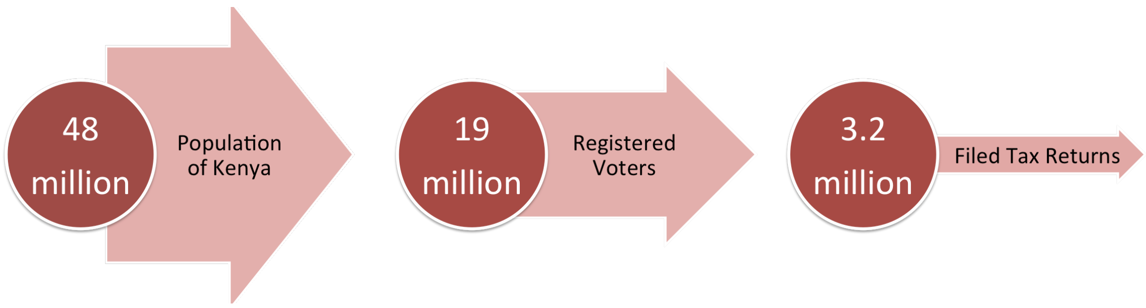
POLICY BRIEF
28/08/2018

Evaluating the Proposed Presumptive Tax

The Turnover Tax and Historical Tax Revenues

The Finance Act of 2007 introduced the Turnover Tax (TOT) to Kenya through the provision of the Income Tax Act, Cap 470, under section 12C. This was implemented from the 1st of January 2008 and applied to any citizen whose turnover from business did not exceed Kshs. 5 million and was above Kshs. 500 thousand during any year of income. The TOT was charged at 3% on gross sales per annum with a tax period of three months (per quarter). The main aim of the TOT was an attempt to rope in Small and Medium-sized Enterprises (SMEs) into the tax net. The TOT followed a separate payment schedule and is taken as a final tax. Failure to pay or file returns hosts attendant penalties. One of the major shortfalls of the TOT has been its collection due to its dependence on the goodwill among the affected taxpayers. Those who fall in the threshold of the TOT are largely in the informal sector and are SMEs who take advantage of the Kenya Revenue Authority's (KRA) limited capacity to enforce compliance. The TOT exempted the following: Persons with business income <500 thousand, Employment income, Exempt incomes, Business incomes that are subject to a final WHT, Limited Companies, Rental Income and Professional or Management fees.

Over the past decade the Kenyan government has visibly struggled to implement the tax regime as well as collecting the returns. This can be attributed to the need for self-declaration by individuals who have not shown goodwill to this regard. Kenya is struggling similarly to other developing countries around the world to establish its tax base and efficiently collect revenues. The KRA expected the TOT to be efficient in expanding the tax base but it was a relatively tedious process that allowed room for exploitation of the system as can be observed with the low tax revenue seen in the country as well as the abysmal tax compliance. According to the KRA Micro Enterprises and SMEs (MSMEs) in Kenya comprise of 98% of registered tax payers but contribute less than 20% of revenue. This does not even include those who are not registered and do not file taxes. The challenge with taxing MSMEs is that ensuring compliance is costly and time consuming due to the poor record keeping of the MSMEs. This would lead to high administrative costs in pursuance of low revenues. Another major challenge is the use of cash and the lack of documentation on cash flows creating room for tax evasion. The problem is systemic as many enterprises choose to ignore taxes and evade without regard for consequence. To contextualise the problem, it is estimated that in 2017 the population of Kenya was approximately 48.5 million. In 2017, about 19 million Kenyans registered to vote in the general election. For the fiscal year of 2017 only 3.2 million Kenyans filed tax returns.



The Proposed Presumptive Tax

The Finance Bill of 2018 is proposing to repeal Section 12C of the Income Tax Act that imposed a turnover tax and replace Section 12C with a Presumptive Tax. The presumptive tax will apply to resident whose turnover from business does not exceed 5 million shillings during a year of income. The tax will apply to anyone issued or liable for a business permit or trade license by any county government in Kenya. The payable tax will be 15% of the value of the business permit or trade license possessed by the individual. The tax will be due for payment when obtaining or renewing of the business permit or trade license. The following are exempt from the presumptive tax: management and professional services, rental business and incorporated companies. This will be a final tax.

A presumptive tax in simple words is a compulsory contribution to state revenue determined by the assessment of basic facts. Unlike the TOT that was dependent on ever-changing information such as account books and records, the Presumptive Tax is based on a standard rate of which 15% is taxable. This has the potential to engage the section of the population that have low tax literacy but wish to be compliant as the process will have set costs that are expected and can be easily calculated. The presumptive tax would rely on a predetermined indicator for which the Finance bill indicates as the single business permit fee, hence the amount that is taxable can be easily determined. The fees for business permits are set by the county government therefore differ between counties. Furthermore, the business permit fees are dependent on a number of factors such as the size of business, the number of employees, the area of the business premises and the nature of the business. Thus there are differences in the taxable amounts depending on the company however it will be easy to determine the taxable amounts as it will be 15% of the fee paid to register the business. The costs usually range from Kshs 10,000 to Kshs 50,000 for most MSMEs.

The main aim of introducing a presumptive tax would be to benefit both the government and individuals by simultaneously increasing tax compliance while reducing the amount of tax individuals are liable to pay. The presumptive tax provide ease of tax assessment thus supporting the planning and paying for businesses and the implementing and collecting for the KRA. The Presumptive Tax should encourage the maintenance of proper records to avoid increased tax burden as well as force more individuals into the tax net as they cannot renew business licenses without paying their due taxes. The KRA will benefit from the reduced administrative costs to implement, pursue and audit the presumptive tax regime. Moreover, the major aim is to minimise the avoidance of tax and to make it hard to evade taxes whilst increasing the tax base by introducing a strong enforcing mechanism.

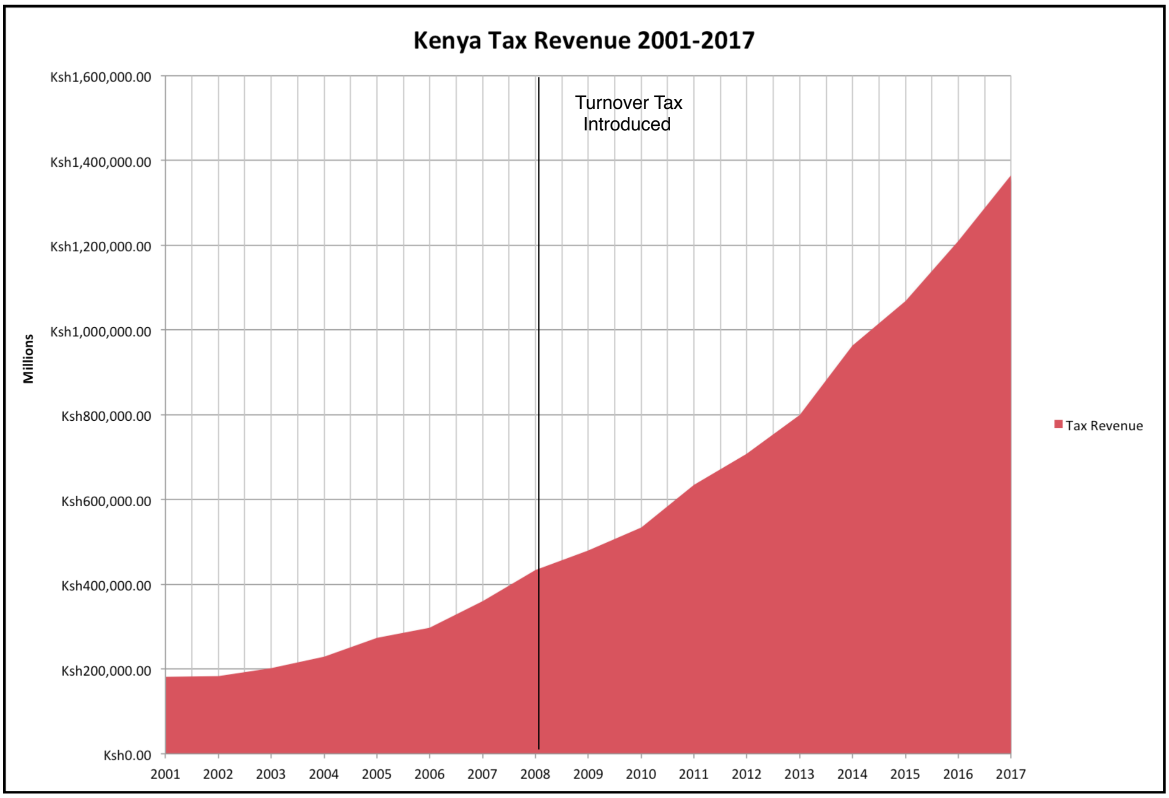
The introduction of the presumptive tax will be integrated into the i-Tax system thus pushing the KRA to better integrate its technology and minimise the need for examination. This will potentially increase the efficiency of the KRA allowing the organisation to pursue tax education on the importance of determining liabilities. Critically the KRA will be able to pursue tax in the absence of proper business records as the taxable income is predetermined and will not change unless the are alterations to the business permit fees. The tax will target the informal sector that has been elusive for so long and utilise the county government infrastructure to enforce collection. The tax should be minimal for now.

Evaluation of the Presumptive Tax

The Presumptive Tax is part of the 2018 Finance bill and is due for presentation and a vote in parliament prior to the end of the year in line with its scheduled launch of the 1st of January 2019. The presumptive tax has the potential to create a positive impact of both the taxman and the taxpayer. For the KRA and the government the new tax regime should streamline the collection process and rope in support from county governments. Furthermore the reliance is business licenses makes record keeping and issue pursuance simpler. Most importantly the move will expand the tax base as companies and individuals will not be able to conduct their business via the renewal of permits or licenses without prior filing and payment of tax. The overall simplicity of the tax regime should lower administrative costs whilst simultaneously increasing revenues through increased participation. For taxpayers the presumptive tax makes filing easier allowing more people to pay their dues and the 15% of business permit fees is relatively low for company when compared to the previous turnover tax especially when focusing on firms that gross upwards of Kshs 1 million. The major positive impact on businesses will be the possibility to predict ones taxes. With the presumptive tax the amount payable to the KRA is pinned to the cost of the business permit or trade license thus can be easily calculated and factored into costs so as to allow the business to better plan its finances and not undergo fluctuations in taxation. The overall outlook of the tax will make it easier to conduct business in Kenya as it is straightforward and leaves little or no room for corruption.

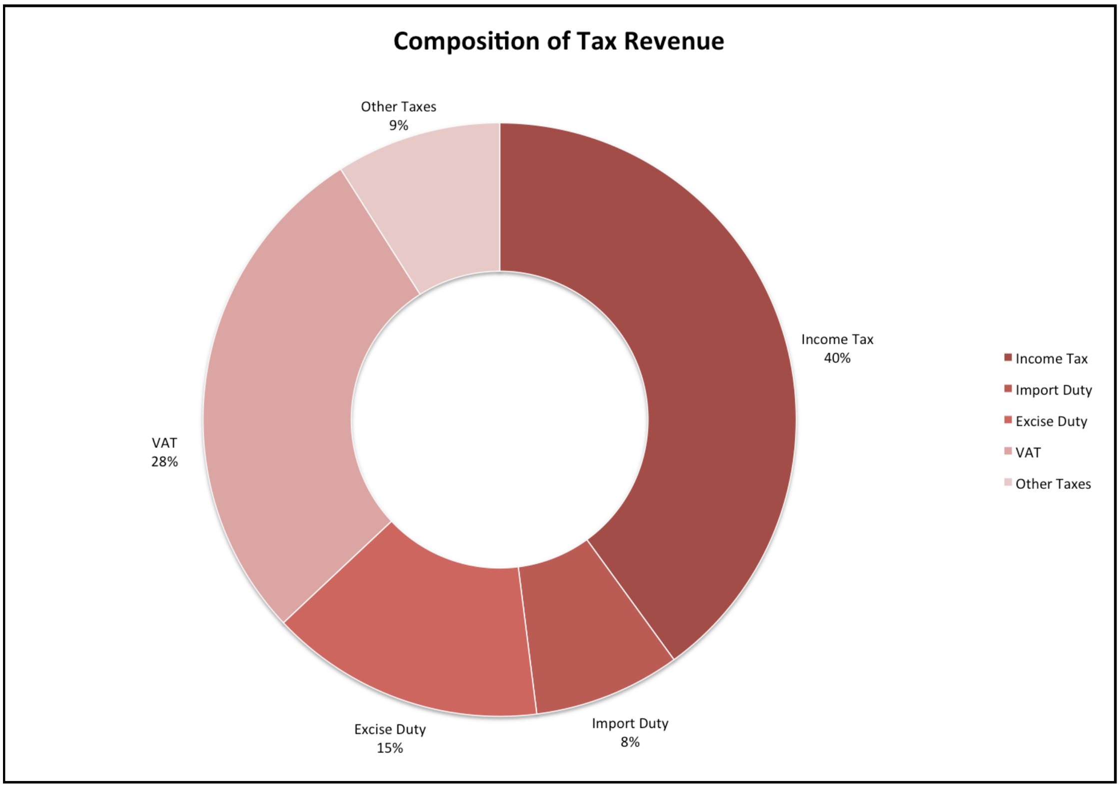
On the other hand the are potential challenges that lie in the rollout and implementation of the new tax regime. Firstly, there are continuity issues that will affect businesses as there are new changes to collection of tax within just ten years of the TOT. There needs to be relative stability that can potentially be achieved through this move. There is potential for increased taxation of MSMEs based on the gross income per year, creating a greater tax burden on those on the lower end of the economic spectrum. One major criticism is the lack of equity in the presumptive tax as there is no consideration of turnover when the tax is charged hence there are possibilities that a company grossing Kshs 550,000 and one grossing Kshs 4,500,000 are taxed the same based on the business characteristics. This will increase inequality and provide a disadvantage to some firm hurting market competitiveness. One critical component for this tax to work is the incentivization of individuals to obtain business permits and to renew them year on year as the tax factor could encourage many in the informal sector to forego business permits altogether. This will be perhaps the greatest stumbling block with regard to capturing the informal sector in the tax net and expanding the potential of tax revenue in the country. Therefore the government will once again base the filing of taxes on the goodwill of the individuals albeit to a lesser extent than with the TOT. Although it may be too soon to ask for specific and technical details of the tax as the bill has not been read and passed by parliament, it stands as a challenge to clarify the following points. Firstly it is unclear to whom the tax collection will fall; the KRA i-Tax platform or the county governments. Secondly it is unclear whether the presumptive tax will be applied to the value of a single business permit or a unified business permit (Nairobi). Thirdly there is no plan to address the need for harmonisation of business permit fees so as to avoid creating unwanted monopolies based on cost of conducting business between different counties. Lastly the KRA is yet to present a plan on tax education with regard to the new presumptive tax to ensure that individuals are aware of the new tax and how to be compliant.

The Importance of Tax Compliance



As of February 2018 the debt owed by the Kenyan government amounted to Kshs 5.011 trillion hitting its highest point in history. Cytonn has shown the level of debt rising by about 22% per year. The external borrowing pushed the debt over the mark and Genghis Capital reported that the government spent over 51% of its revenue on clearing debts in 2018/19. These levels are unsustainable and overburdening to any healthy economy and the public debt in Kenya has been well documented. Tax Revenues are on of the major ways of paying off debt and limiting borrowing however for developing economies there are issues of tax compliance. This forces the government to borrow as it does not have the means to enact its vision through domestic revenues. Furthermore, Kenya has been taking on increased commercial debt while reducing its multilateral debt. The breakdown of debt stands as 44% Multilateral, 30% Bilateral and 10% Commercial.

The collection of tax revenues in Kenya has steadily risen since the early 2000s and has significantly risen to over Kshs 1 trillion under the current government. The proposed presumptive tax has the potential to increase the tax base from the measly 3.2 million or 6.7% of the Kenyan population to at least 10 million by the end of 2020. Expanding the tax base and increasing tax revenues is fundamental to the management of debt and the supporting of Kenya's development. The largest contributor to the overall tax revenue is Income Tax that represents 40% of returns. Income tax is a direct tax on individuals and limited companies. This followed by Value Added Tax (VAT) that contributes 28%. The Cabinet Secretary of the Treasury has stated that the Income Tax Bill is aligned to international best practice and insists that this will support the business environment. The Presumptive Tax can create another hike in tax revenues as observed following by changes in the 2008 Finance Bill that can allow debt management solutions for Kenya.



Recommendations

1. Fully Implement the Presumptive Tax

The presumptive tax should be passed by parliament to replace the inefficient TOT and should be well integrated into the i-Tax platform and implemented efficiently. The KRA should develop and publish a framework on the collection of the tax and demonstrate how the tax regime grows over the coming years. Moreover, the KRA should collaborate with the counties to implement the tax as they have better links to businesses in their locality.
Action: Develop a collection framework and make counties accountable for implementation

2. Integrate Technologies and Share the PIN

There is an increased need for the streamlining of tax service delivery and ease of usage to increase levels of compliance. The inclusion of a unique KRA Personal ID Number (PIN) on the National ID Card could potentially simplify record keeping and encourage more not to evade taxes. The technologies present should be used to make KRA more efficient by integrating mobile banking into the system and allowing mobile submissions of returns.
Action: Integrate the PIN Number with the National ID. Modernise KRA Service Delivery.

3. Improve Tax Education and Publish Public Fund Usage

One of the major criticisms of the tax system in Kenya is that public funds are misused and stolen through corruption. Kenyans are less inclined to pay taxes if they do not understand where the money is going and if they do not trust the government to spend the money well. Furthermore, many individuals do not pay tax as they are unaware of their obligations and general tax literacy due to a lack of accessible information on the matter.
Action: Develop guides on taxes and compliance. Be transparent on public spending.