Commissioner of Domestic Taxes v Econobuild Limited (Income Tax Appeal E119 of 2021) [2024] KEHC 7708 (KLR) (Commercial and Tax) (27 June 2024) (Judgment)

Neutral citation: [2024] KEHC 7708 (KLR)

REPUBLIC OF KENYA

IN THE HIGH COURT AT NAIROBI (MILIMANI COMMERCIAL COURTS)

COMMERCIAL AND TAX

INCOME TAX APPEAL E119 OF 2021

PM MULWA, J

JUNE 27, 2024

BETWEEN

COMMISSIONER OF DOMESTIC TAXES ..... APPELLANT

AND

ECONOBUILD LIMITED ..... RESPONDENT

(Appeal from the Judgment and Decree of the Tax Appeals Tribunal delivered on 13th May 2021 in Tax Appeals Tribunal No. 252 of 2019)

JUDGMENT

1. Econobuild (the Respondent) is a Limited Liability Company duly incorporated under the *Companies Act*, 2015 and involved in the construction of buildings.

2. In 2018, the Appellant who is the Commissioner of Domestic Taxes (the Commissioner), investigated the Respondent's tax affairs to ascertain its tax compliance for the period January 2015 to December 2017. The Commissioner, noted that the Respondent used invoices from eight companies that would print and sell invoices to traders for a commission without actually supplying goods and thereafter the traders would use the invoices to file their returns and in their financial statements to account for expenses to reduce their tax liability. Consequently, the Commissioner issued a tax demand dated 16th April 2018 for underpaid taxes of Kshs. 18,119,941.00, which constituted input VAT of Kshs. 6,302,588.00 and Corporation Tax of Kshs. 11,817,353.00.

3. The Respondent objected to the demand because the input VAT was rightly claimed and they had all the tax invoices for all the supplies; the Commissioner ought to have demanded the taxes from the suppliers who were the agents for collection and remission of VAT and not from it, the customer, as that would amount to double taxation.

4. Through letters dated 24th August 2018 and 10th September 2018, the Respondent provided agreements for subcontracts, site weekly schedules, daily workforce records, petty cash vouchers, site labour schedule and weekly labour wages for Pangani, Githuri and Parklands sites, invoices and delivery notes, cheques and payment slips of the profiled suppliers. In good faith, the Respondent paid the principal VAT, which the Commissioner acknowledged in its letter dated 12th February 2019.

5. In the letter, the Commissioner noted from the documents that the Respondent started filing in iTAX in July 2015 yet the invoices from the profiled suppliers were from July 2015 to May 2017. Therefore, the Commissioner raised an additional VAT assessment of Kshs. 886,565.00 for the period January to July 2015.

6. The Commissioner also found that the Respondent did not incur labour costs as the documents on labour and subcontractor works had no direct link to the profiled suppliers. It reasoned that if the labour costs were provided, the documentation would be in their name and not the Respondent's. Thus, it raised an assessment Corporation tax of Kshs. 13,479,664.00 from the total invoice amount of Kshs. 44,932,211.00 from the ledger provided for the period January 2015 to December 2017.

7. The Commissioner acknowledged receipt through its letter dated 12th February 2019, and further mentioned that the amount would be assessed with the 75% fraud penalty.

8. The Respondent objected to the assessment through its letter dated 11th March 2019. Though the Respondent agreed to pay the additional VAT amount, it requested the Commissioner to cancel its demand for Corporation tax because the expenditure was truly incurred, despite the supplier's non-compliance.

9. The Commissioner requested the Respondent for more documents. Ultimately, it issued its objection decision dated 9th May 2019, confirming the assessment and seeking immediate payment of Kshs. 13,479,664.00.

10. Dissatisfied, the Respondent lodged an appeal before the Tax Appeals Tribunal (the Tribunal). Through its judgment dated 13th May 2021, the Tribunal allowed the appeal and set aside the Commissioner's objection decision of 9th May 2019.

11. Aggrieved, the Commissioner filed the present appeal, through its memorandum of appeal dated 7th July 2021, on the following grounds:

    1. That the Honourable Tribunal erred in law and in fact in failing to find that the Respondent failed to keep the necessary records contrary to Section 54A of the *Income Tax Act* as read with Section 23 of the *Tax Procedures Act*, 2015.

    2. That the Honourable Tribunal erred in failing to find that the Appellant has the powers to call for production of documents under Section 58 and 59 of the *Tax Procedures Act*, 2015.

    3. That the Honourable Tribunal erred in law and in fact in failing to appreciate that the Kenyan tax regime is a self-assessment tax regime under Section 52B of the Income Tax and Section 28 of the *Tax Procedures Act*, 2015.

    4. That the Honourable Tribunal erred in law and fact in failing to find that the Appellant has the powers to issue additional tax assessments under Section 29 and 31 of the *Tax Procedures Act*, 2013 within 5 years based on available information.

5. That the Honourable Tribunal erred in law and in fact in shifting the burden of proof to the Appellant contrary to Section 56(1) of the *Tax Procedures Act*, 2013 and Section 30 of the Tax Appeals Tribunals Act, 2013.

6. That the Honourable Tribunal erred when it framed the wrong issues for determination thus asked itself the wrong questions and in doing so arrived at the wrong conclusion.

7. That the Honourable Tribunal arrived at its judgement based on a misapprehension of the law and the facts presented before it.

8. That the Honourable Tribunal erred in law and fact in failing to consider the evidence and submissions tendered by the Appellant;

9. That the Honourable Tribunal misapplied the law and facts and by ignoring all materials facts placed before it and based its judgement on a biased approach without due regard to the balance of the scales of justice.

12. The Commissioner prays that its appeal be allowed with costs; that the objection decision dated 9th May 2019 be upheld and that the Respondent be ordered to pay the tax arrears of Kshs 13,479,664.00 together with the resultant interest and penalties.

13. In response, the Respondent filed a statement of facts dated 1st February 2023 and written submissions dated 16th November 2023 and contended that the Tribunal was correct in its findings. It urged the Court to dismiss the appeal with costs and uphold the Tribunal's judgment dated 13th May 2021.

Analysis and Determination

14. I have considered the record of appeal, the statement of facts and the parties' respective submissions and authorities. To my mind, this appeal turns on the single issue of whether the Tribunal erred in law and fact in failing to uphold the Commissioner's decision to disallow labour expenses claimed by the Respondent and its finding that the Respondent failed to keep the necessary records contrary to Section 54A of the *Income Tax Act* as read with Section 23 of the *Tax Procedures Act*, 2015.

15. Before I address the issue, I note the principles that guide the Court in such an appeal, are provided under Section 56 of the TPA as follows:

> " 56.
>
> (1) In any proceedings under this Part, the burden shall be on the taxpayer to prove that a tax decision is incorrect.
>
> (2) An appeal to the High Court or to the Court of Appeal shall be on a question of law only.
>
> (3) In an appeal by a taxpayer to the Tribunal, High Court or Court of Appeal in relation to an appealable decision, the taxpayer shall rely on the grounds stated in the objection to which the decision relates unless the Tribunal or Court allows the person to add new grounds."

16. This appeal relates to the Tribunal's findings on fact and a conclusion that, although based on primary factual evidence is erroneous and therefore that becomes a point of law (See Mercy Kirito Mutegi v Beatrice Nkatha Nyaga & 2 Others [2013] eKLR).

17. To be clear, the Court has established that in such an appeal, it can only interfere with the matters of fact if the Tribunal's findings were based on no evidence, misapprehension of evidence or wrong principles. Moreover, In Mwangi v Wambugu (1984) KLR 453, the Court of Appeal succinctly observed that:

> " A court of Appeal will not normally interfere with a finding of fact by the trial court unless such finding is based on no evidence or on a misapprehension of the evidence or the Judge is shown demonstrably to have acted on wrong principle in reaching the finding and an appellate court is not bound to accept the trial Judge's finding of fact if it appears either that he has clearly failed on some material point to take into account of particular circumstances or probabilities material to an estimate of the evidence, or if the impression based on the demeanour of a witness is inconsistent with the evidence in the case generally."

18. The Commissioner submitted that the Respondent failed to keep the necessary records contrary to Section 54A of the *Income Tax Act* as read with Section 23 of the *Tax Procedures Act*, 2015. It faulted the Tribunal for failing to uphold its decision to disallow labour expenses claimed by the Respondent based on lack of supporting documents.

19. As earlier stated, the Commissioner's tax demand for Corporation tax of Kshs. 13,479,664.00 was based on missing trader investigations. The Corporation tax assessment was based on the costs of labour supplied by the missing traders, namely, Arav Hardware & Glass Enterprises, Bashaha Enterprises, Seanet Trading Enterprises, Shanlester Enterprises, Sorez Enterprises, Swala General Supplies, Vidija Enterprises and Vijarada Enterprises.

20. Section 15 of the *Income Tax Act* provides that:

> " 15.
>
> (1) For the purpose of ascertaining the total income of a person for a year of income there shall, subject to section 16, be deducted all expenditure incurred in that year of income which is expenditure wholly and exclusively incurred by him in the production of that income, and where under section 27 any income of an accounting period ending on some day other than the last day of that year of income is, for the purpose of ascertaining total income for a year of income, taken to be income for a year of income, then the expenditure incurred during that period shall be treated as having been incurred during that year of income."

21. Additionally, Section 54A (1) of the *Income Tax Act* provides that:

> 54A.
>
> (1) A person carrying on a business shall keep records of all receipts and expenses, goods purchased and sold and accounts, books, deeds, contracts and vouchers which in the opinion of the Commissioner, are adequate for the purpose of computing tax.

22. According to Section 56 of the TPA, the burden to prove that a tax decision is incorrect is on the tax payer. Similarly, Section 30 of the *Tax Appeals Tribunal Act* provides that:

> " In a proceeding before the Tribunal, the appellant has the burden of proving where an appeal relates to an assessment, that the assessment is excessive."

23. The Court in *Republic v Kenya Revenue Authority; ex-parte Proto Energy Limited, (JR Appn E023 of 2021*) [2022] KEHC 5 (KLR), reflected on the rationale for the above position as follows:

> " The most significant justification for placing the burden of proof on the tax payer is the practical consideration that the Commissioner cannot sustain the burden because he does not possess the needed evidence. Under the system of self-reporting tax liability, the taxpayer possesses the evidence relevant to the determination of tax liability. It is simply fair to place the burden of persuasion on the taxpayer, given that he knows the facts relating to his liability, because the Commissioner must rely on circumstantial evidence, most of it coming from the taxpayer and the taxpayer's records.
>
> The taxpayer must present a minimum amount of information necessary to support his position. This safety valve seems to place the burden of production on the taxpayer without relieving the Commissioner of the overall burden of proof. The tax payers' evidence must meet this minimum threshold. A presumption of correctness arises from the Commissioner's determination/assessment. The presumption remains until the taxpayer produces competent and relevant evidence to support his/her position. When the taxpayer comes forward with such evidence, the presumption vanishes and the case must be decided upon the evidence presented."

24. The record shows that vide its letter dated 12th February 2019, the Commissioner contended that the Respondent used invoices from the profiled traders to account for labour expenses in its financial statements yet there was no evidence that the supplies were made. Although the Respondent claimed that payment for the labour services was by cheques, there was no evidence of payments by the profiled suppliers to the list of casuals and subcontractors or to the Respondent to show that they transferred for their payment. There was also no evidence of the provision of the services. The copies of invoices and delivery notes from the profiled suppliers showed that the supplies were in granite tiles, mild steel, deformed bars, marin ply, tilefix adhesive etc, which were not labour costs. Payments made to the missing traders included a commission which is not an allowable deduction under section 15 of the *Income Tax Act*. The Respondent used books of a different company namely M. R. Shah Construction (K) Limited for the years 2016 and 2017 to account for the daily and weekly workforce schedule. This Company was also engaged in the construction business in 2016 and 2017. There were discrepancies in the daily and weekly workforce schedules namely; signatures on the daily work force schedule were different from signatures on the cash vouchers, workers' schedule(s) were paid. i.e. Pangani week ending 31st July 2015 Ndolo Mutua, Githuri site week ending 28th May 2016 Titus Ombete and all the petty cash vouchers had no authorization from the Respondent. Further, the Commissioner could not ascertain that the ID numbers belonged to the names provided since all were not recognized on iTAX.

25. The Commissioner also contended that although the Respondent availed an agreement to show that it had subcontracted for services it still had control of the subcontracted workers and the work done and the sub-contractors never invoiced it for the payments for the work done. There were discrepancies in the projects in which the Appellant claimed to have incurred labour costs in that the period the projects took place did not tally with the period the costs were incurred. The 3rd Avenue Parklands site commenced in 2014 and was completed in the year 2015. The labour costs were however incurred from July 2015 to June 2016 for the site, July 2015 to June 2016 for 3rd Avenue Parklands site, July 2015 to July 2016 for the Pangani site and December 2015 to June 2017 for the Githuri site. The schedules showed that the costs were incurred in 2015, yet the projects began in 2014. The amount of labour services stated in the financial statements was Kshs. 39,399,922.00 yet the amount in the tax invoices as per the ledger for the period January 2015 to December 2017 is Kshs. 44,932,211.00.

26. In its notice of objection dated 11th March 2019, the Respondent pointed to the documents produced being the master rolls, petty cash vouchers and summaries of monthly totals showing that no PAYE was deducted because the casual payment per staff per month did not cross the PAYE threshold. It also highlighted that the petty cash vouchers and excel sheets produced showed that the payments made to subcontractors fell below the withholding tax threshold of Kshs. 24,000 per month per subcontractor. It also relied on the certificates of practical completion to assert that project commencement documents listing completion dates do not necessarily result in exact completion dates listed. It took the position that the signatures on the master rolls and the petty cash vouchers matched, citing a possible mix-up of the documents for subcontractors with those of casuals.

27. On the issue of ID numbers, the Respondent claimed that they were given by the workers and requested for a provision that required that ID numbers match iTAX for the costs to be deductible. As regards the use of books of M. R. Shah Construction (K) Limited, the Respondent clarified that M. R. Shah was one of its directors and the old books belonged to him.

28. Before the Tribunal, the Commissioner questioned why the Respondent acquired additional labour costs from the profiled suppliers yet the law allows deduction of expenses wholly and exclusively incurred in the generation of income. The Commissioner also questioned why the Respondent would outsource and pay persons not contracted by an agreement to provide labour while it was in charge of hiring, paying and dismissal of the workers. It therefore reasoned that the use of profiled suppliers' invoices to claim for more labour costs was misleading and crafted in such a manner as to reduce tax liability.

29. Having raised these concerns before the Tribunal, the evidentiary burden shifted back to the Respondent to support its case through the production of the necessary documentation under Section 59 of the *Tax Procedures Act*. Faced with similar circumstances, the Court in Commissioner of Domestic Services v Galaxy Tools Limited [2021] eKLR, noted that:

> "What the respondent had done in producing the invoices, the delivery notes and payment schedules was only prima facie evidence of purchase. On producing the said documents, the evidentiary burden of proof shifted to the appellant. The appellant in answer not only queried the said documents but informed the Tribunal that; he had carried investigations on the alleged suppliers and concluded that they never existed, that there was no supply of any goods at all. That the documents produced did not contain critical details to support any reasonable commercial transaction. All this was laid bare before the Tribunal. On the foregoing, the evidentiary burden of proof shifted back to the respondent to show that its documentation was legitimate. This would have been by production of other transactional documentation to support the legitimacy of the alleged transactions. It is at that juncture that sections 59 of the *Tax Procedures Act* and section 43 of the VAT Act kicks in".

30. The Court in *Golden Cara Investments Limited v Commissioner of Domestic Taxes (Tax Appeal E078 of 2023)* [2024] KEHC 5570 (KLR) (Commercial and Tax) (8 May 2024) (Judgment), further elaborated that:-

> "The onus of proof may shift based on the stage of the proceedings and the actions taken by the parties. In *Commissioner of Investigations and Enforcement v Pearl Industries Limited (Tax Appeal E086 of 2020)* [2022] KEHC 51 (KLR) (Commercial and Tax) (31 January 2022) (Judgment) and Commissioner of Domestic Taxes v Trical and Hard Limited (Tax Appeal E146 of 2020) [2022] KEHC 9927 (KLR) (Commercial and Tax) (8 July 2022) (Judgment), the court described it like a pendulum swinging between the taxpayer

and taxman at different points but more times than not swinging towards the taxpayer. This "pendulum of proof" swings at least twice and at most thrice; the first is when the Commissioner asserts its position and the tax payer is expected to disprove this position. Once the taxpayer states its position, the pendulum swings to the Commissioner who then reviews the position taken by the taxpayer. If it is determined that the position taken by the taxpayer is devoid of evidence or that the evidence is insufficient, incompetent and irrelevant, then the pendulum swings back to the taxpayer to prove that the Commissioner was wrong in its position and overall findings."

31. Contrary to the above position, in the present case, the Tribunal erred by placing the burden of proof upon the Commissioner on the basis that fraud must be strictly proved. The Tribunal questioned what kind of evidence would be considered sufficient to prove that indeed the goods and services were supplied considering the assessment for 2015 to 2017 was done in 2018. In my view, the Tribunal also erred by failing to appreciate that the Commissioner has the powers to issue additional tax assessments under Section 29 and 31 of the *Tax Procedures Act*, 2013 within 5 years based on available information.

32. Therefore, on the whole, I find that the appeal is merited and is allowed with costs to the appellant.

It is so decreed.

JUDGMENT DELIVERED VIRTUALLY, DATED AND SIGNED AT NAIROBI THIS 27TH DAY OF JUNE 2024.

P. MULWA

JUDGE

In the presence of:

Mr. Isutsa for Appellant

Mr. Kimosop for Respondent

Court Assistant: Carlos