Commissioner of Domestic Taxes v Githima Limited (Income Tax Appeal E047 of 2022) [2023] KEHC 26190 (KLR) (Commercial and Tax) (23 November 2023) (Judgment)

Neutral citation: [2023] KEHC 26190 (KLR)

REPUBLIC OF KENYA

IN THE HIGH COURT AT NAIROBI (MILIMANI COMMERCIAL COURTS)

COMMERCIAL AND TAX

INCOME TAX APPEAL E047 OF 2022

JWW MONG'ARE, J

NOVEMBER 23, 2023

BETWEEN

COMMISSIONER OF DOMESTIC TAXES ..... APPELLANT

AND

GITHIMA LIMITED ..... RESPONDENT

JUDGMENT

1. This is an appeal from the Tax Appeals Tribunal judgment dated 25th March 2022 allowing the Respondent's appeal. Dissatisfied with the Tribunal's finding, the Appellant lodged the instant appeal against it vide a Memorandum of Appeal dated 4th May, 2022 on the following grounds of appeal –

    i. That the Honourable Tribunal erred in law and in fact in finding that the Appellant 's objection decision did not conform to the provisions of Section 51(10) of the *Tax Procedures Act*;

    ii. That the Honourable Tribunal erred in law and in fact in finding that the interest expense incurred by the Respondent fell squarely within the parameters of Section 15(3) of the *Income Tax Act* and was therefore deductible;

    iii. That the Honourable Tribunal erred in law and in fact in finding that the loan facilities were incurred wholly and exclusively for the production of the income in question for the period of assessment when the Respondent did not provide any proof of the same;

    iv. That the Honourable Tribunal erred in law and in fact in failing to find that the Appellant correctly applied the provisions of Section 24 of the *Income Tax Act* and the Appellant 's decision to deem dividend distribution of Kshs 27l,221,7l0.00/- and compute 5% withholding tax on the same was lawful;

v. That the Honourable Tribunal erred in law and in fact in its interpretation of Section 24 of the *Income Tax Act* which interpretation was erroneous;

vi. That the Honourable Tribunal erred in both law and fact in finding that the Appellant misapprehended the edicts of Section 42A of the *Income Tax Act* when the Appellant lawfully and correctly applied the said provision; and

vii. That the Honourable Tribunal erred in law and in fact in failing to consider the evidence adduced by the Appellant in arriving at its decision.

2. The Appellant 's prayer is for this Court to allow the appeal herein with costs and set aside the judgement of the Tax Appeals Tribunal delivered on 25th March, 2022 in favour of the Respondent, a limited liability company incorporated in Kenya engaged in property rental business and investment related activities.

3. The Appellant, being the principal agency charged with the responsibility of collection and administration of revenue taxes on behalf of the Government of Kenya, carried out a tax audit into the Respondent's tax affairs on Income Tax for the period 2017 to 2019 and Value Added Tax for the period 2015 and 2017. Thereafter, it issued an assessment vide a Notice of Assessment dated 7th January, 2021 on Income Tax for the period 2017 to 2019 at Kshs 3,730,568.15/- and Value Added Tax for the period 2015 and 2017 at Kshs 2,787,704.63/- cumulatively making the total demand under both tax heads Kshs 6,518,272.78/-. The Respondent objected to the said assessment vide a Notice of Objection dated 3rd February, 2021 and thereafter the Appellant issued its objection decision on 29th March, 2021 confirming its earlier assessment.

4. The Respondent's case on the other hand is that it supplied the Appellant with all the information it requested via emails sent on 26th November 2020 and on 19th January, 2021. The Respondent stated that it even had a meeting with the Appellant on 15th December, 2020 and 18th January, 2021 to discuss the contested issues in its Objection. As a result of the foregoing, the Appellant confirmed vide an email sent on 21st January, 2021 that it would make the applicable tax adjustments in line with the findings set out in the summary of its position. However, this was not done instead the Appellant issued the Respondent with its Objection Decision on 22nd February, 2021 demanding payment of Kshs 53,635,115/-.

5. Aggrieved by the Appellant 's objection decision, the Respondent lodged an appeal at the Tax Appeal Tribunal vide a Memorandum of Appeal and filed a Statement of Facts both dated 7th April 2021. Thereafter, on 25th March, 2022 the Tax Appeals Tribunal delivered its judgment allowing the Respondent's appeal

6. The appeal herein was canvassed by way of written submissions that were orally highlighted on 19th September, 2023.

Analysis And Determination

7. It is trite law that an Appeal to the High Court from the decision of the Tax Appeals Tribunal shall be on a question of law only, the Court is not permitted to substitute the Tribunal's decision with its own based on its own analysis and appreciation of facts unless the Tribunal's decision cannot be supported by any evidence. The Court of Appeal in the case of John Munuve Mati v Returning Officer Mwingi

North Constituency & 2 others [2018] eKLR summarized Section 56(2) of the *Tax Procedures Act* as to what amounts to "matters of law" as hereunder -

> "The interpretation or construction of the Constitution, statute or regulations made thereunder or their application to the sets of facts established by the trial Court. As far as facts are concerned, our engagement with them is limited to background and context and to satisfy ourselves, when the issue is raised, whether the conclusions of the trial judge are based on the evidence on record or whether they are so perverse that no reasonable tribunal would have arrived at them. We cannot be drawn into considerations of the credibility of witnesses or which witnesses are more believable than others; by law that is the province of the trial court."

8. Upon consideration of the Memorandum of Appeal, Record of Appeal and Statement of Facts filed by the Respondent together with the written submissions filed by Counsel for parties, I am of the considered view that the issues that arise that arise for determination are –

   i. Whether the Appellant's objection decision conforms to the provisions of Section 51(10) of the *Tax Procedures Act*;

   ii. Whether the interest expenses incurred by the Respondent were within the parameters of Section 15(3) of the *Income Tax Act*;

   iii. Whether the Appellant properly applied the provisions of Section 24 of the Income Tax; and

   iv. Whether the Appellant misinterpreted the provisions of Section 42A of the *Tax Procedures Act*.

Whether the Appellant 's objection decision conforms to the provisions of Section 51(10) of the *Tax Procedures Act*.

9. Section 51(10) of the *Tax Procedures Act* provides as hereunder –

> "An objection decision shall include a statement of findings on the material facts and the reasons for the decision."

10. Upon perusal of the Record of Appeal, it is noteworthy that the Appellant issued the Respondent with two objection decisions one dated 22nd February, 2021 as correctly pointed out by the Tribunal in its judgment and the other one dated 29th March, 2021. A reading of the said Objection decisions reveals that the one dated 22nd February, 2021 contains statements of findings and reasons for the decision, whereas the one dated 29th March, 2021 only contains reasons for the decision. It is now settled law that the effect of Section 51(10) of the *Tax Procedures Act* is to put the tax payer on notice and enable him assess his position before exercising his right of appeal. The court notes that upon receipt of the aforementioned objection decisions, the Respondent was able to assess its position and decided to lodge an appeal against them at the Tax Appeals Tribunal.

11. Accordingly, this Court finds that the Tribunal erred in finding that the Appellant's objection decision was not issued in accordance with the provisions of Section 51(10) of the *Tax Procedures Act*, and holds that the Appellant 's objection decisions conform to the provisions of Section 51(10) of the *Tax Procedures Act*.

Whether the interest expenses incurred by the Respondent were within the parameters of Section 15(3) of the *Income Tax Act*.

12. Section 15 (3) of the *Income Tax Act* provides that –

> " Without prejudice to subsection (1), in ascertaining the total income of a person for a year of income the following amounts shall be deducted -
>
> a. the amount of interest paid in respect of that year of income by the person upon money borrowed by him and where the Commissioner is satisfied that the money so borrowed has been wholly and exclusively employed by him in the production of investment income which is chargeable to tax under this Act..."

13. Notably, Section 15(1) of the *Income Tax Act* allows a taxpayer to deduct expenses wholly and exclusively incurred in the production of that income in computing their taxable income. Section 15(3) reproduced herein above on the other hand allows for deduction of interest paid upon money borrowed by the taxpayer on ground that the money so borrowed has been wholly and exclusively employed by the taxpayer in the production of investment income. In disallowing the Respondent's claim for interest expense, the Appellant found that the said expense was not related to the business of generating rental income.

14. The Respondent submitted that it was entitled to deduct interest expenses of Kshs 76,876,450/- for the years 2016 to 2019 since they arise from a bank loan of Kshs 350,000,000 which was used to refinance acquisition of the Respondent's properties being LR No. 9247/5 and LR No 19964/5 in Naivasha purchased for Kshs 121,380,220/=, and MSA/Block XIX/266 and 267 in Mombasa purchased for Kshs 256,656,665/=. The said properties were initially purchased at Kshs 378,036,885/= by a loan obtained from the Respondent's Directors. The Appellant, on the other hand, submitted that in the accounting methods there is the doctrine of substance over form which holds that the substance rather than the technical form of a transaction governs its tax consequences.

15. The Respondent contended that the interest expense of Kshs 76,876,450/= for the year 2016 to 2019 relates to a bank loan of Kshs 350,000,000/= taken by the Respondent from Equity Bank in December, 2015 to refinance acquisition of the Respondent's properties which were initially financed using a loan of Kshs 378,036,885/= from the Respondent's Directors. In support of this averment, the Respondent provided a copy of the Respondent's Director's written resolution passed on 1st December, 2015 approving the terms of the loan from Equity Bank and confirming that the said loan should be used to refinance the acquisition cost of the Naivasha and Mombasa properties. The Respondent also produces a copy of the short-term loan agreement for Kshs 350.000.000/= and refinancing loan agreement between it and Equity Bank.

16. The Tribunal in its judgment based on the evidence tendered by the Respondent and, which evidence was not controverted and/or rebutted by the Appellant, found that the interest expenses for the year 2016 to 2019 relates to the Respondent's acquisition of property in the year 2012. The said properties were initially purchased through Director's loan but in 2015 the Respondent resolved to refinance them through an external loan from Equity Bank Limited. The Tribunal further held that the Respondent provided the Appellant with loan account statements in respect of the facility as well as the facility documents, therefore it discharged its burden of proof as provided for under Section 56(1) of the *Tax Procedures Act*.

17. Having found that the loan which gave rise to the interest expense of Kshs 76,876,450/= was used to refinance the Respondent's Director's loan to acquire the Nairobi and Mombasa properties more specifically the Mombasa properties which are used in generating rental income as can be seen from the Respondent's financial statements, I find that the said loan was incurred wholly and exclusively for the production of the income in question for the period of assessment being the year 2016 to 2019. Further, I agree with the Tribunal that refinancing a loan allows a borrower to replace their current debt obligation with one that has favourable terms by taking out a new loan to pay off their existing debt. Consequently, this Court finds that interest expense of Kshs 76,876,450/= for the year 2016 to 2019 disallowed by the Appellant in its objection decision falls within the parameters of deductions allowed under Section 15(3) of the *Income Tax Act* thus the same was wrongfully disallowed by the Appellant.

Whether the Appellant properly applied the provisions of Section 24 of the Income Tax.

18. The Appellant contended that its directors, in preparing the Directors report for the years ended 31st December, 2016 to 31st December, 2019 did not recommend distribution of dividend since distribution of the same would prejudice the Respondent's business operations. The Respondent submitted that this decision was informed by the fact that the Respondent had an outstanding loan of Kshs 2,010,177,663 comprising of Kshs 800,000,000/= due to Equity bank and Kshs 1,210,177,663/= due to the Respondent's Directors. The Respondent further submitted that one of the terms of the loan advanced to it by Equity bank was that the Respondent was required to ensure that there are adequate funds in its account at all times to meet the loan repayments as and when they fall due, any default would lead to commencement of recovery process. In order to aptly determine this issue, I will produce the provisions of Section 24(1) of the *Income Tax Act* hereunder -

> "Where the Commissioner is of the opinion that a private company has not distributed to its shareholders as dividends within a reasonable period, not exceeding twelve months, after the end of its accounting period such part of its income for that period which could be so distributed without prejudice to the requirements of the company's business, he may direct that that part of the income of the company shall be treated for the purposes of this Act as having been distributed as a dividend to the shareholders in accordance with their respective interests and shall be deemed to have been paid on a date twelve months after the end of that accounting period."

19. The above provisions empower the Appellant to deem a dividend distribution on the part of a taxpayer's income for that period which could be so distributed without prejudice to the requirements of the company's business. The Court in the case of *Ocean Freight (E.A) Limited v Commissioner of Domestic Taxes* (*Supra*) in a bid to explain the effect of Section 24 of the *Income Tax Act* held as follows -

> "The overarching objective of Section 24 of *ITA* is to check that non-distribution of dividends that would in ordinary circumstances be distributable is not employed as a devise for avoidance of Tax liability. Unlike the English position, the provisions of the subsection 4 is a mechanism for a company, before making a decision on distribution of dividend, to inquire with the Commissioner whether he deems the distribution as a scheme of tax avoidance. The Commissioner, after calling for any information from the company which he may reasonably require, advises the company on whether or not he proposes to take action under Section 24."

20. In view of the fact that the Respondent did not first inquire from the Appellant whether he deems the decision not to distribute dividends as a scheme for tax avoidance, this Court finds that the Respondent

bears the burden of proving that deeming of dividends by the Appellant will be prejudicial to its business. In an attempt to discharge the aforesaid burden of proof, the Respondent submitted to the Appellant copies of the loan agreements between it its directors and between it and Equity Bank to demonstrate that it has an outstanding loan balance of Kshs 2,010,177,663 comprising of Kshs 800,000,000/= due to Equity bank and Kshs 1,210,177,663/= due to the Respondent's Directors thus deeming of dividends will be prejudicial to its business as it will result to its inability to repay the said loans as and when they become due thus exposing it to recovery processes initiated by Equity bank as a result of the said default.

21. Accordingly, I am persuaded that the Respondent discharged its burden of proof as provided by the Court in the Ocean Freight case and the provisions of Section 56(1) of the *Tax Procedures Act*. Further, other than the fact that submitting that an outstanding loan is not a bar to distributing dividends, the Appellant has not offered any reason and/or explanation as to why it failed to acknowledge the Respondent's explanation. For this reason, this Court finds that Appellant failed to properly apply the provisions of Section 24 of the Income Tax in deeming dividend distribution of Kshs 271,221,710/= and computing 5% withholding Tax on the same.

Whether the Appellant misinterpreted the provisions of Section 42A of the *Tax Procedures Act*.

22. It is not disputed that the Respondent leased its property to Equity Bank. It was an agreed term of the lease agreement between the Respondent and Equity Bank that rent was payable on a quarterly basis. It is also not disputed that Equity Bank as an appointed withholding tax agent withhold VAT on the VAT charged on the quarterly lease payments. Sometime in February, 2020, Equity Bank remitted to KRA withholding VAT of Kshs 1,556,598 in respect of the Respondent but the Appellant asserted that the said sum is the current VAT thus the Respondent has undeclared sales of Kshs 76,829,880/= which attracts a VAT charge of Kshs 12,292,781/=.

23. The Respondent submitted that it issued Equity Bank with a reconciliation of the quarterly rent invoices for the period between January, 2017 to December, 2019 and the withholding VAT remitted to KRA by Equity Bank and on 18th January, 2021, Equity Bank confirmed that the said summary was true reflection of all the invoices issued by the Respondent for the period between January, 2017 to December, 2019. In support of this averment, the Respondent produced a copy of Equity's confirmation dated 18th January, 2021. The Appellant submitted that the Respondent bears the burden of accounting for the corresponding income subject to the withholding tax credit claimed.

24. Section 42A of the *Income Tax Act* states that –

    1. The Commissioner may appoint a person to withhold two per cent of the taxable value on purchasing taxable supplies at the time of paying for the supplies and remit the same directly to the Commissioner:

       ...

    2. ...

    3. ...

    4. For the avoidance of doubt, the withholding of tax under subsection (1) shall not relieve the supplier of taxable supplies of the obligation to account for tax in accordance with this Act and the regulations.

    4A. Deleted by Act No. 8 of 2021, s. 39.

4B. The tax withheld under this section shall be remitted to the Commissioner within five working days after the deduction was made.

4C. A person who is required under this section to withhold tax commits an offence if the person—

a. fails to withhold the whole amount of the tax which should have been withheld; or

b. fails to remit the amount of the withheld tax to the Commissioner by the fifth working day after the deduction was made.

4D ...

5. ...

25. In light of the foregoing, it is evident that the supplier of taxable supplies in this case the Respondent is not exempted from accounting for the said tax by virtue of the withholding tax agent withholding the tax. In this case, the Respondent has not only demonstrated to this Court but also to the Appellant the rental invoices issued to Equity bank between January, 2017 and October, 2019 vis a vis the Withholding VAT retained by Equity bank and subsequently remitted to KRA in the reconciliation summary issued to Equity Bank and confirmed by the bank vide its letter dated 18th January, 2021. Further the Respondent has also demonstrated by providing copies of its monthly VAT returns for the period between January, 2017 and October, 2019 that it always accounted for the Output VAT charged on the rental invoices issued to Equity bank in compliance with the provisions of Section 42A (4) of the *Tax Procedures Act* thus discharging its burden of proof pursuant to the provisions of Section 56(1) of the *Tax Procedures Act*.

26. In light of the foregoing, this Court finds that pursuant to the provisions of Section 42A (1) and 4B of the *Tax Procedures Act*, Equity Bank being the withholding agent of the VAT charged on the aforementioned rental invoices is the body that can account for the delay and/or failure to remit the said taxes within the time frames set by the law. As a result, I find that the Appellant erred in assessing additional VAT for the Respondent.

27. In the end, this Court finds that the appeal herein is devoid of merit, consequently, the same is dismissed with costs to the Respondent.

It is so ordered.

DATED, SIGNED AND DELIVERED VIRTUALLY AT NAIROBI THIS 23RD DAY OF NOVEMBER 2023

.....

J. W. W. MONG'ARE

JUDGE

In the Presence of:-

1. Ms. Sega holding brief for Ms. Chelagat for the Appellant.

2. Ms. Amayo & Mr. Kiragu for the Respondent.

3. Amos - Court Assistant