

REPUBLIC OF KENYA
IN THE TAX APPEALS TRIBUNAL
TAX APPEAL NO. 171 OF 2017

KOSE INVESTMENTS LTD-.....APPELLANT
VERSUS
COMMISSIONER OF INVESTIGATION & ENFORCEMENT.....RESPONDENT

JUDGEMENT

BACKGROUND:-

1. The Appellant, KOSE Investment Limited is a company incorporated in Kenya whose main activity is development/selling and letting of property. The company is registered with the Kenya Revenue Authority (KRA) under personal identification number (PIN P051147296L)
2. The Respondent is the Commissioner appointed under and in accordance with Section 13 of the Kenya Revenue Authority Act (Cap 469) and is charged with the responsibility of assessment, collection accounting and general administration of tax revenue on behalf of the Government of Kenya.
3. The Respondent conducted investigations into tax matters of the Appellant for the years of income 2010 to 2015 and issued an additional assessment of Kshs 43,224,071 in respect of income tax dated 11th July 2017. The Appellant objected to this assessment through a letter dated 4th August 2017. The Respondent confirmed the assessment on 17th October 2017. Being dissatisfied with the assessment the appellant filed this Appeal with the Tribunal

GROUND FOR APPEAL

4. The grounds enumerated in the Memorandum of Appeal filed on 17th November 2017 were that;
 - i) The Respondent did not make an objection decision within the stipulated period of 60 days.
 - ii) The Respondent erred in fact and law by bringing to charge related party rent which is received through the company as agent.
 - iii) The Respondent erred in law and fact by bringing to charge interest expense in contravention of Section 2 of the Income Tax Act (ITA) Cap 470 of the Laws of Kenya.

- iv) The Respondent erred in fact and law by incorrectly summing up the additional income in 2013 effectively exaggerating additional income by Kshs 2,306,178.
- v) The Respondent erred in fact and in law by bringing to charge rent deposits which are payable back to the tenants upon expiry of leases.
- vii) The Respondent erred in fact and in law by bringing to charge input VAT disallowed as residential development.
- viii) The Respondent erred in fact and law by bringing to charge accrued costs which are allowable costs.

PRAYERS SOUGHT

- 5. The Appellant prayed the Tribunal to issue orders that;
 - i) The objection decision dated 17th October 2017 is in contravention of Section 51(11) of the Tax Procedures Act, 2015.
 - ii) That the pursuant to Section 51(11) of the Tax Procedures Act 2015, the Appellant's objection dated 4th August 2017 be allowed.
 - iii) The notices of additional assessment dated 11th July 2017, and the objection decision given by the Respondent on 17th October 2017 be set aside and declared null and void.
 - iv) The Appeal be allowed with costs in favor of the Appellant.

APPELLANT'S CASE

- 6. The Appellant submits that the Commissioner did not make an objection decision within 60 days from the date the taxpayer filed that notice of objection and therefore the Appellants objection should be allowed pursuant to Section 51(1) of the TPA.
- 7. The Commissioner brought to charge interest expense contrary to the provisions of Income Tax Act Cap 470 of the laws of Kenya, Section 2 which defines interest as *"interest payable in any manner in respect of a loan, deposit, debt, claim or other right or obligation and includes discount by way of interest and a commitment or service fee paid in respect of any loan or credit.* The Commissioner brought to charge interest of Ksh 13,996,389 claiming that it was a loan to purchase a property. Loan interest is an allowable expense and therefore not chargeable under the ITA.
- 8. The Commissioner disallowed input VAT on residential construction but refused to allow them as part of costs when computing cost of sales effectively understating costs by Ksh 35,858,283. VAT is either claimed or expensed as part of cost. The Commissioner disregarded the fact that this is an actual payment out of the bank and cannot be disregarded.

10. The company made provisions for accruals awaiting actual invoices in the year 2015. These transactions were later completed and actual costs were more than the accrued cost, and brought to charge Ksh7,691,417. This was a clear demonstration that the Respondent was under pressure to create chargeable income where it was not due.
11. The Respondent brought to charge a non-existent figure of Ksh 2,306,178 in the year 2013. This was in the Appellant's view further demonstration that the Respondent was under pressure to collect revenue. The Respondent also went ahead to bring to charge internal and related party bank transfers which are not chargeable under ITA.
13. The Respondent brought to charge refunds from the company's Clearing Agents for containers which are not chargeable under ITA. The Respondent further brought to charge related party rent collected through the accounts of KOSE Investment limited. The rent had been taxed under Philip Kinisu and thus amounted to double taxation.
15. The Commissioner disallowed capitalized improvements and renovations when computing cost of sales. This was despite disallowing revaluation value of Kshs 146,800,795. The cost of renovations and improvements that were capitalized should be allowed as cost of the building because these were actual expenditure. Retrieving support documents has been a challenge because of lapse of time.

THE RESPONDENT'S CASE

16. The Respondent, in their Statement of Facts filed on 15th December 2017 submitted that It engaged the Appellant in good faith in the spirit of fair administrative action in the hope that an agreement on the disputed issues would be reached. When an agreement was not reached, the Respondent had no option but to issue an objection decision on the 17th October, 2017.
17. The Respondent thus submits that the delay was not intentional. The issues raised in the objection decision are weighty and the Respondent seeks that the Tribunal consider the Respondents defense to the Appeal in the interest of justice.
18. The Respondent's submitted that the Appellant's letter of objection dated 4th August, 2017 did not conform to the provisions of Section 51(11) as to constitute a valid Notice of Objection. The said letter is not only open ended but also wanting in precision. Even though the purported notice of objection dated 4th August 2017 States the grounds of objection, it does not conclusively state what amendments the Respondent was required to make to correct the decision.

19. The Respondent submitted that the Appellant failed to produce the necessary information in good time to enable the Respondent to effect the amendment on the assessment.
20. The Respondent submitted that it should be further noted that the slow pace of the review exercise of the matter in dispute was as a result of unavailability of information which was to be provided by the Appellant. This is evident from the mails between the Respondent and the Appellant of which the Appellant kept on promising the Respondent that information would be availed in the near future.
21. The Respondent submitted that it acted in good faith by giving the Appellant a window to provide further information on pending issues. In view of the foregoing, it is our humble submission that the action of the Appellant in purporting to invoke the provisions of Section 51(11) not only demonstrates bad faith on its part but untenable under the circumstances.
22. The Respondent submitted that the Appellant had claimed interest expense on loan advanced for construction of Kose Heights Building in 2015. The loan was obtained from I & M bank. The Building was meant for sale thus not a capital investment. The Respondent examined the I&M interest certificate schedule and analyzed the interest as per loan statement. Ksh 17,396,460 was over claimed as interest expense. This amount was disallowed in the year 2015.
23. The interest of Ksh13, 996,389 was paid on a loan for purchasing a plot in Garden Estate and did not relate to Kose Heights Building. This amount was capitalized with the cost of the land and disallowed in 2015.
24. The Appellant claimed all the input VAT for construction of Kose Heights Building without apportioning between commercial rent (vatable) and residential rent (not vatable). The Respondent apportioned the same (48% commercial and 52% residential).
25. The Respondent reviewed the cost accrual schedules provided, made adjustments and only allowed those expenses that were supported.
26. The Respondent adjusted all interbank transfers and related parties that were supported.
27. The Appellant owns various rental premises. Rent was collected through the account of the Appellant as well as other accounts in the names of the directors. The Respondent traced the monies in the accounts that were rent payments. The Appellant declared part of the rental income. All what remained was treated as undisclosed rent for the Appellant and was charged to tax.

28. On the tenant's deposits, the Respondent reviewed the schedules provided by the Appellant. Those that were proven to be tenant's deposits were not charged to tax. The Respondent reviewed the lease agreements against the schedules provided and also traced the deposits to the account in the bank statements. Those deposits that were not proven to be tenants' deposits were disallowed. Those that were overstated were adjusted e.g. the HFCK deposit paid was Kshs 1,831,260/- and not Kshs 2,229,360/- as indicated.
28. The Appellant provided a schedule on costs accumulation for construction of Kose Heights Building. In the cost accumulation they used the revaluation cost (Kshs 170,000,000/-) of the land instead of the actual cost (Kshs 23,199,205/-) at the time of purchase.
29. The Respondent analyzed all the bank deposits as per the bank statements and forwarded the findings to the Appellant for their comments. The issue was not raised at the objection stage for reconciliation. The Respondent therefore came up with corporation tax.

RESPONDENT'S PRAYERS

30. The Respondent sought the following prayers.
- i) That the outstanding tax arrears as confirmed in the letter of 17th October, 2017 are due and payable by the Appellant.
 - ii) The Respondent prays that this Tribunal considers this case and finds that the confirmed assessments dated 17th October 2017, were proper in law and thus are due and payable by the Appellant.
 - iii) The taxes that are not subject of contention in this appeal be paid immediately before the commencement of this Appeal as provided by law.
 - iv) The Appeal be dismissed with costs to the Respondent.

ISSUES FOR DETERMINATION

31. The Tribunal summarized the issues for determination as follows;
- i) Whether the objection decision issued by the appellant was valid.
 - ii) Whether interest expense on a loan taken by the Appellant was allowable.
 - iii) Whether VAT on construction of residential building was allowable.
 - iv) Whether accrued costs and internal and related party bank transfers should be brought to charge.
 - v) Whether costs incurred as capital improvements and renovations of buildings should be disallowed.
 - vi) Whether the Respondent erred in fact and law by assessing a period outside the legally provided period as provided by Section 29(50) of the Tax Procedures Act, 2015.

ANALYSIS AND FINDINGS

i) Whether the confirmation of the assessment is valid

32. The Respondent issued the additional assessment on 11th July 2017. The Appellant objected to the assessment on 4th August 2017. The Respondent issued its objection decision on 17th October 2017. Thus, an objection decision should have been issued on or before 10th October 2017. The Respondent issued the objection decision on 17th October 2017 which is 7 days later.
33. The Respondent avers that the Notice of Objection lodged by the Appellant did not meet the requirements set out in Section 51(11) of the Tax Procedures Act. According to the Respondent, the purported Notice of Objection dated 4th August 2017 does not conclusively state what amendments the Respondent was required to make to correct the decision.
34. Section 51(4) of the Tax Procedures Act provides that:
“Where the Commissioner has determined that a notice of objection lodged by a taxpayer has not been validly lodged, the Commissioner shall immediately notify the taxpayer in writing that the objection has not been validly lodged.”
35. The Tribunal notes that during the 60-day period, there was continuous correspondence between the Appellant and the Respondent in the form of emails and meetings in an attempt to resolve the dispute. Further, although the Tribunal was seized of the fact that the statutory time limits are to be strictly observed, it was of the view that the 7 days delay was not inordinate. Furthermore, the tribunal was of the view that delay in communicating the Objection Decision is a procedural technicality which in its view should not be the basis for discharging a tax obligation.
36. Persuaded by Article 159(2) (d) of the Constitution, the Tribunal found that it was bound to determine the Appeal on its merits rather than on technicalities. Article 159(2) (d) provides that:
*“In exercising judicial authority, the courts and tribunals shall be guided by the following principles:
(d) Justice shall be administered without undue regard to procedural technicalities.*

(ii) Whether interest expense on a loan taken by the Appellant was allowable

37. The Appellant had taken a loan from I& M bank for construction of Kose Heights Building. The building was meant for sale and therefore the interest was allowable

as it was not a capital expense. The Respondent argued that after analyzing the I & M interest certificate it found that KSh 17,396,460 was over claimed as interest expense and was therefore disallowed. However, a review of the same interest certificate, against the schedule used by the Respondent indicates a different amount;

	2013	2014	2015	Total
Interest per statement	5,423,798.50	21,999,597.10	53,011,593.25	80,434,988.85
Interest per accounts	0	0	83,073,292	83,073,292
Variance				2,638,303.15

The Tribunal therefore found that the Respondent should have disallowed Ksh 2,638,303.15 and not KSh 17,396,460 as the statement showed that the interest paid was Ksh 80,434,988.85 and not Ksh 65,676,832 as indicated by the Respondent.

38. The Respondent disallowed interest expense amounting to Kshs 13,996,389 on a loan taken by the Appellant to purchase of a plot in Garden estate arguing that it would be capitalized with the cost of the land. The Appellant submitted that it is a company whose main activity is development/ selling of property and letting of property. Section 15(1) of the Income Tax Act allows taxpayers to deduct any expense incurred wholly and exclusively in the production of income.
39. The Tribunal found that since the main business of the Appellant was development /selling of property, the parcel of land purchased in Garden Estate was purchased in the normal course of business. Consequently the interest paid on the loan taken to purchase the land was incurred in the production of income and is therefore deductible.

(iii) Whether VAT on construction of residential building was allowable.

40. The Appellant Submitted that the Respondent disallowed input VAT of Ksh 35,858,283 incurred in the development of Kose Heights Building which was developed for sale but refused to allow them as part of the cost of sales thus effectively understating the costs. The Respondent submitted that this was not allowed because the Appellant did not apportion between the residential (Not Vatable) and Commercial (Vatable). The Tribunal noted that the Appellant had claimed in put tax of Ksh 68,959,190 of which the Respondent had apportioned

Ksh 33,100,409 to commercial portion of the building and Ksh 35,858,283 to the residential portion of the building.

41. It is not in dispute that Kose Heights Limited comprised of both residential and commercial units. The commercial units which constitute 48% of the Kose Heights Building are subject to VAT while residential units which make up 52% of the building are exempt from VAT. The input VAT incurred in the development and sale of the commercial units is allowable for VAT purposes whereas that incurred in the development of the residential units is not. The Appellant acknowledges that it should have apportioned the input VAT incurred in the proportion of commercial and residential units. The Appellant however argues that the disallowed input VAT should be an allowable expense under the Income Tax Act.
 42. Residential buildings are exempt under Section 8 of Part II of VAT Act 2013. (Section 10 of 3rd Schedule of VAT act cap 486 (Now repealed)). It is common knowledge that input tax on exempt goods is not allowable and therefore the Respondent did not err in disallowing the input tax. However, the Tribunal finds that input tax forms part of expenses that go into cost of sales and therefore the Respondent should have allowed the Appellant to expense the same together with other expenses under the ITA in the determination of taxable income.
- (iv) Whether accrued costs and internal and related party bank transfers should be brought to charge**
43. The Appellant submitted that the Respondent brought to charge related-party rent collected through the accounts of the Appellant the rent has been taxed under the director (Philip Kinisu). Further the Respondent brought to charge tenant deposits which are funds payable to tenants upon expiry of leases and therefore cannot constitute chargeable income.
 44. The Respondent in response submitted that rent was collected through the account of the Appellant as well as other accounts in the names of the directors. It traced the monies in the accounts that were rent payments. The Respondent submitted that the Appellant declared part of the rental income. All that remained was treated as undisclosed rent for the Appellant and was charged to tax. It further submitted that it had adjusted all interbank transfers that were supported by documentary evidence.
 45. The Tribunal was of the view that it was the responsibility of the Appellant to keep and provide the Respondent with records to explain all the interbank transfers and related party transfers. Furthermore, Section 43(1) of the VAT Act and 54A (1) provides that a person carrying out a business should keep records. In view of failure of the Appellant to provide records to explain the interbank transfers, the

Tribunal finds that the Respondent did not err in bringing to charge the unexplained transfers.

46. Regarding the accruals, the Respondent submitted that it had made provisions awaiting invoices. These transactions it submitted that were later completed and actual costs were more than the accrued cost. It submitted that the commissioner disregarded the final and actual cost and brought to charge Ksh 7,691,417. The Tribunal noted that in its Statement of Facts the items disallowed were audit and other fees, contractor final bill, professional fees, Electrical PCTL, and Electrical Vekaria. No sufficient reasons supported by evidence were given to justify why actual costs were disallowed. The Tribunal therefore found that these expenses should have been allowed.
- (v) Whether tenant rent deposits received by the Appellant could be brought to charge.
47. The Appellant submitted that the Respondent had brought to charge tenant rent deposits. On the other hand the Respondent argued that it had reviewed the schedules provided by the Appellant and made adjustments based on lease agreements provided by the Appellant. The deposits that were not proved to be tenants' were disallowed. The Tribunal found that the Respondent had properly discharged its responsibility by allowing only those deposits that had been explained and proof provided and disallowing those that had not been explained.
- (vi) Whether costs incurred as capital improvements and renovations of buildings should be disallowed.
48. The Appellant argued that the Commissioner disallowed capitalized improvements and renovations when computing cost of sales despite disallowing a revaluation of Ksh 146,800,795. The Respondent on the other hand argued that the Appellant had failed to provide proof that these expenses were actually incurred. The Tribunal perused the Annexures attached to the Appellant's Memorandum of Appeal and found a schedule of renovations. However, the schedule did not contain any proof that the expenses were actually incurred. The Tribunal therefore found that the Respondent did not err in disallowing the costs.
- (vii) Whether the Respondent erred in fact and law by assessing a period outside the legally provided period as provided by Section 29(5) of the Tax Procedures Act, 2015.
49. Appellant submitted that the Respondent in arriving at the assessment considered periods dating back to 2010 which is beyond the period of 5 years provided for under Section 29(5) of the Tax Procedures Act. On its part, the Respondent submitted that the Section 45(6) of the VAT Act which came into force on 1st

September 2013 prohibits the Commissioner from issuing assessments beyond 5 years from the date of filing a return. The Respondent argues that applying this provision to the current matter would amount to retrospective application of the law. The Respondent further bases his argument on Section 68(2) of the VAT Act 2013 which provides:

“Notwithstanding the repeal of the Value Added Tax Act, the provisions of that Act shall remain in full force and effect for the purposes of the assessment and collection of any tax and the recovery of any penalty, payable under the Act and outstanding at the date upon which such repeal becomes effective.”

50. The Respondent avers that the above provision had the effect of ensuring that any VAT that was due under the repealed VAT Act Cap 476 remained payable. Thus, since the VAT Act, Cap 476 did not provide a statutory time limit for the period that the Commissioner could raise an assessment, then Commissioner was right in raising an assessment for the year 2010.

51. The VAT Act 2013 came into effect on 1st September 2013. Once it came into effect it placed a statutory time limit of 5 years for purposes of raising assessments. In the matter under dispute, the assessment was raised in 2017. Thus, the Appellant cannot claim that the VAT Act was being applied retrospectively. Further, Paragraph 7(6) of the repealed VAT Act provided that

All records shall be kept ...for a period of five years from the date of the last entry made therein.

52. The import of the above provision was to put a statutory limit on how far back the Commissioner could audit and assess a taxpayer. Thus, the Tribunal finds that the assessments in relation to the year 2010-2011 were issued outside the statutory time limit of 5 years and should therefore be excluded.

ORDERS OF THE TRIBUNAL

53. The Tribunal orders that:
- i. The objection decision on 17th October 2017 be and is hereby deemed valid.
 - ii. Interest on loans taken by the Appellant be allowed
 - iii. The Appellant be allowed to expense input VAT on construction of residential building.
 - iv. Internal and related party bank transfers not accounted for be disallowed.
 - v. Actual accrual costs be allowed

- vi. Unsupported deposits claimed to be tenant rent deposits be brought to charge
- vii. Unsupported expenses claimed to be cost of renovation be disallowed.
- viii. The assessment be adjusted to leave out the years of income 2010 and 2011.
- ix. Each Party shall bear its Costs.

DATED and DELIVERED at NAIROBI this 18th Day of December, 2019

In the presence of:-

Caleb Ndegefor the Appellant
Addah Seggafor the Respondent

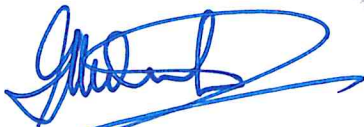
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MEMBER



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MEMBER

