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THE LAW ON TAX INCENTIVES OF MEDIUM ENTERPRISES: A CASE STUDY OF KENYA AND THE REPUBLIC OF KOREA

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2014

DECLARATION

I certify that the work presented in this thesis is to the best of my knowledge and belief original except as acknowledged in the text and that the material has not been admitted either in whole or in part for a degree in this or any other university

I acknowledge that I have read and understood the university rules, requirement, procedures, and policy relating to my higher degree research award and to my thesis.

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ABSTRACT

The importance of medium enterprises as a segment within the small and medium classification of enterprises in Africa has been discussed in numerous literature. In the recent times, tax administrations in Africa have moved their focus to attending to medium enterprises by establishing medium taxpayers' offices separate from large and small taxpayers units.

This paper describes the tax administrative and legislative framework of medium enterprises in Kenya. The paper gives an analysis of the tax incentives to medium enterprises provided by statutes in Kenya. The research interrogates the rationale of the administrative decision by the Kenya Revenue Authority in establishing a Medium Taxpayers Office. This paper seeks to evaluate the effectiveness of the support mechanisms that the administration has taken to ensure cost effective compliance by medium taxpayers.

This paper does a comparative study of the taxation regime in the Republic of Korea (South Korea) and in Kenya. Kenya and South Korea have been independent since the 1960s. South Korea however, has made tremendous steps in economic growth over the past five decades moving from one of the poorest countries in the 1960s to the top twenty wealthiest countries in the world today. Its policy on small and medium enterprises has been important to this process. This paper seeks to analyse the tax incentives provided in the legislative framework of South Korea to small and medium enterprise. The paper seeks to draw recommendations for Kenya from the legal and administrative taxation framework from the South Korean example.

LIST OF ABBREVIATIONS

ATAF	Africa Tax Administration Forum
DTD	Domestic Taxes Department
FSMEA	Framework for Small and Medium Enterprise Act
G-20	The Group of Twenty (G-20) Finance Ministers and Central Bank Governors
GDP	Gross Domestic Product
HNWI	High Net Worth Individuals
IMF	International Monetary Fund
KRA	Kenya Revenue Authority
LTU	Large taxpayers unit
MEs	Medium Enterprises
MSEs	Micro and Small enterprises
MTO	Medium Taxpayers Office
NBSSI	(Ghana) National Board for Small Scale Industries
NGOs	Non-Governmental Organisations
OECD	Organisation for Economic Cooperation and Development
PAYE	Pay as You Earn
R&D	Research and Development
SMBA	Small and Medium Business Administration
SMEs	Small and Medium enterprises
UN	United Nations

LIST OF STATUTES

Republic of Kenya

1. Republic of Kenya, Income Tax Act, 1973
2. Republic of Kenya, Kenya Revenue Authority Act, 1995
3. Republic of Kenya, Value Added Tax Act, 2013
4. Republic of Kenya, Finance Act 2012
5. Republic of Kenya, Stamp Duty Act
6. Republic of Kenya, Telecommunication Tax Act,1980
7. Republic of Kenya, The Micro and Small Enterprises Act, 2012

Republic of Korea

1. Republic of Korea, Income Tax Act
2. Republic of Korea, Enforcement Decree on Income Tax Act
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3. Japan

Act Concerning Prohibition of Private Monopoly and Maintenance of Fair Trade, Act No. 54 of April 14, 1947

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1 CHAPTER ONE: INTRODUCTION TO TAXATION OF MEDIUM ENTERPRISES

1.1 Background of the Study

Policy measures directed at improving the environment in which medium enterprises operate are being taken in Kenya and across the globe.[1] This began in the 1940s with countries such as Japan introducing targeted policies aimed at ensuring fair competition and prohibition of unreasonable restraint to trade.[2] The Republic of Korea (South Korea) enacted The Framework for Small and Medium Enterprises Act in 1966.[3] In the United Kingdom, the Bolton committee in 1971 highlighted the benefits of small firms and the need to give these firms government incentives in ensuring economic growth of the country.[4] Governments today are convinced that they should ensure that the business environment is conducive by minimizing the obstacles to the growth of enterprises which in essence are the obstacles to doing business. [5] These policy measures are aimed at improving the business environment of

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[1]In Kenya the Ministry of industrialization and enterprise development has established the department of medium and large industries whose function is to promote the development, growth, and graduation of medium industries. <http://www.industrialization.go.ke/index.php/departments/industrialization-directorate/medium-and-large-industries> accessed October 14, 2014. In the United Kingdom Small and medium enterprises receive a tax credit (by way of cash) alternatively there is a tax relief on allowable research and development cost of 225% <http://www.hmrc.gov.uk/ct/forms-rates/claims/randd.htm#6>accessed October 14,2014

[2]In 1947, the Act Concerning Prohibition of Private Monopoly and Maintenance of Fair Trade (the Japanese Antimonopoly Act) and the Law for Elimination of Excessive Concentration of Economic Power were enacted to implement measures for introducing a democratic economy.

[3]Act No. 1840 Dec 6, 1966

[4] Bolton report (1971). Report of the Committee of Enquiry on small firms, Chaired by JE Bolton Cmnd. 4811. London: HMSO

[5] It has been argued elsewhere that there is no justification of treating SMEs differently from large enterprises. First, sceptics argue that large firms have numerous advantages to SMEs as they are more labour intensive. Secondly it is argued that large small and medium size enterprises are subjected to the same environment and that research has shown that there is no direct link to certain assertions such as the place of SMEs in poverty reduction. See Thorsten Beck, Asl1Demirgüç-Kunt, and Ross Levine, "Small and Medium Enterprises, Growth, and Poverty: Cross-Country Evidence" World Bank Policy Research Working Paper 3178, December 2003

small and medium enterprises (SMEs), however this paper focuses on policies relevant to medium enterprises.

SMEs contribute significantly to economic growth in Africa.[6] SMEs form an important segment for consideration in tax administration. The vast number of SMEs and the economic nature of SMEs are both reasons why tax administrations face difficulties in properly administering the SME segment. This is more evident in African countries where tax administrations encounter various capacity constraints in terms of skills and financial resources.

Apart from the revenue generating potential of SMEs, broadening of the tax base through inclusion of all businesses into the tax net is also seen as critical for ensuring fairness of the tax system among citizens. The fact that the majority of the labour force in Africa, especially in rural areas, is employed in SMEs also makes this cluster an important aspect for building a constructive state-society relation. This paper highlights the need for tax incentives to medium enterprises.

The importance of medium enterprises will be discussed before describing the legal and administrative incentives available or that should be available to them in the subsequent chapters. Medium enterprises ensure the employment of many persons at a given time. A look at the definitions of medium enterprises given below indicates that medium-size enterprises ensure the employment of up to double or treble the number of employees of their

[6] 'Small and Medium-Size Enterprises'; covers a wide range of definitions. These vary from country to country. In Kenya there is a definition of small enterprises under legislation. There is no statutory definition of medium enterprises however the Ministry of Industrialisation and Enterprise Development is planning to table a bill that will define the medium enterprises. Micro enterprises are considered to form part of this classification. Where micro enterprises are considered together with small and medium-size enterprises then the segment is referred to as Micro Small and Medium Enterprises.

small or micro counterparts.[7] Supporting the growth of medium enterprises will ensure that a significant population has access to meaningful income and thus improvement of livelihoods.

Secondly, medium enterprises have a significant role to play in the internationalisation of enterprises. It has been argued that the rate at which countries grow is substantially determined by their ability to integrate with the global economy through trade and investment.[8] Access to global markets may be easy in the case of large firms due to the benefits of the economies of scale. In developing countries, a significant portion of large enterprises are branches of foreign-owned enterprises.[9] This in essence means that the markets in Africa promotes globalisation of foreign enterprises, while their own remain within the boundaries of their countries.

Medium-size enterprises (MEs) and in our case domestically owned medium enterprises form the next segment that can be used to achieve the goal of integration to the global market while ensuring that the capital generated remains in the country. It may be difficult to realize this goal by means of small enterprises their limited access to resources. Support to the medium enterprises domestically owned can promote the growth of an economy and the entry into the global markets. To reduce the tax burden on these enterprises by giving tax incentives relating to research and development for example, will free up funds to be used in innovation and efforts to access global markets and ultimately ensure growth of the economy.

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[7] See subheading 1.9

[8] Promoting SMEs for Development: The Enabling Environment and Trade and Investment Capacity Building, 2nd OECD Conference Of Ministers Responsible For Small And Medium-Sized Enterprises (SMEs) Promoting Entrepreneurship And Innovative SMEs In A Global Economy: Towards A More Responsible And Inclusive Globalisation Istanbul, Turkey 3-5 June 2004

[9] William McCarten, "Focusing on the Few: The Role of Large Taxpayer Units in the Revenue Strategies of Developing Countries" (Draft, 2004) South Asia Region, World Bank. <http://www.frpii.org/english/Portals/0/Library/Tax%20Administration/Focusing%20on.pdf> accessed October 14,2014

A good example is the case of Samsung, an enterprise in South Korea that has been able to strategically place itself to ensure permeation the global market.[10]

Away from the key benefits of medium enterprises the need to focus on medium enterprises may illustrated as follows. In the analysis of a typical growth curve of enterprises, firms are expected grow in size from small to medium then on to large.[11] Regulations and policies adopted by the government should create an environment that is conducive for such steady growth. There are numerous benefits associated with being a large firm including enjoying economies of scale and numerous incentives. Small enterprises may have a better chance at growth because of many reasons. Firstly, their small size allows for efficiency of management.[12] Secondly, Micro and Small Enterprises (MSEs) firms enjoy cushioning from the government in regulations such as preferential tax regimes. In Kenya, since 2008 firms which have a turnover of 500,000 to 5 million Kenya shillings pay taxes as the rate of 3 % on gross sales.[13] These firms are exempted from paying the corporate income tax of 30% of the taxable profits. Further under the Value Added Tax Act enterprises which expect an annual turnover that is less than five million are exempted for registration for payment of value added tax (VAT).[14]

There is a tendency of small firms to grow steadily until a certain point they are deemed to attain the medium size level. This medium sizes critical point as enterprises may proceed to

[10]Chapter three discusses the incentives to medium enterprises in South Korea

[11]See Small and Medium-Sized Enterprises Growth Study: Actual vs. Sustainable Growth "Firms, therefore, can increase their sustainable growth rates when they increase their retention rates, strengthen their margins, operate more efficiently, and/or when they employ more leverage" <https://www.ic.gc.ca/eic/site/061.nsf/eng/02781.html#point3.1> accessed October 14, 2014

[12] The advent of the mantra 'small is beautiful' was begun by E. F. Schumacher in his book small is Beautiful: Economics as if People mattered in 1973. Thereafter there has been an argument that indeed small is beautiful while others argue that small is no longer beautiful. Jan de Kok Claudia Deijl, Christi Veldhuis-Van Essen, Is Small Still Beautiful? Literature Review of Recent Empirical Evidence on the Contribution of SMEs to Employment Creation 2013Deutsche GesellschaftfürInternationaleZusammenarbeit (GIZ) GmbH<http://www.ilo.org/wcmsp5/groups/public/---ed_emp/---emp_ent/--ifp_seed/documents/publication/wcms_216909.pdf>

[13]Income Tax Act, 1973 section 12C

[14] Value Added Tax Act, 2013 Section 34

be large firms or begin to diminish to dissolution at an accelerating rate. Because it is the interest of governments to prevent such fall and ensure social wealth maximisation, measures should be taken to mitigate the challenges faced by such MEs.

It has also been argued that small firms can easily slither into informality making them invisible and thus not subject to strict supervision.[15] On the other hand, large firms are able to persuade the regulatory agencies to pay attention to their interest. Medium enterprises however are conspicuous and thus cannot slip to be invisible and lack enough resources/muscle to sway the regulatory framers or other stakeholders to serve their interests.[16]

There are many obstacles facing medium enterprises. A survey done in year 1999/2000 covering 80 countries including the territory of West Bank and Gaza ranked the obstacles faced by small, medium, and large firms. In that survey, information collected from 10,090 firms indicated that medium firms rank taxes and regulation second to financing as the top barrier or obstacles to business. This was reported with the aid of the table below. In the same survey tax and regulations emerged as the top obstacle to business for all enterprises.[17]

Figure 1: Percentage Ranking of Firms that Considered Obstacles to be Major

Rank	All firms		Small firms		Medium firms		Large firms	
1.	Financing	36.5	Financing	38.9	Financing	38.0	Political Instability	20.8
2.	Inflation	34.4	Inflation	36.9	Taxes and regulation	37.2	Financing	26.2

[15]See Mirjam Schiffer& Beatrice Weder, Firm Size and the Business Environment: Worldwide Survey Results. Though this is highlighted as a hypothetical scenario it is important to consider the truth of the same as we move ahead. <https://openknowledge.worldbank.org/bitstream/handle/10986/13988/multi0page.pdf?sequence=1> accessed June 3, 2014

[16]ibid

[17]2nd OECD Conference of Ministers Responsible For Small and Medium-Sized Enterprises (SMEs) Promoting Entrepreneurship and Innovative SMEs In a Global Economy: Towards a More Responsible and Inclusive Globalisation Istanbul, Turkey 3-5 June 2004

Rank	All firms		Small firms		Medium firms		Large firms	
3.	Political Instability	34.5	Taxes and regulation	35.5	Inflation	36.1	Inflation	26.2
4.	Taxes and regulation	33.5	Political Instability	35.0	Political Instability	36.1	Street crime	23.9
5.	Exchange rate	28.0	Street crime	30.6	Exchange rate	29.7	**Corruption**	23.4
6.	Corruption	27.7	**Corruption**	30.1	**Corruption**	27.4	Exchange rate	22.4
7.	Street crime	27.2	Exchange rate	28.9	Street crime	25.5	Organised crime	21.7
8.	Organised crime	24.5	Organised crime	26.9	Organised crime	23.4	Taxes and regulation	21.4
9.	Anti-competitive practices	21.9	Anti-competitive practices	23.8	Anti-competitive practices	21.9	Infrastructure	18.2
10.	Infrastructure	17.0	Infrastructure	16.3	Infrastructure	17.2	Anti-competitive practices	16.9
11.	Judiciary	13.7	Judiciary	13.8	Judiciary	14.4	Judiciary	11.6

Source: Schiffer and Weder 2001.[18] (Emphasis mine)

Medium enterprises have been identified as the "missing middle" in various policy instruments in Africa.[19] In the Nigerian Micro Small and medium enterprises (MSME) policy, it is indicated that MEs have characteristics that differ from the small and micro enterprises.[20] The policy indicates that medium enterprises are specific to certain sectors such

[18]Mirjam Schiffer & Beatrice Weder, 2001. "Firm Size and the Business Environment: Worldwide Survey Results," World Bank Publications, The World Bank, number 13988, January.<https://openknowledge.worldbank.org/bitstream/handle/10986/13988/multi0page.pdf?sequence=1> accessed June 3, 2014
[19]The term missing middle has also been used to refer to the Entrepreneurial business with growth potential. This is distinguished from the formal and informal sector. See the Davis Tax Committee Small and Medium Enterprise: taxation considerations interim report, July 2014 <>
[20]Federal republic of Nigeria, the national policy on Micro Small and Medium Enterprises, 2007

as manufacturing, transportation, and information and communication technology and have fairly good access to government and the financial system.[21]

There is therefore need to consider MEs as a sub segment of SMEs in policy formulation. In academic papers, medium enterprises are often bundled together with small and micro enterprises; this paper seeks to explore the need to treat medium enterprise as a segment distinct from large and small enterprises by providing a preferential tax regime

1.2 Statement of the problem

It is true that many governments are faced with the challenge of maximizing tax revenue while minimizing the distortion in the market and reducing the cost of the collection of taxes. The state has also the duty to ensure economic growth and improvement of business environment through its taxation policy. The taxpayers should spend minimum cost, time and effort in complying with tax legislation.

Tax policy should be formed around segments of taxpayers. Medium enterprises form a significant portion of taxpayers in Kenya. They also contribute significantly to the tax revenue available to the government. There is need to interrogate whether this segment requires tax incentives. This paper seeks to indicate the various ways a balance may be struck in ensuring growth of medium enterprises and minimizing their compliance cost. The paper looks at the incentives to small and medium enterprises in South Korea and makes a case of their application to the medium enterprise in Kenya.

The incentives to medium enterprises can take the form of administrative reform or legal reform. As tax administrations seek to be user or taxpayer friendly, it is important to analyse the tangible benefits and challenges faced. The legislative framework should give specific incentives to the medium enterprises. While it may be simple to create blanket incentives, tax

[21] Ibid

incentives should be created where the objectives are apparent and they ought to be co-ordinated to fit into the industrial and development policy of a country.

1.3 Objectives of the Study

The objective of this research is to identify policy and administrative incentives available to the medium taxpayer. This paper seeks to make a case for incentives to medium enterprise in Kenya. Further, the paper provides an analysis of the preferential taxation framework available to small and medium enterprises in South Korea and the viability in application to Kenyan MEs. Lastly, recommendations are made regarding incentives in Kenya.

1.4 Research Questions

This paper answers the following questions:

a. Whether there should be specific tax incentives given to medium enterprises under the legal framework in Kenya
b. Whether there should be a preferential tax administration framework for medium enterprises in Kenya

1.5 Hypothesis

The legislative framework in Kenya should provide incentives to aid in the growth of MEs. This should be in tandem with the general industrial policy and development policies adopted. The law should provide for the definition of medium size enterprises. The administrative mechanisms adopted should also be provided by the law. Lessons can be learnt from the policy mechanisms that have put in place in South Korea regarding small and medium enterprises. Incentives available to the SME segment in South Korea are suitable only for the medium enterprises. Due to the difference in the size of economies, small companies in Kenya are too small to warrant similar incentives offered to small enterprises in Korea. This research makes a case for adoption of incentives to MEs.

1.6 Justification of the Study

Medium-sized enterprises form a significant proportion of the business taxpayers in Africa However, the focus on tax incentives and administration has often been on large taxpayers and most recently on small-size and informal businesses. With the exception of a few jurisdictions, tax legislation has often not provided favourable conditions to ensure growth of medium enterprises. Additionally, the results of the recent reforms regarding taxation, especially in the administration of taxes, have not been documented to allow for analysis/ evaluation of the effectiveness of those reforms.

Consideration of SMEs frequently results in deliberations on micro and small enterprises {MSEs) and the problem of informality as opposed to the small and medium-size (SMEs) enterprises. Even though a few medium enterprises may be informal, a significant number of medium enterprises are formal businesses.[22] Some challenges and market characteristics are shared between the small and medium size enterprise segments. However, those highlighted in the numerous studies on SME category are more often than not relevant to small enterprises.

1.7 Theoretical Framework

This paper is anchored on the principle of economic efficiency. In this section, this principle of taxation is discussed as expounded by Adam Smith and John Maynard Keynes.

Adam Smith in his acclaimed book, 'The Wealth of Nations' indicates that taxes are levied on three major incomes: profits, rent and wages. [23] Even as nations continue to empty the

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[22]Seth Terkper, Managing Small and Medium-Size Taxpayers in Developing Economies Special Reports: Tax Analysts 2003. <http://siteresources.worldbank.org/INTTPA/Resources/SethTerkper.pdf> accessed November 12, 2013

[23]Adam Smith, *An Inquiry Into The Nature And Causes Of The Wealth Of Nations*, (An Electronic Classics Series Publication) Part II of chapter III <http://www2.hn.psu.edu/faculty/jmanis/adam-smith/wealth-nations.pdf> accessed November 10, 2013

pockets of their citizenry, he advocates that taxes ought to be certain and efficient.[24] An efficient tax system, as he is keen to caution, must possess three things.[25] Firstly, the cost of collection of taxes should be reduced to the least possible. Secondly, the taxes levied must not discourage investment. Lastly, the consequences of tax evasion should not be punitive forcing businesses to shut down and resulting in the loss of employment.

Cost effectiveness is another term that is used to connote economic efficiency of a tax system.[26] This dictates the minimization of two apparent costs. Firstly, the cost of the government in the collection of taxes must be curtailed. Secondly is the cost incurred by the taxpayer in complying with the tax systems must be reduced. The cost to taxpayers includes the cost of professionals that are employed by businesses to give advice on tax matters.

Incentives should not increase the inefficiency of tax administration and tax compliance cost of the medium enterprises. Incentives to medium enterprises should ensure that revenues to the government increase overtime while ensuring the growth of medium enterprises. Further as Kenya Revenue Authority (KRA) segments the authority into taxpayers units they should do so without increasing the cost of collecting tax revenue as compared to revenue collected. In chapter two the principle of efficiency as explained by John Maynard Keynesis highlighted as well make a critique of incentives to taxpayers.

In considering the principle of economic efficiency, it is instructive to appreciate the interplay of the principle with other principles of taxation. The principle of fairness is relevant to this paper. [27] This principle is broken down to two facets horizontal and vertical equity. In chapter two the discussion on tax incentives is given in light of the constitutional considerations.

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[24] Ibid 676

[25] Ibid 677
http://www2.hn.psu.edu/faculty/jmanis/adam-smith/wealth-nations.pdf accessed November 10, 2013

[26] Geoffrey Morse and David Williams, *Davies: Principles of Tax Law*, (6th edition, Thomson Sweet and Maxwell 2008) 18

[27] Attiya Waris 'Taxation without Principles: A Historical Analysis of the Kenyan Taxation System' (2007)Kenya Law Review, Vol 1: 272, 276

Relevant to this paper is the horizontal equity that dictates that those with the same level of income should pay the same amount of tax. Other principles that relate to the economic efficiency of a tax system are the principles of buoyancy and the cannon of flexibility.

Generally, the imposition of tax reduces the marginal incentive to earn extra income as taxes cause distortion in the markets. The situation worsens when the system is inefficient. This may prompt medium taxpayers to look for mechanisms of tax evasion and tax avoidance. The analysis and recommendations by this paper have been anchored on various strategies in which tax jurisdictions have ensured economic efficiency.

One key criticism to the economic efficiency principle is that it is tied to the behavioural assumptions that are difficult or impossible to prove. Even if it is clear that the taxpayers will be willing to comply with the tax system when the cost of complying is reduced, the degree of difficulty that will make them to be inclined to evasion of such taxes cannot be measured accurately to determine efficiency. In chapter two the principle of efficiency taxation is juxtaposed to the use of tax policy.

1.8 Conceptual Framework: Taxpayer Segmentation

One of the components of a tax system is determining a tax base.[28] With the development of societies and the growing hunger of governments for more revenue sources, many nations through their tax collection authorities are undergoing organizational restructuring to ensure that tax is collected in an efficient and user-friendly manner.

The concept of tax segmentation is a fairly new concept that has gained prominence in the field of tax administration reform.[29] Though no agreed definition can be given, it could be said that taxpayer segmentation is partitioning taxpayers into subgroups and tailoring

[28] Sally M Jones & Shelley C. Rhoades-Catanach ,*The Principles of Taxation for Business and Investment Palming* , 2010McGraw Hill Arwin 29

[29] In Kenya the Segmentation began with setting up the LTU in 1998 and the MTO was set up in 2010 <http://www.revenue.go.ke/lto/lto.html> accessed October, 2014

treatment according to their capacities and needs.[30] This is borrowed from a marketing concept; market segmentation, which advocates for attention to the needs of each market segment.

Partitioning of taxpayers into subgroups is based on several aspects. Segments are based on turnover (e.g. in Kenya and Ghana) in tax matters and practical parameters like profit, net or gross asset values, floor space, rent, and employees at a general level. Within the segments other subgroups may be created with criteria such as the type of industry (irrespective of the turnover).[31] It has been observed that in recent trends in tax administration reforms, taxpayers outside a large taxpayer unit (LTU) but above the VAT registration threshold can be classified as medium-size taxpayers.[32]

Taxpayer segmentation has been employed in various African countries including Anglophone countries such as Kenya and Ghana[33] and in the Francophone countries such as Cameroon and Senegal.[34] The Kenya Revenue Authority[35] is promising to continue implementing the taxpayer segmentation approach, to address the unique needs of different groups of taxpayers, set up the medium taxpayer office (MTO) to improve effectiveness of

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[30] UN, World Bank, OECD & IMF, *A Report To The G-20 Development Working Group By The IMF, OECD, UN And World Bank Supporting The Development Of More Effective Tax Systems*(2011) <www.Oecd.Org/Ctp/48993634.Pdf> Accessed November 12, 2013

[31] In Ghana the Large tax payer office is divided into subsectors of specialist industries Upstream and Midstream Petroleum Companies; Banking Institutions; Insurance Companies; Mining Companies except quarrie<www.gra.gov.gh/index.php?option=com_content&view=article&id=57:criteria-for-taxpayer-segmentation&catid=11:latest-news&Itemid=26> accessed November 12, 2013

In Kenya the medium tax office includes four economic sectors. These are: the Service Sector; Agriculture and Manufacturing; Retail and Wholesalers; Financial, Insurance, Government and Construction <www.revenue.go.ke/index.php/domestic-taxes/medium-taxpayers-office/about-lto> accessed November 12, 2013

[32] Seth Terkper, (n21)

[33] Medium Taxpayers: taxpayers with annual turnover above ninety thousand Ghana cedes (GHS 90,000.00) but below five million Ghana Cedis (GHS 5 million) <www.gra.gov.gh/index.php?option=com_content&view=article&id=57:criteria-for-taxpayer-segmentation&catid=11:latest-news&Itemid=26> accessed November 12, 2013

[34] Patrick Fossat and Michel Bua, 'Tax Administration Reform in the Francophone Countries of Sub-Saharan Africa'(July 2013) IMF Working Paper Fiscal Affairs Department, <http://www.imf.org/external/pubs/ft/wp/2013/wp13173.pdf> accessed October 25,2014

[35] Republic of Kenya, Kenya Revenue Authority Act ; Chapter 469 laws of Kenya, S. 3

medium taxpayer's administration and to minimize compliance costs to both taxpayers and KRA.[36]

There are varied definitions of medium enterprises in different jurisdictions but the criteria for taxpayer segmentation used are almost similar. The preferred criteria include the turnover, the assets (excluding specific assets) and the number of employees of an enterprise. Definitions are drawn from national legislation and policies. These are not necessarily statutes that provide for with tax-related matters. At the international level different international agencies have published working definitions of segmentation.

MEs are institutions or individuals that operate nationally and internationally; and are segmented based on specified criteria. These include indicators such as amount of turnover, asset-value as well the minimum number of employees. Different jurisdictions use these criteria but with different parameters for each of these indicators/characteristics. As a result, each region and country develops a model or national definition that can be re-assessed and varied and is usually drawn from legislation and policy. At the national level we will highlight the definition provided by tax administration. The criterion used by tax administrations will be discussed in detail in chapter four.

The Kenya Revenue Authorities makes no reference to the term MEs in its policy. The authority instead uses the term 'Medium Taxpayers' in taxpayer segmentation. There is no literature on the definition of the term medium taxpayer however revenue authorities as we will see seem to be guided purely by turnover. This paper moves forward on the basis that a more holistic approach needs to be utilised and as a result all references to MEs as well as medium taxpayers(MTs) will use the definition of MEs set out and the names will be used

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[36] The MTO commenced its operations on 1 November 2010. It serves taxpayers whose turnovers fall between Kshs. 300 Million and Kshs. 750 Million. <www.revenue.go.ke/index.php/domestic-taxes/medium-taxpayers-office/about-lto> accessed November 12, 2013

interchangeably except where it is specifically distinguished. Refer to Appendix C for a table comparing the definitions of MEs different jurisdictions and organisations.

There is no statute defining medium enterprises in Kenya. However In 2012, the Kenya government enacted legislation to ensure the development and regulation of micro and small enterprises.[37] The Micro and Small Enterprises Act provides for the establishment of a Micro and Small Enterprises Authority and defines micro and small business in terms of annual turnover, employees and total assets and financial investment. The definition of a small enterprise may be inferred as forming the statutory lower limit of the medium size enterprise. There is no statutory defined upper limit of medium enterprises in Kenya.

The Kenyan statutory definition of small enterprises is distinguished between different sectors providing a special criterion related to total assets for manufacturing in contrast with that of the service sectors and farming enterprises. A "small enterprise" is defined as a firm, trade, service, industry or a business activity whose annual turnover ranges between five hundred thousand and five million shillings and employs between ten and fifty people. In the manufacturing sector, the total assets and financial investment including the investment in plant and machinery as well as the registered capital of the enterprise, is between ten million and fifty million Kenyan shillings. In the service and farming enterprises, the equipment investment as well as registered capital of the enterprise is between five million and twenty million shillings.[38]

[37] Laws of Kenya, The Micro And Small Enterprise Act No. 55 Of 2012
[38] A "micro enterprise" is a firm, trade, service, industry or a business activity whose annual turnover does not exceed 500,000 Kenya shillings and which employs less than ten people. The whose total assets and financial investment: in the case of the manufacturing sector, the investment in plant and machinery or the registered capital of the enterprise does not exceed ten million shillings; in the case of the service sector and farming enterprises where the investment in equipment or registered capital of the enterprise does not exceed five million shillings

The Draft National Industrialization Bill, 2014 which has not as yet been tabled in parliament provides a definition of 'medium industries.'[39] This is an industry or a business activity in the manufacturing sector whose annual turnover ranges between Kenya Shillings (Kshs.) 5 million and Kshs.150 million, employing not more than 100 but not less than 50 people or where the investment in plant and machinery as well as the registered capital is more than Kshs.50 million and less than Kshs. 500 million.

In other countries such as Ghana, just like in Kenya there are initiatives geared towards small and micro enterprises. For example, the National Board for Small-Scale Industries Act establishes the Ghanaian National Board for Small Scale Industries (NBSSI) which in turn is given the mandate to establish the criteria that constitute a small-scale industry.[40]The board defines "small enterprises" as those enterprises employing 29 or fewer workers.[41] Small enterprises employ between 6 and 29 or have fixed assets not exceeding 100,000 USD (KSH8.9million), excluding land and building.[42] This is lower than in most countries such as South Africa where that prescribes more than 50 as the number of employees that may form the lower limit of mediums size segment.

Additionally, in Ghana, The Venture Capital Trust Fund Act 2004 defines an SME as an industry, project undertaking or economic activity which employs not more than 100 persons and whose total asset base, excluding land and building, doesn't exceed the Cedis equivalent

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[39]The bill was acquired from the Ministry of Industrialisation And Enterprises in Kenya via email from an official at the Ministry.
[40]Laws of Ghana, Act 434 of 1981, section 4(1a)
"…is the apex governmental body for the promotion and development of the Micro and Small Enterprises (MSE) sector in Ghana. It was established…because government views the sector as having the potential to contribute substantially to reducing the high unemployment and to the growth of the economy of Ghana. MSEs account for a significant share of economic activity in Ghana and can play an important role in achieving the development goals for production. The long-term goal is for MSEs to maximize their contribution to the country's economic and social development with respect to production, income distribution and employment and the closer integration of women and people in rural areas with the national economy"
[41]<http://www.nbssi.org/AboutUs.aspx?PageId=16> January 2014
[42] Micro enterprises are those that employ between 1-5 people with fixed assets not exceeding 10,000 USD excluding land and building.

of $1 million (89 million Kenyan shillings) in value.[43] This Act was enacted to provide for the establishment of the venture capital trust fund to provide for the development and promotion SMEs in specified sectors of the Ghanaian economy. The Act does not distinguish between the small segment and the medium segment. However, it can be implied that the above definition is the upper limit of both the number of employees and the asset base that will define the medium tax payer.

In other African countries such as South Africa and Nigeria the definition of medium enterprises is clearly given by legislation or policy instruments. In South Africa, the definition of medium enterprises is provided in the National Small Business Act.[44]Medium enterprises are defined across eleven sectors.[45] There are three parameters used to distinguish medium enterprises; the total full time equivalent of paid employees, the total turnover and the total gross asset value (fixed property excluded). In the case of medium enterprises, the range of employees for most sectors is between 50 and 200 with exception of the agriculture industry that requires 100 employees as the maximum cap. The total turnover ranges from 5 million Rands (approximately Ksh. 31.9million) for the agricultural sector and 64 million Rands (Ksh. 510million) for wholesale trade, commercial agents and allied services.

In Nigeria, the applicable definition is found in the Micro Small and Medium Scale Enterprises National Policy.[46] Therein the medium enterprises are defined according to number of employees and assets excluding land and buildings. The medium size segment entails those enterprises that have 50 to 199 employees and assets ranging from 50 million naira (Ksh. 27million) to 500 million naira (Ksh. 270 million). The policy is clear that where

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[43] Section 28 of the act

[44] The act was amended by: National Small Business Amendment Act No. 26 of 2003 giving updated information in the schedule to the act.

[45] These include agriculture; mining and quarrying; manufacturing; electricity gas and water; construction; retail, motor trade and repair services; wholesale trade, commercial agents and allied services; catering, accommodation & other trade ; transport, storage and communications; finance and business services and community, social and personal services

[46] Available at <http://www.smedan.gov.ng/index.php/download> accessed June 3, 2014

there is a conflict between the employee and asset criteria, then the employee criterion takes precedence.

In South Korea the criteria used in defining MEs results in almost all businesses falling under the category of SMEs.[47] Generally; the number of employees should be less than 1000. The corporation total assets less than 500 billion won (Ksh. 41 billion). There are different criteria for different sectors as well. This upper limit ranges from 300 to 50 employees and 5 billion (Ksh. 410million) to 30 billion (KSH20.billion) for different sectors. The legislative regime of medium enterprises in Korea is discussed chapter three.

The European commission, in May 2003 issued a recommendation concerning the definition of micro small and medium sized (MSMEs) enterprises.[48] The definition applies to the community policies and the European economic area.[49] According to the European commission, the factors that determine whether an enterprise can be classified as an ME include the employee number and the finances of the enterprise. It is made clear that the main criterion is the number of employees or the' staff headcount criterion. The Annex to the recommendation gives the parameters of medium enterprise as an enterprise with more than 50 employees but less than 250 employees. As well as either turnovers of less than € 50 million or a balance sheet total less than € 43 million.

1.9 Research Methodology

The study was enriched by qualitative and quantitative data. This study included interviews, a questionnaire as well as extensive desk based analysis. It is enriched by an analysis of books, journal articles as well as publications by the IMF, OECD and the World Bank regarding taxation policy relevant to the discussion of taxation of MEs. The study included analysis of

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[47] Article 2 of Framework Act on SMEs and Article 3 of Enforcement Decree of the framework Act on Small and Medium Enterprises January 25, 2012

[48] European Commission Recommendation 2003/361/ Available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2003:124:0036:0041:en:PDF>

[49] The recommendation came to effect on January, 2005.

the legislation, policy and all data available on MEs and the role they play in increasing growth and development as well as being potential large taxpayers of the future.

Due to the limited literature available on MEs an extensive questionnaire was also developed and interviews conducted to obtain detailed information from Kenya Revenue Authority. The interviews on tax experts were conducted during the ATAF-Korea Conference on "Tax Administration for the Small Medium Enterprise Development in Arica" in Johannesburg, South Africa from 5 – 7 February 2014 to interrogate the viability of tax incentives for medium enterprises. Interviews were conducted on the officials at the Medium Taxpayer Office at the Kenya Revenue Authority. This restricted to the head of departments. Quantitative data was also obtained from the Kenya Revenue Authority.

The information from the Kenya Revenue Authority is collected via a questionnaire sent to the Kenya Revenue Authority via email.[50] The authority was asked to fill in the questionnaire with officials answering the segments of the questionnaire that were relevant to their department or sub department. This questionnaire was developed in collaboration with the African Tax administration Forum (ATAF). The questionnaire is sent to four other tax administrations in Africa: Cameroon, Ghana, South Africa, and Nigeria. This questionnaire gives insight on the administration of the Medium Taxpayers however for the purpose of this paper the Kenya Revenue Authority response is relevant. The ATAF research team issued a letter of authority to ask the KRA to fill in the questionnaire. Constant reminders via email were sent in the month of August to KRA

A comparative study is made of the tax incentives available to small and medium enterprises in the republic of Korea. Other countries and more so in Africa that share the history of Kenya, lack an elaborate tax incentive regime to medium enterprise. Kenya and South Korea

[50] See Appendix A

have shared the period of self-rule. Kenya however, has not been able to reach the level of economic growth of South Korea. Important lessons are learnt from the policies adopted by South Korea to promote the growth of medium enterprises in Kenya. This questionnaire was not administered to the tax administration in Korea as there tax incentives regime is clear from the available legislation. Information on Korea was also available published articles.

1.10 Literature Review

Bauer discusses diverse issues relating to taxation of small and medium enterprises.[51] His article provides for global indicators as well as functional indicators of effective tax administration. He discusses pertinent issues that are relevant to the developing tax collection processes such as transparency and independence of the revenue collecting authority. Bauer indicates that it is important for states to use the mechanisms in other jurisdictions that have been successful in legislation and administration reform. He points out that the goal for reform should be to narrow the gap between the revenue that should be collected and that is actually collected. The author recommends various actions to be taken to reduce the tax burden to small and medium enterprises. His discussion however does not narrow down to the issues facing the medium size enterprises as a tax segment on its own.

In 2009, OECD published a comprehensive paper on taxation of SMEs.[52] A compelling argument for incentives for SMEs is that they ensure economic growth through positive externalities. They generate benefits over and above those accruing privately to investors such as labour training and innovation.[53] Tax reliefs ensure cushioning from capital markets imperfection resulting from information asymmetry. The article points out that unlike large taxpayers SMEs miss the benefits of cross border transactions and tax planning as in most

[51] Lewis Bauer, Tax Administrations and Small and Medium Enterprises (SMEs) in Developing Countries, Small and Medium Enterprise Department World Bank Group (July 2005)
[52] OECD Tax Policy Studies, 'Taxation of SMEs: Key Issues and Policy Considerations'(No. 18., 2009)
[53]Ibid 85

case the benefits such as tax breaks do not apply to domestic transactions.[54] This article informs the way forward in making taxation of medium enterprises efficient and fair.

The World Bank report on smarter regulation for SMEs gives an account of the current reforms around the world geared at improving tax compliance.[55] These have yielded tremendous results in facilitating the growth of medium enterprises. One good example is the case in Uruguay and Ukraine where medium enterprises can file and pay taxes through an online system, a perk that was only previously available to large tax payers.[56] The report points out jurisdictions in Africa where it is most difficult to pay taxes such Cameroon. The paper discusses the above issues with reference to the SME as a segment; this research will interrogate the shortfalls of the tax system across Africa and draw lessons from them in the paper specifically for medium enterprises.

Morse and Williams, point out that the efficiency of tax law ought to be gauged by the reduction of all costs. [57] The authors indicate that there is the hidden cost that the community incurs in the brain power that is dedicated toward tax compliance. This cost should be minimised. An efficient tax system should be so simple that there is no need for tax experts. This brain power can be used elsewhere such as in the improvement of health. This will inform the case for an efficient tax system that derives its efficiency from the simplicity of the taxation framework.

[54] Ibid 91

[55] The World Bank and the International Finance Corporation, 'Doing business 2013, Smarter Regulations for Small and Medium-Size Enterprises' (10th edition) <www.doingbusiness.org/~/media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB13-full-report.pdf> accessed November 11, 2013

[56] ibid 82

[57] Geoffrey Morse and David Williams, *Davies: Principles of Tax Law*, (6th edition, Thomson Sweet and Maxwell 2008)

Brautigam and Moore, argue for 'associationalism' as a means of ensuring tax compliance.[58] This is a solution in the instances where the nature of the business is so elusive that the cost of ensuring compliance by each taxpayer by the tax authority is burdensome and expensive. The concept of 'associationalism' is be explored in the case where such associations create a new taxable entity that may fall within the category of medium enterprises in terms of turnover and number of employees. This is discussed referring to the tax incentives in Korea given to small and medium enterprises that merge to form larger medium enterprises or larger medium enterprises in the case of medium enterprises merging to form an enterprises that still fall under the medium enterprise category.

Kiser and Sacks, in discussing the recent reform in tax administration in contemporary Africa, point out that the decentralization and privatizing of the administration system can ensure that tax administration is economically efficient. [59] Different African countries such as Kenya and Malawi have implemented this resulting in tremendous strides in the improvement of tax administration. This will inform the discussions around legislative reform that have enabled revenue authorities such as KRA to undertake measures such as tax payer segmentation attending to the special need of medium enterprises in the administration of taxes.

Seth Terkper cautions that tax administration and tax policy in general should not focus on increase in revenue collection especially if these policies are short-term.[60]He indicates that some incentive to medium enterprises different from the incentives to small enterprises include incentives to encourage medium enterprises to use accounting software and

[58]Deborah Brautigam, Odd-HelgeFjeldstad& Mick Moore, *Taxation and State building in Developing Countries: capacity and consent*, Cambridge university press. p. 205

[59] Edgar Kiser &Audrey Sacks , Improving tax administration in contemporary African States: lessons from history in William Martin , Ajar K Mehotia& Monica Prasad (eds), *The New Fiscal Sociology Taxation In Comparative And Historical Perspective*(Cambridge University Press 2009) 198

[60]Seth Terkper (n21).

ultimately improve compliance.[61] There is need for scrutiny of the potential of this segment. However, he cautions that non-compliance is not always synonymous with size and that it is prudent to ensure that the policies enacted are should not overlook the potential of medium enterprises to comply and contribute to the revenue effort.

1.11 Limitation of Study

This study limits its research to the perspective shared by tax experts and tax administration. Due to the incongruity in the definition of medium enterprises/ taxpayer it was difficult to sample medium enterprises are not interviewed. Additionally there is a leaning by the author that any arguments to the benefit medium taxpayers should be limited to persons that are resident in Kenya.

1.12 Chapter Breakdown

Chapter one gives the background of the study. An introduction to the paper as well as a background to the issues surrounding taxation as well as the importance and the need to focus on the medium taxpayer is given. Here, the research objectives and questions are provided. The chapter indicates the methodology used in the paper.

Chapter two explores the development of economic efficiency within the tax system. The theoretical underpinnings of tax policy and tax incentives are discussed. A critique of tax incentives and preferential treatment is also given. The marketing concept, market segmentation is discussed with reference to the taxpayers' segmentation. A case is made for the intervention of government through tax policies and a critique of tax incentives is given. The tax administration segmentation process is prescribed.

Chapter three describes and analyses the taxation (legislative and administration) regime of medium enterprises in Kenya. A comparative analysis is done, borrowing from the taxation

[61] Ibid 219

regime of small and medium enterprises in South Korea and other jurisdictions. The definition of medium enterprises for taxation purposes as defined by the tax authorities is analysed. The chapter describes tax incentives to medium enterprises in the two countries. The Support mechanisms offered to medium taxpayers by the tax authorities is analysed. Lastly there is an extensive discussion on the setting up, benefits and challenges MTO.

Chapter five gives the recommendations and conclusion to the study. The recommendations are useful for the legislative and administrative reform on the taxation regime of medium enterprises in Kenya.

2 CHAPTER TWO: KEYNESIAN THEORY AND MARKET SEGMENTATION

This paper revolves around the legal and administrative incentives that are or should be put in place to enable the growth of medium enterprises the theoretical framework that serves as a foundation for the need of government intervention through tax incentives. In appreciating the Keynesian theory, the use of tax policy to achieve various objectives is discussed. Particularly, we discuss tax incentives to medium enterprises. A critique of intervention through tax incentives is given highlighting the disadvantages and evaluating the constitutionality of preferential tax treatment. Taxpayers' segmentation may be understood by elaborating the marketing concept: market segmentation. The shift of administrations to see tax payers as clients or customers and ensuring that compliance atmosphere is user friendly.

2.1 Keynesian Theory

A good tax system should bear certain qualities. The system should be efficient. In chapter one, the description of economic efficiency as propounded by the classical political economist Adam Smith was given.[62] Adam smith advocated for a tax system that has compact cost of collection, that does not discourage investment and one whose consequences of tax evasion are not so punitive that the businesses are forced to shut down resulting in the loss of sources of employment in the community.[63]

[62] See chapter one

[63] Adam Smith, *An Inquiry Into The Nature And Causes Of The Wealth Of Nations*, (An Electronic Classics Series Publication) Part II of chapter III <http://www2.hn.psu.edu/faculty/jmanis/adam-smith/wealth-nations.pdf> accessed November 10, 2013

There are two views of what comprises economic efficiency.[64] The first view is that an efficient tax system should not influence tax behaviour. This in essence means that an efficient tax system should be neutral. The contrary view, one relevant to this research, is that a good tax system allows individuals or organisation to react to tax by deliberately changing their economic behaviour.[65] This second view was propounded by John Maynard Keynes. In this section John Maynard's view on efficiency, the rationale behind government involvement through tax policy particularly through tax incentives is discussed.

John Maynard Keynes was a British economist in the early 20th century. Labelled an original thinker, his theory was geared at curing the effects of the financial crisis of the 1920s-30s.[66] John Maynard Keynes believed that free markets are adequate in organising the production and allocation of the scarce resources but lack adequate self-regulating mechanisms for maintaining economic stability.[67] Maynard indicates in his book the 'General theory of employment, interest and money' that "The State will have to exercise a guiding influence on the propensity to consume partly through its scheme of taxation, partly by fixing the rate of interest, and partly, perhaps, in other ways.''[68]

Maynard was of the view that government intervention through fiscal policy would have chain (multiplier) effect allowing for increase in income then consumption then the growth of the economy as a whole.[69] The aim of the government policy according to him is to increase the aggregate demand.[70] Maynard's theory is anchored on two assumptions.[71] First, that

[64] Sally M Jones & Shelley C. Rhoades-Catanach ,*The Principles of Taxation for Business and Investment Palming* , 2010McGraw Hill Arwin 29

[65] ibid

[66] Steven Pressman (2009),"A time to return to Keynes", Critical perspectives on international business, Vol. 5 Issue 1/2 pp. 157 – 161 <http://dx.doi.org/10.1108/17422040910938767>accessed July 20,2014

[67] John Maynard Keynes, *The General Theory of Employment, Interest and Money* Available at: <https://ebooks.adelaide.edu.au/k/keynes/john_maynard/k44g/> accessed October 1,2014

[68] Ibid ch 24

[69] Charles R. Nelson Macroeconomics: an Introduction Chapter 11 Keynesian Fiscal Policy and the Multipliers Internet Edition as of January 1, 2006

[70] ibid

desired expenditures must equal production. Expenditures can take one of three primary forms: consumption, investment, or government spending. Secondly, Keynes assumed that savings must equal investment, where savings equal disposable income less consumption, and where disposable income is equal to total income less taxation.[72]

Incentives to medium enterprises will cause the disposable income of medium enterprises to increase. This in turn increases the savings and the ability to consume certain goods and services. Savings then increase the ability of the enterprises to invest in intended development. For example an incentive to promote research and development (R&D) increases the motivation to spend money in R&D and thus increasing innovation and investment and ultimately the growth of the economy.

Governments, as John Maynard indicates, can intervene in two ways. First, by direct spending and second, by tax cuts. According to Maynard the existence of changes in tax policies and rates can have stabilizing or destabilizing effects and the impact of a tax cut or tax expenditure can reverberate throughout the economy.

Maynard was of the view that allocation of government expenditure and the collection of taxes are interdependent halves of a fiscal process.[73] According to him government revenues are functionally equivalent to direct government spending. By allowing for tax incentives it means that the funds that ought to have been put in a pool of government revenue to be distributed remain with specific taxpayers.[74] Tax incentives therefore can be equated to direct government spending to a particular tax segment. It has been argued that the economic

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[71]Listokin Yair, Equity Efficiency and stability the importance of macroeconomics for evaluating income tax policy (2012). Faculty Scholarship Series: Paper 3879. Available at <http://digitalcommons.law.yale.edu/cgi/viewcontent.cgi?article=4854&context=fss_papers>

[72] John Maynard Keynes, (n 65)

[73] Ibid

[74]Ibid

impact of tax incentives is similar to direct government grant of a certain amount to the taxpayer.[75]

According to the Keynesian theory, the government should then be concerned with protecting the citizens and institutions against inherent instability of capitalism.[76] Fundamentally the government should lean on fiscal policies to ensure the growth rate of the economy is steady. Governments can deliberately use tools of fiscal policy to move the economy to the desired direction.

Taxation is one of the variables of fiscal policy.[77] Tax policy is concerned with the design of a tax system that is capable of financing the necessary level of public spending in the most efficient and equitable way possible.[78] Whatever policy is adopted it must not disincentivize on economic activity.[79] Additionally, the government may adopt tax incentives that merit and deserve public support to certain (legal) persons or organisations.[80]

Tax policy reflects the government's attitude, objectives and actions with respect to its tax system. It is in these policies that the normative standards that the government deems most important are visible.[81] The government in finding an appropriate tax base should tailor its policies to allow relief to a deserving tax base. The tax base is described in the form of an

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[75]Ibid

[76]Ibid

[77]There other two standard components of fiscal policy. Apart from revenue (particularly tax revenue) mobilization, there is expenditure, budget reform; deficit containment/ financing. See Matthew Kofi Ocean, ," Fiscal policy and economic growth in South Africa", (2011),Journal of Economic Studies, Vol. 38 Issue 5 pp. 604 – 618 available at <http://dx.doi.org/10.1108/01443581111161841> accessed 18 September 2014

[78]Vito Tansy and Howell H. Zee, Tax Policy for Emerging Markets: Developing Countries, National Tax Journal, Vol. 53, No. 2 (June, 2000), pp. 299-322available at <http://www.jstor.org/stable/41789458> accessed 27/09/2014 09:18

[79] ibid

[80] Sally (n61)

[81] Ibid

item, occurrence, transaction or activity with respect to which tax is expressed in monetary terms.[82]

Tax incentives are part of the broad classification of tax benefits apparent in the tax policy. Tax benefits include all tax provisions that confer some advantage upon the taxpayers.[83] Tax benefits allow for three actions, these are deductions, deferrals, and exemptions. Exemptions relieve the taxpaying obligation completely while deduction allows individual taxpayers to decrease their taxable income.[84] While some tax benefits aim at reducing the accurate gain or profit to be taxed, tax incentives include those deductions, exemptions and deferrals that are specifically intended to induce private activity and not necessarily to aid in the measurement of income or property value.[85] A good example of a tax benefit that is not an incentive is the deductions of business expenses in reaching realistic computation of business taxable income.

In this research tax incentives are discussed at a broad level that is its application to medium enterprises as a distinct taxpayer segment or as sub segments that are industry based. This is in exclusion of targeted tax incentives. Targeted tax incentives, common in the USA, are incentives aimed at one or several corporations.[86] They apply to a limited number of taxpayers. While tax incentives in general aggravate the complexity in the administration of taxes, targeted tax incentives create serious problems relating to accountability and justification.[87]

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[82]Geoffrey Morse and David Williams Davies *Principles of Tax Law*, 6th edition Sweet & Maxwell 13
[83]Tax Incentives as State Action, University of Pennsylvania Law Review, (1973) Vol. 122, No. 2, pp. 414-470 <http://www.jstor.org/stable/3311272> .Accessed: 27/09/2014 09:24
[84] Ibid
[85]ibid
[86]For example in USA the state of Virginia in 1995 gave incentives to IBM and TOSHIBA. See David Brunori 'Principles of Tax Policy and Targeted Tax Incentives 'State & Local Government Review, Vol. 29, No. 1 (winter, 1997), pp. 50-61 Sage Publications, Inc.
<http://www.jstor.org/stable/4355170>
[87] OECD Taxation of SMEs: key issues and policy considerations No. 18 Tax Policy Studies

There are many forms of tax incentives. These include tax holidays, reduced tax rates, investment allowances, tax credits, accelerated depreciation, and subsidies.[88] Other incentives geared at promotion of specific activities by medium enterprises include research and development incentives, special incentives for employment, preferential treatment on capital gains and losses and venture capital investment incentive.[89]

An effective incentive associated with certain elements.[90] Firstly, it should stimulate investment in the desired sector with minimum leakage and minimal opportunities for tax planning. Secondly, it is transparent and easy to understand. Thirdly, it should not be frequently changed and should have certainty in the period it runs for. Fourthly, it should avoid trying to target cyclical depressions. Lastly, the incentives should be developed, implemented administered and monitored by a single agency ensuring low administration cost for both government and the relevant enterprises.

2.2 A Critique of Tax Incentives and Preferential Treatment

In this section the constitutionality of tax incentives is interrogated. Additionally, the disadvantages of tax incentives are highlighted.

2.2.1 The constitutionality of tax incentives / preferential treatment

Tax incentives or preferential tax treatment concern the treatment of a segment of taxpayers differently, the constitutionality of the same must be discussed. The constitution of Kenya indicates that all persons are equal before the law and as such have the right to equal

[88] Sam A. Hicks, Choosing the Form for Business Tax Incentives, The Accounting Review, (July 1978)Vol. 53, No. 3, pp. 708-716 available at:<http://www.jstor.org/stable/245677> .Accessed: 27/09/2014 09:16

[89] In chapter three we look at incentives given in the Republic of South Korea that are aimed at specific objectives separate from ensuring the growth of medium enterprises per se.

[90] Paul Barbour, 'An Assessment of South Africa's Investment Incentive Regime with a Focus on the Manufacturing Sector'(December 2005) ESAU Working Paper 14 available at <<http://www.odi.org/sites/odi.org.uk/files/odi-assets/publications-opinion-files/2515.pdf> accessed October 5, 2014

protection and equal benefit of the law. Equality includes the full and equal enjoyment of all rights and fundamental freedoms.

In the interpretation Article of the constitution a person includes a company, association or other body of persons whether incorporated or unincorporated.[91] Taxpayers regardless of the size are persons that ought to be afforded equal treatment by the law. [92]

Article 201 of the constitution indicates the public finance system shall promote an equitable society and in particular that the burden of taxation should be shared fairly. Equity demands that that taxpayer in similar situations should be taxed in a similar manner (horizontal equity). This paper makes a case for taxation of medium enterprises separate from large and small enterprises. Since the categorisation of MEs is based on companies that have similar turnover, capital assets or number of employees they ought to be treated equally. Further those taxpayers that have different ability to pay taxes should be taxed differently. Vertical equity dictates that those with higher levels of income should pay more taxes. Medium enterprises should then pay less tax as compared to large tax payers and more taxes than small and micro enterprises.

Constitutional scrutiny should begin at the legislative objective of these incentives.[93] A tax incentive might fail to activate any constitutional restrictions for absence of strict government control over private activity, inadequate percentage of government involvement into total operating budget private entity as well as lack of a public function served by the private entity. [94] An initial constitutional analysis of tax incentives is enriching because tax incentives are viewed as government subsidies to private conduct which is economical

[91]Article 260
[92]Article 210
[93]Tax Incentives as State Action, (n 81)
[94]ibid 437

functionally equivalent to legislative provisions calculated to induce economic behaviour in the private sector.[95]

As indicated above, it is important to note that not all tax incentives may be found to activate constitutional restrictions. Tax incentives directed to medium enterprises does not compromise (horizontal) equity. This allows the tax system to treat similarly situated taxpayers the same. Where the incentives are geared towards a particular objective then it is important that the relevant policy instrument is clear on the objective of the same incentive.

2.2.2 Disadvantages of Tax Incentives

There are several disadvantages of government intervention in markets through tax incentives. Firstly, the effect of tax incentives is difficult to predict. This challenge is predicated on the fact that there are so many factors that affect the economic decisions of investors.[96] In order to compute or calculate approximately yielding reliable results it may require that all factors are held constant to gauge the benefit achieved by allowing for certain incentives. Further, it is difficult to forecast the secondary effect of incentives. Incentives have multiple effects over and above the intended objective making it difficult to evaluate.[97]

Secondly, Tax incentives increase the incentive for tax avoidance and offer opportunities for tax planning.[98] It has been argued that just like the case of large companies tax incentives may work against the desired objective. For example, tax incentives of reduced corporate rates to increase disposable income of the enterprise and thus ensure the enterprise economic growth by reinvestment. The medium enterprise may acquire a 'peter-pan syndrome to ensure

[95]Ibid 422
[96]Ralph S. Rice, 'Law Tax Reform and Tax Incentives: Law and Contemporary Problems', Vol. 34, No. 4, Tax Simplification and Reform(Autumn, 1969), pp. 782-804 Duke University School of Law <http://www.jstor.org/stable/1190911> accessed September 27, 2014
[97]ibid
[98] OECD Taxation of SMEs: key issues and policy considerations No. 18 Tax Policy Studies 97

that they maintain the classification medium enterprise and thus continue to enjoy tax incentives.[99]

Fourthly, time bound incentives such as reduced rates or tax holidays tend to attract short run projects which are typically not as beneficial to the economy as longer projects owners.[100] The duration of incentives is also prone to abuse and extension by tactful investors through creative designation of existing investment as new investment. This disadvantage should be viewed in a scale. In the case of extreme incentives such as exemption in tax holidays there is a higher risk of disadvantage as compared to other incentives such as reduced tax rates. Additionally incentives such as reduced tax rates and tax credits enjoy more transparency as it is easier to keep track of the tax payers' activity. [101] Tax holidays on the other hand may seem less costly in the administration of taxes though they may have the long term adverse effects including the loss of the taxes as well as the difficulty in tracking the affairs of the taxpayer. There is difficulty in controlling the taxpayer once the tax incentive is given.[102]

The other difficulty lies in the termination of incentives. This may be faced by the taxpayer as well as the tax administration. Taxpayers on years of enjoying tax incentives have to incur positive cost toward the compliance of taxes, the tax administration have to make arrangements toward the transition of such tax payers to the a different tax segment that enjoys different tax benefits.

From the international taxation perspective, it has been argued that tax incentives are best offered to domestic companies for example in our case medium taxpayers. When incentives

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[99] " we cannot let a child wear diapers forever" Interview with Dr. Kim, Jae-Jin ATAF-Korea Conference on "Tax Administration for the Small Medium Enterprise Development in Arica" in Johannesburg, South Africa 6, February 2014

[100] Vito Tanzi and Howell H. Zee, Tax Policy for Emerging Markets: Developing Countries, (June 2000) National Tax Journal, Vol. 53, No. 2, pp. 299-322available at <http://www.jstor.org/stable/41789458> accessed 27/09/2014 09:18

[101] ibid 317

[102] ibid

are given to foreign companies, they are wasted for the simple reason that investors from abroad are least concerned with the taxation regime in making their investment decisions. Research shows that the tax system ranks fifth or sixth among the factors that are put into consideration by investors. Additional incentives to foreign investors serve to benefit the treasury of the country of the investor as opposed to the taxpayer himself.[103] This is true in the case where income spared from taxation by the host country is taxed by the investors' home countries.

In conclusion, it is important to appreciate that the government has several alternatives to adopt in order to achieve certain objectives. In promotion of the growth of medium enterprises then the government may adopt mechanisms for financing medium enterprises or guaranteeing debts bearing of financial burdens of interests and carrying charges.[104] Tax incentives ought to be weighed against these alternatives.

Every incentive has advantages and disadvantages and it is thus extremely difficult to determine which set of incentives will work. Much of what works will depend on the circumstances of the economy, the competence of tax administration, the type of investment being incentivised as well as the budgeting constraints of the government.[105]

From the above it is clear that achieving an optimal tax system through tax policies may be impossible. However, the goals of the government may be achieved by picking the dynamic objectives of the tax policy, prioritizing, and measuring the effectiveness of such policies. Waris writes:

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[103]Look at the UN and OECD model of taxation double taxation

[104]International Finance Corporation, Telling Our Story—SMEs, Vol 5/ issue 1 2011available at <http://www.ifc.org/wps/wcm/connect/409734804c561178926edaf12db12449/TOS_SME.pdf?MOD=AJPERES> accessed 18 September 2014

[105] Paul Barbour, 'An Assessment of South Africa's Investment Incentive Regime with a Focus on the Manufacturing Sector' December 2005 ESAU Working Paper 14 available at <<http://www.odi.org/sites/odi.org.uk/files/odi-assets/publications-opinion-files/2515.pdf> accessed October 5, 2014

"It is nearly impossible to choose theoretically the best taxation system. Government has to conceptualise the various problems while working out the best possible system and will generally settle for a compromise between conflicting considerations and therefore in the end settle for a sub-optimum tax system."[106]

2.3 Market Segmentation

This research paper makes a case for taxpayers' segmentation. The distinction of different segments in the market is anchored on the need to address the heterogeneous nature of the needs of taxpayers. Let us borrow the marketing concept of market segmentation. Market segmentation is an old management strategy referring to the use of information pertaining particular market segments to design programs to appeal to that specific existing segment.[107] These strategies may be combined with other strategies such as product differentiation. Market segmentation is aimed at the precise satisfaction of the desires of consumers or users with varying wants.[108]

The process of segmentation requires adequate data collection to enable the management of a business to identify clusters of customers with similar needs. The operationalisation of the segments should be done prudently otherwise segmentation will fail.[109] Businesses are advised to ensure that segmentation is not seen as a means of curving out customers to manageable pieces but also to ensure that these needs are ultimately met. Additionally the

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[106] Attiya Waris,(n26)

[107] Peter R. Dickson and James L. Ginter, 'Market Segmentation, Product Differentiation, and Marketing Strategy' (April 1987) Journal of Marketing, Vol. 51, No. 2, pp. 1-10 American Marketing Association Article DOI: 10.2307/1251125 Article Stable URL: http://www.jstor.org/stable/1251125

[108] Wendell R. Smith, Product Differentiation and Market Segmentation as Alternative Marketing Strategies (July 1956)
Journal of Marketing, Vol. 21, No. 1, pp. 3-8: American Marketing Association Article DOI: 10.2307/1247695 Article Stable URL: http://www.jstor.org/stable/1247695

[109] Sally Dibb ,"Market segmentation: strategies for success", Marketing Intelligence & Planning,(1998) Vol. 16 Issue 7 pp. 394 – 406<http://dx.doi.org/10.1108/02634509810244390>

underlying objectives of the segmentation from a business perspective and not just the customer perspective should not be forgotten.

There is a wave in the tax administration across the globe to move customer friendly and user friendly compliance mechanism.[110] The segmentation of taxpayers in Kenya and elsewhere clearly depicts the realisation that taxpayers have different needs and as such ought to be segmented to tailor the programs of tax administration to their strengths and weaknesses. In most countries this began with the establishment of large tax payers units (LTUs) and small taxpayer's offices (STOs). In the recent past tax administrations have established medium tax payer's offices (MTOs)

Taxpayer segmentation as we see in the response from KRA improves the level of compliance by taxpayers. [111] The first step towards effective administration is the formulation of a compliance program. A taxpayer compliance program "is a high level plan which brings together in a single document a description of the most significant compliance risks identified in the tax system and sets out the broad detail of how the revenue agency intends to respond to those risks." [112] Compliance programmes are set around different taxpayer segments, the program identifying the economic, revenue and business environment of each segment and addressing the risk in each of the taxes in those segments. It is important to identify the risks of each segment and to come up with the appropriate response.[113]

In conclusion to cushion the tax administration from segmentation fail, the administration should remind its staff that firstly the taxpayers' needs just like the customers' needs ought to

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[110]OECD, Supporting the Development of More Effective Tax Systems A Report to the G -20 Development Working Group By THE IMF, OECD, UN AND WORLD BANK<http://www.oecd.org/ctp/48993634.pdf> accessed October 14, 2014

[111] Chapter three

[112] Barrie Russell, Revenue Administration: Developing a Taxpayer Compliance Program, Technical Notes and Manuals 10/17 2010 Fiscal Affairs Department International Monetary Fund(IMF)available at <https://www.imf.org/external/pubs/ft/tnm/2010/tnm1017.pdf>accessed July 20, 2013

[113]Ibid

be met. Secondly the underlying objective of taxpayer segmentation is ensuring compliance in a cost effective manner.

2.4 Conclusion

In this chapter John Maynard Keynes' theory of government intervention through tax policy has been discussed. The marketing concept of segmentation has been used to show that tax administration may segment taxpayers according to their need to ensure that their needs are fully satisfied. The merits and demerits of tax incentives are highlighted.

The Keynesian theory indicates that indeed the government has a role to play to ensure that not only growth of economy is achieved but also other objectives such as promoting research and development are realised. Tax policy that is economically efficient can be an instrument of reform through incentives. Medium enterprises should be given benefits to assist in mitigating the adverse market effects. The tax administration ought to look at taxpayers as customers and therefore tailor their services to suit the special circumstances of medium enterprises.

Having laid a theoretical foundation of incentives to MEs in the last two chapters, the next chapter discusses the legal and administrative framework of medium enterprises.

3 CHAPTER THREE: A COMPARATIVE ANALYSIS OF THE LEGAL AND ADMINISTRATIVE INCENTIVES TO MEDIUM ENTERPRISES IN KENYA AND THE REPUBLIC OF KOREA

In this chapter I discuss the taxation regime of medium enterprises in Kenya and the Republic of South Korea. Appreciating the historical perspective of tax reform in the South Korea I begin with the operative definitions in the two countries. The statutory incentives enjoyed by medium enterprises in Kenya and South Korea are then discussed.

The Republic of Korea (herein after referred to as South Korea) has been labelled the 'miracle of han river' for its rapid economic growth over the past five decades.[114]South Korea has moved from poverty of majority of its populations and dependence on foreign support to being ranked the fourteenth in the gross domestic product (GDP) ranking by World Bank in 2013.[115] Just like in Kenya the journey of independence and economic growth began in the 1960s.[116] Today the populations of the two countries are almost the same between (approximately 50 million[117]), the land area of Kenya (582,650 km²) is five times that of South Korea (100,210 km²) but there is a huge gap in the level of economic development.[118] South Korea has through its tax policy ensured growth of its economy among other objectives. Further, I interrogate the tax administration of the medium taxpayers. Here the support mechanisms available to MEs are discussed. I also report on the insights of the tax administration on the benefits and challenges of setting up the medium taxpayer's office (MTO). The information here is derived from interviews conducted at the MTO as well as

[114] UK Heo, Houngcheul JEON, Hayam KIM and Okjin KIM, The Political, Economy of South Korea: Economic growth, Democratisation and financial crisis. Contemporary Asian Studies Series

[115]<http://databank.worldbank.org/data/download/GDP.pdf> accessed October 2014

[116]Korea gained independence in 1945 from Japanese rule.

[117]http://data.oecd.org/korea.htm&<http://data.worldbank.org/country/kenya>

[118]Kenya is ranked 87 in the world bank ranking by gross domestic product in the year 2013<http://databank.worldbank.org/data/download/GDP.pdf> accessed October 14, 2014

responses to a questionnaire investigating the revenue collection of the MTO and other benefits to medium taxpayer.[119]

3.1 A Historical Perspective of Tax Incentives in South Korea

The South Korean tax system has undergone reform since the first military rule in 1961.[120] The focus of reform in the initial stages was on enforcement and implementation of the system, this included simplifying tax administration and intensifying the punishment for delinquency and providing incentives for book keeping and voluntary compliance.[121] This was followed by the need to drive the country to self-reliance by creating export oriented industrialisation.[122] In the 1970s there was increased concern in the redistribution and the pursuit of equality and imparting of a political calculation that was geared towards pacifying the public. In the 1970s consequently there were incentives to heavy industrialisation and incentives for the export industries.[123]

In the 1980s, there were conscious steps made towards an ideal system of fairness and efficiency. Incentives on research and development and investment to small and medium enterprises began in the 1980s.[124] South Korea, being one of newly industrialised economies, together with other Asian countries such as Hong Kong and Singapore and beyond such as Mexico are diverting attention to the development and nurturing of medium enterprises. These countries are shifting their expansion to locally grown enterprises as opposed to foreign investment.[125]

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[119]Interview at the MTO official one and two and Questionnaire (appendix A)
[120] Uk Heo et al (n152)
[121] Taewon Kwack, Kye-Sik Lee Tax Reform in Korea <http://www.nber.org/chapters/c8515> in Takatoshi Ito and Anne O. Krueger, editors, University of Chicago Press Volume ISBN: 0-226-38667-8 <http://www.nber.org/books/ito_92-2> 117 – 136, 118
[122] ibid
[123] ibid
[124] Jong Guk SONG, The impact of fiscal incentives for R&D investment in Korea available at <http://www.oecd.org/sti/inno/40023738.pdf>
[125]Jang-Sup shin & Ha-Joon Chang, *Restructuring Korea Inc, (2003)* Routledge Curzon Taylor & Francis e-Library.

The promotion of (Small and) medium enterprises has been part of the Koreas economic policy since the 1960s. According to the Small and Medium businesses administrator, SMEs account for 99% of all the firms in Korea and provide approximately 88% of the employment in the country.[126] Presently the tax regime ensures that there are numerous incentives to medium enterprises.

The constitution of the Republic of Korea indicates that the economy order should be based on a respect for freedom and creative initiative of enterprises and individuals in economic affairs. The state in this regard is required to coordinate the economic affairs and ensure that there is no domination of the market. The need to protect and foster small and medium enterprises is recognised in the constitution giving this duty to the state.[127]

3.2 Definition of medium enterprises for taxation purposes

KRA has developed a separate definition used in segmenting the taxpayers in Kenya. The criterion used is turnover as opposed to number of employees. Medium enterprises not only include corporations but also high net worth individuals (HNWI) and professionals; government agencies and nongovernmental organisations (NGOs). The Medium Taxpayers' Office in Kenya serves enterprises with turnover of 350million to 750 million shillings.[128]

Three reasons are given for the choice of the turnover in setting apart medium taxpayers.[129] Firstly, the criterion for turnover identifies those taxpayers who do not qualify to be in Large Taxpayers Office, but whose business enterprises deserve attention with regard to revenue monitoring, compliance support and specialized services. Secondly, this classification enables the tax administration to give better and specialized attention to excise manufacturers. Lastly

[126]The Small and medium administrator is a separate vice-ministerial-level organisationand put it in charge of the new, comprehensive scheme to promote SMEs. <www.smba.go.kr/eng/introduce/greeting.do?mc=usr0001702n> accessed october14, 2013

[127]The Constitution of the Republic of Korea, Article 123

[128]<http://www.kra.go.ke/index.php/domestic-taxes/medium-taxpayers-office/about-mto> accessed January ,17 2014

[129]Kenya Revenue Authority, Questionnaire (see appendix A)

it ensures better and efficient service to a select group of taxpayers who contribute a significant portion of tax to Domestic Taxes Department (DTD).It is important to note that one official of KRA indicated that the MTO was not serving medium enterprises in the generic segment of SMEs. The interviewee was of the view that the medium enterprises were served by the General Domestic Tax Department.[130]

On asking the awareness of the incongruity in the definition of medium enterprise with other policy instrument, the KRA responded in the affirmative. They confirmed that classification may be dependent on the scale of operations, investment outlay or the number of staff. Turnover however offers the best classification for tax purposes to monitor compliance of taxpayers.[131] Further, turnover formed the most logical criteria as the LTU which was established earlier on was segmented based on the turnover.[132]

In Korea there is a universal definition for tax purposes and other objectives provided under statute. The oldest statute governing medium enterprises is the Framework Act on Small and Medium Enterprises (FASMEs).[133] The act provides for the fundamental matters pertaining to the direction in which the medium enterprises sector is to advance as well as measures to be taken to develop these enterprises.[134] The act provides for criteria to be used in identifying the medium enterprises that are eligible for policies on development of medium enterprises. These are the number of regular workers, capital, sales or total assets for the relative industries as specified by a presidential decree. Secondly these enterprises must have actual independence of ownership and management such as ownership of shares or an investment relationship meeting the standards specified by the presidential decree.

[130]KRA official, Interview two(anonymous)
[131] KRA, Questionnaire appendix A
[132]ibid
[133]Act no. 1840, Dec 6, 1966
[134]Article 1

The presidential decree attached to the Framework of SMEs act is the Enforcement Decree of the framework Act (EDFASMs) on small and medium enterprises. The decree requires that the administrator of the small and medium enterprises to identify whether a business falls under the scope of the medium business and should annually announce the list posted in the administration website of business entities that fall under the category of medium enterprises. The decree gives the upper cap of the classification of a medium enterprise. These are firms that employ 1000 and below employees, with total assets of below 500 billion won. Additionally the sales immediately preceding the 3 business years is less than 150 billion won and the business entities whose equity capital is less than 100 billion won.

Table 1 of the FASMES provides for the criteria of MEs per sector using the number of workers and the capital or sales. The figure below indicates the description of medium enterprises in South Korea. This is obtained from the Small and Medium Administration (SMBA) in South Korea however only relating to medium enterprises has been extracted.

Figure 2: Republic of Korea, Criteria of SMEs

Sector	**Medium enterprises**	
	No. of workers	**Capital or Sales**
Manufacturing	Fewer than 300 More than 50	Capital worth 8 billion won or less
Mining, Construction and Transportation	Fewer than 300 More than 50	Capital worth 3 billion won or less
Publication, Information and Communication, Administrative and Support Service Activities, Human health and social work activities, Professional scientific and technical activities	Fewer than 300 More than 10	Sales worth 30 billion won or less
Agriculture, forestry and fishery, Electricity, gas, steam and waterworks business, Wholesale and retail trade, Accommodation and food service activities, Financial and insurance activities, Arts, entertainment and recreation	Fewer than 200 More than 10	Sales worth 20 billion won or less
Sewerage, waste management and remediation activities, Education, Repair and other services	Fewer than 100	Sales worth 10 billion won or less
Real estate, rental and leasing activities	Fewer than 50	Sales worth 5 billion won or less

Source: The Small and Medium Business Administration (SMBA), Republic of Korea

http://www.smba.go.kr/eng/smes/scope.do?mc=usr0001146

In an interview with Dr Jae Kim a tax expert in South Korea on what to consider in the choosing the criteria of segmentation he indicated that four things should be considered.[135] First, the questions of equity, second the flexibility of the criteria, the policy targets by the state and the context in terms of the level of the development of the country.

Other countries in Africa also have distinct definitions of medium enterprises. In Ghana, the criterion used is also turnover of the enterprise. By order of the Commissioner-General of the Ghana Revenue Authority taxpayers are divided into three segments: the large medium and small tax payers. The criterion for medium taxpayers includes those taxpayers with annual turnover above ninety thousand Ghana Cedis (GHS) 90,000.00 (KSH2.5 million) but below five million Ghana Cedis (GHS) 5 million (KSH 199 million). [136] The turnover limit is below that of Kenya.

3.3 Taxation Regimes for Medium Enterprises

In this section the legislative framework that governs taxation of the medium enterprises in Kenya and South Korea is discussed. The specific tax incentives are discussed enjoying the next section. It is important to note from the beginning that the taxation regime in Kenya is not tailored to treat medium enterprises preferentially.

The government of South Korea has enacted various statutes governing the framework of medium enterprises. Though the legislative instruments apply to small and medium enterprises there is sufficient clarity from the reading of the law on the regime that medium

[135]Interview with Dr Kim, Jae-Jin, Director , Research Group for Taxation, Korea Institute of Public Finance at the ATAF-Korea Conference on “Tax Administration for the Small Medium Enterprise Development in Arica” in Johannesburg, South Africa 6, February 2014

[136]The small taxpayers include those Taxpayers with an annual turnover of Ninety Thousand Ghana Cedis (GHS) 90,000.00 and below. <http://www.gra.gov.gh/index.php?option=com_content&view=article&id=56>accessed January16, 2014

enterprises fall under. In this section an overview of the taxation framework medium enterprises in Kenya and small and medium enterprises in Korea taxation highlighted.

Medium enterprises in Kenya are subjected to various taxes. The types and rate of taxes paid or remitted by medium enterprises depends on the structure of the medium enterprise. For instance the taxes paid will depend on whether the enterprise is a sole proprietorship, partnership, company, insurance company or venture company.

Income tax is provided under the Income Tax Act.[137] The total income relevant to the imposition of taxes is calculated by deducting all expenditure incurred in that year of income which is expenditure wholly and exclusively incurred in the production of that income.[138] Income tax is imposed on gains, profits, dividends, interest, withdrawals from and payments from a registered pension fund. Since 2013 income tax is imposed on the amount or value of the consideration from the sale of property or shares in respect of oil companies, mining companies or mineral prospecting companies.[139] Corporation tax is levied on companies that are incorporated or registered in Kenya or elsewhere.[140] Corporation tax is levied at the rate of 30% for domestic businesses and 37.5% for foreign business since the year 2000. [141] Partnership income is not taxable for income tax purposes; the share of partnership income is taxable in the hands of the partner at the prevailing individual income tax rates.[142]

Employment income is paid through a system referred to as Pay as you earn (PAYE). Here an income tax that is paid by employee but remitted to the revenue authority by the employers.

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[137] Chapter 470 Laws of Kenya
[138] Income tax Act, Section 15(1)
[139]Finance Act 2012
[140] Income tax is levied on different bases/ income including income from employment, income from the use of property, income from dividends, income from pensions, income of certain non-resident persons deemed derived from Kenya, income from management or professional fees, royalties, interest and rents Trust income, etc. deemed income of trustee, beneficiary. Section
[141] Third Schedule of the income tax act
Under Section 2 of the Income Tax Act Business includes any trade, profession or vocation, and every manufacture, adventure and concern in the nature of trade, but does not include employment;
[142]Section 3(3a) of the Incomes Tax Act

The monies are remitted to the tax authority in the prescribed procedure on or before the end of the following month of income. A graduated rate is levied depending on the level of income. Self-employed persons pay tax as individuals.

Withholding tax relates to certain prescribed income. The rate of taxation is different for each type of income. Different rates are charged for resident and non-residents persons. Withholding taxes are charged on royalties, dividends interest housing bond interest two year government bond interest, other bearer bonds interest, consultancy and agency fees, contractual fees, insurance commissions and income of ship owners. In the case of non-residents the tax is on the gross amount without allowing any expenses.

Excise duty is imposed on goods manufactured in Kenya or imported into Kenya. The tax is imposed under the Customs and Excise Act.[143] Under the act import duties are charged in respect of the goods imported into Kenya at the respective rates.[144]Additionally, suspended duties are in respect of specified goods which are imported into Kenya.[145] Export duties are levied in respect of the goods exported out of Kenya. Excise duty is charged in respect of excisable goods and services at different rate ranging from 5 to 100%.[146] Dumping duties are imposed on goods dumped in Kenya as the cabinet secretary in charge of finance may prescribe from time to time.[147]

The value of goods for which excise duty is levied depends on whether the goods are imported or manufactured locally. In the former it is the sum of the value of such goods and the amount of import duty, suspended duty and dumping duty. In the latter the ex-factory

[143]Chapter 472, Laws of Kenya
[144] First Schedule. fifth column specifies the rates of duty
[145]Second Schedule
[146]Fifth schedule
[147]Section 125A

price is used. This is in exclusion of the value added tax, the cost of excise stamps and the cost of any returnable packaging material.[148]

Value added tax (VAT) is a consumption tax in Kenya is imposed under the VAT Act 2013. It is imposed on supplies made in or imported into Kenya. VAT is at the rate of 16% but may go up to 25% VAT is paid by business whose taxable supplies are 5million Kenyan shillings or more in any period of twelve months. Where turnover of a business falls below this mark then one can apply for cancellation of registration within 30 days.[149] Failing to register for VAT if one qualifies for the same is an offence.[150]

There are other taxes levied in Kenya that medium enterprises may be required to pay. These include advance tax, fringe benefit tax, telecommunication tax, entertainment tax. Advance tax is levied under the income tax act and is levied in respect of every commercial vehicle,[151] fringe benefit tax is paid by every employer in respect of a loan provided at an interest rate lower than the market interest rate, to an individual who is a director or an employee or is a relative of a director or an employee, by virtue of his position as director or his employment or the employment of the person to whom is related.[152] Telecommunication tax is taxed in respect of the hire of telecommunications apparatus from, the licensing of such apparatus by, and the use of such apparatus in the provision of telecommunications services.[153] The highest revenue is collected from income taxes with VAT a close second in with slightly have as much revenue collected.[154]

[148]Section 127C
[149]Section 36
[150]Section 38
[151]Section 12A
[152]Income tax act section 12B
[153]Telecommunication tax act section 3
[154]Data from Kenya revenue Authority , Medium tax payers office (2014)

In South Korea various taxes are imposed on small and medium enterprises. These include income taxes imposed on individuals, corporation taxes on corporations,[155] value added tax at the rate of 10 percent,[156] individual consumption tax, import surtax and stamp tax. Other taxes include education tax; traffic, energy and environment tax, inheritance tax and gift tax act; gross real estate tax; liquor tax act and securities transaction tax.

Taxes are collected under the national Tax Collection Act and the Enforcement Decree of the National Tax Collection Act. Tax offenders are punished under Tax Evaders Act which gives the punishment for offences such as interfering with sincere returns, failing to issue tax invoices, illegal use of tax stamps and failing to collect withholding taxes

The national government and the local governments have the duty to ensure that small and medium enterprises are assisted through the taxation policy in situations where there are changes in the economic environment to enhance their competitiveness and upgrade their industrial structure.[157] The local tax act allows local governments to impose and collect certain taxes. This includes acquisition tax and property taxes levied on acquisition of assets such as land, ships, mining rights, aircrafts, housing and buildings; registration and licence tax , leisure tax, tobacco consumption tax, inhabitant tax, income tax, automobile tax, regional resource facility tax as well as local education tax.[158] The local taxes are earmarked taxes.

[155]Corporation tax is imposed under the Corporation tax Act. It is imposed on income from each business year; it is also levied on liquidation income as well as capital gains. The tax regime (rates and incentives) is different for domestic corporations, liquidation income and foreign corporation for each business yearChapter II III IV respectively

[156]Value added tax act, Article 30

[157] Special act on the promotion of business conversion in small and medium enterprises Art No. 7866 2003 Article 29 ^ article 111 on the tax rates

[158]Act on the adjustment, ETC of the national and local taxes

3.4 Tax incentives to medium enterprises in Kenya and South Korea

In Kenya, there are no specific incentives given to medium enterprises. However, there are incentives that are enjoyed across the board which medium enterprises may take advantage of. As indicated in chapter one, small enterprises enjoy incentives that are not enjoyed by medium enterprises.

On the other hand in South Korea specific incentives are given to small and medium enterprises. The FASMEs gives the duties of the government and SMEs which informs the tax incentives available to SMEs. The central government ought to establish and implement a fundamental and comprehensive policy for SMEs that fits the peculiarities of each region while considering the innovative capacity, competitive level and the growth potential of the medium enterprises.[159]These duties apply *mutatis mutandis* to the local government. The two governments are required to cooperate on these policies and endeavour to maximise support for medium enterprises. Incidentally, SMEs are required to achieve competitiveness through technical development and management innovation.[160] They ought to contribute to the national economic development and increase in national welfare by practicing transparent management. This is relevant in compliance of the tax laws.

The government is required in its policies to ensure internationalisation by facilitating the promotion of exportation and importation by medium enterprises and cooperation with foreign companies.[161] An ombudsman program headed by the ombudsman for SMEs is established under the FASMEs providing for a mechanism to facilitate the maintenance of the regulations affecting medium enterprises.[162] In 2011 in the spirit of promoting medium enterprises an amendment in the act provides for a (small and) medium business week that is

[159] FASMEs, Article 3
[160] FASMEs, Article 4
[161]FASMEs, Article 14
[162] Article 22

designates to small and medium enterprises for awareness and appreciating their importance.[163]

The restriction of special taxation act provides an extensive description of incentives available to the SMEs.[164] The purpose of the act is to contribute to the sound development of national economy by ensuring fair taxation and efficiently implementing tax policy through prescribing matters of special cases of taxation.[165] Therein it is also for certain restrictions in taxes in special cases.

The restriction of special taxation act is geared towards ensuring that there is sound development in the national economy by ensuring fair taxation and efficiency in the tax policy. This is through prescribing matters concerning special cases of taxation such as tax deductions, tax exemptions and limiting heavy taxation.

3.4.1 Tax Deductions

Tax deductions are subtracted from the gross income to compute the taxable income. In calculating the gains and profit of a person no deductions should be made if the same is of a capital nature. In Kenya, the Income Tax Act allows for capital deductions to encourage new industrial enterprises as well as allowing for deductions to represent the diminution in the value of fixed assets by reason of wear and tear.[166] There are five available deductions in Kenya that medium enterprises may enjoy. First, Industrial building allowance is an allowance claimed in respect of capital expenditure (and not the cost of construction) on building used for specific industrial purpose, buildings in use for the welfare of workers as well as some qualifying hotels. Second, wear and tear allowance is an allowance in respect to

[163] FASMEs Article 26
[164] Act no 5584 Dec 28 1998
[165] Article 1
[166] Income Tax Act, Second Schedule

the depreciation of plant and machinery used in a business.[167] This deduction is allowed at different rates of four classes of plant and machinery ranging from 37.5% to 12.5%. The allowance is only on qualifying cost less the qualifying disposal value of assets sold.

Investment deductions is a one off claim granted in the year an asset is first used based on the cost of building and machinery. It is allowed in ordinary manufacture investment.[168] It is also granted in relation to manufacture for export. Shipping investment deductions are granted to resident ship owners on the purchase of new unused power driven ships of a specified weight.

Capital allowance is given in respect to mining operations on capital expenditure incurred in searching for and discovery of, testing or winning access to minerals. Mining allowances are also allowed on the acquisition of patent rights and building machinery and other works.

In South Korea, tax deductions are allowed not only to SMEs but to businesses that support SMEs. he Restriction of Special Taxation Act provides that a deduction is available to any national enterprise that donates a facility such as an automation facility that has been in use for his or her own business to a (small and)medium enterprise. The deduction is also to nationals that transfer the same facilities at a price lower than the fair market value. The enterprise deducts from its gross profits the market price of the facility in case of a donation or the difference of the market price and purchase price by the medium enterprises where the facility is sold at a price lower that the fair market value.[169]

Under the Inheritance Tax and Gift Tax Act, small and medium enterprises enjoy a larger basic deduction for family businesses ran by ancestors for ten years or more.[170] While other enterprises are allowed to deduct a flat amount of 200 million won the small and medium

[167]Second Schedule, paragraph 1
[168] Second schedule, Paragraph 24
[169]Article 8
[170] Act no.5193 of 1996(amended) Article 18

enterprises are allowed to deduct the larger between the 200 million won or 40 percent of the value of the property inherited. If this amount exceeds six billion won then the ceiling for a business that has run for more than 15 years is eight million and for business ran for more than 20 years is ten billion.

3.4.2 Reduced tax rates and tax reductions

In Kenya, newly listed companies listed in an approved securities exchange are entitled to reduced tax rates. [171]If the company has at least thirty per cent of its issued share capital listed then corporation tax is paid at the rate of twenty-five per cent for the period of five years commencing immediately after the year of income following the date of such listing. Where at least forty per cent of its share capital listed, the rate of tax is twenty per cent of the period of five years commencing immediately after the year of income following the date of such listing. The corporation rate of tax of an export processing enterprise is twenty-five per cent for the period after the tax holiday.

In South Korea, similar tax reductions are available to specifically to SMEs. To reduce congestion, a start-up enterprise (SME) established in an area outside the overconcentration control region of the Seoul metropolitan area is granted a tax reduction of an amount of tax equivalent to half of the corporate tax or income tax on income accrued from the relevant business during the period from the taxable year in which income has accrued for the first time from such a business.[172]This incentive is not available to enterprises that are succeeded by a merger, division, and investment in kind or an acquisition if at all the assets of the new company are more than fifty percent of the start-up. Other start-ups that do not qualify include new corporations founded on conversion to a corporation from a business ran by a

[171]Republic of Kenya, Income Tax Act, third schedule of the
[172] Republic of Korea, Restriction of Special Taxation act, Article 6

resident, businesses of the same type as the one before its closure in conducting business again after closure.

A similar reduction is given to SMEs that are certified as venture businesses established no later than December 31, 2015. [173] The incentive is enjoyed by the enterprise for five years in total. The five years begins from the year where income has accrued. Once the certification is revoked then the enterprises cannot enjoy the tax reduction. The reduction applies to enterprises in certain businesses such as mining manufacturing, broadcasting and computer programming.

There is a third reduction that is given to medium enterprises engaging in specified businesses. Here unlike the two reductions already mentioned the rate of reduction is graded different from that of small enterprises. The businesses that enjoy this reduction are listed in the law.[174] There are three relevant to medium enterprises. Firstly, a tax reduction ratio of 5/100 is given to enterprises whose place of business is in an area other than the Seoul Metropolitan area. Secondly for enterprises that run a knowledge based business then the tax reduction is at the ratio of 10/100. Thirdly enterprises enjoy a reduction of the ration 13/100 if the business is located outside the Seoul metropolitan area. An incentive was available to medium enterprises operating petroleum distribution business. The product supply contract entitled the enterprise a tax reduction at equivalent to 20 percent of the income or corporate tax till December 31, 2013

At the local government level medium enterprises which purchase parcels of land in a knowledge industry centre shall be considered as a first purchaser and hence pay a tax after a

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[173] ibid
A venture business is defined under Article 2=2 of the Act on the special Measures for the Promotion of Venture Businesses and may be an investment company or association.
[174] Republic of South Korea, Restriction of Special Taxation Act, Article 7(1)

75% reduction of the acquisition tax. Knowledge centres are established under the industrial cluster development and factory establishment.

3.4.3 Tax credits

The Restriction of Special Taxation Act provides for tax credits to small and medium enterprises for investment. This applies to a national-operating SME making investments in business assets, facilities for the point-of-sale data management system and facilities for information protections system of which the depreciation period is two years or longer. The enterprises make a deduction of 3/100 of the amount of investment concerned from income tax or corporate tax for the taxable year when the investment was completed. Tax credit is also given to enterprises that invest in supporting projects of formalisation of medium enterprises through facilities for enterprise resource planning and facilities for electronic commerce.

Until December 2013, a tax credit was given in order to improve the corporate payment system. A tax deduction is made in the case where the amount of certain transactions is included in the purchase price. The amount deducted is calculated using specific formulas provided under Article 7 Restrictions of Special Taxation Act.

SMEs are awarded a tax credit on income tax or corporation tax at ratio of 30 percent on the amount spent in research and development expenses. This is higher than the ratio of 20 percent that is allowed for large enterprises. Where the general research and human development expenses occurs in the relevant taxable year exceeds the average annual amount of general research and human development occurred in the immediately presiding taxable year then an amount equivalent to half the excessive amount forms the tax credit for the relevant year.

Under article 144 of the Restriction of Special Taxation Act tax credits above are carried forward in instances where there was no income by the national or the level of income was less than the minimum corporate tax of minimum income tax. This is carried over to each taxable year ending within five years from the starting day for the taxable year next to the relevant year. The procedure and requirements for applications for the credit are made as prescribed under the enforcement decrees of the respective acts

3.4.4 Tax deferment

In South Korea, the Corporation Act indicates that where the amount is tax payable by a domestic corporation exceeds 10 million won then while other enterprises are allowed to pay the amount in instalment within one month; SMEs are to pay the amount within an extended period of two months from the day of tax deadline

3.4.5 Tax holidays

In Kenya, a ten year tax holiday is given to a export processing zone enterprise which does not engage in any commercial activities commencing with the year in which production, sales or receipts relating to the activities for which that enterprise has been licensed as an export processing zone enterprise commence;.[175]

A note should be made on the need for incentives whose clear objective is not just to ensure the growth of medium enterprises but also to ensure other social problems are resolved. For example tax incentives mentioned above encourage research and human resource development. Additionally through incentives large enterprises are encouraged to work with the medium enterprises through win-win collaborative schemes that ensure that these large enterprises enjoy certain incentives.

[175] Provided that for purposes of this subparagraph, "commercial activities" includes trading in, breaking bulk, grading, repacking or relabeling of goods and industrial raw materials.

There are two other examples to learn from indicating how incentives to medium enterprises assist the government in achieving certain objectives in South Korea. Firstly in the case of youth empowerment, where youths are employed by small and medium enterprise from January 2012 through December 31, 2013 the amount of tax equivalent to 100 percent of the income tax was exempted with respect of the income earned from SME.[176]

Secondly, there are incentives to ensure employment by small and medium enterprises. This is addressed at the local government level.[177] The local governments are required to allow deductions in the taxes paid by small and medium enterprises that have employees in excess of fifty. The amount deducted is calculated by first obtaining the difference in the number of employees in the month a return is filed and the number of average monthly employees in the immediately preceding year. This difference is then multiplied with the amount of monthly wages applicable. Where an entrepreneur establishes a new place of business and the employees exceed fifty persons then the amount of monthly wages applicable is calculated by dividing total amount of wages in the month a return is filed by the number of employees in the month of return.

3.5 Tax Administrative Framework for Medium Enterprises in Kenya

The tax regime in Kenya is administered by the Kenya Revenue Authority (KRA). The authority was set up as a semi-autonomous corporate body for the administration and enforcement of the laws relating to revenue. [178]The setting up of the Medium taxpayers' office was an administrative initiative by the KRA in its fourth corporate plan.[179] The office was established in November 2010. The setting up of the medium taxpayers office was informed by firstly, the need to improve service options to the taxpayer and to adhere to the

[176]Republic of Korea, Restriction of special taxation Act, Article 30
[177]The Local Tax Act article 101-2
[178]Republic of Kenya, The Kenya Revenue Authority Act Chapter 496 laws of Kenya.
[179] Kenya revenue authority fourth corporate plan 2009/10-2011/12

taxpayer charter which spells out the tax payer rights and obligations. Secondly, the success in terms of increased revenue collection and improved service delivery at the Large tax payers office made a case for further tax segmentation and so the MTO was set up to replicate the success of the LTO.[180]

The MTO serves enterprises with turnover of 350million to 750 million shillings. [181] This criterion is not strict as the office serves enterprises with up to one billion shillings in turnover.[182] The reason given for such leeway is that the capacity of the LTU is exhausted even as medium enterprise continues to grow reaching the LTU segment criterion. The limits of the criterion of turnover are to have a sense of which taxpayers can be served by the MTO.[183]The benefits envisioned to the medium tax payer include the provision of quality KRA services in a consistent manner, minimization of compliance cost, and enhancement of customer service as well as cultivating relationship management that caters to the taxpayer at a personal level.

In responding to the need to have the Medium Taxpayers Office the authority indicated that first the medium taxpayers make a significant contribution to the tax revenue.[184] Further, taxpayer segmentation has allowed for taxpayer compliance monitoring at an industry-specific sector level. It has enabled the Tax Authority to have dedicated personnel who understand the sector issues, challenges, and revenue potential. Lastly, taxpayer segmentation has enabled the Authority to be more responsive to changes in the taxpayers operating environment.

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[180]The Large Taxpayers Office (LTO) was formed as an operations unit in 1998 to provide one-stop shop services in the administration of Income Tax and VAT matters affecting large taxpayers. The office serves enterprises with a turnover of more than 750 million.<http://www.revenue.go.ke/lto/lto.html> accessed 17 January 2014

[181]<http://www.kra.go.ke/index.php/domestic-taxes/medium-taxpayers-office/about-mto> accessed January ,17 2014

[182] Kenya Revenue Authority Interview official one Nairobi, January 26, 2014) hereafter referred to as Kenya Revenue Authority Interview official one

[183] ibid

[184]Kenya Revenue Authority Questionnaire : appendix A

In addition to medium taxpayer the MTO also collects taxes from specialized sectors. This includes medium sized airlines and floriculture firms. The office also collects excise taxes. The MTO also administers the taxpayers from linked affiliates, subsidiaries, holding Companies, associate companies and partners. The rationale to attend to these sectors as indicated by the MTO is that there is need for specialized attention to excise manufacturers. The attendance of the other companies allows for better and efficient service to a select group of taxpayers who contribute a significant portion of tax to Domestic Taxes Department.[185]

The medium taxpayers are divided into four sub segments/ sectors. These are not related to the size but are industry specific. The agriculture and Manufacturing sector, the distributors sector, the finance, construction, government & insurance sector and lastly the services sector.[186]KRA through this sectorisation aspired to be more responsive to the taxpayers needs by understanding the operating environment. The MTO plans to divide the office into eight sectors. These are agriculture, manufacturing &excise, services; distributors and logistics; government, Non-Governmental Organisations (NGOs) & financial service/ insurance; construction and real estate; High Net worth Individuals (HNWI) & professionals, and transfer pricing. Transfer pricing sector will be for **audit only.** Within these sectors there will be a total of 26 sub- sub segments.

3.5.1 Support mechanisms for medium taxpayers

The KRA has an online system that facilitates self-assessment of the monthly and annual tax obligations. This system is called iTax. It works through a simple and secure internet based interface. The system eases congestion and the pressure on tax payers to file tax returns manually. It also creates an environment of transparency and integrity.

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[185]Questionnaire see appendix A

[186] There are a total of 1530 registered medium tax payers 356, 313, 299 and 562 taxpayers respectively as at January 2014.Kenya revenue Authority: official one.

To ensure that taxes are filed online more readily, the KRA has dedicated staff to assist taxpayers who may have difficulties operating the online platform. The authority also invests in account management ensuring personalized support for all tax payers should the need arise. There are constant weekly trainings going on at the KRA head offices to improve the online tax payer's proficiency at using the system. Finally, there are support centres country-wide that serve taxpayers facing any complications with the online system.

Research[187] shows that most Medium Enterprises meet their tax payment obligations on time. Only about 10% of these firms pay past the due date. Constant contact between the tax payer and tax authority and compliance monitoring facilitate timely tax payment. It is noteworthy that while manual payment of tax takes about four hours, online processing and payment takes only two hours. Therefore payment of taxes through an online system is not only more effective when it comes to the number of firms meeting their tax obligations it also halves the time spent meeting these obligations.

Where disputes arise from in depth audits or compliance checks, the matters can be referred to the Local Committees for income tax issues and to the VAT Tribunals. The KRA has established other technical units within each section for handling of disputes before they are submitted to the appeals body. These technical forums are also held at the head office level to discuss issues arising from grey areas in the law and also to discuss and agree to a common ground for areas under dispute.

There are numerous support mechanisms established jointly by the government and the KRA to encourage tax compliance by medium enterprises. These mechanisms include relationship management which ensures any issues the taxpayer faces are solved on an individual basis. A

[187] Section 4, KRA Questionnaire one

compliance monitoring template is in place to ensure all taxpayers have paid their taxes. Finally taxpayer training enhances their knowledge on tax matters.

The implementation of these support services is enlightening as regards the taxation of medium enterprises. The implementation of these mechanisms suggests that tax compliance levels can be increased with close attention being given to taxpayers. It also suggests that relationship management enhances tax knowledge among the taxpayers and that segmentation is vital for greater focus to be achieved.

3.5.2 The Medium Tax Office: achievements

The MTO has experienced success in ensuring high voluntary compliance though improved feedback systems and continuous support. It has continued to have a close relationship with taxpayers through industry association and tax professionals. As indicated in chapter one the revenue potential of medium enterprises must not be overlooked.[188]The medium taxpayers' office has been a success in meeting its target as provided by the Ministry of Finance. The MTO has been meeting its targets and even surpassing the targets for revenue collection in some cases. The figure below shows a graph indicates the revenue collected as compared to the revenue target showing modest variance in favour of the revenue collected by the MTO.

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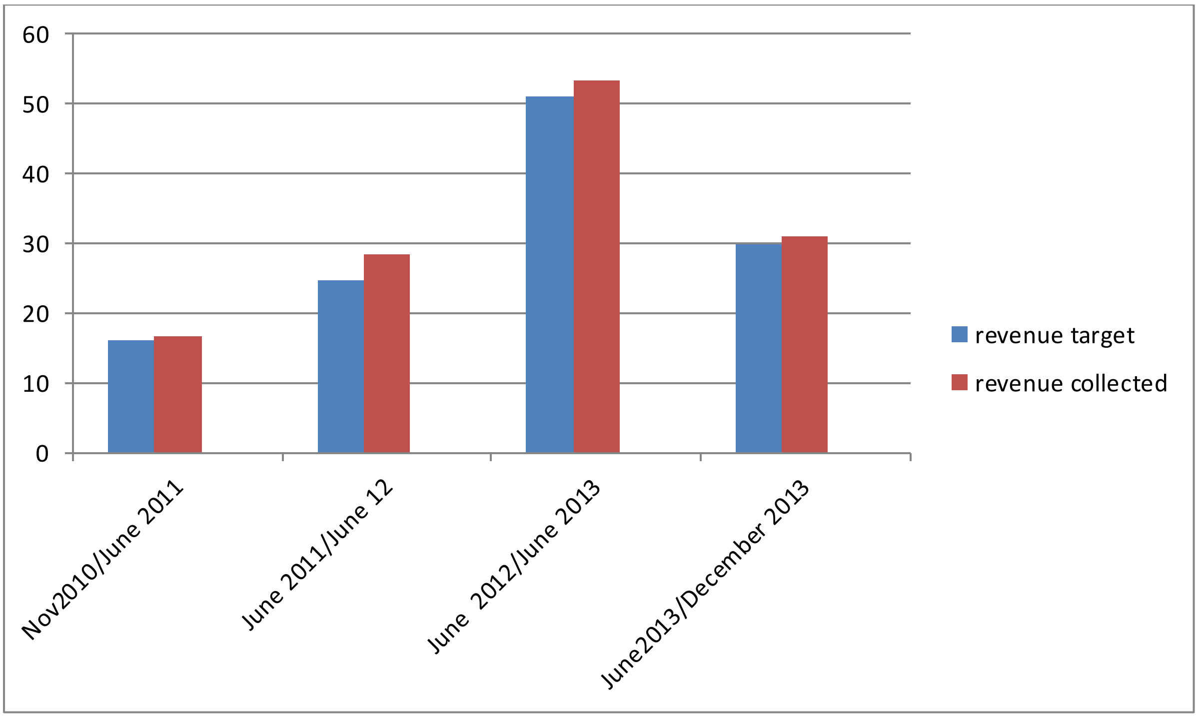
[188] See Seth Terkper,(n21) Chapter one 29

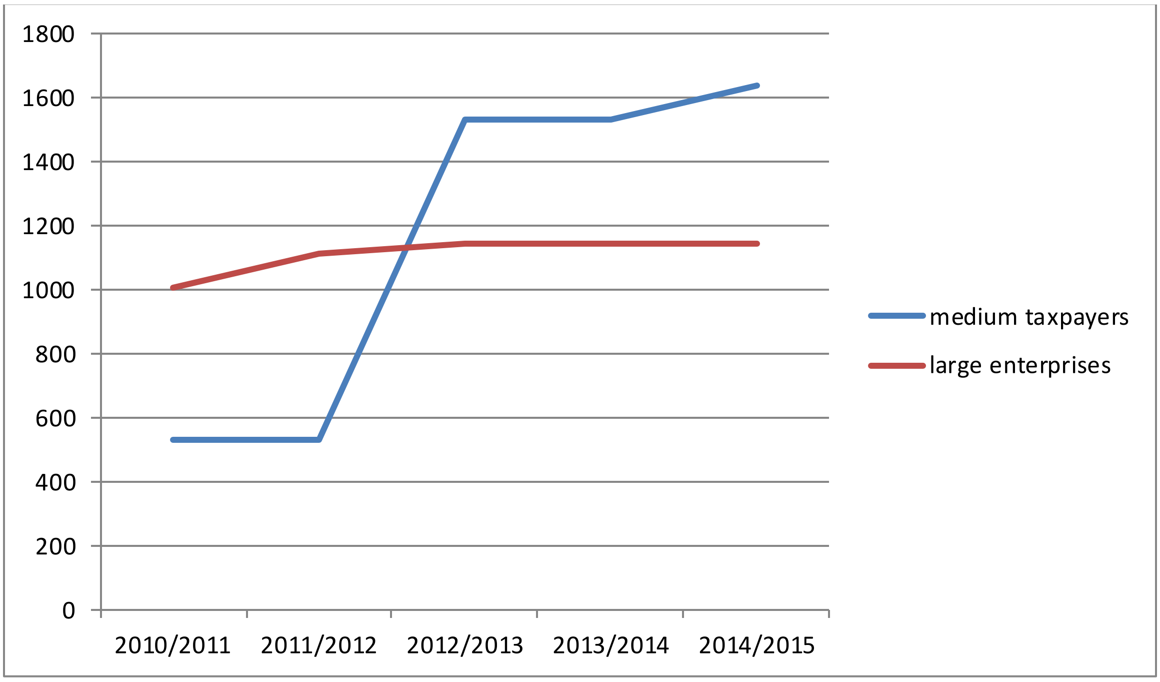
Figure 3: Revenue target and revenue collected by the Medium Tax Office from November 2010-2013 in billions (Ksh)



Source: The Kenya Revenue Authority (2014)

The figure below shows the number of taxpayer registered in the MTO has also increased over the three and a half years of its existence. Their number has increased to surpass the large taxpayers registered in the LTU

Figure 4: Number of taxpayers registered in the MTO and LTU



Source: Kenya Revenue Authority (2014)

The medium tax payers office collects several taxes. These includefirstly, income taxes from PAYE, corporation, individual, withholding , advance income tax and other income tax. Secondly, value added tax, thirdly, excise revenue including duty on domestic and on air and Fourthly, revenue from stamp duty, land rent, sugar development levy and the kenya bureau of standards levy.

Other benefits experienced by the MTO since its inception include effective compliance monitoring, improved relationship between the revenue authority and taxpayers, enhanced quality audits based on an objective risk profiling framework, enhanced compliance to tax laws as well as increased tax collection from excise manufacturers

3.5.3 Challenges Faced by the Medium Taxpayers Office

In response to a questionnaire to the KRA, it was indicated that initially the MTO faced difficulties because taxpayers were initially apprehensive of the close compliance monitoring, but this has improved as they understand the benefits of the relationship management approach.[189]Further the MTO's Inadequacy of staff capacity in terms of numbers and skills to cater for the demands for compliance monitoring, tax audits, taxpayer education and support puts a strain on the available human resource.

In an interview on the challenges that the MTO has experienced since its inception the MTO indicates that their office has been working perfectly (in terms of collection of revenue and customer service delivery) except for the location of the MTO. One interviewee said that the MTO is golden goose that is in a lousy barn. [190]The MTO office has a problem with its sanitary system and this poses a challenge in staff motivation. Additionally since the MTO serves considerably large enterprises its location has been a source of embarrassment when the medium tax payers' top officials and high end officials visit the office only to be requested to go use nearby facilities.

3.6 Conclusion

In this chapter the taxation framework of medium enterprises in Kenya has been highlighted. The definition of medium taxpayers has been also been discussed. The chapter gives an extensive analysis of the administrative framework that the KRA has adopted to foster compliance by medium enterprises while serving the taxpayers' needs. In the next chapter we look at the taxation regime of medium enterprises in Korea.

The setting up of the MTO in Kenya has resulted in faster and more effective response to taxpayers' issues, increase in voluntary tax compliance due to regular monitoring, taxpayers are more knowledgeable on tax laws and procedures. There is improved awareness of the tax obligations as well as the taxpayers' rights and enhanced staff skills due to continuous

[189] Appendix A
[190]Interview KRA official one

training given to staff to cope with challenging work environment in MTO. Lastly the MTO has resulted in focused attention to taxpayers making them more receptive to tax matters.

In this chapter the legislative framework that medium enterprises fall under has been highlighted. Government may give numerous incentives to promote medium enterprises. The Republic of Korea has numerous incentives to medium enterprises geared towards economic growth. This includes research and development and youth empowerment. In this chapter we have also identified the key feature of incentives. They are elaborately provided for under acts of parliament. The incentives have a timeline and limitation to the extension of the time of enjoyment of the incentive. The next chapter gives recommendation drawn from the foregoing chapters.

4 CHAPTER FOUR: RECOMMENDATIONS AND CONCLUSION

Having looked at the taxation framework of Kenya and South Korea this chapter picks out importance of the lessons drawn from the study. This chapter will seek to give the recommendations and concluding remarks. These recommendations include three important phases that should be carried out in the formulation and implementation of a framework that is geared towards ensuring growth of medium enterprises in Kenya through tax policy.

4.1 Step one: data collection and survey

In order to put in place tax incentives that will assist in the growth of medium enterprises there is need to appreciate the status quo. This is important in monitoring and evaluating the process of implementation and the results ensuing from the policies adopted. In South Korea the SMBA ensures that data on the number of medium enterprises, the number of employees in the medium enterprises and the progress over the years is available regularly.[191]

In Kenya, the ministry of industrialisation and entrepreneurship has several departments including that of the medium and large enterprises. This government department should collaborate with the medium taxpayers' office at KRA and the Kenya National Bureau of Statistics (KNBS) in the collection of data that will inform the decision on which tax policies should be adopted in favour of medium enterprises.

4.2 Step Two: An elaborate legislative framework

There is need for an elaborate legislative framework to kick-start the regime for preferential treatment of medium enterprises. Learning from the case of South Korea a model legislative instrument should contain the following parts.

[191] <http://www.smba.go.kr/eng/smes/statistics_01.do?mc=usr0001148> accessed October 14,2014

4.2.1 Part one: definition of a medium enterprise

The research indicates that there is no consistent definition of medium enterprises in Kenya and other African jurisdictions. The definition to be adopted should match the economic climate of the country. It should be revised regularly after every five years to match the growth of the economy. This means that the definition should form part of subsidiary legislation enacted by the cabinet secretary. The criteria of turnover should be retained but the lower limit of 350 million Kenyan shillings should be reduced to 250 million to accommodate more enterprises. Borrowing from the South Korea example, the criteria should also encompass the number of employees. This criterion should be shared with small enterprises. The number should be from one to a hundred employees to include the high net worth individuals (HNWI) and professionals.

4.2.2 Part two: elaborate tax incentives

Incentives should be limited to domestic enterprises. In chapter three we saw that tin South Korea enterprises enjoying tax credits are national enterprises. This is to ensure that the citizenry in Kenya are directly involved in the growth of the economy with the help of the tax policy reform.

The objectives of the tax incentives should be clear from the legislation. A reading of the tax legislative framework in South Korea shows that incentives should not be blindly given. Medium enterprises receive Incentives aimed at improving automation of business, ensuring collaboration of large enterprises and medium enterprises as well as promotion of employment of the youth. There are also incentives given to the medium enterprises that form associations with other medium enterprises. These incentives of this kind are viable in Kenya.

The incentives may be used to promote access to services across Kenya. The purpose of devolution as indicated in the constitution is to ensure that every Kenyan has access to services.[192] Through income tax incentives, the national government can persuade local investors to invest in areas that are not as congested as the cities and the big towns. An incentive may be given to start-ups that are located in rural areas. The county governments through property taxes may give incentives to business start-ups in their counties. Learning from the Korea policy framework, there should be specific incentives limited to domestic corporations and residents

The tax incentives should be in tandem with the industrial policy of the country. Incentives may be given to medium enterprises as a blanket or to specific medium enterprises. There is need for specificity within the sectors. For example in South Korea a tax reduction to venture enterprises is given to specific SMEs. This should help in promotion of certain sectors in tandem with the industrial policy of Kenya

Taxation incentives must not work in isolation. It is important that other incentives are given to the medium enterprises. For example in the case of South Korea the FASMEs allows the government to take necessary measures for smooth financing of small and medium enterprises through the facilitation of a steady supply of financial resources and establishment of a credit guarantee system

4.2.3 Part three: limitation of incentives

Tax incentives to medium enterprises should have limitations. For example, giving the incentives a timeline ensures an extra encouragement to enterprises to act in a certain way within a limited time. The business environment remains certain as investors are aware for how long they should expect to enjoy an incentive. Additionally it also allows for the

[192] Article 6

government to keep track of the effects of the incentives and evaluate the need for extension. For example before the December 2015 limit of the tax reduction to medium enterprises established outside the Seoul metropolitan area the incentive was till December 31, 2009. The same timeline is shared by tax credits to medium enterprises.

A grace period for the enjoyment of the tax incentives should be given where medium enterprises mature into large enterprises. While we cannot allow medium enterprises to "wear diapers forever" as Dr Kim puts it,[193] the transitions should be smooth to ensure that the medium enterprises do not collapse. During this grace period the incentives should be reduced gradually. The incentives also ensure that the MEs do not develop the peter pan syndrome.

4.3 Step Three: Administrative Measures to Ensure Enforcement

There is need to provide for the legislative framework of taxpayer segmentation within the revenue authority. KRA should be staffed with experts who are able to administer the collection of taxes in a cost effective manner. The government should ensure that there is enough funding to support mechanisms adopted by the revenue authority to improve taxpayers' compliance.

4.4 Concluding remarks

Medium enterprises form a significant portion of taxpayers in Kenya. They also generate a significant portion of tax revenue. The legislative framework has however neglected this segment of taxpayers. Learning from the case of the Republic of Korea there is need for an elaborate framework that will provide incentives to medium tax payers to assist in their growth. There is need for coordination of tax administration with other government agencies in the implementation of the policies enacted.

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[193] Dr. Kim, Jae-Jin ATAF-Korea Conference on "Tax Administration for the Small Medium Enterprise Development in Arica" in Johannesburg, South Africa 6, February 2014

In chapter one, the importance of medium enterprises in providing employment, revenue and assisting in the internationalisation of local business was discussed. Chapter two made a case for the intervention of the government through its tax policy to achieve economic stability. In this chapter a concluded that indeed to avoid being repugnancy to law then the objectives of any incentives offered ought to be clear was made. Chapter three drew important lessons from the tax regime of South Korea.

The research has shown that incentives should be given to medium enterprises. These incentives should have objectives that should be apparent from the legislative framework. These incentives can take different forms including tax deductions, credits and exemption. The incentives must be enjoyed for a specific period and reduced gradually to allow for ease of transition to medium enterprises.

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6 APPENDICES:

6.1 Appendix A: Questionnaire to Kenya Revenue Authority

ATAF Study on Medium Enterprises

The Impact of Taxation and Support Services on Medium Enterprises (MEs) in Africa

Researcher: Nyagaka Elizabeth Mokeira

Please read the instructions carefully, kindly assist us with requested information and note that any missing information may compromise the ability of the researcher to do the evaluation.

As a participant in this interview, please note the following

1. This questionnaire contains 26 questions.
2. Email back your response and feel free to seek clarification where needed by emailing any queries to mokeiramo@gmail.com
3. Please type your response where the questionnaire is transmitted electronically; there are no character limits to your response.

SECTION 1: BACKGROUND INFORMATION

The questionnaire may be filled by various persons in different departments within the tax authority. The person concerned will be the resource person for this project within the tax administration and will support the ATAF consultant in completing the questionnaire or **providing necessary support to extract and collect information.**

Name of the Tax Administration:
Country:

Name of resource person 1:
Position:
Email address(es):
Other contact details (phones numbers):

Name of resource person 2:
Position:
Email address(es):
Other contact details (phones numbers):

SECTION 2: UNDERSTANDING MEDIUM TAXPAYERS

1. **How many taxpayers have been registered by the tax authority in the past five years?**

Taxpayers*(Replace the names on this column to suit the names of the segments established in your tax administration)*	Number of registered taxpayers				
	2009-2010	2010-2011	2011-2012	2012-2013	2013-2014
Total taxpayers					
Large taxpayers office/unit					
Medium taxpayers office					

Small taxpayers office					

2. **What is the total revenue collected by the tax authority from the above taxpayers in the last five financial years?**

Taxpayers *(refer to question 1)*	Tax revenue				
	2009-2010	2010-2011	2011-2012	2012-2013	2013-2014
Total taxpayers					
Large taxpayers office					
Medium taxpayers office					
Small taxpayers office					

3. **What types of taxes are imposed on the medium enterprises in your country? *(Kindly indicate the tax rates and tax bases)***

	Tax type	Tax rate	Tax base
1)			
2)			
3)			
4)			
5)			
6)			
7)			
8)			

SECTION 3: TAX ADMINISTRATION ORGANIZATIONAL SET-UP (TAXPAYER SEGMENTATION)

4. **Does the tax authority have a medium enterprises (MEs) office (section) separate from the small taxpayer office? (please highlight)YES/NO**

If YES

a) Which year was the medium taxpayers' office established?

b) How many MEs were registered in the *first five years* of the establishment of the medium taxpayers' office?

Year	Number of registered taxpayers	Tax revenue
Year 1		
Year 2		
Year 3		

Year 4		
Year 5		

c) What criterion (criteria) *(e.g. turnover, assets, number of employees etc.)*Is (are) used by the tax authority to determine the taxpayers falling into the medium taxpayers segment? Please indicate the parameters

Criterion	Parameters
a.	
b.	
c.	
d.	
e.	
f.	

d) What is the rationale behind the criteria used in the medium taxpayer segmentation?

e) Do the criteria above differ from the policy/legislative definition of MEs in your country (i.e. used by other government agencies)?(Please highlight)YES/NO

If YES, kindly indicate the policy/legislative definition, the relevant instrument and the rationale behind the different criteria of classification/segmentation

Policy / legislative definition	Legislative/ policy instrument	Rationale behind the divergence

f) What have been the successes encountered in the administration of the medium taxpayers' office?
   i.
   ii.
   iii.
   iv.

If NO

a) Which office/department of the tax authority deals with medium enterprises?

b) In your opinion, does your tax authority require a specific office for the medium enterprises? Please explain

5. What have been the challenges encountered in the administration of the medium taxpayers' office? *(If there is no medium taxpayers office established, please indicate the challenges associated with not establishing a medium taxpayers office)*

a)
b)
c)
d)

e)

6. **What are the lessons that can be learnt from the establishment of a medium taxpayers' office or the existing organizational set-up around medium enterprises in your country?**
   a)
   b)
   c)
   d)

SECTION 4: SUPPORT SERVICES TO MEDIUM TAX PAYERS (Roads, ICT, Education and training, etc. to MEs)

7. **Can medium enterprises file and pay taxes online? Please explain**

8. **What support services have been put in place to ensure that the taxes are readily filed online?**

9. **Are the medium enterprises meeting their payment obligations in time? Please explain**

10. **In your opinion, what is the average amount of time spent by a medium enterprise in complying with its tax obligations?**

11. **What mechanisms has the tax authority adopted in dispute resolution?**
   a)
   b)
   c)
   d)
   e)

12. **What other specific support mechanisms have been put in place (by the tax authority or the government in general) to encourage tax compliance by the medium enterprises (e.g.: infrastructure, ICT, education and training, educational material, etc.)?**

Mechanisms employed to tax encourage tax compliance	Year of commencement	Brief description
a)		
b)		
c)		
d)		
e)		

13. **Please assess the overall successes or failures of the support mechanisms offered to medium taxpayers in the country. Please indicate how effective each of them has been in the scale of 1 to 4(1: very successful, 2: successful, 3: not successful, 4: failure)**

Mechanisms employed to tax encourage tax compliance*(refer to question 12a-e)*	Rating: effectiveness in encouraging compliance(1-4)	Please briefly explain *successes/benefits and failures/challenges of support mechanisms*
a)		

b)		
c)		
d)		
e)		

14. **What in your opinion, are the overall lessons learnt from the implementation of the support services mentioned above?**
   a)
   b)
   c)

SECTION 5: TAX INCENTIVES TO MEDIUM TAXPAYERS

15. **Should medium enterprises be subjected to a different tax regime as compared to large taxpayers and small enterprises? Please explain**

16. **What legislative/administrative incentives are available for the medium enterprises?**

	Incentive	Brief description
a)		
b)		
c)		
d)		
e)		

17. **Please indicate the rationale for the granting of incentives mentioned above. Kindly indicate how effective these incentives have been in a scale of 1 to 4(1: very successful, 2: successful, 3: not successful, 4: failure)**

Incentive *(Refer to question 18a-e)*	Rationale for the granting of the incentive	Rating: effectiveness of incentives granted (1-4)	Please briefly explain *successes/benefits and failures/challenges of incentives*
a)			
b)			
c)			
d)			
e)			

18. **What are the challenges faced by the tax authority in implementing the incentives granted to MEs?**

Incentive *(Refer to question 17a-e)*	Challenges in implementation
a)	
b)	
c)	
d)	
e)	

19. What government agencies are mainly involved in the granting of tax incentives to MEs (*i.e. government agencies with discretionary power to grant incentives to MEs*)?

a.
b.
c.
d.

20. What in your opinion, are the overall lessons learnt from the granting and administration of the incentives granted to medium enterprises?

a)
b)
c)
d)
e)

21. Please indicate any other mechanisms (with a brief description) that have been adopted by the government to ensure efficiency in the taxation of medium enterprises.

Government mechanism	Brief description
a)	
b)	
c)	
d)	

SECTION 6: TAX REFORM (THE WAY FORWARD)

22. Indicate ways tax administration and policy may be improved to ensure growth of medium enterprises in your country

a)
b)
c)
d)
e)

23. Kindly give any additional comments or information pertaining to taxation of medium enterprises in your country.

Thank you for your time!

6.2 Appendix B: Definition of SMEs: Internationally, Regionally and Nationally

Institution/ country	Number of employees	Turnover	Total assets / Balance sheet total	Total annual sales	Additional criterion
International financial corporation (IFC) (2012)	50 <300	-	\$ 3 million< \$ 15million	\$ 3 million< \$ 15million	Financing less than 1 million
European Commission (2005)	50<250	\$ 12milion < \$ 62 million	\$ 12milion < \$ 62 million	-	-
Kenya	50< 100	\$55,000< \$167,000	Manufacturing <\$555,000 Service and farming <\$222, 000	-	-
Ghana	30< 100	-	\$100,000 (excluding land and building) <1 million	-	-
South Africa	50<200	\$443,000 \$5,681,000			

Note: all figures were converted to US dollars by the author

6.3 Appendix C: Glossary of Terms

1.	Medium Enterprise	Institutions or individuals that operate nationally and internationally; and are segmented based on specified criteria such as the amount of turnover, asset-value as well the minimum number of employees. In Kenya there is no statutory definition.
2.	Medium Industry	An industry or a business activity in the manufacturing sector whose annual turnover ranges between Kenya Shillings (Kshs.) 5 million and Kshs.150 million or employing not more than 100 but not less than 50 people or where the investment in plant and machinery as well as the registered capital is more than Kshs.50 million and less than Kshs. 500 million.(Draft National Industrialisation Bill)
3.	Medium Taxpayer	Term used by Revenue Authorities to distinguish taxpayers served by the Medium Taxpayers Office. In Kenya the segment these are taxpayers with a turnover between Kshs 350million and Kshs 750 million.(KRA)
4.	Micro Enterprise	This is a firm, trade, service, industry or a business activity whose annual turnover does not exceed 500,000 Kenya shillings and which employs less than ten people. The whose total assets and financial investment: in the case of the manufacturing sector, the investment in plant and machinery or the registered capital of the enterprise does not exceed ten million shillings; in the case of the service sector and farming enterprises where the investment in equipment or registered capital of the enterprise does not exceed five million shillings (Micro and Small enterprise Act)
5.	Small Enterprise	This is a firm, trade, service, industry or a business activity whose annual turnover ranges between five hundred thousand and five million shillings and employs between ten and fifty people. In the manufacturing sector, the total assets and financial investment including the investment in plant and machinery as well as the registered capital of the enterprise, is between ten million and fifty million Kenyan shillings. In the service and farming enterprises, the equipment investment as well as registered capital of the enterprise is between five million and twenty million shillings (Micro and Small Enterprise Act)
6.	High Net worth Individual	A unique tax segment whose affairs are generally characterised by enhanced mobility and a high degree of complexity. They consists of high wealth and high income individuals and is of particular interest for tax administrations because of the: complexity of their affairs and the large numbers of entities they may control; amounts of tax revenue at stake; opportunity to undertake aggressive tax planning; and impact on overall integrity of tax system (OECD, 2009).