolated incident within activities that are in other aspects legal. Or tax evasion occurs in the informal economy where the whole activity takes place in an informal manner. This means the business is not only evading tax payments but is also not registered as formal enterprise at all.

⁶⁴ Alm, James and Jorge Luis Martinez-Vazquez (2001), Societal institutions and tax evasion in developing and transition countries. A paper prepared for a public finance in developing and transitional countries conference, Georgia State University

4.1.2 Tax avoidance

In contrast, takes place within the legal context of the tax system that is individuals or firms take advantage of the tax code and exploit “loopholes”, i.e. engage in activities that are legal but run counter to the purpose of the tax law. Usually, tax avoidance encompasses special activities with the sole purpose to reduce tax liabilities. An example for tax avoidance is strategic tax planning where financial affairs are arranged such in order to minimize tax liabilities by e.g. using tax deductions and taking advantage of tax credits. The taxpayer is not obliged to follow the spirit or the underlying purpose of the tax code but only the letter of the law. Yet in practice, this boundary often is less than clear. Sometimes, the loopholes which are explored via tax planning are clear and unambiguous. Often, they are not. Hence, tax avoidance often takes place at the margins of the tax code, in areas where the code is ambiguous and in need of interpretation. In areas where the tax administration decides with a certain degree of discretionary authority, the distinction between avoidance and evasion is blurred. This becomes even more relevant if countries change the tax regulations concerning tax loopholes retroactively.

In many instances, the distinction between tax avoidance and tax evasion is clear only from the ex post perspective, ultimately a post-court perspective. For this reason, tax evasion and tax avoidance are usually treated jointly, despite their difference.

4.2 Low tax morale

Taxpayers' willingness to pay taxes differs widely across the world. It cannot be viewed as simply depending on the tax burden. Rather, empirical research indicates that taxpayers throughout the world pay more taxes than can be explained by even the highest feasible

levels of auditing, penalties and risk aversion.⁶⁵ These high levels of tax compliance result from the tax morale of society that fosters self-enforcement of tax compliance.

Tax morale is, however, not easy to establish. Especially countries without a deep-rooted 'culture' and habit of paying taxes like Kenya find it difficult to establish tax morale.

4.3 Low quality of the service in return for taxes

In general, citizens expect some kind of service or benefit in return for the taxes paid. If the government fails to provide basic public goods and services or provides them insufficiently, citizens may not be willing to pay taxes and tax compliance turnover in a year of income will usually remain low.

4.4 Tax system and perception of fairness

Some studies suggest that high tax rates non-compliance. The intuition is that high tax rates increase the tax burden and, hence, lower the disposable income of the taxpayer.⁶⁶ However, the level of the tax rate may not be the only factor influencing people's decision about paying taxes. In fact, the structure of the overall tax system has an impact as well. If, for example, the tax rate on corporate profits is relatively low, but individuals are facing a high tax rate on their personal income, they may perceive their personal tax burden as unfair and choose to declare only a part of their income.

⁶⁵ Alm, James, Betty Jackson and Michael McKee (1992), Institutional Uncertainty and Taxpayer Compliance, *American Economic Review*, 82 (4), 1018-1026.

⁶⁶ Allingham, Michael G. and Agnar Sandmo (1972), Income tax evasion: A theoretical analysis, *Journal of Public Economics* 1, pp. 323-338.

4.5 Low transparency and accountability of public institutions

Lack of transparency and accountability in the use of public funds contributes to public distrust both with respect to the tax system as well as the government. This, in turn, increases the unwillingness to pay taxes. The taxpayers believe that the amount of taxes that they do pay should be in consonance to the services delivered by the government. Another thing is that the masses are not consulted by the government and KRA when it comes to formulation of legislations pertaining to taxes.

4.6 High level of corruption

If due to high levels of corruption, citizens cannot be certain whether their paid taxes are used to finance public goods and services their willingness to pay suffers and it becomes more likely that they refuse to honour their tax liabilities. A taxpayer might consider evading taxes if the cost of bribing a tax auditor is lower than the potential benefit from tax evasion.

4.7 Weak enforcement of tax laws

While the preceding section discussed the sources for low voluntary compliance and high regulatory costs of tax compliance, the current section turns to challenges in the enforcement of tax laws. There exist several circumstances that restrain tax administrations from performing their functions properly thereby increasing the possibility lack of tax compliances. Shortfalls in tax collection procedures as well as weak capacities of tax administrations to detect and prosecute tax violators are both factors that contribute to a low enforcement of tax legislation.

4.8 Insufficiencies in tax collection

Regarding tax collection, many developing countries like Kenya face difficulties with respect to important premises for a well functioning tax administration, especially with respect to identifying and administering those citizens and firms that are liable to tax payments. Although there has been progress, tax administrations' capacity to introduce and sustain e.g. well-functioning tax registers still pose severe difficulties in many developing countries. Problems of insufficient capacity may also occur due to the organizational set up of the tax administration and its relationship to the ministry of finance. In general, there are two approaches for the organizational set up of tax administration. The first option is where the ministry of finance itself assumes the tax administration function and departments within the ministry of finance collect taxes. The second option is a semi-autonomous revenue authority where tax administration is moved out the ministry of finance into a separate entity.

Often, tax administration and collection by ministries of finance were considered inefficient and suffering from corruption and high compliance costs. Therefore the creation KRA as a semi autonomous revenue authorities has been pursued in Kenya mostly as part of comprehensive tax administration. Additionally, unclear responsibilities regarding the collection and administration of specific types of taxes by different institutions can lead to inefficiencies and tax losses and require a reorganization of the tax administration. Typically, an organizational approach according to the functions of tax administrations is considered more efficient than one following different tax and revenue types.

Moreover, one has to bear in mind that tax administration and tax policy are intertwined spheres. Tax policy directly affects the costs and the organization of the tax administration. Additionally, the capacities of tax administration influence the way tax policy is implemented. Thus, both areas tax policy as well as tax administration have to be taken into consideration when designing successful tax legislations. Otherwise, the proper functioning of the overall system is affected. For this reason, the tax system should be aligned to the administrative and legal prerequisites of the respective country.

Qualified, well trained and motivated tax officials are crucial for the collection of taxes and the performance of tax administration bodies as a whole. In order to motivate tax officials to work in accordance with the interests of the government and to reduce their vulnerability to corruption, attention has to be given to wages and other incentives.

Finally, insufficiencies in tax collection result from the fact that economies of most developing countries are characterized by a large informal sector. Firms and individuals active in the informal sector usually do not pay direct taxes on personal or business income, and they do not charge consumption taxes or excises on their sales. The state loses these potential tax revenues and, as a consequence, lacks necessary funds to provide goods and service. Often, the reasons to be active in the informal economy are not directly related to attempts to avoid taxation but rather to limited options or excessive administrative requirements to enter the formal economy or excessive costs of labour regulations. However, there are also cases where individuals and companies choose to be active in the informal sector with the intention to escape their tax liabilities.

4.9 Weak capacity in detecting and prosecuting inappropriate tax practices

A well-functioning body of tax investigation is essential for the detection and prosecution of cases of tax fraud. The lack of sufficient capacities in tax administrations reduce the probability of detection that again influences the decision of a taxpayer as to whether evade or not. Additionally, the legal framework is an important prerequisite for any enforcement activity. For example, the size and nature of penalties that are incurred after evasion has been detected is directly connected to the level of tax compliance.⁶⁷

Finally, tax laws in many countries, especially in developing countries like Kenya changes rapidly, thus producing instability and low transparency of the tax code. As a result, complicated tax legislation and ongoing changes of the tax code confuse tax administrators and taxpayers alike. Furthermore, it results in tax evasion which is not intentional, but occurs due to lack of knowledge ignorance. In extreme cases, tax evasion and avoidance even become inevitable when the tax system becomes too complex and/or contradictory to follow. The reasons listed above do not occur in isolation and some are mutually enforcing. Often, tax non-compliance is a by-product of deficient political, economic and social governance in a country.

⁶⁷ Fishlow, A. and J. Friedman (1994), Tax evasion, inflation and stabilization, *Journal of Development Economics*, Vol. 43, No. 1, pp. 105-123.

CHAPTER FIVE

CONCLUSION AND RECOMMENDATIONS

5.0 Introduction

As the preceding chapters indicate, there is a large variety of reasons and factors contributing to a situation where tax non-compliance occur on a large scale. This may be derive from low tax morale, high compliance costs or may result in the course of firms' endeavours to maximize profits by reducing their tax liabilities. The practicability and the size of the window of opportunity depend on the specific situation and the predominant type of non-compliance in a country. An effective strategy needs to address the underlying causes and most importantly in this context and needs to be tailored to the Kenyan country environment. If, for example, the observation of tax compliance capacity is low, reform strategies should either not be too ambitious or be accompanied by extensive capacity development initiatives. If, on the other hand, the tax compliance observation capacity is very high, simple reform strategies will likely be successful. Still, such a strategy would be unbalanced in the sense that more complex and more ambitious reforms could already be initiated.

Based on the preceding chapters on the various reasons and modes of non compliance of tax the present chapter describes potential ingredients of such an effective, country-specific strategy to fight specific causes and factors contributing to non-compliance of taxes.

RECOMMENDATIONS

5.1 Measures improving tax compliance

Low tax compliance contributes to a large extent to insufficient revenue mobilization resulting from to evasion and avoidance of tax payments. It involves voluntary compliance of the single tax payer but also further aspects like taxpayer's knowledge on tax procedures necessary for the fulfillment of the taxpayers duties.

The improvement of citizens' tax morale requires measures ensuring and visualizing that the state is acting in a transparent, accountable and efficient manner with the ultimate aim of providing services for its citizens. These measures go far beyond reforms of the tax system or administration by developing a sound state-society relationship and enhancing the legitimacy of the state requires taking into account the entire public system. Such broader strategies cover e.g. the quality of public services, the transparency and control of the public budget or the fight against corruption.

5.2 Taxpayer education and taxpayer service

The importance of taxes for the functioning of the state is not always apparent to the taxpayer. Similarly, individual tax liabilities as well as requirements to comply with the tax system such as filling out different tax forms might be unknown or difficult to understand. By means of taxpayer education and taxpayer service, citizens can be informed and educated about the tax system and be assisted in their attempts to comply with the tax system. Efforts in this direction have been conducted e.g. by the Kenya Revenue Authority.

5.3 Addressing tax compliance costs and administrative costs

Apart from promoting voluntary tax compliance, governments in developing countries as well as development partners should concentrate on measures that reduce taxpayers' costs of fulfilling their tax liabilities.

In this regard, revenue authorities must be aware of the importance of acting service oriented and should therefore monitor customer satisfaction. Many revenue authorities shift towards a customer service orientation which reflects the growing awareness of the need to offer a quality service to the taxpaying public and to be responsive to public concerns. For instance, measures to simplify the taxpaying process and promoting service oriented tax administration include a reduction of the number of tax forms and officers assisting clients in filling out documents or the introduction of online services.

5.4. Measures improving the ability to enforce tax laws

Similarly to low tax morale, the ability to enforce taxes is influenced by a broad variety of factors. Not all of these can be tackled directly by reforms of the tax system or the tax administration but also it is important to put in place measures geared at improving laws that enforce tax compliance.

5.5 Change the perception of the society with regard to payment of tax

One has to bear in mind that the success of tax compliance campaign strategy depends on fundamental changes in the way of thinking and the perception of paying taxes in the entire society. Therefore, this change takes time and requires sustainable, long-term changes and commitment to finally materialize. Yet, one has to acknowledge, that even if social trust can be established and the state is perceived as legitimate, there will remain some degree of tax non-compliance resulting from free-rider behaviour: part of the

population will never be willing to contribute to public services if they can free-ride on contributions of others. While this behaviour can to some extent be addressed by adequate sanction mechanisms, perfect compliance of all tax payers will probably never be established.

5.6. Reforming Tax enforcement laws

Particularly Kenya suffer from the lack of enforcement of national tax laws that can to large extent be traced back to insufficient administrative capacities. Additionally, weak enforcement by national authorities also originates from cross border activities of firms to save or even escape from taxation. Measures in this area include different approaches of organizational reform such like the creation of semiautonomous revenue authorities, setting-up of Large Taxpayer Units as well as capacity development such as trainings and courses on selected topics, e.g. specialized courses in the area of detecting illegitimate profit shifting activities or tax fraud, but also restructuring of the wage schedule to offer sufficient incentives in order to attract and recruit capable staff and to minimize the risk of corruptive behaviour.

Reforms referring to the organization of the administration are a sensible step to enhance law enforcement. Often, the organizational setup of the tax administration is a reason for the extent and prevalence of inefficiencies. Therefore, public administration reforms should aim at simplifying the organizational body of tax administrations and its working structure. For instance, to try to reduce the number of authorities dealing with tax issues and centralize the collection of tax revenues to one single authority.

Between and within different authorities, competences need to be divided and different departments within the institutions need to be mandated explicitly. Especially when it

comes to exchanging information within the institution, simplification of the administrative organization might be a useful contribution.

Strategies to strengthen tax administration should also focus on reducing administrative costs inside the tax administration. For this purpose introducing unique taxpayer identification numbers are considered a useful instrument as they facilitate cross-checking of information between different types of taxes such as VAT and income tax. In addition, monitoring and auditing of tax payments and tax arrears are easier if a unique taxpayer identification number.

5.7 Large Tax Payer Unit

Small number of enterprises bear the lion's share of the tax burden. Focusing on a small group of crucial taxpayers simplifies the enforcement of corporate tax laws and, hence, allows tax compliance at minimum costs, as the Kenyan experience reveals: In 1998, the Kenyan revenue authority formed a large tax payer office (LTO) as a one-stop service, substantially reducing costs of complying with the tax law. The LTO's mandate covers the administration of income taxes, VAT, domestic excises and agency taxes. In 2006, the LTO covered 700 institutions which contributed about 75% of the domestic tax revenue.

The cases of Kenya illustrate that the establishment of LTUs is particularly suitable to target limited administrative capacities. However, despite of these advantages, one has to bear in mind that the creation of LTUs might slow down the process of integrating all citizens into the tax system in the long run. Including small and middle sized enterprises as well as natural persons into the tax system is essential to get society involved in public finance and to strengthen a state's legitimacy and accountability. If citizens pay taxes they are more concerned about how the government spends their money. Taxing also small

taxpayers leads to a critical monitoring of both the government and other, larger taxpayers by the public, thereby strengthening mutual accountability.

5.8 Complex and often changing tax laws

Complex and often changing taxes cause confusion and uncertainty among tax officials and taxpayers. Addressing deficiencies in the tax system is therefore probably as important as process orientated reform actions that enhance the user-friendliness and transparency of the taxation procedure. Particularly small and medium size enterprises (SME) with only limited administrative capacities and private households do not only suffer from the bureaucratic burden of complicated tax procedures but also from the complexity of the tax system itself. Simplifying the corporate income tax structure by reducing the number of tax brackets and high statutory tax rates lowers the tax burden and may support voluntary compliance. A comprehensive reform of the tax law might be more advisable than reforming the system step by step, thereby risking a complex financial law.

5.9 International endeavours to strengthen national tax law enforcement

The liberalization of goods and financial markets and the increased international mobility of capital flows pose a new challenge for countries on the field of taxation. In contrast to purely domestic tax issues, international modes of tax evasion and avoidance e.g. transfer pricing and the existence of tax havens can hardly be solved unilaterally by a single country. Given the low levels of revenues in many developing countries, the revenue shortfall due to lack of sufficient tax compliance. Lack of tax compliance at the international level causes severe problems to fund essential pro-poor programs.

Hence, there is a necessity to solve the problem on an international, regional and bilateral level. The transnational nature of these challenges commands actions to be taken at the

international level through enhanced exchange and cooperation among countries to promote transparency of MNEs' activities.

For instance, unveiling mispricing activities as well as irregularities in firms' transfer pricing practices requires a well functioning cross-border information exchange between domestic tax administrations, auditors and foreign public authorities. Tax Information Exchange Agreements (TIEA) aim at enhancing co-operation with low-tax jurisdictions including tax havens to foster exchange of information which helps to disclose illegal forms of profit shifting.

5.9.1. Summary and Conclusions

This research paper gives an overview of the available knowledge on tax compliance in Kenya. Although non-compliance of tax is a major problem in Kenya, literature and data concerning this topic are still scarce. This is partly explained by the fact that the extent of tax compliance and avoidance is hard to estimate as the phenomena are difficult to observe and precise data is lacking. So far there are no reliable empirical findings which provide a clear picture of size of the problem.

The findings suggest that there are various reasons and facilitating factors for Lack of tax compliance in Kenya. These might be categorized into factors that negatively affect taxpayers' compliance with tax legislation on the one hand and into reasons explaining the weak capacity of tax administration and fiscal authorities to enforce tax liabilities on the other side. In order to develop methods and instruments for ensuring tax compliance it is important to foremost establish a broad understanding of the different reasons underlying these problems.

First of all, there is a need for more detailed research on tax compliance in Kenya. Deeper knowledge that is produced on the basis of common, comparable academic standards and with the aim of collecting reliable country wide data is of key importance.

I would like to conclude by suggesting two concrete proposals for research projects and strategies which would extend the available knowledge on tax revenue mobilization in Kenya. It would be promising to investigate the determinants of tax payments of individual taxpayers using micro data. Since the availability of household data is very limited.

BIBLIOGRAPHY

Ajzen, I & Fishbein (1991.) "*Theory of Planned Behavior*," Vol 50, No 2 Organization Behaviour and Human Decision Processes. 179-211

Allingham, Michael G. and Agnar Sandmo (1972), *Income tax evasion: A theoretical analysis*, Journal of Public Economics 1, pp. 323-338.

Alm, James and Jorge Luis Martinez-Vazquez (2001), *Societal institutions and tax evasion in developing and transition countries*. A paper prepared for a public finance in developing and transitional countries conference, Georgia State University

Alm, James, Betty Jackson and Michal McKee (1992), *Institutional Uncertainty and Taxpayer Compliance*, American Economic Review, 82 (4), 1018-1026.

Blacks Dictionary 9th Edition 2009 page 1594

Brown, R.E & Mazur, M.J. IRS's *Comprehensive Approach to Compliance*. Paper presented at National Tax Association Spring Symposium in May 2003, Washington D.C.

Cobham , (2005). *Tax Evasion Tax Avoidance and Development Finance* .

Daily Nation. August 5, 2006

Daily Nation, 13th july 2008

Director, *Tax world Organization*, 7th April 1999

Fishlow, A. and J. Friedman (1994), *Tax evasion, inflation and stabilization*, Journal of Development Economics, Vol. 43, No. 1, pp. 105-123.

G. Kitenga,(2010) *Introduction to tax law*. Law Africa 2010.

KIPPRA. 2004a. "*Tax Compliance Study*", Tax Policy Unit, Macroeconomics Division,
Kenya

KRA. 2004. *Staff Quarterly Newsletter*, Kenya Revenue Authority, Edition No 22,
December 2004.

KRA (2005b). "*Statistical Bulletin (July 2004-June 2005)*." Nairobi, Kenya: KRA

Moyi, E. D and Muriithi M.K. 2003. "*Tax Reforms and Revenue Mobilization in Kenya*",
Research Paper No 131, African Economic Research Consortium (AERC), Nairobi,
Kenya.

Silvani, Silvani, C.A; *Improving Tax Compliance* . Washington D.C. International
Monetary Fund ,Publication Service.

Simiyu , N.T.T (2003); *Taxation in Kenya*. Nairobi :

TJN – *Tax Justice Network* (2006), Newsletter 2006, Vol. 2(3).

Trivedi & Shehata,s (2005). *Attitudes, Incentives, And Tax Compliance*.

Wanda Tseng and Harm Zebregs (2002), *Foreign direct investment in China: Some
Lessons for Other Countries*, IMF Policy Discussion Paper PDP 02/3.

