EFFECTS OF TAX PLANNING STRATEGIES ON TAX SAVINGS BY MANUFACTURING FIRMS BASED IN INDUSTRIAL AREA NAIROBI

BY

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DECLARATION

This research project is my original work and has not been presented for a degree in any other university or any other award.

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This research project has been presented for examination with my approval as university supervisor.

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ABSTRACT

This study focuses on the effectiveness of tax mitigation strategies on tax savings by manufacturing firms based in industrial area Nairobi. It reveals how effective the tax mitigation strategies available to the manufacturing firms are in creating tax savings. The research was conducted through collection of both primary and secondary data from the manufacturing firms. Questionnaires were developed and given to the firms Finance Officers and completed. The population consisted of 30 randomly selected registered firms as per the Nairobi City Council records of 2012. A descriptive research design was adopted. In analysis and interpretation of the data collected, it was found that claiming capital allowances was not only the most effective strategy for mitigating tax but also the most widely known among the finance officers. The others: tax education, use of debt in capital structure and intelligent sourcing were found to be ineffective in creating significant tax savings. On intelligent sourcing, most firms cited lengthy procedures involved as the reason for ineffectiveness in creating tax savings. Therefore, the strategies laid down by the government in the ITA for creating tax savings were found to be ineffective and consequently contributing very little tax savings, and thus the manufacturers claims that the tax regime is oppressive is valid and requires the government to address it.

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LIST OF ABBREVIATIONS

AGOA- African Growth and Opportunity Act

CDT- Commissioner of Domestic Taxes

COMESA- Common Market for Eastern and Southern African Countries

EAC-East African Community

EPZ- Export Processing Zone

FDI-Foreign Direct Investment

IBD- Industrial Building Deduction

ID-Investment Deduction

ITA-Income Tax Act

KAM- Kenya Association of Manufacturers

OECD-Organization for Economic Cooperation and Development

VAT- Value Added Tax

CHAPTER ONE

INTRODUCTION

1.1 Background

The obligation to pay tax owed to the government is a known fact to many businesses operating in the country. Every individual who wishes to register a business enterprise or any other form of organization in Kenya is legally obligated to regularly file their tax returns or any other form of tax implication to their organization. Normally all firms, including manufacturing ones, are taxed on the corporate tax rate of 30% for residence and 37.5% for non-residence. They are taxed on all forms of incomes generated in a year of income, which is normally a period of 12 months. Companies are required to pay taxes in four installments i.e. by 20th of the forth, sixth, ninth and the twelfth month of a year of income, at 25% of their estimated income in each installment. This normally applies to ordinary companies. However, in the cases of companies in the agricultural sector, they are required to make two installments i.e. by the 20th of the ninth and twelfth month at 75% and 25% respectively of their estimated income. Income tax returns are normally filed at the end of the sixth month after the year-end e.g. in the case of companies whose financial year ends every 31st December, by 30th June the following year (ITA, 2009).

There are many provisions in the law that provide opportunities for tax saving hence, making it able to pay less tax. Unfortunately this fact is only known to just a small percentage of business population. Everyman is entitled to order his affairs so that the tax attaching under the appropriate Acts is less than it would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioner of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to increase tax (Lord Tomlin, in the UK House of lord's case, IRC v. Duke of Westminster, 1936)

One aspect that has been a thorn in the flesh of manufacturing firms in Kenya is the heavy tax burden they have. Manufacturing firms continue to complain about a tax regime that is not conducive for their operations. To this effect, the Kenya Association of Manufacturers (KAM), the umbrella body for manufacturers has officially complained to the government about the tax system in the country. The KAM's annual reports of 2008 and 2009 explained its dissatisfaction with the existing tax laws. Some of its members including Unilever have consequently relocated from Kenya and some are in the process of following suit e.g. BIDCO (K) Limited. Among other reasons cited by these firms are: the hefty taxes that they have to pay annually to the government (KAM's report, 2008 and 2009). It is ironical that while firms in the manufacturing industry continue to suffer from a heavy tax burden, there exists Tax planning strategies in the Income Tax Act, meant to cushion such firms from heavy taxation. This fact leads to the question of whether the Tax planning strategies available in the Income Tax Act have any effect on Tax savings among firms in the manufacturing industry. The available Tax planning strategies available in the Income Tax Act include:

The use of debt in the capital structure; Debt is treated as an allowable expense before arriving at the taxable income. Thus, companies that incorporate debt in their capital have an advantage over those that purely use equity.

Capital allowances; this is an allowance or a deduction allowed against profits, on the expenditure of a capital nature expended on buildings and machinery used for purposes of manufacture. The deduction is given only once during the year of first use of qualifying assets - i.e. the first year of income in which the machinery or/and the building is used for purposes of manufacture.

Tax education; this plays a significant role in tax planning. It is intended to provide knowledge of the existence of opportunities to reduce tax, thus easing the tax burden.

Intelligent sourcing; should be applied to reduce the tax burden whereby, an organization focusses on procuring its inputs only from tax advantaged countries and regions.eg. COMESA.

While the Income Tax Act provides Tax planning strategies aimed at generating tax savings, manufacturing firms in the country continue to express dissatisfaction with the existing tax laws, which they complain give them a heavy tax burden that heavily eats into their profits. This study will demonstrate whether the available Tax planning strategies available to manufacturing firms are effective in generating tax savings. The study will show whether the Tax planning strategies are effective enough to create a significant saving for business people, and if not why that is the case.

This study will establish the most effective strategy for mitigating tax, as well as the most widely known among the finance officers. The research focused on establishing the effectiveness of the following Tax planning strategies in creating tax savings for manufacturing firms in Industrial area, Nairobi: Capital allowances, Tax education, use of debt in the capital structure, Intelligent sourcing of raw materials.

Therefore, this study will establish if the above mentioned strategies, which are laid down by the government in the ITA for creating tax savings are effective and consequently contribute to substantial tax savings, or whether the manufacturer's claims that the tax regime is oppressive is valid and requires the government to address it's tax legislation.

1.2 Statement of the Problem

There has been growing discontent among manufacturing firms in the country owing to the heavy level of taxation in the existing tax regime. These firms have through their umbrella body, KAM, expressed the view that there is an urgent need for the government to shield them from the heavy taxes they are paying, which are threatening to run them out of business. With Kenyan firms reporting that about 68.2% of profit is taken away in taxes, tax competitiveness is low and the country remains among the most tax unfriendly countries in the world. Tax evasion remains high, with a tax gap of about 35% and 33.1% in 2000/1 and 2001/2 respectively. The tax code is still complex and cumbersome, characterized by uneven and unfair taxes, a narrow tax base with very high tax rates and rates dispersions with respect to trade, and low compliance (KIPPRA, 2004).

While some of the firms continue to operate under the unfavorable tax regime, some firms have opted to shift their operations to other countries with more favorable tax legislation that do not heavily undermine their profit levels. Unilever has for instance relocated to South Africa, while BIDCO (K) has expressed desire to shift operations from Kenya and is likely to follow suit. The justification given for such moves is the heavy tax incidence being experienced in the manufacturing industry. (KAM reports 2008 and 2009)

If this trend is not checked and averted, Kenya risks losing out big in its main source of revenue. Tax revenue forms the single largest source of government budgetary resources.

Between 1995 and 2004, tax revenue constituted 80.4% of total government revenue (including grants). Taxation forms a key revenue source for the government. It is used to raise sufficient revenue to fund public spending without recourse to excessive public sector borrowing. Over time, Kenya has moved from being a low tax burden country to a high tax burden country, yet the country faces the obvious need for more tax revenues to maintain public services (KIPPRA, 2004).

Whereas there is a heavy tax incidence in the manufacturing industry, the government has in place legislation through which companies can mitigate their tax burden. These tax saving strategies are defined in the Income Tax Act. Despite the existence of such Tax planning strategies, manufacturing firms continue to complain of a heavy tax burden that threatens to drive them out of business. This brings out the need for a careful analysis and critique on the effectiveness of the available tax planning strategies in creating tax savings among manufacturing firms. This study attempts to measure, analyze and evaluate the effectiveness of the available Tax planning strategies in creating tax savings, hence reducing tax burden. The scope of the study is restricted to the manufacturing companies in Nairobi, industrial area. This study concentrated on ways that the selected firms mitigate their tax burden. Thus, the study does not provide an argument for or against the act of payment of taxes, whether fair or not, but only the effect of Tax planning strategies on creation of tax savings for manufacturing firms. The Research questions in the study focused on establishing whether the manufacturing firms employ the use of Tax planning strategies, and if they do, are such strategies effective in creating tax savings.

1.3 Objectives of the Study

The objective of this study was to determine the effect of Tax planning strategies on tax savings by manufacturing firms in Industrial Area, Nairobi.

1.4 Value of the Study

Contribution to theory and practice

This study analyzes and verifies the effectiveness of available Tax planning strategies thus providing valuable information to manufacturing firms and the general business community on strategies that will enable them reduce their tax burden.

Financial consultants will also benefit from this study by using its findings as source information when providing professional advice to businesses on how they can effectively apply Tax planning strategies to reduce their tax burden.

Findings of this research will help the government identify and seal any loopholes that may exist in the Income Tax Act, in the area of tax planning. This will enable the government to strengthen its laws addressing the effectiveness of Tax planning strategies or come up with new laws should the existing ones be found to be obsolete.

This study will also help the government address the problem of capital flight hence safeguarding job opportunities in the country. This is because the research will assist the government seal taxation loopholes that have in the past been responsible for making manufactures move operations to other countries.

Finally, this study will be beneficial to students, researchers and other scholars who will gain by making further inquiry and research in the topic and come up with more findings that may be useful to the government and business community.

CHAPTER 2

LITERATURE REVIEW

2.1: Introduction

This chapter provides a summary of the supporting literature reviewed in an attempt to identify the theories in the topic selected and thereby demonstrate a research gap, which gives a justification of this study. It will provide a comprehensive discussion of the concept of the taxation, and explore some of the basic concepts in this area of knowledge. Thereafter, the chapter will dwell on the concept of tax planning and investigate how business organizations may save funds using knowledge of the concept.

2.1.1: What is taxation?

Taxation may be defined as that part of public finance that deals with public revenue and public expenditure. It can be defined as a compulsory contribution to the government from its citizens, which will be used to pay for expenses incurred in the common interest of all persons without a reference to a special benefit being conferred to the payers (Sallemi, 2004). It can also said to be a compulsory contribution to the wealth of a person to the state (Moyi and Ronge, 2006).

2.1.2: The Income Tax Act

The Income Tax Act Cap 470 of the Kenyan Law is the main tax law governing the tax system in Kenya. It is normally revised from time to time, especially after the budget speech to meet the government requirements which change from time to time. However, there are other laws that also address other taxes in the country including The VAT Act Cap 476 and The Customs and Excise Act Cap 472 which works in conjunction with the Customs and Management Act of the East Africa (Muriithi ‘et al, 2003)

2.1.3: Government requirements and regulations

The government requires that every person who is subject to taxation to pay the amount due from him and at the required date. Failure to pay taxes in the right amounts attracts penalties and interest and in some cases a jail term (Muriithi ‘et al, 2003).

2.1.4: Types of Taxes

Taxes are classified in three main categories:

Administrative collection arrangements

Direct taxes: this is tax where the taxpayers remit his tax to the tax authority directly. It is levied directly on a person and can vary with one's status. Its impact and incidence is on the same person, e.g. income tax and corporation tax.

Indirect taxes: these are taxes that are levied on "something" and are paid by virtue of a person's association with that "thing". The impact could be on one person and incidence on the other e.g. customs duty, VAT, and excise duty.

Classification based on tax rates

Progressive taxes: these are taxes that normally increase as one's income increases and not only in absolute terms but also as a proportion of the increased income.

Proportional taxes: this is a tax that takes the same percentage of persons' income irrespective of the level of income e.g. VAT.

Regressive taxes: this is a tax which takes a smaller percentage of peoples' incomes as their income increases. People with lower incomes are taxed higher than those with higher incomes.

Digressive taxes: this is a tax which is only mildly progressive i.e. when the rate of progression is insufficiently steep. A tax could be progressive up to a limit beyond which the same rate is charged.

Classification based on tax base

A tax base is a legal description of the object with reference to which the tax applies.

Current flow of output: For instance, exercise duty, income tax e.g. PAYE and corporation tax.

Taxes on stock of capital goods: (wealth e.g. inheritance tax, capital gain tax)

Taxes on imports and exports e.g. import and exports duties.

2.1.5: Why pay taxes?

Taxes are meant to cover the expenditure of the state and such they are not levied for a particular purpose. The government makes no promise to perform a specific service in return for payment of taxes (Webber, 2005). However, the state will normally carry out the following functions:

Protection function

It is the responsibility of the government to maintain peace, order and security in the country. Additionally, it is charged with the responsibility of defending its citizens and boarders from external aggression. For this purpose the government maintains a police and armed forces.

Administrative function

The government is responsible for the administration of the country. For this purpose various ministries, departments and sections have been established to ensure proper and efficient administration in the country.

Development function

The development of various sections of the country, infrastructure and the country's economy at large cannot be possible without government interventions. For tnis the government undertakes the development of agriculture, commerce, transport and communication etc. all such developments contribute to the rapid growth of the economy and the country at large.

Social function

The government provides social amenities to its citizens such as education, health, transport and communications.

2.2: General Literature

2.2.1: Tax and Business strategy

Tax is a compulsory payment to the government and the issue is not whether to pay the tax or not, but how to reduce the effective tax that the business pays. To achieve this end, a company may have to set up an in-house tax department to look into ways of minimizing the tax payable (Thuronyi, 1998). At the end of the day tax is a cost just like any other and companies being profit set-ups must enquire into the possible ways to cut down on this cost. The tax unit must look into the various possible avenues and loopholes that exist can be exploited within the tax law to a company's advantage. This may involve both undertaking and avoidance of certain activities to meet this end.

2.2.2: Tax Avoidance

Tax avoidance is a legal term that means exploiting the tax laws of ones country to his advantage. This is meant to reduce the tax payable via means that are within the law whilst making full disclosure of the material facts on ones' income to the tax authorities. It also includes planning the tax affairs in such a manner that the tax payment is deferred. This is legal and acceptable by the tax authorities (Blackman, 2005). Tax avoidance, is thus the legal utilization of the tax regime to one's own advantage, to reduce the amount of the tax that is payable by means that are within the law.

Examples of tax avoidance strategies include:

Use of tax incentives

Economic theories suggest that governments do actually support tax planning especially where they want to attract investor in their countries. This has been done through various tax incentives, which have led to substantive growth in economies. How tax policy and incentive affects foreign direct investment revealed that, although Taxation is an important part of contemporary civil society and in particular tax, law plays a crucial role in economies by generating revenue for governments to finance public service, facilitate growth, increase productivity, improve their investment climates and enhance the overall quality of life of their peoples. Nonetheless, taxes generally raise the cost of doing business and weaken the link between investment activities and the resultant economic rewards, thereby impeding economic growth and development (Morisset, 1999).

Tax incentive laws have consequently been used by governments as a policy tool for accelerating investment in specific economic sectors, shaping the investment environment of a country or economic region and so overcoming some of the challenges posed by adverse investment conditions. Tax incentives typically utilized in sub-Saharan Africa economies include, investment allowances, tax credits, reduced corporate taxes, VAT and duty exemptions, subsidies, and special regulatory exemption. Candidates for such selectively preferred treatment range from export oriented industries, industrially intensive enterprises, rural development schemes, advanced technological project, to environmentally friendly extractive undertakings (IEA report, 2006)

In countries where there are tax incentives and the governments allow modest tax planning it has been found that investors are more likely to put their capital in such investment destinations. In 2004 it was found that the export oriented apparel sector in Kenya (EPZ), achieved tremendous growth within the last 5 years, due to improved access to the USA under the African Growth and Opportunity Act (AGOA). Apparel exports from Kenya to the U.S increased from US $ 44 million in 2000 to US $226 million in 2004, making Kenya the second-largest export of clothing to the US from Sub-Saharan Africa after Swaziland (AGOA report, 2004).

Establishment of foreign subsidiaries in low tax countries

Many U.S companies have established foreign subsidiaries in countries with comparatively lower corporation taxes to counter the high taxes back at home. Under the current system, U.S corporations must pay taxes on all their repatriated income, regardless of where it is earned. The foreign income of a U.S corporation with an active business abroad, such as a manufacturing operation, is taxed only when it is repatriated. Recognizing the principle that income should be taxed only once, the United States provides a credit against the U.S tax liability for the taxes paid to foreign jurisdictions. This foreign tax credit is limited to what the U.S tax would have been on the total foreign income, so that foreign tax credits in excess of the U.S rate cannot be used to offset the U.S tax on purely domestic income (Werner, 1993).

The current burden of the U.S repatriation tax on investment in low-tax locations is the minor because companies can avoid it by deferring repatriations. These low rates of repatriation indicate that the current system imposes a very small U.S tax burden on income in low-tax countries. The loss of this revenue would be more than offset by other features of the exemption system, as envisioned (Williams, 2000).

Country of Residence

One way a person or a company may lower taxes is by changing ones tax haven, such as Monaco, or by becoming a perpetual traveler. Some countries, such as the U.S and the Philippines tax their citizens, permanent residents, and companies on all their worldwide income. In such cases, a company cannot avoid taxation by simply transferring assets or moving abroad (Jong and Jackbcin, 2003). Nonetheless, most countries impose taxes on income earned or gains realized within that country regardless of the country of residence of the person or firm. Most countries have entered into bilateral double taxation treaties with many other countries to avoid taxing non-residents twice, where the income is earned, and taxed again in the country of residence, and perhaps, for US citizens, taxed yet again in the country of citizenship. There are relatively few double-taxation treaties with counties regarded as tax havens. To avoid tax, it is usually not enough to simply move ones assets to a tax haven. One must also personally move to a tax haven (and, for U.S nations, renounce ones citizenship) to avoid tax (Slemrod, 2000).

Procuring business inputs from well selected sources

Businesses can mitigate their tax burden by sourcing intelligently. Firstly, those subject to Value Added Tax ensure that they may source from suppliers who will charge VAT. That way, the business buying can deduct input VAT from their output VAT and lower tax payable. While this is a matter well established in many businesses, many others especially Small and Medium sized Enterprises do not do this. Another way of mitigating the tax burden is by importing inputs from tax-advantaged countries. This entails, for example, importing from within the east African community (E.A.C) or the Common

Market for East and Southern Africa (COMESA). Custom duty on imports from such sources is lower than duty on imports from other countries. These areas will eventually become Free Trade areas, enabling duty free imports within them (N.A Sallemi, 2004).

Setting up separate entities

Without changing country of residence, personal taxation may be laterally avoided by creation of a separate legal entity, to which ones property is donated. The separate legal entity is often a company, trust or foundation. Assets are transferred to the new company or trust so that gains may be realized, or income earned, within this legal entity rather than earned by the original work. Usually, one is only personally taxed on property and earnings that one actually owns; thus, by donating the assets to a separate legal entity, personal taxation may be avoided, although corporate taxes may still be applicable. If the legal entity is ever liquidated and the assets transferred back to an individual, then capital gains taxes would apply on all profits (Panteghini, 2007).

2.2.3: Tax Evasion

Tax evasion entails the taxpayer deliberately misrepresenting the material facts to the tax authorities with the intention of reducing the tax burden. This is illegal and a criminal offence. It includes in particular dishonest reporting of the incomes generated through suppression or omissions of some, claiming of some non-existent expenses and inflation of some as well as failure to submit ones' tax return (Blackman, 2005).

In the United States, persons subject to the Internal Revenue Code who can earn income by illegal means (gambling, theft, drug trafficking etc.) are required to report unlawful gains as income when filing annual tax returns (James v. united states, 1946), but they often do not do so. Suspected lawbreakers, mostly famously Al Capone was successfully prosecuted for tax evasion when there was insufficient evidence to try them for their non-tax related crimes. The United States Supreme Court has ruled that this does not violate an individual's right to remain silent, and so tax evasion remains a popular method for catching criminals. Other times, tax evasion can be used as a "one more nail in the coffin" by prosecutors stating that if a person earns illegal income, s/he may also be guilty of tax evasion. In practice those carrying on criminal activities generally prefer not to do so, and so can sometimes be prosecuted for tax evasion rather than for other crimes. Soviet spy Aldrich Ames, who had earned more than $2 million cash for his espionage, was also charged with tax evasion as none of the Soviet money was reported on his tax returns. Ames attempted to have the tax evasion charge dismissed on the grounds his espionage profits were illegal, but the charges stood (Sawicky, 2005).

Those who attempt to report illegal income as coming from a legitimate source could be charged with money laundering. By contrast: in the UK law enforcement agencies do not generally have access to tax returns and so illegal earnings can supposedly be safely declared (Webber, 2005)

Custom duties are an important source of revenue in developing countries. The importers purport to evade customs duty by (a) under-invoicing and (b) misdeclaration of the quantity and product-description. When there is ad valorem import duty, the tax base is reduced through under invoicing. Misdeclaration of quantity is more relevant for products with specific duty. Production description is changed match an H.S. Code commensurate with a lower rate of duty (Muriithi and Moyi, 2003).

During the latter half of the twentieth century, value added tax (VAT) has emerged as a modern form of consumption tax through the world, with the notable exception of the United States. Producers who collect VAT from the consumers may evade tax under-reporting the amount of sales. The US has no broad-based consumption tax at the federal level, and no state currently collects VAT; the overwhelming majority of states instead collect sales taxes. Canada uses both VAT at the federal level (the Goods and Services Tax) and sales taxes at the provincial level. Some provinces have a single tax combining both forms (Karls, 1992). In addition, most jurisdictions which levy a VAT or sales tax also legally require their residents to report and pay the tax on items purchased in another jurisdiction. This means that those consumers who purchase something in a lower-taxed or untaxed jurisdiction with the intention of avoiding VAT or sales tax in their home jurisdiction are in fact breaking the law in most cases. Such evasion is especially prevalent in federal states like the US and Canada where sub-national jurisdictions have the constitutional power to charge varying rates of VAT or sales tax. International borders in such countries usually lack customs offices or similar facilities that could effectively control the movement of any goods carried in private vehicles from one jurisdiction to another and most of the respective state and provincial government simply lack the manpower and resources to pursue and prosecute every case of state/provincial sales tax evasion arising from purchases which do not cross state or provincial borders other than for major purchases such as cars (Bartley, 2006)

It is often alleged that tax lawyers and chartered accounts help taxpayers including firms and companies in evading taxes. In the same vein, the Clearing and Forwarding agents help in evasion of Custom duties. It has been suggested that removal of human interface is a reliable solution to this problem (Webber, 2005).

2.2.4: The distinction of tax avoidance and evasion in various jurisdictions

The use of the terms tax evasion can vary depending on the jurisdiction. In general, the term "evasion" applies to illegal actions and "avoidance" to actions within the law. The term "mitigation" is also used in some jurisdictions to further distinguish actions within the original purpose of the relevant provision from those actions that are within the letter of the law, but do not achieve its purpose (Webber, 2005).

In the United States "tax Evasion" is evading the assessment or payment of a tax that is already legally owed at the time of the criminal conduct. Tax evasion is criminal, and has no effect on the amount of tax actually owed, although it may give rise to substantial monetary penalties. By contrast, the term "tax avoidance" describes lawful conduct, the purpose of which is to avoid the creation of a tax liability in the first place. Whereas an evaded tax remains a tax legally owed, an avoided tax is a tax liability that has never existed (Broe, 2008).

The United Kingdom and jurisdictions following the UK approach (such as New Zealand) have recently adopted the evasion/ avoidance terminology as used in the United States: Evasion is a criminal attempt to avoid paying tax owed while avoidance is an attempt to use the law to reduce tax owed. There is, however, a further distinction drawn between tax avoidance and tax planning. Tax avoidance is a course of action designed to conflict with or defeat the evident intention of Parliament. Tax planning is conduct which reduces tax liabilities without "tax Avoidance" (not centrally to the intention of Parliament), for instance, by gifts to charity or investments in certain assets which qualify for tax relief. This is important for tax provisions which apply in cases of "avoidance": they are held not to apply in cases of mitigation (Tooma, 2008).

The clear articulation of the concept of an avoidance/mitigation distinction goes back only to the 1970s. The concept originated from economists, not lawyers. The use of the terminology avoidance/mitigation to express this distinct was an innovation (IRC v Challenge, 1986). In practice the distinction is sometimes clear, but often difficult to draw. Relevant factors to decide whether conduct is avoidance or mitigation include: whether there is a specific tax regime applicable; whether transaction have economic consequences; tax linked fees. Important indicia are familiarity and use. Once a tax avoidance arrangement become common, it is almost always stopped by legislation within a few years. If something commonly done is centrally to the intention of parliament, it is only to be expected that parliament will stop. So that which is commonly done and not stopped is not likely to be centrally to the intention of parliament (Myron, 2002). It follows that tax reduction arrangements which have been carried on for a long time are unlikely to constitute tax avoidance. Judges have a strong intuitive since that that which everyone done, and has long done, should not be stigmatized with the pejorative terms of "avoidance". Thus UK courts refused to regard sales and repurchases (known as bed-and-breakfast transactions) or back-to-back loans as tax avoidance. (Phillis, 2003)

2.2.5: Tax Protesters and Tax Resistance

Some tax evaders believe that they have uncovered new interpretations of the law that shows that they are not subject to being taxed (not liable). These individuals and groups are sometimes called tax protesters. Many protesters continue posing the same arguments that the Federal courts have rejected time and time again, ruling the arguments to be legally frivolous (Phyllis, 2003). Tax resistance is the refusal to pay a tax for conscientious reason (because the resister does not want to support the government or some of its activities). They typically do not take the position that the tax laws are themselves illegal or do not apply to them (as tax protesters) and they are more concerned with not paying for what they oppose than they are motivated by the desire to keep more of their money as tax evaders typically are (Webber, 2005).

2.2.6: Level of evasion and punishment

Tax evasion is a crime in almost all developed countries and subjects the guilty party to fines and/or imprisonment- in China the punishment can be as severe as the death penalty. In Switzerland, many acts that would amount to criminal tax evasion in other countries are treated as civil matters. Even dishonesty misreporting income in tax return is not necessarily considered a crime. Such matters are dealt with in the Swiss tax courts, not the criminal courts. However, even in Switzerland, some fraudulent tax conduct is criminal, for example, deliberate falsification of records. Moreover, civil tax transgressions may give rise to penalties. So the difference between Switzerland and other countries, while significant, is limited. It is often considered that extent of evasion depends on the severity of punishment for evasion. Normally, the higher the evaded amount the higher the degree of punishment (Alistair, 1990).

2.2.7: Tax planning

Tax planning is in no way linked to shady or criminal tax evasion. A proper tax planning strategy is achieved through using the tools that the tax code provides to a business. Utilizing professional solutions in the proper manner may provide a firm with an uncompromised advantage. In fact, tax planning solutions, rather than personal wealth planning could become a firms most powerful wealth accumulation tools (Dionisi, 1995) Many tax and business advisers focus simply on maximum tax savings. All too often, though, they may not share or explain the compliance side of these strategies. There are many legitimate tax advantages available to business owners, investors and entrepreneurs; however, without the correct tax documentation, one may lose out on the benefits (Karls, 1992).

2.3: Empirical Literature

Prior research documents indicate substantial benefits to tax avoidance. For example, studies conducted show that corporate tax shelters save participants $10 billion annually (Bankman, 1999). Likewise, other studies indicate that tax shelters generate deductions equal to nine percent of the total assets (Graham and Tucker, 2006). However, prior research also finds that there is substantial variation in firms' ability to avoid income taxes (Dyreng et al. 2008). Thus, while the benefits associated with tax avoidance are large, the determinants of firms' tax avoidance activities remain unclear (Hanlon and Heitzman 2009). Examining whether the industry expertise of a firm's external auditor and advisor influences its level of tax avoidance is interesting for at least four reasons. First, as described above, firms' tax planning activities can results in substantial tax savings. Prior research examines whether the characteristics of the top executive, the incentives of tax directors and ownership structure influence tax avoidance (Armstrong et al. 2009; Chen et al.2010; Dyreng et al.2009; Ribinson et al.2010). In addition, recent research examines the characteristics of firms that engage in tax shelters (Wilson 2009).

However, little is known about the mechanisms the firms used to avoid income taxes. Accordingly, examining the industry expertise of firms' external auditor provides insight into firms' potential ability to avoid income taxes. Two notable exceptions are Mills et al. (1998) and Cook et al. (2008). Mills et al. (1998) found a negative association between a firm's investment in tax planning and its effective tax rate. Cook et al. (2008) found that auditor-provided tax services are associated with larger fourth quarter decreases in the firms' effective tax rate. Neither study examines whether the industry expertise of the external audit is associated with tax avoidance. Despite the significant savings associated with tax avoidance, there is little empirical evidence on the determinants of firms' tax avoidance activities (Dyreng et al.2009). Further studies examine the association between the orientation of the tax department and tax avoidance and find that tax departments that are organized as a profit centre have lower book effective tax rates relative to tax departments that are organized as a cost centre (Robinson et al.2010).

However, there is no significant association between tax department orientation and cash effective tax rates (Robinson et al, 2010). Similarly, there is a negative association between tax director compensation and book effective tax rates, but do not find a significant association between tax director compensation and cash effective tax rates. (Armstrong et al, 2009). Prior research examines the association between tax avoidance and firm characteristics such as size, capital intensity, leverage and research and development activities (e.g., Gupta and Newberry 1997; Shevlin and Porter 1992; Zimmerman 1983). Extending this line of research provides evidence that firms' tax planning expenditures are associated with lower book effective tax rates (Mills et al, 1998). Further evidence also suggest the magnitude of the tax fees paid to the external auditor is associated with greater fourth quarter reductions in the effective tax rate (Cook et al, 2008). Finally Rego (2003) finds that the magnitude of the foreign operations is negatively associated with the book effective tax rate, indicating that multinational corporations have more opportunities to avoid income taxes.

Further studies examined whether the basis as a manager's compensation targets is associated with tax avoidance and finds that the firms whose managers that are compensated on an after-tax basis have lower book effective tax rates relative to firms whose managers are compensated on a per-tax basis (Phillips, 2003). It is plausible to think that tax factors have also become increasingly important in developing countries for investment projects that can readily operate in other locations with similar non-tax characteristics, but there is no clear evidence to this effect. A review of econometric studies of FDI into Africa, does not even mention tax effects (Basu and Srinivasan, 2002). Another study on Brazil showed that investment in the northeast region did depend critically on tax benefits (Shah and Toye, 1978). Not much has changed since that early review of the case-study literature. Most case studies assign tax considerations an insignificant role (as long as the tax system is reasonably well structured), and emphasize the role of non-tax factors in investment decisions. In some cases, such as Mauritius and

Ireland, generous tax incentives have undoubtedly lured investors (Basu and Srinivasan, 2002). And in others, such as Uganda and Indonesia, the elimination of incentives has no effect on the flow of investment-providing real-world “experiments” to prove that selective incentives are not underlying investment climate is attractive (OECD report, 1997).

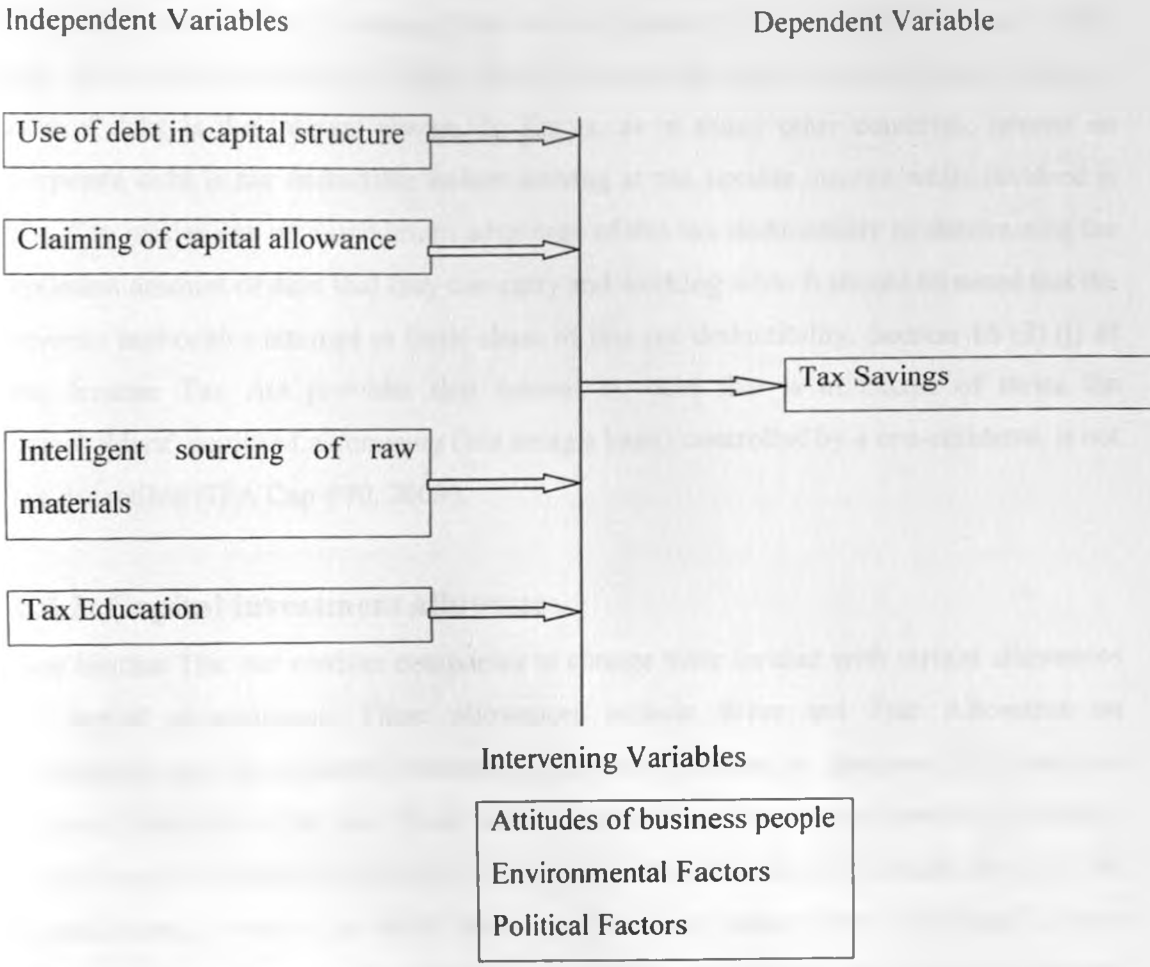
Evidence shows that tax incentives are generally not sufficient to attract major flows of investment. Mauritius, Costa Rica, Ireland and Malaysia are examples of successful countries attracting investments that offer many advantages to investors other than tax breakers, such as stable economics and political conditions, as well as educated labour force, good infrastructure, open trade for exporters, dependable rule of law, and effective investment promotion systems. Experiences such as in Uganda and Indonesia, where tax holidays and selective tax incentives programs were terminated in favor of a more attractive general tax regime, reinforce the theory that special tax incentives are effective in attracting investment or stimulating economic development. A major tax reforms took place in Uganda in 1997. This reform included complete elimination of new tax holidays in favor of a rate of 30% on company income, with generous capital allowances for all investors and unlimited loss-carry forward. A zero import duty was also set on a wide range of capital goods. The elimination of selected incentives also greatly simplified investment licensing. The main effects of this tax reform were (comparing averages of three years before and after 1997): an increase of one percent point in the ratio of investment to GDP, 70% increase in foreign investment inflows, and a one percent of GDP increase in tax revenue. It is worth noting that despite these positive effects, businesses appealed once again for tax incentives in 1998, when asked what the government could do to improve the business environment (OECD report 1997).

In 1984 an ambitious tax reform took place in Indonesia whose main aims were reducing administrative costs, and economic distortions, increasing equity and reduce evasion and corruption. The company tax rate was reduced from 45%to 35% and selective tax incentives were totally eliminated; including tax holidays, preferential rates, special investment allowances and selective accelerated depreciation. Despite the strong fear that foreign investors would shun Indonesia in favor of countries like Malaysia and Singapore, the number of FDI projects dipped in 1984 but then climbed rapidly for the rest of the decade. Additionally, in value terms, FDI fell from a plateau achieved the previous two years, but then scored to new heights after 1987. Once again, despite these positive effects, pressure to restore tax incentives has been persistent, and in 1994 (several Exemptions) and 1996 (discretionary tax holidays, although dropped in 2000 in favor of a new tax allowance and accelerated depreciation) some incentives were reinforced (Chirinko, 1993).

2.4: Gaps to be filled by the study

Empirical evidence shows that not much research has been done in the subject of the study. Most researchers have concentrated on other tax related issues like: the effects of tax incentives on FDI, whether the industry expertise of a firm's external auditor and advisor influences its level of tax avoidance and whether managerial incentives are associated with tax avoidance. Other researchers have concentrated on the effectiveness of tax modernization programs in Kenya. The area on the effectiveness of Tax planning strategies on tax savings has not been given much attention in previous studies in the area of taxation. This study therefore acts as a benchmark for possible future studies as a means of comparison of results and any changes that may take place over time. It also gives an insight as to why manufacturers in the country are discontented on the tax incidence yet there are mitigation strategies availed through the Income Tax Act by the government to mitigate tax, thus exploring whether they are ineffective, inadequate or any other possible explanation for the current state of affairs.

2.5: Conceptual framework



Tax Savings=f (DE, CA, IS, TE)

Where:

DE- Debt in Capital Structure

CA-Claiming of Capital Allowance

IS- Intelligent Sourcing

TE- Tax Education

2.5.1: Use of Debt in the Capital Structure

The capital structure of a company has two components; owner supplied capital (equity) and the non-owner supplied capital (debt). The cost of equity is the dividend while the cost of debt is the interest charge. In Kenya, as in many other countries, interest on corporate debt is tax deductible before arriving at the taxable income while dividend is not. Companies can take maximum advantage of this tax deductibility by determining the optimum amount of debt that they can carry and working with. It should be noted that the revenue authorities attempt to limit abuse of this tax deductibility. Section 16 (2) (j) of the Income Tax Act provides that interest on debt that is in excess of thrice the shareholders' equity of a company (not being a bank) controlled by a non-residents, is not tax deductible (ITA Cap 470, 2009).

2.5.2: Capital investment allowance

The Income Tax Act enables companies to change their income with certain allowances on capital expenditures. These allowances include Wear and Tear Allowance on machinery, and Investment Deduction. They are covered in Sections 15(2) and the Second Schedule of the Act. These allowances serve as investment incentives. Notably, there is an investment deduction of 100% on industrial buildings and machinery used for manufacturer, as well as on hotels constructed from 1st January 2004. Additionally, those who opt to invest outside the principle municipalities of Nairobi, Mombasa and Kisumu have been given a huge boost on investment deduction at 150% of the capital investment in the first year of operation. This is meant to foster rural development. It is expected that that the more the capital allowance claimed by a firm, the higher the tax savings. This study establishes whether firms are aware of capital allowances provided by the government through the Income Tax Act and the extent to which they generate tax savings for the firms.

2.5.3: Intelligent sourcing of raw materials

Businesses can mitigate their tax burden by sourcing their raw materials and intermediate goods intelligently. This is though importing inputs from tax advantaged countries. This entails, for example, importing from within the East African Community (EAC) or the

Common Market for Eastern and Southern Africa (COMEAS) regions. Custom duty on imports from such sources is lower than duty on imports from other countries. These areas will eventually become Free Tread Areas, enabling duty free imports within them. This will indeed reduce the cost of inputs due to reduced or zero tariffs. Thus business total operating cost will reduce through the tax savings created via intelligent sourcing. The more a business sources from lower tax regions the higher the expected tax savings generated. This research explores the level of intelligent sourcing of raw materials applied by manufacturing firms and its effectiveness as a toll for harnessing tax savings.

2.5.4: Tax education

The more informed one is on tax matters the more one stands a chance to take advantage of the available avoidance strategies and create huge tax savings. It is important for business persons who want to engage themselves in tax planning to undergo training on tax matters so that they can fully understand how to incorporate tax planning strategies in their businesses. This requires attending tax seminars, gathering information from local tax magazines and liaising with the tax authorities as well as tax consultants for advice.

This study establishes whether manufacturing firms invest in tax education and the effect this has had on tax savings.

CHAPTER THREE

RESEARCH METHODOLOGY

This study aimed at evaluating the effects of Tax planning strategies on tax savings by manufacturing firms in Nairobi. It had four main research questions:

i. Does claiming of capital allowance lead to tax saving?
ii. Does use of debt in the capital structure of the firm lead to savings?
iii. Does tax education have an impact on tax savings?
iv. Does intelligent sourcing lead to increased tax savings?

Data for the study was collected from finance officers in 30 randomly selected manufacturing firms operating in Nairobi Industrial Area. This was done through administering of questionnaires through hand delivery and collection after filling in. Descriptive statistics mainly frequency counts, and percentages were used to analyze the data. This was done by coding and entry into the Statistical Package for Social Sciences (SPSS version 16.0). Findings were also presented using tables and figures.

3.1: Research design

Research design is a master plan, which will specify the methods and procedures to be used in collecting and analyzing the data (Zikmond, 2006). This study took a descriptive research design, where the descriptive statistics e.g. mean, mode and graphs were used. A descriptive research design was used since the study involved describing the relationship that exists between the set of identified variables, where the dependent variable was Tax savings, and Independent Variables: Capital Allowances, Use of Debt in Capital Structure, Tax education and intelligent sourcing of raw materials.

3.2: Target Population

Population is a group of all items of interest to a statistic practitioner (Keller, 2007). It can also be referred to as the collection of elements, which the researcher wished to make inferences (Copper and Schmindler, 2005). A population in this study formed the basis from which the subjects or samples for the study were drawn. The population constituted finance managers from 30 randomly selected registered manufacturing firms, operating in Industrial area, Nairobi, as per the City Council records of 2012.

3.3: Sample Design

A section that represents the whole population was selected through a census of sampled manufacturing companies in Nairobi's Industrial area. The researcher confined his study to 30 randomly selected manufacturing firms operating in Industrial area, Nairobi, as per the City Council records of 2012.

3.4: Data Collection

Appropriate questionnaires were developed using both closed-ended and open-ended questions and then sent to the various firms' finance manager in Nairobi Industrial Area. These questionnaires were delivered by hired research assistants then picked after telephone confirmation to the various respondents. In some cases interviews were used to make follow-ups on unclear responses.

3.4.1: Description of the companies

The study covered the companies in diverse status in terms of periods of existence; that is those that have existed for less than five years, between five and ten years and those beyond ten years.

3.4.2: Description of the respondents

All the 30 respondents that participated in the study were selected from different sections in the finance department. The researcher considered the designation of the respondents since this was expected to form the basis of determining the response reliability.

3.4.3: Claiming of capital allowances

From literature related to the study, capital allowance was identified as one of the incentives provided by government to manufacturers and also a means of tax planning strategy (EAI report, 2006). This study sought to establish the extent of the respondents awareness of capital allowance as a means of tax saving. The study further sought to collect data on the number of respondents who believe that capital allowances create tax savings and those that do not. Thereafter, the researcher then further sought information concerning the percentage of the total cost saved by use of capital allowance.

3.4.4: Tax Education

The researcher sought information on how many firms engage tax experts for advice and counsel on tax matters. Data also collected on the frequency of holding tax seminars by the manufacturing firms in Nairobi. For companies that hold tax seminars, Data was also collected on the level of attendance of tax seminars by the company officials, in cases where the tax seminars were organized. Further, the research gathered information on the effectiveness of the knowledge gained from the tax seminars in creating tax savings for the firms. Finally, the study measured the percentage of cost saving created by the knowledge gained from the tax seminars.

3.4.5: Use of debt in the capital structure

On the use of debt in capital structure, the researcher collected data on the number of firms applying this strategy. For those that did, the researcher was interested in finding out the ratio of equity to debt in the various firms' capital structures. This was restricted to the following ratio categories of equity to debt respectively: 1:1, 2:1, 3:1, others. Finally, the researcher measured the extent of tax cost saved by incorporating debt in the capital structure.

3.4.6: Intelligent sourcing of raw materials

Here, the researcher sought to measure the extent and effects of use of intelligent sourcing of raw materials and intermediate goods as a means of tax planning. The study attempted to establish how many companies under study do undertake intelligent sourcing, where companies under study source their raw inputs and intermediate goods, ie COMESA, EAC or locally. The researcher then measured the extent of tax savings created by those firms undertaking intelligent sourcing.

3.5: Data analysis

All the data collected was analyzed using quantitative approaches in terms of descriptive statistics. Quantitative analysis is the numerical manipulation and representation of observation for the purpose of explaining and describing the phenomena, which those observations reflect (Baddie, 2004). All the collected data was subjected to editing, tabulation and coding. Descriptive statistics was used for analysis in which the data revealed frequencies, percentages and averages. This was then represented using bar chats, pie charts and frequency tables for ease of communication. To aid in this, a computer program used for data analysis, Statistical Package for the Social Sciences (SPSS), was used.

CHAPTER FOUR

DATA ANALYSIS RESULTS AND DISCUSSIONS

4.1: Introduction

This study aimed at evaluating the effects of tax planning strategies on tax savings by manufacturing firms in Nairobi. The study had four main research questions:

a. Does claiming of capital allowance lead to tax saving?

b. Does tax education have an impact on tax savings?

c. Does use of debt in the capital structure of the firm lead to savings?

d. Does intelligent sourcing lead to increased tax savings?

Data for the study was collected from finance officers in 30 randomly selected manufacturing firms based in Industrial Area, Nairobi. This was done through administering of questionnaires through hand delivery and collection after filling in. Descriptive statistics mainly frequency counts, and percentages were used to analyze the data. This was done by coding and entry into the Statistical Package for Social Sciences (SPSS version 16.0). The findings are also presented using tables and figures.

4.2: Background data of the respondents

The survey was conducted in 30 randomly selected manufacturing companies registered in Nairobi Industrial Area as per the county council of Nairobi records. 23 out of the 30 finance officers responded which represents 76.67% of the total population. The study considered background information of the company relating to the period they have been in existence.

4.2.1: Description of the companies

The study covered companies of the diverse status in terms of periods of existence; that is those that have existed for less than five years, between five and ten years and those beyond ten years. The distribution of companies as per the status is represented in the table below.

Table 4.1: Distribution of Companies on Age Status

Age category	Frequency	Percent %	Cumulative Percent
Less than 5 years	4	17.39	17.39
Between 5 and 10 years	10	43.48	60.87
Above ten years	9	39.13	100.0
Total	23	100.0	

The table above shows that of the 23 companies that corresponded 4 have existed for less than five years, 10 have existed between 5-10 years while 9 have existed for more than 10 years.

4.2.2: Description of the respondents

All respondents in the study had served in their respective companies in different capacities in the finance department. The study considered the designation of the respondents as vital since this was the basis of determining the response reliability. The table below indicates the different titles held by the respondents at the time of conducting the research.

Table 4.2: Description of the respondents by designation

Designation	Frequency	Percent %	Cumulative Percentage
Chief Accountant	2	8.7	8.7
S. Accountant	3	13.04	21.74
Accountant	8	34.78	56.52
Ass. Accountant	2	8.7	65.22
Fin. Manager	3	13.04	78.26
Fin. Officer	5	21.74	100.0
Total	23	100.0	

According to the table 4.2 majority of the respondents were accountants; 34.78%. Senior accountants were 13.04%, Assistants accountants; 8.7%, Finance officers; 21.74%, Finance Managers; 13.04% and chief accountants; 8.7%.

The themes covered in the study were: Claiming of the capital allowances, Tax education, Use of debt in the capital structure and intelligent sourcing of raw materials and intermediate goods. The presentation of the themes was guided by the research questions.

4.3: Claiming of capital allowances

From literature related to the study, claiming of capital allowances was identified as one of the incentives available in the Income Tax Act as a means of tax planning strategy (EAI report, 2006). This study sought to find out how effective capital allowance is in creating tax savings.

Firstly, the study established the level of respondents awareness of capital allowance as a means of tax saving. Table 4.3: revealed the following findings:

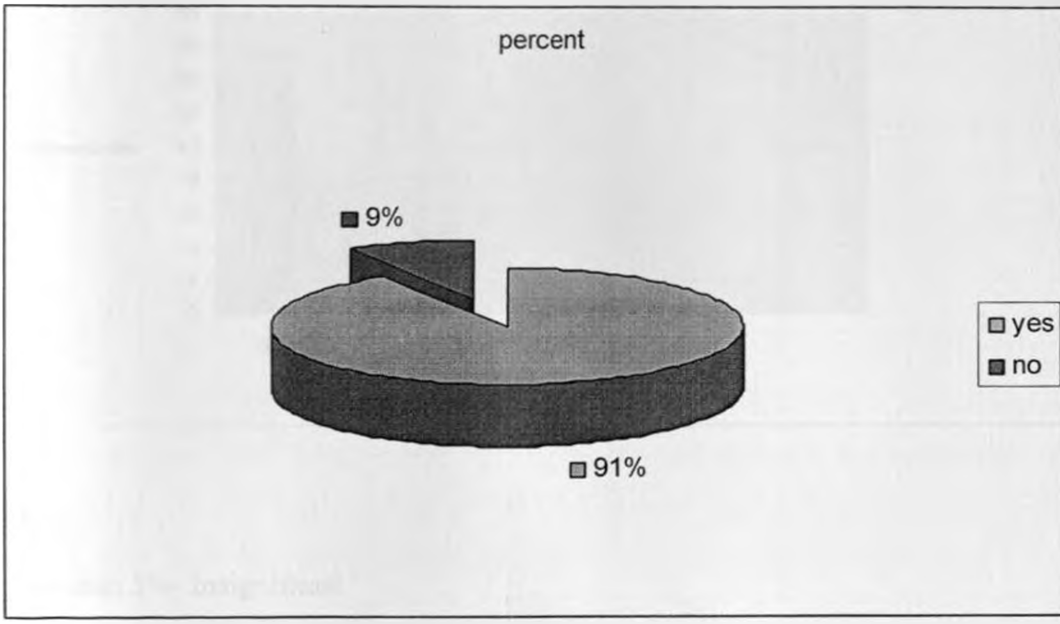
Table 4.3: Capital Allowance Awareness amongst Serving Officers

	Frequency	Percentage %	Cumulative Percent
Yes	22	95.7	95.7
No	1	4.3	100.0
	23	100.0	

The above table 4.3 shows that 95.7% of the respondents are aware of the various capital allowances provided by the government as a means of creating tax savings, while (4.3%) were unaware. This was quite a significant number, showing that capital allowance is the major source of tax saving for firms in the manufacturing sector.

The study went on to enquire on whether capital allowances create tax savings for the firms that were aware of the tax planning strategy.

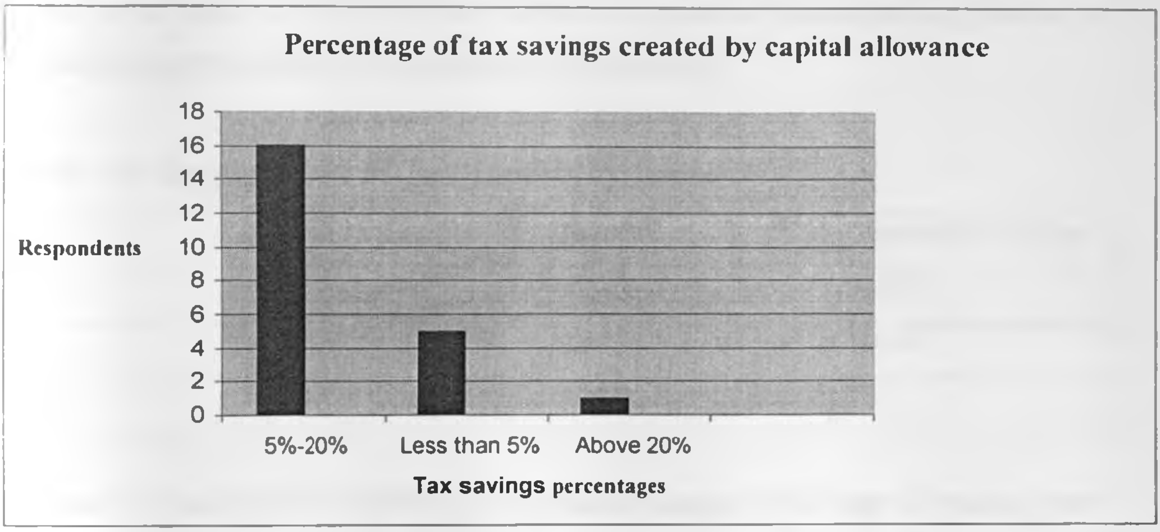
Figure 4.1: indicates the responses from the respondents



The figure 4.1: shows that 21 of the companies under study, representing 91.3% of the respondents responded that capital allowance reduce tax paid to the government. 8.7% of the respondents said that claiming capital allowances does not create tax savings for their companies.

The study further sought information concerning the percentage of the total cost saved by use of capital allowance. Figure 4.2 shows the percentage of tax savings created by capital allowance to the various firms.

Figure 4.2: shows percentage of tax savings created by capital allowances.



KEY:

Less than 5%- Insignificant

5%-20%- Significant

Above 20%- Highly Significant

Figure 4.2 above shows that 16 (69.56%) of companies under study responded that capital allowance creates a tax saving of between 5%-20% which is a significant amount, while 5 (21.74%) said it creates a saving of less than 5% which is significant amount. This shows that capital allowance is a major contributor in creating tax savings for most firms.

Capital allowance was found to be well known amongst the finance officers of the various organizations. It was also found to have significant effects in contributing to tax savings since the research revealed that 69.56% of the firms in the study made savings of between 5% and 20% of their cost from claiming capital allowances. Capital allowance is therefore effective in creating tax savings.

4.4: Tax Education

The research sought information on how many firms engaged tax experts for advice and counsel on tax matters. Table 4.4 below shows the response of firms regarding whether or not they engage tax experts in the process of tax planning.

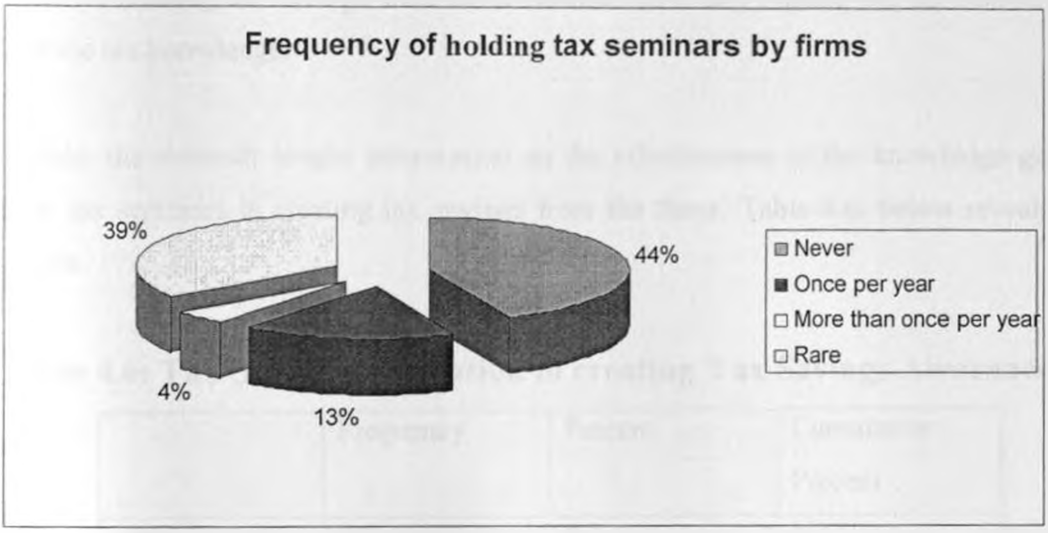
Table 4.4: Engagement of Tax experts by firms

	Frequency	Percent	Cumulative Percent
Yes	14	60.87	60.87
No	9	39.13	100.0
Total	23	100.0	

The study revealed that 14 (60.87%) of the firms engaged a tax exert in training their staff on tax matters while 9 (39.13%) did not. Slightly above half of the firms engaged in the research indicated that they seek tax advice from tax experts. This reveals that there is a balance between firms engaging and failing to engage tax experts for tax advice.

Further the research enquired on the frequency of holding tax seminars by manufacturing firms in Nairobi. Figure 4.3: shows how the firms responded on the subject of conducting tax seminars.

Figure 4.3: Frequency of holding tax seminars by firms.



According to figure 4.3 above, 9 (39.13%) of the firms rarely held tax seminars, 3 (13.04%) held tax seminars once a year, while 10 (43.48%) did not hold any tax seminar. Only 1 (4.35%) held tax seminars more than once a year. This shows that most of the firms never held tax seminars and those who did, majority of them rarely held tax seminars for their staff. This in effect contributes negatively in creating tax savings for their companies because their finance and accounting staff are not oriented on tax matters regularly.

The research also inquired on attendance of tax seminars by the company officials in cases where the tax seminars were organized. Table 4.5: shows the distribution of attendance of these seminars.

Table 4.5: Tax seminar attendance by respondents

	Frequency	Percent	Cumulative Percent
Yes	6	26.09	26.09
No	17	73.91	100.0
Total	23	100.0	

From the table 4.5: above, only 6 (26.09%) of the respondents whose firms held tax seminars attended, while 17 (73.91%) did not attend tax seminars. This has a negative effect on creating tax savings since most finance staffs don't attend the tax seminars to gain the tax knowledge.

Further, the research sought information on the effectiveness of the knowledge gained from tax seminars in creating tax savings from the firms. Table 4.6: below reveals the results.

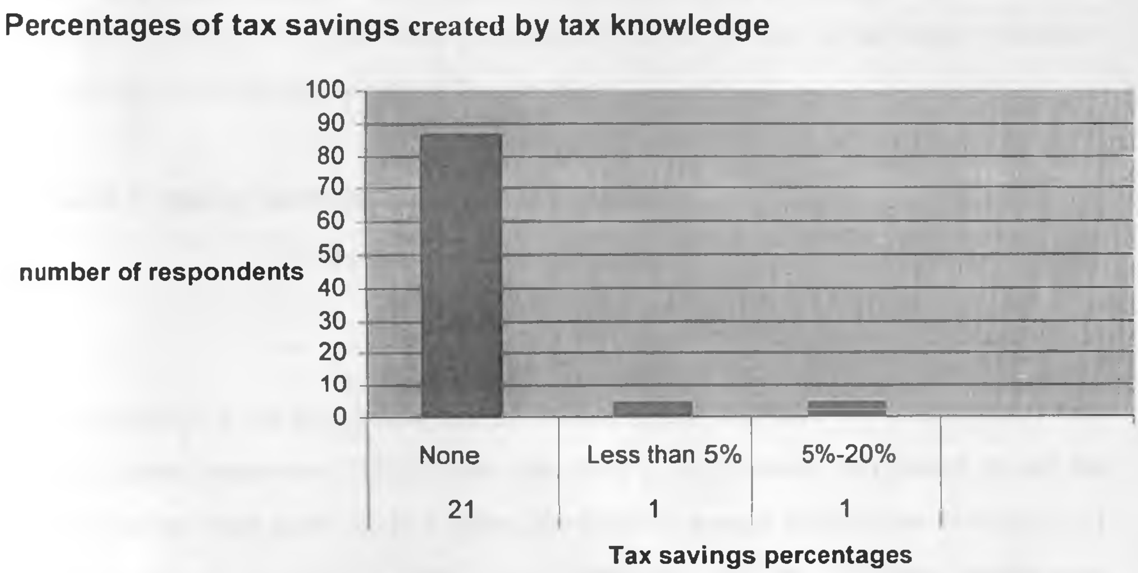
Table 4.6: Tax Seminar Education in creating Tax Savings Awareness

	Frequency	Percent	Cumulative Percent
Yes	2	8.7	8.7
No	21	91.3	100
Total	23	100.0	

From the table 4.6: 2 (8.7%) said attending Tax Seminars helped create tax saving awareness while 21 (91.3%) responded that it did not create tax savings awareness. The findings indicate that tax education has no significant effect in creating tax savings.

The research further sought to assess the percentage of cost saving created by the knowledge gained from the tax seminars. Figure 4.4: shows the responses from the respondents.

Figure 4.4: Percentages of tax savings created by tax knowledge.



KEY:

Less than 5%- Insignificant

5%-20%- Significant

Above 20%- Highly significant

The Rest- Not Sure

According to the figure 4.4 above, 21 (91.3%) of the respondents responded that tax seminars knowledge did not help in creating tax saving while 1 (4.35%) responded that it created less than 5% which is insignificant. Only 1 firm (4.35%) of the respondents reported that tax knowledge created significant tax savings of between 5% and 20%.

Tax education was found to be relatively used by the various firms in the study. It however was found that it had no significant effect in terms of creating tax savings. The study therefore revealed that tax education had very little effect in creating tax savings and thus ineffective in creating tax savings.

4.5: Use of debt in the capital structure

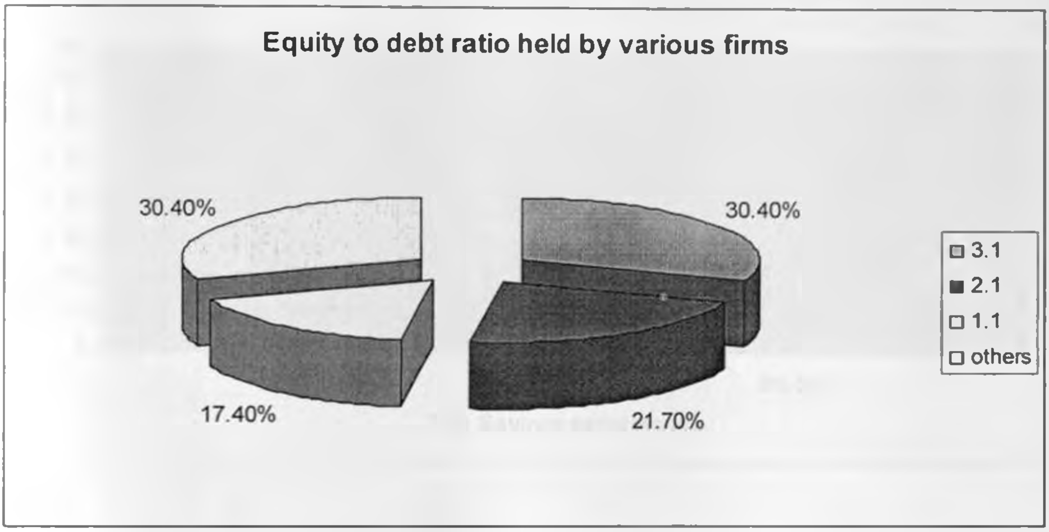
The study sought to establish how effective the use of debt in the capital structure is in creating tax savings. The researcher enquired on the use of debt in the capital structure. The findings are indicated in table 4.7 as follows.

Table 4.7: use of debt in the capital structure

	Frequency	Percent	Cumulative Percent
Yes	23	100.0	100.0

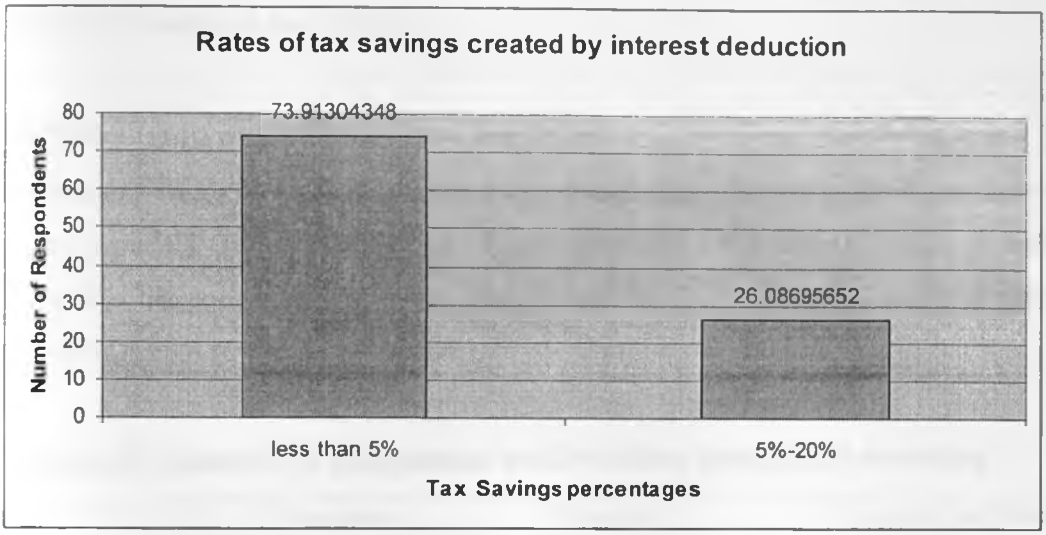
From the table 4.7: all the 23 (100%) respondents agreed that their firms incorporate debt in their capital structures. This shows that debt is a universal component in all the companies that were under study. Further, the research sought information on the ratio of equity to debt in the various firms' capital structures, and the following results were revealed.

Figure 4.5: Equity to Debt ratio held by various firms.



From the figure 4.5: above, it shows that the most of the firms have an equity debt ratio of 3:1 and above. This small holding of debt in the capital structure was explained by the risk averseness of the firms and also their aim to minimize their resulting finance cost. This implies most firms would rather avoid the finance risks and finance costs at the expense of tax savings. The research further sought information on the extent of tax cost saved by incorporating debt in the capital structure. Figure 4.5: revealed the following results.

Figure 4.6: Rates of tax savings created by interest deduction



KEY:

Less than 5%- Insignificant

5%-20%- Significant

Above 20%- Highly significant

Figure 4.6: shows that 17(73.9%) of the respondents said that interest deduction created a tax saving of less than 5% while 6 (26.1%) said that it created a tax saving of between 5% and 20%. The data showed that although all the firms incorporate debt in their capital structure, the equity to debt ratio is very small. This indicates that companies would rather forego the tax saving created by the extra debt rather than incur the associated finance cost and bear the finance risks. This makes use of debt in the capital structure ineffective in creating tax savings.

Use of debt in the capital structure although very popular amongst the firms was found not to be an effective avenue for creating tax savings, mostly because many firms did not have sufficient security to acquire sufficient funding from financial institutions and that most are risk averse and unwilling to incorporate too much debt due to the financial risk involved. They would rather forego the tax gains from savings created than carry the extra financials risk. The use of debt in capital structure was thus it was found to be ineffective in creating tax savings.

4.6: Intelligent sourcing of raw materials

The research further sought to know the extent and effects of use of intelligent sourcing of raw materials and intermediate goods as a means of tax planning. First. it sought to establish if the companies under the study do undertake intelligent sourcing. Table 4.8: shows the results revealed.

Table 4.8: Number of companies undertaking intelligent sourcing

	Frequency	Percent	Cumulative Percent
Yes	13	56.52	56.52
No	10	43.48	100.0
Total	23	100.0	

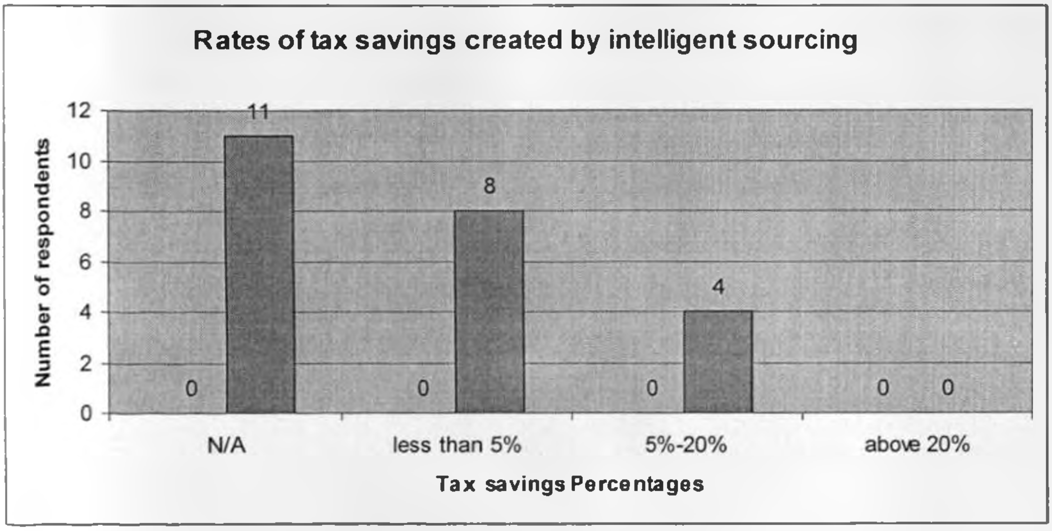
From the table 4.8 shows, 13 (56.52%) of the firms do carry out intelligent sourcing of raw materials while 10 (43.48%) do not. This show a balance between those firms undertaking and not undertaking intelligent sourcing of raw materials. The researcher sought to establish where companies under study sourced their raw inputs and intermediate goods. Table 4.8, revealed the outcome.

Table 4.9: Sources of raw materials and intermediate goods

	Frequency	Percent	Cumulative Percent
COMESA	1	4.3	4.3
EAC	2	8.7	13.0
Locally	8	34.8	47.8
Locally, EAC, COMESA	1	4.3	52.2
N/A	11	47.8	100.0
Total	23	100.0	

The above table 4.9: indicates that 4 (17.4) of the firms do undertake intelligent sourcing of raw materials from low tax regions i.e. EAC and COMESA regions while 19 (82.6%) do not. This shows that most of the firms do not implement intelligent sourcing as a tax planning strategy. This was explained by the fact that the procedure for procuring raw materials from outside the country is lengthy and bureaucratic and therefore creates inefficiency in business operations. Finally the researcher sought to establish the extent of tax savings created by those firms undertaking intelligent sourcing. Figure 4.7: shows the revealed results.

Figure 4.7: Rates of tax savings created by intelligent sourcing.



KEY:
Less than 5%- Insignificant
5%-20%- Significant
Above 20%- Highly significant
N/A-Not Applicable

According to the figure 4.7 above, 11(47.8%) of the respondents said that they do not carry out intelligent sourcing for the purposes of creating tax savings, while 8 (34.8%) said it created a tax saving of less than 5% and 4 (17.4%) said it created a tax saving of between 5% to 20%. The data shows that intelligent sourcing is not a popular strategy of tax planning and therefore ineffective in creating tax savings. This was explained by the lengthy procedures involved in acquisition of raw materials from foreign countries and the bureaucratic bottlenecks experienced.

Intelligent sourcing of raw materials was therefore found to be contributing very little in creating tax savings and thus ineffective. Most respondents attributed this to the lengthy procedures involved in obtaining goods from abroad as well as lack of enough capital to acquire such goods in bulk in order to create reasonable tax savings.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1: Introduction

In this chapter, a summary of the study is presented, together with the summary of the key findings. The chapter also presents a confusion of the study, recommendations and suggestions of the studies that could be carried out in the future.

5.2: Summary of the study

The study sought to find out the effects of tax planning strategies on manufacturing firms based in Nairobi. It was conducted in 37 firms that are licensed to operate in the town by county council of Nairobi. 23 financial officers out of the 37 firms responded to the questionnaires designed by the researcher. A descriptive research design was employed to generate primary data with the help of hand delivered questionnaires. A census of all the 37 manufacturing firms' finance officers responded to the questionnaires.

The researcher used SPSS (Statistical Package for Social; Sciences version 16.0) to process the data collected. Descriptive statistics such as frequencies and percentages were used to summarize the data. The data was represented using tables and bar charts. The analysis of the data enabled the researcher to come up with the following findings based on the major research questions. The findings are summarized under the following themes:

5.2.1: Claiming capital allowance

The findings from the study indicates that nearly all the firms' finance officers are aware of the capital allowances granted by the government and also concedes that it really does not create some tax savings for the firms. Most of the capital allowance was claimed in the form of investment deduction for industrial buildings and machinery, industrial building deduction for industrial building and wear and tear for machinery used for the qualifying business in manufacturing. Most firm finance officers revealed that the capital allowance creates a tax saving of between 5% and 20% of the total cost incurred in a financial year. This represents significant tax saving and therefore making capital allowance an effective strategy for mitigating tax (creating tax saving).

Firms that have existed for long e.g. over ten years, in most cases responded that they were more advantaged than the new ones because of their huge capital investment over time. These capitals investments in fixed and movable assets translated to huge capital allowances and thus the more aged a company is the more capital allowance claimed and consequently the more tax saving created.

5.2.2: Tax Education

The study revealed that there is a uniform distribution of companies that either engage or fail to engage tax experts for tax advice and counsel. However most of the firms either rarely or never held any tax seminars. Seminars attendance where organized was also quite low and thus translating into very low tax savings, if any. This was attributed to low interest in tax related issues at the expense of financial aspects as most firms normally focus on ways and means of generating more revenues to boost their profits rather than cut down on taxes.

5.2.3: Uses of debt in the capital structure

The findings from the study indicated that all the firms under study do incorporate debt in their capital structure. This is of course to supplement the inadequate owner supplied capital. However, most of the firms were found to be quite risk averse as they held a small percentage of their capital in form of debt. This was explained by the potential of financial risk occurring, and therefore most firms choose to forego the tax savings created by the extra debt interest, rather than incur the huge borrowing cost and bear the financial risks.

Indeed three quarters of the firms responded that interest deduction saved an insignificant cost of less than 5% of their total annual cost. This implies that although the interest deduction is one of the avenues created for mitigating tax, it is unpopular with manufacturers and therefore was found to be ineffective in creating tax savings.

5.2.4: Intelligent Sourcing of Raw Materials

The findings from the study revealed that the firms, undertaking and not undertaking intelligent sourcing to be evenly distributed. Of those who carried out intelligent sourcing, they responded that they sourced most of their raw materials and intermediate goods from COMESA and EAC regions. This is because within these regions there is a uniform tariff on imports by citizens or residents residing within the member states. Eventually, these regions are expected to be free trade areas where residents will pay a zero tariff on all their imports.

Of the companies sourcing from low tax regions, only 17.4% indicated that they made a significant saving from intelligent sourcing. The rest either made an insignificant tax saving of less than 5% of their annual cost or were not undertaking intelligent sourcing. Most of the firms that either failed to undertake intelligent sourcing or those that made insignificant savings cited long procedure or documentation involved in importation, lack of capacity to import in large bulks to realize the benefits as most are either too small or medium sized in nature, as the reasons for not undertaking intelligent sourcing. Thus this strategy can only be effective in the case of large firms. This then makes intelligent sourcing ineffective in creating adequate tax savings for manufacturing firms in Nairobi.

5.3: Conclusion

From the findings of the study, a number of conclusions were made. Firstly, the study established that capital allowances were the most widely adopted and most effective of the mechanism of creating tax savings by manufacturing firms in Nairobi. This was enhanced by the fact that most finance officers are aware of existing capital allowances and how they work. Secondly, tax education seminars were found to be unpopular with companies as only slightly above a half of the firms in the study engaged tax experts and where they did it was occasional and the attendance rate was low. This subsequently reduced the level of tax savings created by the knowledge from such seminars. Thirdly, use of debt interest to create tax savings was found to be ineffective since although it is an allowable expense, most firms were lowly geared and therefore could not get the benefit. This was compounded by the fact that most firms are risk averse and avoided financial risks. Lastly, intelligent sourcing of raw material and intermediate goods was found to be ineffective in creating sufficient tax savings. This was mainly because of the rigorous importation procedures and lack of sufficient capital to buy inputs in bulk.

5.4: Recommendations

The researcher contends that the government has set up some mitigation strategies in the Income Tax Act Cap 470 of the Kenyan Laws. However, from the findings it is quite evident that only capital allowance is effective in creating any substantial tax savings while the other three strategies; use of debt in the capital structure; tax education and intelligent sourcing are ineffective in creating tax savings. These observations befit a review of those sections of the Act to address the manufacturers' plight and also a review of importation process to reduce the procedure involved. The government also needs to carry out tax education campaigns to create great tax awareness among manufacturers to avert their flight from the country.

From the study findings, the following recommendations were made to various stakeholders:

The Government: to review the various sections of the ITA to address the manufacturers tax concerns, especially reducing tax rates and creating more effective tax saving mechanisms. The government should also do regular campaigns to create tax awareness among tax payers and especially the manufacturing group.

Manufacturers: to lobby the government to create more tax saving measures and reduce the tax rates as well as the multiple taxes. In essence, the manufacturers can have their issues addressed through engaging the government in forums such as workshops and tax seminars, to try and sensitize the government more on their needs and their role in the economy.

5.5: Suggestions for further studies

The study recommends the following for further study:

- A similar study to be carried out in other towns or cities in the country to find out whether similar findings shall be found on the effects of tax planning strategies on tax savings by manufacturing firms and other sectors of the economy.
- A similar study to be carried out focusing on other productive sectors of the economy like agriculture sectors.
- A study on the attitudes and extent of interest by business people towards tax matters in comparison to finance.

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APPENDIX I: INTRODUCTORY LETTER

EDWARD OWITI
P.O BOX 30023
NAIROBI
D61/9066/2006

TO RESPONDENT;

Dear sir/Madam

RE:MBA RESEARCH PROJECT

Hello? I am hereby requesting you to kindly complete the attached questionnaire. I am undertaking a research at the University of Nairobi, Business Administration [Finance Department], on "The Effects of Tax Planning Strategies on Tax Savings by Manufacturing Firms in Industrial Area, Nairobi."

I wish to bring to your attention that your response will only be used for research work and not for any other purpose, and will therefore not have any recourse on you. A research assistant will be sent to you for delivery as well as for collection of the questionnaire once completed. It is my sincere hope that you will respond to all questions and where there is need for clarity, kindly do not hesitate to ask.

Your assistance in response to this questionnaire will greatly contribute to the success of this research work and thus highly appreciated.

Thank you.

Edward Omolo Owiti

APPENDEX II: DATA COLLECTION INTRUMENT-QUESTIONNAIRE

Please answer the following questions dealing with tax planning strategies used by manufacturing firms in Kenya. All individual responses will remain confidential. Results will be tallied and will be made available to any respondent upon request. Please return the completed questionnaire to the research assistant who will be sent to collect it from you. Thank you.

PART A: Background Information

1. Name of Department:..

2. Designation:..

3. How long has your company been in business?

....

TAX PLANNING STRATEGIES

PART B: Capital Allowances

4. Are you aware of the various capital allowances provided by the government through the Income Tax Act?

Yes ( ) No ( )

5. If yes in 4, which capital allowances does your firm claim?

(Please tick where appropriate)

Investment Deduction (ID) ( )

Industrial building Deduction (IBD) ( )

Wear and Tear ( )

Farm Works Deduction (FWD) ( )

6. In your opinion, does the capital allowance claimed significantly reduce the amount of taxes paid to the government?

Yes ( ) No ( )

7. If yes in 6 above, to what extent has the capital allowances generated tax savings for your firm?

(Tick where appropriate)

Less than 5% ( )

5 to 20% ( )

Above 20% ( )

8. If No in 6 above what do you think makes capital allowance ineffective in creating tax savings? *(Explain)*

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PART C: Tax Education

9. Has your firm engaged a tax expert in the recent past?

Yes ( ) No ( )

10. How frequent are tax seminars organized for management in your organization?

Never ( ) Rarely ( ) Once a Year ( ) More than once a year ( )

11. Have you ever attended a tax seminar organized by your organization?

Yes ( ) No ( )

12. If yes in 11 above, do you think the knowledge gained from these seminars has led to a reduction in tax payable by your firm?

Yes ( ) No ( )

13. If Yes in 12 above, what is the extent of tax savings as a result of the tax education? *(Tick where appropriate)*

Less than 5% ( )

5%-20% ( )

Above 20% ( )

14. If No in 11 above, what do you think makes these seminars' education ineffective in creating tax savings? *(Explain)*

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PART D: Use of Debt in the Capital structure

15. Does your firm incorporate debt in its capital structure?

Yes ( ) No ( )

16. If yes in 15 above, what on average is your firm's equity to debt ratio?

a) 1:1 ( )

b) 2:1 ( )

c) 3:1 ( )

d) Others (Specify) ………………………………

17. Has the interest deduction by your firm led to a significant tax saving?

Yes ( ) No ( )

18. If yes in 17, what is the extent of the tax saving created?

(Tick where appropriate)

Less than 5% ( )

5%-20% ( )

Above 20% ( )

19. If No in 17, what do you think makes the use of debt in the capital structure ineffective in creating tax saving?

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PART E: Intelligent Sourcing of Raw Materials

20. Does your firm undertake intelligent sourcing of raw materials and intermediate goods from lower tax regions?

Yes ( ) No ( )

21. If yes in 20, which region(s) does your firm source from?

(Tick where appropriate)

a) Locally ( )

b) EAC ( )

c) COMESA ( )

d) Others (specify)

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22. Has intelligent sourcing created a significant tax saving?

Yes ( ) No ( )

23. If yes in 22, what is the estimated tax savings created due to intelligent sourcing?

(Tick where appropriate)

Less than 5% ( )

5%-20% ( )

Above 20% ( )

24. If no in 23, what do you think makes intelligent sourcing an ineffective tool for harnessing tax savings? *(Explain)*

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THANK YOU.