

**ADDRESSING THE DIFFERENT TAX POLICY AND TAX ADMINISTRATIVE
CHALLENGES OF MICRO, SMALL AND MEDIUM BUSINESSES**

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Executive Summary

Micro, Small and Medium Enterprises (MSMEs) sector plays a very important role in the developing process of emerging economies. However, there is no universally accepted definition of these enterprises. In the last few decades, the perception of MSMEs has changed from one of small businesses with marginal activity to a sector that accounts for much growth and employment creation. Indeed, in developing countries, MSMEs are considered principal driving force for economic development and poverty alleviation.

Tax regimes and taxation of MSMEs have become increasingly topical and governments globally have sought to accommodate and provide a means for such businesses to participate in mainstream economic activity in a legitimate fashion. Previously, tax administrations had argued that the cost of registering these enterprises and processing their returns far outweighed the benefits in terms of revenue yield.

As in most developing countries, the indigenous private sector in Kenya is dominated by MSMEs. There are over 1.3 million MSEs country-wide, employing more than 2.3 million people. The sector is therefore an integral means of strengthening the Kenyan economy. Despite the fact that the diverse activities are widely noticeable as a source of livelihood for many Kenyans, a number of issues have been raised about the sector. Concerns have basically revolved around legitimacy of the activities when they are carried out in an informal environment their operating environment and their implications and impact on the entire economy. Majority of the firms in the sector do not fulfil business registration requirements and tax obligations. Given the rapid rate at which MSMEs have increased, there is an urgent need to capture their activities into the tax net. For the informal firms in the sector, there is a pressing need for a formalization strategy.

Available literature shows that the informal sector could be taxed by: (i) legitimatising the sector through allowing tax holiday and/or exemptions for certain sectors; (ii) presumptive taxation which involves the use of indirect means to ascertain tax liability; and (iii) indirect tax approach that imposes an appropriate tax burden on those operating in the underground economy.

Despite the above mentioned of taxing the sector, there are specific challenges that underpin small business taxation. These include: (i) having a simplified tax regime versus bringing informal sector into the tax bracket; (ii) the risk of vendors who were initially maintaining books of accounts for tax purposes stopping doing so since they will now fall below the threshold; (iii) the issue of requiring vendors operating informal sector businesses without maintaining accounting records to pay fines or penalties could lead to discouragement of compliance altogether in that the vendor will merely try to evade detection and not pay any tax; and (iv) developing strategies for enhancing compliance based on taxpayer segments coupled with lack of credible data sets that can be used for analysis of taxpayer segments.

In Kenya, national statistics show that out of the 43,057 registered formal sector establishments in 2006, 25,020, (or 58%) of them are Micro and Small Enterprises. The high proportion of MSMEs in the country is a challenge in the endeavour to tax the sector. Other challenges are: (i) high Proportion of Nil and Non-Filers in Kenya Revenue Authority (KRA) Database, (ii) lack of Vital Statistics on the Sector, and (iii) low Remuneration of Employees in the Sector.

Attempts have been made to bring the MSMEs into the tax net with the aim of reducing informality of the sector and simplifying the tax system. This is intended to reduce administrative and compliance costs and thus evasion. The following are steps that have been taken in the sector.

The quest for enhancing tax compliance for MSMEs by according them special tax treatment in line with the international practice began in 2005 when KRA was mandated to develop a simplified tax regime for the sector Unified Tax System (UTS). The qualification criterion for the proposed regime was the VAT threshold of **Kshs 3.0 million**. Business entities with annual turnover below Kshs 3.0 million would fall in this regime and were to pay a fixed amount of tax per year depending on the economic activities they are engaged in and the schedule within which they fall. However, for business entities dealing in more than one activity, the amount of tax payable will be determined after an investigative audit is carried out to establish its major activity. The entities in the UTS regime were not to be subjected to other forms of taxes.

To operationalise the UTS, the 2006/07 budget proposals, the VAT threshold was raised from Kshs 3.0 million (equivalent to US\$ 42,857) to Kshs 5.0 million (equivalent to US\$71,429) and the 85% of the businesses whose annual turnover fell below the new threshold were subjected to a turnover-based tax regime.

The key challenges anticipated in the implementation of Turn Over Tax (TOT) include, addressing the equity principal of taxation in the TOT regime, transition from the TOT regime to the regular regime, low voluntary tax compliance, risk of not keeping proper records or manipulating of the records kept, imposition of penalties and fines may be ineffective, incorrect declaration of turnover, and tax avoidance and tax evasion and fraud.

There are two conclusions that can be drawn from this paper. First, for a revenue authority, there is considerable risk the cost of collection of MSMEs taxes may exceed the relevant resources allocated for that purpose, especially when the authority (such as KRA) operates on a fixed rate. Adopting a simplified tax system may reduce these collection costs.

Literature on countries that have implemented tax regimes indicate that they have experienced problems with tax avoidance and fraud schemes used by larger businesses despite the investigative audits carried out. Revenue Authorities therefore face the challenge of reviewing and updating their simplified tax system to reflect the changes in sophistication methods that are likely to be used by MSMEs in tax evasion.

1. INTRODUCTION

Micro, Small and Medium Enterprises (MSMEs) sector plays a very important role in the developing process of emerging economies. However, there is no universally accepted definition of these enterprises. In Kenya, MSMEs are defined in terms of common characteristic such as number of employees or annual turnover. A business enterprise that employs people between 1-9, 10-49, and 50-99 is considered as micro, small, and medium; respectively. The sector is characterized by small scale level of activity, self employment, with high proportion of family workers and apprentices; little capital and equipment; labor intensive technologies; low skills and low level of access to organized markets. It has evolved rapidly in terms of activities. Participation in informal sector has not only been associated with junior public and private sector employees, but also with corporate executives. Hence, the sector has developed as a means of extension of formal businesses.

In the last few decades, the perception of MSMEs has changed from one of small businesses with marginal activity to a sector that accounts for much growth and employment creation. Indeed, in developing countries, MSMEs are considered principal driving force for economic development. The sector has stimulated private ownership and entrepreneurial culture. It is in recognition of this contribution that many efforts have been dedicated in both developed and developing countries to better facilitate MSMEs in terms of wealth creation, poverty alleviation and their contribution to financing expenditures in government budgets.

Tax regimes and taxation of MSMEs have become increasingly topical and governments globally have sought to accommodate and provide a means for such businesses to participate in mainstream economic activity in a legitimate fashion. Previously, tax administrations had argued that the cost of registering these enterprises and processing their returns far outweighed the benefits in terms of revenue yield. This remains true where such businesses are required to participate in the normal taxpaying regime and this has led to a significant move internationally to offer simplified regimes for this category of taxpayers. Cost versus benefit is still an important issue that needs to be carefully balanced. However, a better balance is greatly facilitated where a simplified regime is implemented.

There is a growing awareness that tax systems can go beyond merely maximizing revenue collection but over the medium- to longer-term can inculcate a higher degree of tax compliance and build a platform to support entrepreneurship and business development. Over time, perceptions regarding small businesses have changed. In the late 70's, small businesses were typically regarded as habitual tax avoiders and evaders. With the advent of private sector

led development paradigm in the early 1980s, the MSMEs represented a higher and growing proportion of GDP in both developing and developed countries culminating into much emphasis on taxing these businesses.

2. CHARACTERISTICS OF MSMEs

The sector is characterized by free entry; small scale nature of the activities; self-employment with a high proportion of family workers and apprentices; little capital and equipment. Other characteristics include labour intensive technology; low skills; low level of organization with little access to organized markets, unregulated and competitive markets, less formal credit, low education and training or services and amenities and cheap provision of goods and services.

3. IMPORTANCE OF THE MSMEs SECTOR

As in most developing countries, the indigenous private sector in Kenya is dominated by MSMEs. The 1999 National MSE Baseline Survey found that there are about 1.3 million MSEs country-wide, employing some 2.3 million people. The contribution of the MSE sector to Gross Domestic Product (GDP) was estimated at 18.4% in 1999. The sector is therefore an integral means of strengthening the Kenyan economy. It has emerged as a major source of employment in Kenya's labour market. The share of the informal the sector's employment to total employment in the country rose from 48.9% in 1993 to 78% in 2006 (Economic Survey, 2007). Other fundamental contributions by the sector include:

- ✚ Increased output of goods and services;
- ✚ Development of a pool of skilled and semi skilled labour force, which is expected to be a base for future industrial growth;
- ✚ Strengthened both forward and backward linkages among socially, economically and geographically diverse sectors of the economy;
- ✚ Increased participation of indigenous Kenyans in economic activities of the country, and
- ✚ Create opportunities to cultivate and nurture entrepreneurial and managerial skills of the country.

Despite the fact that the diverse activities are widely noticeable as a source of livelihood for many Kenyans, a number of issues have been raised about the sector. Concerns have basically revolved around legitimacy of the activities when they are carried out in an informal environment their operating environment and their implications and impact on the entire economy. Majority of the firms in the sector do not fulfil business registration requirements and tax obligations. Given the rapid rate at which MSMEs have increased, there is an urgent

need to capture their activities into the tax net. For the informal firms in the sector, there is a pressing need for a formalization strategy. This will ensure that, firstly; they are legally in the tax net. Second, their tax regime is simplified to enable them fulfil their tax liabilities at minimal costs. Third, this will help tax authorities enhance administrative efficiency, eliminate avenues for tax evasion and enhance tax compliance.

4. METHODS OF TAXING THE MSME SECTOR

There are fundamental differences in initiating a tax regime in developed and developing economies. In developed economies, most small businesses are within the formal category and it has been easy to customise the existing tax legislation to suit their needs. Essentially, the system used does not represent a major departure from existing systems. Furthermore, the location of the taxpayer is easily traceable. However, in developing countries, the task is more difficult in that small taxpayers are not generally compliant with tax, registration, local government requirements and regulations (through ignorance as well as intent). Furthermore, they cannot be easily located or identified by the tax administration because they overwhelmingly operate within the informal sector.

The following are the key features of the small taxpayers sector:

- (i) Small, transient, and often cash-based businesses.
- (ii) High turnover rates - many new businesses created, many others fail, and a few grow. Many of them are family based, sole proprietorships, and partnerships.
- (iii) Large numbers often comprising between 70-80 percent of total taxpayers.
- (iv) Low revenue potential (typically 5-10 percent) of total revenues.
- (v) Expensive to administer.
- (vi) Many remain outside the tax net due to challenges in complying with tax and other government regulations.
- (vii) They have weak accounting capabilities coupled with rudimentary accounting systems.

From the MSMEs perspective, implementation of regular enforcement measures is expensive and an intensive undertaking owing to the enormous numbers and diversity of the sector. In addition, due to the small nature of their transactions, the tax revenues payable or recovered through such enforcement measures are rarely commensurate with the costs incurred in collecting the tax.

Tax authorities experience major problems in identifying informal sector activities, not only because they sometimes include illicit activities, but also because even legitimate activities are

difficult to identify when they are mobile (traders), small-scale (basic services) or elusive (craftsmen carrying out small jobs for cash). These difficulties severely limit the personal and business income tax base that is known and reported to the tax authorities. Usually, only a fraction of small businesses register with the tax authorities. Moreover, only a small share of the overall population is on the payroll of formal sector enterprises and the government, where recorded wages and salaries are readily observable and easily taxable through employer withholding schemes. Despite such handicaps, the experience of several countries in recent years shows that substantial improvement can be achieved with determined effort and an appropriately designed strategy.

4.1. Approaches to Taxing the Informal Sector

The following are three approaches in taxing MSMEs:

4.1.1 Legitimatising the Informal Sector Approach

Available literature shows that one way to capture the shadow economy into the tax net is to legitimatise the sector by allowing tax holiday and/or exemptions for certain sectors. For instance, exempting typically low-yield sectors like agriculture from income taxation will significantly reduce the cost of tax administration. This system has been applied in India where the agricultural sector is constitutionally excluded from central income tax.

4.1.2 The Presumptive Approach

Presumptive taxation involves the use of indirect means to ascertain tax liability, which differ from the usual rules based on the taxpayer's accounts. The term "presumptive" is used to indicate that there is a legal presumption that the taxpayer's income is no less than the amount resulting from application of the indirect method¹. It involves simple and cost-effective techniques to capture domestic transactions and sources of income that frequently escape taxation under conventional norms. These techniques include lump-sum levies on small-scale business activities (standard assessments); the assessment of taxes through indicators or proxies that help estimate a taxpayer's income (estimated assessments); and the collection of minimum taxes irrespective of a taxpayer's actual level of business activity (presumptive minimum taxes). More recently, other methods have gained importance. They include

¹ Tax Law Design and Drafting (volume 1; International Monetary Fund: 1996; Victor Thuronyi, ed.) Chapter 12, Presumptive Taxation

presumptive taxes on imports; withholding schemes designed to capture the incomes of unregistered businesses; and graduated business license fees.

A presumptive tax can be assessed in two ways. These include: First, estimating the taxpayer's income estimated on a specific basis. Secondly, computing taxable income on the basis of key factors associated with income generation such as sales, turnover, number of employees, size of the firm and taxpayer's assets. Presumptive tax is of various types. These include:

- (i) minimum tax concept which is a fixed amount of tax is paid by persons in the informal sector regardless of the actual trading results;
- (ii) Forfeit Tax in VAT which is similar to the minimum tax and is applicable to a class of persons referred to as small traders in lieu of Value Added Tax; and
- (iii) Multi bands tax liability scheme where several fixed income brackets (bands) are set based on sales or turnover.

4. 1.3. The Indirect Approach

This approach imposes an appropriate tax burden on those operating in the underground economy. Indirect taxes could potentially substitute for special regimes aimed at the hard to tax sector to the extent that these taxes reach the targeted sector via the shifting of taxes into wages, returns on capital or consumer prices. It is ideal for economies where final consumption taxes significantly capture many of the informal sector activities and where the proportion of the informal sector to the entire economy is relatively large².

4. 2. Challenges of Administering MSMEs Taxation

Challenges that underpin small business taxation include:

- ✚ Administering a system that adheres to the principles of designing a presumptive tax system regime namely, ease of compliance, ease of administration, compatibility with existing regimes, fairness, and transition across regimes is quite a big challenge;
- ✚ Dilemma of having a simplified tax regime versus bringing informal sector into the tax bracket. The question remains as whether policy makers can achieve both principles;
- ✚ There is the risk of vendors who were initially maintaining books of accounts for tax purposes stopping doing so since they will now fall below the threshold. This will eventually lead to a huge number of them enjoying a lower tax obligation and hence, the tendency to remain in the regime instead of graduating to the regular regime;

² Alm Martinez Vasquez (2003) analysed the impact of size of the shadow economy on tax structure and found that the larger the shadow economy the more reliance a country puts on indirect taxes.

- ✚ The issue of requiring vendors operating informal sector businesses without maintaining accounting records to pay fines or penalties could lead to discouragement of compliance altogether in that the vendor will merely try to evade detection and not pay any tax;
- ✚ Orienting the tax administration system around the key segments of taxpayers;
- ✚ Developing strategies for enhancing compliance based on taxpayer segments and
- ✚ Lack of credible data sets that can be used for analysis of taxpayer segments.

4.3. International Practice in Taxing Micro and Small Enterprises (MSEs) Sector

Small business tax reform is not limited to developing countries. Many developed economies have realized the importance of facilitating small business for improved growth. According to the current international practice, micro and small taxpayers are accorded special tax treatment in the bid to enhance tax compliance. This is attributed to their inability to maintain books of accounts for their transactions and complexities that are inherent in the regular tax regimes. A special tax regime that is based on turnover is usually designed for such firms.

Taxation of the MSE sector in developing countries varies across countries. In **Egypt** for instance, the time a simplified small business regime was being contemplated coincided with the move to increase the VAT threshold. Accordingly, there was a category of vendors who now fell below the threshold but who had previously been required to maintain accounting records for tax purposes. In order not to lose the advantages of good record keeping and allow the vendors between the old threshold and the new to lower their standards of record keeping the simplified small business regime was broken into two distinct components –

- (i) Small businesses whose turnover exceeds LE 150,000 (US\$ 26,544) but does not exceed LE 500,000 (US\$ 88,479). This segment of taxpayer determines taxable income as being cash receipts³ minus cash expenses⁴ and then applies the appropriate normal income tax rate to this result. Tax paid in terms of this simplified regime stands proxy for both income tax and VAT.
- (ii) Micro businesses are deemed those whose turnover does not exceed LE 150,000 (US\$ 26,544). This segment of taxpayers is split into two broad groups:

Service providers: This group of taxpayers determines taxable income as being 70% of turnover and then applies the appropriate normal income tax rate to this result.

³ Cash Receipts include loans and in-kind benefits of any sort in return for services provided but do not include equity injections by the owners.

⁴ Cash expenses include all business expenses including the purchase of capital assets but excluding payments to owners in respect of equity or debt repayments.

Manufacturers: This group of taxpayers determines taxable income as being 40% of turnover and then applies the appropriate normal income tax rate to this result.

In Chile, small businesses are grouped into a number of categories namely, small miners/farmers whose where income is less than US\$232.21 per annum pay tax of 1% of gross income while those with income is between US\$232.21 and US\$298.57 per annum pay tax of 2% of gross income. On the other hand, street vendors / peddlers pay a flat rate of US\$27 per annum; newspaper/magazine street vendors pay 0.5% of gross income; family workshops pay US\$111 or 3% of their gross income. A further option available to the above categories of small taxpayers as well as taxi / bus owners who own no more than one vehicle is to annually pay a percentage of the value of the property they own rather than maintaining accounting records. Concerning VAT, two systems are in operation that may be utilised by small business persons rather than the normal VAT system. These simplified systems are as follows:

- (i) System 1 – Monthly turnover does not exceed US\$1,120 , and
- (ii) System 2 – Monthly turnover exceeds US\$1,120 and sales are to registered VAT vendors.

Small businesses in system 1 are required to pay a flat VAT rate of 10% on gross sales while for system 2, the tax obligation of the small business is carried by the larger business acquiring the good or service.

In Rwanda, all taxpayers below the VAT threshold of RWF 20 million (US\$ 38,000) *per annum* may participate in the simplified regime for small business which amounts to a single tax standing proxy for both income tax and VAT determined at 4% of turnover. There are approximately 1,000 taxpayers registered for this regime although it is estimated that there are about 70,000 active entities with a turnover less than the VAT threshold not on register. Taxpayers making use of this regime may opt into the normal taxing paying regimes at any stage. There are three tax brackets for individuals, being 0%, 20% and 30% and the corporate rate is 30%.

In Tanzania, Small business tax units (SBTUs) within the Block Management System were formed with effect from 1st July, 2004. Taxation of these business units under the presumptive assessment is described under paragraph 2 of the First Schedule of the Income Tax Act, 2004. Small taxpayers whose turnover does not exceed TSH 20 million (US\$ 16,000) *per annum* must utilize a standard assessment which is determined with reference to a table per million TSH. Taxpayers are divided into two categories, those who maintain records and those who do not. For taxpayers who maintain records tax payable is progressive, however, for taxpayers

who do not maintain records this is not so as broad 'steps' are utilized to determine tax liability.

Ukraine introduced presumptive taxation in 1998 by presidential decree to foster the development of SMEs and curtail the informal economy. Alongside the standard tax system, there exist five presumptive tax systems for small businesses. These are: First, a unified tax that applies to businesses operated by natural persons with about 10 employees. Second, a fixed tax in the form of a patent obtained from the local authority by natural persons with less than five employees. Third, trade permit obtained from local administration for small businesses offering services. Fourth, small enterprise tax paid by small businesses involved in intermittent trade activities and finally, market fee charged on small traders selling agricultural produce.

In the **Zambian** system, taxpayers whose turnover does not exceed K200 million (US\$ 40,000) *per annum* must utilize the 3% of turnover regime. There is no option to participate in the normal taxpaying regimes, that is a taxpayer cannot opt into the VAT regime unless turnover exceeds K200 million. The 3% on turnover is a single, final tax payable *in lieu* of income tax and VAT. It was introduced in order to simplify taxes for small businesses, increase compliance, reduce the burden of compliance and encourage those businesses to grow sufficiently in order to graduate to the formal sector.

Other countries that have adopted simplified tax systems for small businesses include Argentina in 1997, Australia in 2001, New Zealand in 2003 and UK in 2004. UK for instance, introduced a flat rate of VAT for small businesses.

5. THE KENYAN CASE

This section focuses on the country-specific challenges in taxing the sector, the current practise, and the Turn Over Tax (TOT) regime that is pending implementation and the anticipated challenges and possible solutions.

5.1 Challenges in Taxing the MSMEs

The following are challenges faced in taxing MSMEs in Kenya.

5.1.1 Large Size of the Sector

National statistics⁵ show that out of the 43,057 establishments⁶ in 2006, 25,020, (or 58%) of them are Micro and Small Enterprises. The high proportion of MSEs in the country is a challenge in the endeavour to tax the sector.

5.1.2 High Proportion of Nil and Non-Filers in KRA Database

Segmentation of VAT registered taxpayers into payment filers, nil filers and non-filers shows that out of the total VAT registered taxpayers of 65,528, in 2006 there are 18,200 payment filers, representing 27% of the registered VAT taxpayers. The number of nil and non-filers was 22,617 (or 35%) and 24,711 (or 38%) respectively. Thus, the proportion of nil and non-filers to the total number of VAT registered taxpayers was 73%, and hence posing administrative challenges in taxing the MSMEs.

5.1.3 Lack of Vital Statistics on the Sector

Out of the 31,956 MSMEs, 45% are in non-commercial community while 7% are in agriculture. Attempts to tax the sector have therefore been complicated by the high proportion of the MSMEs in the non-commercial community. This is because majority of their transactions are cash based and unrecorded. Moreover, a good number of MSMEs are not registered and hence not captured in the national statistics. Attempts to make taxation decisions based on such statistics have been hampered.

5.1.4 Low Remuneration of Employees in the Sector

Despite the fact that the sector is a source of livelihood for a high proportion of Kenya's labour force, most of the employees are either unskilled or semi-skilled and therefore, they are paid wages and salaries that are below the PAYE threshold of Kshs 10,163 (US\$ 150).

5.2 The Current Practice

⁵ Statistical Abstract, 2006

⁶ Establishments are defined to mean specific locations in which a clearly identified type of economic activity is being undertaken. The coverage is limited to the modern sector defined to include all establishments in urban areas, large scale farms, and other modern enterprises located in the rural areas plus that part of the public that is engaged in activities of an "enterprise" nature.

Attempts to bring the MSMEs into the tax net are aimed at reducing informality of the sector, simplifying the tax system. This is intended to reduce administrative and compliance costs and thus evasion. The following are steps that have been taken in the sector.

5.2.1 Advance Tax on Passenger Service and Commercial Vehicles

Advance tax on public service and commercial vehicles in use for carriage of persons and goods for gain or profit was introduced under the Income Tax Act Cap. 470 Section 12(A) with effect from January 1st, 1996. Operators of these categories of vehicles are required to pay advance tax to KRA as a pre-condition for renewal of their annual operating and road licenses until July 2006 when Road License was removed.

The rate for advance tax on commercial goods carrying vehicles is Kshs 1,500 per load capacity per year or Kshs 2,400 per year whichever is higher whereas that of passenger carrying vehicles is Kshs 720 per passenger seat per year). The system requires filing self-assessment returns. Table 1 gives the trend in advance tax collected from the sub-sector.

Table 1: Advance Tax Collection from Commercial PSVs and Freight Vehicles (Kshs Millions)

Financial Year (FY)	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07
Advance Tax Collection	166	229	188	271	473	380	245
Growth (%)	-	38%	-18%	44%	75%	-20%	-36%

On average, about **Kshs 280 million** is collected from Advance tax on the commercial PSV and freight vehicles per year.

The disadvantage of this system lies in the requirement to file returns and yet the sector is characterized by lack of proper record keeping. Stringent enforcement measures are therefore imperative for this tax system to be effective. The tax is also inequitable since the same rate of tax is paid regardless of the number of vehicles a business man owns. This relegates the tax to a motor vehicle tax as opposed to a tax on income.

5.2.2 The Unified Tax System (UTS)

The quest for enhancing tax compliance for MSMEs by according them special tax treatment in line with the international practice began in 2005 when KRA was mandated to develop a simplified tax regime for the sector.

A review of the nature of activities and salient features of the MSMEs in Kenya and the international practice on taxing the sector was done on the basis of which the research team proposed and designed a Unified Tax System (UTS)⁷ for the sector. The system caters for licensing fees and tax liabilities that a business entity is required to pay in order to acquire legal protection for a specified period of time, usually one year.

The regime was graduated into tax schedules defined on the basis of profitability levels of businesses in the sector. Profitability is assumed to be highest for activities taking place within the cities but lowest for those in urban councils, county councils and rural areas. However, since the long-term intention of the initiative was to tie the tax regime to business registration, the tax schedules were aligned to the structure of Single Business Permit Fees.

The qualification criterion for the proposed regime was the VAT threshold of **Kshs 3.0 million**. Business entities with annual turnover below Kshs 3.0 million would fall in this regime and were to pay a fixed amount of tax per year depending on the economic activities they are engaged in and the schedule within which they fall. However, for business entities dealing in more than one activity, the amount of tax payable will be determined after an investigative audit is carried out to establish its major activity. The entities in the UTS regime were not to be subjected to other forms of taxes.

The proposed regime was reviewed by senior officials of the Ministry of Finance (MOF) and the International Monetary Fund (IMF) who foresaw administrative challenges in the proposed regime. As a result, it was recommended that the proposed regime be re-designed on the basis of turnover.

5.2.3 Turnover Tax (TOT) Regime

Following the IMF recommendations on the UTS proposal, the research team embarked on re-designing the presumptive tax regime based on annual turnover of the MSMEs. The team reviewed the VAT database and found that a total of 65,528 businesses were registered for VAT by end of FY 2004/05, of which 20% are businesses in designated sectors where the turnover threshold rule is not applicable while 80% are non-designated businesses at the annual turnover threshold of Kshs 3 million (or US\$ 42,857).

⁷ A unified tax is basically a fixed tax that is paid for a given period of time, usually one year, to guarantee business entities of all legal protection.

Segmentation of VAT taxpayers further showed that 9,435 payment filers who accounted for 85% of the total VAT collections for the year had annual turnover of Kshs 5.0 million and above. This implies that 85% of the total VAT revenue was collected from 14% of the registered taxpayers. This necessitated the need to re-define the tax regime such that firms with turnover below Kshs 5.0 million per year are would fall into the presumptive regime in the bid to get rid of the complexities that are inherent in the regular regime and reduce their cost of compliance. However, due to the low levels of education attained by majority of the players in this sector, most of the traders either keep incomplete business records or do not keep any records at all. From this point of view, design of the turnover tax regime had to take in measures aimed at encouraging book keeping as the best practice.

To this end, as part of the 2006/07 budget proposals, the VAT threshold was raised from **Kshs 3.0 million (equivalent to US\$ 42,857)** to **Kshs 5.0 million (equivalent to US\$71,429)** and the 85% of the businesses whose annual turnover falls below the new threshold were subjected to a turnover-based tax regime as follows:

- a) *Where accounting records are maintained*, the rate was **three percent** of the Gross Annual Turnover.
- b) *Where accounting records are not maintained* MSMEs are required to pay **three percent** of the new upper threshold (Kshs. 5 million), which is Kshs 150,000.00 (equivalent to US\$ 2,142).
- c) *Frequency of tax payment under TOT regime*: To enable the micro and small firms spread their annual tax liability over the year, it was proposed that payment of taxes will be made on quarterly basis. In addition, the regime is simplified more in that the **TOT tax is the final tax**.
- d) *Revenue expectation from TOT*: Assuming that the annual gross turnover for a firm that files a nil-return is Kshs 3.0 million (which is the minimum requirement for VAT registration) while that of a non-filer is Kshs 1.0 million per year, with a tax rate of three percent on the gross annual turnover, the regime was estimated to generate an additional Kshs 2,400 million (or US\$ 34 million) per year. However, the revenue potential is expected to increase with periodic review of the system once operational.
- e) *Passing of TOT into Law*: The proposed TOT regime is contained in the Finance Bill of 14th June 2006 and was to take effect from 1st January 2007. However, legislative enactment is yet to take place.

5.3. Anticipated Challenges in the Implementation of TOT Regime

The key challenges anticipated in the implementation of TOT include:

- ✚ *Addressing the equity principal of taxation in the TOT regimes is an issue.* There are difficulties in ensuring that both vertical and horizontal equity is achieved in the regime. Indeed, this is a global challenge for both the regular and presumptive tax regimes.
- ✚ *Transition from the TOT regime to the regular regime.* Some MSMEs may tend to stagnate in the presumptive regime instead of graduating to the regular regime, especially where tax liability is expected to increase with graduation.
- ✚ *Low voluntary tax compliance:* There is a challenge in voluntary compliance and filing of returns is expected to be poor. This will make it difficult to achieve the overall objective of the regime in enhancing tax compliance of the sector at minimal costs.
- ✚ *Risk of not keeping proper records or manipulating of the records kept.* There is the risk of vendors who were initially maintaining books of accounts for tax purposes to stop doing so since they will now fall below the threshold. This will eventually lead to a huge number of them enjoying a lower tax obligation.
- ✚ *Imposition of penalties and fines may be ineffective.* The issue of requiring vendors operating informal sector businesses but do not maintain accounting records to pay a fine or a penalty could lead to discouragement of compliance altogether.
- ✚ *Incorrect declaration of turnover.* Businesses will have difficulties in determination of turnover and hence the risk of under declarations.
- ✚ *Tax avoidance:* A firm that has a turnover of more than Kshs 5.0 million will take advantage of this legislation to split into small firms in order to enjoy the new TOT regime.
- ✚ *Tax evasion and fraud.* If this regime is not well designed, there is a risk that firms will engage in fraudulent activities to evade taxes. This may lead to a decline revenue collections.
- ✚ *Taxpayers in informal sector are not easily traceable:* Mobility of taxpayers may make it difficult to locate the taxpayers for audit purposes and other taxpayers' services.
- ✚ There is also a considerable risk of administrative costs exceeding the KRA agency fee which may not exceed 2 percent of the revenue to be collected from the regime

5.4. Anticipated Solutions

We anticipate addressing the above and other challenges that we will encounter in the implementation of the regime through the following measures:

- ✚ Design system that will enable periodic reviews and revisions of the thresholds from time to time to ensure their relevance;
- ✚ A time limit needs to be set to define the duration an MSME should be a presumptive taxpayer. This will ensure that there is transition from TOT regime to the regular regime.
- ✚ There is urgent need to ensure proper monitoring of the MSMEs' activities from time to time and update records;
- ✚ Strengthen measures to ensure proper keeping and maintenance of records and books of accounts as specified in the various legislations and schedules.
- ✚ Taxpayers' education to focus on MSMEs. This will give taxpayers information regarding their responsibilities as taxpayers and what they are expected to do to enhance compliance with tax laws.
- ✚ Regular investigative audits should be carried out to ensure that non-compliant taxpayers are fined and penalised in accordance with tax laws, rules and regulations. This will work hand in hand in ensuring that new MSMEs comply accordingly.
- ✚ The special challenge of the micro sector (1-9) employees which arise due to the large numbers, lack of culture of voluntary compliance and segmentation, could be tackled through the use of license fees levied at local level.

5.5. Special challenges of the micro sector (1-9 employees)

Taxation of micro businesses poses special challenge to tax administrators owing to the large numbers and the segmentation in the sector. In addition, small businesses often lack the culture of voluntary compliance. A possible solution of tackling the above challenge is to use simple business licence fees which could be collected by local authorities.

6. CONCLUSIONS

The paper outlined the important role played by MSMEs sector in economic development and the urgent need in taxation of this sector due high revenue potential. The tax regimes that are practised in various countries are broadly classified into two. First, is the standard or regular regime that is applies to the formal sector of the economy and second, the simplified tax system which is applied to the informal sector of the economy. The paper also examined the three approaches that can be used and the inherent challenges involved in taxation of the MSMEs. The three approaches include legitimising MSMEs to net them into taxable bracket, the presumptive tax approach involving simple and cost effective techniques that capture domestic transactions and sources of income, which escape taxation under conventional means and finally imposing an appropriate tax burden on those operating in the underground economy.

A well functioning MSMEs taxation aimed at enhancing the revenue potential of presumptive taxes obviously could be considerably increased by adjusting tax rates and bringing the actual tax burden more in line with that under the standard tax system. However, this will require concerted efforts among revenue administrators in restructuring of the tax, establishing closer links between tax rates and business activities to avoid over-taxation of certain businesses and improve collection and analysis of data on business profit margins. This is not easy to achieve and requires a much greater focus of revenue authorities on designing and updating simplified systems to reflect changes in sophistication methods likely to be employed by taxpayers in the bid to evade taxes. In addition, there is a challenge envisaged in aligning the tax burden of small businesses taxed under a presumptive system with the tax burden under the standard system while avoiding over-taxation of some taxpayers. This may require reducing the simplicity of the system.

There are two conclusions that can be drawn from this paper. First, there is considerable risk in MSMEs that the total costs of administration are likely to be higher than KRA agency fee of 1.5 percent. This can be overcome by harmonising the simplified tax system just like it is done in Ukraine

Literature on countries that have implemented tax regimes indicate that they have experienced problems with tax avoidance and fraud schemes used by larger businesses despite the investigative audits carried out. Revenue Authorities therefore face the challenge of reviewing and updating their simplified tax system to reflect the changes in sophistication methods that are likely to be used by MSMEs in tax evasion. This forum should therefore deliberate on this issue and come up with the way forward