ANJARWALLA & KHANNA

TAX CASES DIGEST

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CONTENTS

Executive Summary

Welcome to our periodic summary of important tax law decisions delivered by the Tax Appeals Tribunal and our Appellate Courts.

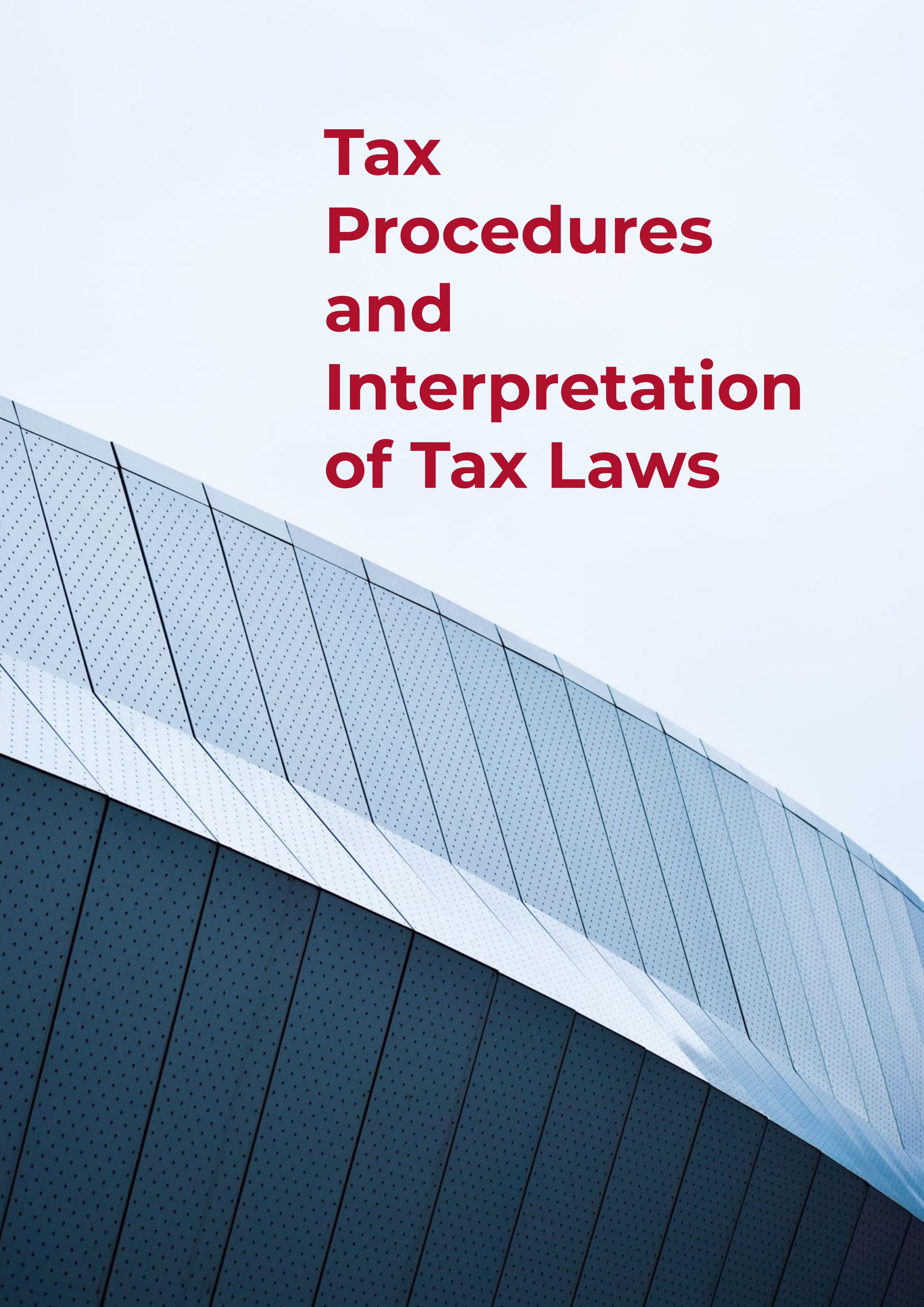
We begin by looking at a number of judgments in 2019 which dealt with various procedural aspects at the center of tax disputes. The Court of Appeal in the case of ***Mount Kenya Bottlers v The Attorney General & 3 Others (2019) eKLR*** reaffirmed the rule on the strict construction of tax statutes; a purposive interpretation that looks to the intention of the legislature cannot be applied to tax statutes. The High Court in the case of ***Republic v Kenya Revenue Authority; Ex-parte: Krystalline Salt Limited (2019) eKLR*** upheld the doctrine of exhaustion of legal remedies, restating the position of the Court of Appeal in ***Republic v National Environment Management Authority (2011) eKLR***, that where Parliament has provided for a statutory appeal procedure, it is only in exceptional circumstances that an order for judicial review will be granted. The only exceptions are where statute provides an alternative dispute resolution forum or where an application has been made to the court for exemption from the exhaustion of internal remedies pursuant to the provisions of Section 9(4) of the Fair Administrative Actions Act, 2015, by demonstrating the existence of exceptional circumstances.

The decision by the Courts to uphold the doctrine of exhaustion of remedies coupled with the enactment of the Fair Administrative Actions Act 2015, has given Tribunals the power to determine matters on the basis of what were previously termed as judicial review grounds; these include, inter-alia, acting in excess of jurisdiction, bias, procedural unfairness, error in law, unreasonableness, abuse of power, failure to provide reasons, breach of the rules of natural justice. In ***Local Production Kenya Ltd. vs Commissioner of Domestic Taxes, Tax Appeal No. 50, 2017***, the Tribunal found that by failing to give reasons for its decision, KRA had acted in violation of the tax payer's right to fair administrative action which includes that every person has the right to be given written reasons if an administrative decision will affect them adversely.

Chapter 2 looks at some interesting developments within the realm of direct taxes. In ***Delmonte Kenya Limited v The Commissioner of Domestic Taxes (2019) eKLR***, the High Court held that the conversion of loans to equity led to an event of realisation of forex losses on the loans pursuant to Section 4A of the Income Tax Act (Cap.470 of the Laws of Kenya) (ITA); in the TAT's view, Section 4A of the ITA does not limit deductibility of forex losses where an asset or liability is disposed or settled in certain circumstances such as issuance of shares. In determining the applicability of Pay As Your Earn (PAYE) on Employee Share Ownership Plan (ESOP) benefits accruing to employees, the TAT in ***Equity Bank (Kenya) Limited v The Commissioner of Domestic Taxes; Tax Appeal No. 161 0f 2017***, held that the grant of ESOPs to eligible employees which subsequently vested at a discount amounted to a taxable benefit under Section 5(5)(a) of the ITA which provides that in the case of an ESOP, the value of the benefit shall be difference between the market value per share and the offer price per share at the date the option is granted by the employer. On the taxation of school fees benefit extended to dependents of the school employees, the TAT in ***Brookhouse Schools Limited v The Commissioner of Domestic Taxes; Tax Appeal No. 119 of 2017***, held that Section 16(2) (a) (iv) should be used in bringing the benefit to charge because it is more specific as opposed to the general provision of Section 5(5) of the ITA. This holding was premised on the principle of generalia specialibus non derogant which stipulates that if a statute contains both a general provision as well as a specific provision, the specific provision will prevail.

The last chapter of this update looks at the increased appreciation of the place of international best practice in tax matters where there is no clarity under Kenyan law. Through a number of decisions delivered in 2019 and 2020, we have seen the TAT and the High Court recognize the OECD VAT/GST Guidelines as persuasive in the determination of disputes relating to internationally traded services. The TAT in its recent decisions in ***LG Electronics Africa Logistics FZE Kenya Branch v Commissioner of Domestic Taxes, Tax Appeal No. 359 of 2018 and Coca-Cola Central East and West Africa Limited v The Commissioner of Domestic Taxes; Tax Appeal No. 5 0f 2018*** noted that the OECD VAT/GST Guidelines would be applicable in Kenya in determining the place of taxation for exported. In the absence of a definition of the terms 'use' and 'consume' under Section 2 of the Value Added Tax Act, 2013 (VAT Act, 2013), the TAT relying on the principles of 'neutrality' and 'destination' under the OECD VAT/GST Guidelines held that what was material was the place of consumption of the services and not the place of supply. Additionally, the TAT held that the customer is determined by service agreement and the jurisdiction of the customer has the taxing rights for the service. The High Court in ***Panalpina Airflo Limited v. Commissioner of Domestic Taxes, Income Tax Appeal No. 5 of 2018***, made a similar holding, noting that internationally traded services should be taxed according to the rules of jurisdiction of consumption pursuant to the Destination Principle.

Tax Procedures and Interpretation of Tax Laws



Rules of Interpretation of Tax Laws

(Mount Kenya Bottlers Ltd & 3 others v Attorney General & 3 others [2019] eKLR)

Introduction

On 19 July 2019, the Court of Appeal in Nairobi issued a judgment overturning a High Court judgment on the interpretation of the amendment of Section 127C of the Customs & Excise Act, (Chapter 472 of the Laws of Kenya) (now repealed) (the ***C&E Act***) by the Finance Act, 2004. The provision relates to the determination of the taxable value for excise duty purposes.

Background of the case

Mount Kenya Bottlers & 3 others (the Appellants) are regional franchisees of the Coca-Cola Company licensed to manufacture, package and distribute liquid soda. The liquid soda manufactured is distributed using returnable bottles and crates (the returnable containers). To guarantee that the containers are returned, the Appellants charged suppliers a predetermined deposit which would be refunded at the time of return.

Between 2006 and 2008 the Kenya Revenue Authority (the KRA) carried out a tax audit on the Appellants and assessed them on excise duty and VAT payable on the returnable containers. KRA's assessment was based on the fact that between 2004 and 2010, the C&E Act, in prescribing the excisable value of goods did not expressly exclude the cost of returnable containers.

Before 2004, Section 127C of the C&E Act provided that the cost of returnable containers shall not form part of the excisable value. However, the Finance Act, 2004 amended Section 127C and removed the returnable containers from the list of amounts expressly excluded from the excisable value. It is on this basis that KRA assessed the appellants on excise duty on the returnable containers on the understanding that the amendment by the Finance Act, 2004 could be interpreted to mean that returnable containers were excisable. Due to the fact that the taxable value for VAT purposes includes any excise duty due, the assessment included a VAT portion being the VAT due on the additional excise duty assessed.

On appeal against the assessment to the High Court, it was held that KRA had acted within the law in assessing the Appellants on the excise duty. Dissatisfied with the High Court decision, the Appellants appealed to the Court of Appeal whose decision is the subject of analysis.

The Appellants' position

The Appellants submitted the following;

a. that the C&E Act was silent on the treatment of returnable containers for excise duty purposes and hence KRA could not charge excise duty;

b. that the C&E Act as amended by the Finance Act, 2004 only gave the KRA power to levy excise duty on 'excisable goods' described under the Act as 'goods manufactured in Kenya or imported into Kenya on which an excise duty is imposed under this Act.' Returnable containers were not excisable goods and hence not subject to excise duty;

c. that only the liquid soda sold by the Appellants was subject to excise duty and the containers would only be subject to excise duty where they were sold together with the soda which was not the case;

d. that charging excise duty on the returnable containers would result in multiple taxation as the same returnable containers were used to sell soda severally by the Appellants;

e. there is no room for intendment or implication as to tax and the KRA can therefore not imply that the amendment by the Finance Act, 2004 meant that the cost of returnable containers was now subject to excise duty. Excise duty would therefore only apply by express stipulation by the C&E Act; and

f. that KRA committed an illegality by assessing the excise duty which was not prescribed under any law contrary to Article 210 of the Constitution of Kenya.

KRA's position

KRA responded as follows:

a. that by the amendment in the Finance Act, 2004, Parliament provided for the items that are not to be considered as part of the excisable value and therefore all other costs including cost of returnable containers are excisable.

b. that the effect of the deletion was to legislate that returnable containers became excisable;

c. that containers were used to produce soda and therefore they were excisable;

d. that the sales invoices issued by the Appellants include a cost for the returnable containers and they were therefore subject to excise duty; and

e. that every stage of the manufacturing process to distribution attracts some excisable value and hence the inclusion of the returnable containers cannot be said to result in double taxation.

ANALYSIS OF
THE COURT OF APPEAL

The Court of Appeal noted that the issue for determination is whether the deletion of the section that previously expressly excluded returnable containers from the determination of excisable value meant that the cost of returnable containers became excisable.

In allowing the appeal, the Court noted the following:

a. (that a purposive interpretation of statute that looks to the intention of the legislature in enacting a statute cannot be applied to tax statutes. A strict constructionist approach should be applied to the interpretation of tax statutes. In this regard, the Court cannot read in or assume that because the amendment did not expressly exclude returnable containers, the returnable containers were included as part of excisable value by implication;

b. that the High Court in arriving at its decision failed to differentiate the rules of interpretation of ordinary legislation from the rules of interpretation of tax statutes; and

c. that in any case, the exclusion of returnable containers from excisable value in past and subsequent statutes was in recognition of the nature of practice in the industry in dealing with the returnable containers. The containers having been manufactured once and used for distribution without sale to either distributors, retailers or end users with the deposit charged refundable. In this regard, the Court observed that levying tax any time the returnable containers are used would result in multiple taxation.

The Principle Of Legitimate Expectation

Lewa Wildlife Conservancy v. Commissioner of Domestic Taxes; High Court Income Tax Appeal No. 17 of 2017

Introduction

On the 26th of September 2019, the High Court in Nairobi issued a judgment in an appeal from a decision of the Tax Appeals Tribunal (the ***TAT***). In the impugned decision the TAT had held that pursuant to the provisions of the Value Added Tax Act (Cap 476 of the Laws of Kenya) (now repealed), Value Added Tax (***VAT***) could not be charged on park entry fees).

One of the issues raised was whether the Kenya Revenue Authority (the ***KRA***) had created a legitimate expectation based on a private ruling issued to Lewa Wildlife Conservancy vide a letter dated 16th February 2001 as well as by the conduct of KRA of failing to demand the disputed taxes for twelve years

Background of the case

The case relates to an appeal by the KRA (the **Appellant**) against a decision by the TAT in favour of Lewa Wildlife Conservancy (the **Respondent**), a wildlife conservancy that charges park entry fees to visitors. Through a letter dated 16th February 2001, the Respondent had sought clarification from KRA on whether the park entry fees and other fees would fall under the definition of 'tour operations' and hence VAT exempt under the provisions of the VAT Act (Cap 476 of the Laws of Kenya) (now repealed). The KRA in a private ruling issued vide a letter dated 16th February 2001 confirmed specifically that park entry fees falls under 'tour operations' and therefore VAT exempt and did not demand VAT on the park entry fees for twelve years.

Subsequently in 2014, KRA conducted an audit on the Respondent and established that the Respondent had not accounted for VAT on park entry fees for the period 2009 to 2013. The KRA raised an assessment seeking inter alia to recover VAT on park entry fees charged by the Respondent on the basis that during those years park entry fees were neither listed under the Third Schedule (Exempt Services) nor under the Fifth Schedule (Zero-rated Supplies) to the repealed VAT Act.

Being dissatisfied with the KRA decision to assess tax, the Respondent filed an appeal to the TAT. The TAT allowed the appeal on the basis that the KRA through the letter dated 16th February 2001 had explicitly stated that game park entry fees were not taxable and had therefore created a legitimate expectation that they were not taxable and the Respondent had relied on this legitimate expectation.

The KRA being aggrieved by the decision of the TAT filed an appeal to the High Court and the decision of the High Court is the subject of our analysis.

KRA's position

KRA submitted the following;

a. park entry fees were VAT chargeable under the repealed Act, because they were neither listed as exempt nor zero rated under the repealed VAT Act;

b. the ordinary meaning of the term 'Tour Operations' which were VAT exempt under the repealed VAT Act was only limited to organizing excursions and it could not cover 'park entry fees';

c. that it cannot be stopped from performing its statutory duty of collecting tax on the basis of legitimate expectation and further that legitimate expectation cannot operate outside the law;

d. that the period when no tax is demanded is not a reason for the KRA not to demand tax and therefore the twelve year period is inconsequential;

e. under Article 210 of the Constitution, there cannot be a waiver of tax except as provided in legislation and therefore the letter to the Respondent could not stand as it effectively waived tax charged by a statute.

The Respondent's position

The Respondent submitted that:

a. the repealed VAT Act did not define what the VAT exempt 'tour operations' related to and the Respondent therefore sought a clarification from the KRA on whether 'park entry fees' would fall under 'tour operations' and therefore would qualify as VAT exempt;

b. a public body can create a legitimate expectation where it provides an express and unambiguous representation. The KRA letter stating that the park entry fees were VAT exempt amounts to an express and unambiguous interpretation of the law and can be relied on. The Respondent further noted that the KRA is mandated to provide clarity to taxpayers and it was therefore reasonable for the Respondent to request for clarity from the KRA;

c. legitimate expectation can be created either by conduct or express stipulation and the KRA letter and failure to collect tax for twelve years created a legitimate expectation to the Respondent; and

d. it was impossible for the Respondent to recover VAT from all of its visitors twelve years later to enable it meet the VAT obligation to KRA.

ANALYSIS OF
THE HIGH COURT

In dismissing the appeal, the High Court noted the following:

a. that the term 'tour operations' cannot be taken to mean or restrictively to refer only to tour operators and had the legislature intended it any other way it would have exempted only activities of 'tour operators.' The park entry fees would therefore be deemed to be exempt under the repealed VAT Act;

b. that pursuant to Article 210 of the Constitution of Kenya, there can be no waiver or variation of tax except as provided by legislation. However, the KRA letter to the Respondent was not a waiver of variation but only provided interpretation of a provision of the repealed VAT Act and could not be deemed to be unconstitutional;

c. that the KRA letter created a legitimate expectation by the interpretation of the legal provision and the KRA could therefore not be allowed, twelve years later, to give a contrary interpretation;

d. that the passage of time as a measure of legitimate expectation should be considered on the basis of the peculiar circumstances of each case and there cannot be a blanket application; and

e. the legitimate expectation in this case was so strongly grounded that it established an economic right in the form of the VAT not charged to the visitors. The passage of time was therefore deemed to be relevant in this case as the Respondent could not recover the VAT not charged to its visitors over the twelve years

Doctrine of Exhaustion of Remedies and Issuance of Agency Notices as an Appealable Tax Decision

Repubic v Kenya Revenue Authority; Ex-parte: Krystalline Salt Limited; Judicial Review Application No. 359 of 2018

Introduction

On 10th June 2019, the High Court dismissed a judicial review application on the grounds that the taxpayer had not exhausted all the available statutory remedies.

Background of the case

The case relates to a judicial review application filed by Krystalline Salt Limited (the **Applicant**). KRA alleged that Water Resources Management Limited (**WMRL**) had unpaid taxes which liability it acknowledged but stated that it was unable to pay due to debts owed by various entities including the Applicant.

On that admission, KRA issued Agency Notices to the said debtor entities including the Applicant who resorted to the High Court to seek orders prohibiting KRA from taking action on the agency notices, serving any agency notices upon its bankers, freezing its bank accounts or suspending its KRA PIN.

The Applicant's position

The Applicant submitted that;

a. the impugned decision made pursuant to Section 42 of the Tax Procedures Act, 2015 (the **TPA**) is premature, malicious, capricious and in bad faith;

b. the said Notice is defective, invalid and ultra vires for failure to comply with Section 42 of the TPA. In addition, the Applicant alleged that the Agency Notice was issued in violation of Article 47, 48 and 50 of the Constitution of Kenya, 2010 as read with the provisions of the Fair Administrative Action Act, 2015 (the **FAAA**);

c. the case fits the exceptions to the doctrine of exhaustion because based on the circumstances, the doctrine of exhaustion is inapplicable;

d. the Tax Appeals Tribunal (the **TAT**) lacks quorum as it is not properly constituted, and, that, the KRA has refused to give its decision to the applicant under Section 42(6) of the TPA therefore rendering no efficacious remedy available; and

e. the TPA does not designate an Agency Notice as one of the appealable decisions capable of being challenged in the TAT, hence it is outside the jurisdictional competence of the TAT.

KRA's position

a. the Agency Notices were issued by KRA in a bid to secure its interest and recover the taxes inn exercise of powers conferred to it by section 42 of the TPA;

b. section 42(6) of the TPA provides a concise procedure which the Applicant should have taken if they were aggrieved by the said decision; and

c. citing section 9(2) of the FAAA, the KRA submitted that an Applicant must first satisfy that it has followed all other avenues and statutory provisions to remedy the administrative action before applying for judicial review.

ANALYSIS OF **THE HIGH COURT**

In dismissing the application, the High Court held as follows:

a. the Act defines "***an appealable decision***" as an objection decision and any other decision made under a tax law other than a tax decision or a decision made in the course of making a tax decision. The words "***any other decision under the tax laws***" is significant. The contested notice falls under the above definition.

b. the contested decision is an administrative decision within the meaning of Section 2 of the FAAA and therefore, pursuant to Section 9(1),(2),(3) and (4) of the FAAA, the requirement for exhaustion of available remedies applies. The said provisions are couched in mandatory terms;

c. the question of exhaustion of administrative remedies arises when a litigant, aggrieved by an agency's action, seeks Judicial Review of that action without pursuing available remedies before the agency itself. The court must decide whether to review the agency's action or to remit the case to the agency, permitting Judicial Review only when all available administrative proceedings fail to produce a satisfactory resolution;

d. an Agency Notice issued under Section 42 of the Act is an appealable decision capable of being challenged in the Tax Appeals Tribunal pursuant to section 52 of the Act. There do not exist exceptional circumstances to warrant bypassing the Tribunal;

e. this is a tax dispute triggered by a decision taken pursuant to the relevant tax law. It does not raise a constitutional question at all to warrant invoking the High Court's jurisdiction. A constitutional question is an issue whose resolution requires the interpretation of the Constitution rather than that of a statute. The issues in the given case could have been resolved by interpreting the facts and the tax relevant statutes. There was no need for constitutional interpretation.

f. for a litigant to qualify under exceptional circumstances, he must apply for exemption from the court. The Applicant ought to have moved the High Court under Section 9(4) of the FAAA and demonstrate the existence of exceptional circumstances. When making the application, the litigant then ought to demonstrate the exceptional circumstances for bypassing the TAT. The conditions above comprise of the exceptional requirement test; Additionally, what constitutes exceptional circumstances depends on the facts of each case;

g. Where Parliament provides an appeal procedure, judicial review will have no place, unless the Applicant can distinguish his case from the type of case for which the appeal procedure was provided. The circumstances do not have to be unique or very rare but they do have to be truly an exception rather than the rule; and

h. The application was considered to offend Section 9(2) of the FAAA as the Applicant did not apply for an exemption as the law requires nor has it satisfied the exceptional circumstances requirement under Section 9(4) of the FAAA.

Impact of the decision

The import of this decision is that Taxpayers can no longer try to bypass the TAT by instituting judicial review matters in the Courts in relation to administrative decisions made by KRA. In any case, the TAT is properly constituted at the moment and parties to potential tax disputes will be expected to respect the doctrine of exhaustion of remedies. The TAT should therefore be the right forum to institute proceedings in relation to tax disputes at the first instance.

This decision has also been instrumental in shedding light to the fact that agency notices issued by KRA will be considered as appealable decisions to the TAT.

Stay of Implementation of a Decision by KRA Pending Hearing and Determination of a Tax Appeal

Shop and Deliver Limited v Commissioner of Domestic Taxes, Tax Appeal No. 141, 2019

Introduction

On the 19th June 2019, the Tax Appeals Tribunal (the **TAT**) issued an order temporarily suspending the implementation, execution and enforcement of Agency Notices issued by the Kenya Revenue Authority (the **KRA**) to the taxpayer's bankers. The crux of the order was that it could not be said that the taxpayer is or will become liable to pay the taxes demanded prior to determination of a matter before the TAT.

Background of the case

The case relates to an application under certificate of urgency filed on 7th June 2019 by Shop and Deliver Limited (the Appellant); a licensed betting company in Kenya seeking to stay the implementation of Agency Notices that the KRA had issued the Appellant's bankers pending the hearing and determination of an appeal before the TAT. The genesis of the Agency Notices was a tax assessment regarding withholding tax on winnings paid by the Appellant to punters.

The Appellant filed a Judicial Review Application before the High Court as a result of being aggrieved by Agency notices the KRA had issued the Appellant's bankers pending the hearing and determination of an appeal before the TAT. The High Court directed that the Appellant ought to demonstrate that it had exhausted the existing alternative remedies before going before it. As a result of this, the aforementioned certificate of urgency was filed.

The decision of the TAT is the subject of our analysis:

The Appellant's position

The Appellant submitted as follows:

a. The Agency Notices had been issued unprocedurally as there was an Appeal pending before the Tribunal. In this regard, the taxes in dispute could not be deemed to be 'unpaid tax' as required in Section 42(1) of the Tax Procedures Act, 2015 (the TPA);

b. all taxes that were not in dispute had been paid and the Commissioner had not demonstrated that there were any undisputed taxes due;

c. the Commissioner's action of using Agency Notices when it was in the knowledge that ADR proceedings were being commenced was in bad faith and meant to circumvent the ends of justice in the Appeal;

d. the Agency Notices had crippled the Appellant's financial operations and if the stay was not granted, the Appellant would suffer irreparable injury as it would not be able to carry out its operations and the appeal would be rendered nugatory;

e. the Commissioner had failed to demonstrate that the Appellant was a flight risk which would deem the Agency Notices necessary.

KRA's position

In response, the KRA submitted that:

a. the action of the Appellant to pay taxes which it had termed as undisputed taxes was a clear indication that it had been evading paying taxes until it was prompted by the Commissioner;

b. the filing of the appeal did not operate as an automatic stay of lawful process and that the Appellant ought to have applied to the right forum to stay the implementation of the agency notices;

c. the Appellant's application was not just an abuse of the court process but a calculated move aimed at defeating the tax demand by hiding behind the High Court Judicial Review Proceedings;

d. the TAT ought to have safeguarded the tax in dispute by compelling the Appellant to provide a valid security of taxes or as it shall deem fit and appropriate.

THE TAT'S **DECISION**

In the judgment the TAT made the following observations:

a. the Appellant invoked Section 18 of the TAT Act that empowers the TAT to make an order staying or otherwise, affecting the operation or implementation of the Commissioner's tax decision, where an Appeal has been filed against the said decision;

b. The power of the KRA to issue Agency Notices is provided for under Section 42 of the TPA. Section 42(1) provides for situations when the Commissioner may use an Agency Notice to enforce tax compliance. Those situations are: when a taxpayer becomes liable to pay a tax and the tax remains unpaid; or the commissioner has reasonable grounds to believe that the taxpayer will not pay the tax by the due date;

c. the only purpose for which a stay may be granted is to secure the effectiveness of the proceedings and determination of the Appeal. This is to avoid a situation where monies are inadvertently collected from a tax payer only to find out after determination that the amounts had been erroneously demanded;

d. the filing of an appeal in itself is a sufficient ground for stay orders and no time limit has been set within which an application for a stay can be made provided it is within reasonable time;

e. regarding the request by KRA for the Appellant to provide security for tax, the TAT noted that tax laws in this country provide appropriate sanctions for non-compliance and therefore found no merit in demanding additional guarantees that the law will be complied with.

In this regard, the TAT issued orders temporarily suspending the implementation, execution of enforcement of the agency notice holding as follows:

a. the KRA's decision to issue Agency Notices to the Appellant's bankers with the purpose of pre-empting an appeal process that was already in motion was in bad faith and in flagrant disregard of the existing due process;

b. prior to the determination of an appeal before the TAT, a taxpayer cannot be deemed to have become liable to pay the taxes being demanded;

c. self-assessment and remittance of some of the taxes by the Appellant did not provide sufficient grounds for the Commissioner to conclude that the Appellant would not pay taxes if and when they became due; and

d. the Commissioner had not demonstrated to the satisfaction of the TAT that it would suffer any prejudice if the stay was granted. This is due to the fact that the Appellant had already paid and continued to pay the self-assessed taxes.

Fair Administrative Action Requires that Reasons Must Be Given for Every Administrative Action Likely to Negatively Affect a Person

Local Productions Kenya Ltd. vs Commissioner of Domestic Taxes;Tax Appeal No. 50, 2017

Introduction

On 17th December 2019, the Tax Appeals Tribunal (the **TAT**) in a judgment held that every taxpayer has a constitutional right to be given reasons for a tax decision made by the Kenya Tax Authority (the **KRA**) pursuant to provisions of the Tax Procedures Act, 2015 (the **TPA**) and the Fair Administrative Actions Act (the **FAAA**).

Further, the TAT held that requirements necessary for a VAT refund are only those provided for in Section 17 of the Value Added Tax (VAT) Act, 2013.

Background of the case

The case relates to an appeal filed by Local Production Kenya Ltd (the **Appellant**), whose principal business activity is producing and commissioning production of television content as well as provision of quality review and control services in relation to television content, against a decision of KRA contained in an objection decision dated 13th December 2016.

The Appellant had applied for the input VAT refunds on the understanding that it supplied zero rated exported services to its non-resident customers. Following a series of meetings between the Appellant and the KRA it was mutually agreed that the KRA would disallow part of the refund claims. However, KRA rejected the refund claim in its entirety vide a notice on i-Tax. The notice did not provide reasons for the decision to reject the Appellant's refund claim. The Appellant lodged an objection against the negative refund decision vide a letter dated 15th December 2016. The Appellant in the objection, provided additional information, including a Transfer Pricing Policy, which was not considered by the KRA in the objection decision.

Aggrieved by the objection decision, the Appellant filed an appeal to the TAT.

The Appellant's position

The Appellant's case was as follows:

a. by failing to give reasons for its decision to reject the refund claim, the KRA acted in complete disregard of Section 49 of the TPA as well as the FAAA which provide that where the KRA has refused an application under a tax law, the notice of refusal shall include a statement of reasons for the refusal and ;

b. by failing to consider the further grounds tendered by the Appellant regarding the refund claim, KRA acted in complete disregard of the principles of procedural justice;

c. a Transfer Pricing policy is not required in order to process a refund claim. The purpose of the said policy is to ascertain gains and profits in accordance with the Income Tax Act (Chapter 470 of the Laws of Kenya) (**ITA**) and not to ascertain VAT refund claims for the period of 1st September 2013 to 31st May 2015;

d. Further, in insisting on a Transfer Pricing (TP) policy, KRA acted in disregard of Section 13 of the VAT Act, 2013 which expressly provides for the manner in which the taxable value of a supply is to be determined.

e. Further, the KRA disregarded the provisions of Section 17 (3) of the VAT Act which provides that the documents required to process an input VAT refund are: an original tax invoice, customs entry and customs receipt for goods, credit note or debit note. A TP policy is not one of the documents required under the law for input VAT processing and KRA cannot include it as a requirement for processing the claim; and

f. the Appellant has freedom of contract and in exercising this right entered into various agreements with its customers that clearly set out the nature of its relationship and the nature with which they conduct business.

KRA's position

The KRA submitted that;

a. there were no procedural lapses in rejecting the Appellant's input VAT refund claim. The refund claim was rejected because the Appellant failed to separate its own export services from those performed on behalf of its' clients; and

b. there was an agency relationship between the Appellant and its customers which allowed them to earn a commission over and above the costs incurred which would be reimbursed as per a Service Level Agreement. The expenses are therefore disbursements settled by the principal and the Appellant cannot therefore sustain an input VAT claim on the expenses.

THE TAT'S **FINDINGS**

The TAT in allowing the appeal held as follows:

a. Section 49 of the TPA obliges the KRA to give a statement of reasons for refusal decisions. This is to be interpreted through the prism of the provisions of Article 47 of the Constitution that is the pillar of the right to fair administrative action. In this regard, the KRA acted in violation of the right to fair administrative action contrary to Section 4 of FAAA which stipulates that every person has the right to be given written reasons if an administrative decision will affect them adversely;

b. by failing to consider the further grounds, the KRA breached by extension the tenets of the rules of natural justice which are fundamental rules that ensure public bodies do not make whimsical decisions to the detriment of the subject;

c. The TAT noted that in interpreting tax statutes, one has to look merely at what is clearly stated and nothing is to be read in or implied. In this regard, given the provisions of Section 17(3) VAT Act are clear on the documents required to process an input VAT refund claim, KRA cannot succeed in introducing additional requirements such as a TP policy;

d. The TAT noted that a written contract cannot be amended by an implied stipulation unless it can be said to be mutually intended and necessary to give efficacy to the contract. In this regard, the TAT observed that there was no agency relationship based on the SLAs entered into between the Appellant and its customer. KRA could therefore not imply that there was an agency relationship contrary to the intention of the parties to the contract.

e. On the above, the TAT set aside the KRA objection decision dated 13th December 2016 and found that the Appellant was entitled to the VAT input tax refund.

Direct Taxes

Deductibility of Foreign Exchange Losses Realised on The Conversion of Debt to Equity

Delmonte Kenya Limited v The Commissioner of Domestic Tax; High Court Income Tax Appeal No. 16 of 2017

Introduction

On 20 December 2019, the High Court of Kenya sitting in Nairobi issued a judgment on an appeal from the Tax Appeals Tribunal (the **TAT**) relating to the deductibility of foreign exchange losses realised on the conversion of a related party loan into equity.

Brief facts of the case

Delmonte Kenya Limited (the **Appellant**) received unsecured and interest free loans denominated in United States Dollars (USD) and Great Britain Sterling Pounds (GBP) from a related party, Delmonte International Corporation (**Delmonte International**), a company incorporated in Panama.

Over the years as the loans subsisted, the Appellant prepared its financial statements on an annual basis in Kenya Shillings (**KES**) and the outstanding balance of the loans was translated into KES applying the prevailing exchange rates, resulting in foreign exchange (**forex**) gains or losses depending on the prevailing exchange rate. Whatever gains or losses were made were deferred from year to year and not taken as deductions for tax purposes. This resulted in unrealised forex losses on the loans as at the end of 2008.

In 2009, the directors of the Appellant resolved to settle the outstanding loans through conversion of some of the debt to equity by issuance of shares and the remaining portion through offsetting the loans against inter-company receivables. As a result, the Appellant computed the unrealised forex losses to KES 401,261,996 in its financial statements of the year 2009, treated this sum as realised losses and deducted the same as allowable expenses.

KRA audited the accounts of the Appellants for the years 2009 to 2011 and raised and confirmed an assessment that disallowed the Appellant's forex loss deductions. The Appellant being aggrieved by KRA's assessment filed an appeal before the **TAT** which was partially successful as the TAT allowed deduction of the losses that were settled by way of offsetting the outstandling loan against the inter-company receivables and disallowed those settled through conversion of debt to equity.

In its decision, the TAT found that forex differences are considered gains or losses when a foreign loan is realised. The TAT observed that such realisation occurs when there is a permanent cessation of an obligation to pay such as when the debt is paid in cash, in kind, in exchange for goods or services, in conversion of debt to equity or in amortisation against receivables between parties and not when the currency of debt is merely translated from one currency to another.

However, on the issue of whether forex losses realized on conversion of debt to equity are considered allowable deductions for tax purposes, the TAT held that they are not deductible under the Income Tax Act, (Chapter 470, Laws of Kenya) (the **ITA**) as such a process is capital in nature. The Appellant being dissatisfied by this determination appealed to the High Court and the decision of the High Court is the subject of our analysis.

The Appellant's position

The Appellant submitted as follows:

a. the TAT erred in concluding that forex losses accrued which were realised upon the conversion of the loans to equity were capital in nature and therefore not deductable for tax purposes;

b. the TAT erred in failing to consider and apply Section 4A of the ITA which expressly allows for deduction of forex losses incurred without any reference to the manner in which they arise particularly the fact that Section 4A does not exclude taking into account forex losses realised on the conversion of debt to equity;

c. the TAT erred in failing to consider that under section 4A (1) (ii) of the ITA forex gains or losses realised in relation to debt (which like equity is a balance sheet item) are tax deductible expenses;

d. the TAT erred by relying on the provisions of Section 15(2)(s) of the ITA which provides for the deductibility of expenses incurred in the issuance of shares to the general public and Section 15(2)(ss) which provides for the deductibility of incidental costs on the listing of shares on a securities exchange – neither of which the Appellant carried out; and

e. the TAT erred in holding that the Appellant was required to surrender more shares from the same amount of currency at the date of conversion of the loan than they would have if the conversion occurred on the date the loan was issued.

KRA's position

In response, KRA argued that:

a. Section 4A of the ITA recognises only those gains or losses that are actually realised in respect to gains or profits from a business and not losses attributable to share capital transactions;

b. where gains or losses were made when purchasing an investment, the difference on the currency change on realisation is a capital gain or loss and will be reflected in the balance sheet and not in the profit and loss account; and

c. Section 16(1) of the ITA provides that the only expenses which are deductible are those that are wholly and exclusively incurred in the production of income of a business. Further that any expenses that are capital in nature are not tax deductible. The forex losses in this case could not be deductible as they resulted from a capital transaction.

ANALYSIS OF
THE HIGH COURT

In allowing the appeal, the High Court made the following observations:

a. It was settled between the parties and rightly held by the TAT that the conversion of the loans into equity led to the realization of the forex losses accrued on the loans;

b. Forex differences are deemed to be on the revenue account where the loan is not related to acquisition, installation or disposition of a capital asset and where it is related with any of these, the forex differences will be deemed to be on the capital account;

c. The TAT itself found, and both parties agreed, that payment of loans through offsetting receivables and through issuance of shares was an event of realisation of a forex loss of a revenue nature. It would therefore be defeating to claim that the loan settled by means of offsetting receivables was a revenue loss while that settled by issuing shares was a capital loss yet the repayment was of a single debt;

d. The ITA does not prevent the repayment of a foreign currency loan by conversion of debt to equity and that the manner of gain or loss is irrelevant. Further, that it does not matter that the transaction is carried out by related parties;

e. That there is a gap in the law as Section 4A of the ITA does not limit deductibility of forex losses where an asset or liability is disposed or settled in certain circumstances such the issuance of shares. Provisions in other countries such as the United Kingdom expressly limit the deductibility of forex losses from certain loan relationships; and

f. That the Appeal should succeed and the Appellant be entitled to deduct the forex loss incurred on the portion of the loan extinguished through conversion of the debt to equity.

Witholding Tax On Accruals

Kenya Revenue Authority v Republic (Exparte Fintel Ltd); Civil Appeal No. 311 of 2013

Introduction

On 5 February 2019, the Court of Appeal in Nairobi delivered its judgment in a civil appeal against a decision of the High Court relating to the applicability of withholding tax (**WHT**) on interest accrued in the audited books of a taxpayer.

Background of the case

Fintel Ltd (the **Respondent**) entered into an agreement with a contractor under which it agreed to pay interest on any contractual fees paid late. A number of payments due to the contractor were delayed and incurred interest. The interest was not actually paid but the obligation to pay was accrued as a liability in the Respondent's books.

As interest is a business expense, the Respondent expensed it as a tax deductible item thereby reducing its corporation tax liability. Following an audit by the Kenya Revenue Authority (**KRA**) demanded payment of the WHT due on the accrued interest. Following the demand, the Respondent filed an appeal to the High Court challenging the demand.

KRA claimed that by recognising accrued interest as a liability in its books of account, the Respondent acknowledged that interest was credited to the account of the third party and therefore fell within the definition of the term "paid" as defined in Section 2 of the Income Tax Act (Chapter 470 of the Laws of Kenta) (the **ITA**). Under Section 2, "paid" means distributed, credited, dealt with or deemed to have been paid in the interest or on behalf of a person.

The Respondent objected to the assessment and KRA issued an objetion decision reinstating its position. The Respondent being aggrieved by the KRA's decision filed a judicial review application to the High Court to seek orders against the KRA decision.

The High Court disagreed with KRA's interpretation, holding that "tax is withheld upon payment and payment is a necessary prerequisite for WHT to apply."

Dissatisfied with the High Court decision, the KRA appealed to the Court of Appeal and the appellate court decision is the subject of analysis.

KRA's position

In the Court of Appeal, the KRA submitted as follows:

a. The payments due to the contractor fell within the ambit of Section 35(3)(f) of the ITA, being professional or management fees in respect of building, civil and engineering works therefore constituting WHT which the law permits the KRA to collect even if it had not paid out the interest;

b. Any amount recognized as an expense in the books of accounts is a credited amount in the payees account and is therefore "paid" within the meaning of Section 2 of the ITA;

c. The word "payable" could be defined in two different ways: that which is due or must be paid and that which may be paid or may have to be paid. The High Court's interpretation that "upon payment" implied "delivery of money or any other valuable thing…" was erroneous as it restricts the meaning of the word "paid" under Section 2;

d. The High Court misapplied the basic principles of accounting, by failing to appreciate the two primary accounting concepts being cash and accrual concepts, which presents options for the taxpayer and in this case the Respondent elected the accrual option. In their statement of profit and loss, the interest charged though not paid to the contractors and remained a debt owing was recognized in the books of account as an accrued expense, the effect of which was to reduce the amount of profit chargeable to tax as corporation tax; and

e. That judicial review should not have been an available remedy to the Respondent without exhausting all other statutory mechanisms elaborately set out under the Tax Procedures Act, 2015 to ventilate its case.

The Respondent's position

a. The term "paid" under Section 2 of the ITA can only mean delivery of money and discharge of settlement. That since the Respondent neither settled the outstanding contractual fee nor paid any interest charged by the contractor, even though the interest was recognized as a liability in the its books of accounts, no WHT was due from that transaction;

b. In terms of section 35(1) and (3) of the ITA, tax is withheld 'upon payment' of the expenses and this means that the fact of payment is a necessary prerequisite for WHT to apply.

c. the settlement of an obligation may be through receipt of cash, cheque or other mode of settlement or discharge and an accrual is therefore not a discharge of debt. 'Upon payment' denotes the discharge of a debt or liability and it was premature for the KRA to demand payment of the WHT before the actual payment of interest. By doing so, the KRA exceeded its powers under Section 2 as read with Section 35(1) and (3) of the ITA; and

d. Without giving of reasons for rejecting the objection, the KRA denied the Respondent a chance to understand the basis of the decision. It is because of this omission that the Respondent resorted to judicial review.

ANALYSIS OF THE **COURT OF APPEAL**

The Court of Appeal in allowing the appeal, held as follows:

a. That the term 'paid' should be given a wide meaning and therefore 'upon payment' can not only mean that money or some valuable thing was delivered.

   Although section 35(5) requires that where WHT is payable, the tax payer must "deduct" and remit the amount to the KRA, the sense in which the word "deduct" is used, as an accounting term refers to the act or process of subtraction of an item or expenditure from gross income to reduce the amount of income subject to income tax. This need not be done physically or practically but as a book entry;

b. That by making the entry of the interest due to the contractor in its profits and loss account, the Respondent reduced its taxable income, which passed to it as a benefit since the amount of profits chargeable as corporate tax was reduced;

c. That the KRA's statutory role is revenue assessment and collection, administration and enforcement of the laws relating to revenue. This role is recognized under Section 120 of the ITA (provision now repealed and transferred to the TPA) which permits the appellant to inquire into the accounts of a company, assess tax and demand payment. An order that quashes the decision made without jurisdiction or in excess of jurisdiction, or where the rules of natural justice have not been complied with, was therefore inappropriate in this case as the KRA was well within its powers.

d. There was no justification for the Respondent to move the High Court after invoking the jurisdiction of the Local Committee; and

e. The appeal by KRA therefore succeeded.

"Winnings" as Defined under the Income Tax Act (Cap 470 of The Laws Of Kenya) is Exclusive of Stake

Pevans East Africa Limited & Others v The Commissioner of Domestic Taxes, Tax Appeal No. 304 of 2019

Introduction

On 6 November 2019, the Tax Appeals Tribunal (the **TAT**) delivered a decision in relation to the taxation of winnings in the betting industry that held that, winnings do not include the stake of punters and found that the Kenya Revenue Authority (the **KRA**) had no legal basis for demanding withholding tax on the punters' stake.

Background of the case

The Finance Act, 2018 introduced a new definition of "winnings" to mean that it "*...includes winnings of any kind and a reference to the amount or the payment of winnings shall be construed accordingly*". This provision became effective as from 21 September 2018.

On this basis, KRA demanded billions of shillings from various betting companies operating in Kenya, some of whom were the Appellants, as arrears on withholding tax on "winnings" without first issuing tax assessments as is the procedure under the Tax Procedures Act, 2015. Further, KRA issued agency notices to the Appellants' respective bankers and any persons holding monies on account of the Appellants demanding payment for the same.

As a result, and being aggrieved by KRA's actions, the Appellants lodged separate appeals at the TAT to challenge KRA's position which were subsequently consolidated and Tax Appeal No. 304 of 2019 selected as the test suit to determine the matter.

The Appellant's position

The Appellants argued that:

a. KRA applied an incorrect and illegal interpretation of the term "winnings" by seeking to impose a 20% withholding tax on the winnings inclusive of the stake;

b. KRA should have interpreted the law "as is" without seeking to extend the definition of "winnings' to the stake contrary to the express provision of the law; and

c. should KRA's position stand, then it would result in an absurd commercial outcome where the gross payout to the punter would result to an amount less than what he or she staked despite "winning" the bet.

We provide an illustration as follows (figures are in KES):

Interpretation of winnings

	KRA	Appellants
Stake	1,000	1,000
Winning	200	200
WHT at 20%	240	40
Gross payout to punter	960	1,160

KRA's position

In response, KRA contended that:

a. withholding tax as a method of tax collection acts on gross income rather than net income;

b. winnings is deemed income and the withholding tax will therefore be charged on the gross amount paid; and

c. the matter had already been determined in the case of ***George Lesaloi Selelo and Commissioner General KRA and 5 others (2019)*** at the High Court in Nanyuki (the ***George Lesaloi case***) therefore rendering the appeal "res-judicata".

ISSUES FOR **DETERMINATION**

The TAT identified the following issues for determination:

a. whether the definition of the term “winnings” included the stake;

b. whether the Appellants had “locus standi” to institute the appeals;

c. whether this matter had previously been determined in the George Lesaloi case; and

d. whether KRA followed due process in issuing demands and agency notices without issuing tax assessments.

ANALYSIS OF THE **TAT**

The TAT made the following observations and held that:

a. The rules of interpretation of tax statutes require that tax statutes should be read strictly and there should be no room for presumption or assumption. Further, “if the intention was to include stakes in the definition of winnings, the Legislature which has never fallen short of words would have specifically stated so.” Therefore, “winnings” as stipulated in the Income Tax Act (Chapter 470, Laws of Kenya) refers to “payouts by the licensee (the betting company) but does not include amounts staked by the punter.”

b. The Appellants demonstrated to its satisfaction that they were the rightful parties to lodge the appeal because they were directly aggrieved by KRA’s actions.

c. The TAT was not convinced that the issue was conclusively dealt with in George Lesaloi case because it did not provide any interpretation or clarification on the issue of the definition of “winnings”.

d. Despite the fact that KRA is empowered to collect taxes, it is bound to exercise its powers in accordance with the law and not flout the legal procedures set out in the taxation statutes available to them. Further, the demand of withholding tax and agency notices without issuing tax assessments was unprocedural and unconstitutional.

Tax Deductibility of Bad and Doubtful Debts and PAYE On ESOP Benefits

Equity Bank (Kenya) Limited v The Commissioner of Domestic Taxes; Tax Appeal No.161 of 2017

Introduction

On 18 December 2019, the Tax Appeal Tribunal (the TAT) issued a ruling on the deductibility of bad and doubtful debts written off as well as the levying of Pay-As-You-Earn (**PAYE**) on the employee share ownership plan (**ESOP**) benefits accruing to employees.

Background of the case

The Kenya Revenue Authority (the **KRA**) carried out a compliance audit on Equity Bank Kenya Limited's (the **Appellant**) with regard to Corporation Tax on bad and doubtful debts written off, Excise Duty on other fees charged by the Appellant and PAYE on ESOP benefits. The KRA issued an assessment as follows:

- Disallowing bad and doubtful debts write-offs deducted by the Appellant in its corporation tax computation;
- Assessing excise duty on various fees such as fees from loan and credit evaluation reviews, income earned on temporary overdraft facilities, income on letters of credit and bank guarantees etc.; and
- PAYE on ESOP benefits accruing to employees.

The Appellant objected to the entire assessment but the KRA issued an objection decision rejecting the objection.

The Appellant, being aggrieved by the decision of the TAT, filed an appeal to the TAT. The TAT pronounced itself on all the issues save for excise duty which it held was subject matter of a suit filed by Kenya Bankers Association on behalf of its members and the same was pending determination in the High Court. The decision of the TAT is the subject of our analysis.

The Appellant's position

The Appellant submitted the following:

a. bad and doubtful debt write offs were expenditure incurred wholly and exclusively in the production of income as required under Section 15(2) (a) of the Income Tax Act, (Chapter 470 of the Laws of Kenya) (the **ITA**) and the guidelines on the deductibility of bad debts issued by the KRA under Legal Notice Number 37 of 2011 (the **Commissioner's Guidelines**). Section 15(2) (a) of the ITA provides that a bad debt that has been incurred in the production income shall be an allowable deduction provided it meets the Commissioner's Guidelines;

b. The Commissioner's Guidelines provide for deductibility where: creditor loses contractual right to the debt through a court order; where no form of security is realizable; proceeds from sale of security are not sufficient to cover the debt; debtor is adjudged bankrupt; cost of recovering the debt is greater than the debt or efforts to collect are abandoned for another reasonable cause. The Appellant maintained that all reasonable efforts were taken to collect the said debts pursuant to Section 15(2)(a) and the Commissioner's Guidelines; and

c. a benefit is only conferred under an ESOP where the employer issues new shares at no cost or at a discount and allocates them to employees so that they can vest a further date. No benefit was conferred to the Appellant's employees under ESOP which would be subject to PAYE. Furthermore, as an employer, the Appellant did not fund the subject scheme and therefore could not have conferred a benefit to the employees.

The KRA's position

The KRA submitted the following:

a. the bad debts written off relating to thirteen customers did not meet the conditions prescribed under Section 15(2)(a) and the Commissioner's Guidelines and therefore did not qualify as tax deductible expenses as the Appellant did not take all the reasonable efforts to collect the debts as envisaged in the law; and

b. the Appellant offered shares to eligible employees which vested . On the vesting date, the Appellant did not subject the benefit to PAYE.

c. a taxable benefit was conferred to the respective employees by offering shares at prices below the prevailing market price. The taxable benefit, pursuant to Section 5(5) of the ITA is the difference between the market value per share and the offer price per share at the date the option is granted by the employer. This benefit accrues to the employee the time the option vests or when the option is exercised by the employee. Therefore, the PAYE assessment on benefits derived from the ESOP was proper.

ANALYSIS OF THE **TAT**

In arriving at its decision, the TAT noted the following:

a. after an analysis of each of the 13 debts included in KRA's assessment, the TAT noted that the Appellant strove to collect its debts using reasonably available means under the circumstances of each facility, except for one. The bad and doubtful debts provisions are therefore tax deductible expenses in 12 of the 13 cases. On the one case which did not qualify, the TAT noted that the Appellant did not demonstrate that the enforcement machinery had been exhausted to collect the outstanding debt;

b. The establishment of an ESOP by the Appellant did not by itself confer a taxable benefit on the employees. Further, the funding and purchase of shares in the Appellant company held by the ESOP did also not confer taxable benefits on the employees; and

c. However, the ESOP units were granted to, and subsequently vested on eligible employees at discounted prices. Section 5(5)(a) provides that in an ESOP, a tax benefit arises on vesting and is calculated as the difference between the market price per share and the offer price at the date an option is granted. PAYE was therefore due on the ESOP benefits to employees and the Appellant was required to compute and remit the same.

Tied Insurance Agents Are Not Employees: High Court Ruling

UAP Life Assurance Company Limited v. the Commissioner of Domestic Taxes; High Court Income Tax Appeal No. 22 of 2017

Introduction

On 4 November 2019, the High Court delivered a judgement on whether tied insurance agents can be deemed to be employees of insurance companies as opposed to independent contractors. The significance of the distinction is that the income of employees is subject to Pay As You Earn (**PAYE**) while the income of an independent agent is subject to withholding tax (**WHT**).

Brief facts of the case

UAP Life Assurance Company Ltd (the **Appellant**) lodged an appeal against a decision of the Tax Appeals Tribunal (the **TAT**) upholding Kenya Revenue Authority's (**KRA**) tax assessment. Following a PAYE review of the Appellant's business by KRA for the period 2011-2014, KRA demanded PAYE on the payments to the tied insurance agents engaged by the Appellant on the basis that they were employees as opposed to independent contractors. The Appellant lodged an objection against the assessment and KRA confirmed the assessment vide an objection decision dated 10 February 2015. Being aggrieved by the objection decision, the Appellant filed an appeal to the TAT.

The TAT in its decision restricted itself to the provisions of the Income Tax Act (Chapter 470 of the Laws of Kenya) (the ITA) noting that the definition of an employee under the Employment Act (No. 11 of 2007, Laws of Kenya) (the Employment Act) and the definition of an agent under the Insurance Act, (Chapter 487 of the Laws of Kenya) (the Insurance Act) wee immaterial.

Section 2 of the Employment Act defines an 'employee' as a person employed for wages or salary. Further, Section 2 of the Insurance Act defines an agent to mean a person not being a salaried employee of an insurer who receives a commission in exchange of soliciting or procuring insurance business for the insurer or broker.

The TAT in its judgment relied on the fact that the Appellant exercises significant control over the tied agents to hold that the agents could be deemed as employees.

The TAT therefore agreed with the KRA that the Appellant as an employer was required to account for PAYE on the payments and therefore dismissed the appeal.

Being dissatisfied with the decision of the TAT, the Appellant filed an Appeal to the High Court. The High Court decision is the subject of our analysis:

The Appellant's position

The Appellant submitted that;

a. the relationship between itself and the tied agents was in the nature of a principal and agent and therefore deemed to be a 'contract for services' and not a 'contract of service';

b. the tied agents were independent contractors as their remuneration was in the form of commissions and discretionary monthly subsidies;

c. in upholding KRA's decision, the TAT had acted in error by not considering the established industry practice, where an agent in the life insurance business is a non-employee sales agent; and

d. the TAT erred in only considering two of the four tests namely the control and integration tests, set out to determine the existence of an employer/ employee relationship. The control test is where an employee is considered to be subject to the command of the employer in the manner they work; the integration test is where the employee is subjected to the rules and procedures of the employer rather than personal command; the test of economic or business reality is where the employee is in the business of his or her own account or works for another person and the employer takes the ultimate risk of loss or chance of profit; and, the mutuality of obligation test is where the parties make commitments to maintain the employment relationship over time.

KRA's position

In response, KRA submitted as follows;

a. tied agents serve under a contract of service as defined under the ITA and the definition of "Employee" and "Emoluments" under the Income Tax (PAYE) Rules;

b. the legal and factual test that applies to determine whether a relationship is that of employment or of an independent contractor, include, the nature of service.

c. Basing its arguments on the "control test" KRA argued that the tied agents could only work for the Appellant, were restricted to fixed places of work and transferable to any of the Appellant's branches or locations and supervised other managers or agent reporting to them and their contracts contained general clauses that are consistent with an employee relationship;

d. the disbursement test revealed that the tied agents were bound to seek approval from the Appellant before incurring disbursements.

e. Further, the remuneration test revealed that the tied agents were also on a monthly retainer and received other benefits such as car loans, mortgages and pension schemes.

ANALYSIS OF THE **HIGH COURT**

In its judgment the High Court found as follows:

a. that the Employment Act is the principal statute for employment matters. The provisions of the ITA cannot override the statutory provisions on the definition of an employee, as the Employment Act is the substantive and primary legislation on employment matters;

b. that given the Appellant was involved in insurance business and regulated under the Insurance Act, an understanding of who is an agent under the Insurance Act was material;

c. that the agents were paid a monthly subsidy and not a salary or a wage and could therefore not be deemed to be employees pursuant to the provisions of the Employment Act;

d. that the existence of a clause in the tied agent's contracts being consistent with employment contracts, that alone could not qualify them as employees;

e. that a contract of employment is a contract of service and not a contract for services. A contract for service is an agreement to undertake a specific project or work with an independent contractor who is left free to do the assigned work and to choose the method to accomplish it;

f. that the income of the tied agents is subject to tax and the KRA has a right to demand tax on the income.

Based on the foregoing reasons, the High Court held that:

a. Had the TAT considered the relevant provisions of the Employment Act and Insurance Act alongside the ITA in considering KRA's decision, it would not have arrived at the decision that the tied agents were employees of the Appellant. The appeal was therefore allowed; and

b. Tax was due on the income of the tied agents and the Appellant should produce documentation to prove that the relevant tax was paid (WHT in this case).

Taxation of School Fees Benefit

(Brookhouse Schools Limited v The Commissioner of Domestic Taxes- Appeal No 119 of 2017

Introduction

On 27 March 2020, the Tax Appeals Tribunal (**TAT**) issued a judgment on the taxation of school fees benefit provided to employees' dependants.

Background of the case

Brookhouse Schools Limited (the **Appellant**) is an educational institution in Kenya. The Appellant provided its employees with a non-cash benefit by allowing its employees to have their dependents attend the school at no charge. The Kenya Revenue Authority (the **KRA**) carried out an audit on the Appellant covering the period of 2010 to 2015. KRA alleged that the Appellant failed to subject the school fees benefit to its employees to Pay-As-You-Earn (**PAYE**) on the specific employees.

After various discussions and correspondence, the KRA confirmed the PAYE assessment. The Appellant lodged an objection which was rejected by KRA in its entirety and which action resulted in a confirmed assessment.

The Appellant being aggrieved with the decision filed an appeal to the TAT and the decision of the TAT is the subject of our analysis.

The Appellant's position

The Appellant submitted the following

a. Section 16(2)(a)(iv) of the Income Tax Act (Chapter 470 of the Laws of Kenya) (**ITA**) provides that, "*notwithstanding any other provision, educational fees of employee's dependants or relatives shall not be an allowable deduction for a person*." In the Appellant's view this is a specific provision;

b. Although KRA relied on Section 5 of the ITA which deals with taxation of income from employment and which seeks to tax benefits from employment, Section 5(4)(d) of the ITA provides that *"educational fees of employee's dependents or relatives disallowed under section 16(2)(a)(iv) which have been taxed in the hands of the employer*" shall not be taxable gains from employment;

c. Section 16(2)(a)(iv) of the ITA is the primary charging provision for the school fees benefit as Section 5 (4)(d) only deems it a benefit if it has not been disallowed under Section 16(2)(a)(iv) of the ITA;

d. Section 5(4) of the ITA is a general provision relating the taxation of the school fees benefit ,whereas, Section 16(2)(a)(iv) of the ITA is the specific provision which should be applied first; In the present circumstances, the school fees benefit has been disallowed on the employer pursuant to Section 16(2)(a)(iv) and therefore it cannot be taxed again in the hand of the employee;

e. With relation to the value of the benefit and assuming Section 5 was deemed to be the taxing provision, the value attributed to the benefit pursuant to Section 5(5) would be the higher of the of the cost to the employer or the fair market value of the benefit;

f. KRA in its assessment has attributed the highest school fees charged to the school's premium student to be the fair market value. In arriving at this position, KRA has failed to consider that there is a lower rate paid by students on scholarships and bursaries. In the circumstances, the taxpayer should therefore be given the benefit of the lower value of the benefit given the rule that in tax matters where there is the possibility of two scenarios in interpreting a tax provision, the benefit must given to the taxpayer so that interpretation that favors the taxpayer should be taken;

g. The Appellant also relied on the case of Pepper (Inspector of taxes) v Hart which held that the value of the benefit should be the marginal cost to the employer in having an extra student attend the school; it means as long as the concessionary fees that has been determined by the school adequately covered the expenses of having the children of the members of staff and the teachers, then it would be deemed to be sufficient;

h. That although KRA alleges it had issued guidance to the Appellant on how to tax the school fees benefit, the interpretation of the KRA was not binding on the Appellant since it had a different opinion; and

i. KRA had issued an assessment which was beyond the five year statutory period.

The KRA's position

The KRA submitted the following:

a. Section 5 of the ITA provides that upon ascertaining the taxable gain or profit of a particular person, the employer is to add to that taxable benefits granted to its employees. Section 5(4)(d) therefore becomes the charging section;

b. Section 5(5) of the ITA provides that the value of the benefit shall be the higher of the cost to the employer and the fair market value of the benefit. Though the ITA does not define market value, it can be defined as that which is at arm's length. Therefore, the market value can only be that which is payable by an ordinary parent in the school; and

c. The Appellant willfully neglected to subject the benefits to tax properly despite receiving guidance from the KRA and therefore KRA was entitled to issue an assessment beyond the five-year statutory period.

ANALYSIS OF THE **TAT**

The TAT in finding that the appeal had merit held that the value of the non-cash benefit should be brought to charge under Section 16(2)(a)(iv) of the ITA.

In arriving at its judgment, the TAT found that:

a. Section 16(2)(a)(iv) should be used in bringing the benefit to charge because it is more specific as opposed to the general provision of Section 5(5) of the ITA. This is in line with the principle of generalia specialibus non derogant which stipulates that if a statute contains both a general provision as well as a specific provision, the specific provision will prevail;

b. However, the KRA is allowed to invoke the provisions of Section 5(5)(b) where cost or the fair market value of a benefit cannot be determined;

c. Therefore, the KRA needs to follow the procedure laid down in Section 16(2)(a)(iv) of the ITA and disallow the cost of the benefit in the Appellant's tax computations;

d. The notice of intention to audit was issued on 1st December 2015 covering the period of 2010 to 2015. The KRA communicated its assessment to the Appellant on the 7th of February 2017. The assessment was therefore within the five-year statutory limit.

Indirect Taxes

Valuation of Goods for Customs Purposes

Penord Ricard Kenya Ltd v Commissioner of Customs & Border Control; Tax Appeal No. 25 of 2018

Introduction

On the 6 of March 2020, the Tax Appeals Tribunal (**TAT**) issued a judgment in an appeal from a review decision issued by Kenya Revenue Authority (the **KRA**) pursuant to Section 229 (4) of the East African Community Customs Management Act 2004 (**EACCMA**). The issues determined were whether KRA could raise a demand beyond the statutory period, whether KRA followed the due process in disregarding Pernod Ricard Kenya Ltd's (the **Appellant's**) transaction value and instead applied the transaction value of identical goods and whether the relationship between the Appellant and Brand Owners influenced the price of its imports and whether brand marketing operations should form part of the customs value of imported goods.

Background of the case

The Appellant is a company incorporated in Kenya, and owned by Pernod Ricard Africa (incorporated in France) which is ultimately owned by Pernod Ricard SA (also incorporated in France). The Appellant engages in marketing and distributing the Pernod Ricard group's products in the Kenyan market. These products are manufactured by Brand Owners (BOs) located across the world.

KRA carried out a post clearance audit on the Appellant. Following the audit, KRA wrote to the Appellant on the 7 December 2017 and demanded additional customs duties on the Appellant's import for the period of July 2012 to December 2016. Being aggrieved by the additional demand, the Appellant made an application for review of the decision pursuant to Section 229 (1) of EACCMA on 22 December 2017. In the application for review and a further letter dated 8 January 2018, the Appellant provided supplementary information to KRA.

The KRA issued a review decision to the Appellant's application for review in a letter dated 18 January 2018. The decision confirmed the KRA's position as set out in the letter of 7 December 2017 including the demand for additional customs duties. Part of the demand for additional customs duties related to a period beyond the statutory time limit of 5 years as provided for under Section 135 (3) of EACCMA.

In making the demand for the additional customs duties KRA alleged that they had reason to believe that the relationship between the Appellant and the BOs (sellers) influenced the price of the imports and on this basis disregarded the Appellant's transaction value and applied the transaction value of identical goods.

The Appellant being aggrieved by KRA's decision filed an appeal to the TAT and the decision of the TAT is the subject of our analysis:

:

The Appellant's position

The Appellant submitted as follows:

a. the KRA erred in law and in fact by seeking to disregard use of transaction value method which is the primary method of customs valuation as provided for under Paragraph 2(1) of Part 1 of the Fourth Schedule to EACCMA. The transaction value is the price paid or actually payable when goods are sold for export in a partner state;

b. the KRA erred in law and in fact by disregarding the provisions of Paragraph 2 (2)(a) of Part 1 to the Fourth Schedule of EACCMA which provides the fact that the buyer and seller are related is in itself not a sufficient reason to disregard use of the transaction value method;

c. contrary to the provisions of Paragraph (2) (2) (a) of Part 1 of the Fourth Schedule to EACCMA, KRA failed to provide reasons to the Appellant as to why in its view the relationship between the buyer and seller influenced the price and by this failure denied the Appellant reasonable opportunity to demonstrate that the purchase price of the imported goods was not influenced by the relationship with the seller prior to uplifting the customs value of the Appellant's imports;

d. even in applying the transaction value of identical goods, KRA acted contrary to the provisions of Paragraph 3(1) (b) to the Fourth Schedule by disregarding demonstrated differences in commercial levels and quantity levels in comparing imports made by the Appellant from the seller and imports made by a third party not related to the seller and who was a customer of the Appellant (Siamanda);

e. the KRA erred in law and in fact by failing to provide the Appellant with data on its application of the transaction value of identical goods that it relied on and the analysis of the computation in arriving at the uplifted values;

f. the KRA erred in law and in fact by failing to examine supplementary information provided by the Appellant and which information provided clarity on application of transaction value method and relationship between the Appellant and seller of the imported goods;

g. the Appellant placed reliance on the OECD Transfer Pricing Guidelines to demonstrate the arm's length nature of the prices between itself and the seller;

h. the Appellant's ability to operate at a profit was sufficient evidence that the transfer prices between the seller and the Appellant were at an arm's length. This was consistent with the OECD Transfer Pricing Guidelines which provide that where an associated enterprise is consistently in a loss making position whilst the MNE group as a whole is profitable, the facts could trigger a transfer pricing scrutiny. But this was not the situation in the Appellant's case; and

i. the KRA erred in law and in fact by rejecting the Appellant's declared transaction value on the basis that brand marketing support payments were made by transfers from bank accounts which were in receipt of sale of the imported goods, when it was clear that these payments were not part of the proceeds of any subsequent resale of the imported goods.

The KRA's position

The KRA submitted as follows:

a. the transaction value had been influenced by the relationship between the Appellant and the seller and prior to the issuance of the demand for additional customs duties, the Appellant had been allowed sufficient opportunity to provide information to support the transaction value;

b. it revealed sufficient information on the comparables to the Appellant to enable the latter respond and, taking care not to breach its obligation to confidential storage and use for purpose, of a different taxpayer's information/data as guided by Section 226 of EACCMA;

c. in related party transactions, once the proper officer is in doubt as the transactional value of goods as per Section 122(4) of EACCMA, the onus of proof shifts to the importer to prove that that a related party transaction has not been influenced by the relationship between two entities;

d. according to Article 2(1)(d) and 2(2)(a) of the Fourth Schedule of EACCMA, for the transaction value to be acceptable as the customs value of the imported goods, the buyer and seller should not be related and if related, the relationship should not influence the price. It is very clear that it is imperative for the Appellant to provide information that the relationship did not influence the price;

e. it preferred the transaction value for identical goods method because the transaction value presented by the Appellant was influenced by their relationship with the seller as established from the invoices and importations by unrelated parties, whose value is more than double the value declared by the importer;

f. pursuant to paragraph 2(1)(c) of the Fourth Schedule of EACCMA, for transaction value to be acceptable as the customs value of imported goods, 'no part of the proceed s or any subsequent resale, disposal or use of the goods by the buyer, will accrue directly or indirectly to the seller, unless an appropriate adjustment can be made;

g. the Appellant was making substantial payments to its suppliers (BOs) over and above payments for the supply of goods as invoiced and declared to customs. From the Transfer Pricing documentation, the BO being brand owners are responsible for the management of the brand; and

h. the tax authority of the recipient of the product would be seeking to ensure that the services in question satisfy the benefit test and that the recipient was being arm's length price for the intra-group services. A tax authority of the service recipient would consider making an adjustment if it considered the services provided a benefit to the recipient but the service charges were excessive.

ANALYSIS OF THE **TAT**

The TAT allowed the appeal and in so doing held as follows:

a. although the KRA could not be estopped from executing its statutory duty, it could only exercise such duties beyond the statutory period in the case of fraud or wilful neglect. In this case, the KRA did not provide evidence that there was wilful neglect or fraud on the part of the Appellant. The KRA was therefore estopped from demanding short levied customs duties beyond the statutory period of 5 years;

b. although both the Appellant and Respondent relied on custom valuation methodologies and transfer pricing to buttress their respective cases, the customs valuation approach and the transfer pricing approach are different and cannot yield the same objective value;

c. customs belongs to the sphere of indirect taxation whereas Transfer Pricing belongs to the area of direct taxation. The scope of transfer pricing is wider than customs as it seeks to allocate profits in a Multinational enterprise and in so doing looks at the profits of the taxpayer and all cross border intercompany trade including goods, services, intangible and financing. Customs on the other hand concerns itself with international trade in goods and seeks to create a level playing field among trading nations;

d. the objective of transfer pricing adjustment is to decrease the value of imported goods, whereas a customs adjustment will seek to increase the value of the imported good;

e. in this case, it was not clear whether, despite the existence of essential coincidence between the two sets of rules, values determined under transfer pricing methods could also be used for customs valuation under the current legislation unless it is to be treated as a fall back method. The most appropriate approach to be adopted was therefore considered to be the customs valuation approach;

f. KRA had failed to disclose the reasons for doubting the truth or accuracy of the information provided by the Appellant that its relationship with the seller did not influence the price and its attempt to anchor this failure in confidentiality without justifying the provisions of the law relied upon had no basis;

g. the transactions between the foreign exporter (seller) and Siamanda could not have been termed as an arm's length transaction having been done through the Appellant. In the circumstance the value of the goods could not be not be objectively determined using the transaction value of identical goods and this method was therefore not appropriate in the given case. The prices were values between the Appellant and its customer and thus not fit for purpose as the transaction value of identical goods;

h. the procedure applied by the Respondent to review the transaction value using values declared by Siamanda was wrong as the Respondent did not follow due process;

i. it is difficult to obtain a transaction value of identical goods imported by an unrelated party because the Appellant was the sole importer of the brands and the fact that even imports by Siamanda were under the control of the Appellant. The Respondent should have considered the transaction value of similar goods imported by unrelated parties as the most appropriate method of determining customs value; and

j. brand marketing operations are local expenses at the country of importation and should therefore not form part of customs value. The expenses related to brand marketing operations incurred by the seller on behalf of the importer and vice versa should be considered not under customs valuation but under domestic corporate taxation and VAT regimes.

The TAT therefore ordered that:

- the part of the demand that was in respect of short levy for the period beyond 5 years be vacated;
- the Appellants goods be valued using transaction value of similar goods; and
- that remittances related to marketing operations be addressed under the provisions of the ITA and the VAT Act and not be used to adjust transaction values under the EACCMA.

Processing of VAT Input Claims and Utilisation of Tax Overpayments

Unga Limited v Commissioner of Domestic Taxes; TAT Appeal No. 156 of 2017

Introduction

In a judgment issued on 4 March 2020, the Tax Appeal Tribunal (the **TAT**) held that the taxpayer was entitled to a refund of overpaid tax. The TAT also found that there is no time limitation in filing a tax return in relation to self-assessment, and that failure to process a Value Added Tax (**VAT**) refund after confirming that the same was due was a violation of the taxpayer's legitimate expectation.

Background of the case

The case is in relation to a VAT claim lodged by Unga Limited (the **Appellant**). The Appellant lodged an input VAT claim with KRA for the period June 2012 to April 2013 in June 2013 and received a written confirmation from KRA that the application had been processed and approved and payment was pending release of funds from the National Treasury.

The Appellant also requested the KRA to transfer the tax overpayments accumulated by the Appellant in 1997 and 1998 years of income to offset the Appellant's principal tax liability for the 2010 year of income.

Upon this request, the KRA notified the Appellant that the tax return for the year of income 1998 was not filed and that the transfer of the tax overpayment to the 2010 year of income was not possible. Further, the KRA stated that the Appellant was barred from filing its return for the year 1998 after the lapse of 7 years as provided by law (now reduced to 5 years under the Tax Procedures Act, 2015 (TPA)). The Appellant informed KRA that the 1998 tax return had been filed but it could not trace a copy of the same although the Appellant had earlier provided a copy of the receipt in respect of installment tax paid for the 1998 year of income.

The Appellant resubmitted the 1998 tax return together with the supporting tax computation and a copy of the respective audited financial statements through a letter dated 1 December 2015. In addition, the Appellant pointed out that the 7 year limit related to the time limit for the KRA making an assessment as per Section 79(1) of the Income Tax Act (Chapter 470 of the Laws of Kenya) (the **ITA**) (now repealed by Section 79 of the TPA) and not to filing of a tax return by a taxpayer.

Through a letter dated 27 June 2017, KRA withdrew the confirmation of the Appellant's VAT refund claim. The Appellant objected to this action by KRA. The KRA rejected the Appellant's objection through an objection decision given through a letter dated 15 September 2017. Being aggrieved by the decision of KRA, the Appellant lodged an appeal against the decision to the TAT. The TAT decision is the subject of our analysis.

The Appellant's position

The Appellant argued that the VAT refund claim should be separated from the corporate tax matters to enhance efficiency in processing of the VAT refunds.

The Appeal by the Appellant was submitted as follows:

a. the KRA is estopped under the doctrine of estoppel from failing to process the Appellant's VAT refund claim after confirming that the same was due and payable;

b. the KRA letter confirming that the VAT refund claim was due and payable created a legitimate expectation to the Appellant and failure to pay goes against the doctrine of legitimate expectation;

c. the failure by the KRA to refund the VAT to the Appellant is a violation of the right to property under Article 40 of the Constitution of Kenya;

d. the KRA's refusal to process the VAT refund is a violation of the Appellant's right to fair administrative action under Article 47(1) of the Constitution of Kenya;

e. the KRA was wrong for finding that the Appellant's tax loss for the year 1998 could not be carried forward to 1999 since the tax loss was not assessed in the year of income 1998;

f. the KRA was wrong for finding that the 1998 financial records of the Appellant included unaccounted for income hence overstating the tax loss for the year;

g. the KRA was wrong for finding that the Appellant's overpayments for 1997, 1998 and 1999 could not be utilised to settle the Appellant's tax liability for 2010 due to the failure by the Appellant to file the 1998 tax return; and

h. the KRA was wrong for finding that the decision to reopen tax issues relating to 1998 was not time-barred as it falls under Section 29(6) of the TPA.

The KRA's position

In rebuttal KRA alleged the following:

a. that when processing a claim. KRA is required to examine the claim and where irregularities, fraud or other deficiencies are discovered bring this to the attention of the applicant. The KRA is also entitled to request for further information. In this case the KRA was therefore entitled to reject the claim as it further emerged that the Appellant willfully and deliberately opted not to file a tax return for the 1998 year of income, which in effect had substantive adverse consequences on revenue;

b. that KRA cannot be expected to pay out a VAT overpayment and at the same time turn a blind eye on the debt of corporation tax from the same entity. The doctrines of estoppel and legitimate expectation cannot prevent the KRA from performing its statutory obligation of collection and receipt of government revenue as provided under Section 5(1) of the Kenya Revenue Authority Act as read together with Section 47(4) of the TPA.

c. that the law stipulates that even a verified tax overpayment will be first applied to clear outstanding tax debts before a taxpayer can get a refund. An overpayment does not necessarily translate to a refund since a refund is the balance of the sum left after set off against the other taxes which are due and payable;

d. the KRA was in compliance with Section 47(4) of the TPA in applying the overpayment due to clear the tax debt under the Income Tax Act being principal tax, penalties and interest in relation to corporate tax;

e. the alleged overpayment by the Appellant could not be ascertained in the absence of the tax return for 1998;

f. the Appellant had not filed the 1998 self-assessment return therefore warranting the KRA to reject the proposal by the Appellant to settle the tax liability for 2010 with an overpayment arising from 1998 as the alleged overpayment could not be verified or ascertained as it could not be traced and thus could result in the underpayment of taxes

ANALYSIS OF THE **TAT**

In allowing the appeal, the TAT made the following findings:

a. A taxpayer is entitled to a refund of overpaid tax according to Section 47(1) of the TPA and as provided under the VAT Act. The application of tax overpayments by the KRA envisaged under Section 47(4) of the TPA is on existing tax liabilities at the time of payment of the refund. Further, the TAT found that the Appellant acted in accordance with the ITA when it carried forward the tax losses it had to 1999 year of income while the Appellant sought to settle subsequent tax liabilities with the tax overpayment;

b. A taxpayer is bound to encounter tax issues as it continues to operate and the KRA can therefore not hold on to a refund payment in anticipation of a tax liability which has not crystallized is not supported by law;

c. The law does not give timelines within which the KRA must refund tax but as a public body, KRA is expected to process the payments timeously;

d. There is no time limitation that applies in regard to the filing of a tax return. The limitation applies with regard to an assessment by the KRA which can only be done within 7 years (now reduced to 5 years) after the year of income to which an assessment relates. The Appellant in this case could therefore file the return for 1998 without being deemed to be out of time;

e. The doctrine of legitimate expectation requires reliance on the representations and the resultant detriment to the claimant in the same way as claims based on promissory estoppel. In this regard, withdrawing the VAT claim confirmation after two years means the KRA failed to exercise its statutory duty by acting unfairly and unreasonably by letting the Appellant believe that it was processing its VAT refund claims. The KRA's actions go against the doctrine of legitimate expectation and the KRA was therefore estopped from withdrawing its letter in which it confirmed the Appellant's VAT refund claim.

The TAT therefore allowed the appeal and noted the following:

a. the Appellant's VAT refund claim was due and payable;

b. the Appellant filed the 1998 return of income with self-assessment upon resubmission; and

c. the KRA's failure to process the VAT refunds after confirming to the Appellant that the same was due and payable goes against the doctrine of legitimate expectation.

VAT on Exports of Services

Coca-Cola Central East and West Africa Limited v The Commissioner of Domestic Taxes; Tax Appeal No. 5 Of 2018

Introduction

On the 31st of March 2020, the Tax Appeals Tribunal (**TAT**) issued a issued a judgement on the determination of what constitutes an 'export of services' for Value Added Tax (**VAT**) purposes and the rules applicable in making such determination.

Background of the case

Coca-Cola Central East and West Africa Limited (the **Appellant**), a Kenyan company is an affiliate of the Coca-Cola Company, which is incorporated and domiciled in the United States of America (**USA**) and is the owner of beverage brands including Coca-Cola (**Coca-Cola Company**).

The Coca-Cola Company transferred the rights to use the Coca-Cola trademarks outside the USA to certain affiliates, including the Coca-Cola Export Corporation (**Coca-Cola Export**), incorporated and domiciled in the USA. Coca-Cola Export and its non-Kenyan affiliates (**Foreign Affiliates**) manufacture concentrates in various locations across the world, outside Kenya. The proprietary concentrate beverages are then sold to authorized bottlers, who make the final beverage for distribution and sale to retailers.

The Appellant and Coca-Cola Export have a service agreement under which the Appellant is contracted to provide brand marketing services in Africa in respect to the brands owned by the Coca-Cola Company, Schweppes Holding Limited and Atlantic Industries.

The Appellant on the understanding that the marketing and brand promotion services provided are zero rated export services lodged an input VAT refund claim under Section 17(5) of the Value Added Tax Act, 2013 (the **VAT Act**). Following receipt of the application, the Kenya Revenue Authority (the **KRA**) conducted an audit of the Appellant's VAT returns and issued preliminary findings through a letter dated 25 January 2017. In the letter of preliminary findings, KRA sought to disallow KES. 725,082,158 from the Appellant's claim due to undeclared output VAT on locally consumed services and sales. The Appellant provided its response explaining its position but the KRA rejected the explanation by the Appellant and issued an assessment. The Appellant objected to the assessment vide a letter dated 04 October 2017.

KRA confirmed the assessment through an objection decision communicated in a letter dated 27 September 2017. The Appellant, aggrieved by the decision of the TAT, filed an appeal and the decision of the TAT is the subject of our analysis.

The Appellant's position

The Appellant submitted the following:

a. The services provided are 'exported services consumed and used outside Kenya' within the meaning of Section 2 of the VAT Act. The services in this case are consumed by Coca-Cola Export which is based in the USA;

b. The Organization for Economic Co-operation and Development (**OECD**) VAT/GST Guidelines (the **OECD Guidelines**) were formulated to give guidance in the interpretation of VAT law of different countries to prevent double taxation as well as preventing tax evasion;

c. The 'Destination Principle' under the OECD Guidelines is designed to ensure that the taxing rights on cross border transaction such as this one are granted to the jurisdiction of consumption of the exported services. For business-to-business supplies, the jurisdiction where the customer is located has the taxing rights over the services supplied across international borders;

d. The purpose of the marketing services was for the benefit of enhancing and encouraging the sales of the concentrates and Coca-Cola Export recharged the marketing costs to the concentrate manufacturers. The cost of imported concentrate includes the recharged marketing costs and this subjected to import VAT. Charging extra VAT in this case would lead to double taxation;

e. The services were exported to a country without a presence in Kenya and the services consumed outside Kenya. Additionally, and no Kenyan company had contracted for the services and as such therefore no direct consumption of the services in Kenya; and

f. The KRA cannot allege that the services are consumed by the final consumer of the beverage products in Kenya as the customer in the service agreement is Coca-Cola Export and its foreign affiliates.

KRA's position

KRA submitted the following:

a. The marketing and promotion services provided by the Appellant to Coca-Cola Export are not export services but actually local sales. The advertisements are done and prepared for the local market, with a local context to make consumers buy more beverages;

b. The services provided by the Appellant should fall under the ambit of Section 8 of the VAT Act which provides, inter alia, that '*a supply of services is made in Kenya if the place of business of the supplier from which the services are made is Kenya*;'

c. The issue of deductibility of input tax by Coca-Cola Export should not arise as the cost is passed on to the importers of the concentrate into Kenya;

d. VAT is a tax where the final or household consumption tax occurs and in this case, the Kenyan consumer, is the final user of the services. Coca-Cola Export cannot be the final consumer of services as the services are consumed in Kenya to influence Kenyans to buy regardless of who provides the services in the service agreement;

e. The Appellant cannot rely on the High Court decisions in ***High Court Income Tax Appeal No. 5 of 2018; Panalpina Airflo Ltd vs The Commissioner of Domestic Taxes and High Court Income Tax Appeal No. 17 of 2013***; The Commissioner of Domestic Taxes versus Total Touch Cargo Holland as the services in these cases related to the export of flowers for consumption by the final consumer in Holland as opposed to the marketing services in this case where the final consumer of the beverage is in Kenya;

f. The OECD Guidelines provide that the VAT should not fall on businesses but on the final consumer who is the Kenyan household consumer. Further that the OECD Guidelines do not consider the 'beneficiary' of the services as alleged by the Appellant; and

g. VAT is charged incrementally based on the increase in value of a supply and VAT on the services is therefore different from VAT on the concentrate hence there is no double taxation.

ANALYSIS OF THE **TAT**

In allowing the appeal, the TAT noted the following:

a. The VAT Act does not define the terms 'use' or 'consumption' as provided under Section 2. The OECD Guidelines are therefore applicable in Kenya to assist to shed more light on cross border transactions such as this;

b. The OECD Guidelines are built on two core principles which are: the "neutrality principle' and the 'destination principle.' Further to these principles. What is material is the place of consumption of the services and not the place of supply of the services;

c. The service agreement stipulates that the Appellant's services are engaged by Coca-Cola Export in relation to marketing and brand promotion and the terms of engagement are clearly outlined. The Kenyan consumer is therefore a 3rd party to the service agreement;

d. The services are consumed by Coca-Cola Export as it benefits from increased sales in Kenya and further to the OECD Guidelines the service agreement identifies Coca-Cola Export as the customer of the services;

e. Whereas the Kenyan consumer is the target audience of the services, the consumer is Coca-Cola Export and further to the Destination Principle, the USA has the taxing rights.

VAT on Exports of Services

Panalpina Airflo Limited v. Commissioner of Domestic Taxes; High Court Income Tax Appeal No. 5 of 2018

Introduction

On 31st May 2019, the High Court delivered a Judgement overruling a decision of Tax Appeals Tribunal (the **TAT**). In the judgement, the TAT upheld the decision of the Kenya Revenue Authority (**KRA**) to reject a Value Added Tax (VAT) refund claim on grounds that the supplied services had been consumed in Kenya and therefore did not qualify as exported services which are zero-rated in accordance with Section 2 of the VAT Act..

Background of the case

Panalpina Airflo Limited (the **Appellant**), is a Kenyan company that provides handling and security services to its parent company, Airflo BV which is a company based in the Netherlands. The Appellant also provides logistical services in respect to exportation of flowers from Kenya. As part of its logistical operations, Airflow BV entered into an agency contract with the Appellant for purposes of offering logistical services in respect to export of flowers from Kenya. The Appellant would therefore be the exporter of the said flowers from Kenya.

The Appellant sought an input VAT refund from the KRA on the understanding that the logistical services provided to its non-resident parent were exported services hence VAT zero rated.

However, the KRA claimed that the said services were not export services and were not zero rated supplies and hence no input VAT refunds would be allowed. The KRA's reasoning was that the services offered by the Appellant in Kenya are to ensure that that the flowers are in an 'exportable' state thus making the services consumed and utilised in Kenya. The Appellant objected to the KRA decision but the KRA issued an objection decision confirming its rejection of the Appellant's VAT refund claims.

Being dissatisfied with the objection decision, the Appellant appealed to the TAT which dismissed the appeal stating that pre-shipment services rendered are considered to have been consumed locally before the issuance of the Bills of lading to Airflow BV when the export commences, and were therefore subject to VAT at the standard rate of 16%.

The Appellant lodged an appeal to the High Court against the decision of the TAT and the decision of the High Court is the subject of our analysis.

The Appellant's position

The Appellant submitted as follows;

a. There was a misconception by the TAT in holding that exporters such as the Appellant should pay the VAT when the applicable law is that services consumed outside Kenya are zero rated; and

b. Section 2 of the VAT Act, 2013 provides that it is the place of consumption that determines whether VAT is payable or not.

The KRA's position

The KRA maintained its position as follows;

a. the services offered by the Appellant in Kenya are to ensure that the flowers are in an 'exportable' state and thus making the services consumed and utilized in Kenya;

b. consumption is not determined by reference to the payer or the location of the person who is requesting for the service;

c. it is not the services that were exported as the export was only in regard to the flowers.

ANALYSIS OF THE **HIGH COURT**

In allowing the appeal and setting aside the TAT decision, the High Court held as follows:

a. that the services in questions were provided to ensure that the flowers were fresh for sale to the customers located outside Kenya. Further, that the services were provided on behalf of a person outside Kenya. That the services can therefore only have been used by the final buyers of the flowers located outside Kenya who bout the fresh flowers;

b. the destination principle which provides that internationally traded services should be taxed according to the rules of jurisdiction of consumption is applicable in this case; and

c. having found that the ultimate consumer of the impugned services is outside Kenya, the services are zero rated export of services. The appellant was therefore entitled to claim input VAT refunds.

VAT On Exported Services and Applicability of WHT on Payments by a Non-Resident to a Kenyan Resident

LG Electronics Africa Logistics FZE Kenya Branch v Commissioner of Domestic Taxes, Tax Appeal No. 359 of 2018

Introduction

On 31 March 2020, the Tax Appeals Tribunal (the **TAT**) delivered a judgment on VAT on exported services as well as on the applicability of withholding tax (**WHT**) on the payments made by a non-resident person not having a permanent establishment in Kenya to a Kenyan resident.

Background of the case

LG Electronics Africa Logistics FZE (the **Appellant**) is the Kenyan branch of LG Electronics Africa Logistics FZE (**LG Dubai**) a company incorporated in Dubai.

KRA conducted a tax audit of the Appellant for the period of January 2010 to December 2016. Following the audit, KRA issued an assessment to the Appellant on corporate income tax (**CIT**), Value Added Tax (**VAT**) and WHT arrears as it had reached a different conclusion in respect to the taxes considered due. The Appellant objected to KRA's assessment and engaged in consultative meetings and discussions resulting in KRA amending its initial assessment on CIT, VAT and WHT, which it subsequently confirmed through an objection decision dated 2 October 2018.

The Appellant conceded the assessment in relation to CIT and settled its liability in full on 12 October 2018. However, the Appellant being aggrieved with KRA's objection decision in relation to the alleged VAT and WHT arrears filed an appeal at the TAT. The decision of the TAT in the appeal is the subject of our analysis.

The Appellant's position

The Appellant submitted as follows:

a. that the VAT assessment by KRA for the years 2010 to 2013 was time-barred and should be vacated in its entirety as it was issued after the time limitation of 5 years;

b. that the transactions between a branch and its non-resident head office do not constitute a supply of services for VAT purposes and should not be subject to VAT. That further to the provisions of the Companies Act, 2015, the Appellant as a branch, is not considered a separate entity but rather an extension of its foreign head office;

c. that the marketing services it provides are contracted for, paid for and provided for the use and benefit of the Appellant's head office in order to push sales in Kenya. That it does not carry out the business of local distribution of LG products in Kenya and it does not provide services to the 3rd party distributors in Kenya;

d. Even where it would be deemed to be providing services to is foreign head office, the services would be treated as exported services hence taxable at 0% for VAT purposes;

e. that there should be a determination of the actual consumer of the services and since Kenyan VAT legislation does not provide guidance on how to determine 'use' or 'consumption' then reference should be had to case law as well as the Organization for Economic Co-operation and Development (**OECD**) VAT/GST Guidelines (the **OECD Guidelines**);

f. that further to the OECD Guidelines, '...as long as there is no evasion or avoidance, the customer remains the customer identified in the business agreement.' The Kenyan distributors are 3rd parties to its arrangement with its head office and the customer therefore remains LG Dubai;

g. the 'Destination Principle' under the OECD Guidelines provides that as a general rule, the country with the taxing rights over internationally traded services should be the country of the customer's location. That having identified the consumer of the services in this case, the Destination Principle should be applied to allocate the taxing rights;

h. that where the Appellant is deemed to be offering services to the Kenyan distributors, the taxable value for these services should be zero;

i. on WHT, that the marketing agents provided services directly to LG Dubai and did not have any contracts with the Appellant. Further that payments were made by LG Dubai and the WHT obligation is not placed on the person to whom the invoices are addressed to.

KRA's position

KRA responded as follows:

a. the issue of the VAT assessment being time-barred does not arise as the objection decision was issued as an amended assessment in line with Section 31(4) of the Tax Procedures Act, 2015 (the **TPA**);

b. the Appellant is tasked with the marketing activities and advertising of LG products in Kenya. The marketing activities are for the Kenyan audience and are meant to influence consumers in the Kenyan market therefore these services are not exported services to the Appellant's head office in Dubai;

c. that reliance on the OECD Guidelines only applies where Kenyan law lacks clarity or there is ambiguity on an issue. In the current case, Kenyan law is clear on the position and the OECD Guidelines should therefore not apply;

d. the decision in ***Coca Cola Central East and West Africa v Commissioner of Domestic Taxes (Appeal No. 11 of 2012)*** is similar in facts and issues to the present appeal and just like in the said case, there were no services exported where services are supplied by a person with a fixed place of business in Kenya and are physically consumer in Kenya despite the payer being outside Kenya;

e. On WHT, that the Appellant worked with marketing and advertising agents in Kenya and the agents invoiced the Appellant for the services provided yet WHT was not accounted for when payments were made to the agents; and

f. the invoices received from the marketing agents were addressed to the Appellant who forwarded the same to its head office in Dubai. The fact that payment was done by the head office does not extinguish the requirements for WHT on the payments that were made.

ANALYSIS OF THE **TAT**

The TAT made the following observations and held that:

a. The VAT assessment dated 5 July 2018 for the period January 2010 to May 2013 was statutorily time-barred as it was a default assessment which has a time limit for issuance under the TPA being 5 years;

b. There is a shortfall under Section 2 of the VAT Act as it does not define the terms 'use' and 'consume' and the OECD Guidelines and case law should be applied to provide clarity;

c. The Appellant is contracted by its head office for the provision of marketing services which then increase sales. Further to the OECD Guidelines, the customer is determined by the service agreement and the jurisdiction of the customer has the taxing rights for the services. The consumer of the services was therefore the head office resulting and not the Kenyan distributors;

d. In relation to WHT, the TAT found that the language of the ITA does not subject payments made by non-resident persons not having a permanent establishment in Kenya to WHT; and

e. However, without prejudice to the above determination, the TAT noted that further to the CIT concession by the Appellant, income was accrued and expenses claimed by the Appellant and therefore WHT was due on the relevant marketing expenses claimed.

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ANJARWALLA & KHANNA

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