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Assessment of Direct Tax Revenue Mobilization in Kenya

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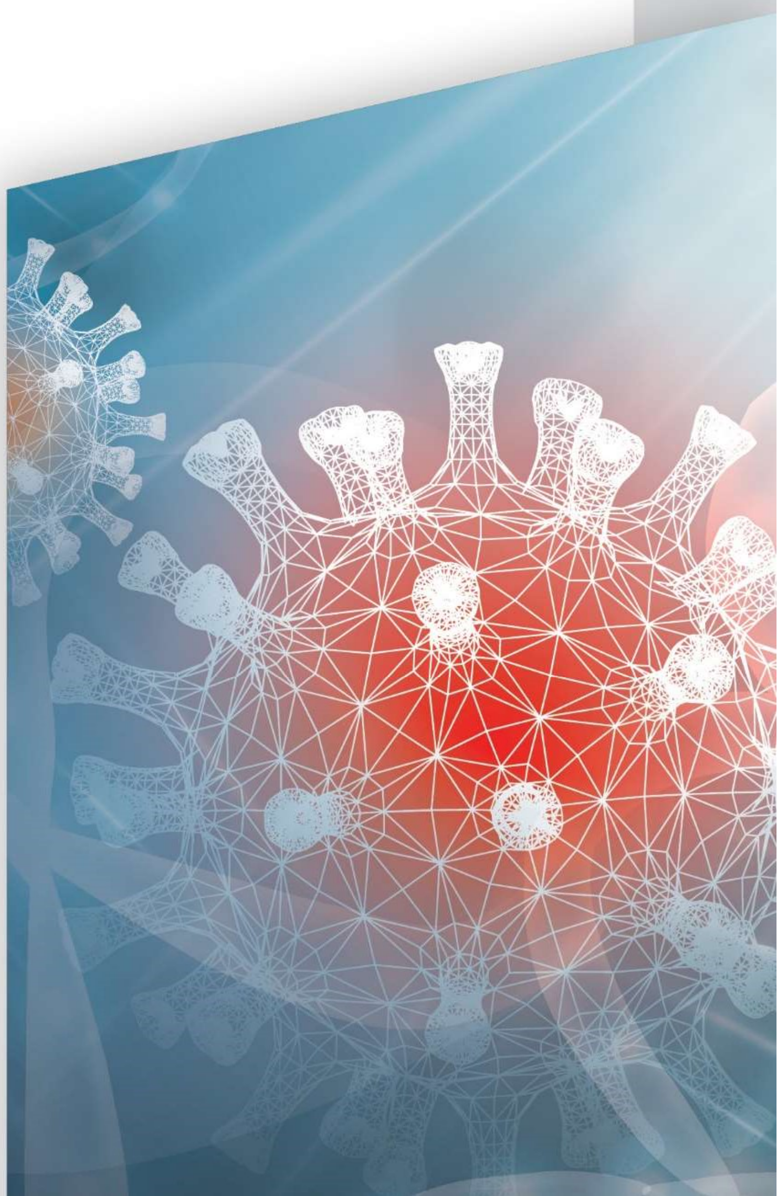

About the COVID-19 Response and Recovery project

This paper is an output from the project “Response and Recovery: Mobilising financial resources for development in the time of COVID-19”, which is co-ordinated by the Debt and Development Finance Branch of UNCTAD and jointly implemented with ECA, ECLAC and ESCAP. This project is one of the five UN Development Account short-term projects launched in May 2020 in response to the COVID-19 crisis.

In this work, a framework to assess external debt and financial sustainability and public sector sustainability through the lens of the achievement of the Sustainable Development Goals (SDGs) is presented. The approach differs in some key areas from the International Monetary Fund’s (IMF) Debt Sustainability Analysis (DSA), placing the external constraints and the resulting possible growth rate at centre stage. This in turn provides information on the fiscal space available to policy makers with which to achieve the SDGs through public investment.

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ABBREVIATIONS AND ACRONYMS

AAI:	ActionAid International
ASM:	Small and Artisanal mining
BEPS:	Base Erosion and Profit Shifting
BMS:	Block Management System
CAP:	Chapter
CGD:	Center for Global Development
CGT:	Capital Gains Tax
CIT:	Corporate Income Tax
COMESA:	Common Market for Eastern and Southern Africa
CS:	Cabinet Secretary
DST:	Digital service taxes
DTAs:	Double Taxation Agreements
DTD:	Domestic Taxes Department
EAC:	East African Community
EBIT:	Earnings Before Interest and Tax
EET:	Exempt, Exempt, Tax
EPZs:	Export Processing Zones
GIS:	Geospatial Information System
GDP:	Gross Domestic Product
ICPAK:	Institute of Certified Public Accountants of Kenya
IMF:	International Monetary Fund
ITA:	Income Tax Act
iTax:	Internet based system of offering tax services by KRA
KAM:	Kenya Association of Manufacturers
KEPSA:	Kenya Private Sector Alliance
KIIs:	Key Informant Interviews
KNBS:	Kenya National Bureau of Statistics
KNCCI:	Kenya National Chamber of Commerce and Industry
KRA:	Kenya Revenue Authority
KRA M:	Kenya Revenue Authority Mobile-Services
MPESA:	Mobile PESA (Money)
MRI:	Monthly Rental Income
M-Service:	Mobile service
NEMA:	National Environnemental Management Agency
OECD:	Organization for Economic Co-operation and Development
PAYE:	Pay-As-You-Earn
PFMRs:	Public Finance Management Reforms
PIT:	Personal Income Tax

PRMF:	Post-Retirement Medical Fund
PSV:	Public Service Vehicle
PTA:	Preferential Trade Area
PWD:	Persons with Disability
RARMP:	Revenue Administration Reform and Modernization Program
RBA:	Retirement Benefits Authority
SDGs:	Sustainable Developments Goals
SEZs:	Special Economic Zones
SSA:	Sub Saharan Africa
TI:	Transparent International
TJNA:	Tax Justice Network Africa
TMP:	Tax Modernization Program
TOT:	Turn Over Tax
TPA:	Tax Procedures Act
UNECA:	United Nations Economic Commission for Africa
WHT:	Withholding Income Tax

EXECUTIVE SUMMARY

The study addresses the disincentive features of direct tax revenue mobilization in Kenya. The primary objective was to undertake a broad review of existing income tax laws using the UNECA-developed analytical framework. The aim was to identify key distinctive features and tax base broadening policy options. The specific objectives were to: carry out comprehensive reviews of the existing income tax system in terms of both policy and legal issues; identify and enumerate key disincentive features; and use existing data to carry out empirical studies to support the policy conclusions and recommendations, and give alternative options for policy adoption meant to maximize direct revenue mobilization.

Information and data were obtained from the following Departments and Sections of the Kenya Revenue Authority (KRA): Research; Domestic Taxes; Large Taxpayers' Office; Medium Taxpayers' Office; International Tax Office; Capital Gains tax; Digital Taxation; Natural Resource Taxation; Tax Policy; System Analysis and Business Support; and Policy and Tax Advisory Division. Information on tax policy and tax expenditures and other related issues was obtained from the National Treasury. Position papers were received from Kenya National Chamber of Commerce and Industry (KNCCI) and Retirement Benefits Authority (RBA). A suggested tax policy framework was obtained from the Institute of Certified Public Accountants of Kenya (ICPAK). Time series data was obtained from the International Monetary Fund data base and Kenya National Bureau of Statistics (KNBS).

Qualitative data was collected from government officials at the National Treasury, KRA, Kenya Association of Manufacturers (KAM), Ministry of Petroleum and Mining, and Ministry of Industrialization and Enterprise Development by way of questionnaires, interviews and visits. Quantitative data was analyzed using descriptive statistics and regression analysis and presented in form of tables and graphs. Qualitative data was analyzed in form of content and thematic areas. The results show that direct taxes are underperforming considering the growth in the bases. The disincentive features of income taxes largely emanate from: tax expenditures; tax exemptions, tax holidays, transfer pricing, double taxation treaties, tax planning, investment incentives, taxpayers noncompliance, the ever expanding digital economy, large informal sector, and incentives for natural resource extraction. The key conclusion is that there is need to amend the Income Tax Act to make rules about exemptions firmly stated in laws and regulations, and to publicly disclose information about exemptions. In addition, establish an appropriate, evidence-based Tax Expenditure monitoring and evaluation policy to limit leakages and improve transparency in income tax exemptions.

SUMMARY OF MAJOR RECOMMENDATIONS

Table 1: Major Recommendations

Section/ Article # Schedule	**Recommendations/Proposed Amendment to Income Tax Act**	**Justification**
	Tax Expenditure	
Section 13 (1)	Amend the Act to make rules about exemptions firmly stated in laws and regulations, and to publicly disclose information about exemptions.	Reduce abuse of tax expenditures
	Establish an appropriate, evidence-based Tax Expenditure Governance Framework.	Limit leakages and improve transparency in income tax exemptions.
	Personal Income Tax	
Section 5 (1)	Introduce five bands; 10 per cent, 15 per cent, 20 per cent, 25 per cent and 30 per cent for each band of ksh.400,000 per annum.	Make the system more progressive and reduce steepness of the brackets.
	Corporate Income Tax	
	Carry out a study to determine who actually pays CIT given the power to engage in tax shifting	Reduce tax shifting.
Section 4B Clause 2(1). Third Schedule	Section 4B to be amended to abolish the ten-year tax exemption enjoyed by companies in the EPZ.	Firms fold up after ten years. No evidence that firms create decent employment opportunities and spur growth. Firms are conduits of loss of tax revenue.
Section 4A (1A)	Amend the Act to limit the amount of losses that can be offset each year to a proportion of the profits of each future year that would otherwise be taxable.	Firms will no longer avoid paying tax indefinitely.
Section16 (1)(b) & 2nd Schedule	Enhance the sharing of information between tax jurisdictions.	To facilitate mutual support, for example through Multilateral Convention on Mutual Administrative Assistance in tax matters.
Section 41 (1)	Renegotiate all existing DTAs or eliminate them.	Reduce MNCs from undermining the income tax base.
Section 41 (1)	Develop a comprehensive double taxation treaty policy and a consistent internal policy to address transfer pricing.	Reduce MNCs from undermining the income tax base.
Section 18(3)	Amend the Income Tax Act to strengthen penalties to parties engaging in transfer pricing.	Close loopholes in the operating rules.
	Develop a consistent set of transfer pricing rules.	Close loopholes in the operating rules.
Section 13 (1)	Develop an efficient framework for granting tax incentives, monitoring, and evaluating them.	Reduce discretion to the CS to grant incentives.

Section 26	Paragraph 10 of the first schedule to the Income Tax Act (ITA) to exclude advancement of religion and education.	Reduce abuse by institutions that make a lot of money with no evidence that they contribute to alleviation of poverty or distress of the public.
	Rental Income Taxes	
Section 6A	Amend section 6A to allow for sharing of data on properties among County governments, National government and other government agencies.	Efficient sharing of data among government agencies; improve declaration; and reduce over claiming expenses.
	Capital Gains Tax	
Section 3 (2)(f) Section 15 Eighth Schedule	Amend the Act to: Tax disposal of property for purpose of administering the estate of a deceased person. Tax transfer of property between spouses as part of divorce settlement. Increase capital gains tax from 5 to 10 per cent to be in line with the peers**.**	Increase CGT performance.
	Pensions	
RBA Act, Section 38	Amend the ITA to allow for exemption of benefits accessed by a member of a scheme to purchase a residential house.	Own residential house.
	Include pensions as part of normal income.	The personal tax exemption will apply.
Section 8 (4), (5)	Amend the act to index the tax-free monthly retirement benefit to the average inflation rate in the previous Financial Year.	Cushion against inflation.
Section 8 (5) (6)	Amend the Income Tax Act to provide for members of registered provident funds who opt to take a portion of their benefits as pension (annuity or income drawdown), to be taxed under the pension tax rules, provided that the benefit is transferred directly to the annuity/income drawdown provider.	To attain the purpose of tax incentives to encourage provision of periodic payments in retirement.
Section 8(6) (a)	Income Tax Act be amended to provide for tax exemption on lump sum death benefits paid from a retirement benefits scheme to dependents of a deceased member to be tax free for the first Kshs. 1,400,000.	To ease the burden on dependents To increase net benefits. Avoid discriminatory treatment for similar family situations
	Withholding Taxes	
Section 5	Adopt withholding tax system for all taxes that can be withheld at the source. Amend laws to tighten the areas of non-compliance Enhance Audit	Enhance tax compliance.
	Dividend Tax	
Section 7(1)(b)	Dividend received by a resident company from its local or foreign subsidiary to be included in the income for taxation purpose or attraction of a tax credit.	Reduce tax evasion and avoidance.

	Increase tax rate from 5 per cent to 10 per cent to collect more revenue at the source and, therefore, reduce tax evasion and avoidance.	
	Consultancy Fees Taxes	
	Increase withholding tax rate from 5 per cent to 10 per cent to collect more revenue at the source.	Reduce tax evasion and avoidance.
	Agency Fees/Commission Taxes	
	Increase withholding tax rate from 5 per cent to 10 per cent to collect more revenue at the source and, therefore, increase tax compliance through reduction of tax evasion and avoidance.	Reduce tax evasion and avoidance. Improve payment of tax in time.
	Management Fees taxes	
	Increase tax rate from 5 per cent to 10 per cent to collect more revenue at the source and, therefore, reduce tax evasion and avoidance.	Reduce tax evasion and avoidance. Improve payment of tax in time
	Extractive Industries	
Part III Section 16	The tax regime for extractive industries should include: a royalty to ensure government revenue from the time production commences; a CIT so that returns to equity are taxed in a similar way as other companies; and an additional tax to ensure the government obtains an increased share in economic rents of more profitable projects. Engagement with international experts on the extractive industry sector to develop capacity on taxation of extractive industry. Approach taxation of the sector through multi-agency. Amend the Income tax Act to strengthen penalties to parties engaging in transfer pricing, miss-invoicing. Review tax incentives policy to be in sync with output.	Increase tax collection from the sector.
	Digital Economy	
Section 18(3) & Section 23	Continuous training of tax administrators in emerging technologies. Continuously review domestic tax laws and align with emerging technologies to seal any revenue loopholes. Develop policies and strategies to facilitate sharing of information with other tax jurisdictions. Amend the Income Act by introducing a section to exclusively deal with taxation of the digital economy. Benchmarking against standards such as those in the BEPS Action Plan.	Increase tax collection from the sector.
	Informal Sector	
	Make KRA the sole tax revenue collector or create collaboration between KRA and County government like the case of Nairobi County where KRA is working in close collaboration in revenue administration. Adopt a unified system for collection of taxes, fees and levies for the National and County Governments. Use of technology in mapping properties and enhance tax administration.	Increase tax base and collections.

	Continuous taxpayer education tailored to the informal sector. Enhance collaborations and exchange of information on taxpayers between the National Government and County Governments. Consider reintroduction of presumptive tax in the agricultural sector.	
	Minimum Tax	
Section 12D	Defer the introduction of minimum tax from 2021 to 2023.	Give businesses and the economy an opportunity to recover from the negative effects of the COVID-19 pandemic.

SECTION 1: INTRODUCTION

1.1 Objectives of the Direct Tax Policy Analysis Assignment

The primary objective of the assignment was to undertake a broad review of existing income tax laws and utilize the UNECA-developed analytical framework to assess the income tax system with the ultimate aim of identifying key distinctive features and highlighting the potential income tax base broadening policy options. Specific objectives included:

a) Carrying out comprehensive reviews of the existing income tax system in terms of both policy and legal issues. This entails also holding Key Informant Interviews (KIIs) with relevant government institutions and representatives of the private sector such as the Chamber of Commerce and sectoral Associations.
b) Carrying out a review of direct tax policy (Personal Income Tax [PIT] and Corporate Income Tax [CIT]), identify and enumerate key disincentives features that could strengthen domestic resource mobilization.
c) Using existing data to carry out empirical studies to support the policy conclusions and recommendations and give alternative options for policy adoption by identifying policy options that maximize revenue mobilization.

1.2 Review of Literature on Direct Taxation

Studies have found that structural, policy, and administration factors affect tax revenue. In several of the studies reviewed, avoidance and compliance have featured prominently (Slemrod & Yitzhaki, 2002; Chen and Chu, 2005). The studies found that income tax compliance is largely affected by tax rates (high tax rates affect compliance negatively), the probability of detection (reduce avoidance), punishment (reduce avoidance), penalties (high penalties and high probability of detection increases compliance), and risk-aversion of the individual taxpayer. According to Allingham and Sandmo (1972), intrinsic motivations such as civic duty (highly related to fiscal performance) is also a factor that encourages compliance especially to the corporate taxpayer.

Under publicly listed corporations with shares traded at the stock markets, there is a separation between ownership and control of the tax paying entity. The shareholders expect their agents to focus on profit maximization through reduced tax liabilities if the cost of detection is low (Slemrod, 2004). In addition, Chen and Chu (2005) studied corporate tax avoidance under principal-agent model and focused on the efficiency loss due to the separation of principal and the agent. The study found a situation in which self-interested agent structure the firm in a complex manner to facilitate transactions that reduce corporate taxes and divert corporate resources for private use. Slemrod (2004), Chen and Chu (2005), and Crocker and Slemrod (2005) set up the theoretical foundation on corporate tax avoidance within a tax paying agency framework. The theory is used in the development of taxation and administration policies and laws to ensure compliance and enhanced revenue collection as expected. According to the theory, strong tax authority can provide additional detection and punishment techniques to reduce evasion by the agents. The authors noted that a system of weak enforcement may increase agents' tax diversion from the tax authority.

The basic principle of tax equity and compliance promotion requires that the tax system have a broad base and low tax rate. A broad base is obtained by allowing few exemptions and deductions to achieve a low tax rate, for a given revenue objective (Creedy, 2001). According to Tanzi and Zee (2001), often the effectiveness of income tax progressivity is severely undercut by high personal exemptions and the plethora of other exemptions and deductions that benefit those with high incomes. The study suggests that progressivity could be improved by reducing the degree of nominal rate, the number of brackets, exemptions and deductions. The personal income tax structure in many developing countries, Kenya included, is riddled with serious violations of basic principles of good tax policy, such as symmetry and inclusiveness. The symmetry principle refers to the identical treatment for tax purposes of gains and losses of any given source of income. The inclusiveness principle relates to capturing an income stream in the tax net at some point along the path of that stream. Violating these principles generally leads to distortions and inequities. Optimal taxation literatures, however, do not provide clear guidance, but clarify the way in which the optimal tax system depends on a wide range of factors, some of which relate to value judgements while others concern behavioral responses or basic conditions, such as abilities, which display considerable heterogeneity in practice (Creedy, 2009). The literature on the optimal design of the income tax by Vickrey (1945) and Mirrlees (1971) find that the ideal tax base is the earnings ability of an individual. In practice, however, earnings ability cannot be monitored for tax purposes. A close observable proxy for it is the labour income.

Disincentives and tax revenues introduced another viewpoint into literature. Friedman (2003) identified negative income tax which has effects on labor supply, gains from work and welfare programs. Disincentives revolve around the income tax structure. Income taxes cause work disincentives. On theoretical grounds, the analysis proves to be more complicated, and the conclusions tend to vary significantly across studies. Tax-induced increases in wages may lead to shorter or longer working time schedules, depending on whether the income effect dominates the substitution effect. In standard static models of the labour-leisure choice, the labor supply curve is upward sloping in the absence of an income effect. Similarly, supply-side economists advocate the implementation of a strategy leading to lower taxes on labour to increase incentive to work. Thus, it appears that income tax-rate cuts are effective only in the context of an upward sloping labor supply curve, where the substitution effect dominates the income effect.

High and persistent labor informality continues to be major sources of tax revenue loss especially for developing countries, where, on average, 60 per cent of the labor force works in the informal sector (Azuara, Azuero, Bosch, & Torres, 2018). A similar phenomenon is observed in terms of production firm informality (La Porta and Shleifer, 2014) which accounts for half of the economic activity in these economies. Labour informalities are in informal firms and provide refuge for the poor against excessive government regulations (De Soto, 2000). They provide employment activity as a way of avoiding taxes and regulations, for both workers and firms (Levy, 2008). Regardless of the causes, informality and low productivity are closely associated and put both workers and firms in a vicious circle that is difficult to overcome without a comprehensive public policy strategy. If the benefits of operating in the formal sector are not perceived as valuable, incentives to formalization are reduced. In this scenario, formalization policies should follow a holistic approach through reducing labour costs to foster demand of low-income workers, increasing the perceived benefits for employees and firms, and boosting labour productivity with reforms in sectors such as education, health, infrastructure, and innovation.

The theoretical appeal of rental taxation is widely acknowledged and accepted. However, it is often considered practically infeasible. One important reason is the measurement of land rents. They are often bundled with buildings, thereby making the rent not directly observable. Among economists, the interest in rent taxation has resurged due to the empirical observation that rents are quickly increasing and that their ownership is highly concentrated. Piketty (2014) pointed out that there has been a sustained increase in the capital/income ratio, which has been driven largely by housing capital. Knoll *et al*. (2017) break down the housing value into its components and identifies increasing land prices as the major driver of the increase in housing prices. Stiglitz (2015) considers different types of rents and argues that they reflect large amounts of wealth and are also highly concentrated and need to be subjected to taxation.

ActionAid (2019) argued that sometimes tax incentives favour new companies over existing ones and underwrite investment that cannot survive without special tax breaks. Incentives might also favour capital-intensive projects over those that use locally produced capital goods and new ones over maintenance of existing ones. Moreover, individuals might use the companies to stash funds away to defer or avoid paying taxes (ActionAid, 2019). Furthermore, Tanzi and Zee (2000) found that tax incentives offered to attract foreign investors might shift the tax burden to immobile factors of production, such as labour. In situations where factors essential to the ease of doing business, such as electricity, water and sanitation, a well-skilled labour force, security and quality healthcare are not up to the required standard, the tax incentives will be more ineffective (ActionAid, 2019).

One avenue through which tax revenues are lost is tax planning. The argument is supported by Tanzi & Zee (2000), who asserted that aggressive tax planning and tax avoidance by multinational companies have led to a sizable revenue loss for many countries.

Rampant abuse of tax incentives has been registered, especially among companies operating in the export processing zones (KRA 2011). This is due to inadequate tax policy design (Wawire, 2020), a situation that is also prevalent in several sub-Saharan African countries (ActionAid, 2019). Some common abuses of tax incentives include: domestic companies restructuring as foreign investors; overvaluation of assets or the creation of fictitious investments (ActionAid, 2019).

With the granting of tax holidays, some old firms reconstitute as new ones and register afresh under new names towards the end of their holiday period, so that they can continue to be tax-exempted from tax (Oxfam International, 2017; Wawire, 2020; Mburu, 2021). Some even close existing investments and restart the same project under a different name but with the same ownership. Others wind up immediately when the exemption expires and relocate. By exempting profits irrespective of their amount, tax holidays confer greater benefit to highly profitable companies that would have made the investment even if the incentive was not offered. Therefore, tax holidays and partial profit exemptions, in particular, offer significant scope for tax relief that is unintended.

Tax holidays have provided an incentive for tax avoidance as those companies that are supposed to pay tax collude with exempted ones to shift their profits through transfer pricing. Furthermore, partial or full profit exemption also opens up transfer pricing opportunities to artificially shift taxable income from non-qualified companies to qualified ones. Similarly, channeling asset purchases through qualifying companies on behalf of non-qualifying ones is also common (OECD, 2013). Aggressive transfer pricing techniques essentially involve the use of non-arm's length prices on intra-group transactions and non-arm's length interest rates on intra-group loans, to shift taxable income to low or non-taxed entities. The companies should, therefore, transact at arms to curb the practice (Section 18(3) of ITA).

Time bound tax holidays attract short run projects thereby distorting investments away from long-term ones towards short-term investments. They also create distortions by encouraging capital to flow to where tax is lowest rather than to where economic return is highest. It is noted that South Africa does not grant tax holiday or loss carry back (Mandy, 2020).

1.3 Taxable Capacity and Tax Effort in Kenya

Taxable capacity is determined by GDP per capita income, population growth rate; trade openness; sectoral shares in GDP; natural resource endowment; and quality of bureaucratic and political institutions (Le, Jensen, Shukla, & Biletska. 2016).

Table 2: Determinants of Taxable Capacity in Kenya: 2000-2002 and 2017 - 2020

	2000–2002	2017-2019	2018-2020
	Mean	Mean	Mean
GDP per capita (KSHS. Millions) (Constant)	33, 642.67	179, 071	181, 588.7
Real GDP per capita growth (%)	-1.1	2.4	1.1
Real GDP growth rate (%)	1.6	4.8	3.4
Inflation (%)	5.9	6.0	5.1
Population growth rate (%)	2.62	2.51	2.59
Real Trade openness (M + X) (KSHS Millions)	30,818.8	48,469.6	42,868
Share of agriculture, forestry & Fishing in GDP (%)	26.8	20.8	20.8
Share of industry and manufacturing in GDP (%)	9.95	8.33	8.15
Share of Mining and Quarrying in GDP (%)	0.46	0.73	0.7
Share of services in GDP (%)	62.79	70.14	70.35
Quality of bureaucratic and political institutions (Index)	0.5	0.5	0.5

Sources of data: Republic of Kenya, Kenya National Bureau of Statistics, *Economic Survey* 2006 and *Economic Survey,* 2020 Nairobi: Government Printer. World Bank: World Development Indicators: Washington DC: World Bank.

GDP per capita: This has increased over the study period. This signifies an increasing tax base since there is a direct relationship between GDP per capita and tax revenue (Manyanza, Wawire, & Onono, 2021). However, average inflation rate increased, thereby eroding the purchasing power of the citizens and, therefore, their capacity to pay taxes.

Population growth: This has slightly declined over the study period from 2.62 per cent to 2.59 per cent. *Ceteris paribus*, taxable capacity was expected to slightly increase due the decline in population growth rate. On the other hand, the population growth rate leads to high employment levels, thus to more taxable incomes in the economy (Wawire, 2006).
Trade openness: Trade openness has improved over the study period, thereby enhancing taxable capacity through exposing the economy to new production technologies, which translates to higher productivity for enterprises (Aloo, 2017).

Share of service: Services sector maintained its dominancy and largely drove the economy. This is a major disincentive to tax revenue mobilization because taxes on the services are regressive and have a disproportionate impact on low income earners (Wawire, 2020). Furthermore, services are majorly digitally driven and hard to trace, hence being a hurdle to revenue mobilisation.

Share of agriculture, forestry and fishing: This share declined during the studied period, although it remained as the second dominant share in GDP. Taxable capacity for agricultural economic activities is low because they are difficult to tax due to their subsistence, unrecorded, informal and rain-dependent nature. Data from sub-Saharan Africa (SSA) shows a decline in the tax revenue-to-GDP ratio as the share of agriculture in the GDP increases (Ghura, (2002).

Share of industry and manufacturing: This share declined slightly. This could be attributed to tax exemptions and generous tax holidays geared towards boosting the manufacturing sector (Abdalaziz, 2012). The tax holidays could easily be a loophole to tax avoidance and might have attracted mainly short-term investments whose objective is profit making at the expense of long term investment (Tanzi, 2001).

Share of mining and quarrying: This share increased slightly over the studied period, despite its magnitude being small. Kenya does not have large endowments of natural resources and, hence, the sector has low taxable capacity.

Quality of Bureaucratic and Political Institutions: This index remained constant over the studied period. It is expected that increases in bureaucracy quality and democratic accountability will lead to a rise in tax revenue. Efficiency of institutions enhances tax revenue collections during periods of social strife, while internal conflicts are shown to cause declines in tax revenues (Manyanza, Wawire & Onono, 2021). However, taxation is a politically sensitive issue and quite often the political pressures and the institutional setting justify decisions that are made. The results are often ad hoc measures that subsequently lead to an unstable tax structure and to an ineffective tax administration that negatively impacts on both tax capacity and tax effort.

Tax Effort: Tax effort indicates the extent to which Kenya has been able to exploit its tax capacity. The effort is determined by the degree of taxpayer compliance, the quality of tax administration and the nature of the tax regime (Le, Jensen, Shukla, & Biletska. 2016). A direct tax structure that is easy to administer, simple to comply with, coupled with efficient tax administration, perception by taxpayers that the tax system is fair, and the benefit derived from public services offered will lead to higher levels of tax effort (Le, Jensen, Shukla, & Biletska. 2016).

The average taxpayer compliance rate in Kenya is about 65 per cent (KRA, 2018). This is an average of registration, filing and payment rates. The available estimated tax compliance gap for 2015/16 was about 17.6 per cent for corporate income tax while for personal income tax, it was 34.3 per cent for 2016/2017 (KRA, 2018). The country could be under-collecting direct tax revenues, given the large compliance tax gaps.

Digitization of the Tax Administration: Performance of direct tax revenues was boosted by digitization of tax administration through the rollout of the iTax system and M-Services (Ndung'u 2017). The iTax system is a web-enabled application launched in 2013 by the KRA. It allows taxpayers to register, file, pay, and make inquiries. The M-Service was launched in 2014 to provide a platform on which a taxpayer uses a mobile phone to make payments and access tax information (Ndung'u, 2017). Digitization has reduced the level of undeclared economic activities and brought into the tax bracket more small and medium enterprises (SME). It has, to some extent, reduced face-to-face interactions which might have reduced corruption and increased efficient tax collection.

1.4 Description of the Direct Income Tax System in Kenya [policy and legal issues]

Income tax is a tax imposed on all the income of a person, whether resident or non-resident. It includes: (1) gains or profits from a business, employment or services rendered, and a right granted to another person for use or occupation of property; (2) dividends or interest; (3) a pension, charge or annuity, and any withdrawal from, or payments out of a registered pension fund, or a registered provident fund or a registered individual retirement fund, and any withdrawals from registered home ownership savings plan; (4) income accruing from a business carried out over the internet or an electronic network including through a digital marketplace; (5) the net gain derived on the disposal of an interest in a person, if the interest derives twenty per cent or more of its value, directly or indirectly, from immovable property in Kenya; and (6) a natural resource income (Income Tax Act CAP 470).

Personal Income tax (PIT) is levied on individuals, both resident and non-resident, engaged in gainful employment and is collected through the Pay-as-you-earn (PAYE) method. Gains or profits include wages, salary, leave pay, sick pay, payment in lieu of leave, fees, commission, bonus, gratuity, or subsistence, travelling, entertainment or other allowance received in respect of employment or services rendered (Income Tax Act, CAP 470). Any person who pays emoluments to an employee is required to register for the PAYE obligation, upon which the person is required to deduct tax from the employee emoluments of a particular percentage depending on the income band of the employee and remit the tax deducted to the Kenya Revenue Authority (KRA) on or before the 9th of the following month.

Currently, PAYE is chargeable to persons of employment income of KSHS 24,000 and above per month. There are three bands: 10 per cent, 25 per cent and 30 per cent. A tax credit in terms of monthly personal relief of KSHS 2,400 is provided to every resident employee. Additionally, insurance relief and mortgage interest deductions are also provided to those employees who qualify.

Gains or profits from employment that are not paid in cash are chargeable to tax. Such gains or benefits include: car benefit; provision of housing; loans at interest rates that are lower than the prevailing market rate; household utilities such as telephone, electricity, water, security, domestic expenses in excess of the allowable limit of Kshs 3,000 per month; pension contribution paid by a tax exempt employer to an unregistered scheme; and pension contribution paid by an employer to a registered or unregistered scheme in excess of the allowable amount of Kshs 20,000 or Kshs 240,00 per year.

Incomes that are not chargeable to PAYE include: meals provided by the employer up to a maximum of Ksh 4,000 per month or Kshs 48,000 per year; night-out of Kshs. 2,000 per day; amounts that are mere reimbursement of expenses for example, subsistence allowance on official duty (per diems) or mileage allowance are not considered taxable pay; medical cover by employer; and in the case of non-Kenyan citizens who are in Kenya solely to serve the employer, expenditure on passages between Kenya and any country outside Kenya borne by the employer.

Others are pension contribution made by an employer, who is a person chargeable to tax, to a registered or unregistered scheme that is within the allowable limit of Ksh 20,000 per month or Ksh 240,000 per year; pension contribution made by a tax exempt employer to a registered scheme that is within the allowable limit of Ksh 20,000 per month or Ksh 240,000 per year; an amount paid by an employer as gratuity or similar payment in respect of employment or services rendered, which is paid into a registered pension scheme; and education fees of employee's dependents or relatives paid from income which has already been taxed in the hands of the employer.

Allowable deductions, which are the amounts deducted from an employee's emoluments to arrive at the amount that is subjected to tax. They include: mortgage interest deduction; interest paid on an amount borrowed either for the purchase or improvement of premises occupied for residential purposes which is deductible against employment income, up to a maximum of Kshs 300,000/- per annum; pension contributions by an employee to a registered pension fund. The allowable deduction is limited to a maximum of Ksh 20,000 per month.

The power to waive or vary taxes and charges: According to Section 77 of the Public Finance Management Act, 2012, the power to waive or vary tax, fees or charges is given to the Cabinet Secretary (CS) in charge of Treasury. The CS may waive a national tax, a fee or charge imposed by the National Government and its entities in accordance with criteria prescribed in the regulations. The National Treasury is required to maintain a public record of each waiver together with the reason and report in accordance with Section 82 of the Act and article 210(1) of the Constitution (Republic of Kenya, 2010). Such waivers or variation must be authorized by an Act of Parliament.

Tax Reliefs: Two types of relief are granted: personal relief and insurance relief. Personal Relief is granted to resident individuals to lighten the tax burden on the taxpayer. It is currently set at Kshs 2,400 or Kshs 28,800 per year, while insurance relief is granted to an employee who has paid insurance premiums for life or health or education polices for himself/herself, his/her wife or child. Relief is given at 15 per cent of premiums paid up to a maximum of Kshs 60,000 per annum. For education and health, the policy has a maturity period of at least 10 years. From 1st January 2022, contributions to National Hospital Insurance Fund (NHIF) qualify for insurance relief.

The following incomes are tax exempt:

1. First Ksh150,000 (andKsh50.000) drugs deduction per month for persons with disability (PWD).
2. Exempt or excluded income include those earnings of people with disabilities so as to enable them to manage their conditions.
3. Medical benefits for employees paid by employer (to improve national health).
4. Relief on pension and provident funds-to encourage saving for pension years.
5. In house canteen food benefit –to enable employers to provide food and increase efficiency.

6. Group insurance cover and personal insurance cover-to encourage insurance taking.
7. Noncash benefit of up to Ksh3,000 p.m. and reimbursement paid by employer- to avoid taxation of small out of pocket expenses and expenses incurred on behalf of employer.

Penalty for late filing and paying: PAYE return should be filed and tax payable on or before the 9th of the following month. A penalty on late filing is imposed on whichever is higher between, 25 per cent of the tax due or Kshs. 10,000. Penalty on late payment is 5 per cent of the tax due and a late payment of 1 per cent per month on the unpaid tax until the tax is paid in full.

Taxation for Non- Resident's Employment Income: Any amount paid to Non-Resident individuals in respect of any employment with or services rendered to an employer who is resident in Kenya or to a permanent establishment in Kenya is subject to income tax charged at the prevailing individual income tax rates. Non-Residents are not entitled to any personal relief. The following are the PAYE tax bands.

Table 3: Pay-As-You-Earn (PAYE) Tax Bands

Tax Band	Rate of Tax (per cent)
On the first Kshs 24,000 per month or Kshs 288,000 per annum	10
On the next Kshs 8,333 per month or Kshs 100,000 per annum	25
On all income amount in excess of Kshs 32,333 per month or Kshs 388,000 per annum	30
Personal Relief	
The applicable monthly personal relief is Kshs 2,400 per month or Kshs 28,800 annually	

Source: Income Tax Act, Cap 470 and KRA's website www.kra.go.ke.

Pension Income: The existing framework for taxing pension income is provided for the Income Tax act. As such, no separate framework exists. Pension income after retirement in form of monthly annuity is taxed up to age 65 years after which the monthly pension annuity is tax exempt. Contribution to registered pension funds is tax deductible up to a limit of KSHS 20,000 per month. The current law does not provide for tax exemption on lump sum payment at 65 years. This privilege was lifted by amendment to 1st schedule paragraph 53 of the Income Tax Act.

In general, tax treatment for retirement benefits sector is as follows:

a) *Contribution phase:* where members contribute (contributions by members and employers) towards retirement benefits, the contributions are not taxed.
b) *Investment phase:* the contributions are invested, usually by fund managers. In this phase the incomes generated are not taxed. This is important because it helps grow retirement benefits for retirees.
c) *Payout phase*: retirees are paid now their benefits either lump-sum for provident funds and/or pensions for largely defined contributions phase. Some pay 1/3 lump sum and the rest of the savings as pensions over regular time periods usually monthly. But the payments during this phase are taxed, but until the retiree is 65 years old. After age 65, retirees' payments are not taxed. So, generally, the tax system for pensions in Kenya is Exempt, Exempt, Tax (EET). Therefore, Kenya has consumption tax treatment of pensions.

Taxation on Purchase of House: A recent amendment to Retirement Benefits Authority (RBA) Act, Section 38, allowed members to access a portion of their benefits to purchase a residential house. They are allowed to access 40 per cent of their accrued benefits for this purpose but capped at Kshs. 7 million.

Low tax-deductible limits for retirement annuity/pension payments: The Income Tax Act provides for tax-exemption on retirement annuities or pension received by a resident individual from a registered retirement benefits scheme or the National Social Security Fund in a year of income. Specifically, the first KSHS 25,000 per month or KSHS 300,000 per annum is tax free and any excess is subject to tax.

Taxation of Post-Retirement Medical Funds: The medical costs incurred by retirees because of old age are substantial. Surveys on retirees have elucidated that they spend a huge portion of their benefits in meeting medical costs. To mitigate this cost of healthcare for retires and in furtherance of provision of universal medical care to elderly persons, the retirement benefits legislation was amended to allow workers to build up funds in their pension schemes during their working life to cater for post-retirement medical care.

The contributions to Post-Retirement Medical Fund (PRMF) are not tax-exempt unlike medical benefits provided by an employer. The Income Tax Act 5(4)(b) provides for tax exemption on medical benefits by the employer. The PRMF Guideline no. 7 provides for access of benefits in form of medical benefits only by a defined medical cover provider. Contributions to PRMF is an accumulation stage aimed at providing a direct medical benefit to members.

Review of Tax-Exempt Limit on Lumpsum Pension Benefits: Tax exemptions on pension benefits reduce the tax burden for employees and, subsequently, increase employee's pension savings. The current tax-exempt limit for pension benefits is Kshs.

600,000 (that is capped at Ksh 60,000/- per year of service for a maximum of ten years). The capping was introduced in 2005 which translates to over 15 years.

Tax Treatment of Provident Fund Benefits: Section 8(5)(6) of the Income Tax Act provides that the first Kshs. 600,000 of the lump-sum paid out of a registered provident fund is tax exempt and the balance is taxed at progressive rates.

Tax on employees of non-taxable employers: The Income Tax Act Section 5(4)© require that employees of non-taxable employers are taxed on the employer's contribution to a retirement benefits scheme as additional income.

Tax Bands on Benefits Payment: The tax bands on benefits paid to retired members are as follows.

Table 4: Tax Bands on Benefit Payment

Pension Tax Bands	Annual Tax Rates (per cent)
Any amount in excess of tax free amounts:	
On first 400,000	10
On next 400,000	15
On next 400,000	20
On next 400,000	25
On any amount in excess of Kshs 1,600,000	30

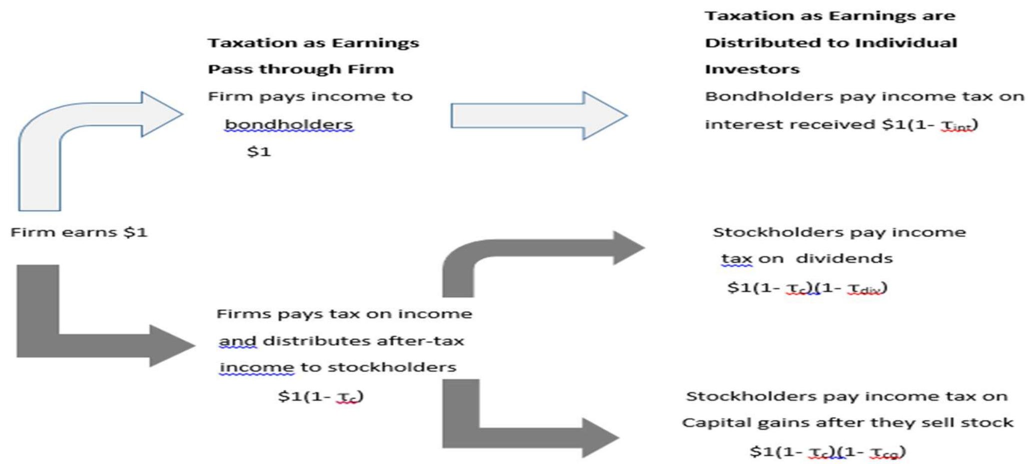
Source: Income Tax Act, Cap 470 and KRA's website www.kra.go.ke. (Section 3(2)(c) of the ITA CAP 470).

Tax Treatment of Death Benefits: The Income Tax Act in Section 8(6) (a) provides that the death benefits for a member of a registered retirement benefits scheme paid to the widow, widower or dependents shall qualify as a group for the same tax exempt amount out of pension income and lump sums available under subsections (4) and (5) respectively as if such amounts had been received by the employee. The tax allowable payment is limited to KShs.25,000 on monthly pension and Kshs. 600,000 on the lumpsum.

Corporate Income Tax: Corporate income tax is a tax paid by the companies operating in the country and is charged on total income. The local companies are charged 30 per cent while branches of non-resident companies 37.5 per cent on their taxable profits.

The following figure illustrates the types of taxes associated with corporates.

Figure 1: Firm's financing decisions and types of taxes associated with it.



Source: Gruber, J. (2011). Public Finance and Public Policy. 3rd Edition. New York. Worth Publishers.

The company pays tax on income and distributes after-tax income to shareholders who pay income tax on capital gains after they sell shares and on dividends. If the company pays income to bondholders, the holders will pay income tax on interest received.

The corporate income tax (CIT) often has a narrow base focusing on foreign and large domestic companies and the depreciation and carry forward provisions are complicated. The CIT rate of 30 per cent is accompanied by a host of tax incentives including tax holidays, tax emptions, operating in free trade such as Export Processing Zones (EPZ), and Special Economic Zones (SEZ) that undermines the tax revenue collections. The Multinational Companies have greater avenues for profit-shifting, transfer pricing and tax avoidance. Hence CIT rate is usually a concern that is even more pronounced due to weak legislative framework, and information asymmetry and capacity between the tax administration and the Companies.

Digital Service Tax (DST): Digital Service Tax (DST) is a tax that is payable on income derived or accrued in Kenya from businesses carried out over the internet or an electronic network, including services offered through a digital market place (Finance Act, 2021b). DST was effected from 1st January 2021 and effective from 1st July, 2021. Its imposition was limited to non-resident corporate and individuals only. The rate of DST is 1.5 per cent of the gross transaction value. It is payable upon offering of a service; hence it is on accruals basis. DST is due monthly and is payable on or before the 20th day of the month that follows when the digital service was offered.

DST is deposited at any appointed commercial bank in Kenya. (Finance Act, 2021b, Income Tax Act Cap 470 and www.kra.go.ke).

Residential Rental Income Tax: KRA (2018) announced rental income tax measures in the fiscal year 2017–2018 that focused on landlords. The Monthly Rental Income Tax (MRI) was introduced by the Finance Act 2015, under Section 6A of Income Tax Act, and became effective from 1st January 2016. Rental income tax is payable by resident persons (individual or company) on rental income earned from the use or occupation of a residential property that includes buildings for commercial and residential usage. The landlord is required to pay rental income tax at a rate of 10 per cent on the gross rent received either monthly, quarterly, semi-annually or annually, though the return must still be filed monthly. No expenses, losses or capital allowances are allowed for deduction from the gross rent at the time of filing the return. Effective from 1st January 2021, the Finance Act 2020, every resident landlord receiving rent income of between Kshs. 288,000 and Kshs. 15 million per annum are obligated to file and pay for MRI tax, while those below or above this threshold file annual income tax returns and declare rental income together with income from other sources (Finance Act, 2020). The earlier minimum and maximum rental income thresholds were Ksh. 144,000 and Ksh.10 million respectively. The change was effected in order to align the MRI with the current lower individual tax bands. There is a clause that requires taxpayers who wish to remain in annual rental income tax regime to do so by requesting the Commissioner General in writing.

The MRI tax return is filed on iTax, on or before the 20th day of the following month and is final. Thus, any income from rent that is subject to residential rental income tax is not liable to any other tax under the Act and, therefore, persons and companies are not required to declare the same in their annual income tax returns. NIL return is filed any month that the landlord does not receive any rent.

Residential rental income is a final tax. Therefore, persons are not required to declare the same in their annual income tax returns. Exemptions include: Non-residents, Landlords earning more than Kshs. 15M per year; Taxpayers who wish to remain in current tax regime on rental income may elect to do so by writing to Commissioner.

Late filing of MRI returns attracts a penalty of: 2,000 or 5 per cent of the tax due whichever is higher for individuals; 20,000 or 5 per cent of the tax due whichever is higher for corporates. It also attracts an interest of 1 per cent per month on the unpaid tax until the tax is paid in full.

Capital Gains Tax: The CGT is levied on the profit from an investment situated in Kenya when it is sold or transferred. The rate of CGT is 5 per cent on net gains and is declared and paid by the seller or transferor of the property or stock. The 5 per cent tax is a final tax i.e., the net gain would not be subject to further taxes. CGT is due on or before transfer of property but not later than the 20th day after the transfer. It is a final tax and, therefore, not subject to further taxation after payment.

CGT is charged on net gains made by individuals on land and marketable securities that include investment in shares listed on the Securities Exchange. Taxes are levied on capital gains made by firms on the disposal of any of their property, whether movable or immovable. This definition imputes that the intellectual property and goodwill are subject to CGT. A company acquiring more than 50 per cent stake in a mineral block or an oil exploration block will pay CGT on the net gain on the value of the transaction. It, therefore, means that transfers of prospecting rights in the mining and extractive sector are taxed.

Transfer for the purpose of levying CGT include: sale, exchange, conveyance or disposal of property; lost or destroyed property; abandoned, surrendered or forfeited property that includes the surrender of shares or debentures on the dissolution of a company.

Transactions that are exempt from CGT include: property transmitted under inheritance; sale of a deceased's property for the purpose of administering the estate of the deceased; compensation for land compulsorily acquired by the government for infrastructure development; land transferred by an individual where the transfer value is less than KSHS. 30,000/=; agricultural property that is less than 100 acres where the property is situated outside a municipality or gazetted township or urban area; residential houses that are owner occupied for a period of three years preceding disposal; and gains on the transfer of property under a transaction involving recapitalization, acquisition, amalgamation, dissolution or other similar restructuring of the corporate identity of a company that is found to be in the public interest.

Withholding Income Tax: Withholding Income Tax (WHT) is tax deducted from income and withheld at source. A person or entity making certain payments deducts tax, at the applicable rate, and remits the tax to the KRA on behalf of the recipient. Examples of payments subject to withholding tax include, among others: management, professional or training fees; consultancy fees, legal fees, audit fees; contractual fees; winnings; appearance at or performance to entertain; royalties; interest and deemed interest; and dividends.

The percentage deducted varies between incomes and is dependent on whether one is a resident or non- resident. The person making the payment deducts tax prior to paying the amount due and the tax withheld/deducted is then remitted to the KRA. The taxpayer is required to generate a withholding tax certificate on iTax, which is automatically sent to the payee once the payer remits the withholding tax to KRA.

Withholding tax deducted should be remitted to KRA by the 20th day of the month following the month in which the tax was deducted. Withholding tax is claimable by the payee when filing their annual tax returns and is not an additional tax.

WHT is a final tax only in the following instances: when deducted in relation to a payment made to a non-resident person with no permanent establishment in country; and when it relates to winnings, qualifying interest, qualifying dividend and pensions for the residents.

The taxpayer is required to declare the income(s) and the withholding tax details when filing the annual tax returns and to pay any balance of tax due. The following table shows rates of withholding taxes for each category of payment.

Table 5: Withholding tax rates for different categories

Payments	**Resident WHT rate (per cent)**	**Non-resident WHT rate (per cent)**
Dividend	10	15
Qualifying dividend	5	N.A
Interest on Bearer instruments of at least 2 years	25	25
Interest on Government bearer bonds with maturity ≥ 2 years	15	15
Interest on bearer bonds with maturity ≥ 10 years	10	25
Interest paid by SEZ to non-resident		5
Fees payable to insurance brokers	5	
Qualifying interest on housing bonds	10	
Qualifying interest on other bearer instruments	20	-
Qualifying interest-other	15	N/A
Royalty, natural resource income	5	20
Royalties paid by SEZ to non-resident		5
Winnings from gaming and betting	20	20
Management fees, professional fees, training fees	5	20
Contractual fees	3	20
Management Fees paid by SEZ to non-resident		5

Rent/leasing of Immovable property	10	30
Rent/leasing of property other than immovable property	N/A	15
Pension/retirement annuity	Graduated scale	5
Sales promotion, marketing, advertising services, and transportation of goods (excluding air and shipping transport services)	N/A	20
Insurance or reinsurance premiums	N/A	5
Payments to sportsmen and entertainers	5	20
Supporting, assisting or arranging an appearance or performance	N/A	20
Gains from business of non-resident ship-owner taxed under Section 9(1) of Income Tax Act		2.5
Gains & Profits from the business of transmitting messages chargeable under Section 9(2) of Income Tax Act		5

Source: Income Tax Act, Cap 470 and KRA's website www.kra.go.ke.

These rates of WHT applicable for non-residents may vary if the payee is a resident of a country which has a double tax agreement with Kenya that provides a different rate. Dividend paid to a resident corporate shareholder with more than 12.5 per cent voting power is exempt from withholding tax. Rate applicable to citizens of the East African Community Partner States in respect of dividends is 5 per cent. Rate applicable on payment in respect of consultancy fees to citizens of the East Africa Community Partner States is 15 per cent.

Any amount withheld should be remitted to KRA on or before the 20th day of the following month. Payment of withholding tax is done online via iTax by generating a payment slip and presenting it at any of the appointed KRA banks to pay the tax due. Taxpayers can also pay via MPESA.

Where a payer fails to withhold tax, the tax shall be deemed to be due and payable by him/her as though he/she was the person who earned the income and the due date for the payment shall be the date on which the amount of tax should have been remitted to KRA. A late payment penalty of 5 per cent shall also apply on the tax due together with a late payment interest of 1 per cent per month for the period that the tax remains unpaid.

The rate of withholding tax on dividends being repatriated depends on whether there is a treaty or not. If no treaty, its 10 per cent. The rate of withholding tax on non-residents' interest is 15 per cent, while for management fees the rate is 20 per cent. Where a double tax treaty exists, the rate is in the treaty. There are different depreciation rules for different asset groups depending on the type (Republic of Kenya, 2021a). The tax allowable is 25 per cent for computers motor vehicle and 10 per cent for plant and equipment for example.

Royalties: Royalty income is received from allowing the use of property. Common royalty payments come from the use of patents, copyrighted works, natural resources, or franchises. Royalties are taxable income. Royalty on export of industrial minerals, on dealership in Gemstones, and on export of gold attract different tax rates depending on the mineral type. Royalty calculation is royalty revenue = sales x royalty percentage.

Turnover Tax: Turnover Tax (TOT) is a tax charged on gross sales of a business as per Section 12(c) of the Income Tax Act, Cap 470. It was first introduced vide Finance Act 2006, replaced by Presumptive Income Tax vide Finance Act 2018 then reintroduced vide Finance Act 2019. The effective date of TOT was 1st January, 2020. TOT is payable by resident persons whose gross turnover from business is more than Kshs. 1,000,000 and does not exceed or is not expected to exceed Kshs 50,000,000 in any given year.

TOT does not apply to: Persons with business income below Ksh. 1,000,000 and above Kshs. 50,000,000 per annum; Rental Income; Management, Professional and Training Fees; and Any income that is subject to a final withholding tax under the Income Tax Act.

TOT is charged at the rate of 1 per cent on gross monthly sales. Expenses are not deductible and it is a final tax. TOT is filed and paid on a monthly basis. The due date is on or before 20th of the following month. The penalty for Non-Compliance includes: TOT late filing penalty is Kshs. 1,000 per month; late payment penalty is 5 per cent of the tax due; and interest on unpaid tax is 1percent of the principal tax due (Income Tax Act, Cap 470 and KRA's website www.kra.go.ke).

Advance Tax: This tax is paid by the owners of Public Service Vehicles (PSV) and commercial vehicles in advance before registering their PSV or commercial vehicles.

Tax Incentives: The KRA implements the issuance of the tax incentives in collaboration with other Authorities for example, Capital Market Authority, Export Processing Zones Authority (for issuance of the EPZ incentives) among others, as provided under the Income Tax Act, Laws of Kenya.

The tax incentives are majorly in form of capital deductions. These deductions are made at the point of computing the gains or profits of a person / company for any year of income. Capital deductions are divided into four:

Industrial Building deductions: It applies to the capital expenditure incurred by a person on the construction of an industrial building to be used in a business carried out by them or their lessee. This allowance is claimed by the person who incurred the capital expenditure, i.e., the owner of the building and the building must be used for the purpose of the business only to enjoy the industrial building deduction. It is granted on a straight-line basis on the balance of constructions. The applicable rates are as follows:

Table 6: The rates for investment allowance

Capital Expenditure Incurred on:	**Rate of Investment Allowance (per cent)**
Buildings	
Hotel Buildings	50 in the first year of use
Buildings used for manufacture	50 in the first year of use
Hospital buildings	50 in the first year of use
Petroleum or gas storage facilities	50 in the first year of use
Residual value to item (a)(i) to a(iv)	25 per year, on reducing balance
Educational buildings including student hostels	10 per year, on reducing balance
Commercial building	10 per year, on reducing balance
Machinery	
Machinery used for manufacture	50 in the first year of use
Hospital equipment	50 in the first year of use
Ships or aircrafts	50 in the first year of use
Residual value items (b)(i) to (b)(iii)	25 in the first year of use
Motor Vehicle and heavy earth moving equipment	25 in the first year of use
Computer and peripheral computer hardware and software calculators, copiers and duplicating machines	25 in the first year of use
Furniture and fittings	10 per year, reducing balance
Telecommunications Equipment	10 per year, reducing balance

Filming equipment by a local film producer licensed by the Cabinet Secretary responsible for filming	25 per year on reducing balance
Machinery used to undertake operations under a prospecting right	50 in the first year of use and 25 per year, on reducing balance
Machinery used to undertake exploration operations under a mining right	50 in the first year of use and 25 per year on reducing balance
Other machinery	10 per year, reducing balance
Purchase or an acquisition of an indefeasible right to use fibre optic cable by a telecommunication operator	10 per year, on reducing balance
Farm works	50 in the first year of use and 25% per year, on reducing balance

Source: Income Tax Act, Cap 470 and KRA's website www.kra.go.ke.

Farm works deductions: This refers to expenditure by the owner or tenant of agricultural land on construction of farm works. Applicable rates include: Farmhouse attracts an allowance of 1/3 of the expenditure on one house. Employee houses also qualify, and any other immovable buildings for the proper operation of the farm attract a deduction allowance of 100 per cent of the whole amount.

Wear and Tear Deductions: This is an allowance that is granted to the investor to cater for wear and tear on machinery.

Table 7: Categories and Applicable Rates for Wear and Tear Deductions in Kenya (per cent)

Class	
Class I @ 37.5	Heavy earth moving self-propelling equipment such as: Caterpillars, tippers, lorries of 3 tonnes and above, tractors (heed, Train, Engine head, buses and coaches, loaders, rollers and graders, transport trucks, combine harvesters, mobile cranes and forklifts etc.
Class II @ 30	Office electronic machinery and equipment e.g. computers and its peripherals, computer printers, scanners and processors, calculators, mobile phones, photocopiers, stamping and franking/fax machines, duplicating machines, photo printers, cash registers, tax registers.

Class III @25	Other self-propelling machines such as motor bikes, saloon cars and hatchbacks, *tutuk,* pick-ups and delivery vans, aircrafts, minibuses (Nissans included), lorries < 3 tonnes.
Class IV @12.5	Other non-self-propelling machine such as; Ship, Bicycles, Wheelbarrow, lifts & conveyor belts, carpets and curtains, partitions in a building, shelves, safes, sign boards and advertising stands, furniture and fittings, plant and machinery, security and alarm systems fixed in a car, tractor trailer, train coaches, milking machinery, beds in a hotel, a plough and lawn mowers, refrigerator, T.V, non-self-propelling forklifts and cranes, boats and petroleum pipeline.
Class v @20%	Computer Software and for Telecommunication equipment its 20% for five years on a straight-line basis

Source: Income Tax Act, Cap 470 and KRA's website www.kra.go.ke.

Investment Deductions: This is a deduction granted on the cost of a building and machinery installed; therein as an incentive to encourage investments. Applicable rates include: 100 per cent investment allowance for investments situated within Nairobi, Mombasa and Kisumu; investments worth 200 Million Kenya shillings situated outside Nairobi, Mombasa, and Kisumu attract a 150 per cent allowance investment allowance; investment Deduction for Manufacturing Under Bond attract an allowance of 100 per cent for production of export goods under bonded warehouses; investment Deduction allowance in the Export Processing Zones is 100 per cent; shipping allowance applies to the purchase of a new and unused power driven ship of more than 125 tons gross or the purchase and subsequent refitting for the purpose of that business of a used power-driven ship of more than 125 tons is 100 per cent investment deductible

Incentives: Export Processing Zones and Special Economic Zones SEZ): Licensed EPZ projects (foreign, local or joint venture) are entitled to the following incentives: 10-year corporate income tax holiday and a 25 per cent tax rate for a further 10 years thereafter (except for EPZ commercial enterprises); 10-year withholding tax holiday on dividends and other remittances to non-resident parties (except for EPZ commercial license enterprises); and 100 per cent investment deduction on new investment in EPZ buildings and machinery, applicable over 20 years.

Other types of incentives are availed to: companies under SEZ scheme for which the corporate income tax rate is 10 per cent for the first 10 years of operation and 15 per cent thereafter; companies locally assembling motor vehicles are subject to a reduced corporate income tax rate of 15 per cent for the first 5 years of operation; companies newly listed on approved securities exchange are subject to a reduced tax rate of 25 per cent for 5 years following the listing. The reduced rate is only applicable to companies listing at least 30 per cent of their issued share capital. If the company lists between 20 per cent and 30 per cent of its issued share capital, the reduced tax rate is 27 per cent for only 3 years.

Branches are taxed at 37.5 per cent while subsidiaries are taxed at 30 per cent subject to transfer pricing rules. The repatriation of balance is not subject to withholding tax. Head office expenses are not allowable unless KRA is convinced that they were exclusively earned to produce income of the branch (www.kra.go.ke**;** Income Tax Act, Cap 470 and East African Community Investment Guide).

Transfer Pricing: Foreign companies can either operate a company or a branch, guided by the Companies Act. Under Section 18(3) of the Income Tax Act (ITA), transactions between a resident entity and its related non-resident should be carried out at arm's length bases. If this is not the case, then there is the presence of transfer pricing abuse which is illegal. Kenya adopted transfer pricing rules in 2006. Since then, KRA has concentrated efforts to deal with this accounting malpractices which results in reduced tax liabilities.

The following transactions are subject to the transfer pricing rules: sale, purchase or lease of tangible assets; purchase or sale of goods and services; provision of services; lending or borrowing of money; transfer, sale, purchase or use of intangible assets; and any other transactions which may affect the profit or loss of the enterprise involved.

SECTION 2: METHODOLOGY

2.1 Research Design

This study utilized two research designs. These are cross-sectional design and longitudinal design. A cross-sectional study sought to measure the relationship between variables at a specified time, either to describe the incidence of a phenomenon or how variables were related. In the cross-sectional design, a survey of relevant key informants was carried out. In the longitudinal design, time series data on direct tax revenues was collected. This was to allow measurement of change in direct tax revenues and its components over time.

The research approaches that were adopted were both quantitative and qualitative. Quantitative approach entailed collecting numerical data on various components of direct tax revenues during the past years as well current fiscal year budgets. The quantitative approach encompassed both the time series design and cross-sectional design. The qualitative approach was employed to collect non-numerical data on identifying and enumerating key disincentives features that could strengthen domestic resource mobilization.

2.2 Analytical Framework

The study utilized UNECA (2021) and Le, Jensen, Shukla, & Biletska. (2016) analytical frameworks to analyse the country's direct tax system. The objective was to identify potential revenue mobilization opportunities and challenges. The analytical frameworks identified some of the main opportunities for income tax revenue mobilization to include: base broadening through elimination of tax exemptions and tax holidays; tapping the potential of property income taxes; improving taxation of capital income, including CGT, thin capitalization rules, transfer-pricing guidelines; dealing with transfer pricing abuses by multinational enterprises and taxing extractive industries fairly and transparently; base broadening policies, such as restrictions to loss-carryover provisions; strengthening digital taxation (with evolution of digital technologies, many businesses have changed the model of conducting their transactions and, therefore, tax administrations should be able to tap income tax revenue realized on such platforms). Enhancing the effectiveness of tax administration through simplification of the tax system, the procedures for paying taxes as well as tax forms; ensuring that taxpayers receive help from government agencies and other institutions in completing tax forms through appropriate services; and reviewing of tax treaties and aiming for more taxing rights. To this end, the study adopted a few of the approaches in the analytical framework, such as diagnostic framework for tax expenditures, assessing the tax base of income tax and use of the PIT and CIT set of questions to provide an in depth understanding of the income tax regime in Kenya.

2.3 Assessment Approaches

To achieve the objective of the study, the approach aims to establish the revenue foregone through income tax expenditures over time collected from the tax administration. The focus mainly on tax expenditures is theyare considered a major factor in undermining domestic tax revenue performance in Sub-Saharan Africa countries (World Bank, 2017). Other areas included are in the study: withholding taxes; digital economy taxation; informal sector taxation; and taxation of extractive industries. The study also conducted interviews by utilizing some of the answers in the comparative analysis of PIT and CIT regime. The responses provided an in depth understanding of the PIT and CIT regime in Kenya. Interview schedules were developed to collect more information on challenges affecting performance of income tax revenue and some of the reforms put in place to tackle the challenges. Specific interview schedules were developed targeting the National Treasury and Kenya Revenue Authority (KRA)'s tax administrators. They were meant to gather views on measures in place to improve efficiency of tax administration for enhancing voluntary compliance and the strategies in place to deal with the challenges encountered in the taxation of both local and multinational companies. The study also focused on strategies in place to effectively tax the large informal sector and suggest policy options based on the best practice or lessons learnt from successful tax administration in dealing with informal sector. The interview endeavoured to identify the kind of capacity building required by the tax administration for effective tax administration. Based on the availability of data, revenue realized from measures, such as audit and compliance checks, was requested. Such data gave a rough idea of the disincentive features of direct tax revenue mobilisation in Kenya, and the contribution of enforcement measures in enhancing revenue performance.

The other key informants interview schedules focused on Kenya Association of Manufacturers (KAM), Kenya National Chamber of Commerce Industry (KNCCI), Retirement Befit Authority (RBA), Institute of Certified Public Accountants (ICPAK), Ministry of Industrialisation Trade, and Enterprise Development, and the Ministry of Petroleum and Mining. The focus was to identify factors that undermine compliance with taxation and the kind of support they would require from the tax administration.
For the recommendations for tax policy change, the study relied on information from the KIIs and on the literature review findings regarding proposed measures to enhance performance of income tax.

2.4 Assessment Activities

The assessment activities entailed a detailed review of the Income Tax Act (CAP 470) as well as key informant-based interviews. The outcome of the assessment activities identified and enumerated key features that could strengthen domestic resource mobilization. The choice of direct tax revenue bases was informed by their contributions to total income tax revenue collected and on estimated potential to enhance income tax revenue performance.

Some of the specific activities were to:

1. Conduct a review of the income tax legislation and other relevant documents, such as the various corporate plans with focus on the income tax.
2. Conduct a thorough literature review focusing on factors undermining income tax performance and the proposed strategies towards enhancing income tax performance.
3. Enumerate the main form of income tax expenditures granted by the tax administration.
4. Collect data on income tax revenue, tax expenditures and GDP overtime.

5. Calculate income tax expenditure as a per cent of GDP and establish the growth in expenditure as a per cent of GDP compared with growth in income tax revenue as a per cent of GDP.
6. Prepare a set of questions for conducting interviews focusing on KRA, National Treasury and sampled KIIs.

Some of the income tax bases which were covered include: employment income, businesses income, property income, residential rental income, dividends income, management fees, contractual fees, agency fees, royalties, interest and rents and capital gains.

2.5 Population and Sampling

The population of interest consisted of stakeholders in tax policy that include but not limited to KRA, National Treasury and Planning, KNCC, KAM, KEPSA, Large Taxpayers, Medium Taxpayers, Small Taxpayers, Taxpayers Association, Parliamentary Budget Office, Parliamentary Finance Committees, ActionAid International (AAI), TJNA, Sectoral Associations, Transparency International (TI), and Kenya Law Society.

The key informants that were purposively selected because they were relevant to the revenue mobilization from direct taxes include: KRA; National Treasury; KNCCI; KAM; KEPSA; ICPAK; Retirement Benefits Authority (RBA), Ministry of Industrialisation Trade, and Enterprise Development, and Ministry of Petroleum and Mining.

2.6 Data Type, Sources and Collection

Both primary and secondary data was collected to assess various components of direct tax policy. Data was obtained from KRA, National Treasury, Kenya National Bureau of Statistics (KNBS) and KNCCI. The following methods were employed to obtain data.

(a) **Desk Review**: carried out a comprehensive review of the existing income tax system in terms of both policy and legal issues. The source of information included: The Income Tax Act (CAP 470); The Kenya Vision 2030; the Constitution, Strategic plans [for National Treasury and Planning, and KRA]; Economic Surveys; Medium Term Expenditure Frameworks; KRA Corporate Development Plans; ICPAK Reports. Evaluation Reports; Annual performance reports [KRA]; Programme Performance Reports [KRA]; Printed Budget Estimates and Statements; Parliamentary Budget Office Reports; and the Auditor Generals Reports.

(b) **In-depth Interviews**: In-depth interviews and discussions were held with relevant key informants from the National Treasury, KRA, KNCCI, RBA, and KAM. The interviews revealed direct tax policy issues/gaps/disincentives that need to be addressed to maximise resource mobilisation from direct tax revenue.

Data collection instruments: in line with these data collection techniques, secondary data collection fact sheet, and interview guide were developed. The fact sheets captured time series data from different components of direct taxes, while the guide was used to obtain qualitative data on gaps and disincentives to revenue mobilisation. The data was collected on the following: total tax revenue; Income tax revenue; Personal Income taxes; Corporate income taxes; Rental income tax; Dividends income tax; CGT; Pension income tax; Contractual fees tax; Agency/Commission fee tax; Management fees taxes; Royalty fees taxes; Extractive Industry; Digital economy; and the Informal sector. The main data sources were KRA, KNBS, and National Treasury.

2.7 Data analysis

The quantitative data collected was analysed using the Excel, STATA and Eviews softwares. Qualitative data was analysed by way of content and thematic areas.

SECTION 3: ASSESSMENT OF INCOME TAX REVENUE

Direct taxes continue to be a significant source of revenue with income and profits accounting for over 48 per cent of tax revenues while personal income taxes and social security contributions account for an average of 25 per cent of total tax revenues (Republic of Kenya, 2020). Income tax shows a decline from 28 per cent for PAYE and 24 per cent for other income taxes in the financial year 2012/2013 to 22.6 per cent and 18.6 per cent in 2020/21 respectively. The average tax revenue-GDP ratio has barely changed in the past 20 years as shown in the following table.

Table 8: Average Tax-GDP Ratio Trends: 2000–2002 and 2017–2020

	In Relation to GDP			**In Relation to Tax Revenue**		
	2000–2002	2017-2019	2018-2020	2000-2002	2017-2019	2018-2020
	Mean	Mean	Mean	Mean	Mean	Mean
Tax Revenue	15.5	15.3	15.17	-	-	-
Income Tax Revenue	5.1	7.37	7.05	36.7	47	46

Source of data: International Monetary Fund (IMF). Available at data.imf.org. Viewed November, 2021.

The average tax revenue-GDP ratio decreased by 0.2 and 0.33 per cent for the periods 2000/2002 to 2017/2019 and 2000/2002 to 2018/2020 respectively. The average income tax revenue as a share of GDP increased from 5.1 to 7.37 per cent over the study period, a change of 2.27 percentage points.

Direct taxes continue to be a significant source of revenue, accounting for approximately 36.7 and 47 per cent of total tax revenue for the periods 2000-2002 and 2017-2019 respectively. However, on the average, the percentage declined slightly by 1 percentage point to 46 per cent for the period 2018/2020 which can be attributed to the effect of COVID-19 in the economy. On the overall, the share of income tax revenue in total revenues has increased indicating that the direct tax system is more progressive in Kenya.

Various tax reforms that have been implemented by the KRA in the past 20 years have not enhanced the buoyancy of the tax system (Wawire 2016; Wawire 2017; Ochieng, Wawire, Manyasa, & Kiguru 2014). These reforms include the Revenue Administration Reform and Modernization Program (RARMP) that began in fiscal year 2004-05 (KRA 2003) with the goal of improving efficiency in tax administration. Digitization of tax administration (Ndung'u 2017) and the Public Finance Management Reforms (PFMRs) meant to enhance the government's responsiveness to fiscal policy priorities and improve accountability and transparency in operations that was launched in 2006 (KRA 2010), are among other reforms that made the income tax structure become more progressive.

The performance of the Kenya's direct tax system requires effort towards identifying more revenue mobilization opportunities to enable the country to attain higher revenue collection. Kenya's low direct tax efforts could be due to factors such as inadequate fiscal policy, low taxable capacity, leakages in revenue collection and weak enforcement and a large informal sector which is hard to tax (Wawire, 2020; UNECA, 2021). Leakages and tax expenditures could have also contributed to low tax revenue. However tax expenditures are anchored in law in accordance with Section 77 of the Public Finance Management Act, 2012 (Republic of Kenya, 2012), and yet there are no policy guidelines on the process of awarding them.

Effort has been made by the KRA together with the National Treasury and the World Bank to develop a benchmark system and a tax expenditure repository to aid in quantifying the tax expenditures. The system uses positive approach as opposed to the normative approach to quantify tax expenditure (KRA & National Treasury, 2021). However, although useful, the benchmark system is not in sync with the data capturing process which hinders the process of quantifying the expenditures.

Since exemptions cannot be denied due to their link with politics, the negative effects of exemptions could be mitigated by inducing transparency and accountability into the system. Lack of a comprehensive Tax Expenditure Framework, which contributes to abuse of the system, limits the ability to monitor the effectiveness of tax expenditure, and reduces transparency in the governance of tax expenditures. Thus, discretionary award of tax expenditure continues to erode the revenue potential of corporate taxation.

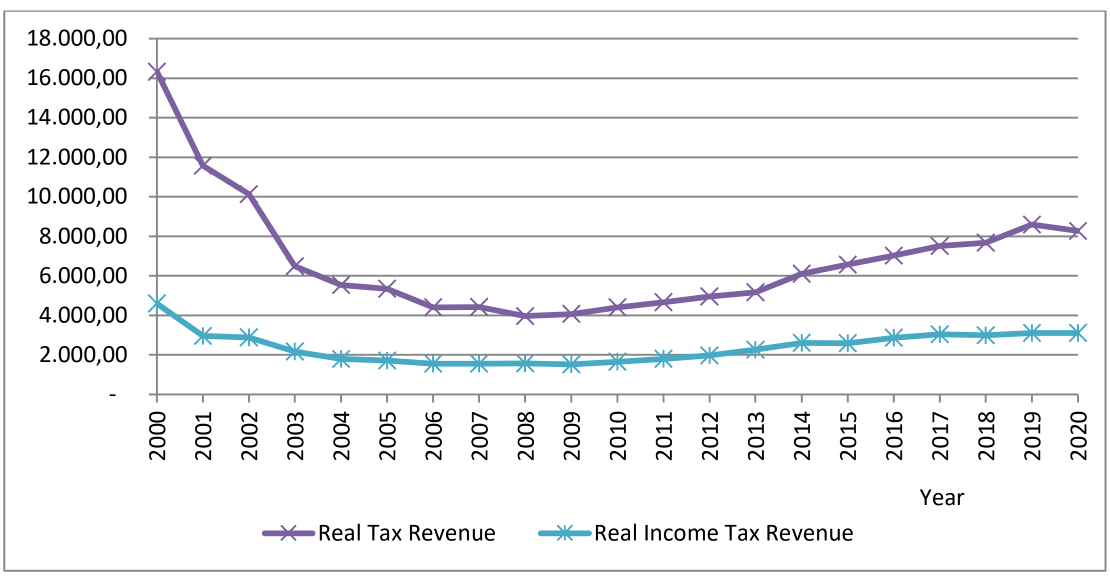
Proposed Amendment: *Amend the Act to make rules about exemptions firmly stated in laws and regulations, and to publicly disclose information about exemptions.*

Proposed strategy: *Establish an appropriate, evidence-based Tax Expenditure Governance Framework to limit leakages and improve transparency in income tax exemptions.*

Organization for Economic Cooperation and Development (OECD) (2013) contended that many lower-income countries, Kenya included, have the potential to increase their tax ratios by at least 2 per cent to 4 per cent of GDP, without compromising fairness or growth. A strong revenue base for Kenya will be able to finance infrastructure, and other key expenditures such as those on public services, and social protection.

The figure that follows shows trends in the real tax revenue vs real income tax revenue for the period 200 to 2020.

Figure 2: Trends in tax revenue and income tax revenue for the period 2000 to 2020 (Ksj.Millions).



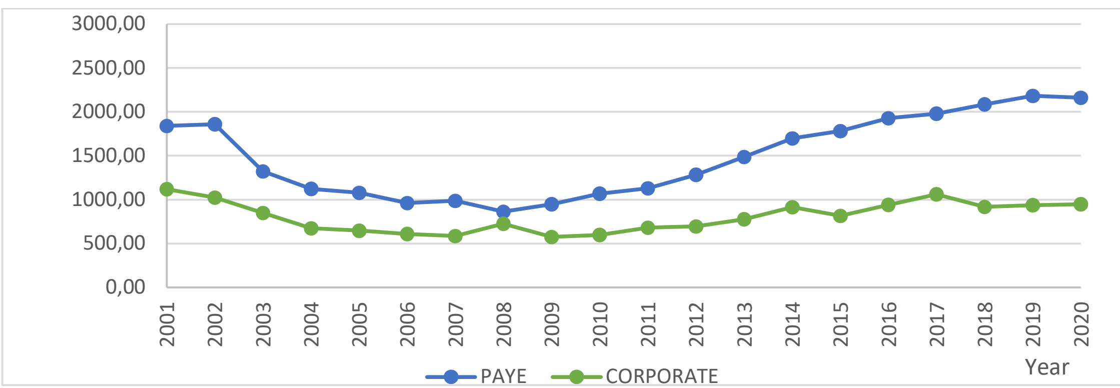
Source of data: International Monetary Fund (IMF). Available at data.imf.org. Viewed November, 2021.

The real revenue declined gradually from 2000 to 2008. After the revenues started increasing sluggishly with total revenue widening the gap. The lowest values were registered in 2007 and 2008 due to post-election violence experienced after the contested general elections. This led to high levels of inflation - that eroded the value of tax revenues - and reduced real economic growth. . Moreover, the income tax revenue is steadier than the total tax revenues. This is because the income tax consists of mostly PAYE which is subject to withholding.

SECTION 4: ASSESSMENT OF PERSONAL INCOME TAX

Figure 3 shows the trend in real PAYE and real corporate income tax revenues.

Figure 3: Trend in Revenue Generation from PAYE (2001-2018) compared to CIT (Kshs. Million).



Both PIT and CIT recorded declining trends from 2000 to 2008, and rose gradually thereafter. The erosion of the base that led to low real tax revenues was caused by high inflation, especially during the years 2007 and 2008, associated to post-election violence. In comparison to CIT, the PIT rose more steadily. Moreover, the CIT has always been below the PIT throughout the period and the gap appears to be widening as years go by. It seems that the CIT is gradually declining.

The following figure shows trends in the shares of PIT and CIT in GDP from the year 2000 -2020.

Figure 4: Trends in Shares of PIT in GDP from 2000 to 2020 compared to CIT (per cent of GDP)

PIT performed better than CIT in the last 20 years as indicated in figure 4. This could be attributed to tax reforms which emphasized withholding taxes through the PAYE system (KRA, 2010). Compulsory filing of individual tax returns through the iTax system, along with digitization (Ndung'u, 2017, are other factors that might have contributed to this rise. However, PIT, as a per centage of GDP, registered a decline since the year 2015 before rising from 2019.

The following table shows average PIT and average CIT as shares of GDP as well as shares tax revenue.

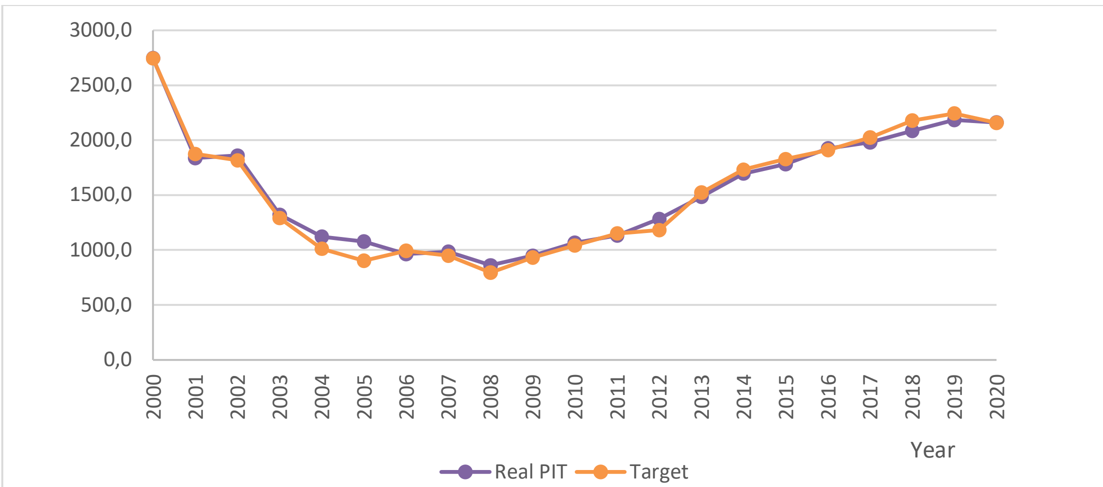
Table 9: Average PIT-GDP and CIT-GDP Ratio Trends: 2000–2002 and 2017–2020

	In Relation to GDP			In Relation to Tax Revenue			In Relation to Direct Tax Revenue		
	2000–2002	2017-2019	2018-2020	2000-2002	2017-2019	2018-2020	2000–2002	2017-2019	2018-2020
	Mean	Mean	Mean	Mean	Mean	Mean	Mean	Mean	Mean
PIT	2.6	4.0	3.93	19.3	26	25.8	50.9	54.8	55.7
CIT	2.5	3.26	3.06	17.4	21	20.2	49.3	44.2	43.4

Source of data: International Monetary Fund (IMF). Available at data.imf.org. Viewed November, 2021

PIT as a share of GDP has increased by 1.4 per cent while its contribution in tax revenue and in direct tax revenue has increased from 19.3 to 26 and 50.9 to 54.8 per cent respectively; an increase of 6.7 and 3.9 percentage points respectively over the study period. CIT registered a decline in its share in direct tax revenue from 49.3 to 44.2, probably due to its disincentive features as discussed in this report. The following figure shows the measures of the deviation between actual and targeted revenue collections.

Figure 5: Real tax revenues and target revenue trends (Ksh. Million).



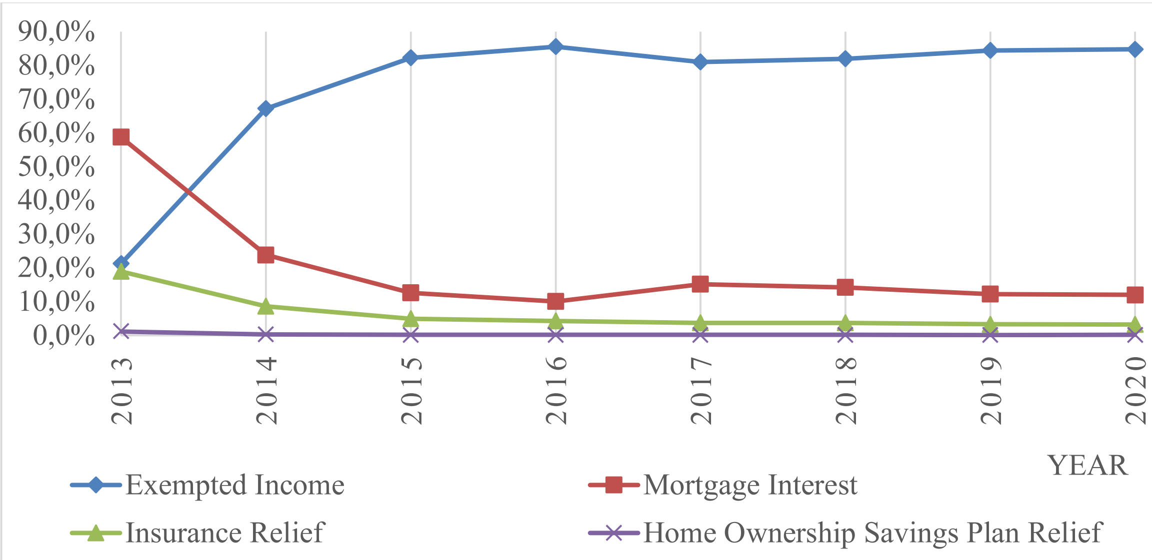
Source of data: KRA Data Base

The figure shows that the real revenues have mirrored the targets for several years. However, for some years such as 2013, 2014, 2015, 2017, 2018, and 2019, the targets were not met. This could be due to low income with most taxpayers operating in the informal sector; low tax literacy levels; cash transactions; poor book keeping; employers failure to remit deducted tax revenues; under-declaration of allowances and taxable benefits; and low tax morale due to misappropriation and misuse of public funds by county and national governments (Oguso & Sila 2019; Maina 2019) . Other factors that could have contributed to missed targets include lags in tax collection, and shocks within the economy, including those caused by the electoral cycles in 2013 and 2017. It is also noted that targets are given by the National Treasury while collection is done by the KRA. It is possible that the target revenue is driven by the spending pressure and not the economic analysis of the activities.

PIT expenditure as percentage of GDP was 0.04, 0.04, 0.05 and 0.04 for the years 2017, 2018, 2019, and 2020 respectively (Republic of Kenya, 2021a). The amounts in terms of nominal values are substantial although the percentages are low.

Trends in the Shares of Mortgage Interest Deductions, Insurance Relief, Home Ownership and Exempted Income in total PIT Expenditure for the period 2013 to 2020 are shown in figure 6.

Figure 6: Trends in the Shares of Mortgage Interest Deductions, Insurance Relief, Home Ownership and Exempted Income in Total PIT Expenditure (percentage of PIT expenditure).



The figure shows that exempted income share in total tax expenditure is the highest. Mortgage interest deductions and insurance relief mostly mirrored each other (Republic of Kenya, 2021a). However, home ownership savings plan relief share performed dismally and, therefore, has not achieved its intended purpose.

Section 39(2) of the Income Tax Act allows for claiming of the tax credits paid in a foreign jurisdiction with treaty or without treaty. Moreover, rules for the determination of taxable income are formulated with reference to the international income definition (KRA & National Treasury & Planning, 2021) that allows tax credit.

PIT rate structure has three income brackets (10 per cent, 25 per cent and 30 per cent) and exempts any income below 24,000 per month. The three income brackets appear to be few and raise the issue of progressivity. Another band for high income earners could be introduced to make the system more progressive or reduce steepness of the brackets.

Table 10: Tax Revenue from PIT Simulations

Assumed tax Band	**Rate**	**Tax**
400,000	0.10	40,000
400,000	0.15	60,000
400,000	0.2	80,000
400,000	0.25	100,000
Over 1,600,000	0.3	
Current Tax Band	**Rate**	**Tax**
288,000	0.1	28,800
100,000	0.25	25,000
Over 388,000	0.3	-
		53,800

Source of data: ITA CAP 470 and Simulation

The PIT schedule applies to foreigners as well as citizens. However, foreigners are not entitled to tax relief and exemptions except diplomats. Note that tax on distributed dividends to foreigners is treated the same as the ones for the citizens although with a higher rate of tax depending on whether there is double tax treaty or not. Currently, the rate on dividends is 15 per cent.

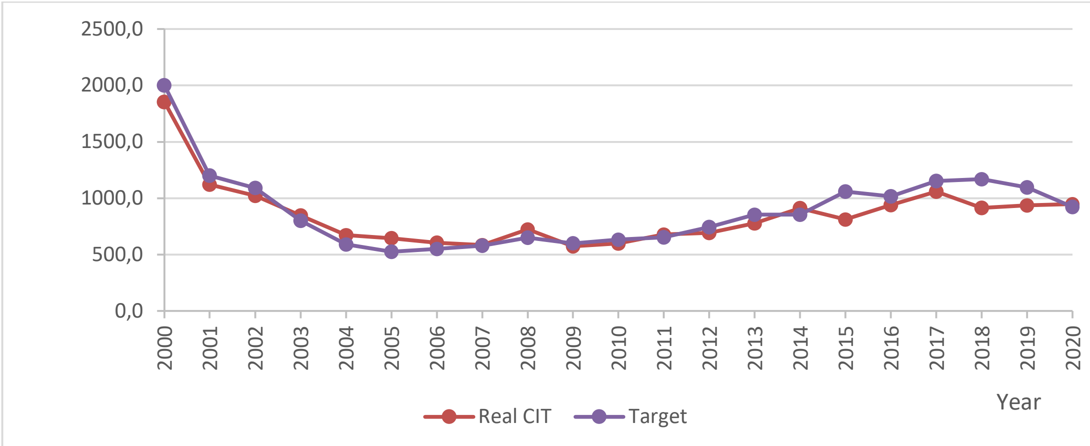
Proposed amendments:
Introduce five bands; 10 per cent, 15 per cent, 20 per cent, 25 per cent and 30 per cent for each band of ksh.400,000 per annum.

SECTION 5: ASSESSMENT OF CORPORATE INCOME TAX

In this section, CIT tax revenue is presented as levels, growth rate, and shares of GDP over a period and also shows performance over time. The trend in CIT is already shown in figure 4 while as a share of GDP. Figure 4 shows that the PIT revenue share in GDP has always been above that of CIT throughout the study period.
Table 9 above shows that CIT as a share of GDP has increased by a paltry 0.76 per cent from 2.5 to 3.26 per cent compared to 1.33 per cent for PIT. Its contribution in tax revenue has increased by 3.6 per cent; from 17.4 to 21 per cent. However, its contribution in direct tax revenue has declined by 5.1 from 49.3 to 44.2 per cent. COVID-19 seem to have affected revenue collection from CIT more than PIT.

The following figure shows trends in the real as well as target revenues over the study period.

Figure 7: Trends in real and target revenue from CIT (ksh. Millions)



Source of data: KRA Data Base.

The figure shows missed targets for seven years in CIT revenue collection. The granting of various tax incentives designed to encourage companies to invest in the country (KRA, 2011) might have contributed to low performance of CIT. These incentives include: capital deductions on industrial buildings, farm works, wear and tear and investment. Furthermore, tax concessions granted to enterprises for promoting employment have led to a decline in revenues (Republic of Kenya, 2021a). The current rates are 30 per cent for residents and 37.5 per cent for non-residents. These rates are the same in the region, i.e., Tanzania and Uganda. Hence, the current tax burden on domestic profits is within the general global trends (OECD, 2013). There is, therefore, no evidence that these rates discourage investment or shift it to other jurisdictions.

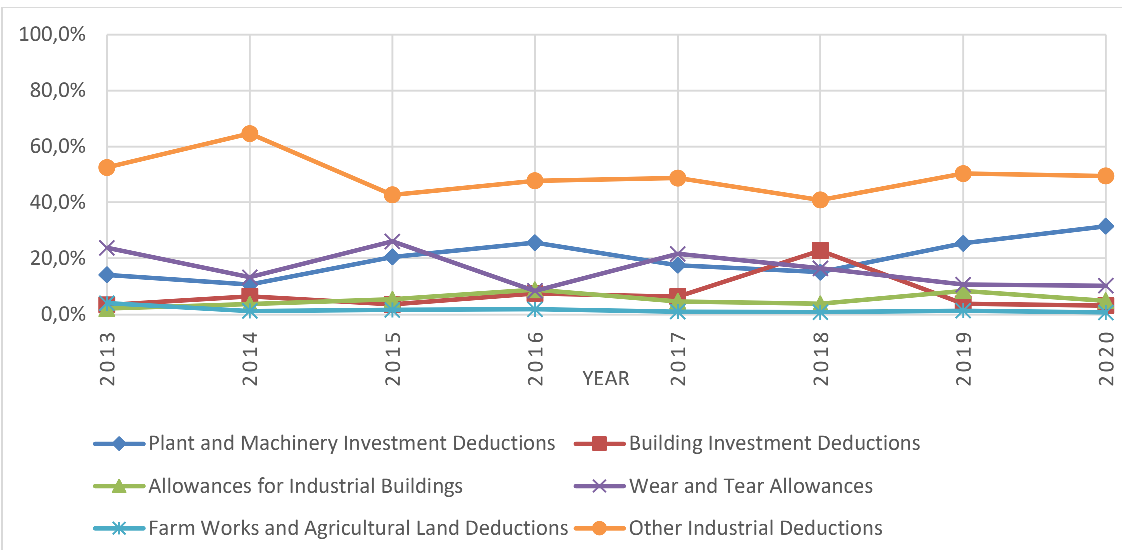
The argument that CIT rate is not a key factor in attracting investments is shared with Morisset and Prinia (2001), Tanzi and Zee (2000), and Bruce (2004), who found that investors rate tax incentives rather low among the factors that they consider in choosing between investment locations. Therefore, it is necessaryto improve non-tax determinants of investment to attract and retain more investments. Levying higher tax rate is also an option since it will not significantly impact on investment.

The tax burden on business enterprises appear to be appropriate with reference to the policy goals and objectives of the tax system which are efficiency, equity, simplicity, stability, and revenue adequacy. The tax burden is also in tandem with the rate in the regional peers, although it falls on a few since the majority are engaged in tax avoidance and tax evasion. However, since the government has not evaluated the level of tax burden for corporate taxes that would be consistent with its broader development objectives and its investment attraction strategy, the observation is not conclusive. In fact, no study has been done to determine who actually pays CIT given the power to engage in tax shifting by corporates.

Proposed strategy: *Carry out a study to determine who actually pays CIT given the power to engage in tax shifting.*

The poor performance of CIT could partly be blamed on tax expenditure pressures and administrative issues. CIT expenditure as per cent of GDP was 0.6, 0.8, 0.6 and 0.5 for the years 2017, 2018, 2019, and 2020 respectively. These percentages are higher compared to those of PIT expenditures, implying that on the average, companies benefit more from tax expenditures than individuals.

Figure 8: Trends in CIT allowances for the Period 2013-202 (percentage of CIT expenditure)

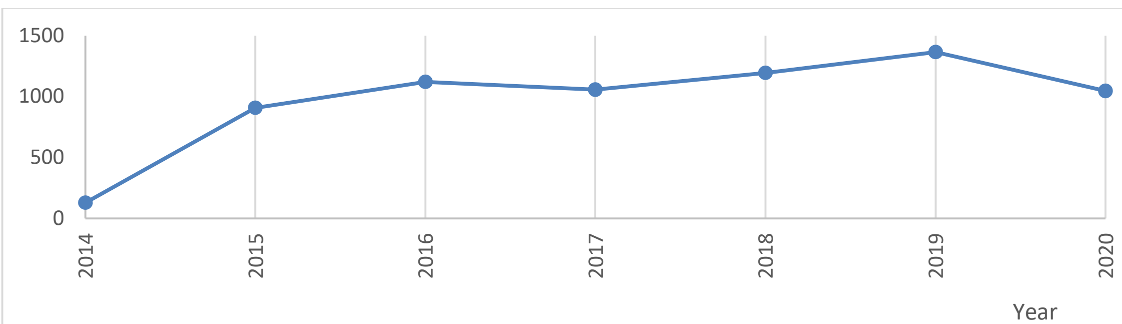


Plant and machinery investment deductions show an increasing trend. While building investment deductions, allowances for industrial building, and wear and tear allowances show declining trends. The decline is attributed to major reforms - harmonization and reduction in the amount of wear and tear allowances - in allowances related to the corporate income tax in 2020 with. Farm works and agricultural land deductions are negligible, implying that agricultural activities are not taken seriously by government in terms of granting allowances.

The CIT includes preferential tax regimes that are not classified as tax expenditures (Republic of Kenya, 2021a). These specific regimes include companies located in Export Processing Zones (EPZ), for which the corporate income tax rate is 0 per cent for the first 10 years and 25 per cent for the following 10 years.

Under section 4B of the Income Tax Act CAP 470, the firm is exempt from corporation tax for the first 10 years and will be eligible to claim capital deductions incurred in these years against the incomes from the 11th year. The aim is to encourage manufacturing for export, create foreign exchange, and increase employment opportunities. However, available evidence indicates that tax holidays and other tax incentives might not have created a substantial difference in the decision and volume of exports at the firm level (Mutuku, Sirengo & Omar, 2021). If the exemption was to be removed, the impact will be negligible because firms in EPZ tend to fold up after ten years. Furthermore, incentives, such as capital deduction allowances, are already in place for all manufacturers. There is also no evidence that firms in EPZ create decent employment opportunities and spur growth. Furthermore, over the years, non-protected industries have increased, hence firms in the EPZ are now conduits tax revenue's loss. The following figure shows a trend in loss of revenues from EPZs through tax exemptions.

Figure 9: Tax Revenue Loss from EPZ (Ksh. Millions)



Source of data: KRA data base

Over the years, the tax revenue losses from EPZ have recorded a gradual rise. This imputes that more tax incentives have been awarded to investors operating the EPZ.

The following Table 11shows a hypothetical cash flow of a firm operating in the EPZ that enjoys a tax holiday for 10 years after which it starts paying tax on the 11th year. The discount rate used is 14 per cent, which is the current lending rate.

Table 11: Hypothetical cash flow of a firm operating in the EPZ

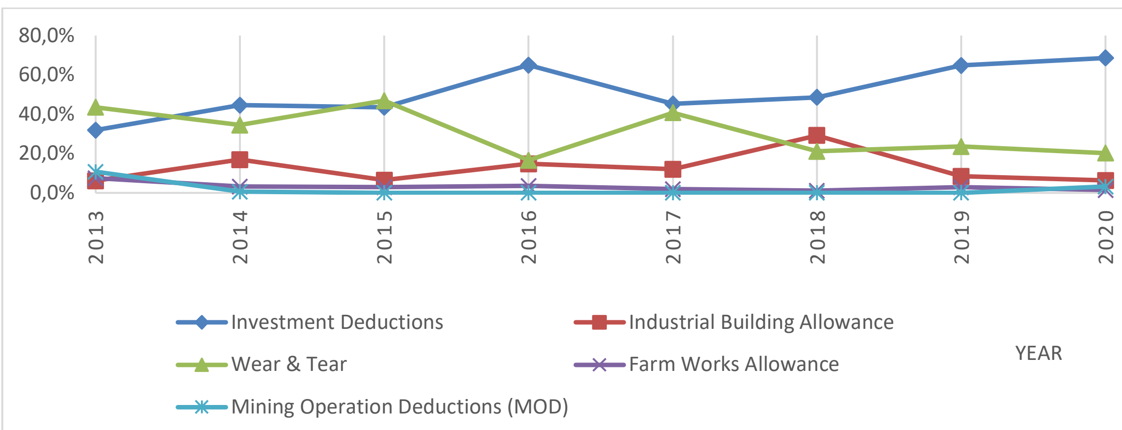
EPZ														
Cash Flow Simulation for the Period ending 2033														
Starting Date	1/1/2021													
	Beginning	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	Total
CASH RECEIPTS														
Cash sales		29,536,190.00	12,953,690.00	27,053,690.00	10,953,690.00	36,953,690.00	9,536,690.00	7,095,360.00	13,953,690.00	24,153,690.00	2,953,690.00	2,953,690.00	2,953,690.00	181,051,450.00
Returns and allowance														
Interest, other income														
Owner contributions														
TOTAL CASH REC		29,536,190.00	12,953,690.00	27,053,690.00	10,953,690.00	36,953,690.00	9,536,690.00	7,095,360.00	13,953,690.00	24,153,690.00	2,953,690.00	2,953,690.00	2,953,690.00	181,051,450.00
CASH PAID OUT														
Salaries/Allowances		360,000.00	360,000.00	360,000.00	360,000.00	360,000.00	360,000.00	360,000.00	360,000.00	360,000.00	360,000.00	360,000.00	360,000.00	4,320,000.00
Rent		1,080,000.00	1,080,000.00	1,080,000.00	1,080,000.00	1,080,000.00	1,080,000.00	1,080,000.00	1,080,000.00	1,080,000.00	1,080,000.00	1,080,000.00	1,080,000.00	12,960,000.00
Packing fee		9,600.00	800.00	800.00	800.00	800.00	9,600.00	800.00	800.00	9,600.00	800.00	9,600.00	800.00	44,800.00
Electricity		50,000.00	500.00	500.00	500.00	500.00	50,000.00	500.00	500.00	50,000.00	500.00	50,000.00	500.00	204,000.00
Fuel/bus fare		30,000.00	30,000.00	30,000.00	30,000.00	30,000.00	30,000.00	30,000.00	30,000.00	30,000.00	30,000.00	30,000.00	30,000.00	360,000.00
Repaires		310,000.00	30,000.00	30,000.00	30,000.00	30,000.00	310,000.00	30,000.00	30,000.00	310,000.00	30,000.00	310,000.00	30,000.00	1,480,000.00
Stationary		5,000.00	50.00	150.00			5,000.00			5,000.00		5,000.00		20,200.00
Bank interest		50,300.00	40,200.00	40,200.00	40,200.00	40,200.00	50,300.00	40,200.00	40,200.00	50,300.00	40,200.00	50,300.00	40,200.00	522,800.00
Purchases		7,500,400.00	11,103,207.60	-	9,801,160.00	13,718,961.20	2,370,080.00	1,585,888.70	-	7,862,750.00	841,005.79	883,050.00	203,000.00	55,869,503.29
SUBTOTAL		9,395,300.00	12,644,757.60	1,541,650.00	11,342,660.00	15,260,461.20	4,264,980.00	3,127,388.70	1,541,500.00	9,757,650.00	2,382,505.79	2,777,950.00	1,744,500.00	75,781,303.29
Other startup costs														
Owners' withdrawal		-												
NET CASH FLOWS BEFORE TAX	-	20,140,890.00	308,932.40	25,512,040.00	(388,970.00)	21,693,228.80	5,271,710.00	3,967,971.30	12,412,190.00	14,396,040.00	571,184.21	175,740.00	1,209,190.00	105,270,146.71
Tax payable if EPZ		-	-	-	-	-	-	-	-	-	-	-	**302,297.50**	**302,297.50**
Present value of tax payable		-	-	-	-	-	-	-	-	-	-	-	**266,021.80**	**266,021.80**
Tax payable if no tax holiday		5,035,222.50	77,233.10	6,378,010.00	(97,242.50)	5,423,307.20	1,317,927.50	991,992.83	3,103,047.50	3,599,010.00	142,796.05	43,935.00	302,297.50	26,317,536.68
Discount factor		1.000	0.877	0.769	0.675	0.592	0.519	0.456	0.400	0.351	0.308	0.270	0.237	
Present value of tax payable if no tax		5,035,222.50	67,733.43	4,904,689.69	(65,638.69)	3,210,597.86	684,004.37	452,348.73	1,241,219.00	1,263,252.51	43,981.18	11,862.45	71,644.51	16,920,917.55

Present value of tax payable if no tax holiday is granted = KSHS 16,920,917.55. Present value of tax payable if tax holiday is granted in = KSHS 266,021.80. Loss of tax revenue due to the granting of tax holiday = KSHS (16,654,895.75).

Proposed amendment: *Section 4B to be amended to abolish the ten-year tax exemption enjoyed by companies in the EPZ*

Tax losses carried forward within the CIT system are currently substantial (KRA, 2018; Republic of Kenya, 2021a). With effect from 2021, losses are carried forward indefinitely. However, there is no loss carry backward provisions except for the firms operating in the oil and gas sector for a period of 4 years [Section 15(4); section 15(4A) of the ITA].

Figure 10: Tax Revenue Loss from Investment Incentives as % of investment incentives, 2013-2020 (Percentage of Investment Incentives).



Investment deductions are quite substantial and show an upward trend over the studied period. This is followed by wear and tear which shows a declining trend overtime. Industrial building allowance has been low despite being above the farm works and mining operation deductions.

Ability to carry forward losses indefinitely or over a long period of time may incentivize companies to remain in a tax-loss-making position, over-claiming losses and might never pay taxes. Hence, there is need to ensure that a company claiming to offset historic losses against future taxable trading profits would have to pay some CIT, so that losses can be relieved in full, and companies can no longer avoid paying tax indefinitely.

Proposed amendment: *Amend the Act to limit the amount of losses that can be offset each year to a proportion of the profits of each future year that would otherwise be taxable.*

Lack of transparency and weak access to information on taxpayers' transactions were cited by several key informants as one of the factors that hampers enforcement, especially for countering the domestic hidden economy, cross-border tax evasion, and illicit financial flows.

Proposed strategy: *enhance the sharing of information between tax jurisdictions to facilitate mutual support for example through Multilateral Convention on Mutual Administrative Assistance in tax matters.*

There is inequitable sharing of taxing rights under Double Taxation Agreements (DTAs). The concern is that tax treaties often fail to prevent double non-taxation that results from interactions among more than two countries. The third country involvement puts a strain on the existing rules (ActionAid, 2019; ICPAK, 2017). Moreover, Multinational companies from non-treaty partners routinely invest in certain jurisdictions simply to exploit treaty benefits, such as a lower withholding rate thereby undermining the income tax base.

Proposed Strategy: *renegotiate all existing DTAs or eliminate them.*

Proposed Strategy: *Develop a comprehensive double taxation treaty policy and a consistent internal policy to address transfer pricing.*

Transfer pricing practice aids Multinational corporations in profit shifting by shifting income from affiliates in high tax jurisdictions to those in low tax jurisdictions in order to reduce their overall tax liability, an argument that is shared with African Development Bank (AfDB) (2010). This permits businesses to reduce their tax burden in the jurisdictions where income producing activities are conducted. Consequently, taxpayers in that jurisdiction bear a greater share of the burden. Furthermore, fair competition is harmed by distortions induced by base erosion and profit shifting (BEPS) (ICPAK, 2017). Transfer pricing is fueled by loopholes in the operating rules. To deal with transfer pricing issues, a unit has been created at the KRA for that purpose. This is complimented by section 23 of the ITA that allows the Commissioner General to ignore or counteract a transaction meant to avoid paying tax.

Proposed amendment: *Amend the Income Tax Act to strengthen penalties to parties engaging in transfer pricing.*

Proposed amendment: Develop a consistent set of transfer pricing rules.
The framework for granting the tax incentives provides high discretion to the CS (Section 29(2)(i) of EPZs Act No. 12 of 1990) (KRA & The National Treasury and Planning, 2021). Therefore, the National Treasury has a framework for granting the tax incentives but the one for monitoring and evaluation of the granted tax incentives

is either weak or non-existent (See also Mburu, 2021).

Proposed strategy: *Develop an efficient framework for granting tax incentives, monitoring, and evaluating them.*

Paragraph 10 subject to section 26 allows tax exemption on income of an institution established solely for the purposes of advancement of religion or education. These includes charitable, religious and educational organizations that are tax exempt indefinitely but must be scrutinized every 5 years. The problem here is that quite a number of these institutions make a lot of money but there is no evidence that they contribute to alleviation of poverty or distress of the public, hence has been abused.

Proposed amendment: *Paragraph 10 of the first schedule to the Income Tax Act (ITA) to exclude advancement of religion and education.*

SECTION 6: ASSESSMENT OF RENTAL INCOME TAXES

The landlord is required to pay rental income tax at a rate of 10 per cent on the gross rent received either monthly, quarterly, semi-annually or annually, though the return must still be filed monthly. The withholding rate for non-residents is 30 per cent of the gross rent. Rental income tax rates in some other African countries are as follows: Uganda 19.15 per cent, Zambia 18.16 per cent, Tanzania 15 per cent, South Africa 12.8 per cent, Mauritius 11.25 per cent, Nigeria 10 per cent, Ghana 8 per cent and Botswana 2.75 per cent. (https://www.globalpropertyguide.com/Africa).

Tax on rent is final, which means that any income from rent shall not be liable to any further taxation. The performance of rental income taxes continues to be dismal. The compliance rate has not been computed. The following table shows rental tax revenue trends as shares of GDP and of total tax revenues.

Table 12: Rental Revenue Trends: 2000-2002 and 2017-2020

	In Relation to GDP		In Relation to Tax Revenue	
	2017-2019	2018-2020	2017-2019	2018-2020
	Mean	Mean	Mean	Mean
Rental Income Taxes	0.004	0.006	0.03	0.04

Source of data: KRA data base.

Rental income as a share of GDP as well as a share of tax revenue are negligible, i.e., the percentages are less than one. This supports the argument that the rental income grossly underperforms every year. The following table shows trend in real rental tax revenue and target.

Table 13: Real Tax, Target, Variance and Growth in Rental Income

Year	Real (Ksh Million)	Target (Ksh Million)	Variance (Ksh Million)	Growth (%)
2015/16	322.8			
2016/17	280.2			-13.2
2017/18	319.0	333.7	(14.7)	13.9
2018/19	354.3	101.0	253.3	11.1
2019/20	342.4	175.4	517.8	-3.4

Source of data: KRA data base.

The real rental income tax performed better in the year 2018/2019 and 2019/2020 but missed targets in the year 2017/2018. The growth in revenue from rent was negative for the years 2016/2017 and 2019/2020. This could be due to widespread under-reporting of income arising from renting of both residential and commercial premises. Some of the factors that undermine the rental income tax performance include: inadequate enforcement; non-compliance by the landlords; inefficient sharing of data among government agencies; non-declaration; and over claiming expenses. There is therefore a need to put in place procedures that will enhance effective taxation of rental income.

Proposed strategy: *Amend section 6A to allow for sharing of data on properties among County governments, National government and other government agencies.*

SECTION 7: ASSESSMENT OF CAPITAL GAINS TAXES

Introduction of CGT was a move to harmonize and align tax laws within the East African Community. Kenya was the only country that did not levy taxes on capital gains. The rate of CGT is 5 per cent on net gains and is declared and paid by the seller or transferor of the property or stock, which is a final tax. CGT is 0 per cent in Burundi, 30 per cent in Uganda, 30 per cent in Rwanda while in Tanzania it depends on; whether the asset is being sold domestically or overseas; whether the transaction is being done by an individual or company and whether it is being carried out by a resident or non-resident individual or company.

Table 14: CGT Rates in Tanzania

Disposal of investment	Domestic Asset (per cent)	Overseas Asset (per cent)
Individual:		
Resident	10	30
Non-Resident	20	N/A
Company:		
Resident	30	30
Non-Resident	30	N/A

Source: East African Community: Income Tax-Capital- Gains Tax

It is clear that the tax rate for capital gains in Kenya is quite low compared to other East Africa countries except Burundi.

The following cases regarding the transfer of properties are tax exempt.

1. Income that is taxed elsewhere as in the case of property dealers.
2. Issuance by a company of its own shares and debentures.
3. Disposal of property for purpose of administering the estate of a deceased person.
4. Transfer of property between spouses as part of divorce settlement.

The share of CGT revenue in GDP and in tax revenue is presented in the following table.

Table 15: CGT Revenue Trend: 2000-2002 and 2017-2020 per cent

	In Relation to GDP		**In Relation to Tax Revenue**	
	2017-2019	2018-2020	2017-2019	2018-2020
	Mean	Mean	Mean	Mean
Capital gains taxes	0.09	0.02	0.60	0.26

Source of data: KRA data base.

CGT revenue as average shares of GDP and tax revenue are a paltry 0.09 and 0.6 per cent, respectively for 2017-2019. For the period 2018-2020, which includes the effect of COVID -19, the tax revenues as average shares of GDP and tax revenue both declined to 0.02 and 0.26 respectively. The real and target revenue for capital gains taxes are shown in the following table.

Table 16: Real, Target, variance and growth of Capital Gains Taxes

Year	Real (KSHS Million)	Target (KSHS Million)	Variance (KSHS Million)	Growth (%)
2014/15	96.6	30.4	66.2	N/A
2015/16	295.9	406.9	(111.0)	206.2
2016/17	115.8	146.1	(30.3)	-60.9
2017/18	650.6	723.0	(72.4)	461.7
2018/19	95.8	134.4	(38.6)	-85.3
2019/20	123.8	249.4	(125.6)	29.3

Source of data: KRA data base.

Table 16 shows that revenue from CGT performed dismally. Targets were missed every year except 2014/2015. The factors that undermine CGT performance include: low compliance levels; non-declaration, legal gaps, over claiming of acquisition costs and lack of records for verification purposes. The challenge faced is how to determine the original cost of property since the records on the acquisition, improvement and maintenance costs may be difficult to obtain for the purposes of calculating the cost of the property. Hence, investors must keep accurate and up-to-date records.

Proposed amendment: *Amend the Act to:*

a) Tax disposal of property for purpose of administering the estate of a deceased person.
b) Tax transfer of property between spouses as part of divorce settlement.
c) Increase capital gains tax from 5 to 10 per cent to be in line with the peers.

SECTION 8: ASSESSMENT OF PENSION TAXES

The existing framework for taxing pension income is provided for in the Income Tax act envisages three phases: contribution phase; investment phase and payout phase. Generally, the tax system for pensions in Kenya is Exempt, Exempt, Tax (EET).

Taxation on Purchase of House: Retirement Benefits Authority (RBA) Act, Section 38 allows members to access a portion (up to 40 per cent of their accrued but capped at KSHS 7 Million) of their benefits to purchase a residential house. However, there is no clarity or any express provision for the tax treatment of the portion of benefits available to a member as withdrawals to purchase a residential house.

Because this is a benefit accorded to members as they work but befits one of their crucial needs in retirement, “a roof over their heads,” tax exemption enhances their affordability of the kind of house they desire to buy. So, what is sought is tax exemption on the amount accessed to buy a house, which paid by the scheme directly to the institutional supplier of the house.

Proposed amendment: Amend the ITA to allow for exemption of benefits accessed by a member of a scheme to purchase a residential house.

Income tax exemption on lump-sum amount and monthly for 65 years and above: Previously, monthly and lumpsum paid to members who are 65 years and above was exempted from income tax. This cushioned the elderly during old age and severe circumstances like the ongoing COVID–19 pandemic. Pensioners have been left vulnerable now. The income tax exemption that was given to the 65 years and above was taken away by amendment of paragraph 53 of the 1st Schedule to the income tax that only exempt monthly pensions and NOT lump sum paid. Besides exposing the elderly, it also introduces unfairness and liability for schemes which have been exempting retirees from taxation of lump sum benefits. The proposal is that Paragraph 53 of the first schedule should be reinstated.

This provision on tax-exempt lump-sum benefits granted to a person who is sixty-five years of age, or more was inadvertently removed without any proposal on the amendment to Income Tax Act. This has resulted in demotivation for workers who wish to retain their benefits until age 65 years to benefit from the tax exemption but has also at the macro level reduced national long-term savings available to borrowers including the government.

Proposed amendment: 1st Schedule, paragraph 53 of the Income tax be amended to include monthly and lumpsum paid to members who are 65 years and above.

Proposed strategy: Include pensions as part of normal income. Then the personal exemption will apply.

Tax Free Amount on monthly retirement benefit: The tax-free monthly retirement benefit was increased from Ksh.15,000 to KShs.25,000 in 2009/2010. Since then, this relief has not kept up with the increase in the cost of living and the rising incomes during members' working lives. The low tax-free monthly retirement benefit at KShs.25,000 has resulted in inadequate disposable income for retirees, notwithstanding their faithfulness in payment of tax during the entire working life.

Proposed amendment: Ament the act to Index the tax-free monthly retirement benefit to the average inflation rate in the previous Financial Year.

Tax Treatment of Provident Fund Benefits**:** In pursuance of Section 8(5)(6) of the Income Tax Act, some members of provident funds may wish to buy pension instead of lump-sum payment at retirement. Currently, the Income Tax Rules require that even if a member of a provident fund opts to take the benefit as a pension rather than a lump sum, the entire amount on retirement is first taxed as a lump sum payout. This is punitive, discriminatory and encourages more members of provident funds to take lumpsum, which tend to be misused and result in old age poverty.

On the other hand, it has been noted that a number of employers are opting to set up provident funds in order to pay lump-sum to their retiring members. This trend negates the purpose of tax incentives to encourage provision of periodic payments in retirement. It is therefore necessary that any change to the tax regime be applied only to existing provident funds.

Proposed amendment: Amend the Income Tax Act to provide for members of registered provident funds who opt to take a portion of their benefits as pension (annuity or income drawdown), to be taxed under the pension tax rules, provided that the benefit is transferred directly to the annuity/income drawdown provider.

Tax Treatment of Death Benefits: In pursuance of the Income Tax Act in Section 8(6)(a), death benefits in respect of a deceased member of a retirement benefits scheme are not paid to the estate of the deceased and are taxed on the assumption that the benefits belong to a single beneficiary. This results in higher taxes on the benefits which in return erodes the final benefits payable to the beneficiaries. If the payment was to be made to the estate of the deceased and not as a lumpsum to the dependents, the first Kshs. 1,400,000 of such a lump sum payment is deemed to be income not chargeable to tax as income of the estate or its direct beneficiaries. Even though amounts above Kshs. 1,400,000 are to be taxed at full corporate rates, this results in a higher net benefit than where benefits are paid from the scheme and taxed at a graduated rate. Death benefits paid from the scheme attract higher taxation than those paid from the estate of the deceased, thus resulting in a discriminatory treatment for similar family situations. For example, a death benefit of Kshs. 4,000,000 would be treated for tax as follows:

Table 17: Tax Treatment of Death Benefits Kshs

	Benefits payable to the Estate		**Benefits payable to the Beneficiary**
Pension Benefit	4,000,000		4,000,000
Less Tax-Free amount	(1,400,000)		(600,000)
Taxable amount	2,600,000		3,400,000
Tax calculation			
	Benefits payable to the Estate		Benefits payable to the Beneficiary
Taxable amount	2,600,000		2,200,000
Tax charged @30%	**(780,000)**	First 400,000 @ 10%	(40,000)
Net	**3,220,000**	Next 400,000@ 15%	(60,000)
		Next 400,000@ 20%	(80,000)
		Next 400,000@ 25%	(100,000)
		Bal 1,800,000 @ 30%	(540,000)
		Total tax charged	**(1,420,000)**
		Net	**2,580,000**

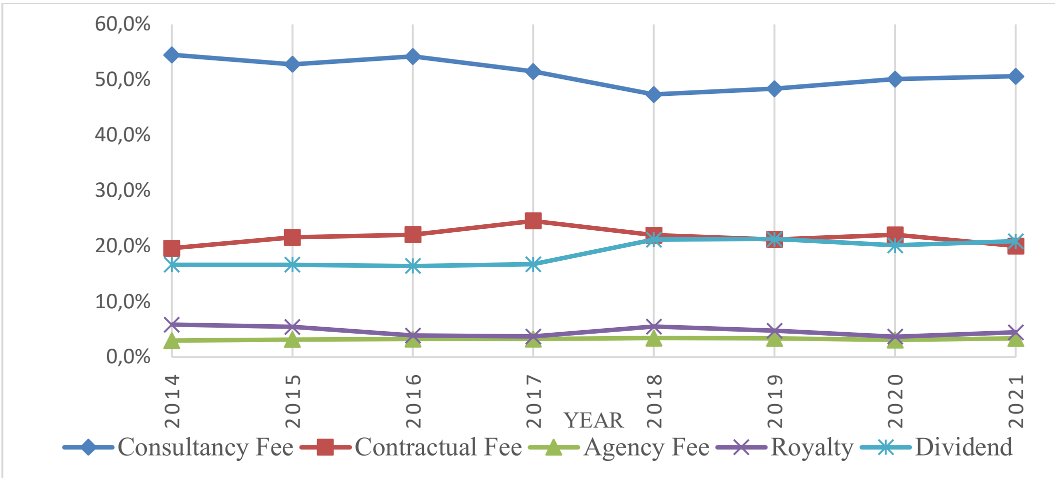
Proposed amendment: To ease the burden on dependents, the Income Tax Act be amended to provide for tax exemption on lump sum death benefits paid from a retirement benefits scheme to dependents of a deceased member to be tax free for the first Kshs. 1,400,000.

SECTION 9: ASSESSMENT OF WITHHOLDING TAXES

Income from taxes requiring withholding taxes include: consultancy fees taxes, management fees taxes, royalty fee taxes, contractual fees taxes, and agency fees/commission taxes. The primary motivation for adopting withholding tax system is to reduce tax evasion and to decrease cost of collection to the tax administration. Withholding tax system is most commonly used for the personal income tax on wages but can also be used effectively for a variety of income and wealth taxes.

The following figure shows trends in revenue from withholding taxes.

Figure 11: Trends in the Share of Tax Revenue from Withholding Taxes (Per cent of Withholding Taxes)



The performance of consultancy fee is way above the rest. This is followed by contractual fee fees in that order. The trends are stable for all the taxes implying that more effort is needed to make them rise overtime.

The table that follows shows average tax revenue share trend for withholding taxes.

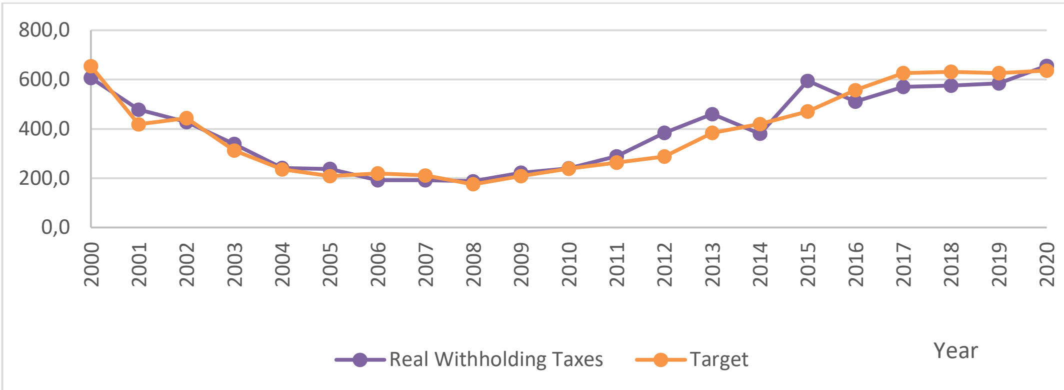
Table 18: Withholding Revenue Trends: 2000–2002 and 2017–2020 Per cent

	In Relation to GDP			In Relation to Tax Revenue		
	2000–2002	2017-2019	2018-2020	2000-2002	2017-2019	2018-2020
	Mean	Mean	Mean	Mean	Mean	Mean
Withholding Taxes	0.62	1.13	1.11	4.0	7.3	7.4
Dividend Taxes		0.131	0.134		0.84	0.89
Consultancy fees taxes		0.33	0.31		2.11	2.08
Royalty fee taxes		0.031	0.030		0.199	0.198
Contractual fees taxes		0.15	0.14		0.97	0.93
Agency fees/Commission		0.022	0.021		0.144	0.141

Source of data: KRA data base.

Average withholding taxes as a share of GDP increased by a paltry 0.51 per cent from 0.62 to 1.13 for the period 2000-2002 and 2017-2019. Its contribution in tax revenue have increased by 3.3 per cent; from 4 to 7.3 per cent. Consultancy fees taxes has the highest share followed by dividends. There is not much difference when data for 2020 is included in the calculation to capture the effect of COVID-19. The following figure shows real and target revenues for withholding tax revenues.

Figure 12: Real and target revenues for withholding tax revenues (Khs. Millions).



Source of data: KRA data base.

KRA has missed targets for withholding tax revenue for seven out of 21 years within the study period. The performance has been moderate. The base has been eroded by high levels of inflation as discussed above. From the KIIs perspective, abuse of tax rates and late payment may have contributed to less collection than envisaged.

Proposed amendments:

a) *Adopt withholding tax system for all taxes*
b) Amend laws to tighten the areas of non-compliance
c) Enhance Audits

9.1 Dividend Taxes

Dividend taxes are charged on distributed gains or profits on which no tax has been paid at the resident corporate tax rate (Section 7A of the Income Act), in the year of income in which the dividends are distributed. Dividends received by a resident company from a company where it holds directly or indirectly more than 12.5 per cent of the shares is exempt from tax. Hence, dividend received by a resident company from its local or foreign subsidiary is tax exempt. The withholding tax rate for dividends paid to Kenyan residents or to citizens of the East African Community is 5 per cent, while for dividends paid to non-residents is 10 per cent. For dividends received from a publicly listed company and from a private company, withholding tax rates are 5 per cent for a resident and 10 per cent for a non-resident and is a final tax.

Where a Double Taxation Agreement exists between Kenya and a foreign country, lower withholding tax rates for dividends may apply, if the recipient of the dividends qualifies under the limitation of benefits provisions. Dividend income received from a subsidiary in a foreign country is exempt from tax. Any expenses that are directly attributable to such exempt income are non-deductible for tax purposes in Kenya.

Average dividend taxes as a share of GDP and tax revenue were a paltry 0.13 and 0.84 per cent respectively for the period 2017-2019 (Table 19). There is not much difference when data for 2020 is included in the calculation to capture the effect of COVID-19.

Table 19: Real and the % Change in Dividend Income Tax revenue

Year	Real (KSHS Million)	Growth (%)
2013/14	213.1	N/A
2014/15	295.5	38.7
2015/16	394.8	33.6
2016/17	343.3	-13.0
2017/18	377.7	10.0
2018/19	357.9	-5.3
2019/20	314.0	-12.3

Source of data: KRA data base.

The revenue from dividends taxes show a positive percentage change from year to year, although the percentages differ with the lowest registered in 2019/2020. Some factors that undermine performance of dividend taxes include: wrong use of rates to calculate taxes, and non-declaration of dividends.

Proposed Amendment: *Dividend received by a resident company from its local or foreign subsidiary to be included in the income for taxation purpose or attraction of a tax credit.*

Proposed Amendment: *Increase tax rate from 5 per cent to 10 per cent to collect more revenue at the source and therefore reduce tax evasion and avoidance.*

9.2 Consultancy Fees Taxes

The withholding tax rate for consultancy fees is 5 per cent for residents and 20 per cent for non-residents. This tax is paid by any person who earns a consultancy fee for acting in an advisory capacity or providing services on a consultancy basis. The withholding agency is the entity that recruited the consultant.

Average consultancy taxes as a share of GDP and tax revenue were 0.33 and 2.11 per cent respectively for the period 2017-2019 (Table 20). There is not much difference when data for 2020 is included in the calculation to capture the effect of COVID-19. The figure reduced slightly to by 0.03 from 2.11 to 2.08 per cent.

Table 20: Real and growth of Consultancy Fees

Year	Real (KSHS Million)	Growth (%)
2014	4,791.2	N/A
2015	12,611.0	34.5
2016	25,723.9	39.0
2017	29,315.6	-18.9
2018	27,442.8	-19.9
2019	30,665.8	-3.8
2020	33,737.9	-3.8

Source of data: KRA data base.

Real revenue from consultancy fees taxes shows a negative percentage change, except for two year. The major challenge with consultancy fees tax is abuse of rates, late payment of taxes and low compliance.

Proposed amendment: *Increase withholding tax rate from 5 per cent to 10 per cent to collect more revenue at the source and therefore reduce tax evasion and avoidance.*

9.3 Contractual Fees Taxes

Contractual fee is payment for work done in respect of building, civil or engineering works. The currently rate is 10 per cent. Average contractual fees taxes as a share of GDP and tax revenue were 0.0.15 and 0.97 per cent, respectively, for the period 2017-2019 (Table 21). There is not much difference when data for 2020 is included in the calculation to capture the effect of COVID-19. The figure reduced slightly to by 0.04 from 0.97 to 0.93 per cent.

Table 21: Real and % Change in Contractual Fees Taxes

Year	Real (KSHS Million)	Growth (%)
2014	250.9	N/A
2015	382.7	52.5
2016	530.2	38.5
2017	503.3	-5.1
2018	392.9	-21.9
2019	356.5	-9.3
2020	343.9	-3.5

Source of data: KRA data base.

Real revenue from contractual fees taxes shows a decline in the % change from year to year, except for 2015 and 2016. Inflation experience over time has eroded the purchasing power of the revenues as shown by the declining real values. The major challenge with contractual fees tax is abuse of rates, late payment of taxes and low compliance.

9.4 Agency Fees/ Commission Taxes

Agency fee is a payment made to a person for acting on behalf of any other person or group of persons, or on behalf of the government, but excludes any payments made by an agent on behalf of the principal when such payments are recoverable. Average agency fees taxes as a share of GDP and tax revenue were 0.022 and 0.144 per cent respectively for the period 2017-2019 (Table 22). There is not much difference when data for 2020 is included in the calculation to capture the effect of COVID-19. There was a slight reduction by 0.003 percentage points.

Table 22: Real and growth of tax revenues from Agency Fees/Commission

Year	Real (KSHS Million)	Growth (per cent)
2014	38.0	N/A
2015	56.4	48.7
2016	78.8	39.7
2017	67.2	-14.8
2018	61.4	-8.7
2019	56.8	-7.5
2020	48.3	-15.0

Source of data: KRA data base.

The real revenue from Agency fees taxes only grew in the years 2015 and 2016. For the rest of the years, the real revenues declined. The major challenge with agency fees tax is abuse of rates, low compliance and late payment of taxes.

Proposed amendment: *Increase withholding tax rate from 5 per cent to 10 per cent to collect more revenue at the source and therefore increase tax compliance through reduction of tax evasion and avoidance.*

9.5 Management fee taxes

The withholding tax rate for management fees is 5 per cent for residents and 20 per cent for non-residents. The double taxation rate applies when a project is financed by a donor whose country has an agreement with Kenya. If not, the rate is 20 per cent on management fees. The major challenge with management fees tax is abuse of rates, non-compliance and late payment of taxes.

Proposed amendment: *Increase tax rate from 5 per cent to 10 per cent to collect more revenue at the source and therefore reduce tax evasion and avoidance.*

SECTION 10: ASSESSMENT OF EXTRACTIVE INDUSTRY TAXATION

Royalty rates on minerals, oil and gas in Kenya are uniform and do not entail a sliding scale. Corporate income tax rate applied to natural resource sector is different from the normal CIT rate. The rates are 5 per cent for residents and 20 per cent for non-residents. In addition, exploration costs are expensed. The tax incentives available for natural resource sector include investment allowance on exploration and development expenditure. The sector also enjoys import duty exemption on equipment meant for exploration, mining, and mineral processing.

The mining sector does not enjoy any tax holidays. However, the Mining Act provides for negotiation of favourable fiscal terms, including the possibility of a tax holiday, for investments beyond USD 500 Million. So far, no investment has surpassed this threshold in Kenya.

Small and artisanal mining (ASMs) do not enjoy preferential royalty treatment in Kenya. They are subjected to the same rates as the big miners. This is because royalties are charged per mineral and it is difficult to differentiate a mineral from an Artisanal Miner from that of a large-scale operator.

The following table shows trends in the share of royalties in GDP and in tax revenue.

Table 23: Royalty Fees Taxes Trends: 2000–2002 and 2017–2020 Per cent

Type of Tax	In Relation to GDP		In Relation to Tax Revenue	
	2017-2019	2018-2020	2017-2019	2018-2020
	Mean	Mean	Mean	Mean
Royalty fee taxes	0.031	0.030	0.199	0.198

Source of data: KRA data base.

Average royalty fees taxes as shares of GDP and tax revenue were 0.031 and 0.199 per cent respectively for the period 2017-2019. There is no much difference when data for 2020 is included in the calculation to capture the effect of COVID-19.

Table 24: Real and % growth of Royalty Fees Taxes

Year	Real (KSHS Million)	Growth (per cent)
2014	74.8	N/A
2015	96.5	29.0
2016	93.5	-3.0
2017	76.5	-18.2
2018	97.9	28.0
2019	80.0	-18.3
2020	57.8	-27.8

Source of data: KRA data base.

The revenue from royalties' fees taxes shows a positive percentage change for 2015 and 2018. The rest of the years registered a decline due to immense challenges faced in the mining industry. The challenges include Transfer Pricing and Miss-invoicing. Sales made to related parties abroad erase the true value of the mineral products and thus lowers both corporate income taxes and royalties. Some studies estimate that close to two thirds of all mineral exports are to the related parties and are thus not arm's length transactions. As much as the mining tax laws contain specific Transfer pricing provisions, capacity and capability to detect these schemes is still low.

KIIs argued that treatment and imposition of CGT in this sector has led to a drastic reduction of mineral right transfers. This has led to a decline of junior exploration companies' interest in the country. It would be instrumental if this is addressed to spur exploration and ultimately mining in Kenya.

The taxation of mining activities seems to be handled by the relevant ministries and not KRA. Moreover, there is special interests on the natural resources both from the national government and county government players and the local communities. This has led to inefficient taxation of extractive activities, an argument that is shared with Tanzi and Zee (2000).

Lack of an appropriate regime for taxing the entire value chain (mid-stream and down-stream businesses, and related transactions is limited) was also cited as another challenge by the KIIs. Other challenges highlighted by the KIIs include: the informal nature of the industry; lack of responsive laws covering the industry; lack of cooperation with other government agencies; capacity challenges; benchmarking prices where applicable; and excessive capital deductions and not in tandem with the firm outputs.

Proposed Strategies:

a) *The tax regime for extractive industries should include: a royalty, to ensure government revenue from the time production commences; a CIT so that returns to equity are taxed in a similar way as other companies; and an additional tax to ensure the government obtains an increased share in economic rents of more profitable projects.*
b) *Engagement with international experts on the extractive industry sector to develop capacity on taxation of extractive industry.*
c) *Approach taxation of the sector through multi-agency.*
d) *Amend the Income tax Act to strengthen penalties to parties engaging in transfer pricing, miss-invoicing etc. Da*
e) *Review tax incentives policy to be in sync with output.*

SECTION 11: ASSESSMENT OF TAXATION OF THE DIGITAL ECONOMY

Performance of direct taxes was boosted by digitization of tax administration through the rollout of the iTax system and the M-Service (Ndung'u 2017). The iTax system was launched in 2013 and allows the taxpayer to register, file, pay, and make inquiries (Ndung'u 2017). The M-Service platform is a mobile phone application that enables taxpayers to make payments and access tax information using their mobile phones launched in 2014 (Ndung'u 2017). The application of technology has reduced the level of undeclared economic activities (tax compliance is about 65 per cent up from 59 % in the year 2015/2016), thereby expanding the tax base by bringing more small and medium enterprises (SME) into the tax bracket (Ndung'u 2017). Digitization has also played a role in increasing efficient tax collection by eliminating face-to-face interactions (Wawire, 2020).

However, due to the virtual nature of digital transactions, tax loopholes are created, which makes it difficult to assess where e-commerce [more expansion] creates value. Furthermore, the changing state of technology has created a challenge in tapping revenue potential from the growing e-commerce and cross-border commerce sectors (Ndung'u, 2017; Wawire, 2020).

The spread of the digital economy also poses challenges for international taxation through base erosion and profit shifting (ICPAK, 2017).The digital economy is characterized by an unparalleled reliance on intangible assets, thus the massive use of data (notably personal data). This raises the difficulty of determining the jurisdiction in which value creation occurs and how the digital economy relates to the concepts of source and residence for income tax purposes (Siavhundu, 2021). These challenges persist despite the rapidly growing service sector providing a large and wide potential tax base as described above.

Proposed Amendment:

a) *Continuous training of tax administrators in emerging technologies.*
b) *Continuously review domestic tax laws and align with emerging technologies to seal any revenue loopholes.*
c) *Develop policies and strategies to facilitate sharing of information with other tax jurisdictions.*
d) *Amend the Income Act by introducing a section to exclusively deal with taxation of the digital economy.*
e) *Benchmarking against standards, such as those in the BEPS Action Plan.*

SECTION 12: ASSESSMENT OF TAXATION OF INFORMAL SECTOR

Kenya is characterized by a narrow tax base and a large informal sector which is hard to tax. This sector comprises a multitude of small and micro enterprises that transact mainly in cash and do not keep proper books of accounts. Hence, understanding the nature of informality in Kenya is key for designing appropriate policy measures.

Most workers in Kenya are employed in the agriculture (the second largest contributor to GDP after services sector) or in small, informal enterprises. While most Kenyans are in the informal sector, the labour laws recognize only the formal sector, thereby making taxing of workers in the informal sector difficult (Murunga, Muriithi, & Wawire, 2021). There is a clear divide between the citizens in this field of informality and subsistence and those in formal employment - and a lack of knowledge on how to bridge this divide. As a result, modern means of raising revenue, such as income taxes and consumer taxes, play a diminishing role in these informal sectors. The possibility that the government will achieve high tax levels is virtually unattained. Because of the informal structure of the economy and because of financial limitations, statistical and tax offices have difficulty in generating reliable statistics. This lack of data prevents policymakers from assessing the potential impact of major changes to the tax system.

Another issue to tackle is the underdeveloped industrial sector while the agricultural sector is very large (Republic of Kenya, 2021c) which is typical to all developing countries. This has revenue implications since taxes from the industrial sector are usually considered easy to collect due to visibility and accessibility of firms, while taxes in the agricultural sector are typically hard to collect due to the subsistence nature of the activities (Mascagni, Moore, & Mccluskey, 2014; Wawire, 2016).

The presence of a large informal sector and the shadow economy that remains untapped pose issues of tax compliance. Moreover, the wealthy are slowly moving their wealth to this sector (Wawire, 2020).

Key tax policy challenges experienced in raising income tax revenue from informal sector include:

1. Policy changes between turnover tax and presumptive tax that resulted in confusion amongst taxpayers.
2. The upward adjustment of Turn Over Tax threshold from a lower limit of Kshs 500,000 to Kshs 1 million and raising upper limit to Kshs 50 million, created options for taxpayers to choose to be in either turn-over tax or corporate income tax obligation.
3. Many micro, small and medium sized business operate informally and transact using cash, thus their transactions are not easily traceable.
4. Technological set back in tracing landlords, such as lack of Geospatial Information System (GIS) technology, hence the need to improve effectiveness of Block Management System
5. Poor book-keeping - many businesses operate informally thus do not have records of business transactions.
6. Low taxpayer literacy and reluctance in embracing technology (such as the KRA-M service meant to improve tax payment among small taxpayers).
7. Inadequate access to data on businesses and permit payment history held by third party firms for scrutiny as guided by law.
8. Lack of unique identifier in county register which makes difficult to trace exact owner of businesses.
9. Many revenue streams at county governments (137 revenue streams for Nairobi City County Government) with many associated revenue collection systems.
10. Limited support from County governments on strategies to collect revenues from the counties.

Proposed strategies:

a) *Make KRA the sole tax revenue collector or create collaboration between KRA and County government like the case of Nairobi County where KRA is working in close collaboration in revenue administration.*
b) *Adopt a unified system for collection of taxes, fees and levies for the National and County Governments*
c) *Use of technology in mapping properties and enhance tax administration.*
d) *Continuous taxpayer education tailored to the informal sector.*
e) *Enhance collaborations and exchange of information on taxpayers between the National Government and County Governments.*
f) *Consider reintroduction of presumptive tax in the agricultural sector*

SECTION 13: MINIMUM TAX

Minimum Tax is the tax imposed under section 12D of the Income Tax Act. The rate shall be 1 per cent of gross turnover as provided under Section 34 and the Third Schedule to the Income Tax Act (CAP 470). The tax is 1 per cent of gross turnover. Businesses have largely been affected by Covid-19 which has forced them to lay off most of their employees due to cash flow issues. Introduction of minimum tax of 1 per cent (KRA, 2020) at the time when businesses are struggling and hoping for a quick economic recovery appears ill-timed. Considering that the government of Kenya instituted measures to cushion taxpayers from the effect of covid-19, introducing minimum tax at this time of uncertainty may be counteractive. Taxes based on turnover are retrogressive and have adverse effects on the economy.

The tax will negatively affect sustained business operations and significantly hamper cash flow and this will push struggling entities to premature closure leading to loss of jobs and taking the economy into a downward spiral of contraction. The business closures will affect all economic sectors including the manufacturing sector and at a critical time for the economy trying to recover from the impacts of COVID19.

Earnings Before Interest and Tax (EBIT) is a company's net income before income tax expense and interest expenses are deducted. EBIT is used to analyze the performance of a company's core operations without the costs of the capital structure and tax expenses impacting profit. This is the appropriate base since it allows a company to pay tax based on its income as opposed to turnover and it is therefore in line with the equity canon of taxation.

Proposal: *Defer the introduction of minimum tax from 2021 to 2023 to give businesses and the economy at large an opportunity to recover from the negative effects of the COVID-19 pandemic.*

SECTION 14: CONCLUSIONS AND OPTIONS FOR POLICY ADOPTION

14.1 Conclusion

From the foregoing, it is clear that there are disincentive features in the Kenyan tax system that affects direct tax revenue mobilization. To address these disincentives, some sections and articles in the Income Tax Act, CAP 470 (2021) require amendments. The key conclusion is to amend the Income Tax Act to make rules about exemptions firmly stated in laws and regulations, and to publicly disclose information about exemptions. In addition, establish an appropriate, evidence-based tax expenditure governance, monitoring and evaluation framework to limit leakages and improve transparency in income tax exemptions. The specific amendments are contained in the text.

14.2 Specific recommendations:

1) *Corporate income tax*: renegotiate all existing Double Taxation Agreements (DTAs); and abolish the ten-year tax exemption enjoyed by companies in the EPZ.

2) *Rental* Income *Taxes*: amend section 6A to allow sharing of data on properties among government agencies.

3) *Capital gains:* amend the Act to allow tax on disposal of property for purposes of administering the estate of a deceased person; and transfer of property between spouses as part of divorce settlement.

4) *Pension taxes*: Amend the income tax act to allow for exemption of benefits accessed by a member of a scheme to purchase a residential house; provide for members of registered provident funds who opt to take a portion of their benefits as a pension to be taxed under the pension tax rules; and widen the tax bands on benefits payment when a member retires at age 50 and above or when retiring on grounds of ill health.

5) Capital gains tax (CGT): amend the Act to allow tax on disposal of property for purpose of administering the estate of a deceased person and transfer of property between spouses as part of divorce settlement; and increase tax rate to 10 per cent to deal with the issue of non-compliance and abuse.

6) *Withholding taxes:* amend the act to adopt withholding tax system for all taxes; and enhance audits.

7) *Extractive Industry:* engage international experts on the extractive industry sector to develop capacity on taxation; approach taxation of the sector through multi-agency; amend the Income Tax Act to strengthen penalties to parties engaging in transfer pricing, miss-invoicing; and review tax incentives policy to be in sync with output.

8) *Digital economy:* introduce a section in the income tax to exclusively deal with taxation of the digital economy.

9) *Informal sector*: make KRA the sole tax revenue collector or collaborator with other agencies in tax administration; and allow data sharing between national and county governments.

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2. Section 15(4) (Carryforward losses); 15(4A).
3. Section 16(1)(b). (Investment allowance).
4. 2nd schedule (Wear and tear).
5. Section 29(2)(i) (EPZ Act).
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