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Tax & Legal Alert
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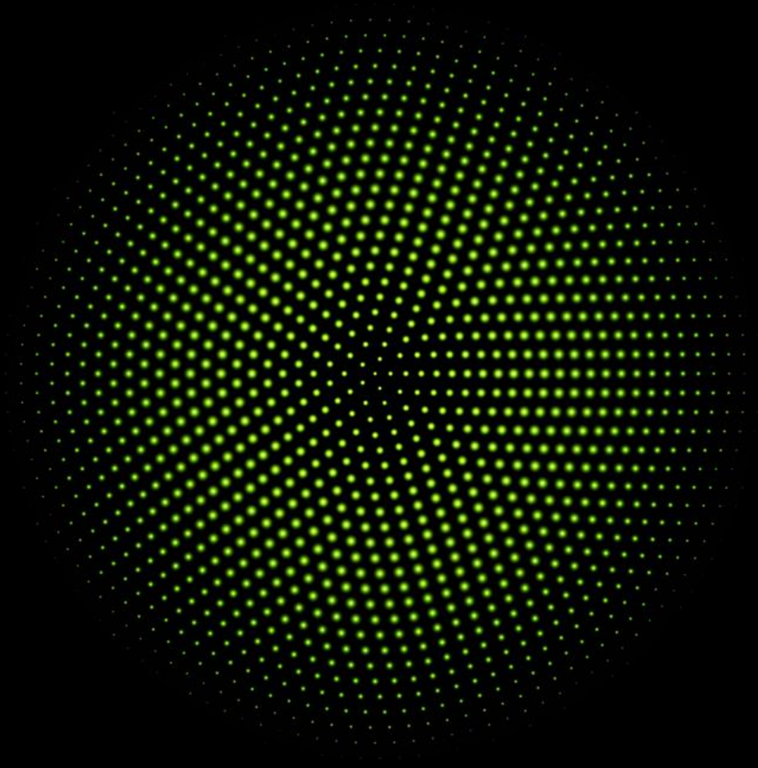


# Tax Alert

## New Rules on allowability of donations and exemption from income tax for charitable organisations.

On 18 June 2024, the Cabinet Secretary for the National Treasury and Economic Planning ("CS") gazetted the Income Tax (Charitable Organisations and Donations Exemption) Rules, 2024 ("the Rules"). The Rules prescribe the application and processing, granting and retention of exemption from Income Tax. Further, they prescribe the procedure for determining the allowability of donations for corporate income tax. The new Rules replace The Income Tax (Charitable Donations) Regulations, 2007, which mainly focused on allowability of donations for corporate income tax purposes.

The Rules have been issued pursuant to Section 130 of the Income Tax Act ("ITA"), which permits the CS to prescribe rules for carrying out (implementing) provisions of the ITA.

In this alert, we summarise the key highlights of the Rules and provide our views. You are advised to read this alert together with the Rules for more details.

## Introduction

Pursuant to the aforecited provision of Section 130 of the ITA, the Rules replace the Income Tax (Charitable Donations) Regulations, 2007, which mainly focused on allowability of donations for corporate income tax purposes. Under the revoked Rules, the procedure for exemption applications or renewals was not comprehensively covered. The new Rules provide the much -needed clarity on the exemption regime.

We summarize the key highlights in the recently gazetted Rules.

| Term | Definition under repealed Regulations | Definition under the new gazetted Regulations | Impact |
|---|---|---|---|
| **Beneficiary** | N/A | A member of the public who may receive a benefit from the activities of a charitable organisation. | This qualifies and confirms the intended and expected receivers of contributions from charitable organisations. |
| **Donation** | Includes a donation in the form of a cheque. | A benefit conferred on a person in kind, cash, promissory note, mobile money or money transfer in any form. | The expanded definition provides coverage for donations of all forms that may be provided to charitable organisations. The one in the repealed Rules only considered cash donations and excluded other forms, which is restrictive |
| **Charitable purposes** | N/A | A purpose which falls within Paragraph 10 of Part 1 of the First Schedule to the ITA | This clarifies legislative undertakings that merit as charitable and those which may be considered as such in law. |
| **Charitable organisation** | Entails non-profit making organisations established in Kenya, of public character and whose purpose is for relief of poverty, or distress of the public, or for the advancement of religion or education. | Charitable organisations can be institutions, body of persons or irrevocable trust of public character. One must be established under the relevant written law. | The definition serves to expatiate and qualify nature of entities that can be deemed to be charitable organisations. Previously, there was no mandatory requirement for a charitable entity to be established under the Public Benefits Organisations Act, 2013. |
| **Governing document** | N/A | A constitution, memorandum or articles of association, trust deed or any other written instrument by which a charitable organisation is established and governed. | This sets out parameters and guidelines which legally guide operations of charitable organisations. |
| **Private benefit** | N/A | A benefit that a person receives other than as a beneficiary of a charitable organisation. | This confines and limits the extent to which a charitable organisation can execute its mandate for charitable purposes. Activities that do not benefit the wider public are considered to be off the course. |

## Qualification for tax exemption

### 1. Establishment and operation

The income of a charitable organisation which accrued in or was derived from Kenya shall be exempt from tax to the extent that the Commissioner is satisfied that the income is to be expended in Kenya and is to be expended for charitable purposes which result in the benefit of the residents of Kenya.

For the income to be exempt, a charitable organisation must fulfill the organisation, operational and public benefit tests. These tests are the key pillars for a charitable organisation to demonstrate that it has been established for charitable purposes only. We discuss these tests in detail in the foregoing sections.

#### a) Organisational test

The Rules provide that the governing documentation of a charitable Organisation should:

i. Limit the objects of the charitable organisation to one or more charitable purposes.
ii. Not empower the engagements in activities that do not further or support one or more of the charitable purposes.
iii. Prohibits provision of any private benefits directly or indirectly by making its income available to any person.
iv. Restricts use of assets to charitable purposes.
v. Upon dissolution, transfer the assets to another charitable organisation with similar objects.

The founding documents of the charitable Organisation should state its primary purpose, specify the activities it intends to carry out, specify its beneficiaries and clearly define the basis for identification of its beneficiaries.

#### b) Operational test

In terms of operations, the charitable organisation should:

i. Engage primarily in the activities that aim to accomplish the purpose for which it was founded.
ii. Not engage in unlawful activities.

#### c) Public benefits test

The operations of a charitable organisation shall be considered to be for public benefit if the:

i. Purpose and activities are beneficial in a manner that the beneficiaries are identifiable, and they can attest to the said benefits.
ii. Benefits are related to the activities of the charitable organisation's purpose.
iii. Benefits accrue to targeted groups or a sufficient population.
iv. Poor people are not excluded from the opportunity to benefit.
v. Benefits do not accrue directly or indirectly to individuals.

Where it is not possible for a benefit to accrue to residents of Kenya in general without limitation or a sufficient section of the public, the charitable organisation shall be considered to benefit a sufficient section of the public if there are no *unreasonable* or *unjustified* restrictions on the opportunity to benefit.

A charitable organisation shall not be considered to have met the public benefit test where it's criteria for defining beneficiaries;

i. Excludes the poor from benefiting;
ii. Is based on personal connections;
iii. Proposes a numerically negligible number of beneficiaries;
iv. Defines its beneficiaries in a manner that is not in tandem with its purpose; and
v. Limits its beneficiaries.

It is also worthwhile to note that public benefit of one purpose shall not be used to offset any lack of public benefit in another where a charitable organisation has more than one purpose.

### 2. Charitable purpose

The new Rules, just like the repealed Rules prescribe that income derived or accrued from Kenya shall be exempt from tax under paragraph 10 of Part 1 of the First Schedule to the ITA if the charitable organisation is solely established for the below purposes:

- Relief of poverty.
- Relief of distress of the public.
- Advancement of religion.
- Advancement of education.

However, the new Rules provide guidelines on what the aforementioned purposes specifically entail. We highlight the same below;

#### a) Relief of poverty

Poverty is defined as the inability to acquire basic necessities of life or simple amenities which would rather be considered essential for a modest standard of living. Some of the activities that the organisations needs to be engaged in so as to qualify for exemption under this purpose would include:

- Provide training, support or assistance to persons experiencing poverty in order to improve capacity to start and manage agricultural operations and other land uses that relieve them from poverty.
- Provide community development such as training and promotion of community-based self-help group projects as well as capacity building and skills development.
- Provide education, training, healthcare and necessary support to enable generation of income or self-sufficiency of the poor.
- Any other community-based support to help the needy persons generate sustainable income.

### b) Relief of distress of the public

Some of the activities that a charitable organisation can undertake for purposes of qualifying for exemption under this purpose include but not limited to:

- Disaster relief to victims of calamities such as floods, war, and famine.
- Prevention of deterioration of society through conflict resolution as well as environmental conservation.
- Care, counselling and education to homeless, abused, abandoned, neglected or orphaned children, terminally ill persons, persons living with disability, disabled etc.
- Rehabilitation, care, counselling and education (including preventative) to persons addicted to a dependence-forming substance or to prisoners or former prisoners.
- Providing housing assistance to the elderly and persons with disabilities.
- Providing healthcare to needy persons as well as providing basic needs to such persons including food, water and clothing.
- Provision of education institutions that cater for orphans, abandoned children or persons with disabilities; and
- Providing grants and school fees for needy people for both local or international curriculum.

### c) Advancement of religion

A charitable organisation established for the advancement of religion may achieve this by:

- Seeking new followers or adherents through proselytizing.
- Provision of places of worship which includes maintenance of buildings used for religious practices, conduction of religious ceremonies, maintenance of church yards and maintenance of artefacts and items used in religious practices.
- Raising awareness of religious beliefs through interpretation of religious doctrines, advancing religious tenets, promoting religious doctrines through music and theatre, theological training colleges and supporting religious office holders through stipends and other living allowances.
- Missionary and outreach work.
- Organizing pilgrimages as part of public worship.
- Any other religious activities authorized under the laws of Kenya.

*“Poverty is defined as the inability to acquire basic necessities of life or simple amenities…”*

### d) Advancement of education

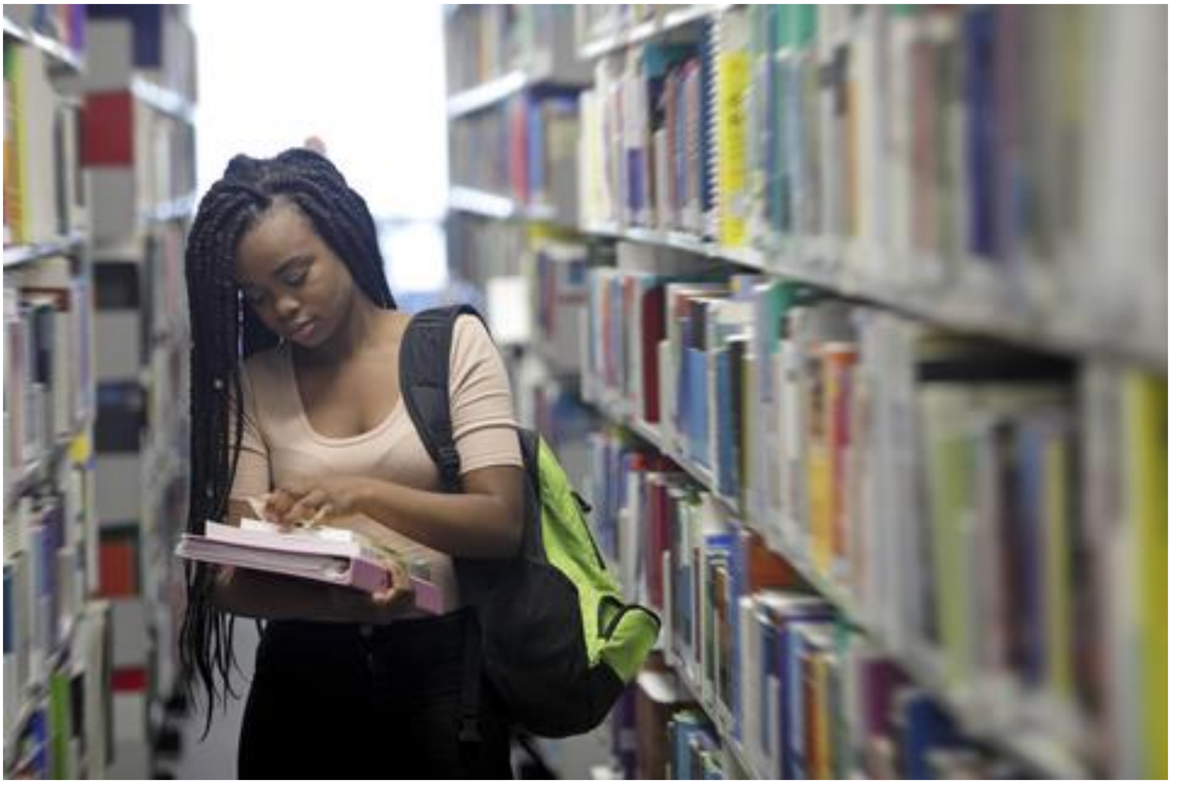
A charitable organisation qualifies for exemption under this purpose where the organization:

- Provides basic education by/through a school as defined by the Basic Education Act.
- Provides university education by/through a university or technical university as defined under the Universities Act.
- Provides technical, vocational education and training by/through an institution as defined under the Technical and Vocational Education and Training Act.
- Provides facilities and training or education of persons living with disability as approved by a relevant Government agency.
- Provides bridging courses to enable educationally disadvantaged persons.
- Provides school buildings, libraries or equipment for approved educational institutions.
- Provides educational enrichment, academic support, supplementary tuition or outreach programmes for the poor and needy.
- Publishes or provides school textbooks.

It is worthwhile to note that for a fee charging educational institution to qualify for exemption, it must ensure that full scholarships are granted to at least ten percent of its student population who must be from poor and needy backgrounds and the selection criteria is full proof.

## Other Key highlights

- The new Rules specifically prohibit charitable organisations from participating in tax avoidance schemes.
- A charitable organisation shall not retain more that an average of fifteen percent of its surplus funds in a period of three succeeding years without applying the surplus funds to its charitable purposes.
- A charitable organisation granted an exemption from income tax under these Rules shall obtain a separate Personal Identification Number for any unrelated business.
- The gains and profits from an unrelated business (business not carried out to support charitable activities) shall not be covered by the exemption granted to the charitable organisation.
- A return, application, notice, or other document required to be lodged or submitted under the Rules shall be lodged or submitted in accordance with the Tax Procedures Act, 2015.
- As with the revoked Rules, a charitable organisation shall at least each year submit an income tax return in the prescribed form (6 months after year end on iTax).



## Exemption application procedure

We highlight the key aspects relating to the tax exemption application procedure. We note that the process is largely similar to what was the common practice before the introduction of the Rules. Nonetheless, we highlight the key highlights below.

- Charitable organisations need to make an application to the Commissioner which includes submission of the application via the iTax platform.
- The application should include certified governing documents, certified copy of registration documents, audited financial statements, schedule of assets including the corresponding value, certified bank statements for three years preceding the application, an introductory letter detailing the name, nature and principal activities of the applicant from the office of the County Commissioner of the county where the head office of the organisation is located, applicant's impact report, beneficiary selection criteria, summary of payments, certified copies of identity documents for office bearers, tax compliance certificate amongst others.
- First time applicants shall be required to have been in operation for at least one year. We note that the Rules do not exclude the requirement to provide certified bank statements for 3 years prior to the application even for the first time applicants. This may appear to be a hindrance to organisations that have been operational for less than three years. To this end, it is our considered view that there is a legislative overlap in the specified requirements which needs harmonization.
- Application for renewal to be made at least six months before expiry of the current exemptions.
- Where the charitable organisation has complied with the new Rules, the Commissioner will issue the tax exemption certificate within 60 days from the date of application.
- The exemption will be valid for 5 years from the date of expiry of the earlier certificate or date of application whichever is later in the case of renewals, and from the date of approval of the exemption in the case of new applications.
- Where an application for tax exemption is declined, the Commissioner should inform the applicant in writing. In addition, an issued tax exemption certificate can be revoked for any just course, but the applicant has an opportunity to appeal the revocation decision and get the exemption certificate reinstated.
- Charitable organisations which exclusively fund, donate to or support other charitable organisations without undertaking a charitable purpose are not eligible for tax exemption.

## Deductibility of donations

i. Donations shall be paid out of the taxable income of a donor provided that the donation shall not result in a taxable loss and not more that 50% of the donations in any year of income shall be to unrelated entities. It is our considered view that this may be a drafting error of the Rules, and the 50% restriction of the donations ought to be towards related entities.

ii. For a donation to qualify for tax deduction, the donor shall:
   - Provide proof of donation in the form of evidence of receipt of the donation by the exempt person;
   - Approved project proposals;
   - Exemption certificate; and
   - Declaration from the donee that the donation shall exclusively be used for charitable purposes.

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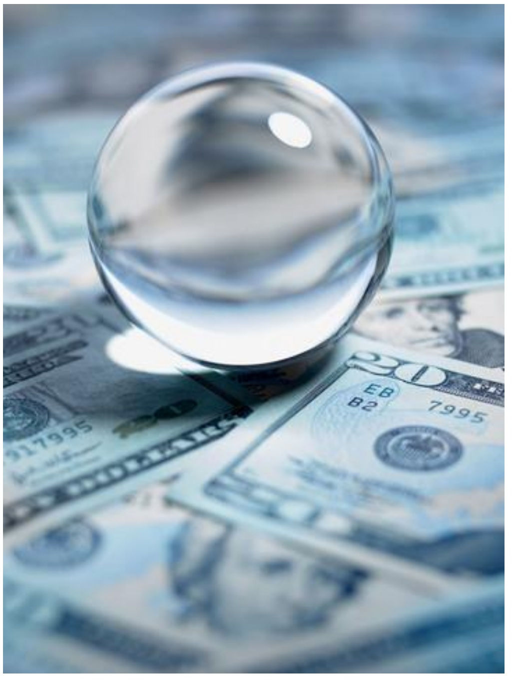

## Our view and conclusion

- The new Rules seek to eliminate the ambiguity that has bedeviled the charitable organisations' space especially in regard to exemption applications. These Rules have enumerated the requirements that institutions need to comply with to obtain income tax exemptions under the various charitable activities. This means that they can save on the amount of time and resources applied towards the exemption application process.
- Further, it is worthwhile to note that the law prescribes a 60-day time period within which the Commissioner must make a decision on an exemption application. This provides certainty and eases planning constraints considering that most donor funded projects are very time sensitive.
- On the flip side, we note that the new Rules provide that a charitable organisation granted an exemption from income tax under these Rules shall obtain a separate Personal Identification Number (PIN) for any unrelated business. The acquisition of a separate PIN for unrelated business will lead to increased administrative requirements. It would be advisable that the institutions with unrelated business be required to separately report the different sources of income and expenses for that business and declare the same in the tax returns as opposed to obtaining a separate PIN for that sole purpose.
- In addition, entities with exemption certificates are required to comply with the new Rules within 12 months of coming into effect of the Rules. We are of the view that the period granted to comply is relatively short considering the volume of documentation needed to fully comply with the new Rules. For entities with valid exemptions, it would be more prudent to assess compliance with the new Rules at the point of exemption renewal.
- As aforementioned, a charitable organisation shall at least each year submit an income tax return in the prescribed form (6 months after year end on iTax). This prescription is consistent with the revoked rules and seeks to make it crystal clear that charitable organisations are required to file returns.
- We note that approved project proposals are a requirement in order for donations to qualify for tax deduction. In our view, this new requirement is bound to be burdensome to donees from an administrative standpoint. This is on the basis that in many instances donees do not apply for donations as the donors, for instance corporate entities donate with an aim of fulfilling corporate social responsibility specifications . The stipulation that donees will henceforth be required to submit proposals for approval by potential donors may be cumbersome and amplify unnecessary administrative bottlenecks, which is counterproductive. In effect, this requirement is likely to hinder deductibility of genuine donations.

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