



**REPUBLIC OF KENYA**

**IN THE HIGH COURT OF KENYA AT NAIROBI**

**COMMERCIAL & TAX DIVISION**

**INCOME TAX NO.07 OF 2018**

**EPCO BUILDERS LIMITED.....APPLICANT**

**VERSUS**

**THE COMMISSIONER FOR INCOME TAX.....RESPONDENT**

**JUDGMENT**

(1) The Appellant **EPCO BUILDERS LIMITED** has filed this Appeal challenging the Decision of the **Tax Appeals Tribunal** (hereinafter the **TAT**), delivered in Nairobi on **27<sup>th</sup> February 2018**. The Respondent, the **COMMISSIONER OF DOMESTIC TAXES** (hereinafter “**the Commissioner**”) opposed the appeal.

(2) The appeal was canvassed by way of written submissions. The Appellant filed their written submissions on **1<sup>st</sup> November 2018**, whilst the Respondent filed its submissions on **28<sup>th</sup> November 2018**.

**BACKGROUND**

(3) The Appellant is a Company registered in Kenya whose main activity is construction. The Appellant carries on the business of construction on behalf of its customers. However the Appellant also constructs its own buildings or buildings for sale. Some of the units so constructed are retained by the Appellant Company as an investment for rental purposes whilst other units are developed for purposes of sale to third parties.

(4) In the year 2011, the Appellant undertook two projects with the Kenya Airways and another development at Brookside area in Westlands. At the end of the year the costs incurred were transferred to the balance sheet as work in progress. The costs included input **VAT** which was debited directly to property inventory and not in the purchases ledger. The land costs for Brookside project were transferred from investment properties to inventory and the deposit and professional fees paid on the Kenya Airways project were debited directly to inventory property.

(5) In **2012** the Appellant undertook the **EPCO Langata Project**. The other two projects were still ongoing and the input **VAT** was all debited in the property inventory. Similarly, land deposits for Kenya Airways project were debited directly inventory property. Professional fees were debited directly to inventory property while land costs for **EPCO Langata project** were transferred from investment properties to inventory.

(6) In **December 2014** a team from the Respondent undertook an in in depth audit on the Appellant and on **10<sup>th</sup> December 2014** an assessment was raised on a number to tax issues. On **9<sup>th</sup> January 2015** the Appellant lodged a Notice of Objection to the taxation. There followed a mediation process which resulted in a consent dated **28<sup>th</sup> June 2016** in the following terms:-

**(1) The Principal amount of tax to be paid for the years of 2010 and 2011 amount is Kshs.1,794,129.90. The total penalties and interest accumulated on the principal tax amount to Kshs.1,760,815.98.**

**(2) That the Appellant shall be at liberty to apply for a waiver of penalty and interest in relation to the above principle tax payable failing valuation they will pay the penalty and interest accrued thereon.”**

(7) Subsequent to this consent the only issue that remained for determination was whether cost of sales were over claimed for the years **2011** and **2012**. The Respondents raised a cost of sales assessment of **Kshs.381,222,639** alleging that the Appellants had over claimed cost of Sales. This is the issue which went for hearing before the Tax Appeals Tribunal. The **TAT** rendered its decision on **1<sup>st</sup> April 2015** and found inter alia that:

**“(i) Since no income was realized from the said three properties, no tax relief can be claimed pursuant to Section 15(1) of the Income Tax Act.**

**(ii) The Appellant has not been able to provide satisfactory explanation and evidence in support of its computation of the costs of sales and the variance in stock levels.**

**(iii) That the Appellant had failed to prove the burden placed upon it by law under Section 30 of the Tax Appeals Tribunal Act.**

The Appellant being dissatisfied with the decision of the TAT filed this current appeal against that decision.

#### **ANALYSIS AND DETERMINATION**

(8) I have carefully considered the submissions filed before me in this matter as well as the relevant law. The main issue raised by this appeal is whether the Appellant had over claimed the cost of sales. There exists a dispute between the parties as to the correct legal principles to be applied in determining the nature of the cost of sales. The Respondent had raised a “**cost of sales assessment**” of **Kshs.381,222,639/=** alleging that the Appellant had over-claimed cost of sales.

(9) The Respondent however contend that the proper way of determining the cost of sale to be claimed in the Profit and Loss Account (P&C) is as follows:-

- Opening stock + Purchases –Closing Stock

Opening Stock – Closing Stock is also referred to as Stock Movement thus the cost of sale claimable would be Purchases + Stock Movement.

The Respondent therefore contends that the Appellant did not apply the proper formula leading to inflation in cost of Sales.

(10) On their part the Appellants maintain that the variances were due to the fact that costs in inventory related to projects that were yet to be developed and as such could not be expensed as no income was being generated from such projects. The Appellants submit that TAT failed to appreciate the distinction between “**Capitalizing**” and “**Expensing**” which they explain in the following way:-

“**Expensing**” a cost indicates that it is included on the income statement and subtracted from the revenue to determine the profit of a corporation for purposes of taxation, which is the accounting practice for construction contracts. “**Capitalizing**” on the hand indicates that the development cost for a project that is being developed for sale is accounted for directly on the balance sheet as an asset and written off the income statement as and when the units developed are sold.

(11) **Section 15(1)** of the **Income Tax Act** provides as follows:-

**“For purposes of ascertaining the total income of a person for a year of income these shall, subject to Section 16 be deducted all expenditure incurred that year of income which is expenditure wholly and exclusively incurred by him in the production of that income.”**

(12) The Appellants contention is that the costs incurred in connection with the **KQ project**, the **Brookside Project** and the **EPCO Langata Project** were never expensed. They maintain that their costs were merely capitalized in the years of income **2010, 2011** and **2012**. The Appellants position therefore is that it was wrong and illegal for the Respondents purport to disallow such costs.

(13) On its part the Respondent counters that the Appellant has applied the wrong values resulting in invalid cost of sales which lack authenticity. According to the Respondent the cost of sales is the difference between the opening and closing stock of the varying amount for the three projects extracted from the balance sheet.

(14) It is manifest that the Appellant and the Respondent used different formulas to calculate the cost of sales. The TAT found that the Appellant used figures from the General ledger and the Profit and Loss Account, whilst the Respondent relied, on figures taken from the General ledger, the Trial Balance and the Balance Sheet which resulted in the variance in figures for the years **2010, 2011** and **2012**. I find that the TAT erred in this regard. From the Appellant statement of facts which was also placed before the Tribunal it becomes clear that the variance arises from the adjustments made to the cost of sales figure in the Profit and Loss Account. The cost of sales attributable to the units for sale are transferred to the balance sheet as inventory. Once the units have been sold the same is then transferred to the profit and loss account as cost of sales.

(15) The Tribunal in its judgment held as follows in paragraph 42:-

**“The Tribunal having carefully and cautiously interrogated the parties, pleadings, written and oral submissions is satisfied that the three properties namely KQ project, Brookside and EPCO, Lang’ata Project which were included in the valued of stock in the general ledger did not generate any income in the relevant years whether they were classified as investments or inventory properties which would form the basis of the claim of the expenditure that generate this income.”**

The Tribunal further stated in paragraph 43 as follows:-

**“Consequently, since no income was realized from the said properties, no Tax relief can be claimed pursuant to Section 15(1) of ITA.”**

(16) I am persuaded and do find that the Appellants costs related to the three projects in the General ledger did not amount to claiming the costs as expenses under **Section 15(1)** of the **Income Tax Act**. Rather the position was that the Appellant simply recorded the purchases as an expense on the Profit and Loss statement. The correct position is that the costs were capitalized. In other words, the Appellant recorded the costs as assets on the balance sheet rather than as an expense in the income statement. By so categorizing the purchase as an asset the Appellant was simply reporting the value which that asset has for their business.

(17) It is this Court’s opinion that the three (3) projects in question did not generate any income for the Appellant and therefore no tax relief could be claimed under **Section 15(1)**. Consequently, I find that the present appeal has merit. The judgment delivered on **27<sup>th</sup> February 2018** by the **TAT** is hereby set aside. Costs are awarded to the Appellant.

**Dated in Nairobi this 21<sup>st</sup> day of May 2020.**

.....

**Justice Maureen A. Odero**