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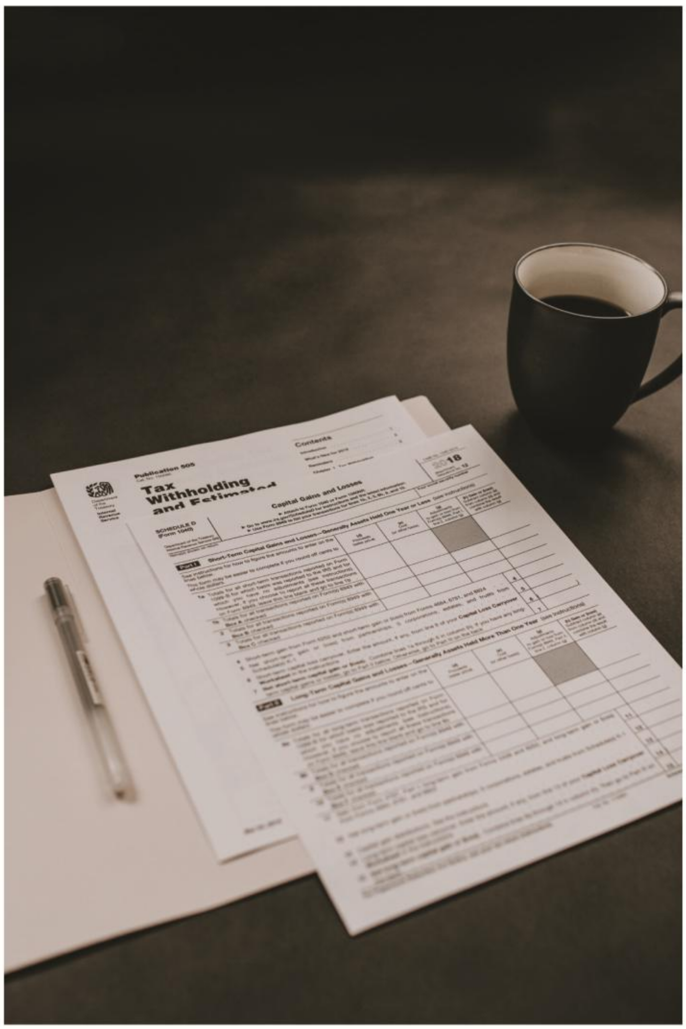

TAX AUDITS

Taxation of Charitable Trust .3

Thin Capitalization .4

Tax Due Dates .5

Newsletter

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Introduction

Warm greetings from all us at M&A!

We hope you and your families are keeping safe during these Covid times.

We are pleased by the fruitful engagements that we have had in our previous editions of our newsletter.

> *We now release our tenth edition of the year 2020 tax newsletter. The newsletter covers recent developments in the taxation regime in Kenya which aims to keep you current and updated on tax matters.*

On the right column of the newsletter you will find contact details for the senior members of our team who can help answer any questions you may have about the issues highlighted in this newsletter or any other matter.

We are interested in your feedback on the items covered and what topics you would like covered in the future.

Please provide any feedback at **tax@mbaya.co.ke**

In this issue

From the Tax Desk

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» From the *Tax***Desk** »

Many taxpayers have received communication from KRA in regards to their annual and monthly declared tax figures. This is in compliance with a public notice issued on 19th June 2020 where the Kenya Revenue Authority (KRA) is currently undertaking comprehensive compliance checks on all taxpayers in accordance with mandate granted under various laws.

These laws include the Constitution of Kenya, 2010, the Tax Procedures Act 2015, the Income Tax Act (CAP 470); the Excise Duty Act 2015 and the East African Community Customs and Management Act (EACCMA) 2004. These instruments provide the basis for the ongoing compliance checks.

The Tax laws empower KRA to review tax returns for accuracy in the determination of taxes paid by each taxpayer. This may be done through returns review, comprehensive audits or investigations. The outcome of which may include additional assessments or in the case of fraud; prosecution of the offenders. Any taxpayer chosen for review under any of these processes is notified and given appropriate time to respond or facilitate the processes.

The compliance checks may cover issues on Individual Income Tax (individuals or corporate companies), VAT, and Customs Duty, Excise, PAYE, Withholding and other taxes administered by KRA.

> *The affected taxpayers are advised to get in touch with a Tax Service Office in order to settle their tax debts or propose payment plans. We at Mbaya & Associates are on standby and ready to offer a helping hand.*

Tax Audits

A tax audit is an examination or investigation of accounting records for taxation purposes. This verification exercise is carried out by the Kenya Revenue Authority (KRA). A trigger is a factor that informs the KRA of the need for a tax audit. Below is a list of some common tax audit triggers.

Factors that Trigger Tax Audits:

These are tax audit factors that are specific to a tax type and are, but not limited to, the following:

1. *Corporate Tax Audit Triggers*

- Failure to separate sources of taxable income where a company has more than one source of taxable income
- Reporting income tax losses into perpetuity
- Unexpected losses in audited accounts
- Variance between gross profit margin and industry average
- Variance between turnover as per VAT returns and annual accounts
- Deducting expenses that do not match the specific business expenses
- Information from other tax audits.

2. VAT Audit Triggers

- Variance between turnover as per VAT returns and annual accounts
- VAT refund claims
- Failure to account for withholding VAT when a company is in a VAT refund position
- Consistent VAT credit position
- Consistent late filing of VAT returns
- Non-compliance actions such as failure to use an ETR
- Failure to remit VAT
- Input VAT claims without corresponding output VAT declared
- Industry-wide tax audits.

3. PAYE Audit Triggers

- Variance between monthly filed PAYE figure and salary amount in annual accounts
- Variance between PAYE remitted and staff costs in annual accounts
- Complete failure to remit PAYE to KRA
- Late remittance of PAYE payment
- High director's standard of living as compared to declared salaries (lifestyle audit)
- Higher salary given to senior staff compared to company directors.
- Significant fluctuations in PAYE on a month-by-month basis.

4. General Triggers:

These factors are not specific to any tax type and include:

- Information from related company audits
- Non-compliance detected during compliance audits
- Changes in the country's legislation
- Information from unhappy employees and 3rd party informants
- Application for closure of income tax ledger during winding up of a company
- KRA intelligence units
- Failure to pay instalment taxes and the balance of tax
- Non-registration of VAT for companies with turnover of more than Ksh. 5 million p.a.
- Amended returns.

Taxation of Charitable Trusts

A Charitable Institution is defined as a non - profit making organization established in Kenya which is of public character and has been established for purposes of the relief of poverty or distress of the public or advancement of education.

The income of charitable trusts is exempt under paragraph 10 of the First Schedule to the Income Tax Act. Under this section, the income of an institution, body of persons, or irrevocable trust, of a public character established: solely for the purposes of:

- The relief of the poverty
- Distress of the public
- For the advancement of religion or education established in Kenya

However, note that for the income to be exempt, any of the following conditions must also be met:

- The business is carried on in the course of the actual execution of those purposes;
- The work in connection with the business is mainly carried on by beneficiaries under those purposes;
- The gains or profits consist of rents (including premiums or similar consideration in the nature of rent) received from the leasing or letting of land and chattels leased or let therewith.

In summary, therefore, the income of a charitable trust is exempted from tax if:

- It is public in character
- If it is established for relief of distress or poverty to the public.
- If it is established to advance religion or education.
- Its total income is used or spent for charitable purposes.

If a charitable trust runs a business, then profits thereof is not taxed if the proceeds are used in the running of the main objective of the organization.

Thin Capitalization

Thin capitalization refers to a situation where a company has more debt compared to its equity financing (highly leveraged). The debt in this thin capitalization context is in form of cash or capital from a shareholder or another party who establishes a special relationship with the borrower. To combat excessive tax avoidance as well as ensure financial stability of corporations, some jurisdictions have enacted thin capitalization rules that restrict deductibility when the debt-to-equity ratio exceeds a certain threshold thus encouraging equity financing. Kenya is one of such country.

Section 16 (2) (j) of the Income Tax Act disallows deductions on interest payments where the highest amount of all loans held by the company at any time during the year of income exceeds the sum of three times of the revenue reserves and the issued and paid up share capital of all classes of the company.

Additionally, where the company is controlled by a non-resident person or is controlled by four or fewer persons and the company is not a bank or a financial institution licensed under the Banking Act (Cap.488), a company is not allowed to deduct the amount of deemed interest which would ordinarily have been charged.

In the above context, "control in relation to a body corporate" is defined to be, " the power of a person to secure, by means of the holding of shares or the possession of voting power in or in relation to that of another body corporate, or by virtue of powers conferred by the articles of association or other document regulating that or another body corporate , that the affairs of the first mentioned body corporate are conducted in accordance with the wishes of that person. In case of a partnership, control is present where the foreign partner (s) has/have the rights to a share of more than one half of the assets or of more than one half of the income of the partnership.

Deemed interest refers to an amount of interest equal to the average ninety-one-day Treasury Bill rate deemed to be payable by a resident person in respect of any outstanding loan provided or secured by the non-resident, where such loan is provided free of interest.

The result of a Kenyan company being thinly capitalized is that;

1. The company cannot claim a deduction on the interest incurred in excess of the prescribed debt-to-equity ratio.
2. Deemed interest on interest free loans from the non-resident related parties is not deductible and attracts withholding tax at the prescribed rate.
3. To defer realized foreign exchange losses charged in the profit and loss account to the extent of the realized foreign exchange losses attributable to the excess loan.

Tax Due Dates

Withholding Tax | 20th Day of the following month

Pay as You Earn | 9th Day of the following month

VAT | 20th Day of the following month

Balance of Tax on Self-Assessment | 4th Month after year end

Monthly Rental Income | 20th Day of the following month

Instalment Tax

1st Instalment |20th day of the 4th month after year end

2nd Instalment | 20th day of the 6th month after year end

3rd Instalment | 20th day of the 9th month after year end

4th Instalment | 20th day of the 12th month after year end

Kindly note that all the returns must be filed on I tax while the payments e-slips must be generated from the I-Tax platform.