

**UNIVERSITY OF NAIROBI  
SCHOOL OF LAW**

**TAXATION OF SMES IN KENYA AS A TAX BASE BROADENING MEASURE-  
IS IT A MERE TAX COLLECTION EXERCISE?**

**BY  
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G62/71952/2008**

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**DECLARATION**

I FRANCIS GIKONYO MUTHUKU, declare that this thesis is my original work and that it has not been submitted for examination for the award of a degree at any other University.

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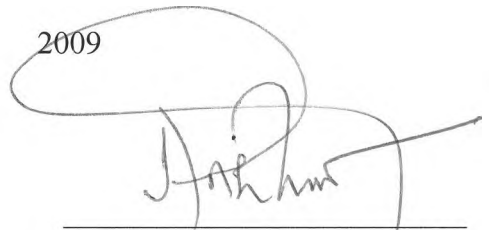


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## **DEDICATION**

I dedicate this thesis to my beloved wife Jane and my three daughters, Veronica, Mary and Sylvia for their support during my writing of this thesis. I cherish most their constant reminder to me: it is worse to start on something and then you do not finish; you had better not start at all. Every time this was told to me, I found time, in spite of my busy schedule of work, to continue writing.

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**FRANCIS GIKONYO MUTHUKU**

# **TAXATION OF SMES IN KENYA AS A TAX BROADENING MEASURE- IS IT A MERE TAX COLLECTION EXERCISE?**

## **ABSTRACT**

The history of the growth and taxation of SMEs is long and dates as far back as 1950s. Initially, the informal sector was regarded as marginal and peripheral. But with time, the sector expanded and became a source of livelihood and a potential taxpayer. With this realization the Government incorporated the sector in its national policy to develop the sector. Later, the focus shifted to tax SMEs to expand the tax base. Tax base broadening would yield; increased tax revenue; and lessening of the tax burden. But at the time there was no legislative framework in Kenya for taxation of SMEs. It was not until 2007 when turnover tax was introduced through section 12C of the Income Tax Act and the Income Tax (Turnover Tax) 2007, Rules.

The 2008/09 Report by KRA on tax collected during the period shows that these Rules have not been effective in the taxation of SMEs as the projected revenue from SMEs was not realised. The objectives of tax base broadening and eventual lessening of tax burden have receded to the background. The rules failed to capture as many SMEs as anticipated, largely due to the many shortcomings in them among them being; failure to isolate and identify the particular SMEs targeted for taxation, categorize them depending on the nature of business activity by each, apply differentiated rates of taxation, provide for appropriate turnover assessment methods and thresholds, introduce necessary and appropriate incentives, and make the system as simplified as possible so as to attract voluntary tax compliance. These measures if taken will invariably strengthen the rules as to capture as many SMEs into the tax net thereby broadening the tax base; lessening the tax burden; and increasing revenue.

**FRANCIS GIKONYO MUTHUKU**

Key words: Turnover tax; SMEs; tax base broadening; tax burden

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## CHAPTER 1- INTRODUCTION

### 1.0 BACKGROUND

Since independence to the present day, virtually all taxes in Kenya have remained the same. Session Paper No. 10 of 1965<sup>1</sup> substantially carried over taxes of colonial times. The session paper only proposed few modifications on taxes to make them more responsive to changes in income. This saw the introduction of a full pay-as-you-earn system, graduated tax rate on income earners and other thresholds.

Later, Session Paper No. 1 of 1986<sup>2</sup> provided for additional taxes like the Sales Tax, VAT, Service Charges, Turnover tax, and abolished others like Poll Tax; Hut Tax. However, no noticeable changes in the bulk of the taxes at independence that were seen. The tax inventory remained the same with most notable items being; Income Tax, Custom & Excise, Sales Tax, Stamp Duty, Roads Maintenance Levy, Estate Duty and so on.

Meanwhile, political and global economic complexities brought in new challenges to and changes in peoples' economic lifestyles, preferences and level of income in Kenya. Many people started engaging in economic activities and therefore presented new areas of potential taxation. Most noticeable of these emergent groups is what is now commonly known as SMEs or Jua kali or the informal sector. The First International Labour Organization (ILO) Employment Mission in 1972 to Africa, Kenya, recognized that the traditional sector, named the "informal sector", had not just persisted but expanded<sup>3</sup> in Kenya. Initially, many believed that the informal sector in Kenya was marginal and peripheral, but following the ILO Report, the Government realized the need to develop the sector. It now embarked on incorporating the informal sector into its national economic policies. As part of the Government's strategic effort towards this end, it published Session Paper No. 1 OF 1986, National Development Plan (1989-1993) and subsequently the Sessional

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<sup>1</sup> Session Paper No. 10 of 1965, *African Socialism and its Application to Planning in Kenya* (Nairobi: Government Printer, 1965)

<sup>2</sup> Session Paper No. 1 of 1986, *Economic Management for Renewed Growth* (Nairobi: Government Printer, 1986)

<sup>3</sup> International Labour Organization Employment Mission, *Employment, Incomes and Equality: A Strategy for Increasing Productive Employment in Kenya*, (Geneva: 1970). and ILO, *Report on 1<sup>st</sup> ILO Employment Mission for Africa, Kenya, 1972*, <http://rru.worldbank.org/Documents/PapersLink/Sida.pdf> accessed on 20.8.09

Paper No. 2 of 1992<sup>4</sup>. These efforts coupled with other factors stimulated growth of this sector which became widely spread through out the country.

With time, after the informal sector had grown and become widespread, the Government's concern shifted and now focused on how to tax the sector. It is after it dawned on the Government that, although the sector controls a wide business population, employs a considerable number of people and generates an enormous income it has remained outside the tax net<sup>5</sup> and has not produced revenue corresponding to their income. The tax base was still narrow and the tax burden heavier on the taxpayers and there was need to expand it. But, at that time, there was no legal framework on the taxation of the informal sector. It was not until 2007, when the Government of Kenya responded to the situation and promulgated the Income Tax (Turnover Tax) Rules, 2007 (herein Turnover Tax Rules) under the Income Tax Act.<sup>6</sup>

Regrettably, in spite of the presence of the Turnover Tax Rules, the situation has not changed; a large number of SMEs operators still remain outside the tax net; the tax base is narrow and the tax burden on the existing tax payers heavier. It has thus become necessary to strengthen the existing legal framework for the taxation of the emergent SMEs or Jua Kali or informal sector in order to capture the SMEs that are outside the tax net as a tax base broadening measure.

To understand the importance of having a broad tax base, it is important to know the problems that would arise with a narrow tax base. A narrow tax base breeds over taxation. This is because the revenue the Government requires will come from the few taxpayers hence; the fewer the taxpayers the larger the amount each will have to pay. This is a common source of frequent coercive and inquisitorial methods of taxation by the Government which consequently, causes interruption of business activities, annoyance and great dissatisfaction from the taxpayers. This consequential effect leads many taxpayers to slide into informality and avoid paying

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<sup>4</sup> Sessional Paper No. 2 of 1992, *Small Enterprises and Jua Kali Development*, (Nairobi: Government Printer, 1992)

<sup>5</sup> Waweru M.G, "Tax Administration in Kenya: Problems and Prospects" A Seminar Paper Presented at the Seminar by Federation of Kenya Employers in 2004 in Nakuru, Kenya [www.kra.go.ke](http://www.kra.go.ke), accessed on 8.1.09

<sup>6</sup> Income Tax Act



taxes. Tax broadening on the other hand, will lessen the heavy tax burden created by the narrow tax base. In tax broadening, the tax burden is distributed among a large number of taxpayers. The tax rate is also greatly reduced such that each taxpayer will pay less than what was payable before the tax base had been expanded. Additionally, the overall tax revenue for the Government will increase as new entrants and income will have been captured. To achieve this the Government must however play its critical roles: First, to facilitate and support the growth and sustained development of the informal sector as a people; secondly, to collect tax revenue from the sector in order to facilitate and support the growth and development of the nation in which the SMEs also partake; and thirdly, to lessen the tax burden on taxpayers by tax base broadening.

### **1.1 STATEMENT OF THE PROBLEM**

In spite of the promulgation of Turnover Tax Rules under the Income Tax Act by the Government of Kenya, a large number of SMEs operators have remained outside the tax net. The tax base has remained narrow and tax burden on the existing taxpayers heavier. It is therefore necessary to strengthen the existing legal framework which governs taxation of SMEs and introduce necessary incentives in their taxation. This will bring many SMEs within the tax net as a tax base broadening measure as opposed to being a mere tax collection exercise. As seen earlier, the benefits that shall accrue on the attainment of tax base broadening will be; lessened tax burden on taxpayers; and increased revenue for the Government. Of course, incidents of tax evasion and overly inquisitorial methods of collection of tax will also be greatly reduced if not completely.

### **1.2 SIGNIFICANCE/IMPORTANCE OF THE STUDY**

This study will establish that it is possible to tax SMEs and expand the existing tax base thereby lessening tax burden on the taxpayers and increasing the tax revenue for the Government. The current legal framework as is has failed to achieve this. As a testimony to this the tax payers are overtaxed at the moment. This is demonstrated by the fact that the tax-GDP ratio has exceeded 25%. This being the case, it is time the legal framework is strengthened and necessary incentives in the taxation of SMEs introduced.

The study will therefore suggest legislative changes to strengthen the Turnover Tax Rules. Some of the suggested changes are: providing for taxation of definite and specified SMEs as is the case with Advanced Tax for Matatu; segmentation of SMEs into different categories; providing differentiated tax rates for different SMEs; tax holidays; laying down proper assessment method for turnover; taxpayer substitution; SMEs registration and census only to mention but a few. These measures will strengthen the Turnover Tax Rules to capture every conceivable SME into the tax net. The result will be broadened tax base, lessened tax burden and increased tax revenue. It is shown by the study that taxation of SMEs could achieve tax base broadening. The study demonstrates however that the exercise should not be reduced to mere tax collection lest it should fail to achieve the objectives of tax base broadening as has been the case with the Turnover Tax Rules.

Undeniably, the idea of identification of SMEs for taxation as a tax broadening measure to raise tax, broaden tax base and lessen the tax burden will not have come at a better time than now. The paper's contribution on this subject of research is by no means a shallow. It is immense and valuable as the suggestions become a useful guide in tax reforms on taxation of SMEs in Kenya.

## **1.3 RESEARCH METHODOLOGY**

### **1.3.1 METHODOLOGY**

In order to gather, within the time allowed, sufficient information to render scholarly support to or denial of the hypothesis set out herein, this study will employ:

- Library research
- Internet services

### **1.3.2 OBJECTIVES**

The objectives of the study are:

1. To collect information on the target SMEs groups to justify the success or otherwise of taxation of SMEs as a tax base broadening measure in Kenya.
2. To suggest appropriate legal framework and method of taxation of SMEs that would strengthen the existing Turnover Tax Rules to achieve tax base broadening.

### 1.3.3 PRIMARY QUESTIONS

This study will seek to answer the following two questions:

1. Is it possible to tax SMEs to raise revenue and broaden the tax base?
2. Will the broadening of the tax base through taxation of SMEs lessen tax burden?

### 1.3.4 HYPOTHESIS

1. It is possible to tax SMEs to raise revenue and broaden the tax base.
3. Because the tax base will have been broadened, tax burden on tax payers will be lessened.

## 1.4 CONCEPTUAL FRAMEWORK

The debate on the informal sector began in the 1950's when W. Arthur Lewis developed a theoretical model of economic development on assumptions that informal labour force will with time be integrated into the formal economy<sup>7</sup>. This has not happened particularly in the developing countries and the sector has persistently remained informal. The debate was rekindled in Africa in the 1970's by the works of Keith Hart of ILO<sup>8</sup>. He emphasized that the informal sector was endowed with dynamism and diversity, and went well beyond "shoeshine boys and street vendors". The sector was henceforth institutionalised within ILO and the debate continued<sup>9</sup>.

Much later, taxation of SMEs became a significant issue and gained prominence in international sphere. It first featured at global level in International Study Conference held in Santa Cruz de la Sierra, Bolivia between 24th and 26th of October, 2005. Later, taxation of SMEs became a major international concern and occupied the entire corpus of the International Tax Dialogue Global (ITD) Conference<sup>10</sup> held in

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<sup>7</sup> Flodman B., "Fact Finding Study: The informal Economy" (SIDA, 2004)  
<http://ru.worldbank.org/Documents/PapersLink/Sida> accessed on 20.8.09

<sup>8</sup>See Hart K., "Informal Income Opportunities and Urban Employment in Ghana" (1973) *The journal of Modern African Studies*, Vol. 11, No. 1 as quoted in Women in Informal Employment: Globalizing and Organizing at p. 1 [http://www.wiego.org/about\\_ie/definitionsAndTheories.php](http://www.wiego.org/about_ie/definitionsAndTheories.php) accessed on 20.8.09

<sup>9</sup> Supra note 3

<sup>10</sup> International Tax Dialogue (ITD) Global Conference, Buenos Aires, Argentina on 17<sup>th</sup>-19<sup>th</sup> October, 2007

Buenos Aires, Argentina on 17<sup>th</sup>-19<sup>th</sup> October, 2007. Much was discussed in detail regarding taxation of SMEs in this conference which became the foundation of legislative reforms on taxation of SMEs in many countries including Kenya. To mitigate the unpopularity of tax due to its exaction nature, the conference emphasized the need for governments not to make taxation of SMEs a mere taxation exercise to raise revenue only; but simplify it to develop the sector, expand the tax base in order to lessen the tax burden of its people. As a result of this recognition, taxation of SMEs has attracted and continues to attract global attention, prominence and importance. For this reason it will also feature as one of the subjects for consideration in the ITD Conference to be held in Beijing, China in October 2009.

The currency, importance and prominence of this subject on taxation of SMEs, has made tax experts, major intellectual brains and governments to put profound efforts to define SMEs in the hope of getting an acceptable and appropriate global method of taxation of SMEs. Yet, there is no universally acceptable definition out of this effort, as any definition given would vary from country to country and circumstance to circumstance. Nonetheless, certain features are common in all available definitions on SMEs. These are; the number of employees, the amount of capital involved, the amount of asset owned, sales made, income generated and the nature of business undertaken by SMEs.

The difficulty in defining SMES is also present in Kenya. The entire corpus of tax laws in Kenya have not defined or used the term SMEs. The Turnover Tax Rules which govern taxation of SMEs has only provided income threshold to define persons eligible for taxation under the Rules. However, the Government has gone a step further to define MSME to be; any business that employs 1-9, 10-49 and 50-99 is micro, small and medium enterprises respectively<sup>11</sup>.

This historical and conceptual development of the informal sector and its taxation constitute the conceptual framework for the study. The formulation of a working definition, identification of particular SMEs and suggestions made on the best way of improving the existing legal framework on taxation of SMEs in Kenya, are founded on

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<sup>11</sup> Sessional Paper No. 2 of 2005 *Development of Micro and Small Enterprises for Wealth and Employment Creation for Poverty Reduction* (Nairobi: Government Printer, 2005)

this historical and conceptual development. Further, the evaluation of the effectiveness or otherwise of the Turnover Tax Rules in the taxation of SMEs as a tax base broadening measure depends exclusively on this foundation. In short, it is the basis of the study.

## **1.5 CHAPTER BREAKDOWN**

The study is divided into 4 Chapters. Chapter 1 is mainly introductory and lays down a brief background of tax regime and inventory in Kenya since independence. The chapter also sets out the problem under inquiry which is; that the existing laws on taxation of SMEs are not adequate and need strengthening. The importance and the contribution the study will make to the existing body of knowledge on taxation of SMEs and the methodology to be used in the research are matters discussed in this chapter. Further, the prominence this subject has cut for itself in the local as well as the international arena is discussed in this chapter. The reading of this chapter makes the reader know from the onset that the mission for the research is to render scholarly support to or deny that taxation of SMEs could pass for a tax base broadening measure.

Chapter 2 deals with aspects of SMEs. It starts with definition of SMEs. In the chapter, it is discernable that it is not possible to have a single universally acceptable definition on SMEs. Every possible definition will depend on the context and invariably, vary from country to country, circumstance to circumstance. This prepares the reader to appreciate and understand the definition adopted for purposes of this paper to mean, refer and represent SMEs. The chapter further examines the importance of SMEs in Kenya which then explains the high proportion of importance ascribed to this subject of taxation of SMEs at the international level.

Chapter 3 builds on the foundation established in the preceding chapters and brings the reader back home, Kenya. It evaluates, on the information obtained by the study, the effectiveness of Turnover Tax Rules under the Income Tax Act in bringing the SMEs into the tax net as a tax base broadening strategy. The study finds regrettably, that in spite of the presence of the Turnover Tax Rules, a large number of SMEs in Kenya still remains outside the tax net. The Turnover Tax Rules lost the spirit of taxation of SMEs as a tax broadening measure to lessen tax burden. Rather, it focused more on and eventually became a mere tax collection exercise to raise

revenue only! Never the less, the Turnover Tax Rules provide a foundational legal frame work for taxation of SMEs which only needs improvement to achieve its purpose. It is in this need that the importance of the study is premised. However, this need is supplied substantively in chapters 3 and 4. In analyzing the effectiveness of the Turnover Tax Rules, the study is nonetheless alive to the fact that these rules have been in operation for less than two years.

Under chapter 3, it is appreciated that implementation of the taxation of SMEs has encountered numerous challenges. The challenges are enumerated and discussed in detail. Indeed, Kenya Revenue Authority has realized there is a problem with taxation of "small traders" as the tax collected during 2008/09 financial year from SMEs significantly fell below the targets set for collection. The tax collection target set for the financial year was Kshs. 450 Million but KRA collected only Kshs. 150 Million. KRA now intends to carry out a study to assess the effectiveness of Turnover Tax Rules in the taxation of SMEs<sup>12</sup>. To address these challenges, the study in chapter 4, proposes possible legal measures to be put in place which will considerably mitigate the challenges facing implementation of laws on taxation of SMEs.

A comparative study of best practices in other jurisdictions is also carried out in this chapter 3. The comparative study becomes an important mine of information in the making of suggestions by the study on the best way SMEs could be taxed as a tax broadening measure in Kenya. Care has however been taken not to transport such best practices to the context of Kenya without ascertaining their adaptation to the local circumstances.

After testing the hypothesis of the study, Chapter 4 will timely conclude by making suggestions on the necessary legal framework and incentives that are needed to strengthen the Turnover Tax Rules as to capture a substantial number of SMEs into the tax net. The main aim will be to broaden the tax base to raise revenue for the Government and at the same time lessen tax burden on tax payers. To achieve this, the Turnover Tax Rules and tax administration should not be reduced to serve a mere tax collection exercise. The Turnover Tax Rules must not make taxation of

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<sup>12</sup> Kathuri B., "KRA to Measure Tax Efficiency in Small Businesses" *The Standard*, 4.6.2009 p.26 Fidelis Mulei, Commissioner in charge of Domestic Taxes lamented that the target set for collection from SME for that financial year was 450 Million but they only collected 150 Million. KRA therefore intended to conduct a survey to asses the effectiveness of turnover taxation of SME.

SMEs worse than it ought to be<sup>13</sup>. The taxation must be guided by strategic simplification of the Turnover Tax Rules and introduction of certain necessary incentives in the taxation of SMEs as to make compliance voluntary.

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<sup>13</sup> Grandy, M., *Tax and Family business*, ( London: Sweet & Maxwell, 1970) p. 71

## CHAPTER 2: ASPECTS OF SME

### 2.0 Meaning of SME

#### Brief introduction

SME is a generic term which stands for and is the recognized abbreviation of Small and Medium Sized Enterprises. These enterprises have been associated with informality and they have hence been generally referred to as the informal sector. The concept of informal sector has been debated since its "discovery" in Africa in the early 1970's...<sup>14</sup> but defining the sector still is a major problem. However, it may be inferred that the various definitions of SME put forth were greatly influenced by one or more of the three schools of thought which are highly regarded to have laid the foundation on the concept of the informal sector. These schools of thought are:

- a) The *dualist school*: Which was championed by the International Labour Organization (ILO) in the 1970's and subscribed to the notion that the informal sector is comprised of marginal activities distinct from and not related to the formal sector<sup>15</sup>. International Labour Organization in 1993 attempted to give a definition of Informal sector, but ended up providing a general description of what enterprises could be regarded as informal sector<sup>16</sup>.
- b) The *structuralist school*: This was popularized by among others Caroline Moser<sup>17</sup> and Alexandro Portes<sup>18</sup> in the late 1970's and 1980's. The school subscribed to the notion that the informal sector should be seen as subordinated economic units (micro firms) which increase competitiveness of large capitalist firms. Unlike the dualist, this school sees the modes and forms of production in the informal and formal sectors as inextricably connected.

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<sup>14</sup> Portes A, Casells and Manuel, , "World Underneath: The origins, Dynamics, and Effects of the Informal Economy" (Baltimore: Johns Hopkins University Press,1989) p. 38

<sup>15</sup> supra note 3

<sup>16</sup> ILO, *Report on the International Conference of Labor Statisticians*,(Geneva, 1993) According to the report: The informal Sector is regarded as a group of household enterprises or unincorporated enterprises owned by households...

<sup>17</sup> Moser, Caroline., "Informal Sector or Petty Commodity Production: Dualism or Independence in Urban Development?" (1978) *World Development*, Vol. 6, Nos. 9-10

<sup>18</sup> supra note 11



- c) The *legalist school*: This was championed by Hernando De Soto in the 1980's. He subscribed to the notion that the informal sector is comprised of 'plucky' micro-entrepreneurs who choose to operate informally in order to avoid cost, time and effort of formal registration.

Since then, there has been a divergence of opinions and definitions on SMEs and despite the effort by major academic brains there has not been any universally acceptable definition of SMEs. All available definitions on SMEs vary from country to country, circumstance to circumstance. Perhaps, it is the amorphous nature of SMEs that makes it difficult to define the sector.

### **What constitutes SMEs?**

Although there is no universally acceptable definition of SMEs, there are certain common factors which are discernable from all available definitions on SMEs. These include, but not limited to, the number of employees in, sales made, capital and assets owned by entities or firms or persons which constitute SMEs. In Kenya SME or MSME refers to and means Jua kali or informal sector. According to the Government, any business that employs 1-9, 10-49 and 50-99 is micro, small and medium enterprises respectively<sup>19</sup>. For purposes of this paper, these common factors shall become the basis of identification of, to mean and refer to SMEs. The composition of the inventory of SMEs target groups outlined in the paper for tax base broadening has substantially drawn from these features. The following comparative analysis of definitions on SMEs underscores primacy of these common features in defining the subject and scope of study of this paper. Significantly, the paper will use the terms SMEs, MSME, Jua Kali and Informal sector interchangeably to mean, refer to and represent SMEs.

### **Comparative definitions**

The character of SMEs is always changing and so are the definitions. However, the definitions of SMEs adopted in different jurisdictions make reference to certain common factors to wit; the number of employees in, sales made, capital and assets owned by, and location of entities or firms or persons to mean and define SMEs. This

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<sup>19</sup> *ibid*

makes it important to look at comparative jurisdictions regarding these common aspects.

However, this comparative analysis is for a limited purpose; to fortify the approach adopted by this study to rely on these common factors to mean, refer and identify SMEs in Kenya. While the comparative study is important, the study will not make any comparison of similarities or otherwise of the SMEs elsewhere with SMEs in Kenya for three reasons: First, the methods and principles applicable for identification of SMEs in one country is different from the other; secondly, terminologies used in different jurisdictions are different and mean different things; and thirdly, the purpose and categorization of SMEs invariably is peculiar to their respective contexts. It will then be imprudent to literally transport the concepts on SMEs from other jurisdictions for use and application to SMEs in Kenya without considering their adaptation to the circumstances of Kenya. As such the study will only draw salient aspects from the comparative study which may, with modifications, inform the legislative reforms on taxation of SMEs in Kenya. It will not per se consider the suitability or otherwise of one or more of these definitions to the context of Kenya.

Of significance to note is that, although the definitions and the SMEs are varying, these common factors which run through all of them speak volumes on SMEs in general. And so they will largely inform the identification of the SMEs and have greatly influenced the selection below although the arrangement is not in any particular order.

### **The United Kingdom**

A brief sojourn in the UK shows; Sections 382 and 365 of the Companies Act, 2006<sup>20</sup> define a SME for purposes of accounting requirements of registered companies and not individuals. In Kenya, Turnover Tax Rules are made under the Income Tax Act and not the Companies Act<sup>21</sup>. The Turnover Tax Rules deal with individuals and have specifically excluded incorporated companies from its application. Worth of note a business which may be considered small or medium in the UK may not be small or medium in Kenya and vice versa. The purpose of the definition in the UK is also

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<sup>20</sup> Companies Act, 2006

<sup>21</sup> Companies Act, 1948

totally different from the context of Kenya. This probably explains why it has been defined in the Companies Act in the UK.

Nonetheless, the UK Companies Act defines SMES thus:

*“Small, if it has a turn over of not more than £6.5 million, a balance sheet total of not more than £3.26 million and not more than 50 employees;*

*Medium sized if it has a turnover of not more than £ 25.9 million, a balance sheet total of not more than £12.9 million and not more than 250 employees”.*

This definition is not applicable to all situations in the UK. Still in the UK, the British Bankers Association [BSA] has, through the British Banking Code [March 2008] defined small business customers as sole traders, partnerships, limited liability partnerships and limited companies with an annual turnover of under £1 million, as well as associations, charities and clubs with an annual income of under £ 1 million. From these two definitions, it is clear the criterion used is that of the amount of the balance sheet, annual turnover and number of employees employed by the concerned persons which define SMEs.

## **USA**

In USA the definition is set by a Government department called the Small Business Administration [SBA] Size Standards Office which has deliberately used the word “size standards” in order to indicate the largest a concern can be to still be considered a small business and benefit from small business targeted fund. There is wide discretion on the department to delineate the “size standards” by considering many aspects such as the amount of capital, annual turnover, the nature of business, the size of business and the number of employees in the firm.

## **European Commission**

Definitions provided keep on changing as and when the circumstances demand in order to be in line with some new economic or technological development. A good example is the European Commission when it replaced an earlier recommended definition No. 96/280/EC with a new one being No. 2003/361/EC of 6. 5. 2003 and

which took effect from January 2005. The new definition enhanced the threshold as to bring even larger entities under SMES and thus poised to benefit from small business targeted fund.

## **Kenya**

In Kenya, there is no Act of Parliament that gives the definition of SMEs. Even the Income Tax chapter 470 and the Turnover Tax Rules which govern taxation of the SMEs neither provide for any definition nor mention any of the terms used to refer, mean or represent SMEs. The income tax merely refers under section 12C to persons and the thresholds which determine persons liable to pay turnover tax.

Rule 3(1) of Turnover Tax Rules provides:

Any person whose income from business exceeds five hundred thousands shillings and does not exceed five million shillings in a year of income shall be liable to pay turnover tax.

Probably, the Act deliberately avoided the use of and to define the term SME after recognizing the difficulty in defining the term. Use of thresholds only to define persons liable to pay turnover tax is a more convenient way of avoiding protracted arguments as to what the term SME mean and to whom it refers.

The newly enacted Micro-finance Act No. 19 of 2006 which came into operation on 2<sup>nd</sup> May, 2008 does not give a definition of SMEs or Micro or low income households whom it is intended to serve. The Act only makes reference to Micro or low income households without providing a definition of the terms or what they represent.

Indeed, in Kenya the definitions are left to and are found in Government policy papers, development plans, budgets and Kenya Revenue Authority (KRA) Unified Tax System [hereafter the UTS] initiative and reports. The terminologies used in Kenya are; the informal sector or the now popularly known Jua kali sector or MSME or MSE. MSME is recognized abbreviation for Micro, Small and Medium Enterprises. The UTS initiative defines MSME thus; any business that employs 1-9, 10-49 and 50-

99 is considered micro, small and medium sized respectively in Kenya<sup>22</sup>. The 1999 National Micro and Small Enterprises Baseline Survey conducted provides a definition that was also adopted in Government's *Sessional Paper No. 2 of 2005*<sup>23</sup> on *Development of Micro and Small Enterprises for Wealth and Employment Creation for Poverty Reduction*. According to the Survey; 'MSE are businesses in both formal and informal sectors, classified into farm and non-farm categories employing 1-50 workers'.

These definitions provided within the context of Kenya are also varying. Even within the same Government Reports, Sessional Papers, Development Plans, Baseline Surveys and United Tax System Reports are provided different definitions. The Acts of Parliament including the Interpretations and General Provisions Act<sup>24</sup> are silent on the definition of SMEs. But of importance is that, all these definitions have common factors which include, though not limited to; the number of employees in, the nature of the business of, sales made, capital, and assets owned or income made by entities or firms or persons which constitute SMEs. In this paper, reference to SMEs or informal or Jua kali sector shall be reference to these factors which shall accordingly define and represent SMEs as persons envisaged under the Income Tax, Microfinance Act, relevant Government Reports, Sessional Papers, Development Plans, Baseline Surveys and United Tax System Reports.

From the foregoing, definitions provided are based on the economic activities undertaken and the annual turnover by the SMEs while others on the employment categories and number of employees in the firm. The location of the players in the sector also describes the sector. For instance, in Kenya, Jua Kali means 'Hot sun'; these are artisans who operate largely without sheltered working place. Notably other factors used to classify the sector are; capital, annual income, type of goods and services rendered and assets they own and so on. The Income tax Act and the Turnover Tax Rules however recognize only thresholds of annual turnover exceeding five hundred thousand shillings and not exceeding five million shillings to define SMEs. Government definitions are broader and at the appropriate time, the study will

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<sup>22</sup> KRA, Unified Tax Initiative, 2005

<sup>23</sup> *supra* note 11 p. 1

<sup>24</sup> Interpretations and General Provisions Act

adopt all these common factors to identify the target SMEs groups for taxation in order to broaden tax base and lessen tax burden. Once this is achieved the amount of revenue collection will also increase.

## **2.1 Categories of SMEs**

### **Nature and characteristics of SMEs**

In Kenya, SMEs are varying in nature and ever changing in character. Most SMEs are highly mobile, unregulated and hence most difficult to control. They largely operate informally with very few of them being registered. They take various sizes, forms and shapes. Traditionally the sector has been regarded as mainly survivalist and other negative aspects have been attributed to it such as; undeclared labour, underpayment, tax evasion, unregulated activities, illegal and sometimes criminal activities only to mention but a few. Nevertheless, today a vast number of the sector provide goods and services whose production and distribution is perfectly legal. On the other hand, some few are formally registered partnerships. The informal sector should therefore not be confused with the criminal underworld economy<sup>25</sup>.

The amorphous nature and heterogeneous character of the informal sector makes identification and categorization of target SMEs groups for purposes of tax base broadening difficult. This will very much depend on the nature of business, character and size, number of employees, annual turnover, location, income made by and capital of the enterprises targeted. This knowledge of the nature and characteristic of the SMEs is crucial as it will enable the study to isolate and identify the major target SMEs groups in Kenya upon whom tax could be levied as a tax base broadening measure.

Among the general and varying characteristics peculiar to this sector, those that are distinctively identifiable are:

- a) **Ease of entry into and exit from business:**

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<sup>25</sup> supra note 7

Most SMEs engage in informal businesses which do not require formal registration or licensing to start or operate. It is easier to enter into and exit from business by the SMEs. Even in those businesses which require licensing, a considerable number of SMEs operators will ordinarily do them without the licences. You will then find that they resort to paying bribes to tax or levy collectors instead of being registered for tax purposes. This has provided SMEs with an apt way to evade detection by KRA thereby evading taxation.

b) **Activities undertaken are largely small in nature and scale:**

SMEs largely engage in small businesses sparsely scattered in different places. Due to the informal nature of SMEs enterprises, some proprietors could own more than one business in different places and under different business names. This way, they succeed in tapping numerous markets and at the same time avoid being easily tracked down by tax collector.

c) **Players in SMEs are largely family relations:**

The informal nature of SMEs, ease of entry and exit from business, and the small size of business they undertake make SMEs to be largely family based. The operation of SMEs is also largely cash based. Some do not have even a bank account. Hence, many operate on trust. This is attributed to the wide believe among many SMEs that family members are more easily trusted.

Other SMEs are set up by family members to supply the family's basic needs. For this reason, the family which owns the business may not be ready to accept members from outside the family.

d) **Capital, equipments employed are little, small and unsophisticated:**

Most SMEs businesses are small and deal in small capital. Some deal in small quantities of items or goods. Others render services which are not large in nature. They therefore do not require or cannot afford big and sophisticated equipments or machinery. Even for those who can afford, due to the nature and size of the business, it would be economically imprudent to invest or to expect SMEs to invest on big and sophisticated equipments or machinery.

They mainly invest small capital and employ small, unsophisticated and conservative equipments.

**e) The technology employed is labour intensive**

SMEs mostly employ manual labour and where absolutely necessary use conservative technology. Their operations are not sophisticated and need not be backed by highly sophisticated technology. They may also not afford the advanced technology. Generally, majority SMEs engage labour intensive methods of production and adapted technology<sup>26</sup>.

**f) Low level of skills in the workers as well as proprietors**

Most SMEs operators do not have specialized skills in the work they do. And so are their workers. In many cases, it may not be necessary to employ such skills as their undertaking do not so demand.

**g) Employment not on permanent basis**

Most SMEs engage in perennial business and of a short term nature. In fact as it has been said, others do survivalist activities. In such a case, permanent employment may not be anticipated. Many proprietors of SMEs operate their businesses themselves without having to employ. Good examples are; taxi drivers, street vendors, Jua Kali artisans, Mechanics, Mitumba dealers and so on.

**h) Low level of organization with limited access to organized market**

SMEs operate informally and most of the time they are not connected to an organized market. Others operate through brokers who then sell the wares to the formal and organized market. Many SMEs, who trade in 'Kiondo' (hand made basket) and wood carvings, work at production level while marketing to the organized market is done by brokers.

**i) Unregulated and competitive markets**

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<sup>26</sup> supra note 7



According to De Soto, SMEs choose to operate informally in order to avoid registration, operational and regulation costs which they consider as burdensome. Although the markets which SMEs serve are highly unregulated De Soto admits at least they are vibrant and competitive.

**j) Limited access to formal credit**

SMEs operate in small and sometimes fragmented businesses. Most of the businesses are not registered and do not have legal personality. SMEs are owned by individuals and who may not have property that is capable of being pledged as security for credit facility. The SMEs do not keep at all or proper records of accounts on which credit worthiness of the firm could be evaluated. And these matters coupled with the immobility of the SMEs make it difficult for financial institutions to extend credit facility to SMEs. As a result, informal sector's entrepreneurs lack collateral or security to obtain credit<sup>27</sup>.

**k) Low levels of formal or technical education and training**

SMEs do not encourage acquisition of formal or technical education and training. They derive their skills informally. As earlier argued, the SMEs apply conservative and conventional technology for production of goods and services. These skills are either passed over by the owners of SMES to their trusted relations or employees of the firm during the course of work or gained by the employees out of long use of the implements of work. This practice kills any necessity for formal or technical education.

**l) Limited access to services and amenities**

Although the Government has developed well worded development and strategic plans on the informal sector, it has not put in place appropriate legal, policy and infrastructure framework to specifically promote the growth of the sector. The SMEs have therefore established themselves informally and in areas with no supporting services or amenities. On the other hand, where there are services and amenities, they have been overstretched or their

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<sup>27</sup> supra note 2

access greatly limited due to high access cost. Corruption in Government has also made access and provision of services and amenities costly.

#### **m) High mobility of the players**

It has been argued that excessive and physical taxation, costs of registration, corruption, excessive Government regulation and other costly business start-ups such as permits and service charges are responsible for informality in the informal sector<sup>28</sup>. As a response to these stringent requirements, many SMEs players opt to operate in the informal sector. Thus, they scarcely establish permanent business operation base and remain highly mobile.

#### **Selection of SMES target groups**

Tax base broadening has been Government's priority since independence. Sessional Paper No. 10 of 1965 identified tax base broadening as a necessary tax reform as would lessen tax burden on the taxpayers. Later, the Government incorporated in its development plans and policies, approaches aimed at achieving tax base broadening in Kenya. Consequently, taxes such as Value Added Tax (VAT), turnover tax, Advanced Tax on Commercial PSV and Freight Vehicles, Road levy tax only to mention but a few, were introduced. The National Development Plan 2002-2008 put it more aptly that; 'the long term objective of the Government is...to increase revenue collection...and expansion of tax base'<sup>29</sup>.

Expansion of tax base may take several forms. First, it may mean introduction of new taxes. The new taxes will target specific persons or groups or class of persons or businesses with taxable income whose taxation has not been provided for under the existing tax laws. Secondly, tax base broadening may entail taxation of income which is at the moment exempted from taxation by law. For instance, religious groups raise enormous sums of money which they invest and generate income but for which no tax is paid as they claim charity. Taxation of such groups will open up new tax

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<sup>28</sup> De Soto H., *Mystery of Capital: Why Capitalism Triumphs in the West & Fails Everywhere Else*,(2000) p. 6

<sup>29</sup> National Development Plan 2002-2008, *Effective Management for Sustainable Economic Growth and Poverty Reduction*,(Nairobi: Government Printer, 2002) p. 9

horizons for tax base broadening. Although this is an important area worth of exploration as a way of expanding the tax base, it is however outside the scope of this paper.

Thirdly, tax base broadening may involve strengthening of existing tax laws to make them effective as to capture as many enterprises as possible within the tax net. The strengthened laws shall cast the net wide at introduction of specific and new thresholds or requirements which will make many enterprises eligible for taxation. Introduction of more incentives which will encourage the targeted persons or groups or classes of people with taxable income to voluntarily comply will bolster additional tax yield. All these will inevitably enlarge the scope of persons liable to pay tax. Since there already existing tax laws and rules governing taxation of SMEs in Kenya, this study will be concerned with this latter approach.

Taxation of SMEs as a tax base broadening measure should however be guided by the principles of fairness and equity in taxation<sup>30</sup>. The focus of the strategy should go beyond mere collection of revenue. Taxation of SMEs should, apart from raising revenue, lead to expansion of the tax base, lessening of the tax burden and also produce a feeling of equity of treatment among tax payers<sup>31</sup>. As a good beginning in taxation of SMEs for tax broadening, the Government must know who will bear the final burden and assess the response of the private sector to the tax broadening strategy<sup>32</sup>. These factors determine the success or otherwise of this exercise and will guide the paper in selecting particular SMEs groups intended to be captured as new entrants to the tax payers club for purposes of tax base broadening.

It has been established that within the informal sector in Kenya, there are particular SMEs which have seen tremendous growth and have in their ranks a vast amount of capital and income. Yet, they have not produced a corresponding growth in tax revenue to the Government<sup>33</sup>. Bringing them into the tax net, the tax administration will achieve three major things; one; increased tax revenue, two; broaden the tax

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<sup>30</sup> Saleem, N.A. and Sokwala, A.M., *Kenya Taxation Simplified*, (Nairobi: N>A Saleem Publishers, 1998) p.12

<sup>31</sup> Wheatcroft G.S.A., *Wheatcroft on Capital Gains Taxes*, (London: Sweet & Maxwell, 1967)

<sup>32</sup> Musgrave R.A and Musgrave P.B., 1989, *Public Finance in Theory and Practice*, (Singapore: McGraw-Hill Book Co, 1989) p. 4 - 5

<sup>33</sup> supra note 5

base thereby lessening the tax burden on the tax payers, and three; attain equity in taxation among all tax payers. These benefits are crucial and important as to justify expenditure by the Government to undertake a further in-depth and extensive investigation through data collection to determine the range of income that is generated by the particular SMEs identified in this paper. The information there from will enable tax administration to ascertain how much tax they should expect to collect from the sector. They will then be able to plan and make critical decisions on tax collection cost efficiency and whether the cost of collection is within collection 3% fee of the total tax collected as recommended by the International Monetary Fund (IMF).

### **Selected SMEs Groups**

It has been shown that SMEs have certain general characteristics. In selecting the enterprises herein, this paper has been guided by these general characteristics. However, the following are noted:

- a) Most SMEs carry out their activities mostly in open-air market or in a temporary structure with no separate and permanent or enclosed individual premises<sup>34</sup>. Businesses falling under this category include; street vendors, scrap metal dealers, hawkers, mitumba dealers, Fisheries, Motor vehicle garages, Fruit and groceries, Ordinary tailoring, Roadside furniture stores
- b) Other SMEs operate in permanent premises but mostly as tenants. They do not own the premises. Some of these enterprises include; Retail traders, Salons and barbershops, Joinery and metal works, Livestock/Butcheries and Meat Eateries, Professional consultancies and fee.
- c) There are other SMEs who operate in permanent premises which they own. These are very few and their business is of a long term nature. Under this category we have Joinery and metal works, Building and construction.
- d) Prior to 1986, farm-based enterprises had not been recognized as SMEs. But it is now recognized that most economic activities carried

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<sup>34</sup> Mukaindo S.M., “The taxation of the Informal Economy in Kenya: Some Preliminary Reflections” LLM seminar presentation in Law of Taxation in 2002

out on the farm generate substantial income<sup>35</sup>. These SMEs working the farm operate within their farms. Majority own the farms though a few lease them.

- e) Except few SMEs with large scale businesses, majority are small whose capital is also small. Virtually all SMEs are cash based.
- f) There is no uni-dimensional classification of SMEs and as such many factors including behavioural considerations are taken into account when placing an enterprise as SMEs.

The SMEs groups which this study identifies for tax base broadening are<sup>36</sup>:

- a. The mitumba industry
- b. Ordinary tailoring.
- c. Roadside furniture stores.
- d. Scrap metal dealers.
- e. Small and Medium agriculture production.
- f. Retail traders.
- g. Salons and barbershops.
- h. Matatu industry, is taxed under Section 12A (1) of the Income Tax Act but it is necessary to obtain more information on their actual income. The Advance Tax under this section will provide a guide and render support to the approach of identifying particular SMEs for taxation as a tax base broadening measure instead of generalized thresholds which may not be directed to any particular group of or persons.
- i. Fisheries.
- j. Motor vehicle garages
- k. Joinery and metal works
- l. Building and construction
- m. Livestock/Butcheries and Meat Eateries
- n. Fruit and groceries
- o. Landlords particularly rental to SMEs
- p. Professional consultancies and fee

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<sup>35</sup> supra note 2

<sup>36</sup> ibid

q. Street vendors/open air markets.

These enterprises cut across all sectors of the Kenya economy and provide one of the most prolific sources of employment creation, income generation and poverty reduction<sup>37</sup>. Capturing of SMEs into the tax net will not only raise tax collection but will widen the tax base and lessen the tax burden as the burden will have been distributed among a larger section of tax payers. But care will be taken to see if the SMEs are already overtaxed. Sometimes, SMEs are subjected to harassment and physical taxation particularly by the Local Authorities. This is against the requirement of the Government policy that Local Authorities will continue to implement creative approaches aimed at promoting marketing for SMEs products<sup>38</sup>.

## 2.2 Global view on Importance of taxation of SMEs

### Importance of SMEs and their taxation in national economy

The subject of Taxation of SMEs is an important one both at national as well as at international level. Taxation of SMEs has increasingly gained enormous proportion of attention as a tax broadening measure than just as a mere tax collection exercise. After collection of data for some time<sup>39</sup>, the Government has become aware that the informal sector in Kenya is a major employer of a vast majority of people, controls a substantial business population and has within its ranks an enormous amount of capital. The Government had established that the majority of future non-farm job opportunities were in the informal sector. According to the Government, unquestionably, the sector offers 'unmatched potential as a source' of employment<sup>40</sup>. The Sessional papers beginning with No. 2 of 1992<sup>41</sup>, No. 2 of 2005<sup>42</sup> and beyond categorically state that SMES 'provide most prolific sources of employment creation, income generation and poverty reduction'.

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<sup>37</sup> supra not 11 p. 1

<sup>38</sup> ibid

<sup>39</sup> Baseline Survey, Micro and Small Enterprises (Nairobi: Government Printer, 1999) and Economic Survey, Micro and Small Enterprises (Nairobi: Government Printer, 2003)

<sup>40</sup> supra note 2

<sup>41</sup> supra note 4

<sup>42</sup> supra note 30

According to the 2003 Economic Survey, employment within the MSE sector increased from 4.2 million persons in 2000 to 5.1 million persons in 2002, accounting for 74.2% of the total persons engaged in employment. This growth was projected to increase from 30.3 to 33.7 percent by 2008<sup>43</sup>. In 2006 national statistics by these surveys showed that out of the 43,057 registered business enterprises, 25,020 (or 58%) of them were Micro and Small Enterprises. The sector contributes up to 18.4% of the country's Gross Domestic Product (GDP). Its contribution to the economy is therefore enormous and cannot be underestimated. The Government then embarked on looking for ways it could stimulate growth of the sector and incorporated the need to stimulate growth of SMEs in its national policies. All Sessional Papers and National Development Plans from 1986 and beyond emphasized this need. Ironically, the sector witnessed tremendous growth yet, is the least contributor to the tax revenue. The tax burden on tax payers KRA considers easy to catch remained heavy. The ratio of total tax revenue to GDP had swollen to 25 percent in 2001<sup>44</sup>. This exceeds the recommended World Bank ratio of 18 percent.

To fasten its grip on tax collection, it became the concern for KRA to tax the sector in order to broaden the tax base, lessen the tax burden on tax payers and satisfy the demands of equity in taxation. According to the Commissioner General, KRA, when addressing members of the Federation of Kenya Employers in Nakuru on 10.3.2004;

***“There is a large informal sector in Kenya that is not within the tax net, yet all must contribute to raising of the resources to finance Government expenditure and thus ensure equity in taxation”.***<sup>45</sup>

This demonstrates that emphasis has now shifted into taxing these SMEs. The Government's quest to bring the sector within tax net began in 2005. The much publicised international practice of according the sector special treatment as espoused in the International Study Conference held in Santa Cruz de la Sierra, Bolivia in 2005 guided the Government in this quest. It then mandated KRA to develop a simplified tax regime for the sector as a tax base broadening measure under the initiative called the Unified Tax System (UTS)<sup>46</sup>. This was after the Government had identified lack of favourable tax laws, regime and policies, and the

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<sup>43</sup> supra note 24

<sup>44</sup> supra note 25

<sup>45</sup> supra note 3

<sup>46</sup> supra note 22

presence of numerous business entry impediments as the major hindrances to the growth of SMEs<sup>47</sup> and taxation thereof. Whether the Government has splendidly played its dual responsibilities of enhancing growth of SMEs and at the same time enabling them to meet their tax obligations is the subject for examination under chapters 3 and 4 of this paper.

The UTS initiative recommended among others that the qualification criterion for the proposed regime be the VAT threshold then of Kshs. 3.0 Million. This means that business entities with annual turnover below Kshs.3.0 Million would now fall under the new regime and would pay a fixed amount of tax on the annual turnover. They recommended further that those entities falling under this regime will not be subjected to other forms of taxes. The initiative opted to adopt this 'simplified' tax system because it operates on a fixed rate and could reduce cost of tax collection. It was also hoped would minimize tax avoidance and tax evasion by the sector. These recommendations were embodied in law through an amendment to the Income Tax Act which saw the introduction of section 12C. Pursuant to this section the Income Tax (Turnover Tax) Rules, 2007 were made to govern taxation of SMEs. They took effect in January, 2008 and are still in force today. But the effectiveness of this simplified tax system as contained in the Rules in broadening tax base, minimizing incidences of tax avoidance and tax evasion, increasing tax compliance by and tax collection from the sector will be dealt with more fully in chapters 3 and 4 below.

The sector has made other fundamental contributions to the economy of the country. It has led to increased output of goods and services. Majority of SMEs activities employ easy and unsophisticated methods of production. Their numerous number and wide presence in almost every part of the country has incredibly increased goods and services to the people at a much cheaper price. That is why the Government considers development of SMEs an appropriate way of promoting economic growth and poverty reduction<sup>48</sup>.

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<sup>47</sup> supra notes 2 and 33

<sup>48</sup> supra notes 2 and 33; Both Sessional Papers identified development of MSEs as an apt way of employment creation, promotion of economic growth and poverty reduction