Africa Oil Kenya BV v Commissioner of Domestic Taxes (Tax Appeal E024 & E051 of 2020 (Consolidated)) [2022] KEHC 15967 (KLR) (Commercial and Tax) (30 November 2022) (Judgment)

Neutral citation: [2022] KEHC 15967 (KLR)

REPUBLIC OF KENYA

IN THE HIGH COURT AT NAIROBI (MILIMANI COMMERCIAL COURTS)

COMMERCIAL AND TAX

TAX APPEAL E024 & E051 OF 2020 (CONSOLIDATED)

DAS MAJANJA, J

NOVEMBER 30, 2022

BETWEEN

AFRICA OIL KENYA BV .... APPELLANT

AND

COMMISSIONER OF DOMESTIC TAXES .... RESPONDENT

(Being an appeals against the Judgment of the Tax Appeals Tribunal at Nairobi dated 25th March 2020 in Tax Appeal No. 347 of 2018)

JUDGMENT

Introduction And Background

1. The appellant is a non-resident company incorporated in the Netherlands with an operating branch in Kenya. It is in the oil and gas business with interests in various oil and gas exploration blocks in Turkana, Kenya particularly known as; block 9, block 10 ba, block 10bb, block 12a and block 13T. The respondent ("the commissioner"), in the exercise of its statutory mandate carried out a tax audit of the appellant's tax affairs in the year 2017 for the years of income 2012 to 2017 in respect of corporation tax, value added tax ("VAT"), pay as you earn ("PAYE") and withholding tax ("WHT"). The audit also included a review of the appellant's farm-out transactions where the appellant assigned its exploration rights for blocks 12a, 13t and block 9 to third parties; tullow oil, marathon oil and maersk oil in 2011,2012 and 2017.

2. In a letter dated June 29, 2018, the commissioner communicated its audit findings to the appellant. It issued formal assessments for corporation tax and VAT whereupon the appellant filed a notice of objection dated July 27, 2018. The commissioner answered the objection by the letter dated September 24, 2018 ("the objection decision").

3. The commissioner held that the appellant entered into farm-out agreements for the various oil blocks where it assigned its rights to other companies and received income from them. According to the commissioner, there were two income streams recognized under section 3(2)(a) of the *Income Tax Act* (chapter 487 of the Laws of Kenya) (''ITA'') as chargeable to tax; the business income from the main business of the entity, that is, 'exploration and production of oil and gas' and the other from 'assignment of rights for use of property' and both described as separate specified sources of income under section 15(7)(e)(ivB) of the ITA which should be accounted for and charged separately as specified. Therefore, in consideration of the amount received by the appellant for farming-out its rights to the third party in block 9, the commissioner assessed the corporation tax payable on therein at Kshs 1,324,213,125.00. It further assessed the sum of Kshs 433,142,567.45 as corporation tax payable based on section 15(7)(ivB) of the ITA on ring-fencing which specifies that the income of one licence area as determined in the ninth schedule is considered a specified source and the gain or loss should be computed separately.

4. The commissioner further noted that under the production share contract (''PSC'') and the joint operation agreement ("JOA"), the appellant was allowed to claim 3% of total allowable deductions and claim the cost as part of the accumulated costs. However, the commissioner held that these agreements provide for accounting and not tax treatment of costs where the costs are allowable in coming up with the accounting profit but not the taxable profit. That the agreement costs for tax purposes would be characterized as general provisions which are not allowable for tax purposes and that merely by disallowing the agreement costs in the submissions to ministry of petroleum and mining, the costs had not been disallowed in the books of accounts of the appellant. The commissioner thus held that the charged amounts were obtained from the ledgers of the appellant and had been claimed for tax purposes, therefore the commissioner confirmed its position of the notice of assessment and disallowed the costs in the sum of Kshs 489,784,237.00.

5. The commissioner further held that the appellant provided shared services such as common office rent, administration expenses/ office running, utilities and salaries paid to other entities it worked with and the appellant was to recharge the service costs to the relevant entities since the costs should be ring-fenced to the requisite block. However, due to the complexity of apportionment of the expense as no record of staff allocation of time and/or resources was maintained and the transaction was not part of the related party transactions benchmarked in the entity's transfer pricing policy, the commissioner decided to split the expenses equally between the entities with the appellant being apportioned an amount of Kshs 67,085,060.00 and the commissioner disallowing an amount of Kshs 1,220,509,354.00.

6. On VAT, the commissioner held that the appellant made taxable supplies in the years 2011, 2012 and 2015 relating to farm-outs that exceeded Kshs 5,000,000.00 and thus, should have registered for VAT and charged VAT on the sales made in accordance with section 34 of the *VAT Act, 2013*. The commissioner therefore confirmed and charged VAT on the farm-outs by the appellant resulting in a tax liability of Kshs 2,778,163,730.42.

7. In response to the appellant's ground of objection that the assessment and demand was time barred under section 29(5) of the *Tax Procedures Act* ("the TPA"), the Commissioner held that the said provision deals with making a default assessment where the taxpayer has failed to submit a tax return and does not apply in this case for income tax purposes. That for VAT purposes, section 31(4) of the TPA indicates that the commissioner may amend an assessment in the case of gross neglect, at any time or in any other case, the date the commissioner notified the taxpayer of the assessment and that since the appellant never filed a VAT return, the date of the notice of assessment applies.

8. The commissioner thus demanded payment of the total taxes assessed above. the appellant appealed to the Tax Appeals Tribunal ("the tribunal") against the objection decision. The tribunal framed the following issues for determination:Whether the income from farm-out transactions is a specified source of income.Whether intangible drilling costs can be claimed against the consideration from the farm out.Whether the tax losses brought forward ought to be ring fenced in block 13T, whether the JOA and PSCs uplifts are allowable for tax purposes.Whether VAT is chargeable on farm-out transactions.Whether the tax assessments for the years 2011 & 2012 contravene the TPA.Whether the appellant can introduce documents with submissions.

9. The tribunal observed that farm-outs could not be treated as a grant of right as such a grant could only be given by the licensing authority, in this case the government. As such, such transfer could only be treated as an assignment of rights that were granted to it. Consequently, the gain or profit from a transfer of rights to a third party are to be dealt with under section 4(f) of the ITA which specifically provides for income of a petroleum company, including income from the transfer of an interest. The tribunal was of the view that revenue from farm-outs should be treated as part of the normal business income chargeable to tax under section 3(2)(a)(i) of the ITA. It held that section 15(7)(e)(ivB), which provides that profits or gains from a PSC contract area are to be treated as a separate source of income, was introduced in 2014 and therefore not applicable to the farm-outs which took place in 2012.

10. The tribunal agreed with the commissioner on the issue of intangible drilling costs which the commission disallowed on the ground that drilling costs had been expressly omitted out of paragraph 7(i) of the repealed ninth schedule as not forming part of qualifying expenditure. it stated that only qualifying expenditure was to be deducted from the consideration.

11. As to whether the tax losses brought forward prior to 2015 ought to be ring fenced in block 13t, the tribunal held that the farm-out in question came into effect on December 1, 2015 while the ring fencing provisions introduced by the *Finance Act, 2014* came into effect on January 1, 2015. Paragraph 9(2) of the repealed ninth schedule indicated that if a contractor disposes of an interest in a petroleum agreement, the cost of which was deducted the exploration expenditure, the consideration for the disposal is considered income of the contractor and chargeable under section 3(2)(a)(i) of the ITA in the year of disposal. That section 15(7)(ivB) on ring-fencing specifies that the income of one license area as determined in the ninth schedule is considered a specified source and the gain or loss should be computed separately. It was the tribunal's view that the impact of ring fencing was that expenditure incurred by a contractor in undertaking petroleum operations in a contract area during a year of income can be allowed only against income derived by the contractor from petroleum operations in the contract area during the year and that petroleum operations means authorized operations undertaken under a petroleum agreement which means that losses from one oil block cannot be used to reduce the taxable income in respect of another profitable oil block. In any event, the tribunal held that since the provision became effective from January 1, 2015 going forward, tax losses carried forward prior to December 31, 2014 were not subject to ring fencing, the import of this being that losses carried forward prior to December 2014 by the appellant were not subject to ring fencing but were to be utilized until exhausted.

12. On the common shared costs disallowed by the commissioner, the tribunal held that the appellant had actually explained that the costs had been shared according to the size of operations among the related parties and to this end, the appellant had discharged its obligation to explain the expenditures by providing its formula for allocating its costs and it was not for the commissioner to suggest the formula.

13. On whether VAT is chargeable on farm-out transactions, the tribunal held that there was no dispute among the parties that farm-outs is a supply of a capital asset and that supply of capital asset is a taxable

supply. The tribunal therefore observed that under section 5(1) of the *VAT Act*, farm-outs are taxable supplies when made by a registered person in Kenya and what was in dispute was whether or not the appellant should have been a registered person. The tribunal was of the view that the nature of business of the appellant involved supply of capital assets in the form of assignment of interests in oil exploration licenses it held in various blocks. It would get a license, add value and sell part of the licensing rights for a gain. The tribunal therefore concluded that the interests it held in various blocks were similar to stock in a stable and could not be treated as capital assets of the nature contemplated in section 34(2)(a) of the *VAT Act*. On the basis that the appellant had submitted that proceeds from farm-outs were by virtue of section 3(2)(a)(i) of ITA taxable as normal business income, the tribunal made a finding that the taxable supply was made in the ordinary course of business and was not solely as a consequence of the appellant selling whole or part of its interest in a business. The tribunal therefore concluded that the appellant should have registered for, computed, collected and remitted VAT on its farm-out transactions.

14. On the final issue concerning contravention of section 29(5) of the TPA, the tribunal held that the onus is on the commissioner to demonstrate to the tribunal with sufficient evidence the grounds for raising tax assessments beyond the 5-year statutory period and not make assertions without producing evidence. The tribunal found that the commissioner had not proved wilful neglect on the appellant's part and held that the commissioner should have complied with the provisions of section 29(5) and refrained from making an assessment beyond five years of the due date.

15. As such, the tribunal made the following final orders:

    i. Demand for Kes 1,324,213,123/= being income in respect of the appellant's assignment of its 50% interest in block 9 to Marathon International Oil Company, in 2012 be vacated.

    ii. Demand for Kes 617,721,941/= being income tax in respect of the appellant's assignment of its 30% interest in block 12a to Marathon International Oil Company (15%) and Tullow Kenya BV (15%) in 2012 be vacated.

    iii. Demand for Kes 433,142,567/= being income tax in respect of the appellant's assignment of its 25% interest in block 13t to Total E&P International K3 Limited, in 2016; be vacated.

    iv. Demand for Kes 2,293,334,065.44 being VAT on farm-out transactions for 2011, 2012 and 2016 be reviewed to exclude assessment in respect of 2011 and 2012.

    v. Kes 489,784,237/= being overhead uplift under a product sharing contract and joint operating agreement; be allowed.

    vi. Kes 67,085,060/= common costs in respect of operated and non-operated licenses be allowed.

16. Both parties have filed their respective appeals against parts of the judgment. The appeals have been canvassed by way of written submissions supplemented by brief oral submissions which i have referred to in the determination.

Analysis and Determination

17. In resolving this appeal, the court is guided by section 56(2) of the TPA which provides that "an appeal to the High Court or to the Court of Appeal shall be on a question of law only". An appeal limited to matters of law does not permit the appellate court to substitute the tribunal's decision with its own conclusions based on its own analysis and appreciation of the facts (see *John Munuve Mati v Returning Officer Mwingi North Constituency and 2 others* [2018] eKLR). In *Mercy Kirito Mutegi v Beatrice Nkatha Nyaga and 2 others* NYR CA Civil Appeal No 48 of 2013 [2013] eKLR, the Court of Appeal

stated that when a court that is limited to dealing with matters of law has a concern regarding the issues that dealt on facts, then the court will also be limited to re-evaluation of the lower court's conclusions and if the conclusions are erroneous in the sense that they are not supported by evidence and the law, the matter becomes a point of law.

18. Having considered the material on record against the mandate of the first appellate court dealing with matters of law only, the two appeals raise the following issues for determination:

    a. Whether the income from farm-out transactions is normal business income and not a separate source of income.

    b. Whether intangible drilling costs are deductible and can be claimed against income from farm-out transactions when ascertaining taxable income.

    c. Whether VAT is payable on farm-out transactions and whether the VAT in question related to the year 2016

    d. Whether the JOA and PSCs uplift costs together with the common shared costs ought to have been disallowed.

    e. Whether losses prior to 2015 ought to be ring-fenced.

    f. Whether the commissioner acted in contravention of section 29 of the TPA.

Income From Farm-out Transactions

19. The commissioner took the position that income from the appellant's farm-outs were a separate and specified source of income that ought to have been treated differently from its normal business income. However, the tribunal was of the view that revenue from farm-outs should to be treated as part of the normal business income chargeable to tax under section 3(2)(a)(i) of the ITA and that the requirement that this income ought to be treated as a separate source of income was introduced by section 15(7) (e) (ivB) in 2014 but was not applicable to the farm-outs in question since they took place in 2012.

20. Before the tribunal, both parties gave various but almost similar definitions of "farm-outs" and "farm-out transactions". These are terms commonly used in the oil and gas industry. The *Black's Law Dictionary* (11th Ed) defines a "farmout" to mean "turning over something (such as an oil and gas lease) for performance by another". It also defines a "farmout agreement" as 'an agreement by which someone who owns an oil and gas lease (the 'farmoutor' or 'farmor') agrees to assign another (the 'farmoutee' or 'farmee') an interest in the lease in return for drilling and testing operations on the lease. For the farmor, 'the agreement either (1) maintains the lease by securing production or complying with the implied covenant to develop or offset or (2) obtains an interest in production without costs. For the farmee, 'the agreement obtains acreage that is not otherwise available or at lower cost that would otherwise be possible.'

21. Paragraph 13 part iv of the ninth schedule of the ITA deals with farm-outs as follows:

    > 13. Farm-outs
    >
    > (1) This paragraph shall apply where —
    >
    > (a) a licensee or contractor has entered into an agreement (referred to as a "farm-out agreement") with a person (referred to as the "transferee") for the transfer of an interest in a mining right or petroleum agreement; and

(b) the consideration given by the transferee for the interest wholly or partly includes the transferee undertaking some or all of the work commitments of the licensee or contractor under the right or agreement.

(2) It this paragraph applies, and the transfer of the interest occurs at the time the farm-out agreement is entered into, the consideration received by the licensee or contractor for the interest shall not include the value of any work undertaken by the transferee on behalf of the licensee or contractor.

(3) If this paragraph applies and the transfer of the interest is deferred until the transferee completes some or all of the work commitments of the licensee or contractor under the mining right or petroleum agreement —

(a) any amount in money payable under the farm-out agreement before the transfer of the interest shall be included in the income of the contractor charged to tax under section 3(2)(a)(i) in the year of income in which the amount is payable; and

(b) the value of any work undertaken by the transferee on behalf of the licensee or contractor shall be excluded in —

(i) the consideration received by the licensee or contractor for the transfer of the interest; or

(ii) the income of the contractor charged to tax under this act.

(4) If an interest referred to in subparagraph (3) is subsequently transferred, the consideration received by the licensee or contractor shall not include any amount included in the income of the licensee or contractor charged to tax under subparagraph (3)(a).

22. It is common ground that the appellant farmed-out its interests in some oil blocks to third parties in 2011, 2012 and 2015 and obtained income for these assignments. The contention is thus whether these gains ought to have been treated as the appellant's normal business income or a separate source of income.

23. This contention is not idle as section 3(1) and (2) of the ITA provides for charging of tax in respect of profits and gains. More specifically and relevant to this appeal is section 3(2)(a)(i) and (iii) which imposes taxes on gains and profits on business and on any right granted to any other person for use or occupation of property respectively.

24. Section 3(2)(g) of the ITA brings to charge gains on disposal of interest in a person owning immovable property such as those in the petroleum industry by providing that "subject to section 15(5a), the net gain derived on the disposal of an interest in a person, if the interest derives twenty per cent or more of its value, directly or indirectly, from immovable property in Kenya". It is also common ground that under section 15(7)(a) of the ITA gains or profits of a person derived from any one of the seven sources of income enumerated therein, referred to as "specified sources" under section 15(7)(e) shall be computed separately from the gains or profits of that person derived from any other of the specified sources and separately from any other income of that person.

25. One of the listed specified sources of income is rights granted to other persons for the use or occupation of immovable property. The commissioner was of the view that income from the farm-outs ought to

have been treated as such under section 3(2)(a)(iii) and not gains from business under section 3(2)(a)(i). It further stated that section 15(7) (a) of the ITA provides that the gains or profits of a person derived from one of the six sources of income specified shall be computed separately from the gains or profits defined under the specified sources and also separately from any other income of that person and that section 15(7)(b) specifies that the losses may only be deducted from gains of the person from the specified sources. Further that as per section 15(7)(c) the specified sources are construed to be mutually exclusive.

26. In rejecting the commissioner's argument, the tribunal held that the farm-outs were not grants of rights but assignments of rights as provided for by section 4(f) of the ITA as read with paragraph 7(1) of the repealed ninth schedule which provided that "an assignment of a right under a petroleum agreement shall not give rise to a chargeable gain under the eighth schedule but, subject to this paragraph, the consideration for the assignment shall be treated as a receipt of the petroleum company, and tax shall be charged accordingly."

27. From the definitions of how farm-outs operate and the provisions cited above, I agree with the tribunal that the farm-outs were not a grant of rights to property but an assignment of licensing rights and interests held by the appellant from the government. The grant of a right in immovable property is done by the government of Kenya to the oil exploration companies such as the appellant through the PSCs and this right, once granted, can only be assigned by the appellant as grantee through farm-out agreements.

28. I therefore find and hold that in as much as the consideration obtained by the appellant for the farm-out is subject to tax, the same ought to be taxed as a business income under section 3(2)(a)(i) and not section 3(2)(a)(iii) of the ITA. Income from farm-outs was only listed as a specified source of income under section 15(7)(e) (ivB) from January 1, 2015 by the *Finance Act* No 16 of 2014. It then follows that only the farm-out transactions effected by the appellant in 2015 were to be treated as a specified source of income and computed separately from the appellant's other sources of income and not the farm-outs effected in 2011 and 2012. Additionally, under section 15(7)(ivB) of the ITA, the income of a contractor such as the appellant from one contract area is a specified and separate source of income which means that expenditure incurred by a contractor in one contract area can only be off-set against income derived from the same contract area, in what is termed as "ring fencing".

29. The commissioner's assessment of Kshs 1,324,213,123.00 was in respect of the appellant's assignment of its rights to Marathon Oil in 2012. It could not therefore stand as the commissioner assessed this income separately from the appellant's business income and yet the 'ring fencing' provision only took effect in 2015. The tribunal was therefore right to vacate this assessment.

Whether Intangible Drilling Costs Are Allowable Expenses

30. The appellant's position is that intangible drilling costs such as site survey costs, seismic acquisition, geological studies and personnel and office costs are deductible from the consideration received from the farm-outs. That the purpose of the JOA and PSCs uplift is to compensate an operator for costs on indirect services and related general and administrative overheads that the operator is not able to bill directly to its partners as it is not possible to associate such costs with a specific project partner. The tribunal agreed with the commissioner and held that paragraph 7 of the repealed ninth schedule of the ITA specifically provided that intangible drilling costs do not form part of qualifying expenditure which can be deducted from farm-out income.

31. When determining the taxable income of a business, certain expenses are said to be allowed or deductible against taxable income. Section 15(1) of the ITA generally allows deduction of expenses

that are wholly and exclusively incurred in the production of income. This is buttressed by paragraph 8(1) of the ninth schedule of the ITA which provides that, "A deduction for expenditure to the extent incurred by a contractor in undertaking petroleum operations in a contract area during a year of income shall be allowed only against the income derived by the contractor from the petroleum operations in the contract area during the year".

32. When determining expenses which are wholly and exclusively incurred in production of income, the nature of business has to be considered because allowable expenses will differ from one type of business to another. Paragraph 7(i) of the repealed ninth schedule specifically excluded intangible drilling costs as a deductible expense. This position is consistent with the commissioner's and tribunal's findings and I do not find any reason to depart from specific and clear provisions of the law.

Whether The Farm-out Transactions Were Subject To Vat

33. The appellant submitted that its farm-out transactions were a 'sale of its business' and not a taxable supply subject to VAT under section 2 of the *VAT Act, 2013*. The appellant relied on section 34(2) of the *VAT Act, 2013* which excludes registration for VAT of a taxable supply of a capital asset of the person and a taxable supply made solely as a consequence of the person selling the whole or a part of the person's business or permanently ceasing to carry on the person's business. The commissioner took an opposite view and opined that the appellant is in the business of petroleum operations and all this comes with the rights awarded by the PSC and which rights, did not constitute a capital asset since that is part of the company's principal business. That the fact that the PSC provides for sale of interest to any other party does not constitute sale of a business since the appellant continues with its business and if the farmee wishes to relinquish its interests in the block, it reverts to the appellant without any compensation which shows that the transfer of interest does not constitute a sale of a business. Thus, the commissioner stated that the threshold of Kshs 5 million for registration applied to the appellant and it therefore ought to have registered and accounted for VAT relating to the farm-outs.

34. The tribunal agreed with the commissioner. The question for the tribunal was whether this taxable supply was capital in nature and/or a sale of the whole or part of the appellant's business so as to exclude the appellant from registration of VAT. I am inclined to agree with the tribunal that the assignment of interest by the appellant as a farmor to the third party farmees cannot be considered a disposal of the appellant's capital assets. Farm-out agreements are structured in a way that a farmor retains an overriding reversionary interest in the farmed-out area after "payout", that is, after the farmee has recovered all of its costs of drilling, completing, and producing the well. Once the farm-out is complete, the interest reverts to the farmor and the farmor and farmee consequently work out an agreement for revenue sharing, if any. Thus, a farm-out agreement can only be treated as a new economic venture between the farmor and farmee rather than a sale of property or services (see P Maxfield & J Houghton, *Taxation of Mining Operations* U 904[5][b][ii] (1987)).

35. I therefore find and hold that the interest held by the appellant in the oil blocks are stocks-in-trade rather than capital assets whose value can be developed and farmed out for gain. The tribunal thus came to the correct conclusion that the appellant's farm-out proceeds were not excluded from VAT and the appellant was bound to register for VAT and pay the same.

36. The parties agree that the tribunal made an error in holding that the demand for VAT was Kshs 2,293,334,065.44 for the years 2011, 2012 and 2016 instead of Kshs 2,778,163,730.42 for the years 2011, 2012 and 2015.

JOA and PSC Uplift Costs And Common Shared Costs

37. The commissioner disallowed 3% JOA and PSC uplift and common shared costs of the appellant arguing that they were not wholly and exclusively incurred in the generation of the income of the contractor in the blocks. Further, that the appellant had already claimed common costs and non-joint-venture costs in its ledgers which duplicated the JOA and PSC costs and that the appellant had not submitted evidence to justify the distribution among the related parties. The tribunal held that even though there was no evidence to justify the distribution, the appellant had actually explained the expenditures by providing its formula for allocating its costs and thus discharged its obligation to explain the expenditure. The tribunal further held that it was not for the commissioner to suggest the formula.

38. I am in agreement with the commissioner's submissions that the tribunal mixed up the issue of the JOA and PSC uplift costs with those of the common shared costs between the appellant and its related entities. in its objection decision, the 3% JOA and PSC uplift costs were disallowed on their own as the commissioner determined that they could not be traced to the profits generated by the appellant and ought to have been "added back" to the appellant's reported accounting profit.

39. It is not in dispute that expenses not wholly and exclusively incurred by a person in the production of income are disallowed and not deductible. Allowable expenses are those that are incurred wholly and exclusively in the production of income and such expenses ought to be supported by evidence which the commissioner has a right to call for under section 59(1) of the TPA. The record indicates that these JOA and PSC costs were unsupported even after the commissioner called for evidence. I therefore disagree with the tribunal that it was enough for the appellant to just offer an explanation without tangible evidence in support of those explanations. Under section 54A of the ITA, the taxpayer has a duty to maintain records to support its transactions, which records are those expected in the ordinary course of business. Further, section 30 of the *Tax Appeals Tribunal Act* and section 56 of the TPA impose the burden of proof on the tax payer to prove the commissioner wrong. Such burden goes beyond mere explanations and involve corroborative documented evidence in support.

40. I therefore find and hold that the commissioner was right to disallow the JOA and PSC costs claimed by the appellant for lack of evidence and supporting records. I further find that the claim for common shared costs incurred by the appellant and its related parties could also not be allowed for lack of supporting documentation and the commissioner was right to confirm the total disallowable amount.

Ring Fencing Of Losses Brought Forward Prior To 2015

41. The appellant farmed-out its interest in block 13t to a third party, Maersk Oil in 2015. From January 1, 2015, section 15(7)(ivB) of the ITA was enacted by the *Finance Act, 2014* introducing 'ring-fencing' whereby income of one contract area was considered a specified source of income and the gain or loss ought to be computed separately from other contract areas. Therefore, if a contractor suffers a loss in respect of petroleum operations in a contract area for a year of income, the amount of the loss is to be carried forward and allowed as a deduction against the income of the contractor derived from petroleum operations only in that specific contract area in the following year of income of the contractor.

42. Prior to the introduction of ring-fencing, such losses could be carried forward and deducted against income from any contract area. I therefore agree with the tribunal that prior to December 31, 2014, losses carried forward were not subjected to ring fencing and as a consequence, they could be carried forward against income of the appellant in any of the contract arears until exhausted. I therefore reject

the commissioner's argument that the tax losses derived prior to ring fencing ought to have been reallocated to the specific blocks that they related.

Contravention Of Section 29 Of The TPA

43. Section 29 of the TPA provides for default assessments. Under section 29(1), a default assessment is issued where the taxpayer fails to submit a tax return for a period as provided. In such a case, the commissioner makes an assessment to the best of its judgment in respect of the amount of the deficit in the case of a deficit carried forward under the ITA for the period, the amount of the excess in the case of an excess of input tax carried forward under the *VAT Act, 2013* for the period or the tax, including a nil amount, payable by the taxpayer for the period in any other case. The commissioner's powers are however limited by section 29(5) and (6) of the ITA which provides that:

    (5) Subject to subsection (6), an assessment under subsection (1) shall not be made after five years immediately following the last date of the reporting period to which the assessment relates.

    (6) Subsection (5) shall not apply in the case of gross or wilful neglect, evasion or fraud by a taxpayer.

44. It is common ground that the commissioner's assessment of June 29, 2018 was beyond the applicable time limit of 5 years for the appellant's transactions in 2011 and 2012. The commissioner averred that the appellant was guilty of gross neglect for failing to register and comply with the provisions of the *VAT Act* when dealing with taxable supplies, failing to declare farm-out revenue separately as provided for under the ITA, failing to apply the ring-fencing provisions, failing to apply the basis to justify the allocation for common costs and intentionally deducting the JOA and PSC costs.

45. On this issue I agree with the tribunal that the commissioner did not allege, let alone prove any wilful neglect on the part of the appellant. Wilful or gross neglect entails an intentional or reckless failure to carry out a legal duty. There is no evidence on record of such conduct on the appellant's part. The appellant's positions on the various tax liabilities were consistent and at no point did it admit liability or demonstrate that it wilfully neglected to pay the taxes demanded by the commissioner. I hold that the appellant, honestly but mistakenly believed that it did not have to register for VAT as it thought its farm out transactions were capital in nature and a sale of its business and that it was entitled to deduct common/shared costs and JOA and PSC costs. This is an issue that has now been resolved and do not find any reason to interfere with the findings of the tribunal.

Conclusion and Disposition

46. For the reasons I have set out above, I conclude that the appellant's appeal succeeds only to the extent that the tribunal erred in holding that the appellant's VAT assessment was Kshs 2,293,334,065.44 for the years 2011, 2012 and 2016 instead of Kshs 2,778,163,730.42 for the years 2011,2012 and 2015.

47. The commissioner's appeal succeeds only to the extent that it was right to disallow the JOA and PSC costs claimed by the appellant for lack of evidence and supporting records.

48. I there amend the tribunal's orders accordingly by including the following final orders as well:

    a. Demand for Kshs 2,778,163,730.42 being VAT on farm-out transactions for 2011, 2012 and 2015 be reviewed to exclude any assessment in respect of 2016.

    b. Kshs 489,784,237.00 being overhead uplift under the product sharing contracts and joint operating agreement be and is hereby disallowed.

c. Kshs 1,220,509,354.00 being common costs in respect of operated and non-operated licenses be and is hereby disallowed.

49. Each party shall bear its own costs.

DATED AND DELIVERED AT NAIROBI THIS 30TH DAY OF NOVEMBER 2022.

D. S. MAJANJA

JUDGE

Court Assistant: Mr M. Onyango.

Ms Mwango with her Ms Omondi instructed by Coulson Harney for the Appellant

Mr Ochieng Gaya instructed by Kenya Revenue Authority for the Respondent.