

**A SURVEY OF INCOME TAX AVOIDANCE BY
COMPANIES IN NAIROBI**

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A MANAGEMENT PROJECT SUBMITTED IN PARTIAL FULFILMENT
FOR THE REQUIREMENTS FOR THE MASTER IN BUSINESS AND
ADMINISTRATION DEGREE, FACULTY OF COMMERCE, UNIVERSITY
OF NAIROBI

1992

DECLARATION

ACKNOWLEDGEMENTS

THIS MANAGEMENT PROJECT IS MY ORIGINAL WORK AND HAS NOT BEEN PRESENTED FOR A DEGREE IN ANY OTHER UNIVERSITY

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THIS MANAGEMENT PROJECT HAS BEEN SUBMITTED FOR EXAMINATION WITH MY APPROVAL AS UNIVERSITY SUPERVISOR

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ACKNOWLEDGEMENTS

I wish to express my gratitude to the University of Nairobi for sponsoring me throughout the MBA programme, and my employers, Bellhouse Mwangi Ernst & Young, who granted me study leave. I am also very grateful to K M Mwarania, my Supervisor, for his unparalleled patience and guidance through this project.

Lastly, but not least, I am indebted to Mary Waweru, my secretary, who spent long hours typing several drafts of the project.

G G KARUU

1992

CONTENTS

iv
PAGE

	Title	
	DEDICATION	i
	<i>Dedication</i>	ii
	To my wife Murangi, daughter Njeri and son Waciira	iii
	<i>Dedication</i>	iv
	<i>Title of Chapter</i>	v
	<i>Abstract</i>	vi
SECTION		
1	INTRODUCTION	
1.1	BACKGROUND	1
1.2	STATEMENT OF THE PROBLEM	12
1.3	OBJECTIVES OF THIS STUDY	13
1.4	IMPORTANCE OF THE STUDY	15
2	LITERATURE REVIEW	
2.1	INTRODUCTION	25
2.2	MICROECONOMICS OF INCOME TAX AVOIDANCE	26
2.3	INCOME TAX AVOIDANCE OPPORTUNITIES	27
2.4	CASE FOR TAX AVOIDANCE	30

SECTION		CONTENTS	PAGE
		RESEARCH DESIGN	
		3.1 POPULATION	44
Title			i
		3.2 SAMPLE SELECTION	44
Declaration			ii
		3.3 DATA COLLECTION	45
Acknowledgements			iii
		3.4 RESPONDENTS	46
Dedication			iv
		3.5 DATA ANALYSIS	46
Table of Contents			v
Abstract		DATA ANALYSIS AND FINDINGS	vii
		4.1 INTRODUCTION	48
SECTION		4.2 RESPONSES	48
1	INTRODUCTION	OBSERVATION	49
	1.1	BACKGROUND	1
	1.2	STATEMENT OF THE PROBLEM	22
	1.3	OBJECTIVES OF THE STUDY	22
	1.4	IMPORTANCE OF THE STUDY	23
	1.5	SUMMARY	26
2	LITERATURE REVIEW		57
	2.1	INTRODUCTION	25
	2.2	MICROECONOMICS OF INCOME TAX AVOIDANCE	26
	2.3	INCOME TAX AVOIDANCE OPPORTUNITIES	27
	2.4	CASE FOR TAX AVOIDANCE	42
APPENDICES			39
BIBLIOGRAPHY			73

SECTION		
	ABSTRACT	
3	RESEARCH DESIGN	
	3.1 POPULATION	44
	3.2 SAMPLE SELECTION	44
	3.3 DATA COLLECTION	45
	3.4 RESPONDENTS	46
	3.5 DATA ANALYSIS	46
4	DATA ANALYSIS AND FINDINGS	
	4.1 INTRODUCTION	48
	4.2 RESPONSES	48
	4.3 GENERAL OBSERVATION	49
	4.4 CHI-SQUARE TESTS	49
	4.5 SIMPLE REGRESSION ANALYSIS	54
5	SUMMARY AND CONCLUSION	
	5.1 SUMMARY	56
	5.2 CONCLUSION	57
	5.3 LIMITATIONS OF THE STUDY	57
	5.4 SUGGESTIONS FOR FUTURE RESEARCH	58
	APPENDICES	59
	BIBLIOGRAPHY	73

ABSTRACT

Income tax reduces the wealth of the taxpayers. To ensure that this wealth loss is minimized, rational individuals engage in tax avoidance activities. They may do this inspite of anti-avoidance legislation.

This survey attempts to find out whether companies in Nairobi are involved in income tax avoidance activities. For this purpose, a questionnaire has been administered on a random sample of companies.

By way of introduction, tax avoidance and the related concept of tax evasion are defined. This is followed by a review of the courts' approach to tax avoidance. After this, tax avoidance opportunities in Kenya are explored and a case for tax avoidance developed.

The survey findings confirm that companies in Nairobi engage in income tax avoidance. The findings also show that strategies used in income tax avoidance vary between categories of companies and in emphasis between tax compliance and non-compliance considerations. They further suggest that income tax avoidance activity increases with the age and size of the company.

- (i) Minimizing tax compliance requirements by minimizing tax payments
- (ii) Factoring in personal considerations that tax considerations with the hope of maximizing opportunities for tax saving or deferral
- (iii) Considering tax effects before entering into other financial transactions and

1. INTRODUCTION

1.1 BACKGROUND

Tax Avoidance

Tax avoidance is the arrangement of financial affairs, so as to attract the lowest possible tax. A Dictionary of Tax Definitions by Hard (1978), defines tax avoidance as "The arrangement of a person's financial affairs so as to legitimately reduce a tax liability". Knowledge of available tax avoidance options broadens a taxpayer's ability to minimize a tax burden.

Taxes may constitute significant costs of a company's total costs. These costs may be more significant than materials, wages and overheads. Taxes may also be looked at as appropriations. Looked at this way they fall in the same class as dividends and transfers to reserve. Whichever of the two views is taken, the end result is the same. Taxes reduce wealth and as argued by Carmichael, "the ultimate benefit of sales to the businessman is the amount of money remaining after he has paid all expenses, including tax".¹

In an effort to minimize taxes, companies may engage in tax avoidance activities. These activities involve:-

- (i) Monitoring tax compliance requirements to minimize tax penalties;
- (ii) Focusing on pre-accounting date tax considerations with the hope of maximizing opportunities for tax saving or deferral;
- (iii) Considering tax effects before entering into major financial commitments; and

¹ Accountancy August, 1969 (p.594)

(iv) Monitoring signals before and after occurrence of major events, such as change of governments, and tabling in parliament of new bills to see if there are actions that could be taken to mitigate any adverse changes in tax legislation.

This survey makes an attempt to establish the existence and extent of income tax avoidance practice by companies in Nairobi. This is done by examining income tax avoidance practice by companies using selected activities.

The literature on tax avoidance sometimes refers to a related concept: tax evasion.

Tax Evasion

Tax evasion, in contrast to tax avoidance, is the illegal arrangement of financial affairs, so as to minimize a tax burden. It is defined by Hard (1978), as "The illegal elimination of a tax liability, by fraud, wilful default or neglect....".

Tax Avoidance and Evasion

"Evasion and avoidance are seen as twin problems of any tax"². Cross and Shaw have argued for joint analysis of tax avoidance and tax evasion activities "partly owing to the significant degree of substitutability and possible complementarity between the two activities from the vantage point of view of the potential tax-payer....."³. The boundary between tax avoidance and evasion is not always clear.

This survey deals with tax avoidance. Tax evasion has been left out of the study for practical reasons. As Pyle (1989), points out of empirical studies in the areas of tax evasion: "The paucity of studies in this area is not at all symptomatic of lack of

² Cope J.M., Business Taxation (P.84).

³ Public Finance No. 1, 1982, Vol. XXXVII (P.36).

interest in the subject. It merely reflects the absence of good data upon which tests can be performed. By its very nature tax evasion means (successfully) hiding taxable income from the tax authority. Therefore, it is fairly obvious that accurate statistics — on the true extent of tax evasion simply do not exist⁴.

Needless to say, tax avoidance reduces government revenue. To minimize these losses governments resort to anti-avoidance legislation.

Anti-Avoidance Legislation

Anti-avoidance legislation reduces the scope for tax avoidance. It is therefore necessary for those engaged in tax avoidance practices to be aware of the existing legislation in this respect. This may enable them to assess the risk involved in the practice of tax avoidance.

The most important and general anti-avoidance provision under Kenyan Income Tax Act⁵ is covered in Sec. 23. Under this section, the Commissioner of Income Tax has powers to direct that adjustments should be made as respects liability to tax to counteract the avoidance or reduction of liability to tax. This is done where the Commissioner is of the opinion that the main purpose or one of the main purposes for which a transaction was effected was avoidance or reduction to tax. If this section was to be interpreted literally, it would leave little scope for tax avoidance. In this respect, those practising tax avoidance may be interested in how the courts construe the provision. To understand the Kenyan court's approach to tax avoidance there is need to examine the relevant case law.

⁴ Tax Evasion and the Black Economy (PIII)

⁵ Chapter 470, Laws of Kenya.

Tax Avoidance - Kenya Courts' Approach

The Kenyan court's approach to tax avoidance can be traced back to the days of the East African Income Tax (Management) Act, 1958. Sec. 23 of the Act was fairly similar to Sec. 23 of the Kenyan Income Tax Act.

An important decision in the construction of this section was made in the Court of Appeal case: The Commissioner of Income Tax v. C W Armstrong (1963)⁶. Briefly the facts of the case were as follows:-

A successful coffee-growing business was run as a partnership of two brothers. In 1954, the business was incorporated under the name of Ibonia Estates Ltd and its shares divided between the brothers; one-third to C W Armstrong and two-thirds to his brother. However, Mr Armstrong's shares were allotted to Kwetu Farm Ltd in which he had effectively been the sole shareholder. The Commissioner of Income Tax, under Sec.23 of the E A Income Tax (Management) Act, 1958, directed that dividends declared by Ibonia Estates Ltd in respect of shares owned by Kwetu Farm Ltd, should be deemed, for income tax purposes, to be the income of Mr Armstrong on the ground that there was reason to believe that the main purpose, or one of the main purposes of the transactions, was avoidance or reduction of liability to tax. The Court found for the Commissioner. Sir Trevor Gould, at the Supreme Court stage in this case, set up the requirements which he said must be satisfied before a direction can be said to be properly made under Sec.23:-

- (i) The main purpose, or one of the main purposes, of the transaction must be the avoidance or reduction of liability to tax;

⁶ Eastern Africa Law Reports (1963) (PP.505-523).

- (ii) It must be just and reasonable that the particular adjustments should be made;
- (iii) The adjustments must be appropriate; and
- (iv) The Commissioner of Income Tax must rely on available factors in arriving at his opinion. He cannot be allowed to speculate.

Newbold, the Judge of appeal, however noted that "each case must be determined on its own facts" (P.516).

In the subsequent relevant tax cases decided based on the E A Income Tax (Management) Act, 1958, M v. Income Tax (1970)⁷, T v. Income Tax (1973)⁸, Income Tax v. Block (1973)⁹, and Income Tax v. T (1975)¹⁰, the principle set in Income Tax v. Armstrong seems to have been followed.

In M v. Income Tax (1970), the Commissioner of Income Tax contended that (i) payment of advance rent was taxable in a single year, and (ii) sons brought in as new partners in a business were not genuine partners but served only in the reduction of liability to tax. It was held that the payment of rent was taxable in one year, and that the sons were full partners and entitled to be treated as such.

In T v. Income Tax (1973), the appellant contested that the Commissioner's direction was neither just nor reasonable. The appeal succeeded. The cases referred to in this judgement were Income Tax v. Armstrong (1963), and M v. Income Tax (1970). It was held that "whether the direction is just and reasonable must be examined by the

⁷ East Africa Law Reports [1971] (PP.338-343)

⁸ Ibid [1973] (PP.397-406)

⁹ Ibid [1974] (PP.352-369)

¹⁰ Ibid [1974] (PP.546-551)

court in order that the court can keep a check on the wide powers of the Commissioner". (P.298).

In Income Tax v. Block (1973), the dispute involved dividends declared by a company which were deemed by the Commissioner to be income of Mr Block for tax purposes. The Commissioner contended that a direction under Sec. 23 could not be challenged on an appeal against an assessment based on it and that the direction was reasonable. For Block, it was contended that a direction could not be made in view of the powers of deeming income of settlement given by sections 24 and 25 of the Act.

It was held that:-

- (i) a direction of the Commissioner can be interfered with if he could not reasonably have formed his opinion on the facts before him or if it is not just and reasonable;
- (ii) a direction may be given under Sec.23 notwithstanding the specific provisions concerning trusts in Sections 24 and 25;
- (iii) if assets have been irrevocably transferred, it is not just and reasonable to make a direction deeming the income from the assets to be that of the transferor;
- (iv) the trust was not irrevocable and the shares would be transferred to Block; and
- (v) the direction was accordingly just and reasonable.

In Income Tax v. T (1975), the Commissioner had asked that The Commissioner of Income Tax v. Armstrong be not followed on the grounds that it was wrongly decided and that it was no longer an authority by reason of subsequent statutory changes. In dismissing the appeal, it was held that The Commissioner of Income Tax v. Armstrong was rightly decided.

The above cases seem to have set the pace for the Kenya courts' approach to tax avoidance. Unfortunately, the Kenya Law Reports were last compiled for 1976 to 1980 and contain no relevant tax cases. The Kenya Appeal Reports compiled for 1982 to 1988 have no relevant cases either. Consequently, the writer has found it difficult to establish the current trend of the Kenya courts' approach to tax avoidance. It was therefore found necessary to refer to the evolution of tax avoidance approach as seen from the point of view of the British courts. It is felt that the British courts' approach may have an impact on Kenya.

Tax Avoidance - British Courts' Approach.

It is also necessary to look at decisions of British courts because they have persuasive, although not sustainable, authority on Kenya.

The British courts' approach to tax avoidance can be traced back to the last century.

In Partington v. Attorney - General, (1869) L.R. 4E. & I. App. H.L. 100, at page 122, Lord Cairns said:

"As I understand the principle of all fiscal legislation, it is this: If the person sought to be taxed comes within the letter of the law he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject

within the letter of the law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be"¹¹

Lord Cairns understanding seems to have been reaffirmed later by Lord Sumner in The Commissioner of Inland Revenue v. Fisher's Executors (1926)¹².

Lord Sumner at page 340 said:

" My Lords, the highest authorities have always recognised that the subject is entitled so to arrange his affairs as not to attract taxes imposed by the Crown, so far as he can do so within the law, and that he may legitimately claim the advantage of any express terms or of any omissions that he can find in his favour in taxing Acts. In so doing, he neither comes under liability nor incurs blame"

A landmark case, in the evolution of tax avoidance approach in the British courts could be said to be: Duke of Westminster v. Commissioners of Inland Revenue (1935)¹³.

Duke of Westminster v. Commissioners of Inland Revenue (1935).

The Duke of Westminster, the appellant, executed a series of deeds in which he covenanted to pay to his employees certain weekly sums for a specified period.

¹¹ Cited in Duke of Westminster v. Commissioners of Inland Revenue, Simon's Tax Cases Vol. XIX Part VII (P.525).

¹² Simon's Tax Cases Vol. X, Part V (PP. 302 - 341).

¹³ Simon's Tax Cases Vol. XIX Part VII (PP.490-529)

The recipients had at the same time, fixed wages, and after the completion of the deeds, continued in the same employment. They also continued to receive wages as well as the sums payable under the deeds.

In this case, the Crown contended that the payments made under the deeds to persons who remained in the Duke's employment were payments for continuing service and were not annual payments deductible from his income for sur-tax purposes.

In the House of Lords, Lord Atkin, at page 511, said:-

" It was not, I think, denied, at any rate it is incontrovertible, that the deeds were brought into existence as a device by which the respondent might avoid some of the burden of Sur-tax. I do not use the word device in any sinister sense: for it has to be recognised that the subject whether poor and humble or wealthy and noble, has the legal right to dispose of his capital and income as to attract upon himself the least amount of tax".

At page 520, Lord Tomlin said:-

"Every man is entitled, if he can, to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow tax-payers may be of his ingenuity, he cannot be compelled to pay an increased tax".

In this case, it was held that the payments made by the Duke to his employees under the deed could not be said to be payments of wages or salaries but were annual payments which were tax deductible for Sur-tax purposes.

This case set up a tax avoidance principle which was to be followed for several years. For example, it appears to have been followed in: Inland Revenue Commissioners v Plummer (1979).

Inland Revenue Commissioners v. Plummer (1979)¹⁴

The respondent, who was employed by a company as a Taxation Manager, decided to participate in a tax avoidance scheme to reduce his liability to surtax. In the appeal, the Crown contended that the payments made by the taxpayer in the scheme were not deductible in computing his total income for surtax purposes. The taxpayer contended that they were deductible. The Crown's appeal was dismissed by the House of Lords. In dismissing the appeal, Lord Wilberforce at page 801 made the following point:-

"the familiar argument was used that Parliament can never have intended to exempt from the taxing provisions an arrangement solely designed to obtain fiscal advantages".

The following observations made in this case are also worth noting:-

(i) By Viscount Dilhorne at page 807:-

"That there are some who carry on the business of devising schemes for tax avoidance is well known." and

¹⁴ 1979 Simon's Tax Cases (PP.793-814)

- (ii) By Lord Fraser at page 813:-
- "..... many transactions which would be generally regarded as perfectly legitimate forms of investment, are entered into solely, or at least predominantly, for tax reasons, and I think it would be wrong to suggest that they might be taxable for that reason alone".

The Duke of Westminster doctrine, seems to have been modified in: WT Ramsay Ltd v. Inland Revenue Commissioners (1981).

W T Ramsay Ltd v. IRC (1981)¹⁵

The Ramsay case was, in the judgement, consolidated with that of Eilbleck (Inspector of Taxes) v. Rawling.

In the two appeals, the question arose whether tax avoidance schemes consisting of a number of transactions, none of which was a sham, but which were self-cancelling, had the effect of producing a loss which was allowable as a deduction for the purpose of assessing capital gains tax. In each case, the scheme included a transaction designed to produce a loss to be offset against a gain previously made by the taxpayer which would otherwise be taxable while another transaction produced a matching gain which was not liable to tax. The House of Lords dismissed the appeal in favour of Revenue. In both cases the scheme was to be treated as a nullity for tax purposes.

¹⁵ 1981 Simon's Tax Cases (PP. 174-192)

In dismissing the appeals Lord Wilberforce, at page 181 said:-

"While the techniques of tax avoidance progress, and are technically improved, the courts are not obliged to stand still".

and at page 192, said:-

"In each case the facts must be established, and a legal analysis made: Legislation cannot be required or even be desirable to enable the court to arrive at a conclusion which corresponds with the parties' own intentions".

The Ramsay decision seemed to depart from the principle set in the Duke of Westminster thereby setting a new approach to tax avoidance which came to be known as the "Ramsay doctrine". Some of the subsequent cases that could have been said to apply the Ramsay doctrine are: Inland Revenue Commissioners v. Burmah Oil Co. Ltd (1981) and Furniss v. Dawson (1984).

IRC v. Burmah Oil Co. Ltd (1981)¹⁶

Burmah Oil Co. Ltd entered into a tax avoidance scheme which was designed to create, for corporation tax purposes, an allowable capital loss. It was held that the tax avoidance scheme entered into by the company, when carried through to completion, involved no real loss and the appeal was therefore allowed in favour of Revenue by the House of Lords.

¹⁶ 1982 Simon's Tax Cases (PP.30-39)

In this case, Lord Diplock, at page 32 said:-

"It would be disingenuous to suggest, and dangerous on the part of those who advise on elaborate tax-avoidance schemes to assume, that Ramsay case did not mark a significant change in the approach adopted by this House in its judicial role to a pre-ordained series of transactions (whether or not they include the achievement of a legitimate commercial end) into which there are inserted steps that have no commercial purposes apart from the avoidance of a liability to tax which in the absence of those particular steps would have been payable".

At page 39, Lord Scarman, in allowing the appeal, emphasized that:-

"..... Ramsay's case marks a significant change in the approach adopted by this House in its judicial role towards tax avoidance schemes".

Furniss v. Dawson (1984)¹⁷

This involved three cases which were consolidated in the judgement: Furniss (H.M. Inspector of Taxes) v. G E Dawson, Furniss (H.M. Inspector of Taxes) v. D E R Dawson, and Murdock (H.M. Inspector of Taxes) v. R S Dawson.

The tax-payers wished to dispose of their shares in two family companies and to defer, their eventual liability to capital gains tax. Accordingly, they executed a scheme designed to sell the shares without attracting a tax liability, but did not receive any cash consideration. The taxpayers sold their shares to an Isle of Man investment company which they incorporated for this purpose and in return were issued shares in that company. On the same day, the investment company resold the

¹⁷ 1984 Simon's Tax Cases, Vol. 55 (PP.324-402)

shares, making neither a profit nor a loss, to an independent third party. The Revenue assessed the taxpayers to capital gains tax on the basis that they had effectively disposed of their shares to the third party.

It was held, by the House of Lords, that the scheme was to be considered in its entirety and thus, as its purpose was tax avoidance without any other commercial purpose, it failed. In this case, Lord Scarman at page 389 said:-

"..... the law in this area is in its early stages of development."

and Lord Bridge at page 391 said:-

"But in another sense the present appeal marks further important step, as a matter of decision rather than mere dictum, in the development of the courts increasing critical approach to the manipulation of financial transactions to the advantage of the taxpayer".

The principle established by this case developed that of Ramsay case. Its scope is far more important than the Ramsay case since it is far wider. In Furniss V. Dawson, the House of the Lords decided that steps which are inserted in preordained series of transactions for no reasons other than to avoid tax may be ignored. The tax consequences are then those which would have occurred if the series of transactions had not included those designed to avoid tax.

A departure from the Ramsay and Furniss doctrine seems to have however, been set following the Court of Appeal and the House of Lords decisions in Craven v. White (1987) and Craven v. White (1988).

Craven v. White (1987)¹⁸

¹⁸ 1987 Simon's Tax Cases (PP.297-343)

This was a Court of Appeal case whereby the Crown, relying on the principles formulated in W T Ramsay Ltd v. IRC (1981) and Furniss (Inspector of Taxes) v. Dawson (1984), claimed that the disposal of assets by the taxpayer followed by disposal of those assets by the company to an ultimate purchaser, should be regarded as a single composite transaction under which there was a disposal of the assets by the taxpayer in favour of the ultimate purchaser.

The judgement of this case was consolidated with that of IRC v. Bowater Property Developers Ltd and Baylis (Inspector of Taxes) v. Gregory, which had different facts but the principles established were the same. The Crown's appeals in all the cases were dismissed in favour of the taxpayers.

In these cases, the principles laid down in Ramsay, from the speech of Lord Wilberforce, were revisited by Parker L.J. and could be summarised as follows:-

- (i) A subject is only to be taxed upon clear words not upon "intendment" or upon the "equity" of an Act;
- (ii) A subject is entitled to arrange his affairs so as to reduce his liability to tax. The fact that the motive for a transaction may be to avoid tax does not invalidate it unless a particular enactment so provides. It must be considered according to its legal effect;
- (iii) It is for the fact-finding Commissioners to find whether a document, or a transaction is genuine or a sham; and
- (iv) Given that a document or transaction is genuine, the court cannot go behind it to some supposed underlying substance.

Slade L.J., at page 308 said:-

".... if the Ramsay principle were to be held to apply to transactions of which the connecting link was so tenuous as that suggested in the Crown's basic contention, formidable uncertainty and practical difficulties would arise in the administration of our tax law, which the House of Lords, in formulating and development the Ramsay principle, did not contemplate and would not have intended".

The limitations of the Ramsay principle, arising from this case, are:-

- (i) There must be pre-ordained transaction or one single composite transaction; and
- (ii) There must be steps inserted which have no commercial purpose apart from the avoidance of a liability to tax.

Craven v. White (1988)¹⁹

The House of Lords confirmed the decision of lower courts.

This case refined, and to some extent, established the boundaries of the Furniss v. Dawson. The Court's rejection of the Revenue's contention that the transaction fell within the Furniss decision was based on the ground that there was no pre-ordained series of transactions.

Lord Oliver identified three factors which had to be present in order for a preordained series of transactions to exist:-

- (i) the intermediate steps had to serve no purpose other than that of saving tax;

¹⁹ 1988 Simon's Tax Cases (PP.476 - 523)

- (ii) all stages of the composite transaction had to be pre-ordained with some certainty, so that the taxpayers had control over the end result at the time when the intermediate steps were taken; and
- (iii) there could be no interruption between the intermediate transaction and the disposal to the ultimate purchaser.

It could not have been said that all the three factors were present in this case.

Lord Keith in reference to Ramsay principle at page 480 said:-

"The principle does not involve, in my opinion, that it is part of the judicial function to treat as nugatory any steps whatever which a taxpayer may take with a view to the avoidance or mitigation to tax"

And at page 487, Lord Templeman said:-

"Parliament intends that a taxpayer shall be free to place an asset out of reach of the taxing provisions. The courts have neither the power nor the desire to interfere."

In their decision the judges tended to distinguish between strategic tax planning, which they considered to be legitimate, and unacceptable tax avoidance. In this connection Lord Jauncey at page 521 said:-

"I do not conceive it to be the function of the court to act as the third arm of the Revenue in seeking to attack tax avoidance at large".

The Craven v. White decision seems to have opened new thinking in tax avoidance.

One then wonders what the current position in U.K. is in this respect.

Ballard (1989) has tried to look at the position of Furniss v. Dawson after the decision in Craven v. White (1988). He observes that "strategic tax planning is alive

and well. That is, it remains permissible to take steps now which may assist in minimizing the incidence of tax on a future but not wholly certain transaction²⁰. Parker, in analysing the Court of Appeal tax case: Moodie v. Commissioners of Inland Revenue noted that "it was clear that Lord Justice Balcombe in particular found it difficult to reconcile the decision in Plummer with the subsequent decision in Ramsay.

Unsatisfactory as it will be for these taxpayers to have uncertainty dragging on longer, it may well be in the public interest for the matter to be aired²¹. W T Docherty and F A Smith in commenting on a new line of attack on group tax planning in their concluding sentences said:- "The position is so unclear that the normal approach of groups to managing their tax affairs is being subjected to uncertainty. It is therefore urgently desirable that the Revenue issues a clear statement of its current practice for open discussion and agreement with the profession".²²

As can be seen from the above, in U.K., the courts's approach to tax avoidance has changed over the years. Soares²³ suggests three elements in trying to predict how courts view a particular tax avoidance transaction:-

²⁰ Furniss v. Dawson and Tax Planning - The Current position by R M Ballard, Tolley's Tax Planning, 1989 (P.375)

²¹ Round in Circles Again, Taxation, Vol. 127, No. 3317, 29 August 1991 (P.581)

²² Is the Ordinary Abnormal? Taxation, Vol. 129, No. 3350, 23 April 1992, (pp.73-75)

²³ Land and Tax Planning (P.13).

- (i) Case law under which the courts have looked to the strict form of transactions giving narrow interpretations of tax legislation;
- (ii) What he terms as the Sargaison v. Roberts Principle under which the courts, in looking at transactions, have tended to ignore technical legal concepts in order to apply tax law in a practical and sensible way; and
- (iii) The "Ramsay doctrine", under which the courts look to the substance of transactions and ignore the technical legal form in which they are carried out.

To Soares suggestions, one is inclined to add the emerging thinking which tends to view tax avoidance as legitimate.

Before concluding on the British courts' approach to tax avoidance, one is tempted to have a brief review of the British public view on the ethics of tax avoidance. Ethics, directly or indirectly, influence the courts' decisions, as well as taxpayers' and their tax advisers' behaviour in this respect.

Tax Avoidance Ethics in U.K.

David Stopforth²⁴ looks at changes over time in the British public viewpoint on the ethics of tax avoidance. He looks at Pre-World War II attitudes, Wartime attitudes and Post-war attitudes.

Pre-war attitudes - During this period the masses tended to be for tax avoidance. For example, in the 1930s, there was a massive increase in tax avoidance schemes.

²⁴ Avoidance for the Masses, Taxation, Vol. 129, No. 3347, 2 April 1992 (PP.1-2)

Wartime attitudes - Tax avoidance during wartime was considered wrong. It is reported that during this period "An accountant (later acquitted) faced criminal prosecution in connection with a tax avoidance scheme"²⁵.

Post-war attitudes - The feeling during this period is that tax avoidance is good if one can find a way.

The courts' approach to tax avoidance, and the attitude to tax avoidance of taxpayers and tax professionals have an impact on the extent to which tax avoidance is practised.

In Kenya, the courts' approach to tax avoidance may be influenced by U.K. tax cases and the awareness of the latter is therefore of relevance to those engaging in tax avoidance. The attitude of the Kenyan masses to tax avoidance is also relevant. This is, however, an area of separate studies.

It is worth noting that although parallel developments in the area of tax avoidance in other parts of the world may influence Kenya Courts' approach in this regard, the latter can adopt different lines depending on local legislation and ethics. This was demonstrated in the case of Commissioner of Income Tax v. C W Armstrong. At page 512, Newbold, J.A. said:-

"With respect to the learned judge, I also consider that the United Kingdom cases to which he referred are of no assistance in East Africa on the question of onus, as the respective statutory provisions are in this respect quite different"²⁶

²⁵ Ibid (p-2)

²⁶ Op cit

Though this be true, international trends on an issue cannot be ignored. This was seen in the U.K. cases, Duke of Westminster v. Commissioners of Inland Revenue (1935) and W T Ramsay Ltd v IRC (1981). In both cases, developments in the U.S. seemed to have had an impact.

In 1934, that is one year before the Duke's case, the U.S. Supreme Court held that "the legal right of a taxpayer to decrease the amount of what otherwise would be his taxes or altogether to avoid them, cannot be doubted"²⁷. In Ramsay, the U.S case: Knetsch v United (1960) was referred to whereby the Supreme Court found that a transaction was a sham because it:

"did not appreciably affect the [taxpayer's] beneficial interestthere was nothing of substance, to be realised by [him] from his transaction beyond a tax deduction the difference between the two sums was really the fee for providing the facade of loans"²⁸

As has already been pointed out, Sec.23 of the Income Tax Act gives the Commissioner wide powers. However, as will be demonstrated in section 2 of this study the provision does not close all the tax avoidance loopholes.

Study Perspective and Scope

OBJECTIVES OF THE STUDY

The main objective of this study was to ascertain whether income tax avoidance is practised by companies in Malawi. Identifying the reasons of the study

main objectives of the study are:

²⁷ Referred to in the article: Tax Avoidance by Savings and Loan Associations before and after The Tax Reform Act, 1969, by E J Kane and J J Valentini, Journal of Monetary Economics (P.41), 1975.

²⁸ Op cit (P.182)

This survey views tax avoidance from a practising accountant's perspective. For the purpose, companies are assumed to be profit maximizers. The survey covers income tax as it provides the most tax avoidance opportunities under the Kenyan tax legislation. Additionally, for most governments, income tax is the principal source of tax revenue. In Kenya, for example, the gross provisional receipts in 1990/91 amounted to K.f.m.2,458.58 (100%) of which K.f.m710 (30%) was from income tax²⁹. This has provided a further incentive to concentrate on income tax.

1.2 STATEMENT OF THE PROBLEM

It is generally feared that companies in Kenya incur tax penalties for reasons which include failure or lateness in submitting income tax returns, objecting to notices of assessments, appealing against notices of amended assessments or confirming notices, and payment of taxes. The penalties have negative and immediate cashflow implications since they may lead to depletion of an organisation's resources.

From casual observation, companies do not always take advantage of all available income tax avoidance opportunities. Consequently this may mean that inefficient investment decisions are made. This problem has less obvious and more long-term cashflow implications. It is however of no mean importance.

1.3 OBJECTIVES OF THE STUDY

The main objective of this study is to establish whether income tax avoidance is practised by companies in Nairobi. Depending on the outcome of the main objective, subsidiary objectives are:-

²⁹ 1991 Kenya Economic Survey (P.65)

- (i) to find out whether there are differences in income tax avoidance practices among specified categories of companies;
- (ii) To find out the areas of income tax avoidance emphasis by companies;
- (iii) To establish whether there is a relationship between income tax avoidance practice and the age of a company; and
- (iv) To establish whether there is a relationship between income tax avoidance practice and the size of a company.

1.4. IMPORTANCE OF THE STUDY

This study is expected to be of interest particularly to the following:-

(i) Corporate Taxpayers

Corporate taxpayers may have an interest in the wealth redistributive effect of a tax system. Income tax avoidance in this respect, enables companies to enhance their wealth, hence the expected interest in a study of this nature.

(ii) The Institute of Certified Public Accountants of Kenya (ICPAK)

ICPAK, through its Council, the Secretariat, and the Taxation and Law Committee, liaises with the Ministry of Finance on various matters including tax legislation and administration. Knowledge of issues surrounding income tax avoidance is likely to be useful in furthering the interest of ICPAK membership. In this respect, this study is likely to be of interest to ICPAK.

(iii) Ministry of Finance

The Ministry of Finance makes tax proposals for debate in Parliament. It is also in charge of income tax administration through the Income Tax Department. Income tax avoidance is therefore of some relevance to the Ministry. Consequently, this study is likely to draw some interest from these quarters.

(iv) Researchers/Scholars

Income tax avoidance in Kenya, as evidenced in local libraries, remains a fairly unresearched area. This study is likely to set pace for studies in the area and as a result may prove to be of interest to researchers and scholars.

¹⁰ Tax Planning for small Companies, by Bill Swisher, *Accountant*, April 1992 (P.18)

¹¹ Tax Avoidance by Savings-and-Loss Associations Before and After the Tax Reform Act of 1986, *Journal of Monetary Economics* 17 (1986, 41-51).

¹² Reported in the article: The multi-billion dollar growth industry called tax avoidance by J. S. Walleweller, *Accountant*, 1992, (99,122-124)

2. LITERATURE REVIEW

2.1 INTRODUCTION

"Tax planning sometimes conjures up great visions of exotic havens and complex schemes"³⁰. The same could be said of tax avoidance which is a component of tax planning, the other component being tax evasion.

Tax avoidance is not only about complicated schemes. Some empirical studies in this area have sought to establish tax avoidance practice and the attitudes towards tax avoidance.

Kane and Valentini³¹, in a survey involving savings and loans associations described tax avoidance opportunities and experience. Using regression models, they found holding company affiliates and surtax-exempt stock associations to be more effective tax minimizers than other savings and loans associations.

In an opinion survey carried out by the Australian Institute of Chartered Accountants³², those responding seemed to be against tax avoidance. The survey involved a proposed statement on taxation standards which, if accepted, would become mandatory and failure to comply could result in investigation and disciplinary action. One of the standards provided that "a member should not promote, or assist in the promotion of any schemes or arrangements which have no commercial

³⁰ Tax Planning for small Companies, by Bill Pritchard, Certified Accountant, April 1992 (P.38)

³¹ Tax avoidance by Savings-and-Loan Associations before and after The Tax Reform Act of 1969, Journal of Monetary Economics (1975) (PP. 41-63).

³² Reported in the article: The Multi-million dollar growth industry called tax avoidance by I G Wallschutzky, Accountancy, June 1982. (PP.122-124)

justification other than the avoidance of tax through the exploitation of the revenue laws". For the purpose of the questionnaire, the term tax avoidance was defined as "reduction of one's tax liability by means which are within the letter of the law, but against its spirit". 59% of the sampled Institute members were reported to have approved the particular standard whereas 72% of the sampled non-Institute members were reported to have approved.

Before we examine some of the income tax avoidance opportunities available in this country, we will ask ourselves as to what motivates companies to engage in tax avoidance practices. In an attempt to answer this question, we will look at the micro-economics of income tax avoidance.

2.2. MICRO-ECONOMICS OF INCOME TAX AVOIDANCE

Microeconomics is, "concerned with the behaviour of individual economic units and their interactions. The two types of economic units typically considered are firms and consumers"³³. This study deals with firms. A firm is viewed as being faced with an optimization problem. Its core choice variables are input and output levels. Other variables include advertising, research and development expenditures, as well as tax. The firm's objective is to maximize profit. Profit for this purpose, is defined as the difference between the revenue a firm receives and the costs it incurs.

For our purpose, we will deal with a firm, and assume for the sake of simplicity, of tax at a constant proportion of profit. The profit after tax could be represented as:

- (i) Tax compliance considerations;
- (ii) Pre-accounting tax considerations.

³³ Varian, H.R., Microeconomic Analysis, Second Edition (P.1), 1984.

Let total revenue of the firm be $R(q)$ and total cost be $C(q)$, both being a function of output produced.

$$\pi = R(q) - C(q) - t[R(q) - C(q)]$$

$$= (1 - t) [R(q) - C(q)] \quad (1)$$

Where π = Profit after tax

and t = tax rate where $0 < t < 1$.

The optimal profit condition may be got by setting the derivative of (1) in respect to q equal to zero.

$$\frac{d\pi}{dq} = (1 - t) [R'(q) - C'(q)] = 0 \quad (2)$$

But when solving we note $1 - t \neq 0$

so that $R'(q) - C'(q) = 0$

hence $R'(q) = C'(q)$

which is $MR = MC$

This suggests that tax does not affect optimal production levels. In order to reduce the tax burden therefore, the profit subject to tax, should be reduced.

We next look at some of income tax avoidance opportunities available to companies in Kenya.

2.3 INCOME TAX AVOIDANCE OPPORTUNITIES

There are many tax avoidance opportunities under the Kenya income tax. For the purpose of this study, the illustrative opportunities will be dealt with under three categories:-

- (i) Tax compliance considerations;
- (ii) Pre-accounting date considerations;

- (ii) Pre-accounting date considerations; and
- (iii) Other considerations.

2.3.1 Tax Compliance Considerations

Tax compliance involves the execution of tax functions within specified deadlines. These functions include filing of tax returns, lodgement of objections and appeals when dissatisfied with assessments and confirming notices, and, payment of taxes.

Non compliance may carry with it tax penalties. Tax penalties are part of taxes and as such, for the purpose of this study, tax compliance is treated as part of tax avoidance. At least, if it is not treated as part of tax avoidance, it should be considered as the basis for it. Without an awareness of tax compliance requirements and consequences for non-compliance it would be difficult to mitigate against tax penalties and carry out tax avoidance practice effectively.

(a) Income Tax Returns

The income tax returns filed by a company are:-

(i) Instalment Tax Return

The instalment tax return and the related tax payment are due nine months within an accounting period. A company is required to pay a percentage of the estimated tax for the

respective accounting year. The appropriate percentage will be phased in over five years as follows:-

Accounting year Commencing on or after	Instalment tax payable %
1.1.90	15
1.1.91	30
1.1.92	45
1.1.93	60
1.1.94	75

The penalty for noncompliance is 15% on the difference between normal tax and the instalment tax, with a 10% allowance, plus 1.5% per month for late payment.

(ii) Provisional Return

A provisional tax return and the related tax payment are due three months after an accounting date. The tax payable is based on total income. However, the tax payable is net of the respective instalment tax. With effect from the year of income commencing on or after 1 January 1992 provisional returns will be discontinued. Under-estimation on provisional return, subject to a 10% margin, carries a 1.5% per month penalty. The penalty for non-submission is 3% per month and is based on normal tax from due date until the date of the estimated assessment.

(iii) Final Return

A final return is due for filing nine months after an accounting date. However, for the years of income commencing on or after 1 January 1992, a final return will be due for filing by the fourth month after an accounting date together with a self assessment. The tax payable, net of the respective instalment tax paid will also be due by the same date. The penalty for non-compliance is 5% per annum on normal tax.

(b) Income Tax Assessments

These could be either original, additional or amended.

(i) Original Assessment

An original assessment is either estimated or based on a return of income.

(ii) Additional Assessment

An additional assessment may be raised following the issuance of an original assessment.

Where a taxpayer is dissatisfied with an original or an additional assessment, an objection against the assessment should be made within sixty days of its issuance. However, an objection is only valid where a final return of income, and accounts, where relevant, have been submitted.

(iii) Amended Assessment

An amended assessment may be issued following the raising of an original or an additional assessment. Where a taxpayer is dissatisfied with the amended assessment, a notice of intention to appeal to the local committee should be filed within thirty days, followed by fourteen days within which to file appeal papers.

(c) Confirming Notices

An assessment may be confirmed instead of being amended. A confirming notice is dealt with in the same way as an amended assessment.

(d) Appeals

Appeals against amended assessments and confirming notices are made to the Local Committee or Tribunal. An appeal is taken to Court if a taxpayer is dissatisfied with the decision of the local committee or tribunal. However, this is allowed only on a question of law or a mixture of law and fact.

A taxpayer has fifteen days within which to file a notice of intention to appeal after which he has another thirty days within which to file the appeal to court. Before a court appeal can be accepted however, a deposit of the total tax in dispute, plus penalties, must be made.

(e) Payment of Tax

Payment of tax on an assessment should be made within thirty days of its service per Sec. 92(2) of the Income Tax Act. In practice, however, the tax is payable usually by the end of the month following.

Where a decision has been made against a taxpayer by the local committee/tribunal, notwithstanding the intention to appeal to court, the tax in dispute, plus penalties, is payable thirty days after notice of the respective decision.

The penalty for noncompliance is 15% late payment penalty plus a late payment interest of 1.5% per month.

In respect of tax liabilities, a company should be concerned with the how and when of payment. A company should conserve cash by making payments only when taxes are owed. Overpayments are interest-free loans to the government, while nonpayments or underpayments may result in a non-tax deductible penalty.

With knowledge of how to play safe with delayed tax payment as well as appraisal of costs associated with non-payment, a company may be able to direct funds to short-term investments to its economic advantage. As pointed out earlier, an underpayment of tax liability does not necessarily mean that a business must pay an underpayment penalty. Consequently a tax advantage could arise from this knowledge.

(f) Tax Correspondence

Tax correspondence is taken as part of tax compliance activities. Tax correspondence should be reviewed regularly otherwise certain action may not be taken or may be taken late thereby increasing the probability of incurring further costs in an effort to redress issues. Tax officials sometimes send signals through letters and timely action therefore becomes necessary.

In conclusion, it should be noted that non-compliance may carry with it heavy penalties. Consequently, every effort should be made to ensure that penalties for non-compliance are avoided or kept to a minimum.

3.3.2 Pre-Accounting Date Considerations

A pre-accounting date review is undertaken to identify, and if appropriate, to mitigate tax liabilities for the period or to avoid potential pitfalls. This could include:-

(a) Deferral of Taxable Profits

It is important to consider whether, subject to commercial constraints, income can be deferred to a later accounting period, or expenditure advanced to an earlier period.

(i) Deferral of Income

The methods that can be adopted include:-

- . Timing of sale of goods or services to fall into a later accounting period.
- . Consideration of the most appropriate method of reporting sales income, especially in specialised trades such as leasing companies, insurance brokers, construction companies, finance and hire purchase companies and commodity dealers, with a view to possible deferral of corporation tax liabilities.
- . Selling goods on consignment so that the recognition of income for tax and accounting purpose is deferred.

- . Extending or shortening the accounting reference date. This could be particularly important where business is interrupted and for seasonal business. However, a change in accounting date requires approval from the Commissioner of Income Tax and this should be obtained.
- . Review of inter-group trading policies to ensure that sales between group companies do not create unnecessary tax liabilities on unrealised profits arising from inter-group sales.
- . Deferral of receipt of investment income. This may apply in a group situation where such income, for example dividend income, is taxed as it arises.

(ii) Advancing of Expenditure

The methods that can be adopted include:-

- . Bringing forward the date on which capital expenditure, qualifying for capital allowances, is incurred. Capital allowances are normally due in the accounting period in which expenditure is incurred and the asset brought into use.
- . Advancing revenue expenditure. Deductions on revenue expenditure, if available, are given for expenditure incurred in a particular accounting period. Advancing revenue expenditure could therefore give relief in an earlier accounting period. This can be done, for example, by accelerating bonuses to directors and staff, making use of specific provisions for bad debts and

slow moving stock items, and also accelerating payments which constitute charge on income.

(b) Management/Service Charges

In respect of a group of companies use of charges or reallocation of expenses should be considered to ensure that some members in the group do not pay corporation tax while others have tax losses in the same accounting period.

However, the question of value added tax (VAT) should not be overlooked.

(c) Capital/Revenue Expenditure

Other possible preaccounting date considerations could include ensuring that taxwise classification of capital and revenue expenditure is correctly made. This enables maximum tax advantage to be available to the company for the period.

As can be seen from the above, some of the pre-accounting date considerations involve long-term company policies. However, these need be re-examined in light of tax minimization goals before the accounting date. However, one needs to emphasize that, any review of a company's tax affairs with a view to achieving tax savings should take into account the commercial requirements of the company such as short and medium term objectives as well as the impact on the company's liquidity or borrowing requirements.

2.3.3. Other Considerations

Other areas which provide tax avoidance opportunities and are of particular importance and relevance to Kenya could include company acquisition, raising finance, employee benefits, family companies, tax incentives, investments, and political and economic changes.

(a) Company Acquisition

The acquisition of a company is an event with short, medium and long term consequences. As a result, the event needs to be thoroughly thought out from as many points of view as possible. Income tax is a major aspect to be considered.

Taxation appears in relation to continuing and past liabilities of the acquired company. Thus, tax affects the value to be placed on the company being acquired, and therefore could be of primary importance. The fundamental requirement is to have a clear understanding of the taxes arising in relation to a purchase and the long term consequences of different kinds of transactions. Only against this background is it possible to carry out an income tax avoidance exercise which will help ensure that the purchaser reaps the greatest economic reward from the transaction.

A very searching examination of the candidate company's accounting policies and tax computations is required before a purchaser can put a value on a company. It may be necessary for the purchaser to ensure that:-

- (i) All tax returns due have been filed;

- (iii) All tax due has been paid;
- (iv) All disputed assessments have been objected against or appealed against, where appropriate, and tax not in dispute has been paid;
- (v) All tax due in the current year but not assessed, has been properly calculated and provided for in the accounts;
- (vi) No artificial or unusual transactions have been entered into triggering any of the principal anti-avoidance sections of the Income Tax Act;
- (vii) Tax losses have been agreed with the tax authorities, and their nature in respect to "specified sources" established; and
- (viii) The candidate company has properly accounted for and paid over all withholding taxes such as PAYE.

(b) Company Finance

When a company requires money it has sourcing options which include obtaining overdraft facilities, loans, issuing bonds, and selling shares. The interest paid in respect of overdraft and loan facilities as well as bonds is tax-deductible. However, dividends paid to the shareholders are not tax deductible. There is therefore a tax advantage in raising finance from sources where the associated cost is tax deductible.

In Kenya, however, it would be important to note the following restrictions on deductibility of interest:-

- (i) Sec. 15(3) of the Income Tax Act requires the satisfaction of the Commissioner that the money borrowed has been wholly and exclusively employed in production of income; and

(ii) Under Sec. 18(4), interest paid by a branch of a non-resident company to the latter is not tax deductible.

(c) Employee Benefits

A tax efficient employee benefit policy may be able to lower payroll costs. The cost of providing such benefits is usually allowable in calculating the employer's taxable profits while the benefit might be tax free or generously treated on the part of the employee. As well as providing remuneration in a cost effective way, the provision of benefits may act as an incentive to the employee, perhaps to work harder and to stay with the company. Homer suggests that "Before deciding on a benefits policy, an employer should therefore consider carefully not just the tax consequences but the overall effect of such a policy....."³⁴.

In Kenya, tax free employee benefits include medical services, value of an annual benefit not exceeding Kshs.2,400 and expatriate staff passages.

Other tax free employee benefits include subsidized canteens, training costs, long-service awards, employer's contributions to pension and approved provident fund schemes, and provision of facilities for sporting, social and recreational activities.

Partly taxed employee benefits include housing and beneficial loan arrangements.

³⁴ Employee Benefits, by A J Homer, 1989 Tolley's Tax Planning (P.203)

Housing - A benefit can arise in respect of occupation by employees where property is owned or leased by the employer. The value of the housing benefit provided by the employer for occupation by his employee, for residential purposes, is subject to tax as a gain from employment in accordance with Sec. 5(2)(3) of the Income Tax Act. The value is equal to 15% of the gain or profit from employment for most employees. Exceptions include a director of a company and an agricultural employee. In the former case, the value is equal to 15% of his total income while the later, it is 10% of gains or profit from employment. A director, however, does not include a whole-time service director. A whole-time service director is a director who is required to devote substantially the whole of his time to the service of a company and who owns not more than 5% of the share capital of the company.

A housing benefit can provide a valuable tax avoidance opportunity as demonstrated in the following example:

Two employees had an annual salary of K.£.12,000 each in 1991. They lived in similar rented accommodation where the annual rent was K.£.4,500 in each case. At the beginning of the year, one of the employees transferred his tenancy to his employer thereby surrendering part of his salary equivalent to

the rent. He was, for tax purposes, therefore housed by his employer in 1991. The 1991 takings, after housing for both employees, ignoring other deductions, was:-

	Housed K.£.	Not Housed K.£.
Salary	7,500	12,000
Housing benefit (15%)	<u>1,125</u>	-
Taxable pay	8,625	12,000
PAYE	<u>1,886</u>	<u>3,405</u>
House Rent	6,739	8,595
	-	<u>4,500</u>
Net pay	6,739	4,095
	===	===

The net advantage from the arrangement was K.£.2,644 (i.e. 6,739 - 4,095). There is therefore a monthly tax advantage of Kshs.4,407/=.

Employee Loans - Where an employer provides an employee with a loan, either interest free or at a reduced rate, the employee is taxed on a notional benefit. The benefit is calculated using prescribed rates of interest. The rate for 1992 is 10% and will be raised to 12% in 1993.

Despite the notional interest benefit, the arrangement could be tax advantageous to employees since commercial rates could be as high as 20 - 30% in the local market.

(d) Family Companies

Tax avoidance in family companies exists especially whenever corporate tax rate differs significantly from individual tax rates. Family companies are not defined under the Income Tax Act. For our purpose, they are taken to be companies where ownership and management is in the same hands. During

the period 1987 to 1993 corporate tax rates and the top personal tax rates for residents are:-

	Corporate <u>%</u>	Personal <u>%</u>
1987	45.00	65.00
1988	45.00	50.00
1989	45.00	50.00
1990	42.50	45.00
1991	40.00	45.00
1992	37.50	45.00
1993	35.00	40.00

As can be seen from the above, in 1987, corporate tax rate differed significantly from the top personal tax rate. Consequently, family companies could be used to avoid tax through non or under-distribution of profit to escape higher rate taxes. To counteract the practice however, is Sec.24 of the Income Tax Act, an anti-avoidance provision through non-distribution of dividends. Tax rates both corporate and personal have been reduced in the last seven years, the top personal rate almost evening out with the corporate tax rate. Consequently tax avoidance through family companies has become less important.

(e) Tax Incentives

Tax incentives in Kenya include investment deductions and tax holidays.

An investment deduction on qualifying expenditure is 35% in the municipalities of Nairobi and Mombasa, and 85% elsewhere. It is, however, 100% for firms manufacturing under bond.

A tax holiday of 10 years is given to Export Processing Zone (EPZ) companies in addition to other tax concessions.

These tax incentives need to be evaluated before setting a firm as income tax can be avoided or minimized depending on the medium used and location of industry.

(f) Investments

Income from some investments is tax exempt. These include interest from Post Office savings bank accounts, premium savings accounts with Postbank and tax reserve certificates. Also an important exemption from income tax are capital gains. It is therefore necessary to review existing opportunities before committing funds to investments.

(g) Political and Economic Changes

Political and economic changes may have an impact on tax. Consequently, firms should monitor signals to see if there are actions that could be taken to mitigate any anticipated adverse changes in tax legislation.

2.3.4. Conclusion

From the above, it is clear that there are many income tax avoidance opportunities and considerations available for companies in Kenya. It is however not known whether the opportunities are exploited by companies in Nairobi. This survey makes an attempt to explore the tax avoidance practices in Nairobi. As expected, some of the opportunities, such as in company acquisitions are rare. Consequently, for the survey, only those opportunities that are considered applicable to most companies and of more recurrent nature are considered.

Before proceeding to explain the research design it may be necessary to put forward a case for income tax avoidance.

2.4 CASE FOR INCOME TAX AVOIDANCE

"For a commercial enterprise, an unnecessarily increased tax burden represents a business waste which not only reduces its distributable profits, but may well make it uncompetitive"³⁵. Tax avoidance, as a tool to reduce tax burden is widely engaged

³⁵ Spitz, International Tax Planning, (P.1)

in some parts of the world. As noted by Gravelle and Rees, "the growth of the tax avoidance industry is a prime example of the rationality with which individuals calculate and organise when the returns make it worthwhile" ³⁶. And as observed by Wallschutzky, "Tax avoidance was one of the most significant growth industries in Australia during the 1970s" ³⁷.

Tax avoidance ensures that a tax burden is reduced to a minimum. This, as seen earlier, may have an economic justification. However, a firm should attempt to evaluate the benefits of income tax avoidance practice as it has associated costs. The benefits which arise from income tax avoidance include tax savings. However, the costs are less obvious and may include:

- (i) Internal resources used in income tax avoidance formulation and implementation which involve gathering and analyzing information or studying tax laws to figure out ways of reducing tax liabilities;
- (ii) Payments made for tax advice by, among others, tax professionals; and
- (iii) Time and money that may be spent in lobbying for changes in tax legislation.

Where benefits exceed the associated costs, engaging in income tax avoidance becomes justifiable for a company. It should, however, be noted that there are practical difficulties encountered in estimating benefits and costs associated with income tax avoidance practice. For this reason, companies may resort to intuitive evaluation methods.

What one could say is that success in tax avoidance practice requires foresight and a thorough knowledge of tax legislation.

³⁶ Microeconomics, Longman Group UK Ltd (P.8) 1981

³⁷ Accountancy, June 1982. (P.122).

3. RESEARCH DESIGN

This section details out the research design which has been used to achieve the objectives of the study.

3.1 POPULATION

The population of this study consists of all the companies in Nairobi listed in the Trade and Industry Guide, 1990 - 91, which incorporates the directory of members of Kenya National Chamber of Commerce and Industry. These companies are 1,389 in number.

Nairobi has been chosen as the research setting since it is the centre of business activities in Kenya. The Guide has been used since it provides names of companies, postal addresses and telephone numbers thereby forming a good sampling frame. However, it has been modified using the 1988 Kenya Telephone Directory and The Nation newspaper telephone directory of 1992.

3.2 SAMPLE SELECTION

A sample of 100 companies was selected using simple random sampling. This was done by assigning the elements in the sampling frame unique numbers ranging from 0001 to 1389. A random number table from the Rand Corporation reproduced in the Statistical Analysis for Decision Making, Third Edition (p.178) by M Hamburg, was used in the selection.

Of the 100, only 37 questionnaires were completed successfully thereby restricting the sample accordingly. A sample size of over 30 may be considered to be large³⁸ and may therefore be representative. In similar studies, where survey data from Nairobi was used, sample sizes of between 30 and 50 have been used with

³⁸ Lucey T., Quantitative Techniques, An Instructional Manual, Second Edition (P.53), 1982

satisfactory results. For example, in 1991, Kithunga, Mahinda, Lusaka and Nganga used sample sizes 32,33,35 and 36 respectively in their MBA Management Projects.

3.3

DATA COLLECTION

Primary data, collected through structured questionnaires, was used in this study.

The questionnaire, a sample of which is included in Appendix I, is divided into three areas. The first (A), deals with classification information, the second (B), deals with income tax compliance, and the third (C), is on other areas of tax avoidance. The questionnaire which has been developed from literature is based on a five point Verbal Frequency Scale. The scale contains five words which indicate how often an action has been taken. It is used to uncover the frequency of some action or behaviour by respondents. The scores attached to the scale are as follows:-

<u>Scale</u>	<u>Score</u>
Always	5
Often	4
Sometimes	3
Seldom	2
Never	1

A score of 1 indicates "inactivity" while a score of 5 indicates "most activity" in respect to a specified action.

The advantages of the Verbal Frequency Scale include "the ease of assessment and response by those being surveyed"³⁹. Its major disadvantage is that it provides only a gross measure of proportion. However, it is appropriate for a study of this nature. Taxation is sensitive and technical and therefore, for better results, the questionnaire was administered through personal interviews by the researcher. As pointed out on page 176 of the National Household Survey Capability Programme on Nonsampling

³⁹

Afreck P.L. and Settle R.B., The Survey Research Handbook (P.137), 1985.

Errors in Household Surveys "Direct interviews usually achieve higher co-operation and response rates and more complete and consistent data. In highly complex fields or involved multisubject undertakings, there may be no feasible alternative, even where literacy is high"⁴⁰. Tax avoidance is a complex field and interviews were considered to be the more appropriate in the collection of the survey data. Interviews involved, in the majority of cases, two visits. The first was to introduce the purpose of the survey and the subject matter. At this point the questionnaire was left with the respondent.

During the second visit, the questionnaire was completed and given back to the interviewer, the researcher.

3.4 RESPONDENTS

The respondents in this survey were mainly the companies' chief accounting officers and depending on the size and structure of an organization, the functions of the chief accounting officer may be executed by personnel under various names: Chief Executive, Managing Director, Finance Director, Financial Controller, Chief Accountant, and Company Accountant. However, in some organizations the functions may be carried out by more than one officer. Consequently, response to the questionnaire was not necessarily restricted to one individual.

3.5 DATA ANALYSIS

Tables, percentages, means, chi-square and regression analysis have been used.

Tables, percentages and means are used in summarizing the data.

Chi-square is used to measure association between specified categories of companies in respect of tax avoidance behaviour. It is also used to find out whether there are

⁴⁰ The 1982 Preliminary Version referring to the UN revised Handbook of Household Surveys.

differences in tax avoidance emphasis by companies as classified in the study. Chi-square is found to be appropriate since no causality is implied and the focus is merely on the degree of association between the variables.

Regression analysis is used in assessing the relationship between tax avoidance behaviour (represented by mean scores) and

- (i) age; and
- (ii) size of a company.

In the first case, age is the independent variable and mean score, the dependent variable. In the second, size is the independent variable and mean score, the dependent variable.

The statistical package at the University of Nairobi has been used to compute the coefficient of determination, which is an indicator of how much influence an independent variable has on a dependent variable.

A table of mean scores and their frequency in the specified categories: equity ownership status (foreign, local or mixed), types of company (public or private), and economic classification (holding, subsidiary or others) is in Appendix II. A table of mean scores, age and size of a company is in Appendix IV. Further analysis is done using chi-square and simple regression. However, before we look at the analysis it may be necessary to look at questionnaire responses.

RESPONSES

The survey response was not encouraging. The response was as shown below:

Response	No.
Successful response	37
Non-response	47
Refusals	26
	110

4. DATA ANALYSIS AND FINDINGS

4.1 INTRODUCTION

The data analysis is based on a mean score which has been calculated for each questionnaire. The scores on the questionnaire range from 1 to 5; from inactivity to most active, in respect to a specific activity. Where a question is not applicable, no score is given. As a result, mean scores should range from 1 to 5. A score of greater than 1 indicates some activity and by implication, an element of income tax avoidance. Mean scores are further classified as high frequency (H) for scores ≥ 3 , or low frequency (L) for scores of less than 3. The questionnaire, as pointed out earlier, is divided into three sections. The first is categories, the second on income tax compliance considerations and the third is on noncompliance considerations. Aggregate mean scores (B&C) as well as mean scores for the second (B) and third (C) sections are calculated. For B & C, B and C the scores are classified into high frequency (H) and low frequency (L) - Appendix II.

A table of mean scores and their frequency in the specified categories: equity ownership status (foreign, local or mixed), types of company (public or private), and economic classification (holding, subsidiary or other) is in Appendix III. A table of mean score, age and size of a company is in appendix IV. Further analysis is done using chi-square and simple regression. However, before we look at the analysis it may be necessary to look at questionnaire responses.

4.2 RESPONSES

The survey response was not encouraging. The response was as shown below:-

<u>Out-come</u>	<u>No.</u>
Successful response	37
Non-response	
Non-contact	47
Refusals	<u>16</u>
	<u>100</u>

A response rate of 37% is poor but not unusual in surveys. A national food survey in the U.K. in 1971, for example, had a response rate of 54% as reported in the UN 1982 manual: National Household Survey Capability Programme, Non-sampling Errors in Household Surveys: Sources, Assessment and Control (p.69). It should be noted that U.K. is a developed country and has a better research environment as compared to Kenya.

The high non-contact rate (47%) was mainly due to recent changes on telephone lines. Some businesses falling in the sample also changed locations. The high rate was also influenced by time constraint of the duration available for the research.

4.3 GENERAL OBSERVATION

From the mean score frequency summary, appendix II, the lowest aggregate score (B&C) is 1.67. From the definition of scores, 1 standing for inactivity, and 5 for most activity, one concludes that income tax avoidance activity is evident in all the firms in the sample. However, most activity is on compliance issues since the B scores appear higher than C scores from a casual examination of the summary. This seems to satisfy the main objective of the study: to establish whether income tax avoidance is practised by companies in Nairobi.

4.4 CHI-SQUARE TESTS

Chi-square tests have been carried out to find out whether differences in income tax avoidance practices (as reflected in mean scores) exist among specified categories of companies, and also whether there are areas of tax avoidance emphasis, compliance, as compared to noncompliance considerations. In these situations, no causality is implied and the focus is merely on the degree of association.

4.4.1 Equity Ownership Status

Equity ownership is classified into three, wholly foreign owned, wholly locally owned and mixed ownership. Ownership may affect the behaviour of a firm. It is therefore worth finding out whether ownership affects the behaviour towards income tax avoidance by firms.

From the table in appendix III the results on equity ownership are given below:-

	<u>Actual Frequencies</u>		
	H	L	Total
Wholly foreign owned	-	1	1
Wholly locally owned	9	20	29
Mixed ownership	<u>4</u>	<u>3</u>	<u>7</u>
	<u>13</u>	<u>24</u>	<u>37</u>

Assuming equal proportion (13:24), the expected observations are given below:-

	<u>Expected Frequencies</u>		
	H	L	Total
Wholly foreign owned	1	-	1
Wholly locally owned	10	19	29
Mixed ownership	<u>2</u>	<u>5</u>	<u>7</u>
	<u>13</u>	<u>24</u>	<u>37</u>

The smallest expected cell frequency for the chi-square statistic to be valid is five expected cases. As the above table shows, three of the cells have less than five cases. Consequently a chi-square statistic has not been calculated. However, using actual observations, it can be seen that the only wholly foreign owned company in the sample, has a mean score classified under low frequency (L) while 31% and 57% of the wholly locally owned and those of mixed ownership respectively have mean scores classified under high frequency (H). The expected observation in the latter two under high frequency is 35%.

From the above, it is not possible to make an inference on income tax avoidance behaviour differences on the basis of equity ownership.

4.4.2. Types of Companies

Limited companies may be public or private.

A private company has a minimum and a maximum number of shareholders limited to 2 and 50 respectively. It is prohibited from inviting the general public to subscribe to its shares. The shares are not freely transferable between members.

A public company has its number of shareholders limited to a minimum of 7 while

the maximum number is limitless. It can offer its shares to the general public. The shares are also freely transferable.

Due to the differences between public and private companies this survey tries to find out whether there is an association between the legal status (public/private) and income tax avoidance behaviour (as measured by mean scores).

The following results are drawn from appendix III:-

	<u>Actual Frequencies</u>		
	H	L	Total
Public	1	1	2
Private	<u>12</u>	<u>23</u>	<u>35</u>
	<u>13</u>	<u>24</u>	<u>37</u>

Without going into further tabulation, it can be noticed that the data does not lend itself to a chi-square test since cases in two cells are less than five. It can however be observed that the two categories have unequal proportions of companies falling under high and low frequency. This may suggest that there could be behavioural differences between public and private companies in respect to income tax avoidance practice.

4.4.3. Economic Status

There are three categories in this group: Holding, Subsidiary and Others. It should be noted that tax law in Kenya does not permit any form of consolidated income tax return combining the profits and losses of affiliated companies. Also dividends paid by one resident company to another are exempt from income tax in the recipient company's hands if it controls 12.5% or more of the voting power of the paying company. As a result, one would expect group companies to exhibit differences in behaviour from the other companies. For this survey, holding and subsidiary companies are treated as being in a group situation. The observed results in appendix III are:-

Actual Frequencies

	H	L	Total
Holding/subsidiary	7	7	14
Others	<u>6</u>	<u>17</u>	<u>23</u>
	<u>13</u>	<u>24</u>	<u>37</u>

We test at 5% level, the following hypotheses:-

Ho: The two categories are independent and therefore there is no relationship between them in their behaviour towards income tax avoidance.

H1: The categories are not independent.

The expected observation assuming equal proportion in frequencies (13:24)

Expected Frequencies

	H	L	Total
Holding/Subsidiary	5	9	14
Others	<u>8</u>	<u>15</u>	<u>23</u>
	<u>13</u>	<u>24</u>	<u>37</u>

Chi-square calculation:-

Observed Frequencies	Expected Frequencies	O-E	(O-E) ²	$\frac{(O-E)^2}{E}$
<u>(O)</u>	<u>(E)</u>	<u>O-E</u>	<u>(O-E)²</u>	<u>E</u>
7	5	2	4	0.80
6	8	-2	4	0.50
7	9	-2	4	0.44
17	15	2	4	<u>0.27</u>
		$X^2 =$		<u>2.01</u>

The value of cut-off point of X^2 for 1 degree of freedom from table in appendix V is 3.841.

As the calculated value (2.01) is less than the table value, we fail to reject the null hypothesis. This suggests that there is a likelihood that group companies behave differently from others in respect to income tax avoidance.

4.4.4 Income Tax Avoidance Emphasis

Income tax compliance considerations are better defined as compared to other income tax avoidance considerations. Consequently, the emphasis of taxpayers in the two areas is likely to be different.

The observed frequencies in Appendix II are:-

	<u>Actual Frequencies</u>	
	H	L
Compliance (B)	29	8
Noncompliance (C)	7	30

We test at 5% level, the following hypotheses:-

H_0 : The two categories, compliance and noncompliance, are independent in respect to income tax avoidance behaviour.

H_1 : The categories are not independent.

The expected frequency is the proportion of the aggregate mean score (B&C), 13:24.

	<u>Expected Frequencies</u>	
	H	L
B	13	24
C	13	24

Chi-square calculation

Observed Frequencies (O)	Expected Frequencies (E)	O-E	(O-E) ²	$\frac{(O-E)^2}{E}$
29	13	16	256	19.69
7	13	-6	36	2.77
8	24	16	256	10.67
30	24	6	36	1.50
			$X^2 =$	<u>34.63</u>

The value of cut-off point of X^2 for 1 degree of freedom from the table in appendix V is 3.841

As the calculated value (34.63), is greater than the table value, we reject the null hypothesis and accept that there is an association between compliance and noncompliance income tax avoidance considerations.

4.5 SIMPLE REGRESSION ANALYSIS

Regression analysis is used here in assessing the relationship between income tax avoidance behaviour, represented by mean scores, and

(a) the age of a company in years; and

(b) the size of a company.

The statgraphic package at the University of Nairobi has been used to plot graphs, mean scores (VARI) regressed on age (VAR2) and mean score (VARI) regressed on number of employees (VAR3); and compute the coefficient of determination (r^2) which is used as an indicator of how much influence the independent variable has on the dependent variable.

4.5.1 Company Age

Mintzberg proposes a hypothesis that "The older the organization, the more formalized its behaviour"⁴¹. He talks of the "we've-seen-it-all-before" syndrome.

This survey's interest is in the relationship between income tax avoidance behaviour and the age of a company.

VAR1 is regressed on VAR2. The coefficient of determination (r^2) read from the printout in appendix VI is .44%.

The coefficient of determination of 0.0044 indicates a very poor relationship between the variables. Thus, the percentage of variance in the mean score that is explained by age is insignificant at .44%. However, an interesting pattern can be observed from the respective graph, appendix VII. The graph shows a steady increase from

⁴¹ Mintzberg H., The Structure of Organizations (P.227)

left to right. This may suggest that as companies grow older, their practice in income tax avoidance increases but at a very slow rate.

4.5.2 Company size

There are many ways that can be used in measuring the size of a company. These include number of employees, turnover, net assets, share of the market, branch network, and product lines. This survey sought data on the first three, employees, turnover and net assets (appendix IV). However, of those interviewed, 60% refused to disclose details of turnover and net assets. Consequently, employees are used as the only measure of size in this study. Employees are however the commonest measure of size used in literature⁴². It is the most favoured base because:-

- (a) It provides a simple measure of size;
- (b) It is a convenient common denominator since most organizations have employees; and
- (c) It is more objective.

The survey interest is to find out the relationship between income tax avoidance behaviour and size as measured by the number of employees.

VAR1 is regressed on VAR3. The coefficient of determination read from the computer printout in appendix VIII is 1.12%.

A coefficient of determination as low as 0.0112 shows a poor relationship between variables. The percentage of variance in the mean scores that is explained by the size of a company, taking employees as the base, is also insignificant at 1.12%. As in the case of age however, the respective graph, when VAR1 is regressed on VAR3, appendix IX, shows a steady increase. It therefore suggests that as companies grow in size, their practice in income tax avoidance increases but also at a slow rate.

⁴² Hodges B.J. and Anthony W.P., Organization Theory, 3rd Edition, Needham Heights, Massachusetts, Allyn & Bacon Inc., 1988 (P.396).

5. SUMMARY AND CONCLUSION

5.1 SUMMARY

The main objective in carrying out this survey has been to establish whether income tax avoidance is practised by companies in Nairobi.

By way of background, tax avoidance has been defined. At the same time tax evasion, a related concept has also been defined and its relationship to tax avoidance explained. Anti-avoidance legislation as a government tool to reduce the incidence of tax avoidance has been referred to. The Kenya and U.K. courts' approaches to tax avoidance has been reviewed and a brief mention of the effect of ethics on society's reaction to tax avoidance has been mentioned.

In the study, the firm has been assumed to be a profit maximizer. Income tax avoidance opportunities in Kenya have been explored and a case put forward for income tax avoidance.

To facilitate uncover income tax avoidance behaviour of firms, a structured questionnaire, based on a five point verbal frequency scale, was administered on sampled respondents. Income tax avoidance behaviour has been summarised by use of mean scores.

From a general observation of the summary of results, the minimum aggregate mean score is greater than one. From the study's definition of what constitutes income tax avoidance therefore, this suggests that companies in Nairobi practice income tax avoidance.

The subsidiary objectives of the study are:-

- (i) to find out whether tax avoidance practice among specified categories of companies is the same;
- (ii) to find out areas of income tax avoidance emphasis; and
- (iii) to establish whether there are relationships between income tax avoidance and the age of a company as well as its size.

Using Chi-square tests, income tax behaviour of group companies has been found to be independent of the behaviour in other non-group companies. Compliance and non-compliance income tax avoidance considerations were found not to be independent.

Using simple regression, it has been found that poor relationships may exist between income tax avoidance behaviour of a firm and its age as well as size. In both cases, income tax avoidance activity tended to increase with increase in age and size though at a very slow pace.

5.2 CONCLUSION

Admittedly, the results obtained in this survey may be trivial. However, it is hoped that they might provide a basis for local research in the field of income tax avoidance, both theoretical and empirical. Allingham and Sandmo, in their analysis of income tax evasion, seemed to have arrived at similar conclusions. They hoped that the approach they used would "suggest other topics for research in the field, both theoretical and empirical"⁴³.

Studies in income tax avoidance may be interesting. However, as found out in this study, getting local survey data on the subject can be difficult. This is partly because of the sensitivity of the subject and possibly because of the rather indifferent research environment.

5.3 LIMITATIONS OF THE STUDY

Problems were faced during the research and included:-

- (a) Identification of the right respondents was not always easy. This was partly because in some cases tax affairs were handled by in-house personnel as well as external auditors. Consequently, the income tax avoidance activity could have been over or understated.

⁴³ Journal of Public Economics Vol. 1 (1972), P.337.

- (b) It was not possible to carry out many interviews thereby restricting the sample size to 37. The representativeness of the sample therefore becomes a major concern.
- (c) The sampling frame used was not tested for comprehensiveness. This may pose a threat to external validity of the survey findings.
- (d) The time allocated for research was relatively short for the area of study. This had an effect on the sample size.

5.4 RECOMMENDATIONS FOR FURTHER STUDIES

This survey deals with income tax avoidance only. Further studies which could be carried out in related areas could include:-

- (a) Tax avoidance behaviour of individuals;
- (b) Tax evasion behaviour of firms and individuals;
- (c) Evaluation of selected tax planning tools;
- (d) The attitude of Kenyans towards the imposition of income tax; and
- (e) Analysis of certain income tax avoidance techniques under the Income Tax Act.

In addition, the approach used in this study could be adopted in a country-wide survey.

Name of Company: _____

Address : _____

Telephone No. : _____

Dear Respondent

I am a postgraduate student in the Faculty of Commerce, University of Nairobi.

In partial fulfilment of the requirements of MBA Course, I am conducting a study in the area of **CORPORATE INCOME TAX PLANNING**.

Please assist me by completing the questionnaire below. The information you give will be used for **STATISTICAL PURPOSES ONLY** and **WILL BE TREATED IN STRICT CONFIDENCE**.

QUESTIONNAIRE

PART A

(1) Equity ownership status of the company:-

- | | |
|---|-----|
| Wholly foreign owned | () |
| Wholly locally owned | () |
| Partly foreign and partly locally owned | () |

(2) Legal status of the company:-

- | | |
|---------|-----|
| Public | () |
| Private | () |

(3) Economic status of the company:-

- | | |
|-------------------|-----|
| Holding | () |
| Subsidiary | () |
| None of the above | () |

(4) For how long has the company been in operation? Number of years _____

(5) How many employees does the company have? Number of employees _____

(6) Turnover of the company (last audited accounts)

Kshs. _____

Year _____

(7) Net assets of the company (last audited accounts)

Kshs. _____

Year _____

PART B

How frequently do you ensure that:-

(1) The company's income tax returns are submitted to the Income Tax Department by the deadline dates?

Always Often Sometimes Seldom Never

() () () () ()

(2) Assessments are checked and if found incorrect, are objected against in time?

() () () () ()

(3) Payment of taxes are made in time to avoid penalties?

() () () () ()

(4) Tax appeals, which include filing notices of intention to appeal and lodgement of appeal papers, are made in time?

() () () () ()

How frequently:-

(5) Do you consider deferral of payment of tax to take advantage of Income Tax Department shortcomings?

() () () () ()

(6) Do you consider deferral of payment of tax for short-term investments?

() () () () ()

	Always	Often	Sometimes	Seldom	Never
Level of correspondence with tax authorities:-	()	()	()	()	()
High ()					
Low ()					
(7) If high, how frequently is the correspondence reviewed?		()	()	()	()

PART C

	<u>Always</u>	<u>Often</u>	<u>Sometimes</u>	<u>Seldom</u>	<u>Never</u>
During approximately three months preceding the company's accounting date, how frequently do you:-	()	()	()	()	()
(1) Consider the level of management/service charges in respect of group companies?	()	()	()	()	()
(2) Consider deferral of receipt of investment income in a group situation?	()	()	()	()	()
(3) Consider dividends or benefits as alternatives to owner-director remuneration?	()	()	()	()	()
(4) Consider profit under-distribution requirements?	()	()	()	()	()
(5) Consider timing of capital expenditure to give tax relief as early as possible?	()	()	()	()	()
How frequently do you:-					
(6) Consider the method of reporting sales income from a tax point of view?	()	()	()	()	()
(7) Consider advancing revenue expenditure to obtain tax relief in an earlier period?	()	()	()	()	()

	<u>Always</u>	<u>Often</u>	<u>Sometimes</u>	<u>Seldom</u>	<u>Never</u>
(8) Consider use of consignment sales to take tax advantage of delayed billings?	()	()	()	()	()
(9) Ensure that the choice of accounting date is correct?	()	()	()	()	()
(10) Consider debt financing as an alternative to equity financing from a taxation point of view?	()	()	()	()	()
How frequently do you ensure that:-					
(11) Taxwise classification of capital expenditure is correctly made?	()	()	()	()	()
(12) Taxwise classification of capital and revenue expenditure is correctly made?	()	()	()	()	()
In recruiting staff, how frequently do you:-					
(13) Consider tax effect of alternative staff remuneration packages?	()	()	()	()	()
THANK YOU VERY MUCH					
G G KARUU					

MEAN SCORE FREQUENCY SUMMARY (B&C, B,&C CLASSIFICATIONS)

	COMPANY (R/N)	MEAN SCORES			B	H	L	C	H	L
		B&C	H	L						
1.	0564	3.60	X		3.71	X		3.54	X	
2.	0131	2.18		X	3.17	X		1.64		X
3.	0274	1.88		X	3.00	X		1.27		X
4.	0926	2.19		X	3.40	X		1.64		X
5.	1173	2.56		X	4.14	X		1.55		X
6.	1228	3.16	X		4.00	X		2.77		X
7.	0634	2.00		X	3.80	X		1.18		X
8.	0228	3.00	X		3.67	X		2.60		X
9.	0909	2.16		X	4.17	X		1.23		X
10.	0913	3.71	X		3.17	X		4.12	X	
11.	0799	2.88		X	3.67	X		2.45		X
12.	0969	3.12	X		3.67	X		2.82		X
13.	0813	3.21	X		3.67	X		3.00	X	
14.	0293	2.79		X	3.67	X		2.38		X
15.	0941	2.63		X	3.67	X		2.15		X
16.	1175	2.35		X	3.67	X		1.64		X
17.	0729	2.00		X	3.00	X		1.50		X
18.	0079	2.06		X	4.14	X		1.36		X
19.	1007	2.22		X	3.00	X		1.92		X
20.	0009	3.79	X		3.14	X		4.17	X	
21.	0676	2.86		X	3.17	X		2.62		X
22.	0074	4.10	X		5.00	X		3.69	X	
23.	0911	3.85	X		4.14	X		3.69	X	
24.	0588	3.12	X		3.67	X		2.82		X
25.	1201	1.67		X	2.00		X	1.45		X
26.	0285	1.80		X	2.28		X	1.54		X
27.	0608	1.65		X	2.00		X	1.46		X
28.	0976	1.69		X	2.33		X	1.30		X
29.	0920	2.60		X	3.43	X		2.15		X
30.	0673	1.83		X	2.14		X	1.64		X
31.	0936	2.70		X	3.40	X		2.42		X
32.	0706	1.93		X	2.43		X	1.33		X
33.	0572	1.83		X	2.28		X	1.54		X
34.	0678	1.73		X	2.33		X	1.50		X
35.	0073	3.47	X		3.67	X		3.33	X	
36.	0634	3.11	X		3.86	X		2.64		X
37.	0602	3.21	X		4.33	X		2.79		X

MEAN SCORE SUMMARY BY SPECIFIED CATEGORIES

<u>In Numbers</u>	<u>B & C</u>	<u>B</u>	<u>C</u>
High Frequency (H)	13	29	7
Low Frequency (L)	<u>24</u>	<u>8</u>	<u>30</u>
	<u>37</u>	<u>37</u>	<u>37</u>

As a Percentage

High Frequency (H)	35	78	19
Low Frequency (L)	<u>65</u>	<u>22</u>	<u>81</u>
	<u>100</u>	<u>100</u>	<u>100</u>

Key

- R/N - Random number of firm
- B & C - Compliance and noncompliance considerations
- H - High Frequency
- L - Low Frequency
- B - Compliance considerations
- C - Noncompliance considerations

MEAN SCORE SUMMARY BY SPECIFIED CATEGORIES

COMPANY (R/B)	SCORE (B&C)	<u>Equity Ownership</u>			<u>Legal Status</u>		<u>Economic Status</u>		
		<u>W/F</u>	<u>W/L</u>	<u>Mixed</u>	<u>Public</u>	<u>Priv.</u>	<u>Holding</u>	<u>Sub.</u>	<u>NHNS</u>
1. 0564	3.60			X		X		X	
2. 0131	2.18		X			X			X
3. 0274	1.88		X			X			X
4. 0926	2.19		X			X			X
5. 1173	2.56		X			X			X
6. 1228	3.16		X			X	X		
7. 0634	2.00			X		X			X
8. 0228	3.00		X			X			X
9. 0909	2.16		X			X	X		
10. 0913	3.71		X			X		X	
11. 0799	2.88			X		X			X
12. 0969	3.12					X	X		
13. 0813	3.21		X			X		X	
14. 0293	2.79		X			X		X	
15. 0941	2.63	X				X			X
16. 1175	2.35		X			X			X
17. 0729	2.00		X			X			X
18. 0079	2.06		X			X	X		
19. 1007	2.22		X			X	X		
20. 0009	3.79		X			X			X
21. 0676	2.86		X			X		X	
22. 0074	4.10		X			X		X	
23. 0911	3.85		X			X			X
24. 0588	3.12		X			X			X
25. 1201	1.67		X			X		X	
26. 0285	1.80		X			X		X	
27. 0608	1.65		X			X			X
28. 0976	1.69		X			X	X		
29. 0920	2.60		X			X			X
30. 0673	1.83		X			X			X
31. 0936	2.70		X			X			X
32. 0706	1.93		X			X			X
33. 0572	1.83		X			X			X
34. 0678	1.73		X			X			X
35. 0073	3.47		X			X			X
36. 0634	3.11		X			X			X
37. 0602	3.21		X			X			X

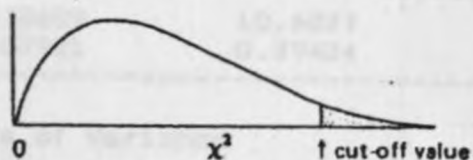
			<u>High Frequency</u>	<u>Low Frequency</u>	<u>Total</u>
Wholly foreign owned			-	1	1
Wholly locally owned			9	20	29
Mixed ownership			4	3	7
			<u>13</u>	<u>24</u>	<u>37</u>
			<u>High Frequency</u>	<u>Low Frequency</u>	<u>Total</u>
Public			1	1	2
Private			<u>12</u>	<u>23</u>	<u>35</u>
			<u>13</u>	<u>24</u>	<u>37</u>
Holding			3	3	6
Subsidiary			4	4	8
Others			<u>6</u>	<u>17</u>	<u>23</u>
			<u>13</u>	<u>24</u>	<u>37</u>
Holding/Subsidiary			7	7	14
Others			<u>6</u>	<u>17</u>	<u>23</u>
			<u>13</u>	<u>24</u>	<u>37</u>
<u>Key</u>			110		
R/N	Random number of firm		120		
W/F	Wholly foreign owned				
W/L	Wholly locally owned				
NHNS	Neither holding nor subsidiary				

MEAN SCORE, AGE AND SIZE SUMMARY

COMPANY (R/N)	MEAN SCORE (B&C)	AGE (YRS)	NO. OF EMPLOYEES	ANNUAL TURNOVER (Kshs)	NET ASSETS (Kshs)
0564	3.60	23	650	311,090,000	53,700,000
0131	2.18	7	15	-	-
0274	1.88	10	31	-	-
0926	2.19	10	14	-	-
1173	2.56	8	2	-	-
1228	3.16	20	35	-	-
0634	2.00	12	40	-	-
0228	3.00	8	30	28,730,000	191,398,000
0909	2.16	23	1,100	1,377,000,000	654,000,000
0913	3.71	10	30	19,612,000	(66,836,000)
0799	2.88	41	20	9,500,000	2,399,000
0969	3.12	22	1,800	1,500,000,000	3,300,000,000
0813	3.21	30	320	25,000,000	40,000,000
0293	2.79	44	1,400	-	-
0941	2.63	30	40	-	-
1175	2.35	16	12	-	-
0729	2.00	7	17	1,500,000	(15,000)
0079	2.06	17	10	-	-
1007	2.22	6	4	-	-
0009	3.79	15	4	-	-
0676	2.86	25	110	-	-
0074	4.10	32	120	132,000,000	110,000,000
0911	3.85	18	108	17,731,000	49,000
0588	3.12	17	2	-	-
1201	1.67	16	40	12,698,000	184,000
0285	1.80	8	26	21,622,000	7,031,000
0608	1.65	14	4	10,260,000	11,935,000
0976	1.69	50	8	-	-
0920	2.60	20	8	-	-
0673	1.83	24	11	-	-
0936	2.70	3	50	-	-
0706	1.93	22	4	-	-
0572	1.83	24	30	-	-
0678	1.73	25	611	86,571,000	662,771,000
0073	3.47	4	17	9,300,000	2,613,000
0634	3.11	30	7	-	-
0602	3.21	20	34	-	-

ev

- /N - Random number of firm
 - Compliance considerations
 - Noncompliance considerations

THE χ^2 DISTRIBUTION

Degrees of Freedom	LEVEL OF SIGNIFICANCE	
	5%	1%
$v = 1$	3.841	6.635
2	5.991	9.210
3	7.815	11.345
4	9.488	13.277
5	11.070	15.086
6	12.592	16.812
7	14.067	18.475
8	15.507	20.090
9	16.919	21.666
10	18.307	23.209
11	19.675	24.725
12	21.026	26.217
13	22.362	27.688
14	23.685	29.141
15	24.996	30.578
16	26.296	31.999
17	27.587	33.409
18	28.869	34.805
19	30.144	36.191
20	31.410	37.566
21	32.671	38.932
22	33.924	40.289
23	35.172	41.638
24	36.415	42.979
25	37.652	44.314

Regression Analysis - Linear model: $Y = a + bX$

Dependant variable: KARUU.MEAN

Independent variable: KARUU.AGE

Parameter	Estimate	Standard Error	T Value	Prob. Level
Intercept	2.53075	0.238689	10.6027	.00000
Slope	4.25468E-3	0.0107921	0.39424	.69580

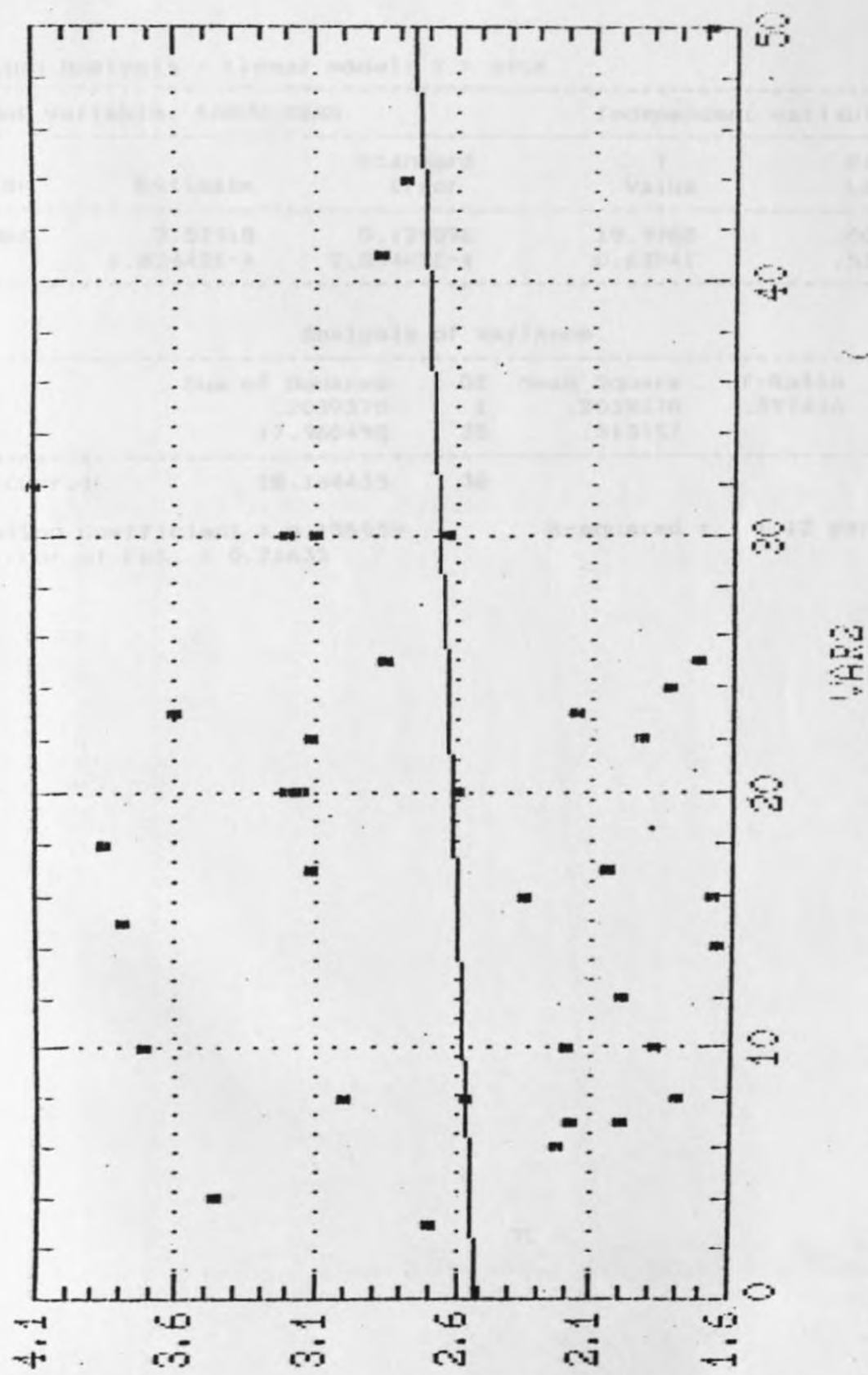
Analysis of Variance

Source	Sum of Squares	Df	Mean Square	F-Ratio	Prob. Level
Model	.0803065	1	.0803065	.155425	.69580
Error	18.084129	35	.516689		
Total (Corr.)	18.164435	36			

Correlation Coefficient = 0.0664913
 Std. Error of Est. = 0.718811

R-squared = .44 percent

Regression of VAR1 on VAR2



Regression Analysis - Linear model: $Y = a + bX$

Dependent variable: KARUU.MEAN

Independent variable: KARUU.SCORE

Parameter	Estimate	Standard Error	T Value	Prob. Level
Intercept	2.57918	0.129096	19.9788	.00000
Slope	1.82442E-4	2.89403E-4	0.63041	.53252

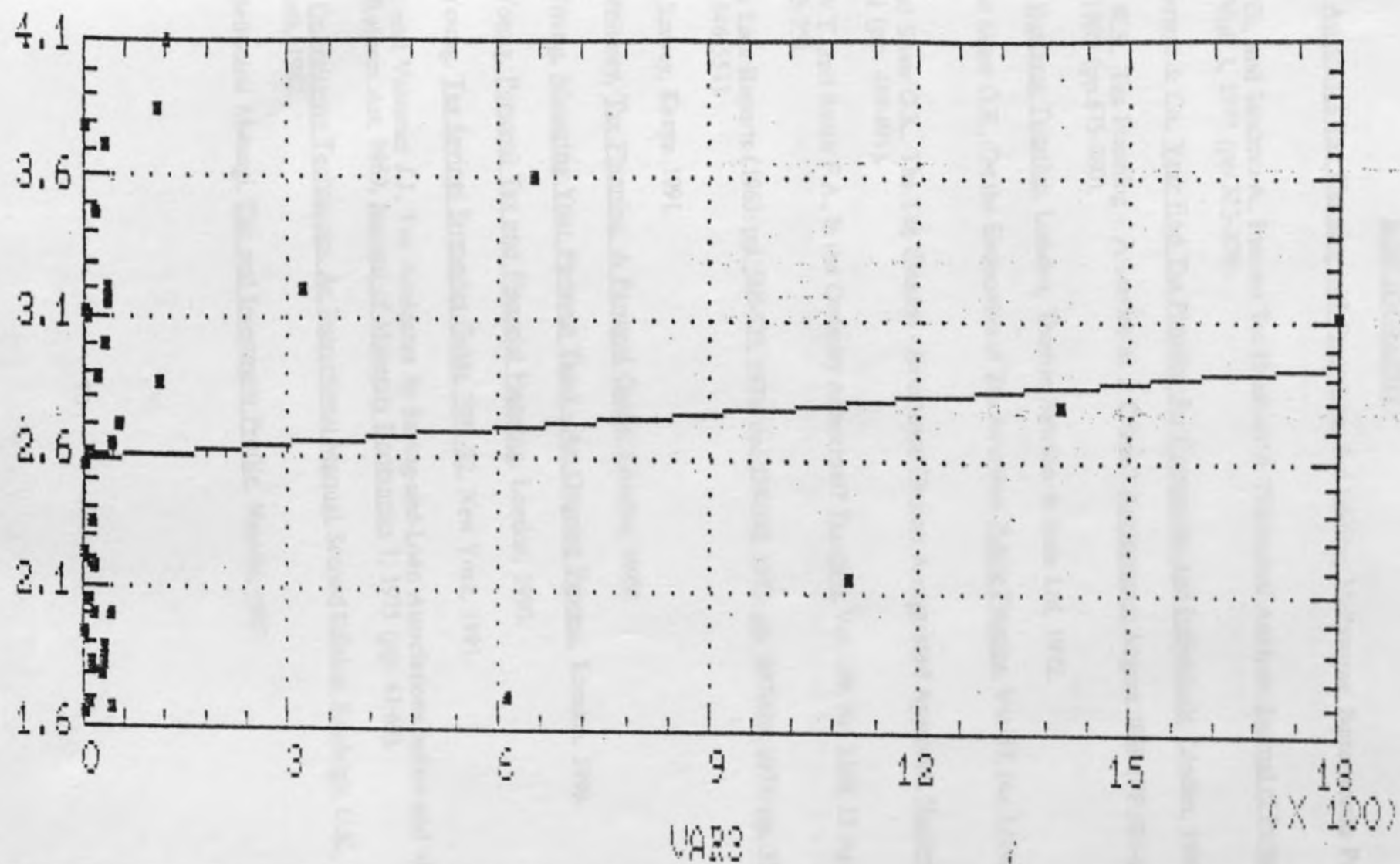
Analysis of Variance

Source	Sum of Squares	Df	Mean Square	F-Ratio	Prob. Level
Model	.2039370	1	.2039370	.397416	.53252
Error	17.960498	35	.513157		
Total (Corr.)	18.164435	36			

Correlation Coefficient = 0.105959
Std. Error of Est. = 0.71635

R-squared = 1.12 percent

Regression of VAR1 on VAR3



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