

Tax Planning and Financial Performance of Small Scale Enterprises in Kenya

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Abstract

In order to ensure the efficiency and effectiveness of activities, reliability and compliance with applicable laws, small scale enterprises need to have adequate tax controls. The study sought to find out the extent to which expenditure on capital assets in tax planning, to determine how tax planning by Capital Structure influence performance of small enterprises, find out how tax planning through Advertisement expenditure influence performance of small enterprises and to assess how tax planning through Legal Forms of enterprise influence performance of small enterprises in Embu CBD. The study had a total population of one hundred and forty nine respondents and a sample of 30 percent was drawn from each stratum. The data was then presented in form of Percentages and Tables. The study found the influence of tax planning by capital structure, tax planning in investment, capital asset planning through advertisement expenditure and found that the Legal Forms of small enterprises in Embu CBD has no significant relationship. The study recommends that small scale enterprises should be ready to seek advice on tax planning. Further to this, the study recommends that there is need to have NGOs to sensitize the respondents as to the need to do formal tax planning as it could increase their Business profitability.

Key Words: Tax Avoidance, Tax Evasion, Tax Planning, Capital Structure.

Introduction

The concept of taxation has been a concern of global significance as it affects every economy irrespective of national differences (Obboh et al., 2012). Within the context of Africa, tax, a concept as old as mankind can be described as an amount, effort, contribution or service rendered either in kind (goat, cow, farm

produce, clearing of grass etc.) or monetary value contributed into a common purse for the running of the society. According to Omotoso (2001), in his definition of the modern taxes, defined tax as a compulsory charge imposed by a public authority on the income of individuals and companies as stipulated by the government decrees, acts or case laws irrespective of the exact amount of services rendered to the payer in return. Thus, taxes constitute the principal source of government revenue and the beauty of any government is for its citizen to voluntarily execute their tax obligations without much coercion and harassment (Adedeji and Oboh, 2012).

Tax evasion and fiscal corruption have been a general and persistent problem throughout history with serious economic consequences, not only in transition economies, but also in countries with developed tax systems (Raza, 2011). In general, tax evasion and corruption can have ambiguous effects on Economic growth: tax evasion increases the amount of resources accumulated by entrepreneurs, but it also reduces the amount of public services supplied by the government, thus leading to negative Consequences for economic growth (Roy and Raffaella, 2011). Previous studies highlight reports of declining effective tax rates and a rising proportion of firms that report little or no tax liability. To date, the maintained assumption in much of the literature is that aggressive tax behavior, rather than economic trends, is the driving factor behind this decline (Desai and Dharmapala 2009).

The Kenya Revenue Authority (K.R.A) is the tax collection agency of Kenya. It was formed July 1, 1995 to enhance tax collection on behalf of the Government of Kenya. It collects a number of taxes and duties, including: value added tax, income tax and customs. Since KRA's inception, revenue collection has increased dramatically, enabling the government to provide much needed services to its citizenry like free primary education and Health Services to all. Over 90% of annual national budget funding comes from local taxes collected by the KRA (GOK, 2010).

It is however important to establish whether the observed increased revenue collection effectiveness has resulted from aggressive tax management by Kenya Revenue Authority (KRA) or whether it is, in part, due to increased use of the new economy business model. This is important because the sources of tax avoidance have distinct policy implications. The policy response to tax avoidance arising from aggressive tax schemes and investments in tax planning is likely to be very different from the response to tax avoidance stemming from a shift in many firms' organizational, operating, and financing attributes, which enable them to exploit their operating flexibility to naturally align with tax incentives that generate tax savings (Drucker 2006).

The decreasing trend in effective tax rates may not be solely due to aggressive tax management but Rather, firms' modifications to their business models resulting from changing economic trends potentially enabling them to reduce tax burdens without additional investments in tax planning (Blouin, and Larcker 2011).

Performance of Small Enterprises

Different approaches are used for performance evaluation in which goal approach, time frame approach, balanced scorecard, system approach, and ineffectiveness approach are included (Jean-Francois, 2004). In stakeholder approach, centre of attention is the ability of a business to meet the needs and expectations of its stakeholders (Daft, 1995). Competing values approach expands the range of other approaches.

By using competing values approach, four other models are developed in which rational goal; internal process, open system and human relations are included (Quinn and Rohrbaugh, 1983). Performance of an organization can be evaluated by focusing on problems and retarding factors that inhibit the performance of organizations (Camaron, 1984). Out of the above mentioned approaches, goal approach is the superlative approach to evaluate the performance due to its straightforwardness (Pfeffer and Salancik 1978). Most trendy approach of performance evaluation of SME's is balanced scorecard approach. Balanced scorecard

has four dimensions in which financial growth, quality, customers and learning growth is built-in (Kaplan and Norton, 1992). Balance scorecard actually focuses on maintaining symmetry between monetary and non monetary measures (Neely *et al.* 1996).

Book-tax differences, on average, are systematically related to earnings growth, future stock returns, and earnings persistence (Hanlon, 2005) and among other implications, book-tax differences are useful measures in evaluating firm performance. Consistent with these studies, Shevlin (2002) and Hanlon, Laplante, and Shevlin (2005) find that while book income explains a firm's annual stock returns better than estimated taxable income, estimated taxable income, on average, has incremental explanatory power for book income. However, there is little evidence regarding taxable income as an alternative performance measure and, in particular, cross-sectional differences in firms that mitigates or enhances the ability of taxable income to inform investors regarding firm performance (Lev and Nissim, 2004).

Some SME's compare their performance with that of other SME's. They evaluate their performance by means of comparative analysis. Performance can also be evaluated by means of ineffectiveness approach. In ineffectiveness approach, focus is on the factors that hampers the feat of organizations. Therefore this study seeks to investigate the extent to which Tax Planning influences Financial Performance of Small Enterprises in Embu town CBD

Tax Planning

The implementation situation of SME income tax planning is distorted tax planning, that is to say, on the one hand, more and more SME pay tax in accordance with the law, and on the other hand, because of the role of the interest mechanism and other various reasons, more and more SME tax-related cases appear (Karing and Wanjala, 2005). According to the survey, the vast majorities SME have not yet started or are considering carrying out tax planning, which can not fight for the legitimate tax interests and ruin financial interests leading to a large number of emerging additional tax burden (Fjeldstad and Rakne, 2003). In addition, SME tax planning is treated unreasonable. Due to the limitations of the concept, SME tax planning activities often encounter misunderstanding, punishment and censor from some basic taxation law enforcement agencies (Karing and Wanjala, 2005).

Tax law is said to be barely connected with the universe and with universal law as we understand it. However, tax law is founded not only on principles but also on practicality. There is no element of perpetuity about tax law, only the constant clash of the immediate and semi permanent (Kibua and Nziok, 2004). A State cannot run a democracy well without taxation and a taxation system cannot be run well without democracy. Oliver Wendell Holmes has said on one occasion, "Taxes are what we pay for civilized society" (Neely *et al.* 1996).

Statement of the Problem

Tax reform today has been moving towards considering new legislation, such as whole new taxes or reliefs, rather than patching of existing taxes by either increasing or decreasing the amount of taxation. This breaks down into the fact that there are ongoing considerations of widening the tax base. Kenya is no exception to this and there are ongoing considerations into taxing the informal or 'jua kali' sector including the taxation of the 'mitumba', the second hand clothing industry as well as the taxation of all informal tax payers of small amounts.

A question that appears to generate surprisingly little debate in Kenya is the scope for legally mitigating taxes payable by individuals and corporate entities. Tax planning is bound to gain increasing significance with the ever greater aggressiveness and sophistication of the Kenya Revenue Authority and other tax

collecting bodies. The trend of increased aggressiveness and sophistication in tools and methods is occurring against a backdrop of a public policy of domestic sources being the primary sources of revenues for budgetary purposes. This results in governmental pressure on tax collecting agencies to improve their revenue collection performance. The result of this trend is the more stringent enforcement of taxation laws. The past and present practice by many of outright evasion is, and likely will continue to be, fraught with risk.

Examining the relation between the new economy business model, tax avoidance and investments in tax planning is important as previous Studies in the tax avoidance literature generally examine how specific firm attributes are related to tax avoidance independently, rather than investigating how firms' overall business models facilitate or hinder effective tax planning (Frank, Lynch, and Rego 2009). Hanlon and Heitzman (2010) argue that despite the much literature, these do not explain the variation in tax avoidance very well. Therefore due to this and such seemingly inexorable trends, the question of tax mitigation by legitimate avoidance naturally occurs. This study intends to find out the influence of small Enterprises tax planning within the current legal environment so as so minimize their tax burden.

Objectives of the Study

- i. To assess to what extent tax planning in investment in capital assets influence performance of small enterprises in Embu CBD
- ii. To determine how tax planning by capital structure influence performance of small enterprises in Embu CBD
- iii. To establish how tax planning through Advertisement expenditure influence performance of small enterprises in Embu CBD
- iv. To assess how tax planning through Legal Forms of enterprise influence performance of small enterprises in Embu CBD

Methodology

Research Design

The study adopted a descriptive survey. This design was deemed appropriate because it enabled the researcher to gather information on attitudes and opinions in relation to effect of tax planning on financial performance of small scale enterprises.

Study Population

The study targeted all the 149 small scale enterprises in Embu Town CBD. However, the accessible populations for this study were the licensed Small Scale enterprises between 2008 and 2012 within Embu CBD.

Table 1 Sample Population

| Business | Population | Sample unit | Percent |
|--------------------------------|------------|-------------|---------|
| Hotels | 16 | 5 | 30 |
| Wholesale/stockiest shops | 23 | 7 | 30 |
| Hardware/Motor Bike retailers | 26 | 8 | 30 |
| Entertainments joints and bars | 27 | 8 | 30 |
| Others types of businesses | 57 | 17 | 30 |
| Total | 149 | 45 | 30 |

Sample Size, Sampling Design

In Embu Town CBD there were 149 Small Scale Enterprise licensed in 2012. The study had 45 (30%) small enterprises as the sample populations of the accessible population. The study used quota sampling method, because of the small population and the desire to reduce the sampling error; all the categories of licensed owner managers were used. The quota sampling method was suitable as some information related to specific category in the licensing of enterprises.

Data Collection Instrument and Procedures

A questionnaire was administered to the sample chosen for the study. The researcher opts for the primary data collection technique in the form of questionnaires which was researcher assisted as all respondents may not be literate enough for the purpose of the questionnaire items. The questionnaires were conveyed to the respondents by use of the drop and pick latter method.

Data Analysis and Presentation

Frequency of various demographic variables was derived for analysis of the demographic aspects of respondents of the selected small enterprises. The demographic variables were business types, gender, age, education level and experience (years) in business. The collected data by way of questionnaire was organized to answer set objectives in the study. Data organization started with coding of the question items, then coded data was tabulated in excel and computer program statistical package for social sciences (SPSS). Data was analyzed using descriptive statistics: - Frequency Distributions and measures of central tendencies, Test of Significance were done by use of inferential statistics. Multiple linear regressions were used.

The Multiple linear regression models were:

$$f(z) = \frac{1}{1 + e^{-z}}$$

$z = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \epsilon$ Where $\beta_0, \beta_1, \beta_2, \beta_3, \beta_4$ were regression coefficients where

z = Financial performance of small scale enterprises

x_1 = Advertisement expenditure

x_2 = Capital Structure

x_3 = Legal Forms of enterprise

x_4 = Expenditure on capital assets

The results of the survey were presented using tables, charts and graphs. The SPSS computer software (Version 17) was used to aid the analysis.

Findings

The study was an investigation of the influence of tax planning on financial performance of small scale enterprises and was a survey of small scale enterprises in Embu central business district and the objectives were to assess to what extent tax planning in investment in capital assets, to determine how tax planning by capital structure, to establish how tax planning through Advertisement expenditure, and to assess how Legal Forms of enterprise tax planning influence performance of small enterprises in Embu CBD.

The background of the respondents, the study found on gender that majority were Male while on age, majority were above 36 yrs, with majority being married while Highest Level of education majority were

of the Secondary school level. The study findings on investment on capital assets the respondents who incurred expenditure on fixed assets were majority while, on the amount claims on Cost of business fixtures, majority had less than 10,000, with on amount claims on Costs of capital assets majority indicated less than 10,000, on the amount claims on Costs of immovable assets there majority who spent less than 10,000.

On capital Structure of the Percentage of total investment with majority had between 26 percent 50 percent of their business as personal savings, while on tax savings made due to the amount of borrowed capital majority had less than 10,000 with tax savings made due to amount of equity invested having majority had between 10,001-20,000 as tax savings and on claims from personal assets had majority who had between 20,001- 30,000.

The results indicated that the extent Cost of business fixtures influence Profitability due to Savings on tax payable having majority indicating much, while on the extent costs of capital assets business influence profitability due to savings on tax payable had majority who indicated much while, on the extent of costs on immovable assets influenced profitability due to savings on tax payable had majority indicating they were not sure, however the extent costs of moveable assets influenced profitability due to savings on tax payable had majority who also indicated they were not sure.

On Advertisement Expenditure, the amount on claims on consumable advertisement with majority indicating much, influence of claims on bill board advertisement with majority indicating very much, on the influence of claims of press advertisement with majority indicating very much, and influence of claims on amount of promotion with majority indicating very Much, on incurred advertisement expenditure with majority indicating yes, Influence of the amount of consumable advertisement contributed to the profitability of business with majority indicating not sure, extent amounts on bill board advertisement contributed to the Profitability of business with majority indicating Not at all, on the extent amounts of press advertisement contributed to the Profitability of their business with majority indicating not at all extent amount of promotion samples contributed to the Profitability of your business with majority who indicating Not at all.

On legal forms of enterprise, the legal form of respondents businesses were majority as sole proprietorship, with majority as partnership, and for the suitability of their business legal status influencing on tax avoidance, majority strongly agreed, while on the suitability of your business legal status on tax evasion, majority were in agreement with majority responding they were not sure the extent to which the legal form of their business contributing to the Profitability of their business on Savings on taxable deductions. The study found that the influence of tax planning by capital structure has no significant relationship just as it found that tax planning through advertisement expenditure is regressed by performance of small enterprises in Embu CBD has no significant relationship. The study also found that tax planning in investment in capital asset has no significant relationship and also the study found that the Legal Forms of enterprise tax planning has no significant relationship

The study found no significant relationship between the independent variable and the dependent variable. The study therefore accepts the Null hypothesis that there is no significant relationship between tax planning in investment in capital asset and performance of small enterprises in Embu CBD. According to findings by Gordon & Li, (2009) forecasted capital investment policies change if firms can successfully evade taxes by conducting all business in cash, Thereby avoiding any use of the financial sector. The forecasted policies by small enterprises are now much closer to them and their perception and the forecasted capital investment policies change if firms can successfully evade taxes by conducting all business in cash as established by Gordon & Li, (2009).

The study found no significant relationship between the independent variable and the dependent variable. The study therefore accepts the Null hypothesis that there is no significant relationship between tax planning by capital structure and performance of small enterprises in Embu CBD. Feige (1996) in a study on Fiscal exchange, collective decision institutions and tax compliance showed that government distrust was associated with an increase in unreported income. The findings are supported by Alm et al. (1993) who found a negative relationship between marginal tax rates and tax evasion which indicate to the study findings that there is little incentive to use structure for tax planning as the tax rates are distinctively insignificant in Kenya.

The study found no significant relationship between the independent variable and the dependent variable. The study therefore accepts the Null hypothesis that there is no significant relationship between tax planning through advertisement expenditure and performance of small enterprises in Embu CBD. Therefore as supported by Kibua and Nzioki, (2004) who found tax planning through advertisement is regarded as business propaganda expenses with reasonable grounds and sufficient evidence a position. This reflects why small enterprises do not use this method of tax planning as it may not add value in the eyes of the customers that they so much wish to attract besides the cost component. The study found no significant relationship between the independent variable and the dependent variable. The study therefore accepts the Null hypothesis that there is no significant relationship between Legal Forms of enterprise tax planning and performance of small enterprises in Embu CBD. These findings get support from Kasipillai et al (2002) whose study on the Influence of Education on Tax Avoidance and Tax Evasion found that there is a close relation between tax evasion and thought viewpoint of taxpayers, and therefore legal form of structure will not add value to such an investor who has an option of tax avoidance.

Conclusion

Due to the corruption levels, low business growth, and management of public finances in the economy, where there is a great extent of corruption, has a related to a high level of tax evasion and the study concluded that there was no relationship between tax planning in investment in capital asset and performance of small enterprises in Embu CBD. The study concludes no significant relationship. The study concludes also that no significant relationship exists between tax planning through advertisement expenditure and performance of small enterprises in Embu CBD and also concluded there was no significant relationship the Legal Forms of enterprise tax planning and performance of small enterprises in Embu CBD.

Recommendations

The tax authorities should address the lack of formal tax planning as this may be a way of evading taxation in the name of tax avoidance. The small scale enterprises should also be ready to open up to advice on tax planning to make savings rather than playing a hide and seek game with tax authorities. Further to this, the study recommends that there is need to have NGOs to sensitize the respondents as to the need to do formal tax planning as it could increase their Business profitability

Implications on Policy Theory and Practice

This study though confined to investigate the influence of tax planning on financial performance of small scale enterprises has established that little tax planning take place among the small enterprises and therefore tax Authorities and the chamber of commerce should write a position paper to address the awareness and use of tax planning by small scale enterprises. This would improve the growth rate of the small enterprises and there after the growth of the economy.

Suggestion For further Study

This study was confined to investigate the influence of tax planning on financial performance of small scale enterprises which it has done successfully. However there is need to investigate the extent to which the respondents were aware of the provision in the tax act so as to take advantage of it. The study would also suggest a study on the influence of tax planning on financial performance of medium scale enterprises so as to establish if tax planning reflects the level of operation in Kenya.

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