Commissioner of Domestic Taxes v Dominion Petroleum Dkenya Limited (Tax Appeal E093 of 2020) [2021] KEHC 283 (KLR) (Commercial and Tax) (19 November 2021) (Judgment)

Neutral citation: [2021] KEHC 283 (KLR)

REPUBLIC OF KENYA

IN THE HIGH COURT AT NAIROBI (MILIMANI COMMERCIAL COURTS)

COMMERCIAL AND TAX

TAX APPEAL E093 OF 2020

DAS MAJANJA, J

NOVEMBER 19, 2021

BETWEEN

COMMISSIONER OF DOMESTIC TAXES ..... APPELLANT

AND

DOMINION PETROLEUM DKENYA LIMITED ..... RESPONDENT

(Being an appeal against the judgment of the Tax Appeals Tribunal at Nairobi dated 24th July 2020 in Tax Appeal No. 136 of 2017)

JUDGMENT

Introduction and Background

1. The Respondent is a limited liability company incorporated in Kenya. Its principal activity at the time relevant to this appeal was the exploration of hydrocarbons, and in particular oil and gas. It entered into a Production Sharing Contract with the Government of Kenya dated 17th May 2011 ("the PSC") in relation to Block L9 located offshore within the Lamu Basin in a bid to accelerate the exploration and development of the potential petroleum resources pursuant to the provisions of the *Petroleum (Exploration and Production) Act* (Chapter 308 of the Laws of Kenya) ("the Petroleum Act (Repealed)") which was repealed by the Petroleum Act, 2019. The Respondent's exploration efforts were unsuccessful and on 13th September 2016, it effectively relinquished its license.

2. The Appellant, ("the Commissioner") carried out an in-depth audit of the Respondent's operations and tax affairs for the years of income 2011 to 2016. By a letter dated 25th April 2017, the Commissioner communicated its findings and invited responses from the Respondent in respect of the following taxes raised: Withholding Income Tax (WHT) on imported services – KES 114,993,666.00; WHT on deemed interest – KES 504,643,172.00 and; Reverse Value Added Tax(VAT) on imported services– KES 714,258,472.00 all totaling KES 1,333,895,311.00.

3. The Respondent responded to the Commissioner's findings in a letter dated 9th May 2017. Commissioner reviewed the findings and by a letter dated 18th May 2017, raised and issued the Respondent with formal tax assessments as follows: WHT on imported services – KES 138,172,223.00, WHT on Deemed Interest – KES 505,530,920.00 and VAT on imported services – KES 718,991,838.00 which in total came to KES 1,362,694,981.00. The Respondent settled KES 78,406,664.00 which was undisputed and objected to the other assessments by the Notice of Objection dated 16th June 2017.

4. The Commissioner, in its Objection Decision dated 7th August 2017, confirmed its assessments on Reverse VAT on imported services, WHT on Local Services, WHT on Management Fees and WHT on Deemed Interest. It vacated its assessment of KES 1,371,150.00 on WHT on expenses not subject to WHT. Thus, the Commissioner held that the total tax payable by the Respondent inclusive of penalties and interest was KES 1,099,900,750.00.

5. The Respondent was dissatisfied with the Commissioner's Objection Decision. It lodged an appeal at the Tax Appeals Tribunal ("the Tribunal"). In its judgment dated 24th July 2020, the Tribunal set aside the Commissioner's Objection decision on Reverse VAT and WHT on Deemed Interest to the extent of the period prior to 1st January 2014. Further, it upheld the Commissioner's Objection Decision on WHT on local services on condition that the amount of KES 656,892,892.00 paid by the Respondent to Apache Kenya Limited for seismic data be excluded from the assessment as it was not subject to WHT. In addition, it directed the Respondent to provide the Commissioner with documentation in support of the errors occasioned by the migration from its Pronto to SUN systems within thirty (30) days of the Tribunal's ruling to facilitate computation of the WHT payable.

6. The Commissioner appeals against the Tribunal's decision on the basis of the 22 grounds of appeal set out in its Memorandum of Appeal dated 18th September 2020. The Respondent has filed its Statement of Facts dated 23rd October 2020. Both parties have filed and rely on written submissions which set out their respective positions.

7. The Commissioner has condensed grounds of appeal into the following three issues for determination which I shall now consider.

   (a) Whether the Respondent was entitled to exemption from VAT remission and whether the Tribunal erred in setting aside the Commissioner's assessment on Reverse VAT.

   (b) Whether the financial agreements entered into by the Respondent and its affiliates were quasi-equity in nature and not interest-free loan agreements and whether the Tribunal erred in setting aside the Commissioner's assessment on WHT on deemed interest.

   (c) Whether the Tribunal's final orders were inconclusive and lacked clarity.

8. Before I consider the issues raised in this appeal, it is important to point out that under section 56(2) of the *Tax Procedures Act, 2015* ("TPA"), the jurisdiction of this court is restricted to, "[A] question of law only". This 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. In *John Munuve Mati v Returning Officer Mwingi North Constituency & 2 Others NRB CA EP Appeal No. 5 of 2018 [2018] eKLR*, the Court of Appeal summarised what amounts to "matters of law" and its relation to issues of fact as follows:

   (38) [T]he 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.

9. The second broad issue which I think is also important is that when it comes to interpretation of tax legislation, the statute must be looked at using slightly different lenses as the language imposing the tax must receive a strict construction leaving no room for intendment or implication (see *Cape Brandy Syndicate v I.R. Commissioners [1921] 1KB 64* and *Mount Kenya Bottlers Ltd & 3 others v Attorney General & 3 others NRB CA Civil Appeal No. 164 of 2013 [2019] eKLR*). I now turn to consider the issues raised by the Commissioner.

VAT Exemption

10. The thrust of the Tribunal's finding on this issue is that non-performance of administrative procedures by the various government agencies should not be used to deny the Respondent the exemption that was granted and communicated to it in writing.

11. The law applicable to VAT exemption at the material time is not in dispute. Section 23(1) and 3(c) of the (Chapter 476 of the Laws of Kenya) ("the *VAT Act* (Repealed)") provided as follows:

> 23(1) Subject to subsection (3), the Minister may, by order in the Gazette, remit wholly or partly tax payable in respect of any taxable goods or taxable services, if he is satisfied that it is in the public interest to do so.
>
> .....
>
> 23(3)(c) Remission under Subsection (1) shall only apply in respect of goods, including motor vehicles and aircraft, and taxable services imported or purchased by any company which has been granted an oil exploration or oil prospecting licence in accordance with a production sharing contract with the Government of Kenya and in accordance with the provisions of the *Petroleum (Exploration and Production) Act* (Cap.308). [Emphasis mine]

12. Resolution of this issue also revolves around the import of Treasury's letter dated 24th May 2011 to the Commissioner, whose contents are common ground and which reads, in part, as follows:

> The services provided to these firms qualify for exemption from VAT in accordance with the provisions of Section 23(3) of VAT Act.
>
> However, the Ministry of Energy is required to write directly to KRA in respect of any specific procurement of services to the oil exploration firms for the processing of the VAT exemption on services.
>
> By a copy of this letter, the Permanent Secretary, Ministry of Energy is advised to be forwarding the specific requests to KRA. In addition, the Ministry of Energy is advised to advise these firms of this procedure.

13. The Commissioner uses this letter to state that in as much as the Respondent qualified for VAT exemption, the same was only applicable and conditional upon notification by the Ministry of Energy. It submits that every time a listed firm wanted to procure a service that qualified, it was mandated to run it by the Ministry of Energy so that it could alert the Commissioner to process the VAT exemption for that service.

14. The Commissioner finds shelter in Articles 201 and 210 of the *Constitution* which provide that "the public finance system shall promote an equitable society, and in particular the burden of taxation shall be shared fairly", and that "No tax or licensing fee may be imposed, waived or varied except as provided by legislation." Thus, it submits that a blanket exemption as such would have been unconstitutional.

15. The Commissioner contends that the Respondent has the responsibility to ensure that its exemptions were gazetted and that failure to gazette the exemption meant that there was no authorisation for the exemption. It submits that the cure for failure by the Minister to gazette the exemption, is for the Respondent to apply for orders of mandamus in judicial review proceedings and not arrogating to oneself a perceived or deemed right. The Commissioner faults the Tribunal's decision that the letter dated 24th May 2011 by the Treasury created a legitimate expectation on the part of the Respondent that VAT on imported services would be exempt. It submits that the preceding letter from the Ministry of Energy was clear that requests for exemption would be on a case by case basis and that Treasury's subsequent response was similarly qualified.

16. The Respondent supports the decision of the Tribunal. It relies on clause 32(3) of the PSC which states that "Such services, materials, equipment and supplies shall be exempt from all customs duties, VAT and import declaration fees provided that the Contractor and its contractors and sub-contractors shall give preference to Kenyan goods and services in accordance with clause 31 thereof." It submits that by virtue of section 4(4) of the Petroleum Act (Repealed), the petroleum agreements and in particular the terms contained therein are fully adopted as part of the law in respect of petroleum activities. It urges that, if clause 32(3) of the PSC provided that services procured by the Respondent were exempt from VAT, then this would be the applicable law and would be read as though it were an express provision of the Petroleum Act (Repealed). It further adds that the VAT Act (Repealed) then gave the Minister the power, through section 23(3)(c) to remit VAT in respect of goods and taxable services imported or purchased by any company which had signed a PSC. The Respondent further submits that since it was exempted from VAT remission under the PSC and the VAT Act (Repealed), it took all the necessary steps to obtain the exemptions for Reverse VAT and as such it cannot be compelled to pay taxes on account of the indolence of administrative bodies.

17. The Respondent supports the Tribunal's decision that it had a legitimate expectation that its VAT remission would be processed. It submits that the letter issued by Treasury as a public body, confirmed that the Respondent was VAT exempt, that the letter and the contents were never terminated and that the exemption was based on the law and therefore legitimate. It cites *Republic v Commissioner of Domestic Taxes & another Ex-parte Kenton College Trust NRB JR Case No. 294 of 2010 [2013] eKLR* where the court held that for a party to successfully rely on the principle of legitimate expectation, it must prove that the underlying expectation is clear, unambiguous and devoid of relevant qualification, that the expectation is reasonable, that the representation was made by the decision-maker and that the decision-maker had the competence and legal backing for making such representation.

18. I find and hold that section 23(1) and 23(3) of the VAT Act (Repealed), which I have set out above, is in mandatory terms and it provides that companies such as the Respondent were entitled to VAT remission in respect of goods, including motor vehicles and aircraft, and taxable services imported or purchased by them in respect of activities covered by the Petroleum Act (Repealed) and that it was within the Minister's powers to grant such remission by an order in the Kenya Gazette.

19. I accept the findings by the Tribunal that the Treasury's letters dated 24th May 2011 and 12th September 2011 is sufficient evidence that the exemption was granted. The Commissioner does not dispute this fact. I also agree with the Tribunal that the Treasury's letter dated 24th May 2011 amounts to an exemption and that the reference to the Ministry of Energy only refers to the procedure to be followed.

There is nothing in the VAT Act (Repealed) that qualified the Respondent's VAT remission for reasons that the relevant ministry, in this case the Ministry of Energy failed to notify the Commissioner of the goods and services that the Respondent intended to procure. Indeed, the record indicates that the Respondent, in its correspondence to the Ministry of Energy had applied, inter alia, for VAT remission in respect of various items, equipment and materials and that Treasury largely responded to it in the affirmative as evidenced by the letter dated 12th September 2011.

20. As I understand, the question whether the Respondent qualified for VAT remission does not arise as the Commissioner is only challenging the procedure. I do not fault the Tribunal for finding that the Respondent qualified for VAT remission as a matter of law. I also hold that imposing a reverse VAT liability on the Respondent based on non-performance of an administrative function would be going against the very spirit of Article 210 of the Constitution as the Respondent has complied with the terms of the statute granting the remission.

21. In addition, such a holding would violate and undermine the Respondent's right to fair administrative action which is protected by Article 47(1) of the Constitution which provides that, "Every person has the right to administrative action that is expeditious, efficient, lawful, reasonable and procedurally fair." This burden to ensure that the administrative processes comply with the constitutional mandate lie on the State and its agencies. Where a person, such as the Respondent has taken advantage of clear statutory provisions, the Commissioner cannot impose procedural impediments particularly where such procedures are not part of the statutory scheme conferring the benefit.

22. For the reasons I have outlined, I uphold the Tribunal's finding vacating the Commissioner's assessment on Reverse VAT.

WHT on deemed interest

23. WHT is a method of tax collection whereby the payer is responsible for deducting tax at source from payments due to the payee and remitting the tax so deducted to the Commissioner. Under section 10(1) of the ITA, the resident company paying interest and deemed interest is required to pay WHT to the Commissioner as follows:

> 10. Income from management or professional fees, royalties, interest and rents
>
> (1) For the purposes of this Act, where a resident person or a person having a permanent establishment in Kenya makes a payment to any other person in respect of-
>
> (c) interest and deemed interest

24. Under section 16(3) of the ITA "Deemed Interest" is defined as "....an amount of interest equal to the average ninety-one day Treasury Bill rate, deemed to be payable by a resident person in respect of any outstanding loan provided or secured by the non-resident, where such loans have been provided free of interest." In essence, it is applicable on interest free borrowing and loans received from foreign-controlled entities in Kenya. Further by section 35(1) of the ITA, a person upon payment of a non-resident person not having a permanent establishment in Kenya in respect of interest which is chargeable to tax is required to deduct withholding tax at the appropriate non-resident rate which is provided for in the Third Schedule to the ITA.

25. Resolution of this issue involves around the nature of financial agreements entered into by the Respondent and its affiliate companies. The Commissioner contends that the agreement between the Respondent and its related companies were interest free outright loan agreements and any payments made to them by the Respondent thereunder fell within the definition of "Deemed Interest".

It observes that all of the Respondent's related party lenders disclosed in their audited financial statements that the loans were interest free and that the Respondent attempted to introduce a 0.1% rate on one of the loans with Dominion Petroleum Acquisition Limited through contracts dated 5th February 2015 and 10th February 2015 respectively which were backdated to an effective date of 1st January 2014. The Commissioner thus accuses the Respondent of attempting to circumvent provisions of the ITA regarding treatment of interest free loans.

26. The Commissioner faults the Tribunal for holding that the "inter-company loans" do not fit the description of a loan as defined under section 16(3) of the ITA when the parties themselves had decided to call those arrangements 'loans' and that there is no such thing as "quasi-equity" from the definition in section 16(3) aforesaid which provides that, '"all loans" means loans, overdrafts, ordinary trade debts, overdrawn current accounts or any other form of indebtedness for which the company is paying a financial charge, interest, discount or premium." The Commissioner urges the court to take cognizance of the fact that this very chicanery called tax planning is the reason we have an entire body of practice called Transfer Pricing to ensure that related-parties transact at arm's length as though they are related.

27. The Commissioner further faults the Tribunal and terms its finding contradictory for holding that these so-called quasi-equity financing agreements had an interest clause while ignoring the explanations of the Respondent about the import of that 0.1% rate, for the Tribunal to claim privity of contract.

28. The Respondent agrees with the Tribunal's findings that the WHT on deemed interest be vacated pursuant to sections 35(1)(e) and 16(2)(j) of the ITA and maintains that in light of these provisions, deemed interest only accrues on interest free loans while in this case, the arrangements between the parties were quasi-equity financing. It states that the arrangements between them were quasi-equity financing arrangements which are legal agreements and not 'loans' as alleged by the Commissioner.

29. The Respondent explains that a company's operations can be funded through debt or equity. Debt financing is where a person provides debt facilities to a company on certain terms i.e. repayable after a certain period of time and with a financial charge which constituted interest. Equity, on the other hand is where a person invests money in a company and in issued shares in the company in return. The Respondent urges the court to note that one key difference between debt and equity financing is that with debt financing, the financier expects repayment of principal and interest whether or not the company makes a profit and the relationship is one of a debtor and creditor. With equity financing, the investor only make returns, by way of a dividend, when the company makes a profit. The Respondent defines quasi-equity financing to refer to funding structures that have both debt and equity characteristics and unlike debt instruments, quasi equity financing mechanisms are often characterized by the lack of predetermined repayment periods, is unsecured and there is generally no intention between parties to create a debtor/creditor relationship, as the underlying assumption when entering into such funding arrangements is that repayment is contingent on future commercial oil and gas production.

30. The Respondent submits that its associated companies provided money to it with the expectation that should Block L9 be commercially viable and the final investment decision be made, the money would be classified as a debt and would be repayable. However, in case the project was deemed to not be commercially viable, the monies received would be classified as equity which would mean that the investors would have effectively lost their money as the company will never make a profit.

31. The Respondent therefore submits that in this case, it received quasi equity funding from related parties including Dominion Petroleum Administrative Services Limited, Dominion Acquisition Limited, Dominion Petroleum Limited, Ophir Energy PLC and Ophir Service Pty Ltd to fund exploration activities between the periods 2011-2014. The Respondent avers that this form of funding

is common in the oil and gas industry as banks would not ordinarily lend to oil and gas companies as the risk that an investment decision will not be made are high and there is a high likelihood that the banks will lose monies lent out to such companies and this is why related companies of the Respondent stepped in and offered funds in the manner set out above. That since the Respondent's exploration was unsuccessful, the related companies cannot be repaid and the amount received from them cannot be treated as a loan.

32. The Respondent submits that the Tribunal looked at the substance of the agreements and not the form and the Respondent invites this Court to look at the substance as well. It further submits that it is trite law that a court of law cannot rewrite a contract between parties and that the parties are bound by the terms of their contract unless coercion, fraud or undue influence are pleaded and proved.

33. The Respondent further submits that the Ministry of Energy was alive to the unique business position of oil and gas exploration companies at the pre-development stage and the importance of quasi-equity funding as stated in the letter dated 14th July 2017 written to Treasury. In the foregoing, the Respondent urges the Court to uphold the decision of the Tribunal in vacating the assessment of WHT on deemed interest, as the provisions of deemed interest as defined under the ITA do not apply to the arrangements between the Respondent and its affiliates and that the Commissioner is trying to infer a meaning that would go against the express intention of the parties both in form and in substance.

34. I hold that the main factor of consideration is whether there was any interest provided for in the financing agreements amounted to a loan; if there was no interest, then WHT on 'Deemed Interest' would apply at the 91-day Treasury Bill rate; if there was interest, WHT would still apply at the rate provided for in the Third Schedule of the ITA. What should be noted is that whichever the case, WHT would still apply.

35. In its judgment, at para. 110, the Tribunal observed that the said agreements were "...all unsecured, interest-free and have no definitive repayment plan...". Further, at Para. 115, the Tribunal noted that the agreements in question dated 28th March and 24th September 2014 both provided for an earlier effective date and had no interest clause. These agreements were later amended by the contracts dated 5th February 2015 and 10th February 2015 respectively to include an interest clause at the rate of 0.1% with an effective date of 1st January 2014.

36. I am in agreement with the Tribunal that in the absence of any demonstrable fraud or illegality, the parties are free to make amendments to their agreements. I also note that the parties may make an agreement that includes equity and borrowing. In this case, there was clearly a lending transaction and the inclusion of the 0.1% interest rate means that "Deemed Interest" could no longer apply at least from 1st January 2014. However, since there was no interest prior to the effective date, it follows that WHT on "Deemed Interest" would apply to any repayments made by the Respondent to its affiliate companies in this period prior to 1st January 2014.

37. I therefore hold that the Tribunal erred in holding that WHT on Deemed Interest ought to be set aside to the extent of the period prior to 1st January 2014 as it ought to be set aside to the extent of the period from 1st January 2014 when the 0.1% interest rate was introduced. This error though, does not negate the soundness of the Tribunal's decision which will be rectified in the final orders.

Whether the judgment was inconclusive and lacked clarity

38. The Commissioner claims that the Tribunal's judgment was inconclusive, lacked clarity and questions its enforceability. The Commissioner agrees that under section 29(3)(c)(ii) of the *TAT Act*, the Tribunal is empowered to "refer the matter to the Commissioner for reconsideration in accordance with any directions or recommendations of the Tribunal". First, the Commissioner questions what

is to follow should the Respondent fail to provide the documents necessary to facilitate the VAT exemption certificates or if the Commissioner found that the said documents were not satisfactory. The Respondent retorts that the parties have begun complying with this directive by the Tribunal and the Commissioner has so far issued a VAT remission certificate dated 3rd September 2020.

39. I fail to see what is not clear in this directive by the Tribunal because how else would the Commissioner process VAT Exemption Certificates without relevant documentation of purchases or imports in support?

40. Second, the Commissioner appears to contest the Tribunal's direction that the Respondent to provide the Commissioner, "…..with documentation in support of the errors occasioned by the migration from Pronto to SUN systems within thirty (30) days of the date hereof to facilitate computation of the Withholding Tax payable." I hold that the Tribunal was simply assisting the Commissioner collect the taxes that were truly, properly and lawfully due to it. The Commissioner has not demonstrated what was inconclusive or unclear about this directive because the Tribunal had already found that the Commissioner's assessment on WHT on local services was justified.

Conclusion and Disposition

41. For the reasons I have set out above, I dismiss this appeal save that the Tribunal judgment dated 24th July 2020 is affirmed subject to the order that the Commissioner's assessment on Witholding Tax on Deemed Interest from 1st January 2014 be and is hereby set aside. For the avoidance of doubt Witholding Tax on Deemed Interest shall apply for the period prior to 1st January 2014.

42. There shall be no order as to costs.

DATED AND DELIVERED AT NAIROBI THIS 19TH DAY OF NOVEMBER 2021.

D. S. MAJANJA

JUDGE

Mr Marigi, Advocate instructed by Kenya Revenue Authority for the Commissioner of Domestic Taxes.

Mr Oduor instructed by Coulson Harney LLP Advocates for the Respondent.