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REPORT OF THE INCOME TAX COMMITTEE, KENYA

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The Government deeply appreciates the care and thoroughness with which the Committee has carried out the inquiry entrusted to it, and the very considerable amount of detailed work which has gone into the preparation of the report. A number of the recommendations have already been met and passed into law in the East African Income Tax (Management) (Amendment) (No. 2) Act, 1954, and further recommendations are acceptable to the Government in whole or in part.

2. The Government cannot, however, accept the proposition put forward in paragraph 13 of the report, in which the Committee states as follows:—

> "It seems to us that East Africa provides a unique and original example of a system of income tax legislation in that, in theory at any rate, we have one legislative body responsible for a part only of the whole legislation—the most important part of that part being that concerned with the definition of and method of computing income—and other and independent legislatures responsible for determining the rates of tax which are to be applied according to the circumstances of the taxpayer to his income, as determined under enactment of that first-named legislative body. If we are right in this, this system should, provided it is properly applied, afford a unique and much-needed opportunity, and the mechanism, for achieving a more realistic measure of income for tax purposes and a better dispensation of equity as between taxpayers than has been achieved up to date. The emergence as factors of consequence, of lack of realism and inequity has, of course, been brought about by the gradual and therefore insidious increase in rates of tax to which we have already had occasion to refer; correction of this inequity has been impeded and even prevented by the fact that income tax has come to play such an important part in the public revenue that it has not been possible to make such correction without making major adjustments in rates or the general system of taxation unless the revenue was to suffer very seriously, and consequently it has been easier or politically expedient to let the position continue or grow worse. To our mind, the High Commission, in its approach to the task of legislating on the management and collection of income tax, should not be concerned with revenue considerations, except to the important but nevertheless limited extent of ensuring that the machinery for collection and management is sufficient, and that schemes for avoidance and evasion are not allowed to flourish. In fact, the High Commission should

be capable of being more impartial and just in its approach to the problems we have indicated than can be, or has been, any government charged with the dual task of determining what is to be taxed, as well as at what rate it is to be taxed."

3. The Government cannot agree that there has been an insidious increase in rates of tax. In fact, company tax has risen by only Sh. 1, from Sh. 4 to Sh. 5, since 1942. As a result of the increases in the rates of child allowances and of the introduction of the education allowance and the old age allowance, and as a result of the reduction in the rate levied on the first section of an individual's chargeable income from the 1942 rate of Sh. 2 on the first £250 to the present rate of Sh. 1/50 on the first £400 of chargeable income, individuals with the same income are, in many cases, paying less tax now than they would have paid on the same income in 1942 or 1948. For example, a married man with one child and an income of £1,000 a year paid Sh. 1,368 in 1942, Sh. 976 in 1948 and Sh. 881 in 1954. A married man with two children and an income of £1,500 a year paid Sh. 3,064 in 1942, Sh. 2,356 in 1948 and Sh. 2,273 in 1954, including the surcharge on chargeable income in excess of £800, and a married man with two children and an income of £4,000 a year paid Sh. 22,150 in 1942, Sh. 19,462 in 1948 and Sh. 21,464 in 1954, including the surcharge on chargeable income in excess of £800.

4. The Government also cannot accept the implication that the East Africa High Commission could have a policy different from that of the Territorial Governments. The Central Legislative Assembly derives its authority from the territorial legislatures, and no Bill to amend the East African Income Tax (Management) Act could be introduced into the Central Legislative Assembly without the agreement of the Territorial Governments.

5. The Government also cannot agree that changes in the definition of "income"—or, in other words, changes in the definition of what is to be taxed—should be made without regard to the effect of these changes on the rate at which income is taxed. The Committee itself recognizes this point, as is shown by the following extract from paragraph 8 of the report—

"It is in fact difficult to divest the study of many sections of the Act of considerations concerned with effective rates of tax and the pattern of those rates. Indeed to attempt to do so would be wrong, if only for the reason that success in the endeavour would almost certainly mean the reaching of conclusions divorced from, and therefore not applicable to, reality."

6. Some of the major recommendations in the report could be implemented only if corresponding revenue were to be raised by substantial increases in the standard rate of tax, or by increases in indirect taxation. It

is felt that changes of this nature cannot be accepted by the Government unless it can be clearly shown that the result of the changes would compensate for the inevitable deterrent effect on the development of the Colony of a substantial increase in the standard rate of company tax or other forms of taxation. It must also be recognized that a time when Kenya is facing a large deficit on the Colony's budget, and when the Colony is dependent upon substantial grants from Her Majesty's Government in the United Kingdom, is not a time at which concessions which would involve a reduction in tax receipts can easily be made. In fact, the Government at present has to examine ways and means of finding additional revenue to finance the increased commitments arising out of the Emergency.

7. The publication of the report has been delayed in order that consideration might be given to its recommendations. It was felt that if the report were published without any indication of Government's intentions, false hopes regarding the extent to which its recommendations could be implemented might be raised. The Government's views on the 39 recommendations, summarized in Appendix "D" to the report, are given below.

8. The following recommendations have been covered by the East African Income Tax (Management) (Amendment) (No. 2) Act, 1954:—

(6) *The capital element of purchased life annuities, provided such have been purchased out of capital or taxed income, should not be subject to tax.*

(13) *The proviso to section 14 (1) (d) should be deleted as being either unnecessary or incomplete in view of the contents of section 8 (3).*

(15) *Losses, other than those excluded under section 15, should be available for deduction from the income of the year previous to that in which the loss is incurred or from the income of any subsequent year, even though not incurred in relation to a trade, business, profession or vocation.*

(19) *The grant of initial allowances in respect of capital expenditure should be made optional on the taxpayer.*

(22) *Where property passes by reason of death then for the purpose of determining what, if any, balancing charges or claims should be made in respect thereof and what deductions should subsequently be made in respect thereof to the successor, the legal personal representative of the deceased should have the right of electing either that such property passes at its residual income tax value immediately prior to death, or that it passes at a fair market value as at the date of death.*

(26) *Where a person becomes entitled to income of a trust or settlement which has been accumulated for his benefit contingently on his attaining a certain age or marrying, provision should be made to enable him to claim the tax benefit to which he would have been entitled if such income had accrued to him absolutely during the currency of his contingent interest.*

(35) *There should be full publication of the essential facts of all appeals heard and of the proceedings and decisions or judgments.*

9. The following recommendations have also been partly covered by the East African Income Tax (Management) (Amendment) (No. 2) Act, 1954:—

(32) *Section* 61 *should be amended so as to make it clear that the proviso to sub-section* (1) *applies to the whole section and reference to the "local Committee" should be replaced by reference to "a judge".*

The first part of this recommendation is covered in the Act, although the Government cannot agree that reference to the "local Committee" should be replaced by reference to "a judge". The system of local Committees is normal practice, and has worked satisfactorily.

(37) *The provisions relating to claims for repayment of tax should be amended so as to accord with those relating to additional assessments.*

The Committee makes it clear in paragraph 206 that the object of their recommendation is to ensure that section 87 cannot be interpreted so as to deny the taxpayer the right of achieving adjustment in his tax liability where he has made some perfectly honest error or mistake and no question of negligence arises. Provision has been included in the Act (section 74 (5)) to cover this point, although to adopt the actual recommendation made by the Committee would mean that there would be no finality to assessments for up to seven years after they were made, and the recommendation as it stands cannot therefore be accepted.

10. The following recommendations are acceptable to the Government in whole or in part:—

(1) *Consideration should be given to the appointment of a committee to examine and report on rates of tax, allowances and exemptions.*

As announced in the Press on the 13th September, 1955, the East Africa High Commission and the British Resident, Zanzibar, have agreed that a Commission should be appointed to inquire into income tax in East Africa, including Zanzibar.

(5) *No change is recommended in the law relating to the charge to tax of the annual value of quarters and residences, but it is recommended that consideration should be given to requiring local government administrations to assist in the assessment of such annual values.*

If and when Local Authorities make improved site valuations, consideration will be given to the extent to which the Income Tax Department could have regard to such valuation lists, bearing in mind the need for maintaining a common basis throughout the country.

(12) *Where a farmer has been assessed to tax on the basis of not taking into account the values of his livestock and produce on hand, and where he sells a substantial part or the whole of his livestock, consideration should be given to spreading the proceeds of such sale over up to six years for purposes of assessing such sale proceeds to tax.*

Where a farmer has been assessed on a cash basis, and intends to sell a substantial part, or the whole, of his livestock, he is already permitted to change on to the valuation basis, and to spread profits over the preceding six years.

(17) *All taxpayers should be placed on the same basis in regard to expenditure incurred on leave passages for them and their families, regardless of whether such expenditure is met by the taxpayer or by his employer.*

The Passage Rules are designed to achieve what is recommended by the Committee, but it is not practicable in all the varying conditions in which expenditure on passages is incurred to give exactly the same measure of relief to all taxpayers. A revision of the Passage Rules is at present under consideration in the light of changed conditions since they were last made, and it is hoped that these revised Rules will be ready for publication before long.

(20) *There should be published, for information only, the maximum and minimum rates of annual deductions applied to various classes of assets.*

So far as is practicable in Kenya, where industry operates under varying conditions, the Department will publish a Schedule of common rates. The Department has supplied a Schedule of the basic rates normally adopted to all practising accountants.

(28) *The East African Income Tax (Pension Schemes) Rules, 1952, should be amended.*

These Rules are at present under consideration. It may be noted that the reason why funds should be established in East Africa is to encourage the investment of capital in East Africa. It has already had a good effect.

11. The Government is unable to accept the following recommendations: —

(2) *Tax should not be charged in respect of income derived from or accrued outside East Africa, whether such income is remitted to East Africa or not.*

East African residents can in a number of countries overseas make investments on which, as non-residents of the country in which the investment is made, they pay little or no tax. If income received in East Africa from these sources were exempted, it would mean that residents could live here without paying tax anywhere. While this might result in the receipt of more overseas income in East Africa, it would tend to drive more capital out of East Africa. It is felt that there is no reason why the East African rate should not be paid where income is, in fact, brought into the country. The loss of revenue if this recommendation were to be accepted would be of the order of £75,000 a year, and might become much greater if the export of capital was encouraged in this way. For these reasons this recommendation cannot be accepted.

(3) *The rate of tax to be applied to the income of an individual should be determined by the aggregate of that individual's total income from Kenya, Uganda, Tanganyika and Zanzibar.*

This recommendation purports to be a summary of the following recommendation in paragraph 26 (a), namely, that "tax shall, subject to the provisions of this Act, be charged for the account of each territory in respect of each year of income at the rate imposed by the appropriate territorial income tax ordinance upon the income of any person accruing in or derived from that territory". This recommendation is unacceptable because it is contrary to the principle upon which the tax is levied in East Africa, that is, that each Government is entitled to the tax it would receive under separate legislation. This principle has been reaffirmed recently by the East African Governments.

(4) *An individual should have a right, to be exercised not more often than once in five consecutive years, to have assessments on him revised on the basis of tax being charged for each of five consecutive years on an amount of income equal to one-fifth of the aggregate income for the five years together.*

An average of five years, as set out in the examples in Table IV on page 17 of the report, would reduce the tax payable in all but a few isolated cases of individuals. If the two examples are looked at, it will be seen that in Year 5 there would be a reduction in revenue in the one case of £1,562, and that the Treasury would have to refund £8,345 in the other. To allow averaging over this period would cause an overall reduction in revenue, and would result in an irregular flow of revenue, which could embarrass the Government financially.

(7) *Clubs which derive not less than three-quarters of their gross receipts on revenue account from members should not be subject to tax on the annual value of the club premises.*

This recommendation has already been considered by the Government, and rejected. Members of clubs benefit from the occupation of premises owned by them, and should pay tax in the same way as owner-occupiers of private houses.

(8) *Section 13 requires some amendments in any case, but in view of the recommendation made in paragraph 26 (summarized as 2 above) this section should be deleted.*

The Committee states in paragraph 57 that section 13 of the Act is unfortunately worded so as to extend exemption in respect of foreign income remitted to the territories only to those who have been in the territory for some temporary purpose, and that, under the law as it stands, any person who is not resident in, and who has not visited the territories for some temporary purpose, is subject to tax in respect of any of his income which may be remitted to the territories. The Committee implies that, because section 13 of the Act does not specifically exempt from taxation foreign income remitted to the territories by a person who is not resident in, and who has not visited the territories for some temporary purpose, such income is liable to tax. In fact, such income is not regarded as liable to tax.

(9) *For the purpose of ascertaining the total income of any person for a year of income there should be deducted all losses, outgoings and expenses incurred by such person for the purpose of producing or in producing such person's income to the extent that such losses, outgoing and expenses, whether incurred during or prior to the year of income, have not been deducted in arriving at the total income of any previous year of income and to the extent that the benefits of such outgoings and expenses are fairly attributable to the year of income.*

While it is accepted that some redrafting of sections 14 and 15 might be desirable, such redrafting would not affect the intended or actual interpretation of the existing law. For example, the strained construction placed on section 14 in the report is not adopted in practice. These sections are based on long experience of the difficulties of determining the proper deductions to be made, and should not be tampered with lightly. They will no doubt be examined by the Commission of Inquiry.

(10) *The law in relation to interest and dividends should be radically amended so as to put the treatment of dividends on a similar basis to that applied presently in the case of interest and (with some exception) tax should be deducted at source on payment of all interest and dividends.*

The Committee points out in paragraph 71 that great caution is necessary in considering whether or not this recommendation should be implemented. It is true to say that the existing method of dealing with company dividends is not entirely satisfactory in any country where income tax is imposed and tax is deducted from dividends, but the Kenya practice is based on normal practice elsewhere, whereas the proposal of the Committee has—as far as is known—no precedent in any other country. The recommendation is designed to assist the administration of the law, but it is not believed that it would, in fact, do so. The Government also cannot accept the Committee's view that there is no difference in principle between dividends on share capital and interest on borrowed money. The existing practice is known and established and, in fact, the Commissioner of Income Tax advises companies whenever asked to do so on the rate of tax to be deducted.

(11) *In the case of agricultural undertakings an option should be extended for the cost of capital expenditure on a wide range of improvements to be claimed as a deduction in full from income of the year in which the expenditure is incurred.*

Farming is the major industry of Kenya, but it is a matter for consideration whether it is advisable to distinguish it from other forms of productive industry, all of which contribute toward the development of the country. The view of the Committee—expressed in paragraph 76 of the report—is that in the long run the taxpayer is generally better off if, in respect of capital expenditure, he claims deductions spread over a number of years approximating to the life of the asset concerned. However, the recommendation would leave an option to the taxpayer and, without knowing how the option would, in fact, be exercised, it is not possible to estimate the effect of the recommendation on the revenue, but the loss in the initial year might be as much as £400,000—a loss which the Government could not accept in present financial circumstances. Nevertheless, the Government considers that this important matter should receive special study by the Commission to be appointed to inquire into income tax in East Africa, including Zanzibar—this study to have due regard to the need for maintaining the revenue.

(14) *Sections* 14 (1) (*e*) *and* 15 (*h*) *should be deleted as being wrong in principle and as not being applied in practice.*

The Committee suggests in paragraph 87 that the provisions of the law relating to employers' contributions to pension schemes are frequently ignored, and that it is common practice where a scheme is not an approved one to allow the employer his contributions to the scheme. In fact, an employer's contributions to a scheme which is not approved may well be regarded as part of the remuneration paid by an employer to an employee, and therefore part of the proper expenses incurred by the employer. It is considered necessary to retain these sections in order to provide control over pension schemes.

(16) *Costs of appeal in legal proceedings relating to a claim for personal allowances should be allowed as a deduction.*

The reason why the Tucker Committee, in paragraph 168 of their report, recommended that the costs of appeal in legal proceedings relating to business profits should be allowed, was because the Committee came to the conclusion that the cost of these appeals is a consequential expense incurred in the course of carrying on a business. The Committee specifically advised that no such allowance should be given in respect of the cost of an appeal which relates solely or mainly to a claim for any of the personal allowances, and the Government accepts this view.

(18) *Deductions should be allowed in respect of reasonable medical expenses incurred by a taxpayer on himself and his dependents.*

Medical expenses are one of the many burdens which fall on the private individual in the course of his daily life and, while there are precedents in other countries for deductions from income in respect of medical expenses, the desirability of accepting the recommendation is doubtful. It would add substantially to the administrative burden falling on the Department, and the Department could not handle this additional burden at the present time.

(21) *Deductions in respect of expenditure incurred by a taxpayer on a capital asset should be granted in respect of the full amount actually expended by that taxpayer, and should not be limited by reference to the expenditure incurred by any previous owner.*

The principle of this recommendation was rejected when the Second Schedule was enacted. It was then accepted that the fact that any excess over the original cost was not deductable for tax purposes had the beneficial effect of keeping the purchase price down, particularly as the seller is not charged with tax on the capital profit which he makes. The effect of the present system is to reduce the cost of the purchaser's capital investment.

(23) *The provisions of the Act relating to deductions in respect of capital expenditure should be recast in simpler form than at present, and so as to permit of deductions in respect of expenditure on all assets, including all buildings and premiums paid for leaseholds, where such assets are used in earning the income.*

While the Second Schedule is elaborate, it has the great advantage of covering adequately the widely varying conditions under which the deductions are granted. Any attempt at simplification on the lines suggested by the Committee would undoubtedly be a source of litigation which should not be invited deliberately. To extend relief to all assets would cost the Revenue a sum of upwards of £500,000 a year.

(24) *A special deduction should be granted in the case of undertakings carried on by an individual or by individuals in partnership to compensate for the disadvantage presently suffered in such cases in the matter of accumulating surtax-free profits as compared with cases where undertakings are carried on by companies.*

(25) *The law in regard to surtax on the undistributed profits of certain companies should be drastically amended in manner set forth at length in the body of this report.*

These recommendations relate to section 22 which deals with the undistributed income of certain companies.

No. 24 recommends a special deduction to individuals in trades, businesses, professions and vocations, but not to employees who are in a similar position. For this reason alone the recommedation would be unacceptable; but if the benefit which the shareholder of a private company gains from section 22 as compared with the private individual is to be revised, the only sound solution would be to deem 100 per cent of the company's profits to be distributed instead of 60 per cent as at present.

The Committee's recommendation that the effect of the section should be modified to encourage development overlooks the fact that the sole object of the section is to put the private company on a basis more comparable with that of the individual or partner. Section 22, in fact, has nothing to do with development; and any measure to encourage development should be applied to all persons engaged in productive industry, whether their enterprise takes the form of a public company, a private company or an individual concern. It is true that the section is by no means perfect, but its practical application is kept continuously under review and if any serious defects come to light appropriate amendments will be considered.

The estimated loss of revenue which would arise from the acceptance of recommendation 24 is estimated as at least £350,000, and the estimated loss, if recommendation 25 were to be accepted, might well exceed £250,000.

(27) *Where the income of a married woman is treated as that of her husband for tax purposes and where husband and wife together contribute to the maintenance of dependent relatives of both of them, two dependent relatives' allowances should be granted.*

This recommendation cannot be accepted. As is clear from paragraph 166 of the Committee's report, the Committee recommend that, where the income of the wife is deemed to be that of her husband, there should be available a Dependent Relative Allowance in respect of each partner to the marriage—one in respect of the husband's dependants and another in respect of the wife's. If this concession were to be given, it would mean that, if one spouse had two dependants and the other none, only one Dependent Relative Allowance could be given, whereas, if both partners in the marriage had a dependant, two allowances would be permitted. This would be inequitable, and the recommendation, in fact, would involve the necessity of granting two Dependent Relative Allowances instead of one.

(29) *Section* 36 *should be amended so as to ensure that no Territory charges tax for its own account in respect of income derived from or accruing in another Territory owing to a disparity in rates of tax between one Territory and another, and section* 37 *should not be amended.*

This corresponds with recommendation No. 3, and is similarly unacceptable.

(30) *The income of a married woman should be assessed on her separately as though she were a single individual, subject to the exercise of an option by both parties to a marriage to the effect that their combined income should be assessed as to one-half thereof on each of them separately as single individuals, with suitable provision for apportionment of personal allowances between them.*

The option to divide incomes between husband and wife would reduce so substantially the tax at present payable that it would have to be restored by a complete revision of the rates of tax and personal allowances. If the examples on page 88 are studied, it will be seen that effect of the recommendation is to relieve the more wealthy families of an increasingly large proportion of tax. For example, the proposal would reduce the tax payable by a married couple with no children by some 5 per cent on an income of £1,000 a year, and by some 36 per cent on an income of £5,000 a year.

(31) *Sub-section* (2) *of section* 54 *should be deleted as being unnecessary in the light of section* 61.

Section 54 provides a means of recovering unpaid tax, while section 61 applies to the examination of the returns of income prior to the assessment of the tax. These sections are therefore not unnecessary.

(33) *English should be the only officially recognized language for the purpose of the Act relating to accounts and books of account, and official recognition of other languages should not be accorded in this respect after the* 31*st December*, 1955.

It would be premature to insist on the universal use of English at the present time when the language cannot be said to be fully established throughout the country. Section 63 enables the Commissioner to take action in appropriate cases.

(34) *That part of sub-section* (3) *of section* 74 *which empowers the Commissioner to examine any person on oath or otherwise concerning another person's affairs should be deleted.*

The sub-section is common in income tax legislation throughout the Commonwealth. Its object is to assist in the collection of tax properly due to the Revenue. Its provisions are used most judiciously and no practical objection has been raised since income tax was introduced into Kenya.

(36) *The penalty exigible for late payment of tax should be replaced by a charge by way of interest calculated monthly, fractions of a month to count as a whole month.*

It is not the intention of the law to levy a charge of interest for the use by the taxpayer of moneys which should have been paid to the Revenue, but to provide for a penalty for failure to pay tax on the due date. The provision for the inflicting of a penalty facilitates collection. There is provision for relief from the penalty in appropriate cases. If the recommendation were accepted it would undoubtedly hamper the collection of the tax which is already difficult enough.

(38) *The Act should be altered so that penalties can only be imposed by, or with the consent of, local committee or some similar body.*

The penalty in section 40 is not imposed by the Commissioner, but by the law against which the taxpayer has a right of appeal. Power to commute penalties is common in revenue legislation, and in the United Kingdom the Commissioners of Inland Revenue (the official body) have corresponding powers. Where penalties are related to Court proceedings the taxpayer always has the alternative of defending those proceedings. The accepted practice of settling out of Court in revenue cases (Customs and Excise as well) is not only welcomed by defaulters, but also facilitates the administration of the tax.

(39) *Sub-section* (5) *of section* 4 *should be deleted.*

It is essential to retain section 4 (5), at least, to enable the Commissioner to exchange information for the purpose of granting relief. An undertaking limiting the exchange has already been given on the United Kingdom/East African agreement.

12. The Government is unable to accept the view put forward in the minority note by Major Keyser and the late Mr. McKnight, which appears on pages 106 to 108 of the report, and accepts the view of the Committee as expressed in paragraph 75. Nevertheless, the Government considers that the points raised in this minority note should be studied, as well as recommendation 11 of the Committee, by the Commission to be appointed to inquire into income tax in East Africa, including Zanzibar—this study to have due regard to the need for maintaining the revenue.

13. The recommendation made by the late Mr. McKnight in his notes, which appear on pages 109 to 111 of the report, is not acceptable. In effect it would mean relieving profits from taxation on the assumption that they would be expended at some future date on the replacement of assets at an enhanced price—in other words, to grant relief in respect of expenditure which might never be made.

THE TREASURY,
NAIROBI.

31*st October,* 1955.

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