MARCH 2019 | 5.45

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TAXATION OF CO-OPERATIVES

Newsletter

MBAYA AND ASSOCIATES

March 2019 | Issue 045 | Volume 5

Introduction

Welcome to the third edition of our 2019 Tax Newsletter. This issue matches and addresses the issues and queries in taxation of Co-operative Societies. In this issue we will also highlight a determined case by the court of appeal on the due dates for payment of withholding tax on accruals. This is a key issue as it affects almost all businesses and organizations in Kenya.

Please find our contact details on the right column. Senior members of our team will assist you by offering clarity on any questions you may have about the issues highlighted in this newsletter or any other questions.

We are interested in your feedback on the items covered and please let us know the topics you would like us to cover in the coming days.

Feel free to provide any feedback at **tax@mbaya.co.ke**

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From a compliance perspective, there will be a number of administrative challenges in accounting for the withholding tax on iTax.

» TAX ALERT, P5

In this issue

From the Tax Desk

Contacts
Head Office
3rd Floor, Western Heights
Karuna Road, Westlands
P. O. Box 45390 – 00100
Nairobi, Kenya
Tel. +254(20)4443868
254 20 4448938
254 20 4446466
Fax: 254 20 4449819

Mike Mbaya | Managing Partner
Email: mike@mbaya.co.ke
Muhungi Kanyoro | Partner
Email: mkanyoro@mbaya.co.ke
Andrew Bulemi | Partner
Email: abulemi@mbaya.co.ke
Leah Nganga | Partner
Email: lwambui@mbaya.co.ke
Christine Yego | Outsourcing Dept. Manager
Email: christine@mbaya.co.ke
Kevin Njenga | Tax Manager
Email: knjenga@mbaya.co.ke
Darlyn Mbaya | Manager and Partner
Savanna Associates
Email: darlyn@mbaya.co.ke

M&A Newsletter

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From the *Tax***Desk**

Taxation of Co-operatives

They are considered as primary societies. Taxation of Co-operatives is governed by section 19A of the Income Tax Act (Cap 470) and the Co-operatives Act (Cap 490). Co-operative Societies are listed in the 4th Schedule of the Income Tax Act.

For tax purposes Co-operative societies have been classified as follows: -

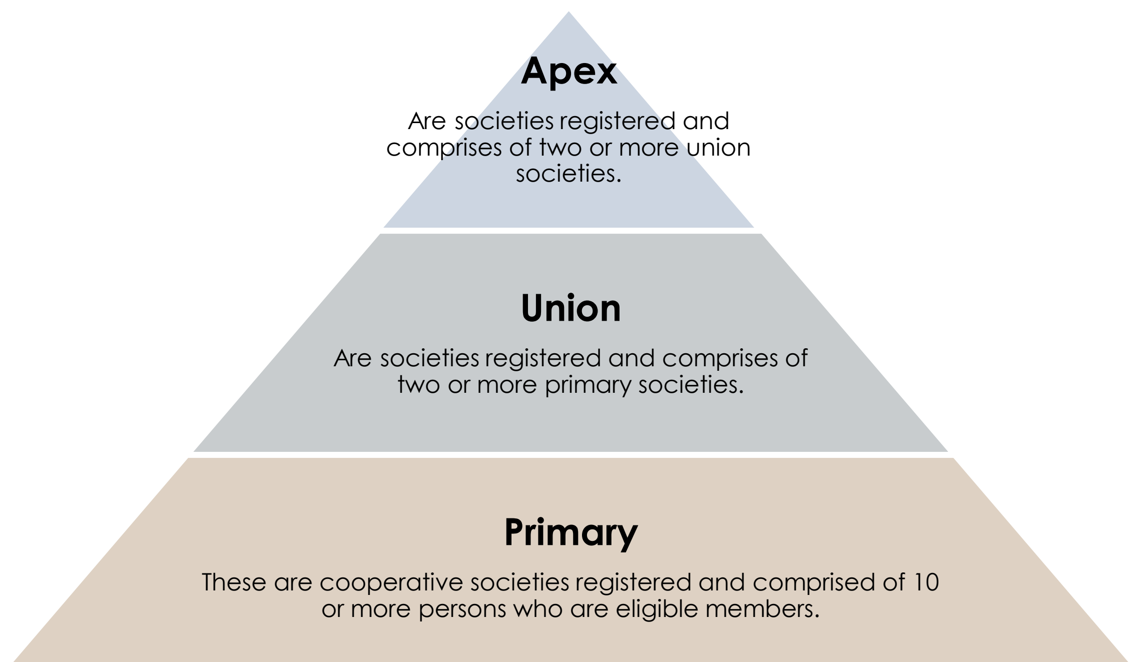
1. Co-operatives registered under the Companies Act e.g. KCC, KPCU, etc.
2. Co-operatives registered under the Co-operatives Act 1997 classified into:
    i. Primary Societies e.g. Marketing Societies.
    ii. Apex Union Societies e.g. District Co-op Unions.
    iii. Sacco Societies.

Taxation of Co-operatives registered under the Companies Act

This form of cooperatives are treated and taxed just like any other corporate entity. They are taxed at 30% on the profits realized and taxes paid as a normal business entity. In this case all the income for a particular year of income is disclosed. The expenses wholly and exclusively incurred in realizing the income are allowed and deducted against the income to realize the profit which is taxed using the rate above.

Taxation of Co-operatives registered under the Co-operatives Act 1997

They are also known as designated cooperatives and are represented into three as follows:



Note: Section 92 of the Cooperative Societies Act can exempt a cooperative from the provisions of the Cooperative Act based on the nature of business of the entity, number of members, manner in which the business is conducted, body corporate carrying business for its own profit and extent of transaction with non-members.

Taxation of Apex and Union Co-operative Societies

Computation of taxable income is similar to that of other business. The determination of taxable income is arrived at by comparing a specified source of income against allowable deductions for that particular source.
Dividends and bonuses are also treated as allowable deductions against total taxable income.

- In this case 100% of total income can be paid as dividends to bonuses leaving the taxman with nil income to tax.
- In case dividends bonuses do not comprise 100% of total taxable income, then the remaining amount is subjected to corporate tax.

Taxation of Primary Cooperative Societies

For Primary Cooperative Societies, the computation of taxable income is like for union and apex societies but the dividends and bonuses payable cannot exceed 80% of total income.
The implication is that the taxman is assured of 20% of total income for tax purposes. This is subjected to corporate tax at rate of 30%.
For **dividends** and **bonuses** to be allowable they must have been:

i. Paid out to members.
ii. Approved at the AGM.
iii. Authorized by Commissioner for Co-operatives.

Dividends could be cash, stock, redeemable preference shares, debentures, or payments during winding up. They are classified as exempt, qualifying or non-qualifying dividends.

i. Non-qualifying dividends are paid by a designated cooperative society. They are taxed under section 19A -S2 and withholding tax is not final. The rate is 5% for residents and 10% for non-residents.
ii. Exempt dividends are paid to exempt persons listed on 1st schedule of the Income Tax Act or those received by a resident company controlling over 12.5% of a company (ITA-S7(2)).
iii. Qualifying dividends are paid by **Saccos** and withholding tax is final.

Taxation for Sacco Societies

They are considered as primary societies. However, their taxation is different from other primary co-operative societies.
The main income accruing from the Sacco is interest on loans granted to members. Since such income has suffered tax through PAYE, then it is treated as the tax exempt income.
Given that the main income is not taxable, the administrative and such other expenses are not considered as allowable deductions against other incomes; that is, Interest income from members is exempt hence expenses are not allowable.

Other income tax is taxed at 30% of 50% of income. Other incomes include rents, dividends, capital gain, commissions from money transfer services, insurance agency & housing schemes to members. These incomes are taxed under specified sources of income

Key Concerns on Taxation of Societies

i. Taxation of primary designated cooperatives based on dividends distributed encourages societies to distribute everything.
ii. Cooperatives are not treated as financial institutions that would allow mortgage interest relief, savings for own dwelling relief.
iii. Officials of Co-operative societies need to be enlightened on taxation and all statutory obligations including NSSF, NHIF,

Tax Alert

Please note that you will be required to pay tax on accruals…

The Kenyan Court of Appeal delivered a judgement on 5th February 2019 to the effect that an accrual (of an expense) in the books of accounts falls within the meaning of the word "paid" for Income Tax purposes and therefore withholding tax becomes due upon such accrual.

In this alert we provide a summary of the facts of the case and the implications to the tax payer.

Background

Fintel Ltd, the respondent in the appeal before the Court of Appeal, entered into an agreement with a contractor for the construction of a rental building. As per the terms of the contract, Fintel Ltd was required to pay the contractor interest on any outstanding fees after the due date. In the course of the contract, Fintel Ltd experienced difficulties in settling the outstanding fees and as a result interest arose on outstanding payments. The interest due to the contractor was recorded as a liability in Fintel's Ltd book of accounts. The Kenya Revenue Authority (KRA, the appellant) carried out an audit of Fintel's Ltd books and issued a withholding tax assessment on interest on the basis that the interest had already been claimed as an expense in the audit accounts.

The KRA's position was challenged at the High Court in the Republic vs Kenya Revenue Authority ex-parte Fintel Limited HC Misc. Civil Application No. 1768 of 2004. The High Court found in favour of Fintel and ruled that "paid" in Section 2 of the Income Tax Act (ITA) assumes its ordinary meaning and the use of the words "include" is merely illustrative of the kinds of activities that constitute payment. The Court held that payment implies delivery of money or some other valuable thing and that payment is prerequisite for withholding tax to apply. The implication of the ruling was that withholding tax would only become due upon actual payment or settlement of obligation.

The KRA appealed the High Court ruling and on 5th February 2019 the Court of Appeal overturned the High Court decision. The Court of Appeal found that the High Court adopted a restrictive interpretation of the word "paid". The main issue of contention was the definition of the words "paid" and "upon payment" as provided in Section 2 and Section 35 of the Act. The Court of Appeal adopted a contextual interpretation of words by using the definition of "paid" in the ITA to interpret the words "upon payment". "Paid" has been defined to include distributed, credited, dealt with or deemed to have been paid in the interest or on behalf of a person. The Court of Appeal held that payment is deemed to be made even where no money has passed over. Furthermore, the Court pointed out that the sense in which the word "deduct" is used for withholding tax purposes, does not require physical movement but includes book entries recognising amounts due, taking into account that the income tax regime is based on the accrual system.

Our View

- This ruling has major implications for all taxpayers both from a practical and compliance perspective. The ruling effectively reverses the prevailing practice of withholding tax on actual payments.
- The implication is that taxpayers will be required to deduct and remit withholding tax on the eligible fees at the point when accrual is recorded in the book of accounts. This will have negative cash flow impact on taxpayers.
- From a compliance perspective, there will be a number of administrative challenges in accounting for the withholding tax on iTax. In many cases the accrued amounts do not match the actual invoiced amounts which may result in the taxpayer underpaying or overpaying the withholding tax on iTax. This also arises where credits/rebates are given or suppliers do not impose expected charges such as interest or penalties. The taxpayer will spend a considerable amount of time reconciling the correct withholding tax position. The iTax system does not allow one to offset tax amounts.
- Where there is an overpayment, the only party allowed to apply for a refund is the supplier/payee. The refund process for withholding tax is currently not established and in practice, there is reluctance to process refunds, not to mention other hurdles such as tax audits that may be triggered when an application for refund is made. Taxpayers would therefore need to ensure any accruals accurately reflect the payment obligation; the timing of accruals becomes even more critical at this point. It would be important for taxpayers to carefully consider the impact of their accruals policy on their withholding tax obligations.
- A few questions linger from the judgement. First, where taxpayers relied on the High Court ruling or prevailing practice, there is possibility of reopening past periods. Secondly, where the taxpayer has made an accrual in their books of accounts for services received, but the supplier has neither issued an invoice nor recognised the income in their books of accounts, there will be a mismatch between the withholding tax and the supplier's income. This will create additional burden of reconciling income with iTax records.

Conclusion

Whereas the Court of Appeal ruling sets precedence and creates greater certainty on the question of the tax point for withholding tax purposes, the overall impact on taxpayers will be adverse. Taxpayers will need to fund tax payments upfront and face additional challenges of accurately accounting for withholding tax.

There is a need for taxpayers to review their compliance status in light of this ruling and consider potential risks and efficiencies vis-à-vis the accruals policy.

For more information on this tax alert, please use the link below and search Civil Appeal 311 of 2013 dated 5th February 2019 under advanced search.

http://kenyalaw.org/caselaw/cases/advanced_search/

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

KENYA REVENUE AUTHORITY

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.