REPUBLIC OF KENYA

IN THE HIGH COURT OF KENYA AT MILIMANI (NAIROBI)

COMMERCIAL AND TAX DIVISION

INCOME TAX APPEAL NO. 19 OF 2017

PRIMAROSA FLOWERS LIMITED.....APPELLANT

VERSUS

COMMISSIONER OF DOMESTIC TAXES.....RESPONDENT

JUDGMENT

1. This is an appeal from the judgment of the Tax Appeal's Tribunal at Nairobi delivered on 7th December 2016 in the **TAT** 193 of 2015 in the matter of Primarosa Flowers Limited vs the Commissioner of Domestic Taxes.

2. The appellant filed Memorandum of Appeal dated 28th February 2017 setting out eight (8) grounds of appeal. The Respondent pleading is as per the statement of fact filed on 26th May 2017, the submissions filed at Tax Appeal Tribunal, whereas the pleadings by the Respondent is as per Respondent's statement of fact and bundle of documents at the Tribunal. The Appellant's pleading is further the replying affidavit, in response to the statements of facts dated 27th June 2017.

Brief facts f the case.

3. The Appellant was selected for corporation Tax audit for the years 2011 and 2012 and for the agency taxes for the period January 2011 to July 2014 after which the Appellant raised objections which were reviewed and assessment confirmed in the light of the objection as per the provisions of section 85(1) (b) of the Income Tax Act and section 32A (3) (b) of the VAT Act 2013. That provoked the Appellant to lodge an Appeal with Tax Appeals Tribunal on 30th August 2015. The Honourable Tribunal delivered its judgment on 7th December 2016 in respect of all issues under adjudication. The appellant proceeded to issue a notice of intention to Appeal to the High Court on 20th December 2016 and lodged the Memorandum of Appeal on 28th February 2017.

4. The Honourable Tribunal in its judgment dated 7th December 2016 made the following findings:-

i) The Appellant was bound to incur losses and gains in the conversion of currency from Yen to dollar and from dollar to Kenyan shillings. It is therefore clear from the reading of Section 73 (2) (b) of the Income Tax Act that the Respondent has powers to estimate the tax payable in certain circumstances of which exist in the Appellant's case.

ii) The responsibility of reconciliation of actual sales vis a vis the export figures lay solely on the Appellant and that this responsibility could not be discharged on grounds that the Appellant relied on third party documents.

iii) The Tribunal found that the Respondent did not meet the justification threshold for collection of tax loss as a result of its preferred conversion method. The Tribunal opined that the Japanese Yen is an acceptable currency for purposes of trade thus disposing the need to convert the Yen to dollars.

iv) The Honourable Tribunal found that the Appellant's argument that the loan to the related company was from different sources and not from the foreign loan as lacking merit and unsubstantiated.

v) The Honourable Tribunal upheld affirmed the question on whether foreign exchange losses incurred through the conversion of debt to equity is allowable. This was pivoted on the provisions of section 4A of the ITA which provides that: "a foreign exchange gain or loss realized on or after 1st January 1989 in a business carried out in Kenya shall be taken into account as a trading receipt or deductible expenses in computing the gains and profits of that business fort the year of income in which the gain or loss was realized."

vi) In conclusion of the Appeal before the Honourable Tribunal, it ruled to dismiss the Appeal brought forward by the Appellant and uphold the Respondent's Confirmation of Assessment Notice dated 29th June, 2015.

5. Aggrieved by the Tax Appeal Tribunal the Appellant preferred the present appeal setting out 8 grounds of appeal as set out in Memorandum of Appeal.

6. Before the hearing of the Appeal the Appellant filed skeleton submissions on 11th November 2017 whereas the Respondent filed its submissions on 11th July 2018. The counsel were given an opportunity to submit orally on their respective rival submissions and in doing so dealt with each ground of Appeal on its own, which grounds of aspect I prepare to consider each ground on its own merit as argued by the counsel.

Grounds No. 1

7. The Appellant's ground No.1 is, that the Tribunal erred in law and applied a wrong statutory regime by endorsing the Respondent's estimation of the Appellant's tax under section 73(3) (b) of the Income Tax Act.

8. In the instant appeal, it is contended by the Appellant that this appeal is not about the computation of tax by the Respondent but is about whether the Tax Appeal's Tribunal **(TAT)** adjudicated the dispute in accordance with the principles of law that govern taxation. It is further urged the Respondent arbitrary attempted to impose tax obligation on the Appellant but the Appellant points out in the appeal it is not seeking evaluation of the tax obligation because the statute gives the court jurisdiction to hear appeals on points of law only. It is therefore Appellant's contention, that it is seeking whether **TAT** applied the correct law and legal principles.

9. It is been urged as the appeal is being considered, it is worthy to note that taxation is on institution whose boundaries are clearly delineated by law and specialized principles. It is urged that the appeal resonates on the following:-

i) The legal (irrefutable) presumption that tax statutes must be interpreted strictly against the state;

ii) If there is doubt in law about whether a tax obligation should be imposed on a taxpayer, the benefit of doubt accrues to the tax payer;

iii) While tax evasion is unlawful and illegal, tax avoidance is not.

10. In **Commissioner of Income Tax vs Vestmont Power (K) Ltd 2006 eKLR, Justice Visram,** held thus:-

"Even though taxation is acceptable and even essential in democratic societies, taxation laws that have the effect of depriving citizens of their property by imposing pecuniary burdens resulting also in penal consequences must be interpreted with great caution. In this respect, it is paramount that their provisions must be express and clear so as to leave no room for ambiguity. Following the Inland Revenue vs Scottish Central Electricity Company case, any ambiguity in such a law must be resolved in favour of the taxpayer and not the Public Revenue Authorities which are responsible for their implementation."

11. In **Keroche Industries Limited vs Kenya Revenue Authority & 5 others [2007] eKLR**; it dealt with an issue that taxation cannot tax by inference or analogy as any attempt to do so perpetrates an illegality; it is arbitrary and oppressive.

"taxation can only be done on clear words and cannot be on intendment. Linked to this is that a penalty must be imposed in clear words. Finally, even where the inclination of the legislature is not clear or where there are two or more possible meanings, the inclination of the court should be against a construction or interpretation which imposes a burden, tax or duty on the subject…"

12. In **Mangin vs Inland Revenue Commissioner [1971] AC 739: Lord Donovan;**

"The words are to be given their ordinary meaning. They are not to be given some other meaning simply because their object is to frustrate legitimate tax avoidance devices."

13. In **Vestey vs Inland Revenue Commissioners [1979] 3 ALL ER at 984;**

"Taxes are imposed on subjects by parliament. A citizen cannot be taxed unless he is designated in clear terms by a taxing Act as a taxpayer and the amount of his liability is clearly defined."

14. Ground No.1 as captured herein above relates to invocation of **section 73(2) (b) of the Income Tax Act** which provides as follows:-

"Where a person has delivered a return of income tax the commissioner may:-

(b) If he has reasonable cause to believe that the return is not true and correct, determine, according to the best of his judgment, the amount of the income of that person and assess him accordingly."

This section gives powers to the commissioner upon a person delivering return if he has reasonable cause to believe, that the return is not true

and correct, to determine, according to the best of his judgment the amount of the income of that person and assess him accordingly.

15. In the instant appeal, this was one of the instances where the **TAT** tribunal had an obligation to investigate or examine whether this was one of the cases where the power of self-assessment was properly exercised and whether the assessment was not true and correct to justify the intervention of the commissioner.

16. The **TAT** framed an issue as follows: - *"whether there was a sales variance between sales."* The product of subject of sales is urged, were flowers, a perishable good and which are only sold in an auction. It is in view of the above proper for determination of the value of the product at the point of export as urged by the Respondent. It is not wrong for the Respondent to aver that upon export of the cut flowers to overseers markets, where the sales take place, the auctioneers then generate the final sales Report which contain the actual sales value for accounts, which of course the Appellant is required to adjust his export entries compared with final sales.

17. I find that the accurate approach that should have been applied in view of the cut flower being that they are perishable and sale is subject to auction, which is determined by varies forces of demands and supplies was to examine the document before it and either endorse the Respondent's decision or ask the Respondent to conduct a fresh assessment on the basis of what had been availed by the Appellant. It cannot in view of the above be said the delivered return of income by the Appellant caused the commissioner to have reasonable cause to believe that the return is not correct or true to call for commissioners of income tax to assess tax payment by the Appellant. The proforma invoices produced before the **TAT** tribunal should have been considered, together with the Respondent's statement of facts, final sales Report and any other forms of evidence availed should have formed the basis for the assessment. In view of that, section 73(2) (b) of the Income Tax Act, should not have been resulted to in view of there being, a proforma invoice, being a document stating commitment on part of the seller to deliver the products or services as notified to the buyer for a specific price, which should have been treated as evidentiary document. Secondly what was before **TAT** Tribunal from the Respondent's statement of facts paragraph 14 were documents not matching and further a case where final report and other documents; from an independent third party quarters, were available but verification showed different figures in some aspects. I find in view of the complexity of the matter and given the colossal amount of money involved, the **TAT** Tribunal should not have taken the position it did and accept the estimations made by the Respondent without considering all avail documents. I find further the treatment of this claim, in the manner the **TAT** Tribunal did, amounts to endorsing an arbitrary taxation and was contrary to the specialized principles. I find merit in this ground and a justification to order a retrial as regards matters raised under ground No.1 of the appeal.

18. The Applicant under ground No.2 of the memorandum of Appeal avers that members of the Tribunal acted in excess of jurisdiction and erred in law by invoking extraneous considerations as a basis for rejecting the Appellant's actual tax loss on account of conversion of Jananese Yen into Dollars and then into Shillings.

19. The 2nd ground of appeal was decided on the same legal basis as the 1st ground of appeal using section 73(2) (d) of the Income Tax Act. This ground relates to the effect of translation of earned income from one currency to another. The Respondent claims that Kshs.5, 000,000 variation resulted from conversation of the sale currency stated in the invoices as Japanese Yen to US Dollar, to Kenya Shillings and not from the claims posed by the Respondent. The Respondent claim, however the multiple conversions were frivolous and unnecessary as the Japanese Yen is an acceptable currency in Kenya, a position that was upheld by the **TAT** Tribunal holding, that no reason had been advanced to justify the collection of a tax loss through conversion of the Yen to dollars then to Kenyan Shillings. It is further urged from the Respondent, that it was found that no documents or evidence were adduced to the effect that the currency of transaction or export document were in dollars or that the payments for the sales were received in dollars.

20. The Appellant contend, and claim that "extraneous factors" were adopted by **TAT,** Tribunal as a basis of rejecting the Appellant's actual loss on account of conversion of earnings in Yen, into dollar, then into shillings.

21. Section 107 of the evidence Act provides:-

> **"(1) Whoever desires any court to give judgment as to any legal right or liability dependent on the existence of facts which he asserts must prove that those facts exist.**
>
> **(2) When a person is bound to prove the existence of any fact it is said that the burden of proof lies on that person."**

22. In the instant appeal, I find the burden of proof that **TAT** Tribunal relied on extraneous factors and that the Appellant carried out multiple conversions lies with the Appellant. In the instant case, the Appellant has not produced any documentary evidence, that the currency of the transaction or export documents were in dollars or payment were received in dollars. I find the Appellant has not discharged the burden of proof to the required standard of proof.

23. In **Mulherin vs Commissioner of Taxation [2013] FCAFC 115** the Federal Court of Australia held that in tax disputes, the tax payer must satisfy the burden of proof to successfully challenge income tax assessments. The onus is on the taxpayer in proving that assessment was excessive by adducing positive evidence which demonstrates the taxable income on which tax ought to have been levied.

24. The income from business where foreign exchange loss or gain is realized provides no foreign exchange loss shall be deemed to be realized where a foreign currency asset or liability is disposed of or satisfied and within a period of sixty days, a substantially similar foreign currency asset or liability is obtained or established *(see section 4A of the Income Tax Act).*

25. There is no dispute in this appeal that **"Yen"** is acceptable currency in Kenya, thus it is accepted as a legal tender but it would have been wrong if the **TAT** Tribunal meant the Appellant should have paid the tax by **"Yen".** May be the concern of the **TAT** Tribunal was the multiple conversion from the currency of transaction to another then shilling leading to a loss in conversion. Section 4A (2) (a) r^1 of the Income Tax provides:-

"(a) is the amount of foreign currency received, paid or otherwise computed with respect to a foreign currency asset or liability in the transaction in which the foreign exchange gain or loss is realized;

(r1) is the applicable rate of exchange for that foreign currency ("a") at the date of the transaction in which the foreign exchange gain or loss is realized."

In view of the **TAT** made no error on issue raised under ground No.2. I find no merit on the same and dismisse it accordingly.

Ground No.3

26. The Appellant under ground No.3 avers, that members of the Tribunal acted in excess of jurisdiction and erred in law by finding that interest expense on bank borrowings were not restricted in proportion to interest-free advances to related parties and interest bearing borrowings.

27. It is the Appellant's contention, under ground No.3, that **TAT** Tribunal erred by finding that interest expenses were not restricted in proposition to interest free advances to third parties. The **TAT** Tribunal view is, that there ought to have been propositional restrictions on income to interest free advances to a third party. The tribunal under paragraph 23 of its judgment added that the loan had *"anti-avoidance measures concerned with deeming loan relationships to exist, where funding transactions in a way that would otherwise keep income out of charge tax"*. It is urged by the appellant if **TAT** Tribunal found that this was legitimate tax avoidance mechanism, and that **TAT** should have held their horses at that point and given benefit to the tax payer.

28. The Respondent contends, that from the audit conducted by the Respondent on the Appellant, it was evident that the Appellant obtained loans from financial institutions which in turn incurred interest expenses. The Respondent however noticed that following the advancement of these loans, the Appellant would then advance interest free loans to a related company; Riverside Ten Limited which resulted in the Appellant's shortfall in cash flow.

29. The position is taken on the basis of five underlying assumptions, by the Respondent that there was actual disbursement; that the sums were received from a sister company and disbursed through the Appellant, then the question of treating it as an interest restriction would not arise in the first place-it was not a bank loan.

30. The **Supreme Court of India in Hero Cycles (P) Ltd vs Commissioner of Income-tax (Central) Ludhiana [2015]** 63 taxmann.com 308 [SC] the court made the following important holding:-

"We are of the opinion that such an approach is clearly faulty in law and cannot be countenanced…. the Revenue cannot justifiably claim to put itself in the arm-chair of the businessman or in the position of the Board of Directors and assume the role to decide how much is reasonable expenditure having regard to the circumstances of the case. It further held that no businessman can be compelled to maximize his profit and that the income tax authorities must put themselves in the shoes of the assessee and see how a prudent businessman would act. The authorities must not look at the matter from their own view point but that of a prudent businessman. Applying the aforesaid ratio to the facts of this."

31. In view of the above I find and hold the members of **TAT** did not act in excess of jurisdiction nor did they error in law by finding that interest expense on bank borrowing were restricted in proposition to interest free advance to related parties and interest being borrowed.

Ground No.4

32. The Appellant under ground No.4 avers, that the members of the Tribunal acted out of jurisdiction and erred in law by importing Australian law and tax regime to fill a lacuna in Kenyan law and then imposing tax obligation not delimited by section 4 A of the Income Tax Act.

33. The Appellant contend, that the **TAT** in a bid to fill a Lacuna in Kenyan tax statutes borrowed from Australian law. So as to arrive at the decision that they did under paragraph 25 of the Tribunal judgment where the tribunal notes:-

"This tribunal notes that it wishes to borrow the best practice left by the Lacuna in the Income Tax Act."

34. The Respondent takes a different view from what **TAT** takes as a claim, on the claim; citing **section 16(2) of the Income Tax Act** to illustrate this aspect is completely covenant and that the debt of equity ratio was more than 3:1 implying there was then capitalization.

35. The **TAT** upon hearing; interpreting the law, proceeded to address the issue related to realization of foreign exchange loss through conversion of debt equity.

36. The Respondent contend, that it reviewed the Debt and Equity ratio for the Appellant including the COH loan as part **of "all loans"** for purposes of **Section 16(2) (j) of the Income Tax Act,** and found that the Appellant was thinly capitalized. The Respondent contends, that the COH loan was interest earning and part of all loans as per the Income Tax Act, as the change to equity never materialized.

37. The Respondent further avers, that the issue advanced by the Appellant in its submissions as to borrowing of the Australian law to fill the lacuna in Kenyan law is misinformed as the extract referred to relates to what amounts to realization of foreign exchange gains which is not in contention here. All the parties are in agreement that there was foreign exchange loss. What is in contention is whether the same can be deferred as provided under Section 4A (1) (ii) (a).

38. The Appellant urged, that **TAT** in this matter failed to note and consider that;

> **(i) Foreign exchange loss or gain is realized when "there is a cessation of the obligation to pay." Elsewhere, the TAT observed that the transaction in question created an obligation that was revenue in nature: meaning that it was a continuing obligation.**
>
> **(ii) That the transaction conversion of equity to debt, created an event for realization of foreign exchange which was revenue in nature: it means that this is a case where deduction of foreign exchange loss should have been allowed as a tax deduction.**
>
> **(iii) That the TAT mentions at paragraph 26, that since the loan was used for capital purposes, the foreign exchange losses relating to such loan were not allowable."**

39. In view of the in undenial admission of **TAT** and the Respondent that there is a lacuna in law, the **TAT** acted prudently to arrive at a decision that is based on the best practice. The **TAT** in its judgment having agreed, that conversion of loan to equity led to permanent cessation of liability and that even if the input of best practice is taken into account from Australian law, it would not give an affirmative to the position taken by the Appellant. That notwithstanding, I find **TAT** made no error as by borrowing from the Australian law, it did so in accordance with the best practice and to arrive at a just decision that our constitution do not prohibit application of general rules of international law and clearly state such laws shall form part of the law of Kenya. This ground fails.

Ground No.6

40. The Appellant under ground No.6 aver, that members of the Tribunal erred in law by finding that foreign exchange losses realized through conversion of debt to equity is not allowable under the Income Tax Act.

41. The Appellant contend, that the **TAT** erred in finding that the Appellant had an obligation to continue paying taxes after the board passed a resolution to convert the loan to equity. The **TAT** in its judgement held under paragraph 27 as follows:-

> **"A resolution is a mere expression of intention and that the effective date is the date when the regulatory requirements are complied with and that is where stamp duty is paid and the transfer recorded in the register."**

42. The Respondent on its part is of the view, that since notice of increase of share capital was only issued to the Registrar in 2014, the conversion into equity happened outside the audit period.

43. The Appellant urges that the **TAT** was in error for the following reasons:-

> **i) First, it equated the instant case of "conversion of loan" from holding company into Capital (shares pending allotment) to "Transfer of shares."**
>
> **ii) "Whether the foreign exchange losses incurred through conversion of debt to equity is allowable.**
>
> **iii) Third, there are no provision of the Companies Act that provides for a time-limit within which "shares pending allotment" needs to be allotted.**
>
> **iv) The TAT's holding, that a Board Resolution is only an "intention" is outside legislative parameters and also illogical.**
>
> **v) It is also illogical because it suggests that registration of an arrangement is what creates a legal effect, yet the act of registration cannot itself be the decision. It is simply registration.**

44. I have considered the submissions and points of law raised in respect of this ground and find that the period of audit was before the conversion into equity and all the time upto 2014 the resolution had not been actualized and remained a mere expression of intention as found by **TAT** and that the affirmative date is the date when regulatory requirements are complied with and that, is as was found by **TAT,** when the stamp duty is paid and transfer duly recorded in the register. In view of the above the sixth ground of appeal is dismissed as it has no merit.

45. The Appellant did not submit on grounds No.5, 7 and 8 of the Memorandum of Appeal but only on grounds No.1, 2, 3, 4 and 6 and as such the grounds which were not submitted on are declared as abandoned.

46. The dispute raised by the Appellant in this appeal and for which I am satisfied a retrial should be held is a dispute, that can be resolved either before the Tax Disputes Resolution under section 55 of the Tax Procedure Act by being handled by the **KRA,** Tax Disputes Resolution or by the **TAT.**

47. The upshot is that the appeal is merited and I proceed to make the following orders:-

> **a) Appeal be and is HEREBY allowed.**
>
> **b) The decision and order issued on 7th December 2017 is set aside.**

c) The dispute is referred back to the Tribunal for re-trial on issue under ground No.1 of the Appeal.

d) In the alternative to (c) above the parties are at liberty to select to refer the matter to KRA, Tax Dispute Resolution for a fresh assessment of tax liability.

e) Each party to bear its own costs as both parties succeeded and failed in some grounds of Appeal.

Dated, signed and delivered at Nairobi this 7th day of March, 2019.

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J .A. MAKAU

JUDGE.